TAX REGIMES VS. VENTURE CAPITALISM IN CENTRAL EUROPE[1]

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I. Preface

This article briefly assesses the "**venture capital friendliness**" of four Central European tax/legal jurisdictions (Poland, Hungary, the Czech and Slovak Republics) following their European Union (EU) accession – in May 2004. It is noteworthy that, notwithstanding the heated debate on tax harmonization currently sweeping across the EU (unsurprisingly drummed up by countries with notoriously overtaxed economies), fiscal policy is, for the foreseeable future, a national domain and its shape offers a powerful incentive to any form of foreign investment, including venture capital. Similarly, the relatively limited extent of venture capital regulation on a pan-European scale works to the advantage of those that are able to deliver an optimal framework for venture capital growth in an otherwise relatively homogenous market.

II. Definition and key drivers of 'venture capitalism'

Private equity represents **medium** and **long-term** financing offered in return for an **equity** stake in potentially valuable, yet **unquoted** companies. In Europe (unlike in the US where "**venture capital**" usually refers exclusively to investments in early stages and in expanding companies), the expression "venture capital" covers all stages, i.e. is synonymous with "private equity". To avoid unnecessary

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confusion, the terms "**private equity**" and "venture capital" are – for the purposes of this article – used interchangeably: encompassing both the seed to expansion stages of investment, and management buy-outs ('MBOs'), and management buy-ins ('MBIs').

In essence, **venture capital investment** is nothing other than a highly risky (but potentially equally rewarding) bet on a company's relatively distant future. As such, the outlook for venture capital growth will on the one hand depend on the company's inherent potential to deliver superior revenues during the investment period, and on the other, on the complex environment in which it operates. Among the key macro-, micro- and socioeconomic variables driving the long-term pace of venture capital expansion are:

- **Entrepreneurial culture**:

A phenomenon quite elusive to quantify, yet of critical importance to the success of venture capitalism. For decades, if not centuries, certain European societies have been consistently averse to investment risk – limiting the bulk of their exposure to debt instruments – whilst others have quickly embraced equity and equity related hybrids. The same goes for cultural differences in the tempo of innovation – ability to design and enhance products and services; as well as general preferences for economic liberalism vs. state protectionism.

- **Availability of long-term financing**:

Venture capital is set to operate in a competitive environment, with the coexistence – if not prolonged dominance – of more established financing sources (e.g. bank loans, debentures, stock markets). The more inflexible traditional financiers are towards new economic ventures, the greater scope for private equity funds and their tailor-made services.

- **Intellectual capital**:

Venture capitalists' true *métier* is investing in projects where intangible assets play a pivotal part. The general standard of education, skills and innovativeness of a workforce to a considerable degree determines the sophistication and quality of its final output. Needless to add, venture capital around the globe pursues a relentless quest for undiscovered or underrated value-creating projects.

- **Tax/ legal environment**:

Venture capitalism is, by definition, tricky business. After all, private equity investors face enormous information asymmetries relating to the transparency of their acquisitions (best summed up by the Latin maxim: *Caveat Emptor*!). Not only does a dysfunctional and oppressive tax/legal environment erode future profits on venture capital investment, but a high or unpredictable level of fiscal/legal opacity often renders elaborate mechanisms of risk control peculiar to the venture capital industry (due diligence, contract terms and enforceability, investment syndication and staging as well as the very process of "hands-on" management) futile.

III. Country comparisons

In examining the appeal of the four tax/legal systems, it is useful to enumerate the following building blocks of each jurisdiction under review:

- **Mergers and acquisitions laws:**

Pan-European and national regulations on mergers and acquisitions (M&A) sometimes restrict trade in unlisted equity or portfolio companies managed by venture capital funds.

- **Venture capital providers:**

As financial intermediaries, venture capital funds mostly reallocate the means of other, more risk-averse financial institutions (pension funds, insurance companies, banks etc.); legal restrictions to such financial intermediation and ultimate investment are sometimes applicable.

- **Company tax rates:**

The scope and rates of Corporate Income Tax (CIT) have a dual impact on the venture capital profit and loss outlook as they have an effect on the taxation of venture capital funds and fiscal burdens borne by portfolio companies.

- **SME breaks:**

Some jurisdictions in Europe offer tax incentives to Small and Medium Enterprises (SMEs); they might apply to portfolio companies as well as local venture capital funds.

- **Personal tax rates:**

Both venture capital funds and portfolio companies are run by individuals who are liable to varying scales of Personal Income Tax (PIT) and Capital Gains Tax (CGT) levies – their prevalence and extent being compelling economic considerations throughout the investment process.

