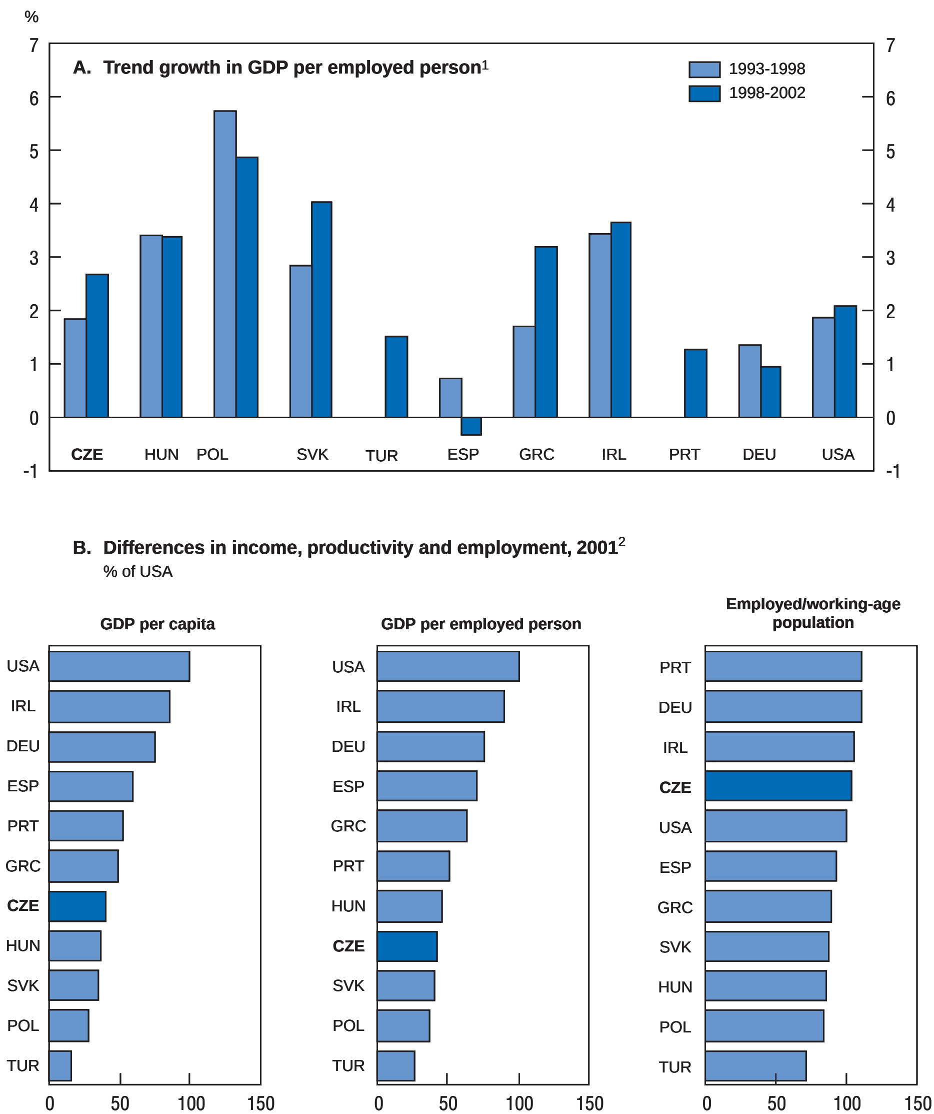
IV. Structural policies for a robust economic performance

The first chapter presented recent economic developments, highlighting the ongoing dualisation of the economy, the relatively slow pace of productivity advance and the continued high employment rate. If the current trends continue, the OECD medium-term baseline (scenario I) described in the same chapter implies a modest improvement in living standards over the next five years. There are significant risks associated with this scenario that could easily generate an alternative outcome characterised by a more rapid productivity growth but also high and persistent structural unemployment (scenario II). A resolute pursuit of structural reforms advocated in this chapter would probably result in less spectacular productivity growth but higher and more sustainable employment and living standards (scenario III).

How has the Czech Republic progressed in the building of institutions that are supportive of a well functioning market economy? Privatisation of large state-controlled banks was successfully completed, making permanent the considerable hardening of budget constraints experienced by domestically-owned firms in recent years. Privatisation in the non-financial sector was also impressive as the state sold its majority stakes in a number of utilities (natural gas, telecom and water services). Rapid harmonisation of legislation with the *acquis communautaire* of the European Union (EU) in the context of pre-accession helped to improve the environment for doing business while massive inflows of foreign direct investment (FDI) continued to be driven by both privatisation and tax incentives. Consequently, the international competitiveness of the Czech economy has improved significantly.[93] A major policy shift in 1998 from emphasising Czech ownership towards FDI promotion has resulted in a significant pick-up of trend labour productivity growth from 1.8 to 2.7 per cent annum. Despite this, Czech productivity growth still lags that in comparable OECD transition economies. Nevertheless, its high employment rate has allowed the Czech Republic to enjoy the highest per capita GDP in this group (Figure 26). Transition economies with high productivity growth suffer either from very high unemployment levels (Poland, Slovakia) or very low labour force participation (Hungary). A major challenge facing the Czech authorities is to find a policy mix that preserves high employment while allowing

Figure 26. **Productivity**



1. Trends estimated using Hodrick Prescott filter with lambda 400 on semi-annual data from earliest available year to 2004. OECD projections used for 2002 to 2004. Caution is required in comparison since trend periods are much shorter for Germany and eastern European countries, some GDP values are chained (POL, GRC, PRT, USA) and some GDP values are expressed in other than 1995 prices (HUN – 1998, TUR – 1987).
2. GDP in current prices and PPPs. Working age is 15-64.

Source: OECD Economic Outlook Database.

market forces to allocate labour to its most productive uses in order to enhance trend growth.

How efficient are the major sectors of the economy? Whereas the service sector has reached one-half of the US labour productivity level in recent years, output per worker in manufacturing has barely exceeded one-quarter (see Annex IV). A strong improvement of performance in manufacturing, a sector that was hit especially hard by delayed restructuring, is necessary for a successful catch-up to the most advanced economies. Even though the labour force participation rate has remained above the OECD average, it has declined in recent years. The containment and reversal of this shift requires, above all, a basic change in incentives that encourage withdrawal from the labour force and low mobility. While government policies have attempted to address some of the key issues,[94] a coherent strategy to tackle all of them in the Czech institutional context has not yet been adopted. The key structural issues related to establishing growth-friendly business environment, the progress achieved as well as the remaining challenges and follow-up recommendations are presented in Table 17.

The remainder of this chapter is organised as follows. The sections on product and financial markets review the structural progress achieved and evaluate policies in these areas. The subsequent section on labour markets examines the evolution of employment and unemployment, investigates best options for achieving and maintaining a strong labour force participation and full employment and outlines the challenges facing the education system. The section on the state sector discusses the stalled public-expenditure reforms and maintains that their implementation should significantly enhance long-term growth prospects for the nation's income and wealth.

Product markets

The agenda in product markets entails a completion of both institutional reforms and restructuring of industry so that its productivity can catch up to the levels obtaining in advanced economies. In the population of medium-sized and large manufacturing corporations, the share of vulnerable firms (loss-making corporations employing over 100 workers) in output and employment declined until 2001, remaining, however, at dangerously high levels of 25-27 per cent in recent years (Vintrová, 2002). This favourable trend was reversed in 2002 (see Chapter I). The continued existence of a large non-viable subsystem explains why the productivity level of Czech industry lags significantly behind that of Hungary, a transition country of comparable size and population. Both economies experienced strong inflows of foreign direct investment to manufacturing but Hungary has been much more aggressive in forcing non-viable firms to exit the marketplace by instituting strict bankruptcy procedures and imposing hard-budget constraints on firms (Kornai, 2001).[95] The previous *Survey* described the efforts of Czech policy

Table 17. **Improving the environment for doing business: key issues**

Key issues/2001 recommendations	Action taken	Assessment	Follow-up recommendation
Panel A: Product markets			
Legal environment			
Improve the legal environment for doing business by reforming cumbersome bankruptcy, customs and registration procedures.	Bankruptcy and registration codes were amended. Authorities drafted a new Bankruptcy and Composition Act that remains to be submitted to Parliament.	Although the performance of bankruptcy judges, trustees and registration authorities improved, the legal framework for industrial restructuring remains unsatisfactory.	The government ought to make a timely passage of new bankruptcy legislation a priority. It should also enable firms to pay a premium for fast-track registration.
Restructuring			
Keep selling bad loans owned by the Consolidation Agency (CKA) to specialised private-sector firms.	After a pause of 1½ years, CKA resumed block sales of receivables.	The resumption of CKA asset sales in large blocks is welcome.	Continue the rapid disposal of CKA receivables through block sales while improving their transparency.
Complete the privatisation process swiftly.	The government resumed privatisation of petrochemical industry.	Privatisation ought to be extended to the remaining few state-controlled sectors.	The recommendation remains pertinent.
Part B: Financial markets			
Transparency			
Impose strict corporate governance standards on all listed firms.	The Czech Securities Commission (KCP) left the adoption of such standards at the discretion of listed firms.	The corporate governance code recommended by the KCP ought to be made obligatory for all listed firms.	The previous recommendation remains pertinent.
Regulation			
Raise the minimum capital requirement and transfer the oversight of credit unions to CNB banking supervision.	The cabinet proposed an amendment increasing substantially the minimum capital threshold for credit unions.	The amendment is a step in the right direction but still remains to be passed by Parliament.	The recommendation has been partly implemented.

Table 17. **Improving the environment for doing business: key issues** (*cont.*)

Key issues/2001 recommendations	Action taken	Assessment	Follow-up recommendation
Panel C: Labour markets			
Welfare benefits			
Adjust non-employment benefits so that they are consistent with wages and productivity.	None. The government has not increased the minimum-living-standard (MLS) benefit levels since October 2001.	The relatively generous welfare benefits encourage voluntary withdrawal from the labour force.	Continue non-indexation of MLS benefit level. Implement the previous recommendation as soon as possible.
Education			
Implement standardised exams at the secondary level. Expand labour-market oriented college programmes.	The government's plan to introduce standardised exams has not been implemented.	Expansion of tertiary education is blocked by the absence of tuition fees.	The recommendation remains pertinent. Public colleges and universities should be allowed to levy tuition fees.
Panel D: Public sector			
Public expenditure reform			
To increase fiscal control over government spending, integrate extra-budgetary funds into the state budget.	This integration is proposed in the fiscal reform package prepared by the Ministry of Finance (MoF).	The recommendation has not been implemented.	The recommendation remains pertinent.
Introduce systematic programme evaluation.	Fiscal reforms proposed by MoF entail first steps towards performance – based budgeting.	The current spending programmes and tax breaks are still not subjected to systematic evaluation.	The recommendation remains pertinent.
Taxation			
Reduce non-wage labour costs, cutting the social-security charges paid by employers.	None.	High payroll taxes continue to discourage employment.	The recommendation remains pertinent.
Corporate income tax (CIT) appears to be excessive for a catching-up economy.	The government plans to reduce the CIT marginally.	High taxation of profits discriminates against smaller firms that cannot benefit from tax incentives for large investments.	Cut the corporate income tax rate to a level comparable to that in successful catching-up economies.

Source: OECD.

makers to improve the legal environment for doing business and to restructure a limited number of large industrial firms through the so-called revitalisation programme. This section describes first recent developments in these areas. It then discusses the impact of investment incentives and privatisation on the FDI inflows that have been driving the economic modernisation. Finally, it reviews the price effects of the government's decision to liberalise network industries.

The environment for doing business

Has the legal environment for doing business improved since the last *Survey*? The government has striven to achieve such improvement by amending the bankruptcy and commercial codes, improving the skills of judges and trustees involved in the process of liquidation and composition of firms under financial distress, intensifying its campaign against corruption and modernising the legal system by introducing a new administrative court circuit. While it is too early to assess the effectiveness of administrative courts, it is also unclear whether the anti-corruption drive of the administration has been successful. Convictions for economic crimes have risen in recent years and some of the perpetrators have been sentenced to lengthy prison terms, creating a deterrent to financial misconduct. Detection of corrupt practices at the highest level of state bureaucracy has reportedly resulted in a tightening of the previously lax appointment procedures.[96] The government's recent decision to expand the use of competitive tenders in public procurement is another step in the right direction because it reduces the scope for bribery in the hitherto non-transparent realm of public investment processes. The authorities have also expedited the performance of commercial court registers, imposing time limits on registration of both new firms and changes of the existing data, subject to the requirement of full and proper documentation. Further, the government intends to transfer the responsibility for registration of new firms from courts to an independent authority to speed up the process further. Despite these reforms, the perception of pervasive corruption has not weakened. The 2002 report of Transparency International ranks the Czech Republic in the 55th position on the basis of its corruption perceptions index, along with Latvia, Morocco, Slovakia and Sri Lanka, and well behind transition economies such as Slovenia, Estonia and Hungary.[97]

Aside from corrupt practices, businessmen complain about widespread administrative inefficiency that prevents them from starting or expanding operations. In spite of significant improvements, regulation of entry remains cumbersome, requiring ten separate procedures and taking on average 67 days to complete. In contrast, only two procedures that can be completed within a day or two are required in the least restrictive OECD country for business entry (Canada).[98] The authorities emphasise that a fast-track entry in the Czech institutional context might well result in a huge burden on the court system through *ex-post* litigation, so that a slower but error-minimising regulation of entry is preferable. Moreover, businessmen who do not intend to apply for investment incentives can register instantly by purchasing pre-registered shell companies from specialised service firms.[99] Most firms that apply for incentives, mainly multinational corporations, are able to cope with the obstacles to entry with ease. However, smaller foreign-owned businesses continue to find entry requirements cumbersome and would benefit most from further streamlining of procedures.

Another key issue plaguing the Czech economy has been the dysfunctional legal framework regulating exit of non-viable firms from the marketplace. How did bankruptcies and compositions develop since the last *Survey*? Petitions for bankruptcy declined and the number of completed proceedings kept rising so that the backlog of unfinished cases declined slightly in 2001 (Table 18). The rising number of applications for composition by debtors has resulted in only a handful of approvals by courts. The low incidence of such voluntary arrangements between debtors and creditors is normal in a creditor-oriented bankruptcy framework.[100] The current legislation permits a prompt sale and reallocation of viable parts of bankrupt firms to outside investors, but the process depends unduly on the abilities of commercial court judges and of the trustees appointed by them. Therefore, instances of successful restructuring by either bankruptcy or composition procedures have been rare (see Box 11). The experience of recent years suggests that restructuring of large industrial firms, either by state-controlled agencies or by court-appointed bankruptcy administrators, can succeed in replacing weak management and preserving viable core activities. To accelerate this process, it appears to be necessary to improve the current legislation to permit fast-track restructuring of insolvent firms with the aid of straightforward composition procedures *and* to transfer the responsibility for managing the exit process from state-owned agencies to specialised private-sector firms.

Industrial restructuring: achievements and setbacks

What have been principal achievements of the government-sponsored restructuring programmes over the last year and a half? The authorities completed financial restructuring of three large industrial firms and subsequently sold them to foreign investors.[101] In all cases, the new owners have started to turn around the companies by aggressive cost-cutting, involving massive layoffs and termination of unprofitable operations. Following a considerable and lengthy effort by the authorities to revitalise the Š*koda* engineering group, the Consolidation Agency sold a major part of its equity stake to the closely-held Appian Group of the United States. Since its inception in 1999, the state-sponsored revitalisation programmes (described in the last two *Surveys*) have been modestly successful, with loss-making sales of six large companies to outside investors contributing to the overdue industrial restructuring at a considerable cost to the taxpayer.[102]

Table 18. **Bankruptcies**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
New petitions[1]	353	1 105	1 826	2 400	2 996	3 311	4 306	4 339	4 650	4 036
Bankruptcies declared	1	66	294	727	808	1 251	2 022	2 000	2 491	2 473
Declared as per cent of new petitions[2]	0.3	6.0	16.1	30.3	27.0	37.8	47.0	46.1	53.6	61.3
Proceedings completed	123	418	921	1 117	1 716	2 047	2 418	2 964	4 087	4 539

1. Petitions for bankruptcy may be lodged by the creditor or the debtor. Only the courts may declare a debtor to be bankrupt. Motions of settlement are separate procedures also made before the courts. They are offers made by debtors to settle with creditors. Few are agreed to by the courts or creditors.
2. Calculated as the ratio of the declared bankruptcies to new petitions.

Source: Ministry of Justice.

Box 11. Bankruptcy and composition

The 1991 Act on Bankruptcy and Composition had been revised 19 times to date. Whereas the original legislation emphasised liquidation of insolvent and illiquid firms, the amendments passed in recent years allow for a court-supervised restructuring of distressed firms under certain conditions. The government is preparing a comprehensive draft of a new Act that provides for fast-track composition procedures. Although the current legislation provides for a creditor-centred bankruptcy system, its application by the majority of Czech judges has favoured debtors instead (Schönfelder, 2001). Furthermore, debtors benefit from unenforceable rules and often low penalties for financial misconduct.[1]

The choice of procedure, *i.e.* bankruptcy or composition, is in the first instance at the discretion of the party filing the proposal, *e.g.* the debtor. Despite their sympathy for the plight of debtors, commercial court judges are eventually forced by provisions of the Act to reject the overwhelming majority of debtors' proposals for composition, declaring the state of bankruptcy instead.[2] Court judges can play a positive role in restructuring operations that permit a survival of the bankrupt firm or its parts providing that they choose a competent trustee and are able to act quickly and decisively while applying the law. To generate a positive yield for creditors, the court-appointed administrator has to be able to manage the bankrupt company, identify plants or smaller productive units that can function as going concerns on their own and find suitable buyers promptly. Once the bankruptcy is declared, the court suspends all creditor claims so that a competent administrator should be able to identify sources of positive cash-flow.

While the bankrupt firm or its parts can be operated under the auspices of the trustee, it is not allowed to obtain new credit. The creditors' committee plays an advisory role in the bankruptcy process and must approve restructuring or liquidation. In turn, the judge must approve the decision of the creditors' committee. In practice, *restructuring by bankruptcy* has seldom been successful. Debtors have often managed to delay the imposition of bankruptcy and the subsequent takeover of the firm by a trustee, stripping assets in the meanwhile. Since 2001 the courts had the option to appoint even before a declaration of bankruptcy an interim administrator to take care of the accounting documents and to secure the debtor's property. However, judges have sometimes acted too slowly and/or appointed administrators turned out to be incompetent. Professional standards for bankruptcy trustees have not been defined yet, *i.e.* anyone can become a candidate. The current bankruptcy legislation does not specify whether the sale of a viable part of the bankrupt firm should maximise its chances of survival as a going concern or the cash value for creditors.

