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CZECH REPUBLIC

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF THE CZECH REPUBLIC

THE LAND

Area (sq. km)	78 864
Arable land (sq. km)	42 798

Population of major cities (thousands) (1.1.1998)	
Prague	1 200.5
Brno	385.9
Ostrava	323.2
Plzen	169.4

THE PEOPLE

Population (thousands, 31 December, 1998)	10 299
Number of inhabitants per sq. km	130.6
Annual population growth, 1992-1997 (per cent)	–0.03
Employment (thousands, 1998)	4 818

Civilian employment by sector (per cent of total, 1997)	
Agriculture	5.5
Industry	40.7
Services	53.8

THE PARLIAMENT

Parliament, as of December 1999 (number of seats)

Czech Social Democratic Party	74
Civil Democratic Party	63
Freedom Union	18
Communist Party	24
Christian Democratic Union	20
Independent	1
Total	200

THE PUBLIC SECTOR

As a percentage of GDP, 1998

Current receipts	38.2
Direct taxes	9.5
Indirect taxes	11.7
Social security contributions	14.5
Total expenditure	35.9
Government consumption	8.1
Subsidies	7.6
Social security benefits	19.0

PRODUCTION

GDP (million US$, 1998)	43 525
GDP per capita (US$, 1998)	4 226
Gross fixed investment (% of GDP, 1998)	31.4

Structure of production (% of GDP, 1998)	
Agriculture	4.2
Industry	39.2
Services	56.6

FOREIGN TRADE

Exports of goods and services (1998)	
(billion US$)	33.9
(per cent of GDP)	60.0
Main merchandise exports (% of total, 1998)	
Machinery and transport equipment	42.5
Manufactures	26.5
Chemicals	7.3
Other	22.9

Imports of goods and services (1998)	
(billion US$)	34.7
(per cent of GDP)	61.4
Main merchandise imports (% of total, 1998)	
Machinery and transport equipment	40.2
Manufactures	21.6
Chemicals	11.6
Petroleum products	3.5
Other	23.1

THE CURRENCY

Monetary unit: Czech koruna

Currency units per US$	
Year 1999	34.6
December 1999	35.6

Note: An international comparison of certain basic statistics is given in an annex table.

This Survey is based on the Secretariat's study prepared for the annual review of Czech Republic by the Economic and Development Review Committee on 2 December 1999.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 21 December 1999.

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The previous Survey of Czech Republic was issued in May 1998.

Assessment and recommendations

Delayed restructuring of the economy precipitated the 1997 currency crisis, necessitating the introduction of a stabilisation package

The recent performance of the Czech economy has been heavily influenced by the stabilisation package put in place following the 1997 currency crisis. As described in detail in the previous OECD Survey, the roots of that crisis were to be found mainly in state-controlled banks that provided relatively easy access to credit, largely unregulated capital markets and confused corporate governance. In such an environment, domestic firms failed to restructure and lost competitiveness, which resulted in a mounting external imbalance and speculative pressures against the currency. Despite rising interest rates, these developments forced the authorities to abandon the fixed-exchange-rate regime in May 1997 and to introduce several macroeconomic and structural measures, including: the announcement of inflation targets, a tightening of fiscal policy, a substantial increase in regulated prices and plans to complete rapidly the privatisation of both the banking sector and a number of state-controlled firms.

The ensuing recession in 1998 and early 1999 helped restore external balance…

The combination of monetary and fiscal restraint provoked a slowdown in GDP growth which, together with the repercussions of the Asian and Russian crises, set the stage for the recession of 1998-99. Indeed, GDP fell by 2.3 per cent in 1998, mainly as a result of falling domestic demand, and declined even further in the first quarter of 1999 despite stronger household and government consumption. By closing the gap between the economy's supply and demand, the recession contributed to correcting the external imbalance. Imports declined, due to the depressed state of the economy, and exports recovered in response to improved competitiveness associated with the 1997 depreciation of the currency, so that the current account deficit shrank to

2.4 per cent of GDP in 1998. Further improvement was registered in the first half of 1999, following a strengthening of exports in the context of stronger activity in Europe.

... but was accompanied by a rapid rise in unemployment, which contributed to a sharp decline in inflation

The drop in output was reflected in a rapid rise in the unemployment rate, from an average of 4.8 per cent in 1997 to 9.0 per cent in the third quarter of 1999, and in a moderation of nominal wage growth, although labour market conditions in Prague have remained relatively tight. These developments, combined with declines in food and energy prices and a pause in the process of liberating regulated prices, led to a substantial reduction in inflation, which fell from a twelve-month rate of 13.3 per cent in the first quarter of 1998 to only 1.9 per cent in November 1999. Net inflation, which adjusts for the direct impact of changes in indirect taxes and administered prices, fell to an even lower level and was actually negative for much of 1999.

The outlook for the near term suggests a return to growth...

The rebound in net exports in the second and third quarters of 1999, coupled with signs of improved business and consumer confidence, suggests that the recession may be drawing to a close. Output also recovered somewhat over that period, although, for 1999 as a whole, real GDP growth is projected to have declined by about ½ per cent. Looking ahead, the overall pace of growth will likely be constrained by ongoing restructuring in the corporate sector and rising unemployment. Hence, despite an anticipated increase in investment spending as the recovery picks up, economic activity is projected to expand by only 1.4 and 2.3 per cent in 2000 and 2001, respectively. Nonetheless, even though high unemployment will continue to restrain nominal wage growth, inflation is expected to rise as some of the one-time factors that contributed to its sharp decline last year unwind. The moderate increase in labour costs should help the competitiveness of Czech exports, which will also likely benefit from the improved international environment. But at the same time the overall strengthening of domestic demand is projected to result in stronger imports, which is likely to be reflected in a small widening of the current account deficit.

... although the pace of recovery is uncertain

The basis for the projected recovery remains narrow, however, and its strength and durability are subject to several uncertainties. *First*, growth may well run out of steam if, despite improved corporate profitability, business investment fails to pick up. *Second*, a more rapid pace of industrial restructuring would likely result in higher unemployment and lower consumer demand with possibly negative consequences for growth in the short run but a more dynamic expansion later on. Conversely, slower restructuring would probably see higher demand in the short term but less improvement in productivity and in the economy's competitiveness, which, over the longer run, would hamper convergence of incomes to OECD average levels. *Finally*, the performance of the economy remains sensitive to exchange rate developments. Sharp movements in the currency in either direction – because of increased capital inflows or international financial market turbulence – would inevitably have implications for an emerging market economy like the Czech Republic.

In these conditions, the currently easy stance of monetary policy appears to be appropriate...

The upsurge in inflation following the 1997 crisis and the necessity to restore confidence in the currency forced the Czech National Bank (CNB) to keep monetary policy tight throughout 1997 and during the first half of 1998. The unexpected rapid deceleration in price increases led to a significant undershooting of the CNB "net inflation" target (of 6 ± 0.5 per cent) in 1998 and it appears that this will also be the case in 1999. In response, monetary policy has been substantially relaxed: beginning in July 1998, the CNB has lowered its two-week "repo" rate eighteen times, from 15 to 5.25 per cent. Moreover, the currency depreciated strongly between November 1998 and April 1999, and, although it has strengthened since then, overall monetary conditions have relaxed substantially. In such circumstances and given the projected rebound of inflation, there does not seem to be a strong argument in favour of further loosening. Current economic conditions do not warrant a tightening either, particularly because, notwithstanding lower interest rates, banking-sector restructuring is keeping credit conditions tight (see below).

... but the communication strategy of the central bank needs improvement

While the current stance of the central bank's policy appears broadly appropriate, the implementation of its inflation targeting framework will continue to be complicated by at least two factors. *First*, the logic of that framework requires that for the same reasons the central bank did not ease policy in reaction to the exogenous fall in food, energy and tradable-goods prices, the unwinding of these phenomena and their impact on inflation should not be resisted in 2000. *Second*, the government has committed itself to adjust regulated prices by the end of 2002 to a level that covers economically justified costs and provides adequate profits. Such a move, whether done in several steps or at one time, would imply that, on average over the next three years, headline inflation will be up to 3 percentage points higher than the Bank's net measure – a difference that may bring the public to question the relevance of the CNB's targets. To meet these challenges, it will be essential for the Bank to explain to the market and the general public that such developments are consistent with the achievement of its monetary policy goals. Focusing more on the medium term would help in this regard, implying that the CNB should place less emphasis on short-term objectives. Moreover, the Bank's task will be facilitated by the government's recent announcement of when, and by what amount, some regulated prices are to be increased. Were such a schedule extended to other administrated prices, the CNB would be able to explain more clearly the relationship between its targets and the full consumer price index and, eventually, could even consider stating its objectives in terms of an indicator that is not systematically biased with respect to headline inflation.

At the same time, a widening structural budget deficit suggests the need to tighten fiscal policy...

The conduct of monetary policy would also benefit from a tighter fiscal stance. After correcting for the 1998 losses of *Konsolidacni banka* and treating the revenues from local government option sales as privatisation revenues, the consolidated general government deficit net of privatisation receipts is estimated to have risen from 2.4 to 4.4 per cent of GDP between 1998 and 1999. More than half of that increase represents additional discretionary spending: indeed, current expenditures rose by 2.8 per cent of GDP, bringing to an abrupt end the decade-long decline in such outlays. Additional transfers to households and enterprises, as well as a 14 per cent wage increase for government employees, played an important role in this respect. Looking ahead, government medium-term fiscal projections to 2005 suggest that, unless steps are taken to control entitlement expenditures, which is the largest and fastest growing component of current expenditures, the budget deficit is likely to remain around 5 per cent of GDP.

while more transparency should be introduced into government accounts

Undue attention by policy makers to the State Budget, which excludes the operations of local authorities as well as various extra-budgetary funds and off-budget agencies used to fund current government expenditures, has tended to obscure their appreciation of the stance of fiscal policy. For example, in 1999, the State Budget was expected to record a shortfall of only 2 per cent of GDP, less half than the estimated consolidated general government deficit. Such differences were partly responsible for the accumulation of a 17 per cent of GDP "hidden debt" over the past seven years, a period during which the official central government debt-GDP ratio recorded a falsely encouraging decline. In an effort to improve the transparency of government accounts, the authorities have taken two important steps. The first involved the initiation of a study estimating the size of the "hidden debt" held by the off-budget agencies and the second the presentation of a medium-term fiscal framework in the 2000 budget based on consolidated government accounts. Both of these initiatives are welcome, although more needs to be done to raise the profile of the consolidated accounts. In particular, the government should attempt to increase the frequency with which these accounts are available so that, when evaluating the public finance situation, both politicians and observers can focus on this broader measure of government activity. Finally, recent proposals to create new extra-budgetary funds with the view, among other things, to run the state pension programme, should be reconsidered. Indeed, experience both in the Czech Republic and elsewhere suggests that such funds tend to generate substantial budget deficits because they are subject to much less political oversight and weaker control mechanisms than on-budget spending programmes.

Enhancing medium-term growth prospects requires a rapid completion of bank privatisation...

While a more balanced and transparent macroeconomic policy framework is necessary to enable stronger economic performance, the most critical problem areas in the Czech Republic remain structural in nature. In this regard, privatisation of the banking sector, improved regulation of capital markets and a more straightforward corporate governance structure are key elements to promoting stronger firm-level and economy-wide productivity performance. Recent reforms in these areas have served to greatly improve the allocation of capital by banks. Thus, regulatory changes in capital markets have increased the distance between the banks, companies and investment funds, reducing many of the conflicts of interest that distorted the governance of some firms. More importantly, the prospect of privatisation and the tightening of prudential rules have led banks to increase provisions and tighten credit conditions, forcing enterprises to undertake a welcome and long-delayed restructuring. So far, two banks, *Investicni a postovni banka and Ceskoslovenska obchodni banka* (CSOB), have been privatised and preparations for the sale of the two remaining banks, *Ceska sporitelna* (CS) and *Komercni banka* (KB), are advancing. Several issues remain unresolved, however. In particular, the government has to decide whether to recapitalise the banks prior to their sale or leave this task to their eventual buyer. One solution could be the transfer of the bad loans of CS and KB to *Konsolidacni banka* (KoB) – the state-owned bank used as a depository for bad loans accumulated in the competitive sector. This would permit a quick sale at a good price. Following KoB's transformation into a non-bank state institution, it should be recapitalised so as to provide it with the means to deal more actively with its loan portfolio, *i.e.* selling those loans for which a buyer can be found and writing off the rest. Such a solution would bring into the open a large part of the government's above-mentioned hidden debt.

... and improvement to the regulation of financial markets

Since the beginning of the transition, the overall allocation of capital within the economy has been distorted by a weak regulatory framework, encouraging widespread fraud and international flight from Czech capital markets. In particular, inadequate supervision remains a major problem as regards the credit unions, where unsustainable financial practices were tolerated for much too long. Nevertheless, in some areas recent reforms have improved conditions substantially, the most important being the establishment of a Securities and Exchange Commission (SEC) in 1998. Although not fully independent of the government, this institution has undertaken an impressive clean up operation, withdrawing the licenses of a large number of brokerages and de-listing many firms for non-compliance with existing rules. Transparency in the investment privatisation fund (IPF) market was also vastly improved by a SEC-initiated opening of closed-ended funds whose shares were trading at significant discounts relative to the market value of the stocks held by them. In addition, a provision requiring all IPFs to reduce their holdings in any one company to not more than 11 per cent resulted, somewhat unexpectedly, in a more straightforward corporate governance structure as the sell-offs of shares by the funds enabled outside strategic investors to acquire substantial stakes in a number of companies. Despite these improvements, potential for conflict of interest still exists because a bank can control one or more IPFs that have holdings in companies which it partly owns. Until the legislative framework is in a position to prevent banks from cross-subsidising such companies through loan deals at preferential or punitive interest rates, they should be restricted from owning IPF management firms. Finally, since the move to consolidate ownership stakes is likely to continue, more protection must be afforded to minority shareholders. This would require still better enforcement of information disclosure rules, and a tightening of those concerning large-scale share acquisitions – perhaps by lowering in steps, from 50 to 25 per cent or less, the threshold above which a purchase offer must be made to all shareholders.

The government's revitalisation agency should help firm-level restructuring...

Another important element in the government programme for speeding up the pace of restructuring in the economy is the Revitalisation Agency, whose manager (a leading international investment bank) was named in mid-October. Owned by *Konsolidacni banka*, this institution, whose operations are to be wound up by the end of 2002, is designed to take charge of a limited number of heavily indebted firms (about ten) in view of their eventual sale. Restructuring of these firms is to involve a debt-equity swap, a recapitalisation or a break-up and liquidation – depending on the solution that the Agency manager sees as most profitable. While the Agency has been given the power to replace the management and boards of firms, to force companies into liquidation and to sell non-strategic assets, it is unclear to what extent the legal environment will permit it to do so rapidly in practice. While it is understandable that the government, through its control of KoB, might wish to overrule some decisions on ''social'' grounds, such a power, if retained, should be used sparingly. Moreover, given that the programme is directed only towards the largest firms and not withstanding the substantial safeguards built into the manager's contract, the government may need to exercise restraint to overcome the temptation to support unviable but politically important firms. Ultimately, the success of the Agency will depend on the extent to which the activities of the firms conferred to it are turned around – either through sale, restructuring or liquidation.

... as will the strengthening of creditor rights...

Whereas the Revitalisation Agency may help the restructuring of the largest of firms, market mechanisms have to be relied upon for the vast majority of enterprises. Here the most important remaining impediment to improvement lies with the statutes and enforcement of bankruptcy legislation. Currently creditor rights are poorly protected, which has the dual effect of contributing to the growing reluctance of banks to provide new loans and the difficulties they have had in collecting existing ones, with the latter problem an underlying factor in the slow pace of enterprise restructuring. In this regard, the government has proposed reforms to the bankruptcy and related laws that will significantly curtail the ability of debtors to strip their assets during the proceedings. It is also preparing new legislation which, if it is to be effective, should allow for workout bankruptcies to give debtors and creditors the incentive to reorganise and restructure firms both within and outside of the court procedure. The new rules should also include provisions allowing specialised firms to act as administrators, not just individuals as is currently the case. Finally, it is imperative that such regulations – once in place – be adequately implemented and swiftly executed. Given that most judges in the Czech

Republic lack experience with bankruptcy proceedings, there might be an argument in favour of the establishment of a specialised court to address such cases.

... and the introduction of a regulatory framework for "natural monopolies"

Finally, the successful transition to a market-based economy will not be complete until a regulatory framework is put into place enabling the eventual privatisation of a number of public utilities. Progress in this regard has been slow, although the government has committed itself to establishing such a system. First steps to the creation of a legal framework for independent regulatory bodies have indeed been taken and draft legislation will be presented to the government by the end of 1999. To be effective, the authorities will need to create and enforce level-playing-field conditions, including the swift creation of appropriate (and preferably independent) regulatory structures, the implementation of transparent price-setting mechanisms and the rapid move to market prices.

Meanwhile, labour market policy needs to focus increasingly on the impact of generous social assistance benefits...

While structural reform of product and capital markets has justifiably been the focus of government attention over the past several years, preventing the rapid rise in unemployment from translating into a permanent increase in structural unemployment is becoming an important policy priority. So far, the government has implemented only a few recommendations of the OECD *Job Strategy* for the Czech Republic, although some general principles for reform have been announced in its *National Plan for Employment*. In developing these into concrete measures, the authorities should give serious consideration to adjusting social benefits for the non-employed, particularly for those with children, so that they are more consistent with wage and productivity levels in the economy. Such a step could be supplemented, if deemed necessary, by in-work benefits to help the working poor. Moreover, in order to ensure that scarce resources are available to those most in need, a more stringent surveillance of partial disability beneficiaries is required. Evidence suggests that some individuals are using it as a more generous alternative to social benefits and that, despite the recent tightening of criteria for the full-disability benefit, the share of population receiving one or the other disability pension remains high.

... while avoiding the expansion of public-employment programmes

As joblessness rises, the government needs also to ensure that, when channelling resources towards active labour market policies, it avoids the creation of new or the expansion of existing public employment schemes, whose cost effectiveness and long run effects have been put into question by both Czech and international evidence. Rather, efforts should be concentrated on ensuring that permanently laid-off workers are quickly routed to the public employment service (PES) and assessed as to their need for job search assistance. This is of particular importance in the context of high replacement rates in the benefit system, where enforcing and monitoring job-search are critical to preventing the development of a dependency culture – especially in high unemployment regions. In this regard, there may be a need to increase staff in the PES as the rapid rise of unemployment may have reduced the efficiency of its services. Finally, the authorities should bear in mind that a wide range of social and labour market policies is consistent with the Community *Acquis* and that social-security charges in the Czech Republic are already burdensome. Thus when considering new measures, care must be taken to assess their benefits against the additional taxes required to finance them. In this regard, the government should first examine and evaluate options that stem from cuts and savings to existing programmes.

The tax system should also be adjusted in order to reduce the high overall tax burden...

Indeed, as discussed in this Survey's special chapter, tax policy is another area where additional structural initiatives should be considered. In this regard, the overall tax burden is much higher in the Czech Republic than it was in other OECD countries when they were at similar levels of development. International evidence would seem to suggest that this could slow the pace at which the Czech Republic can expect to converge to the income levels observed in more developed OECD economies, implying that lowering taxation could have significant long-term benefits. To do so, however, would require parallel reductions in government expenditures in order to avoid a further deterioration of public finances. There may also be an opportunity to rebalance the existing tax burden across different revenue sources. Indeed, the Czech tax system – which was subject to a major reform in 1993 – relies relatively heavily upon social security contributions, while personal taxes and property taxes are under-used.

... as well as to eliminate the bias in favour of self employment and increase the coverage of the standard VAT

In addition, certain features of the system impose unnecessary economic distortions, leaving room for improvement. In particular, income from self-employment is taxed at much lower rates than either capital or labour income, resulting in a substantial bias in favour of self-employment. This preferential treatment could be eliminated relatively easily by raising the share of self-employed earnings that are subject to social security contributions from 35 to 65 per cent (representing labour's share in value added). A second, serious source of distortion derives from the unusually wide range of goods and services subjected to a low VAT rate. Almost 50 per cent of consumption is low or zero-rated which, while having only a limited distributional impact, has not helped to promote the growth of the service sector as had been initially hoped. The additional revenues that could be derived from raising the VAT on these items to the standard rate could be used either to lower the social security burden or the standard rate itself.

Moreover, capital taxation should be made more neutral and action is required to stop the buildup of tax arrears

The taxation of capital incomes is also a source of distortion. Currently, it depends importantly on the manner in which they are distributed. In 1999, the all-in-tax rate varied from 40.9 per cent on dividend income to 15 per cent for interest income. Furthermore, capital income is not subject to the same tax schedule as earnings from labour. While the lowering of the withholding tax on dividend income to 15 per cent in 2000 and the reduction in the corporate income tax rates are steps in the right direction, a number of OECD countries have reformed their capital taxation systems so as to remove the bias in favour of interest income. A similar move would appear desirable in the Czech Republic and could be implemented while preserving the current reliance on withholding taxes. Finally, with tax arrears growing by 1.5 per cent of GDP a year, the government is clearly experiencing difficulty in collecting these debts. While steps to improve creditor rights, as advocated above, should help in this regard, the government needs to take action both to prevent tax arrears from becoming the "lender of last resort" for companies in difficulty and to encourage the restructuring of industry.

To sum up

In sum, the recent recession experienced by the Czech economy appears, by and large, to be a natural response to the internal and external imbalances that provoked the 1997 currency crisis. Demand levels have fallen into line with supply, which has been reflected in a substantial decline in inflation and the current account deficit. While this adjustment process involved a significant social cost, as seen in the rapid rise in unemployment, the economy now seems set to recover. Nonetheless, much remains to be done to ensure sustained growth prospects. As concerns macroeconomic policy, there is a clear need to reverse the trend rise in the structural budget deficit in order to keep interest rates low. This will require a reassessment of the relatively generous transfer system as well as further efforts to improve the transparency of government accounts. A decline in government expenditures would allow the overall tax burden to be lowered, which, combined with a widening of the coverage of the VAT and reduced social security contributions, could help to improve overall economic efficiency. While recent progress towards the privatisation of the banking sector and capital market reforms are important steps in the direction of improved corporate governance, additional action is necessary. In particular, the lack of an effective bankruptcy framework has slowed enterprise restructuring and contributed to the accumulation of the bad debts that have weighed on the Czech economy for most of the decade. Thus, the rapid implementation of amendments to bankruptcy laws will be essential to improving both the health of the banking sector and prospects for firm-level restructuring. Moreover for the newly-created ''Revitalisation Agency'' to be effective the government will have to refrain from influencing its restructuring decisions for ''social'' reasons. As concerns labour markets, significant action is required to reduce the disincentives generated by significant payroll taxes and, compared with average wages, high social security benefits, both of which contribute to rising structural unemployment. Progress on all these scores would ensure better growth prospects over the longer term and, at the same time, prepare the ground for accession to the European Union early in the next decade.

I. Recent economic trends and prospects

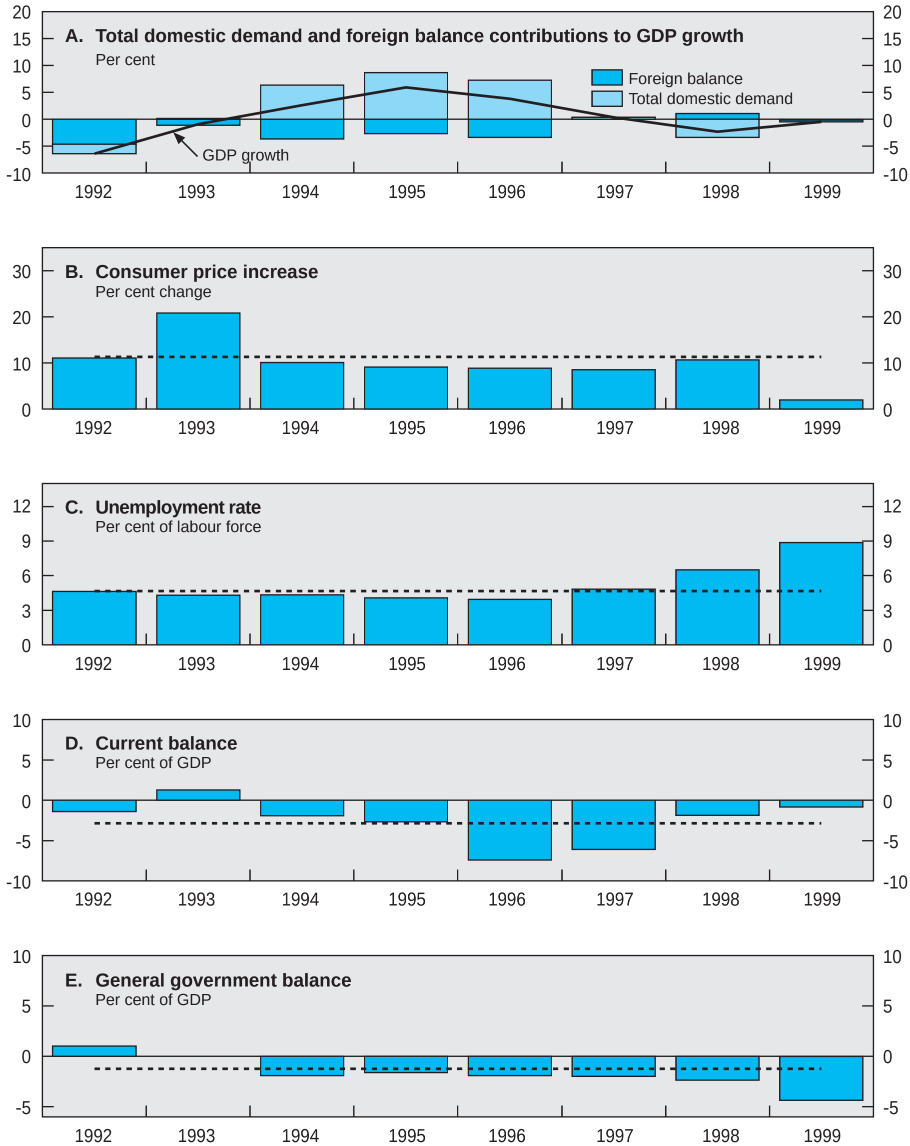
After the 1997 exchange rate crisis, whose causes and effects were discussed in detail in the previous Survey, the Czech economy entered into a prolonged period of adjustment during which most components of domestic demand recorded negative growth (Figure 1). As a result, GDP slowed substantially, and this was reflected in a steep rise in unemployment and a dramatic fall in inflation. In the first three quarters of 1999, signs of recovery emerged as private and government consumption picked up and stronger European demand began to be reflected in more exports. Despite these encouraging signs, the recovery is currently shallow and not broadly based, with several sectors and investment spending still in decline. Uncertainty about the implementation of the government's revitalisation strategy and the pace of industrial restructuring make the depth and sustainability of the recovery difficult to predict.

Significant slowdown in activity

The slowdown in growth in 1997 developed into a full-blow recession in 1998 with output declining at an accelerating rate throughout the year (Table 1). Overall GDP fell 2.3 per cent with drops in consumption and investment contributing to a 2.6 per cent decrease in domestic demand that was partially offset by an improvement in net exports. The fall in GDP continued into the first quarter of 1999 before recording a small increase in both the second and third quarters. The recovery is, however, narrowly based. Strong real wage growth (due to an unexpected fall in inflation) and deficit spending fuelled an expansion in household and government consumption, while improved exports reflected better demand conditions in western Europe. The continued declines in investment, despite a substantial drop in real interest rates, resulted in an overall 1 per cent fall in final domestic demand in the first three quarters of 1999.

Economic performance varied widely across sectors (Table 2). Industrial output fell in 1998 and continued declining in the first three quarters of 1999 (although at a slower pace), while construction was particularly hard hit, posting double-digit declines in each period. Agricultural output expanded

Figure 1. **Macroeconomic performance**[1]



Note: Data for 1999 are OECD estimates.
1. The broken line is the average for 1992-1998.
Source: OECD.

Table 1. **Quarterly gross domestic product**

	1997					1998					1999			
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q1-Q3
	Year-over-year per cent change													
GDP	2.3	0.1	–1.8	1.0	0.3	–0.7	–1.9	–2.6	–3.9	–2.3	–4.1	0.4	0.8	–0.9
Household consumption expenditure	4.7	5.2	–1.5	0.6	2.1	–2.5	–7.1	–0.8	–1.3	–3.0	0.8	1.4	1.5	1.3
Government consumption expenditure (including NPISH)	5.7	6.0	0.9	1.8	3.4	–5.3	1.4	1.3	5.0	0.8	1.3	0.6	0.4	0.7
Gross fixed capital formation	0.7	–6.1	–8.9	–2.3	–4.3	–3.1	–5.9	–6.6	–0.6	–3.8	–8.1	–6.9	–4.7	–6.5
Change in inventories[1]	4.6	–0.7	–1.2	–2.3	0.0	–2.9	–0.2	–1.1	0.8	–0.8	0.4	1.0	–1.4	0.0
Exports	0.6	7.7	10.2	13.1	8.1	25.6	14.7	7.1	–1.2	10.7	–3.0	5.2	8.5	3.6
Goods	1.0	16.4	17.3	19.7	13.7	30.4	14.7	9.2	3.6	13.7	–3.9	10.3	9.4	5.3
Services	–0.5	–13.8	–7.3	–3.8	–6.8	9.0	14.9	0.9	–16.5	1.1	0.4	–11.7	5.6	–2.2
Imports	10.1	8.6	4.3	6.2	7.2	13.5	7.7	5.5	5.6	7.9	1.3	4.2	4.1	3.2
Goods	10.4	11.1	8.9	12.1	10.7	14.5	7.5	6.1	4.8	8.0	–0.1	5.4	3.5	2.9
Services	8.3	–2.4	–12.0	–18.2	–7.6	8.2	9.1	3.2	10.6	7.6	8.6	–1.8	7.1	4.6
Net exports[1]	–5.8	–1.1	2.8	3.5	0.0	5.3	3.7	0.6	–4.9	1.1	–3.0	0.6	2.6	0.1

1. Contribution to GDP growth.
Source: Czech Statistical Office.

Table 2. **Quarterly gross domestic product by sector**

	1997					1998					1999			
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q1-Q3
	Year-over-year per cent change													
GDP at factor cost	2.8	0.4	–1.3	1.5	0.8	–1.1	–2.0	–2.9	–4.1	–2.6	–3.9	0.3	0.0	–1.2
Agriculture, fishing and forestry	18.3	–3.0	–4.9	5.6	2.5	0.0	0.0	17.8	6.4	8.1	3.3	11.5	7.9	7.4
Industry	7.1	3.5	10.8	10.9	8.0	6.6	0.4	–7.1	–6.2	–1.6	–6.2	–2.8	–4.7	–4.6
Construction	–1.9	–0.5	–9.2	4.6	–1.9	–10.7	–16.7	–23.7	–35.2	–22.9	–26.1	–12.0	–3.4	–13.0
Services	–0.6	–1.4	–7.2	–5.5	–3.7	–6.1	–2.1	0.3	1.0	–1.7	–0.6	3.1	2.4	1.7
Trade, repairs, hotels and restaurants	–2.7	1.0	–10.8	–5.5	–4.7	–12.1	–14.9	–8.2	0.4	–8.8	1.2	4.3	–2.3	1.0
Transport and community services	–5.8	2.0	3.7	0.4	0.1	16.1	16.2	12.1	11.0	13.8	–6.0	–2.0	–2.5	–3.5
Financial services	28.6	17.0	–2.4	2.1	11.3	–10.6	1.3	15.8	13.1	3.7	15.2	23.5	16.6	18.4
Business services	–0.7	–8.9	–10.6	–10.6	–7.7	–10.5	4.7	3.6	1.2	–0.5	–3.1	0.3	8.5	2.0
Other services	–10.1	–8.6	–7.8	–8.1	–8.6	–4.7	–3.9	–7.7	–11.4	–7.0	–7.1	–4.3	–2.4	–4.6

Source: Czech Statistical Office.

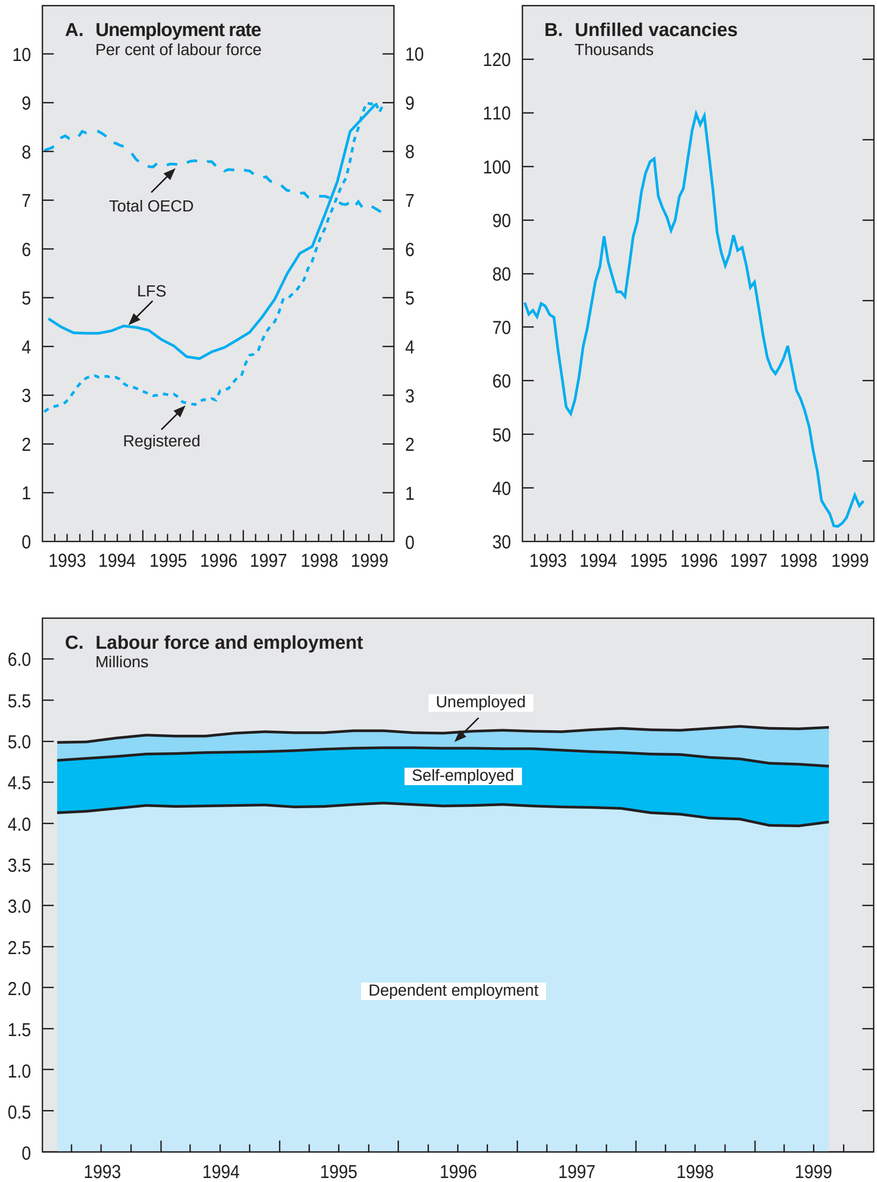
strongly in both years, although these improvements provoked falling produce prices in 1999 and, as a result, sectoral value added in nominal terms declined by 8.7 per cent in the first three quarters of that year. As a whole, the initial drop in output in the service sector was less sharp and recovery began earlier, reflecting differential performance among its components. Financial services, in particular, after having declined sharply in the first quarter in 1998, began recovering almost immediately, posting a moderate real gain for 1998 as a whole and a very large 18 per cent increase in the first three quarters of 1999, perhaps reflecting renewed privatisation activity (see Chapter III).

Export performance has been highly volatile, as a result of exchange rate fluctuations and external developments. Thus, following the April 1997 depreciation, real sales abroad of goods and services slowly expanded during the year, with their year-over-year growth peaking in the first quarter of 1998 at 25.6 per cent. Exports then slowed over 1998 as a consequence of the loss of Russian export markets and reduced competitiveness following an appreciation of the currency. Most recently, the koruna has depreciated again and European demand has picked up strongly, both factors that help explain the strong rebound of foreign sales in the second and third quarters of 1999. Throughout this period, slack domestic demand and the high import content of Czech exports meant that imports have tended to rise and fall in line with exports.

Rising unemployment

The fall in output provoked a rapid and unprecedented rise in unemployment. The unemployment rate on an OECD standardised basis has almost doubled since mid-1997, having reached 9 per cent in the third quarter of 1999 (Figure 2, Panel A). Increased joblessness touched all age groups, but the jump was especially concentrated among the young (whose unemployment rate reached almost 30 per cent) and the less well educated (a rate of 21 per cent). At the same time, long-term unemployment grew to over one-third of all unemployed. Meanwhile, prospects for job gains deteriorated as the number of unfilled vacancies dropped to record low levels (Figure 2, Panel B). The rise in aggregate unemployment also exacerbated regional disparities. The job market remained tight in Prague and its unemployment rate was less than a third of that observed in some regions, such as North Bohemia, where it reached 13.8 per cent. Surprisingly, labour force participation, which was falling prior to the recession, rose in 1998 although it levelled off in the first half of 1999 (Figure 2, Panel C). While this will have contributed somewhat to the increase in unemployment, the most important factor was the 4.3 per cent decline in employment since the first quarter of 1997. Service sector employment proved to be the most resilient over

Figure 2. **Employment, unemployment and labour force**



Source: OECD, *Main Economic Indicators, Quarterly Labour Force Statistics.*

this time period, falling only about 1 per cent, while both industry and agriculture posted large drops, down about 6 and 12 per cent respectively.

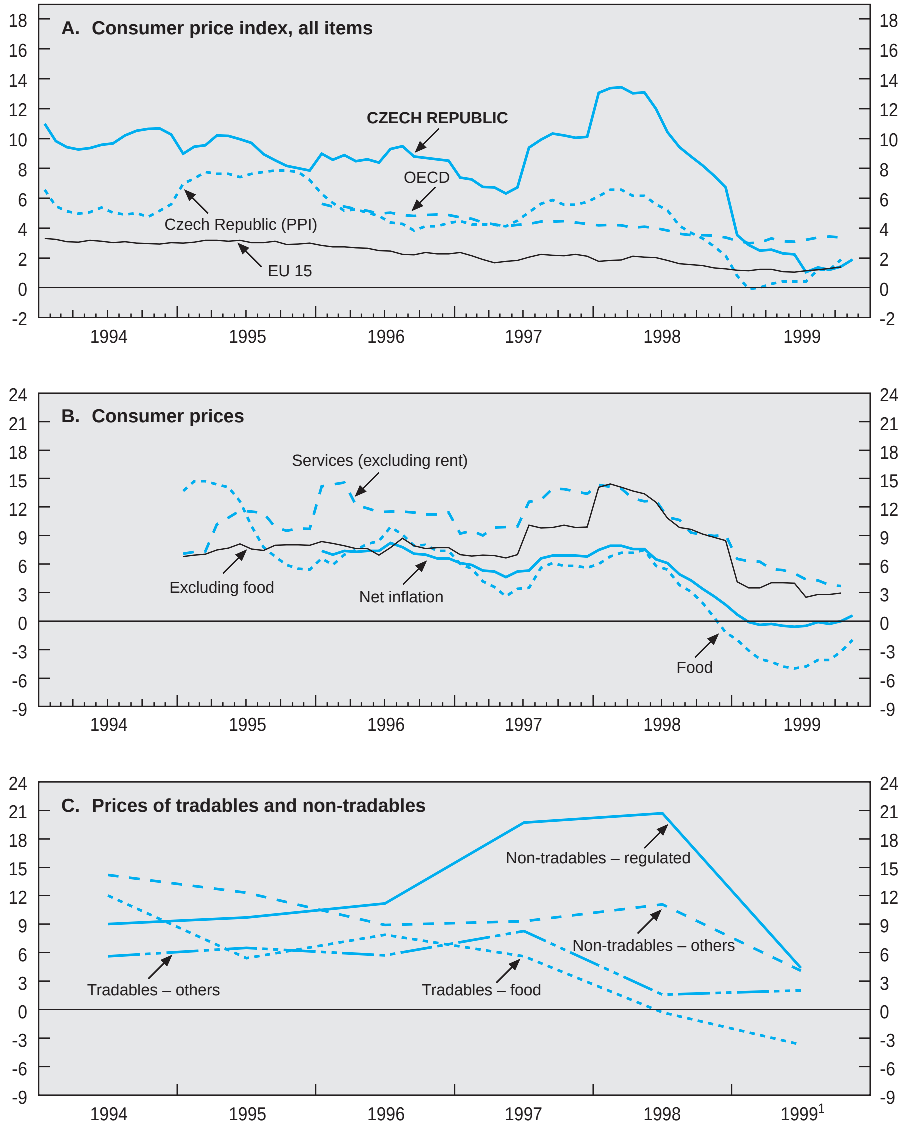
Marked drop in inflation

These developments contributed to a rapid decrease in inflation, whose year-over-year rate fell from 13.3 per cent in the first quarter of 1998 to 1.9 per cent in November 1999. Net inflation, which excludes the impact of regulated prices and controls for changes in indirect taxes, dropped below zero in February 1999 and was 0.6 per cent in November. Overall inflation now lies below the OECD average, whereas just one year before, it was more than triple this level (Figure 3, Panel A). Price behaviour since 1996 has been heavily influenced by increases in non-market regulated prices and exchange rate changes. In particular, the sharp rise in inflation observed in 1997 and early 1998 reflected the depreciation of the koruna in the first half of 1997 and several large hikes in regulated prices. The subsequent disinflation observed in 1998, which left the inflation rate well below the central bank's target (Figure 3, Panel B), was precipitated by the recession, high real interest rates, a re-appreciation of the currency, a substantial slowdown in the increases of regulated prices and falling import prices of food and raw materials. In particular, the latter were estimated to have lowered net inflation by between 2 and 3 percentage points. Similar influences were at work during the first nine months of 1999, and it is once again likely that the Bank's inflation target will be undershot (see Chapter II).

Disinflation has come almost entirely through the tradable goods sector. Over the first three quarters of 1999, the rate of inflation of non-traded goods stood at 4.3 per cent.[1] While it has shown some signs of slowing, it remains substantially higher than for traded goods, which fell from 7 per cent (year-on-year) in 1997 to 1.4 per cent in 1998 and –0.8 per cent in the first three quarters of 1999 (Figure 3, Panel C). The reversal of the sharp decline in commodity prices, particularly oil, and the depreciation of the currency early in 1999 have been reflected in rising headline and net inflation later in the year, a process that is likely to continue in the first few months of 2000.

Despite rising unemployment, average nominal monthly earnings moderated only slightly in 1998, and again in the three quarters of 1999, when they rose 8.4 per cent (Table 3). This average masks large differences among groups of employees. Indeed, in the non-business sector, nominal wages grew almost 14 per cent, while only rising about half this amount in the business sector. The large increase in government wages reflected the decision by the authorities to grant generous settlements to help some parts of the public sector to "catch up", following two years of government sector wage restraint. The steep drop in inflation, however, meant that real wages were boosted substantially for all workers, as

Figure 3. **Consumer price developments**
Year-over-year per cent change



1. September 1999.
Source : Czech National bank; OECD, *Main Economic Indicators.*

Table 3. **Wage developments**

	1994	1995	1996	1997	1998	1999[1]
	Year-over-year per cent change					
Overall nominal wage	18.5	18.5	18.4	10.5	9.3	8.4
Business sector	18.2	19.2	17.7	11.7	10.9	7.2
Non-business sector	19.8	17.0	20.7	5.8	3.9	13.8
Overall real wage	7.7	8.7	8.8	1.9	–1.3	6.1
Business sector	7.4	9.2	8.2	2.9	0.2	4.9
Non-business sector	8.9	7.3	10.9	–2.5	–6.1	11.4

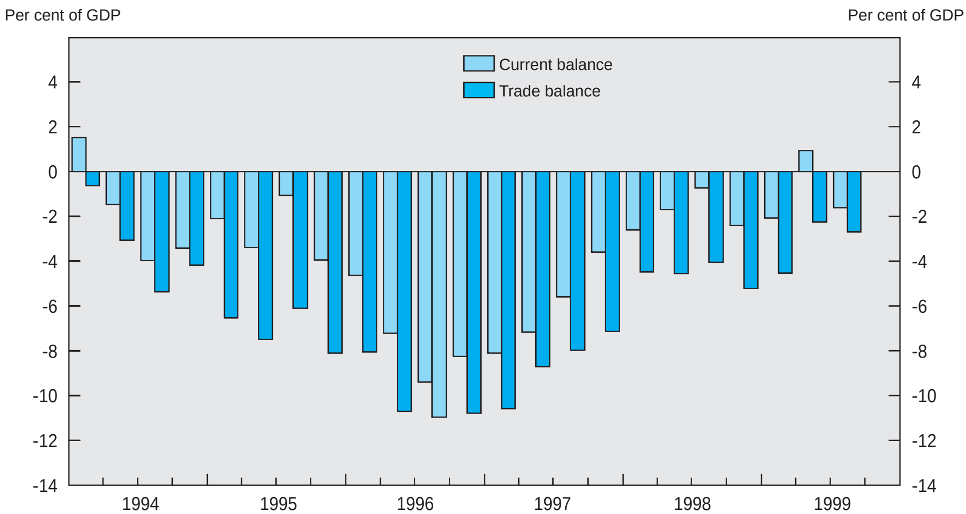
1. Data are for the first three quarters of 1999.
Source: Czech National Bank.

wage bargains had been based on the central bank's much higher inflation targets. Workers in the public sector saw this undershooting of the targets translated into real wage gains of about 11 per cent (on a CPI basis), almost three times greater than those recorded in the business sector. In manufacturing, nominal wages expanded a more moderate 5.6 per cent, but there was a significant increase in unit labour costs in the first six months of 1999 as industrial productivity fell by 2.9 per cent compared with the same period in 1998.

Narrowing of the external deficit

The current account balance improved substantially in 1998 and again in 1999, recording a large surplus in the second quarter (Figure 4 and Table 4). The driving force behind these developments was a dramatic improvement in the trade balance, whose deficit fell from $4.5 billion in 1997 to about $1 billion in the first three quarters of 1999. As discussed earlier, variations in the trade balance and gains and falls in market shares have been heavily influenced by exchange rate movements and fluctuations in external demand (Figure 5, Panel A). In this context, continuing integration with the world economy, improving conditions in western Europe and economic difficulties in the former Soviet bloc have contributed to raising the OECD's and particularly the European Union's share of Czech trade (Figure 5, Panel B). In US dollar terms, the EU is now the destination of about three-quarters of all Czech exports (sales to OECD countries stand at about 80 per cent of the total).[2] This represents a 5 percentage point gain since 1995 (about one-half of which occurred in 1999) and has been achieved largely at the expense of other central and eastern European countries. Recently, the

Figure 4. **Trade and current account balance**



Source: OECD.

current account has also been bolstered by small improvements in income balances and increased net transfers from abroad.

As regards the financial account, inward foreign direct investment almost doubled in 1998 compared with 1997, rising to $2.6 billion, and is likely to surpass this figure in 1999. Given the improvement in the current account deficit, these flows are more than sufficient to finance it and have been exerting some upward pressure on the exchange rate. Aggregate portfolio investment was almost unchanged in 1998 as compared with 1997, although there was a marked shift by foreigners away from debt instruments and towards equity. This occurred despite the weakness of the Prague Stock Exchange index in the second half of 1998 (Figure 6) and, according to the Central Bank, is explained by foreign purchases of shares in off-market firms as investment privatisation funds sold holdings in response to changed regulatory requirements (see Chapter III). In the first quarter of 1999, foreign capital inflows into debt picked up again while those into equity slowed, although the latter rebounded in the second quarter as the potential privatisation of Czech blue-chip companies led to a sharp increase in the stock market. Other investment showed a large outflow in 1998 as commercial banks reduced their level of long-term borrowing abroad, reflecting more prudent policies and increased costs, following reductions in their credit ratings. This trend

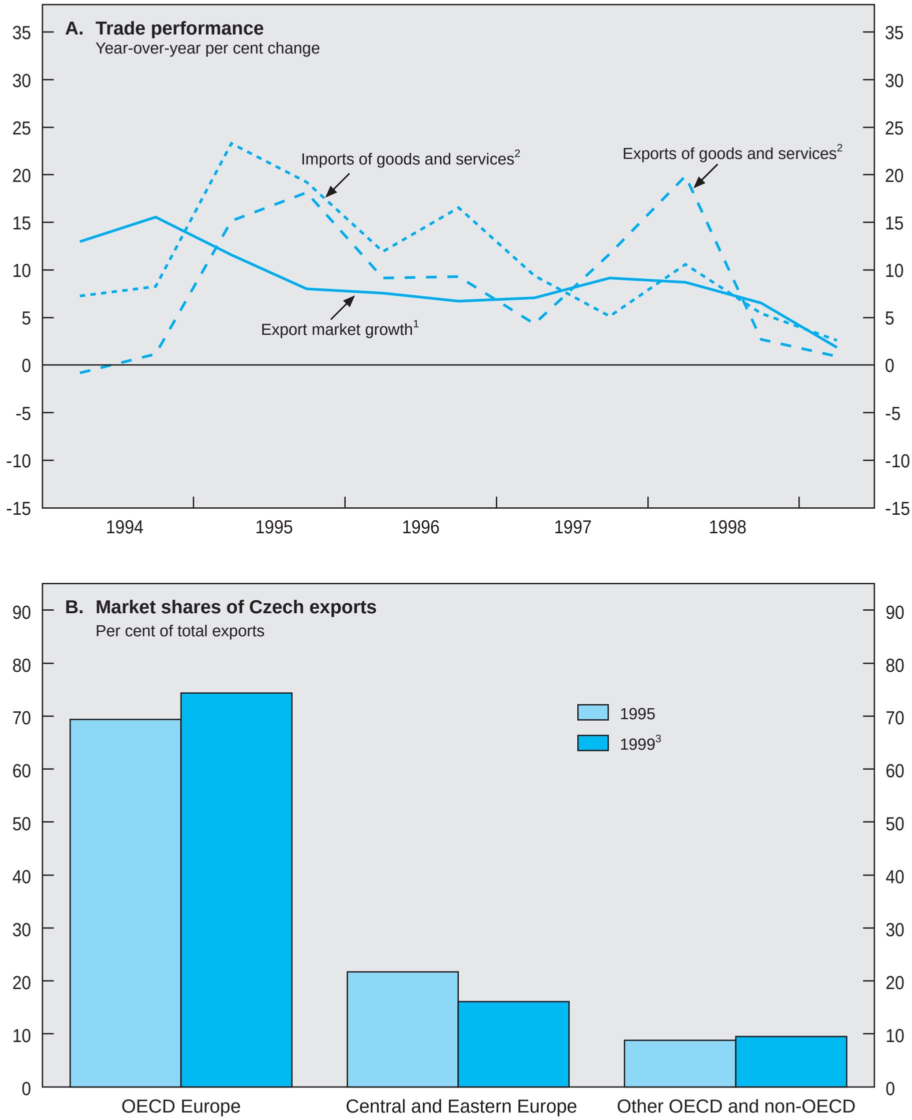
Table 4. **Balance of payments**

	1993	1994	1995	1996	1997	1998[1]	1999[2] Q1	1999[2] Q2	1999[2] H1
	$ billion								
A. Current account	**455.8**	**–786.8**	**–1 369.1**	**–4 292.2**	**–3 211.0**	**–1 335.7**	**–315.1**	**279.0**	**–15.1**
Trade balance[3]	–525.3	–1 381.2	–3 677.9	–5 877.3	–4 540.4	–2 553.5	–557.4	–189.3	–733.5
Exports	14 229.0	15 929.0	21 462.5	21 690.6	22 776.7	26 351.4	6 189.3	6 747.7	12 953.0
Imports	14 754.3	17 310.2	25 140.4	27 567.9	27 317.1	28 904.9	6 746.7	6 937.0	13 686.5
Services balance	1 010.8	488.3	1 842.0	1 923.0	1 763.3	1 792.9	259.2	438.9	704.3
Transport (net)	507.1	389.7	661.2	634.6	683.7	682.9	133.5	210.2	346.3
Travel (net)	1 031.4	645.1	1 242.4	1 121.8	1 267.3	1 850.1	392.6	497.8	893.9
Other services (net)	–527.7	–546.5	–61.6	166.6	–187.7	–740.1	–266.9	–269.1	–535.9
Income balance	–117.5	–20.2	–105.6	–722.5	–791.3	–982.6	–122.3	–133.0	–255.6
Current transfers (net)	87.8	126.3	572.4	384.6	357.4	407.5	105.4	162.4	269.7
B. Capital account	**–554.8**	**0.0**	**6.8**	**0.6**	**9.9**	**2.1**	**–1.0**	**–0.9**	**–1.8**
Credits	205.0	0.0	11.6	1.0	15.5	14.1	2.8	3.5	6.4
Debits	759.8	0.0	4.8	0.4	5.6	12.0	3.8	4.4	8.2
Total, Groups A plus B	–99.0	–786.8	–1 362.3	–4 291.6	–3 201.1	–1 333.6	–316.1	278.1	–16.9
C. Financial account	**3 024.8**	**3 371.1**	**8 225.9**	**4 184.3**	**1 081.9**	**2 923.1**	**434.2**	**–172.2**	**240.4**
Direct investment	563.3	748.9	2 525.6	1 275.5	1 275.2	2 641.1	583.5	653.6	1 239.2
Abroad	–90.2	–119.6	–36.6	–152.9	–25.2	–78.7	–24.1	–48.8	–73.8
In the Czech Republic	653.5	868.5	2 562.2	1 428.4	1 300.4	2 719.8	607.6	702.4	1 313.0
Portfolio investment	1 600.5	854.6	1 362.0	725.5	1 085.7	1 069.4	45.4	195.5	246.2
Equity securities (net)	887.9	453.2	911.8	554.5	435.1	1 199.4	–178.3	181.7	16.3
Debt securities (net)	712.6	401.4	450.2	171.0	650.6	–130.0	223.7	13.8	229.9
Other investment	861.0	1 767.6	4 338.3	2 183.3	–1 279.0	–787.4	–194.7	–1 021.3	–1 245.0
Long-term (net)	805.1	1 108.8	3 367.1	3 110.1	407.6	–909.2	174.0	–92.6	71.8
Short-term (net)	55.9	658.8	971.2	–926.8	–1 686.6	121.8	–368.7	–928.7	–1 316.8
Total, Groups A through C	2 925.8	2 584.3	6 863.6	–107.3	–2 119.2	1 589.5	118.1	105.9	223.5
D. Net errors and omissions									
Valuation changes	103.5	–212.7	594.5	–720.7	352.5	351.0	–14.4	18.9	5.7
Total, Groups A through D	3 029.3	2 371.6	7 458.1	–828.0	–1 766.7	1 940.5	103.7	124.8	229.2
E. Change in reserves (-increase)	**–3 029.3**	**–2 371.6**	**–7 458.1**	**828.0**	**1 766.7**	**–1 940.5**	**–103.7**	**–124.8**	**–229.2**

1. Revised data.
2. Preliminary data.
3. Based on data published by the Czech Statistical Office – according to methodology for customs statistics in effect from 1.1.1996.

Source: Czech National Bank.

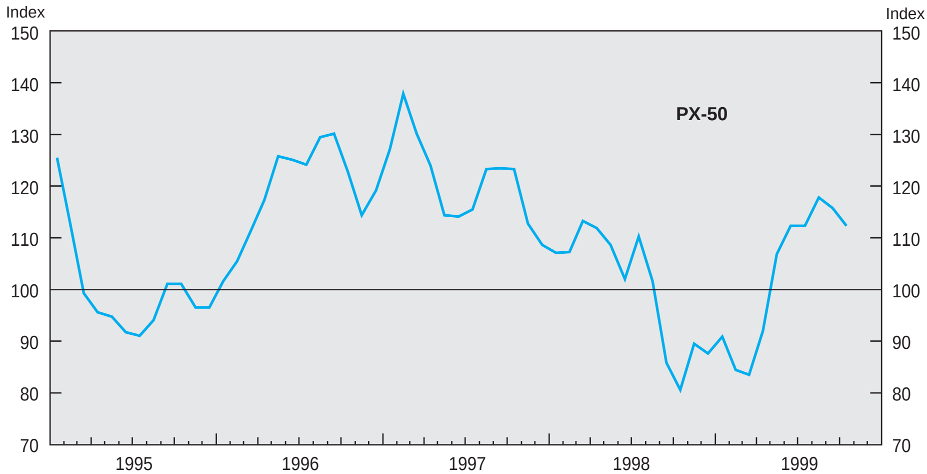
Figure 5. **International trade**



1. Weighted average of import volumes in the exporting markets of the Czech Republic.
2. Constant prices.
3. OECD estimates.

