

# Business risks and opportunities in Central and Eastern Europe



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# Introduction

The economies in Central and Eastern Europe (CEE)<sup>1</sup> have been under pressure recently. Geopolitical tensions between the EU and Russia over the Ukraine crisis, including mutual economic sanctions, have hit production, exports, consumer confidence and investment across the region. At the same time, the German economy has shown inconsistent growth since mid-2014, which has negatively affected those countries that are part of Germany's industrial production chain (such as the Czech Republic and Slovakia).

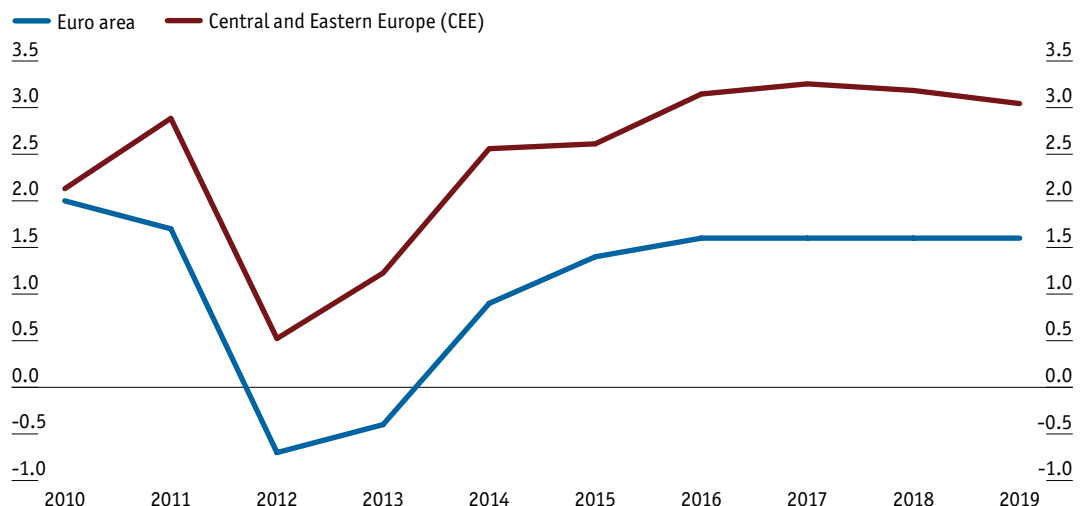
That said, the German economy is strengthening, and we expect it to improve further. Combined with a consolidation of the weak recovery in the overall euro zone, this should help to boost the export-dependent CEE economies. Economic growth in the CEE countries is set to remain moderate at 2.6% in 2015 (the same as in 2014), before rising to 3.1% in 2016.

The five CEE countries analysed here—the Czech Republic, Hungary, Poland, Romania and Slovakia—have much in common as an attractive

Chart 1

## Real GDP growth

(%)



Notes: 2014 values are estimates; 2015–19 are forecasts. CEE: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia, Slovenia.  
Source: The Economist Intelligence Unit.

destination in which to do business. Corporate taxes are generally low across the five countries, especially compared with the euro area and EU28 averages. Moreover, economic growth in CEE will not only continue to exceed that in the euro area, it will also be increasingly driven by small and medium-sized enterprises (SMEs), thus reducing dependence on foreign investment and lending. And the rise in labour costs in China is set to nudge investor attention back to CEE. However, major risks persist across the region, such as widespread red tape and sector-specific taxation.

A closer look at the five countries reveals that they are far from homogenous. They present a diverse range of business risks and opportunities. Despite low corporate taxes, the **Czech Republic's** taxation system remains in need of a major overhaul, in order to ease administrative burdens. Cost competitiveness is falling amid a rising minimum wage. Moreover, red tape, for example in public-sector procurement, remains an issue. However, the government has acknowledged these shortcomings and has initiated reforms to improve contract enforcement and general operational efficiency. Moreover, it is improving funding opportunities and investment incentives for SMEs.

**Hungary** also benefits from a favourable corporate tax regime. However, the risk of arbitrary legislation, such as sector-specific special taxes on large (mostly foreign-owned) businesses remains a problem. The government is actively supporting the manufacturing industries. Other sectors, such as film production and shared service centres, also benefit from tax

credits. As in the Czech Republic, the funding environment for SMEs is improving.

In **Poland**, a programme of major regulatory reform is under way to open previously regulated professions in order to improve market competition. Recent pension reform has dented investor confidence. However, other areas have seen more progress. In particular, regulatory changes and the introduction of tax exemptions will support SMEs as growth engines in Poland. The growing outsourcing market in Poland is also offering opportunities, reflected in momentum for technology start-ups and service centres. The manufacturing sector remains highly competitive.

