



*Best-Practice Guide
for a Positive Business
and Investment Climate*

OSCE



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Contact: Press and Public Information Section
 OSCE Secretariat
 Kärntner Ring 5-7
 A-1010 Vienna, Austria
 Tel.: +43 1 514 36 180
 info@osce.org

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Table of Contents

6	<i>Foreword</i>
8	<i>Acknowledgements</i>
9	<i>List of Textboxes, Tables and Figures</i>
11	<i>Introduction</i>
12	Background
12	What makes the Guide different?
13	Methodology
13	How to use the Guide
13	Summary
16	<i>Chapter 1 The Importance of a Favourable Business and Investment Climate</i>
17	What is a business and investment climate?
17	The importance of a favourable business and investment climate
18	Negative consequences of an unfavourable business climate
18	The importance of foreign direct investment (FDI)
19	Ireland's economic miracle
22	Conclusions and Recommendations
24	<i>Chapter 2 A Business-Friendly Political and Legal Environment is Critical to a Strong Investment Climate</i>
25	The importance of the political environment and key conditions
25	Security
26	Protection and guarantee of investor rights
27	Legislative stability
28	Transparency
30	Corruption
33	Good governance
35	Conclusions and Recommendations
36	<i>Chapter 3 The Importance for the Business and Investment Climate of Policies that Support Macroeconomic Stability and Economic Growth</i>
37	The importance of a strong and stable macroeconomic environment
37	Macroeconomic indicators used by corporate investors
40	Closed versus open economies
40	The importance of diversification to economies built on extractive industries
42	Creating a strong macroeconomic environment
43	Conclusions and Recommendations

44	<i>Chapter 4 Government Actions and Policies that Improve the Business Climate</i>
45	Improving the business climate
45	Tax policy
49	Employment policy and labour market flexibility
50	Labour market reforms in OSCE countries
50	Investment in infrastructure
53	Investment in human capital
54	International and regional integration
57	Privatization of State-owned enterprises
60	Recommendations
64	<i>Chapter 5 The Importance of Law and Regulation to Economic Development</i>
65	Private property rights and freedoms
65	Protection against uncompensated expropriation
66	Regulation and erosion of property rights and business opportunities
68	Immovable property
71	Contractual rights and freedoms
71	Forms of doing business
72	Corporate governance
74	Personal property and secured transactions
75	Bankruptcy legislation
76	Capital markets
77	Banking law and policy
78	Repatriation of profits and capital
79	Foreign exchange controls
80	Competition law and policy
81	Intellectual property and electronic commerce legislation
86	Government procurement
87	Enforcement of the law and protection of private rights
90	Bilateral investment treaties
91	Conclusions and Recommendations
98	<i>Chapter 6 Investment Promotion</i>
99	Investment promotion
99	Investment promotion agencies (IPAs)
103	Investment incentives
103	Fiscal incentives
105	Disadvantaged zones
106	Free zones/Special economic zones
107	Industrial parks
109	Investment guarantees and political risk insurance
111	Conclusions and Recommendations

114	<i>Chapter 7 Small and Medium-Size Enterprises (SMEs): Development and Promotion</i>
115	The importance of SME development
116	Economic impact of SMEs
117	The diminished effect of SMEs due to the informal economy
118	Fulfilling SME potential through improved business climates
119	Creating a supportive SME policy framework
120	Reducing the burden on SMEs
120	Measures for reducing SME-specific constraints
121	Creating a State-supported SME development programme
122	Tax benefits for SMEs
122	Developing entrepreneurial culture and human capital for SMEs
123	Barriers to finance for SMEs
123	Alternative financing mechanism
126	Access to enterprise support services
130	Access to markets and cluster development
132	Conclusions and Recommendations
134	<i>Chapter 8 Sustaining and Strengthening a Better Business and Investment Climate</i>
135	Sustainable development
135	Environmental protection
136	Social development
136	Corporate social responsibility (CSR)
137	CSR and the public sector
138	Codes of conduct for industry
138	CSR: the business case
140	Conclusions and Recommendations
143	<i>Annex</i>
147	<i>Bibliography</i>
154	<i>Glossary</i>
157	<i>List of Abbreviations</i>

Foreword

I am pleased to present the OSCE's *Best-Practice Guide for a Positive Business and Investment Climate*. The Guide has been developed in response to a request made by the OSCE participating States that the Organization should facilitate higher levels of information availability and experience-sharing on best practices in the areas of investment and small and medium-size enterprise (SME) development.

In full accord with its comprehensive concept of security, the OSCE sees the promotion of a positive investment climate as an important priority for its work in the economic and environmental dimension. Foreign direct investment (FDI) is the largest source of external financing in many OSCE countries, and is particularly important for the OSCE's developing and transition economies. FDI has the potential to generate employment, raise productivity, and transfer skills and technology; as it is good for exports, it also contributes to long-term economic development. Sound investment policies – consciously designed to attract FDI, stimulate domestic investment, and develop the SME sector – constitute a solid foundation for sustained economic growth.

The Guide presents the key concepts and best practices by focusing on countries in the OSCE area that have in recent years made significant strides forward in improving their business climates and advancing their economic development. Their experiences and best practices will be invaluable to other countries intent on following their example.

The Guide discusses the critical conditions for a positive and dynamic business and investment climate: a sound and stable political, economic, legal and regulatory environment, supported by good governance, transparency, predictability, and economic openness. It also emphasizes the need for a basic policy framework that addresses issues such as competition, privatization, taxation, customs, labour, education, financial systems and physical infrastructure. A separate chapter is devoted to “law and regulation”, as this field is critical to the creation of an environment conducive to increased investment and business activity: among the issues discussed are property and contractual rights, protection against expropriation, corporate governance, repatriation of profits, and bankruptcy legislation.

The Guide also deals with SME-relevant policy areas such as access to finance, markets, technology, expertise, and business support services. Finally, the Guide draws attention to the importance of sustainable development, emphasizing that adequate consideration has to be paid to social and environmental matters if the policies pursued are to result in balanced long-term development.

It is my sincere hope that the Guide will be a useful tool for policymakers and practitioners seeking to develop new policies, strategies and structures aimed at improving the investment and business climate in their respective countries. I also hope that it will inspire further dialogue and co-operation, not only among our participating States but also between national authorities and other key stakeholders, on how to advance economic development by building up positive investment and business climates.



Bernard Snoy
Co-ordinator of OSCE Economic
and Environmental Activities

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External experts:

Sofiya Aisagalieva, Executive Director, Forum of Entrepreneurs of Kazakhstan
Niko Orvelashvili, Chief Economic Expert, Georgian Economic Development Institute
Nikolay Platonov, Deputy Head of Division of Services and Investments, Trade Negotiations Department, Ministry of Economic Development and Trade of the Russian Federation
Jonathan Coppel, Senior Economist, Investment Division, Directorate for Financial and Enterprise Affairs, OECD
Antonio Fanelli, Principal Administrator, Investment Compact for South East Europe, OECD
Kalman Kalotay, Division on Investment, Technology and Enterprise Development, UNCTAD

OSCE:

Nina Lindroos-Kopolo, Associate Programme Officer and Project Manager, Office of the Co-ordinator of OSCE Economic and Environmental Activities
Alexey Stukalo, Deputy Co-ordinator, Office of the Co-ordinator of OSCE Economic and Environmental Activities
Serhiy Rusnak, Economic Development Specialist, OSCE Project Co-ordinator in Ukraine
Tigran Sukiasyan, Senior Economic Assistant, OSCE Office in Yerevan
Ina Jurasin, Intern, Office of the Co-ordinator of OSCE Economic and Environmental Activities

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List of Textboxes

21	1.1	Economic progress in the Baltic States: A role model further east
32	2.1	Estonia's progress towards an independent judiciary
32	2.2	Anti-corruption efforts in Azerbaijan
38	3.1	Opening up developing economies in the OSCE: The East Asian or Latin American model?
39	3.2	Turkey's recent macroeconomic success
41	3.3	Kazakhstan's diversification efforts
45	4.1	Impact of business environment on firms
48	4.2	Cleaning up customs is a smart investment for governments
52	4.3	The OSCE's 2006 Spotlight on Transport
53	4.4	Hungary's highway infrastructure
56	4.5	Investment compacts
70	5.1	Overcoming shortage of land for commercial and industrial use
79	5.2	Liberal income and capital repatriation policies in selected OSCE countries
87	5.3	E-procurement in Romania
99	6.1	CzechInvest: A leading IPA in Eastern Europe
102	6.2	Regional investment promotion at an international standard in Ukraine
105	6.3	Urban enterprise zones in the United States
106	6.4	The Aegean Free Zone's best practices in free-zone development
107	6.5	City of New York involving stakeholders as a case of best practice
108	6.6	Industrial parks in the Czech Republic and Hungary
109	6.7	Industrial and business parks in Romania and in Serbia
110	6.8	MIGA in Moscow
119	7.1	SME policy in Kazakhstan
124	7.2	OSCE support to Voluntary Farmers' associations in Turkmenistan
125	7.3	Channelling remittances – venture capital for SMEs. A case study: Silicon Armenia.
127	7.4	Examples of business support centres
127	7.5	Business incubator starting in Goris, Armenia
128	7.6	Oxford Innovation Centres, United Kingdom
129	7.7	The Russian Foundation for Assistance to Small Innovative Enterprises (FASIE)
130	7.8	Transnational corporations and SMEs in Russia
131	7.9	SME clusters in Ukraine
136	8.1	Environmental investment opportunities in Russia
137	8.2	The United Nations Global Compact Principles
139	8.3	The small-business case for social responsibility, Turkey

Lists of Figures and Tables

31	Figure 2.1	Share of corporate revenue used for bribery
55	Figure 4.1	Increase in FDI after WTO accession, Bulgaria
55	Figure 4.2	Increase in FDI after WTO accession, Estonia
115	Figure 7.1	Perceptions of effective ways out of poverty
117	Figure 7.2	Contributions to employment and output
118	Figure 7.3	SME access requirements
120	Figure 7.4	Annual administrative costs per employee
19	Table 1.1	Top ten OSCE Countries in 2004: FDI stocks as a percentage of GDP
31	Table 2.1	Top and bottom five OSCE countries in GDP per capita and their scores on Transparency International's 2005 Corruption Perception Index
88	Table 5.1	Contract enforcement in East and Central Europe and Central Asia
116	Table 7.1	Key indicators of SME development and promotion in developed countries
116	Table 7.2	Average index of SME development in transition countries
126	Table 7.3	Typical services provided by business support centres



ImageAfter

Introduction

“We recognize that reforming the business environment is one of the most important areas in the global development agenda for donors and governments.”

Committee of Donor Agencies for Small Enterprise Development,
International Conference on Reforming the Business Environment
(Cairo, 29 November to 1 December 2005), “Conference Outcomes”.

Background

Under its Bulgarian Chairmanship in 2004, the OSCE paid particular attention to the problem of how to build institutional and human capacity for economic development and co-operation. Foremost among the means it focused on were the stimulation of foreign and domestic investment, the development of the small and medium-size enterprise (SME) sector, and the strengthening of human capital. The OSCE 12th Economic Forum and the Preparatory Seminar in Dublin discussed the importance of creating a good business environment for countries aiming to attract investment and develop their SME sectors. It was agreed that the key determinants for a favourable business climate included (regional) security and co-operation, macroeconomic stability based on prudent economic policies, good governance and the rule of law, sufficient institutional and human capacity, and – last but not least – well-developed financial and physical infrastructures. The OSCE was encouraged to intensify its work with government authorities and policymakers on promoting favourable business and investment climates, notably by facilitating the development of investment- and business-friendly legal and institutional frameworks, by promoting good governance measures and best practices calculated to facilitate business development (SME development in particular), and by helping countries in need of supportive infrastructures. It was as a response to the Forum’s recommendations and as a follow-up to the OSCE Strategy Document for the Economic and Environmental Dimension that the OSCE decided to prepare the present publication (“the Guide”), which aims to encourage the implementation of best practices and promote the sharing of information and experience. While there are many high-quality publications related to improving business and investment climates, the Guide is intended to serve as a practical document, specifically tailored to the needs of the OSCE’s developing and transition economies.

What makes the Guide different?

The Guide differs from documents by well-known agencies in the fields of foreign direct investment (FDI), and SME development, and business climate reform such as the Organisation for Economic Co-operation and Development (OECD), the World Bank, the International Finance Corporation (IFC), the Foreign Investment Advisory Service (FIAS), the Multilateral Investment Guidance Agency (MIGA), the United Nations Conference on Trade and Development (UNCTAD), and the United Nations Industrial Development Organization (UNIDO), which have all gathered a tremendous amount of experience, resources and expertise in these areas. Rather than replicate work by the leading experts, the Guide proposes to embrace the key concepts developed by these organizations and recommend to OSCE participating States those practices that have proved successful; the intention is to present – key concepts and best practices to policymakers in a compelling and practical way. The Guide is also distinctive in the following respects:

1. It focuses on the economies of the OSCE, and in particular on the economies of the Commonwealth of Independent States (CIS);
2. Rather than being technical in character, it focuses on practical recommendations that are comprehensible not only to experts and academics but also to policymakers, officials and opinion-makers;
3. Without being directly prescriptive, it offers policy guidance through best practice examples from countries in the OSCE area that have made significant strides in business climate improvement and economic development in recent years.

Methodology

Many works on economic development treat the promotion of FDI and that of SMEs separately. Yet FDI and SME development are two of the most significant catalysts for economic growth and job creation, and tend to be mutually supportive; and conversely, improvement of business and investment climates also generates FDI and SME development. This is why the Guide encompasses both FDI and SME development.

The development of the Guide was managed by the Office of the Co-ordinator of OSCE Economic and Environmental Activities. The expert team working on the Guide researched literature published by leading multilateral and donor organizations on improving the business and investment climate. Visits were paid to the OECD, the European Commission (EC), UNCTAD, and UNIDO to discuss the Guide and share perspectives. In the course of research, the team gathered primary information by distributing a questionnaire to investment promotion agencies, to SME agencies, and to the OSCE field presences in Eastern and South Eastern Europe, the South Caucasus and Central Asia. The initial draft was subjected to a panel review in Vienna in March 2006 by a team of experts from countries in the CIS and Central Asia. In addition, the draft was submitted to external reviewers. Much of the feedback from those reviews is reflected in the Guide (Annex).

How to use the Guide

The objective of the Guide is to assist States, particularly those in the OSCE area, to develop new approaches to improving their investment and business climates. It has been prepared primarily to be used by policymakers and those active in the business and investment community in the OSCE area, and contains analysis of effective and innovative policies and good practices drawn from OSCE countries. Rather than elaborating on the technical rationale for measures favourable to business climates, the Guide provides recommendations, country examples, and resources that are intended to motivate its readers and provide them with mechanisms to conduct their own research on the subject.

When reading the Guide, it should be borne in mind that there is no blueprint for attracting investment: every country has to develop its own strategy, based on its specific conditions and environment and tailored to its needs and resources. Comparisons made in the Guide are not made in order to praise countries blessed with a favourable business climate or to castigate those without. The intention is rather to cement the understanding that business and investment climates do matter, and that a country with the will to improve its climate can raise its economic prosperity.

After the launch of the Guide in May 2006, it is proposed that specialized regional and/or national workshops should be organized to allow decision-makers and practitioners from interested countries to discuss specific areas of the Guide in more detail. The aim will be to assist participants in these workshops not only to familiarize themselves with effective practices carried out in other countries, but also to discuss how particular policies presented in the Guide might be adapted or developed to suit their specific economic situations and to identify key measures for enhancing enhance their respective business and investment climates.

The Guide and subsequent workshops will also help to create a basis for future dialogue and co-operation among various national authorities and other stakeholders, and directly facilitate the exchange of information among States in the OSCE region on effective (and also less effective) policies and practices related to investment promotion and business development.

Summary

Continuing from the present introductory chapter, Chapter 1 demonstrates the importance of any given country's business and investment climate, noting that the OSCE participating States with the most rapidly improving business climates are also those that have achieved higher levels of growth in FDI and GDP in recent years (the countries of Central and Eastern Europe in particular). The role of FDI in economic development is emphasized, as are the opportunities for FDI in developing economies. In 2004, 42 per cent of global FDI inflows went to developing economies.

Developing economies that wish to increase FDI and economic growth can learn from Ireland's economic miracle, in which trade liberalization, a fair and simple tax system, public-private sector dialogue, infrastructure development, and targeted investment promotion contributed to Ireland's becoming the most dynamic economy in Europe. The policies and programmes of the Baltic States also provide helpful examples. The chapter concludes by noting that government's role is not to manage the economy or interfere with market dynamics but rather to provide the enabling framework for enterprises to flourish through a strong business climate. This is particularly critical for countries that lack resources for extractive industries. Improving the business and investment climate is the best option available, and if the government has the political will, it can be accomplished.

Chapter 2 discusses the important role of a sound political environment in attracting FDI and helping businesses grow. Investors are discouraged by concerns about security and stability, and are attracted by increased transparency and good governance. The chapter also focuses on a number of measures for protecting investor rights and increasing legislative stability.

Any given investment location must give potential investors a sense of predictability and security. The chapter identifies the negative effect of corruption on investment and entrepreneurship and discusses practices for countering corruption, including those recommended in the OSCE's Handbook on Best Practices in Combating Corruption.

Chapter 3 looks into a further requirement for investors: encouraging macroeconomic conditions. Macroeconomic stability and GDP growth are keys to increases in investment. The Guide discusses the benefits of economic liberalization and of adopting an "open" economic model similar to that adopted by most of the East Asian countries in preference to the more closed model adopted by some Latin American countries. Turkey's opening up of its economy exemplifies some of the best practices in macroeconomic policy. The chapter concludes by focusing on the need for countries reliant on extractive industries to diversify, and recommends the development of such macroeconomic policies as a medium-term government economic strategy, a disciplined fiscal policy, strong policy support for international trade, and facilitation of international capital flows.

Chapter 4 examines policies that improve the business climate, and reviews successes achieved by simpler and fairer tax systems. Lower overall tax rates and simplified tax administration are generally more effective stimulants to economic development than complex systems of tax holidays and incentives based on the country or industry of the investor. Moreover, while taxes may influence a decision by a foreign investor as to which country to invest in within one region, tax incentives may not attract investors to Eastern Europe or Central Asia from other strongly competitive regions; indeed, such "tax competition" alone is likely to be particularly ineffective if the country has neglected its overall business climate. Labour market flexibility is another important element in strategies for economic growth. Slovakia's 2003 labour market reforms provide an instructive example. This chapter recommends investment in human capital and infrastructure, specifically including infrastructure for transportation – a key element in social and economic development and the theme of the OSCE's 14th Economic Forum. The chapter concludes with a discussion of the privatization of State-owned enterprises, in the course of which the role of the government changes from economic actor to independent regulator and enabler. Privatizations should be transparent and open to foreign and domestic bidders, and should be conducted without post-privatization commitments that threaten the profitability of the enterprise.

Chapter 5 explores the use of legal and regulatory systems in the implementation of economic policies. In a sound business climate, the law recognizes, protects, and makes clear parties' rights and obligations with regard to land, personal property, and contractual arrangements. Competition law also is an important tool by which governments may promote economic efficiencies and ensure that market forces are the key driver in economic activity. A mature business and investment climate creates conditions that encourage the availability of capital – both debt and equity – for business start-up and expansion. Legal and regulatory systems can support this effort through the proper regulation of shareholders' rights and obligations in companies, by structuring and governing capital markets, and by effectively and efficiently enforcing creditors' rights. These and other aspects of legal and regulatory systems require more than the mere adoption of good laws and regulations. The quality of a country's performance in enforcing commercial rights and obligations – through a strong and independent judiciary and alternative dispute resolution methods such as arbitration – is another crucial factor in the sustained improvement of the business climate.

Chapter 6 looks at the role of investment promotion agencies and discusses their principal activities, such as policy advocacy, image promotion, investment generation, and investor services. Among the “best practitioners” mentioned in this chapter are the Czech agency CzechInvest and the OSCE project in Ukraine InvestinRivne. Investment incentives and mechanisms such as free zones, disadvantaged zones, and fiscal incentives are only effective in the presence of a favourable business and investment climate. If such incentives are adopted, they should be applied in a non-discriminatory manner. Given the right circumstances, industrial parks and investment guarantees can also serve as useful elements in an investment promotion policy.

Chapter 7 is devoted to SME development and promotion. It is important to reduce the regulatory burden on SMEs, as these enterprises are disproportionately affected by problems such as complex tax systems, bureaucracy, frequent inspections by the authorities, and the like. Attention is paid to best practices for promoting economic development that assist SMEs to gain access to markets, financing, and business support services. Microfinance institutions, specialized microcredit banks and guarantees that provide alternative financing mechanisms for SMEs are also discussed. The chapter emphasizes the need for knowledge, training and access to information, and gives a descriptive account of programmes for business support centres and incubators designed to stimulate SME development.

Chapter 8 discusses the role of sustainable development in supporting and strengthening the business and investment climate. Sustainable development encompasses economic growth, environmental protection, and social development. The government has the responsibility to balance protection of the environment with fostering private sector development in a manner that does not sacrifice the future for short-term results. Industry codes of conduct and the UN Global Compact provide useful frameworks for encouraging corporate social responsibility.

The Guide also includes an Annex containing summaries of responses to the Guide Questionnaire and a Glossary of technical terms.

Chapter 1

The Importance of a Favourable Business and Investment Climate



Wolfram Kalt

A favourable business climate is essential for attracting foreign direct investment (FDI) and for the development of small and medium-size enterprises (SMEs). A poor business environment – i.e., one plagued by factors that impose heavy costs, delays and risks – impedes economic development and can frighten away FDI. FDI is the largest source of external finance in developing and transition economies. East and Central European and Central Asian countries are well positioned to compete for FDI if they adopt pro-development policies, and laws and practices supporting investment and business development. As has been illustrated by the recent economic transformation of the Irish Republic, even those countries with relatively low levels of FDI can significantly increase their share of FDI by concerted efforts to improve the business climate.

What is a “business and investment climate”?

There is no precise definition of “business and investment climate”. The World Bank defines a business and investment climate as the opportunities and incentives for firms to invest productively, create jobs, and expand. Similarly, for the purposes of the Guide, the business and investment climate serves as the framework that enables foreign and domestic companies to conduct business and seek profits in a given country.

The investment climate can be defined by three broad sets of variables:

- Macroeconomic policies such as fiscal, monetary and trade policies;
- Governance and institutions; and
- Infrastructure.

The business and investment climate is made up of much more than just the tax rates and fiscal incentives available to businesses. Other critical components include: political stability, rule of law, macroeconomic conditions, perceptions of government, and the regulatory environment.

The importance of a favourable business and investment climate

The state of a country’s business and investment climate is a key factor in that country’s ability to attract foreign investment and develop small and medium enterprises. Transnational enterprises prefer to invest in enterprises in countries with a healthy business climate – where cost, delay, and risk are minimized. In addition, SMEs are more likely to flourish in a climate where they are not overburdened by taxes and regulations. The World Bank website puts it as follows: “A good investment climate is an essential pillar of a country’s strategy to stimulate economic growth, which in turn generates opportunities for poor people to have more productive jobs and higher income.”¹

Across the globe and within the OSCE, it is the wealthier countries that tend to have more favourable business and investment climates. There is a definite link between economic growth and prosperity, investment, and business climate. Many of the Eastern European countries without major energy or raw material reserves have transformed their economies into some of the most attractive global FDI destinations through reform of their business and investment climate. According to AT Kearney’s October 2004 FDI Confidence Index, a survey of corporate executives assessing the relative attractiveness of countries as FDI destinations ranked Poland and the Czech Republic 12th and 14th respectively, ahead of such Asian tigers as Malaysia, Singapore, and Taiwan, and also of such developing giants as Brazil.²

Governments often downplay the importance of the business climate when inviting foreign direct investment. They tend to focus on market size, availability of natural resources and costs. While all these factors are important, the investment climate is a critical factor and should not be underestimated.

Guide Questionnaire Responses:

The Slovak Government is attracting investors by improving the [overall] business environment. For that purpose many reforms have been introduced, including, to mention only a few example: tax system reform, labour market reform, pension reform, and bank system recovery.

The Russian FDI inflow has increased due to a complex of measures and general improvements.

[In Malta] It is extremely hard to single out the effect of one factor on incoming FDI. It is a combination of factors that attracts a company to invest in a particular location.

Negative consequences of an unfavourable business climate

Investors seek a predictable and acceptable return on their investment: “Money is a coward,” is a common catchphrase. In order to attain a competitive return, an investor will seek to avoid three key obstacles: cost, delay, and risk. If a poor investment climate – through taxes, fees, fines, corruption and added need for services (lawyers, accountants, consultants, etc.) – increases the cost of the investment transaction, an investor may look elsewhere even though labour, transport and energy costs may be competitive. Likewise, if the impediments brought by the system delay the commencement of profit-making activity significantly, investors may seek to invest elsewhere despite competitive costs. Finally, even if the initial costs and delays are not a factor but the investor is worried about political upheaval, seizure of assets, or legislative changes that could diminish the return, the investor may be willing to accept a slightly less attractive return in another destination in order to minimize the risk.

The importance of FDI

In today’s globalized world, economic growth and job creation in developing and transition economies are dependent on two primary factors: FDI and SME development. FDI is the largest source of external finance in developing countries. Foreign direct investment can increase fixed capital formation and help the balance of payments. In UNCTAD’s view, FDI has the potential to generate employment, raise productivity, transfer skills and technology, enhance exports, and contribute to the long-term economic development of the world’s developing countries. Foreign affiliates of some 64,000 transnational corporations (TNCs) generate 53 million jobs.³

Furthermore, developing countries do attract foreign investment. According to UNCTAD, developing countries attracted 42 per cent of the global FDI flows and the FDI that they attracted increased at a faster rate than that of developed countries in 2004.

Developing countries’ inward stock of FDI (inward FDI stocks being understood as the cumulative amount of direct investment registered by new and existing investors) amounted to about one third of their GDP, a striking increase as compared with 10 per cent in 1980.

Economists argue about whether FDI causes growth or growth causes FDI. The constant that appears to emerge from the academic debate is that FDI growth and economic growth tend to accompany one another.

On the supply side, FDI is affected by the availability of investment capital, generated by corporate profits or loans, which in turn are affected by domestic economic conditions, including growth. On the demand side, growing overseas markets lead TNCs (transnational corporations) to invest more, while depressed markets inhibit them. Over the past two decades, booms in global FDI have followed periods of high economic growth, while declines have followed recessions or periods of slow growth. The decline in FDI flows in 2001 and 2002 followed rapid increases in FDI growth during the late 1990s. There was a similar pattern during the late 1980s and early 1990s, as well as in 1982-1983. The positive recent economic trends suggest that an FDI upturn is in the works following the recent investment recession.

Source: Prospects for Foreign Direct Investment and the Strategies of Transnational Corporations, 2005-2008 (World Bank).

The prospects for the developing and transition economies in the OSCE are good. It is predicted that the OSCE’s developing economies will achieve a higher degree of economic growth than developed economies in 2006. According to the World Bank, South Asia, East Asia, Eastern Europe and Central Asia are all expected to experience growth of over 5.5 per cent in 2005 and 2006. Every other developing region is expected to expand by between 3.5 and 5 per cent per year.

To support investment, it is important to establish the macroeconomic foundation and promote a favourable investment climate.

TABEL 1.1

Top ten OSCE countries in 2004: FDI stocks as a percentage of GDP (millions of USD).

Country	Inward FDI Stocks	GDP	FDI Stocks as a % of GDP
Luxembourg	182 894	31 783	575.4
Azerbaijan	13 408	8 540	157.0
Ireland	229 241	181 520	126.3
Estonia	9 530	11 196	85.1
Netherlands	428 803	577 985	74.2
Belgium	258 875	352 000	73.5
Malta	3 557	5 389	66.0
Hungary	60 328	99 347	60.7
Kazakhstan	22 399	40 754	55.0
Cyprus	8 132	15 419	52.7

Source: UNCTAD.

Many of the OSCE countries have relatively high inward FDI stocks as a percentage of their GDP: Azerbaijan, Estonia, Cyprus, the Czech Republic, Hungary, Ireland, Kazakhstan, and Malta have all been cited recently as having improved their economic performance. FDI has helped them do this. Luxembourg and the Netherlands also have among the highest FDI stocks as a percentage of GDP, partially because of their unique role as financial centres and corporate hubs for companies from other countries. Table 1.1 shows the ten top OSCE countries as regards inward FDI stocks as a percentage of GDP.

The OSCE countries with lower FDI stocks as a percentage of GDP were either countries with large economies or ones with less attractive business climates and relatively closed economies. The United States, although one of the world's largest recipients of FDI, has relatively low inward FDI stocks as a percentage of GDP because of the massive size of its economy and domestic market. It is clear that smaller economies – even developing ones – can be catalyzed by FDI.

Ireland's economic miracle

One of the most striking examples of a country where FDI has been promoted by a strong business

and investment climate and has had a major impact is Ireland. The 1970s and 1980s saw mass migration by Irish workers to the United States and other locations because of high unemployment and poor economic growth. In the mid-1980s, Ireland faced an unemployment rate of nearly 20 per cent, and the highest rate of per capita debt in the world. Its per capita GDP was only 63 per cent of its neighbour the UK. In the 1990s, Ireland underwent a startling economic transformation to become one of Europe's wealthiest countries per capita, coming third after Norway and Switzerland. Ireland's proximity to the USA, its English-speaking population, and European Union (EU) membership have certainly contributed to its economic growth over the past 15 years. But what makes Ireland's case a special one is that without an established industrial base or significant natural resources it decided to exploit its indigenous advantages by developing an outstanding business climate and through intelligent policy-making. Ireland is consistently rated among the world leaders in international indexes on "openness to foreign investment", "globalization", and "ease of doing business".

What steps did Ireland take? Ireland transformed its business climate and offered businesses:⁴

- The lowest corporate income tax rate in Europe at 12.5 per cent;

- Competitive costs due to a young, well skilled workforce prepared to work for moderate wages;
- An environment free from unnecessary government intervention and focused on competition and deregulation;
- Infrastructure including a good international airport with access to a wide number of European and North American destinations, and a good base of universities and institutes of technology;
- Partnership between government, labour, and industry; and
- A keen interest in development and a concern to attract the best companies to locate in Ireland.

Many point to Ireland's low tax rates as the cause for the rise in FDI. But the low taxes were just one element in a much larger programme to attract business. How did Ireland become the Celtic Tiger? The decision to lower the corporate tax to a flat rate of 10 per cent is the best known measure taken by the Irish Government. As Sean Dorgan, Chief Executive of IDA Ireland explained: "Ireland's competitiveness is based not on tax benefits and costs alone, but on knowledge, innovation, flexibility, and connectedness – how everything works together."⁵

There were several other important factors in the Irish miracle apart from the low tax rates:

- *Development of human capital.* Ireland stresses the quality of its workforce with a concerted concentration of secondary and university education; emphasis is laid on "skill sets" (IT skills, for instance) that are attractive to foreign companies.
- *Strong policy of national investment in infrastructure.* Part of Ireland's economic progress was certainly due to its accession to the EU. But the EU provided more than access to markets and structural funds: it provided planning discipline that is useful for any country regardless of whether it is a candidate country. Previously, investment was made on a haphazard basis. "Say, a [section of] road was built until they ran out of money and then they stopped building it and might return to it later or they might not, or they might go and build a road somewhere else. The structural funds, because they are done in six-year time frames, meant that a development

plan or a plan for the economy had to be put in place every six years, so a long-term planning horizon was opened up."⁶ EU funding imposed planning discipline on the Irish authorities.

- *Co-operation between labour and industry – a "social partnership".* Unions agreed to fair but moderate wages in return for the government's support of the welfare state. Partnership committees provided ongoing input into economic decision-making. Systematic dialogue was developed between the public and private sectors.
- *Targeted investment promotion.* Ireland's promotion of foreign direct investment has also been targeted, focusing on four sectors. The first sector is the IT industry: the information and communications technologies. Investors include Intel, Dell, IBM (now Lenovo), and Hewlett-Packard. The second major area is the pharmaceutical and health-care industry. The third area is the international financial services industry. The sector that has been growing most in recent years is the international service industry: software, customer service and support, and shared service activities. Direct investment in Ireland totals more than \$17 billion, in an economy of only 3.5 million people. Ireland has also proved that investment promotion works.

Clearly, the Irish miracle cannot be replicated in all States but the point is that all OSCE countries can attract FDI by exploiting their competitive advantages and developing strong business and investment climates.

The lessons of the Irish economic miracle can be applied in Eastern European and Central Asian countries. The countries of Central and Eastern Europe are attractive FDI destinations not only because of their European location and low costs but also because of the changes in their respective business climates (Textbox 1.1). Not all OSCE participating States have the opportunity of EU accession, but they all have the opportunity to establish a favourable business and investment climate.

TEXTBOX 1.1

Economic progress in the Baltic States: A role model further east

The Baltic countries, Estonia, Latvia and Lithuania, do serve as models for the developing OSCE economies. These are countries that had centrally planned economic systems, maintain no contiguous borders with Western Europe, do not possess abundant natural resources and have small populations yet have managed to transform themselves into some of the fastest growing economies in Europe. While there are some natural advantages via their proximity to the Nordic countries and Russia, the Nordic countries, though advanced economies, are not large economies and Russia is still a middle income country. Proximity to a large middle income or a developed economy is not a guarantee for economic development.

All three countries are now among the global leaders in international indexes on the ease of doing business. In a response to the Guide questionnaire, the Lithuanian investment promotion agency mentioned Lithuania's "ability to adjust and change business conditions." These countries also provide a relatively high level of development at a competitive cost. Pricerunner 2004 reported that Lithuania was the least expensive country in Europe.

What are the keys to the development in the Baltics?

- *Intelligent use of free zones.* Lithuania commented on the success of its free zones and their offering of one-stop shop services and tax incentives.
- *Low corporate tax rates.* All three countries have low and flat corporate income tax rates.
- *Embracing of technology and the IT sector.* All three countries have high PC and Internet penetration, and have managed to attract IT outsourcing from Northern Europe and the USA. Estonia, in particular, is viewed as "South Finland" for IT projects because of competitive costs.
- *Focus on competitiveness.* Most subsidies to specific industries have been eliminated.
- *Prudent fiscal and monetary policies.* The Baltic States have relatively low current account deficits, allow free flow of capital, and have convertible currencies.

The Lithuanian IPA also mentioned the positive impact of import-export insurance, infrastructure subsidies, employee training, exemption from municipal land and property taxes, and investment guarantees as having a positive effect on FDI and economic growth.

While their progress has been notable, the IPA noted that the barriers still remaining were: an insufficient number of well-prepared greenfield locations, shortage of highly qualified labour, and incentives relative to competitors. Nonetheless, Lithuania and other Baltic States have attained strong increases in FDI and GDP growth in the last several years, and provide examples in terms of policy. Interestingly, the Lithuanian IPA reported that they look to Czech Republic, Ireland, and Slovenia as examples for the performance of their investment agencies, incentives programmes, and clustering programmes.

Conclusions and Recommendations

For developing and transition economies without the gift of natural resources such as oil or gas, what is the alternative to improving the business climate? The case studies of Ireland and the Baltic States demonstrate that extractive industries are not the only mechanism for economic development.

Countries without resources such as these must improve their business climates if they are to remain competitive. How else can they attract additional investment and help develop domestic enterprises? Clearly, nearly all business climate-related quality indexes show that the wealthier and the middle income countries have the stronger or faster improving business climates, and that countries that have taken steps to improve their business climates have been rewarded with greater FDI and improved economic performance. While private enterprises must be responsible for their own success, it is still up to governments to provide the best framework possible for those enterprises to operate successfully.

Governments generally do have the means to make it easier for people to do business. Increasing the overall level of technology or spurring economic growth are complex and difficult matters, but changing laws regarding employment, simplifying permit and licensing procedures, developing a national land registry, or supporting infrastructure development are all things that governments can do. If governments wish to attract FDI, they have to engage in prudent policy-making. Weak regulatory regimes and/or poor institutional capacity leading to non-competitive market behaviour or uncollected taxes are bound to have a negative effect on FDI.

The remaining chapters of the Guide will discuss measures that may be taken to make economies more competitive at the macro-level and to facilitate business operations at the micro-level.

A comprehensive tool that countries may utilize to assess their overall investment climate is the *OECD's Policy Framework for Investment (PFI)*. The PFI is a list of specific questions with informative annotations that help governments analyse the efficiency of their business and investment climates. The Guide encourages policy-makers to use the PFI, whether through formal interaction with the OECD or as an internal assessment and planning tool.

ENDNOTES

1 World Bank, "Investment Climate", <www.worldbank.org/investmentclimate>

2 AT Kearney, *FDI Confidence Index*, Global Business Policy Council, Oct 2004,
<<http://www.atkearney.com/main.taf?p=5,3,1,89>>

3 UNCTAD, *World Investment Report 2005*,
<<http://www.unctad.org/Templates/Page.asp?intItemID=1465&lang=1>>

4 IDAIreland website: <www.idaireland.com>

5 Ibid.

6 Breffni O'Rourke, The EU: How Ireland Unleashed its "Celtic Tiger Economy" (Part 1),
RadioFreeEurope/Radio Liberty.

Chapter 2

A Business-Friendly Political and Legal Environment is Critical to a Strong Investment Climate



Good governance, transparency, stability and predictability are indispensable foundations for economic development. If these basic political and legal features are lacking, normally useful stimulants to economic growth – such as abundant natural resources, low taxes, or low labour costs – will not be as effective as they could be. Because political instability and inadequate security disrupt most legitimate business activity, it is up to governments to make the safeguarding of civil, political and economic rights and freedoms their first priority. In addition to securing human rights and preventing crime, governments must protect both foreign and domestic investments against arbitrary or uncompensated seizures, discriminatory sanctions, and government interventions stemming from political events. Governments can improve their transparency and legislative stability by adhering to global or regional standards in commercial legislation; by publishing laws, regulations and government decisions; and by allowing a period of notice and comment prior to final adoption of laws and regulations. Through e-government, the Internet affords low-cost possibilities for shedding light on how governments function and how they interact with and regulate business. Countries can tame corruption – one of the most destructive forces threatening economic development and a healthy society – by adopting appropriate legislation and by establishing independent institutions not only to investigate and prosecute corruption but also act as a check on the arbitrary and unlawful exercise of government power. These and other good governance practices give a clear signal to domestic and foreign businesses that the country in question values their contribution to the good of society and will work with them to achieve mutual benefits.

The importance of the political environment and key conditions

Governments often consider that economic and fiscal conditions are the most critical factors for attracting foreign investment. While economic and fiscal conditions certainly are critical, the most important factor in establishing a favourable business and investment climate is arguably the political and legal environment. Countries may offer low tax rates and free land but if investors fear expropriation of assets, revocation of incentives, labour unrest, civil strife, or inability to deal with natural disasters, then they will be disinclined to invest. Investors have to be confident that the country in question is committed to attracting foreign investment and that investments are safe. Unstable political environments increase risk, which investors generally prefer to avoid. In addition, political factors such as corruption, bureaucracy, and lack of rule of law are not only risks but also add direct cost to the investment. The Black Sea Economic Co-operation Council explains the relatively low levels of FDI in the Black Sea region by citing foreign investors complaining of unacceptable levels of bureaucracy, of unclear, overlapping and frequently changing legislation, and of corruption.¹

The majority of the most economically developed OSCE countries have in the post-war period maintained politically stable governments emphasizing transparency, good governance, and orderly transitions of government. It is no coincidence that these countries are the highest recipients and generators of inward and outward FDI. Transition countries can also be successful in competing for FDI. In the 1980s and 1990s, Central European countries began to embrace these values and are now some of the most attractive destinations for FDI in the world. The countries of South East Europe (specifically: Bulgaria, Croatia, and Romania) are making progress toward a more attractive political environment, and have seen significant increases in FDI inflows recently.

The most important factors in establishing a political environment that supports a strong business and investment climate are:

- Security;
- Protection and guarantee of foreign investor rights;
- Legislative stability;
- Transparency;
- Freedom from corruption; and
- Good governance.

Security

UNCTAD's *Foreign Direct Investment and the Strategies of Transnational Corporations 2005-2008* assesses the global prospects for FDI through surveys. Of the responses to major risks to FDI flows, the second most frequently mentioned risks (81% of respondents) among FDI experts was the global terrorism threat. Among the investment promotion agencies IPAs surveyed, "political instability and civil wars" was the third most mentioned threat. If companies do not believe their people and assets will be secure, then they will not believe this of their investments either. Moreover, the necessity of such measures as extensive physical and IT security, and additional insurance costs and pay allowances for expatriate employees add to the cost of an investment. For many industries, particularly manufacturing industries, stopping and starting production intermittently is extremely expensive. At the 2005 World Economic Forum in Davos, one of the conclusions of "Best Places to Do Business" was summed up as follows: "The report shows that post-9/11, security has become a major consideration for everybody."² Armed conflict is not the only source of security risks. Epidemics such as avian influenza and SARS can dampen investor interest. Governments must ensure that they are perceived as ready to confront health crises, natural disasters and other events that pose threats to security.

Protection and guarantee of investor rights

Even if a country is secure and governments succeed one another in orderly fashion, companies want to be certain that their rights are protected. According to *Doing Business: Protecting Investors*, three of the ten countries where investors are least protected are OSCE countries. An investor must believe that the investment is safe, that fair and equitable treatment is assured, and that disputes can be resolved in a fair and expedient manner.

The payoff from protecting investors is large. Where expropriation of minority investors is curbed, equity investment is higher and ownership concentration lower. Investors gain portfolio diversification. Entrepreneurs gain access to cash. Without investor protections, equity markets fail to develop and banks become the only source of finance. Yet weak collateral or property registration systems block many businesses in poor countries from obtaining even bank loans. The result: businesses do not reach efficient size for lack of financing, and economic growth is held back.

Source: *Doing Business: Protecting Investors* (World Bank).

