Enterprise Development and Innovation Facility (EDIF)
Module 1 Policy Assessment Meeting
Paris, 5 July 2012

1. An EDIF policy assessment meeting was held in Paris on 5 June 2012 at the Organisation for Economic Cooperation and Development (OECD) Headquarters.

2. The meeting was chaired by Inga Stefanowicz from the European Commission (EC), Alan Paic from the OECD Investment Compact for South East Europe and Ioannis Tsakiris from the European Investment Funds (EIF). Participants at the meeting included experts from various institutions including the London School of Economics, University College London, the Warwick Business School, the Vienna Institute for International Economic Studies, Pinto Consulting GmbH, the private equity fund SEAF, the World Bank, the EBRD and the OECD.

3. The aim of the meeting was to debate policy assessments compiled by the OECD and structured around 13 thematic areas relevant for innovative and high growth SMEs (IHGSMEs) in order to prioritise reforms for each Western Balkan economy. Policy analysts from the OECD gave a short presentation for each policy area, which was followed by a lively discussion amongst the experts. The discussion allowed the participants to select the most important policy reforms for each area.

4. These policy assessments will be a key step towards the prioritisation of reforms that forms part of the Technical Assistance pillar of the EDIF project, aimed at improving the operational environment for high growth SMEs in the Western Balkans through a co-ordinated approach between the beneficiaries and the international organisations active in the region. Due to time conflict, only 9 of the 13 policy areas were presented and discussed at the meeting. These were considered to be the most crucial for IHGSMEs. SME Policy, Labour Market, Corporate Governance, and Regulatory reform were the four policy areas not addressed.

5. Inga Stefanowicz, Alan Paic and Ioannis Tsakiris gave opening remarks for the meeting, contextualising the meeting within the Technical Assistance Pillar and the wider EDIF project. Jakob Fexer from the OECD gave a brief presentation on the methodology used to compile the policy assessments around which the meeting revolved.

6. The rest of the meeting consisted in brief presentations of the themes touched upon by the policy assessments in each of the different thematic areas. The contents of the discussions that followed these presentations are described below:

Discussion: Tax Policy

7. Steve Clark from the OECD Centre for Tax Policy and Administration opened the discussion by highlighting many important areas of tax policy pertaining to IHGSMEs including the tax treatment of returns on equity, capital gains, dividends and the tax treatment of innovation and of research and development (R&D).

8. Steve Clark emphasised that incentives, including R&D incentives, erode the tax base. He also argued that in practice, tax incentives do not necessarily succeed in changing firms' behaviour and are also very conducive to corruption. He suggested that SEE countries should, as much as possible, try to couple a low tax rate with a broad base.

9. Steve Clark also explained that when designing a tax policy, governments need to first identify the impact of the policy on investments and then build a tax policy around these considerations. Further items to consider include:
    a. The tax treatment of Multinational Enterprises (MNEs) - Low taxes for MNEs can give these companies an advantage over SMEs, which usually have to pay a domestic and often higher

tax rate. It is therefore necessary to consider the impact of tax policy on SMEs from a broader perspective.

b. The tax base- As much as possible, tax policy and tax incentives should avoid eroding the tax base
c. The implications of tax-planning- use of intangibles (can lead to tax based erosion)/ interest deductibility.

10. Steve Clark also pointed out that, while it is traditionally assumed that it is inefficient to wave taxes on foreign source income, studies have proven otherwise.

11. The EIF brought the tax treatment of investment schemes and more specifically venture capital funds to the discussion. Stephen Roper from Warwick Business School comments that IHGSMEs are scattered across the economy and not just in one sector. Therefore, focusing only on equity would not be the ideal approach. Nonetheless, he argued that it is necessary to consider the tax treatment of business angels.

12. It was pointed out that the Institute for Public Finance in Zagreb produced a good piece of work on labour taxes.

13. Peter Sanfay from the EBRD commented that the IMF should be involved in discussions on tax rates and that Estonia recently implemented a successful reform that could be used as a model for the Western Balkans.

14. Steve Clark concluded the discussion by saying that the countries in the SEE region should first consider simplifying their tax procedures. In particular, they should look at social security contributions. He also emphasised the need to ensure that companies' growths and changes in status do not suddenly increase their tax burdens. He advocated re-creating the SEE Working Group on Tax Policy which enabled high level public officials to discuss tax policy at a regional level and share best practice.