In contrast, *restructuring by composition* does not provide for the sale of the firm or of its parts but rather its turnaround by reducing the debt burden. It is subject to the approval of all secured creditors who may, but are not obliged to, accept a reduction in the value of their claims that are not suspended during the procedure. Subordinate creditors must receive at least 30 per cent of their claims in cash within a couple of years. Large creditors (often banks) have been sometimes indifferent to the survival of a restructured firm or its parts as a going concern

Box 11. **Bankruptcy and composition** (*cont.*)

while small creditors have been known to resort to greenmail, with the objective to force superior terms of settlement for themselves by delaying the composition process (OECD, 2001). Unlike in the bankruptcy procedure, the old management of the firm subjected to composition may be allowed to continue its work under the supervision of a court-appointed trustee. While the choice of procedure (bankruptcy vs. composition) is in first instance made by the debtor, the court then controls whether such motion fulfils legal requirements (including *e.g.* the 30 per cent recovery rate of the value of claims in case of composition), having the power to dismiss motion on such grounds, and final decisions on claims satisfaction are subject to approval by creditors within the limits set by the law.

The draft of the new Bankruptcy and Composition Act entails significant improvements by motivating debtors to initiate bankruptcy proceedings, by allowing creditors to propose terms of composition, by imposing professional standards on and improving the selection of trustees, and by harmonising the hitherto inconsistent provisions of the commercial code, civil procedures code, tax and banking acts. However, until this new legislation will have been adopted, liquidation in the aftermath of excessively lengthy proceedings is likely to remain the principal method for dealing with business insolvency.

1. The Bankruptcy Act stipulates that debtors have to inform courts of insolvency and provide court-appointed administrators with company accounts. In practice, debtors often fail to report insolvency and prosecutors are usually unable to prove that this reflects deliberate misconduct rather than mere incompetence. Therefore, successful prosecutions are extremely rare, albeit increasing slowly in recent years. In cases of asset stripping (known as 'tunnelling') debtors often refuse to hand over accounts, preferring to misplace them instead. The penalty for this infraction (a fine of CZK 50 000, equivalent to some $1 600) is to be paid by the insolvent firm and apparently not an effective deterrent.
2. This and the following paragraph are based on Rais (2000) and Rais (2001).

How much restructuring remains to be done? After a clean up of the banking sector, the problematic medium-sized and large enterprises with heavy debt burdens are mainly those active in the industrial sector, especially manufacturing. The Secretariat estimates that some 230 000 workers currently remain employed in over 500 distressed industrial corporations.[103] This means that about one-quarter of industrial employment is threatened. If one factors in threatened jobs in other sectors (construction, rail transport), there are probably still some 300 000 vulnerable jobs that account for 7½ per cent of dependent employment. The restructuring challenge is thus still extraordinary.

The portfolio of the Consolidation Agency (CKA), a principal creditor of vulnerable firms, has doubled in recent years as it received a huge batch of bad loans associated with the sale of the state-controlled K*omerční banka* (KB) to S*ociété Générale* of France and of the illiquid I*nvestiční a poštovní banka* (IPB) to the Belgian-owned *Československá obchodní banka* (CSOB)[104] as well as with the government's revitalisation programme. The outflow has also picked up as the Agency resumed sales of large packages of receivables to specialised private-sector institutions, after an unnecessary delay of 17 months, and made some progress in the wholesaling of smaller claims to private investors. Its remaining assets have a face value of some CZK 300 billion (about $9 billion) or 15 per cent of GDP. Ultimately, the firms that cannot service their debt held by the Agency will exit the marketplace through liquidations or takeovers.

This exit process will be partly managed by the government that selected a small number of larger debt-laden firms to be restructured through direct sales of CKA-held claims to strategic investors, followed by debt-equity swaps and reorganisation by new owners. Such claims have been excluded from block sales. The experience with this approach has been mixed to date – while CKA managed to conclude a few transactions, the majority of the firms selected for participation in this programme remain in a state of agony (their future being completely uncertain). Hence, a continuous sale of packages of receivables to highest bidders seems to be the best option available. The first large block of bad loans was sold in June 2001 to the highest bidder for 11 per cent of book value while the second one, sold in November 2002, netted 18 per cent of the book value. The recovery rate, although increasing, has remained significantly below the 50 per cent threshold associated with similar sales by the Korean Consolidation Agency in late 1990s. The third block sale was to include mainly overdue receivables of bankrupt firms at a small fraction of their book value. Another 3-4 block sales are planned over the next two years – the CKA portfolio would thus be reduced to 15-20 per cent of its present size and include mainly complicated transactions that involve lengthy court litigation. If the economic performance of industry is to improve appreciably, the remaining block sales ought to be completed as soon as possible. The successful bidders are likely to sell the CKA receivables and equity stakes promptly, accelerating the exit of heavily indebted firms or their recovery. In the first case, outsiders purchase the CKA claims and either take over and restructure the indebted firms or acquire their attractive assets through liquidation. In the second case, the owners of vulnerable firms buy back indirectly their debts at a significant discount that allows them to operate as viable businesses, without soft financing that had been available in the past.[105]

If the Consolidation Agency manages to complete the block sales contemplated over the next couple of years and assuming that about one-half of vulnerable employment disappears subsequently, then the number of vulnerable jobs should be reduced to about 150 000 or 3¾ per cent of dependent employment, *i.e.* to a level that is still about twice as high as in a smoothly functioning market economy. This underlines the need for a rapid implementation of the new Bankruptcy Act so that the number of job losses can be minimised through effective compositions. The main risks to the CKA programme to rapidly dispose of its portfolio are posed by the growing debts of Czech Railways and overdue liabilities of public hospitals that could be transferred to the Agency in the future. Another potential source of bad debt transfers to CKA is the distressed *Union banka* (see the financial markets section).

Privatisation: ambitions vs. *outturns*

Since the last *Survey*, the authorities either completed or advanced privatisation of the banking, natural gas, petrochemical, steel and telecommunication industries, thus significantly curtailing the role of the state in the economy. The scope of change in the ownership of productive assets, illustrated in Table 19, indicates that the number of strategic firms has been pared significantly. Dominant electricity, petrochemical and telecommunication firms are likely to be fully privatised within a few years. Remaining state-owned firms such as Czech Airlines, Czech Airports Authority, Czech Post, Czech Railways and coal mines in northern Bohemia are not yet for sale but may be privatised in the longer term.

While the privatisation of large firms has usually ended in their takeover by strategic investors from abroad, there was a significant exception which has provided an unfortunate signal to foreign investors. While trying to sell its majority stake in a huge petrochemical conglomerate (Unipetrol), the government of the day decided to favour an undercapitalised domestic bidder (Agrofert) over a foreign investor (Rotch Energy of the United Kingdom), even though the latter offered a higher price. In the event, the domestic bidder tried to change the terms of the transaction retroactively and the sale fell through. The new government decided to call another public tender; meanwhile, the viability of some large firms within the Unipetrol conglomerate deteriorated significantly.[106] In another case of unsuccessful privatisation, the government restored a vertically integrated power utility, hoping to attract a significant premium from bidders. However, no bid matched even the minimum price limit so that privatisation of the state's dominant stakes in the power industry had to be postponed. Similarly, the state had to postpone full privatisation of the dominant telecom operator, having been unable to secure full co-operation of a minority shareholder. Aside from these three cases, privatisation of the natural gas conglomerate, a smaller telecom firm, the Prague water services utility and the last state-controlled commercial bank resulted in significant FDI inflows.

Foreign direct investment drives the productivity catch-up

The Czech Republic has continued to outperform its principal regional competitors for FDI inflows (Table 20). An overview of the investment incentives that have facilitated this performance are set out in Box 12. Responding to the

Table 19. **Participation of the National Property Fund in strategic companies**[1]

Company	State's share in per cent		Employment in persons	
	December 1998	December 2002	December 1998	December 2002
Financial sector				
Privatised				
Ceska sporitelna (CS saving bank)	45.0	0.0	16 580	n.a.
Ceskoslovenska obchodni banka (CSOB)	19.6	0.0	4 987	n.a.
Komercni banka (KB)	48.8	0.0	13 861	n.a.
Ceska pojistovna (insurance)	30.3	0.0	8 423	n.a.
Energy sector				
Privatised				
Most Coal Company	46.3	0.0	9 260	n.a.
Paramo (refinery)[2]	70.9	0.0	824	n.a.
Transgas (gas transmission)	100.0	3.0	1 793	1 409
Central Bohemia Gas	48.5	0.0	535	n.a.
Eastern Bohemia Gas	47.1	0.0	658	n.a.
Northern Bohemia Gas	49.2	0.0	713	n.a.
Southern Bohemia Gas	46.7	0.0	273	n.a.
Northern Moravia Gas	47.2	0.0	1 092	n.a.
Prague Gas	49.2	0.0	865	n.a.
Southern Moravia Gas	47.7	0.0	1 350	n.a.
Western Bohemia Gas	45.9	0.0	770	n.a.
To be privatised				
Czech Power Company (CEZ)	67.6	67.6	10 600	7 250
Central Bohemia Power[3]	58.3	58.3	1 877	1 608
Eastern Bohemia Power[3]	48.1	49.6	2 114	1 627
Northern Bohemia Power[3]	48.1	48.1	1 884	1 459
Northern Moravia Power[3]	47.3	48.7	2 112	1 781
Southern Bohemia Power[3]	48.1	48.1	1 302	1 131
Southern Moravia Power[3]	46.7	46.7	2 346	1 787
Prague Power[3]	48.2	48.2	1 517	1 287
Western Bohemia Power[3]	48.1	48.3	1 487	1 377
UNIPETROL (oil and chemicals)[4]	63.0	63.0	8 574	6 483
OKD (coalmines)	45.9	45.9	27 098	18 349
No privatisation plan				
Northern Bohemia Coalmines	54.4	55.4	6 242	5 055
Sokolov Coal Company	48.7	48.7	6 863	5 531
CEPRO (sales and storage of oil products)	100.0	100.0	1 175	855
MERO CR (oil transport and storage)	100.0	100.0	167	161
Steel				
To be privatised				
Nova Hut (steel works)[5]	49.0	67.2	14 681	11 380
Vitkovice – Steel[6]		98.9	n.a.	1 800
Manufacturing				
Privatised				
Chemical Works Sokolov (Eastman Sokolov)	73.7	0.0	851	n.a.
Jan Becher-KV Becherovka (liquor factory	59.0	0.0	344	227
Plzensky Prazdroj (brewery)	0.0	0.0	2 558	2 706
Aero Holding	61.8	in liquidation	21	5
SEVAC (R&D manufacturing of pharmaceuticals)	78.9	liquidated	70	0

Table 19. **Participation of the National Property Fund in strategic companies**[1] (*cont.*)

Company	State's share in per cent		Employment in persons	
	December 1998	December 2002	December 1998	December 2002
Manufacturing				
To be privatised				
Vitkovice a.s. (engineering works)	67.3	67.3	16 109	4 700
No privatisation plan				
SKODA Praha (engineering works)	54.8	54.8	1958	730
Transport				
No privatisation plan				
Czech Airlines (CSA)	56.9	56.9	4 010	4 455
Ceske drahy (Czech Railways)[1]	100.0	100.0	91 870	80 559
Telecommunications				
Privatised				
Ceske radiokomunikace	51.2	0.0	1 550	n.a.
To be privatised				
Cesky Telecom	57.1	51.1	22 277	13 717
Water				
Privatised				
PVK (Prague Water and Sewage)	100.0	0.0	n.a.	n.a.

1. The state is represented in Czech Railways directly rather than by the National Property Fund (FNM).
2. Sold and transferred to the Czech state-controlled Unipetrol petroleum and chemical holding in 2000.
3. The government approved sale of FNM's shares in the 8 regional power distribution companies to the state-controlled power generating company CEZ in May 2002 and the respective sale contract was signed in June 2002. Transfer of shares is contingent on the competition authority's approval.
4. Sale contract signed with private investor at the end of 2001. Since the buyer failed to pay the government decided (in September 2002) to withdraw from the contract and (in November 2002) to repeat the public tender process. In the course of 2000-2001 the Unipetrol holding acquired companies like Paramo, Spolana and Aliachem.
5. The government approved sale of state share to a Dutch investor (LNM Holdings N.V.) in May 2002 and the respective sale contract was signed in June 2002. FNM sold the first tranch amounting to 52.25 per cent of the Nova Hut equity to LNM Holdings on 31 January 2003. The second tranch amounting to 18.25 per cent of Nova Hut will be sold to LNM as soon as an arbitration dispute is settled.
6. Vitkovice Steel was separated from Vitkovice a.s. in 2001 and sold to OSINEK company (100 per cent subsidiary of the National Property Fund) in April 2002.

Source: National Property Fund.

relative weakness of the manufacturing sector, Czech policy makers attracted considerable inflows of foreign capital and know-how through such incentives as well as the privatisation and restructuring programmes described above. Overall, some 60 per cent of the cumulative FDI inflows have benefited the service sector (mainly trade, banking, transport, telecommunications and energy industries) while the remaining 40 per cent have moved into the goods-producing sector (mainly automotive, chemical and ICT industries). The Czech Republic has encouraged fuller ownership changes in state-controlled public utilities than other countries in the region. A year ago, the government extended incentives to technology

Table 20. **Foreign direct investment inflows**[1]

	1995	1996	1997	1998	1999	2000	2001	2002	Period covered in 2002	Cumulative	Cumulative per capita
	US$ million										
Czech Republic	2 568	1 435	1 286	3 700	6 310	4 984	4 922	7 169	Jan.-Sept.	33 907	3 301
Hungary[2]	4 810	2 556	3 134	2 649	3 454	3 483	4 322	1 833	Jan.-Sept.	29 828	2 977
Poland	3 659	4 498	4 908	6 365	7 270	9 341	5 713	2 861	Jan.-Sept.	48 205	1 247
Slovakia	258	370	231	710	428	1 926	1 533	3 390	Jan.-Sept.	9 298	1 722

1. Refer to International Monetary Fund Balance of Payments Statistics Yearbook and Special Data Dissemination Site for details of methodological variations across countries and time.
2. OECD estimate of reinvested earnings was used to derive a comparable time series for Hungary.

Source: Balance of payments of respective national banks, national accounts and OECD.

Box 12. Investment incentives: a strategic game in progress

As is well known, countries compete for investment. In case of two similar transition economies such as the Czech Republic and Hungary, this competition can be usefully viewed as a non-co-operative game, with one dominant strategy (provide incentives) and one non-dominant strategy (don't provide incentives). The country that pursues the dominant strategy is rewarded with a huge pay-off in terms of large FDI inflows, providing that its competitor chooses the non-dominant strategy. This unstable equilibrium obtained until 1998, with Hungary reaping the benefits of pursuing the dominant strategy. Subsequently, the Czech authorities decided to provide strong investment incentives as well. The new and *stable* equilibrium is characterised by a position in which both countries accumulate relatively large FDI stocks, more or less splitting the inflows over time. Each new initiative of one country, *e.g.* provision of incentives in the strategic services sector, is now promptly matched by the other.

Investment promotion has become *the* principal modernisation strategy of Czech policy makers in the late 1990s, following an unsuccessful experiment with policies that promoted national ownership of industry and banking in the earlier part of the decade. Incentives in the manufacturing sector pertain to investment projects exceeding a value of $10 million ($3 million in high-unemployment regions) and entail corporate income-tax relief for 10 years for new firms (or partial income-tax relief for 5 years for existing firms), provision of cheap serviced sites in industrial zones, and job-creation and training grants for local employees. Eligible investments must also meet some additional criteria, including a minimum share of expenditure on hi-tech machinery and full compliance with national environmental standards. Since their inception in April 1998, these incentives, together with the improving environment for doing business, have attracted greenfield investments valued at $5 billion over the first four years from over 100 predominantly foreign corporations and have created almost 40 000 new jobs in the manufacturing sector. A great majority of these projects appears to have been successful, with only a couple of firms deciding to leave. According to CzechInvest, some 90 per cent of FDI firms have re-invested their earnings in the Czech economy. In recent years, such reinvestments averaged $1 billion per annum and accounted for 20-25 per cent of FDI inflows reported in the balance-of-payments statistics.

In 2002, investment support became available also for strategic services and technological centres, including business customer contact, hi-tech service and repair, software development, and R&D centres. If a project meets specific objectives pertaining to the value of investment, employment, export orientation and location, the government provides a 50 per cent corporate tax relief for up to ten years, arranges for university co-operation and provides subsidies amounting to 50 per cent of eligible business costs, 35 per cent of special training costs per employee and 60 per cent of general training costs. The threshold for support is much lower than in the manufacturing sector at CZK 50 million ($1½ million). The actual amount available to each project is calculated as a percentage of the eligible investment expenditure (wage costs during the first two years of the project, Box 12. **Investment incentives: a strategic game in progress** (*cont.*)

capital outlays on buildings, machinery and equipment, including expenditure on intangible assets up to a predetermined limit). The percentage varies according to location from 20 per cent in Prague to 46-50 per cent in the other seven regions of the Republic. Additional incentives are available for structurally disadvantaged regions with declining industries and high unemployment levels. Each project has to be examined by the Czech competition authority that has to certify its compliance with EU rules on state aid.

The volume of incentives-driven investment projects located in disadvantaged regions exceeds the national average by four times, but the picture at the regional level is uneven, with central districts of Bohemia and Moravia outperforming the most depressed northern districts by a wide margin. The superior ability of central districts to attract FDI inflows is clearly linked to their good accessibility. The two most disadvantaged districts (Usti and Ostrava) have suffered from lack of modern road infrastructure that strongly curtails their ability to attract more foreign investors.

centres and the strategic services sector (including software development, ICT expert solution and high-tech repair centres) in order to stimulate further technological progress.

