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# Fiscal Policy in the Czech Republic under Transition

by

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## Table of contents

|   |    |
|---|----|
| I. HISTORY OF ECONOMIC TRANSFORMATION AND<br>MACROECONOMIC DEVELOPMENTS IN THE CZECH REPUBLIC | 5  |
| II. PUBLIC FINANCE DEVELOPMENTS   | 12 |
| 1. General Government Developments from 1990 - 1994   | 13 |
| 2. The General Budget Operations Developments from 1990 - 1994                                | 14 |
| 2.1. Public Budget Operations Developments  | 14 |
| 2.1.1. Changes in the Czechoslovak Public Budget from 1990 - 1992                             | 14 |
| 2.1.2. Changes in the Czech Public Budget from 1993 - 1994                                    | 19 |
| 2.2. Extrabudgetary Operations  | 20 |
| 2.3. State Guarantees   | 23 |
| 3. Structural Analysis of the Revenue Side  | 24 |
| 3.1. Public Budget Revenue Developments in 1990 and 1992                                      | 24 |
| 3.2. Public Budget Revenue Developments in 1993 and 1994                                      | 26 |
| 4. Structural Analysis of the Expenditure Side  | 34 |
| 4.1. Public Budget Expenditure Developments in 1990 to 1994                                   | 34 |
| 4.2. Subsidies for Goods and Services and for Enterprise Developments<br>from 1989 - 1994     | 36 |
| 4.3. Government Service Development   | 38 |
| 5. Public Debt  | 50 |
| 5.1. Net Credit to Government Developments from 1989 - 1994                                   | 50 |
| 5.2. Central Government Debt in the Czech Republic  | 52 |
| III. DESCRIPTION OF OTHER STRUCTURAL,<br>INSTITUTIONAL AND SYSTEMIC CHANGES                   | 57 |
| 1. Privatization  | 57 |
| 1.1. Small-scale Privatization  | 57 |
| 1.2. Large-scale Privatization  | 58 |
| 2. Capital Market   | 59 |
| 3. Banking System   | 60 |
| 3.1. State Assistance and Recapitalization of Banks   | 60 |
| 3.2. Debt Transfers   | 63 |
| 3.3. Debt Exchange  | 64 |
| 3.4. Recapitalization   | 64 |
| 3.5. Other Operations   | 65 |
| 3.6. Privatization of Banks   | 66 |

## *II. Public finance developments*

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|   |    |
|---|----|
| 4. Convertibility                               | 66 |
| 5. Main Vehicles of Microeconomic Restructuring | 66 |
| 6. Reform of Social Care Schemes                | 67 |
| 6.1. Health Insurance                           | 68 |

# I. History of economic transformation and macroeconomic developments in the Czech Republic

The Czechoslovak economic transformation (which then included the Czech Republic) started in 1991. Nevertheless, 1990 was also an important year. A short history of the phases in the transformation process in the period from 1990 to 1994 is as follows.

## 1990

The preparatory work on the Czechoslovak and then Czech reform strategy started in 1990. In this year, the economic strategy of the government consisted of preparing the best possible starting macroeconomic conditions for the implementation of the following liberalization reform steps.

In terms of macroeconomic and microeconomic management, the Central Plan as a management instrument was abolished at the beginning of 1990.

The main vehicle of macroeconomic policy was a restrictive fiscal policy which was aimed at eliminating at least a part of the existing macroeconomic imbalance.

In terms of legal, institutional, and economic steps, the following three measures were the most important:

1. Reform of the banking structure in the sense of replacing the old monobank system with a classical two-tiered banking sector with the central bank as the first tier and commercial banks as the second.
2. Gradual reform of the tax system, primarily consisting of:
  - a) reform of the turn-over tax system:
    - I) elimination of the negative turn-over tax rates;
    - II) simplification of the turn-over tax system by significantly reducing the number of rates.
  - b) reform of the direct taxation system:
    - I) simplification of the direct taxation system, unification of the tax treatment for different types of income and for different categories of taxpayers. (For example, previously a different tax rate was applied to state firms than was applied to private ones.)
3. reduction in the income tax rates by 10% to 75% for banks and 65% for nonbanks.
4. three devaluations of the Czechoslovak crown;
5. which represented almost a 100 % depreciation in the exchange rate for the Czechoslovak crown.

With the exception of these measures, government policies were primarily concentrated on preparing the major liberalization steps, scheduled for implementation on January 1, 1991.

The 1990 macroeconomic results were as follows:

- GDP declined slightly by about 1.2 %;
- inflation reached 9.6 %;
- unemployment was still virtually nonexistent;
- the balance of payments was strongly influenced at the end of the year by massive capital flights out of the country. These were due to expectations of the coming devaluation of the Czechoslovak crown.

### **1991**

On January 1991, the following basic reform package began to be implemented.

#### 1. Price liberalization:

- a) In relation to GDP, after initial price liberalization began, 85 % of goods and services were freed from price regulation. At that time, the prices of some basic foodstuffs, energy for households, public utilities such as city transportation, telecommunication fees, and, last but not least, housing rents were still controlled. During the year, the percentage of liberalized prices increased to 95 % of all goods and services as the prices of basic foodstuffs were liberalized.

#### 2. Limited currency convertibility:

- a) Implementation of the limited convertibility of the national currency - the Czechoslovak crown - began. This applied essentially to current account transactions by legal entities and to the inflow of investment in the capital account of the balance of payments. The regulation of capital flows was maintained on the outflow of both direct and portfolio investments and on the lending abroad by domestic financial institutions (by residents to nonresidents). The inflow of loans from abroad was also regulated (later relaxed in early 1994). At the same time, a 20 % import surcharge was established. In connection with positive developments in the current account, the rate for the import surcharge was reduced twice during 1991 to 18 % in the spring and to 15 % by midyear.
- b) The limited convertibility was supported by a standby facility of 1.8 billion USD provided by the IMF. An additional 375 million ECU were provided by the European Community and 450 million USD later in the year by the World Bank. In addition to this, the central bank issued bonds on the international capital markets for 200 million USD and smaller facilities (totaling together tens of millions in USD) were also provided by foreign governments.

#### 3. Broad deregulation of foreign trade:

- a) Foreign trade activities were largely deregulated with licensing procedures maintained on only some "sensible" commodities (for example, military equipment and some - but not all - medicines).

#### 4. Those liberalization measures were combined with strict macroeconomic policies, consisting of the following points:

- a) Running fiscal surpluses (for example, by the end of May 1991, the surplus of the Czech central budget reached some 21 billion CSK, which was around 2 % of the Czech annual GDP at that time). The fiscal surplus was generated on both the revenue side (the flow of revenue exceeded expectations) and the expenditure side (tight expenditure policies with severe cuts in transfers to the corporate and agriculture sectors and in direct public spending. Social transfers were restricted the least of all transfers, but they too were in real decline).
- b) Restrictive monetary policies, implemented through the following elements:
  - I) quantitative ceilings on the credit supply;
  - II) administrative ceilings on interest rates (discount rate plus a certain margin).
- c) In the first case, these measures were maintained during the whole of 1991 and in the second case till the spring of 1992. After that, the central bank's monetary policies were based purely on "classical" monetary instruments.
- d) In addition, for a limited time period the central bank implemented an advance notice requirement for the purchase of hard currencies for trade purposes (this measure was abolished later during the year in October).
- e) Restrictive income policies targeted on wages and salaries (wage regulation), pensions and all kinds of social benefits, paid out of the state budget (and eventually local budgets). Subsequently, household consumption declined after January 1991 by roughly 25 % (compared with a 16 % decline of GDP), the first decrease was primarily due to a 28 % decline of real incomes.

Massive and quick privatization, which was effectively launched in February 1991 after approval of the necessary legal framework. The first step was with the so-called small privatization, which started in February 1991. An additional important step was the beginning of the voucher privatization in November 1991. (Despite the attention given to it, voucher privatization is by no means the most important component of the Czech privatization scheme. It has been used for no more than approximately 30 % of all assets targeted for privatization).

The adjustment of the tax structure that was initiated in 1990 continued on into 1991 when the four turn-over tax rates were reduced by one to three percentage points each.

Regarding income taxes, the basic corporate income tax rate was reduced to 55 % from 65 % for non-financial corporations and from 75 % for banks.

Part of the reform concept included the establishment of a social safety net, with the so-called passive and active employment policies (passive: unemployment benefits; active: job creation and requalification programs, etc.).

1991 was also the year of additional decisions by the government, targeted at improving the condition of both the corporate and banking sectors. In March 1991, the Consolidation bank was created which took over from commercial banks a significant portion of their existing bad loans. More specifically, this included 80 % of 120 billion CSK of the so-called "credits for permanently revolving stocks". The adoption of the bankruptcy law was an important moment in the reform process.

With the purpose of helping banks and the corporate sector, the National Property Funds (Federal and two republic ones) have issued bonds for 50 billion CSK. The bonds were designated as a first step in the recapitalization of the large banks and secondly to write-off a part of the nonperforming loans from bank portfolios.

The economic results of 1991 were influenced by basically two sets of factors:

1. the reform itself, especially the price liberalization;
2. the collapse of the former CMEA and Soviet Union markets which led to a major reduction of the size of our exports to these areas.

The 1991 economic indicators developed as follows:

After a short period of price adjustment in early 1991, prices stabilized quickly in the second quarter. The total inflation rate for 1991 was approximately 57 % of which most was due to the initial price adjustment.

The output decline of about 14 % during 1991 was to a substantial degree a consequence of the disintegrating former markets in the Comecon countries and especially in that of the former Soviet Union. There was also a negative impact from the decline in domestic demand after the price increases in early 1991. The 1991 unemployment level reached 5 %.

## **1992**

1992 was primarily a year of privatization and restitution. By the end of the year, the number of units transferred by those two methods into private hands reached 120,000. In addition, the bidding procedure of the first wave in the voucher privatization concluded and assets valued at around 200 billion CSK were passed into private hands. The private sector's share of GDP increased from 10 % at the beginning of the year to 20 % by the end. In construction activities, private firms already represented around half of the total output.

The reform steps undertaken in 1992 are as follows:

- the import surcharge was reduced from 15 % to 10 %;
- turn-over tax rates were adjusted (increased) in some cases in order to avoid a bigger price impact from the new tax system (especially the VAT) which was to be enforced in January 1993. This increase was mostly targeted on items grouped under excise taxes in the new system;
- in order to preserve the budget balance and because of the lower than expected tax revenue, it was decided to reduce the volume of budget expenditure in 1992 by some 15 billion CSK (around 3 % of the consolidated central government expenditure);
- in regards to microeconomic management, 1992 was a year when a number of special institutions were created for the promotion of small and medium businesses and exports:

The Czech Moravian Guarantee and Development Bank, the Export Guarantee and Insurance Company, and the Agency for Foreign Investment and Development;

- the Prague Stock Exchange was founded. Nevertheless, it commenced operation only in 1993.

The 1992 economic results were as follows.

- there was an overall GDP decline of 7.1 %. Taken as a whole, this figure is very misleading since the Czech economy reached its lowest output level in the first quarter of 1992 and the recovery phase began after that time.
- inflation was low and the overall price index reached 11 %.
- the unemployment rate declined to approximately 3 %.
- the level of foreign trade was balanced with both the current and the capital accounts of the balance of payments positive. Foreign exchange reserves were kept relatively high and the total foreign debt was moderate.

## **1993**

On January 1, 1993, the split of the former Czech and Slovak Federal Republic occurred.

In the area of the economic reform, the following measures were the most important:

- a new tax system was implemented;
- assets were transferred to coupon investors;
- development in the capital market;
- reform of the local authority finance system.

The tax reform established an entirely new tax system. The former income tax legislation was divided in six different tax acts, while the new system was enforced by a single act, the main feature of which was its relative simplicity and efficiency. The old turn-over tax system was replaced by value-added and excise taxes. In addition, the new tax system included a few new taxes (real estate taxes, inheritance and gift taxes, road taxes).

Together with the tax reform, fundamental changes occurred in the area of the social security, health and unemployment insurance. Contributions for those schemes started to be shared between employers and employees, they are paid separately from tax payments, and they are tax-deductible. There is no sharing for self-employed individuals. For non-active persons such as children, pensioners, soldiers, women on maternity leave and so on, their contributions are paid by the state.

In addition, the health insurance system was separated from the budget and was widely decentralized. There are currently some 17 health insurance companies, each proposing slightly different insurance schemes.

Parallel with the tax reform, the finances of local governments were also reformed. Since this time, a revenue sharing principle has been practiced, according to which the individual income tax on wages has become a source of revenue for the local budgets. In addition, revenue from property taxes are allocated as well to local budgets (the tax legislation remains on the republic level with some discretion on the choice of tax coefficients of the property tax is left to the local authorities). Another source of local budget revenue are user charges, local fees, penalties, and finally, transfers from the central budget and state funds. Those transfers nevertheless only represent a smaller part of local budget resources. In addition, these transfers are provided according to some generally applied rules related to the fiscal and spending capacities of different local entities. The space left for discretionary debates about the level and amount of those transfers between local and central authorities has been restricted to a minimum.

As to the capital market, the Prague Stock Exchange started its activity in April 1993. Later on in May, a parallel market, the RM System (an over-the-counter system) was also launched. In late 1993, the second wave of the voucher privatization began.

As a part of the government's microeconomic restructuring, Ceska inkasni, s r.o. was created. This institution took over a substantial part of Czech enterprises' dubious claims from abroad and was designed to sell them at discount price. The total amount of those claims have reached more than 40 billion CZK.

By the end of 1993, GDP reached about the 1992 level (-0.3 %), after having declined by 2.2 % in the first quarter of 1993 and recovered quite substantially in the remaining part of the year.

The 1993 inflation rate reached 18.2 %. It was strongly influenced by a 8.5 %, once-time-only effect in early 1993 from the implementation of VAT.

As for the economy's external performance, the current account of the balance of payments reached a surplus of 620 million USD and the capital account had a surplus of 2.3 billion USD. Foreign exchange reserves increased steadily (despite only a very moderate amount of borrowing from abroad).

The unemployment rate remained low at around 3 %. This was due to a number of factors, but primarily to the positive employment effects from the expanding private sector, the booming service sector, and the government's active employment policies.

## **1994**

The systemic and institutional changes in 1994 were considerably less important than in the previous years.

The income tax rates were reduced with the marginal tax rate for individual income reduced from 47 % to 44 %. In the case of corporate income taxes, the flat rate was reduced from 45 % to 42 %. Excise taxes were increased slightly with a number of technical details changed in most tax acts. The most important of these changes was the introduction of revenue stamps on tobacco products.

The obligation for firms to surrender all foreign exchange earnings (one of the dominant characteristics of the internal convertibility regime of the Czech crown) was substantially weakened.

An important reform step was the enforcement of the legislation on supplementary pension schemes. This legislation has created the necessary legal background for a diversification of these pension schemes.

The second wave of voucher privatization started and concluded in 1994. Assets with a book value of about 155 billion CZK were offered to be privatized during this wave.

Price liberalization continued (for instance, prices of household heating coal were fully liberalized, gasoline prices were substantially deregulated, and the prices of bus tickets deregulated). The gradual increases of still regulated prices continued (this is especially the case with housing rents, but also with electricity and gas).

An insurance scheme was introduced for individual deposits within banks.

#### Economic results of 1994:

There are two main characteristics of the economic developments in 1994 which differed from the previous years. The first one is the economic recovery, which was visible not only in the growth of aggregate output (GDP), but also in the industrial and construction outputs. The second is the accelerated inflow of foreign capital which has the following causes:

- on a general level, it is connected to the confidence that the country inspires in foreign investors, connected with expanding investment opportunities;
- liberalization of the foreign exchange conditions that occurred in 1994 (the surrender obligation was relaxed, inflows of credits from nonresidents to residents were practically deregulated, and more flexibility applied to the licensing procedures for outward direct investments;
- exchange rate stability (stable in nominal terms since December 1990);
- interest rate differentials between the Czech Republic and the rest of the world.

In brief, the 1994 results were as follows:

- GDP growth reached some 2.3 %;
- inflation was 10.0 %;
- unemployment ended at a rate of 3.2 %;
- the balance of payments<sup>1</sup> had a surplus of 0.5 billion USD in the current account and 1.9 billion USD in the capital account.

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<sup>1</sup> The operations in nonconvertible currencies are excluded.

## **II. Public finance developments**

The general government<sup>1</sup> in the Czech Republic consists of the central government, local authorities, the extrabudgetary funds, National Health Fund (after 1992), and a number of so-called budgetary organizations (agencies performing the government functions and fully financed from the state or municipal budgets) and subsidized organizations (agencies performing the government functions and financed both from their "own" revenue and from the state or municipal budgets).

Up to the initial stage of transformation, expenditure allocation among the three levels of government could be broadly defined in following terms. The federal government was responsible for all pure public goods and for strategic economic services such as energy and communications. The republic governments were responsible for social security outlays and health, all direct subsidies to agricultural cooperatives, and for subsidies to enterprises that were not involved with the production of local public goods. The government units at the local level were responsible for some social security and social services outlays, but were primarily responsible for all subsidies on local public goods such as housing and local transport.

The system incorporated a significant amount of transfers across various levels of government, since only the federal budget was financed entirely from tax revenue. The republic budgets, and more importantly, the budgets of local authorities, received transfers from a higher level of government. Ultimately, the federal budget was responsible for covering the deficits of the republics, local budgets and, under proper consolidation, the overall deficit was reflected only in the federal budget.

Since 1990, there have been substantial changes in both the perceived role of the government in a market economy, and also the respective roles of federal, republics, and local budgets on both the revenue and expenditure sides. In 1991, there were dramatic shifts in the role of the two republics as a result of fiscal decentralization. The role of the federal

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<sup>1</sup> The term "general government" used in this paper includes budgetary operations of the federation (prior 1993), of republics, and local authorities, fiscal operations of National Health Fund, and those of extrabudgetary funds. The term "Public Budget" covers the budgetary operations of the federation (prior 1993), of republics, and local authorities.

Methodological comments to the data reported in this section: data for 1989 - 1992 cover Czechoslovakia, those for 1993 - 1994 only the Czech Republic. Both the Czech and Czechoslovak budgetary methodologies differ from GFS (statistical) standards in some crucial respects: the operations with the so-called state financial assets and liabilities were left aside, expenditures of subsidized organizations were recorded on a net basis during the whole period, and some intragovernmental flows are not consolidated.