Source: OECD.

Figure 6. **Share prices**
1995 = 100



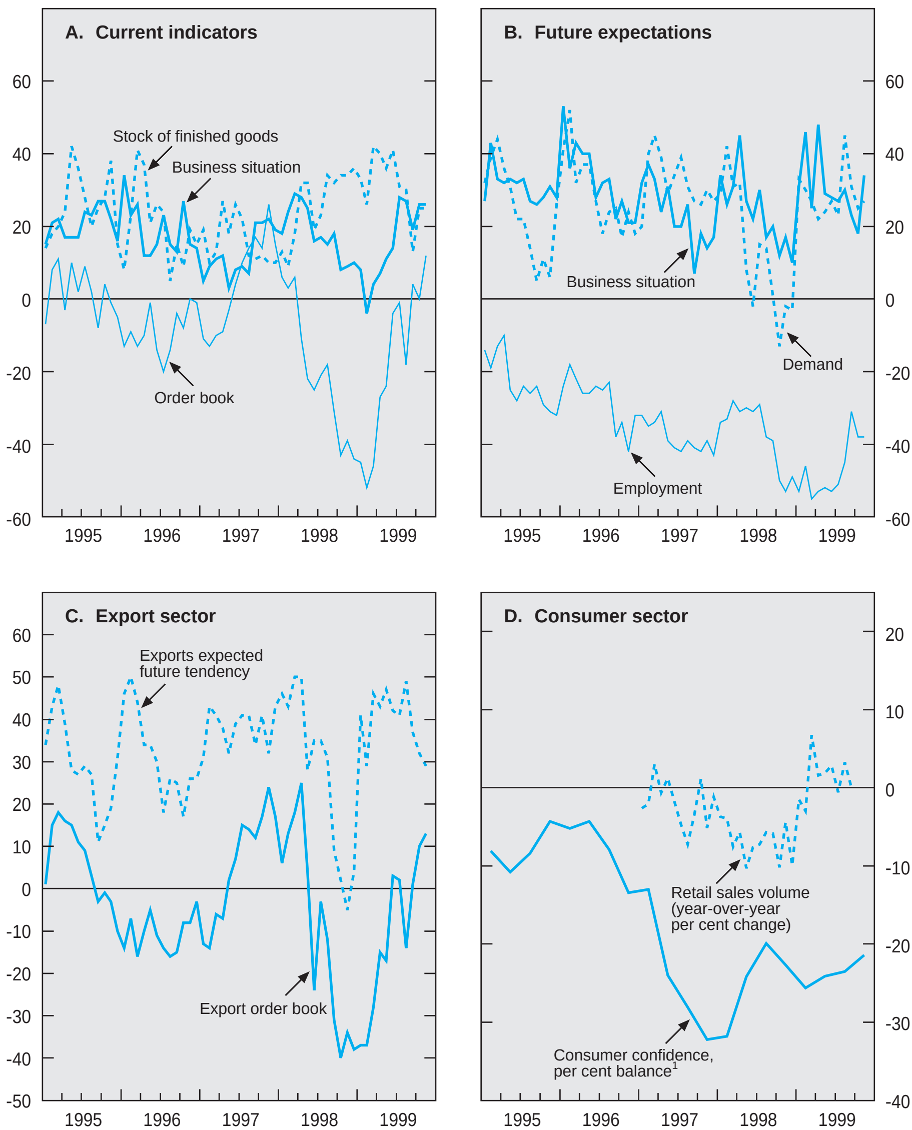
Source: OECD, *Main Economic Indicators.*

continued in 1999, but was concentrated in short-term assets and was mainly the result of a large increase in banks' foreign lending, perhaps reflecting a shift in their portfolio structure towards more risk-free instruments (see Chapter III).

Signs of an emerging recovery

Although it is still too early to say whether the modest recovery observed in both the second and third quarters of 1999 will result in sustained growth, various indicators point to improved business and consumer confidence. After falling throughout 1998, the share of firms indicating that business conditions were positive began to rebound in 1999 (Figure 7). Business expectations for the future, export projections and capacity utilisation data all indicate strengthening towards the end of 1998 and in the first nine months of 1999, while a pickup in housing starts suggests that a turnaround may be in the offing for the construction sector. In addition, consumer confidence, which began falling in late 1996, started to rebound in mid-1998 even as the recession deepened. This pick up in confidence was reflected in rising retail sales, which, in real terms, were 1.7 per cent higher in the first eight months of 1999 than during the same period in 1998, largely as a result of strong real wage gains. Despite this, ongoing firm-level

Figure 7. **Private sector sentiment**
Per cent balance[1]



1. Balance of positive-negative replies.
Source: OECD, *Main Economic Indicators.*

restructuring is likely to hit employment hard as the number of enterprises anticipating lay-offs continues to increase.

While this modest recovery is projected to continue in the rest of 1999, output growth for the year as a whole is expected once again to be negative (Table 5). GDP gains will be sluggish thereafter, growing 1.4 and 2.3 per cent in 2000 and 2001 respectively, as domestic demand expands slowly. Moderate nominal wage increases and rising unemployment are anticipated to keep household incomes and consumer demand growing at about the same rate as overall GDP. Further job losses, as restructuring continues, will generate productivity and competitiveness improvements that are projected to be reflected in stronger

Table 5. **Short-term projections**

	1996 current prices Kc billion	1997	1998	1999	2000	2001
	Volume, annual percentage change					
Private consumption expenditure[1]	810.7	2.1	–2.8	1.5	1.5	1.6
Government consumption	312.5	3.6	0.6	3.2	0.6	1.4
Gross fixed capital formation	500.6	–4.3	–3.8	–4.5	1.5	3.5
Final domestic demand	**1 623.8**	**0.3**	**–2.5**	**0.0**	**1.3**	**2.1**
Stockbuilding[2]	48.9	0.0	–0.8	–0.3	0.1	0.3
Total domestic demand	**1 672.7**	**0.3**	**–3.2**	**–0.3**	**1.4**	**2.4**
Exports of goods and services	831.3	8.1	10.7	3.3	6.7	7.9
Imports of goods and services	931.7	7.2	7.9	3.2	6.2	7.5
Net exports[2]	**–100.4**	**0.0**	**1.1**	**–0.2**	**–0.1**	**–0.2**
GDP at constant prices		**0.3**	**–2.3**	**–0.5**	**1.4**	**2.3**
GDP implicit deflator		6.5	11.0	2.7	3.9	4.4
GDP at current prices	1 572.3	6.8	8.4	2.2	5.4	6.8
Memorandum items:						
Private consumption deflator		7.7	9.7	1.9	4.4	4.2
Consumer price index		8.5	10.7	2.3	4.2	4.5
Industrial production		4.7	3.1	–2.2	3.5	6.0
Unemployment rate (percentage of labour force)		4.8	6.5	8.9	10.1	11.0
General government financial balance[3]		–2.0	–2.4	–4.4	–5.8	–5.5
Current account balance[3]		–6.1	–1.9	–0.8	–1.2	–1.4

1. Includes NPISH.
2. Contribution to GDP growth.
3. As a per cent of GDP.

Source: OECD.

export performance and a moderate rebound in investment expenditures, beginning in 2000. Imports should respond to the increase in domestic demand, with both the result that net exports should have a slightly negative impact on output growth over the projection period and the current account should widen somewhat, although remaining below 1.5 per cent of GDP.

Inflation is projected to pick up again in 2000, as the pace of regulated price liberalisation accelerates, food prices stop falling and recent oil price hikes and the depreciation of the currency feed into domestic prices. Thus, the twelve-month rate of inflation is expected to rise throughout most of 2000 but begin falling in 2001 as the underlying weakness of labour market conditions starts to dominate price dynamics. The currently very low levels of inflation should therefore disappear and move back towards the targets set by the Central Bank, although remaining below 5 per cent. The budget deficit is expected to remain high and increase slightly as rising unemployment lowers receipts and boosts social security outlays.

These projections are based on information as of December 1999 and assume unchanged fiscal policies. In particular, while they incorporate an announced public-sector wage-bill freeze, they do not include other measures proposed in the 2000 budget, which has yet to be passed by parliament. Nevertheless, the final budget is not expected to substantially alter results. This outlook is affected by a number of uncertainties. *First*, so far the recovery is narrowly based and much of the increase in demand has come from household and government consumption, although net exports picked up in the second and third quarters. While investment growth is expected to turn positive in response to increased activity and lower real interest rates, the recent weakness of this component of domestic demand could persist, hampering the recovery. *Second*, should the pace of industry level restructuring prove to be higher or lower than expected, medium-term productivity and unemployment could be affected, with repercussions for long-term growth prospects as well. Additional restructuring would be reflected in more unemployment, lower inflation and slower output growth initially, but eventually would lead to faster convergence to OECD income levels due to improved productivity. Conversely, slower restructuring could yield higher levels of demand in the next few years (due to lower unemployment) but at the price of poorer long-term growth prospects. A *third* source of uncertainty is the exchange rate, which in this projection is assumed to be stable. As the economy has shown itself to be sensitive to fluctuations in the value of the currency, a further substantial depreciation could result in higher inflation and better output performance because of increased export sales. Over time, however, the more rapid price increases would erode the temporary competitive advantage afforded by the lower exchange rate, leaving the country with high inflation and probably lower output if, as has been the case in the past, restructuring is delayed by the temporary boost in competitiveness.

II. Macroeconomic management

Overview

The necessary fiscal and monetary tightening that preceded and followed the 1997 currency crisis certainly contributed to the onset of the 1998-99 recession, which itself was essential to the re-equilibration of demand and supply within the economy. Subsequently, both components of macroeconomic policy relaxed substantially during the course of 1998 and maintained a strongly pro-growth stance in 1999. Looking forward, the conduct of monetary policy will continue to be complicated by the important differences between headline and net inflation, while the undershooting of the Central Bank's targets in 1998 and 1999 will make its communication task even more difficult. As for fiscal policy, it will need to regain a more neutral stance as the economy recovers. Given the large general government deficit, this implies that substantial savings will need to be found – likely from the budget for social and industrial transfers. Over the medium term, the government has committed itself to making its accounts more transparent. This will require the transfer of its "hidden" liabilities into the official debt and the increasing use of the generalised government accounts when evaluating the stance of fiscal policy in order to prevent a further expansion in unrecorded expenditures. The following paragraphs deal with these different issues in more detail.

Monetary policy

The inflation-targeting framework

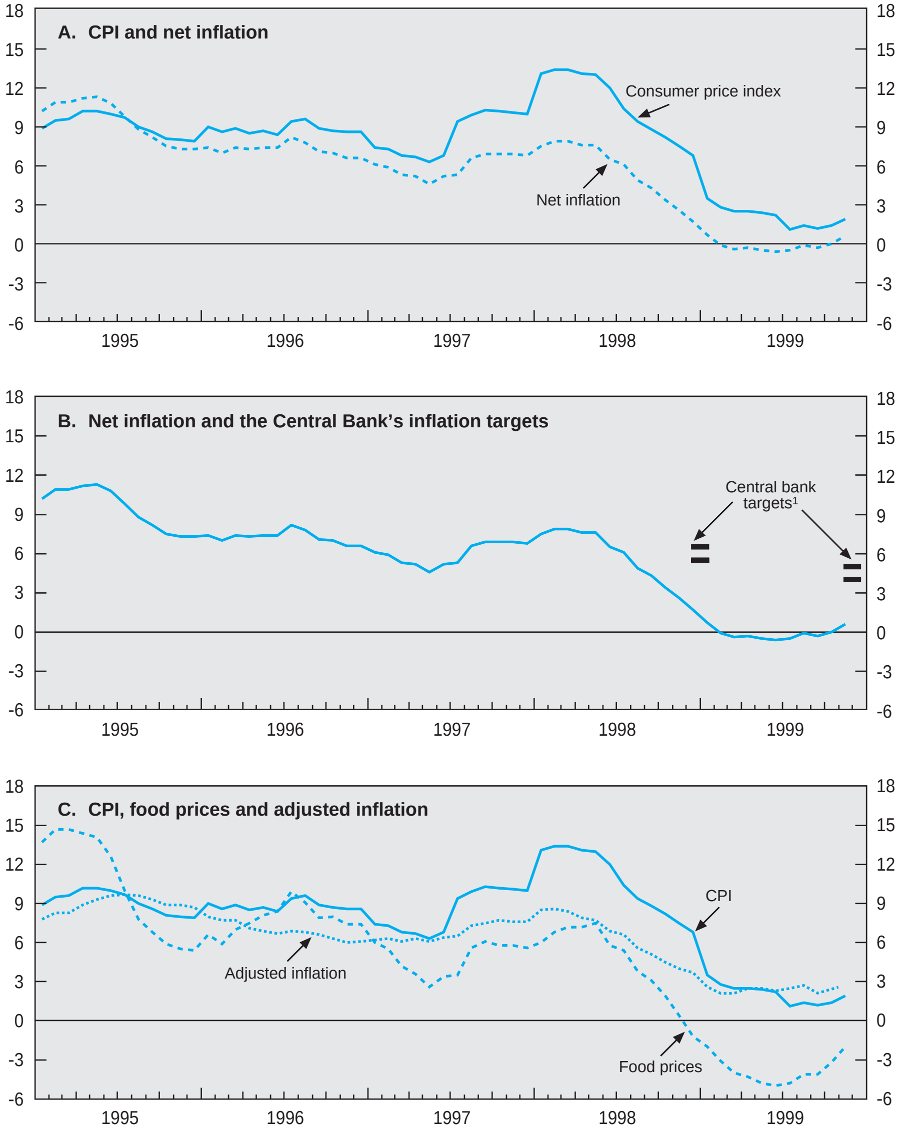
The Czech National Bank (CNB) decided in December 1997 to adopt an inflation-targeting framework to replace the fixed-exchange-rate regime that was abandoned in May of that year, after excessive domestic demand and a rapid rise in the current account deficit led to intense speculative pressures on the currency. The Bank set the goal of reducing end-of-year "net inflation" to 6 ± 0.5 per cent in 1998, 4.5 ± 0.5 per cent in 1999 and 4.5 ± 1 per cent in 2000 (net inflation excludes from the consumer price index regulated goods and services and the influence of changes in indirect taxes). In so doing, it recognised that the existence of a large difference between headline and net inflation rates would limit its ability to influence price expectations. Nevertheless, the monetary authorities felt that because they could not influence regulated prices through monetary instruments, targeting a narrower concept of inflation would improve the overall credibility of the Bank's policy.

As indicated in the previous Chapter, inflation has declined substantially since the introduction of the new regime. With net inflation at 1.7 per cent at the end of 1998, the Bank's inflation target was significantly undershot and it is likely that this will be the case again in 1999 (Figure 8). Falling food and commodity prices were the most important determinants of the undershooting (the decline in food prices in particular, is estimated to have reduced the net inflation measure by between 2 and 3 percentage points). But, even the so-called "adjusted inflation" measure (which corrects for such exogenous factors) has been running below the target.

Since an important component of a successful inflation targeting regime is the extent to which it influences price expectations, the CNB recently made a number of efforts to improve its communication strategy. Most notably it explained its actions in face of the unexpected fall in inflation, while attempting to make more clear the basis upon which its decisions will be made in the future. In this regard, it used its quarterly *Inflation Report* to assess price developments and feature the Bank's policy responses. Also, it began publishing conditional forecasts of inflation in order to assist in expectations formation and announced that policy formulation would rely increasingly upon these projections. Thus, the Bank reported in its October 1999 *Inflation Report* that net inflation would lie between the interval of 0.8 to 1.6 per cent at the end of the year and that headline inflation would be between 2 and 2.6 per cent. For the end of 2000, it foresees net inflation rising to somewhat less than 3.5 per cent and CPI inflation to about one percentage point higher. While its 1999 expectation is lower than its target, the Bank is not planning tighter conditions in response to the projected increase in inflation. Rather, it has explicitly indicated that some events and influences on prices, because of their temporary or one-off nature, should not be expected to provoke a change in the future stance of monetary policy. These include:

– Substantial unexpected changes in the world prices of raw materials, energy sources and other commodities.
– Major deviations of the exchange rate not related to domestic economic fundamentals or monetary policy.
– Large movements in agricultural production that impact on producer prices.
– Extraordinary events, such as natural disasters, that affect costs and prices.

Figure 8. **Inflation performance**
Year-over-year per cent change



1. The net inflation target was 6 ± 0.5 per cent for 1998 and 4.5 ± 0.5 per cent for 1999.
Source: Czech National Bank; Czech Statistical Office.

Finally, as part of its preparation for EU accession, the CNB also issued for public discussion a medium-term monetary strategy. The document, which has yet to be accepted by the government, proposes that, by 2005, the net inflation rate should be 2 ± 1 per cent. Although current net inflation is already below that level, such a strategy implies a slow disinflation process from what is projected by the Bank for the end of 2000. It is, nevertheless, likely to be consistent with the Maastricht convergence criteria and the ERM, namely that the year-over-year change in the CPI does not exceed the average of the three countries with the lowest inflation rates by more than 1.5 percentage points.

Recent interest and exchange rate developments

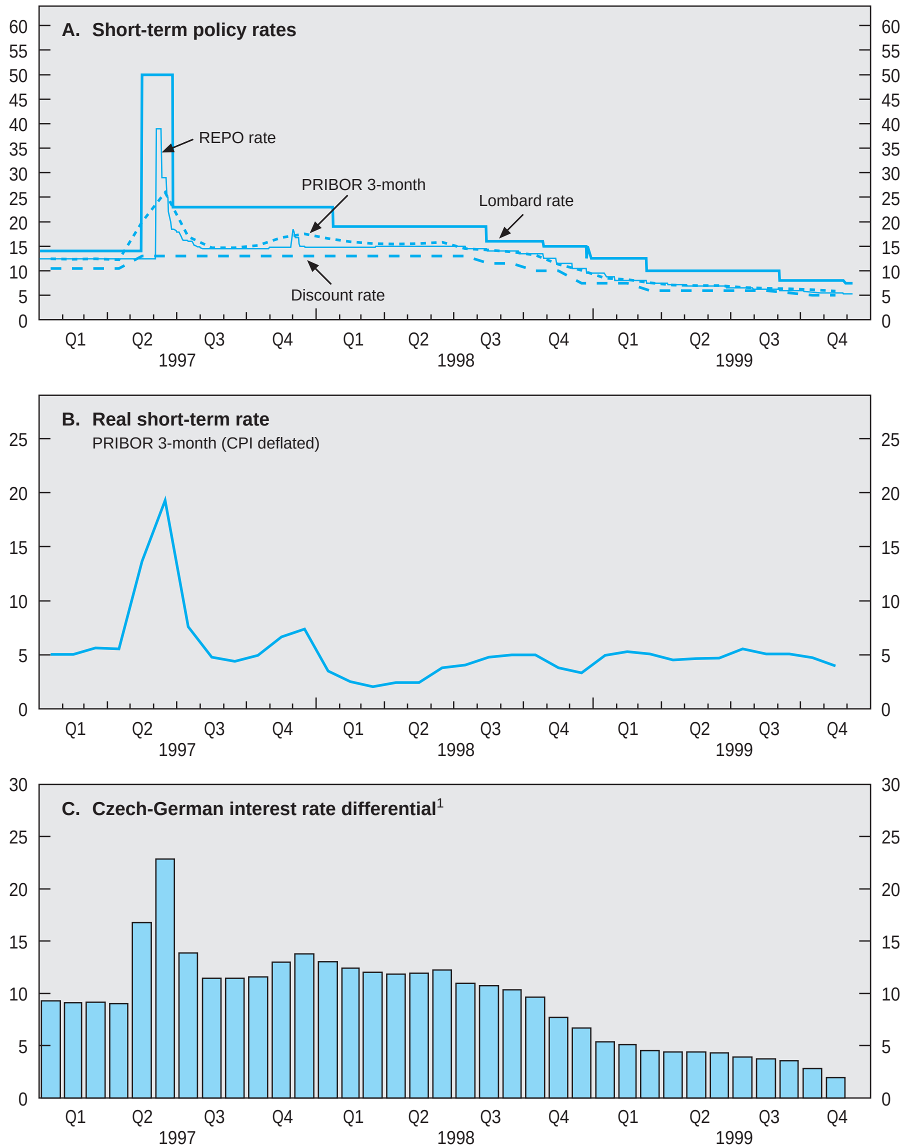
In the aftermath of the 1997 currency crisis, short-term interest rates remained at historically high levels (Figure 9), exceeding 15 per cent until July 1998. They then began a rapid decline, falling to 5.9 per cent in November 1999. Indeed, over that period the bank's main policy variable, the two-week repo rate, was cut eighteen times, falling from 15 to 5.25 per cent. As a result, the spread between Czech and German three-month interest rates fell from about 12 per cent in early 1998 to 2.4 per cent. Long-term interest rates (five-year bonds) also followed the downward trend, maintaining roughly a 1 percentage point positive spread over short-term rates. Despite these dramatic drops, real interest rates, which fell below 3 per cent in early 1998 as inflation peaked, gradually rose (although subject to some oscillation) to reach 5.3 per cent in February 1999 before declining to about 4 per cent in November. With the benefit of hindsight, the significant undershooting of the inflation target suggests that monetary policy was perhaps too slow in relaxing.

Over the same period, the exchange rate was subject to strong fluctuations (Figure 10). Between December 1997 and November 1998 the currency appreciated 10 per cent against the Deutschmark before falling almost as much by March 1999. The initial appreciation of the currency was likely precipitated by the large interest rate differential between Czech and Deutschmark denominated investments, while its subsequent decline reflected the narrowing of that spread, external shocks related to Asia and Russia and the prolonged domestic recession. Most recently, the currency has shown a tendency to appreciate in response to the sharp reduction in the current account deficit and, perhaps, some speculative capital inflows associated with the government's privatisation programme.

The combination of these developments has meant that while monetary conditions in the Czech Republic were tight during the first half of 1998 (and, in fact were tightening somewhat), they began relaxing in the second half of that year and are now close to their lowest level since the beginning of the transition.

Figure 9. **Interest rate developments**

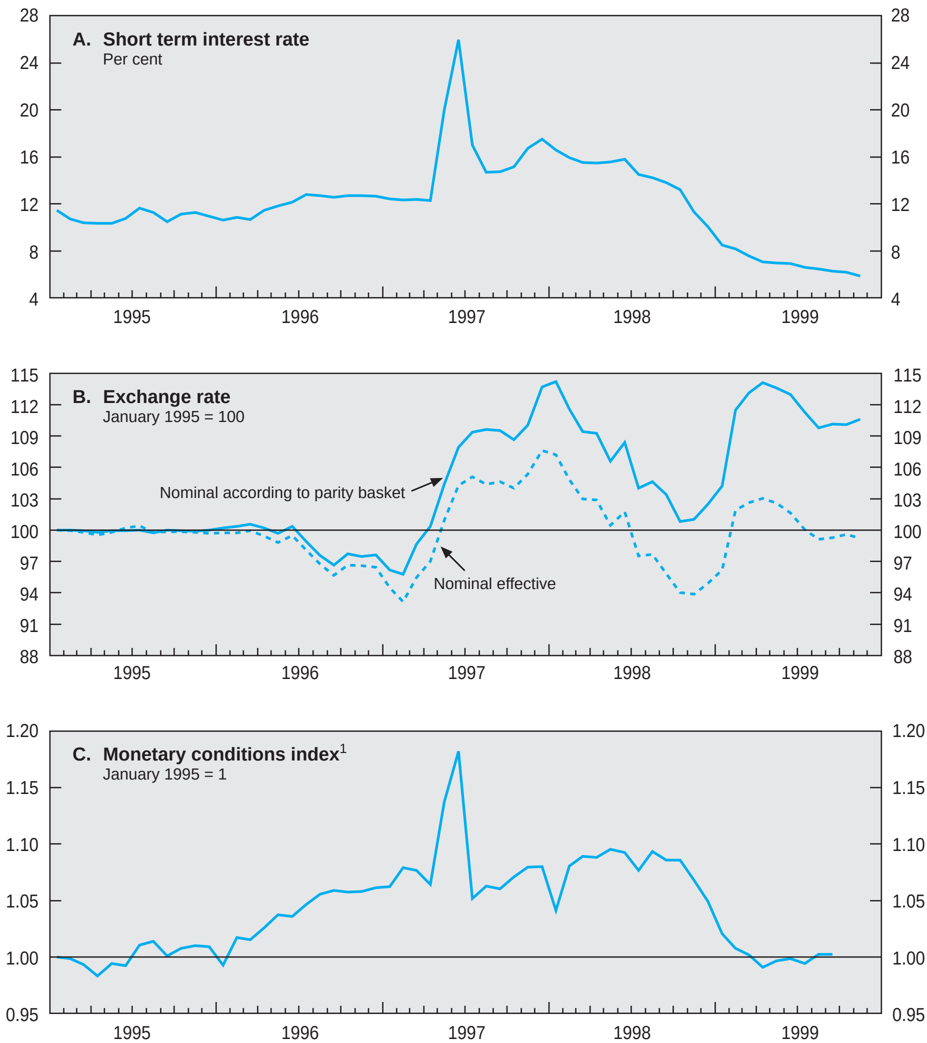
Per cent



1. Czech 3-month PRIBOR *minus* German 3-month FIBOR.

Source: Czech National Bank; OECD.

Figure 10. **Monetary conditions**



1. The monetary conditions index, combining interest and exchange rates, was computed according to the following formula:
   I(t) = I(t - 1) * [1 + (r(t) - r(t - 1)) + a * log (RER (t))], where
   r = real (CPI deflated) short-term interest rate;
   RER = real exchange rate with respect to the deutschemark;
   a = the export to GDP ratio.
   See "Les notes bleues de Bercy", No. 81, February 1996.

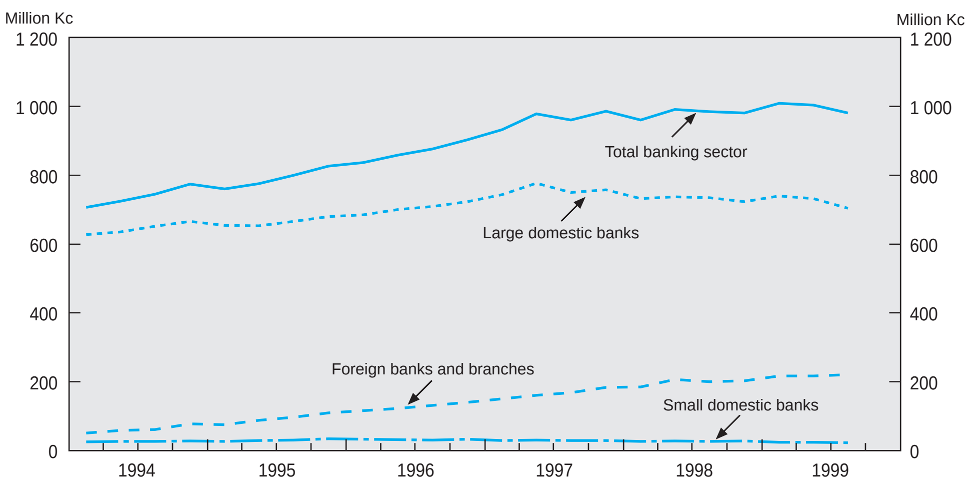
Source: Czech Statistical Office; OECD.

Money and credit growth

Despite the substantial reduction in interest rates, credit expansion in both 1998 and 1999 slowed markedly (Figure 11). Several factors may have contributed to the tightening of credit conditions. *First*, as part of the government's decision to sell off its remaining stakes in the three largest banks, they were required to clean up their loan portfolios (bad debts account for as many as 50 per cent of all loans for some banks). *Second*, the CNB tightened banks' provisioning requirements for loss loans backed by real-estate, thus diverting resources away from lending. At the same time however, capital adequacy ratios for the sector as a whole stood at 12.4 per cent in September 1999, suggesting that a combination of weak demand and high credit risk may also have played a role. The cumulative effects of these factors was to prevent domestic banks from expanding credit, despite the fall in interest rates.

Nevertheless, the growth of money aggregates picked up in 1999 (Table 6). The combination of rising expenditure, improved confidence in the currency and falling interest rates resulted in a substantial increase in the demand for cash, which was reflected in the acceleration of M1. M2 growth also picked up, mainly because of the accumulation of net foreign assets by domestic

Figure 11. **Credit developments by category of bank**
Real, PPI deflated (1995 price level)



Source: Czech National Bank.

Table 6. **Money and credit**

	1994	1995	1996	1997	1998	1999
	End-of-period growth rates					
Monetary growth						
M1	17.2	7.5	4.9	–6.4	–2.6	16.6[1]
M2	20.8	19.4	7.8	8.7	5.2	8.1[1]
Credit expansion	. .	14.9	13.8	15.3	2.3	0.5[2]
	Per cent					
Market interest rates[4]						
7-day PRIBOR	8.5	10.6	12.0	18.4	13.7	5.8[3]
3-month PRIBOR	9.1	10.9	12.0	15.9	14.3	6.2[3]
Memorandum items:						
Nominal GDP growth	13.9	16.8	13.8	6.8	8.4	. .
Income velocity (GDP/M1)[5]	3.0	3.2	3.4	3.7	4.1	. .
Income velocity (GDP/M2)[5]	1.5	1.4	1.5	1.4	1.5	. .

1. September 1999.
2. Third quarter 1999.
3. October 1999.
4. Annual averages.
5. Computed as follows:
   Velocity = $GDP_t/[(M_{t-1} + M_t)/2]$
   Where M_{t-1} = M1 (or M2) at the end of year "t–1"
   M_t = M1 (or M2) at the end of year "t"

Source: OECD; Czech National Bank.

banks and, to a lesser extent, increased borrowing by the public sector (credits to households and firms fell by 6 per cent).

Forthcoming challenges

The successive cuts in interest rates and the depreciation of the currency that occurred in the course of 1999 represent a substantial easing of monetary conditions. The rapid expansion of money supply in the first half of 1999 appears to be an early reflection of that relaxation. A further loosening of monetary policy could prove counterproductive if it results in pushing demand beyond supply, which could rekindle a new upward wage-price spiral. It would be all the more unwelcome since, as indicated in the previous Chapter, inflation is projected to rise in 2000 and 2001 as the temporary factors that pushed it down in 1999 unwind.

On the other hand, an occasional tendency for the currency to appreciate could be interpreted as a sign that there is room for additional relaxation in interest rates. While such a response should not be excluded, the balance of risks appears to argue against it. Indeed, the upward pressure on the koruna mainly reflects temporary factors, principally the cyclical reduction in the current account deficit and, as noted, some speculative capital inflows associated with the government's privatisation programme. To date, the authorities' reaction to these forces appears to have been appropriate and should serve to relieve speculative pressure, as will the expected deterioration of the current account deficit in response to expanding domestic demand.

Great strides have been made towards improving the communication of the CNB's objectives – its quarterly *Inflation Report*, its web site and its annual report are all clear, well-designed and informative. In addition, the adoption of a medium-term monetary policy framework is a positive step that should help the CNB foster forward-looking expectations. Nevertheless, the communication challenge faced by the Bank remains and it has been exacerbated by the under-shooting of the CNB's inflation targets. In this regard, it would be helpful if the Bank were to decide on the appropriate medium-term target range for inflation and a timetable for achieving it. While credibility with international financial markets is important, it is equally so with actors in the domestic economy. Here, the Bank may need to rethink the way it communicates its inflation targets and how it expresses the implications that external shocks will have on its policy. In particular, while the CNB has signalled that certain exogenous, one-time shocks to the price level will not provoke a change to its monetary policy, it has not made clear how such shocks affect its announced objectives. More fundamentally, the Bank may wish to consider abandoning its current practice of setting annual one-year ahead inflation targets and focus more firmly on its recently-proposed medium-term monetary framework. Indeed, its overall message may be clouded by frequent public reference to short-term objectives.

Finally, there might be some merit in refining the measure of net inflation used by the Central Bank. The problem posed by the differences between the headline and net inflation rates is in some respects intractable and is one shared, to a lesser extent, by virtually all other countries operating an inflation targeting regime. However, in the case of the Czech Republic, as indicated in the previous *Economic Survey of the Czech Republic*, the exclusion of regulated prices from the base of the net inflation index makes it much more sensitive to fluctuations in the price of tradeable goods (and thus the exchange rate) than is overall inflation. As a result, the chance of over and under-shooting the Bank's target when the exchange rate appreciates or depreciates is higher than it need be. In this context, the recent announcement by the government of an explicit schedule of hikes for a number of regulated energy prices could, if complemented by similar announcements concerning other administered prices, allow the CNB to target a less volatile indicator than net inflation, whose rate of change would not be systematically different from that of headline inflation. Such a target would be much easier to explain to the public and would facilitate the influencing of expectations formation. The preannouncement of administered price increases would have the additional advantage of reducing the likelihood that temporary political pressures delay price liberalisation, thereby forcing consumers to endure large price increases over a very short period of time.

Independent of the inflation measure used, the decision as to when to raise rates again is likely to prove difficult. The Bank will have to balance rising inflationary pressures, resulting from increases in regulated prices and the unwinding of commodity price shocks, against disinflationary impulses stemming from expanding unemployment and firm-level restructuring. Following the recent large undershoot in inflation relative to the target, it will be especially important that the Bank explain why inflation will rise again in 2000 and why this is consistent with its medium term objectives. Failure to do so in an effective way could seriously hurt its long-term domestic credibility. In the past, this task was made more difficult by the Bank's failure to initially indicate how it would respond to various shocks. It has since made its decision process more clear, which should help agents better form their expectations and understand why targets are not being met. However, more could probably be done by the Bank to pin down expectations and to explain the implications of the divergences between different inflation measures. In this regard, the Bank should be more forward-looking in its public pronouncements, indicating what actions (if any) it will take to meet targets and, if none is anticipated, how long and by how much it expects the path of inflation to deviate from its medium-term objectives without provoking a policy response.

Fiscal policy

Measurement issues

Discussion of fiscal policy in the Czech Republic is complicated by the different concepts used to evaluate its stance. Political and press observers tend to focus on the State Budget and its deficit, which, until 1999, was broadly in balance. However, this concept provides an incomplete indication of the scope of government activity because, on the one hand, it excludes the operations of local governments, various extra-budgetary funds and changes in the State Financial Assets (SFA), while, on the other, it misleadingly includes as a current revenue, proceeds from privatisation (normally treated as a capital transfer in the National Accounts). As a result, reliance on the State Budget data gives a distorted appraisal of government activity, suggesting, in particular, that fiscal policy was neutral in almost every year since the beginning of the transition. The consolidated general government balance, corrected for privatisation revenues, provides a much better indication of the stance of fiscal policy (see Box 1 for a description of the differences between various budget concepts). In contrast to the State Budget figures, it shows a deterioration in almost every year since 1993 (Table 7) and its deficit has been growing much more rapidly. Increasingly, the Ministry of Finance calculates and makes available accounts for the consolidated general government on a cash-flow basis using the IMF's Government Financial Statistics (GFS). In this Survey, unless indicated otherwise, the general government deficit is expressed net of privatisation revenues.[3]

Box 1. Strengths and weakness of different government accounts

In any country, the fiscal stance is most appropriately assessed on the basis of accounts that consolidate all government activity. Ideally such accounts should be available in a timely manner and be recorded on an *accrual* basis, where revenues and expenditures are allocated according to when a liability or a credit is incurred, as opposed to when payment is made (*cash-flow* basis). The table below indicates the extent to which the accounts produced in the Czech Republic meet these prerequisites. The national accounts measure corresponds most closely to these criteria but is only available with a considerable lag. The system of Government Financial Statistics (GFS) provides a consolidated accounting and is available relatively quickly (annually with a six-month delay) but it is recorded on a cash-flow basis. It also suffers from the inclusion of privatisation revenues in its data, which can be corrected by deducting them from the overall balance but nonetheless distorts current revenue figures.

In the case of the Czech Republic, the State Budget's principal advantage resides in the timeliness of its production (monthly). GFS data, corrected for privatisation revenues, provide a better indication of the stance of fiscal policy, although the fact that they are recorded on a cash-flow basis and incorporate privatisation reserves makes them inferior to the kind of accrual based accounts used in many Member countries.

Concept	Operations of central government	Operations of local government	Consolidates government activities	Treats privatisation revenues as a capital transfer	Recorded on an accrual basis	Available in a timely manner
State budget	√	☒	☒	☒	☒	√
Government Financial Statistics	√	√	√	☒	☒	√
National accounts	√	√	√	√	√	☒

Table 7. **Components of the consolidated general government deficit**

	State budget	State Financial Assets (SFA)	State Budget and SFA	Central Extra-budgetary accounts[1]	Social security	Central Government	Local Government	Konsolidanci Banka[2]	Privatisation revenues	Consolidated[3] General Government (exc. Privatisation)
	1	2	1 + 2 = 3	4	5	3 + 4 + 5 = 6	7	8	9	6 + 7 + 8 + 9 = 10
	Per cent of GDP									
1993	0.5	0.0	0.5	1.5	0.5	2.4	0.2		–2.6	0.0
1994	1.2	0.0	1.2	–0.3	–0.2	0.8	0.0		–2.7	–1.9
1995	–0.2	0.0	–0.2	0.9	–0.3	0.3	–0.2		–2.0	–1.6
1996	–0.1	–0.2	–0.3	0.6	–0.2	0.1	–0.5		–1.6	–1.9
1997	–0.9	–0.1	–1.0	0.0	–0.1	–1.1	–0.3		–0.8	–2.0
1998	–1.6	0.2	–1.4	–0.2	0.0	–1.6	0.1	(–0.6)	–0.8	–2.4
1999e[4]	–1.6	–1.1	–2.8	0.0	0.1	–2.7	1.0	(–0.8)	–2.8	–4.4

1. Includes State Funds, National Property Fund and Czech Land Fund.
2. Losses of *Konsolidacni Banka* were recorded as part of the State Budget in 1998 and as part of the SFA account in 1999.
3. Columns may not sum to the total because of consolidation.
4. Data for 1999 are estimates based on Ministry of Finance data adjusted by the OECD. In contrast to official figures, the 1998 losses of *Konsolidacni banka* (0.8 per cent of GDP) have been included in the SFA in 1998 as they were in previous years. In addition, revenue from local government sales of options on the shares of electricity utilities (1.4 per cent of GDP) has been treated as a privatisation revenue and not capital revenue as in the official accounts.

Source: Ministry of Finance.

Budgetary outcomes

General government

The growing general government deficit reflects a relatively flat profile for expenditures over the period 1994 to 1998 and a trend decline in revenues net of privatisation (Table 8). Within expenditure categories, transfers to households have increased substantially, from 16.6 per cent of GDP in 1993 to an estimated 19.7 per cent in 1999. Spending on goods and services has been relatively steady with rising public-sector wages offset by declining employment. Much of the growth in transfer spending has been compensated, in recent years, by substantial cut backs in government investment programmes. On the revenue side, reduced statutory rates have resulted in a decline in the share of indirect and direct taxes, such as the VAT and income tax, as a per cent of GDP (see Chapter IV). In contrast, strong rises in real wages contributed to a substantial increase in the share of social security contributions. Revenue developments from non-tax sources are more difficult to evaluate because the allocation of privatisation proceeds across categories is not known.

The recession and unexpected fall in inflation in 1998 and 1999 contributed to the increase in the *general government* deficit, particularly in 1999 when it is expected to rise to 4.4 per cent of GDP, driven by a 3.3 per cent of GDP hike in expenditures and partially offset by 1.7 per cent increase in revenues (net of privatisation). Indeed, the surge in both current and capital expenditures brought to an abrupt end the process by which the size of government in the overall economy had been slowly declining since the beginning of the transition.

The lack of reliable time series and the substantial changes that the economy is undergoing make estimation of the structural component of the budget deficit, using the standard OECD methodology, problematic.[4] The Czech Ministry of Finance has made some preliminary estimates based on two simpler methodologies.[5] While they differ substantially (Table 9) and are subject to wide uncertainty,[6] they both show that the general government balance has been in structural deficit throughout the period 1994-99 and that most of the 2 per cent of GDP increase in its deficit in 1999 is structural rather than cyclical.

Central government

Actual *state budget* revenues in 1998, which include social security contributions and privatisation revenues, came in approximately as first budgeted but expenditures were some 6 per cent higher. As a result, while originally planned to be in balance, the budget showed a deficit of 1.6 per cent of GDP (Table 10). A transfer to *Konsolidacni banka* (KoB) – the bank created in 1991 as a repository for bad debts following government bailouts of commercial banks (see next Chapter) – to cover its 1997 losses accounted for over half of the deterioration while, despite the substantial rise in unemployment, social benefits and unemployment

Table 8. **Consolidated general government revenues and expenditures**

	1993	1994	1995	1996	1997	1998	1999[1]
	Per cent of GDP						
Revenue	43.8	42.6	41.9	40.4	39.4	38.8	40.5
Total current revenue	43.0	42.1	41.5	39.8	38.9	38.2	40.0
Tax revenue	38.5	37.7	37.0	36.2	36.2	35.7	37.2
Indirect taxes	13.5	13.1	12.6	12.5	12.4	11.7	13.2
VAT	7.6	7.3	6.9	7.0	7.0	6.6	7.5
Excises	3.9	3.9	4.1	3.9	3.8	3.7	4.0
Other indirect taxes	2.0	1.9	1.6	1.6	1.6	1.4	1.7
Direct taxes	9.9	10.0	9.8	9.1	8.5	8.9	8.9
Personal income tax	2.9	4.6	5.0	5.1	5.2	5.2	5.1
Enterprise tax	6.9	5.4	4.8	3.9	3.3	3.7	3.8
Social security contributions	12.9	13.7	13.9	14.1	14.7	14.5	14.6
Other taxes	2.2	0.9	0.7	0.5	0.5	0.6	0.6
Non-tax current revenue	4.5	4.4	4.5	3.6	2.7	2.6	2.8
Non-tax capital revenue	0.8	0.5	0.4	0.5	0.5	0.5	0.5
Expenditure excluding net lending	43.4	43.9	43.0	42.0	41.5	41.1	44.4
Current expenditures	37.2	36.8	35.9	35.6	36.0	35.9	38.7
Goods and services	12.4	11.0	8.9	8.9	8.1	8.1	9.3
Wages and salaries	3.6	4.1	3.6	3.6	3.7	3.4	3.8
Other goods and services	8.8	6.9	5.3	5.2	4.4	4.6	5.6
Transfers to households	16.6	17.4	17.5	17.7	18.9	19.0	19.7
Health insurance	4.5	5.3	5.4	5.5	5.5	5.6	5.8
Pensions	7.5	7.5	8.0	8.1	9.0	9.1	9.4
Other transfers	4.6	4.6	4.2	4.1	4.3	4.3	4.3
Subsidies to enterprises	6.4	7.1	8.3	8.0	7.8	7.7	8.7
Interest payments	1.7	1.3	1.2	1.0	1.2	1.2	1.0
Capital expenditures	6.2	7.0	7.1	6.4	5.5	5.2	5.6
Fixed investment	3.9	4.6	4.6	4.4	3.6	3.3	3.6
Other investment	2.3	2.5	2.5	2.0	1.9	1.9	2.0
Lending minus repayments	–2.2	–2.0	–1.5	–1.4	–0.9	–0.8	–2.3
Lending minus repayments (excluding privatisation revenues)	0.4	0.7	0.5	0.2	–0.1	0.0	0.5
Privatisation revenues	–2.6	–2.7	–2.0	–1.6	–0.8	–0.8	–2.8
General government balance (excluding privatisation)	0.0	–1.9	–1.6	–1.9	–2.0	–2.4	–4.4
Primary balance	1.7	–0.6	–0.4	–0.9	–0.8	–1.2	–3.4

1. Data for 1999 are estimates based on Ministry of Finance data adjusted by the OECD in the manner indicated in Footnote 4 of Table 7.
Source: OECD based on data supplied by the Ministry of Finance, Government Financial Statistics.

Table 9. **Structural and cyclical deficit estimates**

	Total	Hodrik-Prescott method		Barro beta-convergence method	
		Cyclical	Structural	Cyclical	Structural
		Per cent of GDP			
1994	–1.9	–1.1	–0.8	0.0	–1.8
1995	–1.6	0.3	–1.9	1.0	–2.6
1996	–1.9	0.8	–2.7	1.2	–3.1
1997	–2.0	0.5	–2.5	0.4	–2.5
1998	–2.4	–0.2	–2.1	–0.8	–1.6
1999[1]	–4.4	–0.5	–4.0	–1.6	–2.8

1. Estimate.
Source: Ministry of Finance.

insurance spending were broadly as initially budgeted. On the income side, shortfalls in indirect taxes of the order of 10 per cent were offset by an approximately equal overshoot of direct taxes (particularly corporate taxes).

The 1999 State Budget assumed a 1.5 per cent increase in output and 6.9 per cent inflation and on this basis called for a Kc 31 billion deficit. It introduced several special measures. On the spending side, the budget allocation for subsidies to enterprises was increased by 17 per cent as compared with the 1998 budget.[7] The additional money was earmarked to finance a new investment incentive scheme (see Chapter III) and provide additional support to firms hit hard by the recession. The budget also included a large increase in capital spending, with investment to be concentrated in the areas of infrastructure and transportation. In contrast to previous years and because of delays in the preparation of enabling legislation, the 1998 losses of *Konsolidacni Banka* were not paid in 1999, but will be paid in 2000. On the revenue side, the principal change concerned corporate income taxes, where improved profitability was expected to offset more generous terms for deducting investment costs and an accelerated depreciation schedule.

In the event, revenues, which had been budgeted to increase by 6.8 per cent, are now projected to have risen by only 5.5 per cent reflecting falling GDP and lower than expected inflation. Expenditures were also affected and increased an estimated 5.4 per cent, 1.3 percentage points less than originally expected. The government is not anticipating that any sub-category of expenditure will exceed its original projection by a substantial amount, although interest payments are estimated to have dropped 14.1 per cent. Transfer spending is mainly indexed to the previous year's inflation and therefore did not benefit from the additional slowdown in price increases in 1999. Among tax revenues, personal

Table 10. **The State Budget, proposals and outcomes**

	1998 Outcome	1999 Budget	1999 Expected	2000 Proposal	1999 Budget / 1998 Outcome	1999 Estimated / 1998 Outcome	2000 Proposal / 1999 Expected
	Kc billion				Per cent change		
Total revenue	530.0	565.8	559.1	585.4	6.8	5.5	4.7
Tax revenue	509.6	549.9	540.9	569.1	7.9	6.1	5.2
Direct taxes	87.4	89.3	86.7	88.7	2.2	–0.8	2.3
Corporate income	51.1	48.4	51.6	52.1	–5.3	1.0	1.0
Personal income	36.3	40.9	35.1	36.6	12.7	–3.3	4.3
Indirect taxes	191.5	206.8	217.4	233.0	8.0	13.5	7.2
VAT	119.4	131.7	138.7	149.9	10.3	16.2	8.1
Excise	67.8	70.2	73.5	77.6	3.5	8.4	5.6
Motor vehicle fees	4.4	4.9	5.2	5.5	11.4	18.2	5.8
Taxes on property, gifts, inheritance	6.3	6.7	6.8	7.1	6.3	7.9	4.4
Social security contributions	203.9	226.9	210.7	221.6	11.3	3.3	5.2
Taxes on international trade	13.6	12.6	12.0	11.2	–7.4	–11.8	–6.7
Net carryover from previous year	0.3	..	0.0	0.0	..	..	..
Other (including fees and highway tax)	6.6	7.6	7.3	7.5	15.2	10.6	2.7
Non-tax revenue (excluding repayments)	11.3	9.0	11.3	9.5	–20.3	0.0	–15.9
Entrepreneurial and property income	8.2	7.3	9.6	7.7	–11.0	17.1	–19.8
From budgetary and subsid. organisms	5.2	5.7	8.0	6.6	9.6	53.8	–17.5
Interest	3.0	1.6	1.6	1.1	–46.7	–46.7	–31.3
Fines	1.1	1.1	1.1	1.1	0.0	0.0	0.0
Other	2.0	0.6	0.6	0.7	–70.0	–70.0	16.7
Grants	9.1	6.9	6.9	6.8	–24.2	–24.2	–1.4
Repayments (excluded from revenues)	*7.4*	*8.3*	*4.6*	*6.7*	*12.2*	*–37.8*	*45.7*
Total expenditures + net lending	559.4	596.8	589.6	620.6	6.7	5.4	5.3
Current expenditures	507.5	539.5	530.8	564.1	6.3	4.6	6.3
On goods and services	101.4	110.1	112.6	120.1	8.6	11.0	6.7
Wages and salaries	47.4	53.0	53.0	53.2	11.8	11.8	0.4
Other	54.0	57.1	59.6	66.9	5.7	10.4	12.2
Interest payments[1]	19.8	25.1	17.0	18.4	26.8	–14.1	8.2
Transfers	386.4	404.3	401.3	425.6	4.6	3.9	6.1
To enterprises	44.9	33.2	31.0	36.2	–26.1	–31.0	16.8

Table 10. **The State Budget, proposals and outcomes** *(cont.)*

	1998 Outcome	1999 Budget	1999 Expected	2000 Proposal	1999 Budget / 1998 Outcome	1999 Estimated / 1998 Outcome	2000 Proposal / 1999 Expected
	Kc billion				Per cent change		
To subsidised organisations	61.1	66.2	66.6	65.1	8.3	9.0	–2.3
To local authorities	24.9	23.2	25.9	26.7	–6.8	4.0	3.1
To extra-budgetary funds	0.2	0.0	0.0	0.0	..	..	..
To state fund for market regulation in agriculture	1.1	1.6	1.6	2.4	45.5	45.5	50.0
To health funds	23.4	27.6	27.4	28.2	17.9	17.1	2.9
To households	228.7	247.0	246.3	264.1	8.0	7.7	7.2
Social security benefit	221.9	238.9	238.2	254.2	7.7	7.3	6.7
Pension	166.1	176.0	177.8	183.1	6.0	7.0	3.0
Unemployment benefits	4.2	6.0	5.9	7.6	42.9	40.5	28.8
Other benefits	21.9	24.9	23.0	29.9	13.7	5.0	30.0
State social support	29.6	32.0	31.5	33.6	8.1	6.4	6.7
Other	6.8	8.1	8.1	9.9	19.1	19.1	22.2
To abroad	1.7	2.3	2.4	2.9	35.3	41.2	20.8
Other	0.2	3.2	4.8	4.8	..	..	..
Lending (excluded from expenditures)	*8.7*	*7.5*	*5.2*	*3.5*	*–13.8*	*–40.2*	*–32.7*
Capital expenditures	**50.1**	**57.8**	**57.6**	**59.1**	**15.4**	**15.0**	**2.6**
By budgetary organisations	16.5	20.2	20.2	21.3	22.4	22.4	5.4
Transfers	33.6	35.0	34.5	31.3	4.2	2.6	–9.3
To enterprises	6.8	7.8	7.4	7.3	14.7	8.8	–1.4
To subsidised organisations	15.3	16.3	16.3	14.9	6.5	6.5	–8.6
To local authorities	11.5	11.0	10.8	9.1	–4.3	–6.1	–15.7
Other	0.0	2.5	2.9	6.5	..	..	124.1
Lending (excluded from expenditures)	*0.5*	*0.4*	*0.5*	*0.6*	..	..	..
Lending minus repayments	**1.8**	**–0.4**	**1.1**	**–2.6**	..	..	..
Balance	**–29.3**	**–31.0**	**–30.4**	**–35.2**	..	..	..

1. Interest payments in 1999 (expected) and 2000 include transfers to state financial assets.
Source: Ministry of Finance.

income tax, social security contributions, import duties and customs levies are expected to show the largest shortfall for the year, while other indirect taxes (VAT and excise duties) should generate more revenue than the government originally anticipated.

Local authorities

Expenditures of local governments have been declining over the decade, with a large blip in transfers to households and non-profit institutions in 1996 representing the principal exception to that trend (Table 11). Tax revenues have been a stable share of GDP since 1995 and, by and large, this level of government has not spent much more than the sum of its revenues from privatisation and

Table 11. **Local government revenues and expenditures**

	1993	1994	1995	1996	1997	1998
	Per cent of GDP					
Revenue						
Revenue and grants	9.0	9.5	9.4	10.4	8.7	8.6
Revenue	6.3	6.9	6.9	6.5	6.5	6.6
Current revenue	5.5	6.3	6.5	6.0	6.0	6.1
Tax revenue	3.7	4.6	4.9	4.5	4.5	4.6
Direct taxes	2.8	4.1	4.6	4.1	4.0	4.1
Personal income tax	2.8	4.1	4.4	3.2	3.2	3.2
Enterprise tax	0.0	0.0	0.2	0.9	0.8	0.9
Domestic taxes on goods and services	0.1	0.1	0.1	0.1	0.3	0.2
Taxes on property	0.3	0.3	0.3	0.3	0.2	0.2
Other taxes	0.5	0.0	0.0	0.0	0.0	0.0
Non-tax current revenue	1.8	1.7	1.6	1.5	1.5	1.5
Capital revenue	0.8	0.5	0.4	0.5	0.5	0.5
Grants	2.7	2.6	2.5	3.9	2.1	2.1
Expenditures						
Expenditures and net lending	8.8	9.5	9.6	10.9	8.9	8.6
Expenditure	8.8	9.4	9.5	10.8	9.0	8.7
Current expenditure	5.7	5.9	5.9	7.5	5.9	5.8
Expenditure on good and services	3.9	3.8	3.6	3.6	3.6	3.7
Wages and salaries	0.7	0.6	0.6	0.7	0.8	0.8
Other purchases of goods and services	3.0	2.9	2.7	2.7	2.6	2.6
Interest payments	0.0	0.0	0.1	0.1	0.1	0.1
Subsidies	1.5	1.8	1.8	1.7	1.6	1.5
Transfers to households and NPI	0.3	0.3	0.4	2.0	0.5	0.5
Capital expenditure	3.1	3.5	3.6	3.3	3.0	2.9
Acquisition of fixed capital assets	2.5	2.8	3.0	2.8	2.5	2.3
Lending minus repayments	0.0	0.1	0.0	0.1	0.0	–0.1
Local government balance	0.2	0.1	–0.1	–0.4	–0.3	0.0

Source: Ministry of Finance, Government Financial Statistics.

recurring sources. The 1999 budget for local authorities initially projected a small deficit (0.1 per cent of GDP). It anticipated that tax and non-tax revenues would rise 8.3 and 3.6 per cent respectively but that capital revenues and inter-governmental transfers would fall by 29 and 6 per cent each, with the net result that total revenues would rise by only 1 per cent. Expenditures, on the other hand, were expected to rise 3.4 per cent, including an 8.6 per cent increase on current items and a similar drop in capital spending. Preliminary estimates by the Ministry of Finance for 1999 indicate local government tax revenue rose by 3.2 per cent but that their total revenue increased by some 18 per cent, principally because of the sale of some Kc 26.2 billion (1.4 per cent of GDP) in options to purchase shares in a number of electrical utilities. Expenditures are projected to have increased by 6.2 per cent and the local government deficit net of these extraordinary revenues was about Kc 8.5 billion as opposed to a Kc 19 billion surplus if included as current revenue.

The budget proposal for 2000

The budget for year 2000 has yet to be passed by parliament. A third draft has been prepared, following the rejection of the previous two. The cabinet has agreed to limit the state budget deficit to 2 per cent of GDP, which would be consistent with a general government balance deficit – including an expected Kc 32 billion loss by *Konsolidacni banka* – of 5.8 per cent of GDP (net of privatisation receipts[8]). The most recent budget proposal is predicated on an estimate of 1.5 per cent GDP growth, 4.2 per cent inflation and 10.6 per cent rate of unemployment. On a consolidated basis, revenues (less privatisation receipts) are forecast to rise by 4.7 per cent (nominal) and expenditures by 5.3 per cent. Thus by 2000, expenditures as a share of GDP will have increased by about 4.9 percentage points since 1998.

Within the State Budget and as compared with the latest 1999 estimates, the proposal for 2000 foresees tax revenues rising 5.2 per cent. This increase reflects a 2.3 per cent augmentation in direct taxes and a 7.2 rise in indirect taxes. Current expenditures are budgeted to grow 6.3 per cent with most items increasing proportionately, except for unemployment insurance and social benefits – all of which are expected to rise substantially. The 2000 budget does not make provisions to pay the Kc 32 billion – or 1.1 per cent of GDP – losses of the *Konsolidacni banka* and proposes instead to directly issue debt in this amount. For local governments, the Ministry of Finance expects tax revenues to increase by 15.2 per cent, non-tax receipts by 6.6 per cent, but anticipates that capital revenues (excluding options) will rise by 72 per cent. Current and capital expenditures are budgeted to expand by only 2.6 per cent and as a whole the local level of government is expected to return a 0.1 per cent of GDP deficit.