The superior performance of foreign-controlled firms is confirmed in Figure 3 and Table 21. According to CzechInvest surveys (*www.czechinvest.cz*), over 1 200 subsidiaries of multinational manufacturing companies operate in the Czech Republic. These FDI firms produce almost 70 per cent of manufactured exports, account for nearly one-half of sales, employ directly 300 000 workers (one-quarter of employment in manufacturing) and employ indirectly twice as many in some 10 000 local firms in both goods-producing and service sectors. This dynamic subsector creates on average 20 000 net new jobs (direct and indirect) per annum.

The sectoral productivity performance has improved in the wake of massive FDI inflows (Figure 27). However, the productivity of the Czech manufacturing sector still continues to lag its Hungarian and Polish counterparts. One notable exception is the automotive industry, where *Škoda Auto* (part of the Volkswagen group) as well as foreign-owned bus and truck producers can rely on an extensive domestic supplier network, experienced workforce and traditional know-how. The other branch with dynamic productivity growth that is driven by FDI inflows is manufacturing of electrical appliances and optical devices. The industrial strategy based on rapid inflows of modern technology from abroad is promising but entails a danger of sudden reversals triggered by changing comparative cost advantages.

Table 21. **Financial conditions in industry**[1]

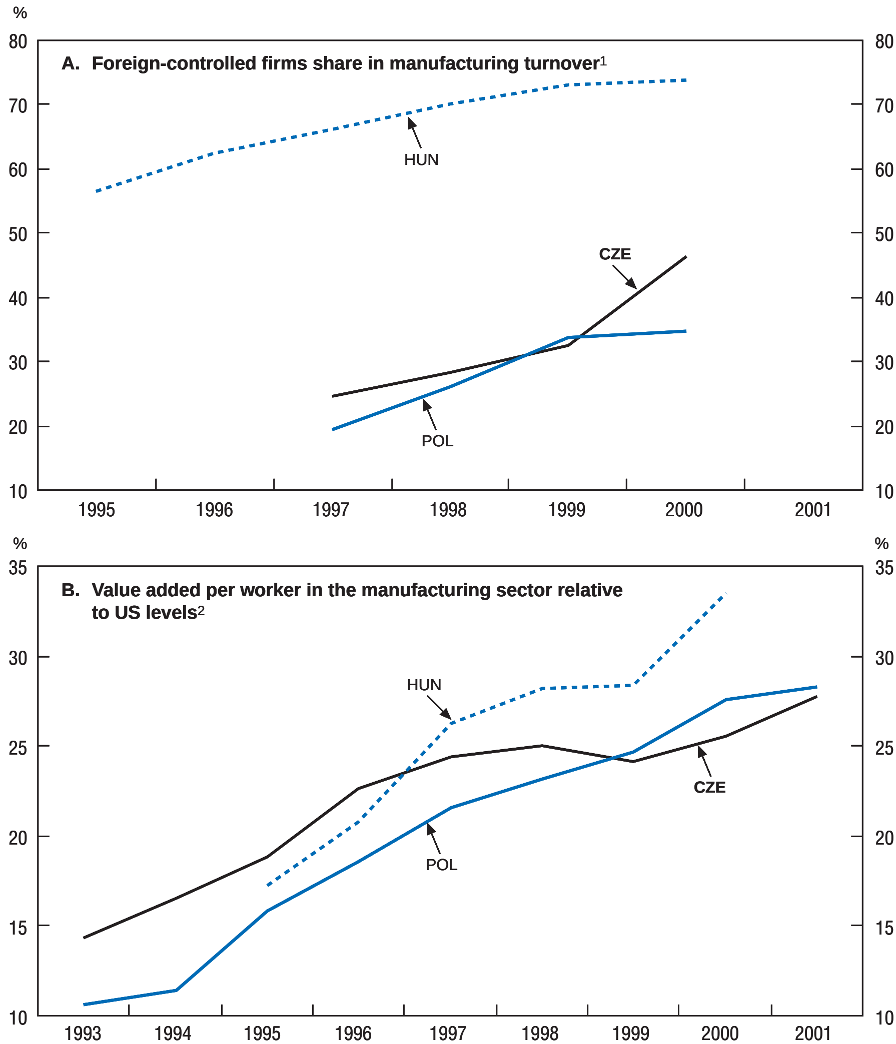
	Domestically-controlled firms		Foreign-controlled firms	Unincorporated firms	Total
	Public sector	Private sector			
	Per cent of total				
Number of firms					
1999	6	78	15	1	100
2000	5	74	20	1	100
2001	3	67	28	2	100
2002	2	65	32	1	100
Employees					
1999	12	72	16	0	100
2000	14	66	20	0	100
2001	7	61	31	1	100
2002	5	60	35	0	100
Output					
1999	16	59	25	0	100
2000	23	47	30	0	100
2001	11	46	43	0	100
2002	7	45	48	0	100
Pre-tax profit					
1999	–29	39	89	1	100
2000	19	35	45	1	100
2001	20	30	50	0	100
2002	18	36	46	0	100
Book value added					
1999	16	62	22	0	100
2000	22	53	25	0	100
2001	13	47	40	0	100
2002	9	46	45	0	100

1. Firms with 100 or more employees. Data for 2002 pertain to the first three quarters.
Source: Czech Statistical Office.

Recent transfers of production from Wales to the Czech Republic (Matsushita) or from Spain to Slovakia (Volkswagen) illustrate this possibility.

Although the Czech authorities were successful in attracting greenfield investment, these inflows remain well below per capita levels in more advanced countries. What are the obstacles keeping potential investment projects away? In addition to the cumbersome regulation of business start-ups, foreign investors complain about the customs rules and procedures that result in huge line-ups of trucks at all border crossings with consequent delays of delivery.[107] These prevent firms located on the Czech territory from taking advantage of up-to-date production methods, force them to hold excessive inventories of intermediate inputs and reduce their ability to develop a more intensive network of inward-processing

Figure 27. **Foreign presence and productivity in the manufacturing sector**



1. Foreign-controlled firms are those with a foreign capital share of more than 10% for the Czech Republic and Hungary and for Poland, those with more than 50%. For Poland from 1999, only enterprises employing more than 9 persons are included.
2. Value added per worker in current prices in the manufacturing sector, for each country, was converted to USD by dividing by a proxy conversion ratio. This ratio, an implied unit value ratio (UVR) for manufacturing, is the product of the UVR [national currency/DEM] in 1996 and the UVR [DEM/USD] for western Germany in 1987.

Source: Czech National Bank; National Bank of Hungary; OECD *National Accounts* and *Labour Force Statistics*; ICOP Industry Database, (*www.eco.rug.nl/GGDC/icop.html*); Bureau of Economic Analysis, US Department of Commerce.

operations. Similarly, outdated legislation governing labour relations prevents firms from optimising employment levels, forcing them to hoard labour and rely excessively on overtime work. The development of road transport infrastructure is based on the implementation of plans elaborated before the emergence of high unemployment, resulting in worsening bottlenecks preventing investment inflows into some of the most structurally disadvantaged regions. Last but not least, foreign firms complain about red tape ranging from the impossibility of promptly obtaining visas for their executives to the refusal of authorities to accept national driving licences from countries such as Canada, Japan or the United States. If the authorities were able to address these concerns, inflows of greenfield and brownfield investment would probably pick up significantly.

Network industries

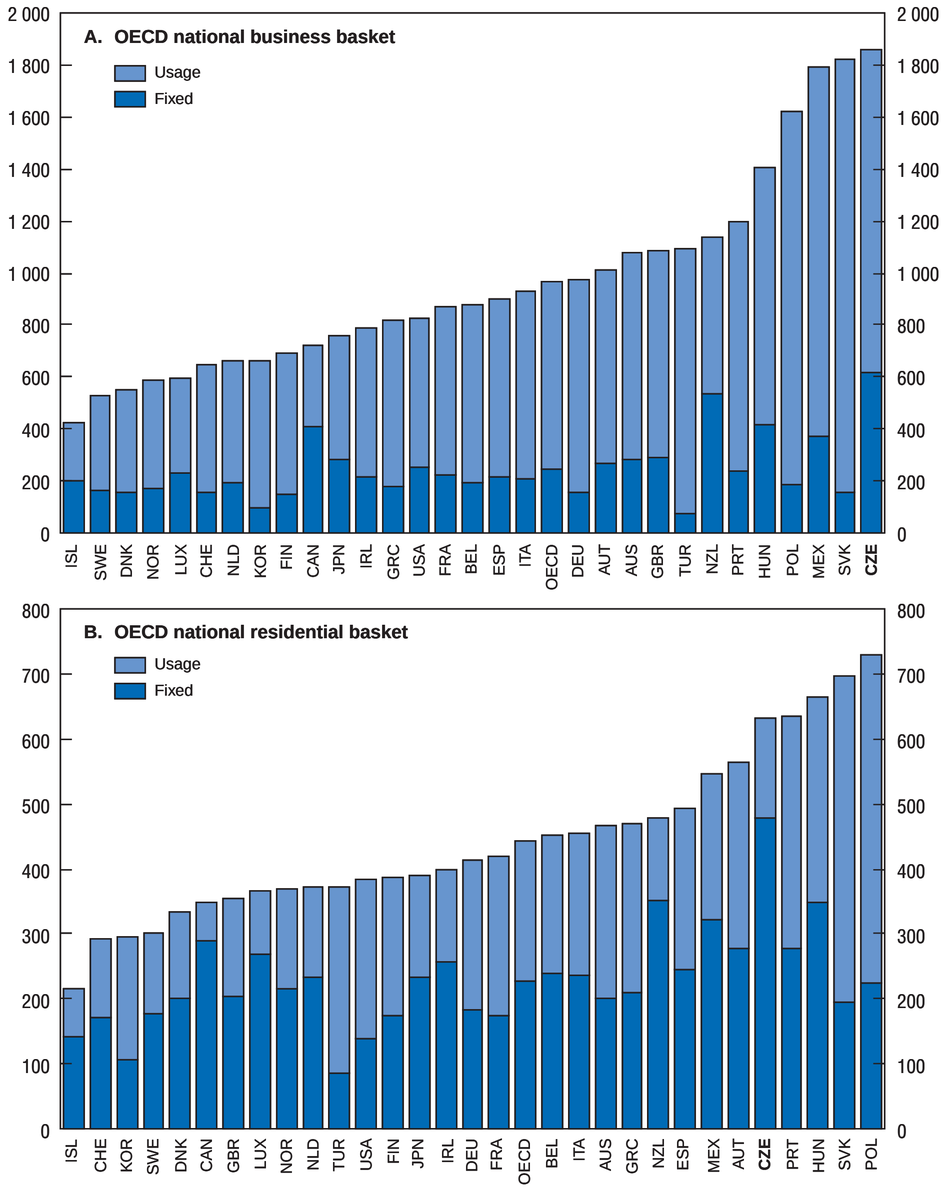
The administration's growth strategy has recognised that privatisation and liberalisation of network industries constitute an important precondition for successful modernisation. The government sold large stakes in network industries to foreign investors and established independent telecom and energy regulators. Despite these significant achievements, the expected benefits have not fully materialised to date. While the expansion of privatisation-related and greenfield FDI inflows is necessary for a significantly improved economic performance, it is not always sufficient. In particular, dominant operators face newly independent but inexperienced regulators.[108] This implies that excessive prices may well reduce the competitiveness of firms and the welfare of consumers for a number of years.

Telecommunications

Telecommunication tariffs for Czech businesses are the highest in the OECD area (Panel A in Figure 28); this is clearly a serious handicap for a country participating in the catch-up race. Also tariffs for households are among the highest in the OECD. The introduction of call-by-call carrier selection in July 2002 and carrier pre-selection as well as number portability in January 2003 would not yet have had time to make an impact on market prices, but should start showing some effects in the second half of 2003 if the regulator (Czech Telecommunications Office or CTO) ensures that effective implementation procedures are in place. The current Telecommunications Act does not provide the regulator with the powers necessary to operate as an independent authority. A particular problem is posed by CTO's financial dependence on the government that controls its funding through the state budget and requires the agency to hire and remunerate staff according to civil service regulations. CTO cannot recruit top professionals, being unable to offer competitive salaries, quite contrary to the dominant firms in the market.[109] Beyond this important shortcoming which should be remedied, the

Figure 28. **Telecommunications tariffs**[1]

USD at PPP



1. As at May 2002. Excluding calls to mobile networks and international calls. Business basket excludes VAT. Residential basket includes VAT.

Source: OECD.

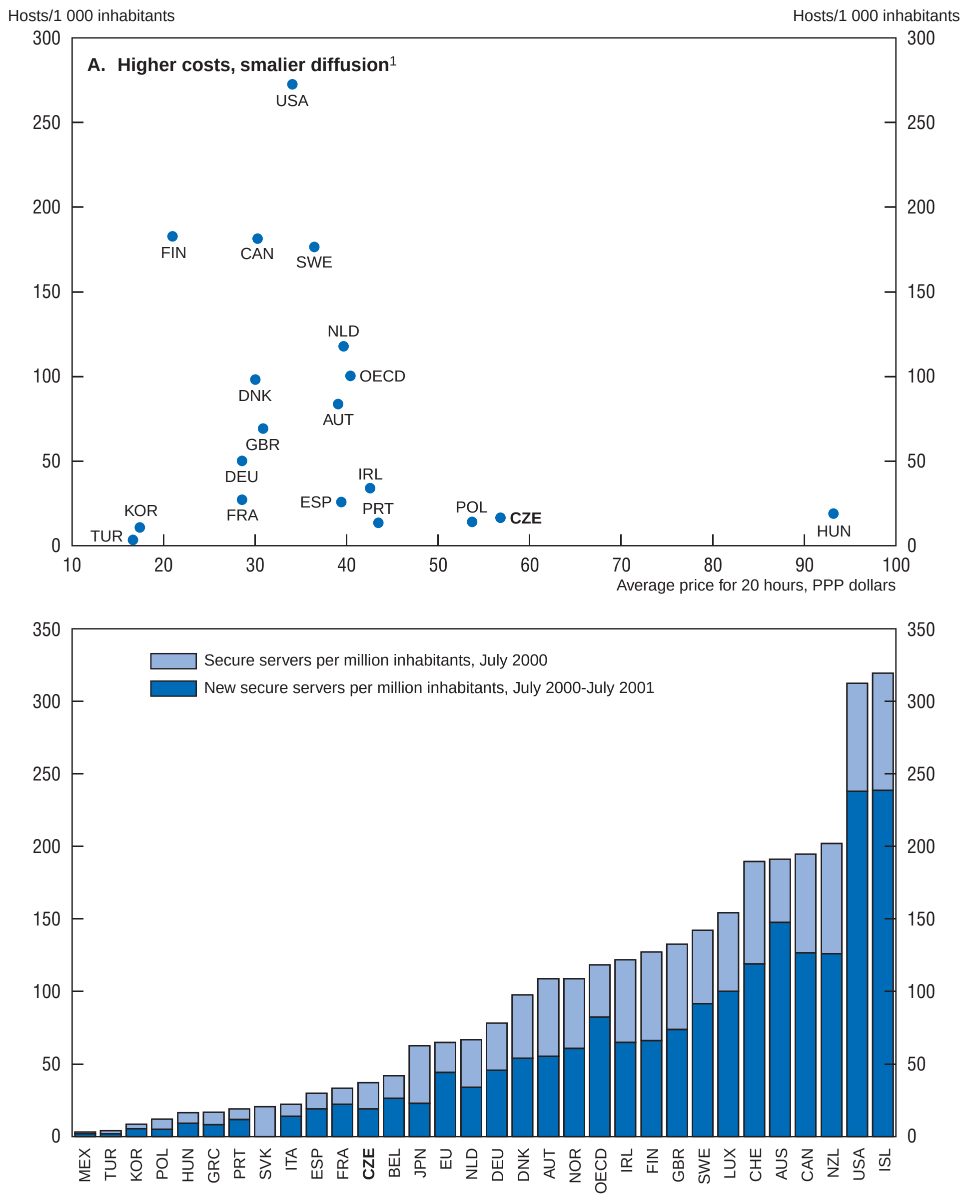
authorities have decided to overhaul the Telecommunications Act in 2003, with the intent to force the partly foreign-owned *Český Telecom* to rent the local loop to any competitor on reasonable terms. Although this legislative advance is welcome, the previous recommendations remain pertinent because only a fully independent CTO can start playing a more active role by imposing rules that promote competition and cut monopoly profits.

In terms of access prices and the internet penetration rates, the position of the Czech Republic remains weak, although the density of secure servers that are suitable for e-commerce exceeds that in other transition economies and some EU countries (Figure 29). Given the comparatively high cost of internet access, the adoption of a pricing model that provides for untimed calls to all subscribers would be a major step in the right direction. Because Czech internet service providers (ISPs) have to pay the incumbent interconnection charges on a timed basis, they cannot offer untimed internet access at affordable rates. Some European regulators (*e.g.* in the United Kingdom) introduced a flat-rate internet access call origination option for internet interconnection, allowing the new entrant ISPs to offer untimed call packages for internet access.

