V. ENTERPRISE SECTOR

V.1 Privatization and Restructuring

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

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

Privatization activities were resumed at the beginning of 2000. Most importantly, all large banks were sold to foreign investors (Česká spořitelna to the Austrian Erste Bank Sparkassen, Komerční banka to Societé Generale, and ČSOB to Kredietbank of Belgium). IPB, the bank privatized in 1998 to the Japanese Nomura, ran into serious financial troubles. Given that it was dealing with the second largest amount of payments in the economy, the Czech National Bank imposed administration on the bank and quickly arranged a sale of the IPB business to ČSOB. Both sides (Nomura and the Czech Republic) are now suing each other for the costs of the incident. Recently, a London arbitrage court ruled that the case should be examined within the Czech judicial system.

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

Recent privatization attempts were generally failures. Privatizations of ČEZ (the main electricity generator with a controlling stake in many regional distributors) and of Czech Telecom (the near-monopolistic provider of fixed-line telecommunications) have been under preparation for years but completion is not in sight. In the case of ČEZ, none of the serious buyers (Enel of Italy and Electricité de France) were willing to meet the government's asking price of 200 billion CZK. Unipetrol, a large chemical conglomerate, was not sold to the highest bidder (British Roche) but to the second highest bid of 11.75 billion CZK by domestic Agrofert, which eventually refused to pay the agreed price and returned the company to the government, after having control of the firm for an extended period of time. The only successful privatization was the sale of Transgas, the gas distribution company, to German RWE in 2002.

Privatization Helps, but it is not a Simple Panacea

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

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

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

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

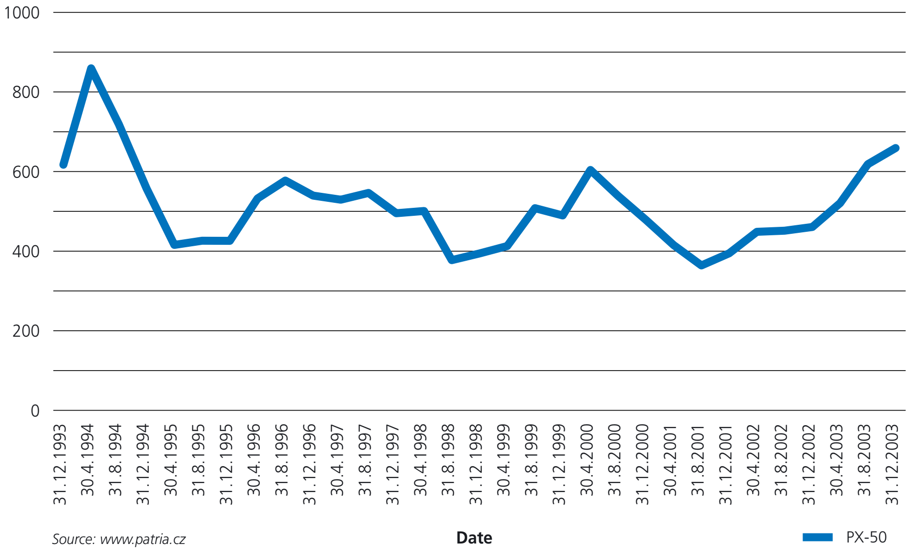
Results were also complex. On one hand, concentrated and private ownership was correlated with better economic performance, but only if the owners were foreign. On the other hand, domestic private ownership in many respects did not significantly improved performance over state ownership. Foreign firms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

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

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

V.2 Czech Capital Markets

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



Source: www.patria.cz

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

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

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

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

First and foremost, the stock exchange has to attract firms to raise capital on the stock market. Czech firms rely almost exclusively on bank credit, partly because of their historically close links to the banks, which often became active shareholders and influenced decision-making in the enterprises. The only attempt by a local company to raise equity via a domestic IPO failed in the first half of 2001 due to low investor interest. In September 2003 the PSE turned to the government for help and plead it to use the exchange as an intermediary in future privatizations and bond issues.