Longer-term fiscal issues

Contingent liabilities

Despite running a fiscal deficit for the entire second half of the decade, relatively high inflation for most of the period meant that nominal GDP grew more quickly than the deficit itself, so that the gross public debt of the Czech Republic has been falling as a share of GDP (Table 12) and is low compared with most other OECD countries. However, this may substantially under-estimate the true extent of the government's indebtedness. Indeed, as discussed in the previous *Survey*, a wide range of contingent liabilities are held by various off-budget (non-government) agencies. Already these liabilities are impinging on the government's books. In particular, the losses of the *Konsolidacni banka* in 1999 (estimated at 1 to 1.5 per cent of GDP) will almost equal the interest payments of the consolidated government on its official debt for that year.

According to a recent government evaluation undertaken in co-operation with the World Bank (1999*a*) the hidden public liabilities of *Konsolidacni banka*, *Ceska finacni*, the National Property Fund (NPF) and various state loan guarantees (net of provisions) amounted to 12.4 per cent of GDP in 1998. In gross terms, this debt represented 17 per cent of GDP and taken together with the official gross debt, it suggests that the true debt/GDP ratio was as high as 30.2 per cent that year

Table 12. **Consolidated outstanding gross government debt**[1]

	1993	1994	1995	1996	1997	1998	1999[2]
	Kc billion						
State budget	158.8	161.7	154.4	161.6	172.2	193.6	227.2
Health insurance	0.0	0.8	0.5	1.2	2.4	1.7	1.2
Extrabudgetary funds	30.0	32.8	40.3	22.5	17.2	15.0	16.0
Local government	3.1	14.0	20.6	28.7	36.1	41.3	42.0
Total	191.8	208.2	211.2	206.7	217.5	240.4	286.4
Domestic	120.2	139.2	131.8	149.6	141.7	175.8	..
Foreign	71.6	69.0	79.4	57.1	49.6	33.9	..
	Per cent of GDP						
Memorandum items							
Total debt	18.5	17.6	15.3	13.1	12.3[3]	13.3[3]	15.5
Domestic	11.6	11.8	9.5	9.5	8.4	9.7	..
Foreign	6.9	5.8	5.7	3.6	3.0	1.9	..

1. End of year.
2. Data for 1999 are not consolidated. In 1998 the unconsolidated total was Kc 251.6 billion or 13.9 per cent of GDP.
3. The total includes debt not identified as either domestic or foreign.

Source: Ministry of Finance.

(Table 13). Most recently, the NPF has indicated that its present and future unfunded liabilities are worth Kc 167 billion, *i.e.* about $4.6 billion of which some Kc 70 billion involves liabilities for environmental damage accumulated under the previous regime. In addition, there is also the potential liability represented by the state's equity position in the commercial banks *Komercni banka* and *Ceska sporitelna* as well as some highly indebted firms such as the state-owned railroad. Indeed, the debt of the latter has been rising rapidly (it was equal to 1.1 per cent of GDP in 1998), as unpaid loans have been rolled over by state-controlled banks. While such implicit subsidies may delay the appearance of the spending on the books of the government, the obligation to the taxpayer to cover them remains – either through implicit state guarantees of the loans or through the government's equity position in the lending bank. Indeed, as discussed in Chapter III, the state has already been obliged to recapitalise the two remaining state owned banks, *Komercni banka* and *Ceska sporitelna* and it is likely that additional state support will be required in order to enable them to write off their bad loans, as their privatisation continues.

Given the existence of this "hidden debt", official figures provide a misleading impression of the overall financial position of the government. Indeed, had the operations of various off-budgetary institutions been included in the general government accounts, the World Bank estimates that the budget deficit in 1998 would have been 3.5 percentage points higher than indicated by official

Table 13. **Hidden public liabilities**

	1993	1994	1995	1996	1997	1998
	Kc billion					
Konsolidacni banka (KoB)[1, 2]	79	81	79	70	86	98
Ceska Inkasni (CI)[2]	20	27	25	17	8	7
National Property Fund (NPF)	29	33	40	22	17	15
State risk-adjusted guarantees	3	3	6	28	74	107
Net hidden public liabilities[2]	131	144	150	137	185	226
Net hidden public liabilities (% of GDP)[2]	**13.1**	**12.1**	**10.8**	**8.7**	**10.9**	**12.4**
Provisions and reserves of KoB and CI	19	24	42	59	71	84
Gross hidden public liabilities	150	168	192	196	256	310
Gross hidden public liabilities (% of GDP)	**15.0**	**14.1**	**13.8**	**12.4**	**15.1**	**17.0**
Reported gross government debt	192	208	211	207	218	240
Reported gross government debt (% of GDP)	**18.8**	**17.6**	**15.3**	**13.1**	**12.9**	**13.2**

1. Activities of *Konsolidacni banka* include financing of the Stabilization Program of *Ceska financni,* which is, therefore, not reported as a separate entity.
2. Net of provisions and reserves.

Source: World Bank (1999*a*).

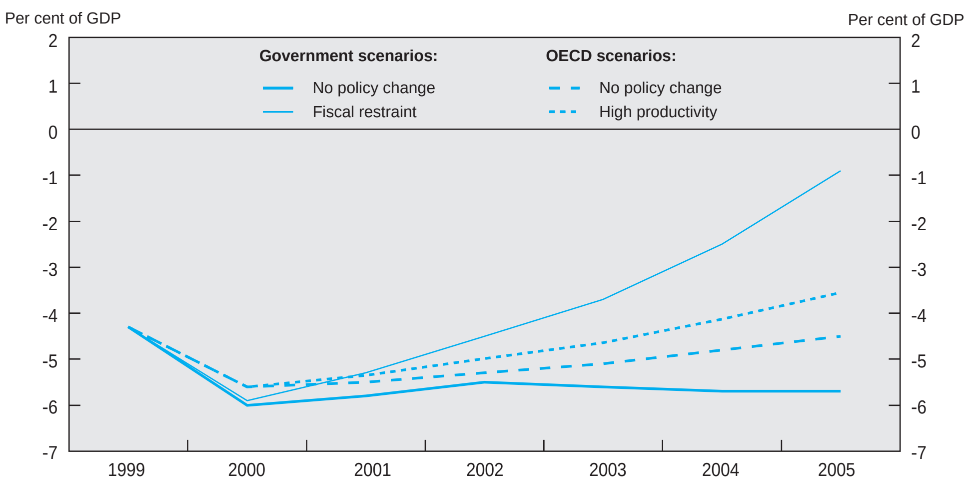
statistics. While it is not clear that all such transactions should be included in the deficit (like privatisation revenues, many of them have the character of a capital transfer), their impact on the country's debt is of economic importance. This is the case, in particular, of the money spent on bank restructuring. While both Hungary and the Czech Republic have spent roughly the same amounts on bank restructuring (about 10 per cent of GDP), so far almost none of this type of expenditure has appeared in the books of the Czech government; rather, it has been financed by transferring non-performing loans to *Konsolidacni banka*. The full amount of the government's liability is thus difficult to discern and the annual burden it imposes on current spending only materialises indirectly and imperfectly as the losses of the bank. In contrast, in the case of Hungary, the expenditure and the interest paid to service it (both now and in the future) appear clearly in the government accounts.

This extensive use of off-budget institutions also has implications for the governance of public policy. Spending that is incorporated into the regular budgetary process is subject to a relatively well-defined political and technical review process whereby the priorities and associated risks of alternative projects are weighed against one another. In contrast, the spending programmes of off-budget agencies frequently bear only a marginal relationship to political objectives and are not necessarily subject to political oversight. Indeed, little analysis is made of the future governmental liabilities created by loan guarantees and, while these are subject to annual ceilings, they are much higher than in other OECD countries, and, as yet, have not constrained the use of guarantees. Thus, when the Czech Railways failed to qualify for a government subsidy, they were instead given a very risky loan guarantee even though in almost every case where soft loans or guarantees are made by an off-budget organisation, it would be cheaper for the government to act more explicitly because the cost of sovereign debt is lower than the interest payments made on the guaranteed loans.

Medium term fiscal framework

Despite the high profile given to the State Budget, the government has made a number of moves towards a more consistent use of the consolidated general accounts in its budgetary documents. Thus, for the first time, as part of its 2000 budget, it presented a five-year medium term fiscal framework. By making more transparent the pressures to which public finances are exposed, such a framework represents an essential component in the longer-term planning of public policy which should enable the authorities to evaluate better different policy options. This is a welcome move that needs to be followed through with greater transparency in all aspects of the government accounts. The government's medium-term documents include two scenarios: one based on unchanged policy and another assuming productivity improvements and higher growth as a result of a continued programme of structural reform. In the "no policy change" alternative, revenues remain a relatively stable share of GDP as do expenditures, after initially falling in 2000 and 2001. As a result, the government deficit is projected to stay in excess of 5 per cent of GDP even after five years of sustained (albeit moderate) growth (Figure 12). Under an alternative scenario, real wages grow less slowly than productivity, allowing the rate of output to accelerate. As a result, VAT and personal income tax revenues fell by 1.6 per cent of GDP between 2000 and 2005. However, this is more than offset by a 4.8 per cent of GDP reduction in expenditures (excluding net lending) which, combined with stronger growth due to enhanced productivity, allows the deficit to fall (perhaps somewhat optimistically) to 1 per cent of GDP. The main sources of savings are reduced transfers to households, lower subsidies to enterprises and even further cuts in capital expenditures. Simulations using the OECD's *Interlink* model indicate that, in the absence of policy changes, the deficit would remain in excess of 4 per cent. The OECD simulations are less optimistic as concerns the ability of high growth to lower the budgetary shortfall. As a result, even assuming significantly better productivity performance and lower unemployment, the OECD "high growth scenario" suggests the deficit would still be above Maastricht levels, unless accompanied by substantial spending cuts.[9]

Figure 12. **Medium-term fiscal projections**
General government deficit



Source: Ministry of Finance; OECD.

Regional government

The government is in the process of setting up a new regional level of government, comprised of fourteen regional and directly elected councils, of which Prague would be one. The reform may generate a simplification of administrative structures as it foresees the phasing out of the 77 sub-national districts and a reduction in the number of municipalities (currently 6 200). For the moment, the details of the powers and responsibilities of the new regional governments have not been decided, although parliament has indicated that it prefers that they be clearly subordinate to it. Indeed, it would appear that powers not explicitly ceded by the centre to the regions will remain the purview of parliament. Furthermore, bills passed by the regions would have the force of by-laws and would, therefore, be clearly subordinate to those of parliament. At this stage, the spending, taxation and borrowing powers of the regional level of government have also not been determined although they will likely be called upon to play an important role in administering EU structural funds. A draft law of regional competencies is to be submitted to parliament in June 2000, with the hope that it will be passed in time to have regional elections by the end of that year. In its deliberations, the parliament should ensure that the budget constraints faced by regional governments are strict in order to prevent them from building up large deficits for which the national authorities would be ultimately responsible. The easiest way to do so would be to legally prohibit them from borrowing, either through the banking system or via the bond market, without the explicit prior approval of the Ministry of Finance.

Assessment

Part of the substantial fiscal easing that occurred in 1999 arose because much of the austerity introduced in 1997 and 1998 could not be sustained. Thus, a third of the 5 percentage points of GDP increase in public expenditures was due to catch-up wage increases and a return to public investment levels observed prior to the recession. Additional important contributions to the overall increase came from a ¾ percentage point hike in transfer to households, and a 1½ percentage point rise due to additional subsidies to firms. The 2000 budget, on the other hand, represents a more discretionary relaxation of fiscal policy. Most expenditure categories are projected to grow more rapidly than tax revenues and the government appears to be relying on additional privatisation to keep the State Budget deficit from rising excessively. Given that the economy is recovering, and in view of the prevailing overall monetary conditions, fiscal policy should assume a markedly tighter stance in 2001. Indeed, foreign-denominated privatisation proceeds may be contributing to a tendency for the currency to appreciate. The government could help alleviate such pressures by not spending these revenues.

Alternatively, it could finance its expenditure with koruna-denominated bonds and sterilise the privatisation proceeds by reducing its net external debt.

The fact that the Ministry of Finance is now producing consolidated government accounts and is evaluating policy on this basis is a welcome development, but more needs to be done to raise the profile of these accounts and encourage both public and political discourse to be conducted with reference to them. Here, the government should consider improving reporting requirements so that such accounts could be produced quarterly or even monthly. The medium-term fiscal framework exercise conducted by the Ministry of Finance and which accompanied the first draft of the 2000 budget represents an important positive step towards improving the basis and the transparency with which fiscal planning is conducted. It is especially useful not only because it concentrates on general government but also because it extends the planning horizon, so that the future consequences of decisions made (or not made) today can be more readily discerned. As such, it demonstrates clearly that fiscal conditions are at a crossroads in the Czech Republic, by showing that failure to make significant savings on the expenditure side in the near term will see the consolidated government deficit rise to levels that are inconsistent with macroeconomic stability.

The work undertaken to evaluate the extent of the contingent liabilities or "hidden debt" in the Czech Republic is also significant. While the creation and accumulation of this debt reflect past decisions concerning privatisation methods and how the state participated in the restructuring of the industrial and financial sectors, it nevertheless represents a real obligation of Czech society with which the government will eventually need to come to terms. Indeed, having identified and quantified the problem, the government should now move to address it, both in order to make its own accounts more transparent but, more importantly, in order to put its longer-term fiscal planning onto a firmer footing. Indeed, given current estimates of such a "hidden debt", the size of current expenditures (and thus the budget deficit) is probably underestimated by more than 2 per cent of GDP because, instead of paying interest on this liability,[10] its principal is growing.

While several options could be pursued to make this "hidden debt" more visible, the most effective would see the government realise the existing contingent liability by paying off its creditors with money raised through the issuance of state bonds. In the case of *Konsolidacni Banka*, which holds most of the debt in the form of bad loans, this could be accomplished by the state re-capitalising the bank so that it could afford to write off loss-making loans and begin to operate according to commercial principals. Such a move would have several advantages. *First*, it would be cheaper as the sovereign interest rate paid on government debt would be lower than that currently being paid on the liabilities. *Second*, it would free enterprises that are viable on an operating basis from the burden of an unpayable debt and from their current dependence on indirect state-financed soft credit. Assuming the government is credible in cutting off these firms from further state-aid, such a move should have positive impacts on their performance while forcing unviable ones to either seek foreign partners or to liquidate themselves. Indeed, such a logic underlies the government's Revitalisation Strategy (see Chapter III), although it is more narrowly focused on the most heavily indebted of the large enterprises.

A number of announcements by the government suggest that it is contemplating setting up several new off-budget funds. While such funds exist in other countries and the central government already runs five of them, there are several strong reasons that would argue against such a move. *First* the funds would no longer be part of the State Budget and, judging by current practice, they would be subject to less political and administrative oversight than currently. It is possible, therefore, that public money would be spent less wisely under such a governance system as compared with one where alternative spending proposals competed with one another on an equal footing. *Second*, experience in other OECD countries suggests that unless such funds operate in a budgetary environment where the national government monitors their revenues and expenditures on a high-frequency basis (and exercises direct and centralised control of them) they tend to generate large deficits that the state is obliged to cover. *Finally*, one of the options under consideration is to allocate to some of these funds all of the revenues currently yielded by several payroll taxes. This would have serious budgetary consequences as payments for these programmes come from general revenues but the revenues from these taxes no longer covers the associated expenditures. As a result, transferring these revenues to a new fund would imply it running a substantial deficit (unless the payroll taxes were raised first), which would have to be met elsewhere in the budget. These factors suggest that such moves, though perhaps attractive to policy makers, at some level, would likely reduce rather than increase transparency in budgetary operations and could jeopardise fiscal stability.

III. Progress in structural reform

The pace of structural reform in the Czech Republic tapered off considerably following the mass (voucher) privatisation of the early and mid-1990s. Czech firms delayed necessary restructuring because of, among other things, a weak corporate governance structure; an inadequate or non-existent regulatory framework for financial markets that did not keep pace with rapid changes in the economy; and state-controlled banks that often supplied easy credit to enterprises. As a result, despite very strong macroeconomic performance in some periods during the 1990s, the fundamental strengths of the country (its proximity to western Europe, its well educated population and its high quality manufacturing sector) were slowly eroded and weakened. As described in the previous *Economic Survey of the Czech Republic* (OECD, 1998*a*), these problems were reflected in the country's poor productivity performance, excessive real wage growth, the banking sector's massive accumulation of bad debts, the flight of international capital, a progressive loss of competitiveness and, ultimately, the 1997 currency crisis.

Since then, significant structural progress has been made to overcome such problems. The present Chapter reviews that progress while revisiting the most critical areas where more concerted effort will be essential if the Czech Republic is to achieve the prerequisites set for joining the European Union (Box 2). The Chapter begins with an examination and evaluation of the steps taken to establish a healthy corporate governance structure. It then turns to developments in the banking sector and capital markets where improvements have been implemented to clean up bank balance sheets and toughen financial market regulation. The Chapter then looks at developments in the labour market, where, in the absence of further reform, there is a real risk of a substantial rise in structural unemployment. The final section addresses a number of public policy issues which bear a longer-term relation to growth prospects, notably pensions and health care reform, and the environment. The issue of how to redesign tax policy to meet post-transition challenges is discussed in the following Chapter.

Box 2. EU accession

In July 1997, the European Commission recommended that the EU begin negotiations with the Czech Republic to join the European Union and an accession agreement was signed in March 1998. As part of the admission process, the Commission undertakes periodic reviews of the Czech Republic's progress in becoming a democratic market-led economy (the so-called Copenhagen Criteria). The first of these reviews was released in November 1998 and it criticised the slow progress made by the Czech Republic in adopting the Community *Acquis*, although acknowledging that it was broadly moving in the right direction. This was followed by a report with a similar message in October 1999, which highlighted the need to speed up legal and structural reforms and was critical of the slow progress made in passing legislation necessary for harmonisation (EU, 1999).

In the area of the economy, the Commission's and government's *Joint Assessment of the Economic Priorities of the Czech Republic* outlines the steps that need to be taken to fully conform to EU economic policies. It places a particular focus on medium-term steps necessary if the Czech Republic is to accede by the government's 2003 goal.

As regards *fiscal policy*, a primary concern is the transparency of public finances, the issue of hidden debts and their incorporation into the consolidated fiscal framework. In addition, the Commission felt that notwithstanding progress in setting up a medium-term fiscal framework, further efforts would be necessary to improve medium-term budgeting, a key component being a planned expenditure review.

As regards *tax policy*, it recommended the harmonisation of the VAT and excise taxes to EU regulations as well as the strengthening of overall tax collection given a trend decline in tax revenues (see Chapter IV).

In the area of *monetary policy*, the Commission noted that the Czech National Bank already employs monetary policy instruments compatible with the European Central Bank framework, but highlighted the need to harmonise minimum reserve requirements to ECB norms (accomplished in October 1999) and reduce inflation and interest rates. In addition, exchange rate stability needs to be improved.

In the area of *structural policies*, the Commission addressed a wider range of issues, highlighting in particular the Czech Republic's successful harmonisation of its technical regulations and standards with those of the EU, but also the need to amend the commercial code, bankruptcy and accounting laws.

Corporate governance and the functioning of product markets

Faced with the stagnation of the transition process, the previous *Economic Survey of the Czech Republic* made a number of recommendations to improve corporate governance and the economic performance of product markets (Table 14). Significant progress has been made to enforce the budget constraints faced by firms and to overcome some of the barriers faced by creditors in this area. At the same time, increased prudential regulation of banks and the prospect of their

Table 14. **Structural surveillance**

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
		Panel A: Product markets	
Allow investment privatisation funds (IPFs) to transform themselves more easily into holding companies so that they can take a more active governance role in firms.	IPF's maximum stake in any one firm was reduced from 20 to 11 per cent and restrictions were placed on their ability to set up holding companies. Closed-ended funds were forced to open up (to become more like mutual funds).	While at odds with the recommendation, these reforms may help improve governance as IPFs have been consolidating their stakes and selling them to strategic investors. Opening up funds should improve transparency and fund oversight.	Ensure that minority shareholders are protected in consolidation by lowering, in steps from 50 to 25 per cent or less, the threshold above which a purchase offer must be made to all shareholders.
Accelerate privatisation of the remaining large state-owned banks.	*Ceskoslovenska obchodni banka* (CSOB) was privatised and the process begun for *Ceska sporitelna* (CS) and *Komercni banka* (KB).	The government has had difficulty in swiftly privatising CS and KB given their large share of classified loans. This burden has been alleviated somewhat by off-loading some of these loans to *Konsolidacni banka* (KoB) at preferential terms.	Ensure that privatisation is completed as quickly as possible. This may involve further bad loan transfers to KoB to help speed up the process.
Pursue more actively the resolution of outstanding debts held by *Konsolidacni banka.*	Government has brought in new management at KoB with a mandate to operate the bank on commercial principles. In this regard, it plans to split the bank into two parts, one operating as a commercial bank and the other as a state financial institution.	The move to increase the use of commercial principles is a welcome development, although the nature of the non-bank institution that will assume the outstanding bad debts remains ill defined.	The commercial banking portion of what is now KoB should be privatised as soon as possible, while the second institution must take a much more active role in collecting or liquidating outstanding bad loans.
Continue privatisation of state holdings in the National Property Fund (NPF) and make its operations and financial condition more transparent.	The government has announced further privatisations (in addition to the banks).	The NPF's accounts remain opaque and its true balance sheet position unknown.	Clarify NPF accounts and create a concrete plan of action to privatise remaining government holdings.

Table 14. **Structural surveillance** *(cont.)*

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
Revitalisation programme.	The government announced a revitalisation programme to help large firms restructure.	The revitalisation plan is a positive step to restructure large firms. The ability of the Revitalisation Agency manager to carry out its tasks may be hampered by the weak protection of creditor rights, while the role of the government in the process is unclear.	Ensure that the new Revitalisation Agency is given the means to quickly restructure large firms. The government must resist the temptation to use its ownership of the Agency to influence its decision making.
Make further progress on regulation of natural monopolies and continue to move prices towards market levels.	The government has pre-announced price hikes for electricity and gas that will bring them up to market levels by 2002. Draft laws concerning the set-up of independent regulators for natural monopolies are to be presented to the government in late 1999.	Progress setting up independent regulators for natural monopolies has been slow, which hampers investment and growth in several sectors. Regulated price setting remains opaque in many sectors.	Create independent regulators as soon as possible. This should include a transparent, verifiable and predictable method for setting regulated prices.
Lift rent controls as soon as possible.	The government is in the process of determining its new rental policy.	Current rent controls discourage investment and hamper labour mobility.	Try and bring rents up to market levels within 5 years.
Clarify the role of banks in firm and IPF management.	Bank Act revised in 1998 to limit the control of banks, either directly or indirectly, over legal entities other than banks.	This change has diminished the potential for conflict of interest.	In the absence of any compelling reason to maintain bank control of fund management companies, this link should be completely severed.
Reform bankruptcy legislation.	Proposed modifications to current bankruptcy law and plans to overhaul it completely.	Reform in these areas is critical to restructuring industry, allowing banks to enforce hard budget constraints and collect delinquent loans.	Quickly pass new legislation to strengthen creditor rights. Include provisions for workout bankruptcies and consider setting up specialised courts to deal with bankruptcies.

Table 14. **Structural surveillance** *(cont.)*

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
		Part B: Financial markets	
Give the Securities and Exchange Commission (SEC) financial and regulatory independence from the Ministry of Finance.	None.	The SEC, despite being the regulatory body for capital markets, is not allowed to create regulations while its ability to enforce many of them is legally unclear.	At a minimum, give the SEC the ability to create regulations while clarifying its legal role in enforcing them.
Increase regulation of the stock market. In particular, make the over the counter market (OTC) more transparent.	The SEC has been given three mandates to improve the regulation of the stock market.	Positive moves to rebuild the reputation of the capital market, but problems still remain in regulation of the stock exchanges and the OTC.	Implement regulation forcing public firms to list with the SEC.
Credit unions *(Kampelickas)*	Several large credit unions were placed under forced administration in late 1999 following liquidity problems. New law on their supervision proposed.	Steps to clean up credit unions are a welcome development but more action is required. The proposed new law does not go far enough in strengthening supervision.	Bring regulation of credit unions up to international standards and enhance prudential supervision.
		Panel C: Labour markets	
I. Reform unemployment and related benefit systems.			
Re-examine the basis upon which benefits in the social assistance and state social support systems are determined.	The government is rewriting the Act on Social Security.	Rising unemployment, along with generous benefits for some households risks generating structural unemployment.	Overhaul social security to realign incentives throughout the system, including adjusting non-employment benefits to be more consistent with wages and productivity.
Strengthen the monitoring of access to disability pensions in order to restrict access to the handicapped.	Access to full disability pensions has been tightened.	While a step in the right direction, the total number of people receiving disability pensions has not fallen, as partial disability recipient numbers have risen.	Consider more frequent assessments of those receiving partial disability benefits to determine their ability to work additional hours.

Table 14. **Structural surveillance** *(cont.)*

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
II. Reform employment security provisions.			
Relax reporting and notice requirements for restructuring firms.	The government has proposed the creation of a guarantee fund to pay wages of employees in firms that are insolvent.	May create a moral hazard problem if firms stop paying wages knowing that the fund will cover them.	Ensure that the fund is used only to pay the wages of workers in firms that are no longer in operation.
III. Improve labour force skills and competencies.			
Improve the preparation for university studies of students following vocational and technical streams.	Standardised examinations for the *Maturita* have been tested as have new standards for education and training.	While moving forward, progress has been slow.	Implement standardised exams. Expand the number of general schools and at the same time increase the training of teachers to improve the quality of education.
IV. Enhance the effectiveness of active labour market policies.			
A systematic evaluation of active labour market policies (ALMPs) should be instituted.	Recent independent evaluation undertaken.	The evaluation highlights the need to adjust programmes.	When adjusting ALMPs, the government should not expand public sector job creation programmes and should ensure that when training is offered, it is designed to meet local labour market needs. Create framework to systematically evaluate these programmes.
Ensure that Public Employment Service (PES) resources rise in line with increased unemployment levels.	PES resources have increased but much less rapidly than joblessness.	Rising client/employee ratios suggest that PES workloads have risen substantially which may have reduced monitoring of job-search.	Increase PES resources and ensure that its regional distribution of staff reflects the dispersion in unemployment.

Table 14. **Structural surveillance** *(cont.)*

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
	Panel D: Public sector		
Healthcare			
Gate keeping	General practitioners (GP) paid on a capitation basis and fee-based system for specialists enhanced.	Should help to control costs, although further enhancements needed. System implicitly relies on GPs to control access to more expensive healthcare; further changes necessary.	Monitor payments closely and ensure that GPs fulfil their gate keeper function. Limit the ability of people to directly access specialists and focus more effort on primary healthcare.
Cost control	Payments to insurance companies negotiated more frequently and limits set on some services.	Helps enforce a firm budget constraint.	Introduce risk-weighting of payments to insurers.
Privatisation	Privatisation of various healthcare facilities begun.	Should allow a greater specialisation of activities in the sector.	Continue privatisation but monitor quality and costs carefully.
Pensions			
I. Public pay as-you-go system (PAYG).	Increase in retirement ages to 62 for men and 57-61 for women by 2007. Proposed creation of an extra-budgetary fund for the pension plan.	Increased retirement ages not sufficient to control costs of PAYG fund given its generosity. Proposed extra-budgetary fund could lead to higher costs *via* relaxed oversight.	The government could consider raising retirement ages for women to those of men, indexing benefits to prices (resulting in a lower replacement rate) or injecting more funds into the system. The government should reconsider the decision to create a new extra-budgetary fund.
II. Private funds			
Early retirement	Reduced early retirement incentives.	Early retirement still possible without actuarial adjustment to benefits.	Access should be harmonised with PAYG fund, or payments actuarially reduced.

Table 14. **Structural surveillance** *(cont.)*

Issues/1998 recommendations	Action taken	Assessment	Follow-up recommendation
Incentive structure	Increased financial incentives to join funds, beginning in January 2000.	Should encourage younger workers to increase their participation in the private funds.	Re-assess the costs and benefits of these tax expenditures after a set time period, for example 2 years.
Regulatory supervision	Improved fund oversight.	This will need further improvement as the types of investments that funds can make expand.	Consider whether the SEC should monitor pension funds. Strengthen timing and content of fund disclosures.

Source: OECD.

privatisation have contributed to a reduction in new credits, cutting off many firms from access to easy credit and thereby forcing them to undertake long delayed restructuring efforts. In addition, some consolidation of firm ownership has occurred as investment privatisation funds sold some of their holdings to strategic investors, helping to improve governance. Progress in other areas has been limited and, although some important steps have been taken, much more needs to be done. The legal framework remains weak and property rights difficult to assert, conditions which continue to make investors wary and slow the process of restructuring. Additional tasks requiring priority attention include: the passing of a new commercial code and bankrupcy legislation (both of which are currently before parliament), the set-up of an adequate regulatory framework for "natural" monopolies, the liberalisation of the many regulated prices that are kept well below market levels, and the privatisation of state holdings.

Problems with the current ownership structure

Various OECD *Economic Surveys of the Czech Republic*, as well as other recent OECD work, have stressed the importance of sound corporate governance in improving economic efficiency. While there is no single model of good corporate governance, the *OECD Corporate Governance Principles* and empirical evidence in general indicate that structures which establish a clear connection between the interests of owners and those of management perform best. As indicated in Box 3, corporate governance in the Czech Republic falls well short of these principles in a number of respects, which may explain why, despite high investment rates, overall productivity growth remains lower than in other neighbouring countries, such as Hungary and Poland (Table 15).

As indicated in the previous Survey, one of the critical weaknesses of the Czech transition was the dispersed ownership structure that was left following the mass privatisation undertaken in the early 1990s, whereby individual stockholdings were consolidated and managed by Investment Privatisation Funds (IPFs).[11] In the context of an inadequate financial-sector regulatory framework, small shareholders were unable to exercise control over managers, and large shareholders were involved in widespread abuses. Energy that could have gone into developing markets and improving productivity concentrated instead on apparently fraudulent financial transactions. Indeed, recent evidence points to the poor track record of voucher-privatised firms where productivity has lagged that of foreign-owned enterprises. A study of the manufacturing sector over 1993-96 found that enterprises privatised to foreign interests had productivity levels twice those of domestic firms, invested five times more per employee, exported one-third more and were more profitable[12] (Zemplinerova, 1998). More recent data indicate that foreign-held companies, while increasing their share in all firms by about 4 percentage points between 1997 and 1998, more than doubled their share in profits

Box 3. OECD principles of corporate governance

Principle	Assessment
Rights of shareholders: The corporate governance framework should protect shareholder rights	Little protection has been afforded to minority shareholders, resulting in fraudulent behaviour such as tunnelling. The Securities and Exchange Commission is making some progress in enforcing property rights but limitations on its authority and ability to make regulations have hampered its effectiveness. Further changes are necessary to ensure that in the cases of takeovers, minority shareholders are protected.
The equitable treatment of shareholders: the corporate governance framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.	Minority shareholders have had little redress via law. Moreover, the legal system is over-burdened and it can sometimes take years for cases to be heard.
The role of stakeholders in corporate governance: The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.	Stakeholders, to a large extent, have had little control over domestically-owned firms.
Disclosure and transparency: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.	Disclosure requirements have been patchy. The Securities and Exchange Commission (SEC) has recently assessed listed firms as to their compliance in this area, and some 1 500 firms have been delisted for lack of disclosure and other problems. Compliance in meeting disclosure is now estimated to be 90 per cent. The SEC is also monitoring trades to ensure no illegal activity is taking place. In addition, the opening of closed-ended funds (to resemble more mutual funds) should allow better monitoring by shareholders and giving them the right to redeem their participation certificates.
The responsibilities of the board: the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders.	In many cases, particularly state-owned firms, the boards have not functioned properly, often serving vested interests, or with members lacking appropriate qualifications to carry out board work.

Table 15. **Productivity and investment**

	Czech Republic	Hungary	Poland
	Per cent		
Labour productivity growth			
1994	1.5	6.5	6.9
1995	5.0	3.4	6.0
1996	3.7	1.9	4.8
1997	0.9	4.3	5.3
1998	–1.0	3.5	3.6
Average 1994-98	2.0	3.9	5.3
Investment-GDP ratio[1]			
1994	28	21	17
1995	32	20	19
1996	33	21	21
1997	32	22	24
1998	31	23	26
Average 1994-98	31	21	21
Memorandum item			
Incremental capital-output ratio[2]			
Average (1994-98)	21.8	9.0	3.4

1. At constant prices.
2. Incremental capital output ratio (ICOR) was computed as follows:
$ICOR\ (t) = \{[investment_{(t-1)}/GDP_{(t-1)}] \times [Real\ GDP_{(t)}/Real\ GDP_{(t-1)} - 1]\} \times 100$

Source: OECD.

over the same period and were also the only group of firms to increase employment (Table 16).

A key recommendation from the previous Survey (see Table 14) was to simplify rules that would allow IPFs to consolidate their holdings to align more closely the interests of shareholders and management. At that time, IPFs were prohibited from taking an ownership stake in any firm greater than 20 per cent and they typically held less than 5 per cent of any one enterprise. New rules introduced in 1998 appeared to create the potential for further fragmentation. They placed restrictions on the ability of IPFs to set up holding companies through which they might have consolidated their shareholdings and taken a more active role in firm management, and they also forced them to divest their interests in any one company from 20 to 11 per cent of its equity by July 1999. Somewhat surprisingly, this divestment process led to further consolidation as various funds grouped their holdings together to create majority stakes that were then sold to strategic investors at a premium. By late 1997, strategic investors held about 17 per cent of all firms compared with only 3 per cent in 1994 and this share is likely to have risen further since then[13] (Table 17). This may be one

Table 16. **Financial conditions in industry**[1]

	Domestically-controlled firms		Foreign-controlled firms	Unincorporated firms	Total
	Public sector	Private sector			
	Per cent of total				
Number of firms					
1997	9	80	10	1	100
1998	7	79	13	1	100
1999[2]	6	78	15	1	100
Employees					
1997	15	76	9	0	100
1998	13	74	12	1	100
1999[2]	13	73	14	0	100
Output					
1997	20	65	15	0	100
1998	18	63	19	0	100
1999[2]	16	61	23	0	100
Pre-tax profit					
1997	32	52	16	0	100
1998	36	36	27	1	100
1999[2]	12	56	32	0	100
Book value added					
1997	20	67	13	0	100
1998	20	64	16	0	100
1999[2]	18	62	20	0	100
Overdue payables					
1997	20	69	11	0	100
1998	16	73	11	0	100
1999[2]	17	67	16	0	100
Primary insolvency					
1997	14	71	15	0	100
1998	10	81	9	0	100
1999[2]	10	72	18	0	100

1. Firms with 100 or more employees.
2. First half.
Source: Czech Statistical Office, Ministry of Industry and Trade.

reason why, despite the recession, the financial condition of enterprises appears to be improving slightly, with operating profits up about 20 per cent in 1998 (Table 18). Nevertheless, while the consolidation of holdings is a positive development for the economy as a whole, minority shareholders remain at a disadvantage. Many were unable to profit from the recent flurry of acquisitions because buyers are not obliged to extend an offer to purchase the stake of

Table 17. **Ownership of Czech joint-stock companies**

	Largest 60 firms		Other 1 500 firms		All firms	
	1994	1997	1994	1997	1994	1997
	Per cent of total market value					
Government	43.1	46.1	4.1	6.5	37.0	42.9
Bank-sponsored IPFs	9.9	8.5	18.0	13.9	11.2	9.0
Other funds/holdings	11.4	16.8	30.2	30.3	14.3	18.0
Strategic investors	3.2	16.9	0.0	21.7	2.7	17.3
Others	32.4	11.7	47.7	27.6	34.8	12.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: World Bank (1999*b*).

minority shareholders unless they seek to acquire 50 per cent or more of shares. In contrast, many other countries set this limit between 25 and 30 per cent (World Bank, 1999*b*). The Ministry of Justice is preparing an amendment to the Commercial Code which seeks to reinforce minority shareholder rights. Expected to be implemented in mid-2000, as currently conceived it would allow shareholders who hold a three to five per cent share (currently 10 per cent) to call a general meeting and would require groups intending to accumulate a 10 per cent or larger share in a firm to get prior approval from the SEC. Failure to do so would see the Commission prohibiting them from exercising the voting rights of those shares.

Under a separate reform, closed investment funds were required to transform themselves, a step which should encourage better enterprise governance, improve the transparency of capital markets and reduce transaction costs. Previously while both open and closed funds existed, the latter did not need to inform investors about the nature of the their holdings and participants could only trade their shares on a secondary market.[14] As a result, the managers of a fund had no direct stake in its performance and trading prices were subject to manipulation. Uncertainty as to the actual worth of funds led to their trading at large discounts relative to their declared values. Legislative changes introduced in late 1998 required that closed funds trading at a discount of more than 40 per cent open themselves. Over time the discount rate above which funds are obliged to transform themselves is to rise until the end of 2002 when all must be open. This welcome development will make IPFs resemble more closely mutual funds and should give investors a better idea as to their value. At the same time, such a reform should encourage IPFs to pay closer attention to their performance and

Table 18. **Balance sheet of non-financial enterprises**[1]

	Current prices (Kc billion)			Constant prices[2] (Kc billion)		
	1996	1997	1998	1996	1997	1998
Sales[3]	1 772	1 935	2 093	1 690	1 761	1 817
Operating costs	1 644	1 806	1 939	1 569	1 643	1 683
of which:						
Intermediate consumption	1 220	1 342	1 441	1 164	1 221	1 251
Depreciation	118	130	142	113	118	123
Labour costs[4]	306	334	356	292	304	309
Other costs	802	838	962	765	762	835
Other revenue	729	766	881	696	697	764
Total profits (before tax)	55	58	73	53	53	63
Operating profits[5]	127	130	154	121	118	134
Net acquisition of fixed assets	240	251	245	229	228	212
Change in stocks	18	15	–12	17	13	–10
	As a percentage of sales					
Intermediate consumption	68.9	69.4	68.9			
Labour costs	17.2	17.2	17.0			
Other costs	45.2	43.3	46.0			
Other revenues	41.2	39.6	42.1			
Total profits	3.1	3.0	3.5			
Operating profits	7.2	6.7	7.3			
	Percentage change					
Sales[3]		9.2	8.2		4.2	3.2
Operating costs		9.8	7.4		4.7	2.4
of which: Labour costs[4]		9.2	6.7		4.2	1.6
Other costs		4.5	14.8		–0.3	9.6
Other revenue		5.0	15.1		0.1	9.6
Total profits (before tax)		4.9	26.3		0.0	18.9
Operating profits[5]		1.9	18.4		–2.8	13.6
Net acquisition of fixed assets		4.6	–2.4		–0.3	–7.0

1. Enterprises with 100 or more employees.
2. PPI deflated.
3. Includes the sales of all products and services of non-financial enterprises.
4. Includes wages and social security costs.
5. Defined as sales minus operating costs.

Source: Czech Statistical Office.

that of the companies in which they hold interests because holdings in an open fund can be immediately redeemed at a well established market price (although sometimes subject to a fee). So far, progress towards opening closed funds has been slow, with only 3 per cent of them having opened up. On the other hand, the whole sector has undergone a substantial consolidation, with the number of investment management companies having fallen from 112 in April 1998 to 60 in June 1999. Over the same period, the number of investment funds fell from 105 to 54, that of open-ended mutual funds from 145 to 57 and of closed-ended funds from 85 to 27. Initial concerns that the opening process would reduce market liquidity proved unfounded, as funds built up substantial liquid assets in preparation for redemptions (the typical portfolio of an investment fund is now 25 per cent shares, 48 per cent bonds, 21 per cent deposits and 6 per cent other assets).

The government has taken steps to sever the links between banks and IPF management companies, but more needs to be done. An amendment to the Bank Act in 1998 explicitly prohibits banks from exercising direct or indirect control over legal entities other than banks and financial institutions; the Central Bank estimates that, by the end of that year, only four banks were in breach of this rule – mainly because the companies concerned were in the process of being liquidated. At the same time, investment companies are now legally prohibited from exercising the voting rights arising from shares owned by the funds that they manage. These changes clearly raise important legal barriers preventing banks from using their position as owners of investment companies to influence firms' behaviour – potentially to the detriment of minority shareholders. However, given past experience and in the absence of any compelling reason why banks should be allowed to maintain ownership of management companies, this link should be completely severed. This would help alleviate any potential for a conflict of interest via a bank using its shareholdings, its ability to appoint board members (although its own employees are prohibited from sitting on a board) and its control of investment fund companies to influence a firm's borrowing policies. In such situations, a bank could force profitable enterprises in which it has a partial interest to take on loans at above market rates that could then be used to subsidise loss-making companies where it also has a holding – to the detriment of the minority shareholders of the first firm. Here, the conflict between the bank's and other shareholders' interests are even more serious when a bank's financial situation is precarious. The bank will be doubly motivated to keep lending to the loss-making firm because both the company and the loan appear on the asset side of the bank's balance sheet and foreclosure could eliminate both. In such instances, a firm's management or the IPF may not act in the best interests of their respective shareholders. Indeed, it is suspected that such practices have occurred in the past, and this may explain why bank-owned IPFs tend to be associated with poorer firm performance than those independent of banks (Weiss and Nikitin, 1998). Currently, half of the market of newly established open-ended funds is controlled by management firms owned by *Sporitelni investicni spolecnost*, which is in turn held by *Ceska sporitelna*.

Investment incentives

A relative lack of foreign direct investment (FDI) was identified in the previous *Survey* as having contributed to the Czech Republic's poor productivity performance. Firms with foreign participation tend to have clear ownership structures and better access to the best technology and management techniques. Over the past year and a half, the country has become much more open to foreign investments and partly because of the sell-off of IPF holdings to foreign strategic investors, the rate of FDI inflow has increased dramatically, although in absolute terms it still lags behind other central European countries (Table 19). In addition, in 1998 the government introduced the country's first programme of investment incentives, which were subsequently enhanced in 1999. The threshold for an investment below which support is denied was lowered from 25 to 10 million euros, and maximum grants associated with job-creation were raised from Kc 80 000 to Kc 200 000 per job. Any potential investor that meets all of the regulations pertaining to the programme qualifies for the incentives which are currently provided in the form of subsidies and decided on case by case, although they will soon be given a legislative basis that will avoid this administrative process.[15] For the moment incentives are only available for greenfield projects, but this restriction is also to be lifted with the passage of the legislation. As of November 1999, these incentives had attracted almost $1.1 billion in investment through twenty projects.

A new government programme to assist municipalities purchase land and set up industrial zones and supporting infrastructure was created in 1999 with initial funding of Kc 158 million. The authorities hope that this measure will address some of the serious problems that potential investors have encountered in finding sites suitable for industrial development.[16] Despite these changes, conditions remain stringent in some areas, *e.g.* investment in machinery must be 40 per cent of total investment and only foreigners with a residence in the Czech Republic can buy land or structures on it. Furthermore, given the expected acces-

Table 19. **Foreign direct investment**

	1993	1994	1995	1996	1997	1998	Total
	$ billion						
Czech Republic	0.6	0.9	2.6	1.4	1.2	2.5	9.2
Hungary	2.3	1.1	4.5	2.0	2.1	1.5[1]	13.5
Poland	0.6	0.5	1.1	2.7	3.0	4.0[1]	11.9

1. Estimated.
Source: Ministry of Industry and Trade; European Bank for Reconstruction and Development (1998).

sion of the Czech Republic to the EU, the country is likely to be the destination of considerable investment, raising the spectre that the incentives will lead to significant deadweight losses. Finally, coordination among various levels of government to ensure that centrally determined objectives are met (particularly after a regional structure is set up).

Bank privatisation

Privatisation of the remaining large state-owned banks is, perhaps, the most critical step needed to improve overall corporate governance and, thereby, economic performance. In the past, the banks have been a source of access to easy credit that enabled firms to postpone restructuring and fund repeated losses even as they granted large wage increases that were well in excess of productivity gains. Indeed, lending by the banking sector is much higher compared with other OECD countries at similar stages of development, *e.g.* Hungary, Poland, Mexico (Table 20), and recent research shows that during the transition firms in the Czech Republic were awash in credit, drawing strongly on bank loans both to start up companies and to expand them (Bratkowski *et al.*, 1998). In contrast, in Hungary and Poland, retained earnings were the principal source of finance (Table 21).

The government announced its intention to sell off its remaining shares in the four largest banks in April 1997. Some two years later only its holdings in *Investicni a potovni banka* (IPB), whose privatisation was begun in 1996, had been disposed of. More recently, the pace of privatisation has picked up. In June 1999 the state's 66 per cent stake in *Ceskoslovenska obchodni banka* (CSOB) was sold to Belgium's *KBC Bankassurance Holding* for about Kc 40 billion,[17] while a second bank, *Ceska sporitelna* (CS), has been tendered for sale with the government now expecting a deal for its 52 per cent share to be completed by early-2000. Finally, preparations for the sale of *Komercni banka* (KB) the largest (and most heavily indebted) Czech bank, are now under way with the public tender announcement published in August and the government anticipating its sale by mid-2000.[18]

The delays in the privatisation of the banks were not without cost. Their declining economic health has reduced their market value, while the government has been obliged to spend some Kc 60 billion since December 1998 to keep them afloat. As regards *Ceska sporitelna*, the government approved a Kc 7.6 billion equity increase and two transfers of bad loans to *Konsolidacni banka* (KoB) (a state-owned depository for bad loans) in the amounts of Kc 10.5 billion and Kc 33 billion respectively.[19] In addition, in August the authorities instructed *Konsolidacni banka* to purchase bad assets worth Kc 23.1 billion from *Komercni banka* for Kc 13.6 billion to maintain the bank's capital adequacy ratio. The government had initially intended to double the bank's equity via a public offering of new shares, agreed

Table 20. **Domestic lending in OECD countries**

	1995	1996	1997
	Per cent of GDP		
Australia	80.9	85.4	87.5
Austria	128.3	129.4	132.0
Belgium	151.9	152.3	147.0
Canada	95.1	99.7	103.3
Czech Republic	**82.3**	**76.4**	**79.8**
Denmark	53.8	55.6	56.0
Finland	67.9	62.9	56.5
France	101.6	102.3	102.2
Germany	130.0	136.7	141.5
Greece	89.6	84.1	..
Hungary	49.1	..	..
Iceland	52.8	53.3	..
Ireland	81.0	83.2	..
Italy	96.6	94.7	92.9
Japan	294.2	295.4	296.0
Korea	69.4	74.5	86.1
Mexico	50.3	38.5	30.0
Netherlands	117.4	123.4	132.6
New Zealand	85.4	88.6	98.3
Norway	76.7	74.5	73.3
Poland	34.3	35.8	36.9
Portugal	90.0	95.5	99.3
Spain	105.5	106.1	108.6
Sweden	122.5	67.8	73.0
Switzerland	183.4	182.3	184.2
Turkey	28.8	34.4	34.1
United Kingdom	125.5	130.1	129.3
United States	130.1	137.1	148.7

Source: World Bank Development Indicators.

Table 21. **Sources of credit for firms**

	Czech Republic	Hungary	Poland
	Per cent of all credit		
Financing start up[1]			
Own capital	53.7	84.8	79.8
Bank credit	20.7	4.2	4.4
Other	25.6	11.0	15.8
Financing investment[2]			
Own capital	23.8	31.4	41.3
Bank credit	36.0	18.0	19.8
Other	40.2	50.6	38.9

1. Per cent of credit derived from each source by newly-established small private firms over the period 1990-94.
2. Same firms seeking additional financing over the 1990-94 period.

Source: Bratowski *et al.* (1998).

to by shareholders in May 1999, but this action was challenged by a minority shareholder and the issue was only resolved in November, thereby delaying the capital increase until late December.[20] The government has also indicated its intention to pump two-thirds of the proceeds from the sale of the CSOB into the sector.

Despite the capital boost, initial interest from foreign investors for both banks was lukewarm given their still high share of classified credits. Nevertheless, the government has entered into exclusive negotiations with *Erste Bank* (Austria), who provided three binding tenders for the bank, one assuming no loan guarantees, another assuming a pre-sale partial cleanup of the 43 per cent of loans that are classified and a final proposal, the nature of which was at its discretion. In its original tender of CS the government indicated a preference for a ring-fencing operation, whereby the purchasing bank would acquire the bad loans but not the credit risk associated with them and the government would set up an incentive structure to encourage collection of the loans. This would have the advantage that the government could minimise its initial costs in the transfer to private hands, while placing loan collection in the hands of the new bank management as opposed to *Konsolidacni banka,* which is already the repository for a huge number of such loans. The disadvantage is a potentially lengthy period of negotiations to settle the contract while the bank's books continue to worsen and the acquisition by the government of yet another future liability of unknown size.[21]

Since launching the initial tender the government has acted to make *Ceska sporitelna* a more attractive to potential investors by transferring much of its bad loan portfolio to *Konsolidacni banka*. How the government intends to proceed with the privatisation of *Komercni banka* has not been made public but it has indicated that it expects to transfer as much as Kc 60 billion in bad loans to KoB to make the bank more attractive to potential investors. Such transfers reduce the dispersion of bad corporate debt by concentrating them in the hands of KoB, which may improve its ability to sell the bad loans or transform them into equity stakes that could then be sold to strategic investors (it is estimated that KoB has some 4 500 debtors owing some Kc 139 billion, 75 per cent of which are thought to be non-performing). However, for this consolidation to reap real economic benefits, *Konsolidacni banka* will have to become much more active in its efforts to collect or sell off the bad debt. So far, it has acted principally as a passive repository and, therefore, has not contributed to a resolution of the burden that these loans place on firms.

Further disposal of state assets is necessary

Recent progress in the privatisation of other sectors has been disappointingly slow. Indeed, the most recent data indicate that the market value of shares still owned by the government is equal to 43 per cent of the total value of all joint stock companies (Table 17). The overall holdings of its agent, the *National Property Fund* (NPF), encompass 38 strategic firms (that it is legally obliged to retain) and 258 non-strategic companies, including golden shares in 60 of them.[22] The authorities have not been clear on how, or when, they will dispose of these assets, nor why they hold the golden shares. The slowness of the divestment process can be partially attributed to the size and importance, in employment and political terms, of some of the strategic firms. For others, such as natural monopolies, the lack of a regulatory framework continues to make their immediate privatisation problematic. Finally the disposal and consolidation of some of the smaller shareholdings is being blocked by court procedures or being held against potential liabilities of the NPF.

The industry revitalisation plan

On 14 April 1999, following months of debate, the government announced an industry revitalisation plan in an effort to overcome some of the political difficulties surrounding the privatisation of its holdings in some of the country's largest and economically-weakest firms. While the government had initially envisaged moving very quickly, a contract with the administrator for the Revitalisation Agency or *Revitalizacni Agentura* (RA) – a consortium of Lazard Frères and Latona Associates of Europe – was not signed until October. The Agency is wholly owned by *Konsolidacni banka* (with an initial capital base of Kc 100 million) and is charged with restructuring the debt and, if it sees fit, the management of a number of large firms that the government has pre-selected for revitalisation. The administrator has chosen not to take an equity position in the RA and will be remunerated on a fee-for-service basis complemented by additional success fees. Other details of the government's contract with the manager have not been released and are considered confidential.

The agency is to have a broad role to play in the overall restructuring of troubled firms, including: administration of assets; determining how to maximise their value; implementing cost cutting programmes and formulating new business plans; as well as deciding whether firms should be wound up or whether their equity stakes should be divested to strategic partners, private investors or management teams (see Box 4). In essence, the government will re-nationalise some firms (or part of them) with the RA manager determining how to best maximise their value for resale, either by disposing of them through liquidation, restructuring and subsequent sale, or simple privatisation. The goal is to select ten companies, staggered over a sixteen-month period, and to complete their restructuring prior to EU accession (anticipated by end-2002). The government has drawn up an initial list of eight firms that are eligible for revitalisation and from which the RA

Box 4. The role of the Revitalisation Agency

There are three key components to the Revitalisation Agency (RA): its structure; the restructuring options it might propose; and the criteria it must use when selecting firms for participation.

The governance structure of the RA is defined as follows:

– A five-person *board of directors* made up of three representatives appointed by the administrator of the RA (including the CEO and chair of the board) and two nominated by *Konsolidacni banka* (which has a 100 per cent stake in the RA). The board is responsible for the implementation of the revitalisation programme.
– A *supervisory board* made up of state administration employees and chaired by a Ministry of Industry and Trade representative will monitor the RA's accounts, its operations and its compliance with laws, articles of association and shareholder resolutions.
– A nine person *investment committee* that encompasses the board of directors and four additional independent members selected by the board of directors and appointed by the shareholders (KoB owns 100 per cent of the agency). The Investment Committee will decide which firms will participate in the revitalisation programme, including how to best to recover a firm's debts and to restructure a company, as well as making recommendations for bankruptcy.

Three restructuring options are proposed, although the exact option (or combination thereof) chosen will depend on the investment committee. Under the *first* of these, banks would be allowed to decide themselves on how to clean up their troubled loan portfolios, and thus firms. The state would cover part of the losses through loan restructuring, and a time frame for settlement would be imposed. In the *second* option, debt-for-equity stakes would be taken by the Revitalisation Agency, by the banks or government, and these stakes then re-sold. A *final* mechanism that was not adopted would have seen the creation of restructuring companies that would, following debt-for-equity swaps, take control of firms (this option would have required changes to the tax system and other laws).

Potential candidates for revitalisation must meet a number of criteria. *First*, the workforce must be greater than 2 000 people; *second*, it must buy more than Kc 1 billion worth of products from domestic suppliers; *third*, it must have debts of over Kc 3 billion at the *Komercni banka*, *Ceska sporitelna* or *Konsolidacni banka*; *fourth*, firms' management must be willing to co-operate with the RA, shareholders must be willing to accept an eventual dilution of their ownership stakes, other creditors must be deemed likely to agree to a restructuring plan; and finally, after taxes and interest payments, the company must be profitable. The government has pre-selected firms for participation (the RA will choose the final candidates from this list). Those actually assisted could be eligible for additional support, such as guarantees on new loans, investment incentives, etc.

can choose (Aliachem, CKD Praha, Spolana, Skoda Plzen, Tatra, Vitkovice, Zetor and ZPS Zlin). The RA manager can propose additional firms but these must be approved by the KoB appointed board members before they can participate in the programme.

The ultimate success or failure of the RA will depend upon the extent that it is able to restructure those firms conferred to it. In this regard, if decisions are to be made on economic and business principles, the government will need to refrain from using its 100 per cent ownership stake in the RA to influence the process. Although concerns over potential job losses are understandable, in many instances they will be inevitable if selected firms are to be put on a sound footing. Such displacements should be addressed through suitable active labour market programmes (see below) rather than conditions imposed on restructuring deals. The success of the programme will also be affected by the extent to which the agency will be able to convince existing shareholders to accept its solutions. As discussed below, weak bankruptcy legislation and poor protection of creditor rights mean that the legal mechanisms at its disposal for coercing co-operation are few. Nevertheless, the large debts of these companies held by *Konsolidacni banka* and the state's substantial equity position in many of them will give the agency some leverage, although the RA may be forced to increase its shareholdings in selected firms to gain additional leverage. Finally, the government has decided to interpret the profitability criteria for client firms in a forward-looking manner. The more ambiguous nature of this test increases the risk that political rather than commercial factors enter into the decision making process.

Reforming the regulatory framework

The privatisation of a number of state-owned assets is being held back by delays in the creation of an appropriate regulatory framework for so-called natural monopolies. This absence is also reflected and exacerbated by the relatively large range of prices that remain administered and the opacity with which they are set[23] (principally by the Ministry of Finance). The lack of well-defined and known formulae makes it difficult for investors to judge the future profitability of investment opportunities, while introducing at least the potential for arbitrariness in the setting of prices.

In addition, as discussed in the previous Survey, prices of a number of goods and services are being held back well below their market levels. Indeed on average, regulated prices are about 45 per cent lower, and the government estimates that their liberalisation would add up to 10 per cent to the overall consumer price index. It is, nevertheless, committed to allowing these prices to rise to market levels by the end of 2002 and eliminating the cross-subsidies between corporations and households (industrial prices are currently 50 per cent higher than household prices). In this regard, the government recently announced that it intends to raise electricity and gas prices in the energy sector by 15 per cent on average as of 1 January 2000. This will be followed by rate hikes of 14 and 13.1 per cent for electricity and 10.7 and 7.5 per cent for gas in the years 2001 and 2002 respectively. In addition, water prices will be increased by about 33 per cent over this period. While this is a positive development, the government has yet to indicate the timing or magnitude of the remaining regulated price increases needed to achieve its goal of ensuring that regulated prices cover economically justified costs and an adequate return on capital by end of 2002.

