4. Improving policy towards business

Policy towards business has evolved considerably over the past decade or so and is now broadly similar to that found in many other OECD countries. The corporate-tax system includes targeted tax relief tilted towards poorer regions and favourable treatment of R&D spending as well as special support to small-and-medium enterprises. Markets are overseen by an independent competition authority, now backed up by the European Commission. And through privatisation the government has reduced direct ownership and control of production to levels comparable with many other OECD countries. Notably, the banking sector has been fully privatised (and there is now a strong foreign presence) and systems have been set up to encourage the development of competitive network industries.

In addition, Czech policy recognises the special challenges of business support that arise from the important role of foreign capital and foreign-owned enterprises in the economy. Given the intense competition for FDI, policy is attentive to the international image of the Czech Republic as a place to invest. Also, efforts are being made to encourage spillovers from the foreign sector to the domestic sector as the foreign sector not only brings new business for supply firms but also exposes the domestic sector to best practices.

Nevertheless, as Chapter 1 points out, policy issues remain. Indeed, Chapter 2 has already drawn attention to the fact that, despite further scheduled cuts, the corporate tax rate is likely to remain relatively high compared with key peer countries, such as Hungary, Poland and Slovakia. This Chapter first looks at three topics in the environment for business where good regulatory conditions are crucial for boosting productivity growth: bankruptcy procedures, the administration of firm start-ups and corruption. This is followed by an overview of developments in targeted measures to help businesses. The final section looks at progress towards competitive markets in telecommunications and energy. The policy assessment is summed up in Box 4.1.

The legal environment for business is hampering restructuring

Bankruptcy: assessing progress towards a better system

Productivity growth is held back by weaknesses in bankruptcy legislation. Poorly performing enterprises are able to continue operating and, even when they

Box 4.1. Policy assessment on the business environment

The legal environment for business

- A **draft bankruptcy act** addresses key problems of the current legislation its finalisation and presentation for parliamentary approval should be given priority so that reform in this area is no longer delayed
- The prospect of speeding up **business registration**, as contained in pending legislation, is welcome and further delays in reform should be avoided
- Further measures may be needed to bring corruption levels down and the plans to **introduce integrity testingand a crown witness system** are welcome. Cutbacks in regulation and red tape would also help reduce opportunities and incentives to engage in corruption.

Targeted support for business

- The creation of a new deputy prime minister position for coordinating growth policy and the amalgamation of all targeted **support for businesses in one agency** are welcome steps in business policy along with the setting up of a new advisory council on business policy.
- A critical look at the **cost-effectiveness of targeted financial support** to businesses should be made and policymakers should ensure that strategies also focus on general measures to improve regulatory environments.
- **Barriers to academics setting up a business should be removed** to allow greater opportunities for direct management and financial interest in commercial applications in science and technology
- The schedule to end **the support programme in steel** agreed with the European Commission is welcome and the authorities should not push for further extension. The payouts for redundancy and one-off sickness **compensation to mining and steel firms** should only serve towards helping firm closure and not be used as a means to help sustain unviable businesses.

Network industries: telecommunications and energy

- It is important for the regulator to be more committed to introducing and implementing regulations to create a more competitive environment in **telecommunications markets**. Local-loop unbundling has to become more widespread, especially as this is a key factor in high Internet prices.
- Vigilance has to be maintained towards monopoly tendencies in the **electricity industry** and the independence and legal powers of the regulators need to be sustained particularly in setting the quality criteria for service supply.
- In the **gas sector**, implementation of the amended Energy Act looks set to bring welcome increase in market access. The Act's impact should nevertheless be monitored with a view to further steps if the level of competition continues to be weak.

close down, assets can be tied up in long legal proceedings.[1] The bankruptcy system is an important factor contributing to asset stripping, along with a framework of corporate governance which, according to some analysis, does not adequately deal with related party transactions and other self-serving activity.[2] There are three key problems with present bankruptcy legislation:

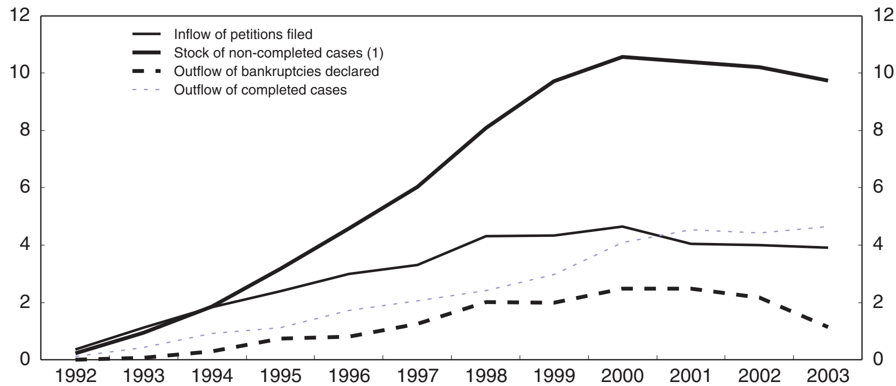
- It is relatively easy for debtors to delay the start of legal proceedings and use the time gained in asset stripping. The Bankruptcy and Composition Act (passed in 1991) stipulates that debtors have to inform courts of insolvency and provide company accounts. However, the risks in delaying formal notice are low as successful prosecutions are rare due to difficulties in proving deliberate misconduct in accounting and reporting. When stripping assets, debtors often claim that accounting records have been "lost". Failure to produce accounts incurs a penalty of only CZK 50 000, though imprisonment is possible if it can be then proven that the accounts were intentionally lost or destroyed.[3]
- If a firm is declared insolvent it invariably ends up being liquidated, *i.e.* attempts to turn firms around through re-structuring, thereby boosting the prospects for creditors are rare. The courts seldom support applications for composition (re-structuring that leaves the current debtors in place but with restrictions and supervision). And restructuring by bankruptcy (re-structuring involving the takeover of the business by a trustee) is rarely successful, in part because asset stripping often leaves businesses with no viable prospects.
- Most of the legal proceedings still under way have passed the first stage of having a decision taken on whether the firm is bankrupt or not. However, subsequent proceedings are often long, particularly in the common case of liquidation.

The problems in bankruptcy legislation have been recognised for some years and solutions have been sought through amendment of the Bankruptcy and Composition Act. The most recent amendment, made in May this year, aimed at removing excessive delays in proceedings. Even before this amendment comes into effect, it looks as though the case backlog has stabilised and is being brought down a little (Figure 4.1). Nevertheless it is clear that there are a large number of cases in the pipeline and many have been there for some time.

A new bankruptcy act has long since been mooted by government officials; indeed the previous *Survey* was provided with details on a new act that was in preparation but which did not then make it through to parliamentary approval. At present the prospects of a new act being passed by Parliament look stronger. A draft act has been prepared and meetings have been held with interest groups in summer 2004 and formal ministerial consultations are set to begin end November.

Figure 4.1. **Case-loads in bankruptcy and settlement**

Thousands



1. Where either bankruptcy has not been decided or it has, but other proceedings continue.
Source: Ministry of Justice.

The draft Bankruptcy Act addresses key problems of the current legislation and its finalisation and presentation for parliamentary approval should be given priority so that reform in this area is no longer delayed. The draft Act proposes to tackle the problems outlined above in the following ways:

– Firms will be encouraged to declare bankruptcy through a number of mechanisms. Contrary to the present system, debtors may file for a three month period of protection whether it is themselves filing insolvency or the creditors.[4] Also, firms will be able to file for "imminent" bankruptcy, from which they can withdraw at any time but which also gives time to put forward a proposal for reorganisation (see below). The attraction for debtors is that taking the lead with a reorganisation proposal may be preferable to delaying the claim of insolvency which would typically give creditors more control. The new law also promises faster proceedings when the debtor files an insolvency petition, as the court must decide on the existence of insolvency within 15 days. Normally the person filing a petition on insolvency can also submit a proposal on how to resolve the insolvency *i.e.* it is possible for the court to not only determine whether there is indeed insolvency but to give approval of the proposed solution procedure.

