



STABILITY PACT
FOR SOUTH EASTERN EUROPE



INVESTMENT COMPACT
FOR SOUTH EAST EUROPE

**Workshop on Enterprise Development and
Employment Generation:
Tools to Facilitate Enterprise Development through
Start-Up Support**

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Stability Pact for South Eastern Europe

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1. INTRODUCTION

On the 7-8th of February 2006, the Stability Pact for South Eastern Europe (Stability Pact) is hosting a workshop on the issue of enterprise development and employment generation with a particular focus on assisting the development of start-up and early growth enterprises. The workshop brings together two key Stability Pact initiatives, the OECD led Investment Compact for South Eastern Europe (Investment Compact) and the Initiative for Social Cohesion (ISC).

As part of its objective to facilitate sustainable economic development underpinned by strong social policies, one of the key tasks of Working Table II (WTII) of the Stability Pact is to ensure a convergence between traditional economic development activities and the necessity for social cohesion. Economic growth and political and social stability cannot be achieved without simultaneously addressing the persistently high unemployment rates in South Eastern Europe (SEE) and stimulating enterprise development. Therefore, WTII has developed the umbrella theme "Enterprise Development and Employment Generation," which involves a series of activities that complement and enhance existing Stability Pact initiatives in areas such as the Investment Compact, the European Charter for Small Enterprises and the Bucharest Employment Process.

Under this theme, the Stability Pact provides a forum that brings together SEE and international experts from the economic and social worlds, allowing them to share experiences, exchange views and co-ordinate actions. Several events have already been organised, which have addressed issues related to entrepreneurship and employment creation:

- Conference on Entrepreneurship and Employment, Bucharest 26th May 2004.
- Seminar on Regional Aspects of Promoting Entrepreneurship and Employment, Skopje, 9th November 2004.
- Workshop on Training for Employability, Thessaloniki, 21st – 22nd April 2005.

Responding to recommendations made at previous events, the forthcoming Istanbul Workshop focuses how the high level of unemployment in the region could be addressed via various initiatives involving enterprise development and start-ups. The workshop is designed to facilitate dialogue between institutions responsible for enterprise development, such as Ministries of Economy and SME Agencies, and their social cohesion counterparts, such as Ministries of Labour, Employment Agencies, Trade Unions, etc., concentrating on the following themes:

- Financial instruments (focus on credit, micro-credit and active labour market measures).
- Non-financial instruments (focus on one-stop shops for business registration, the patent tax and entrepreneurship education and training).
- Tools for areas experiencing industrial restructuring (focus on business incubators).

The purpose of this paper is to briefly highlight some of the principal trends being experienced in the SEE region and set out the key issues for discussion, which will then be elaborated in the presentations to be made at the Workshop. Following the Workshop, a Proceedings Paper will be prepared combining the presentations, discussions, conclusions (in the form of policy dos and don'ts), as well as presenting recommendations to the Stability Pact for further activities in the field of enterprise development and employment generation.

2. FINANCIAL INSTRUMENTS TO SUPPORT NEW/SMALL BUSINESSES

Access to finance is a prerequisite for the development of the enterprise sector - all firms require external finance at some stage of development, be it start-up, survival or growth. In theory, a large number of sources of finance are potentially available for enterprise development such as: internal funds including family and friends, retained earnings, commercial banks, stock markets, equity funds, remittances, leasing facilities, government sources, NGOs, donor programmes, informal sources, credit cards, etc.

This paper, and presentations during the Workshop, will focus on three dimensions of the issue of access to finance, namely:

- The role of commercial banks / micro finance banks.
- The role of Micro Finance Institutions (MFIs).
- The role of active labour market policies and measures.

2.1 Commercial Banks / Micro Finance Banks

The main source of funding for enterprise development, especially start-ups, is internal sources, both in the SEE region and elsewhere. Commercial banks, whether domestic or foreign, as a rule, never consider new enterprise investments (start-ups) as potential clients. The main reason for this is that banks require a track-record so as to assess risk and credit worthiness. Start-ups by definition have no history, no way of proving profitability and often limited collateral to offer. More generally, although the commercial banking sector plays a relatively important role in relation to large enterprises (e.g. Bulgaria and Croatia), it meets a relatively small percentage of the funding needs of SMEs.