Just as the process of liberalising prices has been difficult, the creation of an independent regulatory body and a legal framework in which monopolies can operate are not easy tasks. Here, progress has been much slower than in other countries such as Hungary and Poland. The government is working on several draft laws that would set up such frameworks in several industries. The authorities need to proceed rapidly to bring these proposals into law as continued delays can only further postpone the privatisation and inflow of foreign capital that will permit the various infrastructures involved (telephony, intranet, electricity, gas, etc.) to expand unfettered by the government's budget constraint. In this respect, some recent developments are not reassuring. Indeed, the government refused to allow the private sector partner in the national telecom to buy back shares, a move that would have given them control of the firm. In addition, announcements concerning the imminent sale of the electricity and gas companies have been inconsistent (see Box 5), with the government having undertaken a certain amount of renationalisation by persuading municipalities holding an interest in some utilities to transfer their shares to the central government. While the government has indicated that it would like to continue to protect domestic energy producers, particularly electricity which comes primarily from brown coal, from relatively cheaper imports it is preparing a new Energy Act that will gradually open electricity markets beginning in 2002 and gas markets starting in 2005.

By the same token the government's abandonment in 1999 of its programme of large hikes in controlled rents so as to bring them into line with market rates, only postpones the inevitable need to address the problem which, as emphasised in the previous Survey, perpetuates the serious distortions they cause to labour market mobility and to the construction and renovation markets.[24] The government raised rents by only 9.3 per cent in 1999 and has decided on increases in the following two years of no more than the construction price index with an adjustment factor of up to 20 per cent for Prague.[25] It proposes to then replace the current system of centrally determined rent increases with one where rents are negotiated between landlords and tenants based on the notion of a "normal" level for a given locality or area. These changes would not be sufficient to achieve the government's objective of equalising controlled and market rents by end of 2002 (indeed, rents in Prague are between five to ten times lower than the market rates). Concerns that the social cost (of allowing rents to rise more quickly) would be too high appear to be unfounded. On the one hand, the fact that following past increases, actual rents did not rise as much as the maximum in

Box 5. Progress in regulatory reform

Utilities: The government announced in June 1999 that it would speed up privatisation of its sixteen gas and electricity distribution companies, a welcome development but one which was first announced in 1995, and remains clouded by mixed signals. For example, while municipalities, which hold a 34 per cent stake in the eight electricity distribution plants and have been selling options (the shares themselves are currently non-tradeable) to foreign investors, the majority state-owned electricity company, CEZ has entered into the market to regain control of the options. This is not only a costly exercise but one which delays the process to complete privatisation. Indeed, in the course of 1999, the central government used its moral suasion to prevent the city government of Pesa from selling its stake in the regional distributor. In the area of petrochemicals, the government has decided to push ahead on privatisation of Unipetrol and anticipates its sale in 2000. Most recently, the government has announced its intention to propose a schedule of energy sector privatisations for internal discussion in the first quarter of 2000. Privatisation itself will not proceed until the new Energy Act enters into force, some time in 2001.

Telecoms: The monopoly currently enjoyed by *SPT Telecom* (with one-third of its shares held by the Dutch-Swiss consortium TelSource and 51 per cent held by the *National Property Fund*) is set to expire on 1 January 2001. The government indicated in September that it would like to have the privatisation process completed by this date, but has been indecisive on this issue, rejecting an earlier attempt by *SPT Telecom* to buy some of the government's remaining holdings on the grounds that this would have further diluted its holdings and made it difficult to privatise the remaining shares at a good price. The decision to speed up the sale may reflect the government's efforts to increase its cash reserves as it privatises the banks. Its market value is currently estimated at about $6 billion. The government has also announced that it will accelerate privatisation of *Ceske Radiokomunikace*, hoping to complete the sale by mid-2000. The authorities have approved a new National Telecommunications Policy that will, among other things, describe steps to strengthen regulation, encourage further liberalisation of the market and open it up to competition. Moreover, a new draft Telecom law has passed its first reading in the parliament. The government is also developing a new pricing policy, although it has yet to indicate whether it will move to a price-setting mechanism that includes an explicit productivity adjustment.

Insurance: The government's monopoly on third party motor vehicle insurance through *Ceska pojistovna* ended on 13 July 1999. Insurance companies with a license from the Ministry of Finance will be able to offer car insurance, subject to its approval, beginning in January 2000. Currently, eleven of thirteen applicants have had licenses approved. In addition, a new Act on Insurance approved in November 1999 seeks to put the insurance industry on a more firm footing, forcing insurance companies to split their business into life and non-life insurance units, increase capital requirements, and move regulation towards monitoring financial stability and away from setting insurance conditions, *e.g.* rates, etc. As regards other monopolies, the government still maintains one in the area of workers compensation insurance.

Transportation: Virtually no progress has been made here. The government plans to maintain its subsidies for passenger service on railways (although it no longer subsidises freight) and buses despite the fact that at least in the latter case, many

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countries have easily opened up this market to competition. The argument used to keep it closed is a familiar one: to guarantee service to small communities. The railways also continue to sap government funds: a Kc 8.1 bailout was required in 1998 to cover losses and its debt is now estimated to exceed 1 per cent of GDP (see Chapter II). Moreover, the government has set no date as to when deregulation of passenger railway prices will take effect.

some communities suggests that in these areas the controlled rents are no longer binding and that the programme has been a success, while, on the other hand, the need to allow rents to rise to markets levels does not mean that the state or municipalities could not offer "social housing" at reduced rates to those in need; rather it implies that access to such subsidised housing should be explicitly means-tested and be part of the social assistance programme. In areas where rent controls are no longer binding they could, and should, be abandoned while in other regions the rate of increase should be set high enough to equalise controlled and market rents over a set period of time, say five years. Moreover, to prevent the move to a decentralised rent control system from locking in pre-existing price distortions, it will be essential for rents to be at market levels before introducing the new system. Thus, the proposed method of adjustment could only be adopted quickly in areas where rents are already at these levels. Even if rent controls were abolished, however, legislation would have to be modified because, currently, it does not allow owners to increase rents without a tenant's approval, something that the proposed law would partially achieve by allowing landlords to set rents at the same level as for similar apartments in a given area.

The need for a new bankruptcy law

The plight of several of the smaller firms in which both the state and various other bodies hold interests will not be resolved completely until the bankruptcy law is changed. While some progress has been made in consolidation via sales by the IPFs, the ability of banks to restructure many of their small loans is severely limited. In particular, the current bankruptcy law makes foreclosure costly and cumbersome, while constraining the ability of banks to seize and sell collateral.

There were over 4 300 petitions for bankruptcy and over 2 000 companies were declared bankrupt in 1998, and part-year data suggest this number may be exceeded in 1999 (Table 22). Despite the increase in declarations, the 1998 figures represented only 17 per cent of outstanding petitions, and

Table 22. **Bankruptcies**

	1994	1995	1996	1997	1998	1999[1]
Petitions	1 826	2 400	2 996	3 311	4 306	2 270
Declared	294	727	808	1 251	2 022	1 001
Per cent of outstanding petitions declared	16.1	18.5	13.0	14.4	17.2	8.3
Motions of settlement	921	1 117	1 716	2 047	2 418	1 470

1. January to June 1999.
Source: Ministry of Industry and Trade.

bankruptcy remains a slow process with delays arising because judges are both allowed considerable discretion in accepting a petition – which, if accepted, inevitably leads to liquidation – and rulings can be appealed. In addition, if a bankruptcy is declared, the process of liquidation – and thus creditor's realisation of their assets – tends to be very long, partly because court-appointed administrators are paid, not from the proceeds of any liquidation, but rather by the duration of the process.[26] Thus, once a petition is granted, the actual winding up of the firm can take a considerable amount of time. Moreover, for a bank to seize collateral, a court decision is required, which takes years (the average duration of a commercial case is two to three years) and, when real estate is involved, requires the debtor firm's permission for the actual sale.[27] In addition, seizing so-called moveable assets, such as cars and machinery can be problematic because typically no registry of such possessions is available.

The 2 400 motions of settlement made before the courts in 1998 represent a form of voluntary bankruptcy under which debtors, via the court, make an offer to settle with creditors. Rather than operating as a kind of "work-out" bankruptcy, debtors tend to use this route to buy time since bankruptcy petitions cannot be started while the court considers the motion, which it can reject summarily or place to a vote with the creditors. Indeed, few such motions are ever agreed to, either by the court or creditors, and the latter complain that debtors use the delay to strip assets from the company.

In view of such difficulties, the government has proposed to modify once again the current bankruptcy law (it has been amended on average once a year since the beginning of the transition). In addition, modifications are planned to the *Code of Civil Procedure*. If passed in their current form, the amendments would speed the process and improve the protection of creditor rights. For example, attorney's remuneration would no longer be tied to the number of steps performed, while the means by which writs could be served (currently limited to registered mail) would be expanded to ensure that debtors could no longer delay proceedings simply by not reading their mail. This change, plus a proposal to allow the appointment of an interim trustee prior to the court's appointment of an official one, should help prevent debtors from using these delays to strip assets from bankrupt firms. A third piece of legislation seeks to improve creditor's capacity to realise collateral. Unfortunately, the draft requires that the creditor's claim on the collateral be certified by a notary or the courts. While this may help guarantee future loans, it will be of little practical relevance for the billions of koruna in old loans where a notary was seldom used. Finally, a *Law on Court Seizures* is being prepared. This would serve to eliminate the current onus on creditors to identify assets that could be seized by giving the court investigative powers. Unfortunately the bill is not well advanced and is being delayed by, among other things, ministerial disputes over what powers should be granted. Any changes to legislation, however, will require modifications to the judiciary, which is still poorly equipped to deal with the requirements of a market economy (EU, 1999). Retraining of judges is underway and this will be critical to the success of any new legislation, but it will take time before judges can quickly and accurately interpret new laws as they come on stream.

Despite the constraints faced by creditors under the current laws, declining profits in the banking sector (see below) have forced banks to begin to better manage their balance sheets, and they now appear more ready to take on delinquent firms. One prominent petition concerned the Chemapol group, one of the largest corporations in the Czech Republic. In December 1998 the CSOB, and later Credit Lyonnais, submitted bankruptcy proposals to the Regional Commercial Court. The case was resolved relatively quickly when, in late January 1999, an administrator was appointed to settle claims against the company. In addition, the large engineering firm (CKD) was saved from bankruptcy by banks creating a creditor committee to revamp company operations. Finally, creditor banks took control of Skoda AS (heavy machinery), fired the chairman and are now deciding whether to split it up and sell parts to strategic investors.

Summing up

The lack of a clear corporate governance structure has impeded industrial restructuring and contributed to the poor economic performance of the Czech Republic. Much progress has been made in this regard although additional steps are required. Foremost on the list to improve enterprise governance is privatisation of the remaining state-owned banks. This will help to harden the budget constraint facing firms, thereby encouraging their restructuring. The process to complete their transfer to strategic investors is well underway, and the government should complete it as quickly as possible. The government has been helping clean up banks' balance sheets by transferring a large proportion of banks' bad loan portfolios to *Konsolidacni banka* at favourable terms. This should help speed the privatisation process and may also help to consolidate the loans and equities with one lender, making it easier to arrange a restructuring of the debtor companies, either by their eventual sale or through liquidation. To be successful, however, *Konsolidacni banka* will have to become much more active in managing and selling off its growing bad loan portfolio (which will require skilled people in this area) or ensure that the RA administrator becomes actively involved in finding potential (preferably strategic) investors for such firms as well.

The RA manager is also expected to play a decisive role in the restructuring of several large firms in which the state has direct or indirect (via the banks) interest. Several potential problems loom on the horizon, however. For example, despite the requirement that there be an agreement among creditors on a restructuring plan before a firm is selected, it is not clear that the RA administrator will have the power to: *i)* restructure firms by replacing management and boards (it is not inconceivable that its decisions be blocked by the authorities); *ii)* force a firm into bankruptcy (particularly given current laws); and *iii)* sell off non-strategic assets (given foreclosure laws). This argues for a quick replacement of the bankruptcy law (see below). In addition, the ability of the government to overrule RA decisions on ''social'' grounds should be clarified, and if such cases arise, how restructuring will take place. Financing details have yet to be sorted out, but it appears that the RA does not currently have enough capital to take a significant share in any firm, let alone a number of them. Here, the *Konsolidacni banka* could continue to search for other partners for the RA.

The revitalisation programme is directed only towards the largest firms, thus it is essential that it not become a vehicle for saving them at any cost. In this regard, the incentive structure built into the performance contract negotiated with the manager is a welcome step in ensuring that business principles will be followed. These same principles should also be followed when deciding which firms to assist and when evaluating in a forward-looking manner their potential to become profitable. Finally, it is critically important that the process be begun – and terminated – as quickly as possible with non-viable firms being liquidated, and renationalised assets privatised swiftly and not used as a means to maintain large state-holdings. Moreover, given the history of different governance structures in the Czech Republic, it seems clear that where possible, sales to strategic investors should be preferred and management or employee/management buyouts avoided.

While the revitalisation programme addresses some of the issues facing the biggest firms in the Czech Republic, it includes no measures for the vast majority of enterprises. Here, the overhaul of the bankruptcy law will be of critical importance, both by ensuring that creditor-firms get paid and also by freeing up resources currently employed in unproductive uses. Moreover, many small firms in poor condition will continue to need assistance, which argues for the bankruptcy law's immediate replacement (in conjunction with bank privatisation). Many of the proposed changes in the bills currently before parliament represent important improvements over the existing legislation. If passed, the ability of debtors to delay proceedings and strip assets will be significantly curtailed. In addition, revisions to the means by which administrators are remunerated should increase the chances for speedy resolution, while changes to the law concerning the realisation of collateral will (at least in the future) serve to reinforce creditor's rights. Nevertheless, many additional steps need to be incorporated into the new bankruptcy legislation. In particular, the new law should explicitly allow for workout bankruptcies to give debtors and creditors the incentive to reorganise and restructure firms before declaring bankruptcy. In addition, it is essential that the legislation explicitly indicate that it applies to all new petitions for bankruptcy regardless of the point in time when the debt was acquired. Failure to do so risks having the law overturned because of constitutional prohibitions against the passage of retroactive legislation. The new law should also expand the range of agents allowed to take on the role of administrator (currently limited to physical individuals) to include specialised firms. Finally, long delays between the tabling of a bill and its eventual entering into force (as long as two and a half years) means that the draft should be placed before parliament as soon as possible.

A stumbling block in the area of bankruptcy has been the court system. Judges tend to exercise too much judgement in this area, or are unfamiliar with many of the issues currently facing them, each factor prolonging costly court procedures and trials and hindering restructuring at all levels. In addition to the retraining of judges, consideration should be given to setting up specialised courts to deal with some of the more pressing issues, for example bankruptcies and foreclosures.

The transfer of many state-owned "natural monopolies" to private hands will require the government to continue recent progress setting up a regulatory framework that creates and enforces level playing field conditions. This includes: the swift creation of appropriate regulatory structures; the implementation of transparent price-setting mechanisms; the move to market prices as quickly as possible; and the elimination of sporadic assistance to firms which sometimes suggests the influence of vested interests. As concerns investment incentives, the government hopes to use them to speed up privatisation and improve corporate governance, while at the same time directing investment towards infrastructure projects in the poorest areas of the country. To date, these appear to have been successful in drawing in new funds, but their longer-term impact is unclear and a process for evaluating them should probably be set up in order to minimise associated deadweight losses.

The consolidation and sale of IPF stakes to foreign investors is a positive development. Nevertheless, the potential for confused governance and conflicts of interest still exist because banks can own their management companies in addition to holding shares directly in firms. Links between the IPFs and banks should therefore be severed. In addition, while limits have been placed on the ability of IPF's to set up holding companies, a positive role for venture capital funds does exist and the government should consider allowing their operation, regulated by the Securities and Exchange Commission.

Since the move to consolidate holdings is likely to continue, more protection must be afforded to minority shareholders. In this regard, the draft commercial code, which would improve transparency, should be quickly passed. In addition, better enforcement of information disclosure, and conditions under which minority shareholder stakes can be bought out are required. The Securities and Exchange Commission (see below) will also have to carefully manage the opening of funds to ensure both market stability and the protection of minority shareholders when stakes are sold to strategic investors. One way to do so would be to lower the current 50 per cent threshold above which a purchase offer must be made to below 25 per cent.

The financial system

As described in the previous *Economic Survey of the Czech Republic*, the easy credit policies followed by the large state-controlled banks and a complicated ownership pattern, whereby they held equity positions in many of their debtors, contributed directly to the 1997 currency crisis. Since then, the authorities and the banks themselves have implemented a number of reforms recommended in that Survey (see Table 14). In particular, the Czech National Bank tightened provisioning requirements and revoked the licenses of eleven banks,[28] while the government has proceeded with the privatisation of the remaining state-owned large banks (see above). These actions are, over time, likely to improve the functioning of the banking sector, with the eventual result that it will begin to make a significant positive contribution to the allocation of resources in the economy. For the moment, these steps have forced banks to become more aggressive in managing their portfolios, reducing access to credit and increasing their stock of provisions.

Strengthened prudential control in the banking sector

The principal motivations behind the prudential changes undertaken by the authorities (Box 6) were: the desire to harmonise rules with international standards (and particularly directives of the EU); the significant difficulties apparent in the banking sector, in particular the high share of bad loans in banks' balance sheets; the near bankrupt condition of several banks and the rising share

Box 6. Changes to prudential supervision in the banking sector

The authorities introduced a number of changes to prudential supervision since the previous Survey. Their actions have had two main thrusts: to improve transparency for market participants with the underlying objective to foster market discipline, and to increase the CNB's oversight of their operations. In particular, the CNB:

– Strengthened on-site inspection teams.
– Toughened minimum disclosure requirements and added new requirements on what should be included in a bank's performance reports to ensure that risks are adequately identified. Banks still do not have to follow IAS accounting standards; nevertheless, some of them do so in their audited annual reports.*
– Implemented new rules on the purchase of voting shares. Prior consent is now needed when acquisition leads to a direct or indirect holding of over 10, 20, 33 or 50 per cent of voting rights. Similarly, the CNB must be notified if holdings fall below these levels.
– Created a more vigilant approval process for a bank license, basically strengthening the "fit and proper" test on owners.
– Tightened provisions on loss loans backed by real estate. Because banks have significant difficulty in seizing real estate in the case of loan default, the CNB implemented a regulation in 1998 forcing banks with loans more than one year overdue and secured by real estate (and not by other collateral) to create cash provisions of an equal amount within three years. Understandably, this had – and will have – a large impact on bank profitability, which has been, as noted above, mitigated to a certain extent by the reduction in mandatory reserve requirements.

The government also modified banking legislation by:

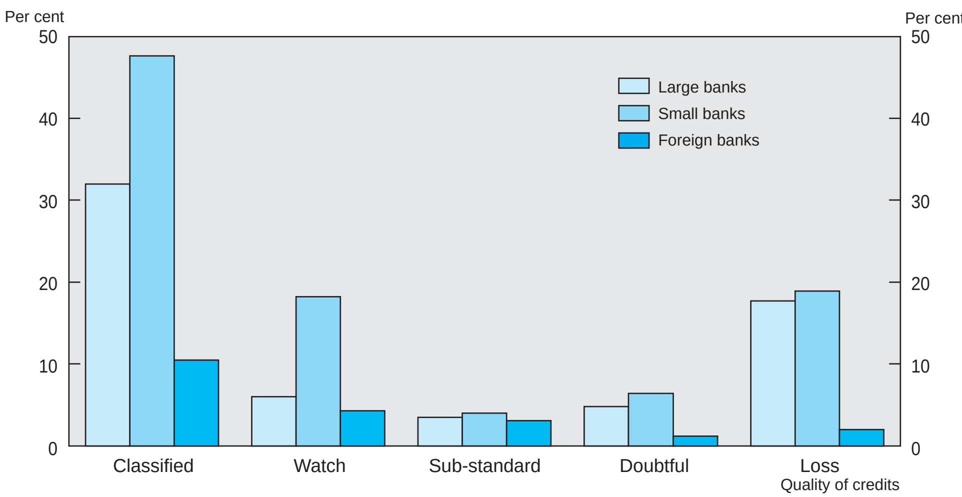
– Placing limits on bank's holdings in other institutions (with the exception of banks, other financial institutions and businesses providing ancillary banking services), obliging the CNB to withdraw a bank's license if its capital/asset ratio declines below one-third of the prescribed limit (if this ratio falls below two-thirds of that limit, the CNB imposes remedial measures).
– Increasing deposit insurance limits by Kc 100 000 to Kc 400 000, and exempting some persons from coverage, including those who have contributed to a bank's poor performance due to criminal activity and persons having a special relationship to the bank and owners of deposits made in connection with money laundering.

* The CNB is currently working on an amendment so that Czech and IAS standards are gradually harmonised.

of off-balance sheet items among bank assets. The most important of these changes was an increase in provisioning requirements for loss loans backed by real estate, the effect of which on bank profitability was offset by a simultaneous lowering of reserve requirements (initially from 9.5 to 5 per cent in early 1999 and then again to EU standard levels of 2 per cent in October). These changes, plus bank privatisation and a fall off of demand due to the prolonged recession led to a significant stagnation in the emission of new credits in 1998 and 1999, and a decline in those offered by domestic banks (Table 23). Here, both supply and demand factors were likely at work as firms' capacity to service debt was reduced by low levels of demand for their products, while at the same time, curtailed lending activity was used to increase capital adequacy in the banking sector, which rose by 2.5 percentage points to 12.4 per cent in the third quarter of 1999.

Banking sector weakness is concentrated among the domestic banks whose losses in 1998 amounted to 0.8 per cent of their total assets and whose accumulation of bad loans represented in excess of 30 per cent of all loans (Figure 13). Indeed, this last ratio was almost 50 per cent for the smaller banks whose losses were nearly twice as big (proportionately) as those of the larger banks (Table 24). Reflecting their very different financial situations, domestic and foreign banks have not pursued the same strategies in 1998 and 1999. Profitable foreign banks were able to take advantage of the troubles faced by their domestically-owned competitors and expand their share in both the domestic deposits and lending sectors (Table 25). In contrast, the domestic banks shifted their asset

Figure 13. **Classified credits by quality**
Share of total credits, 1998



Source: Czech National Bank.

Table 23. **Banks: main indicators**[1]

	End 1994	End 1995	End 1996	End 1997	End 1998
	Kc billion				
Total bank assets	1 354.0	1 711.1	1 910.8	2 247.4	2 437.4
Total bank credits (gross)	722.0	831.7	949.5	1 098.5	1 135.4
Total reserves and provisions	87.6	105.0	111.0	139.1	159.5
Bank profits	6.5	9.7	5.0	–13.9	–22.9
without *Konsolidacni banka*	6.4	9.7	10.1	–3.6	–8.5
	Per cent of total				
Composition of banks' assets					
Total credits	53.3	48.6	49.7	48.9	46.6
Short-term securities	5.1	8.9	5.9	5.9	8.8
Securities in stock	6.4	8.3	8.8	4.4	4.0
Property participations	1.2	1.2	1.0	4.1	3.8
Other assets	35.3	36.4	38.4	41.1	41.6
Distribution of credits by quality					
Standard	64.3	67.2	71.8	73.2	73.1
Classified	35.7	32.8	28.2	26.8	26.9
Watch	9.6	7.2	6.6	6.1	5.9
Sub-standard	5.3	4.8	3.0	2.7	3.3
Doubtful	7.8	4.0	2.8	3.0	3.9
Loss	13.0	16.9	15.8	15.0	13.8
Distribution of credits by maturity					
Short-term			42.4	41.6	40.8
Medium-term			23.9	23.1	22.6
Long-term			33.7	35.3	36.7
	Per cent				
Memorandum items:					
Total loans/assets	53.3	48.6	49.7	48.9	46.6
Total reserves and provisions/total assets	6.5	6.1	5.8	6.2	6.5
Total reserves and provisions/classified loans	31.3	35.1	35.5	41.2	44.3
Loss loans/classified loans	44.5	57.0	58.7	60.6	56.7
without *Konsolidacni banka*	36.5	51.5	56.0	56.0	51.1

1. Banks with a valid license as of December 31, 1998.
Source: Czech National Bank.

Table 24. **Banking indicators by bank type**[1]

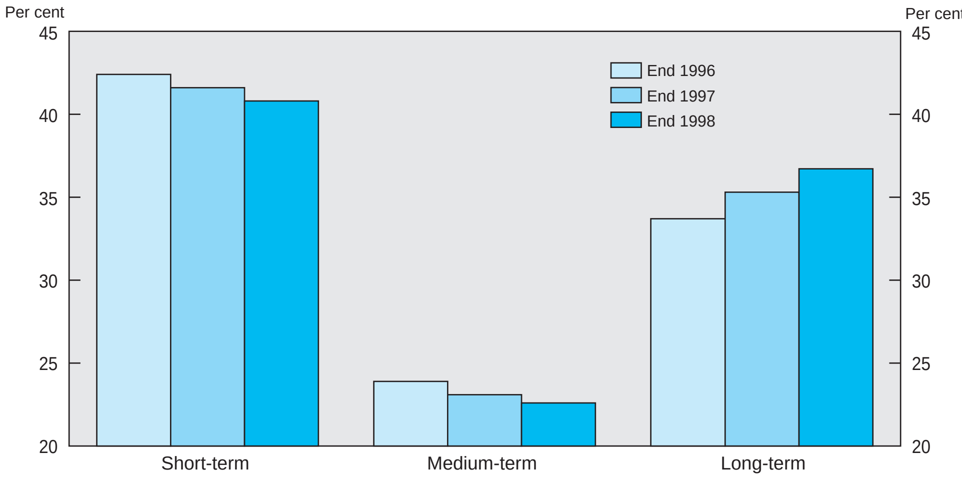
	Large	Small	Foreign
	Kc billion		
Total bank assets	1 610.1	86.3	607.8
Total bank credits (gross)	840.8	31.8	232.1
Total reserves and provisions	137.3	6.9	10.7
Bank profits	–25.6	–2.1	1.4
without *Konsolidacni banka*	–11.2	–2.1	1.4
	Per cent of total		
Composition of banks' assets			
Total credits	52.2	36.8	38.2
Short-term securities	10.2	11.5	5.3
Securities in stock	4.5	8.6	1.4
Property participations	4.3	1.0	1.9
Other assets	35.3	47.3	53.9
Distribution of credits by quality			
Standard	68.0	52.4	89.5
Classified	32.0	47.6	10.5
Watch	6.0	18.2	4.3
Sub-standard	3.5	4.0	3.1
Doubtful	4.8	6.4	1.2
Loss	17.7	18.9	2.0
	Per cent		
Memorandum items:			
Total loans/assets	52.2	36.8	38.2
Total reserves and provisions/total assets	8.5	8.0	1.8
Total reserves and provisions/classified loans	43.2	45.7	44.1
Loss loans/classified loans	60.4	39.8	19.0
without *Konsolidacni banka*	55.2	39.8	19.0

1. Banks with a valid license as of December 31, 1998.
Source: Czech National Bank.

portfolios towards relatively risk-free short-term securities and foreign currencies hence credits fell to about 47 per cent of total bank assets (Table 25). Moreover, holdings of foreign currency credits now represent about one-quarter of all credits compared with only 15 per cent in early 1997. This process was accompanied by a movement away from short-term credits towards those with a longer maturity (Figure 14).

In 1998, bank spreads in the Czech Republic were higher than in most OECD countries (Figure 15), although due to increased competition in the sector

Figure 14. **Credits by maturity**
Share of total credits, 1996-1998



Source: Czech National Bank.

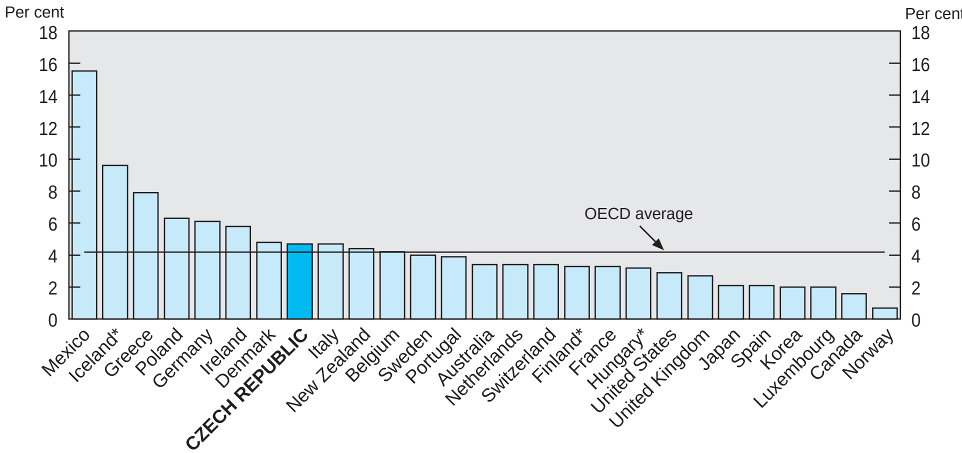
these spreads were narrowing in both 1998 and 1999. Here, it is important to distinguish between foreign and domestic banks. As regards the latter, deteriorating balance sheets forced banks, particularly the large ones to write-off bad loans, and create vast reserves, both to hedge against further losses and to follow the new CNB provisioning requirements as regards real-estate (Table 26). Another important factor was the elevated level of administrative costs in domestic banks,

Table 25. **Market shares of banks in selected products**

	31 December 1997			31 December 1998		
	Credits	Deposits	Securities[1]	Credits	Deposits	Securities[1]
	Per cent of total					
Large banks	82.9	75.3	80.0	79.7	72.1	74.4
Small banks	15.3	3.0	3.4	5.5	2.7	4.3
Foreign banks	0.7	11.6	5.7	8.2	13.3	8.9
Foreign branches	0.6	8.6	1.7	5.9	9.1	1.4
Specialised banks	0.5	1.6	9.1	0.6	2.9	10.9

1. Excluding T-bills and others bills.
Source: Czech National Bank.

Figure 15. **Bank spreads: lending – deposit rates**
1998



* 1997.
Source: World Bank.

Table 26. **Decomposition of the bank interest-rate spread**

Panel A. All banks	1995	1996	1997	1998
Spread[1]	5.8	5.7	5.5	4.8
Administrative costs	4.3	4.8	4.0	4.5
Tax payments	0.2	0.1	0.1	0.3
Accounting profit margin	0.4	1.3	–0.3	–0.8
Provisions	3.4	0.4	2.8	1.1
Residual[2]	–0.2	0.6	0.9	–0.3
Other sources of income (losses)	2.3	1.4	2.0	–0.1
of which: write off of bad loans	–0.9	–2.4	–1.8	–3.7
Panel B. By bank type (1998)	Large	Small	Foreign	All
Spread[1]	4.8	0.7	5.5	4.8
Administrative costs	4.0	8.5	1.8	4.5
Tax payments	0.1	0.1	0.2	0.3
Accounting profit margin	–1.5	–6.9	0.6	–0.8
Provisions	1.0	5.3	0.5	1.1
Residual[2]	–0.4	–9.2	3.9	–0.3
Other sources of income (losses)	–1.7	–2.9	1.4	–0.1
of which: write off of bad loans	–4.7	–2.3	–0.4	–3.7

1. The spread is equal to the difference between average lending and deposit rates. The decomposition represents the contribution of each to the spread.
2. A negative residual implies that banks are funding their portfolios from sources other than deposits.

Source: OECD on the basis of Czech National Bank data.

reflecting (among other things) the beginning of the restructuring process for the large banks and the clean-up and sale of some of the small domestic banks.[29] Interestingly, foreign-owned banks had a higher spread than domestic banks in 1998. One underlying factor might have been that they were able to draw in deposits from more risk-averse clients given their relatively better financial condition while, in order to attract customers, domestic banks were forced to keep their deposit rates relatively high, squeezing margins. Nevertheless, foreign banks also wrote off bad loans in 1998, probably as a result of the recession.

For a country of ten million, the Czech Republic is arguably overbanked. Indeed, some progress towards consolidation has been made since 1996 as the CNB has revoked eleven bank licenses (including four in 1998 and three in 1999) while two others merged their operations in 1998. Nevertheless, the narrowing of spreads may have reached a point where a number of small domestic banks can no longer lend profitably. Some banks have reacted to the situation by attempting to develop alternative revenue sources, but as yet fees and credit cards represent only a small fraction of bank revenues. *Komercni banka*, for example, derives 80 per cent of its earnings from interest and *Ceska sporitelna* is the only issuer of bank credit cards (although *Komercni banka* began to issue them in late 1999). For the moment, development of this market is hampered by the lack of a centralised credit registry to help assess clients' borrowing history and, while such an agency is normally operated by the banks themselves, there may be a role either for the CNB or the government to set one up in the first instance. Since the first half of the 1990s, banks have also begun to develop an active debit card system with almost 1 500 automated teller machines in use (mainly in Prague).

Despite the improvement in prudential standards that banks are required to meet, market risk is not completely covered. While banks must divide their securities activities into trading and investment portfolios (tracked daily and annually, respectively), there remains some concern that by placing the same risk-weighting on volatile stock holdings as on more stable ones, banks may not be adequately provisioning their holdings. Moreover, a large increase in off-balance sheet items (indeed, they are the fastest growing part of banks' assets) has given rise to concerns that they are not monitored adequately. As a result, the CNB, which has oversight for the banking sector (overall responsibility for the financial services sector remains with the Ministry of Finance), took steps to further tighten supervision. In particular, its attention has now turned to market risk and new legislation fully compatible with international standards will be implemented by April 2000. Thus, the CNB intends to:

– Implement a standard method to measure market risk and provide guidelines for the internal models banks use in risk assessment. This is mainly geared towards domestic banks since foreign banks already have this expertise.

– Introduce specific capital requirements for different forms of loans, including for *credit* risk, in particular counterparty risk in derivative deals, and *market* risk, *i.e.* interest rate, equity, foreign exchange and commodities risk (foreign exchange and liquidity risks are currently monitored but only the former has set guidelines with respect to a bank's capital).[30]
– Split bank business between the banking book and the trading book, as well as defining which activities will constitute actions in the latter.

The CNB also introduced measures for consolidated banking supervision. These require banks to indicate, beginning in September 2000, all the financial activities of each subsidiary and associated company in the banking group, and to ensure that the risks of each are properly provisioned. Among other things, the new regulation defines and determines the scope of consolidation (including any exemptions) and the techniques to be used; sets capital elements and the breakdown of assets and off-balance sheet items according to individual risk weights and places a minimum, binding limit of 8 per cent on the capital adequacy of a banking group.[31]

Other banking-sector issues

Over and above these problems, regulators have had to grapple with innovations in the financial services sector that pose challenges to the regime. To date, however, the authorities have managed reasonably well, partly because of steps taken to harmonise regulations with those of the EU and by following other international standards where relevant. Nevertheless, the CNB may soon run into difficulties as firms seek new ways of organising their operations to enhance profitability, especially through the set up of financial conglomerates where banks are made a subsidiary under a parent company. While currently not allowed, one major bank has applied for such a license and, if granted, the CNB will be severely limited in its ability to exercise prudential control.[32] Existing regulations do allow the CNB to track the performance of all bank subsidiaries, but this appears not to be the case when a bank is a subordinated entity. Thus, further modifications would be necessary to the legal framework to ensure, that in such situations, a bank's financial position is reported separately (at least to the regulatory body). This takes on increased importance in cases where the operational structure makes it difficult to assess whether a bank has adequately provisioned loans, or whether the same capital is used to cover risks in more than one legal entity. One way to cope with this would be to apply provisioning requirements to the financial conglomerate, following BIS rules in the area and to allow the central bank to supervise holding companies.

Likewise, the current system does not provide for adequate regulation of non-bank financial institutions. *Kampelickas* (credit unions) are one such example.

The legal framework for these was created by parliament in 1995 and it allows anyone with capital of Kc 100 000 (only $3 000) to set one up. In late 1999, there were 97 operating (with another 20 awaiting registration), controlling about Kc 11 billion in deposits (double the year before) with 110 000 members who were attracted by the relatively high rate of interest paid on deposits (between 10 and 15 per cent) in comparison with commercial banks (who, in early 1999, were offering about 6 per cent). The largest three contain about 60 per cent of deposits and a similar share of members. Unfortunately, the combination of the high rate of return and rapid growth in deposits suggests the possibility that some credit unions were operating as a Ponzi (or pyramid) scheme, drawing in new deposits to help pay returns for current members. This created a potentially extremely dangerous situation and indeed, in early November, the largest credit union was placed under forced administration due to liquidity problems. This was quickly followed with a similar action on several others, freezing about 80 per cent of all credit union deposits. While the final outcome will have to wait for audits to take place, it seems clear that many members will lose a large proportion of their savings, which are not fully insured.[33]

These developments derived in large part from the weak regulatory framework under which the *Kampelickas* operated. While the *Institute for Supervision Over Co-operative Depositories* does exercise prudential supervision, it has only five staff members, and has severely restricted regulatory and monitoring powers.[34] A new draft law concerning the *Kampelickas* is currently before parliament, which would require their licensing (verification of management competency and business plans), implement regulatory rules (such as credit classification, capital adequacy, consolidated balance sheets, etc.), force internal audits, improve deposit insurance and place some limits on acceptable investment strategies. While taking steps in the right direction, this reform would not seem to go far enough in restricting the activities of these institutions, in ensuring that they have an adequate capital base and in imposing sufficiently stringent disclosure requirements. Nor is it clear that the current proposal will pass through parliament. Recent problems may encourage members to more closely monitor activities of credit unions; nevertheless, prudential supervision should be brought up to international standards since failure to bring these institutions under control could have serious repercussions for the economy. A strengthened reform package that forces credit unions to adopt standards similar to banks should therefore be given governmental priority. If such a reform were passed, the government could contemplate moving supervision to the CNB.

Another bank that qualifies as a special institution is the *Konsolidacni banka*, which is supervised by the CNB. It serves as the government's bad loan depository and as one of the government's agents in providing development loans. Supervision is difficult because even if the CNB discovers that the bank is underprovisioned, which appeared to be the case in 1999, it is unable to enforce its statutes because the state can, and does, guarantee that reserves will be forthcoming; this sets the *Konsolidacni banka* on different footing from other commercial banks. As a result, the government plans to separate the bank into two institutions with a commercial banking entity set up to run government programmes (principally operating as a development bank), and a state financial institution created to take on the KoB's bad loan portfolio. Following this break-up, the new commercial bank should be subjected to the same standard rules as other banks and the authorities should contemplate its rapid privatisation. The creation of a separate entity to manage the bad loan portfolio of KoB has the potential to contribute to a better management of that debt by vigorously pursuing collection and liquidation of outstanding loans. Such a programme, if implemented, would help to clear up some of the extensive debt burden weighing on the vast majority of heavily indebted firms not included in the Revitalisation programme. However, failure to be more proactive risks seeing these firms' activity and restructuring continue to be delayed and compromised by the uncertainty represented by these liabilities.

The Czech Republic's commitment to universal banking operations should see banks expand their operations into new areas over time, and probably result in further mergers. Currently, the central bank has 91 staff to carry out regular audits. On the one hand, mergers in the banking industry may make it easier for staff to focus on certain banks, while on the other, a wider range of skills will be necessary as banks become more sophisticated in their treasury and market operations. In addition, as banks move into new areas in the face of increased competition, regulators will have to be vigilant to ensure that prudential supervision and regulations increase commensurate with the potential for further risk. In this regard, to improve co-ordination among all regulators, the Ministry of Finance, the Czech National Bank and the Securities and Exchange Commission signed an agreement in the summer of 1998 to increase mutual co-operation and in the future, could contemplate introducing a broader arrangement where all are located under the same agency. Stability of the banking sector will also require the privatisation of banks to be completed, in addition to the completion of changes to bankruptcy and foreclosure laws so that banks can better manage their portfolios.[35]

The Securities and Exchange Commission

The 1998 Survey noted the poor state of capital markets in the Czech Republic, and OECD recommendations made at that time to improve the situation are highlighted in Table 14. Among the most important of the problems was the inadequate regulation of the financial services sector, which led to widespread fraud with obvious negative consequences on investor sentiment. The Securities and Exchange Commission (SEC) was set up in April 1998 to help establish a clear legal climate, assuage the worries of shareholders and instil investor confidence. Since its inception, it has been busy, rendering 955 decisions in the area of capital markets, of which 56 resulted in Kc 850 million in fines.

During its initial year of operation, the SEC concentrated its activities in three areas. *First*, it began a review of all licenses issued by the Ministry of Finance in the financial market and initiated a reissuing process to ensure that each market participant meets all required regulations. *Second*, it attempted to verify whether each of the 1 700 publicly listed firms created during voucher privatisation was observing disclosure requirements. So far, the Prague Stock Exchange has delisted 1 500 firms principally because of low liquidity. Roughly 90 per cent of firms now observe disclosure requirements (compared with about 50 per cent in 1998) and the SEC is working on new rules that would make registration with it compulsory for any publicly-listed company, which it hopes to have in place by January 2001.[36] In addition, it has encouraged illiquid firms to transform themselves into private companies, although this is not always possible because of a lack of funds to buy out minority shareholders. These measures should serve to weed out firms, reduce market fragmentation and improve governance, in addition to freeing up time for the SEC to focus on other areas. *Finally*, the SEC's 100 professional staff have been working with the EBRD, the CNB and the Ministry of Finance to revise the securities law and the commercial code, with the goals of harmonising them with EU legislation, improving minority shareholder rights[37] and clarifying the SECs role in their enforcement. It expects the current Securities Act to be replaced by 2003 with a comprehensive new act.

Despite these actions, and probably in part because of them, the Prague Stock Exchange (PSE) had a poor year in 1998. Several factors weighed on its performance as both market capitalisation and turnover fell, reflecting price declines (partly in the wake of the Russia crisis), deteriorating economic conditions and the continued lack of trust by investors in the Czech markets. Trade volume and prices did pick up in the first half of 1999, however, partly as a result of foreign interest in bank shares due to their impending privatisation in addition to the consolidation of IPF holdings, discussed above. In contrast to the stock market, bond market activity and liquidity remained high, reflecting in part the preference of investors for bonds over equities and the need for the government to finance its deficit. There have, however, also been some positive signs in the stock market. Market transparency has increased as the share of trades occurring on the more transparent PSE rose relative to the RM-system (RMS) and over-the-counter (OTC) markets. In addition, in 1998, the PSE introduced a new trading module, the Market for Shares and Bonds Supporting System (SPAD) that allows for the continuous quotation of bid and offer prices.

A key recommendation from the OECD (aimed at protecting minority shareholders) was that trades, particularly those made via the OTC, be more transparent with large deal makers offering the same terms to all market participants. Unfortunately, little progress has been made in this area and stocks still trade at multiple prices on the different exchanges in the Czech Republic, partly because the SEC has no authority to force the RMS to have a listing department. Many of these trades take place at terms that are not disclosed, which can only discourage equity purchases by investors who fear that their rights might be overrun. Over time, these and other problems have led companies, particularly blue-chips, to look elsewhere for capital, including London and Frankfurt, where investor rights are more entrenched.

Remaining issues

Despite substantial progress, more needs to be done. One important role of the SEC is to encourage investor confidence in Czech capital markets by making rules and enforcing them. Yet its ability to do so is constrained by its limited financial and decision-making independence. Indeed, while set-up as a regulatory body for capital markets, it is not allowed to issue regulations: the Ministry of Finance retains sole authority in this domain, although the SEC can and does offer recommendations, many of which become regulations or act as *de facto* regulations. Further, even where regulations do exist there has been some dispute as to whether the SEC has the power to enforce them given the vague nature of its role under the legislation. While to-date there have not been any instances of overt political interference, SEC links to the Ministry should be severed and it should become an independent body with the ability to create and enforce regulations. Such independence would foster domestic and international confidence, helping the capital market to once again become a source of funds necessary for economic expansion. Indeed, the government plans to consider such an option. Obviously, the regulations it might promulgate and its own activities would remain subordinate to the law and the democratically-elected government.

The SEC's financial dependence on the government is another source of concern. Allowing it to be self-financing via fees charged on market participants would enable it to access resources necessary to meet the many challenges that it faces (both those of a technical and human resource nature) which, in a forthcoming period of government restraint, might not be available. Indeed, as is the case in other OECD countries, the SEC will also have to constantly upgrade its skills base to keep up with market innovations, and to ensure that prudential supervision and regulation are strengthened commensurate with increased risk and competition in the banking sector. More generally, the SEC has been charged with a large number of mandates and it may be that the sheer quantity of important transitional issues that have occupied its staff may have prevented them from focussing on routine supervisory responsibilities. In this regard, improvements are required to information technology to allow it to better monitor the operations of market participants. While considerable data must be reported to it on a daily basis, current technology is insufficient to allow the SEC to accurately monitor developments and take preventive action in a timely fashion. Resource constraints have prevented it from making major advances in this area and it thus relies on other bodies, such as the PSE to monitor activities. Indeed, it recently denied the PSE's request to be allowed to trade in derivatives, such as share and index futures, fearing that the PSE and, implicitly, the SEC would be unable to adequately oversee such activities.

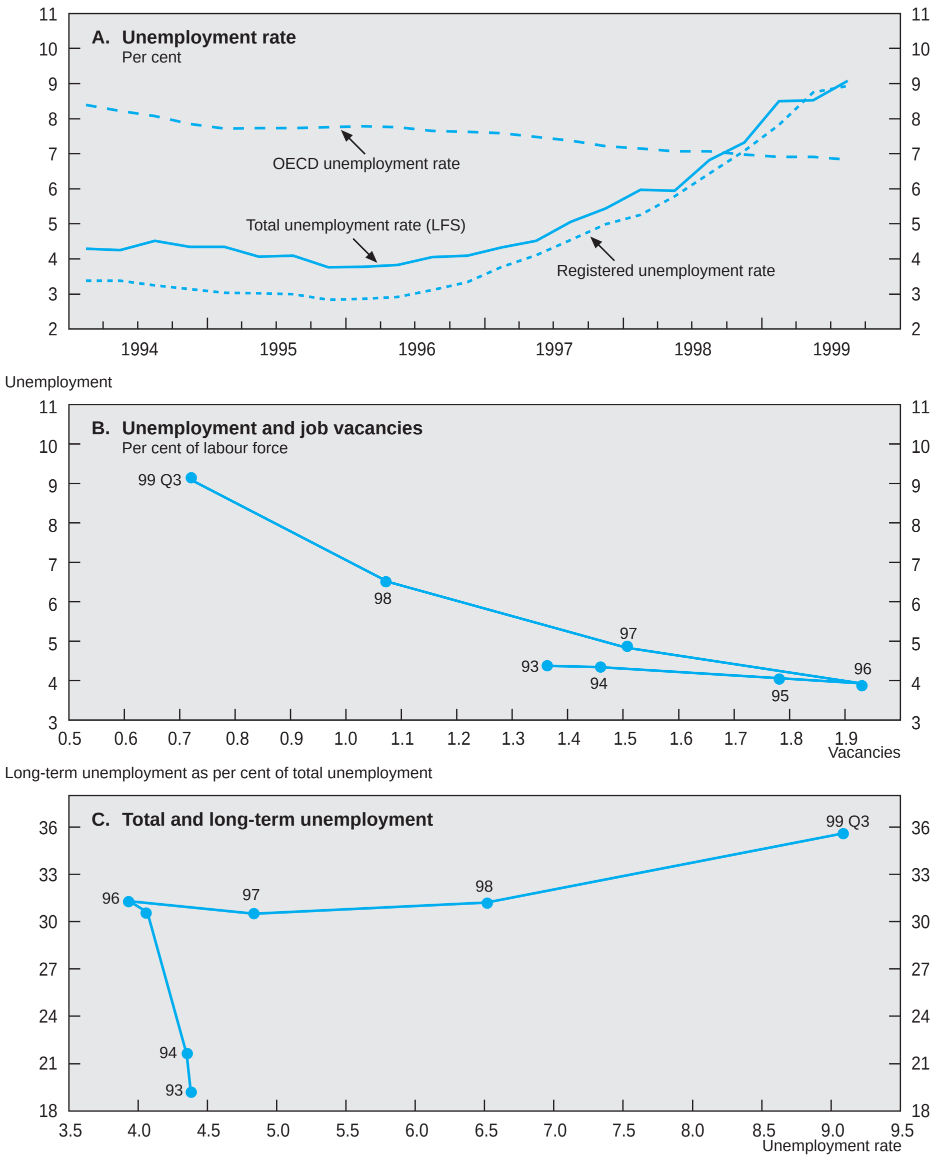
The labour market

As discussed in the first chapter, the economic slowdown and steps towards firm-level restructuring have led to deteriorating conditions in the labour market. In early 1999 the unemployment rate jumped above that of the OECD average for the first time ever (Figure 16). In addition, inflows into unemployment picked up, outflows slowed and vacancies fell, resulting in a rising incidence of long-term unemployment.[38] Worsening unemployment has also manifested itself through increased regional differentials, rising rates for women relative to men and high unemployment rates among the low-skilled and youths (Figure 17). The number of registered unemployed and people on early retirement benefits has, therefore, more than doubled in the past year (Table 27).[39] The need to address structural weaknesses in the labour market and adopt recommendations highlighted in the previous *Survey of the Czech Republic* with respect to the OECD *Jobs Strategy* has, therefore, become more urgent. Progress in this regard is reviewed below (Table 14).

Employment protection legislation

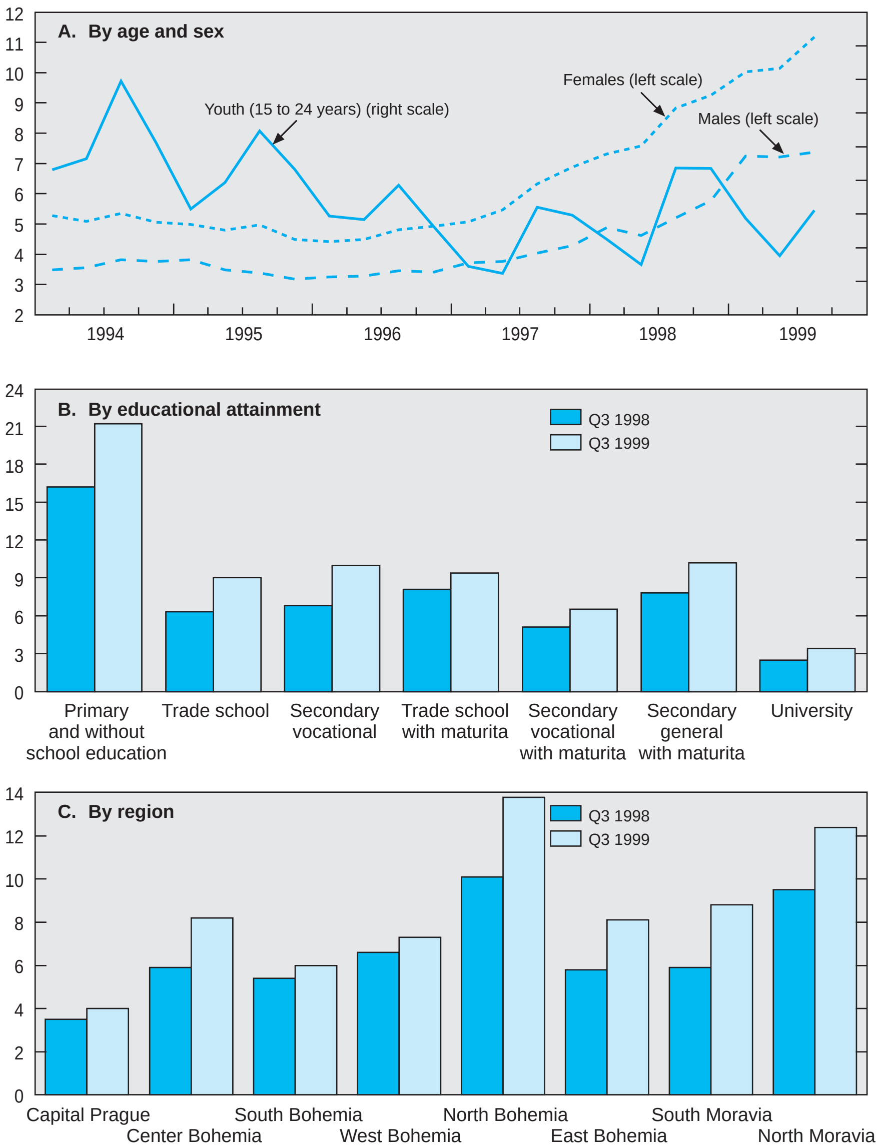
The previous Survey stressed that employment protection legislation, by raising the fixed costs of hiring (and firing), can reduce the job prospects of the unemployed by re-enforcing "insider" power. It warned that with unemployment rising rapidly, regulations in this area could become an impediment to job creation, potentially elevating structural unemployment. The government indicated at that time that it would review such regulations, but has not yet announced any changes to the rules governing individual hiring and dismissal. For example, both employers and employees must still give two months' notice before a contract is terminated (although this can be shortened by mutual agreement). In an effort to facilitate firms' communications with their workers and to conform to EU obligations, the government will require the creation of works councils in all firms.[40] In

Figure 16. **Unemployment rate, vacancies and long term unemployment**



Source: Czech Statistical Office; OECD, *Main Economic Indicators, Quarterly Labour Force Statistics* and *Employment Outlook.*

Figure 17. **Unemployment rate by age, sex, education and region**
Per cent



Source: Czech Statistical Office; OECD, *Quarterly Labour Force Statistics.*

Table 27. **Benefit recipients by income support scheme**[1]

	1996	1997	1998
	Per cent of working age population		
Unemployment insurance	1.3	1.9	2.7
Disability	7.5	7.4	7.5
Full	5.8	5.5	5.5
Partial	1.8	1.9	2.0
Early retirement	0.2	0.5	1.1
Permanently reduced benefit	0.1	0.3	0.6
Temporarily reduced benefit	0.1	0.1	0.9
Active labour market programmes	0.4	0.4	0.2
Total	9.4	10.3	11.5

1. Individuals in receipt of social assistance benefits are not included.
Source: Ministry of Labour and Social Affairs.

addition, a draft law proposes setting up a guarantee fund, initially financed from government revenues but in the future to come from unemployment insurance receipts, that would provide special payments to workers laid off by insolvent or bankrupt firms. The government should ensure that if such a fund is created, it is used only to cover wage arrears owed to workers of liquidated firms and is not used to provide additional unemployment benefits, which would likely have adverse impacts on job-search. Further, the existence of such a fund raises moral hazard issues as firms may suspend payments to workers knowing that the fund could step in to pay wage arrears. Thus, it is essential that such payments not be made in cases where the firm continues operating. For workers displaced through mass layoffs, the government might consider requiring that advance notification is made to the public employment service (PES) of impending plant closures to allow it time to help displaced workers search for new jobs, while making a priority assessment of their needs and arranging quick channelling into ALMPs if deemed necessary.

Collective bargaining

Presently, most wage negotiations are conducted at the enterprise level and, although nothing prevents firms and workers from participating in higher level bargaining structures, the government plans to expand the scope for extension of bargains across branches. Various OECD work has highlighted the dangers of imposing wage increases on firms in this way. These include poor inflation performance, a reduction in product market competition as firms can no longer compete by using alternative skill mixes and the ethical problem of saddling both employers and employees with conditions for which they have not bargained. The authorities should therefore avoid introducing this measure and instead rely on legislation to set minimum conditions and allow the market to determine wage levels that are appropriate for workers and firms. Finally, the government should exercise restraint in negotiating with its employees. Recent public sector wage increases have been well above those of the private sector and, while some have been geared towards sectors where pay levels are low, they could set off a dangerous catch-up spiral when economic conditions clearly warrant wage moderation.

Minimum wages

The previous Survey noted that the minimum wage was very low as compared with market wages and that less than 1 per cent of the workforce earned it. Indeed, social security benefits were much higher than the minimum wage, and it is these that constitute a wage floor for workers. Recognising this problem, the government has decided to increase the minimum wage to a level higher than that of the minimum living standard (MLS) for a single adult (the MLS serves as a reference for almost all social security benefits).[41] In this regard, it will raise the minimum wage by more than 50 per cent in January 2000 to Kc 4 000 per month or 28 per cent of the earnings of an average production worker (Table 28). While this may improve labour supply by enticing some single individuals to accept work, its impact is unlikely to be large as the minimum will remain well below observed wages. Moreover, given the generosity of social benefits (see below) to entice an adult with two children to enter employment would require enormous increases in the minimum wage, leaving it almost at the level of average wages. Thus, in the absence of substantial improvements in productivity and hence in market wages, pursuing such a course of action would probably only serve to price low-skilled labour out of the market.