Businesses operating in **Romania** are benefiting from a strong economic recovery, driven increasingly by domestic demand. In urban areas, Romania has a skilled workforce and strong IT connectivity. However, the general infrastructure remains deficient, the system of tax incentives is complex (despite a low general tax burden) and red tape is an issue, highlighted by a poor absorption rate of EU funds. Moreover, the EU continues to push for improvements in Romania's legal system. SMEs are weaker than elsewhere in the region.

Compared with other CEE countries, **Slovakia's** tax burden is relatively high. Moreover, similar to the Czech Republic, streamlining the overall tax system has been slow. Slovakia's economy is particularly driven by SMEs. Reductions in the administrative burden, improved credit standards and tax credits should boost opportunities for SMEs further. ■

## 1

## Czech Republic

As one of the most mature markets in the region, the Czech Republic continues to offer considerable market opportunities for foreign investors thanks to its high-quality infrastructure, a strong banking sector, robust creditworthiness and a growing middle class. Hence, investors from beyond the EU, such as Visteon Corporation and Amazon of the US, continue to relocate production centres to the Czech Republic in a bid to expand business.

Investor interest is clearly alive and well, but the business environment remains challenging because of rising political instability and persistently loose regulatory norms. Red tape and corruption, particularly in public-sector procurement, are also present, though this is far from unique in the region.

### Policy uncertainty

Recent surveys, such as those released by the World Economic Forum, show that concerns over policy instability and taxation are among the most problematic factors for doing business in the Czech Republic.<sup>2</sup> Its tax burden, particularly payroll taxes, is steep by OECD standards, albeit not as high as in neighbouring Slovakia.

Furthermore, despite the government's pledge to streamline the tax system, compliance with taxation requirements is still overly complicated. In 2014 the government introduced a three-tier system of value-added tax (VAT) and approved a third, lower VAT rate of 10% (which came into force on January 1st 2015 and applies to medical drugs, books and baby food), in addition to the two existing rates of 21% and 15%.<sup>3</sup> Moreover, 2015-16 promises to bring a fresh round of sector-specific tax rises (gambling taxes, for

example, according to a new bill due to come into force at the start of 2016).<sup>4</sup>

### Rising cost of business and regulatory change

Although the level of corporate taxation is competitive relative to regional peers—19% for most businesses and 5% for investment and pension funds—the cost of doing business is beginning to rise in the Czech Republic. This is partly a result of falling cost competitiveness in pockets of the manufacturing sector—the bulwark of the economy—as productivity gains struggle to keep up with further expected rises in the minimum wage, while international competition for services outsourcing is growing.<sup>5</sup> For instance, in September 2014 the Czech Republic (and Poland) outdid other destinations in the region as Amazon's top choices for its latest logistics centres.<sup>6</sup>

Although the era of buoyant productivity rates buffered by low labour costs is coming to an end, the outlook is far from gloomy. The latest round of policy measures—instigated to ensure alignment with existing EU norms and International Financial Reporting Standards (IFRS)<sup>7</sup>—will help the regulatory and investment environment to remain investor-friendly. This includes a new law on public procurement aimed at simplifying existing rules, effective from 2016, as well as the implementation of the Business Corporations Act, effective since January 1st 2014, which will improve contract enforcement and general operational efficiency.<sup>8</sup>

Nevertheless, the long-promised overhaul of the taxation system as a whole, aimed at easing administrative burdens, remains some way off;



a new bill on improving tax collection, which will include new legislation on the electronic registration of sales, is only now being drafted.<sup>9</sup> The Czech Republic is by no means alone in this: Slovakia is facing a similar delay in creating a streamlined taxation system (see Slovakia profile).

### Unleashing drivers of growth

The Czech prime minister announced recently that the EU will allow the Czech Republic to use unspent funds from the old EU programming period.<sup>10</sup> However, a question-mark still hangs over the efficient use of these funds, considering that in 2014 alone the country failed to use an estimated CZK9bn (US\$434m).<sup>11</sup> Nevertheless, despite the sluggish absorption capacity seen in recent years, EU monies promised for 2014–20 (€22bn or US\$26bn, equivalent to around 2% of GDP per year)<sup>12</sup> could help to drive a new infrastructure-project boom in areas left wanting in recent years, such as real estate and transport.

Part and parcel of the push for structural reform are greater funding opportunities for SMEs, or companies with fewer than 250 employees. There are about 1m SMEs in the Czech Republic,<sup>13</sup> considerably fewer than the estimated 4m SMEs in neighbouring Poland (see Poland profile).

