A WORLD BANK COUNTRY STUDY

Czech Republic

Toward EU Accession

Volume 1: Summary Report

CONTENTS

Abstract

This country study is based on the findings of several missions that visited the Czech Republic during the second half of 1998. The report analyzes economic developments in the Czech Republic since 1997. It focuses on assessing the status of the Czech Republic's economy from the perspective of its pursuit for European Union membership.

The report is composed of two volumes. Volume I is the Summary Report that condenses main findings and conclusions. The report focal point is mainly on the need to recover a sustainable output growth path, and the elimination of the remaining structural weaknesses as means to maintain macroeconomic stability while increasing the competitiveness of the Czech economy.

Volume II is the Main Report. It provides the assessment and technical analysis of selected key sectors of the Czech economy. While each chapter is sector-specific in nature, the EU accession process dominates them. Volume II has fourteen chapters and is structured as follows: Chapter I reviews the economic performance since the 1997 currency crisis, focusing on the stabilization and recovery efforts, macroeconomic vulnerabilities and the fiscal stand. Chapter II analyzes growth and income convergence in relation with the EU accession process. Chapter III studies contingent liabilities and their impact on the fiscal front. Chapter IV focuses on inter-government fiscal relationships. Chapter V studies labor market trends, policies and performance. Chapter VI provides an assessment of the foreign trade sector, focusing on trade policy, foreign direct investment, export penetration in the EU and contestability of domestic markets. Chapter VII covers the challenges of the financial sector, evaluating mostly banking, but also capital market issues. Chapter VIII reviews the challenges in the enterprise sector: it concentrates on the changing structure of industry, the unfinished privatization agenda, efforts to attract more foreign direct investment (FDI) and challenges to meet EU quality and environmental standards. Chapter IX analyzes the agriculture and rural sectors in light of the competitive pressures from EU accession. Chapter X reviews the challenges from meeting EU environmental directives. Chapter XI studies public administration performance and reform options. Chapter XII reviews social sector development, focusing on the social safety net, ethnicity and exclusion, and the evolution of the education system. Chapter XIII reviews the challenges in health sector reform. Finally, Chapter XIV analyzes policy reform options in key economic infrastructure sectors, namely telecommunications, energy, gas and transportation.

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CURRENCY AND EQUIVALENT UNITS

Currency Unit = Czech Koruna (CZK)

	1993	1994	1995	1996	1997	1998
CZK/USD	29.16	28.78	26.55	27.14	31.71	32.27
CZK/DEM	17.64	17.75	18.52	18.06	18.28	18.33
CZK/EUR	34.11	34.06	34.31	34.00	35.80	36.16

WEIGHTS AND MEASURES

Metric System

ACRONYMS AND ABBREVIATIONS

AB	Agrobanka
ALMP	Active Labor Market Programs
ALMPs	Active Labor Market Policies
APPs	Auto Power Producers
AT&T	American Telephone and Telegraph
BAT	Best Available Techniques
BATNEEC	Best Available Techniques Not Entailing Excessive Costs
BCM	Billion Cubic Meters
BIS	Bank for International Settlements
CAP	Common Agricultural Policy
CED	Central Electric Dispatching
CEE	Central and Eastern Europe
CEECs	Central and Eastern European Countries
CEFTA	Central European Free Trade Agreement
CEM	Country Economic Memorandum
CEZ	Ceske Energeticke zavody
CF	Ceska Financni
CHP	Combined Heat and Power
CI	Ceska Inkasni
CMEA	Council of Mutual Economic Assistance
CNB	Czech National Bank
CO	Carbon Monoxide
CPI	Consumer Price Index
CPP	Czech Gas Works Group
CR	Czech Republic
CS	Ceska Sporitelna (Czech Savings Bank)
CSA	Czech Airlines
CSB	Czechoslovak State Bank
CSFR	Czech and Slovak Federal Republic
CSO	Czech Statistical Office
CSOB	Ceskoslovenska Obchodni Banka
CU	Customs Union
CZK	Czech Crown
DCG	Domestic Credit Growth
DEM	German Mark
DLOs	District Labor Offices
DPM	Deputy Prime Minister
EAA	Europe Association Agreement
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EEC	European Economic Community
ECU	European Currency Unit
EMAS	Environmental Management Assessment Standard
EMU	Economic and Monetary Union
EOP	Elektrarny Opatovic
ESI	Electricity Supply Industry
EU	European Union
EUR	European Union Currency
EUROSTAT	European Union Statistical Office
FDI	Foreign Direct Investment
FOBAPROA	Mexican Banking Fund for the Protection of Savings
FSU	Former Soviet Union
GACR	Grant Agency of the Czech Republic
GARCH	Generalized Autoregressive Conditional Heteroskedastic
GATT	General Agreement of Tariffs and Trade
GDCs	Gas Distribution Companies
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GE	General Electric
GOCR	Government of the Czech Republic
GS	Goods and Services

GSM	Groupe Speciale Mobile
GSP	General System of Preferences
Ha	Hectare
HEO	Hungarian Energy Office
HIF	Hungarian Communications Authority
HR	Human Resource
HRM	Human Resource Management
ILO	International Labor Organization
ICORs	Incremental Capital-Output Ratios
IEA	International Energy Agency
IFC	International Finance Corporation
IFS	International Financial Statistics
IMF	International Monetary Fund
IMV	Index of Macroeconomic Vulnerability
IPB	Investicni A Postovni Banka
IPFs	Investment Privatization Funds
IPPC	Integrated Pollution Prevention and Control
IPPs	Independent Power Producers
ISO	International Standard Office
ISP	Index of Speculative Pressure
KB	Komercni Banka
Kg.	Kilogram
KoB	Konsolidacni Banka
KW	Kilo-watt
LAC	Latin America and Caribbean
LDC	Less Developed Country
LFPRs	Labor Force Participation Rates
LFS	Labor Force Survey
M	Municipal or Local Government Budget
MATAV	Hungarian Telephone National Operator
MFN	Most Favorable Nation
MIT	Ministry of Industry and Trade
MLS	Minimum Living Standard
MoF	Ministry of Finance
MoL&SA	Ministry of Labor and Social Affairs
MPP	Mass Privatization Program
MTPL	Motor Third Party Liability
MVM	Hungarian Grid Company
MW	Mega Watts
N/C	Non Convergence
NATO	North Atlantic Treaty Organization
NAV	Net Asset Value
NGOs	Nongovernmental Organizations
NIS	Newly Independent States
NO_x	Nitrogen Bioxide
NPF	National Property Fund
NTB	Non-Tariff Barriers
O&M	Operation and Maintenance
OECD	Organisation for Economic Co-operation and Development
OLPA	Office of Legislation and Public Administration
OTND	Objective, Transparent and Non-Discriminatory
P	Private Sector
p.e.	Population Equivalent
PAR	Public Administration Reform
PAYG	Pay-As-You-Go
PCBs	Polychlorinated biphenyls
PCTs	Polychlorinated terphenyls
Pee	First Quarter
P/E	Price Equity Ratio
PECAA	Pan-European Conformity Assessment Agreements
PGRLF	Agricultural and Forestry Guarantee and Support Fund
PHARE	Poland Hungary Assistance for Economic Reconstruction
PPI	Producers Price Index
PPP	Purchasing Power Parity
PRIBOR	Prague Inter-banking Offer Rate
PSE	Prague Stock Exchange
pse	Producer Subsidy Equivalent
R&D	Research and Development
RCA	Revealed Comparative Advantage
RECs	Regional Electricity Companies
REER	Real Effective Exchange Rate
RIAE	Research Institute of Agricultural Economics
RIF	Restitution Investment Fund
RILSA	Research Institute for Labor and Social Affairs
RMS	RM-System
ROW	Rest of the World
S	State Budget
S&P	Standard and Poor's
SB	Single Buyer
SBM	Single Buyer Model
SEF	State Environment Fund
SFA	State Financial Assets
SFMR	State Fund for Market Regulations
SGFFF	Support and Guarantee Fund for Farmers and Forestry
SITC	Standard International Trade Classification
SO_2	Sulfur Oxide
SPJs	Socially Purposeful Jobs
STE	Stedoceska Energeticka, a.s.

STET	Italian Telecom Company	UN	United Nations
TO	Transmission Operator	US	Unites States
TOZ	Perpetual Inventory Revolving Credits	USAID	United States Agency for International Development
TPA	Third Party Access	USD	United States Dollar
TSO	Transmission System Operator	UWWT	Urban Wastewater Treatment Directive
Twh	Tetra-watt		
UCS	Unemployment Compensation System	VAT	Value Added Tax
		VOCs	Volatile Organic Compounds
UK	United Kingdom	WTO	World Trade Organization
ULC	Unit Labor Cost	ZB	Zivnostenska Banka

FISCAL YEAR

January 1 to December 31

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Summary Report

Introduction

The Czech Republic was perceived until 1996 as the most successful transition economy in Central and Eastern Europe (CEE). Given the country's initially favorable conditions, macroeconomic stability seemed to have been firmly established just a few years after the *Velvet Revolution* of 1989. The structural transformation of the economy, from command to market, was perceived by the authorities and the international community as going ahead at remarkable speed. The innovative voucher privatization program was a tool to redefine the role and size of the State, transferring a large amount of assets to the private sector. The so-called Czech miracle -- economic transformation with minimum unemployment and no hyperinflation -- was viewed by many transition economies as a target, but one unable to be reached.

The Czech Republic seems to be the clearest success story in the region. At the end of 1995, it had one of the lowest rates of inflation (9.1 percent) and the lowest rate of unemployment (2.9 percent). The high GDP growth rate (6.4 percent) looked sustainable, as it was accompanied by a moderate current account deficit (2.6 percent) and seemingly balanced fiscal accounts. The macroeconomic policy stand seemed to be underpinned by important structural reforms. Major achievements in the structural area included the liberalization of wages, prices and foreign trade, as well as the voucher privatization program that enabled a massive transfer of enterprises to the private sector in a very short period of time. By 1996, the private sector share in GDP was 74 percent, the highest in the region. Reforms in key social sectors were also underway. While reforms advanced in a number of key areas, growing macroeconomic imbalances and fragile microeconomic fundamental threatened the achievements.

The Czech miracle, however, came to a halt in May 1997. At that time, a speculative attack on the crown -- driven in part by the international communities' perception of an unsustainable current account deficit equivalent to 7.4 percent in 1996 -- forced the authorities to abandon the exchange rate policy regime maintained since 1991, and to introduce a strict austerity program, including tight fiscal and monetary policies. By November 1997, Prime Minister Vaclav Klaus had resigned, a caretaker government had been selected and, in mid-1998, general elections had brought a new government to office. The lack of comprehensive restructuring in the enterprise and financial sectors, as well as the events that followed the May crisis, brought the economy to a virtual halt.

The Czech Republic's future economic development and successful integration into the European Union (EU) depends critically on its capacity to recover a sustainable output growth path. To achieve this, it needs to use the opportunity provided by the bid to join the EU to make the necessary macroeconomic policy adjustments and to further advance the structural reform agenda that will prepare its economic institutions for the challenges that being a member of the EU convey. Membership in the Union will compel the Czech Republic to adjust its policies and laws to the norms set out by the *Acquis Communautaire* -- the set of directives, rules an regulations that govern economic, social and political relationships in the EU. This, in turn, will require that the Czech Republic develop the human and institutional capacity to effectively implement and enforce the *Acquis.* For some EU directives, compliance will mean considerable investments, in human and physical resources. Ultimately, however, the *Acquis* will act both as a benchmark and as a powerful incentive for advancing the country's development agenda.

Macroeconomic Policies in the Pre-Accession Period

The Czech Republic overarching goal is to join the European Union (EU) in the shortest period of time. To do so, it is necessary to implement a strategy that improves its prospect for EU accession. This strategy needs to be based on macroeconomic policies that realign key economic fundamentals --like the fiscal and external balances -- and that generate sustainable growth. This entails promoting economic recovery and implementing prudent monetary and fiscal policies to improve fiscal discipline while addressing the remaining challenges of transition. At the same time, the structural reform agenda needs to be advanced to enhance the prospects for accession into the EU.

Promoting Economic Recovery and Sustainable Growth

The Czech Republic is experiencing its first post-transition recession. The slowdown in economic activity intensified after the currency crisis and turned into a full-fledged recession during 1998. As a result, the Czech Republic is now experiencing its first post-transition recession, with a decline in real output by 2.3 percent in 1998 and an expected fall of 1 percent in 1999. Moreover, unemployment has doubled, reaching 8.3 percent in the half of 1999, the highest level in modern Czech history. Domestic demand declined by 3.2 percent in 1998, with household consumption falling by 3 percent and gross capital formation by 5.7 percent (fixed capital formation by 3.8 percent). Foreign demand helped to mitigate the recession, especially during the first half of 1998. The cushion provided by the foreign balance, however, eroded during second half of the year. As a result, during the last quarter of 1998, output declined at an annualized rate of 3.9 percent, and foreign demand at 4.9 percent. The recession intensified in the first quarter of 1999 with GDP declining at an annualized rate of 4.5 percent. Domestic demand declined at an annualized rate of 1 percent and foreign demand at 3.4 percent during the same period.