In addition, the Czechoslovak methodology was different from the Czech one in some respects which affects the assessment of the gross flows of revenue and expenditure (lending minus repayment are recorded on the gross base, the drawdown of local authority deposits are classified as revenue, the amortization of the government debt (if any) is classified as expenditure rather than financing).

The budgetary operations are presented in the same format as in the State Budget Acts, i.e. both social security (incl. unemployment insurance) and health insurance contributions paid by central and local governments as employers are not consolidated within the general government. The aggregate contributions (to the social security and unemployment system and to the health insurance system) paid by both central and local governments amounted to 3.2 bn. CZK (or 1.4 % GDP) in 1993 and were budgeted (revised budget projections) about 15.7 bn. CZK or 1.5% GDP in 1995. Due to this fact, the reported ratios in 1993 and 1994 (revenue/GDP, expenditure/GDP) are approximately overestimated by 1.5 percentage points.

government dropped from 26.1 % to 21.4 % (measured by its share of public budget revenue), and that of local governments' own revenue from 18.0 % to 5.7 %. The fiscal reform of local government begun in 1993 increased the fiscal autonomy of local government. The share of local governments' "own" revenue was increased from 25 % up to 70 % of their total revenue.

The systemic components of the inherited budgetary system were extrabudgetary funds, the so-called "ministry funds" that provided for the inter-industry transfers of operating surpluses from the more profitable to less profitable state enterprises. The existence of these funds was terminated in 1991. On the other hand, a limited number of new extrabudgetary funds were established to take over the distribution of subsidies to selected sectors of the economy (for example agriculture, environment, culture, and health).

Despite these tendencies and the complex interrelations between the individual components of general government, the long-term developments in public finance have been unambiguous.

## 1. General Government Developments in 1990 - 1994

Table 1: General Government Development in 1989 - 1994

| CSK, CZK in billions |       |       |       |       |       |                   |
|----------------------|-------|-------|-------|-------|-------|-------------------|
| Year                 | 1989  | 1990  | 1991  | 1992  | 1993  | 1994 <sup>1</sup> |
| Revenue              | 464.2 | 464.3 | 522.5 | 590.4 | 491.7 | 516.6             |
| Expenditure          | 465.7 | 461.0 | 514.8 | 558.5 | 479.6 | 536.1             |
| Balance              | -1.5  | 3.3   | 7.7   | 31.9  | 17.8  | -19.5             |
| As % of GDP          |       |       |       |       |       |                   |
| Revenue              | 61.2  | 57.2  | 53.4  | 53.4  | 51.2  | 50.4              |
| Expenditure          | 61.4  | 56.8  | 52.6  | 50.5  | 49.3  | 52.3              |
| Balance              | -0.2  | 0.4   | 0.8   | 2.9   | 1.9   | -1.9              |
| Primary deficit      | -1.3  | 5.0   | 12.9  | 40.1  | 31.5  | -5.8              |
| As % of GDP          | -0.2  | 0.6   | 1.3   | 3.6   | 3.3   | -0.6              |

Notes:

See comment 1), the section II, Public Finance Developments

<sup>1</sup> Projection

Source: Ministry of Finance

The role of the state in the economy of the former CSFR decreased markedly in 1990 - 1992. As a ratio of GDP to general government expenditures, government expenditures fell from 61.4 % in 1989 to 50.5 % of GDP in 1992, while revenue fell from 61.2 % to 53.4 %. A government deficit of 0.2 % occurred in 1989 and has been followed by a small surpluses form 1990 to 1992. 1993 has seen major fiscal (tax and local government financing) reforms. Having these in mind, the government continued its conservative fiscal policy and the expenditure-GDP ratio declined further in 1993.

The 1994 consolidated central and local government budget ended with surplus of approximately 1.3 % of GDP.

## II. Public finance developments

As the CSFR started the transformation with favorable conditions regarding government indebtedness, the primary deficit as a percentage of GDP equaled the total deficit in 1989, and the primary surpluses as a percentage of GDP varied from 0.6 % in 1990 to 3.6 % in 1992.

## 2. The Development of General Budget Operations in 1990-1994

For a better insight into the development of general government budgetary operation, it is necessary to split the general government into its component parts.

### 2.1. Public Budget Operations Developments

Table 2: Public Budget Development in 1989 - 1994

CSK, CZK in billions

| Year        | 1989  | 1990  | 1991  | 1992  | 1993 <sup>1</sup> | 1994 <sup>2</sup> |
|-------------|-------|-------|-------|-------|-------------------|-------------------|
| Revenue     | 413.6 | 460.5 | 500.3 | 549.1 | 413.1             | 431.6             |
| Expenditure | 413.1 | 453.4 | 510.7 | 557.0 | 411.1             | 431.6             |
| Balance     | 0.5   | 7.2   | -10.4 | -7.8  | 2.0               | 0.0               |
| As % of GDP |       |       |       |       |                   |                   |
| Revenue     | 54.5  | 56.8  | 51.2  | 49.7  | 43.0              | 42.1              |
| Expenditure | 54.4  | 55.9  | 52.2  | 50.4  | 42.8              | 42.1              |
| Balance     | 0.1   | 0.9   | -1.1  | -0.7  | 0.2               | 0.0               |

Notes:

See comment 1), the section II, Public Finance Developments: the contributions to the social security and unemployment system paid by central and local governments as employers amounted to 9.9 bn. CZK in 1993 and were budgeted (revised budget projections) about 11.7 bn. CZK in 1994.

<sup>1</sup> The National Health Insurance system was separated from the Public Budget in 1993.

<sup>2</sup> Projections

Source: Ministry of Finance

#### 2.1.1 Changes in the Czechoslovak Public Budget from 1990 - 1992

The original budget for 1990 was actually prepared by the old government. It included a deficit of 5 billion CSK. The way in which revenue and expenditure were planned in this initial budget suggests that the actual deficit would have been even greater. Therefore, at the beginning of 1990 it was agreed to use a provisional arrangement in the budget. During the course of the year, a new budget was composed. It was already of a restrictive nature and resulted in a surplus. The main argument was that fiscal policies should help to consolidate the macroeconomic framework of the economy prior the adoption of the important liberalization measures (initial implementation scheduled for January 1991).

In the course of 1990, some defects in the budget management were removed. The negative turnover tax for food was abolished in July 1990 and replaced by the introduction of a General Income Support to compensate citizens for the increase in basic food prices. The impact of this policy was therefore neutral for people as well as for the budget.

The three devaluations of the Czechoslovak crown that took place in 1990 influenced the level of state financial assets and liabilities.

The budget surplus in 1990 was higher than expected, a consequence of favorable development of main revenues with the exception of the turnover tax yield. The surplus was 7.2 billion CSK, 1.6 % of the overall budget revenue and 0.9 % of GDP.

The 1991 budget - the budget for the first year of the Czechoslovak economic reforms - was again designed to be restrictive and anti-inflationary. The most important budget management measures included unifying the turnover tax rates (reducing the number of rates from over 1,500 to four rates - 0, 12, 22, and 32 %), decreasing the enterprise tax burden by 10 percentage points to 55 % while the rate for financial institutions was cut from 75 % to 55 %, the rate for agriculture and joint ventures remained the same at 50 % and 40 % respectively). The budget reached a substantial surplus in the first half of the year due to a significant increase of taxes paid by enterprises. There was a certain delay in the response of budgetary expenditures, but the later response was then quite strong.

As prices stabilized very rapidly after the initial jump (monthly rates of inflation in the beginning of 1991: January 28 %, February 7 %, March 2 %, April 1.8 %, May -0.2 % and then below 1 %), the budget stance was consequently relaxed so that it was at least neutral if not actually expansive. The 1994 monthly consolidated central budget balance - federal budget plus republic budgets is as follows:

#### 1994 Budget Balance

CZK in billions

| Month          | 1   | 2   | 3   | 4   | 5   | 6    | 7    | 8    | 9   | 10   | 11    | 12    |
|----------------|-----|-----|-----|-----|-----|------|------|------|-----|------|-------|-------|
| Budget balance | 1.4 | 4.5 | 9.4 | 1.0 | 4.6 | -3.2 | -4.7 | -3.1 | 1.5 | -3.4 | -10.7 | -19.4 |

These budget developments were mostly determined by the following two factors:

1. In the first phase (immediately after price liberalization), accounting profits were taxed in an environment of low flexibility on the macroeconomic side where the decline in aggregate demand was not immediately followed by a corresponding decline on the supply side. When combined with the higher than expected price jump, it resulted in the budgeted expenditure amounts declining more than anticipated.
2. In the second phase (starting in the spring), the adjustment of the expenditure side (increased expenditures in order to offset their excessive real decline) was combined with a broad erosion of the tax base, a consequence of the late reaction in the aggregate supply. It is now clear that the mid-year expenditure side adjustment was an overshoot (and the budgetary effect of the tax base erosion was underestimated). The budgetary impact of the decision for additional expenditures was 47 billion CSK. This was nevertheless combined with the impact from reducing turnover tax rates during the year.

In addition, pensions were increased twice in 1991 with an overall negative budgetary impact of over 10 billion CSK.

Those facts finally resulted in a central budget deficit of 17.5 billion CSK, e.g. 3.7 % of budgetary revenue and 1.7 % of GDP which was partly compensated by the local budget surplus of 7.1 billion CSK or 0.6 % of GDP.

When identifying the factors that led to the deterioration of the budget balance at the end of the year, one has to take into account the fiscal federalism arrangements in force at that time. These arrangements clearly led to an inter-republic expenditure competition, while the federal budget was kept in line by the macroeconomic policies of the federal government. In a simplistic way, it is possible to conclude that the federal budget at that time had been allocated the responsibility for the overall, consolidated budget outcome, but not the instruments to enforce a similar fiscal behavior in the whole fiscal system except within the federal budget itself.

It is nevertheless true that the first factor in the positive fiscal development during 1991 consisted of higher than expected inflation, taxation of accounting profits and a low flexibility (slow adjustment) of the aggregate supply to lower aggregate demand, which led to higher than anticipated government revenue.

It is also true that the 1991 budget lesson contributed to acceleration of the work on tax reform as it became clear that if a fiscal crisis was to be avoided, the old income tax based budget revenue system must be replaced by one which would be predominantly based on consumption taxes.

It is equally important to notice the following changes that occurred in the 1991 budget in comparison to the budget from the previous year:

- Despite the additional budget expenditures decided on during the year (as described above), the share of consolidated budget expenditures in GDP decreased by 6 % to 52.8 %.
- This decline was by no means caused only by the reduction of transfers to the corporate sector (a decline by 2.2 % of GDP to 7.8 %), but also of transfers to households (a decline of 1.8 % to 16.3 % of GDP. This shows that even during the initial reform period, social benefits such as pensions declined in real terms.

The second factor influencing the rough fiscal balance of the budget during the early stages of the reform is, that despite the higher than anticipated inflation and bigger than expected decline in output, an expenditure explosion was avoided (with the expenditure discipline more or less being maintained). As an effect of this factor, the real social benefits in the Czech Republic fell down considerably more than in any other transitional economy (even today these benefits are still below the pre-reform levels).

The final budget deficit in 1991 as well as deficits in the future can no longer be financed by direct central bank credits as in previous years. Instead, issues of treasury bills and government bonds were organized to finance deficits and refinanced debt.

The dominant target of fiscal policies in 1992 was to keep control of budget expenditure and to maintain a rough budget balance. As the revenue target was not met, several cuts in different expenditure items were decided upon, representing all together 15 billion CSK (around 4 % of consolidated budget expenditure).

The budget for 1992 was burdened by the necessity of the paying off the 1991 deficit.

In fact, the whole of 1992 was marked by a tendency for budgetary revenues to have a negative deviation from the expected levels. A great number of factors were involved, including overestimated revenues and lower turnover tax yield. Factors in the later included growth in the savings ratio, the shift in the demand of citizens toward goods with lower rates, and increased tax evasion. At last but not least, we should mention that tax arrears appeared as an issue for the first time.

The Czech government adopted a number of measures (including lower expenditure levels than projected) to prevent the budget from reaching an excessive deficit. The policy measures supporting a balanced budget were adopted both on the federal and republic levels (but with different intensity). They included abolition of general income supports (state equalization allowance) for the economically active, reduction of unemployment benefits from 65/50 % of the previous wage to 60/50 %, imposing a maximum ceiling of 3,000 CSK per month on unemployment benefits, reducing the duration of unemployment benefits, tightening eligibility conditions for unemployment benefits, imposing an "import tax" to mimic the turnover tax on imports by enterprises that did not pay the turnover tax and who were able to import under the new internal convertibility rules, increasing the minimum social security payments for private entrepreneurs from 100 to 500 CSK per month, doubling the tax rates on income of working pensioners, and increasing the marginal income tax rate on income above 10,000 CSK a month from 20 % to 33 %.

Due to this fact, the Czech government ended 1992 with a surplus (-1.7 billion CSK deficit on the central level and a 7.8 billion CSK surplus on the local level) while the Slovak government recorded a deficit (-7.9 billion CSK deficit on the central level and 1 billion CSK surplus on the local level). The federation ended up with a deficit of 7 billion CSK.

The fiscal federalism arrangements for 1992 were conceived essentially as they were in 1991 with some exemptions. Under the original agreement, the federal government operated the basic federal functions of the government such as defense and foreign policy. The addition for 1992 was that the federal government also took over the financing of employment policies, including the payment of unemployment benefits. This was essential because of the significant difference between the unemployment rates in the Czech and Slovak republics and because the capacity of the Slovak budget would not have been sufficient eventually to take care of this expenditure.

Unlike in 1991, the main budget proportions were changed on a smaller scale in 1992. While transfers to the corporate sector continued to decline (in nominal terms by 8 %, and in real terms by approximately by 20 %), transfers to households were maintained in real terms at the 1991 levels. Given the decline of output and the consequent decline of revenue for the central budget, especially the revenue coming from direct taxes, this means that the share of transfers to households as a percent of the total budget expenditure increased in 1992 in comparison to 1991.

From the structural point of view, it is important to notice that the 1992 budget included a very strong component targeted at the promotion of economic growth. In nominal terms, investment expenditures were 42 % above the 1991 level (a real increase of about 30 %). On the other hand, spending for public consumption declined in real terms by 2 %.

## II. Public finance developments

Other fiscal decisions taken in 1992 included giving new small businesses the possibility to take a two year tax holiday. However, with the tax reform in 1993, this possibility was abolished and replaced by other provisions in the new tax code such as deducting current losses from profits over the next five years, deducting from the tax base 10 % of investments made for modernization purposes.

The 1992 experience suggests that the third factor of the fiscal balance in the Czech republic consists in the commitment to adjust expenditure to revenue and to make cuts in the budget when needed. It also confirmed that the old tax system was no longer sustainable as the income tax revenue, especially from the corporate income taxes, declined by approximately 15 % in nominal terms in comparison to 1991.

### Methodological note:

The magnitude of fiscal imbalances in the Czech and in the Slovak Republics differed due to the different intensity of the impacts from the transition steps.

While attempting to split the federal budgetary operations between the two republics, we can use at least three different approaches:

1. To allocate the federal budgetary operation to the imputed Czech budget, a ratio of 2:1 was used (Czech/Slovak), Consequently, the 2:1 ratio was agreed upon to allocate the federal debt;
2. Federal taxes and expenditures were split in accordance with the principle of the territorial origin where possible, and the remainder in a 2:1 proportion. The differences between these two sets of figures indicate the scope of the annual implicit fiscal transfers from the Czech Republic to the Slovak Republic. Ranging from 23 to 9 billion CSK, these figures suggest that in actuality, a stronger fiscal restriction occurred in the Czech Republic than in the CSFR as a whole.
3. A third approach on how to calculate the transfer consists in taking into account on one hand the additional level of expenditure decided upon by the Czech authorities during the 1993 fiscal year, and on the other hand, the increase of the Slovak budget deficit in 1993 in comparison to that of 1992. Those two figures represent a rough total of 15 billion CSK.

**Table 3: Public Budget Development in 1989 - 1992**

CSK in billions

| Year        | 1st variant |       |       |       | 2nd variant |       |       |       |
|-------------|-------------|-------|-------|-------|-------------|-------|-------|-------|
|             | 1989        | 1990  | 1991  | 1992  | 1989        | 1990  | 1991  | 1992  |
| Revenue     | 391.6       | 383.7 | 404.1 | 418.6 | 325.7       | 330.5 | 354.4 | 399.4 |
| Expenditure | 390.3       | 378.0 | 408.2 | 417.2 | 300.9       | 316.0 | 332.6 | 377.8 |
| Balance     | 1.3         | 5.7   | -4.1  | 1.5   | 24.8        | 14.5  | 21.8  | 21.6  |

Source: Ministry of Finance and the authors' calculations  
See comment 1), the section II, Public Finance Developments

## 2.1.2 Changes in the Czech Public Budget from 1993 - 1994

The 1993 budget was drafted in a time of considerable uncertainty and under entirely new conditions stemming from the dissolution of the federation and from the introduction of a fundamental tax reform. The Czech budget took over some federal budget functions as well as a proportionate part of the federal debt.

1993 is also the year which represented significant changes in the revenue as well as in the expenditure sides of the budget following the tax reform and reform of social security financing.

Fiscal policies for 1993 did not change in comparison to the previous years in the sense that the balancing of revenue and expenditure was seen once again as one (but not the only one) of the most important policy targets.

Against this background, fiscal policy sought to stabilize financial conditions while at the same time to limit the role of the government in the economy.

Given the size of these uncertainties, expenditure policies were rather cautious at the beginning of the year. As the initial phase of the year turned out to be more successful than originally anticipated, those expenditure policies were consequently relaxed thus contributing more to the country's economic revitalization.

With all of the previously mentioned methodological reservations, it is possible to state that the main structural tendencies in the 1993 budget were similar to those of the previous years such as:

- A real decline of transfers to the corporate sector (those transfers were maintained in nominal terms slightly above the 1992 level, thus declining in real terms by 17 %);
- Nominal increase of transfers to households (by approximately 12 %, a real decline of 8 %);
- Real decline of expenditure for public consumption by some 2 %.

The major change on the expenditure side in 1993 was the creation of the Health Insurance Fund and its separation from the Public Budget. This fund is financed from the health insurance component of the revamped payroll tax as 13.5 % of the gross wage or self-employed base and by transfers from the central budget on behalf of the non-working population.