Foreign investors seek what is known as “national treatment”: in other words, to be treated in the same way as domestic enterprises. Specific economic sub-sectors relating to national security may require separate treatment for foreign and domestic enterprises. However, “protectionism” is not viewed favourably by investors. Both FDI experts and representatives of the transnational corporations surveyed by UNCTAD cited protectionism as the greatest impediment to FDI. Generally, countries with strong business and investment climates treat foreign and domestic enterprises the same, and provide the most competitive environment possible. A country with a set of complex fiscal incentives for foreign investors in some industries and denial of foreign investment in other sectors creates a less competitive economy with an uneven playing field that is expensive to manage both for the Government and for the companies. And it often proves more costly to the former than to the latter.

There are certain basic protections and guarantees that investors seek. The core principles of the investor include the right:

- To equitable and non-discriminatory treatment for foreign and domestic investors, particularly in contract enforcement and payment of debts to the State;
- To invest in all sectors, under all corporate structures, in any form (direct, portfolio, etc.), as permitted and regulated by law;
- To a guarantee against nationalization, expropriation or any other measures with similar effect, and to fair compensation in the event of such a circumstance being necessary for national security reasons;
- To transfer profits abroad in foreign currency after paying the taxes and fees required under the law;
- To benefit from investment incentives under the terms and conditions required by law;
- To land ownership;
- To protection of intellectual and industrial property; and
- To elect to settle disputes in a local court of law that is fair and independent or to seek local or international arbitration.

Measures that countries may take are:

- Developing an investor “bill of rights” or foreign investment law which delineates legal protection provided to the investor;
- Becoming signatories to multilateral compacts and instruments that promote protection of investor rights, property rights etc., such as the United Nations Convention on the Recognition, Enforcement of Arbitral Awards, the World Bank International Centre for Settlement of Investment Disputes, and the OECD Declaration on International Investments and Multilateral Enterprises;
- Developing bilateral and multilateral investment agreements that delineate investment protection and guarantees;
- Developing specific legislation strictly limiting and regulating the use of expropriation, and providing for just compensation in the case of expropriation; and

- Enabling foreigners to purchase and own land, or acquire long-term leases, in a transparent and reasonable manner.

Legislative stability

“It doesn’t really matter whether the profit tax is 17% or 21%. Sure, 17% is better. What matters is that the Fiscal (Tax) Code remains the same for the next five years and I know what taxes I have to pay.”

A quote from a former Balkans regional manager of a major multinational consumer products firm, 2004

One of the keys to creating a political environment that supports a strong business and investment climate is legislative stability. Constantly changing legislation affects the ability of investors to project their returns. Moreover, adjusting business practices such as accounting and auditing, environmental outputs and workforce management adds to an investor’s cost. In addition, even though conditions may be favourable at the time, an unstable legislative environment may give investors the feeling that there is too great a risk of unfavourable conditions arising, which may dissuade them from investing.

In a listing of shares to be traded, a Western European mining company active in Central Asia made the following declaration in its listing document: “The recoverability of the amount shown in the balance sheet in relation to the deferred exploration expenditure asset is dependent upon the discovery of economically recoverable reserves, confirmation of interest in the underlying mining claims, [and] the political, economic and legislative stability of Central Asian countries in which it operates ...”³ This is an instance of investors directly warning shareholders that their return on investment is affected by the legislative stability in the countries in which they operate. If the risk factor outweighs the return on investment, foreign investors will likely take their capital else where. In discussing support for national electricity systems, the European Commission emphasizes that any instability in the system creates high investment risks, normally taking the form of higher costs for consumers.

The following three measures may assist OSCE participating States to achieve greater legislative stability by facilitating greater transparency and predictability both in legislative substance and in the law-making process.

- *Considering adopting commercial legislation comparable or similar to the European Union’s Acquis Communautaire legislation.* This recommendation underscores the need for commercial legislation that is familiar to investors and compatible with international standards.

In the European Union, the Acquis Communautaire provides a well-known code of laws that investors are familiar with and understand well. Adopting laws of a similar character, without discriminating against non-EU OSCE States, provides investors with a sense of predictability and familiarity, and generates a pro-investment mood. Likewise, if investors are currently investing in countries with a certain legislative and regulatory framework, it is much easier and cheaper for them to expand into markets that are governed by the same or a similar framework.

The Guide does not propose that countries not officially part of the EU enlargement process should specifically comply with the Acquis. Each OSCE participating State is sovereign and has its own set of laws based on its own legal and cultural tradition, whether that tradition is common law, civil law, or something altogether different. What it suggests is that these countries would be well advised to be open to commercial law reform and to adopt non-discriminatory laws recognizably similar to those of the Acquis.

Guide Questionnaire Response:

An enhanced policy dialogue with private sector representatives and notably with foreign investors would help assessing reform priorities, provide a reality check on reform implementation and thus allow for reform optimization and acceleration. Moreover, existing foreign investors who already have direct investments in the country are often the best and most credible ambassadors of a country to potential investors in transition economies.

- *Establishing a period of notice and comment for draft commercial legislation.* Governments may wish to consider to provide a 30-day period of notice and comment on business-related legislation, 90 days for legislation with significant commercial impact, with posting of draft legislation on one central place on the Internet and active electronic notification to interested and/or registered parties. Emergency ordinances and surprise executive orders are often viewed poorly by investors unless they come in response to a specific and well-known problem. Advance provision of the draft legislation gives warning to investors and business people that they may need to prepare to change the way they conduct business. In addition, the “comment” provided by the business people usually improves the commercial legislation. Seeking feedback from the business community also often has a positive effect on the business environment.
- *Establishing a calendar of regular legislative events.* The idea is to establish predictability in legislative changes. For example, reviews of tax rates could be done once or twice a year during a specified time window. This would enable firms to prepare for all eventualities in advance.

Transparency

The three measures mentioned above all involve public disclosure and accountability, which are both key elements in transparency. The United Nations Development Programme (UNDP) defines transparency as sharing information and acting in an open manner. Transparency allows stakeholders to gather information that may be critical to uncovering abuses and defending their interests. Transparent systems have clear procedures for public decision-making and open channels of communication between stakeholders and officials, and ensure general access to a wide range of information.

For domestic and foreign investors transparent information on how rules and regulations dealing with investment are implemented and how they may be changed is a critical determinant in the investment decision. Transparency and predictability is especially important for foreign investors who may have to function with very different regulatory systems, cultures and administrative frameworks from their own. A transparent and predictable regulatory framework dealing with investment helps businesses to assess potential investment opportunities on a more informed and timely basis, shortening the period before investment becomes productive.

Source: OECD Policy Framework for Investment.

Slovakia and Estonia, two of the OSCE States with the fastest growing economies and strongest FDI performance, have formal requirements for public notice and consultation on legislation. Armenia has taken steps in this direction. A report from the Armenian International Research Group that evaluated rule of law and commercial laws in Armenia in 2003 made the following observation: “It also has to be noted that other Armenian laws do provide for public participation in the rule-making process through ‘notice and comment’ rule-making. Armenia’s Securities Market Law, for example, which is based on US models, requires that draft regulations of Armenia’s Securities Commission be published in advance to allow for public comment prior to their enactment.”⁴ Using the Internet is generally viewed as the best method for notice and comment. It expands the reach of the notification, and all draft legislation may be found in one central place. Also, electronic notification that draft legislation was posted on the Internet can be sent to interested and/or registered parties.

Transparency is often more important for developing and transition economies, because their low level of investment does not provide “a track record” for investors. For example, the deficiencies in transparency in China are offset by the enormous market size and track record of billions of euros successfully invested.

Developing and transition economies in the OSCE area that do not have the comparative advantages of a nation like China may be able to use a more transparent environment to stimulate greater investment. The OECD's study *Foreign Direct Investment for Development* suggests that companies may be willing to invest into countries with sound legal and regulatory frameworks that would not otherwise be considered as "investor friendly" provided they are able to obtain a reasonable degree of clarity about the environment in which they will be operating. Conversely, there appear to be certain threshold levels for transparency beneath which the business conditions become so opaque that virtually no investor is willing to enter, regardless of the extent of the inducement.

The Opacity Index is an instrument for assessing transparency that has been developed by the Kurtzman Group. The creators of the Opacity Index believe that it is the "everyday, small-scale risks" associated with the lack of transparency that constitute barriers to global investment and commerce. The index uses a methodology called CLEAR: C for Corruption, L for Legal System, E for Economic Policies, A for Accounting and Finance Practices, and R for Regulatory Environment. A series of questions are asked, normally binary in nature, in each of these areas and the answers are used to arrive at a score. Unfortunately, the Opacity Index does not include the countries of South East Europe and Central Asia. As might be expected, the countries with higher levels of economic development were generally "less opaque". Finland, the UK, Denmark, Sweden, and the USA were the five highest rated OSCE countries on the Opacity Index.

Despite the lack of universal coverage, the study reveals some interesting points. The Kurtzman Group claims that for every one point increase in opacity on the index, GDP per capita is lowered by 986 USD, and FDI per capita is lowered by one per cent.

The May 2005 Economic Programme of the Former Yugoslav Republic (FYR) of Macedonia gives specific emphasis to transparency. Greater transparency is sought for privatizations and post-privatizations, with the Central Bank and Ministry of Finance being expected to engage in a greater degree of communication with the public, and in fiscal decentralization. The

United States Agency for International Development (USAID) has been giving the FYR of Macedonia technological assistance to improve transparency and efficiency of government services. The FYR of Macedonia's progress has been noted by the EU. On 16 December 2005, the European Union granted the FYR of Macedonia candidate country status.

Albania was cited for its efforts to become more transparent in the EC's 2005 progress report on stabilization and association. The measures it had taken included: reducing the number of standing parliamentary committees, establishing a legal reform commission, new parliamentary procedures in the legislature, and opening recruitment for civil servants including the use of the Internet. 2004 saw a 41 per cent increase in FDI and the highest inflow of FDI in the country's history.

The following are some examples of best practices that OSCE States may use to raise the level of transparency in government.

- *Broad use of e-Government.* The common and comprehensive use of e-Government expands the dissemination of information, reduces the potential for covert practices, and facilitates the inspection and auditing of activities. Distribution of legislation and regulations, privatizations, and government tenders may all benefit from e-Government.

Publishing commercial legislation and important judicial decisions on the Internet in the national language and in English is not only an excellent way of promoting transparency but also constitutes a notable contribution to the promotion of dialogue with foreign investors.

- *Publishing and reviewing administrative decisions including public tenders.* The publishing and reviewing of administrative decisions assures the business community that the government is accountable for its decisions and willing to face public scrutiny.
- *Support of independent media and press.* Transparency is increased when there is an independent press that is able to investigate and discuss govern-

ment policy and actions without fear of retribution. Governments should not attempt to force media into certain viewpoints by using economic leverage or threatening to withhold information.

- *Adoption of international accounting standards.* Utilization of international accounting standards facilitates the financial assessment of enterprises and investment projects. Foreign companies are better able to assess the financial statements of enterprises.

Corruption

“2 to 4 years. Six months if you are willing to pay.”

September 2005 response by a civil society organization executive in Ukraine to a question about the length of time it takes to start a major investment project such as the construction of a factory

A significant number of responses to the questionnaire conducted in preparing the Guide expressed the opinion that many promising reforms aimed at enhancing economic development had been severely undermined by corruption, with SMEs being especially adversely affected. These observations are consistent with those contained in a large body of literature, including a separate survey of 158 foreign companies by the Consultative Council on Foreign Investment of the Russian Federation. In that survey, 71 per cent of respondents identified corruption as the country's biggest obstacle to new investment. What is corruption? According to the Council of Europe, corruption means requesting, offering, or giving or accepting, directly or indirectly, a bribe or any other undue advantage or prospect thereof, which distorts the proper performance of any duty or behaviour required of the recipient of the bribe. While different cultures may have different perspectives on corruption, one fact is clear: corruption is an inhibitor both to foreign direct investment and to SME development. While investors often learn to “work around” corruption through lobbying, relationship-building, use of the media and other tactics, the simple fact is that corruption costs investors both money and time.

Beyond the stigma and unpleasantness of corruption, it is estimated that operating in a corrupt environment can cost investors up to 4 per cent of their total costs. Four per cent is a sufficiently large deterrent to influence an investor's location decision. Samuel Funkhauser of the European Bank for Reconstruction and Development (EBRD) created the following chart (Figure 2.1) estimating the share of revenue used for bribery in Central Europe, South East Europe, and the CIS countries. Not surprisingly, Central Europe, the region with the highest FDI and GDP per capita was also the region with the lowest average share of revenue used for bribery; South East Europe was next, and the CIS countries had the highest share of revenue. According to the EBRD study, all countries with the exception of one reduced their 2002 share of revenue used for bribery in 2005, with Georgia, Kyrgyzstan, Romania and Albania making particularly notable improvements.

Further assessment of the link between corruption and national prosperity makes it clear that the wealthiest OSCE countries are generally the countries judged to be least corrupt by international observers. Table 2.1 matches the top five OSCE countries in 2005 GDP per capita with their scores on Transparency International's Corruption Perceptions Index (CPI), and does the same for the lowest five. Luxembourg, the country with the highest GDP per capita in the OSCE and the world, was placed tenth in the CPI. Iceland, the country with the best score in the CPI, had the sixth highest GDP per capita in the OSCE. (Note: San Marino has the fifth highest GDP per capita but does not appear in the table because there is no CPI score.)

The Guide does not posit a direct correlation between corruption perception and economic prosperity. But it does emphasize that corruption is clearly a major indicator of the health of a business and investment climate, and that if countries desire to increase economic growth through increased foreign direct investment and SME development, then their governments will need to address the corruption issue. For all OSCE economies, the CPI scores tally with GDP per capita. The Western European economies have the highest GDPs per capita as well as the best CPI scores, with the Central European economies coming next, followed by the South East European and most CIS economies.

FIGURE 2.1

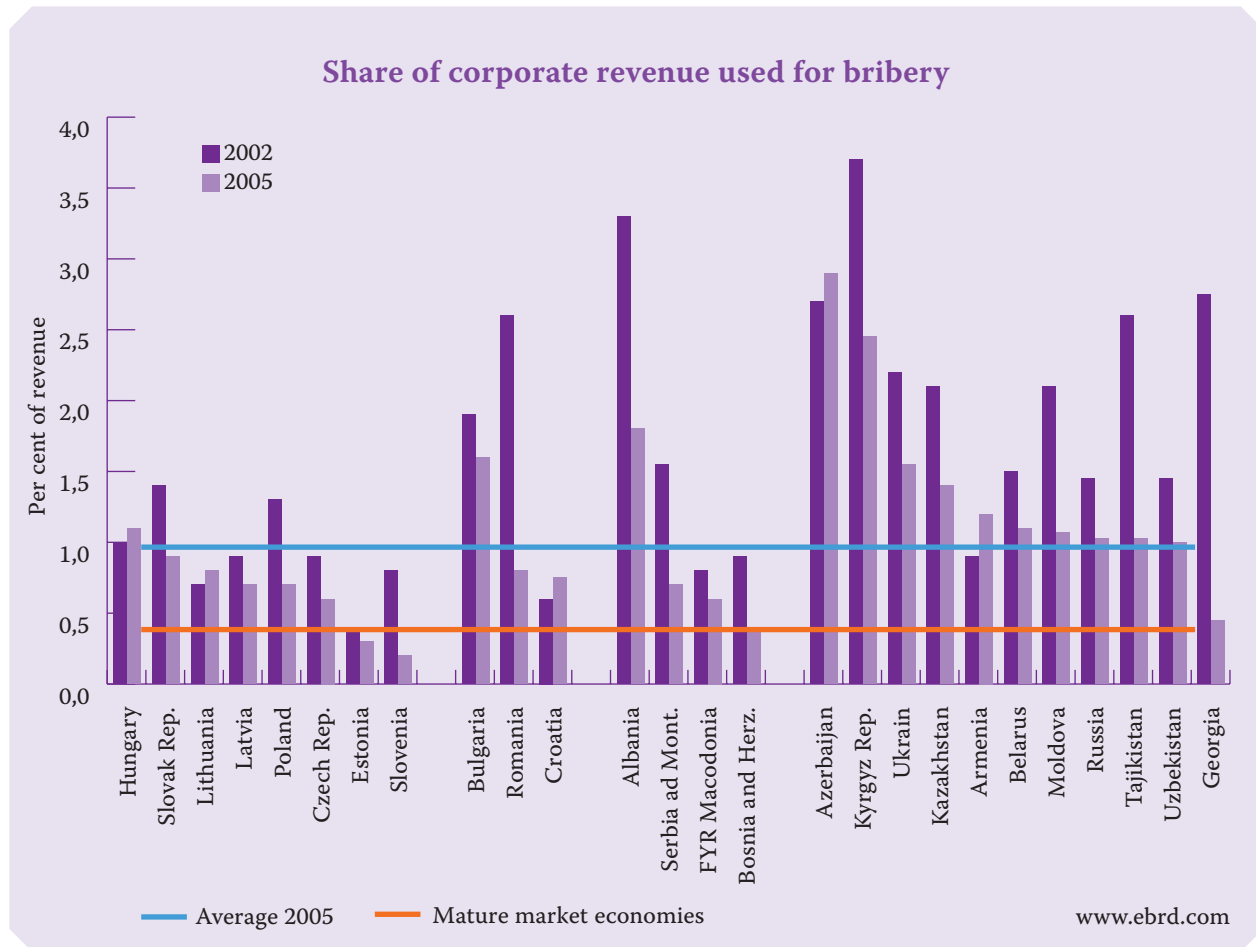


TABLE 2.1

Top and bottom five OSCE countries in GDP per capita and their scores on Transparency International's 2005 Corruption Perception Index.

Country	GDP per capita	2005 TI CPI score
Luxembourg	\$62,700	8.5
Norway	\$42,400	8.9
United States	\$41,800	7.6
Switzerland	\$35,000	9.1
Iceland	\$34,600	9.7
OSCE average		5.3
Former State Union Serbia and Montenegro	\$2,600	2.8
Moldova	\$2,100	2.9
Uzbekistan	\$1,900	2.2
Kyrgyzstan	\$1,800	2.3
Tajikistan	\$1,200	2.1

Sources: Transparency International and UNCTAD.

Practices followed by a number of the countries that have made progress against corruption include the following.

- *Appointment of an independent anti-corruption agency or department.* An independent anti-corruption agency with the authority to prosecute improves a country's ability to fight corruption. Romania's anti-corruption agency has recently targeted very high-level government officials and business leaders in an effort to improve governance and, as a by-product, its reputation as an investment destination.
- *Administrative simplification.* Bureaucracy is a notorious breeding-ground for corruption. Whenever there is a potential rejection or slow-down of an investment project, there is a corruption temptation for the bureaucrat and the investor. Eliminating unnecessary bureaucratic obstacles reduces the number of opportunities for corruption. Slovakia may be taken as a good model for developing and transition economies in OSCE. In a response to our questionnaire on the business and investment climate, the representative from the Slovak Investment Agency noted that the World Bank's database *Doing Business* rated Slovakia the top performer in business reforms, and number four in the world.

TEXTBOX 2.1

Estonia's progress towards an independent judiciary

Estonia's independent judiciary is enshrined in the national constitution. Estonia also adopted the Courts Act in July 2002, enhancing the independence and administration of Estonia's courts. In the opinion of the EBRD: "Although efficiency in courts and the enforcement of decisions could improve, public confidence in the legal system upholding contractual rights in Estonia is the highest among the Bank's countries of operation, and administrative reforms of the judiciary continue apace."⁵

- *Establishing an independent judiciary.* The majority of the CIS and Central Asian countries have constitutional provisions for an independent judiciary. However, very few of them have truly independent judiciaries, because of the dominance of the executive. Creating an independent, well paid, sufficiently trained judiciary is the key to establishing rule of law.
- *Raising salaries and promoting professionalism among civil servants.* In addition to having well-paid judges and magistrates, civil servants must be paid a sufficient salary if they are to resist the temptation of corruption. If civil servants cannot maintain a decent standard of living, then corruption will surely take place. If governments wish to maintain an honest, motivated and professional workforce, they must be willing to pay fair wages. In poorer countries where salaries are low and government revenues are limited, finding funds for higher salaries is a challenge. As well as being one of the measures governments should utilize to improve the business climate, reducing bureaucracy also makes it easier to raise salaries. Eliminating unnecessary functions makes more funding available for current employee salaries.

TEXTBOX 2.2

Anti-corruption efforts in Azerbaijan

A new anti-corruption law for Azerbaijan came into force on January 1, 2005. Under the terms of the law, a new commission will have the authority to require full financial disclosure from government officials. Azerbaijan has also taken steps to reform its civil service, including significant salary increases for government employees. In January 2003, as part of reforms at the Ministry of Taxes, the government reduced the number of employees by 40 per cent but doubled salaries for those remaining. Key business groups such as the American Chamber of Commerce have reported an improvement in tax administration. The government also raised civil servant salaries by 50 to 100 per cent in several other sectors, including health and education.

Moreover, in the medium term, an improved business and investment climate should bring additional tax revenue.

In addition, civil servants should be asked to sign a code of ethics and receive ethics training. The OSCE, USAID, and other donor organizations are or have been providing this type of training in several OSCE countries such as Russia, Kazakhstan, Armenia, and Albania.

- *Whistle-blower law.* Those who witness corruption often fail to act for fear of retaliation in the form of loss of civil service employment, demotion, political retribution and the like. If the whistle-blower is a public servant, he or she should be free to report to bodies such as ombudsmen, anti-corruption agencies or general auditors. A reference law for OSCE countries is the United Kingdom's Public Interest Disclosure Act (PIDA). The PIDA seeks to promote accountability and sound governance in organizations by reassuring employees that it is both safe and acceptable for them to raise genuine concerns about irregularities in the conduct of a business or other organization. It does this by providing employees who raise concerns in accordance with the law with full and immediate protection from dismissal or victimization.⁶
- *Enactment and enforcement of laws against corruption.* A relatively short time ago, some West European countries actually allowed companies to treat bribes paid to do business overseas as tax-deductible. Public corruption in developing and transitional economies was regarded as a fact of life, and few governments of developed countries were concerned to do anything about it. Today, however, with the adoption of such international treaties as the OECD Anti-Bribery Convention and the United Nations Convention against Corruption,⁷ many nations are seeking to correct these practices both at home and abroad. Countries which do not yet have comprehensive anti-bribery legislation in place can find workable frameworks for designing appropriate laws. However, as noted throughout the Guide, merely adopting a policy or enacting a law is entirely ineffective if there is no adequate follow-through or

enforcement. In addition to strong, independent courts, this requires prosecutors with the legal authority and practical power to investigate and prosecute serious cases of public corruption.

On the basis of OSCE Ministerial and Permanent Council Decisions and the Strategy Document for the Economic and Environmental Dimension adopted in 2003, the OSCE has assumed a strong role in the fight against corruption, in close co-operation with partner organizations such as the United Nations Office on Drugs and Crime (UNODC). Joint activities between the OSCE and the UNODC include the promotion of the UN Convention against Corruption.

The OSCE's handbook *Best Practices in Combating Corruption* constitutes a reference guide for legislators, government officials, NGOs, and members of business circles and civil society considering the drafting of their own anti-corruption legislation, national action plans or strategies. The handbook was first published in 2004 and has since been translated into Albanian, Armenian, Azeri, Kyrgyz, Russian, Serbian, Tajik and Uzbek. It is also available in electronic format on the OSCE website: <www.osce.org/eea>. The UN's Anti-Corruption Toolkit is also an excellent resource.

Good governance

“Good governance is now recognized as a crucial prerequisite for well functioning markets and, hence, for attractive investment conditions and a sustainable allocation of investment capital.”

Good Governance and Best Practices for Investment Policy and Promotion, Mehmet Ögütçü, at the UNCTAD workshop Efficient and Transparent Investment Promotion Practices: The Case of LDCs, Geneva, 6-7 June 2002

One of the simplest things that countries can do to improve their business climate is simply to govern well. Regimes that are viewed as corrupt, unstable, or incompetent will deter investors. UNCTAD sees good governance as displaying four principal qualities: predictability, transparency, accountability, and participation.

If governments want good governance to be visible to investors, there are several best practices available for them to employ.

- *Transparent and competitive privatizations and tenders.* If foreign investors do not believe that they have a fair opportunity to compete for privatizations and government tenders, neither will they be likely to believe that they will be treated fairly by fiscal authorities, government inspectors, or in the court system. If privatizations and tenders are made open and competitive, with selection results available for the public record, investors will understand that the government is seeking the most competitive environment possible.
- *Pay State debts promptly and in full.* Sovereign entities often have the luxury of delaying payment to creditors. While this may mitigate governmental cash flow difficulties, it sends a bad message to investors. If the government does not pay for utilities, consulting services, or other products, the attractiveness of investment in infrastructure or municipal bonds is diminished. One anonymous investor mentioned that he would only invest in Eastern Europe if there was a guarantee from the EBRD, World Bank, OPIC, or another such organization, because he had so little faith in the governments' willingness to pay their debts.
- *Create a systematic process of consultation with the private sector.* A regular constructive dialogue with the private sector can bring more than merely exchange of information. Often, by sharing draft legislation, holding public hearings and issue forums, and creating councils in partnership with the private sector, governments receive the benefit of pro bono consulting services, improved commercial legislation, and greater support for government programmes.

Guide Questionnaire Responses:

The Kyrgyz government, in an effort to improve the investment climate in the country, has confirmed a general plan of measures called the Investments Matrix. Its purpose is to remove barriers to the flow of direct investments into the country. The document was put together by the Government of the Kyrgyz Republic and a number

of potential investors, associations, members of parliament, and international financial institutions.

The (Slovenian) Government mentioned that “the Government has established a special council (Companies Friendly Administration Council- Svet za gospodarstvu prijazno upravo), whose main task is to determine strategies for the reduction of administrative barriers.”

In Romania, the Ministry of Finance met regularly with the tax committees of the Foreign Investors Council and the American Chamber of Commerce to collaborate on drafting the fiscal code.

- *Establish an investment ombudsman.* Investors, particularly foreign investors, often face difficulties when working in unfamiliar cultures and regulatory frameworks. Their difficulties are compounded when they face bureaucracies or negotiations with State-owned entities. The establishment of an investment ombudsman's office can be quite helpful.
- *Prepare an annual report on the state of the investment climate.* An annual report on the state of the investment climate provides a government with an opportunity to openly review the progress made on improving the investment climate and to identify areas still needing improvement. In addition, the government can generate additional transparency and predictability by disclosing its plans for the business and investment climate for the following year.

In view of the importance of good governance in the economic transition process in Central and Eastern Europe, the OSCE has played an increasingly active role in promoting activities aimed at introducing best international practices in the area of good governance. The activities supported by the OSCE include assistance towards legal development, transfer of know-how through expert exchanges, and workshops, conferences, and training. All activities are implemented in close co-operation with other international organizations such as the UNODC, the OECD and the Council of Europe.

Conclusions and Recommendations

A stable political environment provides a sound foundation for economic development, and particularly for FDI. Without a stable political environment, there is risk. Risk deters investment. Governments should ensure the establishment of a favourable political environment by:

- Strengthening the perception of security through further integration into the world economy, participation in various forms of international, regional and bilateral co-operation, promoting democratic reforms, ensuring political stability, and promoting confidence-building measures and efficient contingency planning for disasters;
- Keeping legislation stable by changing legislation through transparent processes in defined periods, and maintaining an open dialogue with the private sector;
- Maintaining the highest levels of transparency possible through e-Government, publishing and reviewing administrative decisions, and a free and independent media;
- Combating corruption through codes of ethics, whistle-blower laws, less bureaucracy and simpler administration, ensuring civil servants are paid a ‘living wage’, and creation of an anti-corruption body; and
- Governing well, with fair and competitive tenders, open privatizations, systematic dialogue with the private sector, and the establishment of an ombudsman.

RESOURCES

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Transparency International website: <www.transparency.org>

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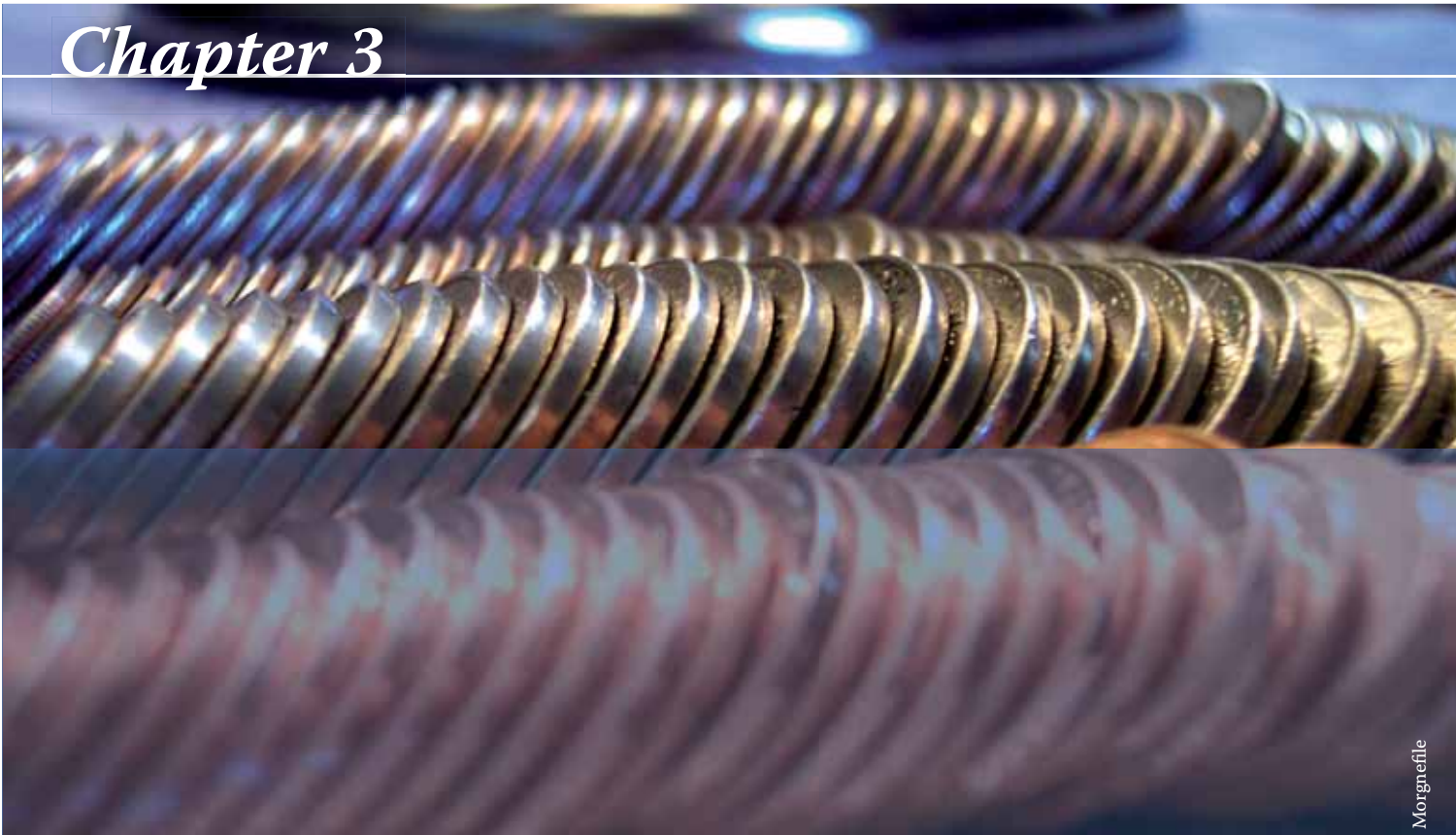
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6 OSCE, *Best Practices in Combating Corruption* (2004), <http://www.osce.org/publications/eea/2004/05/12211_87_en.pdf>

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Chapter 3



Morgnefile

The Importance for the Business and Investment Climate of Policies that Support Macroeconomic Stability and Economic Growth

Macroeconomic stability and economic growth are essential to the promotion of economic development. For corporate investors, the most important indicators of macroeconomic stability are those which directly affect their balance sheets, such as growth in GDP and GDP per capita growth rates, inflation, population growth, and university graduation rates. In addition, interest rates are very important for SMEs and some foreign investors. A country's openness to foreign trade, foreign investors, and foreign workers can affect its success in promoting economic development. If countries with abundant natural resources wish to spread the wealth and lessen the shock of changes within a single industry, they should diversify their economies. Countries should adopt medium-term economic strategies, disciplined fiscal policies, and an open approach to foreign trade and international capital market flows.

The importance of a strong and stable macroeconomic environment

“Stable macroeconomic policies are a crucial part of the enabling policy framework, since they contribute to lowering the risk of doing business by providing a predictable overall climate for business in making investment decisions.”

Addressing Supply-Side Constraints and Capacity-Building, Economic and Social Commission for Asia and the Pacific, Subcommittee on International Trade and Investment, First session, 27–29 October 2004, Bangkok

Macroeconomic stability is considered a prerequisite for economic growth. The IMF defines macroeconomic stability as current-account and fiscal balances consistent with low and declining debt levels, inflation in the low single digits, and rising per capita GDP. This is one of many definitions. Some economists believe inflation in the low single digits is too stringent a requirement. A consistent upward trend is the key to macroeconomic stability. Economic instability resulting in periods of hyperinflation or financial market crashes deters foreign investors. Falling GDP signals a stagnant marketplace. Businesses cannot function and make profit when costs are too high. Price fluctuations can devastate SMEs. A twenty per cent rise in the cost of raw materials can obliterate a small business. A strong and stable macroeconomic environment is necessary to support long-term economic growth.

Macroeconomic indicators used by corporate investors

While economic forums, donor institutions, development banks, investment banks, economists, and academics carefully study statistics related to monetary supply or current account deficit, the majority of corporate investors focus their attention on the indicators that affect their corporate balance sheets directly. Foreign investors look at economic growth, and in particular GDP and GDP per capita growth rates as indica-

tors of investment destinations with potential. Countries with growing GDPs not only serve as potential marketplaces but also have economies that will be able to support investments with the human capital, suppliers, and services that the investor will require to expand and modernize the business as time goes on. A country with low costs but a stagnant economy may on the one hand provide a competitive entry point but may on the other hand not provide a sustainable business model.

Inflation is also important. Investors are often worried about the cost of inputs rising too quickly. Worse, high inflation or hyperinflation is a clear sign that macroeconomic stability has not been achieved. Higher rates of inflation have a significantly negative impact on FDI, which suggests that macroeconomic stability is an important factor in explaining the pattern of FDI ...”¹

Guide Questionnaire Response:

Business and investment climate is favourable in [Bosnia and Herzegovina] and it has improved in the past few years. Developed legal instruments and foreign investment promotion institutions indicate favourable conditions for investments. The positive signals to investors include:

- Stable currency – the convertible Mark (KM) with fixed exchange rate against the euro;
 - Lowest inflation rate in Central and Eastern Europe
 - Opportunities for growth in tourism;
 - Protection of foreign investments – Bosnia and Herzegovina is a member of Multilateral Investment Guarantee Agency (MIGA);
 - Reformed banking system with a significant number of foreign banks;
 - Law on Foreign Investments regulating the policy and principles of foreign investments;
 - Foreign investors have the same rights as domestic investors; and
 - Rights of foreign investors enjoy special protection.
-

Population growth and university graduation rates are often examined to assess potential for human capital. Companies seeking engineers or software developers will look closely to see if a destination country can produce a sufficient number of employees to meet

their requirements. In addition, they will assess local and regional clustering of human capital and look out for large cities or towns with universities as part of the location process. A country's unemployment rate is a double-edged sword. Certain labour-intensive manufacturing companies will seek areas with high unemployment in order to obtain low-cost labour and concessions from governments, whereas other companies in consumer products, services, and other areas will see high unemployment in developing and transition economies as an indicator that a country has not achieved macroeconomic stability and that the domestic market is not sustainable.

For domestic investors and some foreign investors, interest rates are a key macroeconomic variable. If the cost of capital is too high, SME development can be stifled and foreign investment lessened. One of the traditional problems of SMEs is access to finance. If

the only financing available is near 40 or 50 per cent with or burdensome collateral requirements, there is effectively no finance available for SMEs.

The dynamic economic progress and attractiveness to investors of the Central European and Baltic countries in recent years reflects not only their strength in these macroeconomic indicators but also their intelligent economic policy-making. Estonia and Slovakia are consistently cited as being among the easiest places to do business. How do OSCE countries with unattractive macroeconomic indicators develop policies that will provide the foundation for greater economic growth through increased FDI and entrepreneurship? The answer lies not in overzealous activity by the Central Bank or governmental regulation but in the opening of the economy to foreign trade and investment (Textbox 3).

TEXTBOX 3.1

Opening up developing and transition economies in the OSCE: The East Asian or Latin American model?

In the UN discussion paper "Prioritizing Economic Growth: Enhancing Macroeconomic Policy Choice" by Colin Bradford, Jr., the author compares the relatively successful macroeconomic policy choices made by the Asian tigers and the less successful choice made by Latin American countries. He describes the common characterization of the economic policy differences as follows: "Latin America was seen as undertaking inward-looking, price-distorting, interventionist policies which made their economies inefficient and slow-growing. East Asia was seen as implementing outward-oriented, liberalizing, market-driven, export-led growth strategies." Bradford argues that the relative success of the East Asian economies including a strong comeback after the financial crisis in the 1990s has been due to their focus on economic dynamism, open markets, and competitiveness. He continues: "It seems fair to say in retrospect that the leadership of the East Asian economies was more concerned about the competitiveness of their economies in the broadest sense than in the narrower issue of the appropriate level of their exchange rate. One might say they were more concerned about the real effective exchange rate of their economies than

the value (real or nominal) of their exchange rate. This means that they were concerned about the institutional environment, the banking system, labor management relations, the business culture and climate, rule of law and commercial codes as components of competitiveness along with sound macroeconomic policy conditions. The East Asian view of dynamic economic growth was holistic and integrated, and not narrow and technical. Their economic policies were embedded in a broad strategic framework which was inclusive. Their view of competitiveness went beyond getting prices right and beyond getting policies right to a broad sweep of institutional, behavioral and regulatory norms. The strategic perspectives and choices were critical to their success."

The holistic view with a strategic framework may be the key to success. To advance economic growth, a strategic framework emphasizing an open economy with macroeconomic policies oriented toward national competitiveness will provide a stronger macroeconomic environment. Controlling economies tightly in the name of social or financial stability may ultimately retard economic growth and enterprise development.

TEXTBOX 3.2

Turkey's recent macroeconomic success

Turkey has made remarkable strides in securing macroeconomic stability and economic growth after years of high inflation, high unemployment, and low GDP per capita relative to countries in Europe. Turkey's macroeconomic policies and overall liberalization of the economy have not only led to economic growth but have also increased FDI. Deutsche Bank Research's specific assessment of Turkey's liberalization is, "Apart from Argentina none of the other 34 countries surveyed in 1980 was more closed than Turkey. And no other country has liberalized more vigorously in the last 25 years. The two keys to this success are: (1) the major reform initiative in 1980 especially with the goal of fostering competition and (2) the customs union with the EU in 1996. The reforms of 1980 included the abolition of subsidies and price controls, more flexible exchange and interest rates, as well as the liberalization of trade policy."

To describe the policies and results, excerpts from two presentations are provided. The first set of remarks is an account of the panel with the Prime Minister of Turkey, Recep Tayyip Erdogan at this year's World Economic Forum, and the second came from Mr. Andrew Vorkink, Director, World Bank Turkey.

Recep Tayyip Erdogan, Prime Minister of Turkey, began with a survey of the distance Turkey has covered in the last three years and its plans for the future. The record includes over 20% growth, strict fiscal discipline, accession talks starting with the EU and a rise in the stock index from 900 points to 46,000. He also described a business-friendly environment in which new companies can be founded in a matter of days with no discrimination between foreign and domestic investors. He expects to see US\$ 5 billion per year in foreign investment in Turkey from 2005 to 2007. Three years before, the Prime Minister said, Turkey had not been able to pay the interest on its debt. Today it is not only in a position to pay this interest out of tax revenues but it is also meeting the expenses of investment. The financial sector is now healthy after earlier bank deficits, and Turkey has accomplished the transformation from a State-oriented to a market-based economy.

Source: "The New Comparative Advantages", World Economic Forum Annual Meeting 2006 (January 27) .

Turkey has achieved great success in the past four years in recovering from the 2001 crisis and in attaining high growth rates for three consecutive years. The process of negotiations with the EU, which will start in October 2006, is likely to provide a long-term anchor for sustaining this growth performance, which will accelerate Turkey's income convergence with the EU average. The highly dynamic nature of the Turkish economy and its vibrant private sector will be the driving forces behind the "Turkish convergence story" in the years to come.

Turkey's impressive economic performance since 2001 has been underpinned by its improved macroeconomic stability and fundamental transformation of the economy on many fronts. The unprecedented decline in inflation rates to single digit levels and the steady fall in interest rates have contributed to the strengthening of confidence and have promoted growth. The strong fiscal adjustment, leading to a record-high primary surplus figure of 7 per cent in 2004, was a key factor in the sizeable reduction of the public debt burden. Although the level of net public debt as a share of GNP is still high at 63.5% (end of 2004) , the large drop in the public debt (almost 30%) and the improvement in its composition have helped the decline in the risk perceptions of investors, as evidenced by the narrowing down of the international bond spreads and increasing foreign direct investment.

Increased economic activity has, however, led to a widening in the current account deficit in the past year. Although the deficit was easily financed by capital inflows with improved maturities, there is still a risk of reversal in market sentiment for reasons which may have nothing to do with Turkey's excellent performance – such as an increase in global interest rates or persistently high oil prices. A positive development is the increase in the prospects for higher foreign direct investment in 2005 and the years ahead, which is a crucial element in sustained macroeconomic stability and growth.

Of course, such an impressive macroeconomic performance would not have been possible without major structural reforms, notably in the public sector and financial sector, liberalization of markets, and further reforms in the agriculture, energy, and telecommunications sectors.