SME density is nevertheless high and provides employment to almost 70% of the labour force,<sup>14</sup> particularly in traditional sectors such as manufacturing and retail, which will continue to drive growth in the near term as the economic recovery becomes more evenly balanced between exports and domestic demand. However, the impact of the euro area crisis has weighed significantly on the performance of SMEs, including a slowdown in value-added growth by SMEs.<sup>15</sup>

SMEs form an important part of the Czech Republic's return to a sustainable path of economic growth, in line with the government's Small and Medium Enterprises Support Strategy 2014–2020. If SMEs are to regain their role as a driver of GDP growth, similar to the pre-2008 period, they will need to secure greater access to crossborder trade and financing

(from institutional investors such as the European Investment Bank), in addition to improving the absorption rate of EU funds. The country's disappointing absorption capacity with respect to EU structural and cohesion funds—particularly in 2007–13—remains a challenge.

Despite unfavourable export and import procedures and underwhelming levels of innovation-related entrepreneurial activity, there has been progress in SME participation in public procurement. There has also been growth in crossborder activities, as increasing numbers of Czech SMEs look to tie up with similar businesses in emerging markets in East Asia, such as China.<sup>16</sup>

### Incentivising investment

Investment incentives are set to remain in place for the foreseeable future. This includes tax breaks, rebates on corporate income and capital gains tax, employment grants and ten-year tax relief schemes covering businesses investing in key sectors such as manufacturing, information technology (IT) software and research and development (R&D).<sup>17</sup> Financial assistance for businesses in underdeveloped regions is, however, fast overtaking the need for fresh R&D expenditure. The government has pledged its commitment to attracting new foreign direct investment (FDI) into manufacturing (which accounted for more than 25% of gross value added in the first three quarters of 2014) as well as technological and software development.

The recent amendment to the Investment Incentives Act, which comes into force in the first quarter of 2015,<sup>18</sup> will introduce a broader range of schemes targeted at SMEs and microbusinesses operating in the south-east, central and north-west regions that are beset by high unemployment. The focus will be on heavy manufacturing and technology-focused businesses operating in newly designated special industrial zones. As a result, businesses in these areas will be eligible for increased financial aid, cash grants, various forms of corporate income tax relief and property tax exemptions.

## 2

## Hungary

Once notorious for sky-high budget deficits but an otherwise investor-friendly business climate, Hungary has done much in recent years to improve its public finances. However, it has also developed a climate of arbitrary and opaque policymaking that is often seen as discriminating against foreign-owned businesses.

### Sector-specific taxation

Since 2010 the government, led by Fidesz-Hungarian Civic Union, has developed the practice of imposing sector-specific special taxes, including in the banking, energy, telecommunications, retail, media and tobacco industries. Ostensibly levied to raise extra budget revenue, they often penalise large (mostly foreign-owned) businesses. Sector-specific taxes are most often levied on sales revenue in order to prevent individuals or companies from evading taxes by moving profits offshore. Via progressive brackets or minimum flat payments, some taxes appear surgically targeted to bestow competitive advantages or disadvantages on specific individual companies.

On a positive note, sector-specific taxes (which now account for more than 5% of central-budget revenue)<sup>19</sup> have supported significant improvements in Hungary's budget balance, as the deficit has more than halved from 5.5% of GDP in 2011. This has helped Hungary escape penalties for breaking EU budgetary targets and may help the country to regain investment-grade status with credit-rating agencies. These factors could lead to a more stable financing environment for businesses operating in Hungary.

### Attractive corporate tax regime

Special taxes aside, Hungary's corporate income tax regime remains among the most attractive in the EU, with a 10% rate on the first Ft500m (US\$1.9m) of profits, and a rate of 19% above that. This is coupled with tax credits for companies carrying out investments of at least Ft3bn (or as low as Ft100m in areas such as R&D, environmental investments or film production), provided they meet job-creation targets. The size of tax credits and the strictness of eligibility criteria depend on the region of the investment and must be periodically approved by the EU.

The government has floated the possibility of introducing a single unified corporate tax rate in the next few years; it has said this rate would probably be closer to the current lower rate to ensure that the tax burden decreases for the majority of businesses.

However, Hungary is behind most of its CEE peers in implementing corporate reporting using IFRS, but is now studying possible ways to expand the application of these global accounting standards, with a government decision expected in mid-2015. Currently, public companies must prepare their consolidated reports in accordance with IFRS, while this is optional for all other companies. Non-consolidated reports must still be prepared under Hungarian Accounting Standards (HAS), although companies may compile a parallel IFRS report for their own purposes. Future changes will probably waive HAS requirements for companies that prepare their non-consolidated reports under IFRS, thus reducing administrative costs for businesses that

have foreign owners or seek foreign investors and/or financing.

### Deficiencies in institutions and transparency

Sector-specific taxes fit a wider pattern of opaque, and often seemingly arbitrary, legislation. Fidesz has tended to sidestep advance consultation with industry and other stakeholders on tax or business-related legislation and rarely publishes impact studies—if any are conducted at all—leading to its decisions. This leaves businesses with little insight, let alone input, into the drafting of legislation affecting them and is also contributing to increasing perceptions of corruption.

