

CZECH REPUBLIC 2003/2004



Entering the EU

An Economic Survey
Produced by



Center for Economic Research and Graduate Education of Charles University
& Economics Institute of the Academy of Sciences of the Czech Republic

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Prague
March 2004

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www.cerge-ei.cz/publications/books

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ISBN 80-7343-008-8 (Univerzita Karlova v Praze, CERGE)

ISBN 80-86288-97-0 (Národohospodářský ústav AV ČR, Praha)

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I. GENERAL INFORMATION

I.1 Overview of the First Ten Years of Economic Transition

Early Transition Policies and Outcomes

The Czech Republic has awed observers of transition economies. Within three years of the fall of communism, the government liberalized nearly all prices, privatized much of the economy, decentralized wage setting, and opened the country to world trade while maintaining a relatively balanced budget, low inflation, and low unemployment, below 4% until 1995. The Czech GDP per capita level of over five thousand USD, with PPP adjustment factor of about two, was (and remains) high in comparison to other transition countries. Furthermore, the economy appeared to be on an accelerating growth trajectory. By 1995, the initial transformation recession and the negative impact of the split of Czechoslovakia were over and the economy grew by almost 6%. While 1996 recorded still a robust 5%, in 1997, it was becoming increasingly clear that the macroeconomic success was not based on solid macroeconomic foundations.

In particular, mass privatization followed a tacit doctrine of economic nationalism as most property was transferred to local owners, either by offering loans to local buyers or through the voucher scheme. Privatization failed to generate sound corporate governance and often resulted in incestuous ownership relations. Large banks remained under government control in order to “fuel” transition with credit while bankruptcy and fore-

closure laws were weak, making room for lax financial discipline. As a result, while the economy was growing, banks were accumulating nonperforming loans at a distressing rate. While both Hungary and Poland lowered their share of nonperforming loans on all loans from about 28% in 1994 to less than 10% in 1998, the Czech share stood at 33% in 1998, comparable to that of Romania.

The local owners of privatized firms were indebted from the start and lacked the managerial capital to restructure and operate firms, which faced fierce international competition due to a high degree of openness. The loose access to bank credit coupled with a weak legal and impotent judicial system resulted in massive asset stripping (“tunneling”) of privatized enterprises.

Clearly, privatization was only one method of creating private sector output. Throughout the early transition period new (de novo) private firms were also being created. While early on credit to small firms may have been generous, retained profit was a major determinant of new investment. Small firms were apparently the force behind low Czech unemployment. Survey evidence suggests that small new private firms were responsible for almost all of the vigorous Czech job creation during early reforms so that five years into transition de novo firms offered more jobs than the state and privatized firms combined.

General Information

Year	1997	1998	1999	2000	2001	2002	2003
GDP							
GDP Growth	-0.8	-1.0	0.5	3.3	3.1	2.0	2.9
Foreign Trade							
Exports, real y/y %	9.2	10.0	6.0	17.0	11.9	6.1	9.3
Imports, real y/y %	8.1	6.6	5.4	17.0	13.6	4.2	8.8
Trade Deficit as % of GDP	-8.3	-4.4	-3.4	-6.3	-5.5	-3.1	-3.0*
Balance of Payments as % of GDP and Its Main Components							
Current Account	-6.7	-2.2	-2.7	-5.3	-5.7	-6.4	-6.6*
Inflow of FDI	2.4	6.6	11.9	9.3	8.7	13.4	2.8*
Inflow of FDI (bln. USD)	1.3	3.7	6.3	4.6	4.9	9.3	2.3*
Inflation and Interest							
CPI, y/y %	10.0	6.8	2.5	4.0	4.1	0.6	0.1
PRIBOR 2T	18.1	14.2	6.9	5.3	4.7	3.6	2.3
Labor Market							
ILO Unemployment, %	4.8	6.5	8.7	8.8	8.1	7.3	7.8
Employment, y/y %	-2.0	-1.4	-2.4	-0.2	0.3	-0.4	-1.1*
Real Wages, y/y %	1.3	-1.3	6.2	2.4	3.8	5.3	6.4*
Public Finance							
General Government Balance as % GDP	-1.2	-1.5	-0.6	-3.7	-3.2	-3.9	-6.2*
Idem, Excluding Extraordinary Items	-2.0	-1.5	-3.0	-4.3	-5.1	-6.7	-7.0*
Exchange Rates							
CZK per USD	31.7	32.4	34.6	38.6	38.0	32.7	28.3
CZK per Euro	18.3	18.3	18.9	18.2	34.1	30.8	31.8

Source: CSO, CNB, Ministry of Finance, World Bank, (*) CERGE-EI estimates.

The Currency Crisis and Recession of 1997

The weak corporate governance allowed wages to grow two times faster than productivity, which led to higher demand for imports of consumer durables and increasing foreign trade and current account deficits. These were financed by an inflow of short-term foreign capital attracted by high interest rates locked in by the fixed exchange rate regime.

Eventually, however, the implicit liabilities of soft loans to large old firms became explic-

it and the worsening performance of the economy led to an increase of the public budget deficit. Shortly after the current account deficit ballooned in 1996, the imbalances – both internal and external – were noticed by capital markets and led to an attack on the Czech currency in May 1997. The attack forced the surrender of the fixed exchange rate regime and the crown depreciated by approximately 10%. The Czech National Bank used high interest rates to stabilize the currency and also strengthened provisioning requirements, leading to a credit crunch.

Meanwhile, the government was forced to implement a strict austerity program. All of this naturally sent the economy into recession.

The recession was prolonged with GDP in red numbers for two consecutive years while other Visegrad countries enjoyed substantial growth. Registered unemployment increased from 3.9% in 1996 to 9% in 1999 and wage growth slowed down hand in hand with government spending. The recession was driven by a decline of both private spending and investments, while net exports were mostly improving the overall picture – also thanks to the weaker currency.

The downturn shattered the illusion of successful reforms and contributed to the fall of the long-serving coalition government headed by Václav Klaus' Civic Democrats and the resulting early elections of 1998. Further, following party finance scandals, a significant number of Civic Democrats established a new liberal right-center party. The early elections of 1998 were won by Social Democrats, who formed a minority government. Since then, Social Democrats stayed in power. The party won the 2002 elections and formed a coalition government with two smaller centrist parties.

Recent Macroeconomic Development

Starting in 1998, the strict monetary policy of the currency crisis was relaxed by the central bank. Facing recession, the new government revived structural reform and privatization, this time relying on strategic foreign partners. Further, in April 1998 the government introduced an aggressive FDI incentive package for manufacturing investors bringing more than USD 10 million. Yet, 1999 GDP remained in red numbers.

Finally, in 2000 the economy accelerated. Investments started to grow, most of all thanks to the surge of foreign direct investments (FDI), but domestic firms started to invest more as well. FDI inflow continued at similar strength during 2001, thanks to both the incentive package and the expected accession of the Czech economy into the EU. Moreover, private consumption also accelerated (fueled by real wage growth that reached 4% during 2001). Overall, GDP growth stood at over 3% in 2000 and 2001.

When the economy started to grow in 2000 the trade deficit doubled again and remained high in 2001. The current account now also appears worrisome, reminding one of the 1997 crisis. The deficit narrowed from above 6% of GDP in 1997 to below 3% in 1998 and 1999, but 2000 saw worsening to just around 5% of GDP and this trend continued through 2003. The key difference from the 1997 situation, however, is in the financing of the current account deficit. While it was the unstable short-term capital, which financed the current account deficit prior to the 1997 crisis, the recent current deficit was financed by direct investments, which are long-term in nature. The inflow of FDI appears to be able to safely finance the current account deficit.

The one macroeconomic variable that has been under control throughout the whole Czech transition is inflation. Low domestic demand during the 1997-99 recession, combined with relatively strict monetary policy and low commodity prices lowered the average inflation rate to 2.1% in 1999. It also helped that the government froze the upward adjustment of regulated prices of housing and utilities. Later, the revival of domestic demand, higher commodity prices (mainly oil) and several idiosyncratic factors had been

working to increase inflation, which reached the 4% mark by 2000. Since then, however, the country has imported some deflation and inflation remains close to zero.

The main macroeconomic concern of the Czech economy is the high and growing budget deficit. After netting out extraordinary budget items such as privatization receipts and the costs of bank restructuring, the overall balance of the general government mushroomed to 4.8% of GDP in 2000 and grew further in 2001. Excluding extraordinary items, the whole 2001 deficit hovered just below one tenth of GDP. The concurrent economic recovery made clear that the deficit was not merely cyclical. Since fiscal revenue of the Czech government is already high as a fraction of GDP, the adjustment must come on the expenditure side. Yet, most categories of expenditure (including social welfare, housing, and transport) are locked in upward trajectories, even though expenditures on public infrastructure and buildings have already been severely restricted in recent years. Between 1994 and 1999, social security and welfare expenditures rose by 3.2% of GDP. Public expenditure on social welfare persistently exceeds payroll revenues and the deficit is projected to grow even during the expected years of economic expansion. Worse, these deficits occur while the demographic situa-

tion has not yet deteriorated. Towards the end of the new decade it will. In sum, if there is no change in the fiscal policy, the current debt of the country will increase from 20% to almost 42% of GDP between now and 2006 and reach the magic 60% of GDP before 2010.

In sum, after 1999, the Czech economy successfully emerged from the recession with GDP growth rates around 3%. The recovery was driven by private investments, primarily FDI, which also financed the widening trade deficit. While inflation was low, real wage growth resumed after the recession and was so far in line with productivity growth. Unemployment stayed in the neighborhood of 9%. The GDP growth of around 3% and high unemployment of around 10% are expected to prevail in the years to come. The fiscal deficit remains the sorest part of the Czech economy and the government's unwillingness to cut mandatory expenditures does not offer much hope for substantial improvement. Among the other main outstanding policy challenges (also voiced in the annual pre-accession EU reports) are the inefficiency of public administration, the much-needed reform of the judicatory system, the insufficient use of public tenders by the government, and the taming of corruption.

The Czech Republic – An Economic Summary of 2003

Despite the EU slowdown, during 2003, the Czech Republic experienced moderate economic growth of about 3%. Growth was driven primarily by domestic consumption, but investment and exports also helped from the third quarter of the year. The significant FDI inflow of the past continued, although the record level of the 9 billion USD the Czech economy received in 2002 will not be matched as there was no significant privatization this year; the 2003 FDI inflow figure should be at most about 5 billion USD. The continuous massive long-term capital inflow continues to keep the Czech currency under appreciation pressures. To complete the picture, inflation fell also and is expected to be almost exactly 0%.

Yet, despite the moderate economic growth, the employment decline of 2002 continued and registered unemployment reached double-digit levels at the end of 2003. Furthermore, the moderately positive aggregate signals cannot be correctly interpreted without noting the continuous expansionist governmental fiscal policy. The price of the moderate growth is high: the state budget deficit skyrocketed from 46 billion CZK in 2002 to 109 billion in 2003 so that the central government deficit alone constituted almost 5 percent of GDP, with little improvement projected for 2004. The government has prepared – at most – moderate fiscal reform but during the course of the year the real reform steps were even further softened and postponed. The optimistic aim of the reforms is to bring the deficit down to 4% by 2006.

The Czech Republic held a referendum on EU accession in June. The vote was strongly in favor of entering the EU in May 2004 (77.3%), although the turnout was only just above 55%. The European Commission's last pre-accession annual report on the Czech Republic was favorable. It should be noted that the Czech Republic has reached a high level of alignment with the acquis in most policy areas.

Year 2003 in the Czech Republic – Major Political and Economic Events

January

- The President was not elected in the first round of the presidential election; the final two candidates were Mr. V. Klaus and Senator P. Pithart.
- The ČSÚ announced a major revision of foreign trade figures due to errors made (the deficit was reduced from 94 billion CZK to 55 billion).
- Parliament failed to elect the President in the second round of the presidential election; the final two candidates were Mr. V. Klaus and Senator J. Moserova.
- CNB cut rates by 0.25%, unemployment surpasses 10% to 10.2%.

February

- Vaclav Havel's presidential term ended.
- The President of the CSO Ms. M. Bohata stepped down.
- Union Bank got into trouble; later is closed down.
- On the last day of February Mr. Vaclav Klaus was elected President of the Czech Republic; the final two candidates were Mr. V. Klaus and university professor J. Sokol.

March

- *The government asked for a confidence vote. It got 101 votes for, 99MPs were against.*
- *The Czech Republic lost a 10-billion CZK court dispute with CME for failure to protect its investment in private TV channel Nova.*
- *The Iraqi war started. The Czech Republic supported the Allied forces with its chemical brigade in Kuwait and a field hospital in Basra.*
- *The government cancelled a suspicious contract to build the highway to Ostrava.*

April

- *The EU parliament approved EU enlargement by 10 countries. In the case of the Czech Republic 489 votes were in favor, 39 against and 37 abstained.*

May

- *The Minister of Justice stepped down as he was elected to the Constitutional Court.*
- *The Minister of Defense resigned.*

June

- *University teachers went on strike complaining about their salaries and financing of education.*
- *In a referendum on June 13th and 14th on EU accession in May 2004 the vote was 77.3% in favor, although the participation rate was only 55.2%.*
- *Government announces the need of fiscal cuts of 200 billion over three years.*

July

- *President vetoed the VAT increase of services (from 5% to 22%), his veto was later overruled by Parliament.*

August

- *CNB cuts discount rate to 2%.*
- *A major travel agency, Fisher, went bankrupt; the following reorganization was successful.*

September

- *Teachers went on strike during the first day of the school year complaining about their salaries.*

October

- *Liechtenstein refused to sign the enlargement treaty of European Economic Area because of restitution claims against the Czech Republic; the treaty is signed later.*
- *CSO re-calculated the Czech GDP level using ESA methodology; the Czech Republic GDP level is at 64% of EU average.*

November

- *The smallest coins (10 and 20 heller) are abolished.*
- *The final pre-accession EU report on the Czech Republic is published.*

December

- *The Lower House approves the government budget for 2004 with a record deficit of 115 billion CZK.*

I.2 History and Geography



The first signs of people living in what is today the Czech Republic are as old as 1.6–1.7 million years and were found near Beroun in Central Bohemia. The first Slavonic people came in the 5th and 6th centuries. The first written references to the Czechs, Prague, and regions of Bohemia appeared in the 8th and 9th centuries. In about the year 870, the Czech prince Bořivoj was mentioned for the first time. He came from Prague and belonged to the house of Přemysl, which later became the royal dynasty of Bohemia. This dynasty governed the Czech kingdom until 1306. During the reign of the House of Luxembourg (1310–1436), Bohemia was the center of the so-called Holy West Roman Empire of German People and Prague became one of the cultural centers of Europe. A short

period of elected kings ended in 1526, when the Czech Kingdom (Bohemia, Moravia and Silesia) became a part of Austria, later the Austro-Hungarian monarchy.

In 1918, after World War I, Czechoslovakia emerged from the ruins of the Austro-Hungarian monarchy as a modern democratic state. Czechoslovakia consisted of Bohemia and Moravia, Slovakia and Carpatho-Russia (today a part of Ukraine). In 1939, Slovakia separated from Czechoslovakia and the Czech part of the country was occupied by the German army and incorporated as a special autonomous state into the German Empire. In 1945, Czechoslovakia was liberated by the Soviet and American army. The Czechoslovak state was restored without Carpatho-Russia which joined the Soviet Union.

In February 1948, the Communist party gained power (in a formal constitutional way), and Czechoslovakia was under the Soviet sphere of influence until 1989. After the “Velvet Revolution” in 1989, a democratic regime was restored.

In response to the Slovak desire for greater self-determination, a federal constitution was introduced in 1968. Completely controlled by the Communist Party, the Czechoslovak Federation had not satisfied the legitimate aspirations of the Slovak people. From 1990 on, Czech and Slovak political leaders nego-

tiated the future form of the federation. After two years of unsuccessful negotiation and following the 1992 parliament elections, the country was peacefully divided into the Czech Republic and Slovak Republic on January 1, 1993. In 1999 the Czech Republic joined NATO; it will become an EU member in May 2004.

In terms of its area (76,867 square kilometers) the Czech Republic ranks among the smaller European countries. The Czech Republic shares borders with Germany, Austria, the Slovak Republic and Poland.

Milestones of the Czech Lands in the 20th Century

- 1918** After the collapse of the Austro-Hungarian monarchy, the first Czechoslovak Republic as a common state of Czechs and Slovaks was established.
- 1920** A democratic constitution was adopted.
- 1938** The Munich agreement, occupation of part of Czechoslovakia by Germany and Hungary; the so-called Second Republic, Czecho-Slovakia, was established with extended Slovak autonomy.
- 1939** The rest of the Czech territory was occupied by Germany; an independent Slovak State was established.
- 1945** Liberation: the Czechoslovak Republic was restored.
- 1948** Communists took over the country, marking the beginning of a 40-year totalitarian regime.
- 1968** Prague Spring, the invasion of Warsaw Pact armies, a federal constitution adopted.
- 1989** The Velvet Revolution, end of the totalitarian regime.
- 1990** The first democratic parliamentary election in 42 years.
- 1991** Last Soviet military troops leave the country.
- 1992** The separation of Czechoslovakia, establishing the Czech and Slovak Republics in 1993.
- 1999** On March 12, the Czech Republic officially joined NATO.
- 2004** In May 2004, the Czech Republic joins the EU.

1.3 Population

With a population of 10.289 million (2001 census), the Czech Republic is similar in size to Austria, Belgium or Hungary. Its population is ethnically homogeneous with an overwhelming majority of Czechs (94.8%), a Slovak minority (3.1%) and small Polish (0.6%) and German (0.5%) minorities. However, there is also a large and socially segregated ethnic minority of Romanians. The total size of this minority is hard to estimate. The Czech language is a part of the family of west Slavic languages (together with Polish and Slovak). The working age population (15-59 years) accounted for 69% of the total population as of 2000. The prognoses of

demographic development suggest a slow decrease in the population. The population now slowly ages as life expectancy, which is still far behind that in West European countries, increases.

Ethnic Minorities in the Czech Republic

	1991		2001	
	census	%	census	%
Slovak	314,877	3.1	193,190	1.8
Polish	59,383	0.6	51,968	0.5
German	48,556	0.5	39,106	0.5
Ukrainian	8,220	0.1	22,112	0.2
Total	488,933	4.7	807,456	7.9

Source: CSO

Age Structure of Population (in %)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
0-14	20.0	19.5	18.8	18.3	17.9	17.7	17.0	16.2	15.9
15-64	67.1	67.6	68.0	68.4	68.7	69.0	69.3	69.0	70.3
65+	12.9	13.0	13.1	13.3	13.4	13.6	13.7	13.9	13.8
Average Age	36.6	36.8	37.0	37.3	37.6	37.9	38.3	38.8	39.0
Median Age	35.9	36.0	36.2	36.4	36.6	36.8	37.0	37.6	n.a.
Index of Aging*	64.3	66.8	69.6	72.3	75.3	78.1	80.5	85.5	87.0

Sources: CSO Statistical Yearbook of the Czech Republic 2000, <http://popin.natur.cuni.cz>, CSO

* Index of aging – number of persons aged 65 or over for 100 children aged 0-14

Aging of the Czech Population

Czech demographic development is not positive. During the nineties, the population of the Czech Republic stagnated, and even decreased (in 1990 10.363 million; in 1999 10.283 million; the last census taken in the first quarter of 2001 recorded 10.298 million).

The main factors influencing the demographic development have affected it in different ways: the number of deaths steadily sinks, from 129.2 thousand in 1990 to 109.0 thousand in 2000; the infant mortality rate of 4.6 is, together with Slovenia, the lowest among EU candidate countries; the net migration is positive. But the number of births is declining very quickly (the number of live births in 1990 was 130,564, but since that year it constantly decreased

Age Structure Development and Projection (% of Total Population):

Age	1980	1991	1995	2000	2010	2010	2030
0–14	23.5	20.6	18.3	16.2	13.7	13.7	12.4
15–64	63.2	66.6	68.4	69.0	70.2	64.7	63.5
65+	13.3	12.8	13.9	13.9	16.1	21.6	24.1

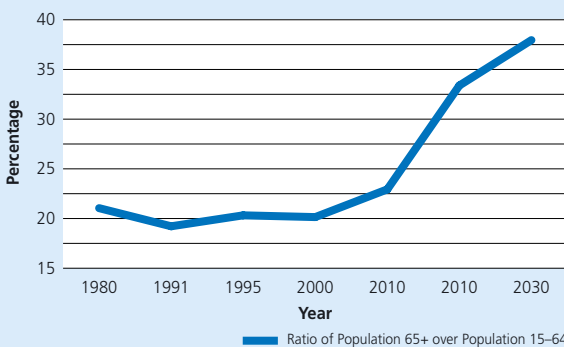
Source: Czech Republic Population Development (CSO, 2001), Projection: Statistical Yearbook 2000, CSO, middle variant

until 1999, when it sank to 89,471. In 2000 the number of live births increased to 90,910 and in 2001 this positive tendency seemed to continue. Nevertheless, the birth rate is very low. In 1992 it was 12.6 births per 1000 inhabitants, while in 2000 only 8.9. This will influence the aging of the population in the future.

Together with individual aging, i.e. steadily increasing life expectancy, the share of the population in older age groups has grown and shapes the dependency ratio, the share of the population aged 65+ on the group of “working age” population aged 15 to 64 – the standard indicator of population aging. Even if at present the share of the elderly in the Czech Republic is lower than in most European countries (in 1998, the average share of people aged 65 and over reached 16.2% in the EU–15, but only 13.7% in the Czech Republic), demographic projections show a high increase of this share in the future.

Demographic factors of aging influence deeply the number of people who benefit from age-related social programs, especially pensions. This is why many countries are advocating reforms that would modernize pension systems and strengthen private pensions savings. On the other hand, life expectancy will be increased by better living conditions of the elderly. This is the true reason for prolonging the eligibility of pension age. These facts call for an active policy of offering to the elderly schooling programs, half time employment, etc. (In the Czech Republic there has already existed for many years a “university of the third age,” with more than 30 branches of tuition, which is still not fully exploited by this generation in comparison with other countries).

Also the birth rate will begin to grow in those societies where many families have decided to postpone their first child for some years. The postponement should last about seven years in the Czech Republic. And for those families who decide to have fewer children or none at all, the adults will have relatively more means of providing for their own old age.

Old Age Dependency Ratio Development Projection

Source: Czech Republic Population Development (CSO, 2001), Projection: Statistical Yearbook 2000, CSO, middle variant

II. TEN YEARS OF POLITICAL TRANSFORMATION

II.1 Constitutional System

The constitutional system of the Czech Republic consists of the Parliament and the President. The Parliament of the Czech Republic has two chambers: the Lower House (*Poslanecká sněmovna*) and the Upper House (*Senát*). The president is elected by both Houses of Parliament for five year terms and has limited and mostly representative responsibilities. He appoints the Prime Minister and the members of the Government, Governor of the Central Bank, ambassadors and the Chief of Staff of the army and signs laws. He can return laws to the Lower House, but his veto can be overridden by an absolute majority of all the members of the Lower House.

The Lower House is the most important legislative body. It has the power to pass laws by a simple majority of the members present during any given session (providing the quorum is met), to cast a no confidence

vote against the government, and to override a veto of the President and of the Upper House.

According to stipulations in the constitution the Upper House has limited legislative action and is only authorized to act upon Lower House legislation. The Upper House has three options when faced with bills approved by the Lower House and must act within 30 days: accept by default (take no action); reject with a suspending veto; or suggest amendments (in both cases by a simple majority). In the latter two instances, the Lower House can vote to either accept or reject the Upper House action by an absolute majority of all members of the Lower House. The Upper House can also initiate legislation. If the Lower House is dissolved, the Upper House assumes its functions until new elections are held.

II.2 Electoral System

The Lower House of Parliament has 200 members elected for four-year terms. A proportional electoral system is used for the Lower House which discriminates against small parties: to enter the parliament a party has to attain at least 5% of the total number of valid votes cast nationally. The country is divided into 8 voting districts and each party nominates an ordered list of candidates for the Lower House in each voting district.

In contrast, the Upper House of Parliament uses the majority system (plurality run-off)

to elect its 81 members with one representative for each constituency. The Upper House members are elected for six years with a periodic replacement schedule in which 27 members are elected every two years. Each political party can nominate one candidate in each of the 81 constituencies. Also, independent candidates can participate providing they submit a statement of support signed by at least 1,000 eligible voters from the relevant electoral constituency. A candidate is elected on the first ballot if he/she receives a simple

majority of valid votes (at least 50% plus one vote). If no candidate receives a majority on the first ballot, then the two candidates who

receive the most votes from the first ballot rerun on the second ballot, and the majority winner on the second ballot is elected.

II.3 Electoral History of the Czech Republic

Given the proportional system used for the Lower House, Czech governments are either coalition or minority governments or both.