The main priorities agreed upon by the experts were: 1) Tax treatment of capital gains, 2) tax treatment of innovation and 3) the simplification of procedures

Discussion: Trade Policy

15. Stephen Roper started the discussion by highlighting that trade policy has wider implications because it also impacts on firms' abilities to import inputs and to export final products. Trade policy can drive innovation and trade openness encourages innovation and productivity. William Bartlett from the London School of Economics debated whether trade liberalisation does indeed improve the climate for IHGSMEs. Experience in the Western Balkans, and particularly in Montenegro, has shown that when trade was liberalized, local industry development was hampered by competition.

16. Much of the debate revolved around how to enable firms to comply with conformity assessment bodies. Slavo Radosevic from the University College London suggested that subcontracting be considered as an option. Gabriel Goddard from the World Bank commented that the World Bank just finished a regional report on non-tariff barriers. He pointed out that getting companies to adopt standards is difficult and suggested implementing a body to assist IHGSMEs only. Antonio Fanelli from the OECD added that there is trade integration on the import side but much less so on the export side in the region. While in the MENA region much work has been done to help SMEs meet standards, in the Western Balkans there has been little of this. Most of the costs are left to the companies and support schemes are lacking. Stephen Roper suggested using vouchers to help companies finance standards conformity assessments.

17. Vladimir Gligorov from the Vienna Institute for International Economic Studies commented that there is not a good understanding on the issue. He argued that it is necessary to question why export

promotion and standardisation are not working. In his view, the main obstacle to exporting is that companies do not articulate the real problems that they face. Because the exchange rates are fixed for most of the countries in the region, with the exception of Serbia, competitiveness needs to be increased via different mechanisms, lower taxes being a potential option.

18. The Vienna Institute for International Economic Studies further argued that the exchange rate policy is central to any discussion on trade policy. The representative highlighted two main problems specific to the region that must be considered when designing trade policy: 1.) All the countries are on fixed exchange rates, with the exception of Serbia, 2.) Based on weak government infrastructure, there is a low capacity for industrial policy. A solution would be to contemplate policy measures alternative to tariffs.

19. Slavo Radosevic argued that no solution can be found within the following three policy areas: exchange rate, industrial policy and trade liberalisation. The only solution is therefore to go into industry specific issues of standards and focus on sectors that are the most important for export promotion. Broad export promotion is not very useful for IHGSMEs. The World Bank added that export promotion programmes would be important for services while standards are more important for industry.

20. Ricardo Pinto pointed out that trade was not the most important policy area for IHGSMEs.

The main priorities agreed upon by the experts were: 1) standards and conformity assessments capacity, 2) export capacity (SME networking and clusters), 3) Building institutional for certification, 4) industry specific export promotion programmes and 5) tax policy as a substitute for trade policy (fiscal devaluation)

Discussion: Access to Finance

21. Stephen Roper opened up the discussions by inviting participants to consider the demand side of access to finance and in particular policies to improve the investment readiness of SMEs. Antonio Fanelli mentioned that the new SME Policy Index has an indicator to assess financial literacy and financial readiness. Alessandro Vittadini from the EBRD said that, based on his experience in a development bank, companies in the region often have low standards for financial control policies. The EBRD is trying to devise schemes to send consultants to the region to help companies improve their internal finances.

22. The Vienna Institute for International Economic Studies pointed out that investment has been going down throughout the region. In his view, it would be very important to address insolvency procedures and the demand for investment.

23. The Vienna Institute for International Economic Studies also said that, at the moment, there is a lot of pressure on development banks to reduce credit guarantee schemes. He explained that it is a problem when the risk, in this case the guarantee, is born by government funds. Then, the credit guarantee scheme has broader fiscal implications.

24. The EIF stated that its position was that credit guarantee schemes can work if they are well designed and allow for leveraging funds. They notably have to be attractive to the banks. In the region, there is liquidity but the investments are risky. Hence, credit guarantees have to enable banks to give out SME loans via portfolios rather than single operations and have to enable banks to choose their portfolios.

25. The World Bank pointed out that it was important to ensure that public funds do not crowd out the private sector and that attracting private sector co-financing has been difficult. Ricardo Pinto added that there have been long discussions about credit guarantee schemes and that the literature provides conflicting evidence on their use.

26. William Bartlett suggested thinking about ways to use remittance incomes, which are quite significant in the region. The Vienna Institute for Economic Studies argued that much work had already been done on remittances and that it has not been very successful. It was agreed that remittances are income support and that there is little chance that these can be mobilized for investment. Domagoj Racic gave a word of caution, explaining that a fund had been set up by the diaspora in North America but fell apart for cultural reasons; the investors wanted to be able to control their investments.