Energy

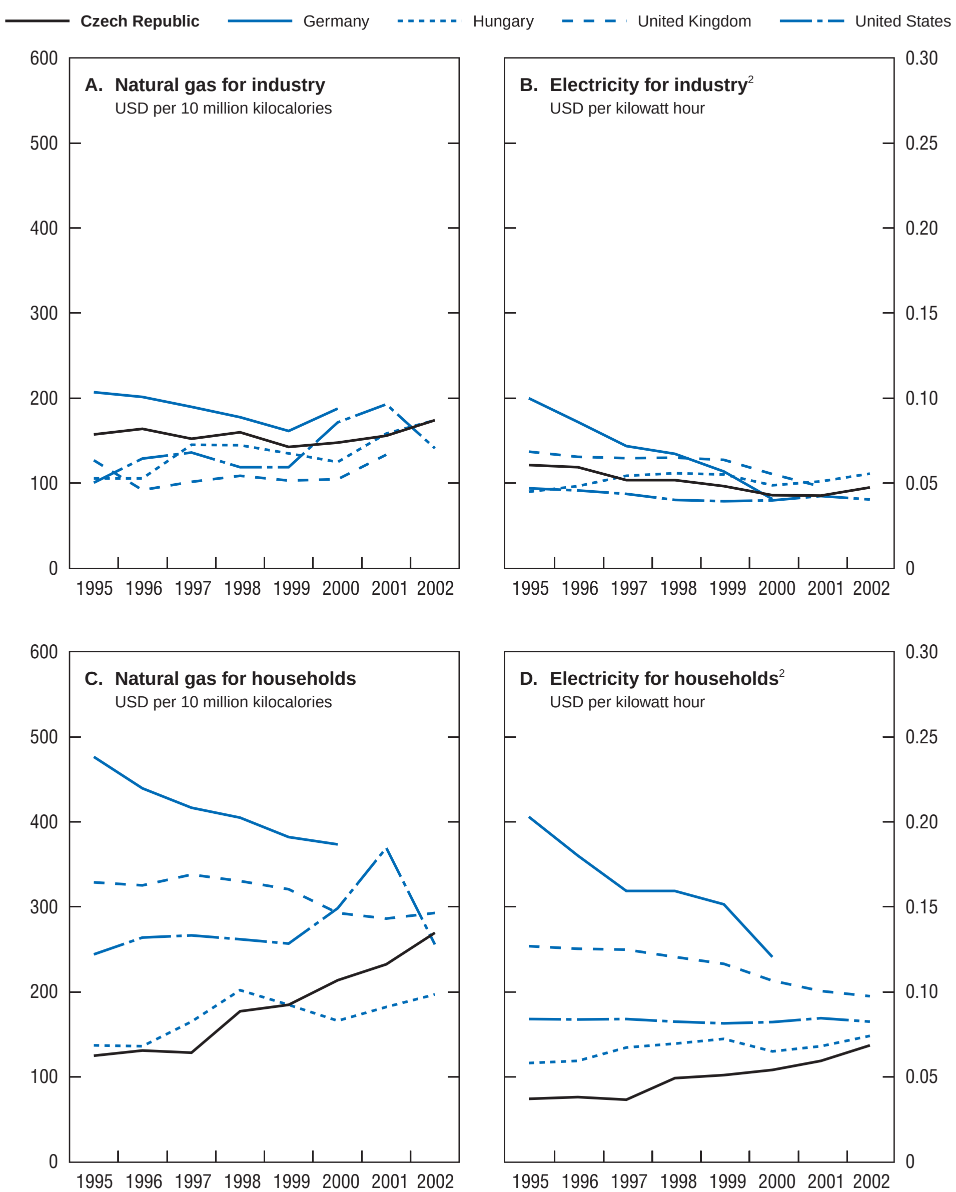
The government imposed vertical integration on the natural gas and electric power industries, despite the serious misgivings of the OECD and IEA. Having effectively restored an integrated gas industry in 2001, the government sold its controlling stakes in the transit firm *Transgas* and six regional distributors, as well as large minority stakes in the remaining two distributors to RWE of Germany, for € 4.1 billion. This created in effect a quasi-monopolistic, partially integrated utility with substantial market power. Further, a contract providing for a takeover of five regional power distributors by the dominant state-owned utility ČEZ (Czech Power Company) was signed in June 2002. At the same time, ČEZ sold two-thirds of the equity in its high-voltage transmission grid to the state.[110] This partial separation of the grid is welcome, providing that it is neutrally managed.[111] While the merger of Transgas with regional distributors was justified by the need to maximise privatisation revenues, the authorities argue that in the case of the power industry it is desirable to create a strong national champion that can effectively compete in the EU market. The competition bureau approved privatisation of the gas industry with minor modifications, forcing RWE to divest its stake in the largest gas storage facility. The competition bureau has expressed serious reservations about vertical integration in the power sector and launched an investigation that resulted in a decision in late December 2002, approving the takeover of regional power distributors mentioned above but specifying that the state-controlled power generator must sell its stakes in four out of eight regional power distributors within a year and to exit completely from the power grid corporation. Despite

Figure 29. **Internet access costs and hosts**
2001



1. Costs include VAT and discounted telephone useage tariffs and cover both peak and off-peak.
Source: Netsizer (*www.netsizer.com*); OECD.

Figure 30. **Energy prices**[1]



1. Data for 2002 are for the first quarter.
2. United States: Electricity prices exclude tax.
Source: IEA, *Energy, Prices and Taxes*, 2002.

this, the partially reintegrated Czech Power Company is likely to retain its dominant position, given its demonstrated ability to reduce wholesale prices that threatens independent power producers.

The vertical mergers described above threaten to reduce competition in the country's energy markets in spite of their gradual liberalisation. This would imply excessive prices for Czech business and residential customers in the longer term, despite some short-term cuts. In the gas market, such cuts reflect the time-delayed change in the decline of the world market oil prices and domestic coal prices[112] whereas in the electricity market, the dominant operator indicated that it could cut end-user prices comfortably by up to 10 per cent, providing that its take-over of regional distributors was approved by the competition bureau.[113] Nominal domestic prices are already at levels comparable to those of advanced OECD countries (Figure 30). Furthermore, the combination of comparable energy prices and much higher energy intensities (1.6 times above the IEA Europe average) results in relatively high energy bills, reducing the competitiveness. Unfortunately, energy efficiency has remained a low priority for the government despite the population and business needs (IEA, 2001). The Energy Efficiency Plan adopted in 1999 should be implemented with sufficient resources.

The electricity market opening has proceeded gradually, with the number of business customers eligible for competitive purchases increasing from 62 in 2001 to 300 in 2002. Preliminary data indicate that eligible firms enjoy a discount averaging 10 per cent of the regulated electricity prices. The market is to become fully open for both businesses and households in 2006. The opening of the natural gas market is scheduled to proceed at a much slower pace, with one-third of the market to be liberalised by 2006. In both gas and power industries, the pace of the market opening now seems to be dictated by the shifting EU minimum standards rather than by the need to improve the competitiveness of the Czech economy. The Energy Regulatory Office (ERO) remains weak, facing the same constraints as the telecom regulator that are described above. Nevertheless, the ERO imposed price adjustments in the first two years of its existence that eliminated cross-subsidies between customer types – industry and household – but not within each type; for instance, space heating continues to benefit from a substantial subsidy from another tariff category.[114] A more consequent realignment of the relative price structure would improve resource allocation.

Financial markets

The principal changes in financial market indicators are summarised in Table 22. Following the consolidation process of recent years, competition is expected to intensify in commercial banking, ultimately leading to better borrowing terms and services for firms of all sizes. A risk of another major banking crisis appears to be remote, given the new ownership structure (95 per cent of banking

Table 22. **Financial markets**

	1995	1996	1997	1998	1999	2000	2001	2002 (Q1 and Q2)
	Per cent							
Sector size								
Sectoral employment/total employment	1.9	1.9	2.0	2.1	2.1	2.1	2.2	2.0
Financial assets[1]/GDP[2]	128.8	124.2	128.8	120.7	121.3	125.2	115.9	114.1
Stock exchange capitalisation/GDP[3]	34.1	33.8	28.7	21.8	24.4	21.6	15.7	20.5
Structure of financial flows								
Credits to non-financial sector (per cent of total banking assets)[4]								
Short-term	16.6	17.6	15.9	13.8	12.8	10.4	8.3	7.7
Long-term	20.3	20.9	20.5	18.1	17.0	14.9	10.4	10.1
Internationalisation of markets								
Credits granted by foreign banks incl. branches[5]/total credits[1]	10.7	13.3	16.9	20.4	35.6	63.5	94.8	94.5
Forex credits/total credits[1]	13.4	15.4	20.5	22.4	23.5	21.8	19.4	15.8
Prague Stock Exchange Index[1]	5 April 1994 = 1 000							
PX-50	450	530	521	440	455	552	411	432

1. End of period data.
2. Ratio of total banking assets to GDP.
3. Stocks only.
4. Credits in CZK only, from 1999 all credits are included (Sector S11).
5. Banks with more than 50 per cent of foreign capital.

Source: Czech National Bank; Czech Statistical Office; Prague Stock Exchange; OECD *Labour Force Statistics*.

assets are now foreign owned) and the significant progress achieved in the area of banking supervision. All banks have maintained a solvency ratio above 8 per cent and most of them have improved profitability. The situation in capital markets is less promising. Following the tightening of supervision and the imposition of new minimum standards, the majority of firms had to be delisted, leaving hundreds of thousands of small shareholders with practically worthless paper. Not surprisingly, risk-averse investments in government bonds, pension funds and life insurance have become much more popular than investments in stocks.

Banking sector

Takeovers of large state-controlled commercial banks by Austrian, Belgian and French financial groups have resulted in a more prudential behaviour and subsequent credit tightening for domestically-owned firms. An improvement in the quality of commercial credits is clearly visible as the share of non-performing loans declined significantly (Table 23). Consumer credits, and especially subsidised mortgages have grown rapidly. The share of total long-term credits continued to rise (Table 22), despite the opposite trend in the non-financial corporate sector. However, dynamic non-financial firms, usually foreign-controlled, have enjoyed easy access to financing for a number of years, either from resident banks or cross-border capital flows comprising FDI, intercompany loans and direct lending by non-resident banks.[115] In contrast, private national firms have typically only limited access to outside finance. According to a recent survey of managers of such firms, about three-quarters of investment is now financed from retained earnings while the share of bank credits has fallen below one-fifth of the total.[116] As in all OECD countries, the majority of national firms are in the category of small and medium enterprises and thus unable to benefit from the generous investment incentives for large projects. In contrast to their counterparts in Hungary, Czech firms have to pay a steep tax on their profits, which increases the significance of outside finance.

The share of loans available to the non-financial business sector has declined in recent years while the household and government shares have increased significantly (Figure 31). While the rapid growth of consumer loans appears to be a natural development in a catching-up economy, the steep increase in the volume of loans to the government sector reflects an unhealthy rise of public debt. The associated crowding-out effect threatens to undermine investment growth unless the authorities pursue fiscal consolidation with more resolve than hitherto. Nevertheless, financing of the small and medium enterprises (SMEs) is likely to improve gradually as the recently privatised banks start competing with incumbents. The creation of a new loan registry, operated by the Central Bank, in the first half of 2002 is important in this respect because it should enable the banks to weed out poor credit risks much faster than before. Figure 31 shows that domestically-

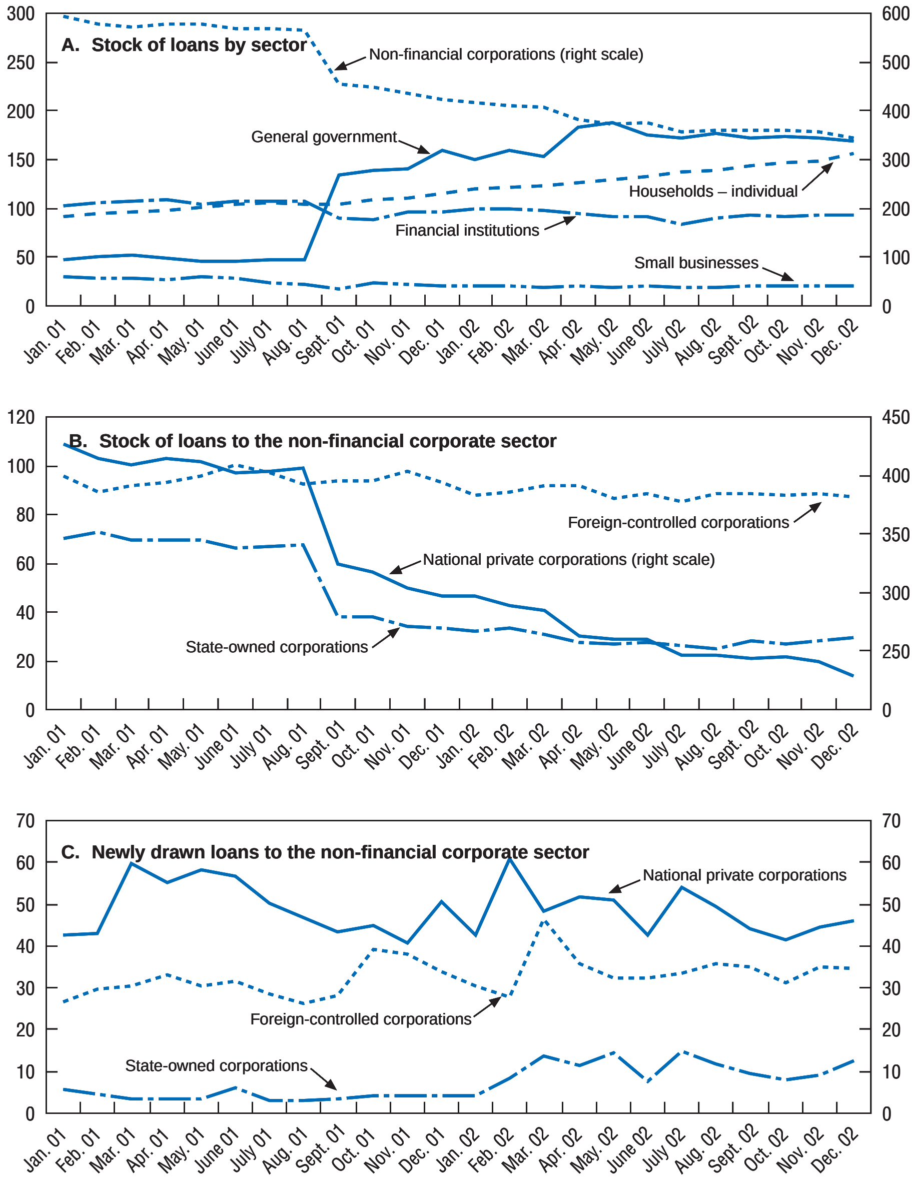
Table 23. **Banks: main indicators**[1]

	1994	1995	1996	1997	1998	1999	2000	2001	2002[4]
	CZK billion								
Total bank assets	1 215.9	1 469.8	1 704.2	1 949.0	2 046.4	2 110.8	2 255.3	2 500.3	2 512.4
Total bank credits (gross)	619.7	710.7	816.6	944.3	963.8	890.6	863.9	974.9	930.8
Total reserves and provisions		85.6	82.7	102.9	109.5	105.7	79.3	79.2	70.2
Bank profits[2]	5.6	10.1	12.3	–1.4	–7.2	–5.6	14.4	17.0	26.5
	CZK billion								
Composition of banks' assets	49.6	44.7	44.4	44.3	42.8	38.3	35.9	36.9	35.1
Total credits	11.2	11.0	10.1	4.9	4.9	7.6	10.0	11.9	12.8
Short-term securities	8.1	10.7	11.3	7.8	7.3	7.2	6.3	6.5	5.6
Securities in stock and for selling	0.4	0.7	0.5	2.9	2.8	2.7	7.2	6.5	6.6
Property participations and securities hold up to maturity	30.7	33.0	33.7	40.2	42.1	44.2	40.7	38.3	39.8
Other assets									
Distribution of credits by quality[2]									
Standard		67.0	71.9	73.3	73.6	67.9	70.2	78.5	82.8
Classified		33.0	28.1	26.7	26.4	32.1	29.8	21.5	17.2
Watch		7.3	6.7	6.2	6.0	10.2	9.9	7.8	7.6
Sub-standard		4.9	3.0	2.7	3.4	4.3	6.4	3.3	2.8
Doubtful		3.9	2.8	2.9	3.6	4.2	3.2	3.0	2.1
Loss		16.9	15.6	14.9	13.4	13.4	10.4	7.4	4.7
Distribution of credits by maturity[3]									
Short-term				42.0	41.3	38.6	36.5	33.9	28.4
Medium-term				24.2	23.1	23.5	21.3	21.6	24.3
Long-term				33.8	35.6	37.9	42.2	44.5	47.3
	Per cent								
Memorandum items:									
Total reserves and provisions/total assets		5.8	4.9	5.3	5.4	5.0	3.5	3.2	2.8
Total reserves and provisions/classified loans[2]		34.8	34.4	39.4	42.5	36.3	30.8	37.7	43.8
Loss loans/ classified loans[2]		51.2	55.5	55.8	50.5	41.6	34.8	34.2	27.3

1. Data are for the end of the year and concern banks with a valid licence as at 30 September 2002.
2. Without credit to Slovak collection unit.
3. Data concern banks with licence as of the end of given year and included CNB.
4. ata as of 30 September 2002.

Source: Czech National Bank.

Figure 31. **Bank loans to the non-financial business sector**
CZK million



Source: Czech National Bank (ARAD Database, *http://wdb.cnb.cz/cnbeng/docs/ARADY/HTML/index_en.htm*).

owned firms account for a falling proportion of bank credit to the non-financial sector. A state-aid financing scheme is available to SMEs but the amounts are relatively modest and unlikely to make much of a difference. Similarly, the amounts provided for SME financing by international financial institutions are low while the associated burden of paperwork exceeds the administrative capacity of most small businesses. Small firms benefit, however, from lax enforcement of various rules. In contrast to the small-business sector, the domestically owned medium-sized firms are in the most difficult position with respect to the financing of investment because they can hardly generate internal funds for investment by evading tax, environmental protection and labour-code statutes with impunity. Thus the best contribution to financing of viable medium-sized enterprises would be a cut in the corporate income tax rate from the current 31 per cent to the statutory levels obtaining in Hungary (18 per cent) or Ireland (12 per cent).

Although another major crisis in the banking sector appears to be unlikely, there are a few risks that deserve to be addressed by the authorities. *Union banka*, the last medium-sized bank owned by domestic interests and the associated financial group, appears to be the residual loss-making part of the Czech banking sector. Following *Union's* unsuccessful search for a strategic investor, it became a target for Invesmart, a little known Italian financial group; prudential regulators at the Czech National Bank (CNB) approved the takeover in late October 2002. The *Union's* new management subsequently started negotiations with the government, requesting a bailout.[117] Clearly, the financial situation of the *Union* group deserves to be closely monitored by the banking supervision department of the CNB.

The credit union sector remains another potential source of weakness, despite its recent consolidation and vastly improved supervision by the Credit Union Supervisory Authority reporting to the Finance Ministry. Nevertheless, the regulations pertaining to the creation and operation of credit unions remain too weak; the minimum capital required for a credit union is still only CZK 0.5 million (some $16 000) and should be strengthened significantly. The cabinet approved a legislative amendment in October 2002 that would increase the capital threshold 64 times to CZK 32 million ($1 million) but this welcome change has not yet been passed by Parliament. Even a capital increase to this still comparatively low level is likely to pose serious problems for some of the 47 credit unions that currently operate without restrictions.[118] Given the similarity of credit unions to banks, the recommendation of the last *Survey* to transfer the supervising responsibility to the CNB remains pertinent.