- **Venture capital tax breaks:**

Certain jurisdictions in Europe provide tax reliefs specifically geared towards investors in private equity or venture capital funds; their review is important in the overall picture.

- **Taxation of derivatives:**

To be adequately motivated, venture capital managers as well as their colleagues in charge of portfolio companies receive performance related remuneration, often in the form of derivatives; their tax treatment is therefore a significant socio-economic factor.

- **Research and development (R&D) breaks:**

Recognising that R&D matters not only to the success of venture capital investment but the economy as a whole, certain countries give preference to intellectual assets by way of lower taxes or administrative deregulation *vis-à-vis* R&D activity.

- **Fund structures**:

Venture capital funds incorporate and operate in a variety of institutional forms – their characteristics have a considerable impact on business operations. For the sake of uniformity, the limited liability company has been selected to assess the ease of business incorporation in the surveyed economies.

- **Enforcing Contracts**

This category looks at the efficiency of contract enforcement by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment the claimant files the lawsuit until actual payment. Contract enforcement standards are a measure of ongoing business settlement security in a given area.

- **Bankruptcy and insolvency standards:**

No matter how carefully managed, venture capital portfolios will sometimes incur a proportion of losses – it then depends on the effectiveness of a given legal system to have the largest possible share of valuable assets recovered as expeditiously as possible.

1. The Czech Republic

The overall tax/legal climate in the Czech Republic is not particularly salubrious to venture capitalism. The fund vehicle that is – theoretically speaking – tailored to the needs of venture capital funds[3] is not transparent from the income tax perspective. The structuring of performance related incentives for fund managers is rather cumbersome from the legal point of view: taxation of option schemes depends heavily on the individual structure of a scheme. Remuneration paid in derivative form (e.g. managerial options) is put on the same footing as regular employment income (i.e. is not preferred). Mergers are subject to prior notification (Decree No. 368/2001) and each has to be suspended until an administrative decision on the proposed transaction is passed (which can last indefinitely). The key legislation on “protection against interference with economic competition” (including mergers) stems from Act No. 143/2001 Coll. on the Protection of Economic Competition. Amendments enacted since the Czech entry to the EU have been aimed at harmonisation with the existing *acquis communautaire*. However, the definition of a merger (or rather ‘concentration of undertakings’) given under the Act remains unequivocal and is further blurred by the concept of ‘control’ introduced as at 1 October 2005, which relates to ‘any ownership titles, rights or other legal means providing influence on the corporate structure, voting or decision-making powers’. No fixed threshold of ‘control’ can be deduced from the legislation and the final judgment on each individual case rests with the Czech Office for the Protection of Economic Competition.

The universe of institutional players allowed to commit financial resources to venture capital is still limited. Since 1st April 2004, pension funds (currently 11 of them active in the Czech Republic) are permitted to allocate their assets to riskier instruments (e.g. derivatives) solely to hedge portfolio related risk exposure (i.e. to exercise ‘efficient portfolio management’). Insurance companies are also barred from direct investment in private equity vehicles, their assets can be placed only in ‘publicly negotiable units and units in open undertakings for collective investment’ (i.e. Undertakings for Collective Investments in Transferable Securities, UCITS in EU parlance). The minimal (weekly) liquidity required of open-ended investment funds under EU laws practically renders them unusable for the purposes of venture capital funding (usually of a longer-term nature).

The Czech Republic does not currently offer any major tax breaks specifically relating to SMEs or venture capitalists, whilst the general flat-rate CIT has been reduced from 26% in 2005 to a still lofty 24% in 2006; the EU-15 (pre-enlarged) average has been still higher (at 30.10%). Stock options are taxed upon exercise; provided than the underlying (stock) has been held for a minimum of six months

3 In Czech: *komanditní společnost*, *k.s.*

a capital gains tax exemption applies on disposal.

The Czech Republic has a progressive PIT system with the following brackets:

Table 1: Personal Income Tax progression in the Czech Republic in 2006

Income bracket in CZK (EUR[4])	**Income tax due**
Up to 121,200 (4,281.72)	12.00%
121,201 (4,281.75)-218,400 (7,715.57)	14,544 (513.81) + 19% for the amount above 121,200 (4,281.72)
218,401 (7,715.60)-331,200 (11,700.5)	33,012 (1,166.24) + 25% for the amount above 218,400 (7,715.57)
Above 331,200 (11,700.5)	61,212 (2,162.48) + 32% for the amount above 331,200 (11,700.5)

Source: PricewaterhouseCoopers CEE – CIS Tax Notes

The standard Czech **Value Added Tax** (**VAT**) rate amounts to 19%, whereas the scope for the preferential 5% treatment has been narrowed following the Czech EU entry.