- Possibilities for "reorganisation" along the lines of the US and German systems will be introduced. The system will enable a judge (following evidence provided by creditors and debtors) to impose a schedule for the partial repayment of debt which if successfully completed will mean the remainder of the debt being written off. The introduction of this alternative way of resolving a firm's in financial difficulty should increase the chances for businesses to be turned around. This should help protect creditors' interests and add to debtors incentives to file for bankruptcy, rather than engage in asset stripping.
- The new draft legislation also aims to favour creditors in other ways. In particular creditors would have more influence on the solution to insolvency chosen, the appointment of the trustee and procedural control of the trustee. It should be noted that the authorities aim to give creditors more influence over the appointment of the trustee before the new Bankruptcy Act comes into force with an amendment to current bankruptcy legislation.

There is no strong focus on cutting back the length of cases in the draft act, though it is aimed that better procedural provisions in the new legislation will help towards reduction in case length. Recent data indicate that there is already some shortening of case length, suggesting that previous policy efforts are paying off. In addition, the new legislation proposes the introduction of an electronic insolvency register and this should also help cut back on some of the procedural delays.

Administrative requirements for setting up a business are cumbersome

Administrative requirements for setting up a business have a reputation for being lengthy and cumbersome. World Bank indicators show the number of procedures to be relatively large and time consuming compared to the OECD average though it is difficult to conclude there are large differences compared with peer countries such as Hungary, Poland and Slovakia.[5] Preliminary results of a recent compilation of structural indicators by the OECD broadly confirm the message of the World Bank data. It is interesting to note that, according to the World Bank indicators at least, the problems in business set-up are limited to administrative burdens in terms of the time and "hassle"; the direct costs of business set-up in terms of administrative fees and minimum capital requirements are not exceptionally high.

Entry onto the Commercial Register is the most widely criticised aspect of setting up a business (details of the process of commercial registration are shown in Annex 4.A1). All firms, except the self-employed, have to enter the register and the process has a reputation of being demanding and for taking a long time to complete. There are also problems in the consistency of court decisions, uncertainties about the documentation required and there are instances where, reportedly, the Registry Court goes into excessive depth with applications. Furthermore, the complexity of proceedings often leads to demands for corrections or completion of proposals by the courts.[6]

Some steps have been taken to help firms in applying to the commercial registry. Notably, the Ministry of Justice in conjunction with the non-government-organisation *Transparency International* have prepared model application forms. The Ministry of Justice also points to an easing of the backlog of applications to the Commercial Register, indeed the backlog of applications has come down from over 30 000 in 1998 to around 15 000 in early 2004. Based on initial proposals in 2003, a new draft law on commercial registration was in preparation by mid 2004 aiming at the standardisation of forms and the introduction of electronic applications. This should help reduce delays due to incomplete forms being sent back for revision. There are also aims to shorten the deadline for standard application cases (currently 15 days), lighten the checking of applications, reduce the number of participants in the application process and to no longer require registration to be accompanied by an official court resolution. The prospect of speeding up business registration is welcome and further delays in reform should be avoided.

The trade licensing system is also cited as a source of frustration and delay for those setting up business. Most business activities require a trade license, with conditions for granting the license varying depending on the activity. A one-stop-shop service allowing combined application for commercial registry and for trade licenses would help ease the administrative burden and has been considered by policymakers, but plans for implementation remain long-term.

One-stop-shop services in general are limited, though moves are under way to remedy this. In July 2004 plans developed by the recently formed Business Environment Development Council were presented to the government. These include the development of integrated information and application systems as well as a network of about 200 offices. The proposed system is aimed at supporting business start-up for the self-employed as well as for incorporated businesses and will assist in applications to the commercial registry and for trade licences, provide guidance on application for targeted support schemes as well as provide general advice and assistance (see below). These moves towards introducing one-stop-shop services for businesses are welcome and should be followed through.

Corruption: assessing the latest policy initiatives

Assessments both by international bodies and the Czech authorities acknowledge that corruption is a significant problem. For instance a report by the Council of Europe (Council of Europe, 2003) assesses corruption to be a serious problem. This was echoed by the 2003 Regular Report by the European Commission and quantitative indicators of corruption generally back this up.

When compared across other OECD countries, the Czech Republic indeed ranks poorly, for example, in the World Bank's general corruption indicator.[7] However, it should be stressed that the Czech Republic ranks much less poorly when a wider selection of countries is considered. For instance, in the context of a broad eastern European grouping the Czech Republic has one of the better rankings according to a recent survey by the World Bank on corruption in transition countries (World Bank, 2004b).[8, 9]

Current policies to reduce corruption are based on a package of measures introduced in 1999 and include legislative and organisational changes, training and media promotion and international co-operation. The measures include commitment by the Ministry of Interior to produce an annual report on corruption. In 2002 additional steps were taken, notably by increasing access to tax records for police investigation. In addition, tax officers joined special anti-corruption teams in the Ministry of Interior and Ministry of Finance to assist in securing damage claims arising from criminal activities and the identification and collection of tax arrears. In 2003 organisational changes were made with the merger of specialised police anti-corruption units.

Despite the continuing efforts to bolster anti-corruption measures, the Ministry of Interior's assessment of progress remains sceptical. The 2003 Ministry's annual report on corruption sees little progress in the results of measures and highlights that corruption remains a serious problem in key areas including state administration, police forces, healthcare, banking and the judiciary, as well influencing the political sphere.[10] The Ministry has since established an anti-corruption commission, responsible for detecting internal corruption and telephone and email lines to most ministries have been set up for citizens to submit complaints about corruption.[11]

Looking forward, there are plans to introduce "integrity testing" for some government employees. A proposal submitted to the government in mid-2004 proposes a system of checking personal finances through an obligatory triennial asset declaration for civil servants, members of security and armed forces, judges, prosecutors and officers of self-governing entities and publicly funded organisations, such as the National Property Fund. Employers would assess the declarations and report suspicious cases to either the financial or law enforcement authorities.

There are also plans to introduce a "crown witness" system – the absence of which is limiting powers of prosecution in serious corruption cases. Crown witness instruments are to be included in a new Criminal Code currently in preparation with the aim of enforcement in 2006. The instruments are to allow discontinuation of an individual's prosecution if they disclose information that could contribute significantly to the detection of a serious crime. Eligibility for this protection requires the individual to confess to the crime for which they are prosecuted, surrender any financial gains from the crime and provide compensation for criminal damage.

The plans to introduce integrity testing and a crown witness system are welcome but further measures may be needed to bring corruption levels down.[12] Cutbacks in regulation and red tape would also help reduce opportunities to engage in corruption.