Source: Remarks of Mr. Andrew Vorkink at CBRT conference "Macroeconomic Policies for EU Accession".

Closed versus open economies

“The opening of economies is, along with the improvement of human capital, the key driver of growth. Countries that succeed in trading goods and attracting foreign direct investment and labour grow much more than countries that fail to become integrated in the global economy.”²

Source: November 2005 report by Deutsche Bank Research (DBR).

An open economy attracts technology and the exchange of ideas, and promotes competitiveness. Openness to foreign trade and investment provides incentives for economies to improve their domestic business environment and infrastructure so as not to lose opportunities (Textbox 3.1). Furthermore, domestic enterprises are compelled to operate more efficiently as they improve processes and develop new products and services.

Deutsche Bank Research measures openness by:

- Openness to foreign trade;
- The level of globalization in foreign policy;
- Openness to foreign capital; and
- Openness to foreign workers.

Four of the five countries that have “opened” their economies most since 1980 are emerging markets: China, India, Mexico, and Turkey (Textbox 3.2). All have seen remarkable economic gains in recent years.

The importance of diversification to economies built on extractive industries

Several OSCE countries blessed with rich natural resources, oil being the most visible example, are attaining high levels of FDI and economic growth due to the recent surge in oil prices. Yet they also need to establish strong fundamental policies.

Foreign direct investment (FDI) is widely acknowledged as playing a crucial role in the development process of developing economies, including economies in transition. As a result, FDI is being sought after by the Governments of these economies, which are in need of external capital for development. While some of the economies in transition in Central Asia and the Caucasus have sizable deposits of oil, gas and minerals, which are major attractions to foreign investors, others are less endowed and have more difficulty in attracting FDI to their fledgling industrial and service sectors. But even in those countries that are well endowed with natural resources, there is a strong need to diversify their economies away from overdependence on those resources and to develop viable value-added manufacturing industries and services. FDI can play a major catalytic role in this process.

Source: Foreign Direct Investment in Central Asian and Caucasian Economies: Policies and Issues.

While funds from oil, gas, and other resources may provide a current surplus of government funds, job creation and increases in purchasing power may still be limited. Moreover, these undiversified economies, dependent as they are on oil and other natural resources, are highly susceptible to fluctuations in market pricing. Russia’s oil and gas reserves have created considerable national wealth and international economic might, but Russia is still behind most of Eastern Europe in GDP per capita and also attracts relatively limited FDI apart from that related to natural resources-based industries. As Sergei Shatalov, First Deputy Minister of Finance of the Russian Federation, said at the 2005 World Economic Forum, “Russia cannot rely on its natural resources alone but must have more transparency to capitalize on its other competitive advantages. The Government still has to make many important decisions, especially about the banking sector and how to govern the oil fund.”³

The economists' traditional description of the evolution of FDI development is that economies start as providers of natural resources, and then as links are made with foreign investors and infrastructure is built they become a destination for labour-intensive industry and manufacturing. As the countries acquire technology and wages rise, they gradually move into services and more capital-intensive pursuits. States that are rich in natural resources need to develop a policy framework that will allow them to move along this evolutionary cycle.

The United Arab Emirates (UAE) provides an interesting example for the CIS and Central Asian States

on how to diversify their economies. H.E. Sheikha Lubna Al Qasimi, Minister of Economy and Planning of the United Arab Emirates, reports that the oil States have been taking a new approach since 9/11 when the Gulf States began investing their oil profits domestically instead of in the US, at the same time consciously resolving to diversify the economy. The result is that 60 per cent of the GDP of the UAE is not in the oil sector. The UAE has also reached free trade agreements with other countries in the Middle East, and the small oil-rich State has made significant investments around the world, including a recent big increase in its equity position in British Airways. As Al Qasimi put it: "Oil does not create jobs for people."

TEXTBOX 3.3

Kazakhstan's diversification efforts

Kazakhstan's net FDI inflow doubled between 2003 and 2004. With oil prices at record levels, the 2005 and 2006 FDI inflow figures should be staggering. Realizing that development of the non-oil economy was essential, Kazakhstan has embarked on a national effort to diversify the economy.

The Government has intensified its efforts to diversify the economy through the development of non-extractive sectors. The Industrial-Innovative Development Strategy aims to develop priority non-extractive sectors in the context of a competitive economy. Detailed studies have identified seven priority clusters: tourism, oil and gas engineering, food, textiles, logistics services, metallurgy, and construction materials. These clusters are expected to facilitate the development of industrial bases outside the extractive sectors. State-owned funds supporting the strategy have identified 24 projects for assistance and a further 350 are under consideration. The Government's efforts to support food industries will help prepare agriculture and agro-industries for WTO accession, while government infrastructure investments are being undertaken to provide an environment conducive to the development of non-oil industries.

The Government's key development efforts also include the promotion of a favourable environment for SMEs by, among other things, streamlining administrative procedures for business operations and setting up a small business development fund to help finance SME business opportunities.

While making efforts toward economic diversification, the Government is also seeking to ensure balanced and inclusive growth through support to rural areas. Priority programmes supporting the rural population are also under way.

The economic outlook for the next three years is positive. Economic diversification remains a priority for reducing the impact of external shocks to the economy, and the Industrial-Innovative Development Strategy is expected to play an important role in promoting a larger non-oil sector. In the medium term, however, the oil and gas sector will remain the principal engine of economic expansion, with services, construction, and manufacturing continuing to play their supporting roles.

Source: Asian Development Outlook 2005, Asian Development Bank.

Creating a strong macro-economic environment

It is difficult to prescribe one set of policies for establishing a strong macroeconomic environment and stimulating economic growth that will be successful in every OSCE economy. Nonetheless, on the basis of the best practices of a number of OSCE transition economies such as Turkey, Kazakhstan, and the Eastern European countries, the Guide would like to provide some general guidance for States that have yet to achieve macroeconomic stability, with an accompanying rider that these policies have to be interpreted and adapted for the country concerned. The Guide, in its efforts to indicate a path to the strongest environment for a favourable business and investment climate, suggests macroeconomic policies that reflect open and diversified economies.

- *Development of a medium-term government economic strategy.* The development of a medium-term economic strategy is critical. A documented strategy increases the perception of stability among investors and financial markets. A well developed strategy based on careful consideration of the various economic and fiscal issues leads to policies being followed not in response to immediate political circumstances but in the pursuit of national objectives.
- *Disciplined fiscal policy.* Variations in fiscal policy leading among other things to fluctuating tax rates frustrate investors both foreign and domestic. The prospect of large debts worries international financial institutions. Controlled government spending combined with competitive tax rates and a simple and stable tax system promote FDI and SME development.
- *Strong policy support for international trade.* A liberal trade policy is important because it provides SMEs with greater market access and attracts foreign investors seeking to export to other regional markets. Moreover, a protectionist image discourages investors. Strong trade policy support implies entering into bilateral and regional free trade agreements, the lowest most-favoured-nation (MFN) tariffs possible in accordance with international norms, WTO accession, unrestricted use of foreign currency in trade, and a non-corrupt and functional customs system.
- *Facilitating international capital market flows.* There can be a tendency to try to “manage” the macro-economy through monetary policy. While a Central Bank has several “levers of influence” at its disposal, it cannot create, direct, or manage a favourable macroeconomic environment all on its own. The private sector must be unleashed to create that environment. Governments help to create a favourable environment when they facilitate international capital market flows through policies supporting currency convertibility, floating exchange rates, and low interest rates.

Conclusions and Recommendations

Investors and entrepreneurs seek opportunity. Economies that show growth and stability provide the highest levels of opportunity and will attract the highest levels of investment. Governments can create opportunity-rich frameworks for business by:

- *Orienting macroeconomic policy toward economic growth.* GDP growth is a critical indicator for corporate investors and raises the potential for investment.
- *Opening up the economy.* Open economies have the best chance of success. Policies embracing trade liberalization, free flow of capital, and free movement of workers stimulate economic activity.
- *Diversifying the economy.* Complete reliance on extractive industries leaves an economy susceptible to commodity price fluctuations, and stultifies job creation.
- *Creating a strategy.* Developing a medium-term strategy makes it easier for businesses to plan. The consequent higher degree of transparency also sends positive signals to investors and other important actors.

RESOURCES

World Economic Forum: <www.weforum.org>

Deutsche Bank Research: <www.dbresearch.com>

OECD Investment Compact: <www.investmentcompact.org>

“Going for Growth: The Economy of the EU”, <http://europa.eu.int/comm/publications/booklets/move/40/index_en.htm>

Stability Pact for South Eastern Europe: <www.stabilitypact.org/wt2/default.asp>

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Chapter 4



Wim Robberechts | Belgian Foreign Ministry

Government Actions and Policies that Improve the Business Climate

A general policy that fosters competition among private actors rather than direct State management of the economy is a fundamental step in the right direction. Tax policies that are transparent, simple, and non-discriminatory are attractive to investors because they enable entrepreneurs to forecast their costs and potential profits more easily than a complex set of nominally low tax rates does. Special tax incentives for foreign investors can distort competition and undermine the financial health of domestic companies. Streamlining refunds of value-added tax on exports helps businesses avoid cash flow problems. Employment policies can stimulate labour market flexibility and support business development by giving employers the ability to hire and discharge workers with relative ease. Investment in infrastructure – roads, transport networks, utility distribution networks, water supply, telecommunications networks, public works and services, and customs systems – allows domestic and foreign companies to take full advantage of local and global markets. Similarly, investment in human capital – improving and maintaining education and job training and retraining – makes a country more internationally competitive. The lessons of regional economic integration, free trade areas, and investment compacts demonstrate that co-operation among trading partners is more likely to produce economic benefits for all parties than isolationism and protectionism are. Finally, the privatization of State-owned enterprises and evenhanded treatment of newly privatized companies shows a firm commitment on the part of the State to allow competition to determine the success or failure of those companies and to ensure the kind of level playing field for business that is most likely to benefit consumers generally.

Improving the business climate

The success of private sector enterprises is ultimately based on the ability of the enterprise to provide products and services that the marketplace wants at acceptable prices and to make a profit in so doing. The lessons of the last fifty years strongly suggest that governmental attempts to ensure the success of companies by directly intervening in their management, or by manipulating competition among firms in a heavy-handed manner, seldom if ever produce optimal results. However, policies implemented to establish a good business climate can help build a basic framework that offers firms maximum opportunity for success.

TEXTBOX 4.1

Impact of the business environment on firms

The opportunities and incentives for firms to invest, create jobs, and grow depend on expected profits. Profits are influenced by costs, risks, and barriers to competition. Governments can have a major impact on each of the following three factors.

- On costs: though the regulatory burden and red tape, taxes, levels of corruption, infrastructure services, labour market regulation, and finance;
- On risks: through policy predictability, property rights, and contract enforcement; and
- On barriers to competition: through regulations controlling start-up and bankruptcy, competition law, and entry to finance and infrastructure markets.

Source: World Bank.

Tax policy

Taxes are indispensable to raising public revenue, which in its turn is necessary for governments to finance their operations and provide their citizens with security and other basic services. However, ineffective, discriminatory, and overly burdensome taxation policies and practices can discourage the voluntary payment of taxes by taxpayers. This brings down tax revenue, increases incentives for public corruption, and tempts some companies to adopt non-transparent, inefficient practices to conceal “off the books” transactions.

In many transition economies, procedures for tax collection are still weak, and tax evasion is widespread. Tax officials have had to learn how to operate a market-based tax system, and many tax offices lack the modern technology and infrastructure needed for optimal performance. Co-operation among different tax collection agencies, such as tax boards and customs bodies, is often poor. Inefficiencies in the court systems frequently make tax collection difficult. These problems tend to place an unequal burden on law-abiding private companies.¹ They also deprive the State of much-needed revenue.

Increasing the risks and potential cost of tax evasion and fostering a culture of good corporate governance can help to deter firms from illegal practices. However, just as bad taxation policies and practices also deter foreign investment and development of SMEs by increasing their costs, introducing risk and uncertainty, and diminishing their competitiveness, pro-development tax policies must be concerned not only with maximizing the collection of taxes but also with maintaining a business environment that fosters economic development. The following paragraphs discuss general taxation policies. Tax policies that are specific to SME development are discussed separately in Chapter 8.

Taxation levels may influence investors' decisions on where to invest within a specific region. However, the high visibility of income tax rates can mislead policy-makers as to their importance in attracting foreign investors and motivating entrepreneurs. Moreover, although tax rates may seem straightforward, they can be deceptive, because progressive taxation regimes often produce extremely complicated sets of rules that can make it difficult for companies to predict their likely tax liability. As a result, sophisticated businesses are less impressed by a low nominal tax rate than they are by a demonstrably low overall tax burden. The evidence also strongly suggests that investors consider basic infrastructure, political stability, and labour costs and availability to be even more important to their investment decisions than tax rates. Thus, although taxes are a very conspicuous and calculable component of an investor's cost, economists warn that tax incentives "are a poor instrument for compensating for negative factors in a country's investment climate."² Moreover, overly generous tax incentives that grant special privileges to foreign investors can hurt SMEs and domestic competition, raise the costs of management, cause marketplace distortions, and lead to greater corruption. All this makes a non-targeted approach that lowers effective corporate tax rates for all firms a more balanced policy for the long term.³

Income tax simplification. Simplified taxation can help level the playing field among companies, encourage voluntary tax compliance, help companies predict their costs better and make more accurate financial projections, as well as make tax collection easier. In general, a simpler, fairer system with low rates that does not discriminate among companies provides the best basis for attracting FDI and developing entrepreneurship.

Flat taxes. One means of simplifying taxation is to eliminate progressive taxation and adopt a "flat tax", i. e., a single rate for profit and income taxes.⁴ This measure can be applied in certain circumstances and for a certain period of time, as a prelude to a possible return to progressive taxation. Many of the Eastern European countries, including Russia and Slovakia, have adopted the flat tax with success. Revenues have actually increased through the attraction of additional taxpayers from the informal economy and through economic growth.

Estonia was Eastern Europe's early adopter in the Flat Tax movement, moving to the flat tax in 1994. The flat tax is essentially a single tax rate on corporate and personal incomes, the idea being that the new simplicity makes it easier for the government to close loopholes and prosecute evaders, and helps taxpayers assess their obligations, raising their motivation to produce or earn more because their marginal tax rate remains constant. The reduced rate also makes tax evasion less attractive. Since adopting the flat tax, Estonia has achieved increases in tax revenue, in GDP growth, and in FDI.

The flat tax has also proven successful in larger countries, including Russia, where the Government reduced the corporate income rate from 35 to 24 per cent. Russia adopted the flat tax in 2001 and experienced a 26 per cent increase in revenue in the first year, due mainly to the payment by former tax scoundrels. In the period 2001–2004, Russia averaged a 35 per cent annual increase in revenues. Similar successes have been achieved in Lithuania, Latvia, Romania, and Slovakia. Many of the countries have flat tax rates in the mid-20s (per cent) but have still achieved remarkable success in attracting additional revenue and FDI, demonstrating that firms find a tax system that allows them to predict their aggregate tax liability accurately more attractive than a complex system with nominally low rates but unpredictable outcomes.

Reinvestment deductions. The Government of Estonia's success in attracting FDI has in part been due to an innovative policy in which profits that are reinvested in the company are not subject to taxation. As well as lowering the overall tax burden, this policy is a positive encouragement to companies to expand their businesses and create jobs.

Value added tax refunds. In many sales tax systems, inputs are first taxed, and then the final output is taxed again after the inputs have been used to produce a commodity. This results in multiple taxation with cascading effects. Value Added Tax (VAT) seeks to avoid the problem of multiple taxation. VAT applies to the final consumption of goods or services by the ultimate consumer. It is collected at each stage of purchase and sale, but set-offs are granted for taxes paid on previous purchases.

Companies registered locally for VAT are allowed to claim credits for VAT they have paid to their suppliers. What companies have to pay the tax authorities on a regular basis is the excess of the amounts charged to customers ("output tax") over the amounts of VAT paid to suppliers ("input tax"). Foreign companies can generally obtain refunds of VAT paid on purchases for which VAT-registered businesses can claim input tax deductions on their local VAT returns. If there were no such relief for foreign businesses, the VAT system could be considered discriminatory and a breach of international trade agreements. In addition, VAT is normally refunded in respect of products exported from the taxing country.⁵

Foreign investors and exporters in some OSCE countries have reported significant difficulties in obtaining VAT refunds. Sometimes the unpaid VAT refund can be offset against other taxes. Frequently, however, the taxpayer "cannot offset against other taxes because the VAT refund is larger than the other taxes."⁶ In some cases, these difficulties arise from the fact that although legislation provides for VAT refunds there is no law or regulation to lay down the practicalities of the refund procedure. In others, the major impediment to VAT refunds appears to be reluctance on the part of authorities to return "revenues" that they are not in fact entitled to keep.⁷ Countries that wish to attract and retain foreign investment and to promote their own domestic export businesses must take steps to ensure that VAT refunds are made promptly and accurately.

Electronic filing. Many of the delays and inefficiencies associated with making tax returns can be reduced through the availability of Internet-based electronic filing. The Republic of Croatia has made significant progress in this respect by introducing a new electronic filing service known as e-Regos,⁸ which will permit electronic VAT registration and the electronic filing of annual income tax returns.⁹

Cleaning up customs is a smart investment for governments

“Countries that fail to keep pace with world-class standards for customs administration will find that investors simply cannot afford the high logistics costs imposed by customs inefficiencies. Finance ministers in these countries will find foreign direct investment migrating to nations with more sophisticated customs administrations.”

Source: International Chamber of Commerce.

High tariff rates on supplies raise the cost of production. Companies seeking to use a country as a low cost location to export from may have their objectives thwarted by tariffs. Inefficiencies in administration that cause delays in customs clearance interrupt production cycles and the ability to deliver goods to market. Customs administration is one of the most frequent locations of corruption, and corrupt customs agencies are among the most visible deterrents to trade and investment.

A number of OSCE countries have faced problems with customs procedures. To address these problems, Lithuania, for example, has taken major steps to improve and modernize its customs processing. The customs reform has included:

- Development of its own Business Strategy for Customs;
- Installation of an integrated tariff management system that helps value and classify goods and apply

tariffs and duties appropriately;

- Regional co-operation with other national customs authorities, particularly with the Northern Dimension which aims to reduce customs clearance times to two hours or less at the borders of Baltic Sea countries;
- Hiring of specialists in various classifications of goods to help with challenges such as industrial and intellectual property protection;
- Carrying out a twinning project with Finland; and
- Establishing a code of ethics for customs officials.

Corruption in customs authorities, if not the largest customs administration problem, is certainly the most emblematic. Hungary has developed an integrated anti-corruption programme that has succeeded in reducing corruption. Features of the Hungarian programme include:

- An integrated customs management system including bar-coded customs declarations forms;
- Rotation of customs personnel;
- Careful recruitment of personnel including background checks, probationary period, and suitability testing;
- Fair salaries;
- Ethics training;
- Closed circuit video;
- Rules on possession of cash and use of personal mobile phone for customs agents; and
- Code of conduct.

Sources: UNDP Lithuania; and “Fight against Corruption in Customs”, a presentation by Janos Nagy, Customs and Finance Guard, Hungary.

Employment policy and labour market flexibility

Labour market flexibility is vital to ensuring the maximum utilization of human capital. A recent study conducted for the World Bank concluded that, “the more flexible the labour market in the host economy relative to the investor’s home country, the higher the likelihood of investment in the host country.”¹⁰

Having a flexible labour market is particularly important for countries that pursue a policy of privatization. Companies that purchase State-owned enterprises will often reduce the number of workers to make the enterprise more efficient and profitable. A flexible labour market is needed to absorb those new entrants. Companies must be able to hire part-time workers, temporary workers, workers with more than one job, and contract workers. If that is not possible, it may result in higher unemployment and workers moving toward the informal economy.

What are the key elements of a flexible labour market?

(1) More freedom to decide on the labour force in accordance with business needs is an important part of improving a country’s business climate.

Businesses are adversely affected by heavy restrictions on labour market flexibility. A firm that cannot adjust the size of its workforce in accordance with its business needs can lose its competitive edge. Indeed, labour costs can reach a point in proportion to revenues that the company will go bankrupt if it cannot reduce those costs.

Countries should protect their workers against all forms of unfair exploitation and discrimination, and should impose protective measures to reduce the likelihood of job-related injuries and deaths. A good starting point in this direction is to implement the 1998 Declaration on Fundamental Principles and Rights at Work of the International Labour Organization,¹¹ which promotes the observance of core labour principles found in several ILO treaties.

To enable OSCE transition economies to take full advantage of one of their major competitive advantages in attracting investment – i.e., a well-trained and educated workforce available at reasonable cost – governments must be careful not to repel investors by placing severe restrictions on dismissals of workers, limits on the use of flexible work contracts, lengthy termination notice requirements, and large mandatory severance payments. Economic, social, cultural, and historical differences among countries make some reforms more feasible in some countries than in others.

(2) Opportunities for employees to work overtime
Many governments put a strict limit on the number of hours an employee may work during a week. This limit is often not uniform from industry to industry, and it can restrict a company’s productivity. In addition, many workers desire the opportunity to earn overtime pay. To accommodate both workers and employers, legislation can forbid employers to force their staff to work overtime but can allow workers to do so voluntarily in exchange for mandatory additional compensation such as “time and a half” (fifty per cent above the normal hourly wage) for overtime hours worked. Laws of this kind allow companies to use their workforce more flexibly while at the same time ensuring a fair deal for the workers. This type of flexibility is particularly critical for SMEs, which have to operate very efficiently to survive.

(3) Reasonable social security/employment taxes
The effective tax burden on employers in many of the OSCE transition economies may be as high as 50 per cent of a worker’s wage or more. A 2004 report prepared by the USAID Labour Market Project in Bulgaria reported that Bulgarian companies were more harmed by high social taxes than were foreign companies.¹² Domestic businesses indicated that they felt squeezed between international competitors and the informal economy. The report concluded that high social taxes push wages down and encourage companies to comply less than fully with labour and tax regulations. An effective pro-employer contribution by companies of 35–40 per cent of wages would place OSCE countries near the median of more developed European

economies. The reduction in revenue from lowering tax rates is usually compensated for by those in the informal economy desiring to pay reasonable taxes, and higher profitability for companies.

(4) Freedom to hire contract, part-time, and temporary workers

Businesses often need workers on a seasonal or project-related basis. They should be able to hire workers to fulfil those specific needs. Requiring firms to hire full-time workers results either in less hiring or in less profitable companies that will either pay lower taxes or not survive at all.

(5) Reasonable obligations regarding vocational training

Employers may be required to provide a reasonable measure of vocational training to enable workers to perform their jobs well and improve their overall attractiveness in the national workforce. Requirements of this kind should not be so onerous as to be detrimental to the overall productivity and profitability of the company.

Labour market reforms in OSCE countries

Portugal amended its labour code in 2003, and 55 per cent of companies surveyed by KPMG thought that these changes would make Portugal a more attractive investment destination. Among the benefits anticipated from the new labour code by companies, the top three were:

- Improvements in flexibility of working hours;
- Tighter control on staff sick leave; and
- Compulsory vocational training.

After restructuring its economy, Slovakia had high unemployment, running at one of the highest rates in Europe. However, with its recent attraction of FDI and the introduction of the new labour code, unemployment has decreased significantly over the past two years. In 2001 and 2003, Slovakia made major changes to its labour code and thereby created

one of the most flexible labour markets in the world. It was cited as the top reformer in Doing Business in 2004 by the World Bank.

Slovakia's reforms included:

- Moving from no part-time labour contracts to part-time contracts for women, students, and retirees;
- Allowing extension of term contracts;
- Increasing the limit of overtime hours worked in a year from 150 to 400, with worker consent;
- Eliminating the requirement for union approval for firing a worker;
- Eliminating the requirement for retraining a worker prior to dismissal; and
- Switching from approval to notification to unions for group dismissal.

Investment in infrastructure

“Romania’s biggest inhibitor to investors is no longer the business climate but infrastructure.”

Former head of the Romanian Agency for Foreign Investments

The quality of a country's infrastructure – its roads, transport networks, utility distribution networks, water supply, telecommunications networks, public works and services, customs system, and educational system – is critical to the attraction of foreign investment and the start-up of SMEs. As the OECD has noted, “Good infrastructure attracts investment by connecting firms to their customers and suppliers, in effect enlarging the size of the market.”¹³ This is consistent with responses to the survey conducted in the preparation of the Guide, some of which identified investments in infrastructure – specifically including science and industrial parks – as having successfully enhanced economic development in certain areas. Transport and utility infrastructure are perhaps the two most critical components, because investors need to be able to bring supplies into their operations and move their products to the marketplace in a prompt and cost-effective manner.

Likewise, access to utilities and a stable supply of energy with stable prices are also critical. If investors have to wait months before their facilities can be connected to basic utilities, the profitability of their investment will decline substantially. Also, the power grid must be stable. A single unscheduled interruption in activity for certain manufacturers utilizing highly calibrated machinery can be very costly.

A recent economic study on the impact of infrastructure improvement makes the following claim:

Investments by governments in providing efficient physical infrastructural facilities improve the investment climate for FDI by subsidizing the cost of total investment by foreign investors and thus raising the rate of return. MNEs (multinational enterprises) may be particularly sensitive to infrastructure availability for locating their investments designed to feed the global, regional or home country markets as these investments are efficiency-seeking in nature.¹⁴

A high-quality infrastructure lowers the cost of entry to investors and entrepreneurs, facilitates the development of exports, and provides a competitive advantage over other destinations that offer similar input costs such as labour and land but have a less developed infrastructure. In countries bordering the EU such as Ukraine and Romania, the desire to provide lower-cost manufacturing and distribution to EU countries has stimulated the development of infrastructure along the Polish border in the case of Ukraine and the Hungarian border in the case of Romania.

The infrastructure study cited above strongly recommends a government policy of infrastructure improvement in preference to special investment incentives as a viable means of encouraging economic development:

A number of developed and developing country governments have indulged in policy competition between themselves to attract MNEs through investment incentives. These investment incentives tend to distort the patterns of FDI in favour of developed

countries given their capacity to provide substantial fiscal incentives. Rather than getting sucked into competition with developed countries by offering investment incentives, governments of developing countries would do well to focus on development of physical infrastructure in their countries. This would help to mobilize the domestic as well as foreign investments and help in expediting the process of their development.

The number of infrastructure projects to undertake depends on government resources, the state of the infrastructure, and the likely return on investment. As the OECD PFI says, “This requires a capability to undertake cost-benefit analyses, financial reporting, sound decision-making processes that give weight to the results of cost-benefit analyses, while allowing a socially acceptable balancing of competing interests and efficient agencies for maintaining and delivering new infrastructure investments.”

Countries that do not have the capacity to develop additional infrastructure may consider public-private partnerships. Public-private partnerships (PPPs) are a great tool for enabling governments to finance infrastructure investment projects. The private entity provides the upfront financing, and the government may compensate the private sector partner through such mechanisms as repayment of debt, bonds, or concessions. In addition, successful PPPs –involving satisfied investors, improved infrastructure, and a transaction based on transparency, fairness, and sound fiscal management – attract other investors.

Governments that lack experience with PPPs need to learn specific management techniques because PPPs differ from procurement or strict repayment of financial debt.

To ensure successful investments in infrastructure, governments should provide specific protection to investors involved in carrying out infrastructure improvements. Investors should have specific contracts spelling out rights, responsibilities, and mechanisms for resolving disputes. The government can provide a sovereign guarantee that assures payment for the project. Should there be difficulties in keeping to the sovereign guaran-

tee, the EBRD, World Bank, and other organizations offer guarantee programmes that guarantee or “support” the client government’s guarantee. As the PFI puts it:

“By reducing the risks faced by infrastructure-providers, the returns that investors require to go forward with infrastructure investment are lowered.”

TEXTBOX 4.3

The OSCE’s 2006 Spotlight on Transport

The theme of the 14th OSCE Economic Forum was “Transportation in the OSCE area: secure transportation networks and transport development to enhance regional economic co-operation and stability”. Transport plays a major economic, social and geo-political role, which in turn explains why it is such an important factor for regional co-operation and stability. It is a basic precondition for national economic and social development.¹ Investment in transport infrastructure constitutes a significant percentage of a country’s economic activity. The European Council of Ministers of Transport (ECMT) estimates that as much as 6 to 8% of a country’s GDP, 6% of employment, 40% of public investment, and 15% of household spending may be related to transport.

Transport provides an indispensable underpinning to the development of international trade. International transport is also crucial for international integration and for the reduction of economic and social disparities across borders. The facilitation and development of secure international transport networks is therefore of strategic importance for all countries.²

Transport is vital to the good functioning of economic activities, to the production and distribution of goods, and to trade. The ability of any entrepreneur, SME, company or country to compete successfully, further develop its activities, and integrate into the national or global economy depends not only on its productive capacities but also on its ability to bring goods to the market at the lowest possible cost and under predictable conditions. Transport costs may constitute an important barrier to market access. One of fDi Magazine’s 28 individual criteria for rating investment locations is transport, and they rate the areas with the “best transport infrastructure” in each region of the world.

Transport infrastructure is a critical determinant in attracting FDI. In addition to its friendly business climate, the city-state of Singapore, a large recipient of FDI, also offers one of the world’s largest container shipping terminals and an airlink to nearly any destination in the world, namely Changi Airport. One of the supporting factors in Ireland’s economic miracle was the development of Shannon Airport. Foreign

investors need links with corporate headquarters, export destinations, and suppliers.

SMEs benefit from lower costs for delivering their goods to the marketplace. Reduced time to market brings about not only lower operating expenses but also the ability to move more goods in less time, which has a beneficial effect on cash flow.

Excellent transport infrastructure is particularly important for landlocked countries. The lack of access to the sea makes an excellent network of roads, rail, and river transport vital for market access and regional integration.

Countries seeking to improve the effectiveness of their transport infrastructure may adopt the following initiatives:

- *Improved customs administration and visa-processing.* Slow processing of customs and visas delays border-crossing and discourages cross-border traffic and commerce.
- *Infrastructure planning.* Governments must have a medium-term transport infrastructure development strategy. A well-designed strategy encourages private sector investment.
- *Maximum utilization of donor funding.* Many countries have funding available for transport infrastructure from the EBRD, EU, World Bank, Asian Development Bank, or other donors, and do not fully utilize the funds available.
- *Understanding of public-private partnerships.* A well-managed PPP enables countries to develop transport links without the burden of direct procurement. The intricacies of PPPs must be understood. The EBRD offers expertise in planning and developing public-private partnerships in transport infrastructure projects.

In short, well planned and funded government investment in transport infrastructure improves a country’s potential for FDI and SME development.

¹ Background Paper, First Preparatory Conference to the Fourteenth OSCE Economic Forum, “The Role Of Transportation to Enhance Regional Economic Co-Operation and Stability”, Dushanbe, Tajikistan, 7-8 Nov 2005.

² Ibid.

TEXTBOX 4.4

Hungary's highway infrastructure

Hungary's central location in Europe is one of its most important competitive advantages. Hungary is considered to be a gateway to Europe: four major European transportation corridors run through the country, making Budapest a central hub in Europe. In order to exploit these benefits, Hungary is determined not only to preserve, but also to enhance its infrastructural network and to improve its integration into the European network.

Major Transportation Corridors



Road network

Over the last few years Hungary has been investing heavily in upgrading and extending its motorway network and road infrastructure. The Hungarian road infrastructure is currently undergoing major government-supported reconstruction to extend the length of four-lane highways, which currently only cover a part of the country (1,053 km by the end of 2006 and 2,530 km by 2015).

Total public road length is 160,000 km in Hungary today. With its public road density per 1,000 km² of 1,720 km has some 52 per cent, Hungary is above the average of the EU-15 countries.

Seven of Hungary's eight major highways start from Budapest and all of them link up with the European road network. The improvement of the highway network and four-lane motorways linking all the major cities in Hungary will result in a decrease of approximately 40 per cent in driving times on the main inter-city routes.

Recently, international co-operation has been strengthened with the neighbouring countries to foster this endeavour by harmonizing road network developments. A top priority of the Hungarian Government is to further extend and reconstruct the road network in Hungary.

Source: ITD Hungary.

Investment in human capital

General education and job skills training. Human capital is one of the competitive advantages that a developing economy can offer through low cost, multiple language skills, and solid education, particularly technical education and vocational training.¹⁵ Countries without vast natural resources can still offer investors human capital. Whether through labour-intensive manufacturing or services, countries that can offer skilled workers at affordable rates will always attract investments. The Washington Group International, a

construction design and engineering firm, has developed offshore engineering centres in developing markets. Although the company has its headquarters in the USA, it performs the bulk of its high-level analysis and engineering tasks in emerging markets. They prefer to take advantage of the better value – both as to quality and as to cost – offered by engineers available in those markets.

One critical component of human capital development is basic education. A strong foundation is created by national school systems providing strong training in business concepts, mathematics and technical disciplines, and foreign languages. It is critical that

governments encourage full participation in education. If children of economically disadvantaged minorities, such as the Roma, do not attend school, then their poverty will persist. Many of the recent success stories in foreign investment and economic growth are cited as attractive destinations because of the quality of the human capital. Indeed, Central Europe's reputation for housing "top talent" and "one of the planet's richest creative pools" earned praise as an economic "powerhouse" in a recent 2005 Business Week article.¹⁶

Instruction in foreign languages – French, German, and particularly English – is a critical component of basic education. India's ability to attract such a tremendous amount of foreign investment is not due entirely to low wages and a great number of software engineers but also to the fact that English is a common language. With reference to the Irish economic miracle, former Prime Minister of Ireland Garrett Fitzgerald said his country was fortunate in that, in addition to the low taxes and relatively low wages in comparison with continental Europe, the Americans and the British "don't speak other languages." If Eastern European countries are snapping up opportunities in the services sector by hosting call centres and technical support centres, it is not least because of their language skills. The Europe Direct or EU hotline which provides information on the European Union by telephone was originally staffed in Belgium. The majority of operations were moved to Romania where English, French, Italian, Spanish, German, Hungarian, and Romanian are commonly spoken. Strong knowledge of foreign languages also allows a greater percentage of jobs related to foreign investments to be taken on by local staff, who also have greater knowledge at their fingertips. One of the impediments to greater investment in some of the countries of the former Soviet Union is the lack of foreign language knowledge. As Russia opens itself to foreign investors and evolves as a large actor in the international economy, this may provide impetus for the other CIS countries to ensure workers are able to communicate in languages other than the local language and Russian.

Business education. Countries with economies in transition can foster economic development by systematically promoting the appreciation of enterprise and the entrepreneur among civil servants and the wider public. In most transition and some developing countries, the overhang from the era of planned economies still persists and where perceptions about entrepreneurs are skewed towards the negative. Bringing about a change in popular attitudes toward entrepreneurs is a long-term process and the best way to succeed is to incorporate business training throughout the whole education and training systems of the OSCE economies, and mounting special business promotion campaigns.

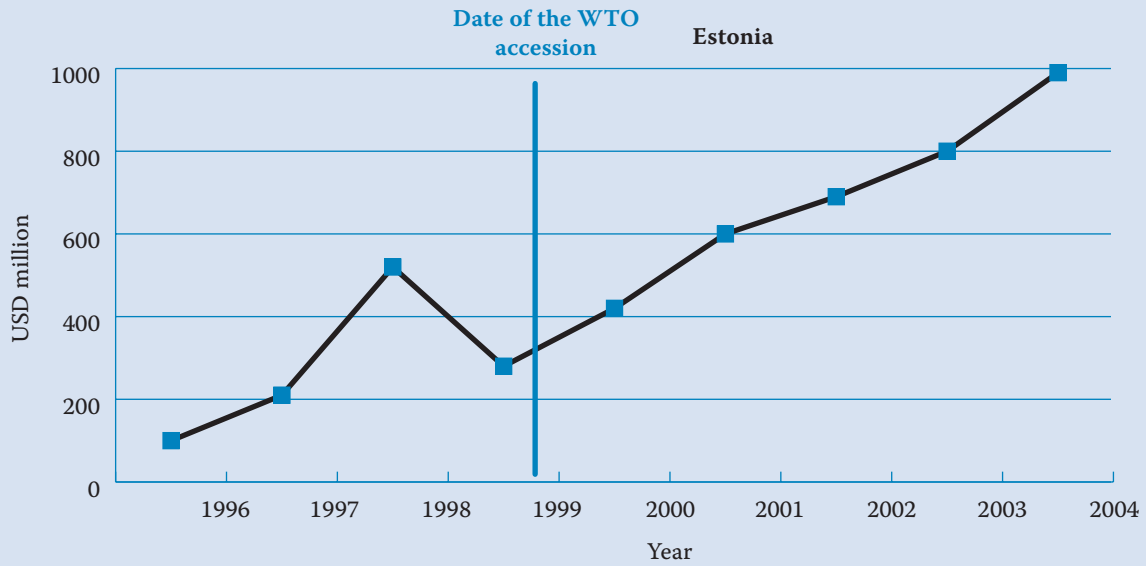
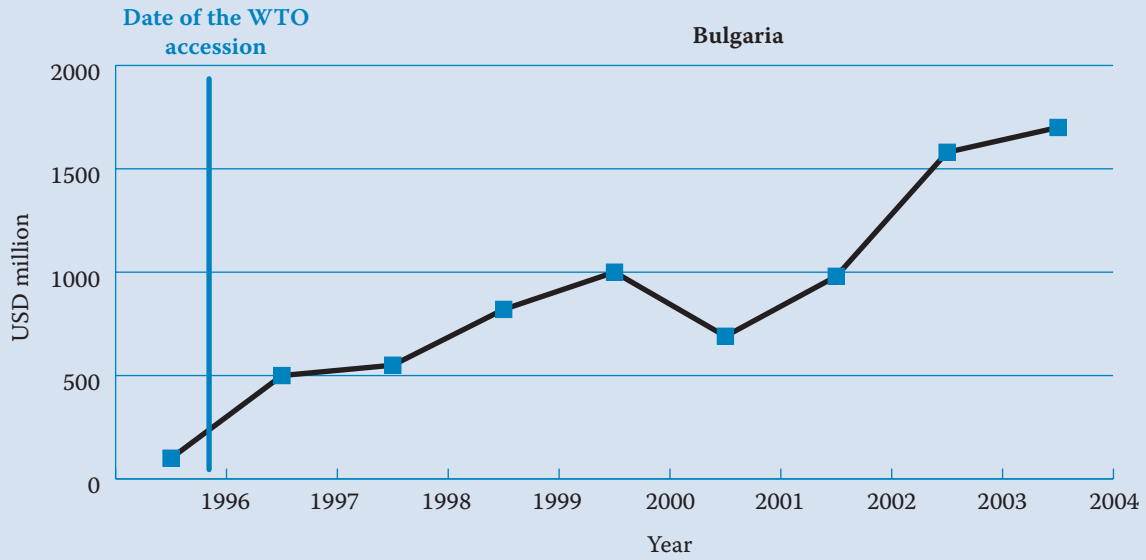
International and regional integration

One of the concrete steps that governments can take to improve their business and investment climate is to pursue international and regional integration. In addition to establishing economic policies that "open the economy", governments are encouraged to participate in multilateral organizations, compacts, and trade and investment agreements that establish business and economic links.

World Trade Organization (WTO) Accession. While most OSCE participating States are WTO members, some are not. Membership in the WTO provides export access in 148 markets. This is vital for SMEs seeking to expand to markets beyond the domestic market. Perhaps more importantly, the process of WTO accession provides a better business environment for stimulating foreign direct investment. Better governance, safety standards, intellectual property protection and other conditions sought by investors are demands of WTO membership. Figures 4.1 and 4.2 show the increase in FDI in Bulgaria and Estonia after WTO accession.

FIGURES.4.1 AND 4.2

Increase in FDI after WTO accession, Bulgaria and Estonia



Source: USAID Ukraine WTO Accession & Investment Promotion Project.

Building relationships with the European Union.

The economic success achieved in Central and Eastern Europe in recent years is due in large part to the EU accession process. The accession process has fuelled investment and interest in the candidate countries on the part of EU countries and because of the rapid economic development brought by their accession process, some recently admitted EU members – including the Czech Republic, Hungary, and Poland – are now being described by some commentators as “developed” economies. Other countries such as Bulgaria, Croatia and Romania are rated as “investment grade” because of their rapidly rising FDI and wages.

For those economies where a formal relationship with the EU is not an option, harmonizing domestic policies and practices with those of the EU can raise investor confidence. Adopting laws, regulations, and policies comparable to the *Acquis Communautaire* provides:

- A common and understood framework and environment to investors;
- Transparency and predictability; and
- A signal to the international community that a government wants to integrate with the larger regional community at an international standard.

Regional free trade agreements. Many of the countries in South East Europe and Central Asia have a variety of bilateral and multilateral free trade agreements but do not have any comprehensive regional free trade agreements. The Stability Pact has been active in trying to unify twenty-nine bilateral trade agreements into one single free trade agreement for South East Europe.¹⁷ Similar initiatives could be undertaken by other countries. The goal of such efforts is to maximize the attractiveness of the marketplace to foreign investors by easing their ability to conduct business throughout the region, and to provide additional nearby export markets for SMEs.

TEXTBOX 4.5

Investment compacts

OECD’s South East Europe Investment Compact has been extraordinarily successful in assisting the nations of South East Europe to raise their FDI levels and improve their business and investment climates. Founded in 2000, the Investment Compact has attempted to increase FDI by:

- **Evaluation and monitoring of progress** in investment reform, including concrete case studies of how to improve;
- **Support in implementation of investment reform** through coaching and peer review;
- **Support in structuring the dialogue** between public and private sector through the Regional Network of Foreign Investors Councils (www.regionalfic.org) and the Regional White Book; and
- **Political support** through an annual ministerial conference focused on a specific theme of investment reform.

The participating countries have their performance measured, and are then given specific advice based on OECD best practices. In addition, the multilateral format stimulates both a desire to improve based on evaluations relative to peer countries and an understanding of the need for regional

co-operation. One of the Investment Compact’s products is the Investment Reform Index, a comprehensive tool used to measure a country’s performance in reforming its investment climate in ten areas: investment policy, investment promotion, tax policy, anti-corruption policy, competition policy, trade policy, SME support, public administration, financial institutions and infrastructure, and human capital.