The recession intensified in the first quarter of 1999, but the first signs of a potential turnaround in economic activity appeared in the second quarter of the year. The initial signs of recovery are coming from the external sector. Foreign demand started to grow again reaching an annualized growth rate of 0.8 percent in the second quarter of the 1999. This recovery induced some momentum on GDP which recorded a fall of 0.2 percent in the same period. Domestic demand, however, continued to decline at an annualized rate of 1 percent. While total consumption is growing again, albeit driven mostly by government consumption, investment continues to be depressed, with fixed capital formation recording a drop of 6.7 percent vis-à-vis the previous year in the second quarter of 1999. The government should, however, be alert to the recent appreciation trends in the Czech crown and its implication on the export sector, especially in light of the sizable capital flows that revitalization of the privatization process -- including the sale of CSOB -- will bring. The right set of monetary, fiscal and exchange rate policies will be necessary to sustain and foster the recovery.

The Czech Republic faces significant challenges as it seeks to lay the basis for economic recovery, sustainable growth, and EU accession. An imperative task is to recover growth and to redirect the economy towards its potential. The required macroeconomic and structural policies needed to achieve these objectives will entail difficult political choices and considerable economic and social stress in the short run, but they are likely to set the foundation for sustainable development and to enhance prospects for EU accession. While the deep-rooted structural problems in the economy should have been addressed several years ago, it is better to address such problems now than to postpone solutions.

Provided that prudent monetary policy and a sustainable fiscal stand are in place, and provided that the structural reform process advances, there should be scope for economic recovery starting in the later part of 1999 and continuing into 2000. The Czech Republic has potential for relatively high rates of growth over the medium-term, on the order of 4-5 percent of GDP, driven by productive investment, deep structural reform and improved export performance. For this to be sustainable risks need to be reduced and real output cycles minimized or avoided.

The need to maintain a sustainable current account deficit would imply stronger fiscal discipline and better monetary and fiscal policy coordination. Stronger fiscal discipline is needed, especially concerning off-budget activities. This fiscal discipline in conjunction with monetary and fiscal policy coordination will be essential to reduce vulnerabilities -- external and internal. A small and sustainable current account deficit could be covered by foreign direct investment. The effort to reduce inflation towards EU levels is already showing promising results, due to the net inflation targeting mechanism introduced by the Czech National Bank in 1998. With the overshooting of the Central Bank's inflation targets, CPI inflation is running at an annual rate of 2.5 percent in March 1999. A balance between growth performance and inflation goals needs to be achieved. Relatively rapid productivity growth in the tradables sector and wage growth restraint in the non-tradables sector will be essential to maintain macroeconomic stability and generate long-term sustainable growth.

At the heart of the recovery of the Czech economy lies the privatization of remaining stake in large state-controlled banks, and the severance of the unhealthy relationship between those banks and large industrial conglomerates. Strategic foreign investors need to be brought in to establish a sound banking culture. This, in turn, will encourage enterprise restructuring, by imposing true hard budget constraints to the real sector. The first step in this direction was given by the government in July 1999 with the privatization of the government's stake in CSOB. Privatization of the remaining state-controlled banks is expected to follow shortly.

The second step has been the announcement of a restructuring program to address the situation in the enterprise sector. The Revitalization Agency was created as a joint-stock subsidiary company of Konsolidacni Banka. The main function of the Agency will be in taking over non-performing assets from the banks' portfolios that are slated for privatization and to restructure -- financially and otherwise -- selected enterprises in distress. The solutions are likely to range from restructuring and sale of enterprises to a strategic investor, to liquidation. The key decision-making authority will be delegated to a renowned investment bank, chosen in an international tender to administrate the Agency's activity, and expected to resume its duties by September 1999.

While improving corporate governance, the revitalization program needs to be tailored and implemented in a way to avoid moral hazard and the perpetuation of non-viable enterprises. First, the contract with the Administrator could include incentives for finding strategic investors for revitalized firms. Second, the design of the program needs to be structured in a way that will prevent the Administrator to focus only on the largest debtors, while medium and small and potentially viable enterprises might be left out completely from the restructuring efforts. Third, the program must be strictly time-bound (1-2 years). Enterprises for which no buyers can be found within such a time frame should be liquidated. It would be very dangerous for the state to face an outcome of the revitalization plan in which it is left as the owner of non-viable enterprises for any significant period of time. In order to prevent such an outcome, appropriate bankruptcy procedure legislation and legal environment have to be provided by the government.

The post-crisis experience of emerging markets suggests that limited credit availability, as well as inflexible labor markets, have contributed to sluggish economic recovery. This means that firms that had planned their future operations based on credit availability cannot continue operating, and as a consequence are not paying their debts. The result of this has been an increase in bank non-performing loans, particularly from small and medium firms in the non-tradable sector that have virtually no access to foreign loans.

In the past decade there has been an enormous effort put forward by the Czech government and the Czech society at large to transform the economy from command to market. The Czech Republic is one of the most open economies in the region with low import tariffs, limited non-tariff barriers, an open capital account, sizable trade flows accounting for a large part of the economic activity -- most of them with the EU -- good levels of FDI -- most coming from the EU -- and educational levels comparable to those in the EU. While the current recession is likely to be costly in terms of output and employment, the sizable progress in economic development made so far needs to be recognized. The Czech Republic is a prime candidate for EU accession, but the authorities should not forget that other CEE transition economies are competing with the Czech Republic in this endeavor.

Fiscal Sustainability and the Challenges of Fiscal Decentralization

Since the beginning of the transition, the Czech government has maintained a fiscal policy aimed at achieving a nearly balanced budget. This policy of seemingly strong fiscal prudence is tainted, in part, by the fact that a number of budgetary operations have been carried outside the budget. These operations have been conducted by extrabudgetary funds and transformation institutions,[1] financed directly from privatization proceeds coming from the National Property Fund (NPF) or from the State Financial Assets (SFA).[2]

Recently, off-budget fiscal risks have become more visible, as state guarantees and agencies that are either explicitly or implicitly guaranteed by the government have generated significant claims on the budget. Still invisible in fiscal records, but already officially recognized by the government, is the stock of hidden public liabilities which has emerged outside the budgetary system as a result of borrowing by various agencies to finance off-budget activities of the government.

The implicit fiscal deficit in the Czech Republic is significantly higher than the deficit calculated through conventional methods. The implicit fiscal deficit of the central government has been around 5.2 and 4.9 percent of GDP during 1997 and 1998, substantially higher than the 1.1 and 1.5 percent of GDP reported official deficit during the same period. The trend outside the budgetary system is clearly troublesome. While the reported gross outstanding general government debt has declined from 17.6 percent of GDP in 1994 to 13.2 percent in 1998, government off-budget obligations, resulting from financing hidden deficits, have been growing rapidly. In the future, these obligations will impose significant pressures on the budget. Moreover, this has generated a sizable amount of hidden debt, as these obligations will have to be properly accounted and funded in the future. Their further growth may truly endanger future fiscal stability, perhaps more so than other important pressures emerging from pensions and other mandatory programs under the budget. Presently, there is no institutional mechanism to monitor government off-budget obligations, and the ensuing fiscal risk, as well as demands on new guarantees and programs to be financed through various off-budget agencies are growing.

The banking sector remains a major source of claims on government financial support. Whether or not activities of the other banks have been politically motivated, the large banks residually owned by the state suffer from a weak portfolio and continue to rely on state support. These troubled banks include Czech Savings Bank and Komercni Banka. CSOB was recently privatized. The activities to support Czech Savings Bank illustrate the problem. In December 1998, Konsolidacni Banka (KoB) transferred CZK4 billion to Czech Savings Bank to cover its losses -- thus increasing KoB's own losses to

[1] Extrabudgetary funds include the Czech Land Fund, the National Property Fund, the State Fund for Culture, the State Fund for Environmental Protection, the State Fund for Soil Fertilization and the State Fund for Support and Development of Czech Cinematography.

[2] State Financial Assets (SFA) comprise the central government's account at the Czech National Bank, in which the state budget surpluses from previous years are deposited.

CZK14 billion -- and purchased bad assets from Czech Savings Bank in the amount of CZK6.5 billion. In addition, Konsolidacni Banka issued subordinated debt for Czech Savings Bank in the amount of CZK5.5 billion so that Czech Savings Bank could meet its capital adequacy requirement.

The present system, in which the government undertakes a large amount of off-budget activities, generates two main weaknesses. First, the hidden public liabilities generate sudden, and not entirely expected, claims on the budget, thus endangering future fiscal stability. Second, off-budget government programs do not explicitly relate to the strategic choices made in the budget process. These weaknesses can be broadly explained by the low transparency of government operations, by fragmentation of the budget process, and by the weak position of the Parliament in public finance decision-making and fiscal control. The budget process does not require, and fiscal reports do not provide, information about government off-budget operations of a fiscal nature or about their financing. This creates scope for fiscal opportunism; policy makers may too easily launch low-priority activities outside the budget and thus commit future budgetary resources to their financing. Other forms of pursuing government programs outside the budgetary system, such as requesting Konsolidacni Banka to support health insurance companies, appear to have no limits.

To minimize future claims emerging from contingent liabilities, the government will need to implement new limits and rules for issuing and dealing with off-budget programs. Specifically, the government will need to introduce effective regulations with respect to the amounts of contingent liabilities and the government risk exposure to them when designing programs of contingent support. Special requirements should apply to the status and responsibilities of agencies, such as credit and guarantee funds, which are entrusted with implementing government programs. Special reporting requirements should apply to all programs and institutions, including non-banking financial institutions and funds that may either explicitly or implicitly generate fiscal risk in the future.

New budget rules and practices should specify government responsibilities vis-à-vis off-budget government commitments and fiscal risks around the following imperatives:

- Identify, analyze and regularly report off-budget government commitments, including hidden and contingent government liabilities, which may affect future public expenditures, such as guarantee claims and residual obligations of state-guaranteed agencies, and may also affect revenues, such as tax exemptions.

- Place tighter limits on state guarantees and off-budget programs, on implicit government obligations, and both direct and contingent liabilities resulting from extra-budgetary funds, local governments and other agencies associated with government policies.

- Before approving off-budget assistance, recognize its risks and its full potential cost. Programs that do not require cash from the current state budget may require significant budgetary resources in the future. From the macroeconomic viewpoint, tight control over all potential government liabilities is more important than a balanced budget accompanied by increasing hidden public debts.

- Link decisions about guarantees and off-budget programs to the medium-term strategic fiscal framework and to budget allocations; based on potential cost estimates, set aside reserves.

- Create proper incentives for the borrower, lender, and program manager by requiring significant risk sharing under state guarantees and other programs.

- Improve reporting of actual performance of programs under state guarantees and outside the budgetary system, set specific performance criteria and review process for such programs, and demand accountability similar as that for the state budget.

- Set completion dates (sunset clause) for guarantee programs and off-budget activities.

The inter-governmental fiscal relations, which define financial liabilities between local and the central governments, are an area of potential fiscal risks. The central government transfers tax revenues, gives grants, provides direct loans and loan guarantees to local governments to fill the financing gap or for equalization purposes. Any local defaults on services of these loans and calls on loan guarantees could create liabilities for the central government. While the law stipulates that the central government has no financial responsibility for local governments financial imbalance, including borrowing and debt service, the law stipulates that municipalities cannot be declared bankrupt. In that event, the central government is likely to take on contingent, or implicit liabilities generated by local authorities. Two factors related to the nature of inter-governmental relations generate potential fiscal risks: (i) assigned expenditure responsibilities at local level and the corresponding unmatched revenue provisions; and (ii) debt financing by the local levels which can increase the perception of soft budget constraints and induce moral hazard.

The Czech governmental and fiscal system is organized as a two-tier system composed of the national center and local governments. The upper level is controlled by an elected Parliament, while local governments are led by mayors elected by local councils, which are themselves elected by the people. There are 6,234 independent municipalities, the majority of which are small, with fewer than 500 residents. Between the two levels of government, 77 district offices act as intermediaries, performing state administration, without self-government functions. The district budget and that of its constituent local municipalities together form the local budgets. Past centralization and the fragmentation of the fiscal landscape have made it a challenge to assure a competent administration of local units, due in part to resource and personnel limitations. Accordingly, it has been proposed that 14 regions with regional self-administration will be established. The new regions and regional governments -- once enacted -- will form an intermediate tier to assist in the interaction of municipalities with the center.