Targeted support schemes for business are widespread

Positive steps have been taken in the administration of business policy as well as in the capacity for developing new policy proposals. A deputy prime minister position has been created to enhance the co-ordination of growth policy, the position is currently held by the former head of CzechInvest. Also, in January 2004 a new agency, the Investment and Business Development Agency covering support to both large and small-scale business (both international and domestic) was created by merging CzechInvest, the Agency for Business Development (ARP) and the Agency for Development of Industry (CzechIndustry). The new agency will operate under the already established name of CzechInvest. In addition an advisory body, the Business Environment Development Council, has been created. The Council comprises public and private representatives, as well as government officials and is responsible for putting policy proposals before government. Putting all targeted support for businesses in one agency is welcome and the new advisory body, if properly balanced in its membership, should be able to make a positive contribution to the development of policy.

One general criticism of targeted support for business, not unique to the Czech Republic, is that a fairly large number of financial support schemes are being run but they are inadequately assessed, either individually or collectively, in terms of either the short or long-term fiscal consequences or in terms of effectiveness in boosting economic growth. Furthermore, a key message from OECD assessment of business support in general is that it is often too focussed on targeted financial support at the expense of measures to improve regulatory environments for business (OECD, 2003 and Annex 4.A2). The recent efforts to tackle problems in bankruptcy and business registration are a welcome sign that Czech business policy is paying due attention to regulatory aspect of business and it is important this continues. A critical look across all the various schemes for financial support would help policymakers further improve the focus of business policy.

Support to investment in manufacturing investment and selected service sectors

Within the international rules on international investment (notably EU rules on state aid), countries heavily reliant on FDI such as the Czech Republic tend to make substantial use of targeted tax and subsidy measures in order to attract investors. Targeted support to large-scale investors is provided through the Act on Investment Incentives. The centre-piece of support is tax-relief for up to 10 years (Box 4.2) which contributes to making the effective rate of business

Box 4.2. Targeted support for manufacturing and selected service sectors

Three programmes provide investment subsidy or tax relief and subsidies for job creation and training for manufacturing activities and selected service sectors. The level of support and eligibility conditions depend on regional unemployment levels, following the approach to state aid taken by the EU. The maximum total support cannot exceed limits set by EU rules on state support. In the Prague region, support for large firms cannot exceed 20 per cent of the value of investment, in the rest of the country the support limits lie between 46 and 50 per cent. Somewhat higher limits are set for small-and-medium enterprises (Box 4.3).

Support for manufacturing

The Investment Incentives Act No. 72/2000 provides support for both new production and expanding existing production.

The main incentives offered are:

- **Corporate tax relief.** Full tax relief for newly established companies and partial tax relief for expanding companies. Both forms of tax relief can be granted for up to 10 years.
- **Job creation grants.** Up to CZK 200 000 per employee depending on the unemployment rate in the district.
- **Training and re-training grants.** Up to 35 per cent of the costs of the training in the regions where the unemployment rate is higher than the country's average.

The key eligibility criteria are:

- Minimum investment amounts ranging between CZK 100 million and CZK 200 million, depending on the regional unemployment rate. At least half of the investment must be covered by the investors own funds.
- At least 40 per cent of the investment must be in machinery.

Support for "technology centres" and business support services

This support is covered by the Framework Programme for support of Technology centres and Business Support Services and has been operating since February 2004 and is a follow-up to two schemes introduced in 2002. The support for "technology centres" is aimed at high-tech activities such as innovation in manufactured products and processes. Assistance to business support services is aimed at various activities including business headquarters and call-centres.

The main forms of support are:

- **Subsidy of business costs** (up to 50 per cent). The costs covered can either be the value of investment into tangible and intangible fixed assets purchased within the first 5 years or the value of two-years of salary of the employees employed within the first 3 years.

Box 4.2. Targeted support for manufacturing and selected service sectors (*cont.*)

- **Subsidy for training and re-training.** Subsidy up to 35 per cent of the specific training costs and 60 per cent of the general training costs. Maximum subsidy of CZK 100 000 or CZK 150 000 for each job position depending on the number of job positions created.

The main eligibility criteria are:

- Minimum investment of CZK 15 million or CZK 30 million, depending on the activity (*e.g.* software development requires a minimum investment of CZK 15 million while call centres require CZK 30 million). At least half of the investment must be self financed.
- A minimum of 15 or 30 new jobs have to be created, depending on the activity.

Support for job creation in high unemployment regions

This support is provided by the Job Creation Support Programme For Regions Worst Affected By Unemployment and has been in place since June 2004. The programme enables manufacturing activities and forms of certain business support to qualify for subsidies to job creation and training under less stringent eligibility conditions compared to those above if they are located in regions with more than 14 per cent unemployment.

The main forms of support are:

- **Subsidised job creation.** Up to 200 000 CZK per employee, total amount of this subsidy must not exceed 50 per cent of the value of two years salary (65 per cent in the case of small or medium enterprises).
- **Financial support for the training and re-training of employees.** Up to 35 per cent of the costs of the training in the regions – maximum CZK 30 000 per employee.

The main eligibility criteria are:

- Minimum investment of CZK 10 million, half of which has to be covered by own equity.
- Creation of at least 10 jobs.

Source: CzechInvest website.

taxation lower than the corporate tax rate.[13] EU membership has meant amendment to the Act. Changes include incorporation of the EU regulation on state aid and the transfer of inspection powers on state support from the anti-monopoly office to the European Commission.

A scheme aimed at encouraging high-tech activities (*e.g.* product and process development of manufactures) and business services (*e.g.* head offices and call centres) has begun in 2004, following up on similar schemes introduced in 2002. Access to the scheme is conditional on some job-creation requirements, and provides subsidies either to investment costs or to wage costs. A special job subsidy scheme for manufacturing and selected service sectors that locate in high unemployment regions has also been set up in 2004 (Box 4.2).

***Support to small-and-medium enterprises* (SMEs)**

There has been little fundamental change to targeted measures for SMEs lately, though recent fiscal measures may be affecting SME behaviour. SMEs are provided with general financial support in the form of guarantees and low-cost loans. In addition there are a large number of more targeted schemes (see Box 4.3). Recent changes to taxation are likely to have a mixed impact. On the one hand, corporate tax rates have been reduced (Chapter 2). On the other hand a new minimum tax payment has been introduced and the turnover threshold for VAT payment has been lowered (it was previously relatively high compared with other OECD countries). There is some tentative evidence that the self-employed may have been negatively affected by these changes; in early 2004, the labour force survey recorded a rapid increase in the number of self-employed registering as being unemployed but this observation has yet to be backed up by other evidence. A possible concern is that the tax changes may be driving more of the self employed into the grey sector.

The government intends to give SME support additional impetus through an "innovation strategy". Until this proposal, there has been no comprehensive strategy on this front – although several aspects of SME policy already deliver incentives for innovation. An outline has been circulated round Ministries that proposes increasing the intra-government co-ordination and support for innovative business activity as well as additional measures for financial support and administrative assistance. The strategy also places emphasis on improving the commercial orientation of university research where there appear to be a number of barriers to incentives. In particular, there are legislative barriers to academic staff wanting to set up a company. As a result, university professors can often only develop commercial spin-offs to research by working with existing companies. Barriers to academics setting up businesses should be removed so as to allow greater opportunities for direct management and financial interest in commercial applications of science and technology.

There is concern that lending to SMEs is constrained by a lack of credit information that contributes to an already relatively prudent approach by the commercial banks. The Central Register of Credits, created in 2002, has

Box 4.3. Support to small-and-medium enterprises (SMEs)

The legal definition of SMEs used for eligibility to support is based on the number of employees and assets. In terms of employees, an SME has less than 250 employees and a "small business' less than 10 employees. The EU rules limit the maximum support to SMEs to 30 per cent of the value of investment for the Prague region and between 61 and 65 per cent in other regions.