However, the situation is beginning to change rapidly in the SEE region due to such developments as: strong competition due to privatisation and participation of foreign banks and greater confidence in the banking sector leading to a consistent expansion of deposits and lending, much of which is leading to greater levels of domestic credit to the private sector, including the SME sector.

A further reason why commercial banks are beginning to reappraise the situation has been the experience of micro finance banks (MFBs) in the region, not least the ProCredit bank. ProCredit operates in all countries of the region (except Croatia) and has consistently proved that it is both possible to lend to small enterprises at relatively high interest rates and be highly profitable, where the arrears over 30 days is consistently low (typically 0,5% or less). This in turn is forcing commercial banks (such as Raiffeisen) to consider seriously cash-flow based methodologies for lending relatively small amounts of money, including to enterprises that have been established for as little as six months.

The above trends are leading to a materially different situation in relation to access to small enterprises generally (though not necessarily start-ups per se). This leads to a number of questions, which the workshop will seek to address:

Issues:

- Why do commercial banks not lend to start ups and why are they cautious about lending to SMEs?
- What are the trends in terms of commercial bank lending to private sector and SMEs in the SEE region?
- What impact are MFBs having on SME lending in the SEE region (in terms of commercial bank's practices e.g. Raiffeisen), as well as on MFIs?
- What can be done to increase the flow of finance for early growth enterprises (MFBs are now lending to entrepreneurs registered as recently as 6 months)?
- What can entrepreneurs do to increase their chances of obtaining MFB finance (dos and don'ts)?

2.2 Microfinance Institutions

Microfinance relates to the provision of very small loans (microcredit) to the economically active, thus assisting entrepreneurs to develop their small, usually micro, businesses. Traditionally, microfinance has been synonymous with a credit methodology that employs collateral substitutes to deliver and recover short-term, working capital loans to potential and existing micro entrepreneurs. The distinguishing characteristics of microfinance include an insistence on repayment via interest rates which cover the costs of credit delivery; a focus on creation of sustainable local microfinance institutions (MFIs); and diversification of the range of instruments which enable clients to build assets and protect themselves against risk of various sorts. The target group is typically non-bankable clients, namely those who do not have access to formal financial institutions, such as the self-employed small entrepreneurs. In rural areas, this includes small farmers, small-scale food processors and petty traders; in urban areas activities are more diverse, including shopkeepers, service providers, artisans, street vendors, etc.

As far as both new and small businesses in the SEE region are concerned, an important development has been the establishment of Micro Finance Institutions (MFIs), usually in the form of Non-Governmental Organisations (NGOs), as a dedicated mechanism of financing SMEs, including start-ups. Such MFIs have traditionally used donor grants and soft loans to target various forms of non-bankable clients with varying degrees of success. However, as such sources of funding begin to dry-up and as the commercial pressures from both commercial banks and micro finance banks increase, the ultimate goal of the microfinance sector is transforming into the creation of financially sustainable MFIs that become a permanent feature of the financial system. A typical goal is to be able to take deposits and draw down commercial funding sources, thus enabling MFIs to significantly expand their activities and outreach, whilst hopefully not losing their traditional focus and target groups, including assisting start-ups and early growth enterprises, especially those established by the more vulnerable groups. These trends and pressures lead to a series of issues which will be addressed in the workshop.

Issues:

- What is the role of MFIs in relation to assisting start-ups?
- What are the key differences between commercial banks/MFBs and MFIs?
- What impact are commercial banks (e.g. Raiffeisen) and MFBs (e.g. ProCredit) having on MFI lending practices to SMEs in the SEE region?
- What has been the experience in the SEE region in terms of start-ups specifically?
- What good practice can be introduced by MFIs to further assist start-ups and early growth SMEs in the region (dos and don'ts)?

2.3 Active Labour Market Measures

The unemployment rates in the SEE region are very high and are even increasing in certain cases (see Table 1), despite recent economic growth in the region.