Between 1992–1998 the Czech governments were coalitions of three or four right-centrist parties: the Civic Democratic Party (ODS), the Christian Democratic Party (KDS), the Christian-Democratic Union (KDU-ČSL) and the Civic Democratic Alliance (ODA). At the turn of 1997/1998, a faction of the Civic Democratic Party established a new right-centrist party, the Freedom Union (US).

In June 1998 the Czech Social Democratic Party (ČSSD) won the Lower House elections with 32% of popular votes, followed by ODS with 28%. The right-centrist parties won together a majority of seats in the Lower

House; however, personal animosities proved to be an obstacle to establishing a coalition. A workable coalition between Social and Civic Democrats seemed to be explicitly excluded by differences in their electoral programs. However, they managed to form an “opposition agreement”: The ODS committed itself to tolerating a minority one-party government of ČSSD in exchange for a dominating role in the Lower and Upper Houses and participation in preliminary consultations on important issues between the ČSSD and ODS. Having together a qualified majority in both Houses of Parliament, the ČSSD and ODS declared their intention to work together to stabilize the Czech political environment and to change the constitution and electoral law “to strengthen-

Composition of the Lower House

Party	1998				2002			
	Votes	%	Seats	%	Votes	%	Seats	%
ČSSD	1,928,660	32.3	74	37.0	1,440,279	30.2	70	35.0
ODS	1,656,011	27.7	63	31.5	1,166,975	24.5	58	29.0
KSČM	658,650	11.0	24	12.0	882,653	18.5	41	20.5
Coalition KDU-ČSL and US-DEU					680,671	14.3	31	15.5
KDU-ČSL	537,013	9.0	20	10.0				
US	513,596	8.6	19	9.5				
Others	675,575	11.3			597,428	12.6		
Total of Valid Votes	5,969,505				4,768,006			
Eligible Voters	8,116,836				8,264,484			
Participation	6,008,926	74.0			4,789,145	58.0		
Not Valid Votes	39,421				21,139			

Source: CSO

en majority elements in proportional electoral system.” Such arrangement ended with the 2002 elections.

The last parliamentary elections were held in 2002. The Lower House elections were won by ČSSD with 30.2% of the vote. Second came ODS with 24.5%, third were the Communists with 18.5% and the fourth Coalition (of KDU-ČSL and US-DEU) received 14.3%. No other party reached the 5% threshold. A striking result emerged: all democratic parties lost compared with the 1998 elections. In particular, ČSSD lost 1.9%, ODS 3.2% and Coalition 4.9% of votes. A warning sign is the rising vote for the communists: they gained 7.5 percentage points, their best result since 1989. This is in part due to the lowest turnout (58%) in post-communist history.

Coalition building in the Czech Republic is notoriously hard because of the strong position of the extreme-left communist party, co-operation with which is naturally a political no-no among the democratic parties. Nevertheless, the ČSSD, KDU-ČSL and US managed to form a government with the weakest possible majority of 1 vote (101 rep-

resentatives in a 200-seat Lower House). The government consists of 11 members of ČSSD (including the prime minister), and has 3 ministers from KDU-ČSL and US-DEU each. Two out of the 17 members of the government are women.

The November 2002 elections were important for two reasons. First, the government could lose its majority in the Upper House, and, second, the composition of the Upper House could play a crucial role in the upcoming presidential elections. The ODS and independent candidates were successful: out of 27 available mandates, 9 went to ODS and (only) 7 to the ruling ČSSD. KDU-ČSL, KSČM and US each got one new senator. However, the important novelty was that 8 new senators were independent or represented parties currently not present in the Lower House. Parties of the government coalition lost their majority in the Senate and now have only 34 out of 81 mandates. However, the independents are likely to vote with the current coalition. The participation in the Upper-House elections is notoriously low and reached a meager 24% in 2002.

Composition of the Upper House

Party	1998		1999		2000		2002	
	Seats	%	Seats	%	Seats	%	Seats	%
KSČM	4	4.9	4	4.9	3	3.7	3	3.7
ČSSD	23	28.4	23	28.4	14	17.3	9	11.1
KDU-ČSL	17	21.0	17	21.0	18	22.2	13	16.0
ODS	26	32.1	25	30.9	21	25.9	25	30.9
ODA (+US)	11	13.6	11	13.6	12	14.8	1	1.2
US-DEU							6	7.4
Others							2	2.5
Independent	n.a.	n.a.	1	1.2	13	16.0	22	27.2
Total	81	100.0	81	100.0	81	100.0	81	100.0

Source: CSO

Current Major Political Parties

The currently most important political parties are listed below and ordered according to their positions on the traditional “left-right” ideological spectrum.

Czech and Moravian Communist Party (*Komunistická strana Čech a Moravy, KSČM*) – an extreme leftist unreformed communist party; opposes Czech membership of NATO; founded in March 1990; successor to the former Communist party of Czechoslovakia, which was founded in 1921; has had stable representation since 1989. Current leader: Miroslav Grebeníček.

Czech Social Democratic Party (*Česká strana sociálně demokratická, ČSSD*) – a left centrist pro-reform party of standard European social-democratic orientation; supports the membership of the Czech Republic in NATO; strongly advocates the Czech entry into the EU; successor to the former Czechoslovak social democratic party which was founded in 1878 and forced to merge with the Communist party in 1948; restored in March 1990; established a minority government in 1998 and is the leader of the current majority coalition government. Current leader: Vladimír Špidla.

Christian and Democratic Union – Czechoslovak People’s Party (*Křesťanská a demokratická unie-Československá strana lidová, KDU-ČSL*) – a centrist party of Christian-democratic orientation represented in government from 1990 to 1998 and a member of the current coalition; advocate of a “social market economy;” supports Czech membership in NATO and in the EU; reformed successor of the former Czechoslovak People’s Party which was founded in 1918. Current leader: Miroslav Kalousek.

Union of Freedom (*Unie svobody-Demokratická unie, US-DEU*) – a liberal right-center party established in January 1998 by former members of the Civic Democratic Party who left the party after the governmental crisis in the end of 1997; advocate of radical economic transition with an appropriate legislative framework and of the regional self-administration, along with Czech membership of NATO and of the EU; represented in the government during the first half of 1998 and a current coalition member; currently polls below the 5% threshold for entering the parliament. Current leader: Petr Mareš.

Civic Democratic Party (*Občanská demokratická strana, ODS*) – a right-wing conservative party; a dominating member of government coalitions in 1992–1997; the driving force of economic and political transition during the first years after the establishment of the Czech Republic; supports Czech membership of NATO; holds a “Euro-skeptic” attitude toward the EU; founded in April 1991 by long-time prime minister Václav Klaus who stepped down at the end of 2002; the leading party in current voter polls. Current leader: Mirek Topolánek.

II.4 EU Referendum of 2003

The national referendum on the access of the Czech Republic to the European Union was held on June 13 and 14. This first nationwide referendum in the country's history was preceded by a government-sponsored campaign supporting the accession. Overall there was strong support for accession (77% for, 23% against, on a turnout of 55%). Among the 14 thousand voting districts the turnout ranged from 12% to 100%. There were only

33 municipalities (all with small populations) where more than 50% of the votes were cast against EU accession and 36 municipalities with higher than 90% support for accession. The turnout was typically higher in smaller municipalities whereas support for accession was higher in larger ones. There were no pronounced differences in either EU-accession support or turnout between the main regions or between Bohemia and Moravia.

II.5 Presidential Elections

The second term of President Václav Havel ended at the beginning of February. According to the Czech Constitution the president is elected by the two chambers of Parliament and no one can hold the presidential office for more than two terms. There was no obvious front-runner replacement for Václav Havel and the presidential election promised to become a long battle. Even though the ruling Social Democrats should have been able to marshal a sufficient majority, they could not agree on their candidate, which opened room for opposition contenders.

There were two presidential elections on January 15 and January 24 during which no candidate gained a winning majority. A third election was held on February 28 with only two candidates nominated: Václav Klaus, the former chairman of the right-wing ODS polit-

ical party and an architect of the economic reforms of the early 1990's, running against a non-partisan university professor Jan Sokol nominated by the government. A record number of 280 members of both chambers of Parliament participated. Through smart political maneuvering, Václav Klaus managed to obtain support not only from his own party but also from the Communists. He received 142 votes (141 would be sufficient to win) and was elected to be the second president of the Czech Republic after 1993.

The election was interesting in one more respect: Václav Havel was the first president in Czech and Czechoslovak history who left the office simply because his term expired. All preceding presidents either died or resigned (usually involuntarily) while in office.

II.6 Regional Administration

The local government in Czech Republic has two layers: 14 regions (NUTS 3) and 6,234 municipalities. These are self-administered

units; people elect their representatives for regional and municipal government. Until December 31, 2002 there were also 76 dis-

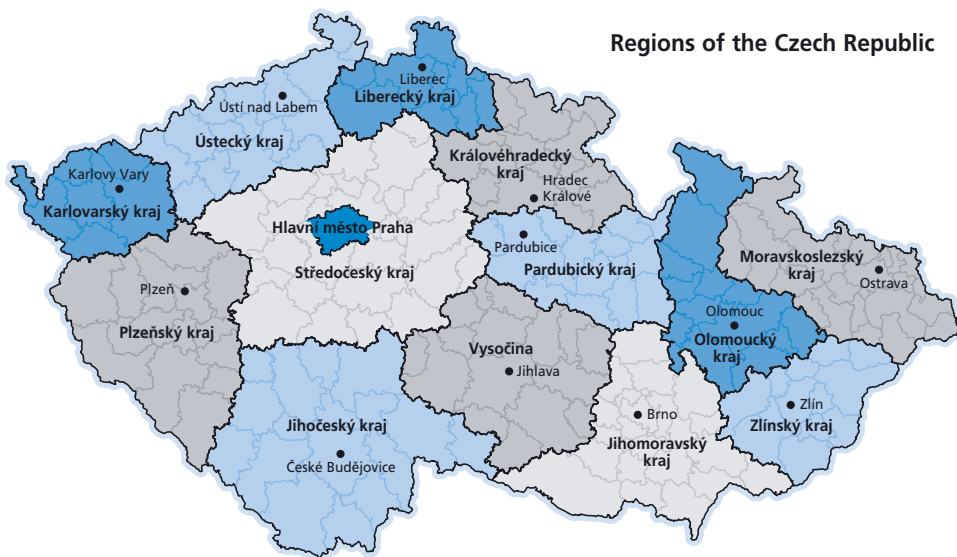
trict offices serving as local branches of the central government and carrying agendas such as ID cards and passports, social security allowances, special child care, legal protection, driving licenses, etc. In 2003 the district offices were abolished and their competences transferred either downstream to 205 so-called “municipalities with extended scope” or upstream to “regional offices”. While the division of administrative responsibilities between the regional governments and the central government is clear, the two groups continue to clash over the division of funds, which are still largely controlled by the center.

After the reform, local governments are responsible for both self-administration and state administration. The municipalities with extended scope provide state administration services also for residents of nearby smaller municipalities. To cover the extra cost they received about 13,000 out of 19,000 officials from the dissolved district offices and a direct grant based on a year 2002 per-official cost. This grant, however, covers only about 60–80% of the state administration costs. Even if this were the original government intention in line with public finance reforms to force savings in administration costs, it also means

Districts (dissolved)					
Number of districts	76				
Minimum size (km ²)	125	Minimum population	42,400	Minimum number of municipalities	16
Maximum size (km ²)	1,944	Maximum population	373,370	Maximum number of municipalities	453
Average size (km ²)	1,031	Average population	119,030	Average number of municipalities	91
Municipalities of extended scope					
Number of municipalities with extended scope	205				
Minimum size (km ²)	48	Minimum population	9,500	Minimum number of municipalities	1
Maximum size (km ²)	1,242	Maximum population	376,172	Maximum number of municipalities	111
Average size (km ²)	382	Average population	44,200	Average number of municipalities	31
Regions					
Number of regions	13*				
Minimum size (km ²)	3,163	Minimum population	304,343	Minimum number of municipalities	132
Maximum size (km ²)	10,057	Maximum population	1,269,467	Maximum number of municipalities	1,048
Average size (km ²)	5,943	Average population	689,166	Average number of municipalities	473

* Data for capital Prague are excluded from the tables since Prague has a specific division.

Regions of the Czech Republic



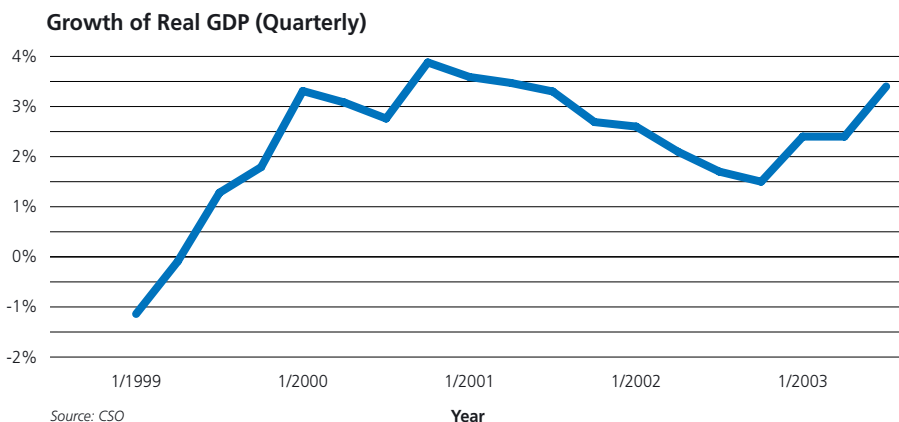
that municipal offices subsidize the delegated state administration from municipal budgets. This additional cost to the 205 municipal budgets is estimated at about 1.6 billion CZK.

A similar problem exists at the regional level. The regional offices took over few administrative duties but most of 659 health, social, and cultural institutions (hospitals, social care institutions, theatres, etc.) formerly administered by the district offices. These institutions are still financed by grants from the central budget, leaving little freedom for the decisions of regional offices. Hospitals in particular were transferred in a bad financial shape and with large debts, which the regional authorities are unable to cover from their own revenues. Secondary education had already

come under the supervision of regional offices in 2002 but the funds still flow directly from the ministry of education. Although the regional offices have been operating for three years, their budgeting is still prepared in an ad-hoc manner. Less than 20% of their revenue, or 11 billion CZK, comes from sources which they directly control. All the rest comes from the state budget as direct subsidies. The Czech government prepared a bill of budget rules that would automatically direct a much higher share of taxes collected at the central level to the regional offices. However, the bill did not pass through Parliament in November thus the provisional system stays in place for 2004.

III. MACROECONOMY

III.1 Gross Domestic Product



The Gross Domestic Product has grown by about 3% over the last four years in a row and is expected to continue at this rate in the near future. Yet, one may expect a much higher growth rate from an economy benefiting from massive FDI inflow and propped up by excessive government deficits.

Private consumption was the leading growth factor, encouraged by (i) growth in households' disposable income as real wages

grew by over 6%, (ii) unexpectedly low inflation and interest rates, and (iii) an increasing variety of commercial banks' consumer loans. The last two factors increased households' willingness to finance consumption by debt – households' indebtedness grew by more than 40% on a year-to-year basis. Another, though temporary factor for consumption growth, was the expected increase in VAT starting from 2004. The share of private consumption on

Decomposition of real GDP (in billion of 1995 CZK)

Year	1999	2000	2001	2002	2003:IQ	2003:IIQ	2003:IIIQ
GDP	1,421.0	1,467.3	1,515.1	1,542.2	392.0	394.8	397.7
Private Consumption	765.6	783.4	813.7	845.1	294.2	298.9	303.9
Government Consumption	266.2	263.6	264.5	239.5	73.0	73.7	73.7
Total Investment	467.4	511.2	556.9	554.9	135.3	152.3	146.4
Net Exports	-88.7	-102.9	-132.7	-163.4	-37.1	-43.7	-60.5

Source: CSO (seasonally adjusted)

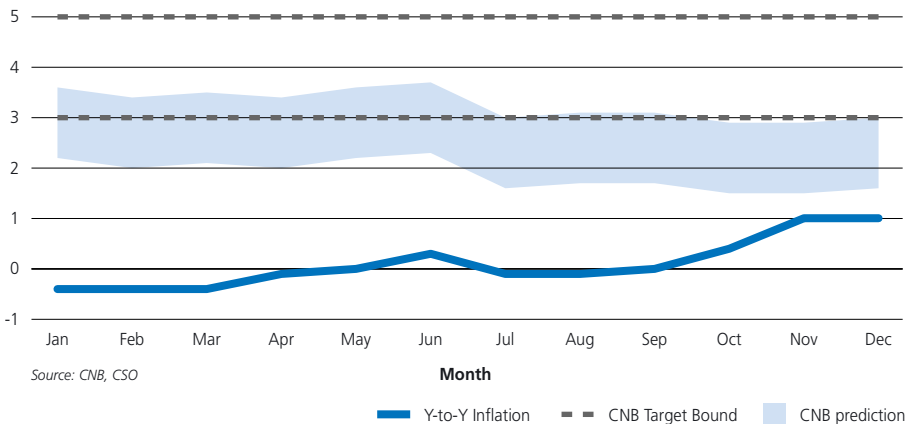
GDP is now above 70%, while government consumption takes another 20%. Government consumption also contributed strongly towards growth and investment accelerated in the third quarter. In the view of the CNB, cautious corporate lending by commercial banks kept total investment down.

From the industry-disaggregated point of view, GDP grew largely due to the increasing

value added in the production sector (year-to-year change of about 3%). Production firms (mainly those with a high stake of foreign capital) concentrated on high-value-added products, which found demand on foreign markets. The service sector grew very slowly this year and the sectors with lower value-added stagnated or were declining (e.g., textile production decreased by more than 3%).

III.2 Inflation

Consumer Price Inflation in 2003



The prediction intervals are those valid when monetary policy decisions were made (usually 15-18 months before the actual period).

Inflation stagnated during 2003. At the beginning of the year, inflation (measured as year-to-year change in CPI) reached its historical minimum of -0.4%. For the rest of the year it stood at -0.1% and reached mild positive levels in June and October.

The continuing exchange rate appreciation of CZK to the dollar presented a major disinflation pressure. The exchange rate appreciated from 30 CZK/USD in January to 26

CZK/USD in December. The decline in food and agricultural commodity prices were another source of disinflation pressures, though not as significant as the exchange rate appreciation. The prices of agricultural commodities started to grow following the summer draught and the resulting poor harvest. Upward inflationary pressures sprang mainly from the growth of energy prices (oil and gas), growth of import prices, and price deregulation. These

tendencies were, however, neutralized by exchange rate appreciation.

Inflation has again managed to undershoot the Czech National Bank's inflation target by more than 3 percentage points. The CNB justified the undershooting on two grounds. First, the appreciation of CZK/USD and disinflation pressures from outside of the economy (persisting weak foreign demand), neither of which were expected when the policy action was taken 18 months ago. Second, the leading disinflation factors were out of reach of monetary policy in 2003. The uncertainty

about the persistence of disinflation pressures in the future led the CNB to cut the key interest rates by 0.25% in June and by a further 0.25% in July. At the end of the year the 2T Repo rate was 2%, the Lombard rate was 3%, and the discount rate was 1%. Because of lower interest rates, the CNB expects inflation to be slightly above the lower bound target of 2% at the turn of 2004 and 2005. The end-of-2003 decision of the government to allow regulated rents to rise by 10% in 2004 may, however, foster future inflation.

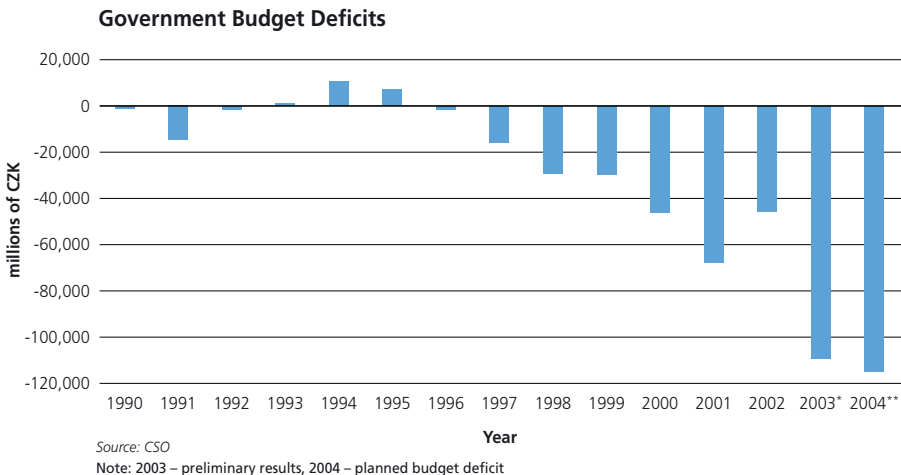
Withdrawal of Heller Coins

The Czech national currency – the crown – consists of 100 hellers. The Czech National Bank (CNB) decided to withdraw the coins with lowest nominal value, namely ten and twenty heller coins as of October 31, 2003. According to the estimation of the CNB, there were more than 700 million ten heller coins and more than 500 million twenty heller coins in circulation, which in terms of crowns amounts to CZK 170 million. The CNB justified its decision by high production costs of the small coins and their low circulation.

The general public feared that prices of many goods, namely small items such as bakery products, would rise due to the withdrawal of the coins. This expectation was supported by the experience with the introduction of euro notes and coins in the EU. According to consumer surveys, 67% of the public felt that prices had been rounded upwards on the occasion of the changeover to the euro, while 28% felt that price increases and decreases had balanced one another out. Only 1.9% took the view that prices had been rounded downwards. However, the inflation figures published by the Eurostat show that, although annual inflation rose from 2% to 2.7% between December 2001 and January 2002, this increase was attributable to several factors not linked to the euro, such as increases in certain taxes, higher prices for fruit and vegetables, and higher oil prices. According to the Eurostat, the currency changeover accounted for only between 0% and 0.16% of the monthly price trend.

In the case of the Czech Republic, the Consumer Protection Act No. 634/1992 gives some rules for a situation like this. The posted prices for individual items need not fit the coin denomination – rounding (up or down, based on the ordinary rules of rounding) should be limited to the total price which consumers have to pay. Thus, it is possible for the price level not to be directly affected by the withdrawal of the coins.

III.3 Public Budget Deficits



Public finance was once presented proudly by the Czech Republic because the government debt was low and the budget was balanced (at least optically). Today, Czech public finance is turning into a nightmare. The state budget is plagued by persistent deficits driven largely by exceedingly high mandatory expenditures. There are also many other off-budget accumulated sources of debt. In 2003 the Czech Republic recorded the largest deficit (measured as a percentage of GDP) among the EU-accession countries. Worse still, there is no real fiscal reforms in

sight (see Part IV for a brief account of the reforms proposed by the Czech government). This lack of action contrasts sharply with the ongoing fiscal reforms in the neighboring Slovakia, which inherited a similarly over-generous set of mandatory expenditures from the Czechoslovak federation.

There are several common definitions of a public deficit. The narrowest definition, the state budget deficit (however defined) ignores local government and municipal deficits and various off-budgetary funds. The (consolidated) public deficit should include state and

Consolidated Public Debt

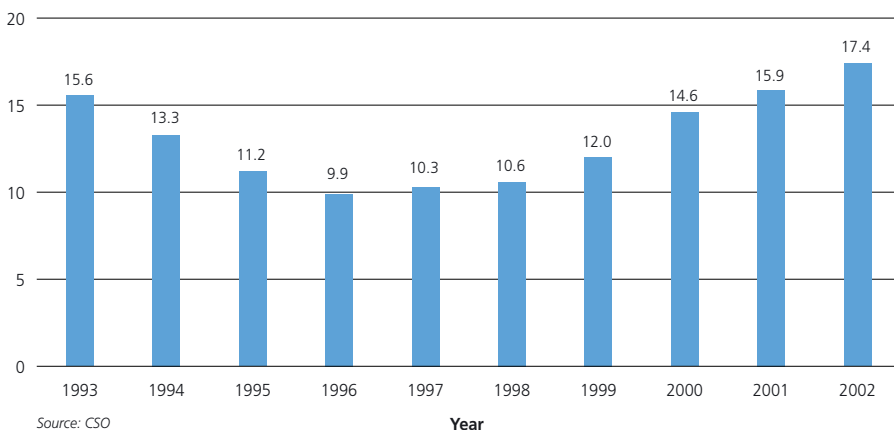
% of GDP	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Public Debt	17.6	15.3	13.2	12.9	13.0	14.5	16.7	18.7	20.3	24.0	30.6	36.4	41.7
Public Debt with Proposed Reform											29.6	33.9	37.6

Source: Ministry of Finance, Czech Republic

Note: Liabilities of CKA are not fully included. Otherwise the public debt would be approximately 28% of GDP in 2002 and 45% of GDP in 2006.

