

Tax and Legal Environment for the Private Equity and Venture Capital Industry in Croatia

Sandra Švaljek, PhD
The Institute of Economics, Zagreb

Round Table
“Uloga fondova rizičnog kapitala
u razvoju hrvatskog gospodarstva”

CEPOR

June 26th, 2007
Zagreb

Objective

- to **replicate the methodology** developed by the European Private Equity and Venture Capital Association (EVCA) and
- to **obtain the internationally comparable indicators** of tax and legal environment favouring the development of private equity and venture capital and entrepreneurship in Croatia

- the methodology used is the one presented in publication jointly produced by EVCA and KPMG in December 2006 under the title: **“Benchmarking European Tax and Legal Environments”**
- countries covered in the publication:
 - old EU (all fifteen countries)
 - new EU (eight countries – Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovak Republic, Slovenia)
 - non EU (Norway and Switzerland)

Purpose of the Benchmarking

- “to provide a benchmarking tool, enabling comparisons to be drawn between the European countries’ tax and legal frameworks, insofar as they affect the development of private equity and venture capital”
- to enhance the understanding of the key factors that determine private equity and venture capital growth
- to highlight the areas where improvements to the tax and legal situation could positively affect the development of private equity and venture capital, and entrepreneurship

BUT,

- the results should be interpreted with care – the list of factors contributing to favourable PE and VC environment is not exhaustive
- the information provided by this benchmarking tool should not be used to evaluate the business and investment opportunity in a country, neither it reflects the entrepreneurial culture nor the competitive PE and VC performance

Methodology (1)

- simple methodology that has been developed over time
- the methodology identifies factors that seem to have foreseeable medium-term impacts on the development of private equity and venture capital and its key actors (investors, fund managers and entrepreneurs)
- those factors can be grouped into three sections, taking into account the actors and the environment they are affecting
 - the environment for limited partners (investors) and fund managers,
 - the environment for investee companies
 - the environment for retaining talent
- the tax and legal environment is assessed on the basis of seven criteria
- each criteria is assessed based on information on various variables (29 variables in total)

Methodology (2)

- for each country **a score is allocated per variable**
 - 1 – best score, given to a favourable environment
 - 2, 3 – indicate less favourable conditions with room for improvement
- based on the scores of the underlying variables, **an average is calculated for each criterion**
- **a composite score** for the country is calculated as unweighted average of the average scores per each criterion
- the composite score enables comparison among all the countries included in the benchmark

- in the 2006 exercise, the cut-off date for the information collected was **1 July 2006**

Private Equity and Venture Capital Industry in Croatia

Country	Total Investment (in % of GDP)
Europe	0,321
Bulgaria	1,110
CEE Average	0,096
Croatia	0,015
Slovenia	0,000

Table 1: Private Equity Investments in 2004 in Europe and selected CEE countries*

Source: EVCA, Eurostat.

Note: *By country of destination of investment

Although the data suggest that the investment levels in Croatia are increasing, in 2004 they were seven times lower than on average in CEE countries and more than 20 times lower than in Europe, in terms of GDP.

Assessment of the Tax and Legal Environment in Croatia (1)

Table 2: Tax and Legal Environment in 2006

	Croatia	Europe*	EU-8**
Total Composite Score	2,26	1,84	2,11
A. The tax and legal environment for limited partners and fund managers			
1. Pension Funds			
A funded pillar one (governmental) pension system	3	2,12	2,50
Availability of incentives for complementary pillar two (occupational) pension systems	1	1,08	1,25
Implementation of EU Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision	3	1,56	1,50
Does your national legislation define any quantitative restrictions for pension funds to invest in the asset class other than those defined by the EU Directive?	3	1,72	2,25
Geographical restrictions for pension funds to invest abroad in other European Countries	1	1,28	1,63
Country Average	2,20	1,55	1,83

Note: *Europe – all 25 countries included in the study; ** EU-8 – eight new member countries covered by the study (Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Slovak Republic and Slovenia)

Assessment of the Tax and Legal Environment in Croatia (2)