Incentives available since the collapse of communism to innovative companies, investors in R&D capital expenditure, high-tech diffusion, contracting scientific researchers or R&D commercialization (institutional cooperation between companies and universities or research centres) have been scant and incoherent. A "Framework Program for the Support of Technology and Business Support Services Centres" designed to promote a knowledge based economy came into law on 17th February 2004 and granted business subsidies of up to 50% of eligible business costs for a maximum of 10 years. Subsidies to cover the costs of training and re-training became available for a maximum of three years. Regional headquarters, software development centres and expert solution centres can thus qualify for such incentives, provided they fulfil the same criteria (as technology centres) for minimum investment and number of jobs created, as well as all general requirements.

Incentives relating to Czech technology centres are subject to the following specific rules:

- A minimum **investment** of CZK 15m (EUR 529,915) over three years.

4 The currency conversions as at 1st March 2006 from www.oanda.com

- At least CZK 7.5m (EUR 264,957,75) of investment from the investor's **own equity**.
- Creation of at least 15 **new jobs** for permanent Czech residents.
- Products of a technology centre must be geared towards the **mass market**.

The Czech Commercial Code provides for the creation of several various types of business entities. The entities preferred by most foreign investors are limited liability companies and branches. Joint-stock companies are also used, particularly for foreign investment into former state-owned enterprises. Banks, insurance companies and other financial institutions, including e.g. investment companies, security brokers, etc., must be established as either a joint-stock company or as a branch/representative office. Joint-stock companies can trade shares on the Prague Stock Exchange if their equity is admitted to trading under Stock Exchange rules. Cooperatives and sole proprietorships are generally of little relevance to foreign investors. The two most relevant types of domestic incorporation thus are: a limited liability company[5] and a joint stock company[6].

The following table shows the average time length and cost relating to the incorporation of a **limited liability company**, which is the prevailing company structure across CE and has been selected for the purposes of cross-country comparisons.

As shown in the table below, company registration is slightly more time consuming and bureaucratic than in the CE and OECD peer groups, yet its costs are relatively limited.

Table 2: Company registration in the Czech Republic vs. CE and OECD: procedures, average duration and costs as at 2005

Indicator	Czech Republic	CE	OECD
Procedures (number)	10	8.8	6.5
Time (days)	40	33.5	19.5
Cost (% of income per capita)	9.5	14.8	6.8
Min. capital (% of income per capita)	39.0	94.9	41.0

Source: International Finance Corporation, Doing Business Database

5 In Czech: *společnost s ručením omezeným, s.r.o.*

6 In Czech: *akciová společnost, a.s.*

Generally speaking, snag-free contract enforcement does not appear to be a major Central European *forte*; ongoing business security in the Czech Republic is nowhere near the OECD averages. Enforcing business agreements is an arduous job in all of the surveyed CE countries; the average time required for a payment dispute to be resolved in the Czech Republic (290) remains below the CE yardstick, however, is a multiple of the OECD benchmark.

Table 3: Contract enforcement in the Czech Republic vs. CE and the OECD: procedures, average duration and costs as at 2005

Indicator	Czech Republic	CE	OECD
Procedures (number)	21	27.5	17.4
Time (days)	290	550.0	29.6
Cost (% of debt)	9.1	10.2	n/a

Source: International Finance Corporation, Doing Business Database

The swiftness and costliness of resolving **bankruptcies** is demonstrated below. Bankruptcy proceedings in the Czech Republic on average take close to a decade, cost a sizeable part of the estate, whereas their success (measured via asset recovery) is usually mediocre.

Table 4: Bankruptcy efficiency in the Czech Republic: average duration, costs and asset recovery as at 2005

Indicator	Czech Republic	CE	OECD
Time (years)	9.2	4.4	1.5
Cost (% of estate)	14.0	17.0	7.4
Recovery rate (%)	17.9	39.1	73.8

Source: International Finance Corporation, Doing Business Database

2. *Hungary*

In comparative terms, Hungary is a highly attractive venue for private equity investment. The vehicle specifically suited to the needs of venture capital funds[7] is tax transparent and legally flexible; it does not require a full-blown legal presence under Hungarian jurisdiction and enables the use of tax efficient capital investment structures as well as managerial incentives in derivative form. Furthermore,

7 In Hungarian: *kockázati tőkealapok*

venture capital funds' management fees and carried interest are not liable to VAT. Private equity investment in Hungary is strongly supported by both pension funds and insurance companies – by law they are allowed to allocate their resources to venture without any restrictions.