Note: The approved reforms will lead to a slightly higher deficit than that estimated for the reform scenario presented in the table.

State Debt (% GDP)



local budgets as well as off-budgetary funds and public health insurance companies. This latter definition corresponds approximately to the Maastricht definition of public deficit. In addition, the consolidated public deficit may account for various additional items. It is important to consider the one-shot nature of privatization revenue, as well as the (hidden) deficits of various transformation institutions, which, in the end, all have to be covered from the central budget.

In 2003, the narrowest definition of the deficit – the central government budget – ended with a record-setting deficit of 109 billion CZK amounting to almost 5% of GDP.

The 2004 central budget has been designed to break this record. The general government balance of 2003 is estimated to be over -6% of GDP. Excluding extraordinary items, this figure is likely to reach 7%. The ongoing economic recovery makes clear that the deficit is not cyclical, but that it will worsen no matter how fast the economy may be growing.

The deficit is even more alarming given that fiscal revenue of the Czech government in 2000 was already high at 46% of GDP compared to that of, e.g., Germany. Indeed, labor taxation stands at close to 50% of gross labor income and weighs heavily on enterprise employment. Hence, adjustment must come

Structure of Public Debt

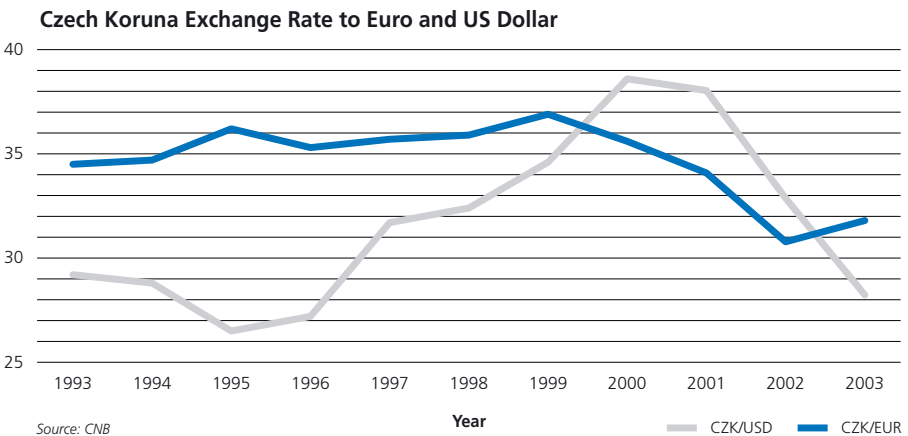
% of GDP	2001	2002	2003	2004	2005	2006
Gross Public Debt	23.6	26.9	30.5	34.2	37.7	39.4
Central Government (excl. CKA)	16.9	17.5	21.8	26.7	31.3	34.0
CKA	4.8	7.5	6.4	4.6	3.2	1.9
Health Insurance Companies	0.0	0.0	0.0	0.0	0.0	0.1
Local Governments and Municipalities	2.3	2.4	2.7	2.8	3.1	3.3

Source: PEP 2003

on the expenditure side. Yet, most categories of expenditure (including social welfare, housing, and transport) are currently locked in upward trajectories by existing welfare legislation. Between 1994 and 2002, the total volume of social allowance rose by over 250 billion CZK, which is over 10% of 2003 GDP. Opportunities for any windfall gains are also becoming scarce, as most large-firm privatizations have already been undertaken. The current government is not willing to seriously cut expenditures and instead plans to improve tax collection, making the Czech Republic even less competitive in terms of tax burden in comparison to other Visegrad countries.

Financing the growing government debt may become more difficult in the near future. The latest auction of government bonds led to unexpectedly high premiums (the state offered 4.6% interest rate, but the market demanded 5.6%). The situation is truly horrifying: if there is no change in fiscal policy, the current debt of the country is set to increase from the current 20% of GDP to over 40% by 2006 and reach the magic 60% of GDP by 2010. Worse, these deficits occur while the demographic situation has not yet deteriorated. Towards the end of the new decade it will (see Section I.3).

III.4 Exchange Rate



The exchange rate was used as a nominal anchor of monetary policy at the beginning of the economic transformation. It was tightly pegged to a currency basket and the level of nominal peg set in 1991 did not change until May 1997. After speculative attacks the crown was allowed to float in 1997. During

the transition period the exchange rate of the Czech crown to the Euro evolved in a relatively stable manner. Differences between points of temporal appreciation and depreciation did not exceed 14% in extreme cases. The largest depreciation occurred during the period following the currency crisis in 1997. But even

the change in the exchange rate during the currency crisis was not as dramatic as those that Asian countries suffered during the same period. The exchange rate of the Czech crown to the U.S. dollar has traditionally been less stable: this may be attributed to close trade and investment ties between the Czech Republic and the Euro area.

Since 2000, the crown has been steadily appreciating and the appreciation against the USD became dramatic recently thanks in large part to the evolution of the exchange rate between the Euro and the dollar. During the first three quarters of 2003 the crown first fluctuated around 31.50 CZK/EUR and then gradually depreciated to levels between 32 and 32.50 CZK/EUR. With respect to the USD the Czech crown appreciated in the first six months from 30 CZK/USD to less than 27 CZK/USD. A correction appeared in the sum-

mer months, but at the end of the year, the Czech crown closed around 26 CZK/USD.

The long-term trend of gradual real appreciation of the crown, driven by convergence of productivity to the EU level, is likely to continue. Given the skyrocketing budget deficits, the crown is unlikely to join the EMU at the first available date in 2007. It also seems that the Czech National Bank does not want to adopt a pegged exchange rate to the Euro (such as the ERM II regime) too soon and not for longer than necessary. However, the CR will have to adopt ERM II at least for the two years before it enters the EMU. In the near future, the behavior of the CZK nominal exchange rate will depend on the inflation differential – if the inflation differential is not too high, the CZK may even experience mild nominal appreciation.

Exchange Rate Volatility Before EU Accession

(Based on: Juraj Valachy and Evžen Kočenda (2003): Exchange Rate Regimes and Volatility: Comparison of the Snake and Visegrad. CERGE-EI Discussion Paper no. 104)

In May 2004 the European Union will be joined by ten new member countries, but none of these will join the European Monetary Union (EMU). One of the EMU-entry requirements is exchange rate stability. How do the transition countries stand against that requirement? To shed light on this question, we contrast the volatility of exchange rates of the Visegrad countries with that of selected EMU countries (the Snake group consisting of Germany, the Netherlands, Belgium, Denmark and France). An important event to consider is the widening of fluctuation range of exchange rates within the EMU's Exchange Rate mechanism (ERM) from a range of $\pm 2.25\%$ to a band of $\pm 15\%$ in 1993. This event roughly corresponds to the situation when the transition currencies were allowed to float.

We find that the candidate countries currently have high exchange rate volatility compared to the low volatility of the Euro-zone countries before their accession to the EMU. The volatility of all Visegrad-group currencies has increased after a floating exchange rate regime was introduced. In contrast, the volatility of most of the Snake currencies decreased after 1993. In general, the currencies of the Snake countries exhibited lower volatility than currencies of the Visegrad countries under both fixed and floating regimes. The key question therefore is what

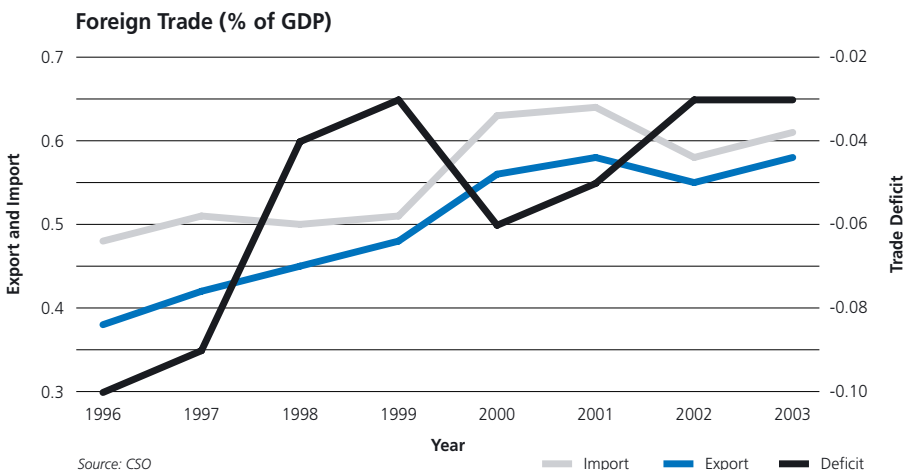
policies the central banks of the candidate countries should implement to bring the exchange rate volatility to levels acceptable by EMU.

It is also worth mentioning how the volatility depends on the interest rate differential. For the Visegrad countries (except Hungary) we found a positive significant correlation between volatility and interest rate differential regardless of the type of exchange rate regime. For the Snake countries the interest rate differential mattered only under the floating regime.

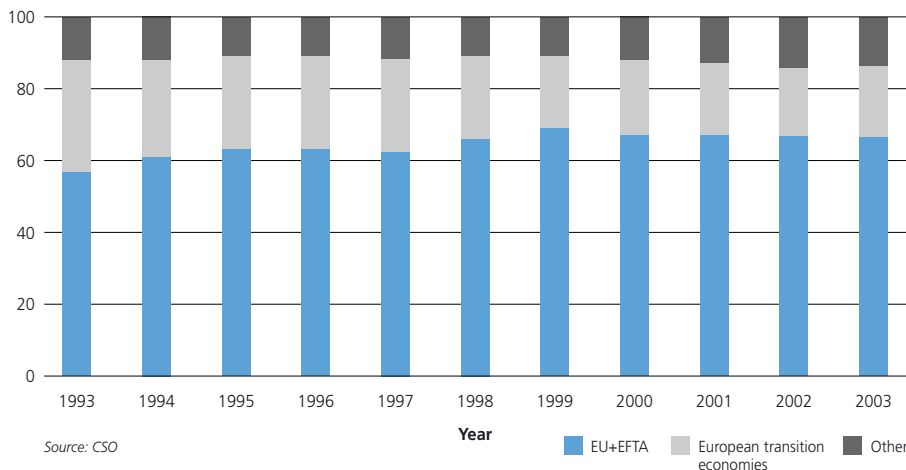
III.5 Foreign Trade and Balance of Payments

The Czech Republic is a textbook example of a small and open economy. International trade is an important component of GDP. The proportions of exports and imports of goods to the country's GDP in 2003 amounted to 58% and 61% respectively. The trend in openness shows an almost invariably increasing importance of international trade for the Czech economy. Both exports and imports consistently grow faster than GDP – exports increased by 9.3% and imports by 8.8% in 2003 (current prices). A trade deficit is and will be present as well, but unlike in the past it will not reach dangerous levels (it stagnat-

ed during 2003). Until 2000, the current account deficit used to be lower than the trade balance deficit because of positive balance on the services account. This effect is now dwarfed by a widening deficit in the income balance. Moreover, this development of income balance is likely to continue because of the huge inflow of direct investment in recent years (see the next section). Unlike in previous years, it is therefore the current account deficit that should be watched closely. However, if we consider the complete balance of payments, there does not seem to be any acute danger. The current



Foreign Trade Turnover by Groups of Countries

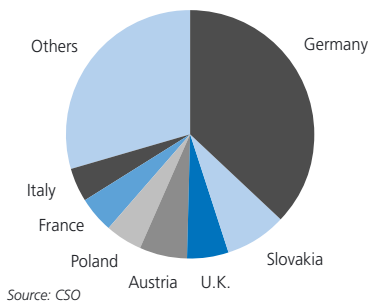


account deficit can be conveniently financed by inflow of direct investment. Moreover, the present exchange rate regime (managed floating) means that any repetition of a balance of payments problems similar to May 1997 is unlikely.

The EU is the main trading partner of the Czech economy. International trade with Germany stands out clearly since it constitutes close to two thirds of the country's trade with the EU and 37% of the overall trade volume. The second largest group of trading partners may be called "other European transition economies" and features primarily trade with the Visegrad countries. The composition of Czech foreign trade has changed. Specifically the share in exports of machinery and transport equipment has doubled since 1993, while raw materials and semi finished products have shrunk in similar proportion. The accession to the EU in 2004 should not

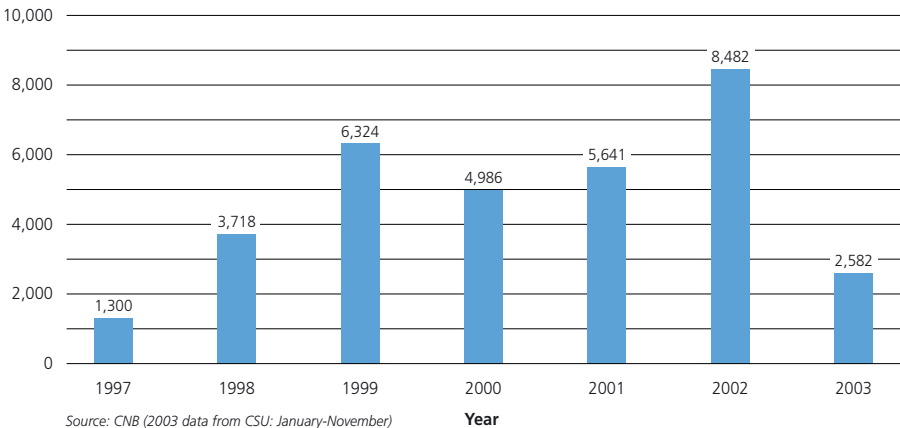
bring any major shift in trade patterns, since the association agreements have already created a free trade area between the CR and the rest of the EU. But the accession will mean that the CR will have to accept the common trade policy with respect to third countries.

Structure of Exports by Destination (2003)



III.6 Foreign Direct Investment

Foreign Direct Investment Inflow (USD million)

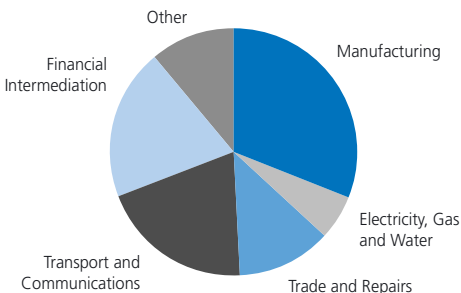


The Czech Republic attracts the highest amount of FDI per capita among Central and Eastern European countries. During 1989–2003 the Czech Republic attracted over USD 40 billion of foreign direct investment (FDI), of which about one half came during 2000–2002. FDI flows into the Czech Republic reached its peak in 2002 due to the takeover of Transgas, a major gas distribution company, by

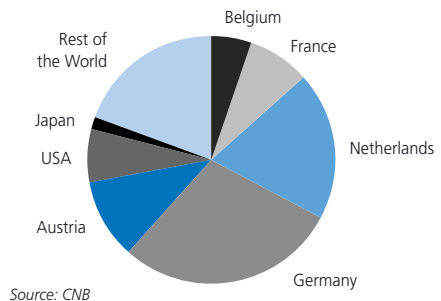
German RWE, the largest foreign investment to-date. In 2003 the inflow of FDI was lower because there were no major privatizations. The majority of the inflows therefore consisted of green-field investment and reinvested profits of existing foreign enterprises.

While large privatization deals have fuelled the rise in FDI in the past, they do not account for more than a quarter of the FDI stock. An

Cumulative FDI in the Czech Republic, 1993–3Q 2003 by Economic Activity (mil.USD)



Cumulative FDI in the Czech Republic by Region, 1993–3Q 2003



Source: CNB

important part of the green-field investments has been attracted by the investment incentives relatively generously allotted to investors that meet certain requirements. By the beginning of 2003, over 130 firms had been awarded incentives and another 50 applications were being processed. Originally, only manufacturers were eligible, but recently service companies can also apply for tax holidays of up to 10 years, financial support for creation of new jobs, job training of new employees and provision of low-cost land and infrastructure.

There are also costs of attracting FDI. First, the state had to financially restructure many companies prior to or during privatization. Here, the sales of Czech Airlines to Air France or IPB Bank to Nomura were major failures

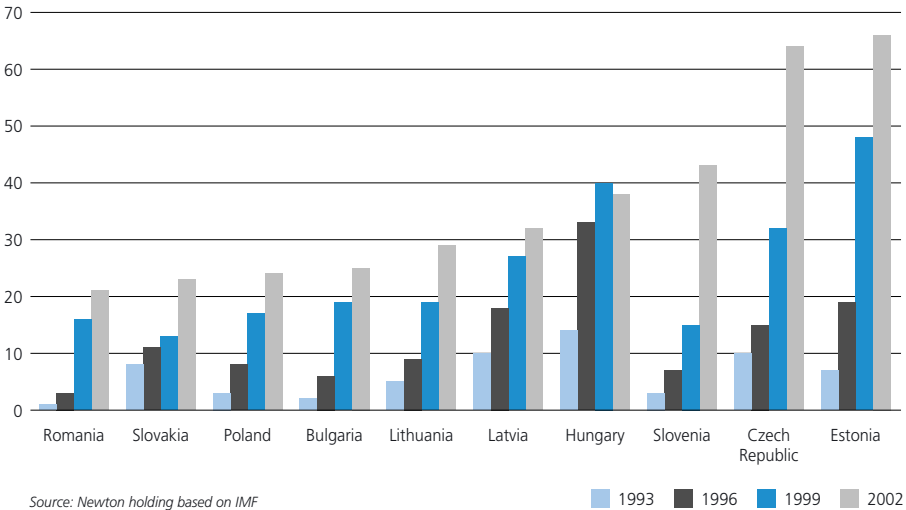
as the government had to buy back these companies. Second, there are costs involved in providing investment incentives. Some investors come, use the incentives and leave. Such was the case of the electronics manufacturer Flextronics, which committed itself to creating three thousand jobs but then withdrew from the country.

In 2003 EU countries continued to dominate Czech FDI. Germany maintained the strongest position, followed by the Netherlands, Austria, and France. There is relatively little investment from the USA and Japan in the Czech Republic, although the share of Japan is growing and part can be hidden in the Netherlands FDI as multinationals often establish companies in Netherlands through which they invest abroad.

The Largest Foreign Investments in the Czech Republic (in mil. of USD)

Total Invest.	Foreign partner, Country	Activity, time span	Name of the Czech company
3,900	RWG, Germany	Gas pipeline and distribution 2002	Transgas
1,460	TelSource, Netherlands, Switzerland	Telecommunication 1995	Český Telecom,a.s.
900	Volkswagen, Germany	Cars, 1991–1998	Skoda Automobilova a.s.
1,110	KBC, Belgium	Banking, 1999	CSOB
1,030	Societe Generale	Banking, 2001	Komerčni banka
629	IOC, The Netherlands, USA, Italy	Petroleum refining, 1995–2000	Ceska rafinerska
500	Erste Bank, Austria	Banking 2000	Ceska sporitelna
499	Assidoman, Sweden	Packaging materials, 1995–1998	Empack Olomouc, Pakaging Zebrač, AssiDoman Zatec,a.s.
450	ABB, Sweden, Switzerland	Electronics, engineering, 1991–1998	11 companies in total
420	Phillip Morris USA	Tabacco, 1992	Tabak a.s.
400	National Energy Corp., El Paso Energy, NRG Energy, USA	Energy, 1997–1999	Energetické centrum Kladno
357	Daewoo-Steyr, South Korea, Austria	Vehicles, 1995	Avia, a.s. Praha

Inward stock as a percentage of GDP



So far, almost 60% of the assets of foreign investment enterprises are concentrated in three industries: motor vehicles, food products and tobacco, and non-metallic minerals. Foreign penetration in manufacturing increased rapidly, reaching 61% of sales by 2003. Foreign-owned firms outperform domestic enterprises in both profits and productivity. They offer higher salaries, attract more skilled labor, and are on average more export oriented than domestic-owned firms.

Some major new investments have been announced for the near future: DHL (the world's largest logistics company) has decided to open its IT Operations Centre for all Europe in Prague, making it the largest technology centre in DHL's network. Within two years it should create up to 1000 jobs, investment reaching approximately EUR 0.5 billion. Toyota/PSA is building a car manufacturing plant

worth EUR 1.5 billion in Kolín – the largest investment project in Central Europe that should bring the Czech Republic approximately 3,000 jobs directly and another 7,000 new jobs through supplier companies and services. It is expected that in the future FDI flows will remain high thanks also to re-invested profits of existing enterprises. Moreover, FDI stock will further grow if the government manages to sell the petrochemical conglomerate Unipetrol, the national electricity monopoly CEZ, as well as Czech Telecom. These deals might bring up to USD 9 billion. FDI will thus also in the future serve as a non-debt source for the financing of current account deficit and public budgets. In the Czech Republic FDI stock to GDP is almost double that compared to developed countries and it implies higher sensitivity to external shocks.

IV. FISCAL REFORM

IV.1 Reform Impetus

As argued in Section III.3, growing and unsustainable public deficits are the major economic problems of the Czech Republic. Because the tax revenue share on GDP is already comparable to that of most developed EU countries, the adjustment must come on the expenditure side. Yet, most expenditure categories are locked in upward trajectories by existing legislation so that the share of mandatory expenditures on the state budget has been steadily rising. The expenditure reductions will inevitably affect the generosity of the welfare state including social assistance benefits, health insurance payments, and pensions. Yet, reducing the size of the welfare state goes directly against the political preferences of the ruling Social Democratic party. Similarly, reducing disincentives of the extensive and expensive Czech social support scheme by reducing some of the available benefits contrasts with the apparent conviction of the current minister of Labor and Social Affairs, an ex-trade-union official.

The set of necessary reforms is truly overwhelming, given the low political feasibility of major changes. The pay-as-you-go pension scheme must be seriously redesigned lest it collapses due to the aging population. Simi-

larly, the health care system lacks self-adjusting mechanisms and thus forcing the government to repeatedly cover its deficits. The minimum subsistence level guaranteed for Czech families in the current system of social assistance benefits provides a major disincentive for official employment to families with two and more children. Subsidized savings plans, which were supposed to help people finance their own housing, are primarily used as plain long-term savings accounts. Off-budgetary transition institutions also threaten fiscal stability with uncertain "postponed" losses and future liabilities.

The proposed reforms do not sufficiently address these challenges. The basic target of the Czech fiscal reforms is to decrease the deficit of public finance to 4% by 2006 (at present it is estimated at over 6.6%). The government's hopes are to decrease expenditures by 200 billion CZK during the next 3 years and to raise an additional 70 billion CZK in tax revenue. The reforms proposed by the Ministry of Finance have been further softened in parliament, thanks in part to the political representatives of trade unions. In sum, the Czech fiscal reforms are an order of magnitude weaker than that carried out by the reform-

Share of mandatory expenditures in the state budget (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003*
Mandatory exp. (%)	44.8	47.6	50.8	52.9	52.1	53.1	53.5	55.7	55.0
Quasi-mandatory exp. (%)	23.0	23.4	22.6	22.2	22.6	22.3	26.6	27.9	26.5
Total share (%)	67.8	71.0	73.4	75.1	74.7	75.4	80.1	83.5	81.5

Source: Ministry of Finance of the Czech Republic

* estimate

oriented right-wing Slovak coalition government in 2003. The reforms are unlikely to substantially lower the tax burden on labor, which is currently much higher than the typ-

ical OECD level and is likely to be one of the main detriments to Czech economic growth. The proposed changes in revenues and expenditures are discussed in the following sections.

IV.2 Tax Reform

The government intends to raise additional resources by means of higher income taxation and higher social-security contributions levied on self-employed entrepreneurs, who, up to now, have been able to effectively avoid most taxation. In particular, the government will set a minimum level of contributions and increase the base from which insurance is calculated. Even entrepreneurs who report no profit will have to pay contributions as if they had profits corresponding to 50% of average gross salary. This measure will become effective as of 2005. The revenue effect of these measures is likely to be small.

Next, the government will boost revenues by increasing indirect taxes, i.e. VAT and consumption taxes. In case of VAT, the changes will be part of EU harmonization. The VAT rate on many services including telecommunications was increased from 5% to 22% as of January 1, 2004. From May 2004, the higher of the two VAT rates should be reduced from 22% to 19%; however, many goods and services (for example restaurants, sports tickets, hygiene products, or cable TV) will be

shifted from the 5% to the 19% rate. Consumption taxes on fuels, spirit and cigarettes will be increased as well, and the bequests tax will be doubled during 2004.

The fact that the Czech economy is competing for foreign direct investment with countries with invariably lower taxation (notably Slovakia, which now features a corporate and personal flat income tax rate of 19%) has led the government to propose also some tax cuts. Corporate tax will be decreased stepwise from 31% to 24% by 2006 (however, at the same time some tax deductions will be restricted) and the tax on real estate transactions was cut from 5% to 3% in January 2004. The revenue from corporate taxation is expected to decrease (the cumulative reduction is expected to amount to almost 40 billion CZK by 2006 according to estimates by the Ministry of Finance). Personal income tax will remain unchanged – which however means that tax brackets will not be indexed.