Unanticipated developments dominated the 1993 fiscal outcome as both revenue and expenditure were higher than projected. The strong performance of revenue was due to increased non-tax revenue (which was by 2.3 % of GDP higher than budgeted), and primarily by the exceptional carryovers of tax obligations from the previous system equivalent to 3 % of GDP. Due to these developments, the government ended up with the surplus of 2 billion CZK or about 0.2 % of GDP.

The main focus of fiscal policies in 1994 was, as in the previous years, to promote the stability of the macroeconomic environment and to promote growth in the economy.

For that purpose, a budget equilibrium was once again seen as a major fiscal policy tool. From the beginning of the year, the revenue side of the budget developed roughly as

anticipated in the budget draft approved by Parliament. On the other hand, a surprising feature throughout the year was the careful behavior of spending agencies (expenditure below budgeted levels) financed out of the central budget. As a result, a large central budget surplus has been produced. It was maintained during all the year and by the end of the year reached 10.5 billion CZK (1 % of the GDP). This fiscal development might have helped contain the negative monetary effects of the increasing inflow of capital into the Czech Republic from abroad. In order to help in the sterilization process, deposits of the National Property Fund (generated from privatization revenues) were transferred from commercial banks to the central bank. The share of central budget expenditure in GDP declined in 1994 in comparison to 1993 by 0.8 %. In structural terms, the following main changes were included in the draft budget for 1994.

On expenditure side, with exception of enterprise subsidies that were projected to remain unchanged in nominal terms, no major category of central budget expenditure was budgeted to fall in relation to GDP. Government wage payments were budgeted to increase by 17.8 % to correct the deterioration of civil service wages relative to the private sector and to continue strengthening provisions for education and the provision of public services (defense, administration, and internal security) in areas where the CSFR economies of scale had been lost or where cutbacks had been experienced in prior years.

The transfers to households were budgeted to grow relative to GDP as a result of the November 1993 indexation of pensions and child allowances, the anticipated increase in sickness benefits, and introduction of aid for low income families necessitated by partial rent liberalization. The total budgeted impact of these changes was to be partly offset by the tighter eligibility requirement for general income support.

### **2.2. Extrabudgetary Operations**

The budgetary operations of central and local governments (Public budget) were supplemented by extrabudgetary funds, which comprise the following:

- The funds of ministries which operated the intra-industry redistribution of state enterprise operating profits were abolished in 1991;
- The Fund for Market Regulation in Agriculture was created in 1991 at the federal level. It is engaged in the buying and selling of selected agricultural products in the market with the goal to stabilize prices and develop trade in these products. After the separation of the two republics, the Fund has continued to operate in the Czech Republic. Fund revenue comes from sale of agricultural products, the positive price differences on imported products, and grants from the state budget. Expenditure is related to purchases at the guaranteed minimum market prices, export subsidies, and costs for the storing, transportation, and sale of purchased products.

**Table 4: Operations of Central Government Extrabudgetary Funds in 1989 -1994**

CSK, CZK in billions

| Year                                      | 1989 | 1990 | 1991 <sup>1</sup> | 1992 <sup>2</sup> | 1993 | 1994 <sup>3</sup> |
|---|------|------|-------------------|-------------------|------|-------------------|
| Revenue                                   | 52.1 | 4.1  | 25.4              | 44.8              | 40.6 | 37.7              |
| from which, transfers from central budget | 1.5  | 0.3  | 3.2               | 3.5               | 3.0  | 0.5               |
| Expenditure                               | 54.1 | 7.9  | 7.3               | 30.5              | 24.8 | 57.2              |
| from which, quasi-fiscal operations:      | -    | -    | -                 | 1.2               | 9.5  | 18.3              |
| Balance                                   | -2.0 | -3.8 | 18.1              | 14.3              | 15.8 | -19.5             |
| As % of GDP                               | 6.9  | 0.5  | 2.6               | 4.1               | 4.2  | 3.7               |
| from which, transfers from central budget | 0.2  | 0.0  | 0.3               | 0.3               | 0.3  | 0.0               |
| Expenditure                               | 7.1  | 1.9  | 0.7               | 2.8               | 2.6  | 5.6               |
| from which, quasi-fiscal operations       | -    | -    | -                 | 0.1               | 1.0  | 1.8               |
| Balance                                   | -0.3 | -0.5 | 1.9               | 1.3               | 1.6  | -1.9              |

Notes:

<sup>1</sup> Does not include the National Property Fund of the Slovak Republic.<sup>2</sup> Includes the National Property Fund of the Czech Republic only, other data are not available.<sup>3</sup> Projections.

Source: Ministry of Finance and the authors' calculations

The extrabudgetary funds in each republic include the following:

- The Environmental Fund, established in 1991, collects sanction payments from companies that exceed their environmental pollution ceilings. Expenditures focus exclusively on financing capital projects and current activities related to environmental protection. This fund took over the functions of the previous Water Fund and Air Protection Fund;
- The State Fund for Soil Fertilization is financed mainly through compulsory charges related to land irrigation. Payments are related to capital and current transfers to enterprises involved in land irrigation projects. This fund has been operating since 1991;
- The State Fund for Culture, formed in 1993, is financed from profits of a special lottery;
- The State Fund for Support and Development of Czech Cinematography commenced its operation in 1993. Its major source of revenue is a surcharge on entry tickets, and the expenditure payments cover subsidies and loans to film producers;
- The National Property Fund was established in 1991 by a special statute as a part of the restructuring/privatization process of state enterprises. It has not been consolidated with governmental fiscal operations. The basic NPF operations are based on the disposal of assets from privatized state enterprises. The statutes of this Fund specify the purpose of using the privatization proceeds. These include amortization and interest on the liabilities of privatized enterprises, transfers to increase the equity capital of privatized banks, and the Fund's own operational expenditures;

## II. Public finance developments

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- The Czech Land Fund was established in 1991 to run operations related to the privatization of agricultural enterprises.

Due to balances in the National Property Fund, the consolidated operations of extrabudgetary funds resulted in a net savings during the 1991 - 1993 period, thus supporting the restrictive fiscal budgetary policy.

### Health Insurance Fund

The Health Insurance Scheme was introduced in 1993 in connection with the general tax reform. Covering the whole population, the scheme is funded by the mandatory contributions of insured persons from their earned income and of employers, including government. In addition, the government provides the contributions on behalf of certain classified social groups in the population without their own source of earned income.

**Table 5: Health Insurance Fund in 1993 - 1994**

|  | 1993       |          | 1994 <sup>2</sup> |          |
|--|------------|----------|-------------------|----------|
|  | CZK in bn. | % of GDP | CZK in bn.        | % of GDP |
| Revenue                                  | 57.0       | 5.9      | 60.7              | 5.9      |
| Contributions <sup>1</sup>               | 54.4       | 5.9      | 60.3              | 5.9      |
| from which, transfers from central govt. | 16.0       | 1.7      | 12.9              | 1.3      |
| Others                                   | 1.6        | 0.0      | 0.4               | 0.0      |
| Expenditure                              | 57.0       | 5.9      | 60.7              | 5.9      |

Source: Ministry of Finance

<sup>1</sup> Includes the health insurance contributions paid by both central and local governments as employers which amounted 3.3 bn. CZK in 1993 and were budgeted (revised budget projections) about 4.0 bn. CZK in 1995.

<sup>2</sup> Projections

### National Property Fund

The National Property Fund of the Czech Republic is a corporate body registered in the Commercial Register. Within the range of the activities related to privatization, the Fund makes agreements on its own behalf and takes other legal actions in respect to the disposal of its property. In particular, it performs the following powers and duties:

- sets up joint-stock and other commercial companies or takes part in their foundation. Makes contributions to them in the form of assets in accordance with the relevant privatization decisions;

- exercises the rights of a shareholder on the basis of its ownership and participation in the business activities of these joint-stock companies;
- concludes contracts for the sale of companies;
- lets its property out on a definite period lease until the property can be utilized for privatization purposes;
- manages the Fund's property (assets), including its shareholdings in the business of the other corporate bodies whose privatization was impossible or which the Fund reassumed ownership after withdrawing from a contract due to the noncompliance with contractual obligations on part of a potential successor to privatized property.

The assets of the Fund are not a part of the state budget of the Czech Republic. It may only be used for the purposes stipulated in the law as follows:

- settlement of liabilities from enterprises earmarked for privatization, in particular liabilities arising credits and loans secured by right of lien (pledge);
- reinforcement of banks and other corporate bodies' financial resources in connection with their actions related to bankruptcy and settlement proceedings;
- compensation of costs related to the removal (e.g. decontamination, pollution clean-up) of environmental damage caused by an existing enterprise operation;
- provide security on credits to the enterprises in which the Fund holds at least a 50 % share;
- balancing the budget of Czech Republic Land Property Fund;
- financing the development of railway transport lines if the Fund's assets acquired through the privatization of the Czech Rail Road Company are involved.

### **2.3. State guarantees**

A less visible potential component of expenditure is the contingent debt service on loans guaranteed by the government. Currently the government provides state guarantees almost entirely for infrastructure project credits extended by international institutions.

The sovereign guarantees are quantitatively limited by statutory limits that are established by legislation. The current limit is that credits repayable in the respective budget year may not exceed 8 % of the central government budgeted revenue.

By the end of 1994, state guarantees totaled 31.4 billion CZK.

The government guarantees are restricted to low risk loans (probability of call assets below 10 %). Given this quality and magnitude, up to the present time the state guarantees have not placed a serious burden on the state budget. The calls in 1993 were approximately 0.8 billion CZK and the 1994 calls were 0.4. billion CZK.

**Table 6: Government Loan Guarantees, 1989 - 1994**

| End of year | CSK, CZK in billions |      |      |      |      |      |
|-------------|----------------------|------|------|------|------|------|
|             | 1989                 | 1990 | 1991 | 1992 | 1993 | 1994 |
| Federation  | 1.9                  | 7.0  | 5.0  | 3.8  |      |      |
| CR          |                      | 0.4  | 2.2  | 21.4 | 32.0 | 31.4 |
| SR          |                      | 0.1  | 14.1 | n.a. |      |      |
| Total       |                      | 7.5  | 21.1 |      | 32.0 | 31.4 |
| As % of GDP | 0.0                  | 0.9  | 2.2  |      | 3.3  | 3.1  |

Source: Ministry of Finance

### 3. Structural Analysis of the Revenue Side

#### 3.1 Public Budget Revenue Developments in 1990 and 1992

Before 1989, general budget revenue was heavily dependent on levies paid by enterprises and on the turnover tax; taxes paid by households represented only a small fraction of the budget revenue. Those proportions were maintained during the whole analyzed period in spite of the fact that after 1990, a process of gradual reduction of the corporate tax burden had been initiated (at the same time, a more uniform tax approach to all types of corporate tax payers was adopted). The weight of indirect taxation slightly increased during this time.

In 1989, the turnover tax yield was influenced by the existence of the negative turnover tax (essentially a hidden retail price subsidy). This amounted to 49.1 billion CSK in 1989. The negative turnover tax on food reached 34.6 billion by July 1990 when it was abolished.

As shown in the above table 7, the overall tax burden of households especially as measured by the individual income tax remained roughly the same during the whole period. The changes adopted in this period were oriented towards unifying the tax treatment of similar economic activities. Additional major changes were postponed until the implementation of the tax reform scheduled for 1993.

At that time, the small and medium entrepreneurs were given a preferential treatment by lower tax rates, tax deferrals, tax reliefs, and by relatively high, flat deductions of costs from their tax base.

The radical change in the 1992 share of the non-tax revenue was due mainly to additional revenue given to local budgets from various sources. This additional revenue for local budgets represented a certain compensation for some of the adverse effects from the privatization and restitution of the former local property (a shift of some revenue from the local to the central budgets). The lost revenue was partly compensated for by the National Property Fund, changes in the level of various local fees during the year, and other changes.

**Table 7: Public Budget Revenue Development in 1989 - 1994**

CSK, CZK in billions

|                       | 1989  | 1990  | 1991  | 1992  | 1993  | 1994 <sup>1</sup> |
|-----------------------|-------|-------|-------|-------|-------|-------------------|
| Total Revenue         | 413.6 | 460.5 | 500.3 | 549.1 | 413.1 | 431.6             |
| Tax Revenue           | 376.8 | 420.5 | 459.1 | 454.8 | 260.6 | 276.3             |
| Direct taxes          | 291.8 | 302.4 | 324.2 | 311.5 | 105.4 | 113.5             |
| from individuals      | 54.7  | 56.7  | 69.8  | 79.4  | 34.5  | 40.6              |
| from corporations     | 237.1 | 245.7 | 254.4 | 232.1 | 70.9  | 72.9              |
| Indirect taxes        | 85.0  | 118.1 | 134.9 | 143.3 | 155.2 | 162.8             |
| Social Security       | 0.0   | 0.0   | 0.0   | 0.0   | 109.0 | 120.1             |
| Non-tax Revenue       | 36.8  | 40.0  | 41.2  | 94.3  | 43.5  | 35.2              |
| As % of GDP           |       |       |       |       |       |                   |
| Revenue               | 54.5  | 56.8  | 51.2  | 49.7  | 43.0  | 42.1              |
| Tax Revenue           | 49.7  | 51.8  | 47.0  | 41.2  | 27.1  | 27.0              |
| Direct taxes          | 38.5  | 37.3  | 33.2  | 28.2  | 11.0  | 11.1              |
| individuals           | 7.2   | 7.0   | 7.1   | 7.2   | 3.6   | 4.0               |
| from corporations     | 31.3  | 30.3  | 26.0  | 21.0  | 7.4   | 7.1               |
| indirect taxes        | 11.2  | 14.6  | 13.8  | 13.0  | 16.2  | 15.9              |
| Social Security       | 0.0   | 0.0   | 0.0   | 0.0   | 11.3  | 11.7              |
| Non-tax Revenue       | 4.9   | 4.9   | 4.2   | 8.5   | 4.5   | 3.4               |
| As % of Total Revenue |       |       |       |       |       |                   |
| Revenue               | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0             |
| Tax Revenue           | 91.1  | 91.3  | 91.8  | 82.8  | 63.1  | 64.0              |
| direct taxes          | 70.6  | 65.7  | 64.8  | 56.7  | 25.5  | 26.3              |
| from individuals      | 13.2  | 12.3  | 14.0  | 14.5  | 8.4   | 9.4               |
| from corporations     | 57.3  | 53.4  | 50.8  | 42.3  | 17.2  | 16.9              |
| indirect taxes        | 20.6  | 25.6  | 26.1  | 37.9  | 37.6  | 37.7              |
| Social Security       | 0.0   | 0.0   | 0.0   | 0.0   | 26.4  | 27.8              |
| Non-tax Revenue       | 8.9   | 8.7   | 8.2   | 10.1  | 10.5  | 8.2               |

Notes:

<sup>1</sup> Projection.

Source: Ministry of Finance

The decline in the 1992 corporate income tax yield reflected both the decrease in economic activities throughout Czechoslovakia as a whole and the discretionary changes in the tax code. This tendency was not reflected as heavily in the 1991 revenue figures. This was because the price jump following liberalization in January 1991 resulted in an increase in company profits and subsequently in tax revenue. A certain role was also played by the specific behavior of the state-owned enterprises prior their privatization. The private sector

was extremely dynamic at that time, but still contributing to GDP only on a lesser extent. Private sector development was basically in small and medium businesses where, as already stated, a preferential tax treatment was applied in that period. Therefore, the private sector dynamism was not reflected in the general budget revenue.

### **3.2. Public Budget Revenue Developments in 1993 and 1994**

Basic changes on the revenue side in the Czech Republic took place in connection with the tax reform adopted in 1993. This tax reform substantially changed the whole revenue of the public sector. It meant a completely new system of indirect taxation, substituting a Value Added Tax on the European model for the turnover tax and making major changes and extensions to the taxation of corporate and personal incomes. The tax reforms also supported the changes in the local budget structure.

The previous tax system in Czechoslovakia exhibited many of the features common to the countries of Central and Eastern Europe. Although there were some moderate changes in the tax system under the socialist regime, the tax system at that time still aimed to provide the central government with convenient mechanisms to transfer enterprise surpluses to the state budget and to sustain the administratively determined price structure. Such a system was unsatisfactory for the economic reform process.

From the very beginning, it was clear that the tax system changes must take place as soon as possible. The tax reform aimed to make the new system as simple as possible, to make it compatible with further development of a market economy, and to dismantle any possible negotiation and bargaining which had been quite frequent under previous system.

To support the transition to the market economy, there were three main aspect of the tax system that required urgent tax reform:

1. the need to establish a system of robust, parametric profit taxes, thereby eliminating the soft budget constraints and establishing an incentive driven economy;
2. to achieve greater uniformity in the tax treatment of different sectors, commodities, and forms of ownership as an important step toward encouraging the development of the price signal mechanism under which resources are guided into their most productive applications;
3. to establish a more unified pattern of individual income taxation. This was required for the corresponding adjustment in the taxation of individual incomes, since distributional objectives could no longer be secured through the structure of administered wages and supported by adequate employment opportunities.

The previous turnover tax was replaced by a system of value-added taxes cum specific excises. The VAT had three rates in 1993 and 1994, 0 %, 5 %, and 23 %. In 1995, the highest rate was lowered to 22 %. The introduction of VAT extended the indirect tax base to services and imports. A corporation income was taxed at a single rate (initially 45 % in 1993 and lowered to 43 % in 1994 and to 41 % in 1995).

An individual income tax was introduced to replace the previous patchwork of taxes on income.

Prior to 1989, the taxation of labor incomes was highly fragmented with different sources of income subject to separate tax schedules. In addition to the basic tax on wages which covered the income of a large proportion of the population, separate taxes were levied on capital and investment income, on incomes from agriculture and on incomes from literary works, to name a few. The tax rates applied to different sources were sharply different, partly reflecting the government's aim of discouraging growth in a non-state sector.

In the new tax system, all wage and self-employed incomes were taxed on a progressive scale (marginal rates varied between 15 % and 47 % in 1993, between 15 % and 44 % in 1994, and between 15 % and 43 % in 1995). Deductions are allowed for social security contributions, basic personal allowance, other allowances recognizing the taxpayers' health and family status, and transportation to work (existed only in 1993). To cope with inflation, the government has attempted to valorize the allowances annually. The allowance type of tax relief granted through the basic allowance has been fairly stable in real terms, while the degree of subsidy for the child allowance has significantly increased since 1993. Interest, dividends, and capital gains were made to subject to 15 % and 25 % tax withheld as source.