	Croatia	Europe*	EU-8**
Total Composite Score	2,26	1,84	2,11
A. The tax and legal environment for limited partners and fund managers			
2. Insurance Companies			
Can insurance companies invest in private equity and venture capital with no quantitative restrictions other than those defined by EU Directive 2002/13/EC?	2	1,60	2,25
Geographical restrictions for insurance companies to invest in asset class in other European Countries	1	1,24	1,75
Country Average	1,50	1,42	2,00
3. Fund Structure			
A dedicated or suitable domestic fund structure or investment vehicle for private equity and venture capital	1	1,09	1,13
Tax transparency for domestic investors	1	1,70	1,88
Tax transparency for non-domestic investors	1	1,70	1,63
Ability to avoid permanent establishment for non-domestic investors	1	1,43	1,13
Ability to be exempted from VAT on management fees	3	1,52	1,63
Ability to be exempted from VAT on carried interest	3	1,26	1,13
Freedom from undue restrictions on investments	1	1,61	1,63
Country Average	1,57	1,47	1,45

Assessment of the Tax and Legal Environment in Croatia (3)

	Croatia	Europe*	EU-8**
Total Composite Score	2,26	1,84	2,11
A. The tax and legal environment for limited partners and fund managers			
4. Tax incentives for PE and VC			
Any form of tax incentives to encourage investment in private equity and venture capital	3	2,04	3,00
B. The Environment for Investee Companies			
5. Company Incentivization			
Provision of a specific fiscal scheme for young innovative companies	3	2,76	3,00
Company tax rate	1	2,04	1,00
Special company tax rate for SMEs	3	2,28	2,50
Country Average	2,33	2,36	2,17
6. Fiscal R&D Incentives			
Fiscal incentives for business R&D expenditure	3	1,64	2,00
Fiscal incentives for R&D capital expenditure	3	1,84	1,75
Fiscal incentives for contracting researchers	3	1,96	2,50
Fiscal incentives for technology transfer	3	2,36	2,50
Fiscal incentives for cooperation between firms and research institutes/universities	3	2,28	2,50
Fiscal incentives for the creation of innovative firms	3	2,68	3,00
Country average	3,00	2,13	2,38

Assessment of the Tax and Legal Environment in Croatia (4)

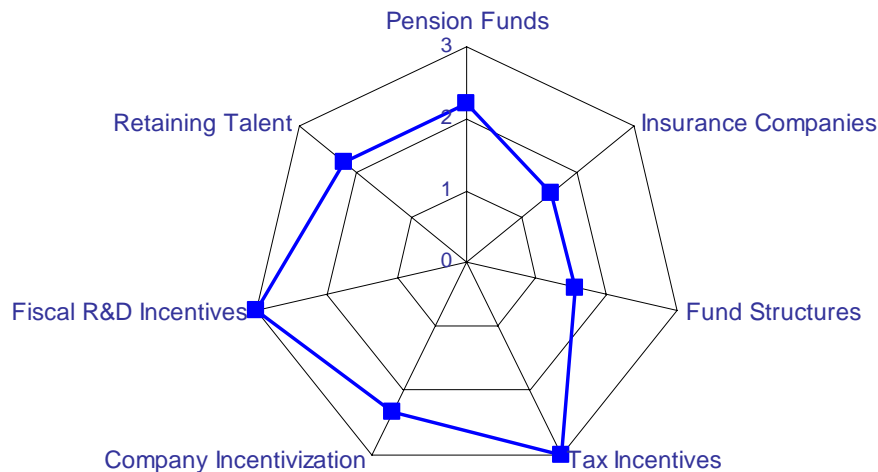
	Croatia	Europe*	EU-8**
Total Composite Score	2,26	1,84	2,11
C. The Environment for Retaining Talent in Investee Companies and Management Funds			
7. Retaining Talent in Investee Companies			
Capital gains tax for private individuals	1	2,04	2,25
Income tax rate for private individuals	3	1,96	1,25
Taxation of stock options	3	2,44	2,50
8. Retaining Talent in Fund Management Companies			
Ability to incorporate a performance-related incentive for the fund managers	1	1,24	1,50
Taxation of carried interest	3	1,76	2,25
Country Average	2,20	1,89	1,95

Source: Author's assessment.