The aggregate impact of these tax changes is likely to leave the share of tax revenue on GDP unaffected.

IV.3 Expenditure Reform

On the expenditure side, the government intends to reduce benefit formulas in the following welfare programs: pensions (see the next section), construction savings, sick

leave benefits, selected welfare benefits, and unemployment benefits.

The **construction savings** program was implemented in the early 1990's as a long-

term savings plan for buying or renovating homes. The government adds 25% to the amount that a person puts into the construction savings account (with a cap of 4,500 CZK per person per year and the restriction that savings must be accumulated for at least five years). Crucially, after these five years, the accumulated funds may be used for any purpose. Currently, 5.5 million individuals participate in the program and the government expects to spend CZK 13.5 billion on the annual subsidy. The reform approved by Parliament is to cut the subsidy to 15% and lengthen the minimum saving period from 5 to 6 years. While these minor changes may result in expenditure reductions in the far future, the widely publicized cuts led to a record increase in the number of participants joining the program before the end of 2003, because the government decided to grandfather the previous program conditions to those joining by the end of the year. Over 2 million new accounts were set up during 2003.

During 2003, the government expects to pay out CZK 34 billion in **sick leave benefits** to workers as compensation for income lost during sickness. The existing sick leave scheme is quite generous: Net sickness-benefit/wage replacement ratio after 2 weeks of sickness is 85% for an average wage worker and is higher than 90% for workers with below average wage. Accompanied by ineffective supervision and weak penalties, misuse by both employees and employers became widespread. As a result, the average duration of a sickness almost doubled during the last decade although workplace and general health conditions improved notably during this period. Indeed, the average Czech worker spends much more time on sick leave than workers in neighboring countries. Extended sick leave is a frequent response to a layoff

notice and workers also abuse short-term sick leave. The reform cuts the net replacement ratio for the first 3 days of sick leave to 28–31% of the daily wage. This is supposed to reduce the incentive to take a short vacation disguised as paid sick leave. On the other hand, the initial reform introduced in January 2004 only slightly decreases benefits at longer durations of sickness.

Czech families can claim a wide range of **welfare benefits**, including:

Child support (paid to families with children whose income is not more than three times the “minimum living standard”).

Welfare supplement (additional child support benefit aimed at families with income at or below 140% of the minimum living standard).

Housing supplement (intended to help poor families meet the cost of housing, although in fact it is not tied to housing per se; it is paid to any family with income below 160% of the minimum living standard).

Transportation subsidy is paid to low income families with children who go to school outside their place of residence. All elementary school children are entitled.

Maternity leave is paid to a parent who permanently looks after her/his children below the age of four. This benefit is not conditional on total family income, only the child-caring parent is restricted in how much she/he can earn.

Very poor families can obtain *additional welfare assistance*, awarded on a case-by-case basis by social workers. Typically it is paid to families which lose unemployment benefits after 6 months of unemployment. All together, welfare benefits cost CZK 34 billion, or about 1.5% of GDP.

The long-term fiscal reform plan envisions a major overhaul of the welfare system dur-

ing 2005–2006. The changes actually implemented for 2004 are relatively cosmetic:

- The transportation subsidy is eliminated.
- Mothers on maternity leave can earn unlimited income.
- Social workers can require beneficiaries to sell “above-standard” belongings (car, VCR, etc.) or to move to a smaller residence as a condition for receiving additional welfare assistance.
- The self-employed claiming welfare benefits because their net income is below $\frac{1}{2}$ of the average wage will be automatically assumed that they earn exactly $\frac{1}{2}$ of the average wage and their benefits will be adjusted accordingly. The stated rationale is that the self-employed can underreport their income and just claim benefits even though they are not poor.

IV.4 Pension Reform

The Czech Republic is heading for significant demographic aging. People over 65 will constitute almost one quarter of the total population by 2030. Aging is in part due to extending life expectancy and in part to the dramatic decrease in fertility during 1990–1999 when the number of children born per woman decreased from 1.9 to 1.1; it presents a formidable challenge to the current state-guaranteed pay-as-you-go (PAYG) pension scheme. With no changes in the PAYG system, its annual deficit could rise from the current 1% of GDP to about 3% before 2020. Aging will also result in increasing health care costs. This is important as health sector spending is already high at 7.4% of GDP in 1999 and 2000; see below.

This calls for a major reform. The current Czech pension system has two main foundations. The main one is the mandatory pay-as-you-go defined benefit pension plan and the marginal pillar is the voluntary, fully funded, defined contribution plan of the so called “extra pension insurance”. While some increases in retirement age have already taken place during the 1990s, their positive effects have been more than outweighed by the concurrent introduction of (actuarially unfair-

ly advantageous) early retirement schemes. In 1998, for example, early retirements constituted almost half of all old age retirements.

2003 has seen the first attempt of the Czech government to reform the PAYG system. Unfortunately, the reform does not successfully address the financial instability of the current system. On the other hand, it does deal with the weak dependence of benefits on contributions. Specifically, the reform will begin by a re-parameterization of the existing scheme and later will lead to the adoption of a new defined-contribution system inspired by the Swedish model.

The reform in the short term simply aims at cutting spending and increasing revenues. To reduce spending, the government will increase the retirement age to 63 for men and women without children by 2013 and reduce the number of years of study that can be included for pension calculation. An increase in revenues may later be achieved by increasing social security contribution from 26% to 28% of the gross wage and by increasing the basis of the social security tax for owners of small firms from 35% to 50% of profits. The government also intends to continue tying the growth rate of pension benefits to the

growth rates of the wage and consumer price indices, which is clearly unsustainable and which has been criticized by all advising international financial institutions.

In the long run, the government envisions adopting a variant of the recently introduced Swedish pension model (also established in Latvia and Poland). The core of the reform is the introduction of “fictitious” “notationally-defined” contribution accounts within the pay-as-you-go plan. These accounts illustrate the amount of “virtual” pension savings to workers. The growth of average pay then defines the rate of returns used to calculate the interest on the account balance. The system is intended to overcome the investment risk associated with private accounts while

tying the worker’s benefits more closely to contributions. In essence, there is no fundamental change in the PAYG system as the current contributions are being spent on the current wave of pensioners. The fiscal instability of the system due to aging is not successfully addressed.

In contrast, the recently approved Slovak pension reform allows workers to invest 9% of their gross wage in their privately owned retirement accounts in pension funds. The missing revenue in the PAYG system is then covered by privatization receipts (currently over 70 billion SKK) put in a lock-box. Privatization revenue in the Czech Republic is always used to cover its generous level of mandatory expenditures.

IV.5 Army Reform

After more than 200 hundred years, young Czech men no longer need to fear being drafted into military service. The Czech army will become fully professional on January 1, 2005. This measure is a part of a major reform of the army, approved by the government in November 2003. The new professional army will run under capacity restrictions during 2006, and depending on future funding sources it should become fully operational after 2010. The basic goals of the national defense system remain unaltered, namely defending the home territory, participating in allied operations abroad, carrying out air surveillance (NATINEADS), accommodating

allied forces (HNS), and fulfilling national non-defense duties.

The reform will naturally involve changes in the army’s labor force. The defense sector is planned to be downsized from the current 50,000 to 35,000 employees by 2008. The last 8,000 conscripts will enroll in compulsory one-year training in the first part of 2004, and will subsequently be replaced by recruiting an additional 4,000 professional soldiers. The replacement is expected to be cost-efficient in the long run: although every professional recruit will cost about 360,000 CZK more per year, each of them will replace two compulsory conscripts and resources will no

Projected min. expenditure necessary for successfully completing the army reform

Year	2004	2005	2006	2007	2008	2009	2010
Expenditure (in billion CZK)	50.7	53.8	58.4	61.3	64.2	67.4	70.3

Source: Ministry of Defense

longer be wasted on the year-to-year training of the conscripts. The number of civil employees will fall by more than 11,000. The downsizing will lead to changes in the organizational

system; the number of garrisons and other army sites will be reduced from around 250 in 1989 to only 73 by 2006.

IV.6 Health Care

The health care sector in the Czech Republic is financed by revenues from a health-insurance contribution (in fact, a payroll tax) of 13.5%. Employers pay 9% of gross wages, and employees contribute 4.5%. Every citizen must have health insurance, and the amount of health services received does not depend on the amount of contributions. The government covers the contribution for the unemployed, the elderly, and children under 18. The contributions are paid to health insurance companies. There are currently 9 health insurance companies – the idea behind this arrangement was to introduce competition into the health care system. In practice, however, the government-owned General Health Insurance Company (VZP) covers 70% of the population and the activities of private insurance companies are heavily regulated. Health care services are provided by both private and public entities. Most of the general practitioners, specialists, and dentists are now private. About 95% of pharmacies have been privatized. On the other hand, 75% of hospitals are still public, and are typically owned

by the regional governments or public universities.

Medical service providers contract with insurance companies. The reimbursement system is based on evaluating procedures by a fixed number of service points depending on their difficulty and cost. In reality, however, each provider segment – physicians, ambulance specialists, dentists, hospitals, etc. – negotiates separately with insurance companies the precise form of reimbursement for six months ahead. The final agreement is usually a mixture of a fee-for-service and up-front payments.

Health indicators have generally improved since 1990. Life expectancy rose from 71.6 years to 74.8 years in 1999. Infant mortality dropped from 10.8 per 1000 live births to 4.6 in the year 2000. However, the health care system itself is in serious financial difficulties and periodically requires large injections of funds. So far, there have been numerous reforms proposed by the Ministry of Health, but no real reform is in sight. The current Minister of Health is about to propose yet another reform and is likely to be introduced during 2004.

Hospital Bailouts

The Czech health care system features an overly dense network of health care facilities with inappropriately regulated prices, excessive use of modern technologies by ambulance specialists and hospitals, insufficient utilization of high-tech equipment, and excessive inpatient care.

More than a half of Czech hospitals have been reporting operating losses over the last several years and the situation has worsened over time. At the beginning of 2003, the ownership of most hospitals had been transferred to regional governments, which marked an end to their soft-budget-constraint financing. As a result, a majority of these hospitals now face serious financial distress.

According to the Ministry of Health, their bailout will cost about 3.5bn CZK. If carried out, as advocated in political circles and by health insurance funds, regional governments ought to cooperate with health insurers companies to lower the number of hospitals to avoid their high fixed costs. Special attention should be paid to further reducing the acute inpatient care which makes up more than half of the total health care bill; by a long way exceeding EU standards.

Paradoxically, further contributing to the excessive hospital capacity and provision has been the relative scarcity of long-term care and home care facilities, because hi-tech hospital and ambulance facilities have been (to some extent unnecessarily) used by the aging cohorts. As debated by the government, some form of "integrated community care" with multi-source financing should in the future reduce the need for acute-care beds for the elderly, potentially saving up to 4bn CZK. In general, it seems desirable to promote integration, e.g. by grouping physicians' practices into contractual networks including sharing staff and equipment.

The Ministry of Health hopes to save resources by further regulating wage increases in hospitals and freezing the prices of pharmaceuticals. However, both health-sector wages and pharmaceutical prices are still 30–40% below international standards, and are likely to catch up after the EU accession, thus exacerbating the cost pressures.

Prices cannot be blamed for the escalating pharmaceutical bill. Many basic drugs (e.g. anti-inflammatory and anti-rheumatic products) are fully reimbursable, even some over-the-counter ones. Partially due to this, the proportion of drug consumption in the total health bill is the highest among OECD countries, around 25% compared to the 15% OECD average. To reduce the over-consumption of pharmaceuticals, the Ministry of Health is planning to introduce a

Financial situation of hospitals in 1999–2002

Year	1999	2000	2001	2002
Total number of hospitals	198	198	186	184
Number of hospitals with operating loss	106	98	97	102
Loss up to 10m CZK	71%	74%	61%	43%
Loss 10–50m CZK	25%	20%	34%	46%
Loss above 50m CZK	5%	5%	5%	11%

Source: Institute of Health Information and Statistics of the Czech Republic

lump-sum payment for prescriptions, to make prescription conditions stricter, and to increase patient participation.

Rather than over-consumption, however, two factors have led to excessive provision of both drugs and services. First, although pure fee-for-service reimbursement of ambulance specialists has recently been eliminated, a remedy still needs to be found for eliminating redundant health diagnostic tests. Related to this, general practitioners should be required to perform the necessary gate-keeping role for access to ambulance specialists and hospital inpatient care.

Second, the excessively benevolent sick-leave scheme administered and financed separately by the social security agency increases demand for health care. Physicians competing for patients have no incentive to deny sick leave and often prescribe superfluous drugs with it. This practice cannot be detected by health insurance companies because sick-leave is administered by the social security administration. A potential remedy for preventing the collusive behavior of sick-leave claimants and doctors lies in merging the sick-leave and health insurance schemes (together with cutting sick leave benefits, see section IV.3).

V. ENTERPRISE SECTOR

V.1 Privatization and Restructuring

The Czech Republic has an important history of early-transition privatization. While privatization of small firms was completed successfully in the early 1990s, the so called large-scale privatization of the mid 1990s was plagued by asset stripping or “looting” and resulted in insufficient restructuring. Many of the old Czech firms continued to receive subsidies hidden as (soft) commercial loans. A state owned bank (Consolidation Bank) set up to clear non-performing loans from the large bank portfolios in the Czech Republic was transformed from a temporary hospital for bad loans inherited from the communist era to a state-run commercial debt-alleviation agency. The largest banks had long-standing creditor relationships with the voucher-privatized enterprises and also made equity investment in these firms through their voucher investment funds. Such joint stock companies exhibited worse performance and higher indebtedness than privately held limited liability firms.

The privatization of many large companies, including banks, was thus much slower than it appeared – despite the significant share of these companies distributed to the public in voucher privatization. In fact, in 1998, most large strategic companies were still under state control – either directly or indirectly through state-owned banks.

Privatization activities were resumed at the beginning of 2000. Most importantly, all large banks were sold to foreign investors (Česká spořitelna to the Austrian Erste Bank Sparkassen, Komerční banka to Societé Generale,

and ČSOB to Kredietbank of Belgium). IPB, the bank privatized in 1998 to the Japanese Nomura, ran into serious financial troubles. Given that it was dealing with the second largest amount of payments in the economy, the Czech National Bank imposed administration on the bank and quickly arranged a sale of the IPB business to ČSOB. Both sides (Nomura and the Czech Republic) are now suing each other for the costs of the incident. Recently, a London arbitration court ruled that the case should be examined within the Czech judicial system.

In order to maximize privatization revenues, the government improved the balanced sheets of the banks by transferring bad loans to the Consolidation Bank or by providing protection against credit risk. The total cost of bank restructuring is yet to be revealed, but is currently estimated to reach CZK 350–400 billion, of which CZK 100–150 billion will be spent on IPB alone.

Recent privatization attempts were generally failures. Privatizations of ČEZ (the main electricity generator with a controlling stake in many regional distributors) and of Czech Telecom (the near-monopolistic provider of fixed-line telecommunications) have been under preparation for years but completion is not in sight. In the case of ČEZ, none of the serious buyers (Enel of Italy and Electricité de France) were willing to meet the government’s asking price of 200 billion CZK. Unipetrol, a large chemical conglomerate, was not sold to the highest bidder (British Roche) but to the second highest bid of 11.75 billion CZK by

domestic Agrofert, which eventually refused to pay the agreed price and returned the company to the government, after having control of the firm for an extended period of

time. The only successful privatization was the sale of Transgas, the gas distribution company, to German RWE in 2002.

Privatization Helps, but it is not a Simple Panacea

(Based on: Evžen Kočenda and Jan Švejnar (2003): Ownership Performance After Large-Scale Privatization, CERGE-EI working paper no. 209)

Few would doubt that economic performance of planned economies was disastrous and that state ownership of firms was in part to blame. This belief motivated large-scale privatizations across Central and Eastern Europe. However, there is surprisingly little convincing evidence that the privatized firms indeed perform better, despite a large number of papers written on this topic. Actually, some of the fastest growing transition economies in the 1990s (e.g., China, Poland and Slovenia) were among the slowest to privatize!

The lack of reliable data is the usual problem. The impacts of privatization are difficult to isolate because of other simultaneous effects, such as changing degree of ownership concentration (some methods of privatization lead to concentrated ownership, others to widely dispersed ownership), or selection bias (decisions which firms to privatize are not random), or datasets covering only a small number of firms for a short time.

Kočenda and Švejnar overcame these problems when analyzing how ownership affects performance of Czech medium and large firms in a complex panel dataset covering virtually the complete population of firms that went through large-scale privatization.

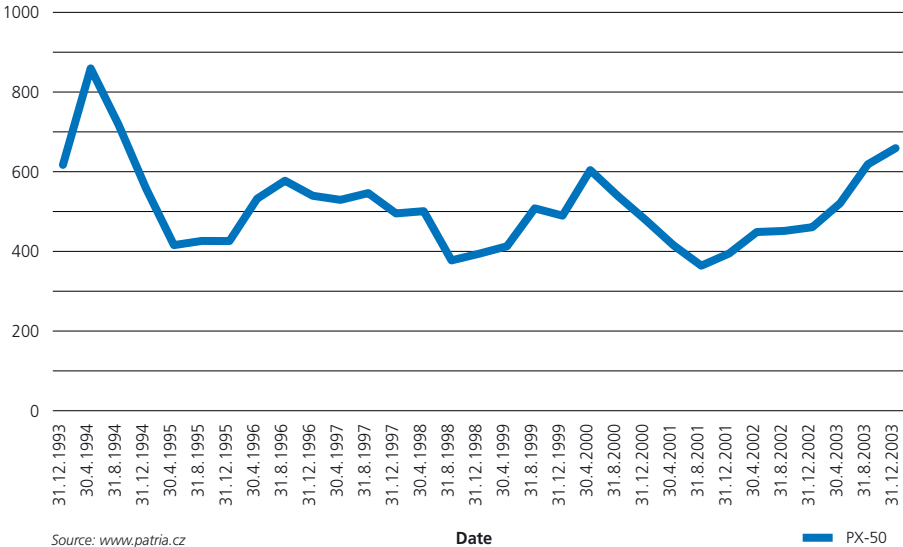
Results were also complex. On one hand, concentrated and private ownership was correlated with better economic performance, but only if the owners were foreign. On the other hand, domestic private ownership in many respects did not significantly improved performance over state ownership. Foreign firms apparently engage in strategic restructuring and increase profits and sales, whereas domestic owners on average seem to reduce sales and labor costs (defensive restructuring). Also, the presence of a large domestic stockholder may not result in superior performance if this shareholder “loots” the firm.

The Czech state remained present in some of the privatized firms by means of the so-called “golden share”. Existence of such golden share has surprisingly proved to be efficient. The authors suggest that the state induces profit-oriented restructuring but also pursues a social objective of employment generation.

The Czech evidence gathered by Kočenda and Švejnar should teach us an important lesson in economics of transition – the label “private ownership” does not matter so much. What matters is not the label, but the real ownership structure. A firm improves its performance if a sufficiently powerful stakeholder (or alliance of stakeholders) exists and if this stakeholder has motivation to push forward strategic restructuring.

V.2 Czech Capital Markets

The evolution of Prague Stock Exchange index (PX-50), 1993–2003



The voucher privatization scheme drove the design and functioning of the Czech equity markets. It was very rapid at the outset, as about 1,700 companies were floated within two years of market establishment. The regulation of the market, however, lagged significantly behind. In the mid-1990s, insider trading, price manipulation, fraud in the investment funds industry, and abuses of minority shareholder rights eroded investor confidence to a large extent. The creation of the Czech Securities Commission in 1998 did not significantly improve the investors' confidence because of weak enforcement of the new rules. The Prague Stock Exchange (PSE) does not serve as a primary source of firms' financing.

By historical accident, there is another stock exchange in addition to the standard-

type PSE: the RM-System (RMS), an over-the-counter exchange that sprung up naturally from the voucher privatization. Its early role was to provide an easy way for ordinary people who obtained shares in voucher privatization but were not interested in being shareholders (the vast majority of them) to sell them to institutional investors. This mission, however, is almost fulfilled and the market share of the RMS has been declining.

The stock market has been plagued by a huge number of illiquid shares, varying information disclosures and low transparency in general. The last problem comes from the fact that most transactions are not carried on the centralized, price-setting market, but either outside the PSE or at the PSE but as so-called "block or direct trades" that do not perform a price discovery function.

The PSE responded to these problems by dividing the existing equities into three tiers according to capitalization and disclosure obligations, by a huge delisting of illiquid shares (currently there are fewer than 100 companies traded on the PSE), introducing a new trading system (SPAD) for bluechip titles, and prohibiting its members to trade these titles outside of the PSE. Finally, the 2002 amendment to the Securities Act set the minimum volume of a publicly traded issue at CZK 33 million and required at least 25% of the shares to be floated. This affected mainly the RMS and forced it into huge delisting.

First and foremost, the stock exchange has to attract firms to raise capital on the stock market. Czech firms rely almost exclusively on bank credit, partly because of their historically close links to the banks, which often became

active shareholders and influenced decision-making in the enterprises. The only attempt by a local company to raise equity via a domestic IPO failed in the first half of 2001 due to low investor interest. In September 2003 the PSE turned to the government for help and plead it to use the exchange as an intermediary in future privatizations and bond issues.

The privatization of government stakes in large corporations (ČEZ, Czech Telecom) also represents a significant risk for future trading at the PSE as these shares account for a half of the PSE turnover.

Despite several reforms and organizational changes the Czech capital market does not yet behave as a standard market. Due to the lack of investors' confidence and resulting low liquidity, its prospects as a stand-alone trading place are not very bright in the longer term.

New trading system on the Prague Stock Exchange

(Based on: Jan Hanousek and Richard Podpiera (2003): Development of the SPAD Trading System and its impact on information-driven trading. Forthcoming in Economic Systems)

Even after a decade of trading at the Prague Stock Exchange, the Czech equity market still suffers from several inefficiencies. One of the changes that the PSE implemented in order to make the market more transparent and liquid was the introduction of a market-maker trading system (SPAD) in 1998. Before that, prices of most liquid shares were set in a continuous auction while prices of the remaining shares were set in a fixed auction. However, the majority of trades in the latter category bypassed the centralized market and settled as direct or block trades without performing any price-discovery function. Thus in 1996 and 1997 the centralized market accounted for less than 10% of total trading volume. Moreover, direct and block trades were conducted over the counter, which made prices non-transparent and increased the trading costs. In contrast, market makers in SPAD maintain continuous quotations of bid and ask prices for selected most liquid securities.

Five years after its implementation, it is possible to examine the role SPAD has played in the development of the Czech equity market. The trading data shows that it has succeeded in shifting trades away from the over-the-counter market and thus enhanced transparency. Already in 1998 the share of trades in the most popular securities conducted through the main segment of the price-setting central market had jumped to over 50% and later increased to

Trading Volume on Czech Capital Markets (CZK billion)

		1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*	2003
PSE	Central Market	2	16	22	29	22	72	142	246	119	72	77 ⁺
	Share of the Total PSE Volume	(22%)	(26%)	(11%)	(7%)	(3%)	(8%)	(12%)	(20%)	(6%)	(4%)	(6%)
	Direct and block trades	7	46	173	364	657	788	1,045	977	1,868	1,721	1,191 ⁺
	Share of the Total PSE Volume	(78%)	(74%)	(89%)	(93%)	(97%)	(92%)	(88%)	(80%)	(94%)	(96%)	(94%)
RMS	Central Market	2.9	4.4	5.8	9.5	7.6	7.5	6.4	2.0	2.7	2.0	1.3 [^]
	Share of the Total RMS Volume			(23%)	(9%)	(5%)	(3%)	(4%)	(9%)	(13%)	(10%)	(20%)
	Direct and block trades	n.a.	n.a.	19	91	151	207	175	67	17	18	5.3 [^]
	Share of the Total RMS Volume			(77%)	(91%)	(95%)	(97%)	(96%)	(91%)	(87%)	(90%)	(80%)
	Share of RMS on the market			11.28	20.36	18.94	19.96	13.26	5.65	0.98	1.10	0.52

* New Methodology on PSE

⁺ Jan–Nov 2003 [^] Jan–Sep 2003

over 90% in 2000 and 2001. In this way SPAD has restored the price discovery function of the exchange. The empirical evidence further suggests that the market has become more efficient over time and that investors have benefited from lowered spreads. Nevertheless, not all aspects of trading have improved with the introduction of SPAD. The estimates of the extent of informed trading for the last three months of 2002 were compared to those for the time period August to November 1999. However, no evidence is found that the extent of informed trading has decreased over time and thus it is possible to speculate on the apparent rigidity of the PSE. Hence, one could interpret the stability of informed trading as an indicator of a very low relative influence of changes in market structure, supervision and enforcement on the extent of informed trading on the PSE.