Using the two-thirds constitutional majority in parliament it won in 2010 and held until early 2015, Fidesz has taken over nominally independent institutions (by loyalist appointments), or reduced their power to act as a check on government policy. Institutions thus compromised include the Constitutional Court, the central bank's Monetary Policy Council and the Fiscal Council, neutering possible challenges to what might be unconstitutional or otherwise unsustainable economic policy.

### New chapter in banking

The area of government intervention with the biggest impact on Hungary's economy is the banking industry. A government-imposed household foreign-currency debt relief programme, likely to be completed by the second quarter of 2015, is estimated to saddle banks with losses of almost Ft1trn. Together with a banking tax and a financial transaction tax (though the latter is mostly passed on to customers), this could significantly constrain the lending ability of banks in 2015.

At the same time, the conclusion of debt relief could open a new chapter for banks, as the programme (and the state's new "bad bank" to take over failed real-estate project loans) will help ease a chronic bad-loan problem, allowing

banks to lend more freely after 2015. Lower debt-service costs for households could lead to higher disposable incomes, translating into stronger demand for products and services.

The government has also pledged to lower the banking tax in the coming years, part of a wider effort to encourage lending to SMEs. That effort, in turn, is aimed at diversifying Hungary's economic growth, which until now has been driven primarily by a handful of large automotive investments and state-run infrastructure projects. To help growth across a wider range of businesses, Hungary will divert some 60% of EU funds available to the country in 2014–20 to support investments by private businesses. This means that SMEs will receive around five times more support with investments than in the last funding period.<sup>20</sup>

### "Re-industrialisation" and education

Two less spectacular, but in the long term equally important areas of government activism, concern education and industrial policy. Fidesz has embarked on a programme of "re-industrialisation" in order to attract and support manufacturing investment. The government is also emphasising the primacy of engineering and sciences in higher education, while downsizing or restricting access to other fields. Moreover, it plans to reform vocational training (de-emphasising general subjects and language skills and pushing co-operation between schools and industry), and expand it at the expense of regular secondary schools.

Although this may boost the labour supply for certain industries, changes in school curriculums may prove detrimental to the overall quality, adaptability and flexibility of the labour force in the long term. The employability of blue-collar workers will continue to be limited by increases in the minimum wage and by high taxes on labour. In the meantime, the labour supply is also affected by a brain drain at both ends of the skills spectrum, with an estimated 500,000 Hungarians working abroad.<sup>21</sup>



In addition to its support for manufacturing industries, the government is also actively supporting the creation of shared service centres, hoping to add to an already respectable number of such centres in Hungary. Available incentives include tax credits as well as training and job-creation subsidies.

### Protests unlikely to bring government down

Thousands of demonstrators have protested since October 2014 against Fidesz's perceived abuses of power and reports of widespread corruption. However, in the absence of leadership and a clear agenda, the protests appeared to lose steam in early 2015, and it is unlikely that they will pose a threat to government stability until the 2018 election. Protesters have distanced themselves from Hungary's leftist opposition parties, which are in any case weak and divided after decisive defeats in 2010 and 2014.

But while a sense of government and legislative stability appears guaranteed through to 2018, Fidesz is far from being a monolith, and internal clashes may cause bureaucratic inertia in some areas of government. Fidesz lost its narrow two-thirds parliamentary majority following a by-election in February 2015. This means that the party will have to win over at least one opposition member of parliament (MP) in order to amend the constitution or make major appointments, as these require the approval of a two-thirds majority of all MPs. Nevertheless, in theory Fidesz can still pass so-called "cardinal" laws (which govern important policy areas and institutions) on its own, as these require only the votes of two-thirds of MPs present in parliament. Hence, the loss of the two-thirds majority is a symbolic rather than a practical setback for the party.



## 3

## Poland

Poland emerged largely unscathed from the recent financial ructions in the euro zone, thus strengthening its reputation—based on sound macroeconomic fundamentals and domestic political stability—as a safe haven for foreign investors. Despite negative FDI inflows in 2013 (that is, a net repatriation of foreign capital), Poland saw a strong rebound in inflows of FDI in the first half of 2014. Foreign money has flowed back into manufacturing operations (particularly cars, rubber and plastics) and R&D-related activities.

### Road to regulatory reform

In the past two years the government has taken steps to make the regulatory environment more investor-friendly and compliant with EU legislation. A special commission set up under the Ministry of Finance to encourage deregulation has made some progress in improving market competition (particularly in telecoms and the media) as the number of state-owned enterprises continues to fall. A 2013 programme to remove entry barriers to about 70% of the country's 250 regulated professions, in line with the government's Better Regulation Programme 2015, is ongoing.<sup>22</sup> To date, about 51 of the 71 previously regulated professions have been either fully or partially deregulated, which underlines the continued complexity in doing business in Poland. Another round of reforms is expected in 2015, to be followed by the deregulation of a further 40 professions in 2016-17.