Capital markets and corporate governance

Some progress has been achieved in the key area of corporate governance. The Czech Securities Commission (KCP) produced its own corporate governance code based on the OECD principles in 2001 and recommended its adoption to all listed companies.[119] KCP expects that most of them will be able to implement the code fully within a few years. Given the significance of good corporate governance for stock-market listing and robust performance of firms, the authorities may want to encourage modern corporate governance practices faster, although there are limits to enlightenment by fiat. A recent Ernst & Young survey has revealed that a large majority of Czech managers are not even familiar with the term "corporate governance". The number of corporate titles traded on the Prague Stock Exchange (PSE) declined further as some blue chip firms delisted, following takeovers by strategic investors. Consequently, seven large issues represent about three-quarters of market capitalisation. The dearth of tradable shares and the increasing public debt has resulted in the exchange becoming mainly a trading facility for government bonds.

How important are takeovers or mergers in the restructuring process? The Czech corporate sector experienced a takeover wave in the mid-1990s in the wake of voucher privatisation,[120] most of the takeovers being extremely hostile and often involving criminal activities. The introduction of strict requirements for the issuers of securities in 2001 reduced considerably the number of isuues admitted to trading. 458 non-liquid share titles were delisted from the public market organiser RM-System and another 18 firms from the Prague Stock Exchange; further 360 issues were excluded due to companies' own decisions, mergers and liquidations. This process continued in the first half of 2002 when 16 titles were delisted from the Stock Exchange and another 155 titles from the RM-S system. A more productive takeover wave took place since the late 1990s as multinational corporations became attracted to the Czech economy. However, these takeovers also resulted in delistings as the new owners acquired practically all the stock in the firms targeted. Moreover, the restricted free float available for trading of the remaining issues at the stock exchange and the RM-System implies that there is only a limited scope for takeovers via the stock exchange. However, continued sales by the Consolidation Agency of debt owed by vulnerable firms may well result in a rapidly rising number of takeovers as opportunities for debt-equity swaps become widely available.

The Securities Commission has recently decided to utilise EU technical assistance funds from the Phare programme to enable its employees to improve their skills by training with experienced regulators in Western Europe. Four brokerage firms went bankrupt in 2001; in addition to their non-compliance with rules for risk and liquidity measurement and management, some criminal activities might have taken place.[121] Furthermore, the share of insider trading has declined but there are signs that it might have remained high relative to developed markets.[122] The strengthening of supervision, along with adoption and implementation of stricter reporting rules, should then support a gradual revival of the equity market. The Securities Commission should persist in its efforts to encourage new market listings and equity investments, helping overcome the disenchantment resulting from the earlier voucher privatisation. Some of the vulnerable firms may return to the stock market under new management and with renewed economic prospects. Public listing would enhance opportunities for investors, notably venture capital investors, to recoup and recycle their placements.

Labour markets

Rising employment, falling unemployment, stable labour force

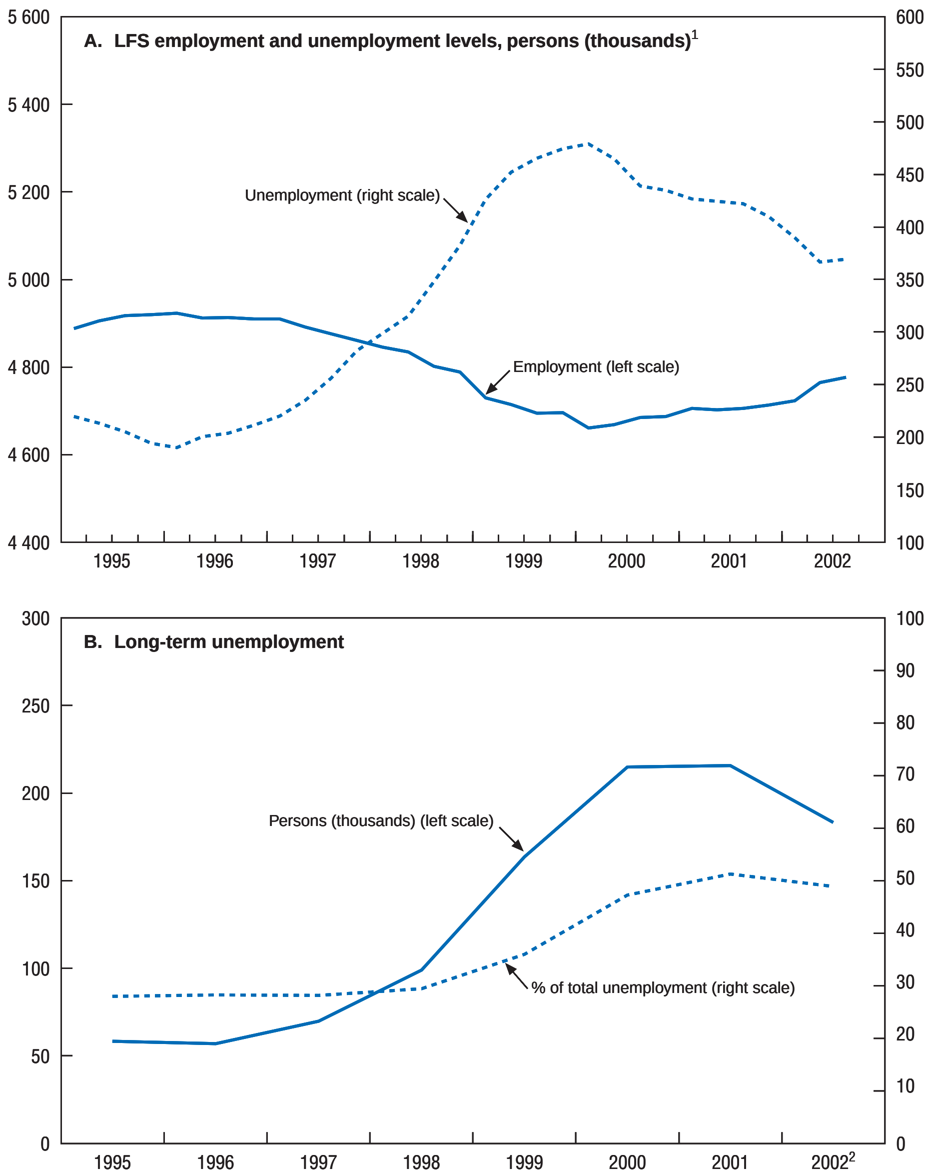
What have been the principal labour market developments since the last *Survey*? Quarterly labour force *surveys* (LFS) indicate that employment has risen since 2000 while involuntary unemployment declined. The labour force kept declining until 2001 and appears to have risen slightly in 2002. These changes are documented in Figure 32 which also shows that *registered* unemployment has increased considerably since the second half of 2001, probably as a result of ongoing layoffs associated with industrial restructuring and the tightening of early-retirement benefits that may well have pushed a group of elderly registered unemployed into the ranks of welfare recipients.[123] Concurrently, the *involuntary* long-term unemployment measured by the LFS declined. Dependent employment measured by the LFS was stagnant in 2002 while self-employment increased strongly. Registered employment data for the first half of 2002 indicate that dependent employment in firms with 20 or more employees declined by 1½ per cent in the business sector while growing by ½ per cent in the non-business sector. Within the business sector, employment of workers in the FDI segment increased as a result of privatisation and superior profitability of FDI firms.

School leavers who enter the labour market for the first time experience the highest unemployment rates (Panel A, Figure 33). As in other countries, unemployment is inversely proportional to the level of educational achievement. The unemployment rate of the least-educated group with primary or incomplete education rose sharply in the wake of industrial restructuring and stayed close to 20 per cent in recent years (Panel B). High unemployment exceeding 10 per cent remains a serious problem in two regions dominated by declining industries, mining (north-western Bohemia) and metallurgy (Moravia-Silesia). The third and fourth highest regional unemployment rates obtain in central Moravia and south-eastern Bohemia where traditional manufacturing and farming industries went through a considerable downsizing in recent years. The remaining four regions appear to be close to full employment (Panel C). The required labour market policy responses entail both labour supply and labour demand stimulating measures.

Labour-supply issues

Although labour force participation remains high, the welfare benefit system and the high tax wedge on employment income weaken work incentives. In

Figure 32. **Employment and unemployment levels and rates**

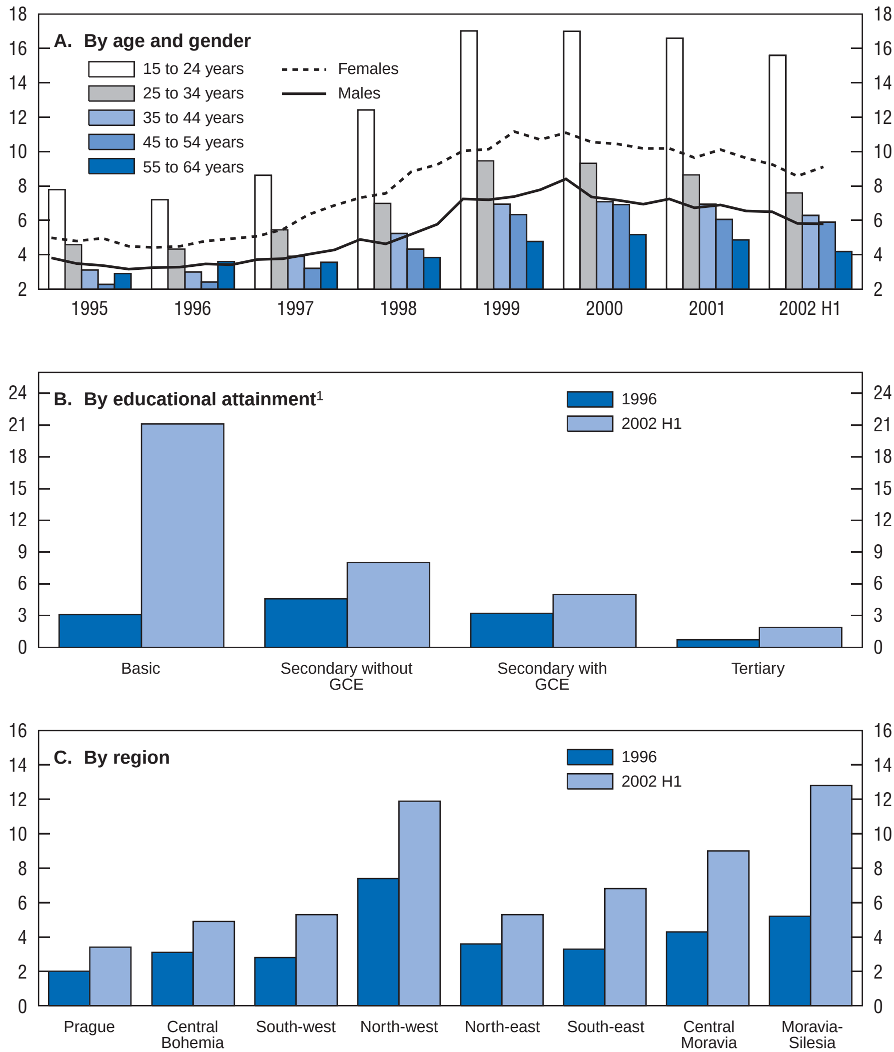


1. Seasonally adjusted by the OECD.
2. Q3.

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

Figure 33. **Unemployment rates by age, gender, education and region**

Per cent



1. According to ISCED 97. "Basic" corresponds to primary and lower secondary education (completed usually by 9th form).
2. "Secondary without GCE" corresponds to lower secondary vocational education taking at most 3 years and providing leavers with no certificate for the labour market as well as postsecondary study not included in tertiary education.
3. "Secondary with GCE" corresponds to general or technical secondary education with a leaving certificate based on final examination.
4. "Tertiary" refers to education in colleges and universities leading to bachelor, master and scientific degrees.

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

response to weak work incentives, the authorities have initiated a number of policy responses. First, the government tried to improve the employability of displaced workers by further integrating training grants into FDI incentive schemes while relying less on traditional active labour market policies where participant inflows decreased (Table 24). Second, new pension-benefit rules introduced in July 2001 made early retirement less attractive by imposing stricter actuarial adjustments.[124] Whereas early-retirement benefits (the main reason for growth in the non-active population) accounted for 58 per cent of new retirement pensions in 2001, their share declined significantly to 32 per cent in the first half of 2002, with the overall number of recipients stabilising and expected to fall in future years. Third, the government kept increasing the minimum wage, arguing that this would improve the incentives to work. Fourth, the government has frozen the nominal level of the basic cash-welfare benefit (known as the minimum-living standard or MLS) since October 2001, reducing its attractiveness in real terms. Fifth, the Minister of Labour announced a reform that would cut-off access to unemployment and welfare benefits for school leavers without any previous work experience; this group accounts for some 11 per cent of the unemployed. The contemplated reform is based on the idea that the money saved on such benefits would be better utilised for the creation of subsidised jobs.[125]

Have the new labour-supply incentives been effective? Although inflows of pensioners in pre-retirement age declined, they still remain significant, suggesting that early-retirement benefits may still be too attractive. The authorities might want to consider increasing the adjustment factors again. The significant

Table 24. **Benefit recipients by income support scheme**[1]

	1998	1999	2000	2001	2002
	Per cent of working-age population				
Unemployment insurance	2.1	2.7	2.5	2.2	2.6
Disability	7.4	7.4	7.4	7.4	7.6
Full	5.5	5.3	5.3	5.2	5.2
Partial	2.0	2.0	2.1	2.2	2.3
Early retirement	1.2	1.8	2.5	3.0	3.1
Permanently reduced benefit	0.9	1.6	2.2	2.8	2.9
Temporarily reduced benefit	0.2	0.2	0.3	0.2	0.2
Active labour market programmes[2]	0.7	0.9	1.3	1.2	0.8
Total	11.4	12.8	13.6	13.8	14.1

1. Individuals in receipt of social assistance benefits are not included.
2. Participant inflows in public employment services, training, measures for youth and the disabled and subsidised employment.

Source: Ministry of Labour and Social Affairs; Czech Statistical Office; OECD.

increase in the number of light disability benefit recipients in 2002 suggests that some older workers have used disability pensions as an alternative to early retirement (Table 24). A tightening or a stricter interpretation of the existing access rules should be implemented. Rising numbers of registered unemployed who are not actively looking for work imply that a growing group of the older workers displaced by industrial restructuring choose welfare benefits over early-retirement benefits. Replacement rates for the long-term unemployed with children have been well above the respective OECD averages in 2001, the latest year available for comparisons (Table 25). In contrast, the unemployment benefit that is limited to six months does not appear to be excessive. The minimum-living-standard (MLS) benefit for adults remains too close to the minimum wage level, discouraging job search by the low-skilled registered unemployed (Table 26).[126] To liberate marginal workers from this unemployment trap, it would be more meaningful to transform MLS payments for single adults and non-child raising adults into in-work benefits. In case of single parents with children, duration of MLS benefits ought to be limited by compulsory schooling. Subsequently, the MLS benefit should be transformed into the in-work benefit applicable to single adults. Although the current legislation entails strict penalties for the abuse of welfare benefits by the registered unemployed not searching for work, it has never been effectively enforced. Thus the widespread abuse of benefits goes hand in hand with employment of illegal workers, mainly from Ukraine, in agriculture, construction and other activities considered undesirable by the Czech unemployed. There are reportedly some 100 000 illegal workers (about 2 per cent of the domestic labour force).[127] The lax enforcement of legislation outlawing such employment helps the smaller, predominantly Czech-owned firms active in these industries to function; however, this "greasing of the wheels" of the labour market constitutes at most a second-best solution. A realignment of welfare benefits that would improve the work incentives of the unemployed able-bodied residents would be a better alternative.[128]

Unsuccessful job-seekers continue to be hampered by their low mobility, lack of relevant skills and, if they happen to be Roma, prejudice on the part of employers (Vecernik, 2001b). Low mobility results from over-regulation of the residential housing market that keeps rents at artificially low levels and precludes an effective enforcement of property rights. Not surprisingly, the supply of new residential housing units has remained extremely low while the number of empty apartments has increased; moreover, the regulated rents are so low that they do not even permit proper maintenance of housing estates.[129] Owners of flats are scared to rent to prospective Czech tenants who are excessively protected. For instance, in the event of a breach of contract, no eviction can take place until the landlord finds a substitute rent-controlled apartment for the tenant. Moreover, the tenant has the right to refuse such alternative accommodation on spurious grounds. Therefore, landlords generally prefer foreign tenants from Western coun-

Table 25. **Net replacement rates of the unemployed**[1]

	First month of benefit receipt				60th month of benefit receipt			
	Single		Couple 2 children		Single		Couple 2 children	
	APW	⅔ APW	APW	⅔ APW	APW	⅔ APW	APW	⅔ APW
Australia	33	45	62	77	33	45	62	77
Austria	60	61	76	82	55	58	72	78
Belgium	64	85	64	79	45	60	68	84
Canada	62	62	91	97	24	35	62	81
Czech Republic	**49**	**66**	**70**	**70**	**37**	**54**	**80**	**100**
Denmark	63	89	73	95	60	85	80	102
Finland	65	79	83	88	53	73	89	100
France	71	78	72	82	30	43	42	59
Germany	60	67	70	75	54	63	65	71
Greece	47	48	44	46	8	8	10	11
Hungary	48	65	60	75	28	28	38	39
Iceland	55	74	66	79	50	68	87	104
Ireland	31	42	57	67	31	41	56	66
Italy	42	39	53	49	0	0	18	21
Japan	67	82	64	77	33	49	68	87
Korea	55	54	54	54	6	9	18	27
Luxembourg	82	82	87	88	50	70	75	93
Netherlands	82	88	89	85	60	74	71	85
New Zealand	39	57	68	87	39	57	68	87
Norway	66	65	74	82	43	53	62	83
Poland	36	53	46	58	33	48	74	93
Portugal	79	88	79	87	49	70	63	87
Slovak Republic	79	77	78	77	38	54	80	100
Spain	74	76	73	76	23	32	39	57
Sweden	71	82	78	90	54	79	85	110
Switzerland	81	91	91	92	54	78	75	100
United Kingdom	46	66	49	54	46	66	80	88
United States	58	59	57	49	7	10	46	59
Average	59	69	69	76	37	50	62	77

1. After tax and including unemployment benefits, family and housing benefits. Replacement rates are calculated with respect to the average wage of a production worker (APW) and two-thirds this wage. Refer to source for details of measurement differences across countries.