The CIT rate has amounted 16% since the beginning of 2004. Additionally, a local business tax of up to 2% (i.e. a maximum total of 18%) has been levied. From 2006, the portion of the local business tax directly attributable to a foreign branch is exempt, provided that it is taxed in the foreign country of origin.

Since the beginning of 2006, SMEs (of a corporate tax base up to HUF 5m, i.e. EUR 19,811.70) have been subject to CIT at 10%. This reduced rate is available to businesses that pay social security contributions on at least twice the minimum salary per employee and receive no other tax relief or allowance.

The Hungarian PIT system operates two rates: 18% and 36%, whose terms are presented below:

Table 5: Personal Income Tax rates in Hungary in 2006

Income bracket in HUF (EUR)	**Income tax due**
Up to 1,550,000 (6,141.62)	18%
Above 1,550,000 (6,141.62)	279,000 (1,105.49) + 36% for the amount above 1,550,000 (6,141.62)

Source: PricewaterhouseCoopers CEE – CIS Tax Notes

It is noteworthy that Hungary has made **human capital** enhancement a vital part of its overall fiscal policy mix. Thus, it has put forward a carefully planned and comprehensive regime aimed at promoting the knowledge based economy; ranging from a variety of PIT deductions (for education, training, culture, information technology and recreation) to institutional and financial support to value-creating business endeavours under the aegis of specially designed government bodies.

The mission of the Hungarian Research and Technology Innovation Fund[8] is to accelerate R&D expenditure. The Fund is managed by the National Office for Research and Technology[9], a government agency set up to coordinate R&D efforts on a nationwide scale. With the exception of SMEs, every Hungarian enterprise is

8 In Hungarian: *Kutatási és Technológiai Innovációs Alapról (KTIA)*.

9 In Hungarian: *Nemzeti Kutatási és Technológiai Hivatal (NKTH)*.

obligated to contribute at least 0.25% of its revenues to the Fund, while the Hungarian government delivers an equivalent amount. The Fund's goal is to provide adequate funding for transparent and independently evaluated projects focused on innovative products and services.

Besides financing resources available under the aforementioned Fund, the Hungarian government has created a set of preferences for entities involved in R&D via tax breaks and non-refundable financial subsidies, which are awarded by public tender and encompass:

- 100% Research and Technical Development (RTD) CIT allowance (also available for subcontracted R&D activities if partner is a public/non-profit research site);
- 300% RTD CIT allowance if the company lab is located at a university or public research institute;
- Tax-free employment of students up to the sum of the official minimum wage;
- Tax-free investment provisions relating to R&D expenditure;
- Tax allowances for corporate donations to organisations of public benefit supporting R&D activities;
- Tax credit for individual donors supporting R&D activities;
- PIT credit of linked to the creation 'intellectual assets';
- Non-refundable financial subsidies individually negotiable with the Hungarian government if the capital infusion exceeds an equivalent of EUR 10 million.

Besides vehicles enabling the absorption or allocation of venture capital funding, portfolio and investment companies can also be structured under a more general corporate model, i.e. the limited liability company[10]. The table illustrates business incorporation averages in Hungary (against CE and OECD benchmarks). Setting such a company in Hungary is a relatively straightforward, albeit somewhat time-consuming and costly exercise, especially *vis-à-vis* the OECD.

10 In Hungarian: *korlátolt felelősségű társaság, Kft*

Table 6: Company registration in Hungary vs. CE and OECD: procedures, average duration and costs

Indicator	Hungary	CE	OECD
Procedures (number)	6.0	8.8	6.5
Time (days)	38.0	33.5	19.5
Cost (% of income per capita)	22.4	14.8	6.8
Min. capital (% of income per capita)	79.6	94.9	41.0

Source: International Finance Corporation, Doing Business Database

Getting an average business partner to pay the money owed is a daunting task across CE. Inability to enforce contractual obligations hampers international investment and remains one of the primary obstacles to macro- and microeconomic growth in the region. Hungary, slightly better than the CE peer group average, remains a laggard by OECD standards.

Table 7: Contract enforcement in Hungary vs. CE and the OECD: procedures, average duration and costs as at 2005

Indicator	Hungary	CE	OECD
Procedures (number)	21.0	27.5	17.4
Time (days)	365.0	550.0	29.6
Cost (% of debt)	8.1	10.2	n/a

Source: International Finance Corporation, Doing Business Database

Hungarian bankruptcy standards are halfway between its CE peers and (usually more developed) OECD economies.