Other countries could also be inspired to form their own investment compact or other regional approach. Whether or not they have the guidance of the OECD, all groups of countries can follow the investment compact model. The Foreign Investor Councils created in South East Europe are all privately funded and do not require government support: all they call for is a strong desire for a dialogue partner. As was noted in a prominent World Bank discussion on reforming investment climates, “There is no substitute for political will and reform champions, and pressure from global or regional agreements such as the World Trade Organization and European Union accession also help.” Thus, if countries have the political will to reform their investment climates, they can achieve results.

Privatization of State-owned enterprises

A significant percentage of GDP in many of the OSCE developing and transition economies can still be traced to State-owned enterprises. As countries try to improve their business climates and compete in the global economy, governments must move from the role of economic actor to independent regulator. The government's duty is to provide the framework for firms to succeed and to adjudicate disputes between firms rather than acting in the place of firms. Privatization is one method of assisting governments to move in this direction.

Government-owned business organizations were a prominent feature of economic life in the twentieth century. State ownership of the means of production was a central tenet of socialist ideology. Under the influence of Keynesian economics, even Western governments such as that of post-war Britain also owned and operated major industrial enterprises. By the 1980s, however, the inefficiencies and distortion of competition¹⁸ associated with State-owned enterprises (SOEs) were evident to countries with market economies. The governments of these countries began divesting themselves of businesses that could be better run by private owners. After the dissolution of the Soviet Union, the new republics began a transition from central planning to market economies. In the process, these countries have also experimented with – and in some cases have wholeheartedly embraced – the privatization of SOEs.

Privatization is intended to promote efficiency by subjecting businesses to the rigors of competition in a free market. In addition, some governments seek to achieve social objectives by using privatization to place ownership of companies in the hands of their workers or of a widely dispersed public. In many cases, however, the results of privatization have been disappointing. Opaque, unaccountable State-owned monopolies have been replaced by opaque, unaccountable private monopolies. Due to corruption, non-transparency, incompetence and political influence in the privatization process, some public assets have been acquired or become controlled by individuals and private companies for a

fraction of their actual value. A lack of opportunities to trade shares often prevents the raising of additional capital needed for expansion. Moreover, in some countries, privatization has been selective and incomplete; many large companies remain under State ownership.

There is neither a single nor a failsafe method of ensuring a successful privatization. Privatization is a politically contentious and complex subject that is influenced by local conditions and the specific characteristics of the entity to be privatized. Nevertheless, some lessons have been learned in the course of more than a decade of privatization work conducted in transition countries by the World Bank, the OECD, and other organizations interested in economic development. The following paragraphs summarize some of those lessons:

Benefits of privatization. Privatization can dramatically increase the productivity of firms and produce other welfare gains such as contributing to the growth of stock markets. However, privatization can in the short term result in increased unemployment. Countries going through the privatization process should anticipate and be prepared to deal with a brief rise in unemployment through retraining and other job transition practices. If carried out correctly, the long-term benefits of privatization – even with respect to employment and wages – should greatly exceed the short-term detriments.¹⁹ However, this requires that the privatization process be transparent, and that supporting institutions exist or be established in the near term, including: adequate rule-of-law protection of private property, competition, a good system of corporate governance, secondary trading of shares, hard budget constraints, and appropriate regulation.

Methods of privatization. Governments privatize firms in three main ways: (1) share issue privatization (SIP), (2) asset sales to a single buyer (trade sales), and (3) mass²⁰ (or voucher) privatization, in which vouchers are issued to employees of the SOE or to the public at large, allowing them to obtain an interest in the privatized company, usually for free or at a very low price. Many economists believe that voucher privatization is less effective for promoting economic development than the other approaches.²¹ They point out that when ownership of companies is widely dispersed,

company management tends to be less efficient because no single shareholder or cohesive group of shareholders has sufficient power to hold management accountable. “Mass privatization policies ... establish the promise of [a large shareholding class], but ultimately depend upon capital markets to achieve the concentration of shares in the hands of strategic investors who can effect control.”²² However, “the markets that are required to permit trading among the millions of dispersed owners cannot form until motivated participants support the institution of markets. It is ... simply not in the interest of most of these participants to create transparent markets.”²³

Genuine privatization. Privatization should mean allowing SOEs to make a complete transition to private ownership, independent management, and competition in the market. The benefits of privatization are unlikely to materialize if the government plans (1) to retain a controlling interest in the privatized company, (2) to intervene in its affairs as if the company were still an SOE, or (3) to compel the company to perform essentially public functions. Therefore, if the government retains an equity interest in the privatized entity, it should be less than a controlling interest. Nor should the government in question hold “golden share” rights²⁴ that give it greater influence over company affairs than other shareholders.

Restructuring before privatization. Occasionally, State officials believe that if they can make the company more productive or more profitable before privatization, they will be able to obtain a higher price in an SIP or a trade sale. This normally consists in “pulling strings” before the enterprise is privatized in order to give it market advantages that it can enjoy once it has been privatized. This of course distorts market competition by tilting the playing field. Moreover, since the rationale of privatization is that governments are not the best business managers, once the decision has made to privatize an SOE, it generally does not make sense to try to suddenly rehabilitate the firm before it is privatized.

Case-by-case privatization versus across-the-board privatization. Privatization may be undertaken on a case-by-case basis, or it may be applied en masse to large groups of SOEs. Normally the case-by-case approach produces better results.

Openness to foreign ownership. Apart from legitimate constraints on foreign participation in the so-called “strategic sectors”, public sentiment, and the desire of local enterprises to avoid international competition, often weighs against allowing foreign firms to bid on companies in privatization. However, as Megginson and Netter have noted, “foreign ownership, where allowed, is associated with greater post-privatization performance improvement than is purely domestic ownership.”²⁵ Moreover, allowing foreign investors to purchase interests in a privatized entity may stimulate further foreign investment. A recent World Bank study has made the following observation:

*The exclusion of the foreign bidders raises substantial problems, especially in the case of mass privatization. When a post-socialist government is about to privatize a large part of the economy, there is insufficient wealth within the country to assure a high price for the assets. Therefore one has to resort either to dispersed ownership, even for small firms, or to non-cash privatization. The latter may result in inefficient insider ownership and/or low privatization revenues, leading to disappointment with reforms.*²⁶

Transparency in the privatization process. The privatization process should be free of conflicts of interest and should be conducted in the open, with adequate notice to the public of all major steps. Making the process transparent to all stakeholders may be more time-consuming than working behind closed doors, but the risks of corruption, cronyism, deterrence of foreign investors, and public backlash all increase with the opacity of privatization.

Post-privatization status. Privatized companies should be subject to the same laws, rules, and regulations as other companies. Any special privileges that a company enjoyed by virtue of being an SOE should no longer apply after it has been privatized. If the privatized company possesses a dominant position in the market, it should be subject to all of the normal competition law prohibitions on abuse of that position. Thus, a privatized entity that engages in cross-subsidization, predatory pricing, or harmful tying arrangements in the sales of goods and services should be subject to the same penalties as any other private enterprise. Governments should allow privatized entities to succeed or fail just like other businesses, and privatized companies should be subject to bankruptcy laws, including the possibility of involuntary reorganization or liquidation. The privatized entity should have the same freedom as other companies to hire and fire workers, deal with labour disputes, and reduce or eliminate lines of business. It should not be forced to operate at a loss in order to keep prices low, to carry out special transfers of technology, or to make further investments not required of other companies.

Recommendations

Taxation policy

- In reforming their taxation systems, governments should:
 - Generally strive to simplify the tax structure;
 - Ensure speedy refunds of VAT on exports; and
 - Offer online tax-filing.

Labour policy

- While protecting the basic rights of workers, governments should reduce unnecessary obstacles to the hiring and termination of employees when and as dictated by the necessities of business.
- Employers should have the right to hire contract, part-time, and temporary workers, and to engage workers voluntarily to work overtime in exchange for reasonable compensation.
- Governments should ensure that requirements imposed on employers for the payment of social taxes and for worker training are reasonable and not unduly burdensome.

Infrastructure policy

- Governments should seek to create modern infrastructures for transportation, communications, and the like. In doing so, they should consider whether public-private partnerships can achieve infrastructure policy goals. Once infrastructures are built, they must be maintained, and this requires long-term planning.

Human investment policy

- Governments should invest significantly in education and vocational and technical training in fields that will keep citizens and their countries competitive for the future.
- States should make efforts to ensure a large supply of workers who can speak the major languages of international business, including English.
- States should make efforts to educate the public on the basic economics of market economies, and should promote specialized education in entrepreneurship.

Regional trade policy

- Those countries that are not already members of the WTO should consider acceding to this body in order to benefit from the access that it provides to foreign markets.
- In general, countries should harmonize their commercial laws with those of major trading blocs such as the EU, so that investors can operate confidently within a system with which they are familiar.
- Non-EU countries should be attentive to the possibilities of entering into regional free trade agreements and investment compacts, as well as other mechanisms that can give them greater access to foreign markets.

Privatization policy

- In privatizing SOEs, governments should:
 - Transfer full, effective control of the privatized company to its private owners;
 - Not retain special “golden share” rights by which the government can block or direct certain decisions of the privatized company;
 - Generally refrain from major rehabilitation of the company before it is privatized;
 - Generally allow foreigners to bid for ownership of the company (except in “strategic sectors” such as the defence industry); and
 - Neither give preferences to nor impose onerous conditions on the owners of newly-privatized companies, but rather allow market forces and management skill to determine the success or failure of the company.

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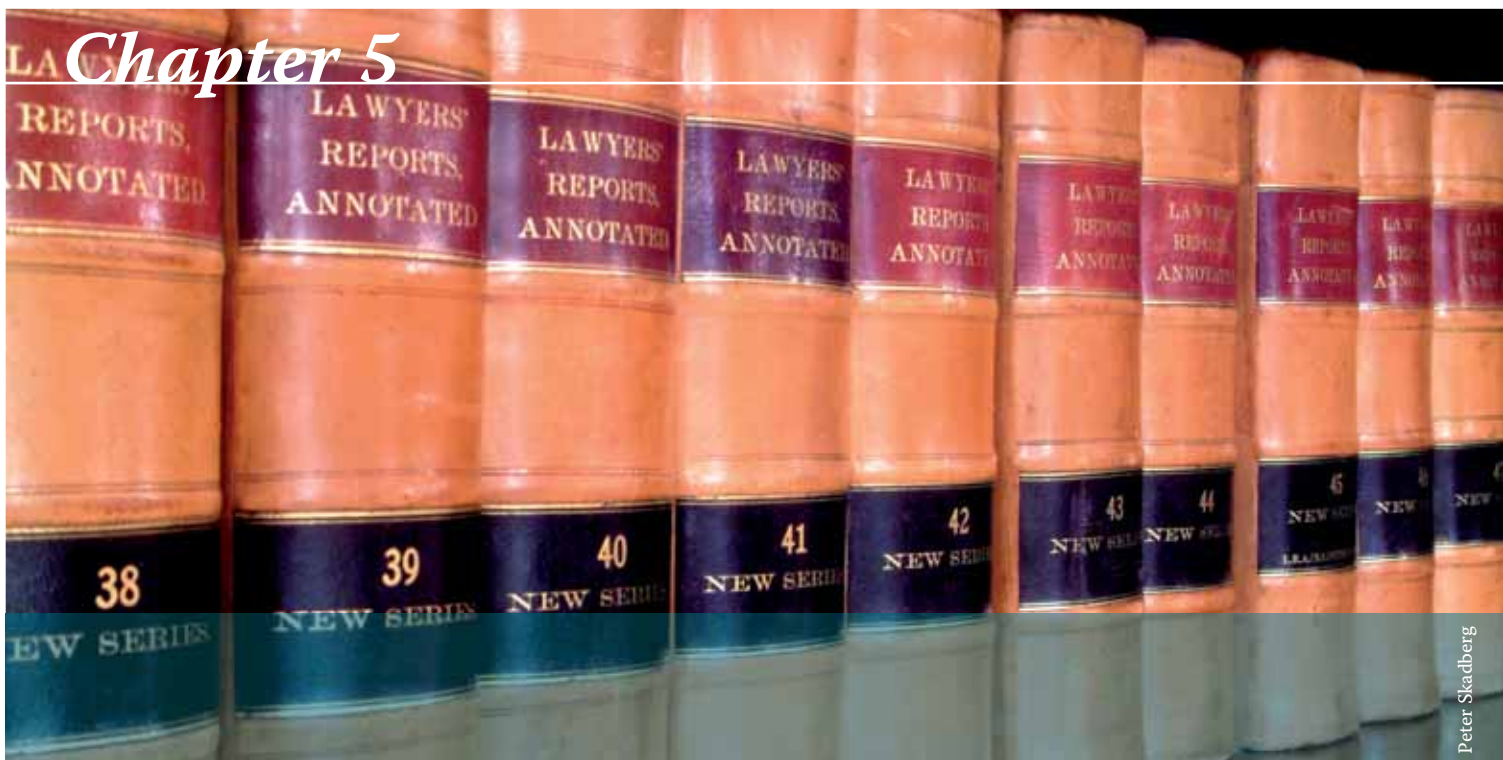
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- 11 The Declaration deals primarily with four topics: (1) freedom of association and the right to collective bargaining, (2) the elimination of forced and compulsory labour, (3) The abolition of child labour, and (4) the elimination of discrimination in the workplace. The text of the Declaration and further information regarding the principles it embodies can be found on the Internet: <<http://www.ilo.org/dyn/declaris/DECLARATIONWEB.INDEXPAGE>>
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Chapter 5



Peter Skadberg

The Importance of Law and Regulation to Economic Development

If countries are to reach their full economic potential, they need to have modern and efficient commercial legal systems to protect businesses' interests in land and personal property and to provide guarantees against arbitrary or uncompensated expropriation. Regulatory bureaucracies should be reduced. To encourage the development of land markets, authorities should make it clear which laws apply, and ensure that modern registration systems are in place, and that adequate resources are devoted to the development of land markets professions. Full freedom of contracts should be allowed between commercial entities, and contracts should be enforced in a timely, predictable, and cost-effective manner. To ensure access to finance for economic development, governments should promote good corporate governance and should adopt modern systems for dealing with secured transactions and bankruptcy, and for the supervision and regulation of capital markets and banks. To stimulate economic development, countries should enact modern legislation to protect intellectual property and to encourage the development of electronic commerce. Competition law regimes should be modernized, and government procurement should be made transparent and non-discriminatory. Foreign exchange controls and restrictions on repatriation of profits and capital should be lifted to attract foreign investment. Governments should also ensure the independence, training, and adequate funding of the judiciary, and should make arbitration and other forms of alternative dispute resolution widely available in commercial disputes.

As transition economies took the first steps toward market economics in the 1990s, any illusion they may have had that prosperity would arrive easily and automatically quickly vanished. They realized that restoring the institution of private property would not of itself lead to the creation of efficient markets. A new set of government, political, social, and cultural institutions would have to be constructed or rebuilt. Among the most important of the institutions in need of rehabilitation would be the national legal systems.

As noted previously, law is a fundamental ingredient in the development, maintenance, and expansion of healthy economies.¹ Its optimal role in this context is as a tool to enable private actors to use their economic freedom in ways that contribute to the common good.

Private property rights and freedoms

Modern market economies presuppose the existence of private property. The right to use, transfer, trade, and exclude others from the use of one's property is vital to a healthy economy and society. Property consists of immovable property (land) and personal property (property other than land). Personal property may be tangible (e.g., machinery, automobiles, inventory, etc.) or intangible (contract rights, shares of company stock, patents, copyrights, etc.). To stimulate economic development and foreign investment, countries must uphold and protect all of these types of property rights.

In order for a market to function effectively, property rights must be secure, i.e., protected against fraud, theft, and crime. Property must also be protected against uncompensated government seizure.² In addition, it must be verifiable. This means that the identity of the owner and the status of the ownership interest should be readily determinable through registries and objective legal rules. Property should be also transferable, and in order to permit secured lending, property-owners should have the ability to pledge their

property as collateral for credit, and to subject such collateral to the possibility of forfeiture in the case of default.

Protection against uncompensated expropriation

It is a basic right of State sovereignty that governments may take private property for public purposes in certain circumstances. In highway, canal, and airport construction, for example, governments must sometimes acquire privately held land from landowners who are not willing to sell their property at a reasonable price. In certain health emergencies, governments must have the power to quarantine and even destroy private farmers' livestock, when it could otherwise spread disease. Beyond these relatively uncontroversial examples, however, some governments have confiscated property for purposes that were not clearly in the public interest: for political reasons, in an arbitrary manner, with or without adequate compensation to the owner. Foreign investors have often proved a politically popular target of nationalization schemes when politicians have wanted to appeal to xenophobia or general populist sentiment. There have also been cases of governments carrying out heavy-handed confiscations of domestic businesses and even smallholder farms. Even when carried out only partially or gradually, such disregard of private property rights greatly undermines the stability necessary for a thriving market economy.³

Limiting the power to take private property. As a first step toward ensuring the security and stability of property rights, governments should by law expressly limit the purposes for which they may expropriate private property. The law should provide that former owners of expropriated property receive compensation from the State. While it would be impractical to attempt to specify every circumstance in which the State may take private property, the law should clearly state that only public uses can justify confiscation, and some attempt should be made to place boundaries on the concept of a public use.

Define the expropriation event that entitles an owner to compensation. Governments should also establish legal standards for determining when an expropriation has occurred, thus triggering the owner's right to compensation. Expropriation is not always a sudden event that formally extinguishes the owner's property rights. It may also be accomplished through confiscatory taxation, by unjustified state interference in the owner's exercise of rights of management, sale, etc., and by "creeping expropriation" – which occurs in a gradual or piecemeal manner. Although these government actions leave the owner's formal property rights intact, they nevertheless can destroy the economic value of property as thoroughly as a sudden, complete seizure of property. At the same time, a multitude of government actions can affect the value of private property, and it would be unreasonable to expect the government to pay compensation in all such circumstances. Thus the question is a subtle one – "at what point along the continuum of interference does a host government expropriate rather than exercise its police powers through implementing regulatory [or other] measures?"⁴ Countries can obtain guidance on distinguishing between indirect expropriation and normal regulatory actions from decisions of several arbitral and claims resolution tribunals.⁵

Defining the measure of compensation. The law should also provide a fair measure of compensation for the owner of expropriated property. A "fair market value" may not be literally appropriate in every situation: the type of property in question may not be the subject of enough trading to observe a pattern of actual sales prices. Nevertheless, there must be some effort to render the property owner an objective value for the confiscated property, rather than a merely nominal amount left to the discretion of the government.

Establishing an independent mechanism to review expropriation decisions. The government agency that expropriates private property should not have the last word on the legitimacy of the expropriation or the adequacy of the compensation. In a State governed by the rule of law, the government itself is also subject to the law, and its powers are limited. A court or other tribunal should have both technical jurisdiction and real power and independence to review and, if necessary, overturn agency decisions regarding

confiscation of property. Courts and other forums for dispute resolution are discussed in greater detail later in this chapter.

Regulation and erosion of property rights and business opportunities

As important as guarantees against arbitrary confiscation of property are to economic development, expropriation is not the only government action that can undermine private property rights. Excessive regulation, complicated licensing regimes, and labyrinthine permission requirements can be costly and time-consuming infringements of the rights of investors and entrepreneurs. While some degree of government regulation of economic activity is inevitable in a modern economy, the Center for International Private Enterprise was certainly justified in making the following observation in a special economic report in 2004: "Regulations that set excessively high barriers to property ownership and its use by its rightful owner tie down the wealth of the country ... Government-made barriers to the establishment of valid property rights trap assets in less than fully productive uses."⁶

Over-regulation contributes to an environment in which official corruption can thrive. A public official seeking a bribe can offer to "grease" the regulatory process by cutting through bureaucratic niceties in exchange for unlawful payments from regulated businesses. As the above-mentioned report also observed:

Bribe-seeking ... government officials regularly make it clear that paying them under the table is more advantageous than paying the full burden of official taxes or fines. While remaining in the shadow is costly, emerging into the official economy is even more so. The complicated documentation procedures for obtaining official licenses require businesses to run through a bureaucratic maze. The exorbitant costs expended in pursuit of legal requirements directly subtract from time spent on gainful and productive business activities.⁷

Thus, in addition to undermining confidence in the entire government and economic system of a country, this consequence of overregulation also creates disincentives for “shadow economy” (i.e., non-taxpaying) businesses to regularize their operations. The following are some of the fields in which over-regulation occurs in countries in the OSCE area.

General accumulation of overlapping, ill-considered, unclear, and inconsistent regulations. Regulatory mazes are not built in a day. Rather, they grow by accumulation. Regulations are often adopted on an ad hoc basis, without appropriate peer review, and without appropriate consideration for the burdens they will impose on business in real life, how the regulation will mesh with existing laws and regulations, and whether it is adequate to deal with different but related situations in the future. To avoid these common problems, the United Kingdom has adopted the Regulatory Impact Assessments (RIA) process, which subjects new regulations to a number of tests of efficiency, clarity, and rationality, including the Small Business Litmus Test to ensure that smaller enterprises will not be disproportionately affected. The Government of the Netherlands is considering addressing the issue of regulatory accumulation by introducing a “sunset principle” under which a law or regulation will exist only for a fixed period of time. At the end of that period, a specific case must be made to re-introduce it, rather than allowing the law or regulation to continue by default. This forces politicians to debate the value of legislation and enables regulated firms to make their case for amendments.

- *Restrictions on access to cash.* Some countries require all inter-firm transactions to be conducted by bank transfer. Cash withdrawals by corporations and other legal entities are sometimes permitted only for payment of wages and travel expenses. Some laws also require cash receipts to be deposited on the same day they are received. These restrictions can impose severe limits on the ability of enterprises – particularly small businesses – to conduct their daily affairs. To the fullest extent possible, these limitations should be lifted to allow unrestricted access to cash.

- *Customs documentation requirements.* An efficient customs system is essential to halting the illegal trafficking of prohibited and restricted goods. It also provides statistical information on international commerce, which is important for economic planning, and it encourages international trade. However, lengthy paperwork requirements can dramatically increase costs and cause delay in international shipping. Several OSCE governments – including Albania, Armenia, Bosnia and Herzegovina, Georgia, the FYR of Macedonia, Moldova, and Romania – have decreased the customs burden by making use of ASYCUDA (Automated System for Customs Data),⁸ a computerized customs management system covering most foreign trade procedures.
- *Lengthy registration and certification procedures.* These procedures can prolong the time required to start a new business, to obtain public utilities services, to close a real estate transaction, etc. Investors care about these delays because delay costs money and can cost them market position. By the same token, they recognize and are drawn to countries that make progress in eliminating unnecessary regulation.
 - a. The Republic of Serbia recently earned this recognition when the IFC ranked it as the world’s top regulatory reformer in 2004. The IFC based its ranking in part on new Serbian regulations that reduced the time to start a new business from 51 days to 15 days.
 - b. In 2005, the Ukrainian Parliament, the Verkhovna Rada, adopted a new law on the system of permits for business activities. The new legislation was enacted to streamline a maze of Ukrainian regulatory requirements involving approximately 1200 types of business permits regulated by 167 statutes, 150 regulations of the Cabinet of Ministers, and more than 1,500 regulatory norms issued by municipalities and State regulatory agencies. According to a speech given by the president of Ukraine upon introduction of the law, the new legislation would, in a single day, invalidate over 1,000 unnecessary regulatory requirements.

Methods of Regulatory Reform – The Guillotine Approach. In order to stimulate economic development, many countries need to cut through mazes of ambiguous, repetitive, and ineffective business regulations that have accumulated over the years. Traditionally, regulatory reform has followed a “bottom-up” approach: the reformers attempt to identify and eliminate “problem” regulations while leaving the remainder of the regulatory edifice intact. In this approach, existing regulations enjoy a presumption of necessity and reform usually takes place in a very slow, piecemeal, and often inadequate manner.

A relatively new method of regulatory reform takes a “top-down” approach known as the “guillotine”. Regulatory reform based on the guillotine identifies an area of regulation that will be analysed and reformed within a specified deadline – the “guillotine date”. The traditional presumption of the legitimacy of existing regulations is reversed: all regulations within the field are eliminated on the guillotine date unless they are demonstrated to be necessary, lawful and market-friendly within the time frame of the reform.

Guillotining regulations is normally done in several stages. First, the legislature must pass a law establishing the guillotine procedure. Then the government directs all public bodies to prepare an inventory of existing regulations. Each regulation must be justified in writing by a certain date, or it will be automatically repealed. Then each regulation goes through reviews by regulatory authorities, an independent review body, and groups of relevant stakeholders. In the course of these reviews, each regulation must pass three tests in which several questions are asked. These may include the following:

- *Legality* – Does the government agency have legal authority to issue the regulation under existing legislation? Is the regulation consistent with superior laws and regulations that would supersede it in the event of a conflict?
- *Necessity* – Is the regulation intended for the benefit of society as a whole, or was it adopted primarily to benefit a particular government authority or a favoured class of private interests? Does the problem that the regulation was designed to ad-

dress still exist? If so, is the regulation carefully tailored to achieve that end? Are the costs imposed as a result of the regulation justified by the benefits it delivers?

- *Market-friendliness* – Is the regulation clear and unambiguous? Does the regulation unnecessarily increase the cost of doing business?

Regulations that fail these tests are either eliminated or rewritten to comply with the guillotine criteria. Regulations that meet these criteria are added to a centralized list. When the guillotine date arrives, regulations not on the list are automatically repealed.

A number of countries – including Moldova, Mexico, Kenya, and Korea – have applied the guillotine approach to regulatory reform. Although the results vary depending on how the reform is implemented, the evidence compiled to date suggests that guillotining can be an effective means of reducing needless bureaucracy and achieving a more carefully considered regulatory system.

Immovable property

Access to land is indispensable for most businesses, and land markets are crucial to balanced economic development. In much of the OSCE area, private land ownership was all but non-existent only fifteen years ago. Some of the first post-Soviet era property reforms related to the privatization of immovable property. However, the early general legislation lacked the specificity necessary for effective implementation. As noted in a recent FIAS study, establishing the framework for land markets takes time and significant effort:

Land markets that allow access to land – and to buildings – through secure property rights, at transparent prices and with efficient permitting processes and land tax systems, are essential to a good business environment. Creating such markets, however, can be a long, complex, politically charged process, especially where most land is still dominated by the state, untitled and where there are conflicting claims.¹⁰

Economists identify three essential institutions in the development of healthy land markets: (1) a registration system that provides “accurate, inexpensive, and legal evidence as to who owns and holds other rights to land”, (2) a legal framework for immovable property, and (3) a profession devoted to dealing in land.¹¹ The experience of the Republic of Georgia in developing these institutions is described below. While progress has been imperfect, the Georgian example is illustrative for transition countries seeking to invigorate the real estate sector of their economies.

Legal framework. Since gaining its independence in 1991, the Republic of Georgia has enacted a series of laws to introduce private land ownership and develop a system of land markets. These laws consisted initially of statutes and decrees placing land ownership in private hands. However, rights and obligations with regard to immovable property were not sufficiently defined. These deficiencies have been addressed to a significant degree through amendments to the Civil Code. In 1997, the Civil Code was amended to introduce a comprehensive definition of immovable property as “a land plot with its subsoil minerals, plants growing on the land, and buildings and structures firmly attached to the land.” The current Civil Code prescribes the general means for acquiring ownership of immovable property (articles 183–85), and rights and obligations with regard to ownership of apartments within multi-apartment buildings (208–38), and elaborates rules applicable to servitudes, including leases, usufructs, rights to build, and rights of temporary usage free of charge. To clarify the law relating to fixtures to real estate – an essential development for the financing of construction – the Commentary to the Civil Code explains that a thing is “firmly attached to the land” if removing it from the land would require substantial efforts and expenses, or would cause unreasonable damage.

Title registration system. Until 1996, responsibility for land title registration in Georgia was divided between two agencies: the Technical Inventarization Bureau, which dealt with privatized buildings, structures and apartments, and the Land Cadastre Department, which registered titles to agricultural land. Because of inconsistencies and errors in the dual system, in 1996 the Law on Land Registration established a new body known as the Public Registry, under the authority of the State Department of Land Management and its territorial divisions, to merge the functions of the two registration agencies. All transactions relating to the creation, transfer, restriction, or termination of rights to land and other immovable property must now be recorded in the Public Registry. Transactions creating an interest in immovable property may be recorded in the Public Registry only if they are evidenced by a written instrument and notarized. Entries in the Public Registry are open for public inspection, and may be relied upon by third parties. Under article 312 of the Civil Code, registration entries are presumed to be complete and accurate until proved otherwise. It is possible to challenge the validity of such an entry by filing an administrative appeal with the Public Registry itself, or by bringing court action against the Public Registry.

The real estate profession. The Real Estate Association of Georgia was formed in 1999 in Tbilisi. With more than 100 members, it provides training and licensing functions for real estate brokers and agents.

The Georgian system of immovable property rights is a work in progress. However, its logic and relative simplicity are solid foundations on which vibrant land markets can be built.

Overcoming shortage of land for commercial and industrial use

Many of the Eastern European and Central Asian countries maintain laws and regulations that make it difficult to obtain land for commercial and industrial use. Without land, businesses cannot establish facilities. Companies that have made long-term investment commitments and are expending millions of euros on land usage, the construction of facilities, hiring workers and paying taxes expect to benefit from land ownership. Trying to impose outdated brownfields on companies is not an effective way of attracting investors or making enterprises competitive. Many companies have a “business model” of land ownership and will not consider locations where they cannot own the land. Foreign investors fear that they will be unable to obtain fair resolution in the case of a dispute with a local landowner.

Although most OSCE countries do allow foreigners to establish local companies that are able to purchase or obtain long-term leases for land, there are some in which foreigners are directly prohibited from owning land. The problem is compounded by the classification of all or most greenfield land as agricultural land. Conversion of agricultural land to commercial or industrial use is often a lengthy process involving tax payments, and sometimes requires an act of parliament. If economies are concerned to attract foreign investment and promote SME development, then they have to make land available to businesses and at affordable rates.

Traditionally, residential land is the most expensive land, followed by commercial, industrial, and then agricultural. Markets can be skewed in Eastern European countries. The shortage of land that is classified for commercial or industrial use has caused the price per square metre of industrial land to be similar to that of residential land. Land-developers in Ukraine report that greenfield industrial land can be three times more expensive than

in neighbouring countries such as Hungary and Poland because of the difficulties in making land available.

The following are best practices for economies with a shortage of land available for business use:

- As a minimum, foreign entities being legally authorized to lease land long-term, and optimally, to purchase and own land.
- The government in question seeking to privatize State-owned land, selling to developers where possible through tender, auction, sealed bid, or use of a commercial broker.
- The establishment of a modern law on land cadastre; USAID and the World Bank have provided relevant technical assistance, establishing a legal framework for land titling, regulation and monitoring, and development.
- The creation of a single, electronic land registry that captures all land titles.
- Excepting reasons of national security, environmental preservation, historic preservation or the like, the granting to local authorities of the right to zone land as residential, commercial, industrial, or agricultural, with a waiver of any taxes for converting agricultural land to industrial land.
- Governments encouraging local municipalities to develop land-use plans and zone land for industrial use in anticipation of potential projects, relieving investors of the obligation to convert land in the industrial zone.

More information on best practices and specific examples of land reform for industrial use can be obtained from: *Land Reform in Eastern Europe, Western CIS, Transcaucuses, Balkans, and EU Accession Countries* on the Food and Agriculture Organization website at www.fao.org

Contractual rights and freedoms

A recurring theme of the Guide is that economic development and foreign investment require freedom and stability in economic relationships. This need is particularly important in contractual relations. Investors and businesspeople generally want the freedom to set the boundaries of a transaction by negotiation and agreement, rather than having unwanted terms imposed by the State. They also desire the assurance that once an agreement has been concluded, it will be enforced as written, rather than being invalidated or re-written by a court in the event of a dispute.

The notion of “freedom of contract” – that contract parties may “freely consent to the restrictions of the legal opportunities they would otherwise have, in order to derive benefit from co-operation and exchange”¹² – is critically important to economic development.¹³ Of course, all countries impose some restrictions on freedom of contract.¹⁴ States have a legitimate interest in prohibiting agreements that violate important public policies. Indeed, some laws that limit freedom of contract in concrete ways – for example, by imposing maximum hours and anti-discrimination requirements in employment relationships, by outlawing fraud and usury in consumer transactions, or by prohibiting price-fixing among competitors – are compatible with strong economic development and may even enhance it. However, some policies can be detrimental to economic growth: ones that force foreign investors to enter into partnerships with domestic companies, for instance, or that allow States directly or indirectly to control the prices on which a firm may conclude its private contracts. And some restrictions can undermine the very foundations of solid economic growth: for instance, ones that unnecessarily limit private parties’ choices, or that seek to protect local interests at the expense of outsiders, or that allow courts to radically alter the parties’ bargain on the basis of very vague notions of fairness and equity. The following are a few examples of restrictions on freedom of contract.

- *Mandatory form requirements for certain contracts.* The laws of some countries require certain

commercial transactions to follow a certain form and to fix the rights and obligations of the parties in an unalterable manner. Although there may be occasions when this is appropriate, governments should be cautious about legislation imposing mandatory terms on private relationships. In general, commercial actors want to be free to decide for themselves what risks they are willing to assume. By prescribing the terms of commercial transactions, governments curb creativity in deal-making and may discourage a significant amount of business.

- *Restrictions on commercial transactions.* In a move characterized by the EBRD as “significantly limit[ing] the scope of permissible transactions of legal entities and individual entrepreneurs,” one East European country recently decreed that companies and individuals engaged in commercial activities cannot (subject to certain exceptions) enter into barter contracts and discharge mutual obligations for termination of contract by novation or compensation, but can only do so by paying money.¹⁶
- *Restrictions on agreements to arbitrate disputes.* As noted later in this chapter, the ability of parties to resolve commercial disputes in arbitration is an important element of modern commercial law systems. Nevertheless, many countries’ laws do not allow parties to commit themselves irrevocably to subjecting their disputes to arbitration. In these countries, a party is free to opt out of arbitration and instead sue in the courts, even if that party has unambiguously agreed to forego litigation in favour of arbitration. Such laws are “widely criticized as limiting the parties’ freedom of contract whilst failing to fulfil any useful function.”¹⁷

Forms of doing business

In the pre-industrial age, business was usually conducted by individuals acting separately or together in a partnership. Partnerships of this kind are still supremely important in contemporary commerce. However, doing business as an individual or a general partnership normally entails at least one potentially significant problem, namely that the individual or the

partners are exposed to unlimited liability: if the business is unsuccessful, its owners will be responsible for all of its debts, even if those debts exceed the amount the owner invested in the business. To encourage greater investment and risk-taking, governments long ago introduced the corporation (also known as the *société anonyme* or *Aktiengesellschaft*) – a juridical entity with an existence in law that is separate from its owners. In the absence of extraordinary circumstances, the most that those who invest in a corporation can lose is the amount of money they paid for their shares.

Because of the limited liability they afford, corporations have been and remain an extremely popular form of doing business. However, the complexity of modern commerce requires that today's investors have a range of options as to the form under which they will do business. As a result, many countries have introduced new types of business organization combining various attributes of corporations and partnerships. Among them are the French “société à responsabilité limitée” (SARL), the German “Gesellschaft mit beschränkter Haftung” (GmbH), and the American “limited liability company” (LLC). Some of these business organizations have become preferred forms for conducting international joint ventures.

In general, governments should make available a variety of business organizations from which investors may choose the one most suited to their circumstances. In addition to legally separate entities, these should include a variety of contractual forms of doing business, one being the franchise – a contract-based relationship between a franchisee (typically a small business) and a franchisor (normally a larger business), in which the former agrees to produce or distribute goods or services in accord with a “business system” developed by the franchisor. The franchisor provides the franchisee with continuing support and advice, trademark licences, research and development, and assistance with marketing and advertising. The franchisee normally pays the franchisor a fee for this relationship and may purchase supplies from the franchisor. By adopting modern business franchise legislation, OSCE countries can encourage greater inward investment, technology transfer, development of private quality control standards, and other benefits that are conducive to a healthy business environment.

Corporate governance

A system of effective corporate governance – i.e., the set of processes, customs, policies, laws, and institutions that affect the way in which business entities are directed, administered and controlled – is essential to encouraging investors to make equity investments in companies. The absence of adequate legal protection means that shareholders' interests in a company are vulnerable to misappropriation or dilution by company executives or other shareholders. Assets can be stripped away from the company, to the detriment of both shareholders and creditors. Company insiders can enter into less-than-arms-length transactions with the company or may trade shares on the strength of non-public information. Inaccurate or incomplete financial information can deter lenders from extending credit to companies.

The negative effects of these practices are not limited to the shareholders and creditors directly affected. On the contrary, they undermine confidence in the corporate system as a whole and thereby generally impair businesses' ability to raise capital and attract investment. In addition, lack of good corporate governance inhibits the secondary trading of securities, in which shares already issued may be resold, purchased, and resold again. This can have a disproportionately negative effect on transition countries which have privatized State-owned enterprises in mass privatizations and have placed shares in the hands of millions of citizens. Without strong secondary markets, “it is very difficult to undo through subsequent trading of ownership titles the damage caused by an initial privatization to ineffective owners.”¹⁸

On the other hand, governance procedures and practices that promote appropriate disclosure and transparency, effective protection of shareholders' and creditors' rights, and clear division of responsibilities among authorities can contribute to the creation and expansion of efficient, vigorous markets.

The OECD has developed a widely acclaimed set of principles to address these problems: the *Corporate Governance Principles*, also known as the OECD Principles.¹⁹ The OECD Principles lay the foundation for legal, institutional, and regulatory frameworks that

maximize investor confidence and potential for economic development. The OECD Principles are six in number and each one is further developed with more detailed recommendations. The subjects of the six OECD Principles are:

- The fair treatment of all shareholders (including foreign and minority);
- The clear division of authority among supervisory and regulatory authorities;
- Co-operation between the company and all its stakeholders in contributing to the common good;
- Transparency in, and disclosure to interested persons of, the finances and operations of the company;
- The prevention of insider dealing; and
- The effective exercise of management and supervisory roles by company executives and the board of directors, including their accountability to the shareholders.

In its involvement in the promotion of good governance across the OSCE area, the OSCE strongly supports the OECD Principles. With assistance from international organizations including the OSCE, several OSCE participating States have made significant progress in strengthening their legal frameworks for corporate governance. The following paragraphs identify some of the positive steps taken by those countries.

Protection of shareholders' rights. To protect existing shareholders against dilution of their interest in the company, the joint stock company law of Moldova²⁰ requires that all the shares be fully paid before they can be transferred. Other shareholder protections under Moldovan joint stock company law:

- Require that a register of shares be maintained by an independent organization and provide that registration of shares in such a register constitutes proof of share ownership;
- Require that dividends be approved at the shareholders' meeting;
- Provide that the company's audited annual report must be approved in the shareholders' meeting;

- Require that dividends be distributed among shareholders in proportion to their holdings in the company;
- Give existing shareholders pre-emption rights to subscribe for newly issued shares in proportion to their shareholding; and
- Allow a shareholder who votes against any of the following to sell his or her shares to the company at a price to be determined by an independent valuation:
 - amendment to the company charter;
 - issue of additional shares;
 - merger or reorganization;
 - winding up or voluntary liquidation; and/or
 - amendment of specific rights attached to a class of shares.

In 2005, Azerbaijan amended its joint stock company law to require approval in a general shareholder meeting of transactions which exceed 25 per cent of the company's net asset value.²¹

In April 2003, the Kyrgyz Republic enacted a new joint stock company law that is regarded as a substantial improvement in the company's corporate governance legal framework. Among other things, the new law strengthened the powers of the general shareholders' meeting, expanded minority shareholders' rights, clarifying the functions and powers of the board of directors, and introduced mandatory buy-out requirements.

Equitable treatment of shareholders. Most of the company laws of OSCE countries require that all shareholders of the same class of shares have the same voting rights. Generally, these laws also require that all prospective purchasers of shares have access to information about the voting rights attached to all classes of shares before they purchase.

Encouraging co-operation between company and stakeholders. The insolvency laws of most OSCE countries permit creditors to be involved in the decision-making process in insolvency proceedings. In addition, several countries encourage consultation between company management and employee representatives.

Transparency and disclosure. Under Armenia’s joint stock company law, companies must undergo an annual audit and must preserve and make available to shareholders the following documents:

- A Company state registration certificate, the Charter and amendments thereto, a decision on Company foundation, and the foundation agreement;
- Documents certifying the Company’s property rights over property in the balance sheet of the Company;
- Internal Company documents approved by the Meeting and other management bodies;
- By-laws of separated subdivisions and institutions of the Company;
- Annual reports of the Company;
- Company share emission prospectus;
- Accounting documents (balance sheet, profit and loss statement, auditor’s report, etc.);
- Financial and statistical reports submitted to public administration bodies;
- Minutes of sessions of Meetings, the Board, the Controls Commission, and the collegial executive body;
- Minutes of enumeration commission and voting ballots;
- Reports of the Company Controls Commission (the Controller), the Company auditor, and central and local government bodies implementing financial control;
- Lists of persons interconnected with the Company (specifying the number of shares owned by them) and significant and large shareholders; and
- Contracts the Company has entered into.

The Armenian joint stock company law also requires “open” companies – those whose shares can be transferred without restriction – to disclose publicly:

- The company’s annual report, balance sheet, and profit and loss statement;
- In the event of an open subscription for shares, the prospectus; and
- An announcement on holding an annual meeting.