Social security and health insurance contributions are calculated as an percentage of the gross wage (36.0 % of the gross salary is the percentage paid by the employer and 13.5 % from the employee in 1993 or 35.25/13.25 % in 1994). In the case of self-employed persons, the rate of 49.5 % (later lowered to 35 %) of net income replaced the old payroll tax with its differential rates.

In addition, completely new taxes on gifts, inheritances, and motor vehicles were implemented.

An important feature of the new tax system was the exclusion of the social security contributions out of the tax system. Unlike the old system, health insurance was formed into a special Health Insurance Fund. As mentioned above, this fund is financed from the health insurance component of the revamped payroll tax (13.5 % of the gross wage or self-employed base) and transfers from the central budget on behalf of the non-working population.

The major consequence of the health fund on intra-governmental fiscal flows was a reduction in local spending on health care. In conjunction with the assignment to local governments of revenue from the new individual income tax on wages and entrepreneurial incomes, this implied a sharp reduction in transfers from the central government to the local level.

As mentioned above, basic structural choices were made on the outlines of the future tax system soon after November 1989. The new tax system was planned to include the following defined groups of taxes:

1. Taxes on goods and services:

a) VAT, including custom duties;

b) selective consumption excises taxes on fuel, alcoholic drinks, and tobacco products.

2. Income taxes:

- a) individual income taxes;
  - b) corporate income taxes.
3. Other taxes:
- a) property taxes;
  - b) road tax;
  - c) taxes on inheritance and gifts;
  - d) taxes on property transactions;
  - e) environmental taxes.

All these taxes then were incorporated into the new tax system with the exception of the environmental taxes which are still under consideration.

The Czech authorities were concerned to create a tax system which could be compatible with that of the European Union. Another concern was to reduce the share of the public sector in the Czech economy, thereby in principle reducing the amount of tax revenue needed in the long term. Within the framework of reducing total revenue, the Czech authorities have pursued a balanced budget objective from the very beginning of the new tax system's existence.

To achieve above mentioned goals the new tax system was and still is quite centralized. The central authority defines the tax base, rates, and exceptions too. That means all taxes are decided on by the central authority including ones which yield revenue for local authorities. Taxes are not only decided upon, but also administered centrally. Tax revenue is described in the following table:

The new tax system, together with other changes in the economy following the progress of the reforms, gradually changed the proportion between tax and non-tax revenue and between direct and indirect taxes.

In the first year of the new tax system, the share of indirect taxes of the total tax revenue increased from about 30 % to 50.8 %. This grew in 1994 to 52.8 % and its increase is expected to continue in 1995.

Consequently, it means a decline in the share of direct taxes from 68.4 % of total tax revenue in 1992 to 41.8 % in 1993 and to 43.8 % in 1994 (it is expected to remain stable in 1995). A decline of total non-tax revenue also occurred, as some revenue previously earned by budgetary organizations was being lost as a consequence of privatization and the local authorities anticipated a slow-down of property sales.

**Table 8: Tax Revenue**

CZK in billions

|                                | 1993  | 1994  |       | 1995  |
|--------------------------------|-------|-------|-------|-------|
|                                | (b)   | (a)   | (b)   | (a)   |
| Taxes on goods and services    | 132.3 | 153.5 | 143.2 | 150.1 |
| VAT                            | 77.1  | 94.5  | 83.6  | 88.5  |
| Custom duties                  | 15.2  | 16.9  | 17.3  | 16.5  |
| Excises                        | 40.0  | 42.1  | 42.3  | 45.1  |
| Income taxes                   | 100.6 | 118.0 | 118.9 | 126.3 |
| Corporate income tax           | 70.9  | 72.9  | 68.9  | 71.1  |
| Individual income tax          | 28.2  | 40.6  | 50.0  | 55.2  |
| Wage tax                       | 32.9  | 37.3  | -     | -     |
| Unincorporated income tax      | -     | -     | 11.4  | 11.7  |
| Other individual income taxes  | 1.5   | 4.5   | 5.7   | 6.2   |
| Other taxes                    | 8.1   | 9.3   | 9.3   | 10.9  |
| Property taxes                 | 3.8   | 6.6   | 5.2   | 5.3   |
| Road tax                       | 4.3   | 2.7   | 4.1   | 4.2   |
| Highway user charges           | -     | -     | -     | 1.4   |
| Taxes from the previous system | 19.6  | 0.0   | -     | -     |
| Total                          | 260.6 | 276.3 | 271.4 | 287.3 |
| As % of GDP                    | 27.1  | 27.0  | 26.5  | 24.0  |

Notes:

(a) budgeted data

(b) revised budget

Source: Ministry of Finance

**Individual income tax**

The individual income tax consists of three parts. The majority of it represents the wage tax. The minor part is the unincorporated tax paid by the self-employed. The rest is the tax on capital income, e.g. on interest, dividends, etc. Capital income taxes are withheld through a deduction-at-source arrangement using the same rates as for corporations (see below).

The tax on earned income consists of a tax free allowance reflecting the taxpayer's personal circumstances, and five tax brackets which are shown in table 9. In 1995, the basic personal allowance given to all taxpayers is 24,000 CZK. If the wife earns less than the single person's allowance, there is a married person's allowance of 12,000 CZK. Each child (up to maximum of four) in the household increases the allowance by 12,000 CZK.

There are some additional allowances and provisions. A disabled person's allowance varies between 12,000 and 30,000 CZK, depending upon the nature of the disability. Pensions are not taxed.

**Table 9: Marginal Individual Income Tax Rates in 1995**

| <b>Annual Taxable Income (CZK)</b> |            |              |
|------------------------------------|------------|--------------|
| <b>Over:</b>                       | <b>To:</b> | <b>Rates</b> |
| 0                                  | 60,000     | 15%          |
| 60,000                             | 120,000    | 20%          |
| 120,000                            | 180,000    | 25%          |
| 180,000                            | 540,000    | 32%          |
| 540,000                            | 1,080,000  | 40%          |
| 1,080,000                          | -          | 43%          |

Source: Ministry of Finance

Regarding the assignment of budget revenue: revenue from individual income tax is a source of revenue for the local governments with the exception of the tax on capital income which is revenue for the central budget.

### **Corporate income taxes**

This tax is levied upon all incomes of companies, where income is defined as the difference between revenue and costs. There is only one rate applied to all companies, irrespective of whether the firm is Czech or foreign owned. The initial rate was 45 % in 1993 and has been gradually lowered to 41 % by 1995.

The corporate income tax law recognizes some deductions. They include tax depreciation, social security contributions paid by employers, tax on immovable property, travel costs up to statutory limits, grants for certain charitable activities within statutory limits, certain expenditure relating to work health and safety protection as well as to environmental protection, and lease payments and financial leases. Losses occurred during an accounting period may be carried over for a period of five years.

The actual tax obligation of a firm under the corporate income tax is calculated on the basis of the previous year's result.

Interest and dividends are taxed at the source and there are two rates: 15 % for individuals in case of interest from deposits and 25 % for companies.

Revenue from these taxes are assigned to the central budget.

## **Taxes on goods and services**

The value-added tax applies to all goods and services including the transfers of immovables and leases, and is paid by all businesses with a turnover exceeding 750,000 CZK in the three successive months. There are two rates:

1. the standard rate was initially 23 % and later lowered to 22 % from 1995. It applies to most goods, a limited amount of services (like catering and repairs), and leases;
2. percent on basic foods, fuel, mineral oils, pharmaceutical products, most books and newspapers, certain medical equipment, and the majority of services;
3. some services are exempted. In addition, when goods and services are exported from the Czech Republic, VAT is refunded.

Excises are applied on hydrocarbon fuels and lubricants, alcohol and spirits, beer, wine, and tobacco products. They are stipulated as a fixed amount per product unit.

## **Custom duties**

The road tax is paid by both companies and individuals engaged in the transport business. It is levied on each vehicle and the rate varies according to the number of axles on a bus or lorry and the engine size of a personal car.

## **Highway user charges**

User charges for highways were introduced from January 1, 1995. The payment differs in accordance with the type of vehicle.

Revenue from all indirect taxes is assigned to the central budget.

## **Property taxes**

Immovable property tax is levied on the owners (individual or corporate) of land, buildings, and structures in the Czech Republic. Unimproved land, agriculture land, commercial buildings and houses are taxed with different rates. The rates on buildings reflect the size of a community they are located in and are based on the buildings' physical parameters.

Revenue from this source is assigned to the local authorities' budget. It is not a very important revenue as the yield is, in comparison to other taxes, low.

## II. Public finance developments

Other property taxes include a tax on transfer of immovable property at the rate of 5 % and inheritance and gift taxes. The last taxes are progressive and take into account individual family relationships. The inheritance tax is not levied on immovable property situated abroad.

### Non-tax revenue

This revenue consists of revenue from budgetary organizations, levies from the Czech National Bank, interest payments on and repayments of governmental loans. The development of non-tax revenue is shown in the table 10.

**Table 10: Non-tax Revenue**

|                         | CZK in billions |      |      |      |
|-------------------------|-----------------|------|------|------|
|                         | 1993            | 1994 |      | 1995 |
|                         | (b)             | (a)  | (b)  | (a)  |
| Budgetary organizations | 11.2            | 12.7 | 13.9 | 15.4 |
| Central bank levies     | 1.0             | 1.2  | 0.0  | 0.3  |
| Interests               | 3.8             | 3.8  | 3.8  | 4.4  |
| Repayments              | 8.2             | 8.9  | 8.9  | 7.9  |
| Others                  | 12.5            | 10.8 | 16.9 | 17.0 |
| Total                   | 36.7            | 37.4 | 43.5 | 45.0 |

Notes:

(a) budgeted data

(b) revised budget

Source: Ministry of Finance

### Revenue from privatization

All receipts from privatization in the Czech Republic are concentrated in a special fund - the National Property Fund. Basically, they do not enter the budget revenue system. The revenue from small-scale privatization is partly frozen for a certain period and revenue from large-scale privatization is being used to smooth the reform process in the Czech Republic. Only a small and decreasing fraction is used for budget expenditure, especially for interest payments of the state debt.

Revenue projections are still subject to a large margin of error. The yields from new taxes are still estimated from incomplete information on the relevant bases and are significantly dependent on the success of new administrative and filing procedures and the collection of appropriate data for the past years.

The Czech economy could not have possibly avoided some transitional costs of implementing the new tax system. These costs arose partly as a result of unfamiliarity on the part of both taxpayers and tax officials with the new tax system. Both formal training

costs, and informal training costs in terms of learning-by-doing occurred. There were also various capital costs involved, for example in purchasing the appropriate computer equipment which was a certain expense at the start of the new system. Revenue costs for the transition were unavoidable as a result of the previous system's incompatibility with the new.

However, the most important revenue losses arose through the initial inexperience and unfamiliarity of those operating and enforcing the tax system. The vastly increased scale of tax administration necessary in a market economy in comparison to a planned economy must be taken into account. One aspect of this is simply the number of taxpayers. A planned economy typically had a highly concentrated industrial structure which has gradually started to become deconcentrated after the economic reforms started, especially in connection with the privatization process.

Due to the privatization process, especially the small-scale privatization which started in 1991, the number of firms has risen substantially. Small firms in particular, involve large fixed costs on the part of the tax administration, while paying relatively little tax.

Under the old system, the vast majority of tax payments were made directly by a relatively few big companies. Their tax liabilities were determined in fact as a byproduct of other operations. The number of taxpayers used to be very limited as the majority of the population paid no direct tax. Therefore, the tax administration was cheap and required few officials for its administration.

After two years of the new tax system's existence, one must admit that in spite of a lack of standardized information, the estimates of total revenue up to now have differed too much in comparison with reality, although there were some errors within particular tax yields.

## **4. Structural Analysis of the Expenditure Side**

### **4.1. Public Budget Expenditure Developments in 1990 to 1994**

Within public budget expenditure, especially since 1991, there has been a relatively substantial decline in the expenditure-GDP ratio from 54.4 % of GDP in 1991 to 42.1 % in 1994. The contraction of current expenditure was even sharper, mainly due to the contraction of government spending on goods and services and transfers to enterprises. The capital expenditure as ratio to GDP has remained stable at about 4 % of GDP over the whole period with a declining weight of capital transfers to enterprises. This especially corresponds with the lowering of the corporate income tax rate (which significantly lowered the cost of capital for enterprises).

The interest payments impact on the budget expenditure was negligible in the period from 1989-1991. The increasing cost of debt service due to foreign debt restructuring are described below in Table 11.

While the main changes on the revenue side have taken place in the context of tax reform, recognition of social security contributions, and the health care insurance system in 1993, the main reform of the expenditure side still lies ahead.

For the most part, government expenditures, especially transfers, still retain some organizational features from a planned economy. These features include minimal targeting of the redistributive transfers by means, virtually no link between contributions and benefits for transfers of a social insurance nature, and almost no use of prices to allocate in-kind transfers such as health care and education. However, policies have attempted to target subsidies more efficiently.

Some progress was made in the area of social benefits in 1995 (see below). In other parts of public sector expenditure, much remains to be done. For example, the introduction of the Planning, Programming and Budgeting System into public spending has been only discussed.

There were some other changes in the subsidy system as a whole. On one hand, the government's role as the supplier of housing and health care has been reduced substantially. On the other, transfers to households to mitigate the impacts of increased unemployment, poverty, and price liberalization have been instituted as new items in the expenditure side of the budget. The health care expenditure has not been reduced, in fact it is growing as a share of GDP. Only the system of payments and spending was changed. It is now organized separately from the budget through Health Funds (see below).

### **4.2. Subsidies for goods and services and to enterprises: Developments from 1989 - 1994**

The expenditure development is to some extent biased by price subsidies (on agricultural and foodstuff products especially), which were replaced by transfers from special extrabudgetary funds given to support cheap loans to farmers and exporters. These flows are included in the next table which covers both the public budget and extrabudgetary funds.

The sharp contraction of subsidies from the general government to enterprises, which fell from 16 % of GDP in 1989 to 4.0 % of GDP in 1994, is the most prominent feature of expenditure development in 1989 - 1994.

The bulk of the reduction took place in 1991 as price liberalization removed many of the subsidies implicit in the administrative price structure. After price liberalization, the subsidies to goods and services were abolished with a limited number of exceptions such as for household heating and public transport. This is why the current subsidies to enterprises and financial institutions have stayed roughly constant in nominal terms and have fallen gradually as a ratio to GDP. The sectors targeted for subsidies have undergone little change, with the major share devoted to traditional sectors such as agriculture and mining. However, policies have attempted to target subsidies more efficiently.

**Table 11: Public Budget Expenditure Development**

CZK in billions

|                           | 1989  | 1990  | 1991  | 1992  | 1993              | 1994 <sup>1</sup> |
|---------------------------|-------|-------|-------|-------|-------------------|-------------------|
| Total Expenditure         | 413.1 | 453.3 | 510.7 | 589.8 | 411.1             | 431.6             |
| Current:                  | 368.6 | 406.2 | 454.3 | 479.6 | 357.1             | 374.1             |
| on goods & services       | 198.4 | 217.2 | 239.3 | 262.8 | 155.7             | 166.8             |
| interest                  | 0.2   | 1.7   | 5.2   | 8.2   | 13.7              | 0.0               |
| transfers:                | 170.0 | 187.3 | 209.8 | 208.6 | 187.7             | 207.3             |
| o.w to households         | 97.0  | 113.8 | 156.2 | 165.5 | 105.5             | 143.0             |
| Capital:                  | 44.5  | 47.1  | 56.4  | 110.2 | 57.9              | 58.9              |
| Govt. investment          | 33.8  | 36.5  | 45.4  | 46.5  | 38.6              | 41.1              |
| transfers                 | 10.7  | 10.6  | 11.0  | 63.7  | 19.3              | 17.8              |
| Net lending               | 0.0   | 0.0   | 0.0   | 0.0   | -3.9 <sup>2</sup> | -1.4              |
| As % of GDP               |       |       |       |       |                   |                   |
| Total Expenditure         | 54.4  | 55.9  | 52.2  | 53.4  | 42.8              | 42.1              |
| Current:                  | 48.6  | 50.1  | 46.5  | 43.4  | 37.2              | 36.5              |
| on goods & services       | 26.1  | 26.8  | 24.5  | 23.8  | 16.2              | 16.3              |
| interest                  | 0.0   | 0.2   | 0.5   | 0.7   | 1.4               | 0.0               |
| transfers                 | 22.4  | 23.1  | 21.5  | 18.9  | 19.5              | 20.2              |
| o.w to households         | 12.8  | 14.0  | 16.0  | 15.0  | 11.0              | 14.0              |
| Capital                   | 5.9   | 5.8   | 5.8   | 10.0  | 6.0               | 5.7               |
| Govt. investment          | 4.5   | 4.0   | 4.6   | 4.2   | 4.0               | 4.0               |
| transfers                 | 1.4   | 1.3   | 1.1   | 5.8   | 2.0               | 1.7               |
| Net lending               | 0.0   | 0.0   | 0.0   | 0.0   | -0.1 <sup>2</sup> | -0.1              |
| As % of Total Expenditure |       |       |       |       |                   |                   |
| Total Expenditure         | 100.0 | 100.0 | 100.0 | 100.0 | 100.0             | 100.0             |
| Current:                  | 89.2  | 89.6  | 89.0  | 81.3  | 86.9              | 86.7              |
| on goods & services       | 48.0  | 47.9  | 46.9  | 44.6  | 37.9              | 38.6              |
| interest                  | 0.0   | 0.4   | 1.0   | 1.4   | 3.3               | 0.0               |
| transfers                 | 41.2  | 41.3  | 41.1  | 35.4  | 45.7              | 48.0              |
| o.w to households         | 23.5  | 25.1  | 30.6  | 28.1  | 25.7              | 33.1              |
| Capital                   | 10.8  | 10.4  | 11.0  | 18.7  | 14.1              | 13.6              |
| Govt. investment          | 8.2   | 8.1   | 8.9   | 7.9   | 9.4               | 9.5               |
| transfers                 | 2.6   | 2.3   | 2.2   | 10.8  | 4.7               | 4.1               |
| Net lending               | 0.0   | 0.0   | 0.0   | 0.0   | -0.9 <sup>2</sup> | -0.3              |

Notes:

<sup>1</sup> Projections

<sup>2</sup> From 1993, the methodology was changed from gross to net base

Source: Ministry of Finance

## II. Public finance developments

**Table 12: General Government Functional Classification of Subsidies, 1989 - 1994**

CSK, CZK in billions

|  | 1989  | 1992            | 1993 | 1994 |
|--|-------|-----------------|------|------|
|  | CSFR  | (underlying CR) |      | CR   |
| TOTAL:   | 122.1 | 38.2            | 38.7 | 39.5 |
| Producer   | 59.2  | 38.2            | 38.7 | 39.5 |
| - agriculture<br>& foodstuffs- forestry<br>& water | 35.0  | 9.1             | 6.4  | 8.0  |
| - mining   | 4.9   | 2.1             | 0.7  | 0.7  |
| - residential heating                              | 1.3   | 2.5             | 4.0  | 5.5  |
| - transportation                                   | 2.3   | 2.1             | 5.6  | 5.5  |
| - housing  | 4.8   | 10.1            | 13.8 | 13.7 |
| - other noninvestment.                             | 5.0   | 1.1             | -    | -    |
| Retail   | 5.8   | 11.2            | 8.2  | 6.1  |
| - food   | 49.1  | -               | -    | -    |
| - nonfood  | 36.1  | -               | -    | -    |
| Foreign trade                                      | 12.9  | -               | -    | -    |
| As % of GDP  | 13.9  | -               | -    | -    |
| Total  | 16.1  | 4.9             | 4.2  | 3.8  |
| Producer subsidies                                 | 7.8   | 4.9             | 4.2  | 3.8  |
| Retail subsidies                                   | 6.5   | -               | -    | -    |
| Foreign trade subsidies                            | 1.8   | 2.1             | 0.7  | 0.7  |

Note:

The data include the transfers from Fund of Market Regulation in Agriculture, and quasi-fiscal operations of the National Property Fund.