Moreover, several key areas, such as pensions, remain heavily regulated. The recent amendment

to the pension reform—resulting in the transfer of around 51.5% of total assets held by open pension funds to the state-run Social Insurance Institution (ZUS) by end-2015—proved unpopular. The impact on investor sentiment was seen most clearly on the previously buoyant initial public offering (IPO) market, which saw only ten IPOs in the third quarter of 2014, following the earlier IPO cancellation for the TV cable operator, Multimedia Polska.

### Harnessing SME growth potential

SMEs have become an important driver of GDP growth in recent years, as the speed of Poland's economic growth continues to exceed that of its regional peers. SMEs have helped to sustain labour market growth and plug investment holes in the absence of robust FDI. In 2013 they provided around 36% of total employment, according to European Commission estimates, and their contribution to gross value added (GVA) in the economy—at around 50%—has gradually risen since Poland's EU accession in 2004.<sup>23</sup>

SMEs are particularly strong in the electronics, wholesale and retail trade, services, construction and manufacturing sectors.<sup>24</sup> Poland is therefore well placed to take advantage of the expected rise in global manufacturing prices, which make up the bulk of the country's foreign sales.

Since late 2012 a series of regulatory changes and the introduction of tax exemptions for SMEs—including those operating in particular special economic zones (SEZs), where as much as 60% of total expenditure is tax-exempt<sup>25</sup>—have helped to underpin entrepreneurial activity. The

government-backed Bank Guarantee Fund (BGK) has put into place a guarantee programme for loans taken out by businesses, including SMEs. This, combined with new credit lines provided by development banks such as the European Bank for Reconstruction and Development (EBRD) or Germany's KfW,<sup>26</sup> is supporting an improved lending environment for SMEs.

However, when it comes to harnessing the growth potential of SMEs over the medium term, challenges remain. Persistent administrative burdens (owing to time lags in the implementation of new measures on financial reporting procedures, for example) and sluggish labour productivity in certain niche areas mean that a greater proportion of SMEs is unable to make inroads into areas of interest to foreign investors, such as technology innovation and sustainable energy. Despite the existence of the BGK, greater access to funding—particularly from corporates and foreign private-equity funds—as well as the limited trading activities of SMEs with non-EU markets remain an issue.<sup>27</sup>

### Investment opportunities

Although many parts of Poland's industrial sector are struggling to recover following the euro zone downturn, it is also poised to capitalise on opportunities afforded by the "manufacturing revolution"—that is, the nearshoring (as opposed to offshoring) of manufacturing and service lines, thanks to advances in digital technologies and new production materials<sup>28</sup>—particularly now that the growth differential between Asian and European markets has narrowed considerably.

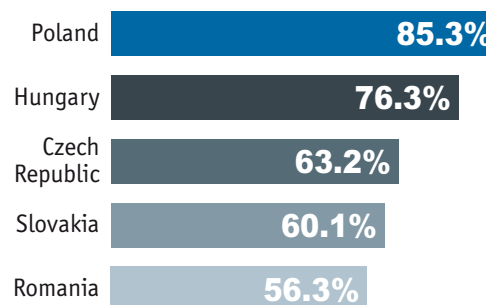
The rise in labour costs in China is set to nudge investor attention back to the CEE economies, and specifically Poland, where prices set by local manufacturers remain competitive, shielded by high productivity rates and a sufficiently weak currency. However, the government will need to do more to loosen labour market regulations, as rising real wages in 2014 have pushed up the cost of doing business.

Foreign businesses are able to draw on a number of government-backed incentives that are partly funded by EU structural and cohesion funds. The largest of these schemes is the Innovative Economy Programme, which covers infrastructure, R&D and industrial-design projects. Capitalising on its already impressively high absorption rate (at 85.3% as of 2014),<sup>29</sup> Poland is due to receive almost €106bn from the EU in 2014–20, which includes payments made under the Common Agricultural Policy, in addition to cohesion and structural funds—the largest amount allotted to any EU member state in this programming period.<sup>30</sup> This should open up investment opportunities in several key areas, such as energy infrastructure, thereby improving investor sentiment.

Chart 2

#### EU Cohesion Fund absorption rates for 2007–13, as of 2014

(%)



Source: European Commission.

### Beyond manufacturing

Poland also stands to benefit from investment trends outside its traditional manufacturing base. Manufacturing industries—buoyed by a recovery in domestic demand in Poland's large internal market—will nevertheless continue to drive economic growth in the short term until the expected surge in SME and start-up activity picks up over the medium term.

