

**Policy Brief nr.5**

**Business Environment Reforms in Central Europe**

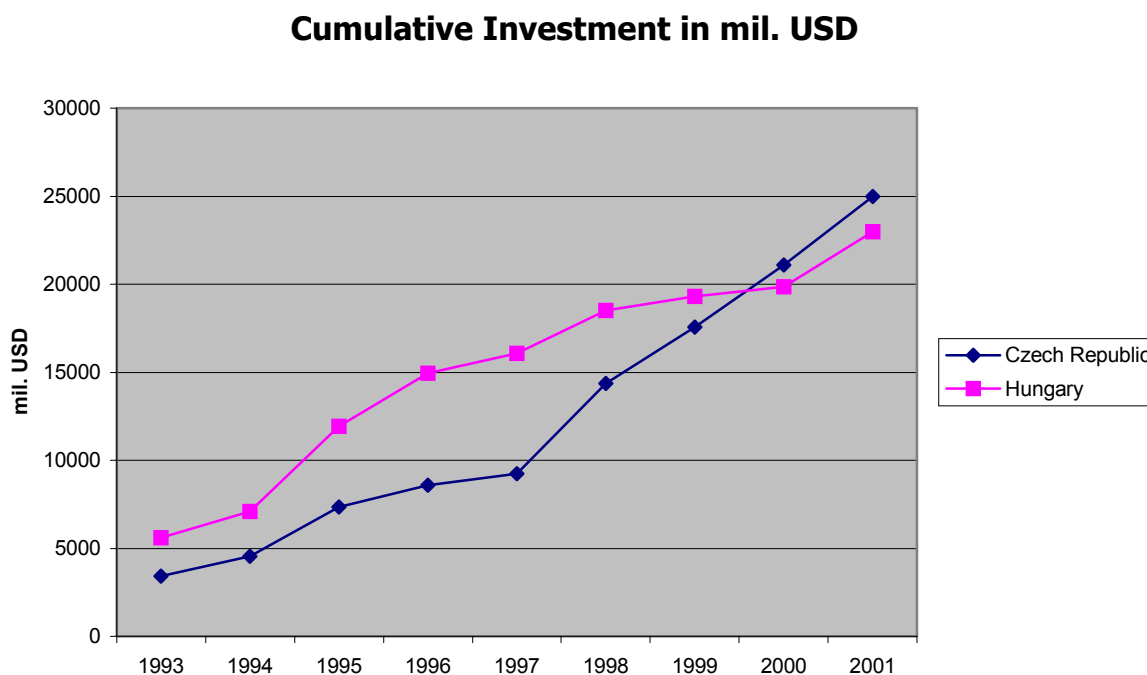
Jan Mladek, Member of Parliament (Czech Republic)

The aim of such reforms is to improve productivity of a given country and to increase GDP growth. Those issues have been addressed from very beginning of the transformation of postcommunist countries after 1989. The right to be owner of capital assets, land and to employ people have been first rights restored after the end of communism. However, during the last 15 years of economic transformation it has been discovered that many processes are more complex than many people believed. There have been three main ways how to create viable enterprises:

- 1. Creation and development of Small and Medium Enterprises (SMEs)**
- 2. Privatization and transformation of large (larger) state enterprises**
- 3. Support to Foreign Direct Investment (FDI)**

With certain simplification it can be said that for relative success of central European countries mainly SMEs and FDIs are responsible. The policy of FDI promotion has been started in Hungary already in late eighties. The other countries have joined Hungary in full scale competition after 1998. The competition in FDIs can be seen in following picture:

Graph Nr. 1:

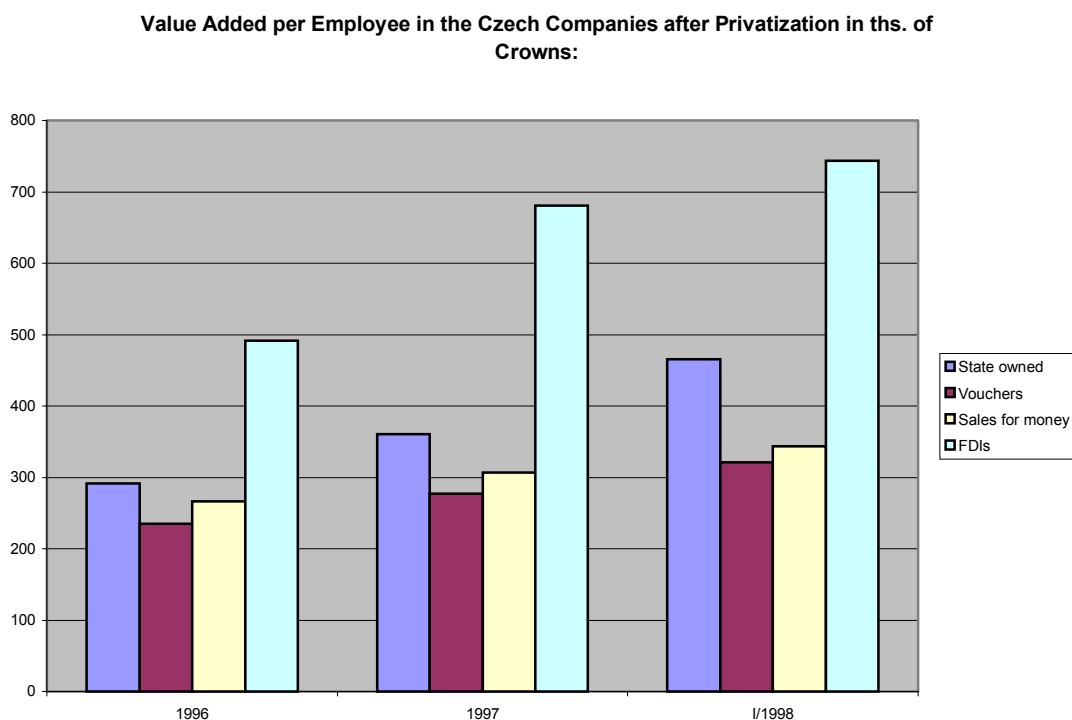


Source: Czech Ministry of Finance and OECD.