Source: Ministry of Finance, IMF

Besides the reduction of transfers to enterprises, a change was initiated of their structure. Before 1990, there were no fixed rules for corporate taxes. The corporate tax system was a nontransparent mixture of "aid" to enterprises in trouble and a drawing-out of profits from profitable ones.

Since 1990, the approach has become gradually more and more oriented towards specifically targeted projects, especially related to the conversion of the armament industry, and also in the compensation for negative effects from price control in the remaining spheres of regulated prices (for example, energy, urban transportation, and rents). After prices were freed in January 1991, food consumption has reduced, and, consequently also production. This development had negative effects on producers. In addition, the liberalization of foreign trade led to an increase of imported food and food products.

The system of subsidies was shifted from a differentiated one to a system involving a more uniform approach to all producers.

Special attention should be paid to agriculture subsidies. For several decades in Czechoslovakia, there was a tradition of agricultural production in large productive entities legally defined as agricultural cooperatives (created by force in the fifties) or alternatively as state farms.

Food prices were heavily subsidized and the final losses of the producers were compensated through the budget by a number of channels. The low food prices in the past led unavoidably to a relatively substantial amount of overproduction and waste in food consumption.

In 1991, as mentioned above, separate Funds for Market Regulation in Agriculture were created in each republic and in 1992 a federal one was added. Their main purpose is to stabilize agricultural products prices. These funds operated interventional purchases in the domestic markets to guarantee the prices of selected basic agricultural products to their producers and, on the other hand, they contributed to the stability of basic food prices for consumers by the occasional sales of their stocks. They played a major role in foreign trade regulation and in eliminating the monopolistic practices of the food producers. In addition to these funds, lending and loan guarantee activities were consolidated into Agricultural and Forestry Support and Guarantee Fund which began operation in January 1994 with an initial capitalization of 3.5 billion CZK. The National Property Fund also seeded a facility by contributing CZK 2 billion.

The far the biggest state budget subsidy goes to transportation. At 6.6 billion CZK in 1995, this is 0.5 % of GDP. The biggest share of it is to compensate for losses in passenger railway transportation and will help to finance railway operating costs. A minor part of this subsidy supplements the lower than standard fares for transporting pupils by bus. An even smaller part is designated for the repayment of interest on credits for the remanufacturing of aircraft engines.

The second biggest subsidy goes to agriculture. In 1995, this is 5.7 billion CZK or 0.5 % of GDP.

The third group of subsidies consists of grants to mines. They contain of temporary income support and compensation for the health problems of laid-off miners, and also help to cover cost of alleviating the environmental damages of former techniques of extraction.

Because the subsidies of central heating, urban transportation, and the railways are justified primarily on the grounds of income distribution, it is proposed that some aspects of these subsidies will be eventually transformed into means tested transfers. A housing allowance which aims to support rent for low income families was introduced in 1994. Transportation of children to mandatory schooling is proposed to be defrayed by a new family allowance, probably in 1996.

### **4.3. Government service development**

There were many changes in the structure of government services. The whole analyzed period was marked by shifts of power from the federal authorities to the republic ones, resulting in the establishing of new ministries on the republic level and the founding of new agencies in accordance with the philosophy of the transitional reforms (anti-monopolistic agencies, labor offices, tax offices, and others) from 1990 to 1992. The

next important moment was the split with Slovakia, after which some economies of scale were lost.

A major decline of expenditure concerning government services occurred in defense. It was mostly due to the change in the political climate in Europe. On the other hand, the decline in military expenditure led to a decline of the armament industry products and to the armament industry conversion. The conversion issue was especially difficult in Slovakia where the military industries were and still are more concentrated in comparison with the Czech Republic.

Many changes occurred in the internal security expenditure. The development of this expenditure could not have ignored the increase in crime which followed the opening of borders and the liberalization of the living conditions in Czechoslovakia.

The most important part of the government expenditure is represented by education and health care outlays. It is necessary to remember that these services were and still are financed primarily from the budget. The role of the private sector was at that time, and in fact still is, only marginal one.

A part of the expenditure increase is due to the price developments reflecting an increase in not only material costs, but also an increase of wages in what was traditionally a low wage sectors. Generally speaking, the increased expenditures in any cases allowed only for the maintenance of the real spending level on those public services.

The first private schools appeared already in 1990. Despite a rapid development of these activities, they still represent only a minority. The main stream of privatization activities in the health care system is expected after 1995.

### **Public Health**

The development of the public health expenditure in 1991 - 1993 (see the next table) shows that substantial changes in the volume of financial flows has occurred. The reform of the financing in this sphere was started by the introduction of the National Health Fund in 1993.

In 1991, expenditures increased only by 3 % in comparison to 1990. However, the involvement of the state (republic) and local budgets was changed. This was connected with the transition of health facility financing, health schools, and training institutions from local authorities to the republic governments (Ministry of Health).

In 1992, expenditures grew by 44 %. This growth was partly influenced by preparing the introduction of the new financing schemes - Health Insurance Fund - scheduled for implementation in 1993. It was necessary to support the set-up of the General Health Insurance Fund (1.9 billion CZK), and to finance other processes attached to the reform. This rapid increase was also an impact of the 1991 one-time-only change of price level following price and trade liberalization (price of medicines and so on).

**Table 13: Expenditures On Public Health**

CSK, CZK in billions

|                                  | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 <sup>1</sup> | 1995 <sup>1</sup> |
|----------------------------------|------|------|------|------|------|-------------------|-------------------|
| Federal budget                   | 0.0  | 0.0  | 0.0  | 0.0  | -    | -                 | -                 |
| Czech R budget                   | 1.1  | 0.9  | 11.4 | 37.6 | 5.4  | 6.6               | 7.5               |
| Local budget                     | 24.2 | 28.2 | 18.6 | 5.6  | 6.4  | 4.0               | 4.6               |
| National Health Fund             | -    | -    | -    | -    | 57.0 | 63.1              | 72.3              |
| transfer from govt. <sup>2</sup> | -    | -    | -    | -    | 16.0 | 12.9              | 13.5              |
| Total                            | 25.3 | 29.1 | 30.0 | 43.2 | 68.8 | 73.7              | 84.4              |
| Ratio to GDP (%)                 | 4.8  | 5.1  | 4.2  | 5.4  | 7.5  | 7.5               | 8.0               |

Note:

<sup>1</sup> Proposed in the State Budget.<sup>2</sup> Payments made by central government on behalf of entitled persons

Source: Ministry of Finance, data compiled in accordance with GFS methodology; expenditures from the federal budget were split between the Czech Republic and Slovak Republic in proportion 2:1.

The above table illustrates the magnitude of changes, connected with the introduction of the new system of health financing. Since 1993, only expenditures which are not covered by health insurance companies have been financed from the state budget (sanitation services, emergency services, preventive health programs, research projects, training health personnel, etc.).

## Education

Expenditures from the public budget for education showed similar features as with health care expenditure (see the next table). There was the same shift between central and local budgets as well as the partial compensation of the inflationary impact.

A significant growth of budget expenditures (43.4 % over the previous year) occurred in 1993. This increase was connected primarily with a wage valorization of teachers. Expenditures of local budgets increased by 12 % and covered mainly the operating activities of kindergartens and primary schools. In 1993, an amendment of the law on schools created the possibility for local governments to claim contributions from parents to cover part of the costs for some education services. In 1993 the expansion of private schools, or better said, of their entitlement to claim the per student subsidy, contributed to the expenditure growth.

**Table 14: Expenditures On Education**

CSK, CZK in billions

|                  | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 <sup>1</sup> | 1995 <sup>1</sup> |
|------------------|------|------|------|------|------|-------------------|-------------------|
| Federal budget   | 0.0  | 0.0  | 0.1  | 0.1  | -    | -                 | -                 |
| Czech R budget   | 4.1  | 4.8  | 20.4 | 27.0 | 42.0 | 47.9              | 46.1              |
| Local budget     | 18.2 | 20.2 | 15.4 | 10.0 | 11.2 | 10.7              | 11.4              |
| Total            | 22.3 | 25.0 | 35.9 | 37.1 | 53.2 | 58.6              | 57.5              |
| Ratio to GDP (%) | 4.3  | 4.4  | 5.0  | 4.6  | 5.8  | -                 | -                 |

Note:

<sup>1</sup> Proposed in the State Budget

Source: Ministry of Finance, data compiled in accordance with GFS methodology; expenditures from the federal budget were split between the Czech Republic and Slovak Republic in the proportion 2:1.

## Cultural services

During the past period, state expenditures on culture were restricted. With the exception of wages, expenditures were allocated primarily for the reconstruction of historical and church monuments, restoration programs for city historical zones, and art monuments.

**Table 15 Expenditures for Recreational, Cultural and Religious Affairs**

CSK, CZK in billions

|                  | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 <sup>1</sup> | 1995 <sup>1</sup> |
|------------------|------|------|------|------|------|-------------------|-------------------|
| Federal budget   | 0.3  | 0.3  | 0.2  | 0.0  | -    | -                 | -                 |
| Czech R budget   | 2.6  | 3.6  | 3.0  | 2.3  | 3.4  | 2.9               | 3.1               |
| Local budget     | 2.8  | 2.7  | 2.1  | 4.1  | 4.6  | 4.8               | 4.3               |
| Total            | 5.7  | 6.6  | 5.3  | 6.4  | 8.0  | 7.7               | 7.4               |
| Ratio to GDP (%) | 1.1  | 1.2  | 0.7  | 0.8  | 0.9  | -                 | -                 |

Note:

<sup>1</sup> Proposed in the State Budget

Source: Ministry of Finance, data compiled in accordance with GFS methodology; expenditures from the federal budget were split between the Czech Republic and Slovak Republic in the proportion 2:1.

## Social expenditure

The development of the transfers to households directly reflects the concern of the government to maintain the support of the population for the economic transformation.

Despite a relatively weak economic performance and a shortfall in budget revenue, considerable amounts of budget funds were allocated to create a sufficient social security net to avoid an excessive decline in the living standard of low-income households.

As a result of this policy, since 1989 there have been no major social conflicts- such as large and long strikes - despite a decline in output and a decline in real wages.

## Pensions

The present pension scheme has its origin in the 1950's, and was reorganized significantly in 1988. Currently, this system no longer corresponds with an incentive driven economy. The first measures modifying the scheme were aimed at eliminating the differences between old and new pensions and on abolishing the special entitlements given to selected groups of pensioners. It also does not reflect the demographic developments which will significantly affect the pension system in the future.

**Table 16: Survey of Changes in Pension and State Equalization Allowances Paid to Pensioners (1990 - 1994)**

| Date        | Base for comment | Valuation  |
|-------------|------------------|--|
| <b>1990</b> |                  |  |
| April       | Pension          | Increase of pensions and valorization of minimum pension (when a sole income of recipient)               |
| <b>1991</b> |                  |  |
| March       | Pension          | 8 % valorization (at least 190 CZK per pension)  |
| May         | SEA              | increased by 80 CZK (to 220 CZK monthly per capita)  |
| July        | Pension          | 110 CZK - average pension increase   |
| <b>1992</b> |                  |  |
| June        | Pension          | 30 CZK - average increase of old pensions,<br>290 CZK - average increase of new pensions                 |
| <b>1993</b> |                  |  |
| March       | Pension          | 10 % valorization of old pensions<br>22 % valorization of new pensions                                   |
| November    | Pension          | 300 CZK - average increase of old pensions<br>30 % valorization of new pensions                          |
| <b>1994</b> |                  |  |
| December    | Pension          | 5 % valorization of old pensions<br>32% valorization of new pensions                                     |
|             | SEA              | 420 CZK - increase of pensions by (200 CZK),<br>transformation of SEA as component of pensions (220 CZK) |

## II. Public finance developments

Since 1990, many measures in the pension scheme have been implemented with impact on the development of pensioners' incomes. In 1990, pensions were increased as well as the minimum floor of the lowest pensions. In the next year, a law on the increase of pensions was accepted which established conditions for the future valorizations of pensions. Pensions have been valorized alternatively: first by fixed amounts; secondly by setting a percentage increase; or on a combined basis, using both methods. During 1991 and 1992, the criterion for valorizations was the growth of living costs (measured by the cost-of-living index of pensioner households); and pensions were increased if this indicator rose by at least 10%. Since 1993, the schemes of pensions valorization have been modified and currently it is related to the cost-of-living index. The 10 % criterion has been preserved. The amount of valorization is not given by law and is left at the discretion of the government. From 1993, pensions have been kept in real terms at 85% of their level before the onset of price liberalization in 1991.

**Table 17: Average Old-Age Pension After Valorization**  
(pension + state equalization allowance)

|                      | <b>Pension<br/>(CZK)</b> | <b>In real terms<br/>(%)</b> |
|----------------------|--------------------------|------------------------------|
| <b>1990</b>          |                          |                              |
| November             | 1,882                    | 100.0                        |
| <b>1991</b>          |                          |                              |
| January <sup>1</sup> | 1,885                    | 79.5                         |
| March                | 2,089                    | 83.6                         |
| July                 | 2,291                    | 85.6                         |
| <b>1992</b>          |                          |                              |
| June                 | 2,482                    | 85.2                         |
| <b>1993</b>          |                          |                              |
| March                | 2,712                    | 77.6                         |
| November             | 3,026                    | 85.3                         |
| <b>1994</b>          |                          |                              |
| December             | 3,374                    | 83.0 <sup>2</sup>            |

Notes:

<sup>1</sup> Start of price liberalization.

<sup>2</sup> Estimate

Source: Ministry of Finance

Up to now, the state policy has aimed at keeping pensions at acceptable levels. At the same time, preparations are underway for the principal reform of the old age security programs towards the multipillar system.

The current mandatory pension scheme is financed on a pay-as-you-go base from pension insurance contributions which are considered as general state budget revenue. There are many factors influencing the growth of these expenditures. In 1991, the number

of old-age pensioners rose more quickly than in the past and there was a substantial fall in the employment of post-productive age workers (225 thousand from 1990 to 1991). At the same time, the Employment Law established the eligibility criteria for earlier retirement. Job seekers who meet certain conditions may claim an old-age pension two years early. From 1990 - 1993, about 130 thousand persons claimed an early retirement.

With respect to the state social policies, the government envisages keeping the present rate of the pension insurance contributions and reforming the pensioners benefits in the mandatory scheme.

**Table 18: Pensions<sup>1</sup>**

|   | 1989  | 1990  | 1991  | 1992  | 1993  | 1994  | 1995 <sup>2</sup> |
|---|-------|-------|-------|-------|-------|-------|-------------------|
| Number of pensions <sup>3</sup><br>(in thousands)   | 2,916 | 2,952 | 2,997 | 3,033 | 3,052 | 3,051 |                   |
| of which:   |       |       |       |       |       |       |                   |
| standard old age <sup>4</sup>                       | 1,707 | 1,736 | 1,777 | 1,804 | 1,815 | 1,811 |                   |
| disability <sup>4</sup>                             | 470   | 483   | 494   | 505   | 517   | 527   |                   |
| others <sup>5</sup>                                 | 739   | 733   | 726   | 724   | 720   | 713   |                   |
| Number of pensioners <sup>3</sup><br>(in thousands) | 2,387 | 2,422 | 2,462 | 2,490 | 2,500 | 2,496 |                   |
| of which:   |       |       |       |       |       |       |                   |
| standard old age <sup>4</sup>                       | 1,706 | 1,731 | 1,772 | 1,798 | 1,808 | 1,803 |                   |
| disability <sup>4</sup>                             | 420   | 429   | 440   | 451   | 462   | 471   |                   |
| others <sup>5</sup>                                 | 261   | 262   | 250   | 241   | 230   | 222   |                   |
| Expenditure (in bn. CZK)                            |       |       |       |       |       |       |                   |
| Total   |       |       |       |       | 76.5  | 88.2  | 105.3             |
| in civil sector <sup>6</sup>                        | 43.6  | 45.5  | 56.1  | 63.7  | 74.2  | 85.3  | 102.0             |
| in special sector <sup>7</sup>                      |       |       |       |       | 2.3   | 2.9   | 3.3               |

Notes:

<sup>1</sup> The difference between the number of pensioners and number of pensions is based on the legal entitlement to receive more types of pensions simultaneously (e.g. old age, widows/widowers, disability etc.)

<sup>2</sup> Projection - revised state budget

<sup>3</sup> Only for the civil sector

<sup>4</sup> Includes full and partial pensioners

<sup>5</sup> Includes orphans, widows, social, wives, widowers, other pensions

<sup>6</sup> The expenditures in civil sector cover the pensions administrated by the Ministry of social affairs. The pensions administrated by Ministry of Defence and the Ministry of Interior are excluded (see special sector).