Prohibitions on insider trading and abusive self-dealing. In order to prevent insider dealing of shares, Article 55 of the Republic of Serbia’s Law on the Mar-

ket of Securities and other Financial Instruments²² requires covered companies to disclose promptly company information which is likely to affect stock exchange prices. In addition, Articles 62–65 of the same law prohibit the unauthorized disclosure of or trading in securities while in possession of “privileged information”. These prohibitions apply to employees, officers, directors, attorneys, accountants, and a range of other individuals, as well as holders of more than ten per cent (10%) of the company’s voting shares, dependent companies, and a catch-all category of “persons who have knowledge of the privileged information, and know or could have known that they have acquired it from persons” who are subject to the restrictions of the law.

Accountability of officers and directors. Chapter IX of Armenia’s joint stock company law stipulates that, to avoid domination of the board by its executive officers, company managers must have less than half the seats on the company board.²³ Article 90(5) of the same law permits any group of shareholders holding 1 per cent or more of the company’s outstanding ordinary shares to sue the officers, directors, and/or manager(s) of the company for damage caused by the act or omission of these persons.

Personal property and secured transactions

As important as equity finance is to economic development, in market economies economic growth also requires ready access to credit. However, many economies are constrained by a chronic shortage of credit. This is due in large part to lenders’ legitimate fears of non-payment. Those fears can be alleviated by enforceable and efficient secured transactions.

In a secured debt transaction, the borrower transfers to its creditor property rights, which the creditor may use to satisfy the borrower’s debt. Mortgages on immovable property are a common form of debt security. However, personal property also has value, and enabling borrowers to use personal property, i.e., movable things and rights – to secure their debts opens up new ways to access credit markets and to make a fuller

economic use of their property. Making personal property available as collateral can make more credit available at a lower cost by reducing the risk to the creditor of non-payment. However, because the movable characteristics of personal property involve different considerations from those involved with immovable property, a separate system is normally required for security interests in personal property.

The EBRD has invested heavily in helping transition economies enact modern secured transactions laws. Its ten Core Principles for a Secured Transactions Law²⁴ lay a theoretical foundation, and its 1994 Model Law on Secured Transactions establishes a framework for implementation of those principles. The Model Law on Secured Transactions contains a number of notable features, including the following:

- A single security right (known as a “charge”) can be used for all types of personal and movable property used as collateral.
- A charge is more than merely a contractual right, but is a right of property in the collateral that gives its owner preference over unsecured creditors in insolvency proceedings.
- The Model Law deals only with business indebtedness.
- The Model Law strives to afford maximum flexibility to the parties to the charge, by keeping restrictions on what those parties may agree to a minimum.
- The parties have broad flexibility in how to define the credit to be secured and the property to be charged. Both present and future property can be used as security.
- Charges are recorded in a public registry that affords notice to the world of the creditor’s security interest.
- Charges can be enforced by self-help, i.e., the secured creditor has the right upon default to sell the collateral and retain the proceeds in satisfaction of the debt. However, any interested party may ask a court for protection and claim damages against the creditor for injury resulting from improper or abusive enforcement.
- When a charge extends to all assets of a business, an optional remedy available to the creditor is to sell the entire business as a going concern.

Bankruptcy legislation

In order to ensure the ready availability of credit for economic growth, a legal system must deal rationally with the situation in which a debtor not only defaults on a single repayment obligation but becomes generally unable to pay its creditors due to debts exceeding assets, and/or problems of cash flow and liquidity. This is the function of bankruptcy laws, which establish procedures by which creditors may be repaid in an orderly manner in accordance with the means which a bankrupt person or entity has available for payment. The bankruptcy process also gives the co-operative debtor a “fresh start” by discharging most of the debtor’s financial obligations. Bankruptcy proceedings may take the form either of liquidation (also known as “winding up”), in which the debtor’s assets are sold and the proceeds are distributed to creditors, or of reorganization, in which a court supervises the “reorganization” of the contractual and debt obligations of a troubled business or individual. A “reorganized” company can emerge from bankruptcy free from most of its prior debts. In the process, the former owners of the troubled company may lose control of it, and in some cases the creditors may become its owners. The rationale of reorganization is that the value of a business as a going concern is often greater than the liquidation value of its assets, which means that creditors may receive more money in a reorganization than a liquidation proceeding.

In a market economy, it is inevitable that businesses will sometimes fail. When this happens, lenders run the risk that their loans will not be repaid, and shareholders can lose the equity that they have invested in the company. For these reasons, investors plan their investments with an eye to minimizing the risks associated with financial failure. Workable bankruptcy systems provide investors a means of assessing that risk and therefore afford a basis for investment decisions that are at once more prudent and more confident. This promotes access to finance – both debt and equity capital – for all businesses. In addition, good insolvency laws promote “the restructuring of viable businesses, the efficient closure of failed businesses, and the transfer of their assets to more efficient market users.”²⁵ Insolvency laws also interact with, reinforce, and are reinforced by, the broader framework of commercial laws, including

those relating to corporate governance, securities trading, taxation, and banking.

Most if not all OSCE countries have enacted bankruptcy laws. However, many of these laws are overly simplistic and do not take into account the complexities of modern commercial transactions. The United Nations Commission on International Trade Law (UNCITRAL) has undertaken significant work in the field of insolvency law. Its 2004 Legislative Guide on Insolvency Law²⁶ surveys bankruptcy law comprehensively and contains 198 recommendations for national insolvency systems. In addition, the 1997 UNCITRAL Model Law on Cross-Border Insolvency²⁷ establishes procedures for difficult cases in which an insolvent debtor has assets in more than one State or in which some of the debtor's creditors are not from the State where the insolvency proceeding is taking place. An extensive study of the UNCITRAL model law conducted for the Government of New Zealand recommended its adoption, concluding that the law's "fair treatment of foreign creditors is likely to influence foreign investment favourably." Within the OSCE region, Poland, Romania, and the Former State Union Serbia and Montenegro have adopted the UNCITRAL model law.

Despite the existence of bankruptcy legislation, some countries have seldom if ever implemented and applied their bankruptcy laws. Reports from the region indicate that some governments have made political interventions in bankruptcy cases, preventing an independent, unbiased adjudication by the courts. However, with assistance from the World Bank, the EBRD, USAID, and other development organizations, some countries within the OSCE region have undertaken important bankruptcy reforms aimed not only at adopting modern legislation but also at improving the actual performance of their insolvency systems. An example from the Republic of Serbia is instructive.

In July 2004, the Serbian parliament adopted a new bankruptcy law²⁹ incorporating a number of provisions from the UNCITRAL model law. The Serbian law lays down procedures for both liquidations and reorganizations. Article 12 of the bankruptcy law establishes special bankruptcy judges, who, among other things, approve bankruptcy proceedings expenses before they are paid, supervise the bankruptcy adminis-

trators, and approve draft reorganization plans submitted by bankruptcy debtors. The law also contains special provisions regarding administrators (also translated in English as "receivers"), who are charged with preserving and administering the debtor's assets during bankruptcy proceedings. These provisions aim to ensure high standards of professional quality, legality, and accountability by requiring candidates for these important positions to possess a university education, to pass a written examination, and to be licensed and supervised by the specially created Agency for Licensing of Receivers in Bankruptcy ("the Agency"). Once licensed, Serbian bankruptcy administrators are bound by a special code of ethics, which emphasizes the administrator's obligations to avoid conflicts of interest, to refrain from self-dealing, and to act in an independent, professionally competent, and impartial manner.³⁰ In less than a year after the new bankruptcy law took effect, the Agency administered examinations and issued administrators' licences to more than 100 applicants.³¹

Capital markets

In addition to the above legal mechanisms aimed at providing stability and predictability of risk in equity investment and the extension of credit, legislation and regulation can contribute to economic growth by supporting the establishment and efficient functioning of capital markets. Capital markets are mechanisms that allow the trading of medium- to long-term financial assets such as corporate stock and public and private debt securities with maturities exceeding one year. Such markets provide liquidity for corporate shares, which is important to current and future economic development because "a greater ability to trade ownership of an economy's productive technologies facilitates efficient resource allocation, physical capital formation, and faster economic growth."³²

Investor protection plays a critical role in the effective functioning of a capital market. The legal and regulatory system should impose a number of requirements, including the following:³³

- The system should ensure timely disclosure to investors of all material information.

- Individuals and firms who are active in any aspect of the securities business (including issuers, underwriters, distributors, and money management and investment advisory firms) should be required to obtain authorization from the appropriate regulatory authority prior to performing these activities.
- Participants in the securities industry should be required to have adequate capital for the type of business activity in which they engage.
- Securities firms should be required to segregate their own accounts and those of their employees from accounts of their customers.
- To protect investors against brokers' negligence or malfeasance or a payments failure, there should be established guarantee funds or other security.
- Compensation for brokers should be based on a system of competitive commissions.
- Each participating institution should be required to have internal and external auditing and oversight mechanisms to monitor compliance with regulations.
- Investors should have access to a low-cost system – normally a form of arbitration – for bringing disputes against brokers, investment advisory firms, etc.
- The appropriate regulatory body should adopt an industry code of conduct mandating that brokers
 - understand their clients' financial needs and can give appropriate advice regarding the suitability of investments;
 - disclose to their clients potential conflicts of interest;
 - handle confidential information in an appropriate manner;
 - with discretionary trading authority invest their clients' capital on the basis of client needs, at the best possible price; and
 - give priority to client accounts over their own when trading their own accounts.
- Set information and prudential requirements for securities offerings or listings;
- Authorize, prohibit or suspend trading of publicly offered securities;
- Monitor issuers of securities to verify their compliance with information requirements;
- Establish rules to ensure transparency and legitimacy in securities trading;
- Set eligibility and membership requirements for the industry;
- Set financial record-keeping standards for the industry;
- Discipline their members; and
- Establish industry practices for the processing of instruments, the clearing and settlement of transactions, and the administration of guarantee and compensation funds.

Banking law and policy

Appropriate supervision and regulation of banks is essential to preventing financial malfeasance and mismanagement. It also is necessary for instilling public confidence in banks. Indeed, one of the respondents to the questionnaires distributed in the course of preparing the Guide considered that there was an “urgent need for enhancing [the] financial sector” as a stimulus to further economic development in Central Asia. The same respondent explained that his country’s “underdeveloped banking system” was the result of inadequate mechanisms for the posting of collateral, of “poor enforcement of property rights (such as real estate/land property)”, and of “difficulty for foreign banks to enter” the domestic market.

In September 1997, the Basle Committee on Banking Supervision, a committee of banking supervisory authorities established by the central bank governors of the Group of Ten countries in 1975, promulgated the Core Principles for Effective Banking Supervision.³⁴ Among other things, the Core Principles deal with the banking industry’s supervisory authority and legislative framework, identify permitted activities of banks, specify licensing procedures, and prescribe prudential regulations and requirements such as minimum capital adequacy requirements, risk management and

Modern best practices in the regulation of capital markets also consider “self-regulatory organizations” (SROs) of market participants as essential partners with governments in regulating financial markets. Governments often delegate to SROs the authority to:

internal controls (on practices such as insider lending and single-borrower lending), and prevention of fraud and money-laundering.³⁵ The Core Principles represent an international consensus on best practices in banking supervision.

The following provisions of the banking law of the Republic of Cyprus³⁶ were identified in a recent international legal analysis³⁷ as exemplifying good implementation of the Core Principles:

- *Clarity in assigning overall responsibility for banking supervision.* Article 26(1) of the Cypriot law provides that the “Central Bank is responsible for the supervision of banks in order to ensure the orderly functioning of the banking system.”
- *Enforcement powers of the Central Bank.* Article 30 provides that if a Cypriot bank fails to comply with an applicable provision of the banking law or a regulation adopted under it, or if the Central Bank believes that the liquidity and character of the bank’s assets have been impaired or there is a risk that the bank’s ability to meet its obligations promptly may be impaired, the Central Bank may take a number of specific actions, including:
 - prohibiting the bank to accept deposits or grant credit facilities;
 - taking control of the bank; and
 - revoking the bank’s licence.
- *Capital adequacy ratios.* Article 21(1) states that the “Central Bank may ... require banks ... to maintain a capital adequacy ratio at such minimum level as may be determined by the Central Bank ... for each bank individually having regard to its circumstances provided that such ratio shall be uniform for all banks within the same class.” Article 41(2) stipulates that in exercising this and other powers, the Central Bank shall be guided by relevant “international practice.”

- *Insider lending.* Article 11(1)(c) and (e) stipulate that in making loans, Cypriot banks may not:
 - grant credit facilities to “any director ... unless the transaction was approved by a resolution of the Board of Directors carried by a majority of two-thirds of the total number of directors ... and the director concerned was not present during the discussion of this subject by the Board and did not vote on the resolution”; or
 - “permit the total value of any unsecured credit facilities ... granted to all its directors together to exceed at any time five per centum of its capital base, or such other lower percentage [established by] the Central Bank.”
- *Provision of information to Central Bank.* Articles 24 and 25 of the Cypriot law establish detailed requirements for the periodic submission by banks of financial statements and other relevant information to the Central Bank, with annual statements to be certified by an approved auditor.

Adoption of the Core Principles, together with a strong commitment of will and resources to professional development in the banking sector, will help countries with economies in transition to create an environment conducive to economic development.

Repatriation of profits and capital

Some countries limit companies’ ability to repatriate capital or remit profits and dividends. These policies deter foreign investment and encourage inefficient and non-transparent practices such as transfer pricing. To encourage FDI, countries should guarantee the ability to repatriate capital and remit profits. Many OSCE countries have now lifted restrictions on income repatriation.

TEXTBOX 5.2

Liberal income and capital repatriation policies in selected OSCE countries

Azerbaijan - *Under the Foreign Investment Laws, foreign investors are entitled to repatriate profits in convertible currency after the payment of any taxes and other fees that are due.*

Business Guide to Azerbaijan (Ernst & Young 2005).

Kazakhstan - *In 1996, Kazakhstan adopted Article 8 of the IMF Articles of Agreement, which stipulates that current account transactions, such as currency conversions or the repatriation of investment profits will not be restricted.*

Doing Business In Kazakhstan: A Country Commercial Guide for U.S. Companies
(U.S. & Foreign Commercial Service and U.S. Department of State 2004).

Russia – *The Law on Foreign Investments ... authorize[s] repatriation of profits and capital.*

Robert Satrom & Dmitry Zhdanov,
Foreign Investment in Russia: Reform and Re-Regulation,
American Chamber of Commerce in Russia (Jan. 10, 2006).

Ukraine - *Foreign investors are guaranteed unhindered and immediate rights to repatriate their profits abroad after complying with the withholding tax regulations.*

Source: Investment in Ukraine (KPMG 2005).

Foreign exchange controls

Restrictions on the use of foreign exchange affect both exporters and importers. These controls typically require those who earn foreign exchange to register their transactions with the central bank, and to surrender part or all of their foreign earnings to the central bank in exchange for local currency. Only authorized dealers and authorized depositories may retain foreign currency in their possession without the consent of the central bank.

Foreign exchange controls usually allocate such foreign earnings for approved imports and other high-priority transactions. The demand for foreign exchange at the official exchange rate usually exceeds the amount surrendered to the central bank. Therefore, foreign exchange provided at the official rate must be rationed in order to prioritize imports of particular commodities (such as basic necessities and inputs for certain industries).

A respected economic study explains how strict foreign exchange controls can undermine economic development, particularly in smaller economies:

Foreign exchange controls effectively place a quota on imports, thus raising their domestic relative price in the same manner as a tariff would. While the adoption of foreign exchange controls may improve the trade balance and the balance of payments (or exchange rate), these controls tend to reduce welfare for a distortion-free small open economy. Imposing foreign exchange controls, in a sense, transforms the imported goods market into a non-traded goods market, and ... this results in terms of trade shocks being transmitted negatively to the domestic economy.³⁸

From the perspective of foreign investors, strict foreign exchange controls diminish a country's attractiveness as a destination for investment. In addition,

domestic companies may respond to foreign exchange controls by minimizing their use of foreign capital and relying more heavily on domestic sources of financing. All of these factors suggest the advisability of lifting strict currency controls as soon as reasonably possible.

Competition law and policy

Economies in transition from central economic planning to competition-based systems have faced formidable challenges. They have had to profoundly re-orient their entire economic structure and mode of thinking. At the same time, many of them also became independent republics, a dramatic change which altered conceptions of relevant markets. Despite laudable efforts to introduce new institutions to support competition as the new economic paradigm, many of these countries still must deal – at all levels of government and throughout society – with a deeply-ingrained culture that expects heavy government intervention in economic matters.

OSCE countries that are EU member states or candidates for EU accession have either completed or are in the process of harmonizing national policies on competition with those established in Brussels. The EU system, based largely on German competition law, is mandatory for all EU member states. It aims at open markets and punishes abuses of economic power by strong State action. The State is generally assumed to be non-interventionist and non-discretionary. The North American competition law systems are similar to, although not identical with, those of the EU regime.

Whether or not a country aspires to EU accession, the recommendations contained in the Guide are broadly consistent with EU and North American competition policies. Market-based economies are generally founded on the premise that competition results in an efficient allocation of resources and benefits consumers by producing an optimal mix of quality, goods and services at the lowest prices.³⁹ The detailed aims of competition policy – maximizing consumer welfare or social welfare, promotion of economic development, and so on – vary according to the political values of a given country or regional economic grouping.⁴⁰ However, there is widespread consensus that competition

law can serve as a legal framework to ensure that effective market forces operate in the economy.

Countries with economies in transition should define clear policies on competition. Because a culture of competition cannot be constructed entirely of laws, regulations, and policies, these countries should conduct educational campaigns to explain the new economic policies to the public so that they can thrive in the new environment.

General competition policy should clearly forbid so-called “hard-core cartel activity” among competitors, such as price-fixing, market segmentation, customer-division and bid-rigging, since there is little to no economic justification for such practices in ordinary circumstances.

The effects of “vertical restraints on competition” – i.e., contracts and business arrangements between a business at a higher level of the industry chain and a business at a lower level – are harder to categorize as unequivocally negative or positive. These include such practices as resale price maintenance.⁴² While vertical restraints can have the effect of excluding competitors and building barriers, they can also increase distribution efficiency by mitigating such distribution problems as general free-riding and opportunistic activity, and they may even have pro-competitive effects. For these reasons, most countries do not automatically condemn vertical restraints other than resale price maintenance, but rather consider a number of factors – sometimes weighing the pro-competitive effects of a practice against its negative effects – before judging the practice lawful or unlawful.

Although mergers and acquisitions can produce and enhance efficiency, they can also be a means for securing monopoly power. Most competition laws, therefore, regulate these transactions and can potentially be used to invalidate them or prevent them from occurring. Regulations in this field typically address methods for defining related markets and for assessing monopoly, and the conditions under which mergers and acquisitions that exceed certain aggregate values or market share thresholds must be notified to the competition authority before being consummated.⁴³

Enactment and reform of competition laws should be conducted in consultation with the business community and consumer protection advocates, who will have to live by the rules being established.

National competition policy-makers should strive to ensure that their policies do not become overly formulaic or mechanical, and that both the policy and the law are grounded in economic realities.

Competition policy alone is not enough; it must be implemented through appropriate laws and regulations. In order to preserve competitive economies, many governments have enacted laws to prohibit abuses by monopolists, to curb collusive practices among firms that should be competitors, and to prevent undue concentrations of market power that could result from mergers and acquisitions. They reflect the reality that while self-interested behaviour on the part of competitors may ultimately produce results consistent with the public interest, what any particular market participant desires may not be in the best interests of consumers.

Modern competition laws normally contain the following components: (1) general regulations, (2) a prohibition against collusion and collusive behaviour between erstwhile competitors, such as price-fixing, bid-rigging, and the like, (3) a ban on abuses of monopoly power or of a dominant position in a relevant market, (4) provisions dealing with enterprises with special and exclusive rights or natural monopolies,⁴⁴ (5) State aid, (6) merger control, (7) unfair competition, (8) rules governing the conduct of government competition authorities, (9) consequences (fines, penalties, imprisonment, and/or civil liability) in cases of violations of the competition law, and (10) a more detailed set of regulations dealing with exemptions, procedures, and other complicated matters.

Countries considering amending or adopting competition laws have many options from which to choose. Several international organizations have formulated model competition laws to serve as templates for developing and transition countries. For example, the World Bank and the OECD published a model competition law in 1999. The Commonwealth Secretariat published a model competition law in 2002. UNCTAD

issued its most recent law in 2003. As a practical matter, the European Union's competition law – reflected in Articles 81 and 82 of the EEC Treaty as well as numerous regulations, directives, and court decisions – has a broad impact throughout the region as candidates for accession have to conform their laws to the EU model. Countries that are not near-term EU accession candidates should nevertheless bring their competition law into conformity with international practice.

Moreover, the competition law authorities should give adequate attention to the methodology, political boundaries, data, and other features that go into defining a relevant market when determining whether a party has a dominant position or whether certain actions are likely to have a substantial economic effect. This can be particularly difficult for countries that were once constituent parts of a larger nation and have recently gained independence. Territorial boundaries will have changed, and there may be significant legal, political, cultural, and linguistic conditions that could affect the definition of a relevant market.

Intellectual property and electronic commerce legislation

Intellectual property rights – which give authors, inventors, and other creators of useful or expressive works the right to prevent others from using their creations – are a staple of modern economic life. Such laws, however, remain controversial in many countries. Introducing and rigorously enforcing effective intellectual property laws comes at a price. Countries with weak patent laws and generic drug companies have been able to enjoy at a lower cost the benefits of innovation carried out in countries where strong patent protection permits pharmaceutical companies to recoup their investments in research and development. Changing such a situation can be politically unpopular and difficult.

Not enforcing intellectual property laws, however, also has its own cost. Ineffectual intellectual property protection is increasingly a source of trade disputes

between highly developed countries and developing or transition countries. Countries with weak intellectual property laws also lose revenues in the form of customs fees and taxes paid by registered owners of intellectual property. Moreover, a growing body of research suggests that adequate protection of intellectual property, combined with market liberalization and pro-competition policies, is a critical element in national strategies to promote foreign investment and economic development.⁴⁵ Conversely, some economists have found that weakness in a country's intellectual property laws leads companies to invest in other countries where intellectual property protection is stronger, and to limit or withhold the introduction of new technologies in countries where less protection is available.⁴⁶

Adequate intellectual property protection is also a prerequisite to joining the WTO, which requires its members to adhere to the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS Agreement).⁴⁷ The TRIPS Agreement establishes substantive, minimum levels of protection in the fields of patents, trademarks, copyrights, geographical designations, layouts of integrated circuits, trade secrets, anti-competitive practices in licensing, and enforcement.⁴⁸

Attaining balance. In setting up their intellectual property policy, countries must balance the need to reward innovators with the need of the public to freely access useful information. Patents, copyrights, plant breeders' rights, and related intellectual property rights (IPRs) are founded on the belief that granting people the exclusive right to economic exploitation of their creations for a limited time will stimulate a high degree of innovation and creativity. There is substantial economic evidence to support this belief. However, a robust public domain – the body of knowledge and expressions that are owned by no one and can be used by anyone without charge – is equally important to a nation's social, cultural, and economic well-being. Indeed, the ability to draw upon an unrestricted store of knowledge is itself a prerequisite to innovation. Overly restrictive, unbalanced IPRs can thus actually inhibit some innovation.⁴⁹

This balance is normally built directly into the IPR legislation. For example, in return for the exclusive rights granted by a patent, an inventor must publicly

disclose how to make and use the invention. Once the patent has expired (normally 20 years after the filing of the patent application), the invention may be used by anyone without charge, and all of the information disclosed becomes part of the public domain. As countries update their IPR legislation, they should bear in mind the need to maintain effective protection without sacrificing a vigorous public domain.

Non-discrimination. The TRIPS Agreement, the Paris Convention on Protection of Industrial Property, the Berne Convention for the Protection of Artistic and Literary Works, and other major intellectual property treaties generally require member countries to treat intellectual property owners from other member States no less favourably than they treat their own citizens. This is a sound principle that should reflect the reality of intellectual property enforcement. As a practical matter, however, all countries must guard against prejudice toward foreigners in the enforcement of IPRs. Not to do so is to send a damaging signal to foreign investors and can create a bad reputation that may be difficult to overcome.

Use as collateral. Like any other asset, IPRs have economic value that can be objectively measured. Indeed, many of today's companies' greatest assets are their intellectual creations. Nevertheless, secured lending systems often do not clearly provide for the pledge of IPRs as collateral for loans. This creates uncertainty in lending transactions and potentially deprives knowledge-based enterprises of credit or unnecessarily increases their costs. Accordingly, legislation should unambiguously provide for IPR owners to be able to use their intellectual property as collateral.

Relationship to competition law. The relationship between intellectual property laws and competition laws is often unclear. Courts need guidance to distinguish legitimate uses of IPRs from abuses of these extraordinary rights. Countries in the process of updating intellectual property laws can look to the EU's Technology Transfer Block Exemption Regulation⁵⁰ and accompanying Technology Transfer Guidelines,⁵¹ and the US Department of Justice and Federal Trade Commission Antitrust Guidelines for the Licensing of Intellectual Property.⁵²

Enforcement issues. To comply with their obligations under the TRIPS Agreement, many WTO member states have enacted legislation that technically complies with TRIPS standards. However, some of those countries' records on the actual enforcement and protection of IPRs have been dismal. This may be due to a number of factors, including: (1) a lingering lack of understanding that IPRs are a items of property and that their unauthorized use is a form of theft, (2) inadequate training in intellectual property issues on the part of judges, prosecutors, and other relevant officials, (3) inadequate legal remedies in the national law for infringement, and (4) a low level of general effectiveness in the national court system. Steps countries can take to improve enforcement include: (1) educational campaigns to raise public awareness of the economic value of IPRs and the seriousness of their misappropriation, (2) specialized training for court and law enforcement officials, (3) the creation of specialized courts and/or administrative procedures to deal with IPR issues, (4) consistent with article 50 of the TRIPS Agreement, making available provisional remedies, including temporary restraining orders and injunctions, to bring infringements to a prompt end, and (5) the general improvement of the national court system.

The scope of patent law. A patent is a right granted by a government to the owner of an invention to prevent others from making, using, importing, or selling the invention for a limited number of years. The TRIPS Agreement requires that patent protection be generally available for any inventions, whether products or processes, in all fields of technology, so long as the invention is new, has involved an inventive step and is capable of industrial application.⁵³ This broad definition of what can be patented (often called "patentable subject matter") is a relatively new development that has been politically controversial. However, the TRIPS Agreement identifies certain categories of inventions that can be excluded from the scope of patents. Among these is a general category for inventions that are contrary to public order or morality.

Most patent laws do not identify specific types of inventions that violate the public order or morality norm. This ambiguity creates significant uncertainty regarding biotechnology inventions. To the extent possible, legislation should avoid such ambiguities in

order to make the conduct of business more predictable. A good example of legislation that defines the scope of the public order or morality exception to patentability is Art. 93(3) of the Polish Industrial Property Law. It provides that the following "shall be considered as biotechnological inventions whose exploitation would be contrary to public order or morality":

*(1) processes for cloning human beings, (2) processes for modifying the germ line genetic identity of human beings, (3) uses of human embryos for industrial or commercial purposes, and (4) processes for modifying the genetic identity of animals which are likely to cause them suffering without any substantial medical benefit to man or animal, and also animals resulting from such processes.*⁵⁴

Patent quality. As the global economic importance of technology increases, national patent offices each year experience correspondingly large increases in the number of patent filings. The increased workload can have a negative impact on patent quality. Patent applications must be reviewed by patent examiners to determine whether the invention for which protection is being sought is new and represents an inventive step in the light of the "state of the art" – i.e., that it would not have been obvious to a technician familiar with what already existed at the time the application was filed. The patent examination process requires that examiners be trained in certain technical fields, and that they compare the claimed invention with scientific, technical, and other literature. Because of scarce resources and growing backlogs of patent applications, examiners do not always have the ability to conduct a thorough and proper examination. As a result, "inventors" are sometimes awarded patents on "inventions" which are either not novel at all or which re-present only a trivial change from what was already public knowledge. This can become a serious problem because it can allow someone to "privatize" part of the public domain or, more often, to cloud the status of certain areas of knowledge and innovation. This kind of uncertainty can serve as a disincentive to innovation, which is precisely the opposite result to that intended by patent laws. For these reasons, governments should place a high priority on quality

patent examination and should devote adequate resources to the patent examination process and to hiring, training, retaining, and rewarding examiners who have the requisite credentials.

Utility models. A utility model registration is an exclusive right granted in some countries for minor inventions or improvements on existing technologies.⁵⁵ Utility model protection generally requires less inventive content than patent protection, and the duration of protection of a utility model is often significantly shorter than that of a patent. It is often used to protect tools and implements that are useful and practical but do not represent a technical step forward in the art.

The TRIPS Agreement does not require WTO member States to enact utility model laws. However, in recent years many developing and transition countries have adopted utility model systems. Research into the economic effects of utility model protection has led some experts to believe that this weak form of IPR protection encourages local acquisition of technical knowledge and “local absorption of foreign innovations.”⁵⁶ A 1980s study of the agricultural implements industry in Brazil indicated that small firms in the industry concentrated on making minor improvements to farm tools and used the utility model system to penetrate niche markets and compete effectively with larger firms.⁵⁷ Countries that do not already have utility model systems should investigate whether adopting one would be appropriate for their national circumstances.

Trade secrets. TRIPS Article 39.2 requires WTO member States to provide protection to trade secrets, i.e., undisclosed information which is not generally known among persons knowledgeable in the field, which has commercial value because it is secret, and which the person who controls the information takes reasonable steps to maintain as secret. Protection of trade secrets is fundamental not only to the existence and prosperity of high technology businesses but to any enterprise that has competitors.

Copyright. Copyright grants the authors of original works of authorship – including literary, artistic, and scientific works such as books, plays, music, articles, films, architectural drawings and computer pro-

grammes⁵⁸ – the right to prevent others from copying, publicly performing, broadcasting, displaying or commercially exploiting the work in another manner.⁵⁹ Because of its application to software and other digital media, copyright has a disproportionate importance to Internet-based commerce.

Commerce on the Internet often will involve the sale and licensing of intellectual property. To promote this commerce, sellers must know that their intellectual property will not be stolen and buyers must know that they are obtaining authentic products. To realize the potential of e-commerce for the distribution of all sorts of information products, from entertainment to education, from business software to databases for scientific research, providers must be confident that their products are safe from piracy. Although most of those products are subject to copyright law, the same advances in technology that make global e-commerce a reality also make it simple and inexpensive for infringers to create and distribute perfect copies of all kinds of work protected by intellectual property rights. This presents a challenge to the very existence of software manufacturers and information technology companies.

The WIPO Copyright Treaty (WCT) and the WIPO Performers and Phonograms Treaty (WPPT), both agreed in 1996, contain provisions intended to address the “digital dilemma,” including articles relating to technological protection, copyright management information, and the right of communication to the public. In particular, Article 11 of the WCT provides in part that contracting states “shall provide adequate legal protection and effective legal remedies against the circumvention of effective technological measures that are used by authors in connection with the exercise of their rights under this Treaty or the Berne Convention and that restrict acts, in respect of their works, which are not authorized by the authors concerned or permitted by law.”⁶⁰ Although the manner in which the anti-circumvention provision has been implemented in some countries has been controversial, the WCT article itself leaves member States substantial room for creativity to achieve the article’s purpose. Whether or not they join the Internet-related copyright treaties, transition countries should introduce some special protections for copyright material in the digital environment.

Countries where copyright piracy abounds should take note of recent efforts undertaken in Ukraine to improve its international standing and pave the way for full participation in the modern information economy. In an effort to rectify inadequate IPR enforcement, the Ukrainian parliament passed legislation in July 2005 which strengthened the country's enforcement authority to stop the illegal production and distribution of pirated CDs and DVDs. Since then, Ukrainian law enforcement officials have conducted multiple inspections of factories licensed to manufacture optical discs and have raided businesses involved in commercial distribution of copyright-infringing products. A number of infringers in Ukraine have been required to pay significant fines for violating copyright laws. Because of these efforts, in January 2006, the United States reinstated its generalized system of preferences benefits for Ukraine and lowered Ukraine's "Special 301" status from "Priority Foreign Country" to a less severe designation on the U.S. Priority Watch List.⁶¹

Trademarks. A trademark is a word, brand name, symbol or device that is used to identify the goods or services⁶² of an enterprise and distinguish them from the goods and services of another. Unlike patents, copyrights, and utility models, the purpose of trademark rights is not primarily to stimulate invention, discovery, or creation. Rather, trademark law is intended to protect the public from confusion regarding the commercial sources of goods or services and to protect business from diversion of trade through misrepresentation or appropriation by one business of another's goodwill. Product-counterfeiting through the use of misleading marks is a form of consumer fraud. It deprives governments of taxes on transactions and can – in the case of items intended for human consumption and safety applications such as food, medicines, and the like – endanger the health and safety of consumers.

Trademark infringement also has obvious negative consequences for legitimate businesses. Companies invest considerable time, effort and money in building

up the loyalty of their customers. Trademarks are a key element in this strategy because they allow customers to identify companies that deserve repeat business. A firm's business reputation and goodwill in the market become linked to the marks it uses to sell its products. Therefore, when an enterprise improperly uses a competitor's trademark or adopts a mark which is confusingly similar, trademark law provides a remedy.

- *Collective marks.* A collective mark is a special trademark or service mark registered for the exclusive use of members of a co-operative, an association, a union or other collective group or organization.⁶⁴ When a collective mark is applied to a product or service, the use of the mark is reserved for use only by its members, who use the mark to identify their goods or services and distinguish them from those of non-members.⁶⁵ Collective marks can increase the market visibility of, and capitalize on goodwill toward, groups of small businesses and even individual proprietorships. Countries should consider promoting the use of collective marks in order to strengthen SMEs.
- *Certification marks.* Certification marks are an integral part of product certification schemes that are designed to verify that products conform to certain requirements, such as (1) originating from a specific geographical region; (2) having been produced in an environmentally sustainable manner; (3) having been produced and marketed in accordance with fair trade standards;⁶⁶ or (4) having been organically produced. Ordinarily, an association or trade organization owns the certification mark and licenses the right to use the mark only to producers who can prove that the goods meet certain quality standards and/or are produced in a specific region. Certification marks enable consumers to place their trust in the quality, geographic origin or other characteristics of goods produced by multiple producers.⁶⁷ By introducing a system of certification marks that can be used by private associations, countries can stimulate creativity in marketing and private development of quality standards, both of which can result in greater revenues for local businesses.

Internet domain names protection. A domain name is “a human-friendly form of an Internet address that is both easy to identify and to remember”⁶⁸ such as “delta.com” or “pioneer.com”. Because of the explosive worldwide growth of electronic commerce, domain names have become critically important business-identifiers for legitimate enterprises. Companies with well-known word marks often register domain names incorporating their mark into the address. However, some Internet vendors have incorporated competitors’ or famous companies’ trademarks into their own domain names in an effort to appropriate some of the other company’s goodwill. National legal systems should protect consumers and legitimate trademark-owners from misappropriation or hijacking by “cybersquatters”, who register domain names containing a famous mark in the hope of reselling the domain name to the legitimate owner of the mark.

Industrial designs. Articles 25–26 of the TRIPS Agreement require WTO members to adopt legislation protecting new and original industrial designs for at least ten years. This type of protection applies only to non-functional elements of the design of industrial objects. Developing and transition countries should not overlook the protection of industrial designs as a means of ensuring that their artisans and designers contribute their full potential to GDP.

General legislation to support development of e-commerce. Specially enacted “e-legislation” can encourage expansion of the use of digital transactions by establishing a legal framework to enable government, companies, and individuals to confidently offer and purchase goods and services over the Internet or electronically. On 23 November 2005, the UN General Assembly adopted the United Nations Convention on the Use of Electronic Communications in International Contracts.⁶⁹ This convention seeks to increase certainty and predictability in the use of electronic communications in connection with international contracts. It deals with the determination of a party’s location in an electronic transaction; the time and place of dispatch and receipt; the use of automated message systems for the formation of contracts; and the establishing of functional equivalence between electronic communications and “hard copy” documents. The convention also establishes means for the electronic authentication of documents.

The European Union has promulgated a number of directives designed to facilitate electronic commerce, including a general electronic commerce directive⁷⁰ and specific legislation authorizing electronic signatures,⁷¹ governing the application of VAT to certain digitized services,⁷² and on the protection of data in electronic communications.⁷³ EU member States and countries seeking accession to the EU must conform their legislation to these directives, and other OSCE countries can look to the EU example for guidance in drafting their own laws.

Government procurement

Goods and services acquired by governments represent a large percentage of global GDP. In many countries, the government is the largest purchaser of goods and services. In many States, however, the procurement process lacks transparency and is closed to foreign competition. Closed or non-transparent procurement systems can also encourage fraud, waste, and corruption. And while there are circumstances in which a country may legitimately decide to contract only with domestic suppliers, a general policy of discrimination against foreign companies in procurement can lead to serious inefficiencies and cloud a nation’s reputation regarding foreign investment.

Efforts to harmonize procurement law by international agreement have been only partly successful. The WTO’s Agreement on Government Procurement⁷⁴ requires non-discrimination against foreign companies in central and local government purchasing and transparency in their rules and procedures. It requires governments to establish domestic procedures – known in some countries as “bid protests” – by which disappointed suppliers can challenge procurement decisions and obtain redress if such decisions violated the rules of the agreement. However, the Government Procurement Agreement (GPA) is designated a “plurilateral” agreement: WTO members are not required to adhere to it. To date, only 28 countries – among them the 25 members of the European Union – have signed the Procurement Agreement. OSCE countries that are negotiating for accession include Albania, Bulgaria, Georgia, the Kyrgyz Republic, and

Moldova. In addition, several OSCE countries are observers to the GPA, including Albania, Armenia, Bulgaria, Croatia, Georgia, the Kyrgyz Republic, Moldova, and Romania.

UNCITRAL also has promulgated the Model Law on Procurement of Goods, Construction and Services (1994),⁷⁵ which represents a skeletal collection of international best practice in the field. The Model Law adopts a general rule that “suppliers and contractors are to be permitted to participate in procurement proceedings without regard to nationality and that foreign suppliers and contractors should not otherwise be subject to discrimination.”⁷⁶ To achieve this result, the Model Law establishes procedures designed to ensure that requests for proposals, invitations for prequalification of vendors, and the like, will be received by foreign as well as domestic suppliers. However, the Model Law does recognize that circumstances such as the requirements of bilateral tied-aid programmes and regional economic integration areas may require some nationality-based restrictions with respect to procurement. Chapter VI of the model law establishes procedures for the administrative and judicial review of procurement decisions, which may be invoked by disappointed suppliers and contractors. The UNCITRAL Model Law has influenced legislation in several OSCE countries including Albania, Azerbaijan, Croatia, Estonia, Kazakhstan, Kyrgyzstan, Poland, Moldova, Romania, Slovakia, and Uzbekistan.

TEXTBOX 5.3

E-procurement in Romania

In March 2002, the Romanian government commenced a web-based public procurement project for basic, standardized products. All tender announcements, bid-processing, and offer appraisals are conducted via Internet. Lists of ongoing and closed bidding, names of contracting officers, and closing prices are available to the public. It is widely believed that this system has reduced costs, increased efficiency and decreased opportunities for corruption in the system.

Enforcement of the law and protection of private rights

The bulk of this chapter deals with legislation and regulations. However, an effective legal system consists of more than just good legislation. Indeed, enacting laws is perhaps the least difficult aspect of creating legal institutions. Without prompt and efficient court enforcement of laws and property rights, legislation can be rendered ineffective, and economic development can suffer as a result.

Economic activity does occur in the absence of effective legal systems for enforcing rights and obligations.⁷⁷ Enterprises that successfully trade with each other for extended periods develop relationships of trust, which make the need for court intervention superfluous. Many agreements also are self-enforcing in that each party benefits from a continuing relationship and the threat of stopping trade induces each party to fulfill its promises. Reputation is also a strong motivation for parties to perform their agreements, since no one will do business with an enterprise that is known for breaking its promises.⁷⁸ In many circumstances, these informal enforcement methods are effective. By themselves, however, they do little to facilitate transactions among strangers. Indeed, as the Nobel laureate in economics Douglass C. North has written, impersonal contract enforcement is necessary in urban societies with specialized producers of goods and services, “because personal ties, [self-enforcing agreements], and ostracism are no longer effective as more complex and impersonal forms of exchange emerge.”⁷⁹

The Latin maxim “pacta sunt servanda” – contracts should prima facie be enforced according to their terms – is the foundational principle of all contract law. Although it is subject to exceptions for contracts tainted by illegality or induced by fraud, mutual mistake and the like, the general principle that the parties are bound by their agreement is absolutely necessary to ensure certainty and predictability in commercial relationships.

Formal rights enforcement mechanisms are important to a healthy economy. Perceptions that the system is unfair or simply so slow, inefficient, and costly that pursuing legal remedies is not worth the

TABLE 5.1

Contract enforcement in East and Central Europe and Central Asia

The World Bank's Foreign Investment Advisory Service (FIAS) maintains detailed data on contract enforcement on a country-by-country basis. Among other data, the FIAS computes the average time in calendar days to resolve contractual disputes, and cost in court or administrative tribunal and attorney fees, expressed as a percentage of the debt value. The chart below contains contract enforcement statistics from the East and Central European and Central Asian countries for which the FIAS has available data.

Country	Time (days)	Cost (% of debt)	Country	Time (days)	Cost (% of debt)
Albania	390	28.6	Macedonia, FYR	590	32.8
Armenia	185	17.8	Moldova	340	16.2
Azerbaijan	267	19.8	Poland	980	8.7
Belarus	225	26.7	Romania	335	12.4
Bosnia and Herzegovina	330	19.6	Russian Federation	330	20.3
Bulgaria	440	14	Former State Union		
Croatia	415	10	Serbia and Montenegro	635	18.1
Czech Republic	290	9.1	Slovak Republic	565	15.0
Estonia	150	10.6	Slovenia	913	15.2
Georgia	375	31.7	Turkey	330	12.5
Hungary	365	8.1	Ukraine	269	11.0
Kazakhstan	380	8.5	Uzbekistan	368	18.1
Kyrgyz Republic	490	47.9			
Lithuania	154	9.1			

Source: www.doingbusiness.org/ExploreTopics/EnforcingContracts

trouble are detrimental. The Table 5.1 compares cost and delay factors in the enforcement of contracts in some OSCE countries.