Table 1: Unemployment Rate (% of labour force) and Real GDP Growth (%) in the Western Balkans (2003-2004)

Country	Unemployment 2003	Unemployment 2004	Growth 2003	Growth 2004
Albania	15.0	14.4	6.0	6.0
Bosnia & Herzegovina	42.0	42.8	3.5	4.0
Croatia	14.3	13.8	5.0	-
Macedonia	36.7	37.2	3.2	1.6
Serbia & Montenegro	28	34	3.0	5.0
Kosovo	49.7	44.4	3.1	5.0

Source: adapted from Mizsei, K. and Maddock, N. (2005a)

Recent analyses of the unemployment statistics illustrate the point that there is a high level of long term unemployment (usually over 70% have been unemployed for longer than one year). Moreover, youth, women, minorities and the less well educated are typically disproportionately affected. Even allowing for the countervailing influence of the informal economy, the unemployment situation is exceptionally problematic.

It is, therefore, necessary to provide interim solutions to chronic unemployment, pending the expected upswing in labour markets, provide work experience to the long term unemployed and/or other groups most seriously affected by unemployment. This would enable their reintegration with labour markets and generally reduce social tensions in areas experiencing high unemployment and poverty rates. Three types of active labour market policies (ALMPs) are being introduced in the region, consistent with the EU's Employment Strategy:

- Public works: labour intensive public works usually focusing on municipalities' local economic development strategies and infrastructure development.
- Wage subsidies: seek to encourage employment and provide a specific vulnerable group of unemployed people (e.g. recent graduates, women, etc.) with the opportunity to gain work experience through subsidising employment.
- Self employment: support to unemployed and/or redundant workers (there is often a close link to closure / restructuring of privatization / State Owned Enterprises) to establish a business plan and become self-employed and/or start an enterprise.

Thus ALMPs support employment creation in two basic ways: directly (job-creation measures such as public works and enterprise creation, as well as hiring subsidies), which is the focus of the Workshop discussion, and indirectly (improving employability through training and by ensuring efficient labour exchanges that provide better labour market information and enhanced job matching). However, as in the case of EU countries, including the new member states, SEE countries are experiencing varying degrees of success in relation to the direct approaches.

It is generally recognised that although ALMPs are an important weapon in the fight against unemployment and poverty, they produce mixed results (e.g. deadweight losses). This leads to the necessity to compare experiences so as to ensure that ALM policies more effectively attain their goals. Therefore, this part of the workshop addresses the following issues, focusing on self-employment measures:

Issues:

- Why is unemployment so extensive and persistent in the SEE region?
- What is the aim of active labour market measures (e.g. public works, wage subsidies, job placements and start-up finance for self-employment)?
- Privatisation and restructuring provides scope for enterprise development (self-employment, start-ups) – how has this typically been used in the region?
- How effective have such mechanisms been in the SEE region?
- What good practice can be introduced by Government and Employment Agencies in terms of making such initiatives more effective (dos and don'ts)?

3. NON-FINANCIAL INSTRUMENTS TO SUPPORT NEW/SMALL BUSINESSES

SMEs account for 98.1% of all enterprises in SEE, which is not very different from the situation in the EU-19 region (Union 15 + Iceland, Liechtenstein, Norway, Switzerland), with an average of 99.8%. However, the region lags significantly behind in relation to other indicators. For example, the SME density is extremely low (13.7 per 1,000 inhabitants Vs 52.8 in the EU-plus countries) SMEs are less important employers

(average of 47% of total employment Vs 66%), the share of the private sector in GDP is still relatively low (ca. 60%) etc. (OECD, 2003).

Indeed, all the evidence (including SME surveys) suggests that in addition to access to finance, small firms, especially start-ups, require other forms of support if the current levels of entrepreneurship are to be exceeded. Numerous barriers confront small enterprises in the SEE region such as lack of access to finance, the onerous tax system, the excessive burden of bureaucracy, the lack of adequate infrastructure, the extent of corruption and bribery, the unfair competition from the informal economy, etc. This part of the workshop focuses on three particular dimensions of non-financial support:

- The necessity to enhance business start-ups through simplified procedures such as the one-stop shop system of business registration and re-registration.
- The necessity to streamline the tax system through measures such as the patent tax, which delivers a clearer and simpler tax for small enterprises.
- The necessity to enhance the entrepreneurship culture in the region, and in particular to establish a model for innovative enterprise learning.