However, there has been a recent outflow of central market trades back to block and direct trades (see table). The limited use of the price-setting centralized market remains a serious problem of the Prague Stock Exchange.

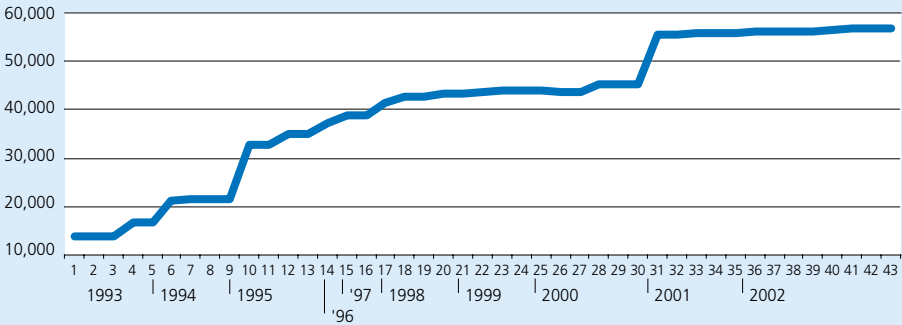
V.3 Taxes

A modern tax system came into force in January 1993 and for most of the citizenry, as well as for the public administration, it was completely novel. The major features of the new tax system were the introduction of value-added tax and a new individual and corporation income tax. Perhaps not surprisingly, regulatory institutions and enforcement

procedures developed gradually and the tax laws were amended many times. In line with the evolution of business and public administration, tax evasion by citizens became widespread. Given the ability of small businesses and self-employed to avoid taxation, the state relies heavily on payroll taxation of salaried employees.

Income Tax Law

Number of Words in the Czech Income Tax Law

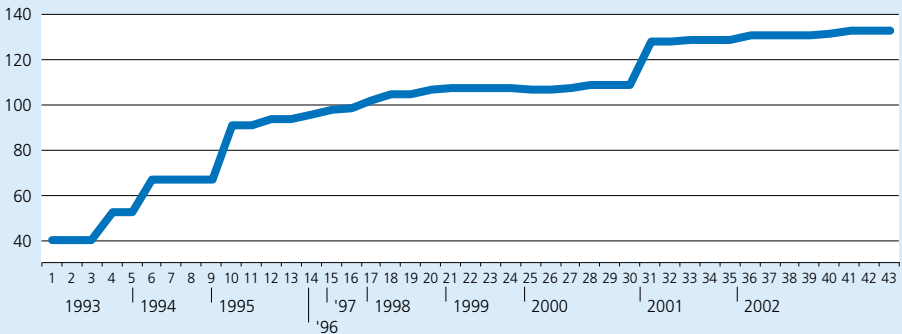


Number of Novels since the Income Tax Law First Came into Force in 1993

Source: Act No. 586/1992 Coll., as amended

In hindsight, the Czech income tax law seems excessively complex. During 1993–2002, there were 43 amendments – approximately one modification every quarter. Not only did the income tax law change substantially in character, it also became extensive. The first version of the law contained less than 14 thousands words, whereas the last one examined was composed of nearly 57 thousand words: a four-fold increase. The number of words rose fairly quickly until the end of 1995, with another relatively big increase in 2001. Naturally, as the income tax law becomes thicker, it contains more loopholes and opportunities for tax avoidance, as the increase in the frequency of the phrase “with exception of” demonstrates.

Number of Phrases “with exception of” in the Czech Income Tax Law



Number of Novels since the Income Tax Law First Came into Force in 1993

Source: Act No. 586/1992 Coll., as amended

Taxes across the Accession Countries

During 2003 the governments in Central Europe reformed their tax systems in order to harmonize their tax law with EU law to make their economies more attractive for foreign investors. In general, the comparison of tax systems across Central Europe shows a weakening of the Czech Republic's competitiveness in the region.

Tax changes in the Czech Republic were quite modest in comparison to other accession countries. Corporate tax will decline from the current rate of 31% to 28% in 2004 and will further drop to 24% by 2006. On the other hand,

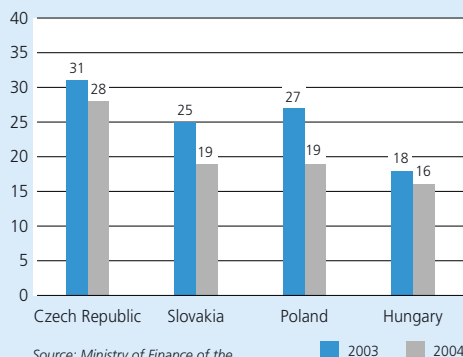
Hungary cut corporate tax to 16% and Poland to 19%. The Slovak government even introduced a 19% flat tax on both corporate and personal income. In Latvia and Lithuania, corporate tax rate is 15 percent. In Estonia the effective rate on distributed profits is 26% and retained earnings are not even subject to taxation.

The Czech value-added tax rates are 22% (standard) and 5% (reduced), although the government proposed to reduce the standard rate to 19%. However, many items (telecommunications and some services) were moved from the reduced to the higher rate as of January 2004, and additional services will be taxed at the higher rate upon EU accession.

On the other hand, the Hungarian government proposed an increase of the preferential rates from 0% and 12% to 5% and 15% respectively. The standard 25% rate remains unchanged. The Slovak VAT went through the greatest change in January 2004. A single 19% VAT rate replaced the reduced and standard rates of 14% and 20%.

As an integral part of the taxation system social security contributions should be considered. The Czech social security taxes are not only the highest in Central Europe but also in all OECD countries. Thus the social security contributions represented 17.3% of GDP in the Czech Republic, 14.7% in Slovakia, 11.5% in Hungary and 10% in Poland.

Changes in corporate income tax rate (in %)



Source: Ministry of Finance of the respective countries

Individual income tax and value added tax in Central European countries

	Individual income tax		Value-added tax	
	2003	2004	2003	2004
Czech Republic	15–32%	15–32%	22%, 5%	22% (19%*), 5%
Slovakia	16–32%	19%	20%, 14%	19%
Hungary	20–40%	18–38%	25%, 12%, 0%	25%, 15%, 5%
Poland	19–40%	19–40%	22%, 3–7%	22%, 3–7%*

Source: Ministry of Finance of the respective countries

* Changes under proposal

V.4 Business Environment

Early Czech transition has been characterized with problems in ensuring the rule of law, extensive credit fraud, an ineffective judiciary system, insider dealing, insufficient use of public tenders, and a general spread of corruption in public administration and commercial courts. While some studies suggest that the Czech Republic is comparable in this regard to other Central European economies, others imply that legal enforcement and bankruptcy procedures are weaker in the Czech Republic than elsewhere in the Visegrad (see feature story below).

These findings reinforce the criticism stated by the European Commission in its last *Regular Report on Czech Republic's Progress towards Accession* from October 2002. According to the Report, "further efforts are needed to improve the overall business environment, in particular through the more efficient operation of the company register and more effective enforcement of judgments by

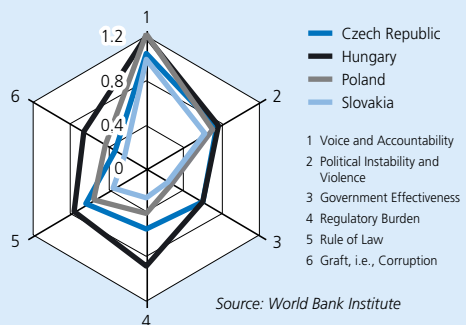
the commercial judiciary." The Commission further criticized "unsatisfactory bankruptcy legislation which has not been changed since May 2000." Unfortunately, since the time of this criticism the bankruptcy legislation has not changed, the company register does not operate more efficiently, and the judicial reform has not proceeded.

As for bankruptcy, it was almost impossible at the beginning of transition since the government feared massive layoffs. The 1994 bankruptcy law and subsequent amendments provided a workable framework. As a consequence, the number of bankruptcy filings grew from 1826 in 1994 to 4009 in 2002, and the number of declared bankruptcies grew from 254 in 1994 to 2155 in 2002. The main weakness of the Czech bankruptcy law is that it fails to allow for restructuring (like the well-known U.S. Chapter 11). All filings lead either to bankruptcy procedure or refusal to declare it, but almost never to restructuring.

Problems of the Czech Business Environment

In 1999, the World Bank Institute (WBI) introduced the concept of **Aggregate Governance Indicators (AGI)** in order to measure the quality of business environment. The WBI approximated the quality of business environment as the quality of governance defined broadly as "the traditions and institutions by which authority in a country is exercised." Aggregate Governance Indicators measure six areas of governance: (1) voice and accountability, (2) political instability and violence, (3) government effectiveness, (4) regulatory burden, (5) the rule of law, (6) graft, i.e., corruption.

Aggregate Governance Indicators 2002

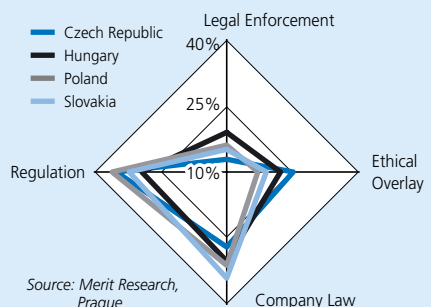


of law and (6) graft, i.e. corruption. The results of the study are available for 1999 and 2002 and are standardized on a scale from -2.5 (the worst) to +2.5 (the best). The point estimates for the Czech Republic in 2002 are not significantly statistically different from those in 1999. Similarly, the differences between Czech, Slovak, Polish and Hungarian indicators are not statistically significant at any reasonable level. However, it is interesting to see that in all of these countries, corruption and government effectiveness belong among the weakest areas of governance, while political voice and accountability represent the best assessed area.

Another attempt to evaluate the quality of the business environment in Central Europe is represented by the **Corporate Governance Risk (CGR)** index designed by Crichton-Miller and Worman from the Institute of International Finance. The methodology distinguishes four elements of corporate governance risk: corporate law, legal processes, regulatory regime, and ethical overlay. The scores are based on questionnaires (and interviews with local top managers) consisting of twenty-eight questions, i.e., seven questions per element. The data for the Czech Republic, Slovakia, Poland and Hungary were collected by Merit Research, Prague, between 2000 and 2002. While the absolute evaluations on the scale from 0 to 28 do not possess a large explanatory power due to methodological limitations, the composition of the risk in the four countries plausibly identifies relative problems and relative successes of the countries' business environments.

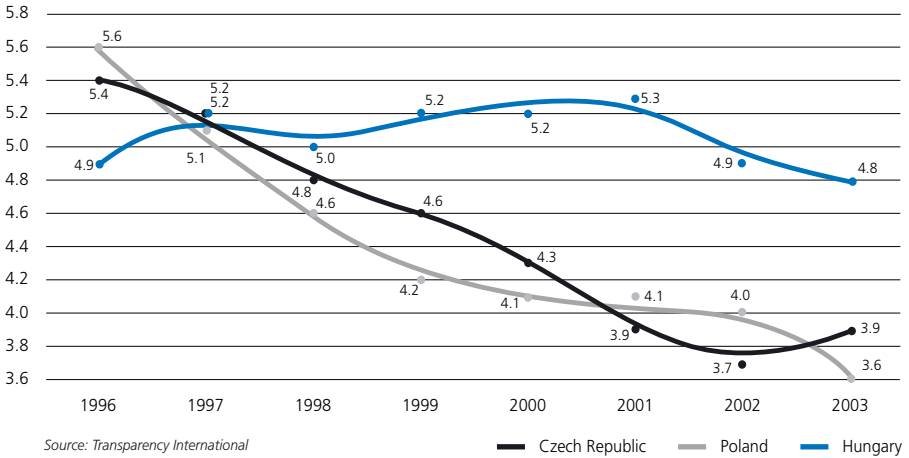
The figure illustrates the relative assessment of the four elements. In a well-balanced case, the diagram would be a regular square with corners at 25% levels. However, the results for all CEE countries are biased towards a relatively better position in company law and the operation of the regulatory system, while law enforcement and ethical overlay represent a relatively more serious problem. More specifically, in all four countries legal processes are extremely slow and cost-ineffective, commercial arbitration is perceived as weak, combating organized crime as inefficient and public tenders as opaque and biased. In addition to these common features, we can find relative successes and failures of the Czech business environment compared to the Polish, Slovak and Hungarian ones. One of the most obvious relative failures is bankruptcy law (and related procedures), the weakest part of the otherwise relatively strong area of company law. This aspect is very well assessed in Hungary, but much worse in Poland and even worse in the Czech and Slovak Republics. Second, law enforcement which is in general a crucial problem of the region proves to represent an even larger problem in the Czech Republic. Other distinguishing features can be seen within the area of regulatory regime which is in general the least problematic. In the Czech Republic, the functioning and independence of banking regulation and protection of market competition are assessed very positively, while capital market regulation and reliability of company records (the company register in particular) received much criticism. The situation is similar in Slovakia but almost opposite in the other two countries.

Corporate Governance Risk 2000–2002



V.5 Corruption

Corruption Perception Index



The 2002 European Commission's *Regular Report on Czech Republic's Progress towards Accession* criticized "the ineffectiveness of combating 'white collar' crime and corruption." While the government acknowledges that bribery in public administration and fraud in the private sector continue to be significant problems, it often comes under fire itself for avoiding the use of public tenders in awarding large public contracts.

The corruption perception index, collected by Transparency International, measures the degree of corruption perceived by business people, risk analysts and the general public; it ranges between 10 (highly clean) and 0 (highly corrupt). The Czech Republic drifted further down the table in the last year. It finished at 3.9, tying with Bulgaria and Brazil for 54th place among 133 countries. This is down from 39th place, and a score of 4.6, in 1999 when the government proclaimed it was getting serious about fighting corruption.

While measures like the corruption perception index ought to be taken with a grain of salt since poor numbers may reflect increasing awareness and better monitoring mechanisms, other pieces of evidence suggest that the reality of corruption in the Czech Republic has not got any better. A survey by the Czech Chamber of Commerce showed that firms generally believe that corruption among government officials is on the rise and the work of courts is worsening. Over 50 percent of the respondents found the work of the courts wanting, especially regarding creditor rights. (Interestingly, the survey found that large foreign companies perceive corruption much more favorably than small Czech firms). In July 2003, audits of Prague City Hall contracts found that almost all reviewed contracts were wanting, with the costs of some of the more gregarious "mistakes" adding up to hundreds of millions CZK. Another corruption scandal featured the judge presiding over the

bankruptcy of Union Banka, who faced allegations of basing his verdict on falsified documents and is currently under arrest. In April, the Lower House dismissed the Broadcast Council (which regulates Czech media); in part because of allegations that at least some members had been bribed at various junctures.

The government created a new Office for Corruption and Financial Criminality by merg-

ing two special units of the state police force. The merger had the unfortunate consequence that some very qualified investigators left for the private sector. Another government plan (which produced much ado) is to fight corruption by means of last resort such as “integrity tests” through agents-provocateurs. This legislation has some chance of being implemented during 2004.

V.6 Nonprofit Sector

The nonprofit sector (called also voluntary or third) in the Czech Republic came into existence only after the fall of communism. Before, there was a limited number of organizations involved in traditionally nonprofit activities but all were centrally organized and under direct state control (associations of hunters or gardeners, Red Cross, etc.). After the fall of communism the number of nonprofit organizations continuously grew from about 9,000 in 1991 to over 50,000 in 2003. Currently the nonprofit sector employs around 3% of the workforce.

The structure of the sector differs significantly from that observed in western countries. Culture and recreation (which includes sports and hunter associations) are the most prominent fields in the Czech Republic, since associations in these fields had existed and had been widely supported under the previous regime. In western countries, in contrast, the thrust of nonprofit activities is concentrated in health care, education, and social care. In the Czech Republic the high involvement of the state in these areas crowds out the nonprofit sector.

Nonprofit organizations have 3 main sources of financing: fees and charges, public sector subsidies, and philanthropy (donations). Fees

and charges are the most important source of revenues (around 47%). Public support is relatively stable (around 39–40%, more than 3 billion CZK a year). The disadvantage of public subsidies is that they are being awarded on a year-to-year basis; therefore do not provide a guarantee of stable support for a particular program or organization. The distribution of subsidies is highly centralized and municipalities do not have sufficient resources to support the organizations and programs they know and thus can assess and monitor best.

Donations from foreign sources have decreased by 25% during 1997–2002 (an estimate by USAID). Many important foreign foundations moved their programs to places with higher needs (Africa, or Eastern Europe), and the sector has to find new donors. There are also attempts to re-establish the tradition of private and corporate philanthropy, such as the proposed “1% law.” It would allow people to designate 1% of their income taxes to a particular nonprofit organization in the country. Thus, the law would not increase the tax liability but only move the decision about allocation of some funds from government to people.

VI. LABOR MARKET

VI.1 Flexibility

The Czech labor market features high employment rates in comparison to EU accession countries. Even though some transition economies, e.g. Hungary, have lower unemployment rates, these occur on the back of much lower labor market participation. The structure and level of Czech employment and unemployment is actually very similar to that of a typical EU-15 economy with the exception of higher long-term unemployment incidence.

However, there are two key problems with the Czech labor market. First, taxation of labor is very high. In the Czech Republic, wage taxes bear down heavily on labor (at almost 50% of gross labor income, they are much higher than the OECD average), and should be reduced to stimulate employment. Second,

the extensive system of social assistance, while alleviating poverty, also generates significant work disincentive effects. The comparison of market wages with the total level of available social benefits is especially work-discouraging for families with children.

Internationally comparable indices of flexibility suggest that the Czech labor market is somewhat more flexible than those of most EU countries and many transition economies. However, this comparison became less favorable during 2003 when neighboring Slovakia introduced a number of flexibility-promoting policies (pro-work structure of support, flexible Labor Code) and when changes in the Czech Labor Code, championed by the trade unions and their political representatives in

Labor market indicators in 2001

	Czech Republic	Slovak Republic	Poland	Hungary	EU Candidates	EU-15
Employment rate (% of population employed)						
15–24 years	34.4	27.7	21.4	31.4	27.0	40.4
25–54 years	82.0	74.6	69.5	73.1	73.8	77.0
55–64 years	36.9	22.5	30.5	23.7	34.6	38.2
15–64 years	65.0	56.7	53.8	56.3	57.8	63.9
Self-employed & family workers*	15.3	8.6	28.0	14.6	27.1	15.7
Contract of limited duration*	8.1	5.0	11.9	7.5	8.0	13.4
Unemployment rate (% of labor force jobless and searching for work)						
15–24 years	16.3	38.9	41.5	10.5	28.8	14.0
25–64 years	6.9	15.9	15.6	5.0	11.3	6.5
15+ years	8.0	19.4	18.4	5.7	13.0	7.3
Unemployment over 12 months**	52.9	58.3	50.1	44.8	52.4	44.0

Source: World Bank

* % of all employed, ** % of all unemployed

the government, limited the use of fixed-term contracts in the Czech Republic. Here, it is also important to note that the level of sick-leave insurance is generous, and is often abused by workers and firms. It is also not

possible to fire an employee who is on sick leave so that the increased duration of sickness and higher outlays of sick insurance funds can partly be thought of as unemployment insurance or temporary layoff subsidy.

VI.2 Unemployment

The ILO unemployment rate (defined as the number of jobless people searching for work over the total size of the active labor force) rose from 7.3% in 2002 to 8% in 2003 so that it returned to its 2001 level. On the other hand, the registered unemployment rate (based on the number of people registered at District Labor Offices and typically collecting some government-funded benefits) reached a new historic high of 10.3% at the end of 2003. Our forecast is that during 2004 the registered unemployment rate will stabilize at levels slightly above those of 2003.

Unemployment rates based on the number of workers registered at labor offices has substantially exceeded the unemployment measure based on the labor force survey (ILO definition) since 2002. This recent development may suggest a growing increase in the misuse of unemployment and welfare programs if individuals who report as being in work in the labor force survey are also reporting as unemployed in government registers and are collecting benefits. Finally, the incidence of long-term unemployment (the share of those unemployed for over one year out of the total number of unemployed) also grew steadily in recent years. (Long-term unemployment is typically higher when based on the ILO definition of unemployment.) Long-term unemployed are often trapped in inactivity by the generous welfare system, rigid housing markets, and their low level of education.

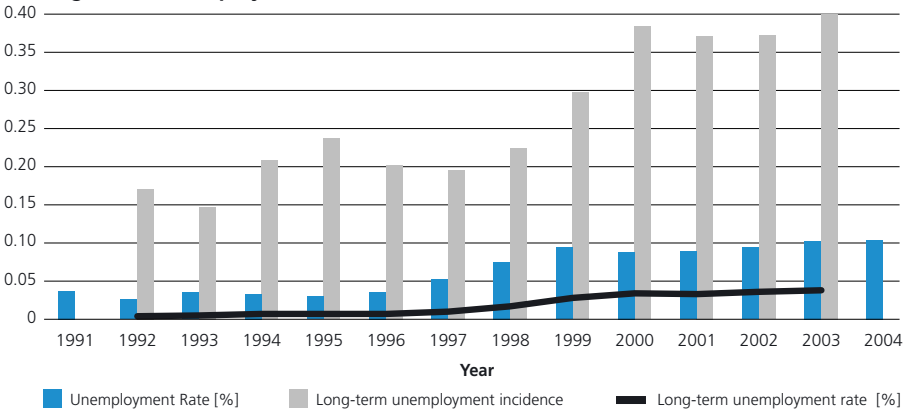
Unemployment Rate and Long-Term Unemployment (LTU) Rate (2002)

	2001		2002	
	Unempl. rate	LTU rate	Unempl. rate	LTU rate
B	6.6	3.8	7.3	3.6
DK	4.3	0.9	4.5	0.9
D	7.7	4.0	8.6	4.0
GR	10.5	5.4	10.0	5.1
E	10.6	5.1	11.3	3.9
F	8.5	3.7	8.7	2.7
IRL	3.9	1.3	4.4	1.3
I	9.4	5.9	9.0	5.3
L	2.0	0.5	2.8	0.8
NL	2.5	0.8	2.7	0.7
A	3.6	0.9	4.3	0.8
P	4.1	1.5	5.1	1.8
FIN	9.1	2.5	9.1	2.3
S	4.9	1.2	4.9	1.0
UK	5.0	1.3	5.1	1.1
EU15	7.4	3.2	7.7	3.0
CR	8.0	4.2	7.3	3.7
HU	5.6	2.5	5.6	2.4
PO	18.5	9.3	19.9	10.9
Accession 10	14.5	7.5	14.8	8.1

Source: *Employment in Europe 2003*, European Commission
Unemployment rate – Unemployed persons as a share of labor force.

Long-term unemployment rate – Unemployed over 12 months as a share of labor force.

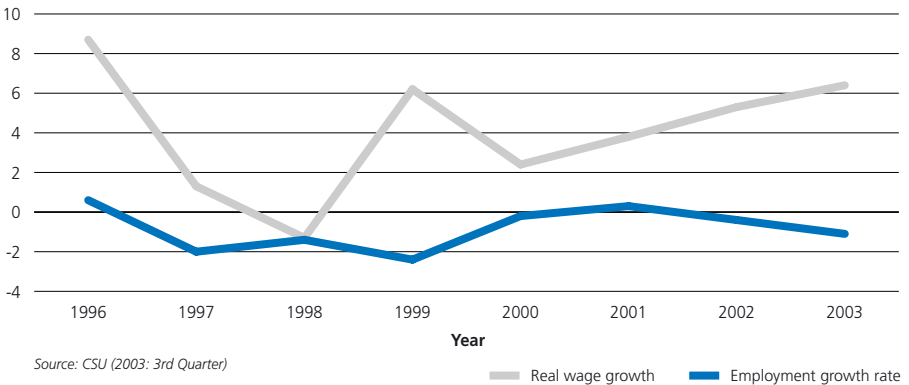
Registered Unemployment Rates



Source: MPSV and own computations. Note: End-year figures. 2004 values is CERGE-EI forecast.

VI.3 Wages

Wage and Employment Annual Growth Rates (%)



Source: CSU (2003: 3rd Quarter)

The real wage growth of 2003 has been hefty at over 6%. While this does not seem to put much pressure on inflation, it may be related to the substantial 3rd quarter drop in employment. (In contrast, during the same period Slovak real wages declined by over 1%, but Slovak employment grew by over 2%.)

The year 2003 also saw yet another increase in the level of the national minimum wage. The level of the minimum wage drastically deteriorated against the average wage level during the mid 1990s so that (generous) social welfare benefits have played the role of an effective wage floor. Since the Social

Democrats took power, there have been regular increases in the level of the minimum wage so that it grew from 3,600 CZK in 1999 to 6,700 CZK as of 2004. This corresponds to a rise from below 30% of average gross monthly salary to almost 40%. While having a minimum wage exceeding the level of wel-

fare benefits helps in avoiding work disincentives and increases tax revenue from service-sector jobs, which often report only the minimum wage, it may also lower labor demand for low-educated workers and lead to an increasing share of informal jobs.