Effective, impartial and independent courts. In the normal course of everyday business affairs, disputes arise frequently. Parties sometimes disagree about the rights and obligations under a law, contract, deed, or other instrument, no matter how carefully the document has been written. Although courts play a critical role in resolving these disputes, their importance far exceeds the mere determination of individual contested cases:

The contribution of courts to resolving disputes cannot be equated with their resolution of disputes that are fully adjudicated. The principal contribution of courts . . . is providing a background of norms and proce-

*dures against which negotiation and regulation in both private and governmental settings take place. This contribution includes, but is not exhausted by, communication to prospective litigants of what might transpire if one of them sought a judicial resolution.*⁸⁰

Strengthening courts may require structural and procedural reforms as well as new techniques of court management. A substantial literature on improving court systems makes a number of common points:

- In the light of the role judges play in establishing a framework for economic development, an independent court system, staffed by well paid and educated jurists, is essential to the long-term well-being of any nation.
- Freeing judges from political pressures of elected officials and legislatures is critical to ensuring an

impartial judiciary. Part of the solution to this issue is to guarantee a degree of job security to judges – whether they are elected or appointed – by providing that they can only be removed from office for serious, clearly defined reasons.

- A judiciary with the power to review legislation and declare it in violation of the constitution serves as an important check on the other political branches.
- Codes of judicial ethics should ensure judges' impartiality by requiring them to step aside (or "recuse" themselves) from hearing cases in which they have a conflict of interest.
- Judicial decisions should be given in writing, with sufficient reasoning to permit an understanding by the parties as well as meaningful appellate review. Except in extraordinary cases, these decisions should be available for public inspection.
- Courts with special subject matter jurisdiction – for example, over complex commercial cases or intellectual property matters – can ensure a more efficient and consistent interpretation and application of the law in difficult areas.
- New approaches to court management may require that judges be relieved of routine administrative tasks, that clerical support be centralized, that judges undergo specialized court management training, and that the litigation process be automated.

Availability of alternative dispute resolution.

Arbitration is a non-judicial means of settling a dispute by referring it to one or more impartial persons for a final and binding decision. Arbitration is favoured as a method for resolving international disputes for a number of reasons:

- 1) It is a private and confidential proceeding;
- 2) It allows the parties to select persons with specialized knowledge to determine their dispute;
- 3) Arbitration procedure is generally more flexible than court procedures, and can be tailored to meet the parties' specific needs;
- 4) Arbitral decisions are not subject to appeal on the merits but are final and binding except in extraordinary circumstances;
- 5) Arbitration can be faster and less expensive than court proceedings;
- 6) Arbitration is perceived to reduce the inequities faced by a party from a foreign country;

- 7) In cases where the state is a party to the dispute, arbitration reduces the ability of the State party to exert improper influence over the determination of the dispute; and
- 8) A number of arbitration treaties now make arbitral awards fully enforceable in signatory countries.

Despite the reasons why parties to international transactions frequently choose arbitration as their preferred means of resolving disputes, some governments discourage private dispute resolution mechanisms. This hostility to arbitration manifests itself in a variety of ways, including regulations dictating mandatory procedures for the conduct of arbitration proceedings or limiting who can serve as an arbitrator, and laws allowing a court "to refuse to stay judicial proceedings begun in violation of an arbitration agreement if it believes there is 'sufficient reason why' the proceeding should not be referred to arbitration."⁸¹ These limitations on the availability and effectiveness of arbitration are disincentives to foreign investment and international contracting by domestic businesses wishing to export their products or services or to collaborate in cross-border joint ventures.

States should generally allow private parties to resolve their commercial disputes through arbitration with as few restrictions as possible. They should also consider acceding, if they have not done so already, to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States,⁸² which establishes a procedure for arbitration of disputes between foreign investors and governments of the countries where they invest. It is often the preferred means for resolving disputes specified in bilateral investment treaties. In addition, countries should consider signing the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (generally known as the New York Convention). Subject to certain exceptions, the New York Convention requires member States to respect arbitral decisions rendered in other member States.

In addition to arbitration, other forms of alternative dispute resolution include mediation and conciliation. These terms are sometimes used interchangeably, and they both refer to a process in which the parties to a conflict seek to resolve their differences through dis-

cussion rather than through litigation. Conciliation normally occurs (as mediation often does) with the help of a facilitator, who assists in settling the dispute. Unlike arbitration, these procedures seek to resolve the dispute without making any determination concerning the merits of any party's claims, arguments, or defences. Nations that encourage the use of all these types of alternative dispute resolution may relieve their courts of some of their increasing burdens and furthermore allow more economic resources to be devoted to truly productive activities rather than costly and time-consuming litigation.

Bilateral investment treaties

In efforts to stimulate cross-border investment, countries increasingly enter into bilateral (or multilateral regional) investment treaties with their trading partners. These binding international agreements are designed to afford protection to investors from one State party in the territory of another State party. They typically contain provisions reflecting several of the principles identified in this chapter,⁸³ including: (1) non-discriminatory treatment of the foreign investor; (2) "fair and equitable treatment" of the foreign investor;⁸⁴ (3) elimination of performance requirements; (4) unrestricted capital and profit repatriation; (5) protection against expropriation based on international legal standards, including compensation at the fair market value of the asset; and (6) resolution of disputes through binding third-party arbitration. Such treaties can increase investment flows and should be strongly considered by countries attempting to stimulate economic development.

Conclusions and Recommendations

The many elements of a successful economic development strategy are highly interdependent, and imbalances in the emphases given to a strategy's various components can impair its overall effectiveness. This is certainly true of legal systems, in which non-legal factors such as history, culture, education and financial resources affect the enforcement of, and acceptance of and voluntary adherence to the law. Moreover, solid legal foundations – such as basic rules relating to property; contracts; civil, economic, and political freedoms; and access to justice – are necessary for the proper working of more detailed legal systems such as those governing the functioning of stock markets. The strengths and weaknesses of one set of laws and regulations also can have a direct impact on the working of legislation in other subject matter areas. For all of these reasons, it is seldom wise or effective to take one country's laws and impose them on another country on a wholesale basis and without regard to local conditions. Nevertheless, the evidence points to several features common to legal systems that can contribute to economic growth in the OSCE region. These common features are incorporated in the following recommendations.

Property and contract rights

- Limit the State's power to expropriate private property to instances in which the property concerned is to be put to public use.
- Clearly define the kinds of expropriation for which compensation is to be paid.
- Provide for mandatory compensation to the owner of expropriated property at a level that is fair to the owner.
- Establish an independent body with power to review and, if necessary, overturn government agency decisions regarding expropriation and compensation to owners of expropriated property.
- Allow full freedom of contract in commercial transactions.

Regulatory reform

- Consider using the “regulatory guillotine” process to clear away accumulated regulations.
- Adopt a regulatory impact assessment procedure for use when formulating new regulations.

Commercial, corporate and securities law

- Make available a variety of forms of business organization from which investors may choose one suitable to the circumstances of their individual situation. This includes both separate legal entities such as limited liability companies and also contractual forms of doing business such as franchise relationships.
- Conform legislation to the OECD Corporate Governance Principles.
- In creating capital market structures, make use of self-regulatory organizations to provide oversight of the activities of brokers and certain other securities professionals.
- Establish mechanisms for investor protection and efficient adjudication of securities-related claims.

Creditors' rights

- Establish clear rules and registries for recording creditors' security interests in both land and movable property.
- Ensure that legislation clearly enables intellectual property, accounts receivable, and other intangible assets to be pledged as security for loans.
- Implement, as appropriate, recommendations from the UNCITRAL Legislative Guide on Insolvency Law.

Banking law and policy

- Conform legislation to the Core Principles for Effective Banking Supervision of the Basle Committee on Banking Supervision.

Money issues

- Lift foreign exchange controls to the fullest extent possible.
- Allow foreign investors full freedom to repatriate capital and profits after payment of taxes.

Competition law and policy

- Define the rationale of competition laws clearly. Normally, economic efficiency and the maximizing of consumer welfare are among the highest goals of competition policy.
- Conduct public education and promotional campaigns to foster a culture of competition.
- Let competition law and policy be informed by rigorous economic analysis, rather than being driven by overly formulaic or legalistic views of the negative impacts of economic activity.
- Threshold limits for submission of mergers and acquisition for review by competition law authorities should be high enough to capture only truly significant potential concentrations of market power and to avoid overwhelming the reviewing agency.

Intellectual property and e-commerce

- Bring national legislation into conformity with TRIPS standards. Care should be taken to clearly define all exceptions to protection under the law of patents, copyright, etc.
- Strive to achieve high quality in the patent-examining process by devoting adequate resources and personnel to the task.
- Conduct public awareness and education programmes to foster respect for IPRs and to communicate the seriousness of infringement as a crime and/or civil infraction.
- Conduct training and educational programmes for judges and law enforcement to deal with both legal and technical aspects of IPRs.
- Establish specialized intellectual property law enforcement units to conduct inspections, seizures, and arrests in cases of commercial piracy.
- Consider establishing specialized intellectual property courts or tribunals.

Government procurement

- Procurements with a value above a certain monetary threshold should be subject to mandatory competitive bidding, and solicitations should be widely advertised, preferably via Internet.
- The procurement process should be transparent, with the possibility of bid protest and independent review of procurement decisions.
- Competitive bidding should normally be open to foreign companies. Exceptions to this norm should be strictly limited, clearly defined, and justified by specific, important public policies.

Enforcement of contracts and other private rights

- Undertake structural, procedural, and management reforms necessary to produce independent, efficient, and professional court systems.
- Remove all truly unnecessary restrictions on the availability of arbitration and the enforceability of arbitration awards in commercial cases.
- Support and promote the use of all forms of dispute resolution (including mediation and conciliation) as alternatives to court litigation.

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Chapter 6



IV Burgenland

Investment Promotion

Many countries have been successful in attracting investment through the use of Investment Promotion Agencies (IPAs). IPAs perform a number of important functions, including serving the needs of investors, advocating business-friendly policies, and cultivating and projecting a favourable image of the country as an investment destination. In addition to using IPAs, the judicious use of investment incentives – such as reduced corporate tax rates, disadvantaged and incentive zones, and industrial parks – can help to improve the business climate, provided that they do not significantly discriminate among investors and that they do not take the place of the institutional reforms recommended throughout the Guide. In countries where key elements of a good investment climate are not yet fully functional, instruments such as sovereign guarantees and political risk insurance can help investors overcome some of their reluctance to do business.

Investment promotion

Because of the importance that FDI plays in most economies, nearly all OSCE economies actively promote inward investment. UNCTAD reports that investment promotion “...covers a wealth of services, ranging from the market information to the undertaking of feasibility studies and environmental impact assessments.”¹ The Multilateral Guarantee Investment Agency (MIGA), a World Bank agency, in addition to its central role of providing political risk insurance, trains and advises developing and transition economies in investment promotion. If a country does not promote investment, then that country is placing the onus of learning about its investment opportunities on the investors, and is all the more likely to lose the competition for attracting investment to another regional economy.

Investment promotion agencies (IPAs)

Investment promotion agencies are an important mechanism for attracting FDI. A national investment promotion or inward investment agency is the nexus for developing a country’s image as an investment destination, improving the investment climate and actively recruiting foreign investors (Textbox 6.1).

The success of an investment promotion agency is ultimately measured by the extent to which it achieves its high-level goal: increasing foreign direct investment. Greenfield investment should be the focal point of an IPA’s efforts. An IPA attains its high-level goal by:

- Making a tangible and significant impact on the removal of barriers to investment, and improving the business environment by striving to understand investor requirements and by developing policy and programme alternatives, investment-friendly policy advocacy, and effective communications and collaboration with other bodies in the government;
- Developing the country’s image as an attractive investment destination by using best practices in

TEXTBOX 6.1

CzechInvest: A leading IPA in Eastern Europe

CzechInvest is regularly cited for its expertise in investment promotion. It acts as the Czech Republic’s exclusive authority to apply for investment incentives, and provides training and expertise to other investment promotion agencies. CzechInvest’s mission has expanded to include administration of EU structural funds and SME programmes.

What has made CzechInvest so successful? Here are some key best practices:

- *Quality:* CzechInvest is the only agency in the investment promotion field to have built a quality management system according to the ISO 9001:2000 standard for all of the services it provides.
- *Focus on the investors not on politicians:* Investment agencies are often political bodies which are “held accountable” for landing specific investors or reaching certain financial targets, and are not focused on serving investors and improving the business climate. As Kandiyoti Sacha of the World Bank has pointed out, governments tend to follow their own narrow agendas, with priorities such as steering multinational corporations to disadvantaged areas rather than trying to meet investors’ needs. CzechInvest’s focus is not promotion but advising and supporting existing and new entrepreneurs and foreign investors in the Czech Republic.
- *Association for Foreign Investment:* CzechInvest has built up a partnership with consultancies that help foreign investors develop their investment projects through the Association for Foreign Investment. Consultancies join the association and agree to adhere to certain conditions, and CzechInvest is able to refer investors to association members for fee-based services over and above the services provided gratis by CzechInvest. CzechInvest has a list of qualified service-providers for investors and receives funding from the dues-based association. The consultancies receive client referrals.
- *Focus on the next wave:* Many IPAs in OSCE transition economies are focused on cost-competitiveness as compared with the West. Globalization has raised and will continue to raise the percentage of the world’s economy that is based on services and human capital, and the cost competition with East Asia will become tougher. CzechInvest recognized this early on and began promoting investments in technology, biotechnology, R&D, and other industries with higher added value.

investment promotion and generation;

- Facilitating generation of investments by providing useful business information to prospective investors as soon as they need it, and making an effective “business case” for the country as an investment destination;
- Establishing its identity as the focal point for current investors to liaise with government and to obtain information for their initiatives and “aftercare services” to expedite their investments, increasing the size of existing investment, and recruiting the support of existing investors in image promotion;
- Acting as an independent agency without political orientation and focused on quality, customer service, and increased investment.

An IPA uses the following means to achieve these ends:

- Accepting the role of investment ombudsman for foreign investors;
- Developing a professionally competent, multilingual, decently paid staff;
- Cultivating a customer service attitude; and
- Striving for success in the conduct of its principal activities.

What are the principal activities of an IPA?

Policy advocacy/Removing investment barriers: Consistently maintaining an independent and apolitical stance, an IPA strives to advocate economic policies that stimulate investment and conform to international norms and standards. An IPA’s role in removing investment barriers focuses on three areas:

- *Identifying significant investment barriers by consulting foreign investors.* In order to have a palpable effect on the investment climate, reforms must be relevant and have significant impact. An IPA takes the foreign investor’s viewpoint in identifying the most important and the most “solvable” barriers to investment. The IPA presents the government with specific policy and programme recommendations based on input from foreign investors.
- *Supporting efforts to reduce the regulatory burden.* The fact that IPA professionals understand

the need for a more streamlined regulatory environment means that they persist in seeking to bring about improvements in such areas as enterprise registration and licensing, and tax administration. The IPA can assist in eliciting best practices and innovative ideas from foreign investors, and can assess satisfaction with changes.

- *Establishing systematic dialogue and co-operation with the private sector.* Integral to a strong investment climate is the practice of systematic dialogue with the private sector. For example, periods of notice are given when commerce-related laws are drafted, and comment from the private sector raises the quality of the final legislation. Discussion forums, public hearings, and other methods are used to promote understanding of investor issues and to explain government strategies or programmes. An IPA helps ensure that the foreign investor has a “voice” in the government. In addition, the IPA can co-ordinate and distribute the flow of information from government ministries to the foreign investment community.

Promoting a positive image: An IPA plays a leading role in promoting a country’s image as an attractive destination for investment. Duties include helping develop the image concept, and creating and delivering key messages. Potential topics for messages include:

- *General increase in political and macroeconomic stability.* Developing and transition economies that have been sites of political unrest, civil strife or economic crises are advised to promote and publicize improvements in political and economic stability.
- *Market access.* If a country with lower costs borders strategic markets such as the EU or Russia, it is a competitive advantage and should be noted in promotional messages. The same applies to strategic access to the Middle East, Asia, etc.
- *Domestic market.* If a country has a large population, and particularly if there is strong economic growth, then the IPA should convey an image of a growing domestic market.

- *Natural resources.* If there are natural resources such as oil, natural gas, lumber, agricultural land, minerals, or other valuable commodities available, the IPA must let investors know that there are investment opportunities available.
- *Regional and international integration.* The IPA should not fail to send clear signals regarding accession to organizations such as the EU or WTO, and on the setting up of and participation in free trade and other international commercial agreements. The image of an economy benefits from a commitment to free trade, lower transaction costs, full market access, and global and regional integration.
- *Competitive costs/return on investment.* Foreign investment is ultimately predicated on comparative return on investment, mitigated by risk. If a country has competitive costs for human capital, land, and/or energy, then the country has a huge competitive advantage in providing an attractive return on investment.
- *Media relations.* A good IPA director makes regular appearances in the national and international media. An IPA composes and distributes press releases for new large investments, new companies entering the market, economic and political events, rating upgrades, etc.
- *Community presence.* An IPA may choose to sponsor such events as forums, question-and-answer sessions and roundtables with investors and government officials, for the purpose of promoting and building up the foreign investment community's awareness of business environment improvements and new investment activity.
- *Thought leadership.* IPA staff often contribute articles to journals and magazines in their field, participate actively at conferences, and are members of relevant professional organizations, all with a view to promoting the country's commitment to and understanding of attracting foreign investment.

The *messages* are delivered through the use of promotional tools, which are effectively the messages' distribution networks. Tools typically provided by IPAs include:

- *Presentations.* Presentations can be delivered to prospective investors either by IPA staff or government officials. The presentations are modular so that they can be modified in accordance with the audience of investors: their particular interest, sector, national origin, etc.
- *Marketing materials.* An IPA produces and distributes up-to-date, attractive materials such as brochures, newsletters, circulars, and CD- and Internet-based presentations, both in English and other foreign languages.
- *PA website.* An IPA maintains a dynamic website that is linked to other key websites and is well aligned with search engines. The website should feature information on the advantages of investing in the subject country. The website normally provides links to sites with information regarding investment opportunities, investment incentives, and enterprise registration.
- *Generating investment:* An IPA assists in the attraction of greenfield FDI through sales, marketing, and promotional type activities. These activities include:
 - *Informational assistance.* IPA staff meet with prospective investors and discuss the country's competitive advantages, and provide information on potential investment opportunities and business partners, contact information for regional and local agencies, and "one stop shop"-type information on the procedures related to investing, including enterprise registration.
 - *Generating leads.* An IPA is concerned to generate leads – contact information for prospective investors for follow-up sales and marketing – through such activities as:
 - Liaison with foreign embassies and business associations;
 - Regular communications and co-operation with regional and local investment promotion agencies;
 - Liaison with economic officials and honorary consuls abroad;

- Acquisition and analysis of lists of participants at conferences, forums, and seminars; and
 - Active tracking of news regarding corporate exploration in the region.
- *Support to other government institutions.* An IPA refers prospective investors to other bodies in the government seeking foreign investment such as the country’s privatization agency, regional and local investment promotion agencies, ministries or agencies with brownfield opportunities, backing up the referrals with informational support.
 - *Investment missions.* An IPA organizes investment missions overseas, focusing on the most attractive sectors, locations, and prospective investors.
 - *Investor-targeting.* In order to make compelling business cases, information provided must be relevant to investors. An IPA does this by:
 - Refining content (brochures, presentations, and web pages) to target the most competitive sectors/industries;
 - Identifying classes of companies that are potential investors;
 - Having presentations and collateral translated into languages of “most interested” countries; and
 - Attending and making presentations at industry-specific conferences.
- Providing investor services:* In addition to promoting FDI to prospective investors, an IPA provides information and customer service support to current investors. The services provided include:
- Enterprise registration assistance. IPA staff explain the enterprise registration process, provide forms to start the process, and direct investors to the appropriate starting point.
 - Site selection information. An IPA provides information (demographics, transport networks, costs, etc.) about locations in a country, to assist investors

TEXTBOX 6.2

Regional investment promotion at an international standard in Ukraine

Modern investment promotion approaches are being utilized in Western Ukraine. InvestInRivne Agency was established jointly by the OSCE Project Co-ordinator in Ukraine (OSCE PCU) and local authorities in the north-western Ukrainian region of Rivne under the framework of the OSCE PCU’s project Assistance to Ukrainian Regions in Attracting Foreign Direct Investments. The Investment Promotion Toolkit, a free set of best practices developed by the Multilateral Investment Guarantee Agency, a member of the World Bank Group, served as a model for setting up the Agency. The model was adapted to comply with Ukrainian legislation and to stimulate co-operation with local authorities and other major stakeholders in the region on facilitating investment attraction and promoting the economic development of the region.

The Agency serves as a “one-stop-shop” for investors, expediting investment approval, company registration and acquisition of licences and other permits needed to start operations in Ukraine. It also serves as a focal

point for investors on issues such as market research, feasibility studies, identifying premises and recruiting staff. It also helps market the Rivne region of Ukraine as an attractive investment location and provides advice to local authorities on improving the investment climate.

Recently, the Agency’s endeavours have been given special recognition by the Financial Times Magazine. The InvestInRivne Agency won the award for Most Cost-Effective City and Region in Europe in the magazine’s European Cities & Regions of the Future 2006/07 competition. The InvestInRivne Agency also came out as winner of the Western CIS and runner-up in the category Region of the Future for all of Eastern Europe. The Rivne region became the first Ukrainian location to win the magazine’s awards.

“The list and the recognition that it brings proves the success of the InvestInRivne model and translates into real investments,” said Dr. Volker Frobarth, the OSCE’s Senior Project Officer responsible for the initiative.

with their search for a good location.

- Investment expansion assistance. An IPA provides information to current investors seeking sources of finance, business partners, service-providers, vendors, or opportunities to increase or expand their investments.
- Liaison with providers of utilities and infrastructure. In certain circumstances, investors who have completed the permit and licensing process may have to wait months to initiate economic activity because electricity is not yet available or a road is not built. An IPA will contact providers such as energy distribution companies, water and sewage providers, departments of public works if the investor is having difficulty gaining access to these services.
- Investor-tracking. An IPA monitors the progress of investments, ensuring that current investments, prospective investors, and leads are tracked on the basis of area of interest, country of origin, timing, size of investment, etc. It also ensures there is appropriate follow-up with investors.
- Investment opportunities database. An IPA will often act as a central connecting point for compiling an online database of investment opportunities.
- Reporting. An IPA reports to the government, general public, and media on investment news, statistics, and the state of the business environment.
- Information requests. An IPA fulfils information requests regarding investment to members of the media, NGOs, foreign governments, academic institutions, and other organizations seeking information about foreign direct investment.

Investment incentives

Role of investment incentives: The emphasis throughout the Guide is on creating a business and investment climate that is non-discriminatory, simple, transparent, and generally low on costs. If investment incentives are not carefully managed, they can create an unbalanced and discriminatory business environment, and should therefore be kept at a minimum.

Nonetheless, certain incentives can accelerate FDI when utilized appropriately. In the course of preparing this guide, the OSCE arranged a review session with business environment experts from region in that session, opinion was divided on the use of investment incentives. Several of the experts from the panel said that “if your neighbours give incentives, then you have to give incentives.” This rationale concurs with the World Bank’s view which is that incentives will generally not influence selection among regions, i.e. China or Eastern Europe, but may have influence on an intra-regional choice when most of the other business environment factors are equal. There was universal agreement that incentives are not a substitute for improvements in the business and investment climate, and that incentives should be seen as a supplement to an existing favourable investment climate. With this understanding in mind, some of the potential incentive mechanisms available to countries are outlined below, with associated best practices.

Fiscal incentives

Governments offer fiscal or tax incentives to investors, usually to foreign investors, to make their country a more appealing investment destination. Common fiscal incentives include:

- Reduced corporate income tax rates;
- Ability to deduct profits that are reinvested into company operations from corporate income taxes;
- Tax holidays or abatements in which companies do not have to pay corporate income tax or social security tax for a specified period of time;
- Ability to carry losses incurred during the early stages of investment forward to later years;
- Reduced or zero social tax obligations for hiring unemployed persons, recent university graduates, ex-military personnel, etc.;
- Exemption from or delay of payment of VAT;
- Delay of payment of VAT until business operations begin;
- Fast-track VAT refund;
- Exemption from or delay of VAT or customs fees on capital investments;

- Deduction of the value or a portion of the value of the capital investment from corporate income tax;
- Accelerated depreciation on capital investments;
- Exemption from taxes on the conversion of agricultural land into industrial land; and
- Grants for training initiatives or job creation in disadvantaged areas.

It is difficult to rank the incentives in an order of effectiveness. Their comparative effectiveness will depend on such factors as the type and sector of investment, how long the investment will take to complete, the relative wealth of a country, and a government's ability to manage the incentives. Estonia has had great success with the reinvested profits incentive. Croatia has attracted some investments through tax holidays. Local authorities in Romania frequently waive the tax on converting agricultural land into industrial land for projects that create jobs and broaden the tax base.

Since the philosophy of the Guide is to advocate a simpler and better investment climate that is non-discriminatory, the Guide supports the OECD's policy on investment incentives, which recommends that incentives should be transparent, open to foreign and domestic investors, not industry-specific, and simple to manage. Incentives should be applied in accordance with a set of rules and not offered for individual investments on a case-by-case basis. The following principles should be applied when selecting incentives:

- There should be an overall government strategy on incentives. Investment incentives must be co-ordinated across ministries. Governments should avoid "stacking" incentives. Investors often receive multiple incentives that cause fiscal deficits by offering far more than was really necessary to attract them.
- Incentives must be transparent. The government in question should be able to monitor the effectiveness of the incentives, and ensure that companies are complying with the regulations. Governments should review the cost-effectiveness of incentives on an annual basis.
- Incentives should be applied for limited periods, with a clear expiry date. The OECD recommends a period of no longer than five years, which in it-

self is quite lengthy. The function of incentives is to attract investors and assist them during the start-up phase of the business, and not to support or subsidize the enterprise.

- The incentives should be applied as non-discriminatorily as possible according to the amount of investment or the specific region, and not according to the country of origin of the investor or the specific industry.
- All incentives should be part of the public record. All incentive programmes and rules should be clearly enumerated on government websites and in publicly accessible government documents.

One specific incentive that should be avoided is that of lengthy tax holidays. Not only can they cause fiscal imbalances and erode competitiveness, but unless the tax holiday is extended after expiration, companies may look to move to a less costly location, or complain that operations cannot continue unless similar conditions are maintained.

Governments are also well-advised to maintain a corporate income tax structure that helps all business by emphasizing simplicity and low rates rather than a complex scheme of incentives aimed at reducing corporate income tax for foreign investors. A complex scheme of incentives is difficult to manage both for the government and for the businesses, creates imbalances in the marketplace, and provides greater opportunity for corruption.

The EU guidelines single out the following criteria, among others, for identifying potentially harmful measures:

- An effective level of taxation which is significantly lower than the general level in the country concerned;
- Tax benefits reserved for non-residents;
- Tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- Granting of tax advantages even in the absence of any real economic activity;
- When the basis of profit determination for

companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; and

- Lack of transparency.

Generally, the EU supports incentives on a regional basis and in the areas of VAT and customs. Large-scale national incentives designed to attract multinational foreign investors are not encouraged. Since accession to the EU, several of the new entrants such as Slovakia have scaled down the level of incentives offered to investors.

A good reference on the fundamental philosophy of applying investment incentives is the OECD Multilateral Agreement on Investment. More information can be found on the OECD website.

Disadvantaged zones

Providing incentives in disadvantaged areas is a traditional method for economic development. Establishing urban enterprise zones or disadvantaged zones is successful when the quality of life for the businesses and residents is competitive. Establishing disadvantaged zones in destitute areas without infrastructure erodes overall competitiveness by giving advantages to non-competitive areas and is not a good tool for their economic development. Incentives will not draw investors or new businesses to areas that are fundamentally unattractive (Textbox 6.3).

TEXTBOX 6.3

Urban enterprise zones in the United States

In the United States, urban enterprise zones have been utilized for decades to revitalize decaying urban areas. In these areas, businesses are offered reductions in income taxes and limited or no property taxes for a period of time to invest in urban enterprise zones. In the 1980s, the city of Baltimore faced urban decay, high crime, and flight of businesses. Urban enterprise zones were established in areas of the city near downtown that featured outmoded factories and abandoned warehouses. The urban enterprise zones offered special incentives designed to attract business. The incentives were:

- No sales tax on equipment for businesses.
- No real property tax for the period the area qualified as an urban enterprise zone.
- Reductions in corporate contributions to employee income taxes.

Businesses were thus given incentives to purchase land, invest in the business, and hire workers. In residential areas, homes that had been seized for legal reasons, abandoned, condemned for health and safety reasons, or on which owners had defaulted for financial reasons were made available for purchase for one US dollar on the condition that the purchaser invest at least USD 100,000 over a number of years in the renovation and refurbishment of the homes. Many of those homes are now worth in excess of USD 500,000.

The key to success in Baltimore was that the urban enterprise zones, although disadvantaged, provided numerous benefits such as roads, housing, access to culture, shopping, and proximity to Washington, DC.

Free zones/Special economic zones (SEZs)

The same holds true for the establishment of free zones or special economic zones, which should also be established in locations that provide a competitive destination for investors. Free zones are designated areas with special incentives, usually exemption from VAT and customs duties, but they can have even more incentives such as relaxation of environmental or labour standards.

The value of these zones is a source of debate. On the one hand, by offering privileged trading terms for manufacturing-based exports, SEZs can attract investment and foreign exchange, spur employment, and boost the development of improved technologies and infrastructure. Critics, on the other hand, claim that SEZs attract investment only by offering distortionary incentives rather than building underlying competitive conditions. They also argue that these incentives create a fiscal burden on the taxpayer and hurt environmental and labour standards. The critics also believe

that the direct and indirect costs of maintaining zone privileges do not benefit the rest of the economy and, instead, lead to enclaves of prosperity.

There are at present 3,000 SEZs operating in 120 countries, accounting in total for more than 600 billion USD in exports and 50 million direct jobs. It is thus clear that free zones are being utilized and having success in some areas. Success in establishing free zones again depends on the overall competitiveness of the zone, and on its location in particular. If there is no access to transport or to labour, then the zone will not be successful. The Arad-Curtici Free Trade Zone in Romania has been successful by locating on the Hungarian border near the border crossing. This enables companies to “offshore” just on the other side of the EU border for lower costs in Romania. Because of its impending accession, Romania has been compelled to adjust its free zone laws. Nonetheless, because of its good location and infrastructure the Arad Zone remains a popular investment destination. Best practices on operating a free zone may be deduced from the example of the Aegean Free Zone (Textbox 6.4).

TEXTBOX 6.4

The Aegean Free Zone’s best practices in free-zone development

The Aegean Free Zone (ESBAS) is a large, active, and constantly growing free zone near Izmir in Turkey that has seen more than 17 billion USD of cumulative international trade since 1990. It is Turkey’s largest free zone. ESBAS’s chairman was named FDI Magazine’s personality of the year for 2005, and ESBAS’s website won the World Free Zone Association’s website of the year for 2004.

How has ESBAS been successful? Their best practices include:

- *Intelligent location.* The location near Turkey’s third largest city of Izmir provides the zone with an ample workforce, excellent quality of life, a growing economy, and location near an export-oriented port.
- *Transportation planning.* Not only is ESBAS only 20 minutes from the port and 10 minutes from the airport but the zone itself is “traversed with a first class network of roads.”
- *Infrastructure and services.* Business have their choice of infrastructure-ready sites or ready-built factories. The zone prides itself on providing turnkey locations at US or Western European standards.
- *Minimal red tape and bureaucracy.* ESBAS makes it easy for investors to operate in the zone and assists with permits and licensing. The zone laws and regulations also allow earnings and revenues to be transferred freely.
- *Intelligent management of incentives.* The zone is free from customs duties until 2009 or when Turkey enters the European Union, whichever comes sooner. The Aegean Free Zone thus offers attractive incentives while maintaining a limit on the scope and period of their availability.

Industrial parks

An industrial park can be defined as a tract of land set aside for industrial use and development. Industrial parks/estates have three basic ownership models:

- State industrial park authority;
- Private sector; or
- Public-private partnerships or joint ventures between the State and the private sector.

Industrial park sites are usually but not always located in areas with excellent communication and transport infrastructure, access to energy, and available workers. While industrial parks may have many names – industrial estates, export-processing zones, business parks, high-technology parks, industrial development zones, and eco-industrial parks – they have two common distinguishing characteristics. Firstly, they accommodate a number of firms in close proximity within a common parcel of land set aside for that purpose, and share infrastructure, utilities, fire and security services, and common areas. Industrial parks also share a common management structure overseeing park activities.

Industrial parks at an international standard normally offer tenants the following:

- Market-based prices for serviced industrial lands either for lease or sale;
- Access to manpower from neighbouring towns/cities;
- Transport links to such important locations as urban areas, airports, train terminals, sea ports and container terminals;
- An efficient telecommunications network offering telephone, Internet, and other advanced facilities;
- Well planned, professionally laid-out lots that are fully serviced with roads, drains, sewers, electricity and water;
- Roads leading to and from industrial parks enabling delivery of goods and supplies;
- Amenities including a industrial park office or centre, public transportation links such as a bus stop and parking, and a pleasant environment including landscaped areas;
- Expedient processing for park entry and commencement of operations; and

- Equal treatment of tenants without discrimination between foreign and domestic investors.

The advantage of industrial parks is that they speed up the development of an investment project, or the beginning of profit-making operations for an SME. Businesses locating outside an industrial park may need to:

- Apply and pay for land acquisition;
- Prepare, fill and level land;
- Pay surcharges to gain access to utilities;
- Build their own waste treatment systems;
- Ensure adequate access to the site;

TEXT BOX 6.5

City of New York involving stakeholders as a case of best practice

In an effort to protect and expand its industrial base, the city of New York, has a programme designating specific areas as “industrial business zones”. Land belonging to New York City including vacant lots and land seized for non-payment of taxes are kept for industrial development, including industrial parks.

To implement this programme the City of New York has set up the Office of Industrial and Manufacturing Businesses, which is responsible for overseeing and coordinating policy implementation and service delivery to industrial and manufacturing businesses. The Industrial and Manufacturing Business Council was set up to oversee and manage the activities of the Office. The Council is a private-public partnership appointed by the mayor to advise the City on industrial policy and to foster strategic thinking on the needs of the industrial sector in the city. The Council has up to 15 members representing interests across the industrial spectrum. Members include representatives from industrial corporations in the area, business leaders, researchers and academics, and advocates for the real estate industry. The Council generates creative thinking on how to best create an industrial policy (including promotion of industrial parks), foster sustained dialogue amongst all stakeholders, and maintain a high level of attention.

Source: USAID Ukraine WTO Accession & Investment Promotion Project.

- Retain service providers for help with the bureaucracy associated with obtaining permits from local authorities; and
- Not be offered the common resources they would have in an industrial park.

Because these services are shared, the total cost of operations is often lower in industrial parks, and SMEs benefit from clustering of businesses. Well-organized industrial parks can help businesses cope with permit and licensing issues, regulations, and access to utilities. Moreover, their success can drive greater economic competitiveness by attracting multinational companies and spurring SME development, which in turn may help the business environment. It should be emphasized that industrial parks cannot be a substitute for a favourable business environment. However, the attraction of first-class companies will often “push” the quality of the business climate higher, as has been seen in countries such as Slovakia, Romania, and Bulgaria, and help countries understand the value of a better business environment.

TEXTBOX 6.6

Industrial parks in the Czech Republic and Hungary

Two countries that have successfully increased industrial development through the establishment of industrial parks are the Czech Republic and Hungary. In the Czech Republic, there is a mixture of State-sponsored and private industrial parks. The Ministry of Trade and Czech Invest report that there are over 84 industrial zones and that in 2004 investors had occupied 70% of the land set aside and developed for industrial use. In the Czech Republic it is estimated that for every crown invested into developing and building State owned industrial parks, private companies will invest an average of 36 crowns into new production facilities within the parks. Hungary offers a very wide selection of industrial parks: investors can choose from more than 160 operating industrial parks according to their business type. Industrial activity in parks in Hungary accounts for 40% of industrial exports and 25% of industrial output. Productivity in industrial parks is 70% higher than the industrial average and only 15% less than the EU average.

There are many examples of best practices in industrial parks, both private and State-owned. Three keys to success, regardless of private or public sponsorship, are:

- *Location.* The golden rule for property development also applies to industrial park development: “location, location, and location.” Unless the location of the industrial park is appropriately chosen, it will not attract many manufacturing firms. Relevant criteria include:
 - Proximity to a railway hub, airport, sea or river port, or highway network. Transportation to the nearest urban centre must be fast, inexpensive, and reliable.
 - Availability of skilled workers at reasonable costs.
- *Infrastructure services.* Manufacturing firms require various inputs including electricity, telephone, Internet, sewage treatment, and transportation. Stable supply, high and consistent quality, and low cost of utilities are essential.
- *Management.* Management must be professional and experienced in industrial park operations, and must be sensitive and devote top priority to the needs of their tenants.

Two interesting examples which may offer innovative practices to governments are Ploiesti Industrial Park in Romania and Beocin Business Park in Serbia.

Industrial parks can help attract FDI and provide a location for SMEs, but they should be seen as a response to market need and part of a sound industrial base. Industrial parks are not a substitute for sound strategies for the business climate or for enterprise development. Furthermore, industrial parks will only help those businesses that are capable of exploiting their advantages. A significant proportion of businesses will not be assisted by the development of industrial parks. Ultimately, industrial parks are enterprises and not policies or programmes. *While they have significant value to communities and help stimulate economic development, it is critical not to burden industrial parks with the responsibility for attaining national economic development goals.*

TEXTBOX 6.7

Industrial parks in Romania and Serbia

Ploiesti Industrial Park is a combined brownfield and greenfield site in the city of Ploiesti, 56 kilometres north of Bucharest. The international airport is between Ploiesti and Bucharest. The park thus provides proximity to the airport and to the capital at lower prices than Bucharest. The industrial park was formerly the site of a defence plant, and the land was ceded by the government to the local municipality and county. The park-developers added parcels of contiguous undeveloped land to the defence plant area, enabling the park's managers to offer pre-existing facilities or land for greenfield development. The Romanian Government offers incentives including a profit tax deduction of up to 20 per cent of total investment in infrastructure, deferred VAT payments, and special incentives negotiated with local authorities on a case-by-case basis. Companies such as Yazaki and Johnson Controls have established facilities at the park.

Beocin Business Park is a corporate social responsibility project initiated by Lafarge Serbia & Montenegro. The Business Park is a non-profit project and all advantages

such as less expensive land and shared services with Lafarge are forwarded directly to the investor. The project has strong government support. The Ministry of International Economic Relations directly supports investors in getting all necessary permissions. Located in the most developed business area of Serbia in the region of Vojvodina (20 km to Novi Sad, 100 km to Belgrade, 30 km to the Croatian border, 120 km to the Hungarian border, 100 km to the Romanian border) the Business Park offers direct access to a highly skilled low-cost labour force. There are no additional incentives other than what is provided to all investors. Former State Union Serbia and Montenegro imposes the lowest corporate tax rate in Eastern Europe (only 10%). The attraction to the park is the availability of land for industrial use, reduced time to begin operations, quality of infrastructure and services, and location. Three international investors, Lafarge, Asamer, and Wietersdorf, have established locations in Beocin Business Park.

Investment guarantees and political risk insurance

In certain situations, companies analyse the prospects of an investment and find that the returns are suitable and that they are able to finance the investment. They may still be concerned that the country's investment climate and political environment create too much risk to proceed with the investment. In order to promote investment in these circumstances, countries will provide what is known as a "sovereign guarantee". With a sovereign guarantee, the government provides a financial guarantee against losses or non-payment stemming from the country's political or legal situation, or in some cases from its economic situation. Civil strife, economic collapse, disruptive transitions in government, government expropriation of assets and breach of contract are events that preclude the completion of an investment and can invoke a sovereign guarantee. Guarantees are not meant to protect

investors from poor business propositions but to help them realize sensible business propositions in an unpredictable environment.

Many investors are unwilling to accept a sovereign guarantee from governments with unfavourable investment climates and political environments. Instead the investor will seek either guarantees from third party sources or purchase political risk insurance. In these circumstances, the third party guarantor, usually a development bank, will offer a guarantee independent of the sovereign government or as a "backup guarantee" to the sovereign guarantee offered by the government.

The EBRD and the World Bank provide guarantees to investors for projects in OSCE developing and transition economies. At present the World Bank guarantee programme is in fact under-utilized and is seeking additional participants. The focus of many guarantee programmes is on infrastructure and industrial projects but opportunities in other areas exist. In 2003,

for example, a local bank in Uzbekistan loaned the Swiss firm Nestlé two and a half million euros for expansion of its business. The EBRD provided a guarantee to the local bank to protect the bank from any transaction failures. There is a cost to guarantees. A percentage of the amount guaranteed is charged to the investor. The amount is usually reasonable, in the low single digits. Nonetheless, utilizing guarantees raises the cost of an investment: one further confirmation of the principle that a favourable business climate lowers the cost of entry.

Political risk insurance is a product that investors purchase to insure eligible projects against losses relating to:

- Currency transfer restrictions;
- Expropriation;
- War and civil disturbance; and
- Breach of contract.

While political risk insurance also adds cost to a project, if an investor is seeking financing, political risk insurance will sometimes enable the borrower to receive more favourable financing because the risk of the project is lowered. The Multilateral Investment Guarantee Agency (MIGA) and the Overseas Private Investment Company (OPIC) are two of the premier development-oriented providers of political risk insurance (Textbox 6.8).