Before 1992, municipal budgets were primarily dependent on transfers from the state, and almost all capital investments at the municipal level were financed through central government grants or subsidies. In 1993, a new tax and municipal financing system introduced “own revenues” from shared taxes and local taxes, paving the way for greater local financial and fiscal autonomy. The present inter-governmental structure reflects important changes in the tax revenue allocation made in 1996. As a result of reductions in operational and capital subsidies, municipalities have come to rely increasingly on own budget surpluses in financing their capital expenses. In addition, they have financed their expenditures through credits, both from commercial and state sources.

The Czech Republic faces important challenges regarding efficient fiscal decentralization. The first challenge of *extensive fragmentation* can be overcome by the implementation of an intermediate level of government provisioned by the Constitution. Experience elsewhere shows that certain issues, such as environmental protection, unemployment, the privatization process, and development planning are better handled within a regional context. The fragmentation problem can also be addressed by regrouping municipalities through the promotion of joint projects, or the creation of special districts.

Revenue composition and revenue sharing constitute the second challenge to fiscal decentralization in the Czech Republic. The composition of revenue leaves little room to make independent revenue decisions, and it prevents competition between municipalities. As the revenue side cannot be used significantly, local entities resort to debt financing to balance the budget. Thus, there is a need for a system of legal standards to harmonize the financial decisions made by local representatives. The decisions regarding the magnitude of local tax burden would be efficiently located in the communities, which would no longer be "passive" recipients of funds.

A third challenge for the future is the development of local tax administration capacity, which is necessary before undertaking further devolution of revenue. The lack of regular exchange of information among municipalities concerning their fiscal flows, the absence of regular evaluation of the impact of the changes in the revenue system and the shift in responsibilities. Thus, there is insufficient data to carry out a proper fiscal analysis of a growing local budget system.

A fourth challenge is the lack of proper instruments of monitoring and control by the Ministry of Finance over sub-national financial operations, which may have increased the appeal for control by tax shares and transfers. Despite no defaults so far, commercial credit accessed by Czech municipalities has caused concern, because of its relatively fast growth in the absence of regulations and the potential risks to the central government. These risks include possible bail-outs of defaults, if hard budget constraints are not in place, and contribution to excessive general government indebtedness. The reaction of the government has been to slow down the growth of the market and to prepare a legal framework for this debt, which has not yet been passed. It is urgently needed to introduce a comprehensive prudential framework for sub-national debt, complemented with central monitoring capacity, in order to limit risky or excessive municipal borrowing and to prevent unpredictable and administrative interventions in the market. It is also necessary to strengthen market discipline through introduction of information disclosure rules for sub-national debt, a legal framework for investor protection and collateral, as well as the maintenance of a clear signal to the market that municipalities operate under hard budget constraints.

A fifth challenge is to improve the transparency and rationale of the system of state-allocated loans and capital grants. Although commercial credit has grown considerably, it occupies only a small segment of banking credit and a negligible segment of the domestic bond market. In contrast, reliance on a variety of state-allocated loans to municipalities has grown. This could lead to under-cutting of the commercial market as well as weakening of budget constraints. Both the capital grant and the subsidized loan system should be reviewed to ensure that they are based on rationale and transparent economic criteria. Additionally, institutional capacity for allocating, monitoring, and evaluating the use of capital grants will need to strengthened at different levels of the government to ensure an effective and transparent implementation of the EU pre-structural and structural funds.

Finally, the role of the private sector in the provision of the public goods needs to be strengthened. Currently, the financing and allocation of public goods is done through political means, not market mechanisms. As most public goods in the Czech Republic are financed or provided by the central government, the unpredictable nature of the various revenues results in vast inefficiency. A desirable feature would be the generalization of formula-based allocations of resources. In addition to grants, regional deconcentrated government, and cooperation between communes, an important direction towards the solution of small municipalities could also be the shifting of responsibilities from governments to markets. The private sector could be used as contractor to acquire economies of scale, but subject to local regulations, to provide local public goods.

Foreign Trade Policy and Foreign Direct Investment

Czech foreign trade developments have gone through two distinct phases: the first phase occurred over 1989-95 and was characterized by exceptionally rapid growth, much higher than in other transition economies; the second phase, which occurred from 1996 on, and was characterized by a considerable slow-down in exports to the EU. Although the growth rates still remained respectable, the increase in 1996 barely kept pace with the growth of EU import demand. The triple-shock of the collapse of the

Soviet Union and the CMEA, the dissolution of Czechoslovakia and a shift towards market-based regime in foreign trade contributed to the initial expansion. The disappearance of political factors that had shaped foreign trade patterns in the CMEA led to the collapse of "Eastern" trade, and sizable portion of this trade was redirected to EU markets: the value of Czech exports there grew at an average of 30 percent annually over 1990-95.

The Czech Republic today faces tougher competition for EU markets from its neighbors. As transition advanced in the 1990s and as the CEE economies recovered from the initial real shock, a fierce competition for a larger trade share in the EU has developed. The Czech Republic has lost some momentum in its export penetration in the EU. Western firms have many choices in the region and exercise those choices in the form of stronger trade links and foreign direct investment (FDI). Most of the foreign trade in the region is closely linked to firms with FDI. While the Czech Republic's trade regime is quite liberal relative to other leading transition economies, it has been unable to maintain its initial export performance trend.

The Czech Republic's capacity to remain competitive has been hindered by several factors. First are periods of real exchange rate appreciation, which were due, in part, to strong capital inflows during 1993-96. Second is the wage pressures, coming from the public sector and from privatized enterprises with weak corporate governance, that have increased public expenditures and negatively affected enterprise profitability. Wage concessions have also been a factor in the appreciation of the real exchange rate, as real wage demands exceeded productivity increases. This trend, however, has subsided in recent years. The third factor affecting competitiveness is the form and pace of restructuring in some enterprise sectors that has negatively impacted the Czech Republic's growth capacity. Policy makers have faced the challenge of dealing with these complicated issues while trying to ensure that the capacity of the Czech Republic to export to the EU is preserved.

FDI has contributed to the development of the Czech economy, its reintegration into world markets and the expansion of stable commercial and production links with firms located in the EU. FDI has contributed to the export success of the Czech automotive industry. It has thus far attracted around 13 percent of total FDI. Skoda Auto, part of the Volkswagen Group, is not only the largest firm in the Czech Republic, but it is now also the largest exporter -- and importer -- accounting for 7 percent of Czech exports to the EU. It has contributed to the development of forward (cost) and backward (demand) linkages among domestic firms. Skoda suppliers have become exporters in their own right.

The Czech Republic needs to increase the contestability of its domestic markets, thereby increasing the competitiveness of Czech firms, and generating a business friendly environment. Such an environment is important, not only to attract needed FDI, but also to enhance the efficiency of domestic firms. The competitiveness of firms, both domestic and foreign-owned, also depends on competition at home from imports and domestic sources alike. This, in turn, hinges critically on a liberal trade and investment regime. There are several measures that might increase contestability of domestic markets. These measures can be summarized as follows:

- To improve *competition policy framework*, as well as rules and enforcement capacities of competition authorities, one may consider granting anti-trust authority to a single independent institution. This institution would be empowered to assess the competition and welfare impact of important policy decisions, as well as actions taken by firms affecting the contestability of domestic markets, and monitor their impact *ex post*;

- To improve the current framework of *state aids*. This would involve establishing transparent monitoring mechanisms, streamlining and reducing the scope of subsidies. State aids should also be subjected to scrutiny by a competition authority once it is reformed;

- To *open government procurement* to foreign contractors over the next years along the lines of the GATT Agreement on Government Procurement. Among other things, this would entail the elimination of preferences offered to resident firms; and

- To *align Most Favorable Nation (MFN) tariff rates on industrial products with those levied by the EU*. This would not necessarily involve a formal lowering of statutory tariffs but might simply entail the change in applied rates.

The Challenges in Social Sectors: Social Security, Health and Education Reform

The Czech Republic's social sector policy has evolved during the transition The changes have been promoted in order to meet two key objectives. First, the Czech authorities had to set an appropriate basis to support the transition to a market economy. An important part of this strategy was an extensive overhaul of the educational sector. The second objective -- closely related to the economic reforms in transition period -- has been establishing an adequate social safety net. Consequently, the Czech social security system has undergone fundamental restructuring during the 1990s with the objective of establishing a system that meets the needs of a market economy. The three main components of social protection consist of: (a) the pension system, (b) social assistance and support, and (c) the unemployment compensation scheme.

Currently, the pension system provides three types of benefits: old-age pensions (for the retired), disability pensions (full and partial) and survivor pensions (for widowers, widows and orphans). Old-age pensions have typically accounted for 70 percent of total pension expenditures, with a positive trend (64 percent in 1980 and 69 percent since 1990). In January 1996, the new Pension Insurance Bill came into effect, which changed the retirement age, the conditions of early retirement and the calculation of the pensions. Expenditures on pensions have been growing from 8.2 percent of GDP in 1995 to 9.2 percent in 1998.

In the past, the Czech Government managed its pension system far more prudently than other transition economies. In particular, during low unemployment rates, early retirement was not used as extensively as elsewhere to provide an outlet for unemployment. Recently, a retirement age increase was enacted, but this long-run reduction in costs was offset by the re-adjustment of benefits, by provisions allowing for greater scope for early retirement, and by additional years of credited time for women providing for childcare. These changes are likely to increase costs in the future.

Since 1994, the original basic obligatory pension insurance was complemented by the new voluntary state-contributory pension insurance. However, the voluntary scheme has only been used by the older population, and to increase its utilization, several recommendations can be made: (i) short-term contributions made by employees close to, or above, retirement age in order to qualify for pension should be eliminated; (ii) contributions and earnings on pension accounts should not be taxed as current income; and (iii) the high replacement rate of the state pension system needs to be lowered to encourage more voluntary pension saving.

The private pension sector also suffers from a number of other weaknesses. First, the institutions may fail to promote supplementary pensions, as they effectively offer short-term savings policies. Second, because the funds have a relatively short time horizon, they may not become providers of long-term resources and will contribute less effectively to capital formation and resource allocation. Third, participants are not required to save a minimum percentage of their earnings, leading to a low average contribution and constraining the growth of the system. Fourth, there are no clear rules on accounting standards and information disclosure, and no guidelines on advertising. As a result, the system is opaque, and the public cannot make informed decisions. Finally, the supervisory function is very weak, and appears to focus on ensuring that no participant receives multiple state contributions; it overlooks the importance of prudent and transparent policies. The Government, however, has already drafted various amendments to the Pension Fund Law that address several, but not all, of the problems identified above.

The pension system will need to be reformed, given the demographic structure of the country, otherwise the costs of the system will require a payroll tax that will not be supportable by the employed population. The government should be concerned about the demographic dynamics that are likely to destabilize the pension system soon after EU accession if appropriate measures are not taken. As noted above, pension expenditures relative to GDP have been growing by 12 percent between 1995 and 1998. Now is the best time to initiate changes in the pension system to make it sustainable by scheduling further increases in the retirement age to take account of changes in life expectancy, improving the actuarial fairness of early retirement provisions, eliminating the accrual of benefits during periods when people are not in the labor force, and limiting the indexation mechanism only to inflation. Further, the link between contributions and benefits should be strengthened, and consideration could be given to partially pre-funding the pension system to spread the burden of retirement financing more equally across generations and to enhance fiscal discipline.

In 1991, the right for everyone to have assistance essential for ensuring the basic living conditions was established. Minimum living standards (MLS) were set for different household types and served as a basis for providing means-testing. The MLS for each household was computed as a sum of two parts: the personal minimum, based on whether one is an adult or a child, and the household minimum, a function of the number of individuals considered to be living together as a household. Households can receive a cash benefit -- social assistance -- equal to the difference in their income and the MLS.

A new and substantially revised social welfare system came into effect during 1995-96. One important thrust of these changes was that the number of means- or income-tested benefits increased. In general terms, transfers today can be grouped as means-tested *social assistance* and non-means tested *social support* to families with children, although some of the social support programs are also means-tested.

Before 1996, all households with children (under the age of 20) were able to receive a package of family benefits irrespective of their level of income. Social support benefits were not taxable, but there was implicit taxation in that these benefits were included as part of total income of a household when applying for social assistance. Since 1996, most of these benefits (in terms of budget allocation) are means tested. The most important elements of the family support benefits are (i) child allowances, (ii) social supplements, (iii) parental contributions, and (iv) others such as housing, transport, funeral, foster care and maternity benefits, the latter accounted as health care support.