Unemployment and related benefits

Social security benefits were identified in the previous OECD Survey as one of the factors tending to increase joblessness, with concrete steps being required. Following this study and an OECD review of social policy (1998*b*), the government had planned a comprehensive overhaul of social assistance in 1999, but the legislation has been postponed. While some steps have been taken, the rapid rise in unemployment and the large proportion of the working age population receiving benefits makes rapid and decisive action on these issues imperative if rises in structural unemployment are to be contained.

The Czech Republic has kept a tight reign on unemployment insurance benefits, having repeatedly reduced their generosity over time. It did so again

Table 28. **The minimum living standard and the minimum wage**

	Minimum living standard, 1998 (monthly basis, Kc)				
		Age of child			
	Adult	0-6	6 to 10	10 to 15	15 to 26
Personal needs (food, clothes and essential goods)	2 130	1 560	1 730	2 050	2 250
		Size of household			
		1	2	3 to 4	5 plus
Household needs (shelter, heating and basic appliances)		1 300	1 700	2 110	2 370

	Minimum living standard as a per cent of:		
	Minimum wage	2/3 average production worker wage	Average production worker wage
Single adult	129	37	25
Couple, 1 child (aged 0 to 6)	299	85	57
Couple, 2 children (aged 0 to 6)	358	102	68
Couple, 3 children (aged 0 to 6)	427	122	82
Couple, 4 children (aged 0 to 6)	486	138	93
Memorandum items:			
Minimum wage 1998		Kc 2 650 (monthly)	
Average production worker earnings 1998		Kc 166 502 (annual)	

Source: OECD and Ministry of Labour and Social Affairs.

in 1998, reinforcing its position as having among the most strict systems in the OECD area, combining short duration (six months) and low replacement rates (40 to 50 per cent). Overall the generosity of benefits for people out of work is high, however, because of the unlimited duration of social assistance benefits and the generous treatment of large families (Table 29). Combined benefits are especially high compared with average wages for households with children, creating considerable work disincentives for workers with two or more children (see Figures 30 and 31 in Chapter IV). This highlights the need to review how benefits relate to the minimum living standard so as to align them more closely to wage and productivity levels in the economy as a whole, or, alternatively, the method by which the minimum living standard is calculated. In particular, the increment to the standard associated with additional household members is much higher than in other OECD countries. In addition, the government will have to ensure that job search is carefully monitored, especially given slack

Table 29. **Net replacement rates of the unemployed**

	First month of benefit receipt[1]				60th month of benefit receipt[1]			
	Single		Couple 2 children		Single		Couple 2 children	
	APW[2]	2/3 APW[2]	APW[2]	2/3 APW[2]	APW[2]	2/3 APW[2]	APW[2]	2/3 APW[2]
Australia	37	50	72	82	37	50	72	82
Austria	57	57	71	77	54	54	69	74
Belgium	65	84	60	76	46	78	63	91
Canada	61	61	68	68	27	38	59	77
Czech Republic	**54**	**60**	**77**	**76**	**36**	**53**	**98**	**100**
Denmark	65	90	77	95	49	68	97	80
Finland	68	83	87	92	62	84	100	100
France	76	85	79	87	43	57	51	58
Germany	70	73	80	76	62	76	73	92
Hungary	67	86	74	90	47	64	59	74
Iceland	55	73	59	81	52	69	80	109
Ireland	33	45	64	72	33	45	64	72
Italy	36	35	47	46	0	0	11	14
Japan	63	72	59	67	35	51	71	87
Korea	55	54	54	53	10	15	10	15
Luxembourg	86	85	90	91	54	75	77	89
Netherlands	75	86	82	86	60	85	78	96
New Zealand	37	52	64	77	37	52	64	77
Norway	66	65	73	75	39	56	72	78
Poland	34	49	42	61	30	42	35	51
Portugal	79	89	77	87	0	0	6	8
Spain	73	71	76	73	27	37	46	63
Sweden	75	78	85	85	62	89	100	122
Switzerland	77	76	88	88	52	74	68	96
United Kingdom	52	75	67	80	52	75	76	91
United States	58	59	59	50	7	11	51	58
Average	61	69	70	77	39	54	63	75

1. Includes all benefits to which the individual/family would be eligible, including unemployment, family and housing.
2. Replacement rates are calculated with respect to the average wage of a production worker (APW) and two-thirds this wage.

Source: OECD (1998*c*).

labour market conditions. One alternative that might allow benefit levels to be retained for working families, but with fewer negative labour market distortions, would involve lowering the level of passive benefits and, where necessary, supplementing them with in-work benefits.

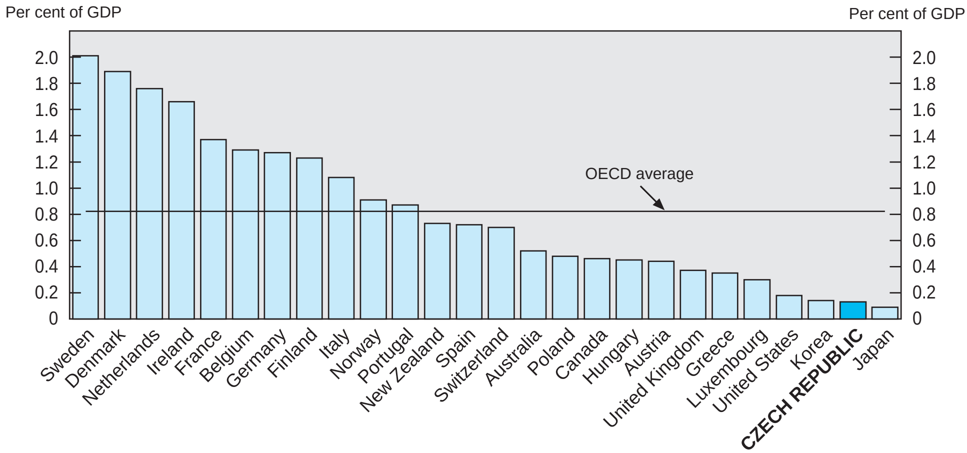
There have been few changes to the other benefits for which people are eligible. Provisions for early retirement, disability and sickness programmes are all unchanged. Indeed, the government abandoned its plan to raise the child allowance because it determined that such a move would be costly and unnecessary since all benefits are already adjusted for family size. As indicated in the previous Survey, the proportion of the population receiving disability pensions is high (Table 27). It would appear that, as is the case in several OECD countries, disability benefits are being used as a more generous alternative to social assistance. The government has responded by tightening provisions for full-time disability, thereby causing recipients to move to the partial disability scheme. While conditions on this scheme are tougher, recipients facing an annual income test on their earnings, the frequency of the medical assessment lies at the discretion of the social security office doctors and the share of the working population receiving this benefit is more than double that in many OECD countries.[42] To ensure that resources are focused on those truly in need, the government should better ensure that a recycling of partial disability beneficiaries does not occur. In this regard, compulsory examinations at frequent intervals could be considered for those on partial disability to assess their ability to work extra hours. Some tightening of early retirement provisions would also seem to be in order. Currently, two options for early retirement exist, neither of which is actuarially neutral (Table 27). The first amounts to an extended unemployment benefit that allows individuals who meet unemployment eligibility conditions to retire up to two years early (with a reduced benefit that reverts to the full benefit when the standard retirement age is reached); and a second option which allows retirement up to three years early if all standard pension qualifying conditions are reached (see below) and where the earnings component is permanently reduced, although not by as much as it would be if actuarially adjusted for the earlier retirement age.

Active labour market policies

The OECD has encouraged Member countries to shift more resources from passive to active labour market measures to improve the job-finding chances of the unemployed. For most of the decade, the Czech Republic fared well in this regard, with the share of expenditures on such ALMPs (almost 50 per cent) consistently above the OECD average. However, in 1998 the share of expenditures on ALMPs out of all programmes plummeted to 36 per cent as passive benefit payments ratcheted up following the rise in unemployment. At the same time, and despite the increase in unemployment, ALMP expenditures in 1998 as a share of GDP were the second lowest in the OECD area after Japan (Figure 18).

The government has responded by boosting spending on ALMPs in 1999 by Kc 500 million, but a further rise may be fiscally difficult given the rapid rise in passive-benefit payments. Moreover, the shrinking revenue base (*i.e.* falling employment) further hampers the government's ability to fund an expansion of ALMPs (see Chapter IV for a discussion of social security contribution rates). Swelling of the unemployment pool has doubled the number of job seekers per

Figure 18. **Active labour market programme expenditures**
1998 or nearest year available



Source: OECD Database on labour market programmes.

staff member from a comparatively low ratio of 47:1 in 1997 to 93:1 in 1999 (Table 30), a number similar to that seen in many other OECD countries. Moreover, there is considerable variation across regions with those hardest hit by unemployment having the highest ratios. Indeed, the rise in unemployment seems to have diverted PES staff time away from ALMP tasks towards benefits

Table 30. **PES staffload indicators by region**
February 1999

Region	Number of staff	Registered Jobseekers	Number of benefit recipients	Registered jobseekers per staff	Benefit recipients per staff
Capital Prague	201	17 332	10 651	86	53
Central Bohemia	500	37 562	19 077	75	38
South Bohemia	314	21 881	12 816	70	41
West Bohemia	375	31 155	14 876	83	40
North Bohemia	680	72 909	29 196	107	43
East Bohemia	540	43 011	23 253	80	43
South Moravia	895	87 100	45 233	97	51
North Moravia	1 115	117 044	49 452	105	44
Czech Republic	4 620	427 994	204 554	93	44

Source: Ministry of Labour and Social Affairs.

administration, with staff ratios per benefit recipient much more similar across regions than the ratio with respect to jobseekers. While the government hired 200 new staff in early 1999, this is not sufficient to deal with the regional disparities and the increased workload, inevitably resulting in less effective monitoring of job-search compliance and less time for screening and channelling of the unemployed towards the most appropriate ALMP.

As high unemployment becomes entrenched, the importance of evaluating the effectiveness of ALMP programmes – one of the *OECD Jobs Strategy* recommendations for the Czech Republic – becomes increasingly critical to ensure their effectiveness and to inspire improvements as necessary. While the government has not yet introduced a framework for such an evaluation, a recent independent quasi-experimental evaluation by Benus, Grover, Berkovskÿ and Rehák (1998) found that:

– Public sector job creation had no significant impact on employment or earnings. Moreover, it increased the duration of unemployment and the amount of benefits paid.
– Training increased both the likelihood of earnings and employment gains.
– The school leavers programme increased employment chances but reduced earnings relative to the comparison group.
– Wage subsidies for jobs in the private sector also produced positive employment but negative earnings impacts.
– Wage subsidies for self-employment had a positive impact on employment but none on earnings.
– Impacts were generally better for women than men and for those with lower education levels.

In light of these findings, and of the worsening unemployment situation, the government plans to target more resources on training. While this is appropriate for unemployed workers whose skills are a poor match for new job openings, the government should resist undertaking large public works projects.[43] Instead, efforts should continue to focus on ensuring that programme participants are carefully screened as to their ability to fill job vacancies, and that training is tailored to the needs of the local labour market and is offered to those most likely to benefit. Monitored job search, along with training for some groups, often prove to be the most cost-effective way to deal with high numbers of unemployed.

The large differences in regional unemployment rates makes action to eliminate the barriers to labour mobility created by the rental market essential. As discussed earlier, the government needs to accelerate the adjustment of controlled rents. In the interim, it might be possible to devise a cost-effective transportation subsidy for firms in low unemployment regions that hire workers living in high unemployment areas. An additional measure that could help relieve regional unemployment would be a reallocation of PES staff so as to equalise staff/jobseeker ratios, thereby ensuring that resources are available where they are most needed.

Education and training

A 1996 OECD study of the Czech education system (OECD, 1996*a*), which was highlighted in the previous Survey, covered many areas where reform was necessary to improve education outcomes and facilitate the transition to post-secondary levels. A persistent problem pertains to the decentralisation of the education system at the primary level, where students are left without systematic testing and assessment of educational attainment. Similarly, the secondary-school-leaving certificate, the *Maturita*, is not standardised and reflects a widely varying quality of education, forcing each university to impose separate entrance exams on applicants. In response to these issues, the government is developing criteria that it hopes to have in place by late 1999 with which to assess the primary level of education, while also proposing to supplement the school-based *Maturita* exam with a series of standardised tests in the Czech language, literature, mathematics and a foreign language. This *Sonda Maturant* was recently given a trial and should be implemented on a national basis by 2001. The government also created the *National Agency for VOTEC* to set standards for vocational education, including the qualifications necessary for various occupations, and has proposed the set-up of the *National Curriculum Council* as an advisory body to the government to help set curriculum reform.

While these steps are commendable, the education reform process is only just beginning and much further progress is necessary to bring standards up to OECD levels. As indicated in the previous Survey, there are still too many teachers and their pay levels are inadequate. Thus, the recommendation that staffing levels be allowed to fall and that savings be used to increase pay remains valid and would help to attract and retain the most qualified individuals. In addition, a system for their continuing training still needs to be set up. At the same time, there remains a need to increase the proportion of students following a general rather than vocational stream, and to expand access to tertiary education. Finally, links with employers should be expanded, particularly for vocational training where the state covers most of the costs.

Recent initiatives

Against the background of rising unemployment, the need to speed-up implementation of many of the *Jobs Study* recommendations has become more urgent. In this regard, in April 1999 the government approved a new *National Plan for Employment* modelled loosely on the European Community's *Employment Action Plans* for Member countries. The plan has four main objectives: *i)* improving employability; *ii)* promoting the demand side of the labour market; *iii)* enhancing labour market adaptability and flexibility; and *iv)* strengthening equal opportunities for men and women. Within each area, several goals have been identified. However, these goals and the means by which they are to be achieved are still at the design stage. As yet, the associated programmes have not been costed, while more details regarding their implementation will be required before their potential labour market impact can be evaluated.

The government also plans to amend the labour code by, for example, increasing the conditions, such as working-time arrangements, over which firms and employees can bargain. Furthermore, it has indicated its intention to set up an extra-budgetary fund to finance social security expenditures. The fund would receive the revenues from social security contributions that now flow into the general government coffers and would take on responsibility for the various transfer programmes currently run by the MLSA (social assistance, unemployment compensation and active labour market programmes). The government argues that this would allow better planning of programmes over the medium term. Unfortunately as indicated in Chapter II, experience with such funds in other countries suggests otherwise. In many cases, the funds run chronic deficits that must be met by the government, while by setting up such funds the government cedes much of its ability to control spending and revenue collection. Medium-term budgetary exercises, such as the one recently completed by the Ministry of Finance, offer a better solution to the problem of planning programme spending over the medium and longer terms.

The Ministry of Education is also in the process of drafting a new law on pre-school, basic school, secondary and higher professional education and is currently soliciting feedback. The new Schooling Bill will set out the government's priorities for the education system so as to meet EU membership criteria, while addressing continued weaknesses in the system. Concrete objectives include enabling two-thirds to three-quarters of young people to take the *Maturita* exam and providing at least half of them with access to some form of tertiary education, while extending the average duration of schooling from its current 14.7 to 16.7 years (the EU average) by 2005. The *National Plan for Employment* sets a goal of increasing expenditures on education to 6 per cent of GDP within three years (largely to finance a hike in teacher salaries) and proposes the creation of an educational fund whereby employers who train their workers will benefit from a tax credit to cover expenses, although it is uncertain whether this would simply result in deadweight losses (as some firms would have offered the training anyway). While the goal of improving educational outputs is laudable, it is not clear that the increase in spending is warranted. At 4.8 per cent of GDP in 1995, spending is already higher than the OECD average, while as already indicated, a more rational solution to the low pay of teachers would be to reduce teacher-student ratios to OECD norms and use the savings to increase the pay of those that remain. As concerns the proposed fund, it would appear that such a programme could be more flexibly handled within the normal budgetary process of the government.

Global appraisal

The Czech Republic is at a difficult juncture. A relatively inflexible institutional framework, along with rising unemployment, raises the prospect of increasing rates of structural unemployment. The government, in recognition of the need for action, proposed a *National Plan for Employment* which for the moment has yet to be turned into specific proposals. As the policy formation process proceeds, the government should consider:

- Implementing those recommendations set out in the *Jobs Strategy* where action has yet to be taken while ensuring that the *National Plan for Employment* is consistent with them.
- Ensuring that the PES is adequately funded and staffed, so that job search can be effectively enforced. High benefits relative to wages create disincentives for low-skilled workers and imply the need for continuous monitoring if they are not to be permanently crowded out of the labour force, particularly in high unemployment regions.
- Avoiding the creation of new public employment schemes – or expanding existing ones – which are costly to the budget and have been shown to have no long-run impact. Permanently laid off workers should be quickly routed to the PES and assessed as to their need for training, geared towards local labour market needs, wage subsidies or job search assistance.
- Continuing to improve the work incentives for those receiving social assistance benefits. While current plans to increase the minimum wage will encourage greater participation, they are likely to generate increased unemployment among the low-skilled. To ensure that work pays, passive non-employment benefits should be adjusted to levels more consistent with wages and productivity, while these could be supplemented, if deemed necessary, by in-work benefits to help the working poor.
- Quickly overhauling social security to help realign incentives throughout the system, including disability and other benefits. In particular, a recycling of partial disability benefit recipients appears to be taking place and the government should ensure that each individual is carefully re-assessed on an annual basis (at a minimum) as to his/her true ability to work additional hours. Early retirement benefits should be adjusted on an actuarial basis to reduce government subsidisation of premature labour force withdrawal. The postponed increase in family

allowances should be abandoned as all benefits are already adjusted for family size. Furthermore, the reform of the social assistance should be completed as soon as possible but the government should shelve plans to create an extra-budgetary fund to finance it. Such a fund would result in a loss in accountability and potentially large pressures to increase spending on already generous benefits (see Chapter II).

– Taking action in the rental market, which remains a significant barrier to labour mobility. In the interim, it might wish to offer a transportation subsidy to firms in low unemployment areas that hire unemployed workers from high unemployment regions.
– Carefully considering policy options when harmonising the labour code with EU practices. A wide range of options are consistent with the Community *Acquis*. Given that the already very high level of social security charges acts as a significant employment disincentive, saddling employers with additional costs would be counterproductive. Along these lines, when deciding how to finance any new measures as part of the *National Plan for Employment*, the government should first examine options that stem from savings and cuts to existing social and labour market programmes. Both the Ministry of Finance (financing of programmes) and the Ministry of Labour and Social Affairs (policy design) have important roles to play in the relationship between taxes and benefits and their co-operation is essential to ensure that work incentives are preserved.
– Continuing to adopt recommendations from the OECD (1996*a*) report on the education system.

The public sector

The government has set for itself the goal of revitalising the public sector. In addition to the creation of a regional level of government (see Chapter II) the authorities are also looking at healthcare reform and a revamp of public pensions. Both of these areas are important to future growth, not the least because of the share of public resources dedicated to them. Moreover, the challenge of cleaning up the environment after decades of neglect will also consume considerable resources, and has implications for health and public finances. This section examines each of these areas in turn.

Healthcare

Healthcare was last discussed in the 1996 *Survey of the Czech Republic* (OECD, 1996*b*). At that time, the system was characterised by a competitive insurance market, dominated by the General Health Insurance Company (GHIC) in addition to several smaller companies, and a fee-for-service model. Funding came from mandatory payroll taxes on both employers and employees with the state paying for those not in employment. Payments did not vary with health status although some effort was made to redistribute funds to insurance companies that enrolled higher-risk individuals since they were obliged to accept any application.[44] Fees were set for each of the 4 400 services that doctors could provide, decided one year in advance, and varied across insurance companies, implying that doctors could be paid different amounts for the same service. Between 1993 and 1996, the government undertook a vast privatisation of health care facilities and, by the end of that year, about 95 per cent of general practitioners operated out of their own offices, while only 1.5 per cent of dentists remained in the state sector. Most hospitals, however, remained in public hands. Since the beginning of the transition, health outcomes have been improving. For example, life expectancy for women has risen about five years since the early 1990s to reach about 78 in 1997, while that of men rose to about 71, which compares favourably with many other OECD countries (Table 31). Healthcare expenditures, which represented about 7 per cent of GDP in 1997, somewhat below the OECD average (Figure 19), rose to reach an estimated 7.5 per cent of output in 1999.

As pointed out in the 1996 Survey, this framework had several undesirable features. In particular, the fee-for-service payment system gave strong incentives for doctors to inflate services offered, while consumers had little motivation to question their necessity. In addition, the points system by which doctors were paid was relatively unsophisticated and did not always reflect current costs. Furthermore, because the system was new, insurance companies faced relatively high initial costs, which delayed payments to health providers, leading disgruntled consumers to switch to the largest firm, the General Health Insurance Company. Indeed, many companies merged or went bankrupt (the number of insurers plummeted from 27 in 1996 to 10 in 1999) and the GHIC's share of the market rose to its current 74 per cent with a client base of 7.8 million. The government was left to pay for many of the bankrupt firms financial commitments. As a result, in 1998 it set up a Securing Fund to which all insurance companies must contribute (except for GHIC) and from which future payments will be made in the case of additional failures.

Since 1997, the government modified the system slightly, primarily to help contain future cost increases.[45] *First*, it now mainly pays general practitioners (GPs) on a capitation basis, covering all of their main costs with a lump-sum-payment per client (rather than per service offered) with only a limited number of explicitly defined services left on a fee basis. Specialists, on the other hand, were left on a fee-based system (comprising about 3 500 services), but its sophistication was increased and restrictions introduced on the number of services that could be offered. Hospitals also remained on a patient-based fee-for-service system, but pilot projects have been undertaken to examine the feasibility of

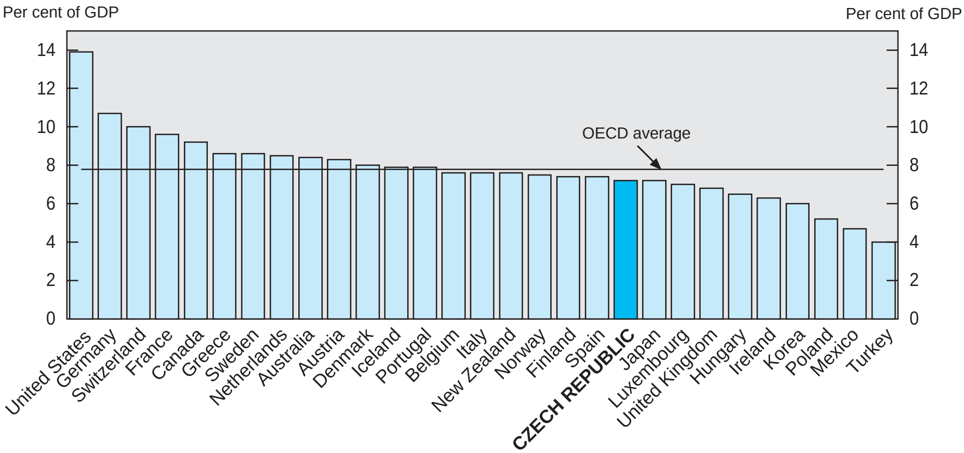
Table 31. **Healthcare indicators**

1997 or latest year

	In-patient care beds	Health sector employment	Hospital employment	Practicing physicians	Practicing specialists	General practitioners	Life expectancy		
							Total at birth	Males At age 40	Females At age 40
	Per 1 000 persons						Years		
Australia	8.5	26.3	16.9	2.5	0.9	1.4	..	37.8	42.5
Austria	9.1	..	15.4	2.9	1.6	1.3	77.5	36.2	41.7
Canada	4.2	25.0	12.1	2.1	0.9	0.9	78.6	37.7	42.6
Czech Republic	**9.0**	**21.7**	**12.4**	**3.0**	**2.2**	**0.7**	**..**	**32.6**	**38.7**
Denmark	4.6	21.1	15.9	2.9	0.1	0.6	..	34.8	39.2
Finland	9.2	42.0	..	3.0	1.4	1.6	77.1	35.4	41.6
France	8.5	26.3	18.5	3.0	1.5	1.5	..	36.4	43.3
Germany	9.4	42.3	11.6	3.4	2.2	1.0	77.3	35.9	41.4
Hungary	8.3	16.1	6.8	3.5	2.8	0.7	69.8	29.0	36.8
Iceland	15.9	33.6	..	3.3	..	0.6	..	38.0	42.2
Ireland	3.7	18.5	4.7	2.1	0.3	0.4	..	35.0	39.8
Italy	6.5	18.0	11.4	5.8	0.5	0.9	..	36.6	42.0
Japan	16.4	20.4	12.4	1.8	..	..	..	38.6	44.8
Korea	4.8	..	..	1.2	..	..	73.5	32.4	39.2
Luxembourg	8.1	18.1	..	2.4	1.6	0.8	..	35.0	40.8
Mexico	1.1	6.1	..	1.3	0.7	0.6	73.6	35.5	40.1
Netherlands	11.5	23.8	9.0	2.6	1.0	0.5	..	36.2	41.2
New Zealand	6.1	17.2	..	2.2	0.7	0.8	77.6	37.4	41.6
Norway	14.7	71.4	16.1	2.5	1.9	0.8	77.7	37.2	42.0
Poland	5.4	..	..	2.4	1.8	..	70.9	30.8	38.3
Portugal	4.1	12.9	10.1	3.1	2.1	0.6	75.0	34.7	40.3
Sweden	5.2	39.0	24.4	3.1	2.2	0.6	..	38.1	42.7
United Kingdom	4.3	20.3	16.6	1.7	..	0.6	76.8	36.1	40.6
United States	4.0	32.6	16.1	2.7	1.5	0.8	76.5	35.9	40.7

Source: OECD Health Data 99.

Figure 19. **Healthcare expenditure**
1997



Source: OECD Health Data 99.

paying hospitals on a prospective basis, adjusting for the mix of patients and their condition (a diagnostic related groups model). *Second*, to help better contain costs, point payments for in-patient care are now negotiated by providers and insurance companies every six months, with final approval being given by the Ministry of Health based on a maximum price per point set by the Ministry of Finance. Within this limit, the Ministry of Health can also vary prices and/or the volume of services that can be offered depending on overall expenditures. As a result, if funds become scarce, the fee per point falls and/or the insurance company must tap into its reserves. In addition, if insurance companies and providers can not come to an agreement, then the government can decide both the point value and volume of services. *Finally*, the government has embarked on a programme of privatising various health care facilities, in particular pharmacies (95 per cent of which are now in private hands) and the remaining dentists and general practitioners and gynaecologists. In addition, a process whereby specialised clinics were allowed to operate privately was initiated as well as pilot projects aimed at evaluating how best to privatise existing facilities. The establishment of private health clinics has resulted, in some cases, in situations where insurance companies have refused to set-up contracts with them, claiming either that they already had sufficient providers or that the care offered was not of high enough quality, and in some cases, non-essential. Where no contract exists with an insurance company, services are provided on a fee-for-service basis, with reimbursement provided only for emergency cases.

Despite these improvements, several concerns remain. The evolving system implicitly relies on general practitioners to fulfil a gatekeeper function, yet this role has never been explicitly defined and direct access to specialists is still possible. Moreover, the number of GPs is relatively low compared with specialists, which, combined with the large number of hospital beds, encourages GPs to pass along many patients to them (see Table 31), resulting in excessive use of high-cost techniques. In addition, payments made to insurance companies do not reflect risk-weighting for different client groups (except for individuals over the age of 60), while government contributions on behalf of the non-employed are set as a fixed amount based on the contribution of someone earning 80 per cent of the minimum wage, which is much lower than the average wage, resulting in a cross subsidisation of these individuals by the employed.

Hospitals are another area of concern. Most hospital doctors are no longer civil servants, which helps to control costs, but there remain a number of other difficulties. For example, when several insurance companies went bankrupt many hospitals were saddled with large debt levels that had to be financed from current revenues, resulting in a rationing of services offered to patients. Also, there does not appear to be a clear plan on how to allocate resources across hospitals (and regions), for example as regards the purchase of new medical equipment. Moreover, there are too many beds, at least compared with other OECD countries, and not enough use of out-patient facilities that can help to contain costs. At the same time, the fee-paid-per-procedure payment system still tends to inflate the number of services offered at hospitals.

One potential source of additional revenue for the system would be to allow co-payments for some elements of healthcare, particularly for non-essential services, and co-payments for drugs, which are heavily subsidised. While the government has recently introduced a new payment system to ensure that the lowest price is paid for drugs, this is probably insufficient. Finally, there are many actors in the healthcare system (*e.g.* the Ministry of Health, Ministry of Finance, insurance companies, hospitals, physicians, etc.) and co-ordination across them appears insufficient.

Thus, though the government has made progress in attempting to control costs while ensuring an adequate level of service, some concerns remain. In particular, the government should:

– Introduce an element of risk weighting in the payments made to insurers, without changing the premiums paid by individuals. One option currently being debated is to introduce payments that vary by five-year age groups, on the assumption that this will better reflect underlying health risks (with the 15-19 age group used as the reference). This may also help put insurance companies on a more even financial footing since currently it is possible for one company to have a large share of clients with high health risks for which they are not adequately compensated. The government should also ensure that its payments on behalf of the non-employed also reflect these variations, and that the points system retained for specialists and hospitals is revised regularly.

– Monitor payments more closely. The system implicitly relies on GPs to fill the role of gatekeeper but this is undermined by allowing clients direct access to specialists. Moreover, the large number of specialists and hospital beds may weaken incentives to control access to more expensive medical care. Because of the imbalance between specialists and GPs, the government should consider limiting enrolments into specialist programmes. In the interim, it envisages that, beginning in 2001, insurance companies will place more emphasis on primary care and adjust the balance of specialists/GPs with whom they contract accordingly.
– Continue privatisation efforts and maintain adequate oversight of privatised organisations to ensure that care is of sufficient quality and that costs are adequately contained. This may help alleviate fears by insurance companies that some privatised facilities are offering expensive care that is not of high quality.
– Improve policy co-ordination among all actors in the system. The Ministry of Health now exercises greater supervision of insurance companies but needs to co-ordinate better its activities with others, including the Ministry of Finance (contribution rates) and insurance companies, and to ensure that resources are distributed across regions equitably.

The pension system

Pay-as-you-go state fund

The Czech Republic runs a state-funded pay-as-you-go (PAYG) pension plan, supplemented by a voluntary private pension scheme (discussed below). The PAYG benefit is two-tier, consisting of a flat rate payment and an earnings-related component, which together make up about 44 per cent of the average wage. The minimum retirement ages are low (60 for men and 53-57[46] for women), but are rising to reach 62 for men and between 57 and 61 for women by the year 2007. Payments and particularly the adjustment mechanism, are relatively generous as they are indexed to both prices (above 5 per cent inflation) and real wages (a so-called Swiss indexation mechanism). Moreover, the flat rate component means that pensions for those with low wages are, on average, substantially more generous. Pensions are paid from general revenues, although a 26 per cent social security charge is levied on gross wages (see Chapter IV).

The demographic position of the Czech Republic is expected to change dramatically over the next few decades, creating a large bulge in the 55 to 75 age group by the year 2050.[47] While there are currently two workers per retired person, this could fall to a one-to-one ratio. The resulting rise in the dependency ratio, combined with the relatively generous nature of the system, will place increasing stress on its financing. Indeed, projections from the Ministry of Labour and Social Affairs indicate that, with no other changes, social security charges would have to rise to a prohibitively high 56 per cent of payrolls by 2050 (Table 32, Panel A) to maintain the current 44 per cent average replacement rate. Almost 20 percentage points of the increase would occur after 2020, when the presently middle-aged cohort moves into retirement. Raising the retirement age to 65 for both men and women would lower the required contribution rate by about 10 percentage points, but would still leave a large financing burden.

Several approaches could be taken to place the system on a sounder financial footing. For example, if benefits were indexed solely to prices, projections indicate that the contribution rate could be maintained at about 30 per cent but at a much reduced replacement rate of roughly 23 per cent (Table 32, Panel B). If retirement ages were also increased to 65 for both men and women,

Table 32. **Sustainability of the public pension fund**

	2000	2010	2020	2030	2040	2050
	Required pension contribution (per cent of gross wages)					
Replacement rate 44 per cent; pensions indexed to wages and prices						
Existing retirement age law[1]	28.7	32.6	38.6	43.3	51.8	56.0
Both men and women retire at 65[2]	28.7	31.5	34.4	36.7	41.9	46.7
Replacement rate variable; pensions indexed to prices						
Existing retirement age law[1]	28.2	25.3	27.4	28.0	30.4	29.9
Replacement rate	43.1	33.9	31.0	28.2	25.6	23.2
Both men and women retirement 65[2]	28.2	24.4	24.5	23.8	24.7	25.1
Replacement rate	43.1	33.7	31.0	28.2	25.6	23.2

Memorandum items:
Wage increases fall to 4 per cent in 2011 and remain there.
Inflation falls to 3 per cent in 2014 and remains there.
Unemployment rate of 11 per cent throughout.
Administration costs of 3 per cent throughout.

1. Under this law, by 2007 men will retire at age 62 and women at an average age of 59.
2. In this scenario, by 2014 men and women retire at age 65.
Source: Ministry of Labour and Social Affairs.

charges would fall further, to 25 per cent. Another option would be to inject more public funds into the system. Estimates place the annual amount necessary to maintain the 44 per cent replacement rate at about Kc 40 billion annually or roughly 2 per cent of GDP in 1999.

Since the demographic situation will worsen only gradually, the Czech Republic has time to put in place measures to reduce the financial stress on the system. For example, the government projections assume that unemployment will remain at an elevated level. A successful programme, aimed at reducing structural unemployment and incentives to early retirement such as recommended in the previous section, would lower dependency ratios and the overall financial burden represented by the PAYG system. Moreover, allowing the replacement rate to fall would encourage individuals to make a greater effort to save for their retirement, which, if combined with other savings vehicles, would also allow individuals to maintain an adequate living standard.

Private pension funds

In this regard, in late 1994, the government passed legislation providing for fully-funded voluntary pension insurance funds with a goal of increasing individual savings for retirement and relieving stress on the PAYG system. Individuals are allowed to participate in only one of the 25 funds in operation (down from the initial 44 licensed as a result of mergers and liquidations), while their contributions are matched up to a threshold by the state (and, on a voluntary basis, by the employer)[48] (Table 33). In 1998, total fund contributions amounted to Kc 30 billion by individuals and Kc 7 billion by the state, with an average state participation of Kc 108 per month per person. On the surface, the funds appear to be a success, with about two million people participating as of the end of 1998. However, fund returns have generally been low, barely above inflation, and costs have been

Table 33. **Participants and contributions to private pension funds**[1]

	Participants	Individual contributions	State contributions	Monthly average wage	Individual contributions/wage	State/individual contributions
	Thousands	Monthly average (koruny)			Per cent	
1995	1 290.1	262.6	93.1	8 736	3.0	35.5
1996	1 564.3	305.5	102.9	9 654	3.2	33.7
1997	1 637.6	333.0	97.4	10 242	3.3	29.2
1998	1 720.0	345.0	98.0	11 482	3.0	28.4

1. Fourth quarter of each year, except 1998 (Q3).
Source: World Bank (1999*b*).

high, leaving open the question of whether or not individuals are participating only to receive the state contributions.

The Ministry of Finance is responsible for regulating the funds and verifies each one quarterly when it makes its matching contributions. Funds are required to place their deposits in an independent entity, usually a bank, and to report to the Ministry every major transaction undertaken, with the need to provide semi-annual and annual public reports on performance, including where possible three years of historical data. What has to be reported in terms of performance measures is, however, not defined and enforcement of this requirement appears patchy. Pension funds are also restricted to holding no more than 10 per cent of their assets in a single company listed on the PSE (or as deposits in any one bank) and a maximum of 5 per cent in other forms of property, although a restriction prohibiting investment in foreign securities is to be lifted as concerns OECD countries in January 2000. Currently, most investments are in state and bank bonds, with equities making up a very small share. Neither the timeliness nor the depth of the audits conducted to verify compliance with these strictures appear adequate.

As a long-term savings vehicle and an alternative to the PAYG system, there were some significant flaws in the first set of arrangements adopted. *First*, clients could cancel their contracts with funds before they reached the official retirement age, taking with them both their contributions and those of the state, either in the form of an annuity or lump sum.[49] As a result, the investment funds probably adopted a more liquid and shorter-term strategy than would have been optimal in order to be able to meet these withdrawals. *Second*, perhaps because of the low return paid by funds, most people appeared to limit their participation to one that maximised the state contribution. At the same time, the relatively high replacement rate for the public pension scheme probably reduced their incentive to contribute more to private pension funds. *Third*, the schemes drew in a significant share of their funds from the inactive population as opposed to those in the workforce, potentially resulting in the peculiar situation where the state provided benefits to these individuals (social assistance, payments from the PAYG fund etc.) and was then forced to match a fraction of them again, effectively increasing benefit rates. *Finally*, only 15 per cent of adherents have been below the age of 35, yet this is precisely the group that should be most interested in supplementing their private savings given the timing of the expected shortfall of the PAYG fund. Perhaps not surprisingly under current conditions, research suggests that the impact of these new pension plans on overall savings has been minimal (Jelinek and Schneider, 1998).

These problems led the government to introduce some changes to supplementary pension rules, which are to come into effect in January 2000. At this time, all new entrants to the scheme will fall under different rules, the most important change being one which prevents a worker from drawing his/her pension before the age of 60, and requiring a minimum contribution period of five years. The state will raise incentives to increase private savings under these private schemes by simultaneously raising its matching contribution rate and the amount that an individual must contribute to be eligible for the funded co-payment. In addition, the government will allow some limited tax deductibility of contributions, while restricting them to those from earned income only.[50] Nevertheless, early retirement will still be possible before the age of 60 once fifteen years' contributions have been reached. Given the extent to which the state is subsidising these pensions, it should ensure that eligibility coincides with that for the old age pension or that such early retirement is associated with actuarially reduced benefits.

Necessity for further changes

If the supplementary pension fund system is to serve as an effective savings vehicle, additional changes will be necessary. *First*, incentives to early retirement need to be eliminated and the ability of participants to draw on the funds, at least those where contributions have benefited from public money, harmonised with those of the PAYG system. At a minimum, those who do retire early should face actuarially reduced payments. *Second*, oversight of the funds will need to be tightened, especially when rules are relaxed on the instruments in which they can invest. Here, the government could contemplate moving supervision to the SEC which monitors other capital market transactions. The government could also impose minimum sizes on funds as was done in Hungary in order to ensure that they have enough assets to diversify portfolios. In addition, the content of disclosure is highly variable and auditing suspect in many of the smaller funds. This may improve as mergers take place, but stronger guidelines on the timing and content of disclosures, in addition to audits, would be required. *Third*, once it is satisfied with the regulatory framework in capital markets, the government might wish to reconsider its decision to not introduce a third compulsory, but fully-funded tier, to the pension system. *Finally*, and for the same reasons enumerated above concerning a social security fund, the government should not proceed with suggestions to set up an independent fund to finance public pensions.

The environment

The communist regime that was swept away by the "velvet revolution" in 1989 left behind a badly-neglected environment. Despite considerable strides forward since that time, including major legislative and institutional changes, the Czech Republic still has some of the worst environmental "black spots" in Europe, a result of severe air and water pollution. Indeed, about one-quarter of the population is exposed to air that does not meet quality standards, while many small municipalities lack wastewater treatment facilities. In the face of these problems, the OECD conducted an environmental performance review in 1998 (OECD, 1999*a*), leading to 55 recommendations for further action in the areas of: implementing environmental policies, strengthening environmental infrastructure, integrating environmental concerns with economic decisions and meeting the country's international environmental commitments. This section focuses in particular on the links between the environment and economic policies.

Environmental policy in the Czech Republic, as in other countries, must not only cope with existing problems, but also adapt to changing consumption and production patterns, for example the move away from public transportation, the move from agriculture towards industry and services, etc. The government initially dealt with these challenges by creating a two-year "Rainbow" programme for environmental recovery which put in place laws such as the Clean Air Act and introduced the use of a number of environment-friendly economic incentive programmes. Since then the government produced a State Environmental Policy in 1995, which set out short and long-term objectives as well as developing the instruments to achieve them.

Over time, the government has steadily devoted more resources to environmental protection, raising spending levels to 2.5 per cent of GDP by 1997 (and about 7 per cent of all investment expenditures) – a high level by OECD standards – where they are likely to remain given the Republic's obligations with respect to EU legislation. The bulk of investment has gone towards combating air pollution, principally financed by public money, either through the State Budget or from the resources of one of two off-budget funds, the State Environmental Fund (SEF, set up in 1992 to combat air and water pollution) and the National Property Fund, the contributions of the latter coming in the form of its commitments to help new owners pay for the clean-up of privatised facilities. Its obligations in this area are estimated to lie in the range of Kc 150 to Kc 400 billion, depending on the actual number of sites that will need clean-up; so far only about Kc 3 billion have been spent.

The Czech Republic has implemented a wide variety of economic instruments to influence behaviour. The most common is the extensive use of charges, in areas such as water consumption and pollution, waste disposal and air pollution, in addition to imposing a punitive 50 per cent surcharge when emission standards are not met. Moreover, it also levies excise taxes (on gasoline and diesel fuels), road taxes, fees for road and motorway use and tax exemptions for environmentally friendly vehicles. While the impact of these instruments is difficult to judge; since their introduction, air pollution (as measured by SO_2 and NO_x emissions) has dropped by more than 50 per cent. Finally, various "green" policies have also been encouraged, such as eco-labelling and more extensive education of the general public. On the other hand, user charges have sometimes been set too low or their level eroded by inflation, while a number of policies, such as subsidised energy prices for households and the low VAT rating given to heating fuel (removed in 1998 when it was increased from 5 to 22 per cent), act as negative green taxes. These may help explain why the Czech Republic continues to be one of the world's largest producers of carbon gases on a per capita basis.

While noting the tremendous progress the Czech Republic has made in the adoption of environmental policies and instruments, the OECD assessment indicates a number of areas where improvement is necessary to ensure that environmental protection is adopted in the most cost-effective manner. In particular:

– Energy pricing needs to be revamped to eliminate cross-subsidies between industry and households (something that should be accomplished by 2002 with the government's recent announcements of energy price hikes, see above) and to ensure that costs (including externalities) are fully reflected in prices and thereby allowing investors to recoup the costs of any environmentally-related investment.
– The *polluter pays* and *user pays* principles needs to be more rigorously implemented, particularly as concerns water resources. For example, the government continues to provide soft loans, via the SEF, for many ecological investments rather than ensuring that polluters pay. The government should develop a broader financing strategy for implementing environmental policies, which encompasses both of these principles and a greater mix of economic instruments, especially in the areas of water supply, waste water treatment and waste management.
– Make greater use of fines and increase the level of user fees. In addition, user charges are typically based on average abatement costs rather than marginal ones and, as a result, few incentives exist to invest in cleaner processes.
– Ministries and localities need to co-operate more actively in the conduct of environmental impact assessments. For example, while FDI incentives must contain an environmental impact assessment, recommendations are sometimes ignored if the investments accrue to distressed regions (which coincidentally are also among the most environmentally damaged). In addition, enforcement of existing laws has sometimes been lax, partly because of a lack of staff.
– While expenditures have risen, more should be channelled to investments that help to prevent pollution, in addition to cleaning up existing problems.

IV. The tax system

Forces shaping the system: past, present and future

The tax system in the Czech Republic is broadly similar to that observed in many OECD countries and it carries relatively few vestiges of the pre-transition system. Nevertheless, several of its features reflect the difficulties inherent in moving towards a market-based economy. Box 7 provides a brief description of the system under communism and the reforms undertaken at the beginning of the transition. The most important of these were the elimination of a large variety of negative tax rates used to subsidise "socially sensitive" consumption and the establishment of a corporate tax system that was rule-driven and not subject to negotiation as had been the case under central planning. Following these initial steps, a more fundamental reform was passed in 1992 by the Czechoslovak parliament but entered into force only in 1993, after the break up of the country into the Czech and Slovak Republics.[51] It replaced the previous tax system with one based on the same principles as observed in the mature market economies of the OECD.

In its main features, the structure of the new system compares with those of most OECD countries. The overall tax burden is about average (Figure 20), although at 36 per cent it is much higher than observed in most of OECD countries when they were at similar stages of development.[52] The tax mix is fairly diversified, with personal income, social security contributions and consumption taxes, accounting for the major part of revenues (Table 34). By international comparison, the share of corporate income tax is average, while those of consumption and social security contributions are high (taken together they account for more than 75 per cent of total tax revenues). Individual income taxes represent a small proportion of tax revenues than in most other countries, while that of other taxes, including those levied by local governments (property taxes and other fees) is very small (Table 35).

Tax revenues, as a share of GDP, have declined in each year since the establishment of the Republic, and are now close to the OECD average (Figure 21). Most of the fall reflects reductions in corporate income tax receipts,

Box 7. The tax system prior to the transition

Although the existing tax framework in the Czech Republic is dramatically changed from the one in operation at the time of the Communist regime, some of its features bear traces of the old system.[1]

Taxes on enterprise surpluses (profits) yielded 11 per cent (a comparatively high proportion) of GDP. This heavy reliance on corporate taxes reflected the state's use of this mechanism, as owner, to appropriate its share of enterprise profits. As a result, the actual rate at which firms were taxed varied widely and was subject to yearly negotiation (both during the planning process and at the end of the fiscal year). Among other considerations, tax rates were set as a function of a firm's profitability and national industrial policy objectives. In this context, the tax administration was an active player in the economic policy and planning process.

The turnover tax was applied to all goods, whether or not they served as inputs in the production process. The tax schedule was extremely complicated, with specific rates (ranging from -.74 to 733 per cent) specified for some 1 506 commodities groups.[2] The consumption of some 428 groups of "socially necessary" goods was subsidised by applying negative turnover tax rates, which ensured that producers covered their production costs while consumers paid a substantially lower price.

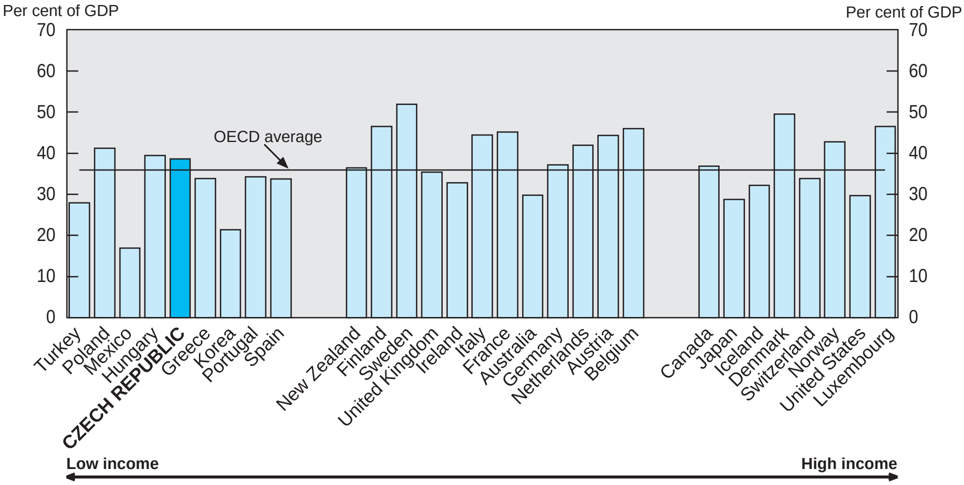
Payroll taxes, were applied at a more or less uniform rate and their share in GDP (12.6 per cent), was higher than the average among OECD and European countries. The narrow spread of earned incomes at that time and the absence of other significant sources of income meant that, even at high rates, the tax introduced relatively few distortions.

Personal income taxes did not exist *per se*. Wage earnings were subject to a schedular tax with the rate paid depending on the age, sex, marital status and number of dependants of the taxpayer, but not their salary. Beginning in 1991, this tax was supplemented with taxes on other forms of income[3] to create what could be called a personal income tax system. This new system remained schedular, with different sources of income being taxed at different rates and wage earnings still subject to different tax rates depending on family situation. Because income from different sources was not aggregated and the tax applied to various income sources was flat the system was not progressive.

While these taxes were more or less appropriate for the pre-transition economy where prices fulfilled only a small allocative role, for the market-based economy of the transition at least three changes were immediately essential. *First*, the corporate taxation system needed to be revised to be made more transparent, eliminating the role of negotiation (*ex post* and *ex ante*) of taxes. *Second*, the wide variation in turnover tax rates had to be abolished to allow prices to reflect resource costs; and *finally*, the personal income tax system needed to be revised in anticipation of the widening of the income distribution and the increased importance of non-wage incomes. Of these tasks, the most difficult and most economically pressing was the transformation of the turnover tax into a value added tax. Such changes were introduced gradually beginning in 1990 and culminated in the major 1993 reform described in the main text.

1. This description of the tax system under communism draws heavily upon Heady, Rajah and Smith (1994).
2. Calculated as a per cent of the net of tax price. During the communist regime these rates were expressed as a per cent of the tax-inclusive price.
3. Income was grouped under income from employment, agriculture or literary and artistic work and "other income" such as income from capital and income from entrepreneurial activity. This other income was subject to the non-wage rates.

Figure 20. **The overall tax burden in OECD countries**[1]
1997



1. Tax revenues as per cent of GDP.
Source: *OECD National Accounts, OECD Revenue Statistics.*

Table 34. **General government consolidated tax revenues**

	1989[1]	1993	1994	1995	1996	1997	1998
	Per cent of GDP						
Profits taxes/corporate income taxes	11.0	7.0	5.6	4.9	4.0	3.3	3.7
Payroll and social security taxes	12.6	16.9	16.6	16.4	16.5	17.0	16.9
Turnover tax (net)/taxes on goods and services	11.4	14.1	13.8	13.2	13.0	12.6	11.9
Wages tax and other taxes on individual incomes/ individual income taxes	7.0	3.8	4.6	5.0	5.1	5.2	5.2
Other taxes (agricultural land, trade taxes, etc.)/ property and other taxes	4.9	0.5	0.6	0.6	0.5	0.5	0.6
Total tax revenues	47.0	42.2	41.3	40.1	39.1	38.6	38.3

1. The figures for 1989 may alternatively be presented on a basis which counts the subsidies paid in the form of negative turnover tax rates as public expenditure. If turnover tax receipts and total tax receipts are calculated gross, before deduction of the subsidies through negative turnover taxes, this gives turnover tax receipts in 1989 of Kc 135 billion and aggregate revenues of Kc 403 billion. As a percentage of total tax receipts calculated on the gross basis, turnover taxes contributed 33 per cent. Total taxes on this basis were 53 per cent of GDP.
Source: Ministry of Finance, OECD *Revenue Statistics.*

Table 35. **The structure of taxation by type of tax**

1997

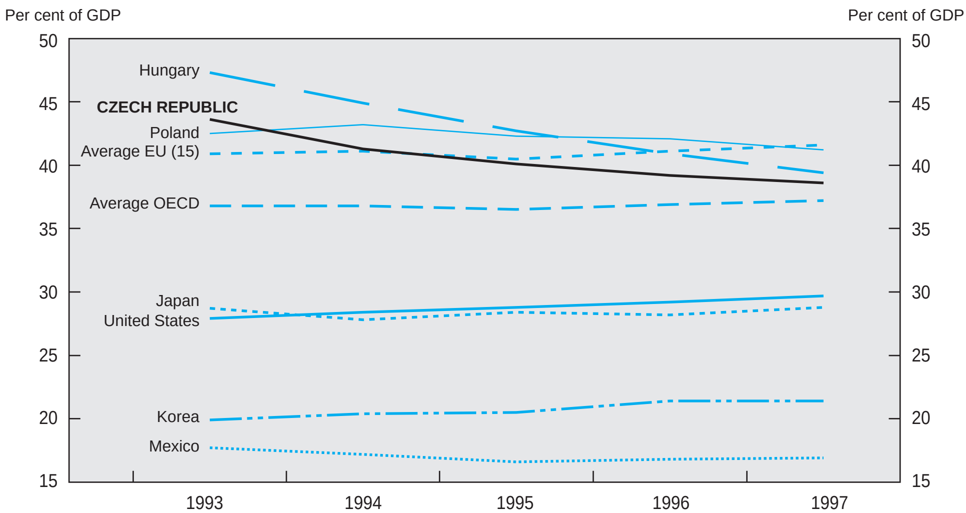
	Corporate income taxes	Individual income tax	Social security and payroll taxes	Consumption taxes	Other taxes, including property taxes
	Per cent of total tax revenue				
United States	9.4	39.0	24.2	16.7	10.7
Japan	15.0	20.5	36.9	16.5	11.0
Germany	4.0	23.9	41.6	27.7	2.8
France	5.8	14.0	43.0	27.9	9.3
Italy	9.5	25.3	33.6	25.9	5.8
United Kingdom	12.2	24.8	17.2	35.0	10.9
Canada	10.3	38.0	15.5	24.4	11.7
Australia	14.6	42.0	6.7	27.5	9.2
Austria	4.7	22.1	40.4	28.2	4.6
Belgium	7.5	31.0	31.8	26.7	3.0
Czech Republic	**8.6**	**13.5**	**43.9**	**32.6**	**1.4**
Denmark	5.2	52.4	3.7	33.0	5.7
Finland	8.1	33.4	25.2	30.9	2.5
Greece	6.4	13.2	32.2	41.0	7.2
Hungary[1]	4.9	16.8	36.3	39.3	2.7
Iceland	2.8	32.8	8.8	47.5	8.2
Ireland	10.0	31.4	14.0	39.7	4.9
Korea	10.5	17.1	9.1	45.4	17.9
Luxembourg	18.5	20.4	25.4	27.0	8.7
Mexico[1]	18.9	14.8	22.1	39.3	4.9
Netherlands	10.5	15.6	41.0	28.0	5.0
New Zealand	10.6	43.2	1.0	34.6	10.6
Norway	12.2	25.7	22.4	37.0	2.7
Poland	7.7	21.5	32.9	34.9	3.1
Portugal	10.9	17.7	26.0	42.0	3.4
Spain	7.8	21.9	35.0	28.9	6.3
Sweden	6.1	35.0	32.5	22.3	4.1
Switzerland	5.9	31.2	36.9	18.3	7.7
Turkey	5.7	21.7	14.5	37.1	20.9
Average OECD[2]	8.8	26.6	26.1	31.3	7.2
Average G7[2]	9.5	26.5	30.3	24.9	8.9
Average EU(15)[2]	8.5	25.5	29.5	30.9	5.6

Note: Consumption taxes equal total taxes on goods and services less "profits of fiscal monopolies" and other "taxes".

1. 1996 data. PEMEX revenues have been excluded from consumption taxes. Individual and corporate taxes have been estimated as well as payroll and property taxes. Unallocated state and municipal tax revenues have been included.
2. Excluding Mexico.

Source: OECD *Revenue Statistics.*

Figure 21. **Total tax revenue**



Source: *OECD Revenue Statistics.*

following the lowering of rates from 42 to 35 per cent between 1994 and 1998[53], and a purposeful narrowing of the tax base. Collections from indirect taxes and property taxes have also fallen, while social security contributions have remained a relatively stable share of GDP. Revenues from personal income taxes have increased substantially but, because the authorities sought to reduce the overall tax burden, these increases did not fully compensate for the losses from other revenue sources.

The decline in revenues, as a share of GDP, was only partially offset by reduced spending and, as a result, the general government surplus observed early in the transition moved into deficit in more recent years. At 42 per cent of GDP in 1998, consolidated government expenditures in the Czech Republic are above the OECD average and much higher than in other lower income countries such as Korea and Ireland (Table 36). The 3.1 per cent of GDP decline in government spending since 1994 reflects a substantial (1.5 per cent of GDP) fall in investment spending and a 3.1 percentage point drop in expenditure on goods and services, offset by a 2.2 per cent increase in subsidies and personal transfers (Table 37) – particularly pensions.

Looking forward, tax policy will be driven by a number of issues. Perhaps the principal one is the necessity of meeting the harmonisation criteria for EU

Table 36. **General government expenditures in the OECD**[1]

1998

	Per cent of GDP
United States	32.8
Japan[2]	36.9
Germany	46.9
France	54.3
Italy	49.1
United Kingdom	40.2
Canada	42.1
Total of above countries	38.8
Australia	32.9
Austria	49.4
Belgium	51.0
Czech Republic	**42.1**
Denmark	55.1
Finland	49.1
Greece	41.8
Hungary	44.3
Iceland	36.2
Ireland	33.1
Korea	25.6
Netherlands	47.2
New Zealand	39.8
Norway	46.9
Poland	45.7
Portugal	43.6
Spain	41.8
Sweden	60.8
Total	39.4

1. Current outlays plus net capital outlays.
2. The 1998 outlays would have risen by 5.4 percentage points of GDP if account were taken of the assumption by the central government of the debt of the Japan Railway Settlement Corporation and the National Forest Special Account.