TEXTBOX 6.8

MIGA in Moscow

MIGA provided USD 56.4 million in coverage for Russia's first privately owned water treatment plant just outside Moscow. The project, which targets the city's growing demand for water supply, involves the construction of a greenfield water treatment plant that will increase Moscow's drinking water supply capacity by 4 per cent. Construction began in September 2003 on a 13.5-year build, own, operate and transfer (BOOT) concession scheme in conjunction with a private enterprise. Water will be channelled from the Moskva River

to a processing plant where it will be filtrated using state-of-the-art technologies. Investment promotion agencies are encouraged to be well acquainted with the financial resources available to them from the European Investment Bank, the EBRD, the International Finance Corporation (IFC), MIGA, the World Bank, the Overseas Private Investment Corporation (OPIC), the United States Trade and Development Agency (UST-DA), and other organizations.

Conclusions and Recommendations

Countries seeking greater FDI must engage in investment promotion. Investment promotion combines policy advocacy, image promotion, investment generation, and investor services. OSCE participating States such as the Czech Republic, Ireland, and the Baltic States have been effective in “reaching out” to investors.

Ultimately, a better investment climate provides a better business proposition to present to the investor. Investment incentives are not a substitute for a favourable business climate and should be used as a complement to a superior business climate. Governments must be careful not to “stack” incentives, and must take care to assess and fully understand their fiscal implications. Otherwise, they run the risk of corruption and poor financial performance. Incentives should be applied in a non-discriminatory manner and should be available to foreign and domestic firms alike.

Recommended best practices are:

Investment promotion

- Improving investment promotion agency performance: strategic and operational best practices may be learned from the activities of leading IPAs such as IDA Ireland and CzechInvest. IPAs are advised to establish links with organizations such as MIGA and the World Association of Investment Promotion Agencies (WAIPA).
- Developing targeted investment promotion campaigns: countries must be able to market the most competitive aspects of their economies – the most dynamic sectors, the growing regions – to the most likely investors.

Investment incentives

- A low overall tax rate and a less complex tax system is better than a series of complex tax incentives based on an investor’s country of origin or industry.
- Fiscal incentives should be applicable for no more than five years.
- Special economic zones such as free zones or export zones should be located in areas that are desirable to investors and not in unattractive brownfields that lower the competitiveness of the investment location.

Industrial parks

- Industrial parks are not a tool of economic development but a response to market needs. Nonetheless, industrial parks are present in nearly all thriving market economies. The State should ensure land is available at a reasonable price to the developers of private parks, and should develop State-sponsored parks that meet investor demand and do not restrain the private sector from developing its own industrial parks.

RESOURCES

MIGA: <www.miga.org>

FDI Promotion Center: <www.fdipromotion.com>

World Association of Investment Promotion Agencies: <www.waipa.org>

OECD Investment Compact: <www.investmentcompact.org>

OECD Investment Division: <www.oecd.org/topic/0,2686,en_2649_34529562_1_1_1_1_34529562,00.html>

UNIDO Investment and Technology Promotion: <www.unido.org/doc/18264>

UNCTAD Foreign Direct Investment: <www.unctad.org/Templates/StartPage.asp?intItemID=2527&lang=1>

World Free Zone Convention: <www.freezones.org>

ENDNOTES

1 “Do the Benefits of Special Economic Zones Outweigh the Costs?”, online discussion, <<http://rru.worldbank.org/Discussions/Topics/Topic40.aspx>>



Chapter 7

Small and Medium-Size Enterprises: Development and Promotion



OSCE | Helen Santiago Fink

The growth of small and medium-size enterprises (SMEs) is a fundamental component of economic development. SMEs are usually a significant source of employment and also help to stimulate innovation, economic dynamism, and competition. The chapter pays particular attention to the impact of SMEs on the economic and social development of OSCE participating States and the importance of a favourable business and investment climate for the successful development of this sector. It also outlines how SME-specific actions initiated by governments in the areas of finance, education, and enterprise support can boost the SME sector without causing market distortions.

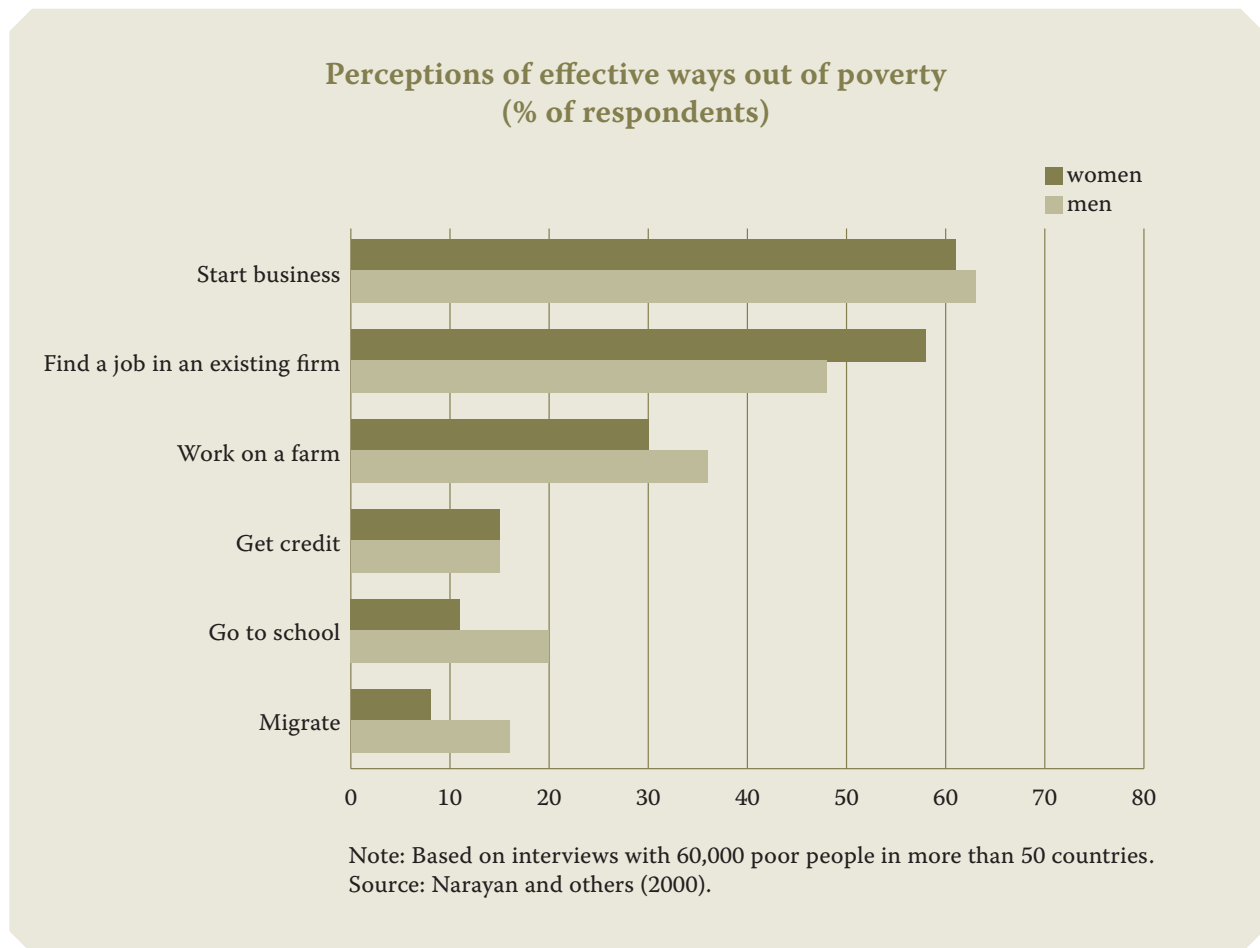
The importance of SME development

The growth of SMEs is a fundamental component of economic development. SMEs comprise greater than 90 per cent of businesses, and generally serve as the largest engine of job growth in developing and transition economies, often accounting for 60 per cent of employment. The vast majority of companies have staffs of less than 100. A survey of sixty thousand indigent persons in more than fifty countries revealed that

starting a new business was viewed as the most effective method of escaping poverty (Figure 7.1).

The development of new enterprises brings new people into the workforce, and new taxpayers, products, and services into the local, regional, and global marketplaces. “SMEs are a source of employment, competition, economic dynamism, and innovation; they stimulate the entrepreneurial spirit and the diffusion of skills. Because they enjoy a wider geographical presence than big companies, SMEs also contribute to better income distribution.”¹

FIGURE 7.1



Economic impact of SMEs

Table 7.1 shows the vital role played by the SME sector in developed economies. SMEs provide a majority contribution to GDP and employment in many

of the world's largest developed economies such as the USA, Japan, Germany, France, Italy and the UK.

TABLE 7.1

Key indicators of SME development and promotion in developed countries

Indicators	USA	Canada	Japan	Germany	France	Italy	Great Britain
SME contribution to GDP	52%	43%	52%	57%	50%	55%	52%
SME contribution to Employment	50%	47%	70%	70%	57%	71%	56%
SMEs as a percentage of all companies	98%	99.8%	99%	99%	98%	99%	99%

Source: 5th All-Russian Conference of Small Business, March 2004.

The impact of SMEs is less dynamic in developing and transition economies, where they play a less significant role in GDP and employment. Countries judged to be making slow progress in their economic transition have the lowest SME share in GDP per capita (28%) and in total employment (29%) (Table 7.2). Experts estimate that in order for the SME sector to make a meaningful contribution to the economy, jobs, and security, a "threshold of about 40 per cent for

the shares of [formal] small enterprises in employment and value added needs to be crossed for new enterprises to absorb the resources released by the old sector and contribute to sustainable growth. Simply having a small number of highly productive small enterprises is not enough. Unless it is combined with rapid growth in the share of employment, the small business sector will not develop the critical mass to lead to aggregate economic growth."²

TABLE 7.2

Average index of SME development in transition countries

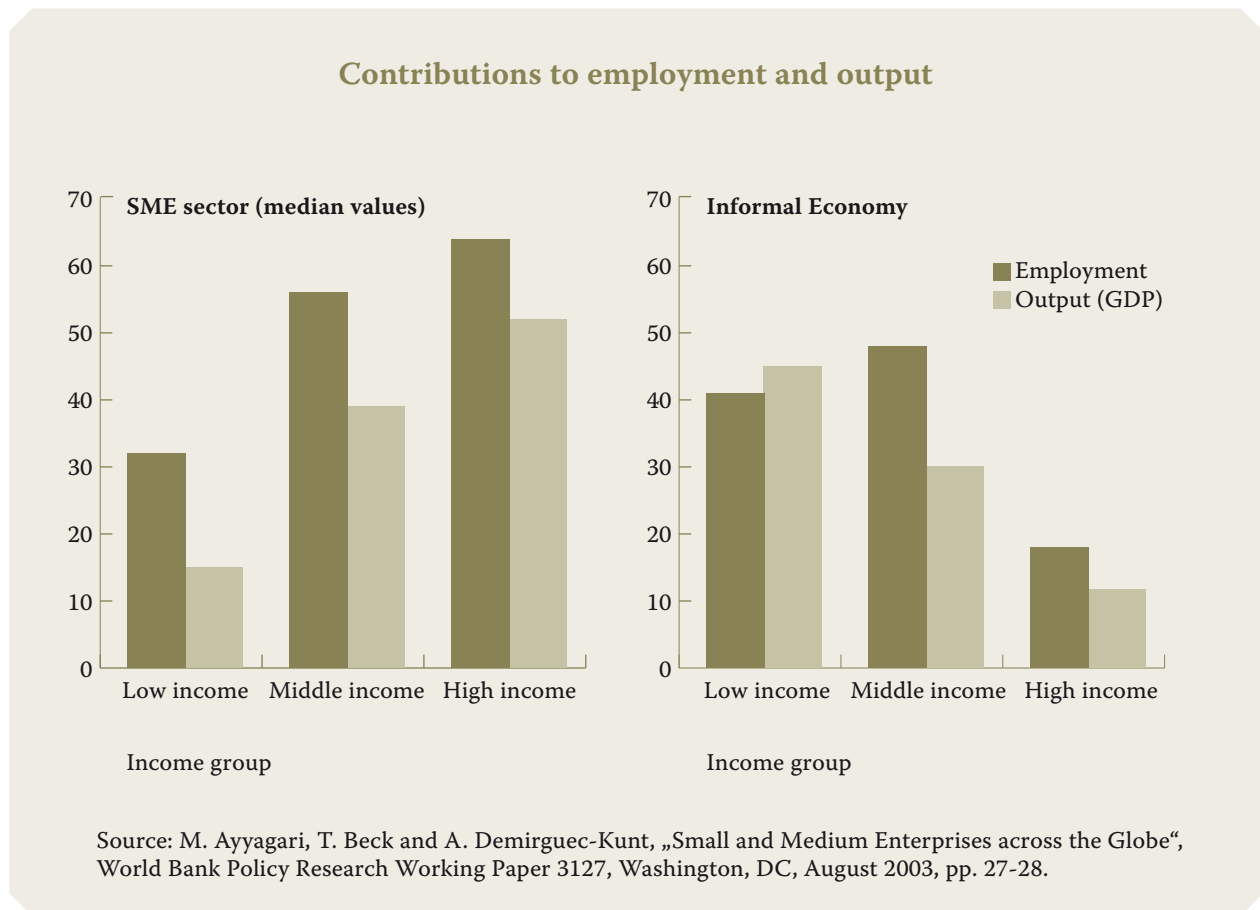
Description	Advanced emerging market economies	Countries making rapid progress	Countries at intermediate stage of transition	Countries making slow progress
Share of private sector in total economy (%)	65.9	67.5	64.0	46.9
Share of SME sector in GDP (%)	51.9	46.5	40.0	27.9
Share of SME employees in total employment (%)	63.1	41.8	35.9	29.2
GDP per capita, US\$	5,758	2,882	1,368	877
SME share in GDP, US\$ per capita	1,354	436	158	33
Index of SME development	0.22	0.13	0.10	0.038

Sources: UNECE Coordinating Unit for Operational Activities database (Geneva, 2004); EBRD Transition reports; SME national focal points.

The diminished effect of SMEs due to the informal economy

The size and attractiveness of the “informal economy” as compared with the “formal economy” diminishes the economic impact of SMEs. Figure 7.2 depicts the situation in low income countries in which employment and output produced by the informal sector is greater than the SME sector. Moving economic activity from the informal economy to legitimate businesses is critical for economic development.

FIGURE 7.2.



Employment with legitimate enterprises ensures that a greater percentage of the workforce is protected by pensions, safety regulations and health benefits; this is particularly applicable to women and youth, who make up three quarters of workers in the informal sector. The OSCE is especially active in assisting the young start legitimate businesses in South Eastern Eu-

rope and the States of the former Soviet Union through its Youth Entrepreneurship Programme (YES). Such efforts help foster greater understanding of market principles and promote growth of private sector activity. Finally, greater legitimate employment bolsters the financial viability of social benefits through increased tax receipts.

Fulfilling SME potential through improved business climates

The SME sector has tremendous potential for contributing to economic growth, job creation, and poverty alleviation. Whether they are Silicon Valley start-ups in the US or small textile businesses in Bangladesh or Africa, new enterprises have a transformative capability. However, in order for SMEs to have the desired effect, entrepreneurs must be motivated to start legitimate enterprises, and their enterprises must survive. The most important factor in convincing entrepreneurs to work legitimately and in helping them to survive is the business climate. If the burdens outweigh the potential gains, businesses have little incentive to leave the informal economy. Even in the best business environments, the majority of new businesses fail. An unfavourable environment with high taxes, corruption, and an oppressive bureaucracy further compromises the prospects of success.

According to the Guide Questionnaire, the critical constraints to SME development most often voiced by respondents were:

- Excessive and controversial business regulation;
- Burdensome administration (registration, licensing, tax, and the like);

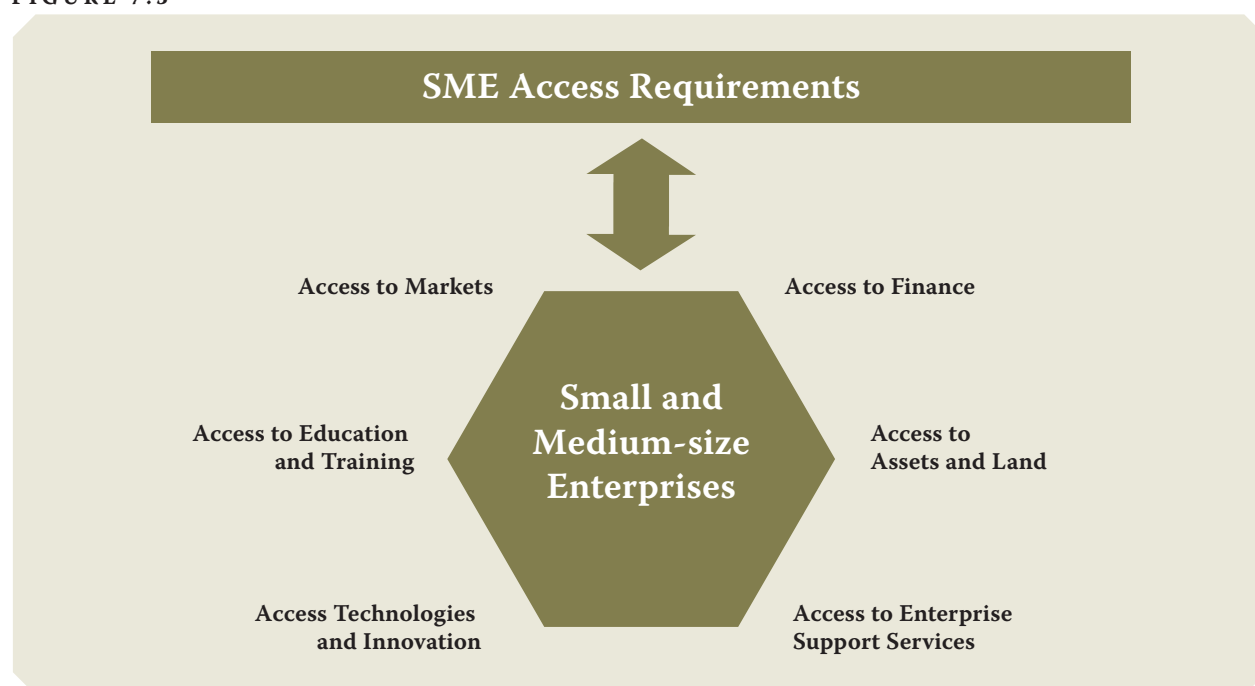
- Corruption; and
- Difficulties in enforcing contracts and resolving disputes.

These barriers to entrepreneurship are similar to those reported in the Questionnaire as barriers to FDI. The specifically SME-related barriers mentioned in the Questionnaire were:

- Lack of start-up and growth capital;
- High taxation;
- Limited access to assets; and
- Lack of managerial skills.

The results of the Guide Questionnaire are in accordance with the findings of SME surveys regularly carried out in 27 transition countries by international development agencies (FIAS, IFC, EBRD) and by national research institutions. Figure 7.3 indicates the six mandatory components to which SMEs need to have access in order to have the best chance of survival. Governments are not expected to provide direct support to private enterprises, but they are responsible for providing an enabling framework for nascent enterprises. Facilitating access to markets, finance, education, land, technology, and support services will allow competitive enterprises to survive and grow in free markets.

FIGURE 7.3



Creating a supportive SME policy framework

In 2003, the OSCE participating States approved the organization's Strategy Document for the Economic and Environmental Dimension, committing themselves among other things to developing a business-friendly environment and promoting SMEs: "Good governance implies the creation of a framework of economic policies, institutions and legislation, in which business can thrive and the confidence of investors can grow. This involves the adoption and enforcement of business-friendly legislation, which promotes and protects private ownership, lays down clear rules and regulations for economic activities and streamlines procedures and formalities. We are determined to establish clear legal and institutional frameworks conducive to the development of business, including SMEs, and to the promotion of investment."³

In June 2000, the heads of State and heads of government of the countries of the European Commission endorsed the European Charter of Small Enterprises⁴ in order to stimulate entrepreneurship and improve the business environment for small enterprises.

In so doing, they committed themselves to working on ten broad areas:

- Education and training for entrepreneurship;
- Cheaper and faster start-up;
- Better legislation and regulation;
- Availability of skills;
- Improving online access;
- Getting more out of the single market;
- Taxation and financial matters;
- Strengthening the technological capacity of small enterprises;
- Successful e-business models and top-class small business support; and
- Developing stronger, more effective representation of SME interests at the EU and national level.

The benefits of the SME charters are not restricted to EU countries. In 2003, the European Charter of Small Enterprises was also endorsed by the West Balkan countries and Moldova. Commitment to the EU SME process has helped these countries to streamline their national SME-development policies and action plans and to measure their annual progress against clear milestones and indicators. The CIS Chambers of Commerce have made attempts to benchmark CIS experience in SME development and standardize SME definitions and support practices.

TEXTBOX 7.1

SME policy in Kazakhstan

In an address to the nation entitled "Kazakhstan on the Road to Accelerated Economic, Social and Political Modernization" delivered on 18 February 2005, the President of Kazakhstan characterized his SME development philosophy as follows:

A fundamentally new ideology of development for small and medium-size enterprises is envisaged whereby a favourable environment for the realization of the true spirit of enterprise will be created. To give a fresh new impetus to private enterprise, non-core functions will be transferred to small and medium-size enterprises.

Of particular note were the President's call for the development of a partnership between government and

the private sector, and his encouragement of government to provide an enabling environment for SME development. Kazakhstan adopted a new law in 2006, entitled "On Private Entrepreneurship", which superseded previous laws and streamlined SME regulations.

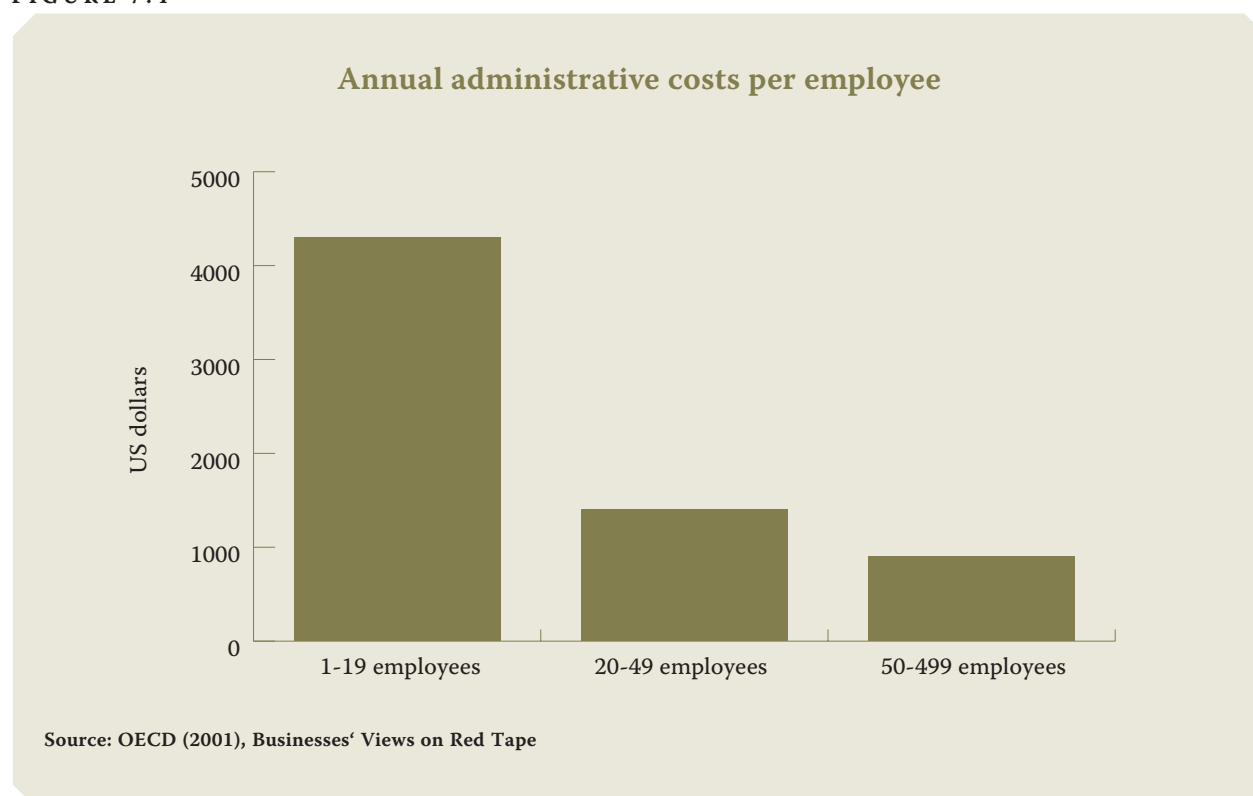
According to the Guide Questionnaire, six State programmes for SME development have been successfully implemented in Kazakhstan. The programmes have contributed to "sustainable development of the SME sector, increase of the SME share in the priority economic sectors, job creation, development of a real competitive environment, improvement of SME legal protection, improved access to credit and finance, development of business training, and access to information resources for SMEs."

Reducing the burden on SMEs

An unfavourable business climate has a greater impact on SMEs than on larger businesses because SMEs tend to have less political influence, insufficient cash flow to undertake or survive legal proceedings, and insufficient resources for compliance with regulations. A study carried out in 11 OECD countries found that

administrative compliance costs per employee were over five times as high for the smallest SMEs than for the largest (Figure 7.4).⁵ Small firms do not have the large-scale operations necessary for spreading the costs of compliance.

FIGURE 7.4



Measures for reducing SME-specific constraints

Many of the constraints (discussed in Chapter 4, Government Actions and Policies that Improve the Business Climate) that affect foreign investors and large companies are the same as the constraints affecting SMEs. With the help of USAID, the EU, and other organizations, many countries are undertaking measures to alleviate the constraints on businesses. Two specific constraints that particularly affect SMEs are the business registration process and State inspections. If a large corporation is investing in a fifty-million-euro factory that requires two years of planning and construction, the costs of a thirty-day registration

process and fifty thousand euros in fees for consultants and lawyers are relatively low. For an SME waiting to engage in its first project, registration costs and delays can be fatal.

Business registration. Timely market entry is particularly important for micro-enterprise start-ups. The time required to register an enterprise is widely regarded as a good indicator of the quality of the business environment. The most advanced countries have one-day business registration, whereas in other countries, registration can take several months. One best practice in speeding up business registration is the one-stop-shop model. In the one-stop-shop model, a business owner is only required to submit registration-related paperwork at one location. Ukraine has

recently attained success with one-stop shops. The Law of Ukraine on State Registration of Legal Entities and Individual Entrepreneurs, enacted in 2004, simplifies the registration process as much as possible. Entrepreneurs no longer have to apply in person at six different State agencies. The new law reduces the entrepreneur's interaction with State officials to a single contact, the State registrar, who accepts applications and carries out all the registration and mandatory reporting functions. This approach addresses the underlying problems, and has reduced the registration processing time to four days.⁶ However, a one-stop shop is not a substitute for a bureaucratic registration process: a single window is no help to businesses if the registration process is still lengthy and the process is not transparent.

State inspections. Inspections are disproportionately time-consuming and costly to SMEs. Generally, the loss of productivity during fiscal audits or inspections is more difficult to manage for SMEs. SMEs cannot afford to pay extensive financial and legal personnel and do not have the administrative staff to assist inspectors. Usually, it is the SME's revenue-earners who have to do the work involved in complying with multiple fiscal audits, health inspections, fire inspections, and the like. For example, Russia has committed itself to minimizing the number of financial and other checks on businesses. The Government has suggested that a moratorium be imposed on checks of small businesses during the first three years of their existence. The aim is to reduce excessive administrative barriers to SMEs by 90 per cent in the next five years, as one of the key elements in the Russian administrative reform currently in process. Other steps countries may take include: limiting the number of inspections a company may be subject to in a given year; developing a company bill of rights which outlines what a company should expect from an inspection; and establishing an avenue for the redress of improprieties associated with an inspection.

SME-friendly regulatory impact assessments (RIAs). Quite apart from the fact that many countries fail to complete RIAs prior to the introduction of new regulations, all RIAs should take special account of SMEs, as new regulations often have a greater impact on SMEs than on larger businesses. In the United Kingdom, all new regulations are subjected to RIAs

which include a "small-business litmus test" to ensure that they will not impose a disproportionate burden on smaller enterprises. In the USA, many States are adopting "regulatory flexibility" laws for small businesses.

Other strategies governments may employ to reduce the regulatory burden on SMEs are:

- Establishing a government office or assigning a representative from the SME agency or ministry to represent SME views in the larger regulatory development and reform process;
- Ensuring that the small-business sector has a voice in business policy-related dialogue between the public and private sectors;
- Ensuring plain-language drafting and compliance guidance specifically aimed at SMEs; and
- Ensuring that IT is widely available to allow SMEs to take advantage of e-government tools.

Creating a State-supported SME development programme

Throughout the Guide, the emphasis of the recommendations is on improving the business and investment climate through the removal of unnecessary regulations, better laws, transparency, and so forth, rather than through incentives or expensive government programmes. The overall goal is economic competitiveness because a competitive economy attracts FDI and encourages entrepreneurship. At the macro-level, the presence of SMEs adds to the competitiveness of an economy. At a micro-level, the SME may have difficulty competing with larger enterprises. While the SME is growing and maturing to the point where it is competitive, it may warrant state support, but the focus of this support should not be on sustaining the SME. Market economies do not support inefficient businesses but create a framework with a reasonable regulatory burden, access to finance, and access to knowledge. Once the enterprises achieve competitiveness, then they are no longer entitled to these benefits.

Tax benefits for SMEs

All enterprises, large and small, must pay their fair share of taxes. In order to assist small businesses to grow and develop into fully-fledged taxpayers, it may be worthwhile for governments to consider granting SMEs limited tax benefits.

Simplified taxes. Complex tax administration systems are a burden on SMEs. Complex tax returns requiring expensive expertise reduce SME profitability. Reducing the amount and complexity of tax-reporting enables SMEs to focus on enterprise development. For enterprises within certain limits based on number of employees and turnover size, the majority of tax systems are based on a simple percentage of income or turnover. In Lithuania, for example, small enterprises with a gross income of not more than 100 thousand lits (USD 26,000) per year can opt for simplified taxation. In Romania micro-enterprises with a workforce of up to 10 persons and a gross annual income up to 100,000 euros pay tax at a rate of 3 per cent of gross income. In Albania, a fixed rate is applied for micro-enterprises with an annual turnover of up to 2 million leeks (USD 14,000). Small enterprises with an annual turnover of two to eight million leeks pay one single tax at a rate of 4 per cent of turnover.

In Russia, SMEs paying taxes under the simplified taxation system have been granted a unified tax rate of 6 per cent of revenue or 15 per cent of revenue less expenses. The entrepreneur has a choice of tax systems. Businesses using the simplified taxation system do not pay VAT, except on goods imported into the customs territory of the Russian Federation.

When offering simplified tax schemes to SMEs, governments should be wary of companies artificially splitting up into small enterprises for the purpose of staying within tax thresholds and qualifying for preferential tax treatment.

Developing entrepreneurial culture and human capital for SMEs

As the OSCE Strategy Document for the Economic and Environmental Dimension notes: “Human resources are an essential factor for economic growth and development, which require knowledge and skills, inter alia, in economic, business, administrative, legal and scientific matters. We will take appropriate measures to promote education and training and will increase co-operation, including with specialized international institutions and organizations, in areas such as facilitating and widening access to educational, research and training institutions through increased fellowships and internship programmes.”⁷⁷

Once an appropriate legal and regulatory framework is established, human capital must be available if enterprises are to be able to succeed in that framework. Incorporating business and entrepreneurship training in national education systems is an integral part of ensuring that enterprises have the human capital necessary to survive and thrive.

Entrepreneurship education. Many OSCE countries, at differing stages of economic development, have recognized the importance of entrepreneurship education and have established national programmes accordingly. In Finland, the National Board of Education has established core curricula for schools at all levels (from compulsory to upper secondary) that include the promotion of entrepreneurship as a basic objective, both as a cross-curricular theme and as a subject. The period 2004–2006 has seen new curricula being developed that further emphasize the importance of entrepreneurship. All secondary schools in Finland offer entrepreneurship education as an optional subject, with all vocational secondary schools having it as a mandatory element of the curriculum. When it comes to the concrete implementation of the programmes, co-operation is systematically encouraged between schools and businesses, and teachers training events are organized.

In Poland, the National Ministry of Education and Sport has introduced entrepreneurship into the national curriculum. Since 2002 there has been a compulsory subject in secondary and vocational education known as “Basics of Enterprise”.⁸ Objectives include developing entrepreneurial attitudes and learning about how to start an enterprise. Tasks to be fulfilled by schools are clearly defined by the Ministry of Education. Schools can make use of existing programmes, including those offered by NGOs, or devise new programmes in compliance with criteria set by the educational authority.

Vocational skills development. Medium-size businesses often cite the “lack of skilled labour” as an even greater constraint to success than “access to finance”. Most SMEs do not have the resources for in-house training and vocational education, which is why many OSCE countries are active in promoting vocational skills among young people.

One example of just such a programme is the Albanian National Training Programme for SMEs. The programme objective is to develop an entrepreneurial culture, improve the capacity of business support providers, and improve the competitiveness of existing enterprises. The programme consists of basic and advanced business modules and of sector-/cluster-specific business modules and consulting.⁹

The Ministry of Economy and Labour of Austria has developed novel apprenticeship programmes focusing on “high-tech apprentices”, special needs apprentices, and on enabling apprentices to attain an education certificate through practical training.

Barriers to finance for SMEs

SMEs need capital to grow. They need to lease space, purchase equipment, and hire employees. While commercial bank lending is developing across Eastern Europe and Central Asia, financing for SMEs remains insufficient, particularly in the transition countries. To be fair, interest rates are declining in general, and more banks are beginning to develop programmes for the SME market. Nevertheless, access to finance is often limited.

The major barriers for SMEs to obtain financing are:

- Banks perceiving investments as risky and too time-consuming for relatively small loans;
- High interest rates and high collateral required by banks;
- Lack of track records and business plans;
- Perception that management is unprofessional; and
- Geographic concentration of the banks in the capital and large cities reduces SME access in outlying regions.

Because SMEs have difficulty gaining access to traditional lines of credit, governments and donor organizations have helped to develop alternative financing mechanisms for SMEs.

Alternative financing mechanisms

Microfinance programmes. The microfinance industry is relatively new in comparison with traditional banking – it is in fact less than twenty years old. However, microfinance has proven to be one of the most effective tools for reaching micro-entrepreneurs unable to access regular bank credit. Microfinance institutions (MFIs) include State-supported SME development funds, donor-funded microfinance organizations, credit unions, and credit co-operatives. MFIs have developed robust lending and monitoring techniques and demonstrated high repayment rates from their micro-clients.

Microfinance programmes are effective tools for generating economic development and alleviating poverty. Micro- and rural finance supports stable, market-oriented development by working with the portion of the population that is beyond the reach of the traditional market economy. By targeting the poor and expanding opportunities through the provision of credit and business support, these programmes empower people by helping them to increase their income, and the increased number of jobs create broader access to a means of livelihood, as described in the case of Turkmenistan (Textbox 7.2).

OSCE Support to Voluntary Farmers' Associations in Turkmenistan

The OSCE Centre in Ashgabad has been funding a revolving micro-credit pilot project for four voluntary farmers' associations (VFAs) in Akhal and Lebap regions since early 2004. This project is implemented under a cost-sharing arrangement in co-operation with the European Union's Tacis Programme. The OSCE component includes training, equipment and a revolving microcredit fund. Four VFAs were selected for the pilot phase of OSCE's support for job security and employment creation. The participating farmers first underwent a three-month community-level training course in basic business practices, accounting, planning, and trading skills. They then prepared their individual credit applications with the corresponding business plans. The credit, dispersed in amounts ranging between 100 to 250 USD, payable in Turkmen manats, was paid in October 2004. Funding was required for such things as domestic animals, seeds and

seedlings, the improvement of cattle and fowl-rearing facilities, greenhouses, soil and drainage infrastructure, and marketing channel development.

The VFAs repayment rate has been 100 per cent with no defaults. During project-monitoring visits to the sites, the participating farmers have expressed their satisfaction with the project, explaining that their achievements would not have been possible without the micro-loans, as they have no alternative access to credit or capital funding. All four VFAs indicated their readiness to continue the project and to expand their membership base. The Centre is currently planning to continue its support to the sector by extending the VFA project and expanding the variety and number of beneficiaries, or through the development of credit union facilities.

Source: OSCE Center in Ashgabad, News Release 2005.

MFIs often require initial support from governments and/or donors (except for credit co-operatives) to provide the start-up loan portfolio, staff training, purchase and/or upgrade of accounting and managing information software, hardware, safes, furniture, and training. However, in the long run, microfinance institutions should be operationally and commercially viable so that financial services can be provided to the underserved over the long term, resulting in a substantial and sustainable increase in the volume and range of financial services for micro-enterprises. To achieve this, the following measures should be taken:

- Developing a legal framework for MFIs to be able to perform deposit-taking and lending operations;
- Innovative solutions of collateral-related problems, such as the acceptance of more flexible forms of collateral, particularly for SMEs with few fixed assets, or the use of group guarantees;
- Greater emphasis on cash flow than balance sheets in assessment of borrowing capacity; and
- Effective and transparent loan application assessment methodologies.

In 2003, the Kyrgyz Republic adopted the Law on Microfinance Organizations,¹⁰ with Kazakhstan and

Tajikistan following its example in 2003 and 2004. With the adoption of these laws establishing the legal status of MFIs, indigenous organizations obtained the right to establish microfinance operations.

Specialized microcredit banks. In the last 15 years, major international development and financial organizations have established a number of specialized microcredit banks in many OSCE transition countries. These greenfield microcredit banks, such as the KMB Bank in Russia, create significant competitive pressure on larger banks to lower their minimum threshold in the market, expand their retail operations, and offer accessible products to micro and small businesses. Pro-Credit Bank, funded by both donor and private funds, is active throughout Eastern Europe and Central Asia.

Loan guarantee schemes. Guarantees are one of the instruments for providing credit to small businesses whose property is not sufficient to cover the collateral requirement of the bank. Guarantees can be provided by government, business associations, and/or private banks. They cover 50 per cent to 90 per cent of the credit amount, with the guarantee commission ranging from 1 per cent to 5 per cent. Guarantees can be provided to the bank in the form of a letter of guarantee, securities and/or bank deposit. State guarantees are

usually managed by a guarantee or SME fund, and the credit applications are assessed by the bank officers and jointly monitored by the bank and the guarantee fund.

The SME Guarantee Facility has been in operation in the EU since 1998. It provides guarantees to banks to cover their SME loans, and additional guarantees to national and regional guarantee schemes. At the end of 2003, the facility signed contracts with 48 financial intermediaries for a total amount of 308 million euros. At the end of 2003, the cumulative number of SMEs benefiting from the facility was 166,279 as compared with 127,812 a year earlier. Final beneficiaries with 10 employees or less comprised 93 per cent of the total number of SMEs and final beneficiaries with less than 50 employees comprised 97 per cent of the total number of SMEs.¹¹

Some OSCE participating States have had mixed

success in implementing guarantees. The best practices and lessons learnt from credit guarantee schemes implemented in OSCE countries can be summarized as follows:

- A first-time guarantee should not exceed a maximum of 50 per cent of the credit amount, in order to prevent irresponsible performance under the guarantee, either by the borrower or the bank;
- The total amount of the State guarantees should not exceed the guarantee fund's account in the recipient bank, to ensure that potential loss will be covered;
- A commission fee of 1 per cent to 3 per cent should be charged in advance of the guarantee provision to cover the guarantee management costs, in addition to the commission charged annually; and
- A guarantee fund should be independently and transparently managed to avoid fraudulent practices, and arrangements should be made so that the guarantee fund portfolio can be objectively assessed at any time.

TEXTBOX 7.3

Channelling remittances – venture capital for SMEs. A case study: Silicon Armenia.

The money that migrants send home – remittances – constitute an important source of income not only for migrants' families but also for the migrants' home countries: for developing countries remittances are second only to FDI as a source of external finance, and for the last five years remittances have significantly exceeded the size of international aid flows. Remittances can be used for consumption but also for investments such as building homes and starting businesses. One excellent example of taking remittances and channelling the funds into diaspora investment is SiliconArmenia.

SiliconArmenia was established as the primary Armenian high-tech/ICT industry portal, designed to promote Armenia's burgeoning technology sector through increased exposure to international markets, prospective customers, partners, and investors. SiliconArmenia is a bridge between Armenia's strategically important high-tech/ICT industry and members of the Armenian diaspora who are in positions to help this sector flourish. By creating business links and a dynamic network between companies in Armenia, the Armenian diaspora and the global technology community, the portal seeks to exploit the capabilities of the Armenian diaspora to help Armenia's economic development.

Mission:

- To contribute to increased employment, productivity and market share growth of the Armenian high-tech/ICT industry;
- To support the creation of an ideal business environment in order to attract additional foreign investment in the Armenian high-tech/ICT industry;
- To advance the creation of an information society and knowledge-based economy in Armenia;
- To position and brand Armenia within the global marketplace as a high value/low-risk high-tech/ICT location for investment.

The single most important constraint for expansion of companies, in particular SMEs, in developing countries, including Armenia, is lack of market knowledge and the high cost of entering new markets. This project seeks to alleviate this constraint by facilitating business linkages between companies in home countries and businesses owned/managed by the diaspora. Existence of diaspora resources is a major potential comparative advantage. SiliconArmenia attempts to help Armenian IT companies exploit that comparative advantage.

Source: SiliconArmenia.

Access to enterprise support services

As businesses often start in homes, SMEs frequently suffer from a lack of office and industrial space, efficient production technology, management and control systems, and access to consulting and IT skills. Enterprise support services provide SMEs with access to these inputs, which are so critical to a successful enterprise.

Business support centres. Among the support institutions, business advisory, counselling and information centres have proven particularly effective instruments for helping entrepreneurs start new businesses and survive their start-up period, and for strengthening existing enterprises. The primary purpose of business services centres is to help launch start-ups and to increase the competitiveness of existing SMEs (Text-box 7.4). The majority of the services should be provided at low cost, or entirely free for start-ups (Table 7.3).