Table 8: Bankruptcy efficiency in Hungary: average duration, costs and asset recovery as at 2005

Indicator	Hungary	CE	OECD
Time (years)	2.0	4.4	1.5
Cost (% of estate)	14.0	17.0	7.4
Recovery rate (%)	35.8	39.1	73.8

Source: International Finance Corporation, Doing Business Database

3. The Slovak Republic

The outlook for venture capital growth in this country remains a big unknown. On the one hand, Slovakia is implementing a liberal macro-economic policy mix, while on the other, the task of overcoming a relative backwardness of its financial sector (including the still limited venture capital penetration in GDP or per capita terms) will be a Herculean one.

On 1st January 2004, Slovakia undertook a fundamental overhaul of its tax system. Arguing that in an era of ongoing globalization and increasing labour mobility, high direct taxes stifle long-term economic competitiveness, the Slovak government put forward a simple, transparent, **business-neutral and egalitarian tax system** in a radical departure from longstanding emphasis on direct levies. To ensure tax uniformity, a flat rate of 19% was introduced across the board (for CIT, PIT, CGT and VAT). Thereby, Slovakia broke with the tradition of active tax policy employed as a key instrument for advancing socio-economic goals. The reform is a first of its kind throughout Central Europe and a comprehensive evaluation of its far-reaching implications would be premature from today's perspective; however, the initial impression is favourable. Astonishingly to some, in April 2004 the Slovak budget was already in the black, a remarkable event after a prolonged period of persistent deficits. The Slovak government has since hinted at the possibility of further cuts, if tax collection remains strong; which will have a positive impact on business activity in any shape or form, including private equity investment.

While being transparent on the tax side, Slovakia does not offer any specific incentives for private equity investors, R&D oriented spending, researcher costs, science commercialization or innovative establishments. No preferential tax schemes apply to Slovak SMEs or complex financial instruments, such as financial derivatives.

In Slovakia, there are no vehicles particularly suited to the needs of venture capital funds. Therefore, such investment business can be done in general forms, i.e. a limited liability company[11] and joint stock company[12]. For reasons of cross-country comparability, the Slovak limited liability company has analysed with regard to incorporation, contractual security and bankruptcy routines.

Registering such a company does not pose a major problem. It is slightly more complicated on the bureaucratic side than the peer group, however, relatively speedy and inexpensive.

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11 In Slovak: *spoločnosť s ručením obmedzeným, sro*

12 In Slovak: *akciová spoločnosť, a.s.*

Table 9: Company registration in Slovakia vs. CE and OECD: procedures, average duration and costs as at 2005

Indicator	Slovakia	CE	OECD
Procedures (number)	9.0	8.8	6.5
Time (days)	25.0	33.5	19.5
Cost (% of income per capita)	5.1	14.8	6.8
Min. capital (% of income per capita)	41.0	94.9	41.0

Source: International Finance Corporation, Doing Business Database

Contractual safety in the Slovak Republic ranks on a par with the CE group. As mentioned earlier on, this trails far behind the OECD averages.

Table 10: Contract enforcement in Slovakia vs. CE and the OECD: procedures, average duration and costs as at 2005

Indicator	Slovakia	CE	OECD
Procedures (number)	27.0	27.5	17.4
Time (days)	565	550.0	29.6
Cost (% of debt)	15.0	10.2	n/a

Source: International Finance Corporation, Doing Business Database

Bankruptcy efficiency measures for Slovakia are representative of the CE region as a whole. Their development is significantly inferior to OECD yardsticks.

Table 11: Bankruptcy efficiency in Slovakia: average duration, costs and asset recovery as at 2005

Indicator	Slovakia	CE	OECD
Time (years)	4.8	4.4	1.5
Cost (% of estate)	18.0	17.0	7.4
Recovery rate (%)	38.6	39.1	73.8

Source: International Finance Corporation, Doing Business Database

4. *Poland*

To date, the vast majority of venture capital invested in Poland has derived from offshore fund structures. This has been motivated by a relative over-regulation of the investment business, including the framework governing domestically incorporated investment funds (which have been restricted from larger investments in unlisted instruments); as well as general over-taxation. Under the Polish Investment Funds Act of 27th May 2004[13], the so-called **non-public assets (investment) funds**[14] can be set up out of open- or closed-ended investment funds, whereby at least 80% of the assets are allocated to private equity. Despite its theoretical functionality for venture capital funding, the troublesome regulatory admission, disclosure and supervision rules make it an unwieldy tool with regard to legal structuring, except for pension funds and insurers. Capital flows from institutions are considerably hampered by continued valuation mechanisms, which favour liquid instruments[15]; valuation of private equity portfolios is usually possible only upon exit.