A notable example is the nearshoring of services and industrial production in areas such as financing, accounting and banking services, IT solutions, software development and e-services. The surge in technology start-ups in the past 18

months is symptomatic of this trend. In response, several major international companies, such as Google<sup>31</sup> and IBM<sup>32</sup>, plan to open up new campuses and service centres, respectively, in 2015 and 2016. This has helped to solidify Poland's position as the leading outsourcing centre in the EU. Poland has become the world's third-largest outsourcing market after China and India, and its Association of Business Service Leaders expects employment in the business services sector to reach 170,000 by the end of 2015.<sup>33</sup>

Supporting this trend are the activities of companies operating in Poland's 14 SEZs, whose lifespan has been extended to 2026. These provide tax breaks and other advantages for foreign investors. In the absence of a robust privatisation scheme, additional injections of liquidity have also come from the government-created investment firm Polskie Inwestycje Rozwojowe S.A. (PIR S.A.), which has co-financed infrastructure and investment in energy (especially renewables) and chemicals.



## 4

## Romania

Romania's business environment is challenging, with weaknesses in infrastructure and an unpredictable legislative and fiscal environment. That said, Romania has a skilled urban labour force, particularly in IT. Its business outlook has been strengthened by changes in its strategic and political environment in 2014. The election of Klaus Iohannis, an ethnic-German Protestant, as president in November 2014 reflects a widespread desire for change. Moreover, the deteriorating situation in neighbouring Ukraine (and Moldova) has increased Romania's geopolitical importance to the EU, the US and NATO, thus increasing the prospect of external assistance and finance to stabilise the economy and improve infrastructure and legislative practices.

**Strong economic recovery**

Businesses are also benefiting from a strong economic recovery in Romania in recent years. On the supply side, growth has predominantly been driven by agriculture with two consecutive record harvests, supported by industry and the automotive industry, in particular. On the demand side, growth was underpinned by the export sector in 2013, but has more recently been boosted by domestic consumption, stimulated by robust real wage growth. In 2014 Romania achieved a surplus in its trade in goods and services for the first time in the post-communist era, driven by the rapid growth of exports of IT and business services.

However, unlike in other CEE economies such as the Czech Republic and Slovakia (see country profiles), SMEs are playing a less important role in Romania's growth story. Large enterprises

have been the main drivers of growth in industry and services. The small business sector was badly affected by the 2008-09 downturn and has been slower to recover than elsewhere in CEE. The European Commission observed in 2014 that "Romanian SMEs are less competitive, less innovative, and have a weaker technological base than their larger counterparts".<sup>34</sup>

**Deficient infrastructure, but new impetus to improvement**

Romania's infrastructure is weak by EU standards, with supply chains disrupted by inadequate road and rail links. Rail services are predominantly state-owned, exceedingly slow and provide poor passenger and freight services. Motorway construction has fallen far behind schedule, with delays caused by contractual disputes and payment problems. Improved infrastructure (especially the construction of pan-European motorways) is central to the EU's programme of development and financial assistance for Romania. Moreover, bureaucratic inefficiency has resulted in a low absorption rate of EU funding to improve infrastructure. As of 2014, Romania had only absorbed 56.3% of available assistance from the EU Cohesion Fund allocated for the period 2007-13.<sup>35</sup>

Meanwhile, reluctance to allow foreign companies to control energy supply has delayed the privatisation of utilities, contributing to a lack of modernisation and capacity. Romania has ambitious plans for energy independence by 2030 by doubling nuclear capacity and developing new natural-gas deposits to limit dependency on Russia. It is likely that infrastructure



development will be a key focus over the coming years.

In terms of IT connectivity, urban areas are well served with fixed-line and mobile Internet connections, with the market dominated by leading international suppliers providing a good service to the business sector. The capital Bucharest is now reported to have the fastest broadband speeds in Europe. Household penetration rates lag significantly behind EU averages as a result of poor coverage in rural areas, while urban areas are approaching saturation.<sup>36</sup> The power of the Internet was illustrated in the presidential election in November 2014, when a social media-inspired reaction against the tactics of the prime minister and favourite to win the election resulted in his unexpected defeat.

### Low tax burden; complex system of tax incentives

Romania's major taxes are "flat" personal income, corporate income and capital gains taxes at 16% and VAT at 24%. Employers' social security payments are in three bands: 15.8%, 20.8% and 25.8%, depending on the nature of the work. Enterprises may also face locally imposed taxes, while successive governments have imposed "ad hoc" emergency taxes on properties and buildings and increased fuel and excise duties under pressure to meet budget-deficit targets, creating an unpredictable fiscal environment. However, the current government is aware of the problem and says it will avoid the introduction of further new taxes to create a more certain business environment.