Czech Returns to Schooling: Does the Short Supply of College Education Bite?

(Based on Stepan Jurajda: Does the Short Supply of College Education Bite? CERGE-EI Working Paper No. 213, July 2003.)

The Czech Republic has one of the highest secondary school completion rates in the OECD, but one of the lowest shares of college graduates in the labor force. Public colleges, which provide the bulk of tertiary education, are prevented from charging tuition and are highly over-subscribed. Each year about a half of college applicants is turned down. This is a hotly debated issue. The high excess demand for college education may be due to its low cost or it may correspond to a high labor-market demand for college-educated workers. We therefore quantify the market price of education – the wage returns to education and the college/high school wage gap – using 2002 data on hourly wages of almost one million of salaried employees.

Education is clearly the dominant observable wage determinant. Four simple education degrees alone explain about 30% of the total wage variation, while all other explanatory variables (worker experience and region of employment, firm size, industry and ownership type) increase the share of explained variation from 30 to 43%. Using regression analysis, we

Educational Structure of Employment and Wages by Education, Gender and Age in 2002

Education / Age	15–23	24–30	31–37	38–44	45–51	52–61	15–61
Men: Average Hourly Wage Relative to Secondary Education with GCE (Maturita)							
Primary	0.76	0.69	0.66	0.65	0.59	0.58	0.63
Apprenticeship, no GCE	0.83	0.75	0.71	0.70	0.66	0.65	0.70
Secondary with GCE	1.00	1.00	1.00	1.00	1.00	1.00	1.00
University and higher	1.09	1.51	1.94	1.91	1.81	1.77	1.85
Women: Average Hourly Wage Relative to Secondary Education with GCE (Maturita)							
Primary	0.76	0.66	0.67	0.65	0.63	0.61	0.66
Apprenticeship, no GCE	0.77	0.67	0.69	0.68	0.65	0.64	0.68
Secondary with GCE	1.00	1.00	1.00	1.00	1.00	1.00	1.00
University and higher	1.05	1.57	2.07	1.75	1.83	1.70	1.78

Source: Own calculations based on the MPSV/Trexima ISAE data.

estimate that for each year of education a workers' wage increases by about 10%, which is a relatively high return to education in international comparison. Furthermore, the college/high school wage gap is much higher than those found in the EU economies. In particular, it is about 50% higher than comparable gaps in Austria or Germany, both of which have somewhat similar educational systems and enrollment patterns. There is also some evidence that the gap has increased between 1998 and 2002. These findings are consistent with the interpretation that the continuing dramatic oversubscription of Czech public colleges is due to insufficient supply (lack of funding) and not to low cost (tuition-free). The short supply of college education apparently 'bites' on the Czech labor market.

The economic costs of having relatively few college-educated workers are potentially large and diverse. Today, the country is less likely to attract high-value-added foreign direct investment that requires an abundant college-educated labor force. Tomorrow, the gains from technological innovations will be smaller. Finally, EU accession will open EU universities to Czech students on an equal-access basis. Those who are unable to get enrolled in local tertiary education are likely to do so abroad. To the extent that these future EU-based students will be unlikely to return to the Czech Republic upon graduation, the insufficient supply of college education may result in a brain drain.

VI.4 Welfare

Reducing the expensive and extensive Czech system of social support is essential for achieving stability of public finance (see Section IV.3 where we discuss the recent fiscal reform plans in this area) as well as for lowering unemployment. The latter effect is possible because of the work disincentive effects of the current welfare system.

While Czech unemployment benefits are not particularly generous, unemployment registry is the pre-requisite for collecting a wide array of social benefits. The government guarantees all families the so-called minimum subsistence level of income (minimum living standard), which depends on the number of adults and the number and age of children living in a household. These social assistance benefits are likely to discourage work among low-education high-fertility households.

To illustrate the work disincentive effect of these support schemes, consider the situation as of 2002, when the average gross monthly wage was about 15,000 CZK and the pre-tax minimum wage was 5,700 (4,715 after tax) CZK. At that time, the minimum living standard for a single individual was 4,100 CZK and a family of two adults and two children aged 11–15 was guaranteed an income of approximately 12,000 CZK, which is above the after-tax average monthly salary. Furthermore, in some cases, other forms of social support (child and parental allowances) are available on top of the guaranteed minimum subsistence level. The negative dependence of benefits on earnings amounts to implicit taxation of labor income. The current system therefore levies a 100% implicit tax on earnings up to about a half of the minimum living standard.

Earnings and Social Welfare

Unemployment Benefits Rules	50%(40%) of previous wage during first(second) 3 months of unemployment
Sickness Insurance Rule	50% of wage during first 3 days, 69% for next days up to cca 460 CZK per day including weekends; not taxed; paid from state budget revenues.
Sickness Expenditures (expected 2002, CZK)	31 bil. CZK
Guaranteed Minimum Living Standard	
a) household 1 adult, 1 child (11–15 years of age)	6,870 CZK
b) household 2 adults, 2 children (11–15 years of age)	11,980 CZK
Minimum Wage (monthly, effective January 2003)	6,200 CZK
Average Wage (1st Q.2002, gross)	14,749 CZK in enterprises, 12,047 CZK in public sector.
Average Eldery Pension (June 2002)	7,033 CZK, not subject to taxation.

Source: Sociální politika, No. 11/2002, MPSV

Slovak Reform of Social Assistance

Until recently, the Slovak social assistance system was largely similar to the Czech one. However, starting 2004, Slovak unemployed will face a fully overhauled system of social support, which makes even low-wage employment financially more attractive than collection of benefits.

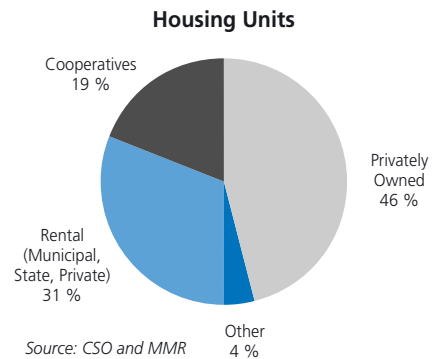
While the level of traditional social assistance benefits is drastically reduced, various new “activation” and/or “protection” bonuses are being introduced. The “activation” bonus is offered to those actively seeking a job, retraining, or in short-term public works. Further, for long-term unemployed who find a job, an “activation” bonus of 1000 SKK is provided for the first 6 months of the job and as much as 25 percent of a worker’s salary can be deducted for the purpose of determining whether a household is below the minimum subsistence level. To remain in the unemployment registry, workers are required to visit the Labor Office at least once every two weeks and the frequency of visits rises to one per week for long-term unemployed. There is also a new benefit of up to 10 thousand SKK available for those moving at least 30 kilometers in order to acquire a job. Finally, starting 2004 Slovak child allowances do not depend on income level and are not means tested. They consist of a universal SKK 500 payment amended with a SKK 400 labor-income tax deduction.

VI.5 Internal Migration and the Housing Market

The territorial labor mobility in the Czech Republic is consistently extremely low in spite of large and growing regional disparity of unemployment rates. Even unemployment-rate differences of more than 15 percentage points between the highest- and lowest-unemployment districts are not enough to motivate labor mobility in a small densely populated country. Statistical data indicate 20 cases of internal migration per 1000 inhabitants, and this low migration rate did not substantially change over the last thirty years. Furthermore, about 40% of all migration occurs within the small 76 districts as opposed to across districts. During 2002, only 6% of those moving reported change of work as their main migration motivation. In fact, the main recent migration flows has been the flight of urban households to suburban municipalities.

One of the main culprits of low mobility is the continuing system of rent control, which benefits primarily those tenants who resided in their apartments at the time of the breakdown of communism and which affects both public and private landlords. The major problem with the scheme of rent deregulation adopted in the 1990s is the idea of uniform percentage increases, since the original rents did not differentiate based on locality. Not surprisingly, the gap between market and rent-control rents is largest in the capital of Prague. (For instance, the monthly rent for a regulated one-bedroom apartment is in the region of 2,000 CZK while market rents for the same apartment in good neighborhoods range around 10,000 CZK.) Rent control leads

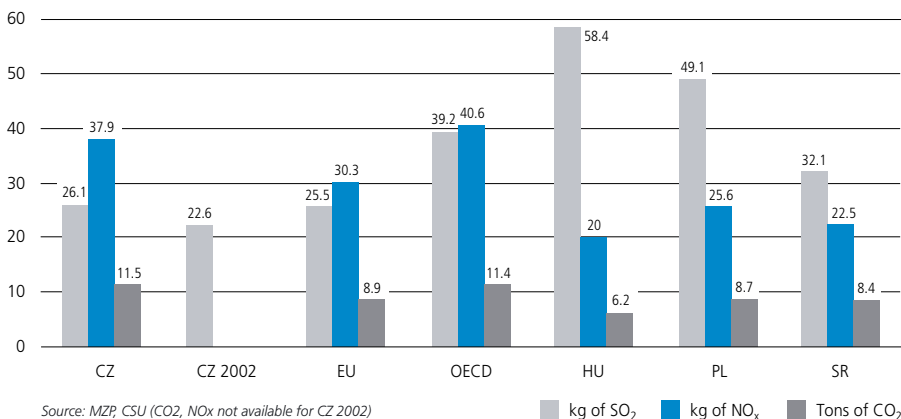
to disrepair of the housing stock and fosters a shadow market, which is estimated in billions of CZK in Prague alone; this money does not enter GDP, nor is it taxed or used for the improvement of the housing. The government has not been able to agree on effective deregulation and used ruthless tactics to avoid constitutional court rulings declaring the existing rent control a violation of proprietors' rights. Controlled rents were frozen for a major part of 2003. At the end of the year, the government coalition was again not able to agree on opening the housing market. Instead, the coalition agreed on yet another small across-the-board rent increase of 10% for 2004. One of the factors behind this decision is the fiscal squeeze the government faces. Any opening up of the housing market would have to be supported by government transfers to households that would not be able to pay the market rent. Instead, the current government forces the landlords to incur the difference between market and controlled rents.



VII. ENVIRONMENT

VII.1 The Environmental Success of Transition

Emissions per Inhabitant in 1999



Significant improvements in environmental protection took place during the first decade of pro-market reforms. Not only are the new legal standards comparable to those of the EU, but huge reductions in emissions and significant improvements in environmental quality can be noticed in everyday life.

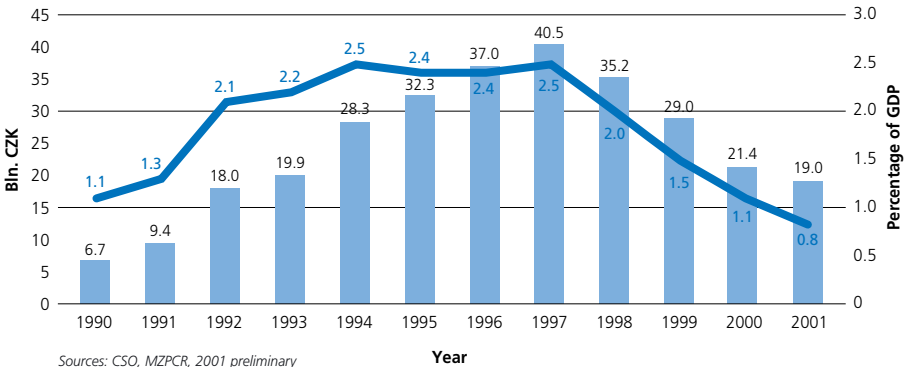
Today's usage of hard fuels is half of what it was in 1989. The unleaded fuel share in gas consumption rose from a mere 1% in 1990 to 81% in 2000. From 2001, the import and sale of leaded gas has been prohibited. In addition, due to new regulations the total share of cars with catalytic converters increased from 1% in 1990 to 32% in 2000; while a significant portion of cars without a catalytic converter were designed to use unleaded fuel.

The Czech Republic is now a signatory of both the Vienna and Montreal treaties on

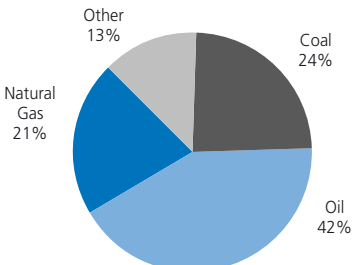
the protection of the ozonosphere. Although there was a sharp decline in the emissions of sulphur dioxide and carbon oxides during the last ten years and the current emissions per inhabitant are similar to OECD and EU averages, the emissions per square kilometer are still double that of the EU average and three times higher than the OECD average. In addition, the relative emissions of carbon dioxide are higher than the EU and OECD averages. We should also note the high portion of coal as a primary energy resource. However, the Czech Republic compares favorably in this regard to other Visegrad countries. Unfortunately, the Czech Republic increased its production of nitride oxides because of the increasing number of passenger cars.

Major air pollutants of sulphur and carbon dioxides (e.g., power plants) had a temporary exemption from the emission limits until Jan-

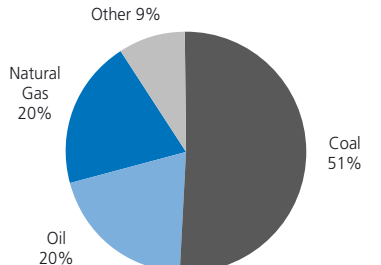
Investment in Environmental Protection



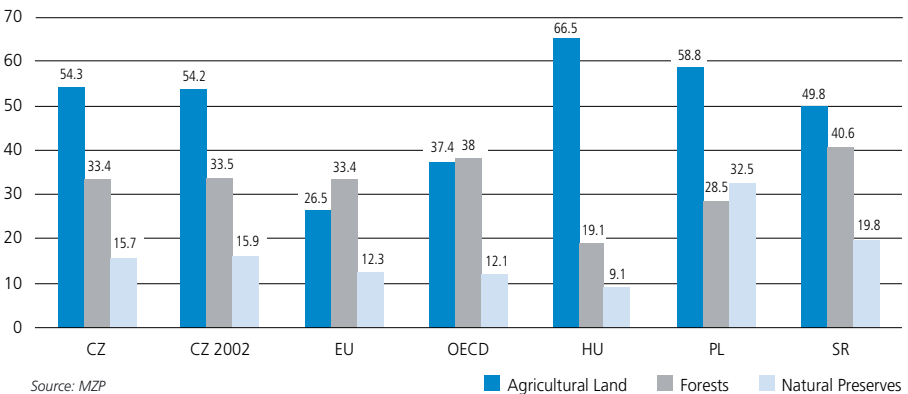
Composition of Primary Energy Resources OECD



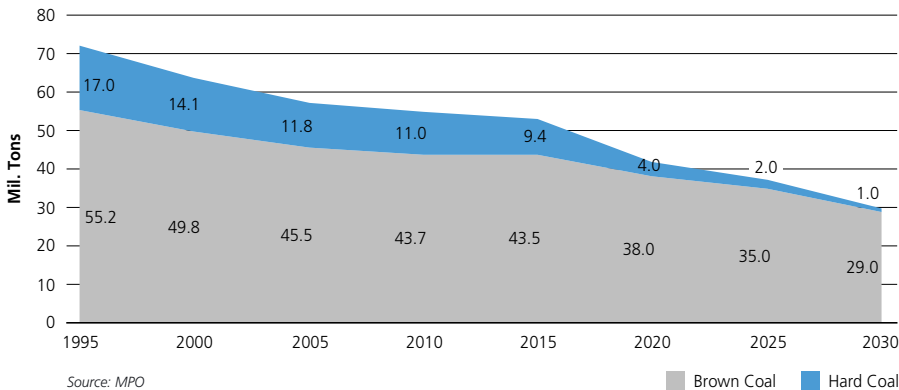
Composition of Primary Energy Resources in the Czech Republic



Land Area in 1999 (% of Total Area of the State)



Coal Mining Prediction

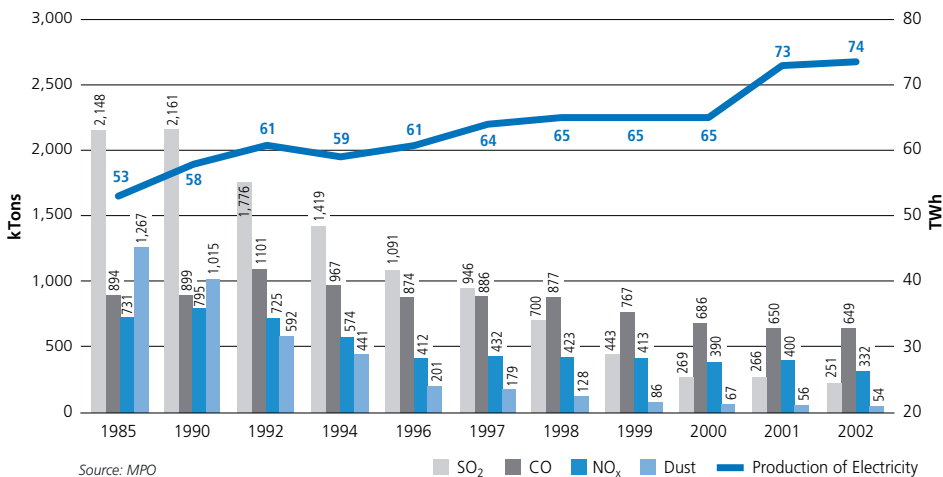


uary 1999. From that time on, all major polluters have been expected to utilize new technologies. Indeed, sulphur dioxide emissions dropped to one eighth of the level of the 1980's and even dust emissions were reduced by nineteen times. Moreover, a further reduction is predicted once the newly finished nuclear plant near Temelín is in full operation. The other nuclear power plant in

Dukovany currently produces about 20% of the country's total electricity supply. The future share of nuclear energy consumption is estimated to be about 38% while coal mining should decline.

Noise from transportation is an area, where future improvements are necessary. A large portion of the population of the Czech Republic continues to be exposed to excessive

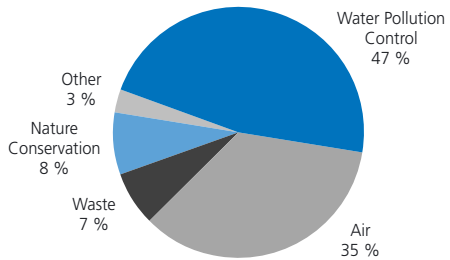
Waste and Electricity Production



noise from transportation. In Prague, almost 40% of the population is exposed to noise levels greater than 65dB during the daytime; in other areas, between 10–30% of the population are exposed to such noise levels. In the Czech Republic, about 4.5% of the population is exposed to a risk detrimental to health due to noise pollution caused outdoors.

Finally, a major legislative achievement of transition and EU accession was the introduction of Environmental Impact Assessment (EIA) of all major constructions and activities affecting the environment. It is a systematic process by which the impacts of planned activity on the environment are identified and assessed using both qualitative and quantitative assessment techniques. The outcome of an EIA usually takes the form of an environmental impact statement (EIS). The EIS pro-

Total Expenses Structure of Environmental Fund in 2002



Source: Environmental Fund

vides the means of conveying to the decision makers the nature, magnitude and significance of the proposed activity's environmental impacts. The EIA process is an important element in the system of preventive environmental protection instruments.

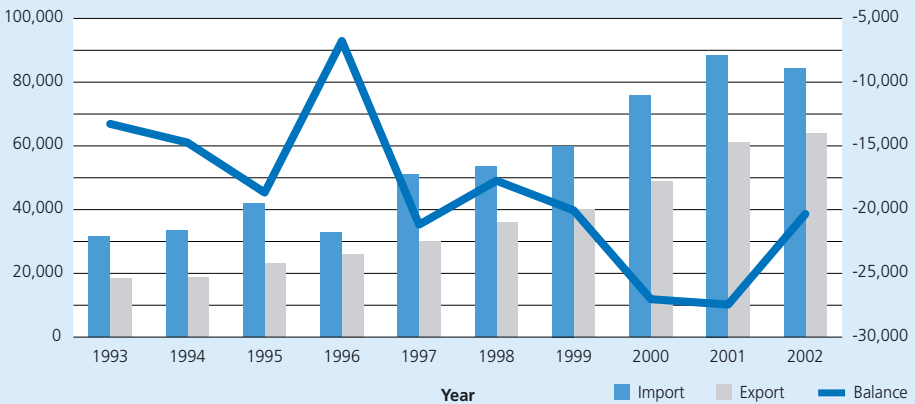
Foreign Trade in Environmental Goods in the Czech Republic

Based on Tošovská, E.: *Analysis of Environmental Goods' Export, Import and Tariff Rates in the Czech Republic in the Period 1993–2002*. CERGE-EI Discussion Paper No. 111, 2003.

The growing significance attributed to environmental protection and sustainable development leads countries to focus on foreign trade in goods, which may improve environmental protection and utilization of natural resources, i.e. "environmental goods" (EG). (For example, components for waste-water treatment facilities fall within the EG category.) The issue of EG found its way onto the agenda of multilateral trade negotiations within the World Trade Organization. In particular, there are now negotiations in progress for possible reductions of tariff and non-tariff barriers to trade in environmental goods. A substantial amount of work to identify the scope of environmental goods had already been undertaken by the OECD and APEC, culminating in two product lists of candidate goods.

Our analysis of environmental goods' export, import and tariff rates in the Czech Republic is based on the OECD environmental goods' categorization and covers the period from 1993 to 2002. We find that the total Czech trade balance in EG trade has been negative throughout the whole period under review: the Czech Republic imports more EG than it exports. The technology-content of Czech EG exports is lower than that of imports, with the exception of the export of high-value-added noise- and vibration-abatement equipment. In 2002, the share of

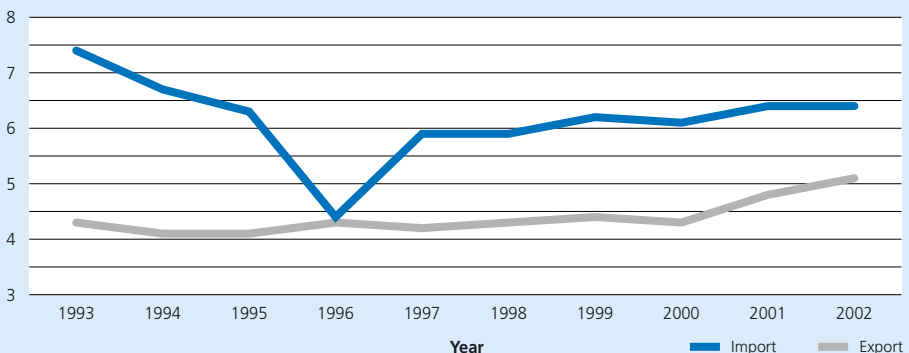
Foreign Trade in Environmental Goods, 1993–2002 (mil. CZK)



environmental goods amounted to 6.4% of total Czech imports and 5.1% of total Czech exports. The largest share in both the EG imports and exports has been in waste-water management goods; air-pollution control goods are the second largest import commodity. The Czech Republic’s trading partners in general trade are also its main partners in EG trade (i.e. Germany from the EU countries and Slovakia and Poland from the transition countries).

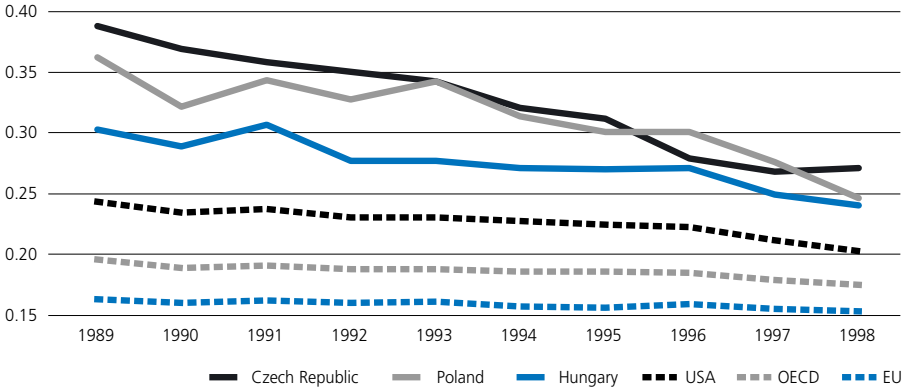
The Czech Republic has a high degree of openness towards imports of environmental goods as illustrated by the following points: (i) all of Czech Republic’s tariff lines for environmental goods are bound at the level of the applied most-favored nation (MFN) rate; (ii) around 12% of the tariff lines for environmental goods are duty-free – which is 4 times the EU rate; (iii) the simple average of bound customs tariffs on environmental goods imported to the Czech Republic is 4.0, (a drop of 28% compared to 1996); and (iv) an overwhelming majority of tariff lines on environmental goods are subject to duties of 5% or less.