There are two general schemes of financial support. Both of these are administered by the Ministry of Trade and Industry with support disbursed by the Czech-Moravian Guarantee and Development Bank:

- "**Guarantee**". Subsidised guarantees on operating loans (maximum subsidy CZK 3.5 million over three years), subsidised guarantees on capital investment (maximum subsidy CZK 0.25 million per capital investment) and underwriting of bonds for bids in commercial tenders (maximum CZK 5 million).
- "**Credit**". Fixed-interest loans where rates and repayment period depend on the region and on recommendations from government business advisory services. The maximum value of a loan that can be subsidised is CZK 7 million.

In addition there is a host of more targeted schemes to support SMEs:

- "**Start**". Interest free loans of up to CZK 1 million for first-time entrepreneurs.
- "**Market**". Subsidies to certification costs for EU environmental standards.
- "**Co-operation**". Subsidies (maximum value CZK 1.5 million) for joint projects between SMEs in information systems, marketing and training.
- "**Village**". Subsidies equal to 5 per cent interest on a bank loan to entrepreneurs in municipalities with populations of less than 3 000.
- "**Regeneration**". Subsidies equal to 3 per cent interest on a bank loan to entrepreneurs in towns and villages identified as of historic and cultural interest.
- "**Special**". A CZK 4 000 per month subsidy for up to four years for each person employed from a disadvantaged group.
- "**Marketing**". 50 per cent subsidy of marketing expenses (maximum subsidy CZK 100 000) aimed at increasing export capacities of SMEs.
- "**Consulting**". Subsidies for enterprise consulting, subsidised rents and service charges in business centres, subsidised training for entrepreneurs and special support for the association of women entrepreneurs.
- "**Design**". 50 per cent subsidy for design services.

improved the situation (Annex 4.A3). And, in a welcome move, the Central Register of Credits will publish aggregate indicators of enterprise debt burden and debt quality by enterprise characteristics. This should in particular help assessment of first-time borrowers where a lack of credit history hampers risk assessment.

Encouraging R&D and the use of high-level technologies

Goals have been set, though not typically achieved, in terms of state support to R&D. The current targets are for support worth 0.58 per cent of GDP in 2004 and for this to increase to 0.6 per cent in 2006. As in many other countries, support is partly provided through favourable tax treatment of R&D expenditure. In this regard, support is set to increase with the increase in the maximum tax deduction on R&D spending to 10 per cent of a firm's tax base in January 2005 (Chapter 2). In addition new targeted schemes have been launched recently. Notably, the Ministry of Industry and Trade has launched three R&D programmes this year. "Impuls" aims at promoting R&D in new materials, industrial products, manufacturing technologies, information technologies and control systems. In addition, "Tandem" aims to strengthen links between business and the scientific community and "Pokrok" provides financial support to public and private research institutions for research into engineering processes and materials as well energy research.

There have also been developments in legislation on patents and trademarks. Legislation regarding patent attorneys was approved in November 2003 and includes setting up a professional chamber of attorneys as part of harmonisation with EU legislation. Legislation on trademarks has also been harmonised with EU standards and a new act on industrial design aimed at more strongly encouraging applicants for patents has been proposed.

Support to the steel and mining sectors

Support for the mining and steel industries continues. For the steel industry, special dispensation has been granted by the European Commission for the Balance and Exit programme to continue until 2006. It has been agreed that the total value of support to the end of the programme should not exceed CZK 14.5 billion. The schedule to end the support programme in steel agreed with the Commission is welcome and further extension should not be sought. Direct support for the mining sector comprises of assistance in financial liquidation and environmental clean-up of three state-owned mining companies with an estimated cost of CZK 11.5 billion over the period 2004-2007.[14] The assistance is not classified as public support following a decision by the Office for the Protection of Economic Competition and conforms to EC regulation on state aid to the coal industry.

A new, and indirect, form of support for the mining and steel industries has recently been set up. The government passed legislation in 2003 allowing state payouts to firms to help cover the costs of redundancy and one-off sickness compensation payments to employees. In the 2004 budget, CZK 1.7 billion was set aside to cover these payouts in the mining industry and CZK 1.2 billion in the steel industry. The legislation is classified as temporary but no date has been set for its termination. The payments are not classified as public support; the Czech authorities claim the money paid covers arrears relating to social security. The payouts for redundancy and one-off sickness compensation to mining and steel firms should only serve towards helping firm closure and not be used as a means to help sustain unviable businesses.

Dominance prevails in network industries

The system of regulation and supervision of the network industries is similar to that in many other OECD countries; pricing and other technical issues are dealt with by industry-specific regulators while supervision and monitoring of competitiveness is carried out by the competition authority (the Office for the Protection of Economic Competition). Looking specifically at telecommunications and energy, entry and price deregulation is underway and in many areas there is commitment to a timetable of further reforms, notably in widening price deregulation in consumer markets for gas and electricity (details on these sectors, along with other network industries are shown in Annex 4.A4). In addition, a new Act on Electronic Communications has been approved by the government and is currently being voted on by Parliament, and legislation transposing new EU directives is in the pipeline for the energy sector.[15, 16]

However, while there has been commendable progress in many aspects of the legal and regulatory environment for network industries, progress in the level of competition in many telecommunications, gas and electricity markets is disappointing. This is largely because in many areas of each industry, the incumbent remains dominant, being successfully able to put off potential competitors from entering or able to make it difficult for them to compete effectively. To some extent this probably reflects reluctance by successive governments for a rapid development of competition because of concerns that this would reduce the revenues from selling off state shares in the incumbent. This is likely to remain an issue in telecommunications and electricity as buyers for the remaining state shares are being actively sought. In telecommunications, sale of the state's 51 per cent stake in Cesky Telecom is planned for 2005 while in electricity sale of the 68 per cent state in CEZ will not take place before 2007 (Chapter 2). This aspect of the privatisation process, does not of course mean that privatisation should not go ahead, as removal of state ownership in networks ultimately reduces the risk of undue protection of the incumbent.

Telecommunications

In telecommunications, the incumbent, Cesky Telecom, is successfully managing to retain market power in some key activities.[17] In fixed line communication, call-by-call carrier selection, carrier pre-selection and number portability were introduced in 2002. However the fixed-line market is still dominated by Cesky Telecom.[18] Legislation for unbundling the local loop came into force in

August 2003, but the incumbent has been successful in delaying implementation. In particular, the unbundling contract offered by Cesky Telecom was neither very attractive to other operators, nor entirely in line with the Telecommunications Act. Although two contracts on local loop unbundling were signed in February 2004, not much unbundling has so far taken place.

Though mobile phone networks are providing competition in vocal communication and have undoubtedly taken market share, this pressure has not as yet brought large reductions in the incumbent's prices for fixed-line calls.[19] For instance, Cesky Telecom's prices per minute have remained constant since 2001 in both local and long-distance calls, and the fixed monthly fee grew by 60 per cent (Table 4.1).[20] Furthermore, the prices are high. Cross country comparison of baskets of phone services for both household and businesses shows Czech prices remain significantly higher than the OECD average (Figure 4.2). Though retail prices have remained stuck at high levels, interconnection charges for the phone companies have fallen by more than 50 per cent since 2001.[21] Further increases in competitive pressure can be expected from simplification of market access, abolition of the fixed retail registration fee, and from mobile-number portability (measures which are intended to be part of new Act on Electronic Communications).