Some of the key systemic improvements within the social protection net relate to the rationalization of social assistance through a system of income support that has reduced public expenditures and has targeted benefits towards the poorest members of the community. The targeting mechanism used is the minimum living standard, which is price-indexed and is adjusted periodically to ensure that it reflects the consumption baskets of lower income Czech families. This system is scheduled to be updated in the future to encourage work and to provide greater discretion on the part of social workers to deal with individual financial and personal circumstances.

Despite many recent changes the structure of the social assistance and social support systems exhibits problematic signs in terms of the implied incentives for the recipients. The system has moved in the right direction by increasing the number of benefits that are means-tested, but the level at which targeting mechanism of the minimum living standard is set is still relatively high. As a result, (i) targeting is not as narrow as might be desired; (ii) social transfers represent a non-trivial part of income for families with children and (iii) the scheme might have a serious work disincentive effect.

As the Czech Republic prepares to enter the EU, it is incumbent that its social protection system are in line with the other EU countries. Considerable effort has already been made in that direction. Nonetheless, it is equally important that the Czech Republic not be burdened by some of the problems inherent in the social protection systems of a number of EU countries, since these problems would be magnified in the Czech Republic, which lacks the income cushion to support overly expensive social entitlements.

As for the unemployment compensation scheme, some adjustments were made at the beginning of the transition period, but it is becoming clear that further improvements are necessary, particularly in order to meet the challenges of the recent growth in unemployment. The challenge, however, arises with effort to devise such a program that would minimize the work disincentive effects.

With increasing unemployment rates, the current social protection programs might be used more extensively, adding to a further fiscal deficit. Moreover, the social programs might also produce adverse incentives for unemployment reduction:

- The parental allowances might exacerbate female unemployment by providing an incentive for longer career breaks.

- With a protected MLS income for a family of four, there will be little financial incentive for a parent to find a job given the high implicit tax rate resulting from the post-employment reduction in the several layers of allowances -- especially in the lowest-income families.

- Given the opportunity for early retirement, some individuals will select this option, thereby increasing expenditures on pensions.

With the objective of achieving a balanced public budget, the possibilities of the social protection expenditure cuts need to be assessed. Social assistance and support expenditures form the smallest of the three programs, and cannot significantly affect public expenditures. However, within this budget, expenditures for persons with disabilities have been rising at a rapid rate, particularly in comparison with expenditures for the poor population. Accordingly, the government should reassess those programs which could better be provided as cash assistance in an equitable manner, reducing expenditures that are excessive and transferring some of the in-kind benefits to appropriate non-governmental organizations. Such rationalization would also free up the resources of the state administration to focus on poverty.

Within the efforts of human development, the Czech government also began to address the socially excluded and disadvantaged minority population of Roma or Gypsies. Estimates suggest a Roma population in the order of 300,000, about 3 percent of the national population. This minority has been particularly affected by the transition period in several ways:

- Roma, often occupying unskilled jobs, were usually the first to be laid off when employment in state-owned enterprises contracted. Many of the Roma continue to live in isolated apartment blocks formerly associated with enterprises, but it is difficult for them to maintain the standard of their housing.

- Their survival depends on social assistance payments, which sometimes provides a disincentive to work. Isolation also precludes easy access to health facilities, and this, together with an unhealthy lifestyle, predisposes Roma to higher levels of illness.

- Since Romany language is their mother tongue, Roma's children's access to the Czech education system is limited.

The combination of limited education, high unemployment, unhealthy lifestyle, poor housing, and high birth and death rates has turned the Roma into a third-world enclave isolated and embedded as a series of small pockets of population among a first-world Czech nation. A growing prejudice and discrimination against Roma have further reinforced this unfavorable situation. Roma are widely seen by non-Roma as feckless and prone to criminality. This discrimination has extended to frequent denial of access to employment, so that in practice Roma have had few legal opportunities for self-betterment, with the result that the popular prejudice against them has tended to become self-fulfilling, as they have lapsed into either apathy or petty criminality, for want of more productive options. Unemployment, lack of skills and opportunities, and discrimination have made Roma communities economically unviable.

Recently, following EU and other international concern, the national authorities have begun to address the above situation, designing a broad program of actions. Despite continuous manifestations of prejudice against Roma at the local level, there have been promising initiatives to improve access to education for Roma children (such as preparation classes), and to eradicate prejudice among the police and judicial authorities. A much greater effort is still needed to provide adult training to increase Roma access to employment and self-employment, and to facilitate use of medical and public health facilities by Roma.

The health sector in Czech Republic has undergone a radical reform since 1990. Unlike the rest of the region, the Czech Republic initiated a sweeping reform that restructured, refinanced and reoriented its health system. Despite the gains associated with these changed, and in some cases because of them, fiscal pressures have persisted over this same period. Indeed the challenges for the health system lie in establishing and ensuring clear and consistent policies in the health sector, coping with the existing debt overhang among providers, addressing the regulatory and enforcement weaknesses of the current system, and strengthening incentives for improved cost containment, including further downsizing. These elements will define the costs and effectiveness of the Czech Republic's health system.

The process of accession to the European Union is likely to impose sizable expenditure pressures on the Czech Republic. This will come at the time the country is facing the need to rationalize its expenditure policies, consolidate the budget process and impose real fiscal discipline on operations conducted outside the budget and by transformation institutions. While there is little demand from the transposition of the *Acquis Communautaire* on the health sector, concern has already been expressed by the EU regarding the health financing system and its viability over the longer term. As the process of accession to the EU advances, an affordable and efficient health care system that does not compromise the government's expenditure envelope and the quality of services provided is necessary.

The current financing system is fragile. The percent of GDP devoted to health has remained relatively constant and current deficits have been manageable, however, underfinancing is emerging, particularly in the largest health insurance company, and highly indebted providers introduce instability into the sector. As the health system evolves, these issues will remain paramount and deserve to be carefully monitored along with the policy issues noted above.

The Czech Republic's health reform had important effects on both health care and its financing. It was highly successful in dismantling the previous system of delivery and finance, and increasing spending to improve medical care. However, there remains a serious debt overhang, and lack of incentives in the system to continue the needed improvements to raise both efficiency and effectiveness of health care, both of which will be required to satisfy the professionals in the system and the financial imperatives of the Ministry of Finance. Because of the nature of the health care market, controlling public expenditures entails clear policies, regulations that define and enforce the rules of the game, appropriate incentives in the system to foster desirable behaviors, and strategies to keep the volume and cost of services in check.

A major problem is the highly fragmented nature of health policy in the Czech Republic. Policy shifts and implementation have been led by multiple actors often not working in concert, including the Ministry of Health, the Health Insurance Fund and the Parliament, among others. There is no clear leadership in the sector, and the myriad of amendments to the original Act is testament to the lack of a clear vision. This lack of vision affects both the nature of the system and its costs. Without more concerted leadership, progress will be difficult if the past is any guide. Legislation and regulations proliferate to address narrow issues without regard for the broader concerns of the system or its finances. Roles of accountability, however, are ambiguous.

The policy toward the health insurance companies and their regulation needs better consistency. In 1998, large wage increases were instituted by Parliament for all government workers, thereby raising health care costs without commensurate increases in premiums or controls on costs or volume of health care under health insurance. Although technically this did not affect all health workers, it raised wages in public facilities, and implicitly forced private hospitals to follow suit to retain staff. Given the already strapped financed of the health insurance companies, this move undermined the financial order achieved in 1997. If this is not monitored, insurance companies will revert to past practices of under and late payments to providers, risking renewed hospital debt accumulation. Strengthening regulation of insurance companies is essential. However, allowing some product competition and differentiation of benefits and policies across insurance companies while maintaining financial stringency can yield benefits and at the same time contain costs.

An important means of fostering clearer policies and greater internal consistency is through policy analysis to advise policymakers and guide policymaking. Tracking costs, assessing the effectiveness of incentives, evaluating regulatory measures or determining how to foster both quality and cost containment are examples of the kinds of issues that policy analysis can inform. Many of the issues could be addressed, monitored and evaluated through such efforts. Some countries use grants to solicit such analysis from universities or private research groups, and this could be applied in Czech Republic. Such analysis allows adjustment to the health system and its financing through a more transparent and consistent assessment, and could lead to more coherency in health policy.

There is need to improve cost containment efforts where they are inadequate. Some of the incentives under the current system effectively control costs –alternative payment system for physicians (e.g., capitated primary health care), adoption of new medical protocols, reimbursement only for basic services or technologies, commission to control acquisition of medical technology -- should be maintained. There are, however, areas of particularly high priority: (i) further reducing beds and hospitals, and continuing to shift services to outpatient settings where quality and efficiency are enhanced; (ii) track the number of physicians being trained to control oversupply, which raises overall costs; (iii) improve the drug pricing and reimbursement regulations to encourage cost consciousness, enhance information systems of drug use and pricing to inform policymakers as well as providers, payers and consumers, and reduce the public subsidy from 80 percent of costs to proportions closer to other OECD countries; (iv) allow some product competition and differentiation by insurance companies while maintaining financial requirements; (v) permit greater cost sharing by consumers for items where there is a likely ability to pay, such as pharmaceuticals, or upgraded quality (e.g., more expensive diagnostic or treatment technologies or high quality medical materials), as is done for hospital hotel services now. This maintains a basic level of subsidized care, and retains patients who contribute to the health insurance funds, but are willing to pay a premium for small increments in quality; and, (vi) the debt overhang of hospitals needs to be dealt with, and it needs to be done by government. Commensurate with paying off debts, must be great financial stringency in the health care system should be required to avoid the problems of the past and to signal the serious of the issue for the sector.

Longer-term projects that deserve attention in the short run are information and quality. A high quality, interactive management information system to assist the government, insurers and managers track the volume and costs of care. Some elements of a management information system (MIS) already exist, but systematizing and broadening it would pay off in improved overall management. Upgraded MIS would allow monitoring of hospital management performance, and enhance hospital managers' ability to manage. Quality assurance, clearly something that has been given attention in some areas, deserves higher priority, because such practices not only raise quality, but they can often reduce costs.

An important part of tackling the rising unemployment rate and promoting the human development of the Czech Republic, is the establishment and consolidation of a dynamic education system. Only education institutions adjusted to the aim of meeting the requirements of the market economy can assist the Czech Republic in successfully overcoming the transition period. From 1948 to 1989, the education system was subject to close ideological control, exercised through the Ministry of the Interior. After completing basic education, the majority of children were channeled into short-duration secondary vocational schools, where they took occupationally specific courses leading directly to jobs in production enterprises. Uniformity was stressed, not only in pupil performance, but also in the management and budgeting of education, and in teacher remuneration, which lead to the stagnation of the system.

A fundamental change occurred at the end of 1989 with the depoliticization and decentralization of education, the ending of the state monopoly, and the introduction of pupil and parental choice of study options. Other major changes included the introduction of normative financing, together with the diversification of sources of funding beyond the state budget, and the initiation of a significant degree of flexibility in curricula at the school level.

The educational environment in the Czech Republic is dynamic in several respects: (i) overall enrollments are tending to decline as a function of the declining population, (ii) within this broad trend, university and other post-secondary enrollments have increased, along with technical secondary and to some extent gymnasia, whereas vocational secondary education has substantially decreased and kindergarten is slowly declining, (iii) private education has been introduced, especially at the technical secondary level, (iv) extensive decentralization took place, with district education authorities playing a key role, but even municipalities becoming involved in kindergarten and basic education, (v) normative financing has become the dominant method of allocating educational expenditures.

In other respects, the system resists change: (i) the growth of private schools has not resulted in any significant decline of public schools, (ii) the number of teachers has declined slightly, but less than enrollments, so that teaching loads have declined further (the decline in teaching numbers is heavily concentrated among secondary vocational instructors and kindergarten teachers, while other categories have increased, sometimes substantially), (iii) there has been limited recruitment of young teachers with modern training, leaving the teaching force conservative and resistant to innovation, (iv) the administrative fragmentation since 1989 makes it more difficult to introduce systemic improvements in education, e.g. standardized national examinations.

The level of education that appears the most problematic is upper secondary, especially the vocational stream. While this latter has been contracting in enrollment terms, not in the number of schools, it absorbs an increasing share of expenditures. Moreover, graduates of this stream have increasing difficulty in finding employment. There appear to be strong vested interests within the education system still wedded to the concept of training for specific vocational competencies, instead of making the switch to training for the occupational characteristic of a dynamic market economy. Since many of the programs in vocational education relate to industrial occupations no longer needed in an increasingly service-oriented economy, the inappropriateness of much current provision is thereby exacerbated. The expansion of non-state initiatives in this sector would offer scope to increase its relevance, except that this development has not been accompanied by any significant closure of the outdated facilities.