3.1 Simplified Start-ups: the One-Stop Shop

Doing business is difficult in the SEE region. In some countries, entry and exit obstructions and other administrative obstacles may be irritants to small enterprise development, but in transition economies where small enterprises possess limited human and financial resources, these may represent a major barrier to doing business, restrict the number of business start-ups and/or have an impact on the size of the informal economy.

One of the most comprehensive analyses of regulations and barriers to starting and operating a business is the World Bank's Costs of Doing Business (2005). This, supported by other studies (such as the OECD, 2003), reveals that the costs, complexity and time involved in starting a business in the SEE region are high:

- Procedures (number): ranges from 5 in Romania to 13 in Macedonia.
- Time (days): ranges from 28 in Romania to 54 in Bosnia and Herzegovina.
- Cost (% of income per capita): ranges from 7.4 in Romania to 46.2 in Bosnia and Herzegovina.
- Minimum capital (% of income per capita): ranges from 0 in Romania to 120.3 in Serbia and Montenegro.

Other problems include the high minimum capital requirements, the complexity of licences and permits, etc. Nevertheless, a clear trend in the region has been the significant effort expended into ways of simplifying the process of registration, connected with the Charter for Small Enterprises process. There are various ways of improving the registration process: create single access points for business, remove court involvement in the process, make electronic registration possible, introduce temporary business licences, standardise paperwork, introduce "silence is consent" rules for registration, etc.

The key approach being considered widely, if not necessarily implemented, in the SEE region is the single access point for business, otherwise known as the business help centres or "one-stop shops." Where this has been tried, this has often resulted in a "**one-more**-stop shop," actually increasing delays and problems, resulting in recommendations that a better approach would be to nominate an existing agency, such as the company register, as the single point of access which brings together representatives of various agencies. It is estimated by the World Bank (2005, p.22) that these typically take less than half the time to register a business compared with countries without such a system.

The situation in the SEE region is quite mixed, with countries such as Romania establishing such systems. This provides an opportunity to address the following issues:

Issues:

- Why are obstacles to business entry important to tackle in the SEE region?
- What are the main obstacles and types of measures that can facilitate this process?
- What has been the focus of the Romanian efforts (one-stop-shop)?
- How effective have such mechanisms been in Romania and the region?
- What good practice can be introduced by Government and SME Agencies in terms of making one-stop shop initiatives more effective (dos and don'ts)?

3.2 Streamlining Taxation: the Patent Tax

The design of the tax regime and the quality of the tax administration are of critical importance to small enterprises, both new and established. The creation of a tax system that is stable, clear and simple is essential for businesses with limited capacity to devote to onerous fiscal compliance procedures. Entrepreneurs highlight a series of problems common to the SEE countries: chronic instability due to frequent and often sudden changes of the tax laws and regulations; the lack of transparency, internal consistency and co-ordination between local and national regimes; the poor quality of the tax administration, which is often viewed by the entrepreneurs as inefficient and inflexible, partly because there is little consultation and training, and the high levels of corruption (OECD, 2003).

A further feature worth noting is that the tax system is characterised by a high degree of complexity. The situation in Bosnia and Herzegovina, where the two entities (Federation and Republika Srpska) and the District of Brcko apply their own taxes and operate their own tax administration is extreme. But the SEE countries tend to have numerous taxes at national, regional and local level, the frequency of payment is often high and the rules and regulations are often unclear.

Several countries have sought to introduce new taxation regimes for small enterprises and individual entrepreneurs, such as an SME tax in Albania and the patent taxes in Albania and Moldova. The experience of Moldova is worth noting in that individuals may purchase a temporary licence to carry out business activities such as retailing, workshops, crafts, etc. The patent works both as a temporary business licence, as well as a form of tax pre-payment, exempting individuals from having to keep records of their activities. The patent tax appears to have been well received, and may well have contributed to reducing the level of the informal economy. The Workshop will explore the potential of the patent tax in the SEE region. It is also worth exploring whether, once businesses start growing, the usual difficulties of obtaining licences, dealing with the tax office, coping with state inspections, etc. re-appear.