27. Steve Clark emphasized the importance of looking at taxes and taxes on capital gains. It is difficult to evaluate what tax incentives are appropriate, if any. For instance, tax breaks on SMEs can lead to too many investments in unsuccessful projects. It is particularly important to look at where taxes can impede investment.

28. The EIF highlighted the importance of ensuring that venture capital ecosystems are in place in the country, one of the goals of the EDIF project. Low taxes on capital gains and the ease of establishing a fund are very important incentives to establish venture capital in a country. The Vienna Institute for International Economic Studies pointed out that capital gains tend to be low in the region.

The main priorities agreed upon by the experts were: 1) Investment readiness and financial reporting, 2) attracting private investors and investors from the Diaspora, 3) credit guarantee schemes for innovation and for exports, 4) taxation of capital gains and regulations for venture capital investment schemes

Discussion: Anti-Corruption

29. Slavo Radosevic opened up the discussion, arguing that public procurement can promote innovation and thus that transparency in public procurement can help support innovative SMEs.

30. The EBRD commented that high growth export-oriented firms face different corruption challenges, in particular in customs at the border. It was agreed that more information on the subject had to be gathered.

31. William Bartlett questioned whether there was some form of corruption specific to the Western Balkans. He suggested that there are different levels and forms of corruption, ranging from low level corruption, mainly bribes, to high level state capture by large enterprises. Large privatisations are unavoidably ridden with corruption and should not be the focus of reforms aiming to improve the climate for IHGSMEs.

32. There is no research to base any of the recommendation: need for research studies.

33. The Vienna Institute for International Economic Studies points out that corruption is most rampant in 'discretionary decision-making', most often occurring in face-to-face transactions where corruption mutually benefits the parties involved. In order to combat this problem, decision-making needs to become more automatic, like a 'machine', in order to minimise the discretionary aspect. More online transactions in the form of e-governance could be a solution. Sanijn Arifagic from the RCC confirmed that initiatives like these have been started in the region and have been successful.

34. A final point of discussion was the possibility of using high level cases to show that corruption is not acceptable. Many experts believed that this was not relevant for SMEs who experience corruption on a smaller scale.

The main priorities agreed upon by the experts were: 1.) Transparency of public procurement (e-procurement), 2). Minimize discretionary decision-making (e-government), 3). Corruption on the border

Discussion: Innovation

35. The World Bank pointed out that it is currently working with the EC in the region on enhancing the institutional capacity for innovation in companies, an area where a lot of activity is going on. The representative suggested using the work being done at BICRO as a best practice example of supporting innovation through grants and other financial instruments. The Unity Through Knowledge Fund in Serbia was also pointed out as a best practice. Domagoj Racic added that, although this fund has been successful overall, it does not commercialise research much.

36. The lack of cooperation between ministries, universities, and private sector was pointed out as a major problem in innovation policy.

37. Stephen Roper brought up a number of issues:
    a. The need to "de-bottle neck innovation systems";
    b. Competence research centres should be mentioned when discussing innovation strategies.
    c. The sheer lack of funds in innovation. Even when strategies are in place public sector funding remains a major obstacle;
    d. Innovation is an important policy theme for future competitiveness and public awareness should be part of innovation strategies.

38. Most of the experts pointed out that innovation should not focus only on high tech industries. Stephen Roper notably mentioned the importance of innovation in the services sector and in the public sector. Slavo Radosevic pointed out that companies do not export because they are innovative but because they can export at a reasonable price. He argued that this point is often misunderstood by policy makers and results in policies encouraging R&D in more 'upstream' firms while downstream activities are often neglected. He describes this as a tension between excellence and relevance in innovation strategies. He gave the example of Serbia who had recently increased its R&D. While this increases excellence, it is not very relevant for the economy. Innovation policy should therefore focus on cooperative innovative projects: projects that merge upstream and downstream activities. He also suggested considering cooperative non R&D innovation and legitimizing non R&D projects, citing the Norwegian paradox as an example.

39. The EIF commented that technology transfer should not be only between universities but also between across countries, through the adaptation of technologies abroad. The Vienna Institute for Economic Studies also suggested imitating successful projects carried out abroad. Promoting international projects could potentially "unlock" innovation in the region.

40. The Vienna Institute for Economic Studies also brought up the problem of brain drain.

41. William Bartlett pointed out that there was a disjunction between research and the business sector in the region and emphasised the need to re-build those link, possibly by merging different research institutions

The main priorities agreed upon by the experts were: 1) Support to product improvement (ISO standards, engineering, software, cooperative (non R&D) innovation projects), 2) Technology transfer from university and from abroad, 3) Capacity for innovation to companies, 4) Funding for innovation strategies/inter-ministerial coordination.