Assessment of the Tax and Legal Environment in Croatia (5)

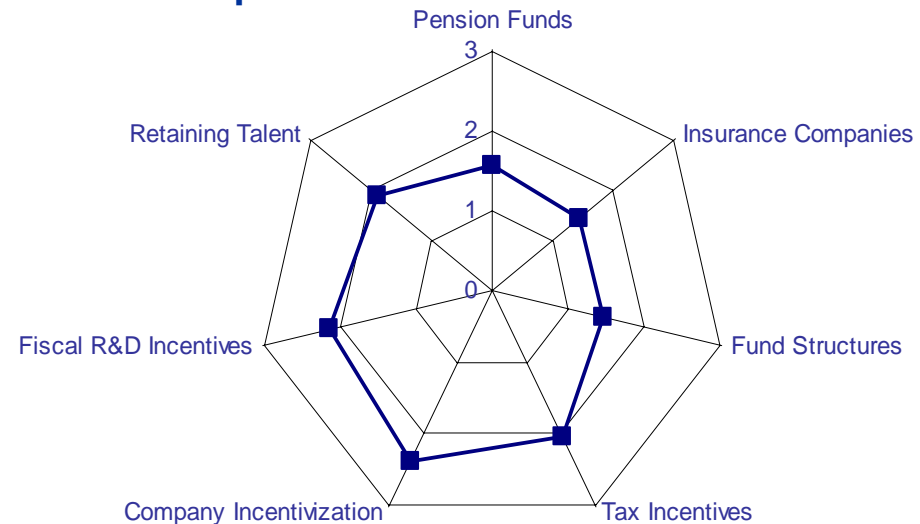
Croatia does not provide a favourable environment for supporting entrepreneurship and development of innovative firms since the appropriate fiscal incentives are missing. Domestic fund structures are rather good and the environment for insurance companies to invest in PE and VC is close to the European average.

Figure 1: Current situation in Croatia per criterion



Source: Author's assessment.

Figure 2: Current situation in Europe per criterion



Source: EVCA.