Issues:

- Why are taxes / tax burden so important to SMEs in the SEE region?
- What are the main types of measures that can reduce the burden on SMEs?
- What has been the focus of the Moldovan patent tax?
- How effective have such mechanisms been in Moldova and the wider region?
- What good practice can be introduced by Government in terms of making patent taxes more effective (dos and don'ts)?

3.3 Entrepreneurship Culture and Learning

Policy makers in the SEE region are beginning to place emphasis on the development of an enterprise culture in society, something which is increasingly seen as the key to creating a society capable of coping with the complexities and challenges of the globally competitive economy. The EC (Entrepreneurship in Europe, 2003) defines entrepreneurship as: "... *the mindset and process to create and develop economic*

activity by blending risk taking, creativity and/or innovation with sound management, within a new or an existing organisation.”

It is important for policy makers to focus on entrepreneurship since it:

- Contributes directly to job creation and growth (increasingly small firms are the major providers of new jobs).
- Is crucial to competitiveness (increased efficiency and innovation in firms, offers consumers greater choice and lower price).
- Unlocks personal potential (money and status but also freedom, independence and “the challenge”).
- Is in society’s interest (entrepreneurs are key drivers of the market economy and their achievements provide societies with wealth, jobs and consumer choice).

The challenges in developing enterprise culture may be summarised as:

- Ensuring a clear definition of what this means.
- Designing instruments to measure the enterprise culture on an ongoing basis.
- Ensuring that the stakeholder and enabling environment empathises with the values of the entrepreneur.
- Designing organisations, especially the education and training system, to embed the culture.
- Supporting the design of programmes in the education and training system at all levels (primary, secondary and college) aimed at underpinning enterprise.
- Supporting publicity campaigns, competitions and awards that promote business ideas, innovation and entrepreneurship at all levels of society, etc.

(UNDP, World Bank, Dialogue Series, 2005)

Progress is being made in the SEE region, but the education systems are not yet fully capable of promoting entrepreneurship. For example, activities targeted at promoting entrepreneurship at primary and secondary level mainly take the form of optional and extra-curricular courses, and although some national initiatives exist, these are primarily donor-supported. At post-secondary level, there are some specific courses offered by public and private universities. As for the enhancement of entrepreneurship of the adult population outside the formal education system, actions currently focus mainly on “how to create a new business” and on providing training and consultancy services for managers of existing businesses. These tend to be organised by networks of local/regional business centres and employment services, again often supported by donors.

The European Training Foundation (ETF) is in the process of preparing a comprehensive framework to accurately ‘map’ entrepreneurship learning and employment legislation in the region, which should provide valuable information for governments and donors alike on areas of particular concern. The EC, in co-operation with the ETF, is to undertake a strategic study of the entrepreneurship learning environment in the region. This will focus on enhancing the competitiveness of the SME sector and entails a critical review of the entrepreneurship learning environment in the region, including a feasibility study for the potential for establishing a SEE Academy for Entrepreneurship Learning (Stability Pact, forthcoming, “Enterprise Development and Employment Generation in SEE: Seeking a Comprehensive Approach”).

These initiatives are encouraging, but countries can do more to incorporate entrepreneurship into the educational system in a comprehensive manner. As noted in the EC report on the Charter for European Small and Medium Enterprises (January 2004) for the Western Balkans and Moldova, developments in all these fields are gradual and need to be further and systematically promoted. Part of the workshop is, therefore, devoted to the issue of culture of entrepreneurship and enterprise learning and will cover the following issues:

Issues:

- Why is development of a culture of entrepreneurship and enterprise learning important in the SEE region?
- What are the main types of measures that can facilitate this process?
- What is a good model of innovative enterprise learning in the SEE?
- How effective have such initiatives been in the region?
- What good practice can be introduced by Government and others such as SME Agencies in terms of making such initiatives more effective (dos and don'ts)?