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

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

New trading system on the Prague Stock Exchange

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

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

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

Trading Volume on Czech Capital Markets (CZK billion)

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

** New Methodology on PSE*
+ Jan–Nov 2003 ^ Jan–Sep 2003

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

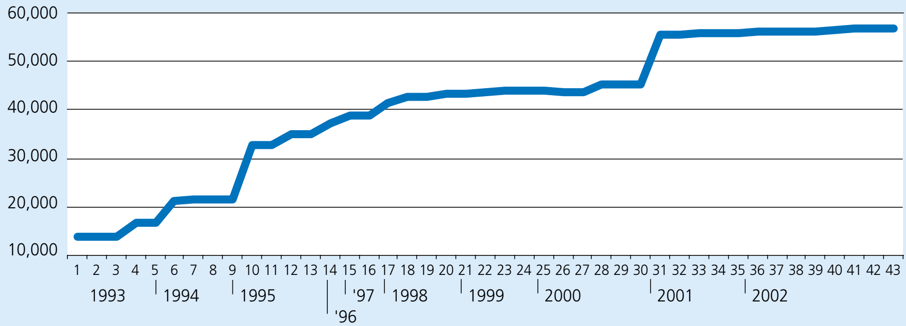
However, there has been a recent outflow of central market trades back to block and direct trades (see table). The limited use of the price-setting centralized market remains a serious problem of the Prague Stock Exchange.

V.3 Taxes

A modern tax system came into force in January 1993 and for most of the citizenry, as well as for the public administration, it was completely novel. The major features of the new tax system were the introduction of value-added tax and a new individual and corporation income tax. Perhaps not surprisingly, regulatory institutions and enforcement procedures developed gradually and the tax laws were amended many times. In line with the evolution of business and public administration, tax evasion by citizens became widespread. Given the ability of small businesses and self-employed to avoid taxation, the state relies heavily on payroll taxation of salaried employees.

Income Tax Law

Number of Words in the Czech Income Tax Law

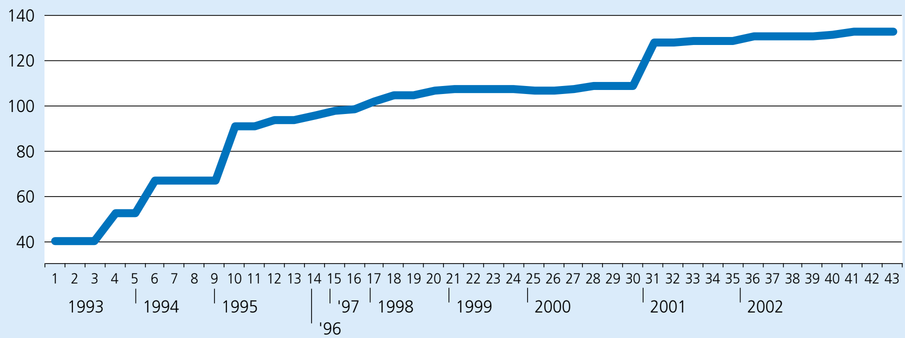


Number of Novels since the Income Tax Law First Came into Force in 1993

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

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

Number of Phrases "with exception of" in the Czech Income Tax Law



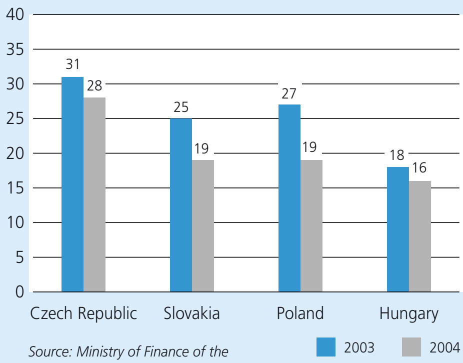
Number of Novels since the Income Tax Law First Came into Force in 1993

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

Taxes across the Accession Countries

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

Changes in corporate income tax rate (in %)



Source: Ministry of Finance of the respective countries

Tax changes in the Czech Republic were quite modest in comparison to other accession countries. Corporate tax will decline from the current rate of 31% to 28% in 2004 and will further drop to 24% by 2006. On the other hand, Hungary cut corporate tax to 16% and Poland to 19%. The Slovak government even introduced a 19% flat tax on both corporate and personal income. In Latvia and Lithuania, corporate tax rate is 15 percent. In Estonia the effective rate on distributed profits is 26% and retained earnings are not even subject to taxation.