Since 1st January 2004 the Polish CIT rate has amounted to 19%, which is competitive regionally and internationally, and has already led to profound resentment among some of Poland's economic partners in the enlarged EU (notably Germany and France). Additionally, Polish CIT laws provide for a "tax credit" addressed to SMEs and available in the second year of a company's history (with certain additional *caveats* applicable). The tax credit allows an SME to spread its CIT liabilities over a five-year period to reduce fiscal burdens on start-up.

Although the upper PIT bracket of 40% is generally perceived as exorbitant by many Polish taxpayers, it is still no match for the EU-15 ('old EU') average of 47.19%, especially in the absence of local business taxes levied on income in Poland. The fairly optimistic picture is somewhat blurred by the arbitrariness of Polish tax authorities – whose decisions on equivalent tax problems oftentimes vary from office to office.

13 *Ustawa z dnia 27 maja 2004 r. o funduszach inwestycyjnych* (Dz.U. z 2004 r., nr 146, poz. 1546).

14 In Polish: *fundusz aktywów niepublicznych*

15 E.g. the minimal return rate (Polish: *minimalna stopa zwrotu*) *vis-à-vis* Polish pension funds.

Table 12: Personal Income Tax progression in Poland in 2006

Income bracket in PLN (EUR)	Income tax due
Up to 37,024 (9,815.04)	19% minus 530 (140.50)
37,025 (9,815.31)-74,048 (19,630.10)	6,504 (1,724.21) + 30% for the amount above 37,024 (9,815.04)
Above 74,048 (19,630.10)	17,612 (4,668.93) + 40% for the amount above 74,048 (19,630.1)

Source: PriceWaterhouseCoopers CEE – CIS Tax Notes

At present, Poland does not provide a consistent system of tax breaks for R&D spending or employment of researchers (with the exception of grandfather clauses on Special Economic Zones). Since 1994, Poland has offered territorially oriented incentives in the form of 14 Special Economic Zones[16] – designated areas where manufacturing or distribution have been conducted on preferential terms. Among other issues, the key preferences involved state subsidies to R&D capital expenditure of up to 50% (proportions have varied from zone to zone and mirrored unemployment rates) of the initial outlays, with additional breaks (of up to 15% percentage points) available to SMEs. The amendments to the SSE Act taking effect from the date of Polish accession the EU (1st May 2004) converted the existing SSE framework into one compatible with European Union laws, scrapping some of the benefits.

With the exception of the aforementioned 'non-public asset fund' concept, no preferential legal vehicles exist with regard to venture capital activity. Businesses can be incorporated in two general forms:

- Limited liability company[17] (used for CE benchmarking under this survey).
- Joint stock company[18] a corporate form required to perform certain regulated activities (insurance, banking, brokerage etc.).

Polish bankruptcy laws provide for a mechanism whereby time-limited court protection is awarded to companies anticipating solvency problems. After the period lapses, the companies can again be subject to all legal enforcement and

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16 In Polish: *Specjalne Strefy Ekonomiczne, SSE*

17 In Polish: *Spółka z Ograniczoną Odpowiedzialnością, Sp. z O.O.*

18 In Polish: *Spółka Akcyjna, S.A.*

receivership.

In terms of direct access to local institutional capital, pension funds and insurance companies are cut off from large-scale investment in private equity; while merger laws impose a number of restrictions (business concentration, sensitive industries etc.) effectively blocking a merger for the duration of administrative proceedings.

Since the beginning of 2004, Poland has levied a 19.00% CGT on equity gains (listed or not), which is roughly in line with the EU-15 (pre-accession) average (of 19.20%). No PIT oriented incentives exist in respect of individuals engaging in venture capital investment, whereas stock options are taxed on exercise and the underlying (stock) on disposal, with tax exemptions concerning the exercise of options in specific circumstances.

Additionally, the basic (standard) VAT rate in Poland at 22% ranks among the highest in enlarged Europe.

Establishing a business under Polish jurisdiction does not differ substantially from the rest of the CE legal systems but costs slightly more and requires a larger capital commitment.