TABLE 7.3

Typical services provided by business support centres

Computer and related services	Professional services	Renting and leasing services	Labour-related services	Operational and other services
hardware consultancy	legal activities	renting of transport and construction equipment	recruitment of personnel	security activities
software consultancy	accounting- tax consultancy	renting of office machinery incl. computers	Provision of per- sonnel	industrial cleaning
data processing	management consulting			secretarial assistance
data base services	market research			translation activities
technical testing and analysis	advertising			packaging activities
	Technical services architectural ac- tivities- engineer- ing activities			fairs and exhibitions

TEXTBOX 7.4

Examples of business support centres

More than 500 business advisory and information centres and business support agencies exist throughout the United Nations Economic Commission for Europe (UNECE) region; of these, 274 are Euro Info Centres (EICs) that have been established with the assistance of the European Commission. In Central and Eastern Europe there are 43 EICs. In the Baltic States, there are two EICs and one correspondence centre. Over a thousand business support institutions have been established in the USA.

In Azerbaijan, more than 40 regional Business Advisory Centres are helping to develop small and medium-sized businesses throughout the whole country.

Russia has a whole range of services working to promote SME development, such as regional SME Support Funds and the Russian Agency for SME Development. The Agency has in turn created a regional network of agencies, covering more than 50 regions in Russia. The agencies offer services for examining investment projects, and expert financial advice on such matters as auditing and accounting. They provide information about business partners, about the region's business climate, and about legislation, taxation, accounting rules, and reporting. They also help prepare contracts and documentation, give legal support in negotiations and registration and organize courses and seminars on how to run a business in Russia.

Business incubators. A business incubator is defined as an organization that creates favourable conditions for a start-up company. An incubator helps businesses gain access to lenders and investors, office equipment, consulting services, and training programmes (Textbox 7.5).

The concept of business incubation has only evolved in the last 30 years. The "first generation" of business

incubators (1980s) were essentially offering affordable space and shared facilities to carefully selected entrepreneurial groups. In the 1990s, incubators supplemented workspace with counselling, skills enhancement, and networking services for tenants within the facility and affiliates outside. A shift has also been experienced in the business model of the incubators from not-for-profit incubators to for-profit. The for-profit incubators are intended to energize ICT companies.

TEXTBOX 7.5

Business Incubator Starting in Goris, Armenia

One of the local economic development activities supported by the OSCE field office in Armenia was the establishment of a business incubator in the city of Goris. The fact that approximately 80 per cent of the region's GDP is produced by four mining companies means that economic diversification and support for SMEs are high-priority matters.

Together with UNDP Armenia, the OSCE Office in Yerevan sponsored a feasibility study and planning exercise for the establishment of a business incubator in Goris.

The results have been submitted to an expert on best practices for business incubation so that an action plan may be drawn up for attracting donor funds to upgrade the premises provided by the local authorities. Completion of the upgrade will be followed by a "Successful Start" initiative, which will be jointly implemented with the GTZ Pro SME project with the initial aim of identifying viable business ideas and entrepreneurs capable of implementing them.

Source: OSCE Field Office, Yerevan, Armenia.

Innovation centres. Innovation is a key determinant of firm competitiveness both in fast-growing high-tech sectors and also in more traditional sectors. The ability of most small businesses to survive, grow, and generate new quality jobs depends increasingly on their capacity to put innovation at the core of their business strategy. In turn, small innovative firms play a vital role in raising growth potential by ensuring the vitality of regional and national innovation systems. The average inno-

vation cycle takes from five to seven years before it produces a marketable product. Even high-risk venture capital would not support the earlier innovation stages. Government can support innovative start-ups and involve private partners at the technology commercialization stage. FASIE in Russia is an example (Textbox 7.7). Innovation centres provide opportunities for growth to innovative SMEs (Textbox 7.6).

TEXTBOX 7.6

Oxford Innovation Centres, United Kingdom

Innovation centres are different from business support centres and offices with managed workspace. They provide small companies with workspace in an instructive and supportive environment. Their aim is to maximize the formation and development of businesses with potential for growth. Typical features include:

- Professional small-company infrastructure and image;
- Communities of like-minded entrepreneurs, individuals, and companies;
- The flexibility of a straightforward licence to occupy with only one month’s notice;
- Selection on entry to ensure business viability and growth potential;

- Practical help and access to a network of information sources and advisers;
- Close relationship between centre management and client businesses; and
- Focus for support measures aimed at fast-growing companies.

According to the UK Small Business Service, the Oxford innovation formula for business support certainly seems to work. Their research shows that start-up businesses using one of Oxford’s innovation centres have a much higher chance of success: they show a survival rate of 89 per cent over the crucial first two years, which is substantially better than the UK average of 78 per cent.

Source: <http://www.oxin.co.uk/busenv/index.php>

TEXTBOX 7.7

The Russian Foundation for Assistance to Small Innovative Enterprises (FASIE)

The FASIE is a non-commercial State organization established in 1994. It has an annual budget equalling 1.5 per cent of the federal R&D budget (a little over a billion rubles in 2006) and has offices in 29 regions of the Russian Federation.

The Foundation's key objectives are as follows:

- The implementation of government policy for the development and support of small innovative enterprises;
- Offering direct financial, informational and other aid to small innovative enterprises, and the implementation of projects to develop and produce new high-tech products; and
- Creating and developing an infrastructure for SMEs.

The FASIE is an initiator and participant in the development of laws and legislative acts providing State and social support for small businesses.

Since its creation, more than 4,000 SMEs from various regions around the country have applied to the foundation. The foundation's tender commission and experts have selected around 2,000 projects for funding.

As of 1 January 2006, the FASIE has received more than 10,000 R&D project applications, and 4,000 received funding of over 2.5 billion rubles. The projects are evaluated by boards of independent experts, which are comprised of scientists, economists, and marketing specialists. In all, 2,455 independent experts are involved in project selection.

Most of the FASIE's grants are given to support R&D commercialization of small, innovative, and technology-intensive companies in the areas of machinery-building and instrument-making (21%); SME support infrastructure (18%); medicine and pharmaceuticals (17%); construction and new building materials (13%); computer software and hardware (12%); food-processing and agroindustry (10%); and electrical and power engineering (9%).

Up to 15 per cent of the FASIE's budget is spent on such items as innovation and technology centres, offices of R&D commercialization, involvement of students and young scientists in R&D commercialization, and management training. More than thirty ITCs have been established in Russia, with aggregate floor space of over 100,000 square metres rented at lower-than-market rates to hundreds of innovative SMEs.

The SMEs supported by the FASIE have put more than 1,000 patents into serial production, achieved tens of billions of rubles in sales, while the taxes paid by them exceeded the federal budget investment in their projects by a factor of 2.4. The beneficiary SMEs have shown major increases in productivity. FASIE-supported SMEs constitute a significant share of the Russian market in their respective industries, e.g., software, and scientific and environmental instruments.

The FASIE is particularly concerned to gradually move its support to projects that are at earlier stages of the innovation cycle and to develop co-operation with venture structures and other funding agencies involved in innovation projects.

Source: www.fasie.ru

Access to markets and cluster development

An emerging opportunity to reap the potential benefits of global trade is represented by the integration of SMEs into international chains of production at various stages of added value through the establishment of linkages with larger firms and foreign affiliates. For SMEs, these linkages represent a way of accessing critical missing resources, the most important of which are international markets, finance, technology, management skills and knowledge.

SMEs may complement large firms in their value chains, exploiting advantages of flexibility and lower transaction costs due to closer contact with customers and quicker decision-making, while large enterprises exploit advantages of scale. Competitiveness is thus a question of having the right mix of small and large firms and an adequate division of labour that combines economies of scale with flexibility and the advantages of specialization.

TEXTBOX 7.8

Transnational Corporations and SMEs in Russia

Boeing reportedly helped several Russian firms meet the international quality standards required to supply material and parts for international airliner production. Similarly, Ikea, Pratt and Whitney and McDonalds have developed local SME supplier networks. Via its Backward Linkages programme the IFC is hoping to develop similar supplier networks in conjunction with its investment in Ford's Russia operations. In each case, the local

SMEs are trained to meet the exacting quality standards of a dynamic, multinational corporate customer. In effect, these local SMEs have found a niche in the global value chain.

Source: From *Knowledge to Wealth: Transforming Russian Science and Technology for a Modern Knowledge Economy*, World Bank Policy Research Working Paper 2974, February 2003.

SME clusters. An additional best practice is encouraging linkages between SMEs and multinational enterprises (MNEs). When MNEs and SMEs interact, often the result is the development of domestic supplier networks, clustering, and technology spill-over. Governments can facilitate linkages by providing general and “matchmaking” information. The OECD provides more explicit information on policy practices in its publication *Encouraging Linkages Between Small and Medium-Size Companies and Multinational Enterprises*.

The most successful clusters – such as Silicon Valley, Emilia Romagna in Italy, and Baden-Württemberg in southern Germany – demonstrate that the SME cluster approach can boost regional development through collective efficiency. Networking in clusters offers an important way for individual SMEs to address their problems and to improve their competitive position at the same time. Cluster initiatives in OSCE countries have proved that networking is more likely to succeed when enterprises operate in proximity and share business interests such as markets for products, infrastructure requirements, or the need to challenge external competition. Within such groups, or clusters, enterprises' joint initiatives are stronger because of the critical mass of interested parties, are more cost-effective because of shared fixed costs, and are easier to coordinate because proximity fosters mutual familiarity and trust.¹²

TEXTBOX 7.9

SME clusters in Ukraine

In 1997 local entrepreneurs and authorities in the Khmel'nitski region collaborated on the creation of sectoral clusters. The construction cluster, for example, has created as many as 5,000 new jobs, and the textile cluster up to 3,000. In the early 1990s, more than 90 per cent of garments in the Khmel'nitski region were imported from Poland, Turkey, and the UAE. Ten years later, 75 per cent of fashionable clothes were produced by enterprises from the textile cluster. The development of a tourism cluster in Kamenets-Podolsky during the period 1999–2003 brought about a threefold rise

in the number of tourist visitors. The development of the tourist business has stimulated the local construction and food-processing clusters. The positive results of clustering have triggered interest in emulating this undertaking in other regions and towns in Ukraine (e.g. Prikarpat'e, Poles'e, Crimea). The clustering of business models in Ukraine is supported by both governmental and non-governmental business promotion agencies, which organize information sessions and training seminars for companies and local administrations.

Source: <<http://www.unece.org/ie/wp8/industres.html>>

The main attributes of industrial districts or clusters are the following:

- geographical proximity of SMEs;
- sectoral specialization;
- predominance of small and medium-size firms;
- close inter-firm collaboration;
- inter-firm competition to innovate;
- a socio-cultural identity that facilitates trust;
- active self-help organizations; and
- supportive regional and municipal governments.

The most successful clusters are government-supported bottom-up initiatives such as the electronic engineering clusters in St. Petersburg, Zelenograd, and Tomsk in Russia, or Ukraine's grassroots cluster initiatives (Textbox 7.9).

Real service centres. An element in the promotion of Italian industrial districts that has attracted a great deal of attention are the "real services" that offer business development support services that are highly customized to the specific industrial tradition of the area. Over 130 real service centres were identified in 56 industrial districts. These centres offer a wide array of services including the following.

- credit guarantee;
- export insurance and/or promotion;
- organization of trade fairs;
- access to information on the evolution of markets/technology;
- client-rating;
- consultancy;
- training;
- waste management;
- pollution control;
- quality certification and award of trademarks;
- product promotion;
- support to innovation;
- bulk purchase of inputs; and
- product-testing.

These centres are publicly owned by producers' associations, local government, or SME support agencies, or by combinations of these bodies in partnership.

Conclusions and Recommendations

Given the importance of SMEs in job creation, poverty alleviation, economic growth and innovation, governments should take responsibility for stimulating SME development. The following measures are recommended to governments intending to develop an “SME-friendly” legal, regulatory, and administrative environment.

In the area of SME policies and programmes:

- Designing SME programmes that will help SMEs overcome the effects of market failures, but without unduly distorting market structures or creating barriers to competition, and evaluating programmes regularly for effectiveness and efficiency.
- Focusing programmes on: improving management skills; making finance available on reasonable terms; increasing SMEs’ ability to compete for government procurements; giving SMEs quick access to advice and information; building SME capability to exploit information and communication technologies; and improving linkages with other SMEs and large firms to encourage the emergence and development of innovative clusters.

In the area of business regulation:

- Developing a simple, transparent, and low-compliance-cost tax system with fair tax rates, with consideration being given to reduced and/or simplified taxes for micro-enterprises.
- Simplifying the business registration system, and ensuring the availability of Internet-based registration.
- Streamlining business-licensing requirements.

In the area of financial services:

- Ensuring that financial sector regulations (banking, insurance, leasing) recognize SME constraints and that appropriate legal and regulatory instruments are introduced to make it possible for assets commonly available to SMEs to be used as collateral.

In the area of business culture, education, and training:

- Developing entrepreneurial culture through business education and promoting a positive image of entrepreneurship.
- Providing SMEs with favourable conditions for setting up and joining membership organizations.

RESOURCES

OSCE, Office of the Co-ordinator of OSCE Economic and Environmental Activities: <<http://www.osce.org/eea/>>

OSCE, *Strategy Document for the Economic and Environmental Dimension*, <<http://www.osce.org/item/16350.html>>

OSCE, *Best Practices in Combating Corruption*, <http://www.osce.org/eea/item_11_13568.html>

OECD, Centre for Entrepreneurship, SMEs and Local Development:

< http://www.oecd.org/department/0,2688,en_2649_33956792_1_1_1_1_1,00.html>

< <http://www.doingbusiness.org/>>

EBRD, *Transition Report and Business Environment and Enterprise Performance Survey (BEEPS)*,

<<http://www.ebrd.com/pubs/econo/series/tr.htm>>

European Charter for Small Enterprises, <<http://europa.eu.int/scadplus/leg/en/lvb/n26002.htm>>

The Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs,

<http://www.oecd.org/document/16/0,2340,en_2649_201185_32020176_1_1_1_1,00.html>

OECD, *Encouraging Linkages Between Small and Medium-Size Companies and Multinational Enterprises*,

< <http://www.oecd.org/dataoecd/62/30/35795105.pdf>>

Oxford Innovation Centres: < <http://www.oxin.co.uk/busenv/index.php>>

ENDNOTES

1 Dr. Supachai, Secretary-General of UNCTAD, 2006.

2 Supachai Panitchpakdi, *Transition: The First Ten Years*, World Bank (2002).

3 *OSCE Strategy Document for the Economic and Environmental Dimension*, <<http://www.osce.org/item/16350.html>>

4 European Charter for Small Enterprises, <<http://europa.eu.int/scadplus/leg/en/lvb/n26002.htm>>

5 OECD, *Promoting Entrepreneurship and Innovative SMEs in a Global Economy: Towards a More Responsible and Inclusive Globalisation*, (2004), <www.oecd.org/searchResult/>

6 IFC Ukraine.

7 *OSCE Strategy Document for the Economic and Environmental Dimension*, <<http://www.osce.org/item/16350.html>>

8 See *Summary Report of the Conference on the European Charter for Small Enterprises, Luxembourg* (European Commission Enterprise and Industry Directorate-General, 15–16 June 2005), <http://europa.eu.int/comm/enterprise/events/charter/doc/2005_lux/lux_summary.pdf>

9 *Report on the Implementation of the European Charter for Small Enterprises in Moldova and the countries in the Western Balkans* (Brussels, 2005).

10 <<http://counterpart.org/kg/Russian/useful/59>>

11 EU, *The activities of the European Union for small and medium-sized enterprises* (SME Envoy Report, 2005).

12 <<http://www.unido.org/doc/4310>>

Chapter 8

Sustaining and Strengthening a Better Business and Investment Climate



OSCE

Governments should take a long-term approach to economic development, and should not short-change the future in return for short-term gain. A philosophy of sustainable development aims to meet the needs of the present without compromising the ability of future generations to do the same. Among other things, this means protecting the physical environment against pollution, deforestation and desertification, and loss of biological diversity. In the long term, lax environmental enforcement will make a country less, not more, attractive as an investment destination. Environmental regulations should be rational and should be applied without discrimination between enterprises in any given common field. Countries with major natural resource deposits should strive for transparency and accountability in the extractive industries and the agencies that regulate them. Without coercing companies, governments can still take positive steps to promote corporate social responsibility (CSR), encouraging firms to commit themselves to operating their businesses in a manner that attains or surpasses the ethical, legal, commercial, and public standards expected of them by society. Governments can also reinforce trends toward excellence in corporate behaviour by working with firms to develop non-binding codes of industrial conduct that demand widespread respect.

Sustainable development

Hitherto, the Guide has mainly focused on initiatives calculated to promote better and more profitable business and investment in OSCE countries, with the aim of raising their levels of economic prosperity. It has advocated that countries seeking greater FDI and entrepreneurship should “open up” their economies, and eliminate unnecessary regulations. However, countries must be sure of the sustainability of the investments they attract and the economic development that will follow. While governments should limit their role as actors in or managers of business activity, they still need to monitor business activity to see that society and the environment are protected.

The following three elements are often quoted as being the three pillars of sustainable development:

- Economic growth;
- Environmental protection; and
- Social development.

While the desire for economic growth is the main motivator behind the Guide, it would be remiss not to acknowledge the importance of the other two pillars for the long-term sustainability of investment in OSCE countries.

Environmental protection

The Millennium Declaration and the related Millennium Development Goals (MDGs) explicitly commit the world community to making progress in achieving environmental sustainability within the context of a broader global agenda aimed at reducing poverty and malnutrition, and expanding education and health care. As with business climates, it is the more competitive and wealthy States, such as the Nordic countries that have what are generally regarded as sound environmental policies.

Governments should thus think twice before lowering legitimate standards or compromising on their enforcement in order to attract FDI. While lowering environmental standards may lure some polluting industries away from the more environmentally stringent economies, it is a practice that will inevitably threaten national sustainability in the longer term. Especially in the case of agriculture-based economies, large scale urban pollution has disastrous consequences on the ecosystem of the surrounding agro-regions, not to mention the health of the population generally. In coastal areas, inadequate facilities to deal with effluent run-off can seriously damage the local fishing industry. The tourist industry is also dependent on environmental protection: one only has to think of the importance to tourism of clean beaches and the like. It is difficult to strike the right balance between environmental protection and economic and technological progress. However, requiring environmental risk assessment to be based on science is a sound practice that will protect the environment without needlessly disrupting economic development. But governments should also avoid regulations and remedies that are greatly disproportionate to the perceived risk of an activity.

Environmental regulations should be applied without discrimination to all enterprises that engage in the same kinds of activities. If strict environmental standards are applied only to a subset of actors – foreign companies, for example – those standards undermine the entire structure of environmental protection, stifling economic development and possibly fomenting corruption and cronyism. Universal application, on the other hand, promotes a level playing field on which competition – the foundation of a market economy – can flourish.

Environmental protection and sustainability bring opportunities for investment. Countries can attract high-technology carbon-reducing industrial projects through international emissions trading mechanisms. Countries that have ratified the Kyoto Protocol are eligible to host Joint Implementation (JI) and Clean Development Mechanism (CDM) projects.

Environmental investment opportunities in Russia

The Northern Dimension Environmental Programme is an innovative co-operative initiative that was undertaken in response to calls from the Russian Federation and the international community for efforts to tackle some of the most pressing environmental problems in north-west Russia. It is being implemented jointly by the EBRD, the Nordic Investment Bank (NIB), the European Investment Bank (EIB), and the World Bank.

The NDEP consists of 16 priority projects with a combined total cost close to two billion euros. The projects aim to deliver environmental solutions to north-west Russia in the fields of district heating, solid waste management, wastewater treatment, and energy efficiency.

The NDEP is making a real difference to the environment – and the people – of north-west Russia and to the Northern Dimension generally.

The NDEP provides a strong international framework, backed by adequate financial resources, for governments, international financial institutions, private investors, Russian authorities and others to work together on solving the region’s long-standing environmental problems. The NDEP is a remarkable instance of the European Commission, the Russian Federation, the EBRD, the EIB, the NIB and the World Bank pooling their expertise and resources on the design and implementation of a whole pipeline of environmental projects.

Source: www.ndep.org

Environmental degradation, resource scarcity, the uneven distribution of natural resources or resource abundance are emerging as potential triggers or accelerating factors of tensions within and among countries. Environmental decline and resource scarcity are just two elements in a complex web of causalities in which a whole range of socio-economic problems are closely intertwined. Environmental degradation and natural resource scarcity are at once causes and outcomes of these socio-economic problems or are intensified by them.

As the OSCE Strategy Document for the Economic and Environmental Dimension puts it: “Environmental degradation, the unsustainable use of natural resources, and mismanagement in the processing and disposal of wastes have a substantial impact on the health, welfare, stability, and security of our countries, and can upset ecological systems.” This is why the OSCE is strongly involved in promoting co-operation in OSCE participating States in the area of the environment, in particular through its Environment and Security Initiative (ENVSEC): www.envsec.org.

Social development

The countries with oil reserves in the Caspian Sea have recently experienced a surge in foreign investment and economic growth. Nonetheless, half their combined populations live on less than one dollar a day. When economic growth has a very limited effect on social development and poverty reduction, it is no great benefit to the country concerned and erodes popular support for a better business climate. If governments wish to improve and strengthen the business climate, they should encourage – and not simply direct – businesses to recognize their corporate social responsibility. Collaboration between governments and businesses accelerates social development.¹

Corporate social responsibility (CSR)

That business leaders are becoming increasingly aware of the need for corporate social responsibility is demonstrated by the increasing number of bodies that have adopted the Ten Principles of the UN Global Compact (Textbox 8.2), and by the business community’s commitment to making a contribution to the attainment of the UN Millennium Development Goals.

What is the definition of CSR? Corporate social responsibility is defined as a global movement in which companies and organizations are voluntarily integrating social and environmental concerns into their operations and reporting practices.² Some of the more powerful driving forces behind corporate responsibili-

ty are the possibility of enhancing competitive advantage, “reputation management”, pressure group and consumer politics, regulation or the threat of regulation, and changes in the way production and marketing are being organized globally.

TEXTBOX 8.2

The United Nations Global Compact Principles

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights within their sphere of influence; and

Principle 2: Make sure that they are not complicit in human rights abuses.

Labour

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: The elimination of all forms of forced and compulsory labour;

Principle 5: The effective abolition of child labour; and

Principle 6: Eliminate discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;

Principle 8: Undertake initiatives to promote greater environmental responsibility; and

Principle 9: Encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

CSR and the public sector

As Peter Woicke, Executive Vice-President of the International Finance Corporation has remarked, “For businesses to continue to improve their social and environmental performance, the public sector needs to provide two key contributions: (1) clarity in its regulations, the baseline standards it requires of all firms, and (2) predictability of government intervention.” The voluntary CSR practices of private enterprises are not and cannot be an effective substitute for good governance. Since CSR is by nature voluntary, it is critical that governments do not pressurize – and are not be perceived as pressurizing – companies into CSR. This damages the business climate and increases the spec-

tre of corruption. The best way for governments to promote CSR is to create a favourable business climate. A government that acts responsibly models good behaviour and promotes good behaviour on the part of companies at all levels: international, national and local. Governments can best support and strengthen the business climate not by mandating or managing CSR activity but by encouraging an atmosphere where companies develop sustainably and act responsibly.³

The public sector can also play a role in providing incentives for CSR. While numerous countries have allowed taxpayers to direct money to NGOs or charities, Hungary and Romania have introduced the 1 per cent law which allows companies to earmark one per

cent of their profit tax for a specific registered NGO or charity. Governments can also provide incentives to companies in energy-intensive industries to diversify their energy supply and undertake energy efficiency measures that will have positive financial implications and lessen the “ecological footprint”.

Codes of conduct for industry

A growing number of industries are voluntarily developing codes of conduct aimed at maintaining high levels of business, ethical, social, and environmental behaviour.

The Kimberley Process. The Kimberley Process is a joint initiative undertaken by government, civil society and the diamond industry to stem the flow of diamonds used by rebel movements to finance wars against legitimate governments. Illicit trade in these precious stones has contributed to the scale of the devastating conflicts in countries such as Angola, Cote d’Ivoire, the Democratic Republic of Congo and Sierra Leone. The Kimberley Process Certification Scheme is an innovative, voluntary system that imposes extensive requirements on participants to certify that shipments of rough diamonds are free from conflict diamonds. The Kimberley Process has 45 official participants, including the European Community. Kimberley Process participants account for approximately 99.8 per cent of the global production of rough diamonds.⁴

Electronics Industry Code of Conduct. This industry code was developed recently to establish and promote unified industry expectations for socially responsible practices across the electronics industry’s global supply chain. HP facilitated collaboration on the code between itself, Dell, IBM and electronics manufacturing companies Celestica, Flextronics, Jabil, Sanmina SCI, and Solectron. Released in 2005, the code paves the way for a harmonized approach for monitoring suppliers’ performance across several areas of social responsibility, including labour and employment practices, health and safety, ethics, and protection of the environment.

Leading companies have worked to ensure that their human rights commitments are reflected in corporate practices. In some industries, notably the clothing industry, companies have agreed not only to codes of conduct, but also to independent monitoring based on principles from the Fair Labour Association, in order to increase the chances that they and their suppliers will live up to their word.

CSR: the business case

The business case for CSR is becoming increasingly apparent as “doing good and doing well are increasingly needed and mutually reinforcing” (Textbox 8.3). The concept of responsible competitiveness in which businesses are systematically and comprehensively rewarded for more responsible practices and penalized for the converse is becoming the norm. Many studies confirm that the way a company manages social and environmental issues is often a good indicator of overall risk levels and general management quality, both of which are strong determinants of companies’ long-term success.⁵ A recent report on the oil and gas industry by Goldman Sachs, for example, concludes that the companies with the best track record in terms of social responsibility and a long-term vision about a low-carbon future are also the ones dominating the market share of strategic projects. The EU promotes responsible entrepreneurship and CSR among large businesses and SMEs in particular. CSR can also be worth pursuing for SMEs: it can open up new business opportunities, bring about higher customer satisfaction and loyalty, develop more motivated staff, improve relations with the local community and public authorities, save costs, and enhance company reputation.

TEXTBOX 8.3

The small-business case for social responsibility, Turkey

ARGE is a management consulting firm established in 1991 with 15 employees and a turnover of one million euros. ARGE provides advisory services in the areas of business strategy, business excellence methodologies, institutional and organizational development, and change management.

ARGE encourages all its employees to spend one paid working day a week on NGO activities in order to improve the quality of life in the community at a local, national and global level. The aim is to increase the management quality and effectiveness of civil society organizations. ARGE's chairman initiated and led the *National Quality Movement* in Turkey in 1998 and new quality award categories for SMEs, the public sector and — for the first time in Europe — also for NGOs. A case study was prepared to demonstrate the application of the EFQM (European Foundation for Quality Management) excellence model to NGOs.

ARGE also encourages cross-sector partnerships between different organizations. It has initiated and participated in the first secondee programme with the Turkish Quality Association to encourage individuals with management experience to work at an NGO on a half-/full-time basis. ARGE was also instrumental in setting up the Corporate Volunteers Association to promote volunteerism in the private sector. It contributed

to this scheme by providing voluntary work in planning, managing and publicizing these efforts as well as by developing content and methodology for dissemination. Participating companies evaluate voluntary contributions by their employees in their annual performance reviews.

ARGE works together with various civil society organizations to promote good governance principles in NGO management. It has established a certificate programme for NGO management in collaboration with Bosphorus University.

Business benefit:

- ARGE was ranked as one of the top three management consulting firms in Turkey by a survey published in *Dünya* a leading business newspaper.
- Promoting volunteerism also helps motivate and retain highly qualified personnel.

Benefit for society/stakeholders:

- The Corporate Volunteers Association attracts more professionals to voluntary work, helping in the building of more effective civil society institutions.
- Over 1,000 private/public sector institutions and NGOs have improved their management quality, benefiting employees and stakeholders alike.

Sources: <http://www.generationeurope.eu.com>; www.arge.com

Conclusions and Recommendations

Sustainable development is impossible without a strong business and investment climate. There must be an appropriate framework for regulation and governance for firms to survive and act responsibly. Environmental regulation is an area where government must provide balanced regulation that will safeguard the national interest as well as the commercial viability of enterprises. Once an appropriate framework is in place, governments can bolster the long-term sustainability of the business climate by encouraging – and not mandating or pressurizing – enterprises to act responsibly. Corporate social responsibility activity is the decision of the enterprise. Firms involved in CSR activity tend to be more profitable. Best practices in this area include agreeing to industry codes of conduct, and encouraging employees to participate in volunteer work.

RESOURCES

UN Division for Sustainable Development: <www.un.org/esa/sustdev/>

OECD Sustainable Development:

<http://www.oecd.org/topic/0,2686,en_2649_37425_1_1_1_1_37425,00.html>

The UN Global Compact: <www.globalcompact.org>

Arge: <www.arge.com>

Northern Dimension Environmental Programme: <www.ndep.org>

ENDNOTES

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Annex
◆
Bibliography
◆
Glossary
◆
List of
Abbreviations



Annex

Questionnaire Results and Analysis

A questionnaire for the Guide on Best Conditions for Enhancing the Business and Investment Climates was distributed in February 2006. In total, 26 responses to the questionnaire were received, from a total of 17 OSCE countries:

- Albania
- Armenia
- Azerbaijan
- Bosnia and Herzegovina
- Former Yugoslav Republic of Macedonia
- Georgia
- Hungary
- Kazakhstan
- Malta
- Montenegro
- Russia
- Serbia
- Slovakia
- Slovenia
- Tajikistan
- Turkmenistan
- Ukraine

The respondents to the questionnaire included 9 multilateral organization field offices, 10 national investment promotion agencies, and 6 SME development agencies.

1. What makes a good investment and business climate?

Description	% of respondents
Business legislation and regulation	73%
Investment incentives and promotion	65%
Government policies	54%
Political and macroeconomic performance and stability	38%
Geographic location, natural resources	31%
Country image and international rating	31%
International agreements, openness	31%
Banking system	23%
Stable monetary and fiscal policy	19%
Infrastructure	15%
Role of migrants' remittances	15%
Labour: skills, education level, costs	12%

2. What are the key barriers to foreign direct investment?

Description	% of respondents
Legislation in general	58%
Physical infrastructure	54%
Judicial system, investor rights protection	38%
Government policies	35%
Administrative burden	35%
Corruption	35%
Business entry and licensing difficulties	27%
Country reputation, economic and political stability	27%
Land and construction permits	23%
Skilled labour availability	19%
Market deficiencies (size, price policies, monopoly)	15%
Geographic location, natural resources	15%
Tax and customs: regulation and administration	12%
Banking system	12%
Investment incentives and promotion	12%
Accounting standards	8%

3. What are the key barriers to SME development?

Description	% of respondents
Access to credit	54%
Legislation – general: drafting, adoption and enforcement	50%
Lack of business skills	50%
Corruption	46%
SME support infrastructure	46%
Business regulation and enforcement	35%
Tax and customs: regulation and administration	31%
Bureaucracy in general	27%
Market deficiencies	27%
Government policies (or lack of)	23%
Physical infrastructure	19%
Co-operation with big business	12%
Access to land, construction sites, etc.	12%

4. What are the countries demonstrating best practices?

Country	Times mentioned
Estonia	6
Latvia	4
Ireland	4
Czech Republic	4
Finland	4
Poland	4
Lithuania	3
Norway	2
United Kingdom	2
Kazakhstan	2
Slovakia	2
Hungary	2
Slovenia	1
Kyrgyzstan	1
Georgia	1
Montenegro	1
Iceland	1
The Netherlands	1
Sweden	1

QUESTIONNAIRE CONTENTS:

1. How would you describe the overall business and investment climate in your country?
2. What are the main barriers to foreign direct investment?
3. What are the main barriers to SME development and entrepreneurship?
4. Have there been any significant steps taken in the past five years to improve the business and investment climate? Which actions were taken and which were most effective? Why? Are there any actions taken that were not particularly effective or were disappointing? Which actions and why?
5. Are there any particular laws or regulations that have been already established or amended recently that have led to an increase in foreign direct investment?
6. Are there any planned legislative or regulatory changes expected in 2006 that you think will be particularly helpful for the business and investment climate?
7. Have there been any specific government programmes that have been effective in attracting foreign direct investment or fostering SME development? Are there any programmes to attract remittance or direct funds from members of the diaspora into investment?
8. What mechanisms does your country use to promote foreign investment? An investment promotion agency? Regional investment bodies? Incentives? Which have been most effective? Please elaborate.
9. Are there other countries, particularly fellow OSCE participating States, which you regard as an example for the development of your own business and investment climate? Which countries and why? Have you been able to implement any of their practices?
10. Please feel free to add any additional comments related to your country's business and investment climate, or comments that you think might be helpful for the Guide.

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Glossary

When used in the Guide, the following terms are to be understood in the sense given below.

Arbitration: a means of dispute resolution which is an alternative to litigation, and in which the parties have agreed to submit a dispute for a binding decision by a third party.

Bankruptcy: the legally declared inability of a debtor to pay its creditors.

Bid protest: a legal challenge to the award of a government contract, or to the acceptance or rejection of a proposal or bid to a government procurement opportunity.

Business environment: the enabling framework for companies, foreign and domestic, to conduct business and seek profits in a given country.

Cadastral: a public inventory of data concerning immovable property within a certain region, country, or district, based on a survey of the region concerned.

Capital adequacy: the ability of a bank to face risks by relying on amounts of money that have been paid in by the shareholders, together with certain other reserve funds.

Capital markets: markets for medium- to long-term financial assets, such as corporate stock and public or private debt instruments with a maturity of at least one year.

Certification trademark: a trademark that “certifies” goods or services as being of a certain standard or possessing certain qualities or other characteristics.

Cluster-based development: an economic development technique which targets the industries that naturally exist in a local economy and focuses available resources on developing what is most needed to nurture those industries, such as customized vocational training, physical infrastructure, and specialized research programmes at local educational institutions.

Collateral: an asset that guarantees the repayment of a loan. If the loan is not repaid according to its terms, the creditor may use the value of the collateral to satisfy part or all of the debtor’s loan obligation.

Collective trade mark: a special trademark or service mark registered for the exclusive use of members of a co-operative, an association, a union or other collective group or organization.

Competition law: a system of rules, regulations, and legislation aimed at avoiding the concentration and abuse of market power on the part of private firms.

Conciliation: a form of non-binding alternative dispute resolution in which a neutral party attempts to guide parties to resolution of a conflict. The primary goal of conciliation is to resolve differences through seeking concessions. The term conciliation is sometimes used interchangeably with mediation, although the terms may have different meanings in a given context.

Copyright: an exclusive right that protects works of authorship, such as writings, music, computer software, films, and works of art.

Corporate governance: the set of processes, customs, policies, laws, and institutions that affect the way in which business entities are directed, administered and controlled.

Corporate social responsibility: a company’s commitment to consistently operate its business in a manner that attains or surpasses the ethical, legal, commercial, and public standards expected of it by society.

Cybersquatter: a person who registers a trademark as a domain name, hoping to obtain a profit later by reselling the domain name to the trademark owner.

Domain name: the alphanumeric name given to Internet Protocol (IP) addresses so that users can easily remember the address.

Expropriation: the action of a government when it takes away a private business or other asset from its owners.

Fixtures: property such as buildings and machinery which are so attached to land that they cannot be removed from the land without causing substantial damage.

Flat tax: a system in which everyone is taxed at the same rate, regardless of how much they earn.

Franchise: a business relationship between a franchisee (usually a small business) and a franchisor (usually a larger business) in which the former agrees to produce or distribute goods or services in accordance with an overall “business system” devised by the franchisor. The franchisee is normally licensed to use the franchisor’s trademark, and often purchases supplies from the franchisor.

Free riding: a situation in which a market participant benefits from the actions of another, but avoids the costs of that action because it has no obligation or incentive to pay.

Freedom of contract: a legal principle by which one has the freedom to decide, by one’s own volition, whether to form a contract, what kind of contract to form and with whom.

Greenfield development: development occurring on land that was not previously urbanized.

Golden share: a class of share in a corporation or other business entity that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder’s ownership interest or representation on the governing body.

Goodwill: the reputation, image, and expectation of a business that it will engage in repeat transactions with its customers.

Guillotine (regulatory): a method for rapidly reviewing a large number of regulations and eliminating those that are no longer needed without the need for legal action on each regulation.

Immovable property: land and property affixed to land which cannot be removed without damaging either the land or the affixed property.

Incentives (for investment): policy instruments used to attract foreign direct investment and to derive greater benefits from it. Examples of investment incentives include financial incentives, such as grants and loans at concessionary rates; fiscal incentives, such as tax holidays and reduced tax rates; subsidized infrastructure or services; market preferences; and regulatory concessions.

Informal economy: economic activities of companies that are engaged in legitimate business but that do not fully comply with regulations concerning taxes, the labour market, or product markets.

Infringement (of intellectual property): the unlawful taking or use of any advertising idea, material, slogan, style, title, invention, work of authorship, or other right in violation of intellectual property laws.

Injunction: a legal order that compels a party to carry out or refrain from carrying out a certain act.

Insolvency law (also known as bankruptcy law): a legal regime designed to pay creditors’ claims and allow a debtor a fresh start after the debtor has become unable to pay its debts.

Intellectual property: legally protected rights in creations of the mind, such as inventions, literary and artistic works, and symbols, names, images, and designs used in commerce.

Jurisdiction: the power of a court or other government body to decide a contested matter.

Macroeconomic: pertaining to the major, general features of a nation’s economy, such as the level of unemployment or inflation.

Mediation: a forum in which an impartial person, the mediator, facilitates communication between parties to promote reconciliation, settlement, or understanding among them. The term mediation is sometimes used interchangeably with conciliation, although the terms may have different meanings in a given context.

Money-laundering: the act of converting the proceeds from criminal activities (such as drug-trafficking, smuggling, embezzlement, corruption, tax evasion, or organized crime) into funds or other assets that appear to be legitimate.

National treatment: the right of foreign companies to act under the same laws and regulations as, and to be treated as an equal with, domestic companies.

Nationalization: the process by which a government takes ownership of previously privately-owned companies or other assets.

Pacta sunt servanda: a Latin maxim used in law to refer to the principle that parties to contracts should comply with their agreements.

Patent: a right granted by a government to the owner of an invention to prevent others from making, using, importing, or selling the invention for a limited number of years.

Plant breeder's rights: an intellectual property right granted to breeders of new, distinct, uniform and stable plant varieties.

Privatization: the legal transfer of assets (especially state owned enterprises) from public to private ownership.

Public domain: the state information, knowledge, or expressions being available to anyone without restriction on use, copying, or distribution, and free of claims of intellectual property rights.

Recuse: in the legal context, "to recuse" means to withdraw from a hearing or other proceeding because of a possible conflict of interest, lack of impartiality, or appearance of a lack of impartiality.

Remittance: the transfer of money by migrants to their home country while they are abroad.

Repatriation (of capital): a foreign investor's remittance of capital from the country of investment to its home country.

Resale price maintenance: arrangements between sellers and buyers operating at different levels in the distribution of the same product or service to fix prices at one or more market levels at a set amount or within a prescribed range.

Rule of law: a characteristic of a legal framework in which law imposes meaningful restraints on both the State and individual members of the ruling elite. In a State governed by the rule of law, all citizens and the state itself are equal before the law.

Secured transactions law: the legal system that allows the owner of personal (movable) property to pledge that property as collateral for a loan.

Servitude: a right that one person has over property belonging to another person.

Share issue privatization: privatization of a State-owned enterprise by selling shares in the enterprise to private investors in the stock market.

Small and medium-size enterprises (SMEs): enterprises within certain limitations of size and type, as measured by the company's workforce, and its revenues and/or assets.

State-owned enterprise: a business entity, a majority of whose assets are owned, directly or indirectly, by any agency or instrumentality of a government.

Sustainable development: development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

Temporary restraining order: a temporary injunction which may be granted at the outset of a litigated dispute in order to preserve the status quo pending final resolution of the dispute.

Trade secret: information, including a formula, pattern, compilation, programme, device, technique or process that (a) has independent economic value because it is not generally known to and is not readily ascertainable by a proper means by other persons who can obtain economic value from its disclosure or use and (b) is the subject of reasonable efforts to maintain its secrecy.

Trademark: a word, brand name, symbol or device which used to identify the goods or services of an enterprise and distinguish them from the goods and services of another.

Utility model: an intellectual property right applicable to a new model of implements or tools or any industrial products or parts thereof. Utility model protection laws usually do not require the same high level of inventiveness that is required for the issuance of a patent.

Value added tax: a consumption tax in which taxes are levied at each step of a manufacturing or production process where value is added to that product, as well as at the point where the consumer purchases the end product.

List of Abbreviations:

CIS	Commonwealth of Independent States
CPI	Corruption Perceptions Index
CSR	corporate social responsibility
DBR	Deutsche Bank Research
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ESBAS	Aegean Free Zone
FDI	foreign direct investment
FIAS	Foreign Investment Advisory Service
FYR	Former Yugoslav Republic
GPA	Government Procurement Agreement
IFC	International Finance Corporation
IPR	intellectual property right
MFI	microfinance institution
MFN	most-favoured-nation
MIGA	Multilateral Investment Guidance Agency
MNC	multinational corporation
MNE	multinational enterprise
NIB	Nordic Investment Bank
OECD	Organisation for Economic Co-operation and Development
PFI	The OECD Policy Framework for Investment
PPP	public-private partnership
RIA	Regulatory Impacts Assessment
SEZ	special economic zone
SIP	share issue privatization
SMEs	small and medium-size enterprises
SOE	state-owned enterprise
SRO	self-regulatory organization
TNC	transnational corporation
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
UNODC	United Nations Office on Drugs and Crime
USAID	United States Agency for International Development
WTO	World Trade Organization
YES	Youth Entrepreneurship Service