The prospect of EU accession has significant implications for the Czech education system. EU membership will place the Czech Republic in a very competitive economic environment. This indicates the need to accentuate modernizing tendencies in the education system, in particular at the secondary and post-secondary levels, which will involve investments in staff retraining and equipment updating. Any further investment in the system presupposes savings in existing provisions in order to make room for new initiatives. There should be urgent attention to the closure of under-utilized and irrelevant facilities, especially in the vocational stream, with the concomitant staff reductions or redeployments. One possible channel of modernization will be the development of close institutional linkages with parallel schools or colleges in the present EU member states, with staff and student exchanges facilitating the adoption of innovations.

A more symmetrical structure of educational administration would enable the Ministry of Education to focus more attention on adaptation of the system to the pressures of the market-oriented EU environment. This will also require that the Ministry leads the effort to develop constructive partnerships at regional, district and school levels, in order that these levels become sources of initiative and innovation. Extensive retraining of administrators as well as principals and teachers will be necessary to achieve this new environment, and it will also require a continuing publicity effort directed to parents, students, and the local communities to engender their support for progress. There is likely to be an expanding component of non-state educational provision, which will also have to be brought into a changing environment as an active partner.

Maximizing the Benefits from Joining the EU Single Market

The challenge of accession to the EU comes from the need to develop policies and institutions to facilitate restructuring and to enhance the capacity of the Czech economy to benefit from the increased competition of the EU single market. To achieve this, the authorities need to concentrate in improving the environment under which the financial and enterprise sectors operate and in developing a strategy to reform key components of the economic infrastructure.

Reforming the Financial and Enterprise Sectors

The 1998-99 recession has served to highlight the deficiencies in the structural front, particularly those related to microeconomic foundations of the banking and enterprise sectors. The financial conditions of the banks remain weak. Sources of weakness include poor corporate governance, significant non-performing loans, poor ability to assess risk, and the belief that the Czech authorities would not let banks fail. In an environment of increasing guarantees, bank managers have little incentive to do proper risk assessment, thus helping increase financial sector vulnerability. The need for banks to comply with harder regulations in the banking system -- concerning collateral provisioning for non-performing loans -- resulted in a severe credit crunch that reduced the availability of new credit to the real sector. High interest rates also played an important role in the decline of credit demand. This was compounded by the recognition by local Bank's that their loan portfolio had deteriorated, thus limiting credit supply. As a result, large banks virtually stopped lending. The growth in the banks' credit to both enterprises and households declined in 1998 to just 5 percent. The reduction in credit served to reveal the weak microeconomic fundamentals prevailing in the Czech economy and its enterprise sector.

Now that the Czech banking reform program has gained momentum and is addressing the key shortcomings in the sector, it is important to minimize the likelihood that the reform program is derailed by the possibility of high short-term cost associated with some elements of the reform. The main part of the reform agenda consists of privatizing the large state-owned banks. The recommendations below aim at minimizing the net cost to the State of the privatization viewed as a whole:

- *Acceleration of Legal Reforms.* In the Czech context, the legal environment is a powerful external variable, which impacts the net cost of the privatization transactions. If the Government acts quickly to alter the legal conditions surrounding the seizure and the sale of collateral and the bankruptcy process, the value of the classified assets of the Czech Savings Bank (CS) and Komercni Banka (KB) could be increased significantly, with equally significant potential benefits to the post-privatization owners of those assets. Similarly, consideration should be given to accelerating the timetable for adopting a new bankruptcy law.

- *Administration of the Privatization Process.* The bank privatization process is administered by a steering committee composed of representatives of the National Property Fund (NPF), the Ministry of Finance, and Czech National Bank. The committee supervises the activities of those investment banks retained to act as financial advisers to the NPF. The Government makes the final decisions regarding the privatization process. Given the likely technical complexity of the CS and KB privatizations, to contain costs it may help to obtain the services of an outside adviser in order to enhance the committee's strengths. The adviser would provide support for analyzing the broader implications of the bank-specific recommendations made by the banks’ financial advisers.

- *Pre-Privatization Governance of the State Banks.* A number of steps could be taken to improve bank governance in the pre-privatization period. The NPF or the supervisory boards could retain advisers to assist them in defining targets for placing the banks on a time bound program of operational and asset quality improvement and by monitoring the achievement of each bank's operational restructuring program. The governance structure of the banks could be amended to ensure that credit decisions and the effectiveness of controls are monitored by improving the reporting relationship between the supervisory boards and internal and external auditors. Given the scope for improvement in the banks' performance, relatively small investments in good governance could bring large benefits by the time the banks are privatized. Also, tax rules should be reviewed to allow a faster build-up of provisions already in the pre-privatization stage.

The fragile financial situation of a large segment of the enterprise sector is a source of particular concern. The poor state of many of the large, domestically owned industrial conglomerates has been a drag on the economy, and the banking sector in particular, throughout the transition. The lack of corporate governance, the neglect of investor protection, poor lending decisions by banks, and a failure to close non-viable production units have all resulted in the survival of large, inefficient, politically powerful, socially important and excessively indebted corporations. This lies at the heart of the current economic malaise. Addressing the problems of the corporate sector in a manner that does not generate a wrong incentive structure will prove to be one of the key policy dilemmas of the current administration. This legacy of the past must be cleared and an efficient industrial system reconstructed.

Banking reform measures need to be closely accompanied by a set of reforms related to the future performance in the enterprise sector:

- *Complete privatization of the remaining state assets in the enterprise sector by sales to strategic investors*. Any pre-privatization enterprise restructuring should not include new capital investments. Experience has shown that attempts to increase the selling prices of state enterprises by making pre-privatization investments are not likely to be recovered in the purchase price. Instead, the restructuring should consist of unbundling conglomerates, creating an adequate social safety net for affected workers, and possibly the restructuring of some enterprise debts. Also, regulatory frameworks for the increase of competition in the field of public utilities must be prepared, and privatization should follow.

- *Recovery of Assets of Transformation Institutions.* In the Czech Republic, large amounts of classified assets are in State hands in the transformation institutions. The restructuring program under the auspices of the Revitalization Agency needs to be carefully tailored and executed, focusing on devising an appropriate incentive structure for the independent administrator. The role of the state participation should be minimized, and the private sector participation encouraged. Moreover, there should be a clear separation of functions between the economic development role which is currently delegated to Konsolidacni Banka (KoB) and the handling of the non-performing assets of this bank. Development banking activities should be clearly brought under the supervision of the Czech National Bank.

- *Steps need to be made to improve corporate governance*, especially by increasing managers' accountability to the owners, transparency, introducing shareholders rights and fixing foreclosure and bankruptcy provisions. Corporate governance will benefit from measures that clarify the duties of directors, improve disclosure and the quality of information, enhance the ownership structure of commercial banks and improve monitoring of boards by shareholders.

- *Effort in the enterprise sector must be made to meet the EU quality, environmental, and safety requirements*, so to prepare the Czech real sector for the strong competition that EU accession conveys, as well as to facilitate EU penetration by Czech companies.

The capital market needs to be further strengthened to recover credibility and to be a real source of corporate financing. The government reacted to the emergence of problems in the capital market by strengthening the regulatory framework in several steps. In 1996, several amendments to the Commercial Code and the Investment Fund Act were introduced. These amendments improved, among other things, disclosure and minority shareholder protection rules, and prevented a further conversion of investment funds into holding companies. However, it became apparent in 1997 that these improvements had not improved governance of investment funds significantly nor arrested fraud. For this reason, new amendments were drafted in 1997 and enacted in 1998: they included amendments to the Act on Banks, the introduction of an autonomous Securities Exchange Commission, and amendments to the Investment Fund Act. In addition to these changes, the Government is also preparing improvements in the regulatory framework for pension funds and insurance companies that may significantly affect the way these institutions operate, and could have a positive impact in the overall efficiency of the capital market.

The central question faced by Czech policy-makers is whether the changes that have been recently enacted, combined with those that are under elaboration, will enable the capital market to

perform all its functions efficiently and will contribute to the development of the Czech economy. Despite the improvement in the quality of the regulatory and institutional framework of the capital market, it is still uneven across sectors. For investment funds, it has greatly improved with the introduction of the Investment Fund Act. More improvements, however, are necessary. For pension funds and insurance companies, the regulatory framework still has severe deficiencies. Amendments to the Insurance Act and the Supplementary Pension Insurance Act will strengthen transparency and discipline in the market, but further reforms are needed, especially in pensions.

Further improving the capital market will require a concentrated effort from the government. Reforms are needed in the securities market, investment funds, pension funds, insurance companies and in the general area of improving corporate governance. These reforms can be categorized in the following way:

- To improve securities market, the broad objectives of the Commission for the security market should be to restrict the number of publicly tradable companies (to those that really fit this profile and that may benefit from open access to the capital market), integrate the different trading channels, and ensure compliance with the regulatory framework, while also proposing and implementing further improvements in legislation. These actions would ensure the achievement of price convergence, increase market liquidity, restore confidence, and open more possibilities for new equity issues.

- To improve performance of investment funds, the Securities Commission should ensure orderly opening of the investment funds. Moreover, pricing rules need to be updated; the regulatory framework needs to be adjusted to conform to that of the EU; space needs to be opened for genuine venture capital funds, and holding companies need to be regulated to improve transparency and enhance governance.

- Regarding the performance of pension funds, measures need to be implemented to improve the current voluntary system without changing its character, thereby strengthening the regulatory framework for these funds. However, as problems in the banking system and capital market are resolved, the authorities may consider the feasibility of adopting a three-pillar pension system along the lines of the reforms implemented in recent years in Poland and Hungary.

- To strengthen the insurance sector and to ensure greater compliance with EU directives, the authorities are considering a number of amendments aimed at improving management performance in insurance companies, facilitating private sector entrance, leveling the field to foreign participants and reducing monopolistic positions in some markets.

The effort needed to regain the credibility of the Czech capital market institutions is considerable. The benefits from having a capital market that can channel savings into productive investments, however, surpass the costs. On the road to EU accession, addressing the deficiencies of the capital market will prove, not only essential, but also strategic in order to enhance the prospects of the Czech corporate sector.

Facilitating Labor Market Adjustment

Among transition economies in Central and Eastern Europe, the Czech Republic was unique in coping with the reallocation effects on employment during the initial years of the transition. While other transition economies suffered from high and persistent levels of unemployment, the Czech economy did not experience this painful aspect of transition.

The 1997 currency crisis and the follow-up recession is slowly changing the face of the Czech labor market. Unemployment has been rapidly growing since the 1997 crisis, and the gap between vacancies and jobs has widened. The unemployment rate reached 8.3 percent of the labor force in the second quarter of 1999. At the current speed, the unemployment rate is likely to reach or surpass 10 percent during 1999. While this level of unemployment is low in comparison with many transition economies, particularly the Slovak Republic, it is worrisome since the short-term perspectives for economic recovery are slim. Moreover, regional variability in the unemployment rates are high and also growing.

Migration flows are not likely to ease the pressure on the labor market. A number of factors induce one to think that labor flows within the Czech Republic and toward EU countries will probably remain small. First, regional mobility in the Czech Republic is weak due, in part, to housing shortages. Second, the income differences between the EU and acceding countries tend to be smaller than those countries that have been observed to generate sizable migration.[3] Third, the unemployment problems faced by many EU countries discourage migration, even at the country level. Finally, during the last wave of accession, the potential migration flows expected from Greece, Portugal or Spain toward previous EU members never materialized despite the elimination of national borders.

Pursuing a strategy conducive to the recovery of a sustainable growth path, and therefore towards job creation, continuous adjustment and innovation, is essential for the Czech Republic. Wage moderation would improve external competitiveness; the public sector needs to take the lead in signaling this intention to the market.

While the recession has made labor market conditions more difficult, it has by no means affected everyone equally. Women have been affected more than men. Already during the transition, the income differential between men and women has increased; women are now more likely to move to unemployment and less likely to emerge from it. While Czech society places a high value on family, labor policies are making women "more expensive" than men, thus sending the wrong incentives to the labor market. Consideration should be given to redesigning labor policies affecting women to retain the social value without inducing the incentive distortion that hurts women's prospects.

With increasing unemployment and with the potential to develop long term unemployment, there is room for improving programs in support of unemployment. The system of unemployment assistance should be reviewed to avoid threshold effects and poverty traps. Work-tests should be enforced to avoid a waste of scarce public resources. Efforts to evaluate and improve the effectiveness of active policies should be continued. To reduce regional variation in unemployment rates, consideration should be given to other types of policies, complementary to labor market programs, particularly those fostering the development of public transportation, housing and mortgage financing.

In the area of the labor market, the Czech Republic's compliance with the Acquis Communautaire implies recognizing both a set of minimum rights for workers and standardized labor conditions resembling those prevailing in the EU. The White Paper prepared by the EU identified four areas of social legislation (linked with labor markets) where legal harmonization and convergence is needed, namely: (a) equal opportunity for men and women; (b) health and safety at work; (c) labor law and working conditions; and (d) coordination of social security schemes.