Ranking of Croatia in 2004 and 2006

Table 3: Overview of the composite scores per country in 2006 and 2004

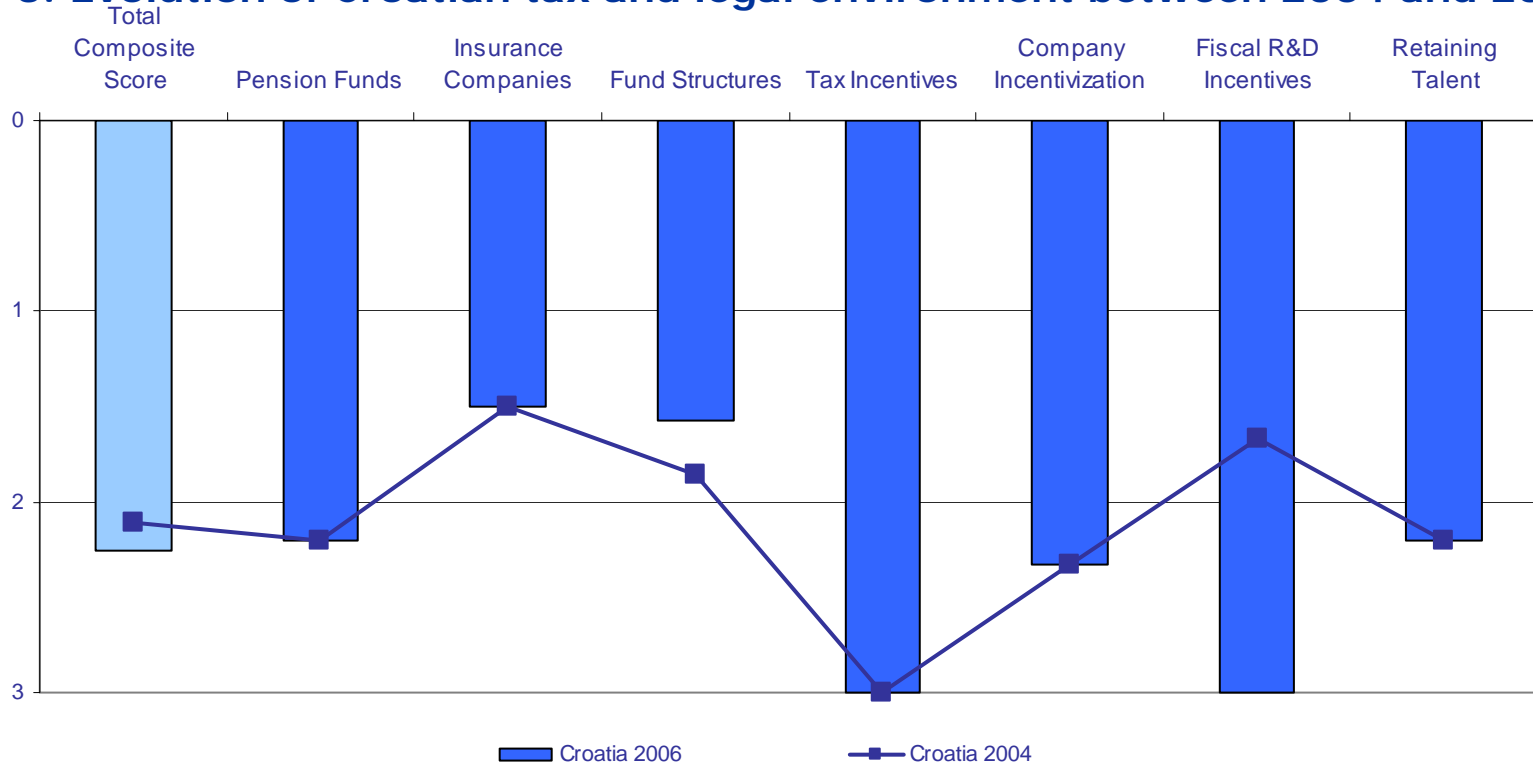
Country	Total Composite Score 2006	Country	Total Composite Score 2004
Ireland	1,27	United Kingdom	1,26
France	1,36	Luxembourg	1,49
United Kingdom	1,46	Ireland	1,53
Belgium	1,51	Greece	1,75
Spain	1,52	Netherlands	1,76
Greece	1,55	Portugal	1,81
Netherlands	1,60	Belgium	1,82
Luxembourg	1,62	Hungary	1,86
Portugal	1,71	Italy	1,86
Italy	1,72	France	1,89
Austria	1,74	EU15	1,92
Denmark	1,75	Switzerland	1,95
EU15	1,77	Spain	1,96
Hungary	1,83	Europe	1,97
Switzerland	1,83	Norway	2,04
Europe	1,84	Sweden	2,05
Finland	1,91	Croatia	2,11
EU8	2,07	Czech Republic	2,12
Estonia	2,08	Poland	2,13
Norway	2,08	EU4	2,15
Sweden	2,12	Finland	2,30
Latvia	2,12	Germany	2,37
Germany	2,15	Austria	2,42
Poland	2,16	Denmark	2,46
Slovak Republic	2,17	Slovak Republic	2,49
Czech Republic	2,21		
Croatia	2,26		
Slovenia	2,26		
Romania	2,35		

Source: Author's assessment, EVCA.

Evolution Between 2004 and 2006

Between 2004 and 2006 Croatian tax and legal environment slightly deteriorated due to the abolition of fiscal incentives for R&D. With the adoption of new Law on investment funds there was some improvement in fund structures.

Figure 3: Evolution of Croatian tax and legal environment between 2004 and 2006



Source: Author's assessment.

Conclusions

- when included in benchmarking exercise, Croatia is placed almost at the end of the ranking, and its composite score is worse than the average score of the eight new member states
- since the overall score for Croatia deteriorated since 2004, Croatia could not retain its 2004 position
- there is **much room for improvement** in the tax and legal environment for private equity and venture capital industry in Croatia
- existing legislation is **particularly unfavourable in respect to the lack of fiscal incentives** for investors in PE and VC, entrepreneurs and innovative firms, as well as for researcher, highly qualified company managers and investment fund managers