A key concern in telecommunications is that Internet costs are high and connection speeds often slow, dissuading households and workers from increasing computer literacy and restricting the development of on-line services. For example, comparison of 512Kbps broadband services using OECD data for 2003 (the latest available comparison) suggests prices to be relatively high in the Czech Republic, about the same level as in Hungary and Slovakia but very much higher than in Poland and the United States (Table 4.2). Measured relative to the cost of living, Internet services prices are more than twice those in other European

Table 4.1. **Prices charged by the incumbent for local and long-distance calls**[1]

CZK/min, excluding VAT[2]

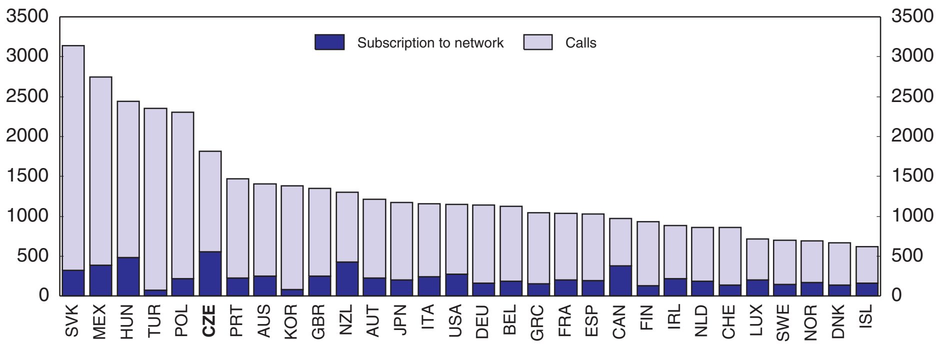
	Jan-01 through Jan. 02	Feb-02 through Aug. 03	Sep-03 through Dec. 03	Since Jan. 2004
Local, peak	1.38	1.33	1.33	1.33
Local, off peak	0.76	0.67	0.66	0.66
Long-distance, peak	3.52	3.48	3.47	3.47
Long-distance, off peak	1.62	1.62	1.61	1.61
Long-distance, night	0.95	0.95	0.95	0.95
Monthly fee (CZK)	166.67	284.77	284.77	284.76

1. Cesky Telecom's service plan Home Standard.
2. VAT rate 5 per cent until 1 January 2004; change from 5 to 22 per cent as of 1 January 2004, and from 22 to 19 per cent as of 1 May 2004.

Source: Czech Telecommunications Office.

Figure 4.2. **Annual cost of small business telephony, May 2004**[1]

USD PPP



1. VAT is excluded. Subscription to network includes connection charges and annual rental for domestic fixed line services. The cost of calls is based on domestic fixed line calls, international calls and calls from the fixed network to mobile networks. Estimates of domestic call costs assume 3600 calls per year and take into account time and day points, duration of call and distance.

Source: OECD, Directorate for Science, Technology and Industry (Information, Computer and Communications Policy Division) and Teligen.

Table 4.2. **Broadband prices: comparison of best offers in 2003 with download speed 512 Kbps**[1]

	Company	Access type	Monthly charge	
			USD	USD PPP
France	9Telecom	ADSL	26.03	24.40
Sweden	Tele2	Cable modem	30.06	25.86
Poland	Aster City	Cable modem	30.42	63.23
Ireland	Irish Broadband	Fixed Wireless	33.96	29.60
United States	N.E.T.	Fixed Wireless	34.95	34.95
Denmark	Redspot	Fixed Wireless	37.35	29.74
United Kingdom	PIPEX	ADSL	37.35	35.40
Portugal	Portugal Telecom	ADSL	39.60	52.03
Slovak Republic	UPC Chello	Cable modem	45.23	106.34
Norway	Telenor Avidi	Cable modem	46.78	38.21
Hungary	UPC Chello	Cable modem	46.88	93.25
Iceland	og Vodafone	ADSL	47.03	39.71
Czech Republic	Tiscali	ADSL	47.16	91.33
Australia	Telstra-Big Pond	ADSL	50.08	57.07
Luxembourg	Coditel	Cable modem	50.93	47.20

1. The latest available OECD international comparison as of autumn 2004.

countries. Although the industry regulator has pushed for open competition in the provision of flat-rate Internet access, a healthy level of competition has yet to emerge. For instance, the network operator had been apparently able to prevent other operators from making broadband offers via ADSL technology.[22] This seeming abuse of network control clearly needs to be dealt with.[23]

The technology used for high-speed Internet provision is up-to-date and the real problems in pricing lie in regulation. This might improve as the legal and operational powers of the Czech Telecommunication Office's will be strengthened by a new Act on Electronic Communications, which will also see the remuneration of managerial staff of the regulator increase.

To sum up, it is important for the regulator to be more committed to introducing and implementing regulations to create a more competitive environment in telecommunications markets. Local-loop unbundling has to become more widespread, especially as this is a key factor in high Internet prices.

Energy

Electricity

In the electricity industry the incumbent, CEZ, remains dominant in production, distribution and sales, despite that markets (except for transmission and distribution) are open to competition. In production, most power plants are owned by CEZ and these generate about 65 per cent of domestic production. Five of the eight distribution and sales companies are also controlled by CEZ and have a market share of about 60 per cent. The Office for the Protection of Economic Competition has criticised the continuing vertical integration and has ruled that CEZ can only own four distribution and sales companies, and that stakes in the transmission company and a regional distributor must be sold. CEZ is challenging this decision, though it has nevertheless recently sold its stake in the transmission company. Vigilance has to be maintained towards monopoly tendencies in the electricity industry, and the independence and legal powers of the regulators need to be sustained.

Several steps have been taken to free-up electricity prices. In 2003, the accounts of regional distribution companies were made more transparent by the elimination of the redistribution of financial resources among the companies. Also, large-scale users can now buy electricity on the open market. Choice-of-supplier for all users except households is scheduled for 2005 and full liberalisation is scheduled for 2006 (Table 4.3). To sum up, as of 2006, only the network and its access prices will remain regulated. Greater competition in the selection of the universal service provider will be introduced in the amendment to the Energy Act. This Act will also stipulate legal separation of distribution activities from production and/or trade by the end of 2006. Although there are signs that the increased

Table 4.3. **Opening of energy markets**

	Electricity	Gas
1 January 2002	Annual consumption over 40 GWh	
1 January 2003	Annual consumption over 9 GWh	
1 January 2004	Customers with continuous metering	
1 January 2005	All customers except households	Consumers with aggregated annual consumption over 15 million m^2, license holders of gas power plants and producers of gas-powered CHP.
1 January 2006	All end customers	All customers except households
1 January 2007		All customers

Note: The schedule for opening of the gas market is the result of a derogation on the fulfilment of the EC gas directive No. 98/30/EC.
Source: Energy Regulatory Office.

liberalisation has certainly reduced prices for the big users, it is not expected that the impact of price liberalisation for households will be as significant. Households may indeed have fewer incentives to engage in active search, particularly if liberalisation is hampered by a burdensome administration for changing the provider. Also, even with liberalisation, some argue that electricity prices are going to increase because the planned shift towards a greater use of renewable energy sources will increase costs.[24]

Gas

Almost all of the Czech Republic's gas is imported; close to three quarters comes from Russia and the rest from Norway.[25] In privatising the gas industry in 2001, the government sold the incumbent business entirely to the German energy company RWE and the industry has since remained dominated by this company.[26] Gradual liberalisation of the market will start in 2005, in accordance with the relevant EU treaty and the new gas Directive. One step towards opening the gas market was made in 2004 with the introduction of account unbundling that will increase the transparency of pricing. Amendment of the Energy Act, in the process of parliamentary approval in autumn 2004 (see above), will introduce several steps towards creating a better regulatory environment for competition. These include introducing regulated third-party access to the pipeline and gas storage, definition of last-resort suppliers (and their responsibilities) and obligation to legally separate transmission from other activities. The implementation of the amended Energy Act therefore looks set to bring welcome increase in market access. The Act's impact should nevertheless be monitored with a view to further steps if the level of competition continues to be weak.