Source: OECD (1999*c*).

accession. At the moment, the most serious changes involve the alignment of a number of indirect taxes (VAT and excise rates) with EU norms. In addition, there are numerous smaller tasks aiming at fine-tuning that need to be accomplished but which will undoubtedly take time. Over the medium term, the tax-system faces important challenges emanating from the changing nature of the Czech economy. Its reliance on indirect taxes and payroll taxes from dependent employment means that the rise in unemployment and fall in labour force participation of the past few years have had a strong impact on the overall tax base. Similarly, the decreasing importance of large-scale manufacturing firms in the economy and the concomitant rising share in total output of small service-sector firms implies

Table 37. **General government consolidated expenditure by function and economic type**

	1993	1994	1995	1996	1997	1998
	Per cent of GDP					
By function						
Total expenditure	43.9	45.2	44.0	43.1	42.3	42.1
General public services	3.4	3.7	3.8	4.1	2.4	2.3
Defense	2.4	2.4	2.1	2.0	1.7	1.7
Public order and safety	2.3	2.5	2.5	2.6	2.0	2.0
Education	5.3	5.4	5.3	5.3	4.6	4.2
Health	2.8	6.9	6.8	6.7	6.6	6.7
Social security and welfare	15.7	11.8	11.7	11.7	13.9	14.1
Housing and community amenities	3.9	3.5	3.0	2.9	3.6	3.1
Recreation, cultural and religious affairs and services	0.8	0.9	1.0	1.0	1.0	0.9
Economic affairs and services	5.9	7.0	6.8	6.2	5.8	6.4
Fuel and energy	0.4	0.4	0.3	0.8	0.2	0.2
Agriculture, forestry, fishing and hunting	1.1	0.9	0.8	0.7	0.9	0.9
Mining, manufacturing and construction	0.6	1.3	0.2	0.1	0.1	0.1
Transportation and communication	2.8	3.3	3.4	3.1	3.2	3.0
Other economic affairs and services	1.0	1.2	2.2	1.4	1.3	2.1
Other expenditures	2.1	1.5	1.5	1.3	1.2	1.2
By economic type						
Total expenditure	43.9	45.2	44.0	43.1	42.3	42.1
Current expenditure	37.7	37.9	36.8	36.5	36.7	36.8
Expenditure on goods and services	12.6	11.4	9.1	9.1	8.3	8.3
Wages and salaries	3.7	4.2	3.7	3.7	3.8	3.5
Interest payments	1.8	1.3	1.2	1.1	1.3	1.2
Subsidies and other current transfers	23.3	25.2	26.4	26.4	27.2	27.4
Subsidies	6.4	7.2	8.5	8.2	7.8	7.8
Transfers to households and non-profit institutions	16.8	17.9	17.9	18.2	19.2	19.4
Capital expenditure	6.3	7.3	7.3	6.6	5.6	5.3
Investment	3.9	4.7	4.7	4.5	3.5	3.2
Purchase of stocks	0.0	0.0	0.0	0.0	0.0	0.0
Purchases of land and intangible assets	0.0	0.0	0.0	0.0	0.2	0.2
Capital transfers	2.3	2.5	2.6	2.0	1.9	1.9

Source: Ministry of Finance.

increases in the cost and complexity of tax administration.[54] An additional transitional pressure is likely to flow from plans to introduce a new regional level of government. For the moment, its nature and tax powers are unspecified (see Chapter II) but its introduction will certainly play a role in the future development of tax policy in the Czech Republic.

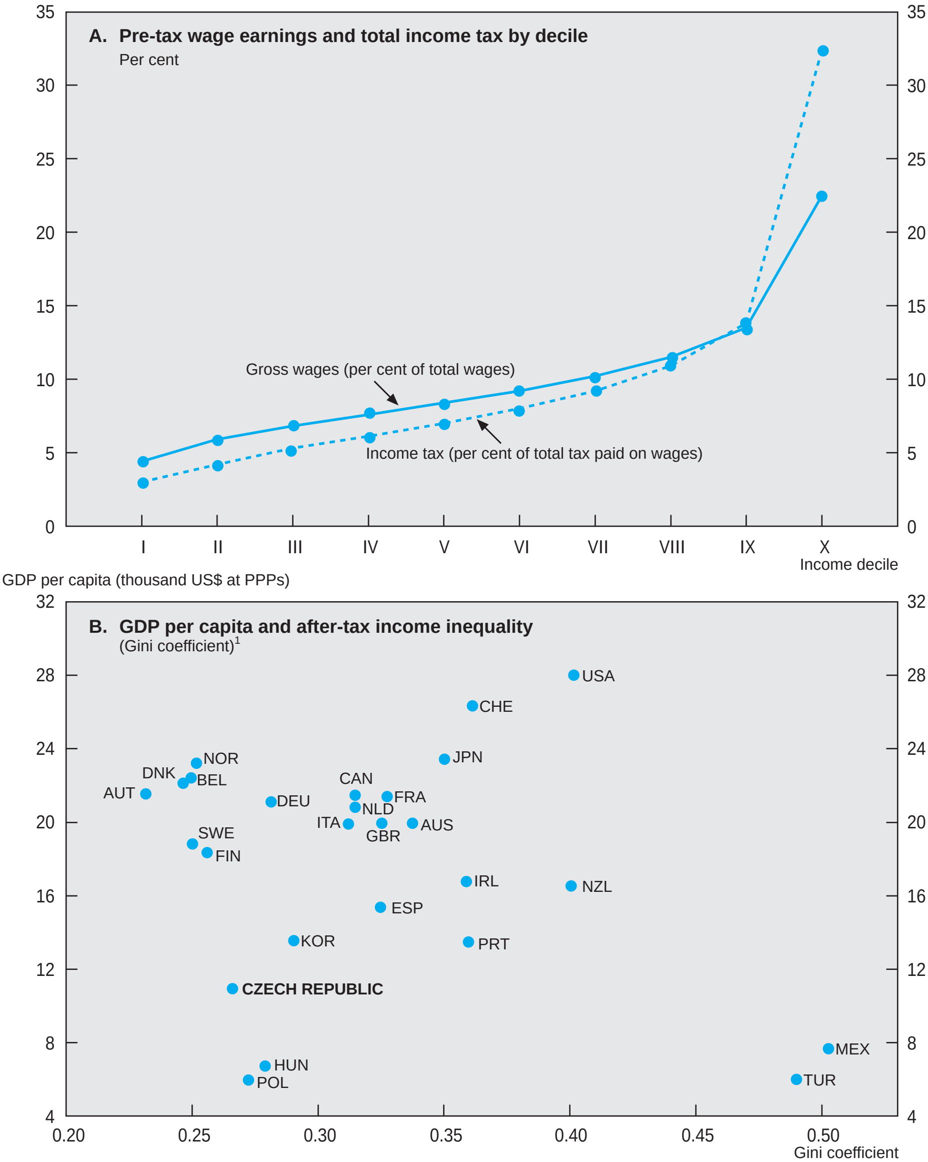
Over the longer term, the tax system will face increasing pressure to meet growing expenditures from existing entitlement programmes. As indicated in Chapter III, an ageing population and a relatively generous pension scheme that is indexed on wages rather than inflation will impose a considerable additional demand on the system. By the same token, health spending can be expected to increase as the population ages. While improved productivity performance and the general process of catch up in the economy will counterbalance these pressures somewhat, they are likely – nonetheless – to require some hard decisions concerning spending. A more fundamental and longer-term concern revolves around the creation of fiscal conditions that will maximise the speed with which living standards converge to those in western Europe. While the international evidence is not conclusive and the issues involved extend well beyond distortions created by the tax system, high levels of government spending (and taxation) have often been found to be associated with slower economic growth. With standards of living in the Czech Republic some 40 per cent lower than in the rest of the OECD, the need to keep economic distortions and other impediments to growth at a minimum is of primary importance if convergence is to be achieved within a reasonable time frame.

Main features

Personal taxes

The personal income tax system (PIT) applies a progressive rate schedule to all earned income[55] and income from some other sources (principally intellectual property and rents from secondary dwellings). The schedule comprises five income brackets with rates ranging from 15 to 40 per cent, the number and top rates having been reduced since its original implementation in 1993. A wide range of tax allowances, awarded on the basis of marital status and family size, helps to promote horizontal and vertical equity. Standard deductions range from 18 to 58 per cent of the earnings of an average production worker (APW).[56] The degree of progressivity in the system is about average, with the top 20 per cent of wage earners paying 46 per cent of all personal income taxes (Figure 22, Panel A). However, as compared with most OECD countries relatively few taxpayers are exposed to top rates and not all personal income is taxed according to this schedule (see Table A1 in Annex I). Distributed income from capital holdings is taxed under a separate flat-rate regime at rates ranging between 0 and 25 per cent depending on the manner in which the income concerned is distributed (Table 38). These rates are low by international comparison (Figure 23) and are substantially below the top income tax rate. Nevertheless, the after-tax distribution of taxable income in the Czech Republic is among the most evenly

Figure 22. **Tax and the distribution of income**



1. The Gini coefficient is a measure of income inequality: the higher the coefficient, the wider the income distribution. Data are for 1996 or nearest year available.

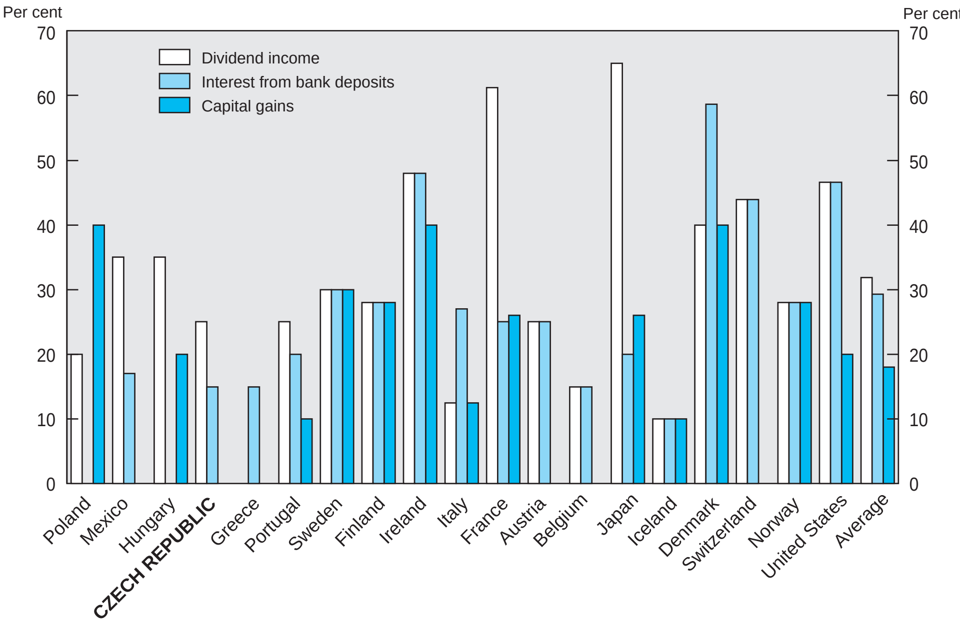
Source: Ministry of Finance; World Bank, *World Development Indicators, 1998.*

Table 38. **Principal statutory personal income tax rates**[1]

Income	Tax base	Rates		
		Tax bracket	Tax rate	Lower threshold as a percentage of APW wage
1. Income from labour	Wage income, occupational pensions and income from entrepreneurial activity net of deductible expenses	0-102 000	15	0
		102 001-204 000	20	0.65
		204 001-312 000	25	1.3
		312 001-1 104 000	32	1.99
		Above 1 104 000	40	7.03
2. Distributed income from capital	Dividends and other income from profit distribution		25 per cent final withholding tax	
	Interest payments from deposit accounts and saving books		15 per cent final withholding tax	
	Capital gains		Exempt (under certain restrictions)	
	Dividends and interest paid by a Pension Fund and annuities paid by private pension schemes		15 per cent final withholding tax	

1. Data are for 1 January 1999.
Source: OECD, Ministry of Finance.

Figure 23. **Highest "all-in" rates on capital income**[1]
1998



1. "All-in" rates include surcharges and local tax rates when applicable. Countries are ranked by ascending GDP per capita at purchasing power parities.
Source: OECD.

distributed in the OECD area (Figure 22, Panel B) principally reflecting the evenness of the pre-tax distribution of income.

In addition to personal income taxes, labour income is subject to social security taxes. The entire social security system was described in detail in the previous *Economic Survey of the Czech Republic* (OECD, 1998*a*) and progress in its reform since then is discussed in Chapter III of this survey. The various compulsory contributions that are part of it were first introduced in 1993 and the aggregate contribution rate, both statutory and net of other taxes, is among the highest in the OECD area (Table 39). Only healthcare payments are earmarked contributions. Payments from the other social security taxes enter general revenues and over the period 1993-98 receipts from these sources have exceeded expenditures on the programmes that carry their names by 14 per cent.[57] Social security contributions represent the largest and a growing share in government revenues,

Table 39. **Social security contributions of top income wage earners**

1998[1]

	Employee contributions		Employer contributions	
	Legal rate	Net rate[2]	Legal rate	Net rate[2]
United States	1.45[3]	1.45	1.45[3]	0.88
Japan	12.75	cap	27.75	13.88
Germany	14.25	cap	20.75	cap
France	13.60	7.60	35-45[4]	20.42-26.25
Italy	9.19	4.96	38.90[5]	21.99
United Kingdom	10.00[6]	cap	10.00	6.90
Canada	2.80	cap	2.90	1.54
Australia	1.50	1.50	n.a.	n.a.
Austria	17.15[7]	cap	17.65	11.65
Belgium	13.07	5.10	35.06[8]	20.98
Czech Republic	**12.50**	**7.50**	**35.00**	**22.75**
Denmark	9.00	3.70	0.33	0.22
Finland	8.05	4.54	28.70	20.66
Hungary	11.50	1.50	40.64	32.88
Iceland	n.a.	n.a.	5.83	4.08
Ireland	6.75	2.25	12.00	cap
Korea	2.30	1.38	10-40	6.88-27.54
Luxembourg	10.70	cap	16.35	cap
Mexico	5.25	cap	18.95	12.51
Netherlands	7.65	cap	19.80	cap
New Zealand	n.a.	n.a.	n.a.	n.a.
Norway	7.80	7.80	15.51	11.17
Poland	n.a.	n.a.	48.00	30.72
Portugal	11.00	6.60	23.75	14.87
Spain	6.40	cap	30.80	19.77
Sweden	6.95	cap	38.66	27.84
Switzerland	13.40	7.52	6.55	4.38
Turkey	14.00	6.30	25.00	14.00

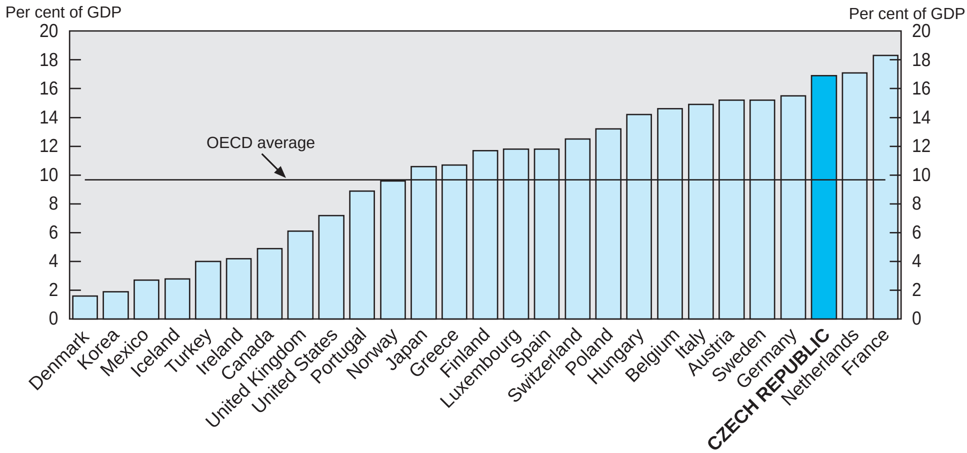
1. Data are for 1 January 1998.
2. The net rate differs from the legal rate when employee's contributions are deductible from the personal income tax or when employer's contributions are deductible from the corporate income tax and where ceilings apply.
3. For wages in excess of $68 400 only the Medicare tax applies. For wages below this amount the rate rises to 7.65 per cent because it includes social security contributions of 6.2 per cent.
4. Employer's contribution rates vary between 35 and 45 per cent, depending on the wage level and the type of employee.
5. A supplementary contribution to the work injury fund (INAIL) of 1 per cent is compulsory for manual workers.
6. The rate is 2 per cent on the first £62 per week and 10 per cent on the next £403 per week, up to the upper earnings limit of £465 per week.
7. Blue collar workers must pay 17.7 per cent. In addition certain employees must pay a state union contribution (0.5 per cent) and a bad weather contribution (0.7). Employers face a 18.2 per cent rate for blue collar workers.
8. This rate applies when there are more than 19 employees and is 33.25 when there are fewer than 10. For firms with between 10 and 19 comployees the rate is 33.25.

Source: *European Tax Handbook 1999*, OECD.

having increased between 1993 and 1997, from 38.6 to 43.9 per cent – well above the OECD average. Indeed, only France and the Netherlands collect a larger share of GDP in revenues from this source (Figure 24).

Table 40 reports the principal parameters of the health and social security systems for both the employed and the self-employed. Employee and self-

Figure 24. **Social security contributions**
1997



Source: *OECD Revenue Statistics.*

Table 40. **Social and health insurance contributions**
1999

	Employee	Employer	Total	Self-employed
Contributions rates				
Health insurance	4.5	9.0	13.5	13.5
Social insurance				
Sickness benefit	1.1	3.3	4.4	4.4 (voluntary)
Pension	6.5	19.5	26.0	26.0
Employment policy	0.4	3.2	3.6	3.6
Total	8.0	26.0	34.0	34.0
Total	12.5	35.0	47.5	47.5
Contribution base				
Health insurance		Gross wages		35 per cent of annual net income. The ceiling is 486 000 Kc. The floor is twelve times the minimum wage.
Social insurance		Gross wages		35 per cent of yearly net income. The ceiling is 486 000 Kc. The floor is 18 300 Kc.

Source: Ministry of Finance.

employed contributions are fully deductible from the personal income tax base and employer contributions are fully deductible from the corporate income tax base (see below). The total contribution rates applied to wage and self-employed income are the same (except that for the latter participation in the sick-leave programme is optional), but the base upon which they are levied differs importantly between the two groups. For the self-employed the contribution rates are applied to only 35 per cent of self-employed income, subject to both ceilings and floors,[58] whereas all of an employee's earnings are taxed without reference to floors or ceilings.

Value-added tax

With few exceptions, Czech value-added tax (VAT) rules follow the EU model. VAT is charged on all taxable transactions, including domestically-produced supplies in kind, and imported goods. Exported goods are zero-rated while small firms, financial and social-security services are exempt.[59] The tax is imposed at an internationally high standard rate of 22 per cent (down from 23 per cent prior to January 1995) although it falls within the recommended interval of the EU (Table 41). There is a reduced rate of 5 per cent which, in an apparent effort to serve redistributive goals, is applied to an exceptionally wide range of "socially sensitive" items[60] including foodstuffs, pharmaceutical products, telecommunications, heating fuels, construction and most services (see Table A2, Annex I). The wide range of activities exempt from VAT or subject to reduced or zero rates means that the effective VAT rate (the ratio of VAT revenue to consumption) is low by international comparison as is the productivity[61] of the tax (measured as the ratio of the effective to the statutory rate).

The taxation of firms

Corporate income tax

Corporate income tax (CIT) is levied on the worldwide income (profit) from all activities of legal entities, including limited partnerships and domestic income earned by permanent establishments of foreign companies.[62] Deductible business expenses include physical depreciation of capital, interest on liabilities, provisions for bad debts and social security contributions. At the beginning of the transition, the statutory corporate tax rate was higher than in most OECD countries (Table 42) and depreciation periods were extremely long. Since then, the rate has been gradually reduced, reaching 35 per cent in 1998[63] – a level comparable to that observed in most OECD countries. Most recently, depreciation schedules were also shortened (effective beginning 1999) and now range from four to 30 years, broadly in line with OECD practice.

Table 41. **VAT productivity and effective VAT rates**

1997[1]

	VAT per cent GDP	Standard VAT rate	Effective VAT rate[2]	VAT productivity[3]
	A	B	C	C/B per cent
United States	n.a.	n.a.	n.a.	n.a.
Japan	1.8	5.0	3.1	89.0
Germany	6.6	16.0	11.5	76.6
France	7.9	20.6	14.7	71.3
Italy	5.7	20.0	9.8	51.6
United Kingdom	6.9	17.5	10.8	61.8
Canada	2.5	7.0	4.3	61.4
Australia	n.a.	n.a.	n.a.	n.a.
Austria	8.2	20.0	15.3	76.4
Belgium	7.0	21.0	12.5	59.5
Czech Republic	**7.1**	**22.0**	**12.6**	**57.4**
Denmark	9.8	25.0	22.2	88.7
Finland	8.2	22.0	18.1	82.2
Greece	7.5	18.0	11.6	64.3
Hungary	7.9	25.0	14.4	57.6
Iceland	9.4	24.5	17.3	70.7
Ireland	7.7	21.0	17.4	83.0
Korea	4.3	10.0	8.5	84.8
Luxembourg	5.7	15.0	..	..
Mexico	3.1	15.0	4.7	31.5
Netherlands	7.0	17.5	13.2	75.3
New Zealand[4]	8.8	12.5	15.2	121.5
Norway	8.8	23.0	21.7	94.4
Poland	8.4	22.0	..	..
Portugal	7.9	17.0	14.4	84.4
Spain	5.8	16.0	9.9	61.9
Sweden	7.3	25.0	14.5	58.2
Switzerland	3.4	6.5	5.7	87.6
Turkey	6.5	15.0	9.9	66.0
OECD average[5]	6.7	17.7	12.5	72.7
G7 average[5]	5.3	14.4	9.0	68.6
EU average[5]	7.3	19.4	14.0	71.1

n.a. Is not applicable.
.. Is not available.
1. As of 1st January 1998 (except for Germany) where the standard VAT rate was raised from 15 to 16 per cent on 1st April 1998.
2. Effective VAT rate is VAT revenue divided by base (*i.e.* consumption expenditure).
3. VAT productivity is effective VAT over standard rate.
4. The general sales tax at standard rate is levied on 60 per cent of the value of the supply for long-term stay in a commercial dwelling which may partly explain why the effective VAT rate exceeds the standard rate.
5. Simple average over available countries.

Source: Adapted from OECD *Revenue Statistics* (1998*e*), OECD *Consumption Tax Trends* (1998*d*) and Analytical database.

Table 42. **Trends in basic rates of central government corporate income tax**

	1986	1991	1995	1996	1997	1998
	Per cent					
United States	46	34	35	35	35	35
Japan	43	38	38	38	38	34
Germany[1]	56	50-36	45-30	45-30	45-30	45
France	45	34-42	33	33	33	33
Italy	36	36	36	36	36	37
United Kingdom	35	34	33	33	33	31
Canada	36	28	28	29	29	28
Australia	49	39	33	36	36	36
Austria[2]	50	30	34	34	34	34
Belgium	45	39	39	39	39	39
Czech Republic[3]	**75**	**55**	**41**	**39**	**39**	**35**
Denmark	50	38	34	34	34	34
Finland	33	23	25	28	28	28
Greece[1, 4]	49	46	35-40	35-40	35-40	35-40
Hungary[1, 3]	55	40	18-41	18-42	18	18
Iceland	51	45	33	33	33	30
Ireland	50	43	40	38	38	32
Korea[5]	27	34	34	34	28	28
Luxembourg	40	33	33	33	33	30
Mexico[6]	39	..	..	34	34	34
Netherlands	42	35	35	35	35	35
New Zealand	45	33	33	33	33	33
Norway	28	27	19	21	21	28
Portugal[1]	42-47	36	36	36	36	34
Spain	35	35	35	35	35	35
Sweden	52	30	28	28	28	28
Switzerland	4-10	4-10	4-10	4-10	4-10	4-10
Turkey	46	49	25	25	25	25
Average basic rate[7]	44.5	37.1	33.8	33.8	33.8	33.1
Range (maximum-minimum)	48.0	32.0	22.0	18.3	18.3	20.0
Standard deviation[7]	9.8	7.4	5.6	4.9	5.1	4.4

Note: Austria, Canada, Finland, Germany, Italy, Japan, Norway, Portugal, Switzerland and the United States also have sub-central corporate taxes. Rates rounded to nearest percentage point. Many countries also have special rates for firms with lower profits and for particular sectors.

1. When two rates are shown, the first one applies to retained earnings, the second one to distributed income.
2. 1986 data are national data.
3. The first column applies to 1988 instead of 1986. In 1988, in Hungary, the first 3 million forints was taxed at 35 per cent.
4. The last column applies to 1997 instead of 1998.
5. Adjusted taxable income less than 100 million won was taxed at 20 per cent in 1991 and since 1997 at 16 per cent.
6. Mexican corporate tax data for the first year considered are from national sources and concerns 1988 instead of 1986.
7. This average excludes Switzerland, takes into account the rates on retained earnings for Germany (respectively 50 per cent in 1991 and 45 per cent in 1995-98), 34 per cent for France in 1991 (rate applicable from the second part of the year onwards), 40 per cent for Greece in 1995 and 1997 (rate applying to non-listed corporate profits) and 42 per cent for Portugal in 1986.

Source: OECD, *Owens and Whitehouse* (1996), *European tax handbook,* 1999.

The statutory CIT rate in the Czech Republic was the eleventh highest in the OECD in 1996, the last year for which comprehensive comparative data are available (Table 43). Since then it has fallen to 35 per cent, which raises its rank to fourteenth in 1998. Partial relief from CIT is provided to firms when they distribute earnings to shareholders while various special rules concerning the treatment of international firms are described in Box 8. Except when a dividend is paid out to a pension fund, a company receives a credit against its own CIT liability equal to one half the 25 per cent withholding tax on the dividend paid out, reducing in these instances the effective corporate income tax on distributed earnings to 26.9 per cent. Moreover, the deductibility of interest income (a cost to the firm but a return to capital for the economy), various fiscal depreciation rules and tax evasion mean that not all of economic profit is subject to the CIT. Similar factors tend to reduce the CIT tax base in other OECD countries as well. As a result, the statutory rate is a poor indicator of the extent to which profit is taxed. Indeed, the ranking of countries according to statutory CIT rates is quite different from that

Box 8. Special rules concerning inter-company activities

Special tax rates apply to domestic-source income derived by resident companies from subsidiaries in which they have an ownership in excess of 25 per cent. A 25 per cent final withholding tax is levied on:

– Dividends and other income.
– Interest paid abroad that is disallowed under thin capitalisation rules.
– The difference between the agreed price and the market price under the transfer-pricing rules when paid from a subsidiary abroad.
– Fees paid abroad to a board of directors or a supervisory board.

Transfer pricing and thin capitalisation

Prices agreed between related parties that differ from prices contracted with independent customers in similar commercial transactions may be adjusted by the tax administrator. Companies can, however, dispute this treatment if they properly document their transfer prices. Similarly, interest charged on loans between related debtors and creditors must in general be equal to 1.4 times the Czech National Bank Discount Rate (11.5 per cent in 1998). This provision does not apply when the creditor is resident abroad and the interest rate charged is below the central bank's discount rate.

When a company's debt to equity ratio exceeds prescribed limits, thin capitalisation rules may limit the deductibility of interest charges on loans. Interest paid on foreign loans provided by related parties in excess of the ratio 4:1 between the aggregate value of foreign value of foreign debt and all equity of the company is not deductible for tax purposes. The ratio for banks and insurance companies is 6:1. However, newly established companies are exempted from thin capitalisation rules in the year of establishment and during the subsequent three calendar years.

Table 43. **The taxation of profit**

1996

	Combined statutory corporate income tax rate	Corporate income tax as a per cent of GDP[1]
	Per cent (rank)	
United States	39.5 (10)	2.7 (15)
Japan[2]	50.0 (3)	4.7 (1)
Germany[2]	56.3 (1)	1.4 (23)
France	41.7 (6)	1.7 (21)
Italy[3]	53.2 (2)	4.0 (6)
United Kingdom	33.0 (19)	3.8 (7)
Canada	46.1 (4)	3.3 (10)
Australia	36.0 (13)	4.7 (2)
Austria[4]	34.0 (16)	2.1 (18)
Belgium	40.2 (7)	3.1 (13)
Czech Republic[5]	**39.0 (11)**	**4.2 (4)**
Denmark[6]	34.0 (16)	2.4 (16)
Finland	28.0 (22)	3.2 (11)
Iceland	33.0 (19)	0.9 (24)
Ireland	38.0 (12)	3.2 (12)
Mexico	34.0 (16)	2.3 (17)
Netherlands	35.0 (15)	4.1 (5)
New Zealand[7]	33.0 (19)	3.5 (8)
Norway[8]	28.0 (24)	4.3 (3)
Portugal[9]	39.6 (9)	3.3 (9)
Spain[10]	35.8 (14)	2.0 (19)
Sweden	28.0 (22)	2.9 (14)
Switzerland	39.8 (8)	1.9 (20)
Turkey	44.0 (5)	1.5 (22)
Total average	32.5	2.9

Note: Combined rates include surcharges and local tax rates where applicable. The numbers in parenthesis indicate the rank of each country for each measure. A low number indicates a high rate and *vice versa*. Averages are simple averages over available countries.

1. Corporate income tax revenues (item 1200 in country details of OECD *Revenue Statistics*) as a per cent of GDP.
2. In addition to item 1200, CIT includes the enterprise tax reported under item 1100 (taxes on income, profits and capital gains of individuals) in country details of OECD *Revenue Statistics*.
3. In addition to item 1200, CIT includes the item Retenue d'acompte sur bénéf. sociétés (40 per cent) reported under item 1100 (taxes on income, profits and capital gains of individuals) in country details of OECD *Revenue Statistics*.
4. In addition to item 1200, CIT includes tax on industry and trade and contribution to chamber of commerce reported under item 1100 in country details of OECD *Revenue Statistics*.
5. In addition to item 1200, CIT includes tax on unincorporated individuals reported under item 1100 in country details of OECD *Revenue Statistics*.
6. In addition to item 1200, CIT includes the Danish Realrenteafgift, a tax on yields of pension scheme assets, reported under item 1300 (unallocable between 1100 and 1200) in country details of OECD *Revenue Statistics*.
7. In addition to item 1200, CIT includes property speculation reported under item 1300 (unallocable between 1100 and 1200) in country details of OECD *Revenue Statistics*.
8. The CIT-GDP ratio includes corporate income taxes on oil and gas activities for which the combined CIT rate is 78 per cent. This explains in part why the ratio has a low ranking with respect to the combined rate.
9. In addition to item 1200, CIT includes the sum of Impôt professionnel, Impôt industriel, Impôt foncier rural et urbain, Impôt industrie agricole reported under item 1300 (unallocable between 1100 and 1200) in country details of OECD *Revenue Statistics*.
10. In addition to item 1200, CIT includes local taxes (property and business taxes mainly) reported under item 1300 (unallocable between 1100 and 1200) in country details of OECD *Revenue Statistics*.

Source: OECD *Revenue Statistics*, OECD *National Accounts*.

based on CIT revenues as a share of GDP (Table 43, column 2), although such ratios need to be interpreted with care (Box 9).

The promotion of new investment, innovation and entrepreneurial activity is of great importance to countries undergoing economic transition. Initially, the Czech Republic, together with other Central and Eastern European countries, introduced a number of corporate tax incentives, principally in the form of tax holidays (time-limited tax exemptions), to domestic and foreign companies. However, experience with these programmes was unsatisfactory suggesting the need for reform.[64] A lack of experience in administering the incentives and poor understanding of investors' motives meant that, in many cases, the schemes failed to stimulate growth as intended (Erdös, 1994 and OECD, 1995). In introducing its 1993 tax code, the Czech Republic abolished tax holidays as an investment incentive (with the exception of a five-year tax exemption for small-scale energy producers). These were replaced with a series of activity-specific allowances, credits for expenditure on new plant and machinery and temporary exemptions from tax; including, for foreign-owned startup activities, a three-year exemption from the 25 per cent withholding tax on interest paid on inter-company loans. In addition, accelerated depreciation (granted for the acquisition of new machinery and equipment) and investment expenditure allowances were widely used.

Low levels of foreign investment as compared with other transition countries, convinced the authorities to introduce a range of incentives in 1998. These included: relief from customs duties for certain kinds of investment goods, subsidies for education of employees and relief from income tax for certain kinds of investment. The incentives are subject to certain conditions, including that investments must exceed $10 million, be greenfield projects and that eligible firms have at least $25 million in capital. They carry the additional requirement that the tax credit be reinvested within two years. For the moment, the legal basis

Box 9. Measuring the extent to which capital income is taxed

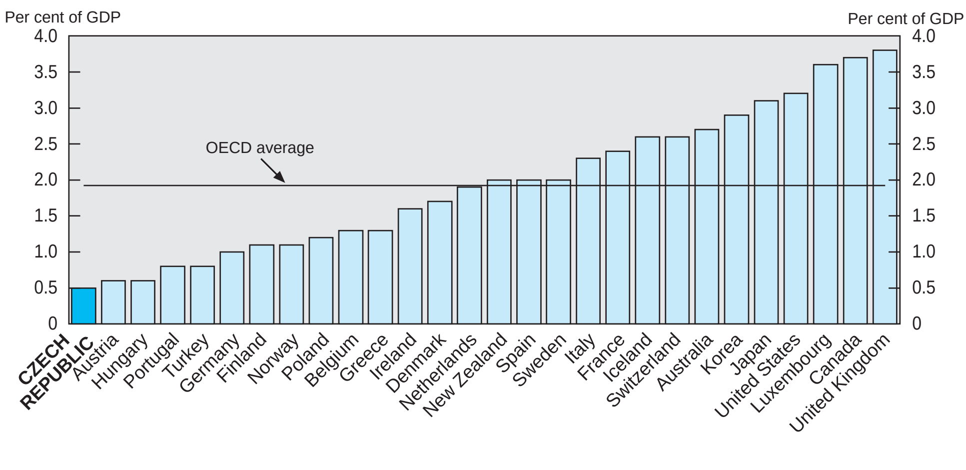
The ratio of corporate income tax revenue to GDP reported in Table 43 attempts to measure the extent to which capital income (profit) is taxed in OECD countries. As such, this indicator suffers from three principal weakness: 1) it includes only corporate income tax in the numerator, whereas capital income is also frequently taxed in the personal income tax system; 2) the denominator does not bare a stable relationship to profit over time or across countries and 3) whereas estimates of the incomes generated in the informal sector (*i.e.* "non-declared) are included in National Accounts data, and, therefore, comprised within the denominator. However, they do not generate income tax revenues and, as a result, the CIT/GDP ratio underestimates the extent to which the formal sector is subject to taxation. Furthermore, the size of this bias differs across countries in proportion to the size of the undeclared economy in each country.

for the incentives has not been established and the government is using the state subsidy act to provide the funds. Take up of this programme has been much higher than that of the previous one, with estimates suggesting that inward foreign investment qualifying for some sort of relief has been as high as $1 billion since its introduction. For the moment, however, it is too early to evaluate the relative costs and benefits of the programme. Such analysis should be conducted once the scheme has been operational a bit longer.

Taxation at the sub-national level

Local governments have very limited tax and spending autonomy (local provision of health care, education and social services are responsibilities of local governments but they are centrally regulated and financed). Own taxes of sub-central governments – mainly property taxes – account for only 1.3 per cent of total tax revenue (Figure 25) and local authorities collect only one-quarter of that amount directly (OECD 1999*b*), with the majority of their tax revenue and collections depending on the central government. Since 1993, revenues from property and other taxes have fallen by half as a share of GDP suggesting that the centrally-determined tax scales have not been adjusted in line with inflation. The principal source of municipal revenues is transfers from the central budget, with their size being based on the number of resident individuals and the location of the

Figure 25. **Property tax revenues**
1997



Source: *OECD Revenue Statistics.*

accounting office of incorporated businesses. This last feature has given rise to some municipalities offering incentives to attract company pay-offices. While such competition is beneficial to the municipality, which receives more in additional central transfers than it gives up in incentives, it results in an overall reduction in tax revenues in the economy and real-side distortions in the location decisions of firms.

Administration and enforcement

The administration of the tax system is the responsibility of the Ministry of Finance. Overall, its task is greatly simplified by the system's reliance on withholding taxes for personal income on the one hand and the relatively high threshold for VAT-payers on the other. Nevertheless, the cost of running the system is considerable (2.6 per cent of revenues in 1998) with more than half that amount accounted for by the collection of indirect taxes. Increasingly, the Czech tax authorities are introducing the most modern tools in their efforts to enforce compliance. Thus, all tax subjects – legal entities or physical persons – have a taxpayer identification number which is used by the administrative authorities and electronic means are being used to detect individuals or firms who are suspected of under-declaring their incomes or evading taxation entirely. Nevertheless, the government is increasingly concerned that some firms and workers are avoiding taxes and compulsory social security contributions by under declaring their wages. The self-employed are responsible for their own assessment and are a particularly difficult category of taxpayer to monitor. Here, the authorities increasingly compare data from various administrative databases (such as business permits, municipal fee records) to identify self-employed individuals who are not paying tax. Despite these efforts, tax arrears represent a growing problem for the economy. By the end of 1998 they accounted for Kc 114 billion or 6.4 per cent of GDP and their share in GDP has increased at an accelerating rate. Total arrears increased by 26 per cent in 1998 or 16 per cent in real terms, with arrears in all tax categories growing faster than nominal GDP (Table 44). The second set of columns in the table represent a lower estimate of the share of taxes due that are unpaid each year.[65] On average at least 3.5 per cent of taxes went unpaid in 1998 and the addition to arrears was 1.4 per cent of GDP. In some categories of taxation, these rates are alarmingly high suggesting that failure to collect taxes in the past may be generating a vicious circle of non-payment. The authorities argue that as much as 50 per cent of these arrears are uncollectable, reflecting unpaid taxes of failed companies. However, their data systems do not, as yet, permit them to identify this component, making it impossible to verify the claim. Moreover, even if this figure is accurate, the rate of increase in arrears remains problematic.

Firms complain that the system does not make sufficient distinction between innocent mistakes and wilful tax evasion. Penalties in both cases[66] are the same and only a court can reduce the penalty based upon its assessment of

Table 44. **Breakdown of accumulated tax arrears**

	Increase over previous period[1]			Increased arrears as per cent of tax due[2]		
	Increase 1993-96	Increase 1996-97	Increase 1997-98	1996	1997	1998
Value added tax	42.7	20.6	22.1	5.5	3.7	4.6
Excises	113.9	32.4	4.2	3.0	3.2	0.5
Corporate tax	37.0	16.0	68.4	3.7	1.8	6.8
Wage tax	52.1	70.1	57.1	2.7	2.8	2.5
Road tax	4.2	39.1	34.4	1.4	1.6	1.8
Inheritance tax	95.7	21.5	29.4	1.1	1.2	1.5
Gift tax	283.1	2.3	18.0	61.6	4.1	21.8
Real property transfer tax	133.0	55.9	38.2	12.6	14.5	12.5
Real property tax	8.6	24.5	28.8	1.5	3.2	4.4
Customs duties	–10.2	0.9	52.7	–0.5	0.1	4.1
Social security contributions	92.9	48.1	22.4	3.6	4.1	2.7
Other taxes	52.8	49.5	31.1	5.4	81.8	87.4
Total	54.2	33.7	26.1	3.8	3.7	3.5

1. The first three columns show the percentage increase in tax arrears over the stock of tax arrears of the previous period.
2. The second set of columns shows, for each tax, the annual increase of the stock of tax arrears over the total tax due in the same year. The total tax due is calculated as the sum of yearly tax revenues and the yearly increase of the stock of tax arrears.

Source: Ministry of Finance, OECD.

the taxpayer's intent. This state of affairs is exacerbated by the fact that there is neither a body of precedent as in the United Kingdom nor a mechanism by which firms can get a binding ruling on various tax practices. Non-binding advance rulings can be acquired from the Ministry of Finance although there is no defined procedure to be followed. There is also an industry led-forum which, in co-operation with the Ministry of Finance, provides a regular series of opinions. Unfortunately, neither they nor the Ministry's advance rulings are binding and it is entirely possible for a penalty to be imposed by a given tax administrator on a treatment that had previously been authorised. Indeed, it is not unheard of for one administrator to rule in favour of a tax practice, while a second rules against it in another jurisdiction. The tax authorities are looking for mechanisms to redress this situation.

Problems with the system

The overall tax burden

As compared with other OECD countries at a similar level of development, and like Poland and Hungary, the overall Czech tax burden is high. Firms operating and investing in countries such as Ireland, Mexico, Korea, Greece, Turkey and even Spain and Portugal face much lower taxes. While Czech labour costs are relatively low, and investments there remain attractive, productivity is also low and the cumulative effect of high taxes is likely to reduce the attractiveness of the country as a destination for investment and ultimately also reduce the speed with which living standards are able to converge to the OECD average. Indeed a great deal of work done both in the OECD and elsewhere suggests that, for countries with relatively high overall tax burdens, a 10 percentage point drop in taxes can translate into as much as a 0.5 per cent increase in annual growth rates (see Box 10). Part of the distortionary impact of the current tax regime could be reduced by cutting the rates and widening the bases upon which taxes are currently imposed, but more fundamentally there may be a need to re-examine the level and composition of expenditures of which transfers and subsidies comprise fully 64 per cent of the total.

In the communist system the authorities promoted social goals by the extensive use of negative turnover taxes and wide range positive rates. Currently,

Box 10. Taxation and economic growth

The direction of tax effects on the level and growth of income is not always clear. Taxation may, in fact, be beneficial for the economy if it provides the financial basis for the provision of public goods that improve average living standards and social welfare. More and better public goods and services can serve to increase the productivity of private fixed and human capital and hence increase economic growth, while government transfers reduce poverty and improve social cohesion. On the other hand, higher taxes increase distortions and may reduce saving, investment and work incentives and adverse effects on economic efficiency may grow disproportionately with the increase in the tax burden.

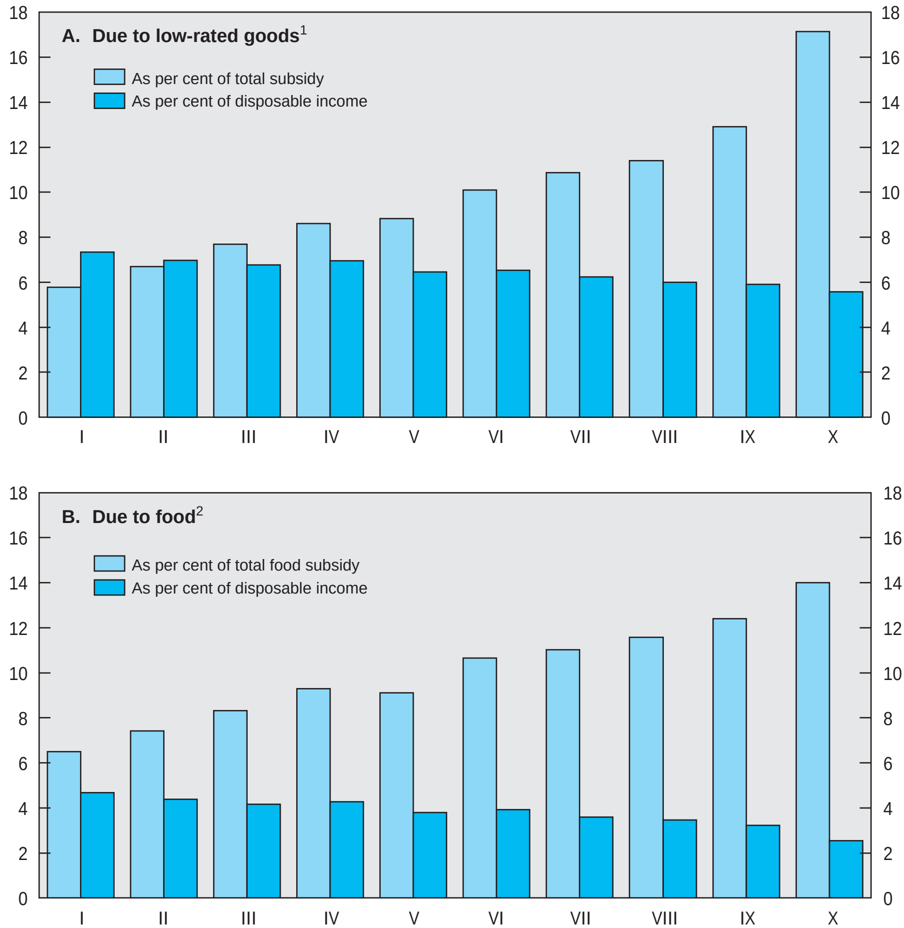
As the net effect of taxation on economic performance depends on the level and structure of taxation, and whether tax revenue is spent in a productive or unproductive way, the benefits and costs of taxation are difficult to disentangle empirically. Nevertheless, a number of studies have sought to do so. Leibfritz *et al.* (1997) examined the relationship between taxation and growth for a sample of OECD countries (not including the Czech Republic, Mexico and other relatively low-income countries) and found that a 10 percentage point increase in the tax/GDP-ratio is accompanied by 0.5 percentage point lower growth. This result is qualitatively consistent with the findings of King and Rebelo (1990), Barro (1991) and Plosser (1992). But several other studies, including Easterly and Rebelo (1993), Levine and Renelt (1992) and Slemrod (1995) have found a non-significant or even positive correlation, leaving some researchers to suggest that there may be non-linearities implying a positive growth effect if taxes are increased from a low level and a negative growth effect if they are increased from a high level.

the high proportion of goods and services subject to the reduced VAT (see Table A2 in Annex I) suggests that this tax (as is the case in many OECD countries) is used in a similar way. Unfortunately, as an instrument of redistribution it is not very effective, principally because the implicit subsidy it provides is equally available to the rich and the poor and the consumption patterns of each group are broadly similar. Thus, the rate of implicit subsidy received by individuals with the lowest earnings is 7.3 per cent and falls only gradually to a still high 5.6 per cent for the richest 10 per cent of the population (Figure 26). Moreover, because both groups purchase low-rated goods and services, the higher purchasing power of the rich means that they benefit, in absolute terms, three times as much from the implicit subsidy than do the poor. The importance of the subsidy derives from the unusually wide range of goods and especially services taxed at a low rate in the Czech Republic. The authorities indicate that special treatment was designed to help the service sector expand its share in total output. However, it would not appear to have been very successful in this regard. The share of services in real GDP not only remains lower than in more mature OECD countries,[67] but has also actually declined since the VAT was introduced, from 54.3 per cent in 1993 to 51.8 per cent in 1999. Many OECD countries subject food to a lower VAT and the lower panel of the figure illustrates the redistributive impact of the low rating of food items alone. Although the variation in subsidy rates across deciles is larger (implying more redistribution), the extent of redistribution remains limited and the richest decile still receives twice as much in implicit subsidy than the poorest.

That the VAT does not succeed in significantly redistributing income despite the exceptionally wide range of low rated items would not in itself be a problem if it did not seriously distort the relative price of goods and deform the allocation of resources within the economy. While nearly every country with a VAT has exemptions and goods and services that are taxed at a reduced rate, the very low productivity of the Czech VAT suggests that the extent of the resulting distortions may be greater than is the case elsewhere. Indeed in terms of value, only 47 per cent of total goods and services consumed in 1998 were subject to the standard VAT. While it is difficult to get a sense of the economy-wide costs of these distortions, it is useful to note that the current system provides an important implicit subsidy to the consumption of a number of energy sources and constitutes a negative green tax. It may partially explain the Czech Republic's poor ranking in terms of per capita energy consumption and production of greenhouse gases (see OECD, 1999*a*). In addition, the fact that heating, telecommunication services and construction work are not subject to the standard VAT rate is in violation of EU regulations.[68] Applying the lower rate to almost all services other than those in the tourism sector is also an unusual practice. Reducing the number of low-rated goods would widen the base upon which the high rate is levied, raising the possibility of reducing the standard rate of VAT, which if accomplished in a revenue neutral manner would fully compensate for the inflationary impact of

Figure 26. **Distribution of implicit VAT subsidy**

1998



1. The implicit VAT subsidy due to low-rated goods is calculated as expenditure on low-rate goods by decile multiplied by the difference between the standard and low VAT rates, *i.e.* 17%. The basket of low rate goods contains: food, rent and municipal services, central heating, hot water, household equipment and operations, personal and medical care, transport and communications, culture, education, sports and leisure services. The estimate of subsidy does not consider substitution effects between consumption and savings or within the consumption basket. Total consumption, consumption of food and disposable income by decile are from the Ministry of Finance.
2. The implicit VAT subsidy due to food at each income decile is calculated as expenditure on food by decile multiplied by the difference between the standard and low VAT rates, *i.e.* 17%. The estimate of subsidy does not consider substitution effects between consumption and savings or within the consumption basket.

Source: Ministry of Finance, OECD.

raising rates on currently low-rated goods and services. Indeed, unofficial estimates suggest that just raising the VAT rate on heating would allow the standard rate to be reduced from 22 to 19 per cent without loss of revenue. Subjecting an even larger range of goods and services to the standard rate would allow it to be lowered even further. Alternatively, the additional revenues could be used to reduce distortions elsewhere in the tax system – perhaps most usefully by lowering social security contributions.

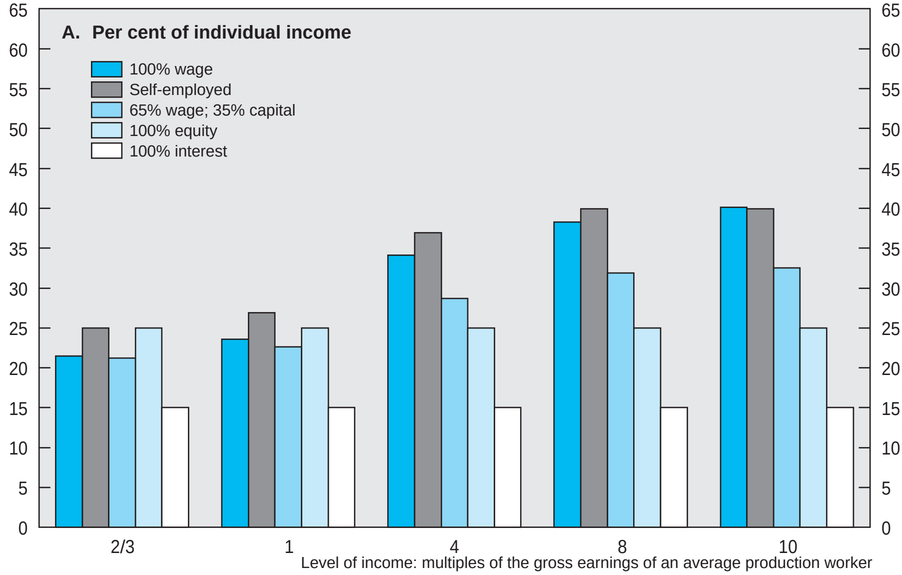
The bias in favour of capital and self-employed income

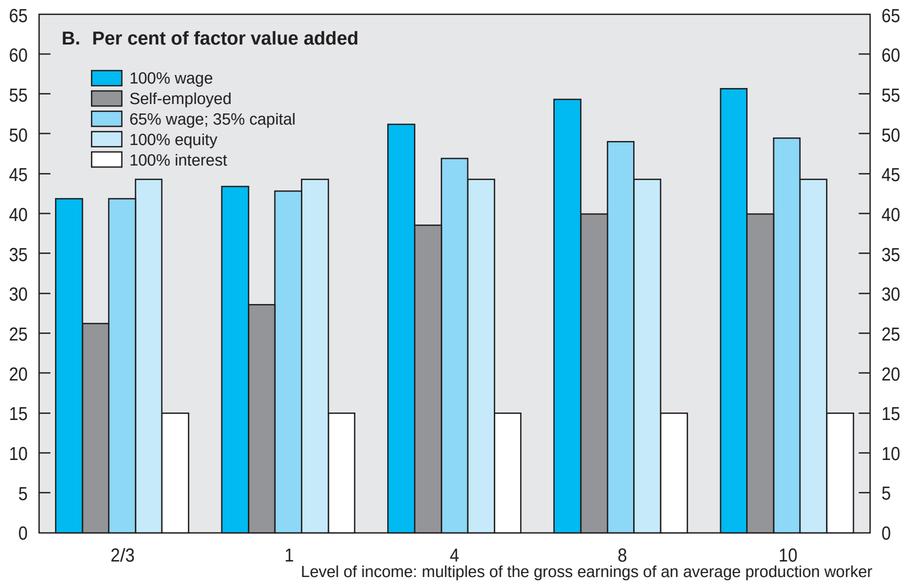
Generally speaking, the personal income tax (PIT) system (in combination with various benefit schemes) is a more appropriate tool for achieving redistribution goals than is the value-added tax. On the one hand, special credits and allowances can be employed to ensure that assistance is narrowly targeted on those segments of the population most in need, while, on the other, a progressive tax system can be used to ensure that the burden for this assistance is borne by those most able to pay. While the PIT schedule applied to labour and some forms of property income is progressive, the overall progressivity of the personal income tax system is more difficult to determine because the tax-treatment of self-employed income and capital income means that the principle of horizontal equity is not respected. In addition, as compared with other OECD countries relatively few people are subject to the highest rates. Finally, the flat withholding rates applied to most forms of non-labour income means that personal income from these sources is taxed well below both employee and self-employed earnings over all income ranges.

Panel A of Figure 27 attempts to illustrate the interaction of these factors. It reports the total taxes that would be paid by an individual (including the social security contributions of employees and the self-employed – but not those of the employer) depending upon the source and level of his or her income. Thus, the first group of five bars indicates the differences in the average tax rate paid by an individual whose total income (from all sources) is equal to two-thirds of the annual wage of an average production worker depending upon whether his or her revenues come from: wages alone; self-employment only; 65 per cent wages and 35 per cent equity income; 100 per cent equity income; and finally 100 per cent in the form of interest. The subsequent group of histograms shows the same calculation at different levels of income. In each case, there is a significant difference in tax paid depending upon the source of income, with wage earners and the self-employed systematically paying the most tax and individuals receiving their income from interest paying the least. Not shown, because no personal income tax is paid, is the case of someone receiving capital income in the form of capital gains.

Figure 27. **Average tax rates by level and type of income**

1999





Source: OECD.

While Panel A of Figure 27 suggests that on average a self-employed person pays more tax than an employee and that, at all income levels, those whose income is drawn from capital sources would pay the least, in fact the chart tells only part of the story. Because employers (and employees) pay high social security taxes and firms pay corporate income tax, the total "all in" tax paid on labour and capital inputs is different. In Panel B all of these factors are taken into consideration, illustrating that the total tax paid on the earnings of the self-employed is substantially lower than that of the employee at all levels of income. The difference stems principally from the smaller base on which the self-employed make social security contributions as well as the contribution ceiling from which they benefit. Indeed, it is not immediately obvious why only 35 per cent of self-employed earnings are subject to SSC. Economically, one could argue that only the salary portion of their operating surplus should generate social security – but in that case 35 per cent would appear to be far too little. Within the economy at large, 65 per cent is closer to labour's share in value added. The third column in each group of histograms in Panel B of Figure 27 illustrates the impact on the "all in rate" of tax of imposing SSC on 65 per cent of a self-employed person's net revenue. Clearly such a change would substantially equalise the overall tax burden faced by employees and the self-employed.

The existing tax bias in favour of the self-employed is presumably the reason that it is commonplace for senior employees of Czech firms to set themselves up as independent consultants. Companies can afford to pay them substantially more at no additional cost, while they remain in what is effectively a dependent-employee relationship with a single employer. Indeed, on a per capita basis, the self-employed pay in income tax and compulsory social security payments only half of what employees pay, even though their earnings are twice as high.[69] A feature that is partially explained by the substantial difference between the all-in rates of taxation on self-employed over a wide range of earnings (Figure 28).