Discussion: Human capital

42. Slavo Radocevic argued that, in recent years, the structure of industries in the region has changed, as have human capital priorities. The present priorities include:
    e. Incentives for direct vocational training;
    f. Industry and technology specific training;
    g. The system of transparency of these skills and a system of certification.

43. The EBRD commented that several surveys of skills have already been carried about by the employment agencies in Croatia and the Former Yugoslav Republic of Macedonia, the results of which reveal that soft skills are lacking in the workforce.

44. The World Bank referred to the need for higher education reforms. The World Bank is currently working on this area, comparing the outcomes of the higher education systems in the region with PISA standards.

45. The Vienna Institute for Economic Studies pointed out that human capital needs to be connected with labour market policy. At the moment, there is a huge drop in employment, especially in Serbia. Many people are trained to work abroad and may not gain the skills necessary for local IHGSMEs. He argued that the aim of a human capital strategy is employing people. Policies should therefore not be geared towards PISA standards but towards local demand. Employment is the scarcest commodity in the region. Many experts agreed upon the importance of increasing internships in the region to enable students to gain experience on the labour market.

46. A discussion revolved around where efforts for reforming the education system should be directed, the first, secondary or tertiary level. Determining this requires a long term vision by politicians. The point was raised that education reforms require long term vision by politicians. At present, it is unclear where the efforts to improve human capital in the region should be directed: first, secondary, or tertiary level.

The main priorities agreed upon by the experts were: 1) technology and industry specific skills, 2) monitoring teaching quality and educational outcomes, 3) incentives for vocational training in firms, 4) financing secondary education

Discussion: Competition Policy

47. The Vienna Institute for Economic Studies argued that the issue of competition policy is more relevant for big firms.

48. The Vienna Institute for Economic Studies also pointed out that the shadow economy should not be placed under the umbrella of competition policy. The shadow economy should be considered as a complement rather than a substitute to the real economy and therefore does not affect competition. Slavo Radosevic added that policy makers cannot deal with the shadow economy directly because it is a result of deficiencies in many policy areas. The EC agreed with Slavo Radosevic's statement that the shadow economy does not fall under competition policy.

49. The representative from the World Bank raised the point that the outputs of competition policy in the region are quite weak. He also addressed the need to look into specific case studies of cartels and mergers to explore policies to increase competition in the region.

Discussion: Infrastructure

50. Several experts pointed out that many donors are involved in improving the infrastructure in the region. The World Bank added that the Former Yugoslav Republic of Macedonia has recently inaugurated a new cargo system in their airport. He further commented that the main area in need of was public private partnerships. The Vienna Institute for Economic Studies questioned the added value of working on infrastructure, given that donors already paid much attention to that policy area. There is indeed a problem because some SMEs in rural areas do not have access to infrastructure, but these tend not to be high growth SMEs.

51. Slavo Radosevic argued that all regulators should publish contracts and licenses in order to increase transparency and also suggested using cross-country regulatory bodies because infrastructure, and especially transport infrastructure, is a policy area very suitable for regional cooperation.

52. The RCC raised the point that value chains could be supported by additional developments in the infrastructure and that policies should aim to match infrastructure to industrial agglomeration patterns.

53. Investments to improve energy efficiency could be worthwhile.

The main priorities agreed on by the experts for infrastructure were: 1) public private partnerships, 2) the decentralised development of business parks with high value added services 3) the simplification of administrative procedures to access infrastructure

Discussion: Investment climate

54. Nikola Stefanovicz from the private equity fund SEAF said that there is a need for a campaign to improve the perception of people who made money through successful business endeavours and to encourage people in the region to value entrepreneurship

55. William Bartlett argued that intellectual property rights and property rights more generally remain weak in the region.

The main priorities agreed upon by the experts were: 1) bankruptcy procedures and costs, 2) the enforcement of contracts and an efficient court system for small claims, 3) the use of internal best practices to reduce regional disparities for administrative procedures

Conclusions

56. It was agreed that the OECD will apply the experts' opinions to the beneficiary-specific reform recommendations identified through desk research. The OECD will then revert to the experts in writing to finalise this part of work over the summer.

57. The final and shortened list of policy assessments together with the former policy assessments will be circulated to the beneficiaries for their input prior to the roundtables.

58. A series of roundtables will be held in the beneficiary countries in the fall to enable countries to further prioritise reforms. These priorities will then form the basis for the implementation of the TA component of the EDIF project.