Notes

1. For a recent in-depth account of the Czech bankruptcy system see World Bank (2004a).
2. See the World Bank's 2002 assessment of corporate governance for further detail on related party transactions (World Bank, 2002).
3. The number of criminal convictions for intentional misplacement or destruction of accounts has increased significantly in recent years, as well as criminal convictions for frustrating or seriously impeding the activity of the bankruptcy trustee. The Czech authorities view this as a positive development, reflecting improvements to legislation, increasing detection and success in prosecution, rather than increase in the level of criminal activity.
4. During a period of protection, no bankruptcy may be declared or reorganisation or composition permitted. The debtor cannot sell the business during the period of protection.
5. The World Bank's "Doing Business" database for 2003 shows the Czech Republic and Poland to have 10 procedures in starting a business, while there are 9 in the Slovak Republic and 6 in Hungary. At the same time, however the time taken to set up a business is longer in Hungary and Slovakia at 52 days compared with 31 in Poland and 40 in the Czech Republic. The OECD averages for these statistics are 6 procedures and 25 days.
6. Extremely protracted registration proceedings are typically limited to complex situations such as merger cases rather than the straightforward registration of new business. So criticism that new business registration takes too long should to some extent be diluted.
7. The World Bank's general indicator of corruption is a composite indicator based on several business surveys on corruption. These issues are discussed in Kaufmann *et al.* (2003).
8. The in-depth report on corruption by the World Bank, *Anti-Corruption in Transition* 2 is a follow-up to a 1999 study. The corruption statistics come from a survey of firms conducted in conjunction with the European Bank for Reconstruction and Development – the so-called BEEPs database. The first round of BEEPs was conducted in mid-1999 and was based on interviews with owners and senior managers in about 4 000 firms in 24 transition countries. The second round was conducted in mid-2002 and involved about 6 500 interviews in 26 countries. The report focuses on two measures of corruption, one which indicates the degree to which corruption is seen as an obstacle to business in the country and a bribe frequency index.
9. Corruption indicators are giving mixed signals on the trend in corruption. The widely published "corruption perception index" by Transparency International (a composite indicator based on several business surveys) is sometimes cited in the media and

other reports as indicating that corruption has been increasing in the Czech Republic. Indeed the index has deteriorated over time but what this actually means is unclear. A lower value of the index can arise because country coverage of the index has increased over time and it is possible that the index reflects a country being pushed further down the ranking and not that the measure has deteriorated in an absolute sense. In addition, the index reflects a *perception* of corruption and experts at Transparency International think that the trend for the Czech Republic might partly reflect rising expectations about acceptable levels of corruption. Furthermore, the recent World Bank report on corruption in transition countries (World Bank, 2004b) in fact contradicts the corruption perception index. Survey results for 1999 and 2002 indicate that fewer businesses now see corruption as a serious obstacle and that there has been a substantial reduction in the frequency of bribery.

10. The Ministry of Interior's assessment that the current anti-corruption measures are not effective enough is echoed in a recent study by Transparency International (Transparency International, 2004) which includes a survey of individuals' perceptions of the effectiveness of anti-corruption measures in the capital cities of the Visegrad countries. Prague is seen as having the weakest anti-corruption measures across respondents in the four capitals.

11. State authorities are already obliged under the criminal procedure code to report without delay to police or public prosecutors any indications that crime, including bribery, has been committed.

12. In autumn 2004 the Ministry of Justice was preparing a new act on conflict of interest which should also help in the fight against corruption. Legislation in Britain, France and Slovakia is being used as a guide to prepare the new act.

13. It should be noted that some calculations of the effective tax rate (for example those made by the accounting firm Ernst and Young) do not count tax holidays in the calculation of effective tax rates.

14. The three state mining companies receiving support for financial liquidation and environmental clean up are no longer producing coal and have skeleton staff: DIAMO, s.p. has 367 employees, P*alivový kombinát* Ú*stí*, s.p. 281 employees and V*ýchodo České uhelné doly*, s.p., 39 employees.

15. The Act on Electronic Communications is currently in the pipeline. It will transpose the EU directives on regulation, licensing and authorisation, access and interconnection and universal service. The law will significantly simplify market access and will grant the regulator the powers to issue rulings to assure effective competition on the market, universal service etc.

16. The amendment of the Energy Act has been passed by Parliament and is expected to come to force in December 2004. The main features of the amendment are: incorporation of EU directives stipulating the common rules of the internal markets with electricity and gas, changes regarding the opening of electricity and gas markets, the obligation of legal separation of the functions of transport, transmission and distribution from non-regulated activities, and precise definition of the competencies of the Ministry of Industry and Trade and the Energy Regulatory Office in the energy sector.

17. Until January 1, 2001, Cesky Telecom had the exclusive right to provide international and long-distance telecommunications fixed-line services while being responsible for the maintenance of the fixed network and the universal service.

18. Figures for 2003 show Cesky Telecom to have a market share of over 95 per cent in the ISDN services provided *via* the public fixed telephony network, and nearly 50 per cent market share in the services provided *via* the public telephony network overall.
19. Statistics on mobile phone penetration indicate that there are approximately 97 mobile telephone numbers per 100 inhabitants (2003 figures, note that one mobile telephone user may effectively have several numbers because of transfers between mobile companies).
20. In 2004, telecommunications services were moved from the 5 per cent VAT rate to the 22 per cent rate. This tax increase was transferred entirely onto customers through price increases.
21. Interconnection charges are regulated by the Czech Telecommunications Office on the basis of long-run average incremental cost.
22. Problems in competition in Internet provision are illustrated by a ruling by the competition authority that Cesky Telecom abused its position during much of 2002.
23. The use of the cable-TV network for the Internet is as yet limited because the cable network is not very large, however other transmission formats are coming onto the retail market, for example EDGE and WiFi.
24. Renewable energy resources are typically more expensive in terms of production and transmission. To avoid this being reflected in higher prices (the Ministry of Industry and Trade aims for 5 per cent of energy production to come from renewable resources in 2005 and 15 per cent by 2030) the retail price of renewable energy will be subsidised and funded by higher prices for the transmission of electricity from all sources.
25. Domestic gas production provides only about one per cent of supply.
26. The Czech gas market incumbent, Transgas, was privatised in the end of 2001, along with the state's share in eight gas distribution companies, to RWE Gas. A merger of Transgas with RWE Gas AG in 2002 was approved by the Czech Competition Office on the condition to divest its upstream interest in MND.

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Annex 4.A1

Registration of a company in the commercial register*

A company comes into existence by registering in the Commercial Register maintained by the competent Regional Court. Consequently, it may commence its business activities only after its registration. Prior to that, it may only perform activities related to the incorporation of the company (*e.g.* leasing premises for its registered office). The statutory body of the company must apply to the Commercial Register to register the company within 90 days from the date *i*) when the company was founded or *ii*) when the company's trade licenses were issued.