Source: OECD, *Benefits and Wages* 2002 Edition, Tables 3.2, 3.5.

tries who can afford to pay higher rents and appear to be protected less zealously. In addition to its pernicious effect on labour mobility, rent control has been abused by debtors.[130] According to a recent estimate, a deregulated housing rental market would increase employment significantly by enabling the unemployed in disadvantaged areas to get jobs in more prosperous regions.[131] Such detrimental effects underline the need to strengthen property rights if the Czech economy is to become a well functioning market system. The solution to the other two problems facing the unemployed that are willing and able to work is less

Table 26. **The minimum living standard and the minimum wage**

	Minimum living standard (CZK per month) October 2001				
	Adult	Age of child			
		0 to 6	6 to 10	10 to 15	15 to 26
Personal needs (food, clothes and essential goods)	2 320	1 690	1 890	2 230	2 450
		Size of household			
		1	2	3 to 4	5 plus
Household needs (shelter, heating and basic appliances)		1 780	2 320	2 880	3 230

	Minimum living standard as per cent of 2003 wages:		
	Minimum wage	⅔ average production worker wage	Average production worker wage
Single adult	66	37	25
Couple, 1 child (aged 0 to 6)	149	83	56
Couple, 2 children (aged 0 to 6)	176	98	66
Couple, 3 children (aged 0 to 6)	209	116	78
Couple, 4 children (aged 0 to 6)	236	132	88
Memorandum items:			
Minimum monthly wage, CZK, January 2003	6 200		
Average production worker monthly earnings, CZK, estimate for year 2003	16 588		

Source: Ministry of Labour and Social Affairs; OECD.

straightforward. The value of retraining without mobility appears to be questionable – in the chronically high-unemployment regions with extremely low vacancies, it is unclear what kind of skills ought to be provided by training. With respect to the Roma, the authorities continue to implement a special affirmative programme in public education (see the following section). According to the authorities, some affirmative measures pertaining to retraining and awarding of public contracts have been made available to the working-age Roma population that is characterised by an exceptionally low labour force participation; however, there is no evidence documenting outcomes of such measures. The authorities are encouraged to address this problem more systematically by evaluating and improving targeted programmes aiming to improve the employability and reducing the welfare dependence of members of this ethnic community representing some 3 per cent of the population.

Labour-demand issues

Demand for labour is hampered by the inability of employers to hire workers on a flexible basis and excessive job protection measures, including the prohibition of firing employees who are on sick leave. An extraordinarily generous sickness benefit scheme, with practically unlimited access and allowing for payments even for weekend days, has become very attractive to low paid workers and employees who expect to be laid off.[132] The abuse of the scheme is widespread – the average incidence of sickness in the workplace increased gradually between 1993 and 2001 from 5¼ to 6¾ per cent of employed workers, and the number of working days lost per worker jumped to 25 per annum.[133] Medium-sized and large firms respond by hiring more labour than required by production technology or by offering additional bonuses (14th and sometimes 15th monthly salary) to "healthy" employees. These practices increase the effective cost of labour, resulting in poorer competitiveness and lower employment in the longer run. A number of small businesses allegedly misuse the scheme by "encouraging" their employees to book sick during periods of slow demand. In this case, social costs of production exceed private costs, a situation leading to resource misallocation and unnecessary public spending.

The previous *Survey* noted that provisions of the 2001 Labour Code concerning notification and compensation of employees are too onerous, contributing to a higher cost of firing. The experience of other OECD countries indicates that high institutional obstacles to firing significantly reduce the chances of workers to be hired and obstruct adoption of modern production techniques (Scarpetta and Tressel, 2002). Therefore, the authorities ought to reform the counterproductive sick leave and notification provisions. A more fundamental change is needed in the basic framework governing employment contracts, moving the Czech practice away from the cumbersome fully binding sectoral framework agreements toward much more flexible agreements between employers and employees on an individual or plant basis. In recent years, the government extended such agreements to non-unionised firms in construction, engineering, textiles and other industries, limiting relative wage flexibility that is essential for a better allocation of labour resources and, ultimately, increasing unemployment.[134] Furthermore, if the authorities intend to preserve high employment rates, then an employment-friendly legal framework encouraging part-time and temporary work practices should be adopted.

Demand for labour is also curtailed by the labour-cost increasing social-security charges that are highest in the OECD as a proportion of tax revenues. Especially low-skilled workers are likely to be priced out of the labour market by such statutory provisions.[135] To stimulate increased employment and promote competitiveness of the economy, the authorities should reduce significantly social-security charges paid by employers. In particular, the employer-paid charges on low wages should be cut to in order to increase demand for this type of labour. Further, the government SME programmes promoting entrepreneurship and business start-ups ought to be complemented by a simplification of the complicated tax system and cumbersome regulation of entry that remains more complicated, time consuming and costly than in many OECD countries.

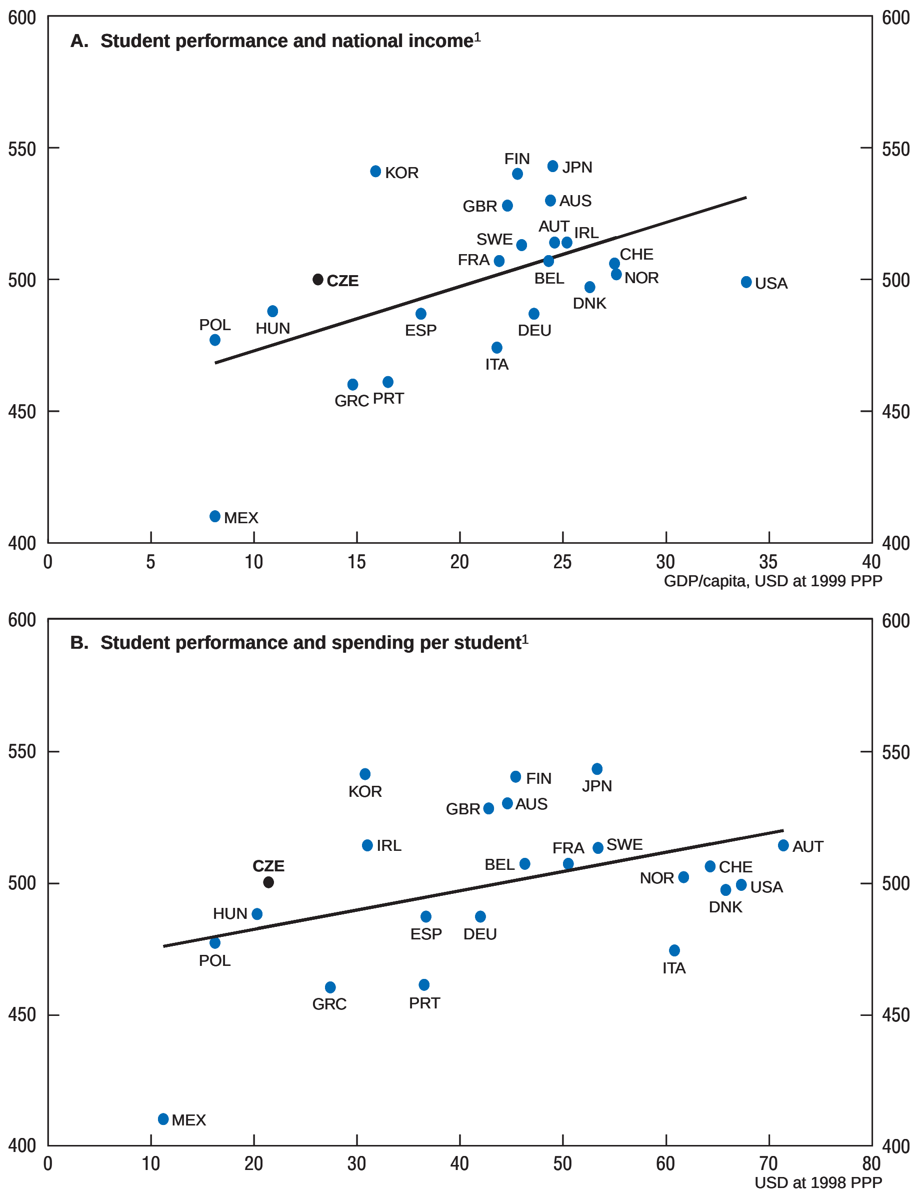
Education and training

Recent OECD research in the Programme for International Student Assessment (PISA)[136] revealed that the overall literacy performance of Czech 15-year old pupils is close to the average of member countries, with some variation across the key indicators (literary – below average; mathematical – average; and scientific – above average). The outcomes are better than expectations based on the per capita national income or per student spending levels (Figure 34) and indicate the availability of human capital suitable for economic modernisation. However, the performance of Czech students is less stellar than in earlier, more traditional tests.

The OECD study mentioned above indicates that in both the Czech Republic and Hungary, literacy could be considerably improved by mitigating the adverse impact of low socio-economic status on student performance. In both countries, low status is strongly correlated with ethnicity. This suggests an effective way of speeding up the formation of human capital by investing more in special programmes targeting the Roma minority. The alternative would be to ignore the issue and thus create a growing underclass of unemployable population.[137] Czech authorities have allocated more funds and teaching assistants to special programmes targeting Roma pupils in the public school system in recent years but no evaluation of outcomes is available yet.

Another labour-market issue is defined by the low number of places available at market-oriented colleges awarding BA and BSc degrees.[138] One important obstacle to the expansion of post-secondary education is posed by the free access principle that largely limits supply to publicly funded services and results in strict limits on enrolment. Given the considerable returns to education, the economic logic of providing free post-secondary schooling is far from obvious. Equity objectives can be pursued by a competitive scholarship programme and a student-loan scheme ought to be considered. However, colleges and universities should be able to charge cost-recovery tuition fees while eliminating barriers to enrolment as far as possible. Further, a standardisation of the secondary school-leaving exams would permit a straightforward assessment of applicants for admission; it would also provide employers with meaningful information about the skills of prospective employees. A new draft School Act, including provisions for such standardisation, is to be submitted to Parliament in the first half of 2003 but it remains unclear whether and when it will be adopted.

Figure 34. **A comparison of education outcomes**



1. Performance is the average of mean scores on the reading, scientific and mathematical literacy scales. Spending per student is cumulative expenditure on educational institutions for the student up to age 15 years.

Source: OECD Programme for International Student Assessment (PISA) 2000.

The actual ability of their population to speak English and German effectively enables the transition economies of Eastern Europe to compete for foreign direct investment. While the proportion of Czech students enrolled in secondary schools who study at least one foreign language is impressive and the percentage of working-age population who are able to speak English or German fluently compares favourably with Hungary and Poland, the foreign-language competence still lags considerably EU member countries such as Finland or the Netherlands. A major disadvantage of the Czech public school system is that it cannot attract and retain competent teachers of Western languages. While there are no easy solutions, the authorities should provide for a greater differentiation of teacher pay on the basis of demand and performance than hitherto.[139] It will be also necessary to reduce over-employment in the primary school system. Since 1999, the intake of new pupils has been decreasing by 20 000 six-year old children per annum while the number of teachers has declined by only 100 persons, or just about 10 per cent of the decline that would have left the student-teacher ratio unchanged.

Public sector

Earlier sections of this chapter have shown how government policies have striven to improve the environment for doing business by modernising key commercial legislation, attracting strong FDI inflows through privatisation and investment incentives, opening telecommunication and energy markets, stabilising the financial system, maintaining good standards of education and providing a comprehensive social-safety net. The improved health outcomes described in the previous chapter contribute to enhanced capacity to work. However, all these important results of government activity come at a high price reflected in the considerable tax burden that impacts negatively on the nation's economic efficiency and discourages employment of labour. Moreover, the discussion of fiscal issues in Chapter II shows that this burden is likely to remain heavy in the medium term in the absence of radical changes to spending policies. This section discusses briefly the public administration reform, then examines efforts of the authorities to cope with infrastructure bottlenecks and closes with some taxation issues.

Public administration reform

The new Civil Service Act, adopted in 2002, has created conditions for impartial state administration since it limits political appointments to the deputy ministerial level and above and establishes a set of new financial incentives and performance criteria for professional administrators. Moreover, an Institute of Public Administration has been established in the Government's Office to ensure training and education of competent civil servants. While these changes are generally positive and desirable, there appear to be some shortcomings. Provisions of the new legislation should cover some 75 000 officials, *i.e.* about 40 per cent of employees in the public administration. The implementation of a new salary classification and incentives scheme, postponed for the time being, is estimated to cause additional costs to the state budget of CZK 7 billion per annum; it is worrisome that the authorities expect no savings from increased efficiency that should result in significant employment cuts in the overstaffed public administration.[140] An earlier section of this chapter signalled a concern with possible regulatory capture and recommended that the staff of the agencies regulating network industries should not fall within the scope of civil service legislation so that they can attract top talent while paying competitive salaries. The government chose to subject regulatory agencies to the new civil service pay scales; it remains unclear whether this is sufficient to deal with the financial incentive problems specific to these agencies.

Infrastructure development

Despite significant allocations of public funding, infrastructure development has continued to be impeded by the absence of cost-benefit analyses in the selection of priorities and the rare use of transparent tenders. Another difficulty results from the heterogeneous nature of financing of public expenditures on road infrastructure. The Ministry of Transport and Communications (MTC) is responsible for the planning of transport infrastructure development while the extra-budgetary State Fund of Transport Infrastructure (SFTI) disburses funding for the development and maintenance of roads and railways.[141] As its main revenue source consists of privatisation proceeds,[142] once the privatisation process is completed the SFTI will lack sufficient financing to meet its predominately long-term investment liabilities. These considerations imply that SFTI ought to be reabsorbed by the state budget and public infrastructure financed from general tax revenues.

In recent years, the authorities emphasised new investment to develop trans-European network (TEN) corridors. Given the share of public infrastructure expenditure in GDP, which has fluctuated since 1994 at between 3 and 3½ per cent, the emphasis on new development resulted in poor maintenance (World Bank, 2001). Furthermore, the priority TEN corridors have been chosen in the mid-1990s, *i.e.* before industrial restructuring created large pockets of high and persistent regional unemployment (see Box 13). The government decided in the late 1990s to overcome the problem with the aid of a new type of privately arranged project financing rather than by changing its spending priorities. The subsequent paralysis of decision making and the apparent non-viability of concession-based financing in high-unemployment areas imply that it would be more effective to eliminate acute infrastructure bottlenecks with the aid of public financing while reducing costs through open non-discriminatory tenders.[143]

Box 13. Infrastructure investment issues

Roads

The central government has the administrative responsibility for developing and maintaining major motorways (500 km) and national highways (5 500 km). According to a recent report of the Auditor General (NKU),* 8½ per cent of these priority roads are in extremely poor shape (4½ per cent in 1998). Regional governments are responsible for secondary highways (15 000 km) and local roads (34 000 km). According to the same NKU report, 15½ per cent of the regionally administered network is in extremely poor state. Moreover, MTC has not prepared any integrated programme for reconstruction, modernisation and repair works of the motorways and highways network, which would specify priorities, terms or financial conditions. In addition, existing sub-programmes are often managed poorly and provisions of the Act on Public Tenders routinely violated, which results in wasteful allocation of available resources. *Ex-post* cost analyses performed by NKU show that on average 12 per cent of programme expenditure is unnecessary because cost-minimising procedures are neither encouraged nor monitored by MTC.

Another problem is posed by two regions with extremely high unemployment (north-eastern Bohemia and Moravia-Silesia) that fail to attract sufficient FDI inflows due to poor road access. As a partial solution to this problem, the previous government decided in 1998 to prioritise a new motorway project (D47, 80 km) with the aid of private project financing. Nevertheless, this well-intentioned project has become quite controversial. It was approved hastily without any detailed legal and economic analyses and without a public tender. The chosen foreign company (Housing & Construction, an Israeli firm) agreed to build and then operate the D47 motorway for 25 years and transfer it to the state afterwards. During this period, the state should pay an annual toll fee of CZK 3-6 billion. Total costs should not exceed CZK 120-125 billion, including interest payments on €-denominated bonds to be issued by Housing & Construction. According to independent experts, the cost per km will be three times higher than that of a typical motorway financed with public funds. Repeated delays that are associated with interpretations of relevant contracts and the current government's attempts to renegotiate some provisions, imply that if the project proceeds, construction will start only in 2007 and be completed in 2009. To date, the government released no cost-benefit analysis showing that the construction of the D47 motorway would relieve the road access problem better than cheaper alternatives such as a completion of a missing section of the R35 highway that would also significantly improve the road connection between Ostrava and Germany.

Railways

Delayed restructuring of the railway services resulted in a continuous drain on the state budget, averaging about 1½ per cent of GDP per annum. Although employment was reduced over the 1990s, it remains excessively high in the estimation of the state-owned dominant operator, Czech Railways (CD). Despite the

Box 13. **Infrastructure investment issues** (*cont.*)

separation in January 2003 of CD into a state-owned corporation providing passenger and freight services and an infrastructure state agency, no major rationalisation of the services is anticipated. Construction of new TEN corridors takes precedence over maintenance, resulting in a large maintenance backlog (World Bank, 2001).

A recent Auditor General's report (2001/25) on the use of the funds approved for modernisation of strategic railway corridors indicates similar drawbacks as in the case of road construction and maintenance. These shortcomings include poor project management of existing programmes, inappropriate target setting and uneconomical use of financial resources. Furthermore, it is pointed out that the Czech Railways had an inappropriate influence on the government's decision making. Lack of sufficient programme preparation and documentation, mismanagement and inadequate ex-post control of CD activities resulted in unnecessary cost overruns.

Other NKU reports indicate wasteful investment spending in other sectors as well, such as healthcare and regional development. Violations of public procurement legislation appear to have been massive. Administrative competence of line ministries (Transport, Industry and Trade, Health, etc.) appears to be very poor. The Finance Ministry is often powerless. For instance, an NKU report on support programmes for the Ostrava region states that 99 per cent of the funds were used inappropriately. The Ministry of Industry and Trade ignored Treasury warnings, continuing to disburse programme funds. Management of public finances appears to be still weak and bereft of adequate long term planing, programme assessment (cost–benefit analyses) and continuos control. Public investment funding is provided without sufficient financial analyses and overall programme integrity.

* This report was published on the Auditor General's website (*www.nku.cz*).