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[3] Measured in PPP terms, the income per capita of the Czech Republic was 59 percent of Germany's and 92 percent of Greece's income per capita in 1998.

Compliance with some EU regulations could increase labor costs and adversely affect labor demand and enterprise competitiveness abroad. Implementing such regulations means also setting up ways to monitor compliance by firms (labor inspection, for instance) and allowing workers to exercise their rights (through administrative and judiciary bodies). Budgetary resources will need to be devoted to these activities. Once the broader impact of reforms is factored in, however, the net impact on economic efficiency and welfare is likely to be positive. The pre-accession strategy should thus focus on: (a) the early adoption of those EU norms that would make labor market institutions more flexible; (b) the gradual adoption of those reforms/or enforcing the compliance with existing laws in cases where benefits exist but which also entail transitional costs (health and safety at work); and (c) delaying adoption of EU norms which will restrict flexibility (the case of firing costs).

In the run-up to accession, there is an opportunity to make the Czech Republic's labor markets even more efficient. In a time of rapid economic change, labor market flexibility would ease the reallocation of factors of production from non-competitive to competitive firms, thus feeding economic growth while reducing unemployment. Moving quickly towards mutual recognition of educational and training systems and professional qualifications with the EU will help the Czech Republic strengthen its human capital. Investments in education are likely to have the highest returns. The rapid professionalization of its civil service needs to be part of this process. Preparing for, negotiating, legislating, and implementing EU norms requires intensifying the training of civil servants, including intermediate and technical staff.

As the fiscal situation permits, there should be efforts to reduce taxes on labor, in particular the social security contributions for health, pensions, sickness and employment insurance. High taxes on labor are not only harmful to job creation but may also encourage tax evasion. While it is likely that this is currently less a problem in the Czech Republic than in other transition economies, small firms typically cannot afford the same compensation costs as larger enterprises; they are more difficult to target for audit and enforcement. Thus, if taxes are too high, fewer small firms will be established, wages will tend to be under-reported, and the size of the informal sector will tend to increase. The experience of other transitional economies suggests that, in an economy undergoing rapid structural change, a vicious circle of increasingly high tax rates and a shrinking tax base could be set in motion.

Economic Challenges in the Infrastructure Sector

The Czech Republic needs to develop and implement appropriate microeconomic policies in the key infrastructure sectors. Any economic reform program that seeks to improve the efficiency and productivity of the Czech economy must include certain key elements of microeconomic and industrial organization policy. Otherwise, as the experience from several countries reveals quite clearly, the beneficial impacts of macroeconomic and trade reforms will be constrained. The implementation of appropriate microeconomic policies is especially important in the key infrastructure sectors of the economy because the efficient functioning of these sectors is vital both to sustained economic growth and international competitiveness. Failure to adopt policies that promote microeconomic efficiency will place the Czech economy at a significant competitive disadvantage relative to the economies of the current member states of the EU and other acceding countries.

Like the other Central and Eastern European countries, the Czech Republic faces several challenging tasks in the economic infrastructure area: (i) designing and implementing post-privatization market and governance structures that promote effective competition and credibly limit the powers of government to intervene in the operations and finances of privatized enterprises; (ii) adopting (retail) pricing policies that are consistent with the dual objectives of economic efficiency and social equity; and (iii) designing competitively neutral mechanisms to support universal service.

Achieving the public interest goals of privatization requires that the government prepare to limit its regulatory powers over privatized enterprises. Indeed, for privatization to unleash the forces of private enterprise, regulation cannot be just another form of state control like the one that preceded the reform. This requires an appropriate regulatory structure that strictly limits intervention only in activities with fundamental economic and technological characteristics that are inconsistent with the workings of competition and contestability; most importantly, this requires some credible commitment to investors that their value will not be subjected to political expropriation. The creation of such mechanisms that enforce substantive and procedural restraints on arbitrary administrative intervention is especially important in the infrastructure sectors where the establishment of transportation and distribution networks requires very large investments that are largely sunk.

One of the key elements of protecting the public interest is the avoidance of any residual regulation that effectively prevents the achievement of financial viability by the operating entities in the various sectors of the economy. The public will hardly be well served by a set of regulatory rules which constrain these operating entities in their ability to raise capital for modernization and expansion and which, consequently, condemn them to a system that is obsolete and characterized by service deterioration. Therefore, preserving financial viability should play a crucial role in any rational program of regulatory policy.

The current structure of prices entails significant elements of cross-subsidization. Whatever their rationale, such pricing structures are unsustainable in an open entry environment—like the one that is a prerequisite for accession to the EU. Therefore, to the extent that accession to the EU will require the introduction of competition into key sectors of the Czech economy, such competition will cause today's pricing structures to collapse. Policymakers need to plan now for a smooth transition to competitive pricing. That is the only way to avoid serious dislocations for the Czech industries and their customers. Ignoring this problem will almost surely cause those customers without viable alternatives (i.e. the small consumers and the poor) to suffer the most.

The deregulation of key sectors of the economy requires a substantial amount of effort in designing competitively neutral mechanisms to support universal service, foster desirable social goals and generate positive economic externalities. Indeed, those goals should be pursued efficiently and without distorting competition. The need to adopt support mechanisms that are explicit and sufficient to advance certain publicly articulated universal service principles, and to assist consumers who would otherwise be disadvantaged, is even more pronounced in the Czech Republic as it liberalizes key sectors of its economy. Traditional regulation and public ownership in the Czech Republic have, in many domains, led to prices with systematic elements of cross-subsidization. However, as was noted above, it will be impossible to maintain significant cross-subsidies in the structure of prices for long, given the liberalization measures that are being enforced by the accession to the EU. Therefore, with market liberalization, either new sources of subsidy must be found, or prices that were below incremental costs must be raised to compensatory levels.

Minimizing the Costs of Adopting the **Acquis Communautaire**

The Czech Republic is facing sizable challenges from adopting and implementing the EU norms and directives jointly known as the Acquis Communautaire. Three sectors are likely to present the strongest challenges for the authorities. First are the investment challenges that complying with the *acquis* in the environment sector convey. Second are the challenges to adapt the agriculture sector to the new economic environment. Third are the challenges from reforming the public administration in light of the demands from EU accession.

Coping with EU Environmental Directives

The Czech Republic's environmental legislation is based on the Environmental Protection Act of 1992, the following acts on protection of specific parts of environment, such as nature and air, and the 1995 State Environmental Policy. In recent years, the country has made progress in harmonizing its environmental laws and regulations with those of the EU, and is working hard to complete the process. The principal gaps relate to legislation on water, waste, integrated pollution prevention and control, and genetically modified organisms.

The environmental elements of the acquis present particular challenges for the Czech Republic for several reasons:

- *The Scale and Scope of EU Legislation Concerning Environment is Broad and Mandates Substantial Investment*. Even without the imperative of EU directives, the Czech Republic would choose to make the required or similar investments at some stage in the future. Accession, however, accelerates the investment program and reduces the scope for the Czech Republic to adopt different implementation policies.

- *The Benefits of the Necessary Investments will be Seen Only in the Long Term but the Costs will be Immediate.* The costs will affect each Czech household. Government at all levels will need to engage in systematic consultations with the public and will need to invest in awareness-raising campaigns. In the short term, environmental investment may have to be considered a price of joining the EU.

- *The Requirements of EU Directives do not Always Correspond with the Czech Republic's Immediate National Priorities.* The challenge is to identify actions that will have both domestic and transboundary benefits and, where this is not possible, to be clear about tradeoffs.

- *The Investment Programs Required to Upgrade Infrastructure could Exacerbate Regional Disparities in Income and Employment*. Therefore, investment programs should be examined carefully for their local and regional impact, and appropriate transfer mechanisms implemented where necessary.

The European Union plans to make funds available to the accession countries to help finance the investments related to the environmental acquis. This represents a tremendous opportunity for the Czech Republic to meet their sectoral and environmental priorities and to relieve the burden of these investments on households, particularly on lower income groups. The country needs to plan carefully to make best use of these funds, as there is a significant danger that they may be used in an ad hoc manner, which would not allow them to realize these benefits.

Compliance with the environmental acquis will affect the public sector through two channels. The first channel is the costs of adjusting the institutional and regulatory framework; the second is the investment requirements that must be made by the State and municipalities in different environmental areas.

The backbone for any successful implementation strategy will be to strengthen institutional capacity in order to develop policies that bring the greatest environmental benefits for a given expenditure, and to develop policies that use public and external funds most wisely, both in terms of maximum environmental benefit and reducing distortions elsewhere in the economy. This will be particularly challenging because so many of the issues involved cut across sectoral areas of responsibility, as well as across different levels of government. Furthermore, building up capacity to enforce laws or set incentives for improving compliance will be essential in meeting many of the regulations that affect the private sector. The administration will have to change many of its public agencies that deal with environmental issues, including possibly creating some new bodies. A preliminary estimate indicates that the administration will need at least 820 new staff members.

In terms of implementation, the country has made great progress, however, substantial investment is still required. The level of environmental expenditures has stabilized at around 2.4 percent of GDP, which exceeds that of most EU member states even at the height of their environmental investment programs. Environmental investment expenditure grew in real terms between 1990 and 1996, from EUR0.6 billion in 1990 to EUR1.2 billion (in 1996 prices). Overall, the share of central government expenditure has declined since 1992, while private sector investment increased due to the new environmental legislation.

The investment requirements for the EU compliance have been estimated at approximately EUR 6.6-9.0 billion[4] (in 1998 prices). If operation and maintenance costs are included, and the investments are annualized over their expected lifetime, the total annual costs are EUR1.2-1.7 billion or 2.5-3.7 percent of 1997 GDP. The public sector will play an important role in financing these investments. The most important areas for public sector financing will be drinking water, sewerage, wastewater treatment, waste and improvement of ambient air quality. The responsibility for these areas lies mostly with local governments or municipalities. Many of the investments show substantial economies of scale, and require cooperation among municipalities, as well as central government support.

The government should use public and EU subsidies to direct investments towards strategic goals. This is particularly important for wastewater collection and treatment, and for municipal solid waste. This prioritization has various aspects. Large scope for improving efficiency in many utilities remains. Realizing this potential will reduce the upward pressure on tariffs; eligibility criteria for grants could be used to encourage utilities to improve their performance. In addition, limiting the proportion of grant funding, and thus requiring municipalities to contribute significantly from their own resources, will give an automatic incentive to municipalities to operate their utilities more efficiently. Technical assistance from the EU and other sources could also be used to help the less efficient utilities improve their performance.

The costs of the investments themselves can be dramatically different, depending on some of the basic design parameters. For example, it will be important to ensure that wastewater treatment plants are large enough to take advantage of the substantial economies of scale, traded-off against the increased sewerage costs, even though multi-municipal co-operation may increase the institutional difficulties of the investments. It will be important to remember that not all investments of the same size have the same environmental benefit. Benefits depend on the conditions in the receiving environment. Developing detailed plans so that authorities know which investments have the greatest environmental impact can be used as a further mechanism to direct investments strategically in the interim period towards full compliance.

Full compliance with the EU drinking water directive will require replacing the supply of water of those currently using shallow wells with an alternative supply that meets EU standards. This will require either building a new small water supply system or expanding existing systems. The investment cost to comply with this directive is in the range of EUR0.8-1.7 billion. The first estimate assumes that piped water supply coverage will increase from 86 percent to 94 percent; the second estimate assumes

[4] These estimates do not include costs related to cleaning up past pollution, estimated at about EUR2.2 billion.

100 percent coverage. The institutional costs related to water protection have been estimated at EUR3.6 million per year.

By far the largest costs of implementing the environmental acquis are associated with the Urban Wastewater Treatment Directive. This specifies that all settlements with more than 2000 inhabitants have sewer systems and wastewater treatment plants. The level of treatment required depends on the characteristics of the receiving water. The directive gives a timetable for compliance depending on the size of settlements, but the Commission expects accession countries to negotiate their own timetables for compliance. Precise interpretation of the requirements is particularly important for this Directive, as different interpretations give varying costs (difference can be as high as EUR1 billion).

Despite the positive trends in the waste management sector during recent years, there are some significant risks associated with the absence of a comprehensive strategy for waste management at the national, regional and local levels. Hazardous waste infrastructure built by the private sector is having problems securing waste because of nearby landfill sites with much lower fees. At present, there is excesses capacity for landfills, and a deficit of recycling or related-activities producing energy from waste. The new approach towards packaging waste aims to encourage adoption of environmentally more friendly products and packaging. The new legislation, however, is not fully compatible with EU directives. Further amendments are expected in the year 2000. Overall investment and annual recurrent costs associated with the transposition of the EU legislation into the Czech Republic have been estimated at EUR254-392 million and EUR59-97 million, respectively. Local governments will have responsibility for about 51 percent of the investment.