The following documents must be attached to the application:

- documents showing the valid incorporation of the founder and the power of its representatives to act on its behalf, not older than three months;
- incorporation documentation, *i.e.* founder's deed or memorandum of association;
- specimen signatures of directors;
- evidence that the company's basic capital was fully paid up (usually shown through a bank statement);
- residence permits of foreign directors;
- a statement of trustworthiness signed by each director and member of the supervisory board;
- extracts from the criminal registry for each proposed director and supervisory board member;
- company trade licenses;
- evidence of a title (ownership right or lease agreement) for the premises where the registered office of the company will be situated;
- powers of attorney for any person to be registered in the Commercial Register in relation to the incorporation of the company (*e.g.* executive officers).

* Reproduced from the CzechInvest website.

Table 4.A1.1. **Steps in commercial registry**

Foundation deed		Bank account basic capital		Trade certification	
• Name and seat • Partners specification • Business activity • Capital • Statutory body • Company bylaws (a.s.)	→	Minimum CZK 200 000 (s.r.o.) CZK 2 000 000 (a.s.)	→	Foreigners must obtain: • Residence permit • Proof of fluency in Czech language for responsible representative • Proof of impeachability of character	→
Notary office		Czech or foreign bank registered in the CR		Trade licensing office	
Commercial registration		Tax registration		Investment	
→ Identification number IC	→	• Required within 30 days of comm. registration • VAT depends on turnover	→	• Full repatriation of profits guaranteed	
Regional court		Financial authorities			

Source: CzechInvest.

Annex 4.A2

Targeted measures to attract FDI: lessons from international experience

A recent OECD assessment of policies and incentives for attracting foreign direct investment provides a useful checklist for assessing fiscal FDI incentives (OECD, 2003b). Broadly speaking, the assessment of practice across countries voices concerns that while targeted FDI measures such as fiscal derogations, grants, job training, infrastructure subsidies and R&D support can play a useful role in growth strategies, targeted FDI incentives can be an expensive policy choice. General measures to improve the regulatory environment for business can often be cheaper and have more sustainable impact. The assessment also finds that targeted FDI measures often get chosen over alternatives because of insufficient broad economic assessment of the policy options through cost benefit analysis and evaluation. Inadequate cost-benefit analysis is also cited as a problem among lower level choices about what specific areas and projects to target with FDI measures. The analysis suggests a number of measures to help tighten discipline in FDI policymaking and increase the use of economic criteria, such as the setting of output criteria, time limits for projects, and *ex post* assessment of policies.

Annex 4.A3

Credit registers of enterprises

Credit registers allow banks exchange information on the amount and quality of their clients' debts. Two credit registers were launched in the Czech Republic in 2002.

In 2002 the CNB launched the **Central Register of Credits**. The Register contains information on loans and other balance-sheet and off-balance-sheet obligations of corporations and non-incorporated entrepreneurs. All banks (including branches of foreign banks) as well as the Czech Consolidation Agency must provide data. The database is now widely used by the banking sector. Each entry includes information on the type, purpose as well as the value, maturity etc. of the loan; auxiliary information on the industry category of the business is also included. Each bank receives a monthly report on credit commitments of all its clients and on-line enquiries can be submitted for own and external clients. The register contains information on about 250 000 debtors. The Register's administrators are preparing indicators of debt by industry, sector and size of the company, to help creditors assess aggregate trends and assist in lending to businesses without a credit history.

The **Czech Banking Credit Bureau** is a company owned by five founding banks that runs a commercial register of the loans to households and non-incorporated entrepreneurs. The register functions since mid-2002. Currently, it contains entries from 12 banks and building societies, covering the financial situation of about 2.5 million individuals.

A non-banking register of client information is being developed also on a commercial basis, and will collect information from leasing companies, credit-card and consumer-credit providers, mobile-phone operators, etc. This registry will start operating in the first half 2005.

Annex 4.A4

Regulation of network industries

	Name of incumbent	State ownership of incumbent	Privatisation completed	Privatisation outlook	Restrictions on the number of competitors allowed to operate	Main competitors	Vertical/ horizontal separation (network ownership and control)	Pricing regulation	Regulator
Electricity									
Production	CEZ	67.6%	32.4% sold on capital markets	No privatisation planned before 2007	No	Energeticke centrum Kladno; Elektrarny Opatovice; Sokolovska uhelna	Vertical separation of the network (initially controlled by CEZ)	No	Energeticky regulacni urad
Transmission (high-voltage grid)	CEPS	100%	No		Yes	None	Separated from production	Transmission tariff set by the regulator	Energeticky regulacni urad
Distribution (low-voltage grid)	Regional distributors (5 out of 8 owned by CEZ)	0% (direct ownership)	Privatised	Not applicable	Yes	CEZ (owns 5 distribution companies; E-On (2), RWE(1)	Legally separated from production and transmission, 5 distribution companies out of 8 are under control of CEZ	Distribution tariff set by the regulator	Energeticky regulacni urad
Sales	Strictly speaking, there is no incumbent, but CEZ has a strong interest in the sector *via* ownership of some distribution companies	–	Not applicable	Not applicable	No			Price caps on households and customers connected to low-voltage network	
Gas									
Transmission and distribution	Transgas (RWE)	0%	Yes	Not applicable	No	None	No separation	Price caps	Energeticky regulacni urad
Heat	Local monopolies		Yes	Not applicable	No			Cost-based	Energeticky regulacni urad

Regulation of network industries (*cont.*)

	Name of incumbent	State ownership of incumbent	Privatisation completed	Privatisation outlook	Restrictions on the number of competitors allowed to operate	Main competitors	Vertical/ horizontal separation (network ownership and control)	Pricing regulation	Regulator
Telecommunications									
Fixed line	Cesky Telecom	51%	27% in 1994 to TelSource (a consortium of KPN and Swisscom) – this owner sold its stake in 2003	Privatise the state stake in 2004-2005	No	Allatel;Tele2; Contactel; GTS CZECH	Cesky Telecom owns local loops	Price caps on Cesky Telecom's charges to final users, cost-based pricing of interconnection to Cesky Telecom's fixed-line network	Cesky telekomunikacni urad
Mobile	Strictly speaking, there is no incumbent, but Cesky Telecom has a strong interest in the sector *via* control over one mobile-phone operator	–	Not applicable	Not applicable	Yes (3 licenses)	Eurotel (Cesky Telecom), T-Mobile, Cesky mobil		Cost-based pricing of interconnection	Cesky telekomunikacni urad
Data and Internet	Strictly speaking, there is no incumbent, but Cesky Telecom has a strong interest in the sector as an owner of the fixed-line network	–	Not applicable	Not applicable	No	Czech On Line; Contactel; Tiscali	Main infrastructure owned by Cesky Telecom,main competitors built their own infrastructure	Cost-based pricing of interconnection	Cesky telekomunikacni urad
Post	Ceska posta	State company	None	None	Yes monopoly in defined services	Messenger; DHL; UPS	None	Price caps	
Railways									
Infrastructure	Railway Infrastructure Administration	State organisation	No	No		None	Separated	Price-caps	Ministry of Finance
Services	Ceske drahy	100%	No		No	None		Cost-based	Ministry of Finance

Regulation of network industries (*cont.*)

	Name of incumbent	State ownership of incumbent	Privatisation completed	Privatisation outlook	Restrictions on the number of competitors allowed to operate	Main competitors	Vertical/ horizontal separation (network ownership and control)	Pricing regulation	Regulator
Air travel	CSA	56.4% + 34.6% in Czech Consolidation Agency	34.6% sold to Air France who sold it back to Czech Consolidation Agency		Yes			No	

Source: Czech Government.