The government also operates a complex system of tax incentives, including accelerated depreciation, property tax exemptions and incentives for siting in development areas and industrial parks. Moreover, specific schemes of state aid are available, particularly for large foreign investments, subject to EU approval. Priority sectors for attracting investment incentives include energy efficiency and

renewables, environmental protection, the introduction of new technologies, R&D and IT. Romania operates a system whereby skilled IT employees in designated sectors are exempt from income tax, which makes the IT sector highly competitive compared with other economies in CEE. Proof of Romania's skills in IT is the country's current-account surplus of around €1bn in telecoms and IT services in 2013 and in January-October 2014.<sup>37</sup>

As a member of the EU Romania is required to implement IFRS, with foreign companies and their subsidiaries meeting international standards of reporting. The quality of accounting information supplied by domestic companies is reported to be of variable quality, with some companies struggling to comply with new regulations, which have been implemented gradually. However, financial directors of listed companies report an improvement in the quality of financial information in an environment that is changing rapidly, and further significant progress is likely in the coming years.<sup>38</sup>

### Legal system under scrutiny

Romania's legal system is driven by its EU membership and is subject to the EU's Cooperation and Verification Mechanism (CVM), as the EU has judged that the implementation of legislation in Romania does not meet EU standards. Despite progress in recent years, the EU continues to express concerns regarding the following issues:<sup>39</sup>

- lack of independence of the judiciary;
- failure of courts to follow established precedents;
- government emergency ordinances overriding existing laws;
- parliamentary interference in legal processes and judicial decisions; and
- widespread corruption.

Consequently, the business environment is affected by the following problems, which have

been the subject of periodic disputes with the EU:

- opaque procedures for awarding contracts;
- difficulties in enforcing contracts;
- unfair competition, particularly with highly subsidised state-owned enterprises;
- sales of energy at below market prices to favoured customers; and
- failure to prosecute domestic companies for legal infractions.

Nevertheless, the legal system is responding to external pressure for change. The EU investigates

abuses of state aid and competition law to create a more predictable business environment. Groups representing foreign businesses and Western embassies consistently lobby for improvements and transparency in the legal environment. The incoming president has expressed a renewed commitment to implementing the rule of law and eliminating corruption. A major expansion of the anti-corruption campaign was launched in January and February 2015, with a number of high-profile arrests.



## 5

## Slovakia

Slovakia offers a different proposition to investors looking for decent returns: it is a small yet mature market. However, unlike its immediate neighbours, it has an abundance of spare capacity and considerable slack in its economy. The recent upturn in merger and acquisition (M&A) activity reflects the rising tide of new opportunities, but there are shortcomings.

### High tax burden

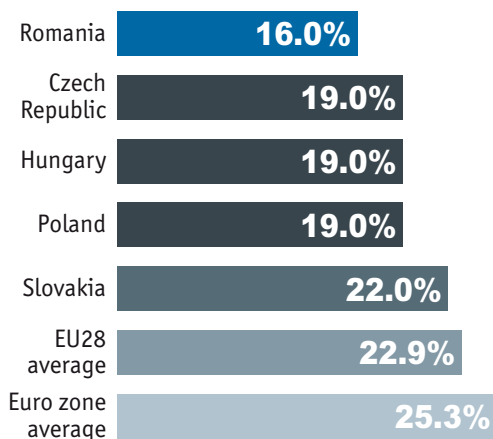
On the whole, investors take a negative view of the array of tax reforms introduced in Slovakia over the past three years. Some of the changes include higher payroll levies for sole traders, the abolition of the flat tax system, higher property taxes and the reversal of the previously tax-free status of dividends. Slovakia has the highest rate of corporate taxation in CEE, currently standing at 22%, even after a 1-percentage-point deduction in early 2014. There has also been a considerable delay in streamlining a unified system for joint income and payroll tax collection, otherwise known as UNITAS, which is unlikely to come into force before 2016.<sup>40</sup>

Since coming to power in March 2012, the centre-left government has raised taxes or changed the existing system of taxation for individuals and corporates three times. The most recent changes, approved by parliament in October 2014, leave the existing rates of corporate and income tax in place, but they are designed to boost tax collection in order to plug holes in Slovakia's rising public debt levels.

These amendments, in place since January 1st 2015, are likely to result in higher tax burdens for businesses arising from a combination of factors:

Chart 3

#### Standard corporate tax rate (%)



Note: The values for the euro zone and EU28 are simple averages of the adjusted top statutory tax rate on corporate income in 2014.

Sources: European Commission; The Economist Intelligence Unit.

the eradication of certain tax-deductible costs upfront; the introduction of new depreciation limits (where there were none before) on certain assets acquired by businesses; and an extension of duties on transfer pricing to domestic transactions.

The impact of these changes will be felt most acutely by entrepreneurs and companies with a low tax base. However, Slovakia, by virtue of its membership of the single currency area, is more compliant with EU regulatory norms than some of its CEE neighbours, particularly in terms of improved contract enforcement and the ease of starting up businesses.