Table 13: Company registration in Poland vs. CE and OECD: procedures, duration and average costs as at 2005

Indicator	**Poland**	**CE**	**OECD**
Procedures (number)	10.0	8.8	6.5
Time (days)	31.0	33.5	19.5
Cost (% of income per capita)	22.2	14.8	6.8
Min. capital (% of income per capita)	220.1	94.9	41.0

Source: International Finance Corporation, Doing Business Database

Poland is an unrivalled champion of payment tardiness throughout CE: it takes almost a thousand days to see a payment dispute through in a Polish court. Trade credit, despite the continued fall in interest rates, remains a financing tool favoured by many businesses having a monopolistic or quasi-monopolistic position.

Table 14: Contract enforcement in Poland vs. CE and the OECD: procedures, average duration and costs as at 2005

Indicator	Poland	CE	OECD
Procedures (number)	41.0	27.5	17.4
Time (days)	980.0	550.0	29.6
Cost (% of debt)	8.7	10.2	n/a

Source: International Finance Corporation, Doing Business Database

The Bankruptcy and Restructuring Act passed in February 2003 has accelerated and somewhat optimised asset recovery proceedings despite the slightly higher (than in all CE) costs involved.

Table 15: Bankruptcy efficiency in Poland: average time, costs and asset recovery as at 2005

Indicator	Poland	CE	OECD
Time (years)	1.4	4.4	1.5
Cost (% of estate)	22.0	17.0	7.4
Recovery rate (%)	64.0	39.1	73.8

Source: International Finance Corporation, Doing Business Database

IV. Venture capital fund raising and investment in Central Europe

1. Fundraising

Private equity fundraising can be seen as a forward-looking measure of investment sentiment with regard to particular markets. By this token, Poland is set to embrace the bulk (71.87%) of all assets earmarked for all Central Europe. Hungary is perceived as the second (in absolute terms) and first (relatively to population, size etc.) market in the region. In all likelihood, the amount of investment expected to come to the Czech and Slovak Republics will not differ substantially.

Table 16: Private equity fundraising in CE in 2004 (by geographic origin)

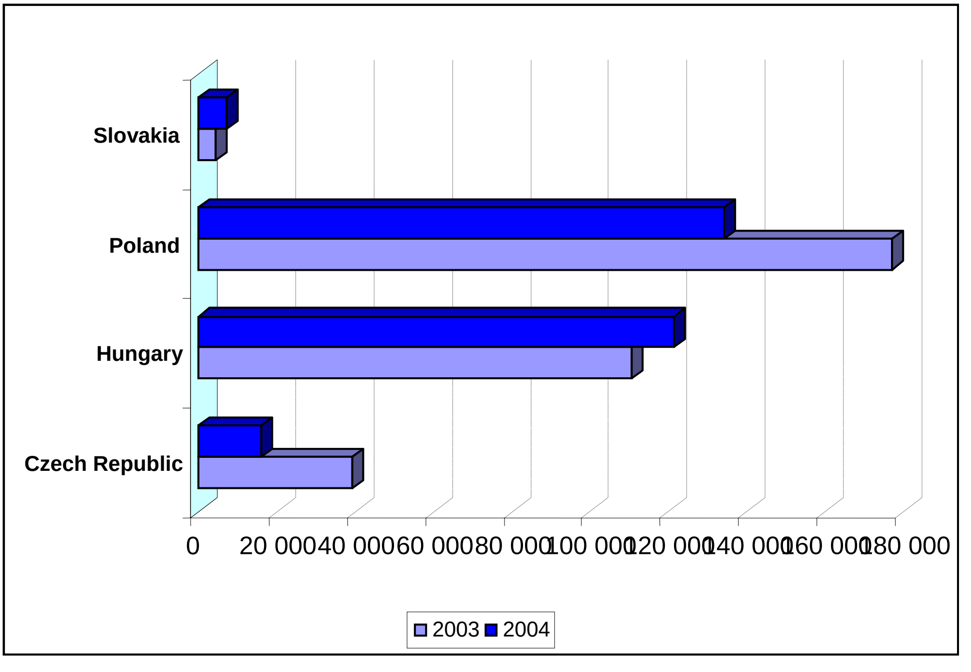
EUR '000	Czech Republic	Hungary	Poland	Slovakia	CE (total)
Domestic	4,839	39,013	407	2,438	46,697
EU	n/a	69,812	224,438	531	294,781
Non-EU	n/a	n/a	79,036	2,287	81,323
Total	4,839	108,825	303,881	5,256	422,801

Source: EVCA

2. Investment activity

In 2004, Poland was a leader in absolute investment terms in all Central Europe (almost a half of the total), however, the rather dramatic fall in Polish year-on-year investment and significant gains made by the running-up Hungary considerably narrowed the gap. Venture capital assets committed to the Czech market in 2004 accounted for a mere 36.54% of the 2003 level. Slovakia, a nascent private equity market, visibly expanded between 2003 and 2004.