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

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

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

Individual income tax and value added tax in Central European countries

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

Source: Ministry of Finance of the respective countries

* Changes under proposal

V.4 Business Environment

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

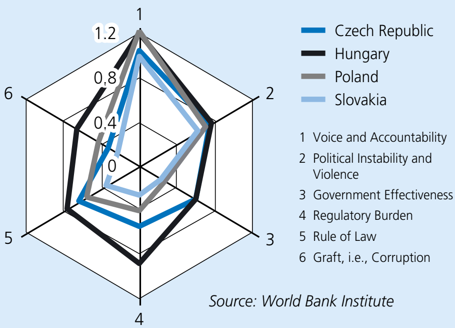
These findings reinforce the criticism stated by the European Commission in its last *Regular Report on Czech Republic's Progress towards Accession* from October 2002. According to the Report, "further efforts are needed to improve the overall business environment, in particular through the more efficient operation of the company register and more effective enforcement of judgments by the commercial judiciary." The Commission further criticized "unsatisfactory bankruptcy legislation which has not been changed since May 2000." Unfortunately, since the time of this criticism the bankruptcy legislation has not changed, the company register does not operate more efficiently, and the judicial reform has not proceeded.

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

Problems of the Czech Business Environment

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

Aggregate Governance Indicators 2002

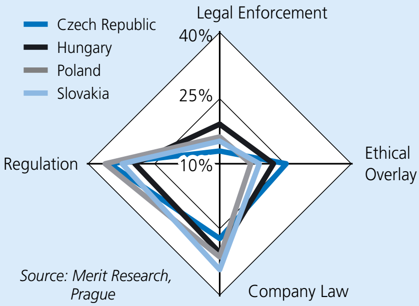


Source: World Bank Institute

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

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

Corporate Governance Risk 2000–2002

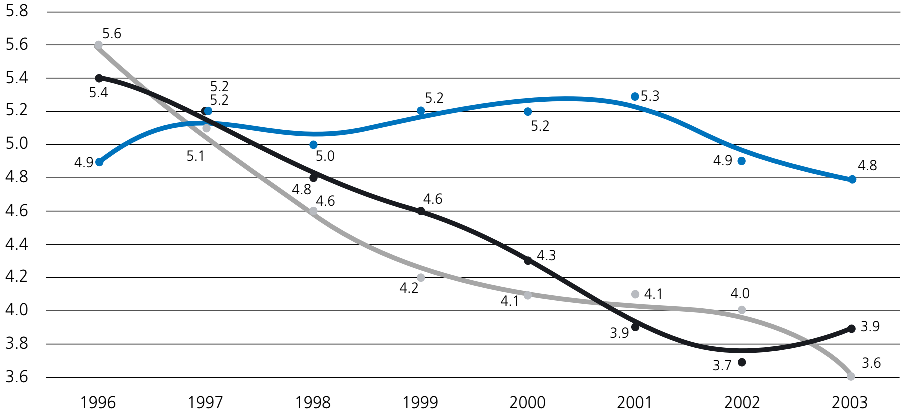


Source: Merit Research, Prague

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

V.5 Corruption

Corruption Perception Index



Source: Transparency International

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

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

While measures like the corruption perception index ought to be taken with a grain of salt since poor numbers may reflect increasing awareness and better monitoring mechanisms, other pieces of evidence suggest that the reality of corruption in the Czech Republic has not got any better. A survey by the Czech Chamber of Commerce showed that firms generally believe that corruption among government officials is on the rise and the work of courts is worsening. Over 50 percent of the respondents found the work of the courts wanting, especially regarding creditor rights. (Interestingly, the survey found that large foreign companies perceive corruption much more favorably than small Czech firms). In July 2003, audits of Prague City Hall contracts found that almost all reviewed contracts were wanting, with the costs of some of the more gregarious "mistakes" adding up to hundreds of millions CZK. Another corruption scandal featured the judge presiding over the bankruptcy of Union Banka, who faced allegations of basing his verdict on falsified documents and is currently under arrest. In April, the Lower House dismissed the Broadcast Council (which regulates Czech media); in part because of allegations that at least some members had been bribed at various junctures.

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

V.6 Nonprofit Sector

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

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

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

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