Share of environmental goods in export and import (%)



VII.2 Energy Intensity Remains High

Total Final Energy Consumption per GDP

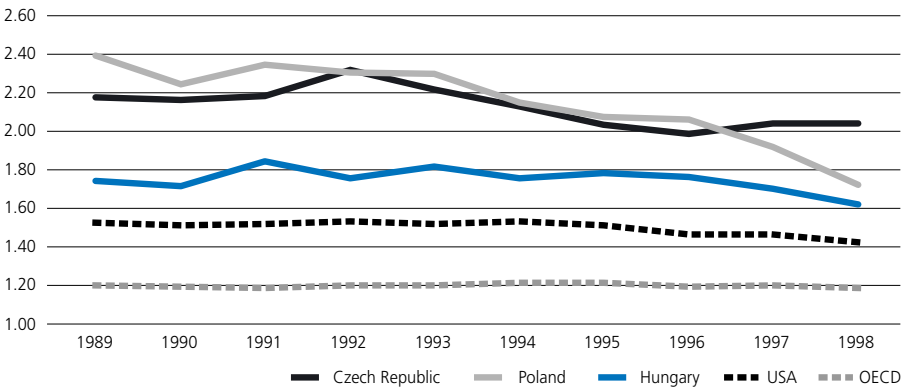


Source: International Energy Agency, *Energy Balances of OECD Countries* (Paris: OECD)

How efficiently economies manage energy resources can be expressed on an aggregate level by the total final energy consumption or supply of primary energy resources per unit of GDP—energy intensity. Energy intensity is measured as the total final consumption in

toe per USD 1,000 of GDP at 1990 prices and using exchange rates expressed in purchasing power parity (1 toe = 41,868 MJ). The Czech Republic managed to decrease its energy consumption rapidly over the 1990s, but as of 1998, the Czech economy still used 1.8

Total Primary Energy Supply per GDP (Relative Lag to the EU Values, EU = 1.00)



Source: International Energy Agency, *Energy Balances of OECD Countries* (Paris: OECD)

times more energy to produce USD 1 of GDP than the EU countries did.

It is more illustrative to compare the countries relatively to each other, selecting the EU as a base. Relative lag is computed as the ratio of total primary energy supply for a given country and the same value for the EU and expresses how many times is the particular country's production more intensive. The development of the time series reflects the combined effects of structural changes in industry, efficiency improvements, imports/exports of primary energy resources, and fuel substitution.

The Czech economy uses two times more primary energy resources to produce USD 1 of GDP than the EU. The values for the Czech Republic are quite close to that of Poland, but considerably higher than for Hungary. The

relative position of Hungary and developed countries remained the same over the 1990s: Hungary operates on 1.7 times, USA 1.5 times, and OECD 1.2 times the EU level. During the 1990s Poland managed to decrease the lag from 2.4 to 1.7 whereas the Czech Republic only from 2.2 to 2.0.

The big difference between total final consumption and total primary energy supply in the Czech Republic is caused by oil imports and considerable electricity exports. The Czech economy is still biased towards more energy intensive industries, particularly to those that consume primary energy resources. Currently, the prices are not fully liberalized. The new modern Energy Act was approved in 2000, however, the privatization of state-owned monopolies failed during 2002.

Temelín Case

In 1980 the Czechoslovak government finalized its decision to build a new nuclear power plant by selecting a site near the town of Temelín. Two years later, in 1982, a contract was signed with the Soviet Union to provide the necessary technology. The final construction permit was issued in late 1986; however, the site preparation had already started in 1983. The total planned output of four 1000 MW units was obviously too large to be finished and justified under the new economic conditions which followed the events of 1989, so in 1990, the Czechoslovak government decided to cut the capacity by one half and to reduce the originally planned four units to only two. Due to economic and political changes after 1989, the dates for completion were adjusted several times.

Later the original Soviet-controlled technology was replaced with more modern Western technology to meet the highest safety standards. In 2000, after 20 years of construction and 100 billion CZK spent, the first unit was finished and ready for testing. By this time, environmental and pressure groups had succeeded in involving a good part of the general public in Austria in protests against the power plant and its proximity to the border. This has subsequently widened the political gap between the two countries. The Czech Republic and Austria agreed in Melk on a way to solve the problem. In 2002, the second unit of the power plant was finished and the tests have started and continued into 2003. In the end, the Temelín nuclear power plant was not used by Austria in the EU accession negotiations.

VIII. THE CZECH REPUBLIC IN THE EUROPEAN UNION

VIII.1 Entering the EU



EU Accession Referenda

Country	Date	Yes	No	Votes Cast
Cyprus	No referendum	n.a.	n.a.	n.a.
Czech Republic	June 13–14, 2003	77.33%	22.67%	55.18%
Estonia*	September 14, 2003	66.92%	33.08%	64.02%
Hungary	April 12, 2003	83.76%	16.24%	45.59%
Latvia	September 20, 2003	67.00%	32.30%	72.53%
Lithuania	May 10–11, 2003	91.04%	8.96%	63.30%
Malta*	March 3, 2003	53.65%	46.35%	90.86%
Poland	June 8, 2003	77.45%	22.55%	58.85%
Slovakia	May 16–17, 2003	93.71%	6.29%	52.15%
Slovenia	March 23, 2003	89.61%	10.39%	60.23%

Source: PriceWaterhouseCoopers

* The referendum is not binding

In May 2004, the Czech Republic, along with nine other countries, will become a member of the European Union. While the entry marks the culmination of a long accession process, it will not lead to any dramatic instant changes in the Czech economy. The effects of the integration process vis-à-vis the EU countries are already evident and will continue to be so for the foreseeable future. On the other hand, the EU accession will instantly liberalize trade and investment relations

with other accession countries, which will likely lead to a faster integration process on this front. Ultimately, EU accession will lead to a dramatic economic change when the Czech Republic joins the EMU and accepts the euro as its currency.

The negotiations with the EU were completed at the end of 2002 and, at the December summit in Copenhagen, the date of accession was set at May 1st 2004 in order to enable the new member states to participate

The Situation of the Candidate Countries I. (Data for 2002)

	CR	Hungary	Poland	Slovakia	Slovenia
Surface (1,000 km ²)	79	93	313	49	20
Population (millions)	10.2	10.2	38.2	5.4	2.0
Number of Votes in EP	24	24	54	14	7
GDP per Capita (in EUR)	14,400	13,600	9,500	11,400	17,700
GDP Growth (%)	2.0	3.3	1.6	4.4	3.2
Unemployment (%)	7.3	5.6	19.9	18.6	6.0
Inflation Rate (%)	1.4	5.2	1.9	3.3	7.5
Share of Agriculture in GDP (%) ¹	3.7	4.3*	3.1	4.5	3.3*
Life Expectancy (Men/Women)	72.1/78.4	68.3/76.6	69.5/78.1	69.9/77.6	72.1/79.6

Source: Czech Statistical Office, Canstat

* 2001 ¹ as % of gross added value



in the 2004 European Parliament elections. On 16th April 2003 the Heads of States and Ministers met in Athens and signed the Accession Treaties, which were subsequently ratified

in national referenda. Key issues that caused controversy and received much public atten-

tion included agricultural subsidies, Beneš decrees (which were used after World War II to expel the large German minority), and the case of the nuclear power plant near Austria (see part VII). In the end, none of these issues proved to be an obstacle to accession.



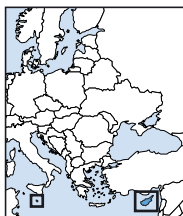
The Situation of the Candidate Countries II. (Data for 2002)

	Estonia	Lithuania	Latvia
Surface (1,000 km ²)	45	65	65
Population (millions)	1.4	3.5	2.4
Number of Votes in EP	6	13	9
GDP per Capita (in EUR)	10,000	9,400	8,500
GDP Growth (%)	6.0	6.7	6.1
Unemployment (%)	9.1	13.1	12.8
Inflation Rate (%)	3.6	0.4	2.0
Share of Agriculture in GDP (%) ¹	5.4	7.1	4.7
Life Expectancy (Men/Women)	65.2/77.0	66.2/77.6	65.4/76.8

Source: Czech Statistical Office, *Canstat*

¹ as % of gross added value

The Czech Republic confirmed its will to join the EU in a referendum held on 13 and 14 June 2003. The results were quite unambiguous with 77% of participants saying "Yes" and 23% saying "No". The turnout rate was also relatively high at 55%, regardless of the fact that no minimum threshold was required for the referendum to be valid. As for political support for accession, it was highest among the parties of the ruling coalition (Social Democrats, Christian Democrats and the Freedom Union). The opposition Civic Democrats also expressed themselves in favor of entry but with many reservations and the former chair of the party and the current president, Václav Klaus, refused to give a clear yes in media coverage before the referendum. Finally, the Communists were against the accession.



Similar referendum results were obtained in other accession countries (except Cyprus, which held no referendum). The highest support rate was achieved in Slovakia (94%)

and Malta featured the lowest level of support (54%).

The attitudes and expectations of the Czech population regarding EU entry are not always as optimistic as the high support achieved in the referendum would suggest.

The Situation of the Candidate Countries III. (Data for 2002)

	Cyprus	Malta
Surface (1,000 km ²)	9.0	0.3
Population (millions)	0.8	0.4
Number of Votes in EP	6	5
GDP per Capita (in EUR)	17,400	11,700*
GDP Growth (%)	2.2	1.2
Unemployment (%)	3.8	7.4
Inflation Rate (%)	2.8	2.2
Share of Agriculture in GDP (%) ¹	4.3	2.8
Life Expectancy (Men/Women)	74.8/79.5	75.8/81.0

Source: Czech Statistical Office, Canstat

* 1999 ¹ as % of gross added value

In general, following from the Pew Global Attitudes Project “What the World Thinks in 2002”, people in the Czech Republic, as well as in most other Central European countries, are more supportive of the EU than they are of their national governments, which explains the high support for entry. However, when asked whether they expected personal benefits from the Czech Republic’s membership of the EU, only 36% answered yes while 40%

answered no. In most of the other accessing countries (all except Estonia, Latvia and Slovenia), the people were more optimistic (Eurobarometer 2002.2, December 2002). In questions regarding the impact on their living standard, people were quite optimistic about the growth of their wages. On the other hand, the negative expectations typically concern the accessions’ impact on prices.

Transitory Periods

*Because of the large differences in economic performance and in prices and wages between the current and future member states, there were fears on both sides of the potentially negative impact of enlargement on certain markets and social groups. To calm these fears, certain transitory periods were required and negotiated. During these periods the full application of *acquis* will be postponed. Below is a list of the most important transitory periods and their brief characterization:*

- *Free movement of workers from the Czech Republic into EU. For the period of two years there will not be automatic access to the labor markets of the current member states. Under certain conditions, this period can be prolonged by another three years and, under yet further conditions, by additional two years. After a maximum of seven years no further restrictions are possible. It is completely up to the individual current member states whether they will insist on this transitory period or open their labor markets earlier. Five countries, Denmark, Ireland, Netherlands, Sweden and United Kingdom, have promised free access to their labor market from the moment of entry.*
- *Seven-year transitory period for the acquisition of agricultural land and forests in the Czech Republic by current EU citizens. However, no restrictions shall apply to EU-born farmers with permanent residence in the Czech Republic.*
- *Five-year transitory period for the acquisition of secondary residential structures. As of today there are already no restrictions for the acquisition of immovable property by companies registered in the Czech Republic and by the subsidiaries of foreign companies.*
- *Agriculture. Gradual build-up of direct payments to the Czech farmers will occur in two stages. In the first stage (2004–2007), the direct payments will start at 25% of the EU level in 2004 and will increase by 5 percentage points every year. In the second stage (2008–2013), the direct payments will increase by 10 percentage points every year until 2013 when they get to the EU level. The Czech Republic will be allowed to make additional payments, also limited by certain ceilings, above the direct payments from the EU from its own resources.*

Payments to Czech Farmers

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Direct payments from EU (in % of EU level)	25	30	35	40	50	60	70	80	90	100
Maximum additional payment to % of EU level	55	60	65	75	85	95	100	n.a.	n.a.	n.a.

Source: Ministry of Foreign Affairs

- *Maximum five-year transitory period in road transport, disabling Czech road transport entrepreneurs from offering their services in the current member states. Negotiations are still being held regarding this transitory period, as the Czech Republic opposes its implementation. The major focus is on agreement with Germany, which represents a crucial market for the Czech truckers.*
- *Taxes. Permanent exemption enabling the Czech Republic not to require persons subject to VAT to register for this tax if their annual turnover is less than EUR 35,000. Transitory period until the end of 2007 for the application of lowered VAT rate on certain products and services (mainly heating and construction works). Transitory period until the end of 2006 for gradual increase of the excise taxes on cigarettes to a minimum level valid in the EU.*
- *Transitory period until the end of 2004 for the liberalization of the gas market. As of this time, the CR should achieve a market openness of at least 28%.*
- *Certain transitory periods in the area of environment. Until the end of 2010, for the clearing of municipal wastewater. Until the end of 2007, for the reduction of pollution by some pollutants from large combustion facilities. Until the end of 2005, for the treatment of packages and packaging waste.*
- *Transitory period of five years for a gradual build-up of contributions to the capital and reserves of the European Investment Bank; the first installment will not occur before mid 2005.*

Farewell to Regular Reports

*Although negotiations with the EU were closed in December 2002, there remained some areas in which further progress with economic reforms and with the adoption, implementation and enforcement of *acquis* needs to be made. The areas in need of improvement are stated in the last European Commission report, issued in October 2003. This report concludes the process of regular annual assessments of the candidate countries.*

In the area of economic issues, the Commission points out the need for deeper reform of the social benefits system, pension system and healthcare. Another economic problem is seen in the Czech Consolidation Agency (ČKA). The process of the sale of ČKA assets to private investors needs to accelerate in order to free the economy of the misallocation of resources. Also the transparency of the process remains a question and needs to be dealt with.

Regarding the adoption, implementation and enforcement of *acquis*, the emphasis is on the requirement that the Czech Republic meets all the commitments arising from the negotiation process. The Czech Republic has almost fully harmonized its legislation with the *acquis*. However, there are still certain areas, which are not yet fully in accordance or in which the alignment needs to be finalized. The most serious concerns are in the following areas:

- Rules regulating the mutual recognition of professional qualifications;
- Several issues in the Agriculture area (e.g. veterinary and phytosanitary regulations);
- Road transport regulation;
- The long postponed closure of duty free shops;
- Inappropriate public procurement legislation allowing for preferential treatment of Czech firms and including clauses enabling the avoidance of public tenders;
- Legislation in the area of foodstuffs.

The Commission examined not only the formal adoption of the rules but also the quality of their enforcement. In the area of implementation and enforcement, the Commission concluded that the Czech Republic was generally able to implement and enforce the *acquis*. The areas in need of improvement are the length of court proceedings and the fight against fraud, corruption and money-laundering.

VIII.2 Institutional arrangements

Number of votes in the European Parliament

	1999–2004	2004–2007	2007–2009
Belgium	25	24	24
Bulgaria	–	–	18
Cyprus	–	6	6
Czech Republic	–	24	24
Denmark	16	14	14
Germany	99	99	99
Greece	25	24	24
Spain	64	54	54
Estonia	–	6	6
France	87	78	78
Hungary	–	24	24
Ireland	15	13	13
Italy	87	78	78
Latvia	–	9	9

	1999–2004	2004–2007	2007–2009
Lithuania	–	13	13
Luxembourg	6	6	6
Malta	–	5	5
Netherlands	31	27	27
Austria	21	18	18
Poland	–	54	54
Portugal	25	24	24
Romania	–	–	36
Slovakia	–	14	14
Slovenia	–	7	7
Finland	16	14	14
Sweden	22	19	19
United Kingdom	87	78	78
(Max) Total	626	732	786

Source: European Parliament

The coming enlargement of the EU has brought about a need for a change in its institutional system. The foundations of the current system were laid down in the 1950s, when there were only 6 member states. Since then, the number of states has increased substantially but, apart from the introduction of direct elections to the European Parliament, no major changes have occurred in the EU's institutional setup. In 2004 the number of members will increase to 25, introducing dramatic dispersion in the level of economic development. Thus, it was generally accepted that institutional reform must be agreed

upon before the enlargement takes place. The process leading to such an agreement was completed at the Nice conference, where the so called Treaty of Nice was signed.

The treaty enhanced the role of the European Parliament and the Commission and distributed power (votes) across member states. However, the distribution of power across states is now again being hotly debated (with Poland and Spain being the countries which gained most from the Nice treaty). Each member country will have its EU commissioner and the selection of the Czech candidate is now in progress.

The European Constitution

The accession process having been completed, the Czech Republic is already focusing on its position within the enlarged EU. This position will depend, to a substantial extent, on the outcome of the current negotiations regarding the European Constitution. This document, prepared by the European Convent, a body established exclusively for this purpose, will bring together the founding treaties of the European Communities. Apart from that, it will bring changes to the decision making process within the EU, reflecting the substantially higher number of members. The negotiations represent an extremely complicated procedure as all the national governments, including the Czech one, are under strong pressure to achieve maximum satisfaction of national interests. However, to ensure that national interests are not overruled within the EU, one would have to stick to consensual decision making and this would prevent the Union from achieving progress on many fundamental issues. In such a case, the EU could lose momentum and become a useless, bureaucratic and costly superstructure of the national governments.

The most controversial issue is the system of voting in the Council of Ministers, the most important legislating body of the EU. The big states, especially Germany, France, Italy and the UK, pursue a mechanism that would account for the differences in the population among member states. Their favored proposal assumes that decisions would be taken by the so-called double majority, consisting of at least 50% of member states representing at least 60% of the EU population. This would, for example, mean that no decision could be passed if Germany and any of the two remaining states named above were against because this triple would always represent more than 40% of the population and could block the decision in question.

Some countries, including the Czech Republic, would be willing to accept a variant of this system but only with the thresholds being adjusted in favor of the smaller states. For example,

some of the suggestions assume that the two thresholds could be set at the same level, either at 60 or at 50 percent for both. Poland and Spain have a different attitude. They require that the system agreed upon in Nice in 2000 is embodied into the Constitution. This system ascribes a specific number of votes to each country and specifies what majority has to be obtained for which decisions. The allocation of votes according to the Nice Treaty is especially favorable for Spain and Poland.

There are two more important points of disagreement in the draft of the European Constitution, although in these cases agreement is more likely to be achieved than in the above problem. The first concerns the number of European Commission members. The draft Constitution assumes that the Commission would have 15 members with voting right and 10 members without voting right. Therefore, in some periods some states would not have a commissioner with a voting right. The smaller countries, including the Czech Republic, disagree with this system and wish to maintain the current principle of one commissioner with full voting rights per country, i.e. 25 commissioners with equal rights.

The last thing on which the member states disagree is the question of some reference to religion in the Constitution. The traditionally catholic states like Poland, Spain, Italy and Ireland, require that the Constitution preamble includes an explicit reference to Christianity. This is opposed, for example, by France, which has a large Muslim population. Also, it could represent a problem after the assumed accession of the Islamic Turkey.

The key negotiations regarding the Constitution were held in Brussels on December 13, 2003. As expected before their commencement, the crucial point turned out to be the allocation of votes in the Council of Ministers and, in particular, the contradictory attitudes of Poland and Spain on the one hand and Germany and France on the other. These starting conditions offered only a low chance of some acceptable compromise. Finally, the skeptical predictions came true and the negotiations broke down only shortly after their beginning as Poland and Spain made clear that they were not going to step back from their requirements on the implementation of the Nice Treaty into the Constitution. This, however, does not mean a final end to the efforts, of which the Constitution is a significant part, to reform the EU decision-making process. New talks are supposed to start at the beginning of 2004.

VIII.3 How Will the EU Benefit from the Enlargement?

The enlargement of the EU brings benefits both to the countries invited to join the EU in 2004 and to the current 15 EU members. While the new entrants will be net financial receivers of EU transfer funds for the first several years, the most important stream of benefits received by both entrants and incum-

bents occurs in terms of improved safety, regional stability and will be manifested throughout the whole EU economy.

1. Economic benefits

The new enlarged EU will become the largest free trade zone in the world in terms

of the number of consumers and will be comparable to the United States in terms of the total volume of GDP. Current EU firms will get direct access to an additional 70 million new consumers without any quota or tariff limitations. Independent studies estimate the neighboring countries will gain an additional 0.5% of GDP growth after the enlargement. Due to the lower labor costs in the new countries EU firms from high labor costs areas could gain from investing in the new member countries and hence be able to compete with low-cost American and Asian firms. In addition, as the new entrants grow richer, they will become a natural additional outlet for sophisticated design and high-value-added products that are hard to find a new market for.

2. Safety

As the new members of the EU club will be part of the developed Europe, they will have incentives to protect common values against both external and internal threats.

The common immigration and safety policies enable both new and old members to fight organized crime, money laundering and terrorism more effectively. The closely watched borders will move eastward from the current members as the current border countries will become surrounded by EU members.

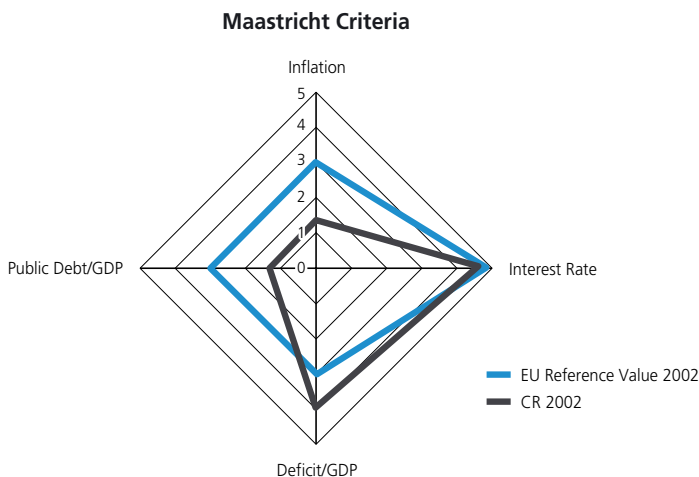
3. Stability

Although the risk of war in the accession countries is quite low, it will become almost nil after the accession and hence further increase regional and global stability. During the period of negotiation the new members had to adopt legal and business standards of the current EU members. This ultimately led to the improvement of their business environment, political culture and decrease of corruption; and such process will continue after the entry of the new members. Therefore, these countries become less risky and more stable. In addition, as a by-product, conducting business in the new countries will become cheaper.

The Common Agricultural Policy (CAP)

The EU can benefit from embracing 10 new members (Poland in particular) because their entry may exert pressure on the (long overdue) reform of the current system of agricultural subsidies. Such reform was politically not feasible within the current EU-15. The CAP consists of enormous subsidies for farmers. Among economists, it is widely considered to be a disaster. According to some estimates, the CAP may cost EU member countries as much as 3% of their total GDP per year when the indirect costs that farm protection imposes on other sectors (manufacturing, trade, and services) are taken into account (see Gylfason (1995) "The Macroeconomics of European Agriculture", Princeton Studies in International Finance, No. 78). Georganta (1997) "The Effect of a Free Market Price Mechanism on Total Factor Productivity," International Journal of Production Economics, suggests that had the CAP not applied to Greece in the years after it joined the EU, the growth rate of total factor productivity in agriculture would have been approximately four times what actually occurred under the CAP. The impact of CAP in the Czech Republic is likely to be similar, locking un-competitive farmers into an unproductive sector while preventing the efficient or environmentally friendly ones from growing.

VIII.4 Convergence?



One of the easiest ways of comparing economic performance of countries seeking membership in the EU is to measure their distance from the four convergence criteria set out in the Maastricht Treaty. Two are related to monetary issues, one is fiscal, and one is currency oriented. **(1) Convergence in inflation** is satisfied when inflation is not higher than 1.5% above the average of the three best-performing countries. **(2) Interest rate convergence** defines the maximum interest rate as 2% above the average of the three lowest interest rates among EU states. **(3) EMR convergence** requires two years with-

out currency revaluation or devaluation. **(4) Convergence in deficit** stipulates a maximum budget deficit at 3% of GDP a year and governmental debt at 60% of GDP.