Chart 1: Private equity investment in Central Europe in 2003 and 2004 (EUR '000)

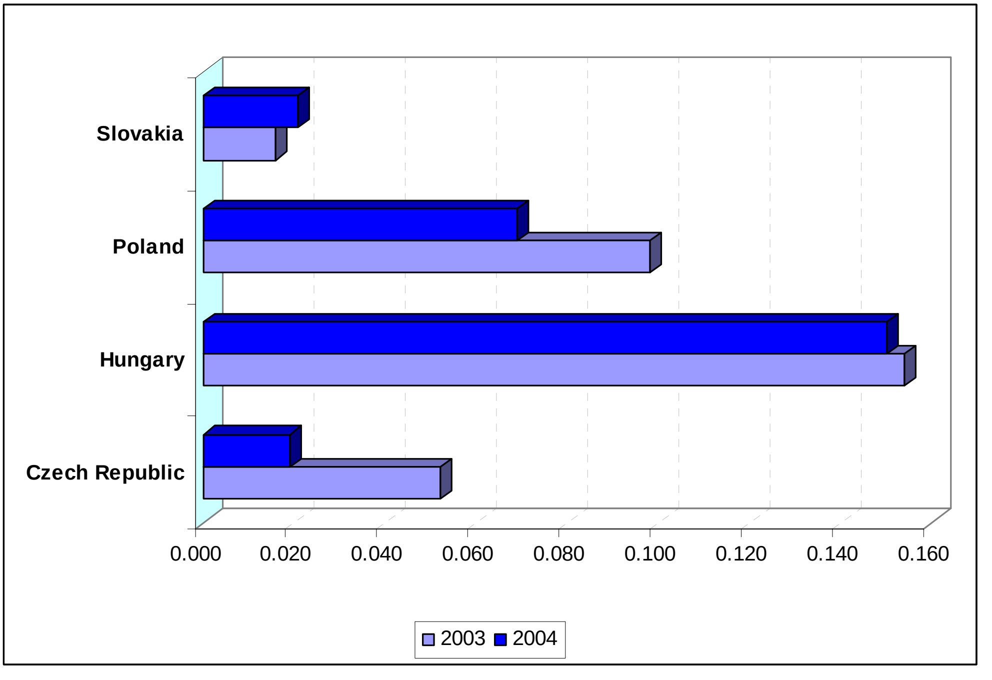


Source: EVCA

3. Venture capital penetration

Hungary, arguably the most private equity friendly tax/legal environment in Central Europe, also posted the highest investment/GDP values among the peer group in 2004 and 2003. Interestingly enough, private equity inflows in 2004 receded in all CE economies except Slovakia, where overall 'saturation' still remains rather insubstantial. The Czech Republic noted the largest investment drop in per-GDP terms.

Chart 2: Private equity as % of Gross Domestic Product (GDP) in Central Europe in 2003 and 2004 (EUR '000)



Source: EVCA

V. Conclusion

In Central European comparisons, Hungary currently ensures a legal and taxation framework most suited to venture capitalists' needs. The functional business environment has fostered unparalleled venture capital growth in relative terms.

Slovakia has followed a path of tax uniformity and neutrality, which has improved the general investment climate and, consequently, spurred foreign capital inflows.

Still, plenty needs to be done to make venture capital an established asset class there.

Poland (a country benefiting from numerous scale related and strategic advantages as well as recipient of most venture capital in absolute numbers in the region) is currently reforming its business environment to attract further investment and retain its leadership in CE.

The Czech market requires substantial legal and tax changes to withstand competition from Central European peers and benefit from larger capital inflows.

VI. Sources:

- Cato Institute
- Central banks
- Central European statistical bureaus, economic, foreign and finances ministries
- Central Intelligence Agency – The World Factbook
- Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche business guides
- European Union economic sources
- Eurostat
- International Finance Corporation: Doing Business Database
- Investment, securities business regulators
- OANDA currency converters (www.oanda.com)
- Organisation for Economic Cooperation & Development (OECD)
- Czech, Hungarian, Slovak and Polish Venture Capital Associations
- European Venture Capital Association (EVCA)
- Heritage Foundation
- United Nations economic surveys