### SMEs into the future

Slovakia is bound by set EU norms regarding reporting requirements for large firms, defined

as those that employ over 2,000 people. These regulations, which have been formalised in line with IFRS, reduce the risk of auditing and accounting difficulties, but they do not apply to SMEs.

Slovakia's economy is driven by SMEs, whose activities are governed by the Investment Stimulus Act and the soon to be implemented National Act for SMEs. According to estimates published by the European Commission, they provide around 67% of gross value added in the economy, almost 10 percentage points above the EU average.<sup>41</sup> The number of SMEs has almost doubled since 2008, particularly in manufacturing and retail—a trend that is largely attributable to decreasing administrative burdens and easing credit standards for the private sector. SMEs have also helped to reduce barriers to investment by opening the door to incentive schemes, such as national cash grants for job creation and other tax reliefs.

Slovakia's public financing programme is diverse and brings together an array of government-backed venture-capital and private-equity funds that are on hand to provide liquidity for short-term investments to SMEs and entrepreneurs, particularly those engaged in R&D. The latest income tax amendment outlines tax relief of up to 25% for real costs incurred during R&D projects and 25% for wage costs of newly hired graduates (during the year when the graduates are hired).<sup>42</sup>

### Capitalising on incentive schemes

In its draft budgetary plan, presented annually to the European Commission under existing EU rules and published in October 2014,<sup>43</sup> the Slovakian

government acknowledged the importance of support for technology start-ups, as well as innovative products and services. However, it admits that the lack of transparency in public tenders and procurement remains a significant weak spot,<sup>44</sup> as is the high bureaucratic burden associated with administering EU-funded projects, which weighed on Slovakia's absorption rate of EU funds in 2007-13.

Rising levels of portfolio investment, above and beyond headline FDI, suggest increased liquidity flows from institutional investors—in the first half of 2014 portfolio investment inflows were more than four times the size of FDI inflows. This, in addition to a higher uptake of syndicated loans, should offset expected cuts in government investment spending. For example, in December 2014 the International Investment Bank announced its participation in a syndicated loan organised by UniCredit Bank to Slovak Gas Holding, which holds 49% of the shares in Slovakia's main gas distributor, SPP.<sup>45</sup>

The resurgence of public-private partnerships (PPPs), particularly for development and infrastructure projects in newly designated industrial parks, is likely to support investor sentiment in the absence of a robust privatisation programme; the long-awaited tender for Slovak Telekom is yet to be officially announced.

Finally, Slovakia is on the crest of a fresh wave of public tenders,<sup>46</sup> following an approved amendment to the existing law on public procurement in early December 2014, which aims to increase transparency and competition in the tender process.<sup>47</sup>



## Conclusion

Business opportunities in Central and Eastern Europe are manifold. Economic growth in the CEE region will continue to exceed the euro area average. Corporate taxes are low compared with the euro area. The rise in labour costs in China is set to bring investor attention back to the CEE region, especially Poland, given the persistently strong competitiveness of local manufacturers. However, the strength of cost competitiveness is under threat in parts of the region, highlighted by the rising minimum wage in the Czech Republic. Countries in the region are actively supporting their manufacturing sectors, for example through investment incentive schemes. Outsourcing and the growth of shared service centres continue to offer major opportunities in countries like Hungary and Poland.

The emergence of SMEs as an increasingly important growth engine in the region is significant, as it could herald a new era of sustained growth. For example, Slovakia has led the way in boosting the funding environment and tax credits for SMEs. And the Czech Republic's strategy to achieve sustainable growth includes a major push to support SMEs, for example through the Small and Medium Enterprises Support Strategy 2014-2020.

However, major business risks persist across the region. The risk of arbitrary legislation,

notably sector-specific taxes, is a problem, for example in Hungary and the Czech Republic. Taxation systems in CEE remain in need of a major overhaul, with slow progress on this front in countries like the Czech Republic and Slovakia. In Romania, the system of tax incentives is overly complex. Hence, the administrative burden when doing business there remains problematic. Absorption rates of EU funds are uneven across the region, with Poland leading the way, but with major difficulties in Romania, for example. However, the need for significant regulatory reform is also evident in Poland, notably in the area of regulated professions. Positively, some governments are taking action to address red tape, for instance in the area of public-sector procurement. The extent to which governments will make progress on regulatory reform and streamlining bureaucracy and taxation systems will be a key determinant of business expansion in the coming years.

As this paper shows, the CEE region continues to offer a plethora of evolving and diverse business opportunities and risks. Potential investors cannot ignore the interaction of these risks and opportunities and the key trends, such as the growing importance of SMEs, that will shape the business environment in the region.



# Endnotes

<sup>1</sup> Defined here as Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.

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