The Czech Republic has made an enormous effort to control pollution from stationary sources, and particularly from power plants. Overall emissions of SO_2, NO_x, and particulate matter have steadily declined since the early 1990s, but are still above the average of OECD countries. Since large static sources are the major source of pollution, further efforts are needed to reduce the significant proportion of local brown coal with relatively high sulfur content. The declining trend, however, is largely the result of passing and enforcing stringent air regulations, which have encouraged “end-of-pipe” investments and retrofitting of old production facilities.[5] The Czech Republic still needs to undertake preventive measures and introduce new and cleaner technological process. Investment costs to comply with EU legislation in the area of air pollution have been estimated at between EUR1.0-1.6 billion. Less than 50 percent of the investment will be borne by local government.

Despite considerable effort to meet targets for air pollution reduction, concentration of traditional pollutants tends to exceed standards in some urban areas. Using the Czech air quality classification system, about 23 percent of the population live in areas exposed to heavily polluted air. Adopted measures to prevent air pollution may be sufficient to reach values set down in standards for concentration of suspended particulate matter, SO_2, and even CO. Nonetheless, reaching valid standards for emission of nitrogen oxides will be difficult because of the expected increase in car traffic. Control of transport-related pollutant emissions requires a large number of specific actions -- improving vehicle technical efficiency, switching to fuel system with lower emissions, encouraging shifts toward modes with lower emissions, and managing transport demand. A national transport strategy for 2000 and beyond is under discussion, and will include broad objectives aiming to stabilize and reduce environmental burden.

While Czech companies still produce significant amounts of hazardous waste they also spend large amounts for dealing with environmental problems. A recent survey indicated that only around

[5] The 1996 survey of 100 industrial enterprises reveals that only 30 percent of the surveyed enterprises have invested in new technological processes. See the chapter on enterprise sector in this report.

14 percent of Czech companies expect to incur significant costs in complying with EU standards -- compared with 61 percent for Bulgarian, 40 percent for Polish, and 30 percent for Hungarian firms. Nevertheless, the private expenses to be incurred have not been quantified and are expected to be large. Similar investment in Ireland, for example, was estimated at about ECU56 per capita (in 1990 prices). In implementing the directive, the authorities should encourage investments that reduce pollution before it is generated rather than treating pollution at the "end of the pipe". These "end-of-pipe" solutions tend to be more expensive than process changes, and thus have limited impact in enhancing the long-term sustainability of the production growth of Czech manufacturing.

An investment program of the scale outlined above will necessarily involve an increase in the costs to consumers. Some utilities and municipalities may have access to EU grants and/or concessional finance, but many will have to borrow on commercial terms. Most of the investments have high operation and maintenance costs, which neither outside sources nor the central government will subsidize. Consequently, utilities and municipalities will have to pass a large part of the additional costs on to consumers.

The share of "environmental utilities" in the household budget will rise. In the least costly scenario -- compliance by 2015 with the low cost, flexible interpretation of the requirements -- the share of utilities in the household budget rises from 10 percent to 12 percent. By contrast, the high cost, less flexible interpretation of the requirements increases the share of utilities in the household budget up to 13 percent. The major factor affecting household budgets is the timing for compliance. Under the low cost scenario, compliance by 2005 will take 16 percent of household expenditures. Grant financing for capital, however, does not appear to make significant impact on the household budget, because operating costs are high. Finally, the impact will be far larger on the rural populations than on urban areas. If compliance is phased in until 2015, utilities will actually take slightly less of the household budget for urban households but will take at least an additional five percent of rural household budgets.

The analysis of the impact of environmental expenditure on households points to three clear messages. First, increases in the prices of environmental utilities are inevitable even if significant concessional finance is available. Second, as the impacts on rural households will be greater than on urban groups, the government will need to establish transfer mechanisms to spread the burden between population groups. Third, early compliance will have a major impact on households, particularly low-income households. The government should consider phasing investments in slowly over a long transition period so that incomes can grow in line with price increases.

Preparing the Agriculture and Rural Sectors for Competition in the EU

The share of agriculture in the economy contracted significantly during the transition, reaching about 4 percent in 1998. The share of employment in agriculture dropped to 5.5 percent in 1998. This resulted in an improved labor productivity of more than two-thirds of the average EU. The general economic recovery facilitated the transfer of labor from agriculture to other sectors while the total unemployment rate remained stable. The Czech Republic is a net importer of agricultural and food products. The relatively poor product differentiation developed by the food industry and the relatively poor performance of the agricultural marketing chain -from producers to users and foreign clients -- in terms of cost has limited the ability to export and even to compete with imported goods.

Reforms in the agricultural sector have been slow. They have been stretched over a long period of time and did not reserve any breathing space in this continuous decline before the current difficult international market conditions. The level of government support to agriculture declined until 1996. This trend changed in 1997 and recent measures resulted in an increase in the support and protection of agriculture. This level of support, however, cannot be considered excessive in comparison with most of the developed market economies.

Direct market intervention is the major support instrument. It includes border measures as well as direct and indirect intervention in the market by the State Fund for Market Regulation. In 1994-96 market intervention was limited to wheat and dairy products. It now covers all cereals, milk and dairy products and beef.

Credit subsidies and guarantees represent the second largest component of support programs. They are implemented through the Support and Guarantee Fund for Farmers and Forestry. The credit policy is shifting away from providing interest-free loans to farmers towards loan guarantees and interest subsidies, and towards increased support to larger-scale farming operations. The current situation of the Fund is causing some concern for the mid- to longer-term budget outlook as the value of the counterpart assets of the Fund has decreased significantly from their original but non-market based value.

An increase in direct market support and border protection would be a misguided and artificial response to real problems in agriculture. It is important to complete the remaining tasks of transition: financial consolidation of the farms, privatization of remaining state-owned land, improvement of competitiveness and developing a market conforming institutional framework. However, at a time of weak international prices, increased social tensions in rural areas seem to lead to increased intervention and protection. This would be a misguided and artificial response to real problems at a time when agricultural structures need an overhaul and improvement in competitiveness before EU accession takes place.

The consolidation of ownership and the settlement of outstanding financial issues in farming has yet to be achieved. The major features of the farming structure include: (i) dominance of larger-sized farms (for 75 percent of the total agricultural land, the average size of a farm is 1,000 ha); (ii) leasing of land as a major form of tenure (mostly short to medium term, therefore largely inhibiting longer-term investment of this land); (iii) low profitability; (iv) significant indebtedness especially the cooperative farms; and (v) barely restructured collective farms still run as they were during the pre-transition period with limited motivation on the part of the members. The initial issues of land privatization and restitution have been largely resolved, and the new farming organizations are consistent with the principles of a market economy. In order to create a viable farming structure under EU conditions the authorities need to further transform collective farms; settle farm debts, sell the remaining state-owned land, and open agricultural land for foreign investors. In principle, membership in the EU would require that agricultural land markets be opened to competitive forces from anywhere within the Union. Presently, foreign ownership of agricultural land is not allowed in the Czech Republic, and foreign agricultural land ownership is a rather sensitive issue, as it is in other EU accession countries

Well-functioning factor markets would constitute the basis for a good market-based structural adjustment of Czech agriculture. This would imply less distortive interventions from the state or from outdated laws. It would involve the development of modern instruments of exchange of land, labor, finance, and an element often forgotten in economies in transition: exchange of risk through modern and market-based risk management techniques. At a time when Czech agriculture is faced with new challenges resulting from the accession to the EU, factor markets clearly constitute a significant constraint to be addressed by the Czech Republic to ensure reasonable chances to adjust to these new challenges with the proper instruments. A modern and well-functioning set of markets (both factors and products) should be the priority for government policies in agriculture.

The network of wholesale enterprises trading agricultural products remain weak and inefficient in several sub-sectors. This will have negative consequences after accession to the EU for which the

Common Agricultural Policy intervenes at the wholesale level. If the agricultural wholesale markets are non-competitive, the benefits from market support will not trickle down to farmers and will be captured by wholesalers.

The food industry is highly diversified, with no single major sub-sector emerging as a leading outlet to agriculture. Considering the geo-climatic characteristics of the country, it would seem that the fruit and vegetables processing and dairy sub-sectors are less developed than one would expect. Moreover, small-scale food processing appears relatively under-developed in terms of both absolute numbers and contribution to the economy. FDI in food processing remains primarily limited to a few large enterprises. FDI is not playing a significant role in the transformation of the agri-food sector by bringing new technology, new know-how and substantial capital (including working capital) as part of the privatization process. Most of the agroprocessing in its current form would likely have limited competitiveness under EU conditions: the accelerated development of this sub-sector is thus an essential precondition to coping with the competition after EU accession.

The Czech Republic needs to strengthen private representation in the sub-sectors of the agriculture and food economy. The representation of private interests for each profession in the various agricultural and food subsectors constitutes an important missing element. This is a strikingly common feature in Central and Eastern European countries, with the exception of Hungary, where such representation is highly developed in a majority of agri-food sub-sectors. In the EU, such representation is a crucial element of the implementation of the Common Agricultural Policy: it contributes to a better understanding of private interests by the European Commission and the governments in the EU, and of government policies by the concerned private sector. In addition, many decisions related to trade, research, and technology, market information, and training could proceed in common by professionals belonging either to the same profession or to the same marketing chain. The development of such organizations should be promoted and facilitated. Technical cooperation with similar foreign organizations could be explored to develop a sound understanding of the role of such organizations.

The Czech Republic's agricultural policy framework and support system needs to focus on the following objectives:

- A more effective use of budgetary support to agriculture requires the revision of support programs to focus on efficiency enhancement rather than on price and export subsidies.

- The various instruments of government intervention in the sector, especially the various support programs, need to be integrated into a more consistent, and predictable framework.

- Changes in the Czech agricultural policy framework need to take account of the evolving nature of the instruments and requirements of the Common Agriculture Policy as they result from the decisions of the Berlin summit of April 1999 and the in-coming adjustments required by the World Trade Organization.

- The full adjustment of price support to EU levels should be postponed until the time of actual accession.

- Measures to reduce social tensions and to provide social protection in rural areas need to be separated from the major instruments of agricultural policy aimed at improving efficiency and competitiveness.

- Structural measures to support the functioning of agricultural markets (factors and products) should be preferred to direct support to a partly non-performing and still not reformed collective farming sector.

A comprehensive approach which integrates agriculture into an overall rural development framework is needed. Such an approach should include a set of specific measures to support the emergence of competitive agriculture, the further development of the rural service sector and related industries to provide off-farm rural employment and additional demand for agricultural and other products. It should include the improvement of rural infrastructure, including education and social services, and the development of an appropriate social policy to properly address specific social problems affecting rural populations.

Rural development, particularly in less-favored regions of the Czech Republic (mainly mountains), faces several challenges:

- *A Decentralized Approach*. In a country of relatively small dimensions and with a strong historical background in terms of central planning, the challenge here is to ascertain that the rural development program is conceived, developed, implemented and, in part, financed by local rural institutions -- “the bottom-up approach.” In other words, rural development needs to be driven by local demand as expressed by the ultimate stakeholders in rural development, the rural communities, and their inhabitants;

- *A Multi-Sectoral Approach*. The various and often complementary aspects of rural development imply the collaboration between various line Ministries (transport and infrastructure, health, education, environment, agriculture, etc.) to assess whether the decentralized programs would fit with the national policies and EU rules and regulations;

- *The Financial Engineering of Mostly Small-to Medium-Size Projects*. The challenge here is to ensure the active participation of various financing institutions (Czech and foreign) to mobilize various sources of funds available to the country. These sources vary significantly depending on the type of project the local communities have prepared;

- *Fair Prioritization for Financing Based on Technical Criteria to Reduce the Risk of Preferential Treatment Given to Certain Communities Rather than Others on the Basis of Political Favoritism*. A strong technical analysis of priorities by local/regional policy-makers which would be screened by central government on the basis of simple technical criteria (e.g., unemployment, the level of education in the region, private sector projects waiting for public infrastructure, etc.); and

- *Collaboration with Private Sector (Enterprises, NGOs, etc.)*. This collaboration constitutes a challenge for public sector agencies like municipalities and villages although it also strengthens the sense of ownership in the region and facilitates implementation.

Improving Public Administration

An important aspect of the Czech Republic's candidacy for EU accession involves bringing its public administration and governance capacities in line with the EU member countries. This is a critical task, as joining the EU will impose severe pressures to the public administration both to transpose the *acquis* and to enforce it.