Heavy tax burden

The central government's failure to initiate expenditure reform throughout the public sector threatens to prolong the heavy tax burden for many years. The new government aims to stabilise the tax quota (including social-security contributions) at the relatively high level of year 2000 (39 per cent of GDP) and keep it fixed until 2006.[144] The statutory corporate income tax rate of 31 per cent is somewhat below the OECD average but well above the levels in countries such as Hungary (18 per cent) and Ireland (12 per cent) which have continued to modernise their economies with the aid of strong FDI inflows. High taxation of profits penalises national SMEs that, unlike larger foreign affiliates, do not qualify for the generous tax incentives described above. Heavy social security taxes, with the highest share of GDP among the OECD countries, increase total labour costs considerably, contributing to unemployment. The apparent direct relationship between high labour taxes and high unemployment rates in EU countries suggests that the Czech authorities should address the high level of social-security contributions, cutting in particular those paid by employers. At the same time, the planned changes in the VAT rates and increases of excise taxes on tobacco products and alcohol beverages are unlikely to increase revenues sufficiently to compensate for significant reductions of taxes on capital and labour; this underlines the need for consolidation of public spending.[145]

The personal income-tax administration is still based on deductions by employers and only the self-employed and those with more than one source of income file individual returns. An introduction of mandatory individual tax returns, processed rapidly by a computerised system, would be beneficial. It would permit the authorities to rationalise the complex system of social benefits. Furthermore, this reform should be complemented by a cost-reducing transfer of responsibility for the collection of contributions from the social-security administration to the tax authority, creating a unified revenue agency. Tax collection costs are excessively high, amounting to approximately 2½ per cent of tax revenue, probably the highest in the OECD area. The fact that costs associated with the tax collection exceed the revenue from property taxes illustrates this inefficiency and points to the need for action.

Notes

1. As a result of the corporate governance shortcomings of the unconventional privatisation and banking strategies, such as voucher privatisation and government-controlled banking ("banking socialism").
2. Inventory movements in national accounts also include an error term.
3. According to available estimates, the trend growth rate of the economy is currently around 4 per cent in Hungary, 3½ per cent in Poland and only 2¾ per cent in the Czech Republic.
4. The recently completed OECD research project on the sources of long-term growth found that the real increase in capital stock has been the single most important source of growth in OECD economies in the past decades (OECD, 2002a). The Czech economy has already an incremental capital stock/GDP ratio higher than in most other countries; however, this includes large portions of capital of undetermined economic value. Massive suboptimal capital allocation in the 1990s, both as reinvested earnings within firms subject to loose corporate governance, and investment projects financed by loans granted by state-controlled institutions outside conventional banking disciplines, helped build-up largely irrelevant capital stocks. The estimation of their share in the total capital stock is impossible but may represent a lion's share of investment effected in the 1990s.
5. The problem is less acute in the financial services industry where foreign banks already control over 95 per cent of assets. The weight of FDI firms in manufacturing has increased less rapidly but is nevertheless impressive in OECD standards; they account for about one-third of employment, one-half of sales and two-thirds of exports. However, the unfinished restructuring within the nationally controlled manufacturing subsector is large and keeps reducing the aggregate productivity level significantly (see Annex IV).
6. According to the current legislation, able-bodied welfare recipients ought to look actively for work but authorities have been unable to enforce this provision effectively.
7. These features of the labour market institutions are described and analysed in more detail in Chapter IV.
8. The unemployment rates in these four regions in the first half of 2002 were respectively 3.4 and 4.9 per cent in Prague and the surrounding area and 5.3 per cent in south-western and north-eastern Bohemia.
9. See Czech Republic Today, Intellinews, 18 July 2002.
10. Those unemployed for more than one year represent 50 per cent of the total unemployed population which is high in international comparison. A group of older job seekers that were unsuccessful in finding employment for more than four years

account for 12 per cent of involuntary unemployment. These high proportions of the long-term unemployed suggest that the skills and/or location of a sizeable portion of the unemployed need to be upgraded, if they were to be given a chance of finding jobs at present labour cost levels. In contrast, the participation of persons over 30 years in the formal education system remains close to nil, while retraining courses are dominated by the employed. See Chapter IV.

11. Structural unemployment estimates are in the neighbourhood of 7 per cent. The OECD medium-term projections use a non-accelerating inflation rate of unemployment (NAIRU) of 6.8 per cent for the Czech economy. Assertive reforms in labour markets, notably labour tax cuts re-activating the demand for low-skilled labour, and regional reforms making high unemployment areas better accessible to outside investment and facilitating outward labour mobility, would lead many unemployed to move back to effective labour reserves. The Czech Republic has already improved the accessibility of many of its lower employment regions to foreign direct investment and needs to carry on these efforts. Effective training policies on a larger scale would also help (see Chapter IV).

12. Approximately from $190 to $210 – *e.g.* within the range of minimum wages in Poland and Hungary.

13. According to press reports, the Minister of Industry and Trade had advocated a more limited increase of 3.5 per cent, employers wanted no change while trade unions had demanded a 15 per cent hike.

14. Vulnerable jobs refer to employment in loss-making firms. Due to lack of statistical data on employment in the entire population of such firms, vulnerable employment is approximated by the number of jobs in larger loss-making industrial firms employing more than 100 workers. They account for some 7 per cent of dependent employment in the Czech Republic. For more details, see Chapter IV.

15. According to the latest Dun & Bradstreet credit rating survey completed in October 2002, the number of perfectly creditworthy (Category 1) enterprises in the total population of 4 987 rose to 422 (8.5 per cent, a jump doubling their share compared to May) while at the same time those "in jeopardy" (Category 4) also increased to 350 (6.9 per cent, also almost doubling from May). According to past records, 74 per cent of these vulnerable firms are expected to stop activities in 2003.

16. At present centrally-bargained wage guidelines are re-negotiated and implemented at enterprise level.

17. In earlier accession countries such as Greece and Portugal these EU transfers represented up to 4 per cent of GDP in certain years. However, full utilisation of these funds requires domestic participation in the funding of projects, which may be constrained by fiscal strains (see Chapter II).

18. This would happen because a second-tier of workers with below average human capital is made economically productive.

19. FDI and its positive consequences for the Czech supply structure also play a role.

20. As most of the required catch-up in regulated prices due to better cost-recovery is already completed in the Czech Republic – notably in energy and telecommunications – there is limited "repressed" inflationary pressures in this section of the consumer basket, as a difference from other countries in the region. Future pressures are nevertheless expected in pharmaceutical and housing prices (see Chapters III and IV).

21. This safeguard did not need to be exerted to date.

22. See Kovacs (2003).
23. Given some legal aspects of the second requirement of the agreement, which were refined in May 2002, the obligation of the collection of 20 per cent of all privatisation proceeds started to be enforced only from June 2002 (after the Transgas privatisation). In other words, only the conversion part of the agreement has been implemented in 2002.
24. By the end of 2002, this agreement was actually implemented only as regards the conversion channel (*i.e.* off-market, bi-lateral transactions) while the bulk of the privatisation receipts were actually converted, the government paying CNB the agreed fees and CNB sterilising the growth in monetary base through its two-weeks repo facility.
25. Monetary authorities estimate that the trend real appreciation rate has decreased and is closer to 4 per cent per year. This deceleration may be explained by the maturation of the first wave of post-transition shocks and the possible narrowing of productivity differentials between manufacturing and service sectors. Even if the precise calculation of an equilibrium appreciation rate is elusive, CNB uses several indicators to diagnose the gap between actual and equilibrium appreciation – including mark-ups and competitive performance in the enterprise sector.
26. The unadjusted credit supply kept falling due to the impact of exchange rate and one-off factors related to the earlier restructuring of bank credit portfolios.
27. The interest rate channel in the monetary transmission mechanism in the Czech Republic works through CNB basic rates via interbank market interest rates (PRIBOR) to credit and deposit interest rates for clients. This relation is verified econometrically for the period of the big interest rate slow-down (in the period July 1998-December 2002, the two weeks CNB repo rate declined from 18.30 to 2.75 per cent, one year PRIBOR from 15.8 to 2.6 per cent, interest rates for newly granted credit from 16.0 to 2.6 per cent and for deposit from 11.0 to 2.2 per cent). Controlling for other factors, CNB estimated that a decrease in nominal short-term interest rates by 25 basis points induces a rise in inflation four quarters later of 0.3-0.4 percentage points.
28. Net aggregate outcomes of restructuring do not only depend on the rate of exits of low productivity firms, capital and employment, but also on their pace of recycling into higher productivity activities.
29. ERM II excludes the current free floating regime without a mutually agreed central rate, it re-establishes the exchange rate as an operational target. If the Bank were to choose the "right" reference rate, then it could remain fixed until the country joined the euro-zone.
30. The real rate of appreciation of the currency is driven by the catching up process, but the combination between inflation and nominal appreciation to achieve it depends on the monetary and exchange rate regime selected. Like other transition and EU accession countries the Czech Republic is at this stage implementing a low inflation target and floating (and appreciating) currency, but its future participation in the ERM II and subsequently in the EMU will reduce the room for appreciation. The additional margin remaining for higher inflation will also be limited by EMU rules but at that stage the natural (equilibrium) appreciation rate will be further reduced and can be more easily accommodated. Any brisk appreciation in the course of this adjustment path may take the rate of appreciation above equilibrium, with unwelcome consequences for the real sector if firms do not exhibit sufficient downward price and wage flexibility.
31. The authorities use the GFS86 methodology for fiscal policy evaluation because cash-based government accounts are available promptly and the national budgetary classi-

fication is compatible with them, allowing for quick inter-temporal comparisons of expenditures and revenues (see Annex I). In contrast, the ESA95 framework that is fully compatible with Czech national accounts is more suitable for the fiscal policy stance assessment but is more demanding in terms of statistics, economic analysis and accounting.

32. The previous OECD *Economic Survey of the Czech Republic* (2001, p. 112) included a special chapter on fiscal spending reforms. Its main recommendations included budgetary reform, systematic programme evaluation and improved transparency.
33. This Fund was included in the general government sector since 2001. An act passed in 2000 has changed its main activity to distribution of subsidies. Up to 2000 the Agriculture Fund was included in the non-financial corporations sector because its main activity consisted of market intervention operations.
34. Fourteen elected regional governments were created by a new Law on Territorial Government. District offices, which represented the central government but were part of local governments until 2000 were phased out by the end of 2002, and part of their assets and personnel were transferred to the regional governments.
35. International fiscal reports exclude these privatisation-related expenditures and revenues from the scope of the fiscal stance, treating them "below the line" (see Annex I).
36. With regard to its income per capita level.
37. Hanousek and Palda (2002) suggest that the total tax burden may be resented by large segments of the population and tax avoidance and tax evasion may have increased. However, there is no further evidence on this issue.
38. And a registered unemployment rate of 9.9 per cent, inflation rate of 2 per cent and wage growth of 5.5 per cent.
39. This figure does not include a pending investment loan by the European Investment Bank for flood reparations and the related government spending. The transaction will be included in the general government accounts when approved by Parliament.
40. OECD projection.
41. Such as foreign and domestic private business investment.
42. On the basis of last decade's records, the elasticity of general government deficit to GDP expressed as a percentage of potential GDP may be estimated at between 0.7 and 0.9 per cent. However, this estimation is fragile because of lack of sufficiently stable cyclical GDP and fiscal records (see Table 12).
43. Outstanding liabilities of CKA for bank cleaning purposes are estimated at around 10 per cent of GDP, in addition to a similar amount that has already been disbursed.
44. Act on Budgetary Rules (218/2000). Only transfers to local governments are included.
45. With the exception of "environmental guarantees", which remain non-transparent in this document.
46. The medium-term budgetary outlook was introduced for the first time in 2001 and this practice continued in 2002, this latest outlook covers the time period 2003-05.
47. The medium-term outlook includes information on the yearly balance of the pension system but no estimates of the present value of longer-term PAYG deficits. Projections by the OECD Secretariat (see Box 5 and Chapter III) point to the likelihood of a total social-security deficit amounting to 6-8 per cent of GDP over the coming decades if entitlements or contributions are not modified. This is a tremendous fiscal challenge which begs for policy response. Generational pension accounts were introduced in the

United States in 1993, followed by Germany, New Zealand, Norway, Sweden and the United Kingdom. Governments of Australia and Canada estimate implicit liabilities stemming from their public pension systems on a regular basis. In Hungary, since the late 1990s the annual state budget includes an attachment with a 50-year pension projection.

48. By contrast, domestic political pressures for fiscal consolidation have been rather slight.

49. Such a reform would help restore the financial sustainability of the public pension system and if it were implemented, the consolidated deficit could fall below 4 per cent of GDP by 2005 (see Box 5). The previous *Survey* described how actual pension expenditure exceeded the minimum amounts implied by indexation rules. See OECD (2001).

50. The responsiveness of health care services to society's preferences determines their allocative efficiency, and their capability to minimise costs at given quality their technical efficiency.

51. Health services and products funded from private sources and excluded from the scope of social insurance will be labelled, through this chapter, "complementary services". This includes services or comfort elements, which are not considered as medically necessary (and therefore not reimbursed) and medically necessary services which are demanded outside the public health system for non-medical reasons (such as convenience of access, preference for certain technologies, etc.). Services considered as "complementary" in many other countries are in the Czech Republic either categorised as "medically necessary" or altogether banned – as there is practically no free market for privately funded health care.

52. Relatively small interregional differences in life-expectancy may be related to differences in environmental, working and living conditions – for instance northern Bohemia has suffered from intensive combustion of poor quality cool. Improvements in health status seem to benefit to all age groups and there is no evidence of noticeable inequalities across social groups, other than the discriminating influence of education. There are symptoms of health status differences according to ethnic origin (the Roma minority might be disadvantaged) but no study has checked if differences remain after controlling for education.

53. Even in these areas however, mortality rates are less than proportional to incidence rates in international comparison – possibly pointing to the ability of care providers to deal with the detected cases. Improvements may also be due to the availability of modern technologies and drugs following liberalisation.

54. During 1919-24, the newly independent Czechoslovak Republic was one of the first countries to extend obligatory health insurance to the entire wage-earning population. In 1966, the Czechoslovak law on health services promised full and free health care services on the basis of citizenship alone (and not according to employment status and employer affiliation as in other socialist countries). The "Basic Charter of Citizen Rights" of 1990, which is a part of the post-transition Constitution, re-asserted the principle of free and equal health care. Article 31 declared: "Everybody has the right to the protection of his/her health. Citizens are entitled under public insurance to free medical care and to medical aids under conditions set by law." Health insurance entitlements are therefore defined by law and not by government policies and regulations.

55. It must be admitted that the health status of the population depends only partially on the quality of health services. It is equally influenced by factors such as income levels,

education, nutrition, working conditions etc. Diets have considerably improved, compared to the late 1980s when the Czech population had a very low consumption of fruits and vegetables, 37 per cent of the population smoked, and the levels of blood cholesterol were the highest in Europe. In 2000 by contrast, the Czechs consumed 155 kg of fruits and vegetables per capita against 132 kg in 1993, the largest improvement in OECD countries. Nonetheless, the upgrading of treatments (including emergency interventions and surgeries) and medication (including the administration of more effective drugs) had major effects, in particular in the area of circulatory diseases.

56. For example, the losses incurred by the two large Prague hospitals equalled their annual turnover. In the course of the big payments crisis some providers refused to offer services without direct cash payments by patients, a big step back from social insurance.

57. Capitation payments follow service flows to the extent each physician provides a "coverage service" to a variable pool of patients and is paid in proportion.

58. Only certain over-the-counter drugs, categories of aesthetic surgery, in-vitro fertilisation, sophisticated dental care and certain medical devices are paid out-of-pocket, under maximum price regulations. They make up only a small share of health expenditures (8.6 per cent).

59. The "equilibrium" amount of health care resources remains unknown, as markets for privately-funded services are not authorised. With demand for health care by certain population groups being highly income elastic, additional demand is likely to develop in an environment of liberalised transactions.

60. This is confirmed formally in the annual report of the General Health Insurance Fund, 2000.

61. After eliminating the outliers, and referring to the third most stringently endowed region in each medical speciality as a benchmark for others.

62. The approach adopted here fails to control for the special status of the Prague area as a medical excellence centre, necessarily a more intensive employer of sophisticated human and technological resources. Yet anecdotal evidence reveals that the region, beyond its technological sophistication, also suffers from mainstream excess capacity.

63. Leaves of absence are compensated from the very first day, at a "social income" rate calculated as a percentage of the minimum wage. This income may assure a replacement rate superior to 100 per cent for low wage earners, as it is also paid during weekends and holidays. Large numbers of low-income workers take sick leave for weekend periods (when they do undertake undeclared work, including on the surrounding Fridays and Mondays). Sick leaves are also utilised to postpone job cuts by declining firms.

64. The Czech social-security administration employ physicians who check sick-leave claims on a random basis. However, the low number of such controllers and the frequent collusion between the sick-leave claimants and their physicians preclude any detection of massive fraud.

65. Two factors underlie the higher health spending for older cohorts. First, a large proportion of health expenditures are incurred at the end of the life cycle. This effect concerns therefore only the oldest cohorts, and not the generations below them, even if they are also ageing. Secondly, older and frailer population groups generally recourse to more frequent services and many health technology innovations cater to their needs.