<sup>7</sup> The data for 1989 - 1992 are not available

Source: Ministry of Labor and Social Affairs, Ministry of Finance

## II. Public finance developments

The mandatory pension scheme was complemented by supplementary pension schemes with state contribution in 1994. The supplementary pension schemes are based on private Pension Funds which provide the contribution-based personal savings and annuity plans. The establishment of the Funds, eligibility conditions, basic entitlements, and the minimal variety of pensions plans are regulated by a special law.

The government contributes within this scheme to policy holder accounts, providing incentives for individual involvements. Its construction is regressive with the state contribution of 40 % to the lowest insurance saving deposits, and declining to 24 % for the highest savings deposits. Contributions from the state budget reached some 0.5 billion CZK in 1994. They are expected to increase considerably as the scheme expands.

Next to these pillars there is a commercial one, the weight of which is still negligible.

### Other social programs

In the past five years, substantial changes on the expenditure side of the social program financing have occurred. They consisted of structural changes which were realized as part of the ongoing economic transformation.

**Table 19: Expenditures on Social Security and Welfare**

|                             | CSK, CZK in billions |      |       |       |                   |                   |                   |
|-----------------------------|----------------------|------|-------|-------|-------------------|-------------------|-------------------|
|                             | 1989                 | 1990 | 1991  | 1992  | 1993 <sup>3</sup> | 1994 <sup>1</sup> | 1995 <sup>1</sup> |
| Federal budget              | 0.0                  | 8.5  | 21.3  | 17.6  | -                 | -                 | -                 |
| Czech R budget <sup>2</sup> | 63.8                 | 70.2 | 84.6  | 92.8  | 100.8             | 139.6             | 153.1             |
| Local budget                | 4.9                  | 5.4  | 4.5   | 7.0   | 9.1               | 3.4               | 4.4               |
| Total                       | 68.7                 | 84.1 | 110.4 | 117.4 | 109.9             | -                 | -                 |
| Ratio to GDP (%)            | 13.1                 | 14.8 | 15.4  | 14.6  | 11.9              | -                 | -                 |

Notes:

<sup>1</sup> Proposed in the State Budget

<sup>2</sup> Including pensions.

<sup>3</sup> The data for 1989 - 1993 are in GFS format, i.e. the intrabudgetary flows are netted. To make them comparable with 1994-1995 budgetary data, the state and local authorities contributions to the social insurance and for the state employment policy - which they pay as an employer - must be added. In 1993, these contributions were 1.8 billion CZK on the central level and 7.3 billion CZK on local level. After this adjustment, the total social expenditures in 1993 were 118 billion CZK.

Source: 1993 GFS statistic yearbook with our own recalculation (expenditures from the federal budget were split between the Czech Republic and Slovakia in a proportion of 2:1), and the Ministry of Finance.

## **Social programs (benefits)**

In regards to the financial sources (revenues) from which benefits are financed, it is possible to divide them into two groups: benefits financed from earmarked sickness insurance contributions and sickness pays are financed from general budget revenue.

In the period from 1990 to 1994, many measures to valorize existing benefits or to introduce new ones were adopted.

In 1990, the parent's childbearing entitlement was lengthened to include the first three years of a child life. A state equalization allowance was enacted as a new entitlement.

In 1991, the following benefits were increased: the state childbirth support, the state equalization allowance for children and pensioners, and the board and lodging allowance. The base for calculating sickness pay -which is set as percentage of gross wage with a given ceiling- was increased. The law was adopted, recodifying the subsistence minimum and related benefits.

In 1992, benefits for the foster-parental care and parent's benefit were revalued. The payment of the state equalization allowance for economical active persons was discontinued (other recipients continued to receive the benefit).

In 1993, the subsistence minimum, the related benefits, and family benefits (including foster-parental care benefits) were increased.

In 1994, the law on government contributions to increased gross rents (after their partial liberalization) was accepted; the ceiling of sickness pays was increased once more; and there was also an increase in maternity benefits. The subsistence minimum and other benefits connected to it were increased as well. Contributions to foster-parents for handicapped children, room and board allowance, maternity benefits, and funeral allowance were increased. The state equalization allowance was increased for children in families with an average income of lower than a 1.5 multiple of the living minimum.

Up to the split of Czechoslovakia in January 1993, benefit programs were financed from three budgets. Expenditures for the state equalization allowance and programs of the state employment policy (unemployment benefits) were covered from the federal budget. The republic budgets covered expenditures for sick pay, family benefits, and other social allowances. Local budgets were the third source. Transfers to households from local budgets were paid out in cases where a persons' short-term personal circumstance could not be solved by other regular benefits. Benefits could be given in cash or in kind, they could also be given as a loan.

The development of benefit programs is shown in the next table. Except for the state equalization allowances, expenditures increased in absolute terms from 1992. A similar tendency can be observed of specifically aimed social policies, especially those focusing on the welfare of low income families with children.

In 1993, the share of expenditures covered from other sources than social insurance contributions - that is, basically from general revenue - was about 12.4 %. For 1994, this is expected to decrease to 9 %.

The main regulatory acts, for example those on mandatory pension schemes, state social support, and social assistance have not completed the legislative process.

## II. Public finance developments

The reform of the social security system will be started in mid-1995. This will fundamentally change the existing structure of benefits and qualification conditions for entitlement. The social reform is aimed at stabilizing, or even reducing, public budget expenditures for social support and assistance and to make the system more self-financed.

**Table 20: Expenditures for Social Programs**

|   | 1990        | 1991         | 1992         | 1993         | 1994 <sup>1</sup> |
|---|-------------|--------------|--------------|--------------|-------------------|
| Benefits covered from Sickness Insurance          |             |              |              |              |                   |
| Sick-leave benefits                               | 6.90        | 7.25         | 8.15         | 9.67         | 12.65             |
| Assistance in case of attending a family member   | 0.73        | 0.56         | 0.57         | 0.67         | 0.86              |
| Maternity benefits                                | 1.35        | 1.40         | 1.44         | 1.62         | 1.90              |
| Compensation benefits for pregnancy and maternity | 0.02        | 0.02         | 0.10         | 0.18         | 0.20              |
| Support on the birth of a child                   | 0.26        | 0.35         | 0.36         | 0.42         | 0.48              |
| Child allowance                                   | 10.19       | 9.81         | 9.50         | 9.62         | 12.48             |
| Funeral contributions                             | 0.02        | 0.12         | 0.12         | 0.11         | 0.12              |
| Other state budget allowances                     |             |              |              |              |                   |
| Parent's benefit                                  | 1.50        | 3.01         | 3.82         | 4.43         | 5.15              |
| Room and board allowance                          | 0.41        | 0.50         |              |              |                   |
| State equalization allowance <sup>2</sup>         | 8.4         | 20.47        | 14.40        | 13.08        | 10.40             |
| Other   |             |              |              | 0.01         | 0.01              |
| Social transfers from local budgets               | 3.03        | 1.37         | 2.38         | 2.90         | 3.40              |
| <b>TOTAL EXPENDITURES</b>                         | <b>32.4</b> | <b>44.36</b> | <b>40.84</b> | <b>43.12</b> | <b>48.15</b>      |

Notes:

Expenditures of non-civil sector are not included.

<sup>1</sup> Proposed in the State Budgets.

<sup>2</sup> Estimates on the base of federal budget social expenditure for 1990 - 1992.

Source: Ministry of Labor and Social Affairs, Balance Account of Local Budgets.

## Unemployment programs

Considerable changes have occurred in the financing of the governments' employment policy.

Until 1993 (in the former Czech and Slovak Federal Republic), the financing of employment policy was fully covered by the federal government. The needed financial means were drawn from the federal budget in which a special source was created to finance employment policy problems. The amount of this source was related to the expected development of the labor market. The basic structure of the projected employment policy expenditures (active policies of employment or AEP) was defined at tripartite negotiations between the government, trade unions and employers in the General Agreements.

**Table 21: Expenditures on Employment Policy**

(thousand CSK, CZK, as a percentage of GDP)

|  | 1991      |       |      | 1992      |       |      | 1993      |       |      | 1994 <sup>1</sup> |       |
|--|-----------|-------|------|-----------|-------|------|-----------|-------|------|-------------------|-------|
|  | A         | B     | C    | A         | B     | C    | A         | B     | C    | A                 | B     |
| 1.Passive provisions   |           |       |      |           |       |      |           |       |      |                   |       |
| 1.1.Benefits   | 1,674,505 | 68.3  | 0.23 | 1,412,195 | 44.9  | 0.18 | 1,375,390 | 63.5  | 0.15 | 1,641,074         | 71.4  |
| 1.2.Other  | 2,767     | 0.1   | 0.00 | 11,158    | 0.4   | 0.00 | 41,279    | 1.9   | 0.00 | 51,338            | 2.2   |
| 2.Active provisions  |           |       |      |           |       |      |           |       |      |                   |       |
| 2.1.Retaining for unemployed   | 39,980    | 1.6   | 0.01 | 97,602    | 3.1   | 0.01 | 73,359    | 3.4   | 0.01 | 80,578            | 3.5   |
| 2.2.Socially purposeful jobs<br>(newly created jobs)                         | 544,881   | 22.2  | 0.08 | 1,294,148 | 41.2  | 0.16 | 463,045   | 21.4  | 0.05 | 313,424           | 13.6  |
| Of which:  |           |       |      |           |       |      |           |       |      |                   |       |
| at employers   |           |       |      | 736,596   | 23.4  | 0.09 | 170,567   | 7.9   | 0.02 | 163,355           | 7.1   |
| support to small business  |           |       |      | 232,024   | 7.4   | 0.03 | 47,288    | 2.2   | 0.00 | 38,861            | 1.7   |
| jobs for unemployed youth  |           |       |      | 325,528   | 10.4  | 0.04 | 245,190   | 11.3  | 0.03 | 111,208           | 4.8   |
| 2.3.Publicly useful jobs   | 78,390    | 3.2   | 0.01 | 223,027   | 7.1   | 0.03 | 159,605   | 7.4   | 0.02 | 161,140           | 7.0   |
| 2.4.Workshops for handi-<br>capped   |           |       |      | 55,699    | 1.8   | 0.01 | 48,667    | 2.2   | 0.00 | 51,339            | 2.2   |
| 2.5.Shortened working hours in<br>companies introducing new<br>manufacturing |           |       |      | 36,400    | 1.1   | 0.00 | 4,368     | 0.2   | 0.00 | 632               | 0.0   |
| 2.6.Other (early departure of<br>foreign workers)                            | 109,744   | 4.5   | 0.02 | 14,800    | 0.5   | 0.00 | 364       | 0.0   | 0.00 | 111               | 0.0   |
| 1.Passive provisions   | 1,677,272 | 68.4  | 0.23 | 1,423,352 | 45.3  | 0.18 | 1,416,669 | 65.4  | 0.16 | 1,692,412         | 73.6  |
| 2.Active provisions  | 772,995   | 31.5  | 0.11 | 1,721,676 | 54.7  | 0.21 | 749,408   | 34.6  | 0.08 | 607,224           | 26.4  |
| 1.+ 2. Total expenditure   | 2,450,267 | 100.0 | 0.34 | 3,145,029 | 100.0 | 0.39 | 2,166,077 | 100.0 | 0.24 | 2,299,636         | 100.0 |

Notes:

- A - Expenditures in thousands, CZK
- B - Percentage share of expenditures
- C - As a percentage of GDP
- <sup>1</sup> Data of November 30

Source:

Ministry of Labor and Social Affairs  
Ministry of Finance  
Author's calculation

The General Agreement for 1991 stipulated that 25 % of the reserve should be spent for AEP. The budget reserve for both republics was 9.4 billion CSK. During the year however, only 2.45 billion CSK of the total was used in the Czech Republic, of which 31.5 % were reallocated for AEP. This experience was reflected in the General Agreement for 1992. Expected higher rates of unemployment led to an increase of 11 billion CSK in the budgetary reserve of which at least 30 % had to be spent on AEP. Both republics exceeded the limits with 54.7 % spent for active employment policies in the Czech Republic.

In 1993, the state budget reserve of the newly independent Czech Republic for state employment policies was 6.5 billion CZK. The previously defined 25 % limit for AEP was increased by the Tripartite to 34.6 %. In 1994, the financial reserve for the state employment policies was 5.5 billion CZK, but expenditures reached only 3.0 billion CZK. In the state budget for 1995, the reserve for the state employment policies is 3.5 billion CZK.

With the introduction of new tax and social insurance systems at the beginning of 1993, the principles for financing the employment policy were altered. The newly approved law on social insurance and unemployment policy stipulated the shares from employers and employees to finance the state policy of employment, with employers contributing 2.25 % of their wage bill and employees 0.75 % of their gross wage. These resources were channeled to a special employment reserve in the state budget.

The development of expenditures for the state policy of employment from 1991 on, (see table 21) documents the tendency of expenditures on the passive employment policy to rise as compared to the stability of the active ones. It is evident that besides the objective reasons for this change, which are related to the development of unemployment in 1993, restrictions were put in place on the active employment policy expenditures. At the time when the active employment policy was introduced, labor offices drew financial means according to their needs, practically without any limitation.

The progression of the economic reforms in a relatively short time, however, created conditions for using other forms of financing to back the active employment policy programs. The responsibility of parties involved in these programs was increased ( support for small and medium sized enterprises and newly established enterprises), and the benefits provided for retraining schemes were reduced, as well as the number of entrants to other costly projects.

It is necessary to say that conditions for the payment of unemployment benefits were much "softer" until 1992. This was due to the expected serious imbalance in the labor market following the start of the transformation process, and subsequently the need to support the affected workers until the time when systemic changes began to take effect.

The "softness" of the set eligibility conditions also reflected efforts to make unemployment, which was a completely new phenomenon in Czech society, more

"socially acceptable" for the population. This fact is often interpreted as an continuing of the former state's paternalism.

The evaluation of the first year's experience led to the conclusion that the conditions set for the payment of unemployment benefits had an disstimulating effect on the activity of the unemployed in seeking jobs. At the same time, developments showed that a decisive proportion of job seekers returned to work within the first six months of their initial unemployment.

## **5. Public debt**

The budgetary methodology before 1989 did not use the terms "public debt" or "state debt". Only state assets and the state liabilities existed at the time. These assets and liabilities were not influenced primarily by the budget deficit or surplus (because the policy of a balanced state budget) but their level was determined by occasional operations including the re-evaluation of stocks, the impact of foreign exchange rate changes on the financial balances of foreign trade organizations, etc. The most important operation prepared by the previous government at the end of 1989 was the take-over of governments credits abroad (before they were included in the central bank balance and as a new part of the state financial assets and liabilities).

### **5.1. Net credit to government developments in 1989 - 1994**

The net credit to government covers the deficit of the state budgets including local budgets, the development of the state financial assets and liabilities, and extrabudgetary funds on the central and local level. For policy purposes, it was decided not to include the National Property Fund as part of the net credit to government. The same holds for the loans received from European Union, World Bank, and the G-24 which are described below as a part of the state debt.

The net credit to government increased substantially between 1991 and 1992: it was influenced in this period by a number of factors which were not immediately connected with current economic developments. The developments can be derived from the elimination of distortions in the relationship between the government and the banking system in the previous years, and from the removal of distortions in the exchange rate.

A high proportion of the net credit to government in 1990 resulted from state financial assets and liability operations. This especially concerns the take-over of government credits abroad by the federal government, dealing with the economic impact of the major exchange rate changes economy (three devaluations of the CZK to the USD and the revaluation to the transferable ruble), and the shift of financing

foreign trade with countries of the former CMEA area from transferable rouble`s to free currencies. In comparison with those operations, the result of current budgets played just a minor role.

In the following years, the net credit to government was reduced, especially in connection with international institutions' loans to the government - the WB, EU, G-24, and others. A similar effect was generated by the exchange of transferable rouble assets into USD. An opposite effect was caused by the current budget deficits in 1991 and 1992.

Regarding the financing of the state debt, the most important change went into effect in February 1992. The State Bank Act established limits to the financing of budget deficits. Direct credit financing of the budget deficit has been prohibited by the law with one exception - technical credits to cover the time lag between expenditure payments and revenue accrual is permitted, but it cannot exceed 5% of the current budgetary revenue. Consequently, 1992 was the first year when the state participated in the emerging Czechoslovak money and capital markets.

After the split of Czechoslovakia, both Czech and Slovak Governments took over their appropriate share of the CSFR state debt including "new" debt (debt assumed from the foreign trade bank - CSOB). The development in the Czech Republic is illustrated in the table below. The data for 1990 - 1992 simulates the split between the republics.

**Table 22: Net Credit to Government, Developments in 1990 - 1994**

|  | CSK, CZK in billions |             |             |             |                         |
|--|----------------------|-------------|-------------|-------------|-------------------------|
| <b>Net Credit to Govt.<sup>1</sup></b> | <b>1990</b>          | <b>1991</b> | <b>1992</b> | <b>1993</b> | <b>1994<sup>2</sup></b> |
| TOTAL                                  | 36.1                 | 31.6        | 74.7        | 59.1        | 48.7                    |
| Central Govt.                          | n.a.                 | n.a.        | 83.7        | 72.1        | 60.9                    |
| Local Govt.                            | -7.6                 | -11.6       | -11.5       |             |                         |
| state funds                            | -1.4                 | -1.4        | -0.7        |             |                         |
| Memo item:                             |                      |             |             |             |                         |
| clearing account                       |                      |             |             |             |                         |
| with SR                                | 0.0                  | 4.6         | -4.4        |             |                         |
| NPF <sup>3</sup>                       | -7.1                 | -24.5       | -16.7       | -14.3       |                         |

Notes:

<sup>1</sup> End of year.

<sup>2</sup> Preliminary data

<sup>3</sup> National Property Fund of CR

Source: SBCS, Czech National Bank, Ministry of Finance

## **5.2. Central government debt in the Czech Republic**

The major component of the net credit to government resulted from the state budget operations and state financial assets and liabilities, that means the central government operation excluding the operations of extrabudgetary funds. This defines the gross government debt.