The neutrality of taxes on capital income

Panel B of Figure 27 also makes it clear that different forms of capital income within the Czech system are taxed at substantially differing rates. Research indicates that such gaps tend to affect firms' financing decisions and the allocation of resources in the economy.[70] Indeed, the gap between the "all-in" rate on distributed earnings from equity holdings and interest payments is startling. It arises from two principal sources: 1) the rate of withholding tax charged when firms distribute profits via different channels and 2) the extent to which these earnings are subject to CIT (directly or indirectly through deductions allowed for some kinds of distributions). Indeed, the "all-in" tax rate on profits varies even more widely because of differences in the deductibility of dividends distributed in different ways and because of different depreciation rules applying

Figure 28. **Average statutory "all in" tax rates**[1]
1999

1. Includes income tax and social security contributions paid by employers, employees and self-employed.
Source: Ministry of Finance, OECD.

to different forms of physical capital. As a result, depending upon the manner in which a given Kc 100 in profit is distributed, it will be taxed at anywhere between 15 and 52.2 per cent (Table 45). Capital that is reimbursed in the form of interest is taxed at the lowest rate as it is fully deductible from the corporate income tax base and only subject to a 15 per cent final withholding tax. Capital gains, which are not taxed at the level of the individual, are the next most favoured form of distribution. Finally, the actual "all-in" tax rate paid on equity holdings that are distributed through dividends will depend upon the route that the dividend takes before arriving in the hands of the individual shareholder. Here rates are 44.3 per cent in the case of a dividend payment that is paid directly to a shareholder or which passes through either a mutual fund or a second firm that holds more than 20 per cent of the stock of the first. In the case where the holding falls below this threshold, the distribution is subject to a second round of taxation and the all-in rate rises to 52.2 per cent. The case of a pension fund is somewhat special as the initial distribution is not subject to withholding tax and a lower 15 per cent withholding tax on the subsequent distribution applies. Nevertheless, this lower withholding tax would have to be reduced still further if there were to be neutrality because when dividends are paid to a pension fund there is no tax

Table 45. **Tax rates applied on capital income, by type of distribution**

1999[1]

	Dividends					Capital gains	Interest payment
	Direct	Qualifying participation	Non-qualifying participation	Mutual fund	Pension fund		
Corporate Income Tax (CIT)[2]	35	35	35	35	35	35	0
Initial distribution							
Withholding tax	25	25	25	25	0	0	15
CIT rebate[3]	12.5	12.5	12.5	12.5	0	0	0
Subsequent distribution							
Withholding tax	n.a.	0	25	0	15	n.a.	n.a.
CIT rebate[4]	n.a.	0	12.5	0	0	n.a.	n.a.
"All in tax" rate[5]	44.3	44.3	52.2	44.3	44.8	35	15

1. Rates are for 1st January 1999.
2. As a per cent of pre-tax profit (excluding interest payments).
3. As a per cent of profit net of CIT.
4. As a per cent of distributed profit (pre-tax profit less CIT plus CIT rebate).
5. As a per cent of pre-tax profit under the assumption that all profit is redistributed (including any reductions in corporate tax liability arising through tax allowances).

Source: OECD.

allowance provided to the firm to offset its corporate income tax liability as is the case when dividends are distributed directly to shareholders.

Another way of looking at the issue of the neutrality of the taxation of capital income is to calculate the pre-tax real-rate-of-return that a firm needs to generate to guarantee an after-corporate-tax real rate of return equal to a bank deposit earning a 5 per cent return, depending on the source of its finance. Such a calculation has the advantage that it allows the influence of fiscal depreciation rules to be examined. In Table 46, the pre-tax rates of profit necessary to generate the required 5 per cent rate of return are reported for a number of OECD countries. The impact of the different "all-in tax rates" on various forms of distribution in the Czech Republic is reflected in the required rates of return on equity investments (7.1 per cent), capital gains (6.5 per cent) and loans (4.5 per cent). The extent of non-neutrality in the Czech Republic, as measured by the standard deviation of these rates of return, is about average; indeed only New Zealand and Norway exhibit perfect neutrality. The second block of columns in Table 46 reports the results of a similar exercise aimed at measuring the extent to which the tax system (principally through depreciation rules) favours certain kinds of physical investment. Here, the Czech system as it existed in 1998 is even more neutral with the required rate of return for machinery and equipment almost the same as that for buildings. Inventories remain disadvantaged (as indeed they are

Table 46. **Required rates of return[1] to capital in manufacturing (cost of capital)**

Top personal taxes, real rate assumed to be 5%, inflation included, 1998

	Sources of financing[2]				Type of assets[3]				Overall	
	Retained earnings	New equity	Debt	Standard deviation	Machinery	Building	Inventories	Standard deviation	Average[4]	Standard deviation
United States	4.19	7.25	3.95	1.84	3.78	5.06	5.01	0.72	4.41	1.28
Japan	8.04	10.26	4.02	3.16	5.40	8.74	7.78	1.72	6.86	2.28
Germany	3.14	2.67	3.06	0.25	2.63	3.34	3.71	0.55	3.07	0.41
France	7.36	10.52	4.38	3.07	5.82	7.44	7.45	0.94	6.64	2.05
Italy	5.31	5.67	3.65	1.07	4.04	4.86	6.30	1.15	4.77	1.00
United Kingdom	4.44	5.05	4.06	0.50	3.96	4.33	5.34	0.72	4.37	0.55
Canada	6.87	7.59	3.88	1.97	4.79	6.67	7.41	1.35	5.89	1.51
Australia	4.32	4.15	4.15	0.10	3.76	4.42	5.10	0.67	4.24	0.45
Austria	4.28	6.22	3.59	1.36	3.40	4.52	5.76	1.18	4.24	1.14
Belgium	5.53	6.72	3.54	1.61	4.18	4.89	6.79	1.35	4.95	1.33
Czech Republic	**6.52**	**7.15**	**4.46**	**1.38**	**5.68**	**5.88**	**6.46**	**0.41**	**5.87**	**0.91**
Denmark	3.37	4.09	3.84	0.37	3.17	3.51	4.72	0.82	3.61	0.57
Finland	5.59	4.21	4.21	0.80	4.54	5.05	5.85	0.66	4.97	0.70
Greece	5.91	5.91	3.32	1.49	4.70	4.05	6.92	1.50	5.00	1.34
Iceland	6.46	6.93	4.31	1.40	5.33	5.90	6.56	0.62	5.76	0.97
Ireland	3.04	5.01	3.90	0.99	3.15	3.42	4.59	0.77	3.54	0.80
Luxembourg	5.79	4.59	3.81	1.00	4.38	4.93	6.39	1.04	4.97	0.95
Mexico	5.30	5.30	4.35	0.55	4.73	4.82	5.69	0.53	4.96	0.49
Netherlands	1.35	7.17	3.74	2.92	2.59	3.08	2.78	0.25	2.77	1.98
New Zealand	4.62	4.62	4.62	0.00	4.57	4.40	5.00	0.31	4.62	0.20
Norway	4.25	4.25	4.25	0.00	3.95	4.20	5.00	0.55	4.25	0.35
Portugal	5.62	8.20	3.40	2.40	5.04	5.02	5.35	0.18	5.10	1.56
Spain	5.33	4.35	3.66	0.84	4.37	4.85	5.03	0.34	4.65	0.60
Sweden	5.45	6.17	4.16	1.02	4.74	5.14	5.71	0.49	5.07	0.71
Switzerland	3.28	5.91	4.49	1.32	3.72	4.05	4.43	0.35	3.97	0.90
Turkey	..	..	..	..	..	..	..		..	..
Average	5.13	6.11	3.97	1.30	4.26	4.90	5.64	0.77	4.74	1.04

1. The pre-tax real rate of return represents the cost of capital to the firm when accounting for corporate and personal tax rates. See OECD (1991) for discussion of this methodology. Wealth taxes on individuals and corporations are excluded from calculations.
2. Assumes capital consisting of 50% machinery, 28% buildings and 22% inventories.
3. Assumes capital financed 55% through retained earning, 10 per cent through new equity and 35 per cent through debt.
4. Average calculated using the weights indicated in footnotes 2 and 3.

Source: Gordon, K. and Tchilinguirian, H., (1998); OECD.

in most countries) because they do not benefit from any depreciation allowance. Finally, it is worth remarking that in all six cases the required return from an investment in the Czech republic was higher than the OECD average. This reflects, in part, the very long depreciation periods that were in place in 1998. While these were shortened early in 1999, OECD calculations using the new shorter depreciation periods suggest that Czech required rates of return nevertheless remain higher than average.[71]

Additional issues concerning the taxation of firms

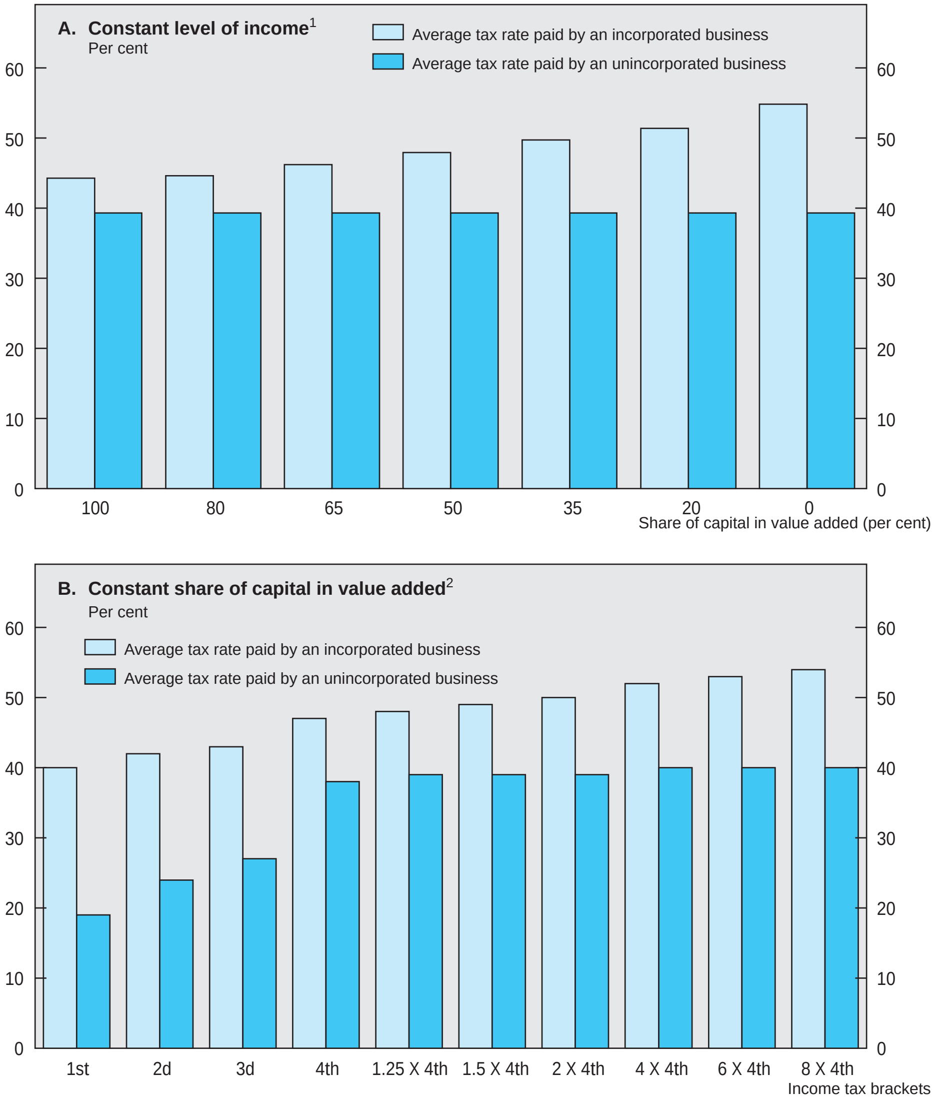
An additional complication in the Czech tax code is that it does not recognise corporate groups (*i.e.* holding companies) and therefore does not permit consolidation of revenues (and losses) across members of conglomerates. As a result, each company is taxed separately and profits and losses may not be shifted between affiliated companies. This treatment creates a natural incentive for firms to favour horizontal (and potentially monolithic) corporate structures so that losses generated in disparate activities can be used to reduce the tax burden in profitable ones. To the extent that these entities succeed in consolidating their revenues and losses, they will be able to reduce their overall tax liability, and, at the limit, the prohibition on holdings will have no impact on tax revenues. It may, however, have a negative effect on overall economic efficiency if, as might be expected, such large corporate structures are more difficult to manage than smaller and more independent firms working as separate profit centres within a holding structure.

In addition to the incentive for an individual working for a firm to establish him or herself as a putatively self-employed consultant, the tax system favours more generally the operation of unincorporated as opposed to incorporated firms. Panel A of Figure 29 illustrates the total effective tax rate paid by an owner-operated firm with value added equal to twice the upper boundary of the top market of the personal income scale tax schedule. As the share of the wage bill in pre-tax value added rises from 0 to 100 per cent, the rate of tax paid by an incorporated business increases, whereas it remains constant for a non-incorporated firm that is treated for tax purposes in the same way as a self-employed worker. Panel B holds the share of wages constant at 65 per cent (the average share for the business sector as a whole) and shows the variation as income rises from the frontier of the lowest personal income tax bracket to eight times the highest bracket. Panel A makes it clear that, except in the case where almost all of a firm's value-added derives from the employment of capital, the tax system offers a clear incentive to not incorporate, while in Panel B this incentive is shown to persist even at very high incomes.

Finally, beginning in 1998 the tax system allows firms a deduction for specific bad debts.[72] Thus, a creditor can deduct 20 per cent of the value of debts

Figure 29. **Average statutory tax rates on incorporated and unincorporated businesses**

1999



1. Income equals twice the lower boundary of the top personal income tax rate.
2. Share of capital and labour are 35 per cent and 65 per cent, respectively.

Source: Ministry of Finance, OECD.

more than six months overdue and 33 per cent of debts with arrears of more than twelve months. In addition, taxpayers are entitled to claim as a tax-deductible expense unpaid receivables relating to bankruptcy and liquidation proceedings due by 31 December 1994.

Implications for the labour market

The combination of high social security contributions and high personal income tax rates on labour income means that statutory marginal tax wedges on labour in the Czech Republic are high, although they are broadly in line with those observed in many European OECD countries. The total labour tax wedge[73] for a single person is about 48 per cent for someone earning a little over the earnings of an average production worker (APW) and then rises to above 50 per cent for someone with 1.7 times APW earnings (Figure 30). The wedges for married couples with two children are a little smaller and also smaller than in some OECD countries (such as Belgium, Canada, Germany, Hungary and Italy) but are much larger than in a number of other countries with which the Czech Republic competes directly (*i.e.* Greece, Ireland, Portugal and Spain) and the United States.

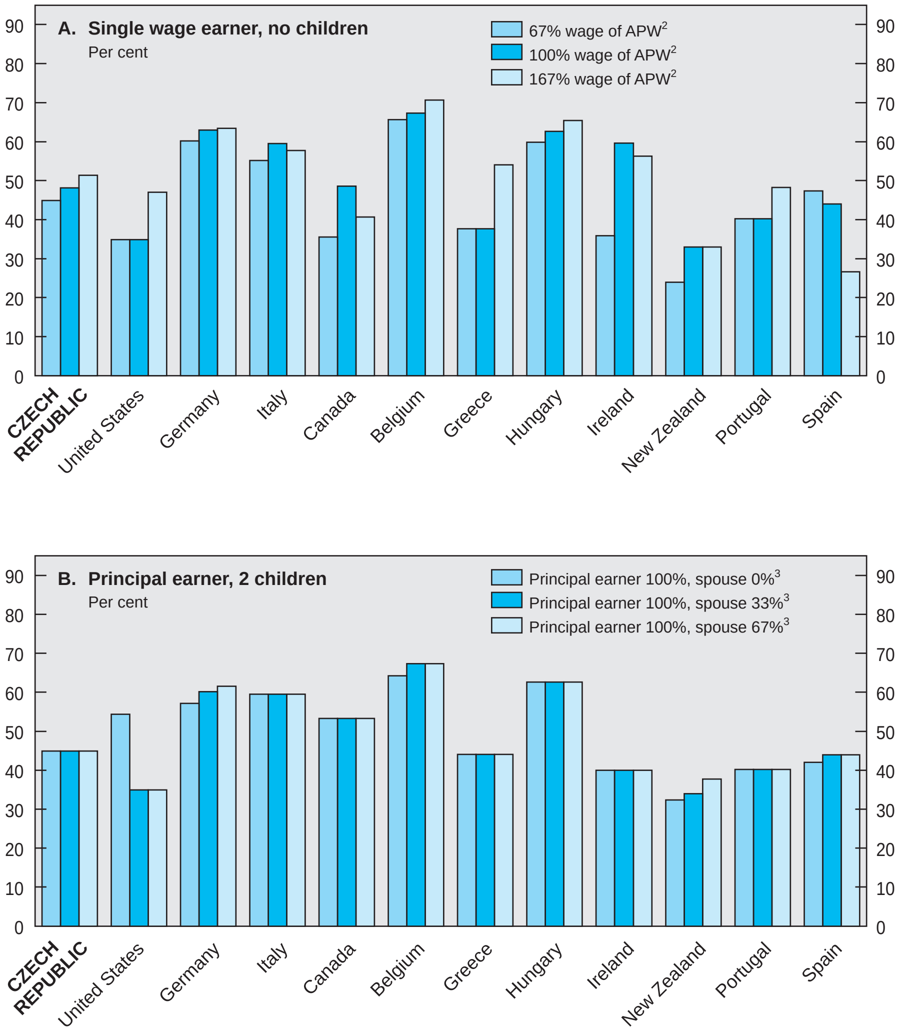
The *OECD Jobs Study* (1994) and a number of follow-up studies have shown that a high overall tax wedge – and especially – high social security taxes tend to raise the cost of labour which is associated with high rates of unemployment among the less-skilled and lower rates of employment. While to date the Czech Republic retains a relatively high level of employment, the recent up-surge in unemployment suggests that these kinds of effects could be materialising now. As discussed both in the previous *Economic Survey of the Czech Republic* and in Chapter III above, the disincentive effects of these high tax rates in the Czech Republic are greatly magnified because benefits form an effective floor, below which net wages of low-productivity workers cannot fall. Indeed, the combination of higher taxes and generous benefits for households with children creates serious unemployment and poverty traps with marginal tax rates (inclusive of benefit withdrawal) close to or in excess of 100 per cent in many cases (Figure 31).

Suggestions for reform

Recent tax policy initiatives

Most recently, the government has undertaken a number of reforms in the tax system, some of which will serve to address issues raised in the foregoing.

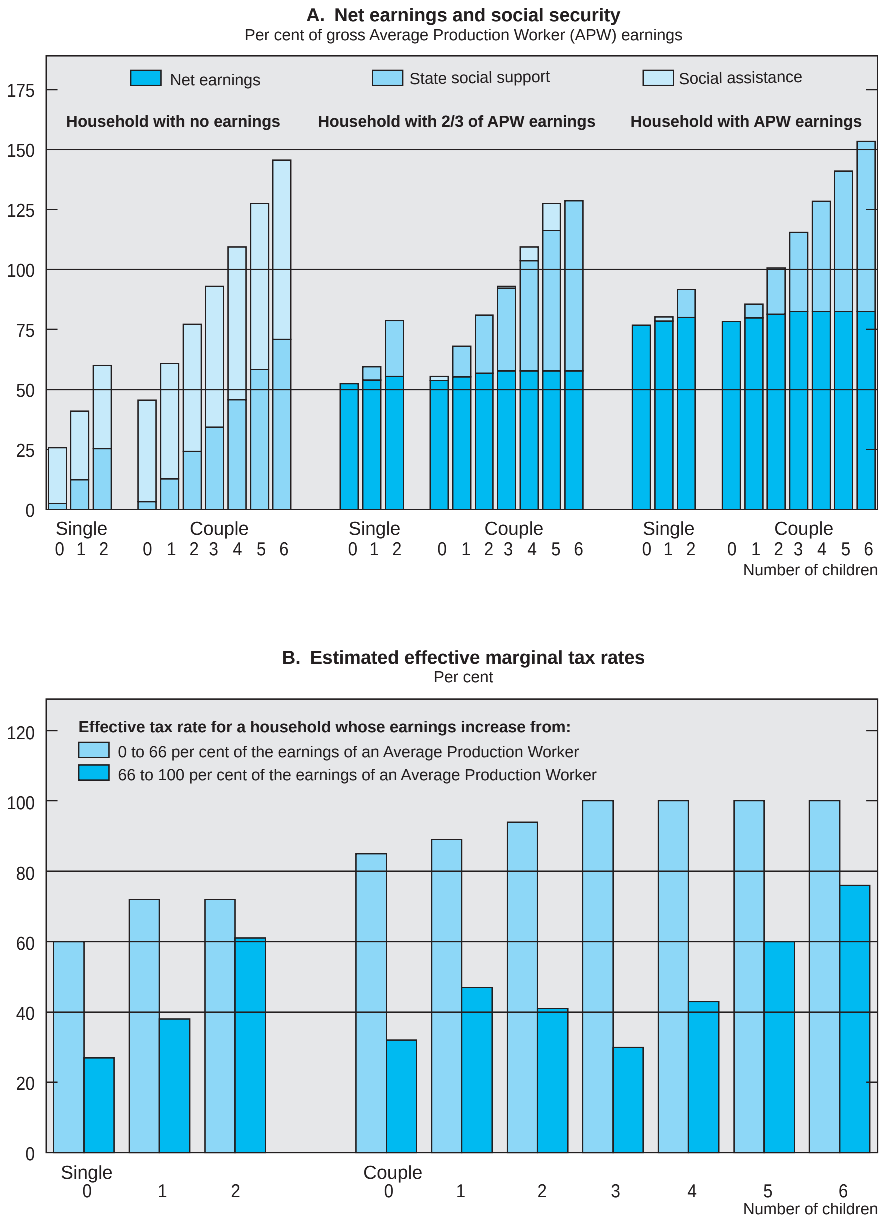
Figure 30. **Marginal tax wedges by family type and wage level**1
1997



1. Marginal tax rates covering employee's and employer's social security contributions and personal income tax, with respect to a change in gross labour costs.
2. APW: Average production worker in manufacturing.
3. Refers to proportion of wage of APW.

Source: OECD, *Tax/Benefit Positions of Employees.*

Figure 31. **The interaction of taxes and transfers**



Source: Ministry of Labour and Social Affairs, OECD.

Taxation of capital income

– As of 1 January 1998 interest income earned by legal entities and self-employed individuals on debentures issued in and after 1998 is taxed as part of the corporate income tax base. The 25 per cent withholding tax is treated as a prepayment, which is deducted from the final corporate tax liability. Previously, interest paid from Czech sources to legal entities and self-employed individuals was subject to a final withholding tax of 25 per cent.
– In early December 1998 and effective 1 January 1999 the Parliament approved an amendment shortening legal depreciation periods for most forms of physical capital (*i.e.* increasing the depreciation rates). These now fall within the range observed elsewhere in the OECD.
– As of 1 January 2000 the corporate income tax rate will be reduced to 31 per cent.
– Effective from 1 January 2000, the withholding tax on dividends and capital gains earned on holdings of less than six months will be lowered to 15 per cent from a previous 25 per cent.

Personal income tax

– Effective from 1 January 2000, the top personal income tax rate of 40 per cent will be abolished and the marginal personal income tax rate will drop to 32 per cent. This concerns individuals earning Kc 1.1 million (*i.e.* roughly more than $31 000) a year or more.

Indirect taxes

– A rise in indirect excise taxes on fuel (petrol 1.39 Kc/L, diesel 1.04 Kc/L) and cigarettes (0.73 or 1.22 Kc, depending on length), effective 1 July 1999 (increasing revenues by an estimated Kc 4 billion, and increasing the price level by about 1 per cent).
– Effective 1 April 2000, a small number of additional services have been added to the list of items taxed at the reduced VAT rate.

Scope for further action

The preceding review reveals a tax system in the Czech Republic that is broadly similar to those operated in other OECD countries. It exhibits a number of non-neutralities, some of which reflect the economy's command and control past. However most of them, like those observed elsewhere, reflect compromises between, on the one hand, the desire to minimise economic distortions and, on the other, the need to implement a system that is administratively and politically practical while maintaining at least some redistribution of personal incomes. Reform should continue in this vein. While radical changes are not called for, there is nevertheless considerable scope for reducing the distortions and inefficiencies that the tax system currently introduces (Box 11). Moreover, with Czech living standards at only 60 per cent of the OECD average, designing the tax system so as to support a rapid and sustainable rate of productivity growth is necessarily a critical policy objective.

In this context, the tax system cannot be looked at entirely in isolation from the expenditures that it is required to finance. Here, strong consideration should be given to attempting to streamline the benefit system. As is the case in Hungary and Poland, expenditures and especially transfers constitute a much larger share of GDP than they are in other member countries at similar or even higher levels of economic development. The government should undertake an in-depth examination of the redistributive impact of the tax-benefit system as a whole. While such a comprehensive examination has not been carried out here, principally because of a lack of required data, it appears that, as is the case with the implicit VAT subsidy, many programmes achieve little net redistribution, while requiring substantial sums of money to flow through the government's coffers. Focusing aid more on those most in need might be able to achieve the same redistribution but with much lower financing costs and less potential damage to overall economic efficiency. In the absence of savings on expenditures, the available evidence on the relationship between the overall tax burden a country faces and economic growth suggests that the high overall tax rate in the Czech Republic could threaten the pace of convergence with the rest of the OECD.

Without reducing the level of expenditures, the overall tax burden cannot be cut. Nevertheless, there appear to be opportunities to widen a number of tax bases and reduce some of the higher and more distortive tax rates by rebalancing the overall tax mix and eliminating certain anomalous characteristics of the system. In particular, there is opportunity to broaden the base of the personal income tax (only Greece derives a smaller share of total revenue from this source) and the VAT and to increase revenues collected from real-estate property (second lowest in the OECD), while at the same time lowering social security contributions and payroll taxes (only France and the Netherlands rely more heavily on this source). A re-balancing of revenue sources could be engineered so as to have a number of beneficial impacts.

As recommended in the previous *Economic Survey of the Czech Republic*, lowering payroll taxes and transferring some of the tax burden currently carried by these involuntary contributions to both labour and capital income would also serve to reduce the serious work disincentives that they generate. With the exception of health-care, these contributions are not earmarked taxes and most of the services paid for are universal in nature and not related to a recipients' work history. Budget neutrality under the current dual personal income tax system, could be ensured by increasing the rates in the progressive income tax schedule

Box 11. Summary of tax-policy recommendations

Consider reducing expenditures to lower the overall tax burden

The government should consider re-examining its tax and benefit system with an eye to reducing total expenditure on benefits, while improving the extent to which they are focussed on helping those most in need. The high tax burden required to finance the personal transfers under the current system may be having important negative impacts on the country's potential growth, thereby slowing the pace of convergence to income levels observed in other OECD countries.

Reduce the number of goods and services subject to the reduced VAT rate

The unusually wide range of services and goods subject to the low VAT rate should be reduced so as to decrease distortions. Additional revenues could be used to finance lowering of social security contributions or a reduction in the standard rate.

Reduce the importance of social security contributions in total tax revenues

High compulsory social security charges are associated with rising and high rates of structural unemployment throughout the OECD. In order to improve employment incentives for low-skilled workers these rates should be reduced by transferring responsibility for the financing of some social programmes to a broader tax base.

Increase property taxes

As compared with other countries local governments have relatively small own-tax revenues. In particular, property tax revenues have not kept pace with inflation.

Eliminate the bias in favour of self-employed work forms

The low share of self-employed earnings subject to social security contributions introduces a serious bias in favour of this work form. Raising the share taxed from 35 to 65 per cent, which broadly corresponds to labour's share in value added, would increase horizontal equity and efficiency within the economy.

Improve tax compliance

While tax evasion and avoidance are not perceived by the authorities as being serious problems the rapid accumulation of arrears suggests potentially important problems in the enforcement of tax law, while under reporting of wages may be a growing problem.

Decrease non-neutralities in the taxation of capital income

Low "all-in" tax rates on interest payments and capital gains privilege these distribution methods to the detriment of dividends. Setting the withholding tax on interest income equal to the corporate income tax rate and eliminating the taxation of capital gains and dividends within the personal income tax would provide a more even treatment.

as well as the withholding taxes applied to distributed capital income. In addition to improving the functioning of the labour market (see Chapter III) and reducing the risk of rising structural unemployment, such a reform would, by lowering social security contribution rates, go a long way to reducing the present bias in favour of self-employment. However, more might be done in this regard and the reform should be complemented by raising the share of self-employed earnings subject to social security charges. Not only would this allow rates to be lowered, it would serve to further reduce the bias in favour of this work form and diminish the tax advantage that unincorporated firms currently enjoy, potentially resulting in less tax evasion. Finally, to improve horizontal equity, the ceilings placed on the contributions of the self-employed should be eliminated or also be made available to employees. Of the two options, the first is to be preferred in so far as the existence of such ceilings contributes to the overall regressivity of the tax system.

The benefits of lowering social security contribution charges would be enhanced if capital income were also made to carry at least part of the burden currently borne by labour alone. Here an adjustment in the distribution of the tax burden could be accompanied by measures to remove non-neutralities in the existing taxation of capital income. At the moment, returns to capital distributed in the form of interest payments and capital gains are taxed at much lower rates than other sources of capital income resulting in a bias in favour of these forms of savings. The government's plan to further lower the corporate tax rate and to decrease the withholding tax on dividends to 15 per cent would reduce the extent to which interest income and, to a lesser extent, capital gains are privileged. However, by lowering the rate of tax on capital income in general, the relative tax burden on labour income will increase, while the bias in favour of interest income will not be eliminated. An alternative solution that would preserve the advantages of the current system's reliance on easy-to-administer withholding taxes might be envisioned. One possibility, which has been applied in some OECD countries (including Norway and Finland), would equalise the all-in-tax rate on capital income by setting the withholding tax on interest income equal to the corporate income tax rate and eliminating the withholding tax on other forms of capital income. In this way, all three forms of income from savings (*i.e.* dividends, interest and capital gains) would be taxed at precisely the same rate.[74] Further, the base widening implicit in such a reform might also offer the possibility of lowering rates.[75] Although other reforms could be implemented, they would tend to be administratively more difficult to put into practice.[76]

Economic efficiency could be further enhanced by reducing the unusually large number of goods and services subject to the reduced VAT rate and using the increased revenue to lower statutory tax rates. Two options recommend themselves. The first would see the government use the additional revenue to lower social security contribution rates which would simultaneously reduce the distortions produced by this tax and serve to lower the economy's dependence on labour taxes for revenues. The second option would be to lower the standard VAT rate. By proceeding in a revenue neutral manner, the impact on inflation could be eliminated and domestic resistance kept to a minimum, while the distributional impact of the change would be small. Given that EU accession will require that a number of these services and goods (in particular central heating) be taxed at the standard rate, the timing would appear to be near ideal. Indeed, with domestic activity and inflationary pressures at an all time low, the probability that firms would fail to pass on the savings from the lower VAT are small.

Most observers indicate that tax evasion is not as serious a problem in the Czech Republic as in some other transition countries or even as compared with a number of western European OECD economies. However, the dramatic accumulation of tax arrears is cause for concern and there is some indication that firms and workers are under reporting earnings. While implementation of the kind of reforms discussed in Chapter III to improve the capacity of the government to enforce its claims on delinquent debtors will certainly help, more needs to be done to ensure that firms do not get behind in their taxes. Indeed, a clear definition of compliance and the prompt implementation of a regular programme to measure it are essential first steps. In addition, efforts should be extended to improve the tax administration's data systems so that additions to arrears from penalties on old unpaid taxes can be distinguished from new delinquencies. More generally, the government should avoid adopting a relaxed stance to collections in cases where firms are performing poorly. Rather, it should pursue restructuring or other payment solutions, as would any other creditor. Failure to do so would just encourage these firms and others to continue using the government as a lender of last resort.

Beyond the issue of arrears, the strengths of the current tax administration system can be enhanced in a number of areas. In particular, in order to reduce the extent to which uncertainty surrounding tax treatment is a factor in firms' decision-making processes, the predictability of the tax system's administration could be enhanced by introducing binding tax rulings. This would be particularly helpful in a country like the Czech Republic that lacks precedents upon which decisions could be based or, for that matter, a court system that operates on the basis of such precedents. At a minimum, there should be an explicit recognition in the statutes that, even at the initial administrative level, taxpayers who made an honest mistake (especially one based on the non-binding rulings of the tax authority) should not be subject to the same penalties as an individual acting with fraudulent intent. In addition, the allocation rule for revenues from corporate taxes should be made independent of the location of their head offices in order to eliminate harmful competition among municipalities. Indeed, redistributing these revenues on a per capita basis might be the most sensible solution to the problem. More generally, the various incentives in the tax system that favour unincorporated firms at the expense of incorporated firms and self-employment to the detriment of dependent employment, make the administration of the tax system more difficult and increase the likelihood of evasion. A number of the changes enumerated above will serve to reduce this bias in the system. However, the rapid expansion of smaller firms that are less likely to be audited and the apparently high incidence of financial fraud within the economy suggest that the authorities will need to continue to be vigilant and that undue complacency concerning compliance would be misplaced.

In the context of the creation of a new level of government, the authorities might wish to increase the importance of property taxes. As compared with most OECD countries, funding from this source is relatively low in the Czech Republic. Increasing funding would provide greater flexibility to local officials to manage the substantial programmes for which they are responsible and to compete effectively for investment. On the other hand, care should be exercised to ensure that increased own-tax revenues for municipalities do not result in an undesirable increase in the variance in the quality and quantity of services that municipalities can afford to offer.

Finally the government should re-examine existing roles concerning the tax treatment of holding companies. Given that firms can avoid the revenue implications by forming large conglomerates, it might be more efficient to relax the restriction on revenue consolidation so that they can choose the most efficient corporate form. In some cases this will undoubtedly be a conglomerate, but in others it may well be some sort of holding structure. Such a reform would, however, likely require amendments to the regulatory framework for holding companies in the Czech Republic.

Notes

1. The prices of non-tradeable, non-regulated goods rose by 4.1 per cent and that of regulated prices 4.4 per cent. Among tradeables, food prices fell 3.7 per cent and others rose 3.2 per cent.
2. Because of exchange rate fluctuations these export shares are significantly different (but still growing) when stated in terms of koruna.
3. In the GFS some such revenues are recorded as repayments.
4. In particular, a lack of data on the stock of capital and of an estimate of the non-accelerating wage rate of unemployment prevent a standard estimate of potential output from being made.
5. One is derived from a simple Hodrick-Prescott filter while the other uses Barro's β-convergence estimator. The two estimates yield substantially different estimates of the rates of growth of potential output, with that of the latter being somewhat more appealing (2.8 per cent). In decomposing the budget deficit, only the sensitivity of revenues to the cycle was estimated.
6. Much of the uncertainty derives from the short time period over which the indicator must be estimated.
7. Expenditures, however, were down 27 per cent on the actual outcome for 1998 because the 1997 deficit of *Konsolidacni banka* was paid from the state budget in 1998.
8. As per the Ministry of Finance's medium-term fiscal framework documents, this assumes a Kc 73.5 billion consolidated deficit gross of privatisation receipts and sales worth Kc 42 billion. In addition, it excludes from expenditures the 0.8 per cent of GDP to 1998 losses of *Konsolidacni banka* but includes the 1999 losses of that institution.
9. The OECD high growth scenario assumes that an accelerated pace of labour and product market reform lowers the unemployment rate by 2 per cent and increases trend productivity growth by 1 percentage point.
10. Were that debt to be converted today into state bonds, the government's gross debt would rise to a still relatively low 30 per cent of GDP. Assuming that the additional debt were to share the same term structure as the existing liability, then government interest payments would rise proportionately, by about 2.3 per cent of GDP.
11. The previous two *Economic Surveys of the Czech Republic* provide more detail on the set-up and purpose of IPFs.
12. In some cases, voucher privatised firms also had significant foreign ownership, for example Tabak, Cokoládovny and Vertex. As a result, the difference between foreign-held firms and those that were voucher privatised may be overstated.
13. The changes in ownership patterns reflect, among other things, price fluctuations. For example, the government's overall holdings increased by about 6 percentage points

between 1994 and 1997, but this was due to the increase in their value rather than additional equity purchases, as the prices of small holdings fell relative to larger enterprises such as the utilities held by the government (World Bank, 1999*b*).

14. Under the first mass voucher privatisation, only closed funds existed; open funds were created in the subsequent voucher privatisation.

15. To get the incentives, investors submit the necessary forms to CzechInvest, the government agency charged with administering the programme. It verifies that all conditions are met and then makes a recommendation to government on whether to approve an incentives package. This may require an environmental impact assessment as well as a decision by the competition bureau on the potential impact on the domestic economy. Decisions by the latter two groups may be considered by the government when making its decision but a negative ruling by either does not necessarily imply that the government will reject the application. The Ministry of Industry and Trade then monitors compliance and assesses it within three years of the initial investment.

16. In the past, environmental issues, difficulties in arranging zoning regulations, restitution claims and the simple problem of amassing enough contiguous land to build and industrial site have posed serious problems to investors. In many instances, land is widely-owned or the title is in doubt because of unsettled restitution claims. This, plus the difficulty in getting government approval for the sale of state-owned plots, have served to substantially raise the costs of making investment.

17. In addition, the International Finance Corporation of the World Bank took a 4.3 per cent stake in CSOB following the KBC purchase, to help strengthen the capital base of the bank.

18. The government decided to stagger the privatisation to allow those who did not win the *Ceska sporitelna* tender to compete for the *Komercni banka* tender too.

19. Other moves included restructuring the CS supervisory board and board of directors with the appointment of new members, although they were not all completely removed because the *National Property Fund* felt that some continuity in management would be useful. Moreover, because of the importance of CS in the retail market, and the widespread knowledge of its difficulties, changes were made to management to forestall any possibility of a bank run. These factors are not seen as important for the *Komercni banka*. In addition, there is a view that it would be difficult to get qualified people to run the banks, both because of a shortage of talent and because few people would be interested in such a job.

20. The minority shareholder used his three shares to legally challenge the procedures followed at the general meeting. The courts ultimately ruled against him, but these proceedings delayed the equity offering by over six months. The state's stake in *Komercni banka* is expected to remain at 48.7 per cent, of which the Czech Republic holds 34 per cent and the Slovak Republic the remainder. An agreement between the two governments, which is subject to parliamentary approval, would see the Czech Republic assuming the Slovak Republic's share.

21. One problem confronting the government has been the issue of social loans, *i.e.* loans given to citizens prior to the transition to help them acquire homes. As part of the clean up of the balance sheet of *Ceska sporitelna*, the government intends to transfer Kc 15 billion of these loans to *Konsolidacni banka*.

22. Despite the legal obligation with respect to strategic companies, the government has indicated to the EU that it no longer sees any strategic reason for not privatising all of its holdings.
23. A price cap formula is used for telecoms, while there is no specific formula for the electricity and gas sectors. The government has recently completed a detailed cost analysis of them that should help it set prices in the future, with an eye to allowing cost recovery plus adjustments for inflation, exchange rates and profits.
24. Rent control applies to only about one-third of all households. New housing is not subject to it nor are government privatised holdings or on new rental contracts for apartments which have become vacant.
25. Large towns can also lower rents by up to 15 per cent. Smaller towns are able to increase rents by a maximum of 10 per cent and lower them by a similar amount. Whether the adjustment factor will be imposed is to depend on a host of factors, including access to public transportation.
26. Another problem relates to the qualifications of the administrators. They are typically lawyers who may have little specific knowledge in administration of the assets of a firm. While there are several large accounting firms with this knowledge, the law makes it difficult to appoint them in this capacity.
27. In addition, there appears to be a common concern among banks that if seized real estate were in fact sold, this could lead to a glut on the market, leading to falling prices and the need to create further provisions.
28. Another bank, the Moravia bank, ran into severe financial difficulties in the summer of 1999 and in October, the CNB decided to liquidate it. Its risk weighted capital adequacy dropped below the 8 per cent limit as classified loans soared above the 30 per cent level, forcing the CNB to expel it from its stabilisation programme, of which it had been involved since 1997. After rejecting one buyout offer from GE Capital on the grounds that it was not a "good fit", prospects appeared bleak that another partner could be found. At least part of its loan difficulties stemmed from credit extended to state-owned corporations, loans granted on the basis that the government would continue to bail out such firms.
29. The elevated level of administrative costs among small domestic banks reflects, to a large extent, the write-off of goodwill by GE Capital when it purchased Agrobanka.
30. There is no country risk provision although the CNB plans to monitor this area.
31. The regulation also stipulates the range of assets and off-balance sheet items to be included in the credit exposure of a bank and sets limits on the net credit exposure that the group must observe *vis-à-vis* its debtors. In addition, it limits the group's holdings in legal entities other than banks to 15 per cent of the group's capital in a single entity and a total of 60 per cent of the group's capital in the sum of all entities.
32. The CNB is legally able to deny a banking license in such situations because the financial operations of the banking entity would be non-transparent, but it is unclear whether it would take such a step.
33. A credit union support fund was set up by fourteen institutions, each contributing 4 per cent of their deposits. But with only Kc 20 million in the fund, this is insufficient to cover much of the probable losses.
34. When the Institute discovers any wrongdoing, it cannot revoke a license. It can force a credit union into conservatorship and shut it down (and transfer assets to another credit union as an option) only when it has discovered that a law has been breached,

for example embezzlement. It mainly operates through moral suasion, in particular by working with the Association of Credit Unions, which can publicise the names of institutions which it feels are not run well.

35. In addition, the situation where individuals can hold anonymous bank accounts should be abolished to better control tax compliance.

36. Voucher privatisation resulted in firms become publicly listed through an act of law. As a result, and given the SEC's brief existence, there has been no regulation in place to force companies to register with it.

37. Among other things, the Ministry of Finance is considering forcing investors who intend to hold more than 10 per cent of shareholders equity or voting rights of securities dealers to ask for prior SEC approval.

38. Although the slow rise in long-term unemployment may seem puzzling, larger inflows initially reduce overall duration before long-term unemployment becomes entrenched.

39. It is also likely that the number of individuals receiving social assistance has increased, but data in this area are not available.

40. Under EU regulations, in the absence of such councils or union representation, a firm would be required to talk directly to each employee.

41. The minimum wage in the Czech Republic is relatively low compared with that in other OECD countries, and its value in 1998 was 23 per cent of the average production worker wage, down from 53 per cent when first introduced in 1991 (its level was not fully adjusted to inflation). Its impact on employment is likely to be minimal at such levels.

42. Rates for Western Germany, Greece, New Zealand and Portugal are 3.5, 3.8, 3.3 and 1.5 per cent respectively (OECD, 1997) compared with 7.5 per cent in the Czech Republic.

43. Both the Czech research cited in the text and international evidence indicate there is little positive lasting impact on either earnings or employment for such programmes.

44. In particular, all of the state contributions and 60 per cent of those made by employees/employers were pooled together and then, from this fund, payments to insurance companies for clients 60 years of age and older were three times as large for clients under this age.

45. The discussion and evaluation of recent developments draws heavily on work done by the World Bank (1999*a*).

46. The actual retirement age for women will vary in this age range depending on the number of children raised.

47. United Nations data confirm the relative seriousness of the ageing problem in the Czech Republic. They predict that the ratio (of those aged 65 and over divided by the working age population as opposed to the employed) is expected to rise from 20 per cent in 1999 to 61 per cent in 2050. For most other OECD countries, this ratio will be between 35 and 45 per cent at that time, up from roughly 20 per cent now.

48. Each individual must contribute at least Kc 100 a month to their fund. The state matching contributions are then as follows: for a contribution of Kc 100-199, Kc 40 plus 32 per cent of the amount above Kc 100; Kc 200-299, Kc 72 plus 24 per cent of the amount above Kc 200; Kc 300-399, Kc 96 plus 16 per cent of the amount above Kc 300; and Kc 400-499, Kc 122 plus 8 per cent of the amount above Kc 400. The amounts are

not adjusted for inflation, and there is a maximum state contribution of Kc 120. As an additional enticement, the state subsidy is increased 25 per cent during the first two years of an individual's enrolment.

49. Anyone over the age of 50 can terminate his/her contract and receive an annuity or lump-sum provided that the minimum inscription period of the fund has been met. By law, this period can be no more than five years and in practice most funds have shorter periods. People below the age of 50 can also terminate contracts, receiving an annuity or cash, after a period of fifteen years in the system.

50. The contribution arrangements from January 2000 are:

Beneficiary's contribution	State contribution
0-100	0
100-199	50 + 40 per cent of the amount over 100
200-299	90 + 30 per cent of the amount over 200
300-399	120 + 20 per cent of the amount over 300
400-499	140 + 10 per cent of the amount over 400
500 and more	150

The amount that can be deducted from taxes is the difference between the individual's contributions over the tax period reduced by Kc 6 000 with a maximum allowance of Kc 12 000.

51. Both the Slovak and Czech Republics adopted the 1992 Czechoslovak legislation. Since then, subsequent modifications have caused the legislation in each country to diverge increasingly.

52. Of the five non-transition OECD countries (Greece, Ireland, Korea, Portugal and Spain) which have or had a similar or lower level of income compared to that in the Czech Republic in the preceding 35 years, all had lower average tax burden at that time than the Czech Republic does now. Their aggregate tax rates ranged between 17 and 24 per cent and averaged about 20 per cent. Looking at the remaining OECD countries, their average tax burden in 1965 was 28 per cent at a time when their incomes were on average twice as high as those currently observed in the Czech Republic.

53. It was 42 per cent in 1994, 41 per cent in 1995 and 39 per cent in 1996 and 1997.

54. The smaller size of the average reporting unit and the overall increase in their number implies the large losses of economies from scale.

55. However, the taxable base of the self-employed may be determined as the difference between the income and the related deductible expenses. Alternatively, the taxpayer may opt for a lump-sum deduction of expenses from income as defined by the tax law (see Annex I).

56. Each taxpayer is entitled to a basic personal allowance of Kc 34 920 (about 18 per cent of the earnings of an average production worker). An additional allowance of Kc 19 884 is granted for a spouse living in the taxpayer's household if the spouse's annual income does not exceed Kc 34 920. Further, an allowance of Kc 21 600 is granted for each dependent child. Annex I provides more details on the conditions and allowances associated with these and other taxes on personal income.

57. This surplus would leave place to a deficit of 10 per cent if other social benefits such as the child allowance and administrative costs were added to the expenditures. Moreover, it is expected that rising joblessness will mean that, in 2000, expenditures

on the pensions, employment policy and sickness benefits will exceed revenue from the payroll taxes.

58. The effect of the floor is that no self-employed worker pays less social security contributions than would a minimum wage worker. On the other hand, the amount of contributions paid by a self-employed affected by the ceiling is the same as paid by an employee earning about 2.6 times an average production worker's salary.

59. A zero rating implies that companies can claim refunds of the tax paid on their inputs and that no VAT is paid on their sales. In contrast, exemption implies that VAT is paid on the inputs of a firm but not on its own value added. Firms with an annual turnover in excess of Kc 3 million or whose three-month turnover exceeds Kc 750 000 must register in the VAT system; smaller firms pay VAT only on their inputs. As compared with other OECD countries, this threshold is relatively high.

60. However, most of these low-rated items do not fall in the seventeen ''socially and culturally sensitive'' categories recognised by the EU.

61. The IMF reports a measure of the productivity of VAT defined as VAT revenues divided by GDP divided in turn by the statutory VAT rate. This measure gives a sense of the additional revenue that could be expected from a percentage point increase in the VAT under some very strict assumptions. The measure reported here is somewhat more informative and has a clear economic interpretation – as it measures the ratio between actual VAT revenues and the revenues that would be expected if the VAT were successfully collected at its standard rate on all consumption goods. It therefore indicates the extent to which exemptions, zero-rating, reduced rates and tax evasion erode revenues. As such it is also an approximate measure of the distortions that these deviations from the standard rate introduce.

62. Non-incorporated firms, including unlimited partnerships and that share of total profit accruing to general partners in limited partnerships are treated for tax purposes in the same way as the profits of the self-employed. In all of these cases, the salaries of the employees of the firm (other than that of the self-employed individual or the partners) is deducted from sales in determining the taxable base. As is the case for the self-employed, social security contributions would be paid on 35 per cent of this amount and personal income tax on the amount left after payment of the social security contributions.

63. It is scheduled to be lowered again in early 2000 to 31 per cent.

64. The principal form of corporate tax incentives available in the initial phase of transition was tax holidays of two years for new operating companies. But the tax incentives granted have sometimes led to unexpected results: some companies were not able to benefit from the tax holiday because they were running losses at the beginning; others, targeting quick returns, made use of the incentives but did not play an important role in promoting economic development.

65. This is a lower estimate because the numerator includes the sum of additional non-payment less payments on pre-existing arrears.

66. The tax law distinguishes three types of penalties:

a) Late payment – if the taxpayer files a tax return and he doesn't pay his liabilities in time, he is charged with 0.1 per cent per day of the unpaid tax up to 500 days and afterwards 140 per cent of the discount interest rate of the Czech National Bank.

b) If the taxpayer files a revised tax return from his own initiative, he is charged 0.05 per cent per day of the amount by which the tax liability increased on the revised tax return. The penalty is calculated from the day when the correct tax return should have been filed.

c) If a tax administrator finds that a tax return is not correct, whether as a result of a mistake or evasion, the tax payer is charged 0.2 per cent per day of the amount by which the tax liability is increased by the tax administration.

67. This share was 51.8 per cent in the Czech Republic in 1998 as compared with 78 per cent in France, 63 per cent in Germany and 64 in Austria in 1996.

68. Table A2 in Annex I provides a complete listing of the goods and services taxed at reduced VAT rates for all OECD countries.

69. OECD, Calculations based on Table 9.8 of the Czech Statistical Office (1998).

70. Graham and Lemmon (1998) document that firms facing high corporate tax rates tend to have high levels of debt. This result confirms work by Schulman *et al.* (1996) for Canada and New Zealand as well as that of Desai (1997), who reports a positive cross-sectional correlation between debt usage and taxes across a sample of 51 countries. More recently, Graham (1999) found that an increase in corporate taxes has a positive effect on debt finance, while an increase of personal taxes on interest relative to equity income has a negative effect.

71. Estimates suggest that using 1999 depreciation rates and tax rules the required rates of return for equity would be 6.64 per cent, for debt 4.07 per cent and for capital gains 6.02 per cent. Among asset types, they would be 4.93 per cent for machinery, 5.41 per cent for building and 6.46 per cent for inventories.

72. Previously, tax relief was available only under very specific situations. For example the debtor had filed for insolvency or for bankruptcy or had gone into liquidation and the creditor registered a claim at court.

73. These include income taxes, social security contributions, and cash transfers.

74. The first two are taxed by the corporate income tax rate, while interest payments (which are deductible from the firm tax base) are taxed in the hands of recipients with a flat tax rate identical to the corporate income tax rate.

75. The extent to which a lower rate would be feasible will depend on the relative importance of the offsetting revenue impacts of a higher tax rate on interest income and the lower "all-in" tax rate on dividend income implied by the reform.

76. An alternative solution would reduce vertical and horizontal inequity by subjecting all income (both capital and labour earnings) to the same progressive income tax schedule and offering tax credits to individuals to the amount of taxes withheld at the firm level. While such a reform would widen the tax base of the personal income tax system it would also increase the "all-in" tax rates on capital income requiring that these be reduced either by giving firms corporate income tax credits in proportion to dividend payments and realised capital gains, or by adjusting the various withholding tax rates. While perhaps technically superior, this would be much more difficult to administer. In contrast to the current scheme where firms need only report the total amount of each income distributed, under this revised scheme both they and the government would have to record such information for each individual recipient.

Glossary

ALMP	Active labour market programmes
APW	Average production worker
BIS	Bank for International Settlements
CIT	Corporate income tax
CNB	Czech National Bank
CPI	Consumer price index
CS	*Ceska sporitelana*
CSO	Czech Statistical Office
CSOB	*Cesko slovenska obshodni banka*
EBRD	European Bank for Reconstruction and Development
ERM	Exchange rate mechanism
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GFS	Government Financial Statistics
GHIC	General Health Insurance Company
GP	General practitioner
IMF	International Monetary Fund
IPF	Investment privatisation fund
Kob	*Konsolidacni banka*
KB	*Komercni banka*
KBC	Bank Assurance Holding of Belgium
MLS	Minimum living standard
MLSA	Ministry of Labour and Social Affairs
NPF	National Property Fund
OTC	Over the counter market
PAYG	Pay-as-you-go pension fund
PES	Public employment service
PIT	Personal income tax
PSE	Prague Stock Exchange
RA	Revitalisation Agency
RMS	RM-system
SEC	Securities and Exchange Commission
SEF	State Environment Fund
SFA	State Financial Assets
SSC	Social security contribution
VAT	Value added tax

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Annex 1

Details of the tax system

Table A1. **Main features of the tax system**

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
1. Taxes on income			
1.1. Resident individuals 1.1.1. Personal income tax (PIT)	The PIT is levied on resident individuals on their world-wide income. Individuals with more than one source of income must return the tax-file on or before the 31st March of the year following the tax year. The tax year is the calendar year. Income is defined as any benefit obtained regardless of whether it is in cash or in kind. Non monetary benefits are valued at their fair market value.	Each taxpayer is entitled to a basic personal allowance of Kc 34 920. An additional allowance of Kc 19 884 is granted for a spouse living in the taxpayer's household if the spouse's annual income does not exceed Kc 34 920. Further, an allowance of Kc 21 600 is granted for each dependent child living in the taxpayer's household, and an additional Kc 13 080 per payer receiving a full invalidity pension. A Kc 10 464 allowance applies if the taxpayer takes part in a systematic educational or training programme.	Each line refers to an income tax bracket whose lower limit is given on the line and upper limit on the next line.
	Spouses or couples are always taxed as individuals, according to the basic tax schedule.	Losses can be carried forward for 7 years. No carry-back is allowed.	
	The taxable base is the aggregation of separate taxable bases for each category of income:	Contributions by employees to statutory health and employment insurance and social insurance as well as payments to foreign schemes are deductible in full.	
	1. Income from dependent services and public services It is defined as income from present or former employment and income from the work of members of co-operatives.	Donations to municipalities and organisations which support activities such as science and education, culture, medicine, ecology etc. are deductible if the total value of the donation is at least 2 per cent of the taxable base of the donor or Kc 1 000. The total amount of deductible donation in a year may not, however, exceed 10 per cent of the taxable base.	

Taxable income	Percentage on excess
0	15
102 000	20
204 000	25
312 000	32
1 104 000	40

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	2. Income from entrepreneurial activity and from independent services	The rules determining non-deductible and deductible items are the same as for corporations.	Personal income tax rates (see above).
	The taxable base may be determined as the difference between the income and the related deductible expenses.	In the case of certain activities, the taxpayer may opt for a lump-sum deduction of expenses from income in the separate branches of the category as follows: 50 per cent of income from agriculture; 30 per cent of income from intellectual property and similar rights; 25 per cent of income from trade and from other entrepreneurial activities.	Income from authors' contributions to newspapers and radio/television broadcast is subject to 10 per cent final withholding tax rate, provided their contribution does not exceed Kc 3 000 per payer.
	3. Income from capital assets which includes: – dividends, interest and other returns from securities or from participation in a legal entity; – profits shares of limited partnerships; – gains from the sale of shares and option rights; – discounts on bills of exchange; – interest from loans and savings deposits; – annuities based on private insurance (including foreign-source pensions). If employees acquire shares for less than their nominal market value, the difference between the acquisition cost and the sale price is taxed as a capital gain on disposal only.	Capital income from the following sources is tax exempt: – gains from the sale of a dwelling if it was used as primary home by the taxpayer for 2 years; – gains from the sale of immovable property (excluding dwellings) owned by the seller for at least 5 years if the property is a residential property; – gains from the sale of motor vehicles, aeroplanes, and ships, which have not been used for business profits, if the assets have been held for at least 1 year before disposal; – gains from the disposal of securities held for at least 6 months; – compensation for damages; – allowances and benefits from social insurance or from other social care; – most benefits from private insurance; – gains from the sale of movable and immovable property, which have not been used to generate business income or independent services; – gains from the sale of shares repurchased by the employer.	Dividends and other income from profit distribution are subject to a 25 per cent final withholding tax rate. Interest payments from deposit accounts and saving books are subject to 15 per cent final withholding tax. Dividends and interest paid by a *Pension Fund* are subject to a final withholding tax of 15 per cent.