4. ENTERPRISE SUPPORT AS A TOOL TO LESSEN THE IMPACT OF INDUSTRIAL RESTRUCTURING INCLUDING THE ROLE OF BUSINESS INCUBATORS

Dealing with industrial change and restructuring is a complex and multi-dimensional challenge. Much of the international investment attracted through privatisation, while highly desirable, leads in the short to medium term to reduced employment and a period of 'downsizing' with consequential serious impact on local employment and the local economy. In the longer term more competitive and vibrant companies will re-emerge but this process may take years. To what extent can this process be managed in order to allay the worst features of sinking employment and undermining of local economies.

Much restructuring can take place in cities and towns that are dependent on a few traditional industries and the subsequent unemployment can have a negative impact on entire areas. Several EU countries including UK, Italy and Germany have extensive experience of trying to support enterprise development in deprived urban areas and a review of this experience using a mixture of financial incentives, incubators and targeted education and training can provide some valuable ideas for South Eastern Europe.

In particular, business incubators are an established policy instrument for economic and employment development - it is estimated that over 4,000 are already in operation throughout the world. Incubators essentially provide the conditions to foster new business ideas and innovation, as well as providing the environment and facilities to ensure implementation. Incubators can help tackle challenges such as: how to stimulate new enterprise; how to support early stage businesses and enable them to survive and grow; how to promote more local and regional development; and how to nurture technology development and the application of academic research, etc. Incubators have often been established in response to industrial restructuring such as downsizing and plant closures (often associated with State Owned Enterprises), in partnership with local municipalities, companies and communities. Moreover, they have also been used to promote enterprise in vulnerable groups such as women entrepreneurs, as well as certain ethnic groups where the level of entrepreneurship is perceived as being inadequate.

The range and scope of incubators has been wide and innovative in its application and this trend continues today in the SEE region. Nevertheless, the primary focus of incubators remains essentially to provide new and young developing firms with premises, infrastructure and a range of services and support that can improve their ability to survive and establish their operations during the early developmental period. It is the combination of good physical facilities, focus on start-ups and SMEs and availability of "soft" advisory and support services are what distinguish business incubators from other initiatives such as industrial centres or parks (OECD-UNIDO, 1999, pp.51-53).

It is estimated that there are 30-40 incubators in the SEE region. All countries appear to have established something that is, or at least resembles, an incubator (OECD, 2003), however the nature of the incubators varies dramatically and few resemble the original

conception of incubators. Most appear to have been established prior to 2000, when many SEE countries experienced severe industrial restructuring, often associated with the process of privatisation. Indeed, quite a few incubators appear to have already closed down and the rate of establishment of new incubators has slowed down since. Part of the reason for the lack of sustainability is that few incubators in the SEE region conform to internationally accepted norms (such as minimum rentable space of 2,000m² – 4,000m²; 20-30 tenants; and occupancy rates of 85%) so as to be financially sustainable. Only the Romanian incubators approach the minimum threshold in terms of size, but even here only five of the original 10 business incubators continue operating.

Therefore, although incubators offer the prospect of responding to industrial restructuring, they do not appear to be very sustainable in the region. This is in part because they have typically been used to reduce the impact of SOE restructuring and/or closure, which has resulted in a strong poverty mitigation focus, rather than focusing on individuals/enterprises with high growth potential and a long-term perspective. Indeed, there appears to be a need to be a greater focus on:

- Developing a greater focus on hi-growth, hi-tech enterprises, which harnesses the skills of ambitious and innovative entrepreneurs.
- Developing links and joint ventures with universities and research institutes as a means of capitalising on R&D, thus capturing the benefits of innovation.

In this context, the experience of the Osijek, Croatia is instructive, since it combines an entrepreneurial centre (business support centre) approach with a relatively large incubator which focuses primarily on innovative entrepreneurs. Therefore, the final part of the conference concentrates on the following issues:

Issues:

- Why are business centres used to assist start-ups and does it make sense in the region?
- Key aspects of providing enterprise support in deprived urban areas
- What are the main different types of models of implementation (hi-tech, hi-growth vs poverty alleviation)?
- What is the Osijek model and how successful has it been?
- What are the advantages and disadvantages of these types of initiatives and how successful have they been in the region?
- What good practice can be introduced by Government and SME Agencies in terms of making such initiatives more effective (dos and don'ts)?

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