66. Since 1998 the General Health Insurance Fund has foregone annual government subsidies of CZK 800 million to be (partly) freed from such funding responsibilities.
67. An EU-sponsored co-operation programme with Netherlands aims at transferring recent experience and know-how in the area of integrated community care.
68. Newly introduced or more widely provided care includes, hip and knee endoprostheses, advanced pacemaker implantations and bone marrow transplantation.
69. All screening tests have also a certain share of false positive results, *i.e.* subjects with a positive test but no disease, so that all positives have to undergo additional and often expensive testing.
70. Vecernik, 2001b.
71. Citizens have at present access to complementary services and products in a small number of markets in stomatology, artificial incubation, esthetical surgery and, unrestrictedly, in pharmaceutical markets where drugs with additional attributes (in addition to the fully reimbursed reference product in each therapeutic group) are paid out of pocket. In care markets *stricto sensu*, such commercial differentiation of services, including more convenient and comfortable and therefore more expensive hospital wards and examination techniques are not developed. Commercial development of such services is banned, but quality differences which naturally arise within existing capacity are arbitraged through out-of-market means, notably under-the-table payments to parties controlling access to such resources and by superior information of the elite groups who know which specialists to consult.
72. Except for "child GPs", a well-established Czech speciality. An individual paediatrician follows a baby from birth to up to 18 years of age, providing a range of testing, preventive and referral-to-specialist services. This surveillance was compulsory before the transition and continues to be voluntarily used by large numbers of parents.
73. PPP exchange rates equalise the price of a representative basket of consumption goods and services in domestic and international markets. This adjustment does not suffice to equalise the price of health services and products to their level in partner countries, because local health prices are lower than the other domestic prices. This concerns principally physicians' and health personnel's salaries and to a lesser extent medical product prices.
74. Physicians' and other medical professions' wage claims are reinforced by the growing international standardisation and transferability of their skills, and their emigration prospects after EU accession. The Czech Medical Chamber has been energetically contesting the government intervention in medical professions' wage and fee negotiations with health insurers since 2000. Pharmaceutical producers also request faster price increases and threaten to discontinue production of the most "price repressed" products, notably generic drugs.
75. Service sector prices tend to converge internationally in proportion to productivity and wage growth across sectors (the so-called Balassa-Samuelson effect). Health sector prices will in principle converge internationally only when productivity and wage catch-up between countries will be completed. Higher labour mobility in the health sector may however accelerate this process more than in other sectors.
76. The methodology utilised in these projections is inspired by the approach taken in OECD, *New Directions in Health Policy*, 1995, which is now refined for more elaborate projections in the framework of the OECD Health Project. A similar but less detailed approach was utilised in the special chapter on health care reform of the 2000 *Economic Survey of Hungary*. Annex III provides a summary of this methodology.

77. All mandatory health insurance expenditures (even if funds are not formally in the public sector) and direct health-related spending from the state budget have been aggregated as general government expenditures. This approach is consistent with recommended national accounts principles.
78. Projected in the framework of the growth scenarios of Chapter I, Box 2.
79. This is a conservative assumption, not allowing for any "superior good" character for health care services (which would imply an above-unity elasticity of health service demand to income, at macroeconomic level). It also implies a relatively limited aggregate impact from ageing, in line with lower Czech elderly spending coefficients.
80. This is a conservative price evolution path because it projects only a domestic price equilibration process, without any direct catching up to international and European prices.
81. The Minister for Health has changed once a year from 1990 to 2001, and none of the many draft Health Acts prepared has been adopted by the government and submitted to Parliament. Health policy is a contentious area within the winning coalition since the June 2002 elections and only a very short general statement on health policies has been made by the new government.
82. It may be argued that health insurance funds are purchasing agents on behalf of the entire population. However, as health care coverage is a formal constitutional liability of the general government, health insurance funds operate as the spending agents of the general government.
83. Their boards and executives have been in charge for longer periods than government ministers. The CEO of the largest fund (VZP) has not changed since 1991.
84. The important role that they played in the 1997 "capacity norm" exercise has been a significant contribution. In line with the Ministry of Health recommendations and following this assessment VZP refused to conclude new contracts with 176 providers and terminated contracts with 130 others (Czech Association of Health Services Research, 1998). Health insurance funds have also contributed knowledge and been a negotiation party in the settlement of reimbursement rates in the DRG experiment.
85. These attempts have not been always successful. HIFs are not entitled to refuse contracts to providers except under rare circumstances and face political and regulatory difficulties in enforcing quality, performance and other standards. They nevertheless act in this direction.
86. Legal and regulatory rules and political influences do not always facilitate the utilisation of the available information. On the providers' side, information on the efficacy of treatments and the performances of alternative (and competing) providers cannot be made public on grounds of "privacy of information". On the other hand, HIFs are entitled to present and recommend the best performing suppliers to their enrolees. HIFs also follow the drug prescription behaviour of physicians and inform them yearly on their prescription behaviour, in comparison to colleagues of same disciplines. On the patients' side, the most blatant area of waste, namely sick leaves, the identity of the physicians involved in granting the needed certificates cannot be traced by HIFs as benefits are handled by another social security agency.
87. True competition is lacking but there are strong incentives for risk selection. While 60 per cent of the premia collected are centralised in a compensation fund, risk equalisation is based on age and grouped only into two categories – ordinary enrolees and enrolees older than 65 – without regard to differences in morbidity.

88. The incentives and decision rights that the DRG system will create for hospital managers and physicians will need to be monitored. Hospital managers, now exposed to hard budget constraints, will see their governance rights strengthened. Physicians will remain less driven by financial considerations and are expected to continue to act as quality agents. Tensions between the two parties (*i.e.* between a previously secondary and previously omnipotent party) would be counterproductive and should be avoided.
89. The 11 university and teaching hospitals, which represent around 23 per cent of acute bed capacity are not affected by this law and will be managed by the Ministry of Health.
90. Regulatory safeguards will be necessary to ensure the transparency of such operations. Private investors need also to demonstrate, and financially guarantee, their ability to run these essential facilities in the public interest.
91. Hospitals had managed to obtain changes in payment mechanisms in late 1990s, shifting their financing away from FFS and restoring quasi-budget funding on the basis installed capacity. See above.
92. Labour-intensive care strategies and technologies are penalised when hospitals do not need to amortise capital and depreciation costs but need to fully fund current costs including labour and pharmaceutical inputs.
93. The Czech Republic's position in the IMD World Competitiveness Scoreboard moved from the 40th place among the 49 economies assessed in 2000 to the 29th place in 2002. See IMD (2002). The latest available comparison based on the economic freedom index and comparing 123 countries, ranks the Czech Republic in the 38th position, second to Estonia (35th position) among the transition economies. See Gwartney and Lawson (2002).
94. For instance, the three-year old government's pro-growth strategy recognised the need to improve the legal environment for doing business, corporate governance, industrial restructuring, and liberalisation of network industries and professional education. However, it has not addressed the need to improve significantly the efficiency of the public sector and work incentives.
95. Productivity growth over the 1990s was also considerably faster in Poland than in the Czech Republic. See Landesmann and Stehrer (2002).
96. For instance, a former high official appointed to implement the government's anti-corruption drive in the Ministry of Foreign Affairs was taken into custody in July 2002 and charged with embezzlement, arranging a contract killing of an investigative journalist and other crimes.
97. The 2002 corruption perceptions index for the Czech Republic has the value of 3.7 points (on the scale of 0 to 10 points between the poles of extreme corruption and its complete absence), well below 4.9 points awarded to Hungary (33th place), 6 points for Slovenia (27th place) and 9.7 points for Finland (1st place). See Transparency International (2002).
98. See Djankov *et al.* (2000). According to the data provided to the Secretariat by the authorities, the Czech performance improved considerably since late 1990s, with the average entry time declining from 97 to 67 days, the number of procedures falling from 11 to 10, and the cost of entry falling from 25 to 4 per cent of per capita GDP. The entry time can be reduced by 34 days if the applicant obtains relevant documents from the Criminal Register in Prague and the registering court personally rather than by mail;

however, this option increases the entry cost for the entrepreneurs not residing in the capital.

99. Even in case of a purchase of a pre-registered company, the records must be updated in the Commercial register with names and addresses of new owners, directors, etc. Reliable data in the publicly accessible Register improve transparency of the business environment.

100. In mature market economies with creditor-oriented bankruptcy rules such as Germany and the United Kingdom, the number of successful compositions represents about 1 per cent of bankruptcies. In contrast, the incidence of compositions is significantly higher in the debtor-oriented bankruptcy systems of the United States or France.

101. The truck maker *Tatra Kopřivnice* was sold to the US-based SDC financial group, the tractor producer *Zetor* to a Slovak entity (HTC holding), and the integrated steel mill *Nová Hut'* to the LNM holding controlled by Ispat International, the 8th largest steel producer in the world. The prospects for the sale of the second state-controlled steel mill (*Vítkovice Steel*) and its principal supplier of coke (OKD) are unclear, while a domestic group owns the remaining integrated steel mill.

102. Sales of two other firms participating in the revitalisation programme (*Vítkovice Steel and ČKD Holding*) as well as the residual part of the *Škoda* engineering group remain to be completed.

103. Each of these vulnerable firms employs more than 100 workers. See Ministry of Industry and Trade (2002).

104. For a description of the IPB collapse and its subsequent sale to CSOB, see OECD (2001), p. 144.

105. CKA is not allowed to resell bad loans to the original owners of distressed firms. According to numerous press articles, these owners are sometimes able to buy back discounted claims on their firms through a chain of transactions following the CKA block sales. See *e.g. Hospodářské noviny*, 20 November 2002.

106. Unipetrol was created by consolidating both profitable and loss-making firms in the petrochemical industry with the aim to minimise post-privatisation job losses. Provisions of the public tender for privatisation of this artificial conglomerate included clauses limiting the right of the prospective new owner to close unprofitable parts of the conglomerate for a period of eight years. Low bids reflected the impact of such restrictions.

107. Despite a simplification of customs procedures in July 2002, border crossings for trucks appear to have remained congested.

108. These dominant operators are either fully controlled by a foreign conglomerate (natural gas industry) or partly state controlled (major telecom firm) or fully state controlled (largest electricity producer and distributor).

109. Technical assistance provided by the Spanish telecommunications authority as part of an EU programme helped to somewhat offset this handicap by upgrading skills of the current CTO staff. Moreover, the government created a working group of representatives of the regulatory agencies and the respective line ministries to address the problem; this group started to meet in November 2002.

110. A subsidiary of the FNM purchased 51 per cent while the Ministry of Labour and Social Affairs acquired 15 per cent of the high-voltage grid. The latter transaction is supposed to provide the yet to be established Social Security Agency with initial funding.

111. The partial separation of the grid is insufficient to ensure neutrality as long as CEZ keeps exercising management control on the basis of its minority share.

112. The linkage between the domestic price of coal and the regulated price of natural gas appears to be unique in the OECD area.

113. CEZ makes it clear that this is the maximum price cut it considers acceptable, regardless of the price decision of the regulator. See *Profit*, 5 August 2002.

114. The energy regulator plans to remove this distortion within two years.

115. See Hájková, (2002).

116. See *Trend*, 31 July 2002, p. 6.

117. If these negotiations result in a rescue plan, the competition authority will have to assess its terms and approve the bailout only if it conforms to the state aid rules of the European Union.

118. Government-appointed administrators run two credit unions while 29 have been subjected to bankruptcy proceedings. Another 51 credit unions have been liquidated while some 90 000 clients received up to 90 per cent of their savings from a guarantee fund financed mainly by the state budget.

119. For principal features of the KCP corporate governance code, see OECD (2001), p. 149.

120. For a description of the Czech voucher privatisation and its unfavourable impact on the capital market and industrial sector, see the 1998 and 2000 *Economic Surveys*.

121. The largest bankruptcy of this kind took place a year ago, resulting in losses of CZK 2.2 billion to some 30 000 clients of the KTP Quantum brokerage. Its chief executive has been in custody since May 2002. See *Respekt*, 16 December 2002.

122. See Hanousek and Podpiera (2002).

123. According to the labour force survey data, the group of registered unemployed who are either unable or unwilling to work grew from 35 to 57 thousand persons between the first quarters of 2001 and 2002, *i.e.* by 60 per cent.

124. At the same time, delayed retirement was made more attractive by increased benefit levels.

125. This initiative appears to have been inspired by the UK programme for unemployed school leavers.

126. In addition to the MLS benefit paid by the state, welfare recipients also qualify for housing and other benefits provided by local authorities. Therefore, the incentive to accept a minimum wage job is quite weak.

127. Another 100 000 foreigners work in the Czech Republic legally. Over one-half of them are Slovak citizens who need no work permit, given the bilateral labour-market agreement between the Czech and Slovak Republics.

128. The government has submitted recently to Parliament an amendment to the Act on Social Needs (No. 4821/1991) that regulates welfare benefit levels. The amendment stipulates that only 70 per cent of earned income should count in the calculation of the welfare benefit, motivating recipients to seek low-paying jobs. While the amendment would somewhat improve work incentives, it is unclear whether Parliament will adopt it.

129. The poor maintenance of housing estates has already resulted in growing transfers on an *ad-hoc* basis.

130. "Rent control is so effective a means to devalue collateral that on the eve of execution or bankruptcy debtors frequently have been renting out their property." Schönfelder (2001), p. 414.

131. The estimated increase of employment (50 000) persons would generate budget savings that are equivalent to 1 per cent of GDP. *Prague Business Journal*, 2-8 December 2002, p. 5.

132. The sickness insurance scheme is also available on voluntary basis to self-employed persons.

133. The experience of Flextronics, a multinational manufacturer of electronic products, provides a good illustration of the problem. Once the firm announced that it would close its plant in Brno (the second-largest Czech city), the incidence of sick leave increased so drastically that labour had to be imported from neighbouring Slovakia at higher cost, in spite of high local unemployment in Brno.

134. The number of non-unionised employees affected by administrative extension of sectoral agreements increased from 173 000 in 2000 to almost 270 000 per annum in 2001 and 2002 (*i.e.* 8½ per cent of the dependent employment registered in the business sector).

135. At the same time, self-employment is promoted by artificially low social-security contributions that remain below the levels paid by minimum-wage earners.

136. See (*http://pisa.oecd.org/Docs/Download/PISA2001(english).pdf*).

137. Growing because the fertility rate of the Roma minority and its age structure imply a much faster population growth than that of the non-Roma majority. See Kalibová (1999).

138. According to feedback received by the CzechInvest agency, some secondary and post-secondary education programmes have become increasingly divorced from labour-market realities, resulting in growing numbers of graduates with irrelevant skills and shortages of those whose technical skills and language abilities are needed in the private business sector.

139. Some measures to remedy the problem are to be provided in the draft of a new Act on Teaching Staff that is to be submitted to Parliament in the first half of 2003.

140. The number of employees in the public administration sector increased steadily from 132 675 in 1993 to 182 358 persons in 2001.

141. In a limited way the European Union also provides some funding (ISPA and optionally SAPARD for local infrastructure).

142. Apart from road tax, a percentage of the excise duties on hydrocarbon fuels and lubricants, and user fees on some motorways.

143. The current law provides for a 10 per cent cost advantage for domestic bidders that may result in unnecessarily high project costs.

144. While the Czech Republic's tax to GDP ratio is only a little higher than the OECD average, it exceeds by 5 percentage points the average of the low-income group of member countries that includes Hungary, Greece, Korea, Mexico, Poland, Portugal, Spain, Turkey and Slovakia. This finding is consistent with a recent study of the World Bank on taxation in transition economies (Mitra and Stern, 2002).

145. The planned changes in VAT and excise duties are driven by the need to harmonise Czech tax regulations with those of the EU. The Finance Ministry's medium-term revenue projections indicate that these changes will not generate enough revenues to allow deep cuts in profit and social-security taxes.

Glossary

AUT	Austria
AUS	Australia
BEL	Belgium
CAN	Canada
CHE	Switzerland
CEZ	Czech Power Company
CKA	Czech Consolidation Agency
CNB	Czech National Bank
CSO	Czech Statistical Office
CZE	Czech Republic
CZK	Czech koruna
DEU	Germany
DNK	Denmark
ESP	Spain
EUR	Euro
FDI	Foreign Direct Investment
GBR	United Kingdom
GFS	Government Finance Statistics
GRC	Greece
FIN	Finland
FRA	France
HUN	Hungary
HIF	Health Insurance Fund
IMF	International Monetary Fund
IRL	Ireland
ISL	Island
ITA	Italy
JPN	Japan
KCP	Czech Securities Commission
KOR	Korea
LUX	Luxembourg
MEX	Mexico
MoF	Ministry of Finance
NOR	Norway
NLD	Netherlands
NZL	New Zealand
POL	Poland
PRT	Portugal
SNA	System of National Accounts

SVK	Slovakia
SWE	Sweden
TUR	Turkey
USA	United States
VZP	General Health Insurance Fund of the Czech Republic

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BASIC STATISTICS OF THE CZECH REPUBLIC[1]

THE LAND

Area (sq. km)	78 864	Population of major cities (thousands) (1.1.2000)	
Arable land (sq. km)	42 798	Prague	1 186.9
		Brno	383.6
		Ostrava	321.2
		Plzeñ	167.5

THE PEOPLE

Population (thousands, 31 December 2001)	10 206	Civilian employment by sector	
Number of inhabitants per sq. km	129.4	(% of total, 2001)	
Annual population growth, 1996-2001 (%)	–0.02	Agriculture	4.8
Employment (thousands, 2001)	4 707	Industry	40.4
		Services	54.8

THE PARLIAMENT

Chamber of Deputies, as at March 2003 (number of seats)

Social Democratic Party	70	Freedom Union/Christian Democratic Union	31
Civic Democratic Party	58	and People's Party Coalition	
Communist Party	41	Total	200

THE PUBLIC SECTOR[2]

% of GDP, 2002

Current receipts	40.9	Total expenditure excluding net lending	46.2
Direct taxes	9.8	Government consumption	21.7
Indirect taxes	10.3	Subsidies to enterprises	2.4
Social security contributions	16.1	Social security benefits	13.5

PRODUCTION

GDP ($ million, 2001)	56 754	Structure of production (% of GDP, 2001)	
GDP per capita ($, 2001)	5 561	Agriculture	4.2
Gross fixed investment (% of GDP, 2001)	28.3	Industry	40.0
		Services	55.8

FOREIGN TRADE

Exports of goods and services (2001)		Imports of goods and services (2001)	
($ billion)	40.5	($ billion)	42.0
(per cent of GDP)	64.9	(per cent of GDP)	68.2
Main merchandise exports (% of total, 2001)		Main merchandise imports (% of total, 2001)	
Machinery and transport equipment	47.4	Machinery and transport equipment	42.2
Manufactures	24.3	Manufactures	20.2
Chemicals	6.4	Chemicals	10.9
Other	21.9	Petroleum products	9.1
		Other	17.6

THE CURRENCY

Monetary unit: Czech koruna		Currency units per $	
		Year 2001	38.0
		Year 2002	32.7
		Feb. 2003	29.4

1. An international comparison of certain basic statistics is given in an annex table.
2. Data are based on the OECD-adjusted general government accounts which differ from but are based upon the Czech Ministry of Finance data produced in accordance with the IMF's Government Financial Statistics.

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•

The Secretariat's draft report was prepared for the Committee *by* Rauf Gönenç *and* Jaromir Cekota *under the supervision of* Andreas Wörgötter.

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