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	4. Income from leasing or rents Rental income includes leasing income from movable and immovable property. The tax base may be calculated according to the general rules or it may be reduced.		
	5. Other income – gains from the sale of movable and immovable property which have not been used to generate business income or independent services; – income from occasional activities including occasional leasing of movables if the total income in a tax year exceeds Kc 10 000; – other pensions primarily derived from Czech state pension schemes. The taxable base of *other income* is calculated according to the general rules, except that such calculations may not result in a loss.		A tax of 20 per cent is levied on winnings in public and advertising competitions. A tax of 15 per cent is deducted from incomes from secondary dependent activity, provided their aggregate does not exceed Kc 2 000.
	6. Pension income Taxable income is the amount of private and other pensions, reduced by the purchase price divided the difference between the taxpayer's expected lifetime and the age of the taxpayer when he first receives the pension. Occupational pensions are treated as income from former employment and taxed according to the rules for income under 1.		

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	Foreign source income received by a resident individual is included in his taxable income.	In the absence of a treaty, unilateral relief is provided by way of a foreign tax credit for income taxes paid abroad. This credit is limited to amount of Czech tax that would have been payable had the income been earned in the CR.	Alternatively, foreign source dividends and interest, as reduced by foreign taxes paid, may be declared separately and taxed at the 25 per cent withholding tax rate.
1.1.2. Capital gains	Capital gains are taxable if the asset has been used to generate income or to carry on business or independent services. The gain is determined as a difference between the purchase price (or nominal value) and the sale price, decreased by the expenses relating to the sale.	For exemptions see above.	Capital gains are taxed as *other income* (see above).
1.1.3. Owner occupied housing	There is no tax on imputed rental income. For gains from the sale of a dwelling, see above.		
1.1.4. Fringe benefits	Benefits are treated as taxable employment income.	12 per cent of the purchase price of company cars provided both for business and private use is included in the taxable base of the employee. The following benefits are tax exempt: – refresher courses for employees; – catering provided by the employer; – trips abroad as incentive award up to Kc 10 000 per annum.	

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
1.2. Non-resident individuals	Non-residents are taxed only on their income derived from Czech sources according to the rules applicable to residents. However, certain types of income received by non-resident individuals are subject to withholding tax.		Withholding tax rates on certain types of income received by non-residents: 15 per cent on registered certificates of deposit 25 per cent on: – income from licenses and copyrights; – income from bonds and other securities; – interest from loans and debt-claims of every kind; – rental income; – income from consultancy and technical services provided in the CR.
1.3. Business 1.3.1. Corporate income tax (CIT)	CIT is levied on the world-wide income of legal entities (incorporated public companies and private companies) and on associations and foundations to the extent that they carry on a business. Limited partnerships are subject to:		35 per cent on profits of the legal entities. 25 per cent on profits derived by investment companies and investment and pension funds.
	CIT tax on the income attributable to the limited partners. The tax year is the calendar year. Taxable income equals gross income from various sources less expenses and losses carried forward from preceding periods for up to 7 years.	*Deductions* allowed from the business tax base are: – expenses incurred in generating and maintaining taxable income (*i.e.* insurance premiums, social security contributions); – royalties and interests; – lease expenses with a leasing period above 20 per cent of the expected useful life of tangible assets and of at least 3 years;	Withholding tax: Special tax rates apply to domestic-source income derived by resident companies. The 25 per cent final withholding tax is levied on: – dividends and other income; – interest (paid abroad) disallowed under the thin capitalisation rules;

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	Corporate income tax returns must be filed by 31 March of the year following the tax year. If the tax return is authorised by a chartered accountant the deadline is 30 June. The time limits may be extended up to a maximum of 3 months.	– paid real estate tax, road tax, and other items; – donations, in the limit of 2 per cent of the tax base, to resident municipalities, communities and legal entities designed to finance science, education, culture and other ecological and humanitarian purposes.	– the difference between the agreed price and the market price under the transfer-pricing rules (paid abroad); – fees paid abroad to a board of directors or a supervisory board.
	Advance payments are required from all companies whose last known liability is more than Kc 20 000. A legal entity with tax liability of more than Kc 10 mln. for the previous year must make monthly advance payments; with tax liability between Kc 100 000 and 10 mln. must make quarterly advance payments; and with a liability between Kc 20 000 and Kc 100 000, must make two instalments equal to 40 per cent of the tax liability of the preceding year by 30 June and 15 December. Interest is included in the taxable income of recipient companies. Royalties are normally included in the recipient's gross income.	The main types of *exempt income* are interest income from securities secured by a mortgage and interest on Eurobonds issued by a resident company. Depreciation allowances are available for both tangible and intangible assets that are used for business purposes. Inventories may not be depreciated. Both straight-line and accelerated methods are allowed. The taxpayer must determine at the beginning of the depreciation process, which method to use, which cannot be changed for the entire period of depreciation.	From 1998, the 25 per cent withholding tax on interest gains continues to apply but it is credited against the whole year's tax liability. *Depreciation period for tangible assets:* 4 years: Category 1 vehicles, computer equipment, hand mechanised tools; 6 years: Category 2 machines not in category 1, trucks, tractors; 12 years: Category 3 machines used in specific industrial process – steel plants, paper, manufacture and certain areas of cultivation.

Table A1. **Main features of the tax system** *(cont.)*
Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	A partial integration system applies to profits (*i.e.* dividends) distributed both to companies and to individual shareholders. Double taxation is relieved in that a company may credit against its corporate income tax liability an amount equal to 50 per cent of the withholding tax imposed on dividends previously paid out of profits.	*Tangible assets:* Depreciable assets are classified in 5 depreciation categories: A 10 per cent initial depreciation allowance is granted for the acquisition price of machinery and equipment from the taxable income of the first owner of the assets, provided it is not sold or leased within three years. This deduction does not affect the depreciable value of the asset.	20 years: Category 4 buildings made of wood or structures for energy generation; 30 years: Category 5 buildings not in category 4, tunnels, roads. All other assets are treated as falling under category 2. Leased assets may be depreciated only using the straight-line method.
		Intangible assets: May be depreciated if their initial price exceeds Kc 40 000 and they have an expected useful life of at least 1 year. For lower values, intangible assets may be written off in the year of acquisition.	*Depreciation period for intangible assets:* 4 years: software know-how; 5 years: costs of forming a company, as well as immaterial results of research and development; 6 years: licences, industrial rights, technical and other know-how; 12 years: patents.
		Accelerated depreciation: The 1st year depreciation is established as a quotient of the acquisition price and an initial coefficient stated in the law. To determine the amount of depreciation in subsequent years, the acquisition cost must be doubled and divided by the respective coefficient minus the number of already depreciated years.	*Investment allowance:* The taxable base may be reduced by the following percentages of the purchase price or cost of production: 10 per cent of purchased or leased tangible assets, including machines, equipment, tools and means of transport; 15 per cent of equipment and machinery for sewage disposal and utilisation of waste materials; 20 per cent of the machinery used in agriculture and forestry.

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	Foreign source income is fully taxable under ordinary business income tax.	Foreign tax credit. A credit is granted for tax paid abroad on income from a foreign source. This credit is limited to the amount of foreign-source income times the Czech CIT rate.	Ordinary rates.
	Provisions for bad debt.	Transfers to provisions for bad debts are deductible for tax purposes if certain conditions are met.	Foreign source dividends, liquidation proceeds and certain types of interest constitute a separate tax base, which is subject to a 25 per cent final tax. However, if the parent company holds 20 per cent or more of the foreign subsidiary equity stock repatriated dividends are tax exempt.
1.3.2. Capital gains	Capital gains are normally included in ordinary business income. Ordinary losses can be carried forward for 7 years (see above).	Capital losses from the sale of securities may only be set off against similar gains during the relevant tax year. Under a special carry-forward option, unused net loss can be carried forward for up to 3 years. The same rule applies for capital losses from the sale of shares in public companies. Capital losses from the sale of shares in private companies are not tax-deductible.	Corporate taxpayers, other than banks, may write-off bad debts at 20 per cent for debts more than 6 months overdue and at 33 per cent for debts more than 12 months overdue. Write-off rates vary according to the maturity period of the bad debt:
1.3.3. Tax incentives	The granting of tax incentives for direct investments was terminated in 1992, but taxpayers who were entitled to use tax incentives available under previous legislation may continue to benefit from such incentives according to the conditions provided by the legislation.		

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
1.3.4. Groups of companies	There is no group taxation in the CR. All entities are taxed separately. Profits and losses may not be shifted between affiliated companies. Intercorporate dividends are taxed in the hands of the recipient corporate entity. The partial integration system explained above also applies to intercorporate dividends.	A dividend received by a resident company with a qualifying participation (*i.e.* at least 20 per cent of the capital), and redistributed to its own shareholders holding a qualifying participation of its capital, is exempt from withholding tax. Investment funds do not qualify for this exemption.	
1.3.5. Tax on payroll	It was abolished in 1993.		
1.4. Non-resident companies	Only income derived from Czech sources is subject to taxation.		
	A final withholding tax applies to dividends, interest and royalties paid to non-resident companies. The rate may be reduced under a tax treaty.		The rate of the withholding tax is 25 per cent in all cases.
	A special withholding tax applies to rental income and income from consultancy and technical services provided in the Czech Republic.		1 per cent withholding tax in the case of financial leasing, if the leased asset is subsequently purchased by the lessee.
1.5. Transfer-pricing	Prices agreed between related parties should not differ from prices contracted with independent customers in similar commercial transactions. Companies can however, properly document the difference in prices. Similarly, interest charged on loans between related debtors and creditors must generally equate to 140 per cent of the Czech National Bank's Discount rate (DR). This provision does not apply when the creditor has its residence abroad and the interest rate charged is below the DR.		

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Rates
1.6. Thin capitalisation	Interest paid on loans provided by related parties in excess of the ratio 4:1 between the aggregate value of foreign value of foreign debt and all equity of the company is not deductible for tax purposes. The ratio for banks and insurance companies is 6:1. Newly established companies are exempted from thin capitalisation rules in the partial year of establishment and in the subsequent three calendar years.	
2. Social security contributions	Social security contributions are determined as a per cent of the monthly gross income of employees and of the yearly net income for the self-employed. Social security contributions are shared between employers and employees according to the scheme presented in the next column: Contributions by employees to statutory health and employment insurance and social insurance as well as payments to foreign schemes are deductible. The tax base of the self-employed is 35 per cent of yearly income net of expenses incurred to generate, assure and maintain income. The maximum assessable base for social and health insurance is Kc 486 000. The lowest base for health contributions cannot be below twelve times the minimum wage and the lowest base for social insurance cannot be below Kc 18 300.	At the inception of their activities carrying taxable income, legal and private persons are required to register with the district social insurance administration body at the place where the legal person has its main offices or where the private person has his residence.

	Employee	Employer	Self-employed
Health insurance	4.5	9.0	13.5
Social insurance			
Sickness benefit	1.1	3.3	4.4 (voluntary)
Pension	6.5	19.5	26.0
Employment policy	0.4	3.2	3.6
Total social insurance	8.0	26.0	34.0
Total	12.5	35.0	47.5

Source: Ministry of Finance.

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
3. Real estate taxes			
3.1. Tax on land	An annual tax is payable by the owner of land. A tenant is a taxpayer of land in respect of rented land if the original owners boundaries no longer exist because the plots were united with others. A user is a taxpayer of land tax if the owner of land is unknown. Land tax includes taxation of agricultural land (arable land, hop-fields, vineyards, gardens and orchards) commercial forests and ponds for intensive fish farming, built-up areas and courtyards, developed land and other land.	Land owned by the state, by the municipality and by accredited diplomatic representatives. Plots of land forming one functional unit with the building used for religious services of churches, public service companies, schools, museums, galleries, libraries, medical establishment, social care establishment, foundations or used for improvement of environment.	The tax rates vary between 0.25 per cent and 0.75 per cent. The tax rate is 1 Kc per sqm for building plots and 0.1 Kc per sqm in other cases. These rates are multiplied by coefficients ranging from 0.3 per cent to 4.5 per cent according to the size of the municipality.
	The tax base of agricultural land are average prices in the cadastre areas. These prices are derived from quality of soil and calculated according to valid price decree. The tax base of commercial forests and ponds used for intensive fish farming are average prices according to valid price decree. The tax base of built-up areas, developed land and other land is the actual area of the plot of land in square meters.	Land used as parks and sport grounds for the public. Agricultural land and woodland after cultivation. Agricultural land for a period of 5 years and commercial forests (up to 10 years) if restituted to owners. Land used for public transport.	

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
		To this tax are not submitted: land which is subject to the building tax, protective and special woodland, water areas except ponds for intensive fish farming and land used for the defence of the state.	
		Buildings owned by the state, by the municipality, by the accredited diplomatic representatives. Buildings used for religious services of churches, public service companies, schools, museums, galleries, libraries, medical establishment, social care establishment and foundations; or used for improvement of environment.	The tax rates are: – dwelling houses – Kc 1 per square meter multiplied by the coefficient in the same way as in the case of developed land; – buildings for individual recreation purposes – Kc 3 per square meter, non residential area Kc 1 per square meter; – garages built separately from dwelling houses – Kc 4 per square meter.
		Newly constructed houses for a period of 15 years. Culture monuments for period of 8 years. Buildings used for public transport. In certain cases, buildings are exempted form the building tax if they are not used for business activity or leased.	Structures for business purposes: – used for primary agricultural production, forestry or water management Kc –1 per square meter of the built-up area; – used for industrial production civil construction, transport, power engineering, Kc per square meter of the built-up area; – used for other business activities Kc 10 per square meter of the built-up area.
3.2. Tax on building	An annual tax is payable by the owner of building. In case that building is managed by the Czech authorities and rented, the tenant bears the tax. The tax is levied on buildings and structures submitted to building inspection.		Other structures Kc 3 per square meter of the built-up area. These rates are multiplied by coefficients ranging from 0.3 per cent to 4.5 per cent according to the size of the municipality.

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	The tax base is the area of the ground plan of the overhead part of a structure in square meters.	To this tax are not submitted: dams, water supply system, sewage system, structures used to distribute energy, public roads.	
4. Inheritance and gift tax	Acquisition of movable and immovable property situated in the Czech Republic by inheritance shall be liable to inheritance tax and the taxpayer is the inheritor.	If the acquisition of property by inheritance concerns persons included in the first category, it shall be exempt from inheritance tax.	The rates in category I range from 1 per cent to 5 per cent, in category II from 3 per cent to 12 per cent and in the third category from 7 per cent to 40 per cent and when computing inheritance tax the final amount shall be multiplied by a coefficient 0.5.
	Gift tax shall be imposed on the donated movable, immovable property and on the other property benefit, the taxpayer is the acquirer. The inheritor and acquirer (beneficiary/donnee) are classified in three categories:	Acquisition of movable personal belongings of individuals, unless these things were for a year prior to acquisition included in the descendant's business property, if the value of such property acquired by each individual taxpayer does not exceed Kc 60 000 in persons in category II and Kc 20 000 in category III. The same exemptions and the same values for both categories for the acquisition of deposits and financial meanings. The tax shall be collected only on that part of the value of movable property or from the finance by which it exceeds the said limits.	

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
	I: Spouses and relatives in the direct line (children, grandchildren, parents).	Exempt from gift tax:	
	II: *a)* other relatives in the collateral line, namely siblings, nephews, nieces, uncles and aunts; *b)* children's spouses, husband's children and parents, spouses of parents and individuals living with the heir, donor or decedent in a common household for at least a year prior to the transfer or prior to the death of the decedent and who for that reason took care of the common household or who were dependent on the heir, donor or decedent of their support.	Acquisition of movable personal things of individuals (unless the things were included in the donor's business property for a year prior to acquisition) if the value does not exceed Kc 1 mln per persons in category I, Kc 60 000 in category II and Kc 20 000 in category III. The same sums in the same categories are exempt concerning deposits and financial meanings.	
	III: All other persons.		
5. Real estate transfer tax	Real estate transfer tax is paid by the transferor (seller). The tax base is the price determined by the Act on Property Valuation, with effect from the day when the real estate concerned is acquired. The price determined by the Act shall be applied in cases where the contracted price is lower that the price determined by the Act. If the contracted price is higher than the price determined by the Act, the tax base shall be calculated from the contracted price.		The rate of real estate transfer tax shall be 5 per cent of the tax base.

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
6. Domestic taxes on goods and services			
6.1. Value-added tax	Subject to VAT: 1) the supply of goods and services effected for consideration; 2) the importation of goods. Supply is defined to include, goods on which VAT was wholly or partially deductible, forming part of a taxable person's business assets and which are used for private purposes or disposed of free of charge of for purposes other than those of the business.	*Threshold for registration:* Individuals and legal entities must be registered to VAT if their turnover (excluding turnover for exempt taxable supply) exceeds Kc 750 000 during the previous three months.	5 per cent low rate: foodstuff, pharmaceutical products and most services. 22 per cent standard rate. Zero-rated: exportation of goods and services.
	Taxable amount: The taxable amount is everything which constitutes the consideration which has been or to be obtained by supplier from the purchaser (selling price) including taxes, duties, levies and charges excluding VAT.	*Exemptions:* Postal services, broadcasting, hospital and medical care, welfare and social security work, education, financial services, supply of building and parts thereof after two years, rental of real property.	
6.2. Excises	Excise taxes are levied on specified goods. The tax is levied under a value-added system up to the wholesale level.		Beer: Kc 24 per hectolitre per degree Plato. Wine: Kc 250-2 340 per hectolitre of product. Alcoholic beverages: Kc 23 400 per hectolitre of absolute alcohol. Mineral oils: Kc 8 700-12 950. Tobacco: Kc 740-803.
	In imports, the tax is assessed by the tax administrator (customs authority) in accordance with the Customs Act. The customs duties are also calculated by the customs authority.		

Table A1. **Main features of the tax system** *(cont.)*

Updated to 1 January 1999

Tax	Nature of tax	Deductions and exemptions	Rates
7. Taxes on international trade and transactions			
7.1. Import duties	Customs duties are levied on the customs value of most imported goods. See excise duties.		
7.2. Export duties	There are no taxes on exports.		

Source: OECD, Ministry of Finance.

Table A2. **Trends in value-added taxes – tax parameters**

	Year VAT introduced	Initial standard rate	1998 standard rate	Zero rated goods	Lower rated goods (major items)
United States	None	None	None	. .	. .
Japan	1989	3	5	None	None
Germany	1968	10	7	None	Books, food, newspapers, transport
France	1964	20	20.6	None	Medicine, equipment for the disabled, books hotels, entertainment, authors' rights, museums, transport, travel, passenger travel, accommodation, agriculture, books, catering, food, newspapers and water
Italy	1973	12	20	Books, newspapers, scrap iron, recycled paper	Food, medicines, telecom, weekly publications and accommodation
United Kingdom	1973	10	17.5	Children's clothing, food, passenger transport, books, newspapers, domestic sewage and water, prescription drugs, medicine, certain supplies for the disabled	. .
Canada [1]	1991	7	7/15	Medicine, basic groceries, exports, certain financial services, certain agricultural and fishing products, medical devices, international travel and transportation services, agriculture, precious metals	None
Australia	None	None	None	. .	. .
Austria	1973	16	20	None	Agriculture, books, food, forestry, hospitals, newspapers, art, culture, letting transport, wine
Belgium	1971	18	21	Cars for handicapped, newspapers and certain weeklies	Agriculture, original art, clothing, food, coal and coke, gold

Table A2. **Trends in value-added taxes – tax parameters** *(cont.)*

	Year VAT introduced	Initial standard rate	1998 standard rate	Zero rated goods	Lower rated goods (major items)
Czech Republic	1993	23	22	Postal, broadcasting, financial and social security services, exportation of goods and services	Most food products, animals, water, pharmaceutical products, aids for the disabled, thermal energy, newspapers, periodicals, books, new buildings, construction activities, recreation, cultural and sport activities, transportation, telecommunications, funerals and all remaining services (excluding road transport freight, accommodation, tourism and most repairs)
Denmark	1967	10	25	Newspapers	None
Finland	1969	11.1	22	Newspaper and magazine subscriptions, some printing services, vessels and international transport	Food, non-alcoholic drinks, animal feed, medicine, books, passenger travel, accommodation, TV licences, admission to cultural entertainment, sporting events and to the cinema
Greece	1987	16	18	None	Books, culture, food, medicine, newspapers
Iceland	1989	22	24.5	International transport, food, fuel and equipment delivered for use in ships and aircraft engaged in international traffic, shipbuilding	Food, newspapers, books, hotels, warm water, electricity and fuel oil used for the heating of houses and swimming pools
Hungary	1988	25	25	International transport, food, fuel and equipment delivered for use in ships and aircraft engaged in international traffic, shipbuilding	Most food products, water, washing, dry-cleaning, pharmaceutical products, aids for the disabled, electricity, household fuel, newspapers, periodicals, books, social housing, hotels, motels, boarding houses, transportation, funerals

Table A2. **Trends in value-added taxes – tax parameters** *(cont.)*

	Year VAT introduced	Initial standard rate	1998 standard rate	Zero rated goods	Lower rated goods (major items)
Ireland	1972	16.4	21	Books, children's clothing and footwear, oral medicine, certain medical equipment, certain goods, seeds fertilisers	Newspapers and certain periodicals, fuel for certain purposes, electricity, works of art, veterinary services, agricultural services, car and boat hire, driving instruction, photographs, concrete, holiday accommodation, restaurant/hotel meals, building services, immovable goods, repair services, waste disposal, certain foods, cultural and sporting events
Luxembourg	1970	8	15	None	Agriculture, books, food, fuel, medicine, newspapers
Mexico	1980	10	15	Patent medicines, most food products (except luxuries and soft drinks), exports, most animals and plant products (except rubber), gold, sales of jewellery and art	10 per cent rate applied along the US border
Netherlands	1969	12	17.5	None	Accommodation, agriculture, books, catering food, supplies to the disabled, medicine, newspapers, passenger transport, water, entrance fees for sports, art and antiques
New Zealand	1986	10	12.5	Fine metals from refiner to dealer, exports	Long-term stays in a commercial building
Norway	1970	20	23	Books, newspapers, certain aircraft and ships, transport services by ferrying vehicles, second-hand vehicles	None
Poland	1993	22	22	Basic medicines, newspapers, periodicals, books, housing units, feed, fertilisers, pesticides, farm machinery and equipment, domestic air services	7 per cent rate for food products (unless exempted), children's goods, medicines, medical supplies, building materials, basic appliances, passenger transportation, telecommunications. 17 per cent rate for electricity, fuel

Table A2. **Trends in value-added taxes – tax parameters** *(cont.)*

	Year VAT introduced	Initial standard rate	1996 standard rate	Zero rated goods	Lower rated goods (major items)
Portugal	1986	16	17	None	Books, food supplies to the disabled, medicines, entertainment, newspapers, fuel, transport, electricity, accommodation and restaurant services
Spain	1986	12	16	None	Books, social lodgings, catering, certain cultural and entertainment services, food, hotels, restaurants, supplies to the disabled, medicines, transport, newspapers, public amenities, burial services, agriculture and forestry, domestic passenger transport
Sweden	1969	11.1	25	Commercial aircraft and ships, aircraft fuel, prescription medicine, printing of certain publications	Accommodation, food, passenger transport, ski-lifts, newspapers, certain works of art, imported antiques, collectors' items
Switzerland	1995	6.5	6.5	None	Water, food, medicine, books, newspapers, non-commercial television
Turkey	1985	10	15	None	Agriculture, leasing, second-hand cars, newspapers, books, magazines, basic foodstuffs, natural gas, certain entertainment and cultural services

1. 15 per cent Harmonised Sales Tax (HST) applies in those provinces that have harmonised their provincial retail sales tax with the federal GST (the 15 per cent GST is composed of a provincial component of 8 per cent and a federal component of 7 per cent.

Source: First column, Owens J. and E. Whitehouse (1996), ''Tax reform for the 21st century'', Bulletin for International Fiscal Documentation, Vol. 50, No. 11/12. Others, adapted by OECD from *Consumption Tax Trends,* OECD (1999, 3rd edition).

Annex II

Chronology of main economic events

1998

May

Maximum producer and importer prices for medically related goods and pharmaceuticals raised on average by 8.5 per cent.

Railway tariffs increased on average by 15 per cent.

June

Parliamentary elections held. No clear majority is gained by any party.

Agrobank is sold to GE Capital Bank.

The stabilisation programme set up in 1996 for small and medium-sized banks is closed.

The Czech National Bank (CNB) tightens minimum disclosure regulations for banks.

July

The CNB, the Securities and Exchange Commission and the Ministry of Finance sign an agreement on co-operation in banking supervision and state oversight in the area of capital markets.

Messrs. M. Zeman and V. Klaus conclude an opposition agreement between the Czech Social Democratic Party (CSSD) and the Civic Democratic Party (ODS). Mr. Zeman is named Premier of the Republic and Mr. Klaus, Chairman of the Lower House of Parliament. Mr. J Tosovsky is appointed CNB Governor for a six-year term.

Consumer and producer gas prices are raised on average by 27 and 10 per cent respectively, while electricity prices increase by 24 per cent.

On 17 July, the two week repo rate is reduced 50 basis points to 14.5 per cent.

The CNB lowers the minimum reserve requirement from 9.5 to 7.5 per cent.

The CNB issues new regulations on the classification of loans. Banks are required to create 100 per cent cash provisions within three years for loans that are in default by more than a year and which are backed by real estate.

August

On 14 August, the two-week repo rate is lowered to 14 per cent while the discount rate is reduced for the first time since May 1997, by 150 basis points to 11.5 per cent.

September

The Czech National Bank introduces new provisions on what must be included in a bank's performance report.

The Republic's long-term foreign currency debt rating is lowered by Thomson BankWatch from BBB+ to BBB.

The CNB lowers the two-week repo rate to 13.5 per cent on 25 September.

October

The two-week repo rate is reduced on 27 October from 13.5 to 12.5 per cent, the discount rate to 10 per cent (from 11.5 per cent) and the Lombard rate is lowered 1 percentage point to 15 per cent.

November

The government announces price changes effective 1 January 1999. These include a rise in telecommunications rates by 3.9 per cent, the possibility of raising bus tariffs by 8 per cent, a decrease in maximum importer prices of gas supplied to distributors of 10 per cent and an increase in the minimum state purchase price for milk of 4 per cent.

The CNB lowers its two-week repo rate 100 basis points to 11.5 per cent on 13 November.

The CNB sets the short-term inflation target for net inflation at the end of 1999 to 4.5 per cent ± 0.5 percentage points.

Standard and Poor's downgrades the Czech Republic's long-term foreign currency credit rating from A to A-.

December

The government announces no change in the producer price of electricity for January 1999.

The CNB decides to lower the minimum reserve requirement from 7.5 to 5 per cent effective 28 January 1999.

The CNB announces new provisions to protect the banking system from Y2K risk.

The CNB lowers the two-week repo rate to 10.5 per cent on 4 December and subsequently to 9.5 per cent on 23 December. On the latter date, the discount rate is lowered to 7.5 per cent.

1999

January

The two-week repo rate is reduced to 8.75 per cent and then to 8 per cent on 18 and 29 January respectively.

February

The CNB announces tougher provisions on the requirements for a banking license application.

The CNB issues a new decree on prior consent for increasing or decreasing an owner's voting shares in a bank.

The government announces that maximum rents in non-co-operative apartments are to be raised an average 9.3 per cent in July 1999. The maximum price of pharmaceuticals is to be lowered by 4 per cent on average as of 1 May.

March

The Czech Republic becomes a member of the NATO alliance on 12 March.

The minimum price of milk is reduced 7.7 per cent as of 1 April.

The CNB lowers the two-week repo rate to 7.5 per cent on 12 March and the discount rate to 6 per cent.

April

On 8 April, the CNB publishes its medium-term monetary strategy.

On 9 April, the CNB lowers the two-week repo rate to 7.2 per cent.

On 14 April, the government announces its *Industry Revitalisation Programme* to put industry (and state-owned banks) on a firmer financial footing.

The government approves a new *National Plan for Employment* to deal with rapidly rising unemployment, which it hopes to introduce in 2000.

The government announces its intention to privatise *Ceska sporitelna*.

May

On 4 May, the two-week repo rate is lowered to 6.9 per cent.

The CNB announces that minimum reserve requirements for banks will be reduced from 5 to 2 per cent as of 7 October 1999.

June

On 29 June, the two-week repo rate is reduced to 6.5 per cent.

The government announces that postal tariffs are to be increased 15.1 per cent as of 1 January 2000. The price of milk is to rise 8.3 per cent as of 15 July.

Privatisation of *Cesko slovenska obshodni banka* (CSOB) is completed with *Bankassurance Holding* (KBC) of Belgium taking a controlling interest through the purchase of the state's 66 per cent stake.

The call for tenders for the last remaining state-owned bank, *Komercni Banka*, is published.

July

The minimum wage is increased by Kc 400 to Kc 3 600.

The two-week repo rate is lowered to 6.25 per cent on 30 July.

August

The maximum price of gas charged large companies is lowered by 4 per cent and that charged medium-sized customers by 3.4 per cent.

The Revitalisation Agency is created as a wholly-owned subsidiary of *Konsolidacni banka*.

September

The two-week repo rate is reduced to 6 per cent on 3 September while the discount and lombard rates are lowered to 5.5 and 8 per cent respectively.

October

The two-week repo rate is lowered twice during the month to 5.75 per cent on 3 October and then to 5.5 per cent on 27 October. On the latter date, the discount and lombard rates are lowered 50 basis points each.

The government chooses a consortium of *Lazard Frères* and *Latona Europe* to become administrator of the Revitalisation Agency.

STATISTICAL ANNEX

Table A. **Selected background statistics**

	Average 1993-98	1993	1994	1995	1996	1997	1998
A. Percentage change							
Private consumption[1]	3.3	2.9	5.3	5.9	6.9	2.1	–2.8
Gross fixed capital formation[1]	4.4	–7.7	17.3	19.8	8.2	–4.3	–3.8
GDP[1]	1.5	–0.9	2.6	5.9	3.8	0.3	–2.3
GDP price deflator	10.7	16.2	11.0	10.2	9.7	6.5	11.0
Industrial production[1]	0.9	–5.0	2.4	–0.9	1.7	4.7	3.1
Total employment	–0.2	–1.2	1.1	0.9	0.1	–0.6	–1.4
Compensation per employee (business sector)	16.1	24.4	17.3	17.6	17.7	10.6	9.4
Productivity per worker	1.8	0.3	1.7	5.0	3.9	1.1	–1.0
Unit labour costs	13.9	23.6	16.3	11.0	13.3	9.5	10.0
B. Percentage ratios							
Gross fixed capital formation as per cent of GDP	29.3	25.4	28.7	32.0	31.8	30.2	27.5
Stockbuilding as per cent of GDP	2.2	1.9	1.0	2.0	3.1	3.0	2.4
Foreign balance as per cent of GDP	–3.6	–0.2	–2.7	–4.8	–6.4	–5.9	–1.4
Compensation of employees as per cent of GDP	58.1	54.2	56.8	57.2	59.1	60.8	60.3
Direct taxes on households as per cent of GDP	4.7	2.9	4.6	5.0	5.1	5.2	5.2
Household saving ratio as per cent of disposable income	6.8	6.0	1.9	6.2	8.3	8.7	9.6
Unemployment rate as per cent of labour force	4.7	4.3	4.4	4.1	3.9	4.8	6.5
C. Other indicator							
Current balance (million US dollars)	–1 724.7	463.6	–812.2	–1 373.7	–4 297.1	–3 278.0	–1 050.5

1. In constant 1995 prices.
Source: Czech Statistical Office and OECD.

Table B. **Supply and use of resources**

Billion koruny, constant 1995 prices

	1992	1993	1994	1995	1996	1997	1998
Private consumption[1]	611.7	629.3	662.7	701.7	750.0	765.5	743.7
Public consumption	294.3	294.0	287.2	275.1	271.8	281.5	283.3
Gross fixed capital formation	340.8	314.7	369.2	442.4	478.5	457.9	440.7
Final domestic demand	1 246.8	1 237.9	1 319.1	1 419.2	1 500.3	1 504.9	1 467.7
Stockbuilding	5.3	16.2	15.2	27.6	46.4	46.7	34.9
Total domestic demand	1 252.1	1 254.1	1 334.3	1 446.8	1 546.7	1 551.6	1 502.6
Exports of goods and services	589.5	633.8	635.0	740.8	809.2	875.0	968.9
Imports of goods and services	559.2	617.6	665.7	806.5	922.0	988.1	1 066.5
Foreign balance	30.2	16.2	–30.7	–65.7	–112.8	–113.1	–97.6
Gross domestic product	1 282.4	1 270.3	1 303.6	1 381.1	1 433.9	1 438.5	1 405.0

1. Including collective consumption expenditure.

Source: Czech Statistical Office and OECD.

Table C. **Labour market indicators**[1]

	1993	1994	1995	1996	1997	1998
Main indicators, thousands						
Unemployment	220	221	208	201	248	336
Employment	4 803	4 863	4 908	4 915	4 884	4 818
Dependent	4 168	4 214	4 220	4 221	4 197	4 090
Self-employed	635	649	688	694	687	727
Labour force	5 023	5 084	5 116	5 116	5 133	5 153
Working age population (15-64 years)	6 891	6 957	7 028	7 067	7 089	7 114
Derived indicators, per cent						
Unemployment rate						
Total	4.4	4.4	4.1	3.9	4.8	6.5
Male	3.5	3.7	3.5	3.4	4.0	5.1
Female	5.4	5.2	4.8	4.7	5.9	8.2
Youth[2]	32.5	34.6	32.4	30.1	28.6	30.4
Participation rate						
Total	72.9	73.1	72.8	72.4	72.4	72.4
Male	80.5	80.6	80.6	80.5	80.4	80.2
Female	65.4	65.5	65.0	64.3	64.4	64.7
Employment population rate	69.7	69.9	69.8	69.5	68.9	67.7
Sectoral civil employment, thousands						
Employment	4 848	4 885	5 012	5 044	4 993	
Agriculture	333	340	314	303	278	
Mining	111	101	92	86	80	
Manufacturing	1 512	1 428	1 445	1 441	1 434	
Electricity gas and water	88	90	91	88	84	
Construction	453	444	450	452	433	
Wholesale and retail trade	609	702	749	775	801	
Hotels and restaurants	112	137	142	155	157	
Transport and communications	385	353	355	363	345	
Financial intermediation	65	76	85	89	93	
Real estate	303	340	389	382	388	
Public administration and defence	133	146	162	168	175	
Education	324	321	322	322	309	
Health and social work	263	258	262	268	267	
Other community and personal services	159	147	154	152	149	
Sectoral civil employment, annual change						
Employment	–1.6	0.8	2.6	0.7	–1.0	
Agriculture	–22.0	2.1	–7.8	–3.4	–8.4	
Mining	–10.2	–9.4	–8.9	–5.6	–7.2	
Manufacturing	–4.4	–5.5	1.2	–0.3	–0.5	
Electricity gas and water	–4.7	3.0	1.1	–4.1	–4.1	
Construction	11.0	–1.9	1.3	0.3	–4.0	
Wholesale and retail trade	11.9	15.3	6.7	3.6	3.4	
Hotels and restaurants	11.0	22.8	3.5	9.6	0.9	
Transport and communications	5.2	–8.3	0.7	2.2	–5.0	
Financial intermediation	26.9	17.8	11.5	4.9	4.9	
Real estate	–10.5	12.2	14.2	–1.8	1.5	
Public administration and defence	7.5	10.2	10.5	3.9	4.5	
Education	–0.7	–0.8	0.0	0.1	–4.1	
Health and social work	–1.9	–1.9	1.6	2.2	–0.3	
Other community and personal services	–9.8	–7.6	5.2	–1.5	–2.3	
Memorandum items:						
Incidence of long term unemployment[3]	18.3	22.2	30.6	31.3	30.5	31.2
Productivity index, 1993 = 100	100.0	101.5	106.6	110.5	111.5	110.4

1. Labour force survey definitions.
2. Individuals 15-24 years old.
3. Unemployed for 12 or more months, as a per cent of total unemployment.

Source: Czech Statistical Office and OECD.

Table D. **Costs and prices**

Annual percentage changes

	1993	1994	1995	1996	1997	1998
Rates of pay						
Compensation per employee (business sector)	24.4	17.3	17.6	17.7	10.6	9.4
Average monthly earnings (manufacturing)	25.4	16.2	18.2	17.9	12.7	10.1
Productivity per employee (business sector)	0.3	1.7	5.0	3.9	1.1	–1.0
Unit labour cost						
Nominal	22.9	15.7	10.4	13.0	9.1	8.4
Real[1]	6.7	4.7	0.2	3.3	2.6	–2.6
Prices						
GDP deflator	16.2	11.0	10.2	9.7	6.5	11.0
Private consumption deflator	21.5	10.7	9.2	8.1	7.7	9.7
Consumer price index	20.8	10.0	9.1	8.8	8.5	10.7
Consumer price index, food			11.9	7.7	4.7	5.5
Producer price index (industrial goods)	9.2	5.2	7.6	4.8	4.9	4.8

1. Deflated by the GDP deflator.

Source: Czech Statistical Office and OECD.

Table E. **Monetary indicators**

	1993	1994	1995	1996	1997	1998
Monetary aggregates (annual percentage change)						
M1	17.3	17.2	7.5	4.9	–6.4	–2.6
M2	20.5	20.8	19.4	7.8	8.7	5.2
Velocity of circulation						
M1	2.9	2.8	3.0	3.3	3.8	4.2
M2	1.4	1.4	1.3	1.4	1.4	1.4
Interest rates						
Official discount rate	8.0	8.5	9.5	10.5	13.0	7.5
3-month PRIBOR	13.1	9.1	10.9	12.0	15.9	14.3

Source: Czech Statistical Office and OECD.

Table F. **Balance of payments**

US$ billion

	1993	1994	1995	1996	1997	1998
Current account	456	–787	–1 369	–4 292	–3 211	–1 059
Exports of goods	14 229	15 929	21 463	21 691	22 777	26 351
Imports of goods	14 754	17 310	25 140	27 568	27 317	28 905
Trade balance	–525	–1 381	–3 678	–5 877	–4 540	–2 554
Non-factor services, credits	4 723	5 157	6 718	8 179	7 162	7 494
Non-factor services, debits	3 712	4 668	4 876	6 256	5 399	5 701
Balance of non-factor services	1 011	488	1 842	1 923	1 763	1 793
Factor income, credits	547	789	1 195	1 170	1 409	1 520
Factor income, debits	665	809	1 300	1 893	2 200	2 226
Balance of factor income	–118	–20	–106	–723	–791	–706
Transfers, net	88	126	572	385	357	408
Capital account	–555	0	7	1	10	2
Financial account	3 025	3 371	8 226	4 184	1 082	2 767
Direct investment, net	563	749	2 526	1 276	1 275	2 485
Portfolio investment, net	1 601	855	1 362	726	1 086	1 069
Other investment, net	861	1 768	4 338	2 183	–1 279	–787
Errors and omissions	104	–213	595	–721	352	231
Change in reserves	–3 029	–2 372	–7 458	828	1 767	–1 941

Source: Czech National Bank.

Table G. **General government revenue and expenditure**

Billion koruny

	1993	1994	1995	1996	1997	1998
Current receipts	438.7	498.0	572.9	626.2	653.0	696.2
Direct taxes	104.8	124.2	142.1	150.2	152.3	172.8
Indirect taxes	156.2	159.6	176.6	196.4	208.6	212.3
Social security contributions	132.1	162.3	192.5	222.2	246.8	264.4
Other current recepits	45.6	51.9	61.7	57.3	45.3	46.7
Current disbursements	379.6	435.3	495.9	559.9	605.0	654.5
Government consumption	126.9	130.4	123.4	139.3	136.4	146.7
Property income paid	17.7	15.4	16.6	16.3	20.8	21.3
Social security benefits	169.6	205.6	241.3	278.2	316.8	345.6
Subsidies	64.8	83.1	114.1	125.5	129.4	139.2
Other current transfers paid	18.4	16.2	17.1	16.9	22.4	23.0
Current balance[1]	59.0	62.7	77.0	66.3	47.9	41.8
General government balance[1]	0.3	–22.4	–22.3	–30.0	–33.6	–43.0
General government balance as per cent of GDP[1]	0.0	–1.9	–1.6	–1.9	–2.0	–2.4

1. Excluding privatisation revenues.

Source: Czech Statistical Office and OECD.

Table H. **Financial markets**

	1994	1995	1996	1997	1998
Sector size					
Sectoral employment/total employment	1.6	1.7	1.9	2.2	
Financial assets[1]/GDP[2] (per cent)	114.5	123.9	121.6	133.8	133.8
Stock exchange capitalisation/GDP[3] (per cent)		71.4	53.2	29.5	22.9
Structure of financial flows					
Credits to non-financial sector[4] (per cent of total banking assets)					
Short-term	..	18.2	17.4	19.8	18.9
Long term	..	12.5	13.9	16.9	17.0
Internationalisation of markets					
Credits granted by foreign banks/total credits (per cent)[1]	6.0	7.8	9.2	11.5	13.5
Forex credits/total credits (per cent)[1]	5.6	15.5	17.3	22.3	23.4
Prague Stock Exchange Index[1]					
PX-50	550	450	530	521	440
CNB-120[5]	753	684	758	756	559

1. End of period data.
2. Ratio of total banking assets to GDP.
3. Stocks only.
4. Credits in koruny only.
5. December 1993 = 1 000; rebased on March 1995, when March 1995 was set equal to 1 000.

Source: Czech National Bank and OECD.

BASIC STATISTICS:

INTERNATIONAL COMPARISONS

BASIC STATISTICS: INTERNATIONAL COMPARISONS

	Units	Reference period[1]	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland	France	Germany	Greece
Population												
Total	Thousands	1996	18 289	8 060	10 157	29 964	10 316	5 262	5 125	58 380	81 877	10 465
Inhabitants per sq. km	Number	1996	2	96	333	3	131	122	15	106	229	79
Net average annual increase over previous 10 years	%	1996	1.3	0.6	0.3	1.3	0	0.3	0.4	0.5	3	0.5
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	8 344	3 737 (94)	3 675 (95)	13 676	4 918	2 593	2 087	21 951	35 360	3 824 (95)
of which: Agriculture	% of TCE	1996	5.1	7.2 (94)	2.5 (95)	4.1	6.3	4	7.1	4.6	3.3	20.4 (95)
Industry	% of TCE	1996	22.5	33.2 (94)	26.7 (95)	22.8	42	27	27.6	25.9	37.5	23.2 (95)
Services	% of TCE	1996	72.4	59.6 (94)	71.4 (95)	73.1	51.7	69	65.3	69.5	59.1	56.4 (95)
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	398.9	228.7	268.2	579.2	56.2	174.9	125.1	1 536.6	2 353.5	91.2 (95)
Per capita	US$	1996	21 812	28 384	26 409	19 330	5 445	33 230	24 420	26 323	28 738	8 722 (95)
At current prices using current PPPs[3]	Bill. US$	1996	372.7	172.4	222	645.1	..	118	96.7	1 198.6	1 736.1	133.5
Per capita	US$	1996	20 376	21 395	21 856	21 529	..	22 418	18 871	20 533	21 200	12 743
Average annual volume growth over previous 5 years	%	1996	3.9	1.6	1.2	2.2	2	2.2	1.6	1.2	1.4	1.3 (95)
Gross fixed capital formation (GFCF)	% of GDP	1996	20.3	23.8	17.3	17.7	33	16.7	16.1	17.4	20.6	17 (95)
of which: Machinery and equipment	% of GDP	1996	10.2 (95)	8.8 (95)	7.5 (95)	6.6	..	7.9 (95)	6.4 (95)	7.8	7.6	7.7 (95)
Residential construction	% of GDP	1996	4.6 (95)	5.9 (95)	4.6 (95)	5.4	..	3.2 (95)	3.5 (95)	4.4	7.3	3.3 (95)
Average annual volume growth over previous 5 years	%	1996	5.6	2.1	0.3	2.2	9.4	2	–4.1	–1.5	0.2	0.5 (95)
Gross saving ratio[4]	% of GDP	1996	18	21.9	22.2	17.8	..	17.6	19.6	18.7	20	16 (95)
General government												
Current expenditure on goods and services	% of GDP	1996	17	19.8	14.5	18.7	21.5	25.2	21.9	19.4	19.8	20.8 (95)
Current disbursements[5]	% of GDP	1995	35.6	48.6	52.2	45.8	..	59.6	55.9	50.9	46.6	52.1
Current receipts	% of GDP	1995	34.9	47.4	49.9	42.7	..	58.1	52.8	46.9	45.9	45
Net official development assistance	% of GNP	1995	0.36	0.33	0.38	0.38	..	0.96	0.32	0.55	0.31	0.13
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	12 596	12 152	13 793	12 959	..	12 027	10 282	12 506	12 244	9 473
Passenger cars, per 1 000 inhabitants	Number	1994	460	433	416	466	282	312	368	430	488	199
Telephones, per 1 000 inhabitants	Number	1994	496	466	449	576	209	604	551	547	483[8]	478
Television sets, per 1 000 inhabitants	Number	1993	489	479	453	618	476	538	504	412	559	202
Doctors, per 1 000 inhabitants	Number	1995	2.2 (91)	2.7	3.7 (94)	2.2	2.9	2.9 (94)	2.8	2.9	3.4	3.9 (94)
Infant mortality per 1 000 live births	Number	1995	5.7	5.4	7.6 (94)	6.3 (94)	7.7	5.5	4	5.8 (94)	5.3	8.1
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	1.7	5.2	2.7	2.4	..	3.2	3.8	2.6	4.2	11.8
Consumer prices	%	1996	2.4	2.9	2.2	1.4	11.9	1.9	1.5	2	3.1	11.6
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	60 288	57 870	170 223[7]	202 320	21 910	51 030	40 576	288 450	521 263	11 501
As % of GDP	%	1996	15.1	25.3	63.5	34.9	39	29.2	32.4	18.8	22.1	12.9 (95)
Average annual increase over previous 5 years	%	1996	7.5	7.1	7.6	9.7	..	6.2	12.1	6.3	5.4	5.8
Imports of goods, cif*	Mill. US$	1996	61 374	67 376	160 917[7]	170 931	27 721	44 987	30 911	271 348	455 741	27 402
As % of GDP	%	1996	15.4	29.5	60	29.5	49.3	25.7	24.7	17.7	19.4	30.4 (95)
Average annual increase over previous 5 years	%	1996	9.7	5.9	5.9	7.7	..	5.6	7.3	3.9	3.3	6.6
Total official reserves[6]	Mill. SDRs	1996	10 107	15 901	11 789[7]	14 202	8 590	9 834	4 810	18 635	57 844	12 171
As ratio of average monthly imports of goods	Ratio	1996	2	2.8	0.9	1	..	2.6	1.9	0.8	1.5	5.3

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
10. Refers to the public sector including public enterprises.

Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics*, Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Hungary	Iceland	Ireland	Italy	Japan	Korea	Luxembourg	Mexico	Netherlands	New Zealand
Population												
Total	Thousands	1996	10 193	270	3 621	57 473	125 864	45 545	418	96 582	15 494	3 640
Inhabitants per sq. km	Number	1996	77	3	52	191	333	458	161	48	380	14
Net average annual increase over previous 10 years	%	1996	–0.3	1.1	0.2	0	0.4	1	1.3	2	0.6	1.1
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	3 605	142	1 307	20 036	64 860	20 764	212 (95)	32 385 (95)	6 983	1 688
of which: Agriculture	% of TCE	1996	8.4	9.2	10.7	7	5.5	11.6	2.8 (95)	23.5 (95)	3.9	9.5
Industry	% of TCE	1996	33	23.9	27.2	32.1	33.3	32.5	30.7 (90)	21.7 (95)	22.4	24.6
Services	% of TCE	1996	58.6	66.2	62.3	60.9	61.2	55.9	66.1 (90)	54.8 (95)	73.8	65.9
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	43.7 (95)	7.3	70.7	1 214.2	4 595.2	484.8	17	329.4	396	65.9
Per capita	US$	1996	4 273 (95)	27 076	19 525	21 127	36 509	10 644	40 791	3 411	25 511	18 093
At current prices using current PPPs[3]	Bill. US$	1996	..	6.3	68.8	1 148	2 924.5	618.5	13.5	751.1	324.5	63.6
Per capita	US$	1996	..	23 242	18 988	19 974	23 235	13 580	32 416	7 776	20 905	17 473
Average annual volume growth over previous 5 years	%	1996	–2.4 (95)	1.5	7.1	1	1.5	7.1	4.8	1.7	2.3	3.7
Gross fixed capital formation (GFCF)	% of GDP	1996	19.3 (95)	17.5	17.2	17	29.7	36.8	20.8	18	19.7	20.9
of which: Machinery and equipment	% of GDP	1996	..	6.7	5.5 (95)	8.8	10.1 (95)	13	..	8.8	9.4	10
Residential construction	% of GDP	1996	..	3.9	4.9 (95)	4.5	5.3 (95)	7.6	..	4.7	5	5.6
Average annual volume growth over previous 5 years	%	1996	–0.9 (95)	–1.4	6	–1.4	1.3	6.9	0.2	–0.7	2.2	9.6
Gross saving ratio[4]	% of GDP	1996	..	15.6	21.7	20.5	31.4	34.2	37.5	22.7	25.7	16
General government												
Current expenditure on goods and services	% of GDP	1996	24.9 (95)	20.8	14.1	16.4	9.7	10.6	13.6	9.7[10]	14	14.4
Current disbursements[5]	% of GDP	1995	..	35.1	39.2 (94)	49.5	28.5	15.1	..	..	51.8	..
Current receipts	% of GDP	1995	..	36	39.3 (94)	44.5	32	25.1	..	..	50	..
Net official development assistance	% of GNP	1995	..	..	0.29	0.15	0.28	0.03	0.36	..	0.81	0.23
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	..	14 244	10 020	12 224	13 912	7 354	17 811	5 045	12 477	10 895
Passenger cars, per 1 000 inhabitants	Number	1994	212	434	264	517	342	115	544	91	383	457
Telephones, per 1 000 inhabitants	Number	1994	170	557	350	429	480	397	564	93	509	470
Television sets, per 1 000 inhabitants	Number	1993	427	335	301	429	618	215	261	150	491	
Doctors, per 1 000 inhabitants	Number	1995	3.4	3.9 (94)	3.4	3.0 (94)	1.7	1.6 (92)	1.8 (94)	1.1	2.2 (93)	1.6
Infant mortality per 1 000 live births	Number	1995	11	6.1	6.3	6.6 (94)	4.3	9	5.3 (94)	17 (94)	5.5	7.2 (94)
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	..	..	3.7	3.5	1.8	..	..	–1.6	2.4	1.5
Consumer prices	%	1996	23.2	2.6	2.2	4.5	0.7	5.3	2.4	19.7	2.5	2
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	15 674	1 891	48 416	250 842	411 067	129 715	..	96 000	203 953	14 316
As % of GDP	%	1996	35.9	26	68.5	20.7	8.9	26.8	..	29.1	51.5	21.7
Average annual increase over previous 5 years	%	1996	8.9	4	14.8	8.2	5.5	12.5	..	17.6	8.9	8.2
Imports of goods, cif*	Mill. US$	1996	18 105	2 032	35 763	206 904	349 149	150 340	..	89 469	184 389	14 682
As % of GDP	%	1996	41.4	27.9	50.6	17	7.6	31	..	27.2	46.6	22.3
Average annual increase over previous 5 years	%	1996	9.6	3.4	11.5	2.5	8	13.9	..	12.4	7.8	11.8
Total official reserves[6]	Mill. SDRs	1996	6 812	316	5 706	31 954	150 663	23 670	..	13 514	18 615	4 140
As ratio of average monthly imports of goods	Ratio	1996	..	1.9	1.9	1.9	5.2	..	..	1.8	1.2	3.4

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
10. Refers to the public sector including public enterprises.

Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics*, Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Norway	Poland	Portugal	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
Population											
Total	Thousands	1996	4 370	38 618	9 935	39 270	8 901	7 085	62 695	58 782	265 557
Inhabitants per sq. km	Number	1996	13	123	108	78	20	172	80	240	28
Net average annual increase over previous 10 years	%	1996	0.5	0.3	–0.1	0.2	0.6	0.8	2	0.3	1
Employment											
Total civilian employment (TCE)[2]	Thousands	1996	2 110	14 977	4 475	12 394	3 963	3 803	20 895	26 088	126 708
of which: Agriculture	% of TCE	1996	5.2	22.1	12.2	8.7	2.9	4.5	44.9	2	2.8
Industry	% of TCE	1996	23.4 (95)	31.7	31.4	29.7	26.1	27.7	22	27.4	23.8
Services	% of TCE	1996	71.5 (95)	46.2	56.4	61.6	71	67.4	33.1	71	73.3
Gross domestic product (GDP)											
At current prices and current exchange rates	Bill. US$	1996	157.8	117.9 (95)	103.6	584.9	251.7	294.3	181.5	1 153.4	7 388.1
Per capita	US$	1996	36 020	3 057 (95)	10 425	14 894	28 283	41 411	2 894	19 621	27 821
At current prices using current PPPs[3]	Bill. US$	1996	106.7	..	130.1	587.2	171.4	180.6	383.3	1 095.5	7 388.1
Per capita	US$	1996	24 364	..	13 100	14 954	19 258	25 402	6 114	18 636	27 821
Average annual volume growth over previous 5 years	%	1996	4.1	2.2 (95)	1.5	1.3	1	0.1	4.4	2.2	2.8
Gross fixed capital formation (GFCF)	% of GDP	1996	20.5	17.1 (95)	24.1	20.1	14.8	20.2	25	15.5	17.6
of which: Machinery and equipment	% of GDP	1996	8.4	..	11.7 (93)	6.1 (95)	7.9	9.3	11.9	7.6	8.3 (95)
Residential construction	% of GDP	1996	2.6 (94)	..	5.2 (93)	4.3 (95)	1.9	11[9]	8.4 (95)	3	4.1 (95)
Average annual volume growth over previous 5 years	%	1996	2.8	5.4 (95)	2.2	–1	–2.6	–0.8	6.9	1.3	6.9
Gross saving ratio[4]	% of GDP	1996	29.9	..	21.6	20.7	16	27.1	22.3	14.6	16.6
General government											
Current expenditure on goods and services	% of GDP	1996	20.5	16.9 (95)	18.5	16.3	26.2	14.3	11.6	21.1	15.6
Current disbursements[5]	% of GDP	1995	45.8	..	42.5 (93)	41.2	63.8	47.7	..	42.3 (94)	34.3
Current receipts	% of GDP	1995	50.9	..	39.8 (93)	37.9	57.5	53.8	..	37.2 (94)	32.1
Net official development assistance	% of GNP	1995	0.87	..	0.27	0.24	0.77	0.34	0.07	0.28	0.1
Indicators of living standards											
Private consumption per capita using current PPPs[3]	US$	1996	11 593	..	8 522	9 339	10 096	15 632	4 130	11 865	18 908
Passenger cars, per 1 000 inhabitants	Number	1994	381	186	357	351	406 (93)	451	47	372	565
Telephones, per 1 000 inhabitants	Number	1994	554	131	350	371	683	597	201	489	602
Television sets, per 1 000 inhabitants	Number	1993	427	298	190	400	470	400	176	435	816
Doctors, per 1 000 inhabitants	Number	1995	2.8	2.3	3	4.1 (93)	3.1	3.1 (94)	1.2	1.6 (94)	2.6 (94)
Infant mortality per 1 000 live births	Number	1995	4	13.6	7.4	6 (94)	4	5	46.8 (94)	6.2 (94)	8 (94)
Wages and prices (average annual increase over previous 5 years)											
Wages (earnings or rates according to availability)	%	1996	3.2	..	..	5.8	4.8	..	..	4.9	2.7
Consumer prices	%	1996	1.9	..	5.6	4.7	2.7	2.2	81.6	2.7	2.9
Foreign trade											
Exports of goods, fob*	Mill. US$	1996	49 576	24 417	24 614	102 067	84 836	79 581	23 301	259 941	625 075
As % of GDP	%	1996	31.4	20.7	23.8	17.5	33.7	27	12.8	22.5	8.5
Average annual increase over previous 5 years	%	1996	7.8	..	8.6	11.2	9	5.3	11.1	7	8.2
Imports of goods, cif*	Mill. US$	1996	35 575	37 185	35 192	121 838	66 825	78 052	43 094	287 033	795 289
As % of GDP	%	1996	22.5	31.5	34	20.8	26.5	26.5	23.7	24.9	10.8
Average annual increase over previous 5 years	%	1996	6.9	..	6.1	5.5	6	3.2	15.1	6.5	10.3
Total official reserves[6]	Mill. SDRs	1996	18 441	12 409	11 070	40 284	13 288	26 727	11 430	27 745	44 536
As ratio of average monthly imports of goods	Ratio	1996	6.2	..	3.8	4	2.4	4.1	3.2	1.2	0.7

* At current prices and exchange rates.
1. Unless otherwise stated.
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4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
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