### **Debt situation at the time of the Czech Republic's emergence.**

On January 1, 1993, the date when the Czech Republic started to exist, the gross government debt was 158.8 billion CZK (5.5 billion USD) or 15,385 CZK (532 USD) per capita. This debt was equal to 19.8 % of GDP. The total debt was composed of three parts:

1. According to the agreement with Slovakia, the Czech Republic took two thirds of all assets and liabilities of the former Czechoslovakia while SR took one third. The division was based on the proportion of Czech to Slovak inhabitants in the federation. This portion of liabilities represented 88.9 billion CZK, or 56 % of all government commitments at the founding of the Czech state. (Most of these obligations emerged as mentioned above from the takeover of direct credits provided from central bank to government, from the settlement of devaluations and revaluations of CZK at domestic banks in 1991 (43.4 billion CZK), and from the transfer of direct foreign debt (22.1 billion CZK) from the banking sector to government accounts.)
2. The new state took over all obligations of former Czech Republic, an amount totaling 20.3 billion CZK, i.e 12.8 % of the new government's obligations.
3. The Czech Republic also took all foreign debts of CSOB over into government accounts. This totaled 49.6 billion CZK or 31.2 % of the total government debt. (These foreign debts were created during socialism as a result of politically motivated decisions.) The administration of CSOB had to accept these decisions because it was acting as a financial agent of the government at that time. By transferring these debts into government accounts, the bank was thereafter able to function as a normal commercial bank. This bank still administers the old foreign debts for Czech government.

Thus, the starting balance of outstanding domestic government debt was 54.8 % of the total domestic debt. Of this, foreign debt incurred after 1989 was 22.1 billion CZK (765 million USD) or 13.9 % of the total outstanding government debt.

Overall stability in the total level of the short and long-term indebtedness in 1993 was brought about by reducing the domestic debt by 0.7 billion CZK and by

increasing the foreign debt by the same amount in direct credits. In addition, exchange rate differentials exercised a negative impact on the revaluation of the debt.

The reduction of the total debt (by 4 billion CZK) at the end of 1993 is fully attributable to elimination of short-term debt, i.e. the debt serving the liquidity purposes of the government (financing the current deficits).

Developments of the government debt can be characterized as a stabilization in the total amount of the state liabilities. An overview of the balance and financing of the total government in 1993 and 1994 is shown in tables 23 to 26.

**Table 23: Total Debt Balance and Financing in 1993**

CZK in billions

| Debt                   | Balance of outstanding debt |           |            |     |       | 31 Dec |
|------------------------|-----------------------------|-----------|------------|-----|-------|--------|
|                        | 1 Jan                       | Financing |            |     | net   |        |
|                        |                             | borrowing | repayments | adj |       |        |
| I. TOTAL               | 162.8                       | 149.7     | 151.1      | 1.4 | - 4.0 | 158.8  |
| II. Funding            | 158.8                       | 126.9     | 128.3      | 1.4 | 0.0   | 158.8  |
| Domestic               | 87.1                        | 124.3     | 125.0      | -   | 0.7   | 86.4   |
| Foreign                | 71.7                        | 2.6       | 3.3        | 1.4 | 0.7   | 72.4   |
| III.Liquidity purchase | 4.0                         | 22.8      | 26.8       | -   | 4.0   | 0.0    |

Source: Ministry of Finance

The 1993 policy of stabilizing debt at 158.8 billion CZK till the year 2000 continued into 1994. The total debt was reduced by 1.6 billion CZK (or 1% from the January 1, 1994 level). The current deficits, which occurred in the beginning of the year were financed by T-bills.

The foreign debt was lowered mainly due to exchange rate developments. In line with this, the domestic debt increased by 3.8 billion CZK.

**Table 24: Total Debt Balance And Financing in 1994**

CZK in billions

| Debt                   | Balance of outstanding debt |           |            |       |       | 31 Dec |
|------------------------|-----------------------------|-----------|------------|-------|-------|--------|
|                        | 1 Jan                       | Financing |            |       | net   |        |
|                        |                             | borrowing | repayments | adj   |       |        |
| I. TOTAL               | 158.8                       | 181.8     | 182.9      | - 0.5 | - 1.6 | 157.2  |
| II. Funding            | 158.8                       | 174.8     | 175.9      | - 0.5 | - 1.6 | 157.2  |
| Domestic               | 86.4                        | 174.8     | 171.1      | 3.7   | -     | 90.1   |
| Foreign                | 72.4                        | 0.0       | 4.8        | - 0.5 | - 5.3 | 67.1   |
| III.Liquidity purchase | 0.0                         | 7.0       | 7.0        | -     | 0.0   | 0.0    |

Source: Ministry of Finance

## Long-term domestic government debt

The total balance of outstanding long-term debt did not change substantially during 1993-1994. This was consistent with the objectives of the government's conservative debt policy. The 1993 and 1994 balances and financing of domestic government debt are shown in the tables below:

**Table 25: Domestic Debt Balance and Financing in 1993**

CZK in billions

| Debt                   | Balance of outstanding debt |           |            |       |        |
|------------------------|-----------------------------|-----------|------------|-------|--------|
|                        | 1 Jan                       | Financing |            |       | 31 Dec |
|                        |                             | borrowing | repayments | net   |        |
| I. TOTAL               | 91.1                        | 147.1     | 151.8      | - 4.7 | 86.4   |
| II. Funding            | 158.8                       | 174.8     | 175.9      | - 0.7 | 86.4   |
| CNB                    | 58.0                        | 0.8       | 14.6       | -14.6 | 43.4   |
| Com.banks              | 17.7                        | 0.0       | 11.2       | -11.2 | 6.5    |
| T-bonds                | 9.7                         | 10.5      | 0.7        | 9.8   | 19.5   |
| T-bills                | 1.7                         | 113.8     | 98.5       | 15.3  | 17.0   |
| III.Liquidity purchase | 4.0                         | 22.8      | 26.8       | 0.0   | 0.0    |

Source: Ministry of Finance

**Table 26: Domestic Debt Balance and Financing in 1994**

CZK in billions

| Debt                   | Balance of outstanding debt |           |            |       |        |
|------------------------|-----------------------------|-----------|------------|-------|--------|
|                        | 1 Jan                       | Financing |            |       | 31 Dec |
|                        |                             | borrowing | repayments | net   |        |
| I. TOTAL               | 86.4                        | 181.8     | 178.1      | - 3.7 | 90.1   |
| II. Funding            | 158.8                       | 174.8     | 175.9      | - 0.7 | 86.4   |
| CNB                    | 43.4                        | 0.0       | 11.0       | -11.1 | 43.4   |
| Com.banks              | 6.5                         | 0.0       | 0.7        | - 0.7 | 5.8    |
| T-bonds                | 19.5                        | 15.1      | 6.3        | 8.8   | 28.3   |
| T-bills                | 17.0                        | 159.8     | 153.0      | 6.8   | 23.8   |
| III.Liquidity purchase | 0.0                         | 7.0       | 7.0        | 0.0   | 0.0    |

Source: Ministry of Finance

The government's liabilities continued to be transformed from credits into securities as this was a cheaper way of financing government debt. The overview of the medium-term securities issued in 1993 and 1994 is given in table below:

**Table 27: Medium-term securities issued in 1993 and 1994**

| T-bonds                | Issue Date | Maturity Date | Amount in mill.CZK | Issue Price CZK | Coupon | Yield             |
|------------------------|------------|---------------|--------------------|-----------------|--------|-------------------|
| 1st issue              | 03/18/93   | 03/18/97      | 2,095.0            | 2,095,000,000   | 14.6   | 14.60             |
| 2nd issue              | 07/08/93   | 07/08/96      | 3,030.0            | 3,016,402,000   | 14.0   | 14.19             |
| 3rd issue              | 10/12/93   | 10/12/95      | 3,088.2            | 3,164,506,790   | 10.0   | 8.60              |
| Reopening of 2nd issue | 12/14/93   | 07/08/96      | 1,670.8            | 1,754,790,980   | 14.0   | 11.91             |
| 4th issue              | 05/10/94   | 05/10/96      | 4,878.15           | 4,970,001,020   | 8.75   | 7.70 <sup>1</sup> |
| 5th issue              | 08/12/94   | 08/12/99      | 5,000.0            | 5,274,087,900   | 9.25   | 7.88 <sup>1</sup> |
| 6th issue              | 11/18/94   | 11/18/96      | 5,000.0            | 5,003,639,666   | 8.45   | 8.41 <sup>1</sup> |

<sup>1</sup> Tax free

### Short-term domestic government debt

As concerns the government cash management, the Czech National Bank act does not allow the state budget deficits to be financed by direct credits from the central bank. By this ruling, the law anticipated that government budget current deficits would be covered by securities with short maturities, better known as Treasury bills. These securities are issued in an amount that is always greater than the forecast deficit. The maximum amount outstanding of these securities is limited by budgetary regulations up to ceiling of 16 billion CZK. For current deficit financing (liquidity purposes), there were two T-bills issues in the beginning of the year, the volumes of which were 10 and 4 billion CZK respectively with 6.1 % and 6.43 % rate of return.

### Long-term foreign government debt

The foreign indebtedness of the Czech Government has been relatively stable during 1993 and 1994, primarily because most of the borrowing from international institutions and groups of countries took place in the time of former CSFR, as well as in CSOB operations. Tables 28 and 29 show the balance and the financing of foreign debt in 1993 and 1994.

**Table 28: Balance and Financing of Foreign Debt in 1993**

CZK in billions

| Debt                    | Balance of outstanding debt |           |            |       |       | 31 Dec |
|-------------------------|-----------------------------|-----------|------------|-------|-------|--------|
|                         | 1 Jan                       | Financing |            |       | net   |        |
|                         |                             | borrowing | repayments | adj   |       |        |
| I. TOTAL                | 158.8                       | 181.8     | 182.9      | - 0.5 | 1.6   | 157.2  |
| II. Funding             | 158.8                       | 174.8     | 175.9      | - 0.5 | -1.6  | 157.2  |
| Domestic                | 86.4                        | 174.8     | 171.1      | -     | 3.7   | 90.1   |
| Foreign                 | 72.4                        | 0.0       | 4.8        | - 0.5 | - 5.3 | 67.1   |
| III. Liquidity purchase | 0.0                         | 7.0       | 7.0        | -     | 0.0   | 0.0    |

Source: Ministry of Finance

**Table 29: Balance and Financing of Foreign Debt in 1994**

CZK in billions

| Debt                    | Balance of outstanding debt |           |            |       |       | 31 Dec |
|-------------------------|-----------------------------|-----------|------------|-------|-------|--------|
|                         | 1 Jan                       | Financing |            |       | net   |        |
|                         |                             | borrowing | repayments | adj   |       |        |
| I. TOTAL                | 71.1                        | 2.5       | 3.3        | 1.6   | 0.8   | 72.5   |
| "SAL" from WB           |                             |           |            |       |       |        |
| II. Funding             | 158.8                       | 174.8     | 175.9      | - 0.5 | - 1.6 | 157.2  |
| Domestic                | 86.4                        | 174.8     | 171.1      |       | 3.7   | 90.1   |
| Foreign                 | 72.4                        | 0.0       | 4.8        | - 0.5 | - 5.3 | 67.1   |
| III. Liquidity purchase | 0.0                         | 7.0       | 7.0        |       | 0.0   | 0.0    |

The loans from the WB, EU, and the G-24 were extended to support the balance of payments. Repayment will start in 1997 according to the loan agreements. An active debt policy was carried out by amortizing some of the convertible currency debt administrated by CSOB. By causing a reverse in currency appreciation, this negated the intended reduction of this debt. Hedging currency risk is one of the main tasks in managing the government debt.

### Costs of debt service

The costs of interest payments on the debt reached 13.7 billion CZK in 1993. No principle was repaid. Debt service, expressed as the proportion of outlays for servicing government debt to total revenues of state budget in 1993, was only 3.3 % and to GDP 1.5 %. Finally, the service fees for administrators of medium-term issues totalled 74 million CZK.

The interest payments for 1994 were 13.7 bn. CZK, e.g. 1.3 % of GDP. Again, no principle was repaid in this year.

### **III. Description of other structural, institutional and systemic changes**

#### **1. Privatization**

Privatization is the cornerstone of the Czech transition to market economy.

Prior to the market transition, the share of the private sector in the Czech economy was less than 4.2 % of GDP. Privately owned assets were only 2 % of the total amount of registered property.

To allow the private sector to develop rapidly, a variety of privatization techniques have had to be used. In addition, two restitution acts were passed, creating a legislative framework for the return of properties to original owners. More than 100,000 apartment buildings, office buildings, and commercial-retail properties were restituted.

Privatization consisted basically of two main schemes, the so-called small and large-scale privatization.

##### **1.1 Small-scale privatization**

The small-scale privatization, organized in 1991-1993, primarily concerned small economic entities (shops, restaurants, hotels, and small factories). Units were sold through public auctions. Within the small-scale privatization, 22,212 units were sold (15,225 in 1991, 6,132 in 1992, and 855 in 1993).

By December 1993, the sales of assets in the course of the small-scale privatization had produced revenues of CZK 31.772 billion CZK. Interest revenues, mainly from term deposits, came to 4,313 billion CZK.

By the end of 1993, the expenses from the small-scale privatization were as follows:

- 2.019 billion CZK to strengthen the budgets of local authorities;
- 1.385 billion CZK for other purposes, including operating expenses of running the small-scale privatization program.

By the end of 1993, the closing balance of the small-scale privatization account was 32.106 billion. Of these assets, 16 billion CZK is a term deposit in the Czech National Bank. The interest revenue from this deposit is used to subsidize the interest

rate of loans extended by commercial banks for the privatization of the health sector. The remaining amount is deposited in various short-term deposits in around 30 small commercial banks.

## 1.2 Large-scale privatization

Large-scale privatization includes a tremendous amount of assets formerly owned by the state. Their total nominal value has been estimated to be as high as 1,211.0 billion CZK.

In order to achieve the quick privatization of those assets, different privatization techniques, both standard and non-standard (the voucher scheme) were utilized. They are shown in table 30.

**Table 30: Privatization Techniques**

| Technique                                     | CZK in billions |  |
|---|-----------------|--|
|   | value of assets |  |
| Total   | 1,211           |  |
| voucher privatization                         | 300             |  |
| transferred free of charge <sup>1</sup>       | 543             |  |
| sales (direct, public tender, public auction) | 225             |  |
| permanent stakes of joint-stock companies     | 143             |  |

Note:

<sup>1</sup> Consists primarily of restitutions to former owners and of asset transfers to local authorities (mainly housing)

Source: National Property Fund

Revenue from large-scale privatization has been channeled into the National Property Fund. Use of this revenue is controlled under a special regulatory regime.

The most innovative element of the privatization was the so-called voucher privatization. It enabled participants (Czech citizens only) to bid for the shares with a booklet of coupons ("vouchers"). A network of high speed computers was put in place to simulate a securities market by adjusting the individual price of privatized firms throughout the five rounds of the voucher bidding in response to demand.

For technical reasons, voucher privatization was divided into two waves. The total number of privatized firms in the two waves reached was approximately 2,200 with a rough book value of 14 billion USD.

Voucher privatization included approximately 30 % of the total value of assets selected for privatization.

Foreign investment is an important component of the privatization program. Since 1990, the Czech Republic has received some 3 billion USD in foreign direct investment.

As result of the quick privatization, around 60 % of the 1994 GDP came from the private sector (40 % of the industrial output, 71 % of construction activities, 85 % of services and 90 % of agriculture).

In 1994, the second wave of voucher privatization was conducted with around 5 billion USD of assets. The first round of bidding concluded in late April and the whole procedure was finished in December.

## **2. Capital Market**

The Czech capital market has become an important phenomenon in our economy.

The Prague Stock Exchange opened in April 1993. Currently there are more than 1,000 different issues of negotiable securities with a face value exceeding 30 % of GDP. The yearly turnover on the main market is approximately 50 billion CZK. Parallel with this, there is important trading on a over-the-counter basis, which is estimated to add as much as another 400-500 billion CZK of turnover.

Apart from the Stock Exchange, the Czech capital market is also organized through the RM-System. In this OTC system, shares of joint-stock companies privatized in the voucher privatization are traded. The RM-System was designed to cope with the Czech Republic's wide distribution of share ownership. The system's main features are its simplicity of use, nationwide distribution of outlets, possibility for secondary trading, and cheap settlement fees.

The current situation concerning shares from the voucher privatization is as follows:

- around two thirds of investors decided to bid for shares in the two waves through investment funds;
- following the transfer of the acquired shares to individual investors, some two million of them have proceeded to sell these shares.

Those two factors lead to the conclusion that both during and after the voucher privatization, a sufficient concentration of capital has occurred.

### **3. Banking System**

The central bank of the Czech Republic is the Czech National Bank. The central bank is by law totally autonomous from the government. To run monetary policies, the central bank uses standard indirect instruments such as minimum reserve requirements, prudential rules, the discount rate, and refinancing auction credit on inter-bank money market.

The commercial banking industry consists at this stage of some 56 licensed commercial banks. In terms of ownership, the banks can be divided as follows:

- 26 completely Czech-owned banks comprising:
  - one state-owned bank (Konsolidacni banka);
  - four predominantly state-owned banks (the state holding up to a 40 % stake);
  - 21 completely privately-owned banks.
- 11 private, partially foreign-owned banks of which:
  - eight are universal commercial banks;
  - three are specialized banks (building societies).
- 19 private, entirely foreign-owned banks of which:
  - nine are branches of foreign banks.

Associations for banks, insurance, and other specialized institutions resemble similar institutions abroad. Most of the banks are universal commercial banks, performing a variety of services. Each of the larger banks has daughter companies in the investment and privatization funds and in leasing and consulting enterprises. Most of the banks have connections to the international banking industry.

#### **3.1 State assistance and recapitalization of banks**

The development of a market-based banking system has figured prominently in the transformation program of the former CSFR during 1990-1992 and subsequently in the Czech Republic. In particular, priority has been given to the establishment of a healthy commercial banking sector. The efforts to this end have not been limited to the introduction of more effective banking regulation and supervisory regime and the establishment of an efficient payments system. The main problem has been the weak structure of the balance sheets inherited by the banks at the onset of the reform process.

The commercial banks that were newly constituted with the introduction of the two-tier banking system in January 1990 (three commercial banks - Komerční Banka (KB), Všeobecná Uvěřovací Banka (VUB) and Investiční Banka (IB) - had inherited loans issued by the monobank prior to 1990 as well as the other savings banks (Czech Savings Bank (CS), Slovak Savings Bank, and specialized banks ((Ceskoslovenská Obchodní Banka (CSOB), Živnostenská Banka (ZB)). These banks that functioned under central planning were severely undercapitalized and their loan portfolios were of poor quality.