The other success story are SMEs. Economic freedoms obtained after fall of communism allowed the development of SMEs. Starting from scratch, very natural selection of entrepreneurial talents is something externally beneficial for postcommunist countries. The SMEs are of crucial importance in two areas: employment and political stability. SMEs, mainly those in services and manufacturing were helpful in absorption of labour surplus from old state sector. SMEs are also one of the pillars of stability and democracy. Only democracy with large class of entrepreneurs and owners can be really stable. There can be market economies with efficient large companies and tiny class of owners, which may tend to lack of stability and lean toward authoritative regime.

Privatization and transformation of large enterprises can be hardly described as a success. The results of those companies are fluctuating between average performance and the failure. One research in the Czech republic from 1999 has shown that FDIs are clearly outperforming companies privatized by voucher, to local entrepreneurs or those once still state owned:

Graph nr.2:



Source: Mládek, J.: „Nejhorší výsledky mají kupónově zprivatizované podniky“, *Hospodářské noviny* (Voucher privatized companies have the worst results), 15.2.1999

Despite all efforts to improve management and corporate governance in those privatized or still state owned enterprises, the stories about success are rather rare.

It seems that the best results can be reached by stimulation of FDIs and SMEs. Here is however useful to ask questions:

***1. For whom the new companies will produce goods and services?***

**2. *Where they will produce?***

**3. *How they will produce?***

The excellent business environment can be for nothing, if there is not market for the products. It means that from FDI's are the best ones those serving foreign markets. Those serving domestic markets are usually improving quality of products, productivity, but they are also in direct competition with domestic enterprises. Even more acute are the markets for SMEs. The success stories of quick development of SMEs is connected with those regions where the consumers are foreign tourists or generally foreigners. Those are capital cities and boarder areas with easy access from wealthier countries. To get those wealthy consumers is necessary to create for them as easy as possible visa regime (preferably no visa), easy access by all means of transport, large number of border crossing points (Czech-German boarder has every 15 km crossing point) and large but not least the offer of hotels, pensions etc.

Where to produce is another important issue. Foreign companies do prefer Greenfield investment, to build new factories on the green field. The aim of the countries should be brownfield investment, but this is the target for future. Companies do prefer green field because they are afraid of the problems connected with take over of existing assets, mainly of hidden liabilities. Those can be of different types, but ecological ones are major nightmare of brownfield investment. To get FDI's in current harsh global competition is necessary to prepare for them the possibility to buy the land for new companies construction. Long term lease (50 years, 99 years) can be substituted for land ownership, but it is clearly **SECOND BEST OPTION**. The buy out of the land from private owners in order to sell it to foreign investor can be nightmare sometime as was seen recently in Slovakia in purchase by the state from private owners for carmaker. The nationalization of the land by the state should be avoided if possible. Protection of the private ownership is one of the cornerstones of market economy. Nationalization with compensation to private owner can be used in public interest (highway, railway) but is a bit questionable if is used in favor of other private owner (carmaker). Generally country should provide for FDI not only land for reasonable price, with demanded infrastructure, qualified labour force and some tax holiday. The last thing is the most questionable, because creating unequal conditions between FDI or large investors and the rest of the economy (this is the case in the Czech Republic). The second option is so called equal tax that is decreasing tax burden for all companies. The prices of this approach is the increase in indirect taxation (VAT, excise taxes).

For SMEs the question where to produce even more acute. Here the experience of Central Europe is saying the most efficient way how to obtain the assets were restitution or better reprivatization in kind. The old owners or their heirs have got back restaurants, hotels, service facilities, production sites etc. Contributing to it had been small privatization that has been used for small assets. The other source of those facilities were bankruptcies and liquidation of large companies.

When there is a market for the company products and a company has where to produce, we are coming to the conditions for business. There are two areas where the government can act directly: telecommunication and banking. Phone connection, fax and internet are minimum conditions to be in business. This can be reached by privatization of telecom to strategic investor and/or by development of competition in this area. More difficult is banking sector. All banks in the country should be run by international standards, competition encouraged and thus to solve the problems with time needed for money transfer and the time needed for creation of the account. Licensing of the businesses is the permanent

trouble. There is no easy solution. Some activities must be licensed, but too much of licensing is undermining the economic activity. Partial solution are classes of licensing. Some trade should be free, some licensed moderately and some heavily. The aim is to have as much as possible free trades, but the distribution of trades is question for political debate. Taxation is another important issue. Overall taxation or tax burden in Central Europe is rather low. The issue for discussion is distribution of tax between direct taxation (inclusive so called health and social insurance or payroll tax) and indirect taxes. There is a belief that low direct taxation can stimulate economic growth, the pioneer of the approach is Slovakia with 19% flat income tax. The other countries in Central Europe are following with certain delay.

Specific problems is misusing the social benefits and sick insurance. Slovakia in 2004 took drastic measures to minimize of those benefits and to increase incentives to work. Even the Czech Republic, having more cautious approach in last years, is following this trend. Sick payment was reduced and more controls, including criminal investigations are done. There were companies whose only business was to suck sick insurance from the system. Another step are obligatory public works (8 hours per week) for unemployed people. It should stimulate their activity to look after job or to get out of the scheme.