Glossary of acronyms

AETR	Average Effective Tax Rates
ALMP	Active labour market policy
ARP	Agency for Business Development
a.s	Joint stock company
CEEC	Central and eastern European countries
CEZ	Czech Power Company
CKA	Czech Consolidation Agency
CLRTAP	Convention on Long-Range Transboundary Air Pollution
CNB	Czech National Bank
CPI	Consumer Price Index
CSSD	Czech Social Democratic Party
CzechIndustry	Agency for Development of Industry
CzechInvest	Agency for Foreign Investment
CZSO	Czech Statistical Office
ECB	European Central Bank
EIA	Environmental impact assessments
EMS	European Monetary System
EPL	Employment Protection Legislation
ERM II	Exchange Rate Mechanism II
ESA95	European Standard Accounting
EURES	European Employment Services
FDI	Foreign Direct Investment
FNM	National Property Fund
GFS	Government Finance Statistics
GHG	Greenhouse gas
ICT	Information and communication technology
IT	Information technology
KDU-CSL	Christian Democratic Party
KOB	Consolidation Bank
MLA	Adult minimum subsistence allowance
MLS	Minimum Living Standard
MTEF	Medium-term expenditure framework
NDC	National Defined Contribution pension scheme
NGO	Non-governmental Organisation
PIRLS	Progress in Reading Literacy Study
PISA	Programme for International Student Assessment
PPP	Purchasing power parities
R&D	Research and Development
RILSA	Research Institute for Labour and Social Affairs

Roma NGOs	Roma non-governmental organisations
SDVR	The proposed new medium-term budgeting framework
SEA	Strategic environmental assessments
SMEs	Small and medium enterprises
SNA	System of National Accounts
SZDC	Railway Infrastructure Administration
VAT	Value-added tax
VOCs	Volatile organic compounds

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BASIC STATISTICS OF THE CZECH REPUBLIC, 2003

LAND

Area (1 000 km^2)	79	Major cities, 31.12.2002 (1 000 inhabitants)	
Agriculture, 2002 (%)	54	Prague	1 187
Forest, 2002 (%)	34	Brno	387
		Ostrava	315

PEOPLE

Population (1 000)	10 211	Employment (1 000)	4 698
Inhabitants per km^2	129	Agriculture (%)	5
Natural increase in population (1 000)	–18	Industry (%)	40
Net immigration (1 000)	26	Services (%)	56

GOVERNMENT

Public consumption (% of GDP)	24	Chamber of Deputies, as at March 2003	Seats
General government total revenue (% of GDP)	42	Social Democratic Party	70
Public debt, national accounts definition (% of GDP)	37	Civic Democratic Party	58
		Communist Party	41
		Freedom Union/Christian Democratic Union – People's Party Coalition	31
		Total	200

PRODUCTION

GDP, current prices (billion CZK)	2 551	Origin of value added (%)	
GDP per capita (USD, current prices)	8 864	Agriculture	3
Gross fixed investment (% GDP)	27	Industry	38
		Services	59

FOREIGN TRADE

Exports of goods and services (% GDP)	62	Imports of goods and services (% GDP)	65
Main exports (% of total merchandise)		Main imports (% of total merchandise)	
Machinery and transport equipment	50	Machinery and transport equipment	43
Manufactures	35	Manufactures	31
Chemicals	12	Chemicals	11

CURRENCY

Monetary unit: Czech koruna		Currency units per euro	
Currency units per $, 2003	28.13	Year 2003	31.84
		Aug 2004	31.63

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

Executive summary

Following accession to the European Union the big issue for the Czech Republic is to strengthen growth prospects. Growth potential at present is somewhat above 3 per cent, implying a moderate pace of catch-up to living standards in the EU and elsewhere. There is room for greater ambition in growth performance, and it is welcome to see this reflected in the programme of the new Czech government. This *Survey* underscores four main challenges.

Fiscal consolidation

Fiscal consolidation is the dominant challenge for macroeconomic policy, and is not only necessary to cope with ageing and to bring down the tax burden but is also needed to fulfil euro-area entry conditions. A welcome programme of fiscal reform has begun, including proposals for a system of multi-year aggregate spending ceilings and significant expenditure cuts. However, to date, mainly revenue-raising measures have been implemented while the full impact of expenditure measures is yet to be realised. The attempt to secure broad political consensus on pension reform is commendable, but it must be underscored that whatever reform is finally implemented, it will have to bring considerable fiscal savings. Health-care reform also has to deliver savings, but concrete proposals have yet to be made. To facilitate assessment of the true fiscal position, extra-budgetary funds need to be more fully integrated in mainstream government budgeting procedures. Also, with the further decentralisation of public services, the need for good budgeting practices and accountability in regional and municipal governments is all the more important.

A successful entry into the euro area

The Central Bank and the Ministry of Finance have formulated a transparent strategy for entering the euro area, that foresees minimising the time spent in the Exchange Rate Mechanism (ERM II). Annual reports will assess the economic conditions in relation to the Maastricht Criteria and a request to enter ERM II will only being made if the probability of a positive first assessment by the EU authorities is high. The choice of a 3 per cent inflation target for the run-up to euro entry is justifiable on medium-term grounds. However there may be some difficulty communicating the consistency of this target with the Maastricht criterion for price stability. The Czech authorities should therefore pay *close attention to how the Maastricht criteria are interpreted and applied by the European Commission and the ECB and adjust their communication strategy accordingly*.

Making the environment for business more growth-friendly

Most of the catch-up in living standards will have to come from boosting productivity growth. This means swifter re-allocation of resources across firms as well as stronger in-firm productivity growth. While the Czech Republic is a strong competitor for attracting foreign direct investment, policy towards poorly performing firms and business start-ups has problems, slowing down the exit and entry of firms. Bankruptcy procedures are cumbersome, often long and usually end up in liquidation, with asset stripping not uncommon. Reforms have long-since been planned, and it is welcome that new legislation looks finally set to go ahead. The legislation aims at strengthening the role of creditors, speeding up proceedings and allowing composition to play a bigger role. Likewise, efforts to streamline business registration are welcome and should be implemented as soon as possible. The general business climate is also damaged by issues in network-industry competition, as some services, notably Internet, are expensive in international comparison.

Improving the functioning of the labour market

Mobility between jobs and regions is weak. Administrative extensions of collective wage agreements, strict employment protection legislation (EPL) on individual dismissals, rent control, severe poverty traps (particularly for families) and a high tax wedge have contributed to considerable long-term unemployment. The Roma population is hit especially hard in this respect. Migration is to some extent mitigating the labour-market rigidities with Slovaks filling skilled vacancies and other eastern Europeans (mainly Ukrainians) taking up unskilled jobs that are unattractive for locals. Tackling the unemployment problem requires measures across a wide front, but most notably social benefit reform is needed along with reduction in the tax wedge as well as easing of EPL. The widespread social and economic exclusion of the Roma needs more attention, particularly in the education system. A more open immigration policy is needed to address immediate issues such as the inconsistency between granting work permits as well as for better alignment of immigrants' skills with those needed on the Czech labour market.

This Survey is published on the responsibility of the Economic and Development Review Committee *of the* OECD, *which is charged with the examination of the economic situation of member countries.*

•

The economic situation and policies of the Czech Republic *were reviewed by the* Committee *on* 11 October 2004. *The draft report was then revised in the light of the discussions and given final approval as the agreed report by the whole* Committee *on* 28 October 2004.

•

The Secretariat's *draft report was prepared for the* Committee *by* Philip Hemmings, Ann Vourc'h, Dana Hajkova *and* Boris Cournede *under the supervision of* Andreas Wörgötter.

•

The previous Survey *of the* Czech Republic *was issued in* April 2003.

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OECD