Public administration reform in the Czech Republic remains in its early stages in several key areas. After years of heated debate, an intermediate tier of government, comprised of 14 regions s likely to be established. While it is still uncertain when will they be created, many implementation issues (such as competencies and staffing) remain to be resolved. Due to its prominence, the issue of regional reform has become almost synonymous with administrative reform, with the result that equally crucial components of reform -- including legislative and management frameworks for government staff -- have been relegated to the sidelines. Uncertainty regarding intergovernmental relations and the lack of specification of a vertical administrative structure has also resulted in central government bodies being free to establish what has become a complex web of deconcentrated offices (e.g., tax and employment offices, and a variety of inspectorates) at the subnational level. Despite stated intentions to create a uniform legal framework for government employees, human resource management remains the domain of individual ministries. Similarly, effective formulation and coordination of policy at the central level is complicated by the tendency of the line ministries to focus on narrow sectoral interests at the expense of broader cross-sectoral views.

Efforts to improve the Czech Republic's public administration since the "Velvet Revolution" do not appear to have been particularly strong. This is perhaps not too surprising, given that the Czech Republic's public administration functions relatively well when compared to its CEE neighbors. This "benign neglect" also appears to have reflected the higher priority given to private sector development relative to public sector modernization. This prioritization was perhaps most stark under the Klaus government. By now, however, undeniable progress in developing the domestic private sector is creating conditions that can be expected to be broadly supportive of public sector modernization. These would include such things as rising expectations on the part of the business community and the citizenry regarding the quality of public policy decision-making and its implementation. Examples of such rising expectations would include less ideological policy deliberations, greater transparency and predictability of the regulatory environment, reductions in the prevalence of corrupt practices, as well as improved quality, timeliness and client-friendliness of public services and their delivery. Modernization of the public administration could help to meet these rising expectations as well as reinforce gains made on the private sector development side of the equation.

Spending on wages and salaries has been relatively stable over the past several years. The cost of wages and salaries in consolidated general government expenditure[6] constituted an estimated 9.1 percent of total expenditures in 1997. This appears somewhat low, though not excessively so, compared to the median of 11.2 percent for current EU member states, and 12.5 percent for a sample of eight EU applicant countries.[7] The preliminary figure for 1998 is even lower at 8.5 percent. Because of the great variability among countries in government functions and size, comparisons of this sort should be treated with caution. The comparison does demonstrate, however, that the Czech Republic is not facing an excessive wage bill burden. As a percentage of total goods and service spending, the Czech Republic's wage bill is high relative to other EU accession candidates, but about average when compared to EC member countries.

There is no Civil Service Act in place in the Czech Republic, and no official category of "civil servant." Like all other employed persons in the country, government workers are regulated by the Labor Code (Law 65/1965), and thus have a contractual relationship with the specific employing ministry rather than the state as a whole. While this lacuna is by no means solely responsible for the Czech Republic's lack of progress in establishing a modern and responsive public administration, it continues to pose one of

[6] Consolidated central government in the Czech Republic includes the Cabinet office, parliament, ministries, president's office, supreme court, government agencies, local governments, extrabudgetary funds and health insurance organizations.

[7] Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania.

the more serious roadblocks to the Government efforts to meet EU accession norms in the area of public administration.

Significant resources and attention at the highest levels need to be devoted to creating a framework for the Civil Service. This includes ensuring that appropriate expertise is allocated to produce a new draft law capable of successfully passing through rigorous internal review and parliamentary and cabinet processes. In addition to resolving some of the human resource management complications, such an act should lay the groundwork for subsequent fine-tuning of issues related to the civil service in implementing regulations. Important examples of weaknesses that such an act should address include: inadequate protections against politicization of the civil service, insufficiently attractive conditions of employment, inadequate institutional arrangements to hold public servants accountable for their performance, and institutional arrangements that fail to create adequate pressures and mechanisms for holding agencies responsible for their performance.

Regarding the technical support needed for policy formulation and coordination, the structures, processes and capacities within the Czech Republic's Cabinet present a mixture of strengths and weaknesses. On the positive side, the Department of the Cabinet Agenda in the Prime Minister's Office appears to provide stable and capable support to the policy formulation process. Line Ministry staff report that the framework laid out in the Procedural Code and recently-revised Legislative Rules satisfactorily balances the need for review of policy proposals with that for timely processing. Furthermore, the process effectively resolves many, though not all, conflicts prior to Cabinet meetings, as it is intended to do. The Department of the Cabinet Agenda appears to be a well-managed unit held in high esteem by its line ministry counterparts and plays an important role in the smooth functioning of this system.

The absence of a professional cadre of policy analysts within the Cabinet constitute an important weak link in the Cabinet's technical support structure. While line Ministries appear to be able to provide technical assessments of such tradeoffs from the perspective of their own Ministries, it is important for the Cabinet to have an independent technical capacity to integrate (but not replicate) those various assessments. It is perhaps also worth noting that the creation of such a unit within the Prime Minister's Office could also form part of a medium-term strategy for creating a professional, merit-based civil service. The existence of such a unit could enhance the attractiveness of a civil service career by offering the possibility of landing a prestigious position within the Office of the Prime Minister as the potential apex of one's career as a civil servant.

In the area of creating a firmer basis for civil service/human resources management, the following actions are particularly pressing.

- *Draft and Enact a Civil Service Law*. The existing draft Civil Service Law is quite problematic. Tellingly, virtually no progress has been made in revising it to address the serious problems identified in the incisive and detailed commentary provided by SIGMA in August of 1994. Given the lack of progress on improving that law over the last 4+ years, it would appear that the time is ripe for starting over with an entirely new team. While lawyers will certainly be required as members of such a team, that new team should be lead by persons with substantive expertise in human resource management.

- *Prepare Subsidiary Civil Service Legislation*. Once a Civil Service Law is in place, the balance of the legal framework for creating a professional, merit-based civil service will need to be established. This would include policies and guidelines aimed at ensuring, for instance, transparent and competitive recruitment, selection and promotions procedures, merit-oriented personnel performance appraisal policies and guidelines, mechanisms for administrative appeal of personnel actions, etc.

- *Revise Public Sector Remuneration Structure, Policies and Practices*. The existing level and structure of remuneration in the public sector is not competitive with the domestic private sector, especially within the more highly skilled ranks. In order to enhance the attractiveness of employment conditions within the public sector, the Government needs to prepare a fiscally sustainable strategy for making remuneration more competitive. That strategy should also address the need for enhancing the transparency of the processes and practices under which compensation decisions are made and their results monitored.

- *Strengthen Mechanisms for Holding Organizational Units Accountable for Policy and Program Implementation*. Grants of autonomy (delegations of authority) are substantial but are perhaps provided under terms and practices that are a bit too laissez-faire to ensure that they will be used in ways that consistently and effectively meet policy objectives. While financial accountability appears to exist at an aggregate level for budgetary units (i.e., for broad budget category envelopes), little seems to exist in the way of mechanisms to ensure accountability for delivering results with those fiscal (as well as human) resources.

- *Strengthen the Administrative Units Responsible for Ensuring Good Civil Service/Human Resource Management*. The Department of Public Administration within the Ministry of Interior is understaffed and under-resourced. It has neither the capacity to provide helpful technical assistance on matters for personnel management to budgetary institutions nor to ensure adequate oversight of personnel management policies. Moreover, analogous capacities in personnel departments of line ministries are apparently variable. In both cases, the efforts to strengthen these capacities should aim at building human resource management units that are *facilitators* of good personnel management by line agencies and their managers, rather than HRM units that view their role as doing the personnel management themselves.

- *Strengthen Mechanisms for Nurturing Public-Sector-Specific Human Capital by Fostering Career Development within the Public Sector*. While general human capital skills can be directly recruited, given attractive conditions of employment within the public sector, important specific human capital skills and knowledge are unique to a given public sector and its public agencies. Examples include knowledge of specific policies, procedures and practices that are unique to, for instance, the Czech public sector and its public agencies. Institutional memory is a phrase that captures important aspects of such specific human capital. Because of this, it is important that human resource management policies and practices provide adequate mechanisms for building such human capital in-house. At least three broad types of such mechanisms are worth mentioning (a) those that make a career in the public sector *attractive*; (b) those that *facilitate* career development; and (c) those that *protect* public employees from arbitrary impediments to their career growth.

In addressing the most pressing challenges to improving capacities for policy formulation and coordination at the center, the government would like to consider the following options:

- *Revise the Current Cabinet Structure.* The current DPM-based authority relations within the Cabinet appear unlikely to provide a stable and collaborative institutional basis for policy formulation and coordination. The Government should consider options for creating a Cabinet structure that would be more supportive of the Prime Minister taking charge of the policy level deliberations himself/herself. Such a structure would probably rely on a system of committees and subcommittees of the Cabinet, rather than DPMs, to deal with the policy substance of particular proposals before putting them before the full Cabinet. Those committees and subcommittees would be supported by a single, professional policy analysis unit within the Office of the Prime Minister (see next recommendation). Such a Committee structure could avoid the major risks currently posed by the four-DPM arrangement.

- *Create a Single, Professional Policy Analysis Unit within the Office of the Prime Minister*. Such a unit would provide professional analyses of policy proposals, focusing particularly on inter-sectoral tradeoffs and coordination issues raised by them. The processes for staffing that unit should be integrated into an overall strategy for creating a professional, merit-based civil service, with these positions being part of the pinnacle of that civil service.

- *Strengthen Ministry-Level Policy Formulation Capacities*. For Cabinet decision-making processes to function effectively, Ministry-level policy analysis capacities are essential. As such, one important priority of administrative reform will need to be the strengthening of capacities for sectoral policy analysis within line Ministries.

Concluding Remarks

The Czech Republic's development strategy should consist of three different types of policies and/or reforms: (i) "win-win" policies and reforms where early implementation is desirable on its own right, regardless of its accession to the EU; (ii) policies and reforms which are not a formal EU requirement but are nevertheless essential to the growth and stabilization strategy -- such as privatization and pension reform; and (iii) policies and reforms, required by the accession process, whose adoption will demand more time and careful sequencing of actions in order to maximize their benefits. Examples of the latter include the adoption of the CAP and the full set of EU environmental standards.

An example of the first type of (win-win) reforms is deregulation of infrastructure -- energy, telecommunications and transport -- where EU directives envisage an enhanced role for markets and private-sector participation. Early adaptation of an institutional and regulatory framework for competition in infrastructure services is likely to attract substantial private investment and help to improve the Czech Republic's competitiveness. Another example involves some of the financial and enterprise sector reforms where bank and enterprise privatization, restructuring and improvements in governance and the legal framework will enhance the prospects for sustainable development and EU accession by the Czech Republic.

The second set comprises those reforms that need to be implement even if they are not a formal requirement of accession. Many large, socially sensitive or politically powerful enterprises have avoided major restructuring; their losses continue to be a drag on the growth potential of the economy. Privatization, while persistent, is still an unfinished agenda, particularly in key sectors, which remain dominated by the public sector. Without strategic privatization, state-owned firms and banks could find it increasingly difficult to compete in a European single market and could thus create future fiscal and unemployment pressures. Moreover, public finances remain vulnerable to adverse trends in contingent liabilities. Speeding up the pace of reform in these areas (social security reform, privatization and restructuring) is critical to increasing domestic savings and maintaining the dynamic supply response of the economy.

The third type of policy touches on those areas where meeting EU standards as set by the Acquis Communautaire will require a gradual and phased approach. Indeed, the Czech Republic will derive substantial environmental benefits from meeting some EU standards, which will also enhance the health of the population and further attract tourism. In certain areas like air-quality, the benefits are likely to be large relative to the costs. In other areas, such as water quality and wastewater treatment, the direct benefits are smaller, less immediate and difficult to measure, while the necessary investments are of such a magnitude that early compliance may not be financially or technically possible. There are other areas where EU environmental legislation is linked to the functioning of the single market, such as the management of dangerous chemicals, waste management, and fuel standards. In these cases, the benefits of being able to take advantage of access to the EU are large and immediate relative to the likely cost of compliance. A strategy to first meet the most urgent environmental goals will probably obtain strong public support and hence offer policy-makers an opportunity to take bold decisions that may be otherwise politically difficult. It will also help with future access to structural or transitional funding for environmental investments.

Membership in the EU is the most important development agenda for the Czech Republic. Accession, however, goes significantly beyond simple implementation of specific economic instruments or acts of European law. It is, first and foremost, an issue of creating the proper conditions under which the Czech Republic will be capable of reaping the benefits of integration. Adoption of the *acquis* should be viewed as an instrument to increase the well being of the population, to speed up restructuring, and to modernize the economic and the legal systems. Misalignment *vis-à-vis* such requirements will undermine the smooth functioning of the economy. Joining the EU is an enormous task that requires the focus and full commitment of the government and society at large.