The Czech level of inflation has recently become acceptable but the distance from the reference numbers is widening in the public deficit criterion. Further, unless fiscal reform takes place soon, the public debt threshold will be broken as well. While the Czech Republic has a functioning market economy with the capacity to cope with the competitive pressure and market forces of the Union, the country has made little progress in catching

Maastricht Criteria

	Inflation	Interest Rate	Deficit of Public Budgets (% of GDP)	Public Debt (% of GDP)
EU Reference Value 2002	2.9	4.8	-3.0	60.0
CR 2000	3.9	7.4	-4.0	16.6
CR 2001	4.5	5.7	-5.5	23.3
CR 2002	1.4	4.6	-3.9	27.1

Source: National Bank of Belgium, The Bank of England, CNB (Česká Národní Banka)

Budget Deficits of EU - Accessing Countries (% of GDP)

EU Methodology (Maastricht)	2002	2003 ^{est.}	2004 ^{est.}	2005 ^{est.}
Bulgaria	-0.6	-0.7	-0.5	0.0
Cyprus	-3.5	-1.9	-0.6	-0.3
Czech Republic	-3.9	-6.0	-5.7	-5.5
Estonia	1.3	0.0	0.0	0.0
Hungary	-9.2	-4.5	-3.0	-2.5
Latvia	-3.0	-2.5	-2.2	-2.0
Lithuania	-2.0	-1.7	-1.6	-1.5
Malta	-6.2	-4.6	-3.9	-3.1
Poland	-4.1	-3.6	-3.3	-2.2
Romania	-2.2	-2.4	-2.4	-2.4
Slovak Republic	-7.2	-4.1	-3.1	-2.6
Slovenia	-2.6	-1.3	-1.0	0.8
Turkey	-10.0	-5.9	-3.0	-0.5

Source: Preparation of the Candidate Countries for Participation in Economic Policy Co-ordination

up with the EU GDP per capita levels, primarily because of policy failures resulting in the 1997 currency crisis and recession. If the Czech Republic fails to overhaul its fiscal expenditures, it is unlikely that it will be able to move closer to the EU's level of econom-

ic performance. Yet, the potential for convergence (in absence of further policy failures) is strong, thanks to a well-skilled labor force and a relatively high level of gross fixed capital formation with strong FDI.

Can Countries with Such Low Growth Rates Ever Catch Up with the EU?

The growth data from transition countries suggest that these countries have not trimmed much from the income gap between themselves and the EU during the last decade. There is however a substantial argument that incomes have been converging at a much faster rate because statisticians tend to (or at least tended to do in the early transition years) overestimate inflation rates. These high rates were caused by neglecting the improvements in quality and variety of goods, which were provided at higher prices. Thus the growth of nominal GDP was ascribed to inflation instead of technological improvements.

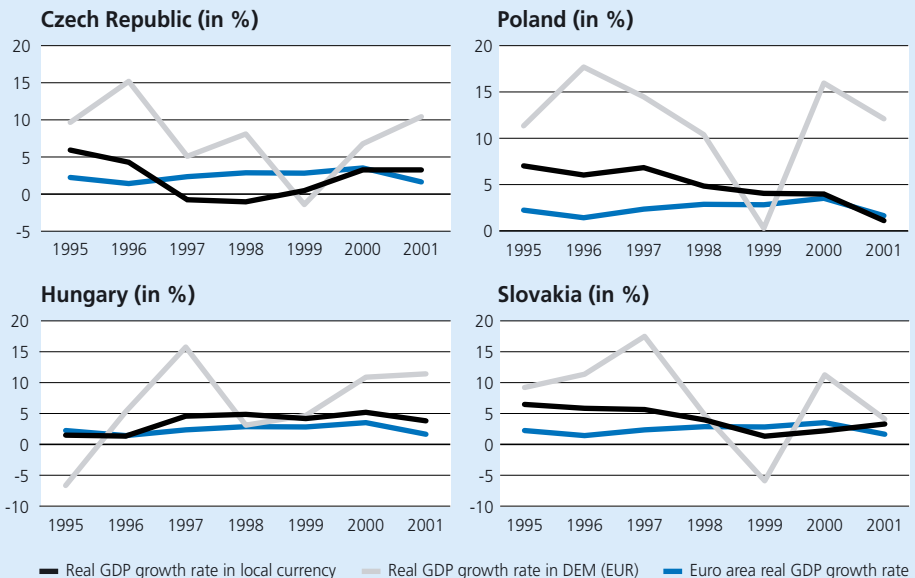
One possible approach to demonstrating this overestimation of inflation is to look at the growth of GDP converted to a foreign currency of a developed economy. This method is based on the theory of purchasing power parity (i.e. the long-run comparability of the consumer basket prices in both countries). Purchasing power parity requires the full flexibility of the domestic currency that devaluates according to "true" inflation. Since the currencies of the

Czech Republic, Hungary, Poland, and Slovakia are internationally traded in large amounts, we can assume that their exchange rates cannot be influenced domestically over a long period of time. We have chosen DEM as the foreign currency since Germany is the biggest trading partner of the transition countries in question. (From 1999 onwards, the DEM exchange rate is computed using the euro exchange rate.)

GDP expressed in Deutsch Marks is then deflated by the German GDP deflator to obtain the real GDP series. The figures compare the growth rate of real GDP expressed in the domestic currency, growth rate of real GDP expressed in DEM, and the growth rate of the Euro zone GDP for comparison.

As expected, the growth rates expressed in DEM are most of the time significantly higher than the growth rates in local currencies for all countries. In the case of the Czech Republic, the Euro area outperformed the Czech GDP growth (measured in local currency) in four out of seven periods displayed. However if we consider the GDP converted to DEM, the Czech growth rates are strictly higher than those of the Euro zone for all the years except 1999, and are as high as 15 percent. We get a similar picture looking at the figures of Hungary, Poland and Slovakia.

When we subtract the DEM-measured GDP growth in a transition country from the GDP growth in the Euro area, we obtain a much better measure of the true speed of convergence. On average, the transition country's growth exceeds the Euro area growth by 4.5% (Slovakia), 4.8% (Czech Republic), 6% (Hungary) and 9.2% (Poland). The transition countries seem to be converging to the Euro zone's income levels at a much faster pace than is usually perceived. This belief of slow convergence speed may be a statistical illusion rather than a real phenomenon.



Source: OECD Statistical Database

VIII.5 EU Accession and Labor Migration

Labor mobility was a contentious issue during the accession negotiations. Germany and Austria in particular insisted on a transitory period before lifting all restrictions on employment of Czech workers inside the current EU.

The average monthly wage in the EU is about four times higher than the average wage in the Czech Republic while living in the EU is only about two-and-a-half times more expensive. This wage gap has triggered fears that labor markets in the West will be flooded by cheap labor from the East, crowding out indigenous workers, reducing wages and social standards. The final agreements allow the current EU-15 countries to restrict the employment of Czechs for up to 7 years.

Yet, the expectations of large inflows of Eastern European workers are probably exaggerated. Europeans in general and Czechs in particular are very immobile (see chapter VI.2). If large within-country differences in wages and unemployment are not sufficient to induce people from North Bohemia to move

a mere 100km to Prague, why should they move even farther abroad where they would lack the language skills? A sneak preview of how much migration can be expected is provided by a German policy of attracting foreign IT professionals by giving away 20,000 work permits. Three years after the program was introduced, only 319 Czechs took advantage of it. Cross-border commuting from the Czech Republic to Austria and Germany, while prevalent in the early 1990's, has actually been declining since then. The reported number of commuters at the German border reached a high of 12,400 in 1992, while today it is around 5,000. For yet more evidence we can look at the accession of Portugal, Spain and Greece in the 1980s, when similar restrictions on labor movement were imposed. Once lifted, no significant labor migration occurred.

Economists' estimates of the inflow of Czech workers into Germany produced an upper bound of 35,000 workers over a four-year period, but the actual number is expected to be much lower.

Do Czechs Want to Work Abroad?

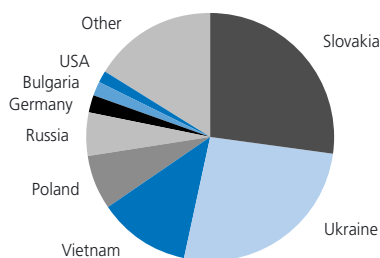
The Germans may fear an inflow of workers from the East, but are the Czechs interested? The Czech Research Institute of Labor and Social Affairs conducted surveys about the intentions to work abroad or the actual migration experience. (Complete results are available at <http://www.vupsv.cz/> in Czech, English and German).

- *In one piece of research concerning pendlers (over-the-border commuters), a sample of 1,197 citizens from border regions were questioned with the help of labor offices, and customs officers. 5.1% of citizens had at some point experienced commuting to Austria, 2.7% to Germany. Only 2.2% went abroad at some point for a longer stay. The prevailing age of pendlers is 40–49 years, and only one fifth of them are women.*
- *A nation-wide survey of more than 4,500 citizens verified that the vast majority of respondents (86%) are not interested in working and living abroad. Among those respondents*

who would consider emigration, only 12% have taken concrete steps to get information about it. Among them are mainly young people who want to study, travel and get short term experience abroad. The most popular countries for possible emigration are Germany, USA and Canada, and Austria. The increasing popularity of the English language among the young should further mitigate the concerns about the Czechs' migration to Germany and Austria in the longer term.

Once the Czech Republic joins the enlarged EU, it will increasingly have to deal with a new challenge: immigration to the Czech Republic by non-EU citizens. Currently, foreign inhabitants in the Czech Republic represent 2.3% of the population, which is low relative to that of the EU (9% in Austria and Germany), but higher than in other CEE countries. The pie chart shows the distribution of foreigners holding residence permits as of end of 2002 by their country of origin.

Legal foreign residents by country of origin



Legal Migration from and to the Czech Republic (Number of Persons)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
From the Czech Republic to Austria (Emigrants), from Austria to the Czech Republic (Immigrants)														
Emigrants	127	226	182	29	26	16	41	57	59	137	92	93	235	377
Immigrants	19	138	255	444	281	314	307	201	178	144	122	102	131	339
From the Czech Republic to Germany (Emigrants), from Germany to the Czech Republic (Immigrants)														
Emigrants	832	1,226	1,393	205	79	108	195	207	237	245	361	379	701	1,087
Immigrants	38	4,30	1,286	1,671	1,391	1,374	1,198	942	859	688	560	537	470	987

Source: Statistical Yearbooks of the Czech Republic

Illegal Migration from and to the Czech Republic

Citizenship	1993	1994	1995	1996	1997	1998	1999	2000
Czech	1,537	1,648	2,040	2,526	2,014	1,715	1,948	
Foreigners	41,765	18,832	17,132	21,179	27,325	42,957	30,377	
From the Czech Republic	41,327	17,030	15,374	18,680	22,011	37,142	26,951	27,585
To the Czech Republic	1,975	3,450	3,798	5,025	7,328	7,350	5,374	6,134
Crossing the Border with								
Austria	1,663	1,320	1,114	1,762	2,251	3,480	4,535	3,660
Germany	40,133	16,047	14,407	16,654	20,860	32,859	19,820	20,021

Source: Ministry of Interior

The 1999 Immigration Act made the entry and residence conditions for most foreigners actually stricter. However, traditionally, Slovak citizens have enjoyed virtually unrestricted

access to the Czech labor market – with the only requirement being registration at an employment office.

VIII.6 Capital Markets in the Accession Countries

The main stock exchanges in CEE (Bratislava, Budapest, Ljubljana, Prague and Warsaw) were established at approximately the same time in the early 1990's. Their startup was different; Bratislava and Prague started with large amounts of equities from the voucher privatization while the other three markets gradually increased the number of listed securities.

Later, the stock exchanges developed in different ways. The Budapest Stock Exchange introduced derivatives and index trades, in Warsaw short positions were made possible, in Prague the dealer's market was set up besides the traditional auctions. All these developments contributed to an increase of liquidity and attraction of foreign investors. However, the exchanges still do not function as standard developed stock exchanges and they lack full transparency. Making the markets system more transparent is the key to attracting new investors and new firms seeking cash.

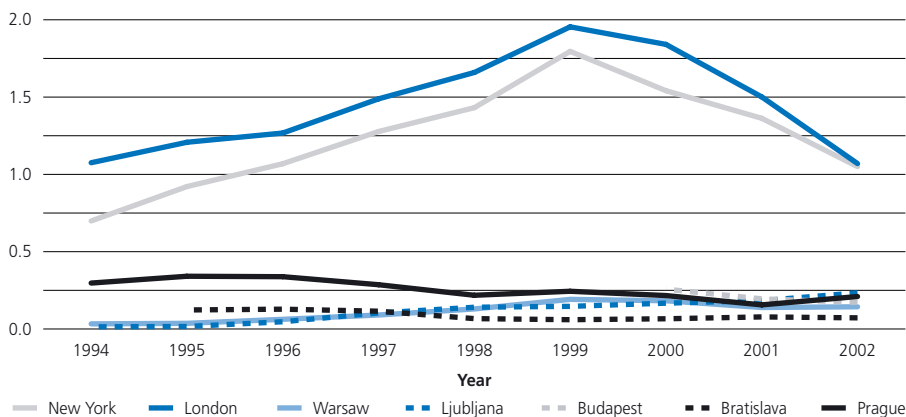
All the problems notwithstanding, investment in these markets sometimes produced enormous returns (sometimes highly volatile, too). The table shows that the last year was particularly good and the gains in indices exceeded 13% in all markets. Measured in dollars, the gains in the indices were enhanced by appreciation of the local currencies, so the return on a dollar investment in the Prague index would surpass 50%.

The exchanges should cooperate more closely in order to increase liquidity. After all, each of them is a very local market with an unavoidably limited base of investors and tradable securities. So far, they have only been publishing a common index (CESI) since 1996. One of the most serious obstacles to closer integration is the large costs of a new trading system that no exchange is willing to undertake. Only Ljubljana Stock Exchange bought a new system in 2003, which made future cooperation even more problematic.

Year-to-year returns on stock market indices in local currencies (%)

	Jan 2000- Jan 2001	Jan 2001- Jan 2002	Jan 2002- Jan 2003	Nov 2002- Nov 2003	compound return Jan 2000-Nov 2003
Czech Republic	-9.47	-15.28	9.46	34.42	12.84
Hungary	-14.69	-0.46	-7.68	14.64	-10.13
Slovakia	19.28	34.38	28.02	19.67	145.56
Poland	-9.25	-8.75	-13.81	31.16	-6.39
Slovenia	-1.38	17.47	50.06	13.94	98.08
Average	-3.10	5.47	13.21	22.77	42.04

Market Capitalization as a Share of GDP



Source: International Federation of Stock Exchanges, website of the respective exchanges, authors' calculations

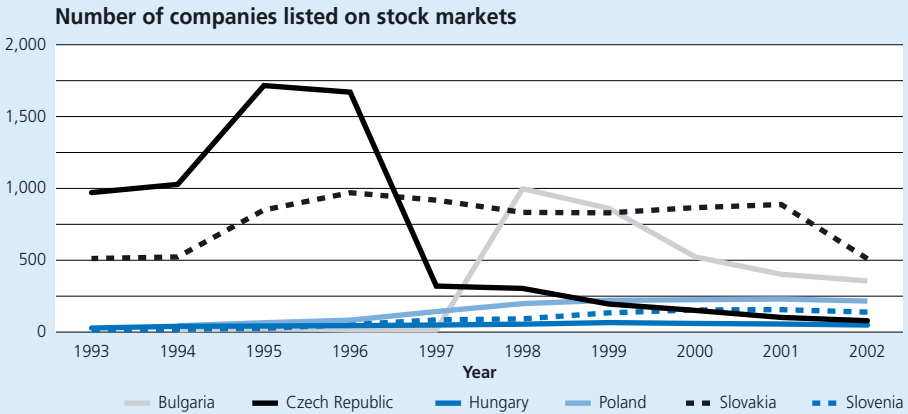
Whatever the stock exchanges intend to do they should do it fast. After EU accession competition from the established European markets, namely Deutsche Bourse and Vienna, will increase and with it the risk that many

investors and most liquid securities will leave. It is also possible that the local stock exchanges will integrate with some of the bigger European ones and thus will cease to function as separate markets.

Does the method of privatization affect capital market development?

The problems faced by CEE's stock markets today can to some extent be attributed to early transition privatization policies. The most questionable in this respect is the voucher privatization method that was with certain modifications implemented in the majority of transition economies. It was popular because of its high speed. Moreover, it seemed well suited for the nonstandard environment where there were few buyers with sufficient funds, a weak banking sector, valuating firms was a tricky business and foreigners were reluctant investors.

Yet, voucher privatization also had some unanticipated costs. In countries that used it, the shares of privatized companies were usually subject to mandatory listing on the stock exchange (see table). This is a strange way to create a capital market because privatization authorities, not firms themselves, were the ones to decide who would be listed. Some firms that would otherwise prefer to be privately owned ended up being public. Some firms that would not meet listing requirements of a typical western stock exchange were listed, too. Such strict administrative arrangements bypassed the traditional market development by gradual selection of the best firms. This method was very common in the stock markets in these countries, but it was non-transparent and most of the securities were illiquid. Massive delisting followed (see graph).



Source: Homepages of national stock exchanges

Note: The numbers above include companies listed at both official and free markets. However, the frequency of trading and conditions necessary to enter these markets differ around countries

While delisting is not bad per se, delisting hundreds of companies within a short period of time certainly sent a negative signal to investors, whose confidence was already fragile because of imperfect legislative framework and weak enforcement.

On the other hand, capital markets that started with a small number of issues and voluntary initial public offerings (namely Poland and Hungary) were not plagued by these problems. Warsaw Stock Exchange in particular has been relatively successful in attracting both issuers and investors. 27 new companies were introduced to the Warsaw Stock Exchange in the last two years.

All in all, it is possible to speculate that mass privatization has negatively influenced the creation and functioning of capital markets in the transition economies. Such long-term consequences of mass privatization were not anticipated at the time when privatization decisions were made.

Origins of stock markets in transition countries

Mandatory listing after voucher privatization	Voluntary initial public offerings	Mandatory listing of minority packages during privatization
Bulgaria	Croatia	Armenia
Czech Republic	Estonia	Azerbaijan
FYR Macedonia	Hungary	Kazakhstan
Lithuania	Latvia	Kyrgyzstan
Moldova	Poland	Poland
Romania	Slovenia	Russia
Slovakia		Ukraine
		Uzbekistan

Source: Claessens S., Djankov s., Klingebiel D. (2000): "Stock Markets in Transition Economies," Financial Sector Discussion Paper No.5, The World Bank.

IX. COMPARATIVE STATISTICS

Comparison of Selected Economic Indicators for CEFTA Countries *

General Characteristics in 2002

	CZ	HU	PL	RO	SL	SK
Surface	78,886	93,030	312,685	238,391	20,273	49,034
Population (end of year)	10,203	10,159	38,232	21,773	1,995	5,379
Urban (end of year)	73.8	64.9	61.7	53.4	50.8	56.0
Women (end of year)	51.3	52.5	51.6	51.2	51.1	51.5
Economically active	50.4	40.6	45.0	46.2	48.7	48.6

Level of Development in 2002

	CZ	HU	PL	RO	SL	SK
GDP Total (Current Prices, Bln. of National Currency)	2,275.6	16,980.1	772.2	1,512,256.6	5,284.5	1,073.6
GDP Total (Bln. USD)	69.514	70.978	189.288	45.749	21.997	23.679
GDP Per Capita, USD ER*	6,813.1	6,986.7	4,951.0	2,101.2	11,025.9	4,402.1

* Notes: ER – Using Yearly Average Exchange Rate

Real Growth Rates in 2002

	CZ	HU	PL	RO	SL	SK
GDP	2.0	3.3	1.4	4.9	3.2	4.4
Gross Capital Formation	0.2	3.2	-7.0	35.0	2.3	3.5
Industrial Production (NACE Classification)	4.8	2.8	1.5	6.0	2.4	6.7
Construction	-6.5	8.8	-0.7	1.7	13.5	3.3

* CZ – Czech Republic, HU – Hungary, PL – Poland, RO – Romania, SL – Slovenia, SK – Slovakia

Unemployment, Wages and Prices in 2002

	CZ	HU	PL	RO	SL	SK
Unemployment Rate, % LFS	7.3	5.8	19.9	8.4	6.4	18.5
Average Gross Monthly Wage, USD ER*	484.4	511.9	522.9	161.0	980.0	298.0
Real Growth Rate of Wages	5.3	13.6	2.4	2.1	2.0	5.8
Consumer Price Indices (COICOP)	1.8	5.3	1.9	22.5	7.5	3.3
Industrial Producer Index	-0.5	-1.8	1.0	24.7	5.1	2.1

*Notes: ER - Using Yearly Average Exchange Rate

Government Deficit, Current Account and Debt in 2002

	CZ	HU	PL	RO	SL	SK
Deficit as % of GDP	-0.5	-3.0*	-5.1	-2.6	-3.0	-4.6*
Foreign Debt Per Capita, USD	2,575.8	2,556.6	2176.3	2,450.3	4,410.5	2,451.8
Current Account (% GDP)	-6.4	-4.0	-3.5	-3.3	1.7	-8.2

* 2001

Exports and Imports in 2002

	CZ	HU	PL	RO	SL	SK
Imports, USD mln.	40,736	37,612	55,113	17,862	10,932	16,629
Growth of Imports	4.2	5.1	107.3	115.1	3.3	n.a.
Exports, USD mln.	38,488	34,337	41,010	13,876	10,357	14,478
Growth of Exports	6.1	5.9	8.3	17.5	5.4	n.a.
Trade Balance, USD mln.	-2,248	-3,275	-14,103	-3,986	-575	-2,151

* in constant prices

Source: CESTAT

X. FORECASTS

Forecasts

	Forecasts for 2004			Actual values in 2003
	CERGE-EI	MF	Patria	
GDP (% Change, Constant Prices)	2.7	2.8	3.1	2.9
Industrial Production (% Change, Constant Prices)	5.8	na	6.1	5.8
CPI (% Change, Nominal)	3.5	3.1	3.3	0.1
PPI (%)	1.0	1.7	2.5	-0.3
Wages (% Change, Nominal)	4.8	6.4	5.9	6.4
Unemployment Rate (% , End of Period)	10.9	8.0	10.4	10.3
State Budget Balance (bln. CZK)	-130.0	-109.8	-121.4	-109.1
Foreign Trade Balance (bln. CZK)	-80.0	-47.0	-79.1	-71.2
Current Account Balance (% GDP)	-6.2	-6.3	-6.7	-6.6
Exchange Rate (CZK/USD, Average)	28.5	25.2	25.8	28.3
PRIBOR 3M (% , Average)	2.2	2.3	2.3	2.3

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CZECH REPUBLIC 2003/2004

Entering the EU

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Authors: Zuzana Bakošová, Radim Boháček, Ivo Burger, Libor Dušek, Martin Fukač, Zuzana Fungáčová, Ekaterina Goldfain, Jan Hanousek, Štěpán Jurajda, Michal Kejak, Alexander Klein, Evžen Kočenda, Ondřej Knot, Lubomír Lízal, Daniel Műnich, Andreas Ortmann, Michal Ostatnický, Vilém Semerák, Petr Sklenář, Lucie Soukeníková, Katarina Svítková, Ondřej Rydval, Eva Tošovská, Bohdan Vaněk, Marie Vavřejnová, Ondřej Vychodil, Petr Zemčik, Alena Zemplinerová

Editorial assistants: Ctirad Slavik, Tomáš Konečný

English editing: Lawrence Smith

Published by: Charles University in Prague – CERGE
The Economics Institute of the Academy of Sciences
of the Czech Republic
Politických vězňů 7, 111 21 Prague 1

Prague 2004

ISBN 80-7343-008-8 (Univerzita Karlova v Praze, CERGE)
ISBN 80-86288-97-0 (Národohospodářský ústav AV ČR, Praha)

List of Abbreviations

AV CR

Akademie věd České republiky
Academy of Sciences of the Czech Republic

CEE

Central and East Europe

CEFTA

Central European Free Trade Agreement

CERGE-EI

Center for Economic Research and Graduate
Education – Economics Institute

CESTAT

CESTAT Bulletin of Czech Statistical Office

CNB

Czech National Bank

CPI

Consumer Price Index

CSO

Czech Statistical Office

ČKA

Česká konsolidační agentura
Czech Consolidation Agency

ČSOB

Československá obchodní banka

EIA

Environmental Impact Assessment

EU

European Union

GDP

Gross Domestic Product

IMF

International Monetary Fund

IPB

Investiční a poštovní banka

KCP

Komise pro cenné papíry
Czech Securities Commission

MF

Ministry of Finance

MPO

Ministerstvo průmyslu a obchodu
Ministry of Industry and Trade

MPSV

Ministerstvo práce a sociálních věcí
Ministry of labor and social affairs

MZP

Ministerstvo životního prostředí
Ministry of Environment

NATO

North Atlantic Treaty Organization

NUTS

Nomenclature des Unités Territoriales
Statistiques

OECD

Organization for Economic Cooperation
and Development

PPP

Purchasing Power Parity

PSE

Prague Stock Exchange

VAT

Value-added tax

WTO

World Trade Organization



CERGE-EI would like to acknowledge
Academy of Sciences of the Czech Republic
for its generous gift to
Czech Republic 2003/2004 publication



THE ACADEMY
OF SCIENCES
OF THE CZECH
REPUBLIC



ISBN 80-7343-008-8
ISBN 80-86288-97-0



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