In regards to capital asset ratios, the three banks which took over the commercial banking functions of the State Bank of Czechoslovakia in 1990 had only a 1.0 - 1.5 % capital asset ratio. In addition, the capital asset ratios of the two savings banks are believed to have been below 1 %.

Under the system of central planning, financial resources were administratively allocated, frequently at highly concessional terms, and financially weak enterprises were generally allowed to service outstanding loans through additional borrowing. Thus, the inherited loan portfolio had little relation to real assets or to the future profitability of enterprises.

The portfolio quality deteriorated further following the introduction of reforms and the elimination of trading arrangements under the CMEA. The resulting sharp decline in output and enterprise profitability seriously impaired the ability of enterprises to service their debt. In such an environment, efficient financial intermediation is hampered. Not only does this tend to undermine the credibility of the payments system, it also results in the tendency of additional bank lending to become captive to existing loss-making clients instead of being decided on the basis of commercial criteria.

It is difficult to give a precise estimate of non-performing loans in the former CSFR on the eve of the transformation program. The standards for the classification of loan portfolios only began to be implemented around the middle of 1992. Banks previously did not have any system for rating the riskiness of loans, though they did keep a record of payments which were overdue and could not be serviced due to lack of funds in the enterprises' accounts.

The total volume of credits in Czechoslovakia in the first quarter 1991 (in that time the problem of bad loans began to be solved) was approximately 700 billion CSK. Credits to enterprises and cooperatives were about 570 billion CSK. The largest part of the later group of poor credits were the "permanently revolving credits for inventories" which totaled 169 billion CSK. These were initially extended at below market terms. For example, the monobank would grant credits without a fixed term of maturity to enterprises, after having siphoned off their initial surplus to the state budget. This included the following relatively large group of credits:

- uncollectable receivables abroad (dubious export loans to LDC) - 27 billion CSK;
- credits for so-called integration actions in the USSR - 12 billion CSK;
- credits on nuclear power plants - 12 billion CSK;

### *III. Description of other structural...*

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- housing loans (including credits to households and cooperatives - 30 billion CSK; and
- social loans - 30 billion CSK.
- An additional 120 billion CSK of credits (investment and commercial loans) were estimated to be essentially like bad loans.

As a result of applying commercial banking criteria, these non-performing loans were then estimated to be about 400 billion CSK or 60 % of total credits. Our estimate is close to the Working Paper of Czechoslovakia Central Bank estimate of 66 %. The highest estimates by some officials in the central bank on the eve of reforms was that about 75% of total outstanding credits were of questionable value. On the other hand, there were "soft" estimates of 29% from the World Bank CSFR (Financial Sector Review, 31 March 1991).

Efforts at improving the banking system have focused on strengthening the balance sheets of commercial banks - specifically those who inherited loans issued by the monobank prior to 1990 which were thought to be largely non-performing. It is necessary to say that at the beginning of 1990, seven "old" commercial banks were owned by the state. The authorities' strategy has focused on assistance in capitalizing the banks, establishing the means for transferring debts out of individual banks, exchanging poor quality debts for official assets, and on encouraging banks to create loan loss provisions.

There were two ways to finance these activities:

1. receipts from the National Property Fund (NPF);
2. State Budget (including increasing the state debt).

It is necessary to stress that the problem of "bad loans" has two separate origins:

1. the "old bad loans" came from the central planning period when there were unclear distinctions between fiscal and monetary policies. Many of these so-called debts were de facto grants, quasi-grants, or compensations;
2. the "new bad loans" which are connected with the transformation period such as debts resulting from the collapse of CMEA on one hand and the "pioneer" loans to private firms on the other.

Government measures implemented in authorities in the CSFR adopted a combination of both standard and nonstandard approaches to strengthen the balance sheet of banks. It was a step-by step strategy, utilizing both centralized (global) and decentralized (individual) measures. The main "global" steps were made in 1991. The authorities later used some "individual" steps.

### **3.2 Debt transfers**

The first massive step was the creation of the Consolidation Bank (Konsolidacni banka - KOB) in March 1991. This bank was established by the Federal Ministry of Finance to serve as a holding institution for the administration of bad debts (this bank was split into two separate banks - one in each republic in 1992). This operation took over 110 billion CSK (about 26 billion CSK in credits to Slovak subjects) out of the 169 billion CSK of the permanently revolving inventories (the TOZ credits) of the books of two commercial banks - KB and VUB. On the liability side, the KOB took over matching amounts of the commercial banks' liabilities to the central bank (the redistribution credits) and the deposits made by the savings banks.

The TOZ credits, originally extended at 6 % interest and with no maturity date, were officially abolished at the beginning of 1991, but problems arose when banks and enterprises attempted to negotiate the maturity and interest rate on replacement loans. The enterprises wanted a longer-term maturity than which the banks were reluctant to accept. The TOZ debts transferred to the Consolidation Bank continued to be at an interest rate of 13 %. This corresponded to the average cost of funds, but was lower than the market rate. There was no reduction of the enterprises' initiative to service these debts as the Consolidation Bank had the mandate to initiate bankruptcy or take other measures in the event of nonpayment. No cancellation of TOZ debts from the books of enterprises occurred.

For the commercial banks involved, the beneficial impact was threefold: it reduced the share of long-term credits in their portfolio at a time of considerable uncertainty; with assets reduced by about one fourth, their capital assets ratio increased; and it reduced their dependence on the resources of the savings banks.

At the end of 1992, the Federal Government assumed direct responsibility for specific state-related assets and liabilities which were denominated in both convertible and non-convertible currencies, held by CSOB (bank for foreign trade). The liabilities were primarily a part of government's external debt in convertible currencies. The assets were in nonconvertible currencies, reflecting the receivables from members of the former CMEA and some developing countries with whom the government had barter or clearing arrangements. As the assumed assets exceeded the assumed liabilities by 21 billion CSK, the government covered this amount through a claim against it by the CSOB. There was a net liability in convertible currencies equivalent to 56 billion CSK, while net assets in nonconvertible currencies were about 77 billion CSK. As a result of these transactions, the CSOB was relieved of all credit, currency, or liquidity risks in respect to the specified assets and liabilities.

The second massive step was the "action writing off and recapitalization of banks" performed simultaneously in late 1991 and at the beginning of 1992. This was achieved through the three National Property Funds (Federal - 5 billion, Czech - 30 billion, and Slovak - 15 billion) issued bonds totaling 50 billion CSK.

### **3.3 Debt exchange**

In late 1991, commercial banks received 38 billion CSK in bonds from the National Property Funds (these bonds were subsequently fully paid off in cash by the NPF) in exchange for the banks writing off an equivalent amount of claims on enterprises with large debts, but good economic potential (the written-off loans were incurred prior to 1990 and the selected enterprises were included in the first privatization wave). Czech banks received from the Czech National Property Fund for these purposes 22.2 billion CSK (KB - 15.04 billion CSK, IB - 2.65 CSK, CSOB 2.2 billion CSK, and KOB - 2.31 CSK).

Another individual payment of 1.9 billion CSK was made for a similar purpose from the NPF to Consolidation Bank in 1993 (payment in the place of Skoda Plzeň).

In late 1992, the Consolidation Bank engaged in a second round of debt operations in which it purchased from commercial banks non-performing loans with a face value of 15 billion CSK at a discount of 20 % (i.e. 12 billion CSK). The majority of these loans had been provided on a non-commercial basis and were allocated to the commercial banks when the two-tier banking system was established. Since commercial banks had made partial provisions for losses against these loans, the operation resulted in an improvement in their capital base. The loans bought by the KOB were not written off from the books of enterprises.

An additional type of the authorities' involvement in the issue of commercial bank loans to enterprises were the state guarantees. At the end of 1992, the Czech and Slovak Ministries of Finance took over loans which they had previously guaranteed, amounting to 13.3 billion CSK from the IB. The bulk of this debt represented receivables initially guaranteed by the government as part of government-sponsored construction projects in former CMEA partner countries.

An additional 20 billion CZK of non-performing foreign trade loans held by CSOB were taken over by a special facility at the Czech Ministry of Finance at the end of 1993. Two special collection entities (Czech and Slovak) were established at the same time. In both cases, the non-performing loans were replaced by new claims on the government.

In May 1994 the Czech Government decided to provide 7 billion CZK of NPF resources to Agrobanka, KB, and KOB to write off the bad loans of state farms which were being restituted to former owners free of liabilities.

### **3.4 Recapitalization**

The authorities provided 12 billion CSK of capital infusion to the major commercial banks in late 1991 through the issuance of National Property Fund Bonds

(the bonds carry no interest and are to be repaid by being exchanged for shares in privatized companies within 5 years). The share of the Czech banks in this was 7.8 billion CSK; KB - 0.6 billion CSK, IB - 2.3 billion CSK, CSOB - 1.1 billion CSK, and CS - 3.8 billion CSK. The result of this first "global" recapitalization was a moderate improvement of the capital ratios.

The Czech National Property Fund spent another 4 billion CSK (in bonds) for recapitalization purpose in 1993 - 3 billion CSK for KOB and 1 billion CSK for CSOB. An additional 2 billion CSK was spent by the Czech Ministry of Finance and the Czech National Bank for the recapitalization of CSOB in 1993.

There was also another kind of recapitalization of the banks. In 1992, the Czech NPF issued 23 billion of bonds to two commercial banks (KB and IB) as subordinated debt which served to increase their supplementary capital base. These bonds were issued as guarantees for the repayment of loans made by the banks to enterprises privatized in the first round of large-scale privatization. However, since bankruptcies did not take place as had been anticipated, the bonds were repaid in 1993. The NPF also transferred a further 15.8 billion CSK in early 1994 and 15.0 billion CSK in the end of 1994 to strengthen the general reserves of the Consolidation Bank.

## **6.5 Other operations**

There are two special components of the state involvement in the case of the "old debts".

First, there is the "property detriment". The state has covered so-called property detriment to banking institutions, which they incurred before 1989 from the granting of long-term credits with low interest rates (this includes credits for individual house and cooperative housing construction). The reimbursement of the property detriment (a subsidy of the difference between the present discount rate and interest rates they had to charge in the past) to the CS and IB was originally paid by the State Budget. Since 1993, it has been paid by the NPF, 2 billion CZK in 1993 and 2.6 billion in 1994.

Secondly, there has been the realization of state guarantees from the State Budget or NPF. For example, in 1992 NPF paid a credit of 0.9 billion CSK instead of Skoda Mlada Boleslav; this was for a loan credit guaranteed by the government. It is necessary to say that the government has been relatively cautious in granting guarantees because a ceiling on the volume of these guarantees has been set by parliament and the government is under the impression that banks were only willing to bear small risks.

## **Privatization of banks**

Since the beginning of banking reforms, the government and the banking sector have been relatively independent despite the fact that all the large commercial banks continued to be state enterprises until their privatization at the end of 1992.

The government has lost the power to decide which or how much credit a certain bank or banks should give to their clients and - of course - the responsibility for the banks financial situation. Government influence has been primarily reduced to personal contacts and lobbying, plus the influence gained from its significant ownership share in the larger traditional banks. The government holds 40 % of the equity in the Ceska Sporitelna, Komerčni Banka, and Investični Banka; CSOB shareholders include both the central banks of the Czech and Slovak Republics. Only Zivnostenska Banka was fully privatized through a combination of the voucher method and direct sales of shares to foreign institutions.

According to international accounting standards, banks should create provisions for loss category loans and must reach the standard capital adequacy requirements.

## **4. Convertibility**

The Czech crown is partially convertible. The convertibility applies to:

- roughly all current account operations (with some exceptions as unrequited transfers of individuals abroad) and most capital operations are unrestricted.
- the capital account, as follows:
  - inflow of both direct and portfolio investment from abroad is unrestricted;
  - outflow of direct investment is practically unrestricted (there is a formal licensing procedure from the central bank;
  - outflow of portfolio investment is prohibited;
  - real estate purchases by nonresidents in the Czech Republic is restricted.

## **5. Main Vehicles of Microeconomic Restructuring**

The following chapter provides a list of measures that were taken directly to promote the consolidation of the corporate sector on the micro-level. There are also

measures which were rather indirect, but which had a microeconomic motivation (among other reasons) to the decision to implement them.

Indirect measures included:

- exchange rate policies, accompanied in the first phase by the import surcharge;
- limited price and wage controls, aimed at preserving the comparative advantages of the Czech economy.

Direct measures included:

- transferring 80 % of the credits extended in the old system to finance the "permanently revolving stocks" from commercial banks to the newly established Konsolidacni Banka in 1991 (85 billion CSK);
- recapitalization of banks and the write off of a part of corporate liabilities in late 1991, financed by privatization receipts (30 billion CSK);
- repurchase of classified claims by the Consolidation Bank from large commercial banks in 1992 and 1993 (40 billion CSK);
- cleaning the balance-sheet of the CSOB (Ceskoslovenska Obchodni Banka) by the transfer of its dubious claims abroad (generated in the old system) to a special settlement unit, taken charge of by the government (40 billion CSK);
- sovereign guarantees, issued by the government and the National Property Fund (approximately 30 billion CSK).

## **6. Reform of the Social Schemes**

The transformation of the social security system is one of the last major steps to be undertaken during the Czech economic reforms.

Prior to the changes in 1990, the social security system in Czechoslovakia mirrored the dominate political doctrine of social egalitarianism. This was demonstrated by an all-encompassing paternalistic state and by the separation of social security from its economic base. In addition, the development of the social security system was marked by the mechanical creation and growth of direct and indirect social transfers to households. In fact, the social security system developed without respect to other economic aggregates. The qualitative aspects of transfers were eliminated and social benefits were gradually replaced by flat income supplements to the population. Due to these developments, wage equalization was established and citizens grew increasingly dependent on the social security system.

The basic goal of reforming the social security system was derived through an analysis of the initial economic situation as part of the wide-ranging economic transformation. The goal is to renew the balance between economic efficiency and

social security on the basis of market economy principles and to incorporate democratic elements into the relationship between the citizen and the state.

The reform of the social security system includes three social institutions or sub-systems, that give benefits and services to meet the needs of citizens as agreed upon by society. These sub-systems include social insurance, the state social support system, and social aid. Included in the new social security system is both a higher level of individual responsibility and social cohesion resulting from the state's participation in the established systems.

The noted changes require the reform of social security financing. In the first place, this is connected with the establishment of transparent financial flows in the system, so that the rates for contributing to social insurance may be tied to the tax system. In 1993, in addition to the new income taxes, obligatory payroll contributions into the social security system were introduced. In this way, the revenue side of the system's financing has been reformed. The present transition to a three pillar system includes steps to reform the expenditure side.

The long-term goal of the state financial policy in the social security sphere is a stabilization of expenditures where the revenue is derived from sources other than payroll contributions. Only in this way will it be possible to create a barrier against higher taxes or an increase in the budget deficit.

## **6.1 Health Insurance**

The priority in the reform of health care financing, the simultaneous reform of the revenue and expenditure sides, was determined by the need to start the transformation of this branch of the public sector. This began by transforming the financing of direct health services and medicaments into a function of social insurance. Since January 1993, a mandatory Health Insurance Fund for residents in Czech Republic has been in operation. The Fund is run by the General Health Insurance Company (with its policy holders representing about 60 % of the population) and a number of competing open insurance companies. All health insurance companies providing the mandatory insurance are regulated according to special legislation.

The premium is paid from wage incomes and some other kinds of taxable incomes (from 1994, the premium calculations will also include rentals). The state pays the insurance premium on behalf of some groups of people listed in the law (for example, women on maternity leave). The rate of health insurance is uniform at 13.5% (4.5 % for employees and 9 % for employers) of the contribution base.

Table 31: Health Insurance Contributors

| Policy-holder   | Payer                         | Contribution base                                 |                               | Accounting period <sup>1</sup> |
|---|-------------------------------|---|-------------------------------|--------------------------------|
|   |                               | Minimum   | Maximum                       |                                |
| employee <sup>2</sup>   | employee                      |   | total incomes                 | month                          |
|   | employer                      |   | minimum wage                  | x                              |
| self-employed   | self-employed                 | 12-multiple of the minimum wage                   | 35% of incomes<br>486,000 CZK | year                           |
| person with other income <sup>3</sup>                                   | person with taxable income    | 35% of income,<br>12-multiple of the minimum wage | 486,000 CZK                   | year                           |
| person without taxable income   | person without taxable income | minimum wage x                                    | x                             | month                          |
| children, youth in training, recipients of social benefits <sup>4</sup> | state                         | 65% of the minimum wage<br>x                      | x                             | month                          |

Notes:

<sup>1</sup> Month or year.

<sup>2</sup> The contribution base of employees with a severe health handicap is always actual received income. The contribution base of employees for whom the state pays is a sum exceeding 77 % of minimum wage.

<sup>3</sup> Persons with incomes from capital property, rents, and other taxed incomes, (irregular incomes from employment or business).

<sup>4</sup> This category also includes old-age pensioners, persons on maternity leaves, unemployed, persons on obligatory military service, and other.

The calculation is based on the annual tax return with advanced payments. All participants - employers, employees, self-employed - pay the premium into the account of the health company where they are registered. In the case of persons for whom the state pays premium, the Ministry of Finance turns payments over into the special pool account which is administered by the General Health Company. The state covers the health insurance for about 5.8 million people who can be registered with various health companies. These collected means are distributed from this account in accordance with the number of registered persons multiplied by the coefficient reflecting the policy-holders' age structure. This coefficient is given in a special regulation.

Health insurance companies are obligated to create basic, reserve, and other funds (e.g. a fund for supplementary insurance). The revenues of insurance companies are supplemented by revenue from the company's own business, and other revenues (penalties, payments of employers for the preventive or special care of employees, etc.). Expenditures include payments for health services and medicines prescribed or

### *III. Description of other structural...*

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provided by health institutions to registered policyholders on the basis of agreements between institutions and insurance companies, payments for necessary health services given elsewhere, and adjustments to other companies.

In the basic fund of companies, contributions are concentrated for the financing of health care. The companies reserve funds were established to cover deficits in the basic fund. The companies are obliged to file separately for the fund means and their use.

The representatives of policyholders, their employers, and the state participate in companies' boards of directors. The companies are obliged to submit their insurance plans as well as their closing balances to the Parliament at the same time as the State Budget or State Final Account respectively.