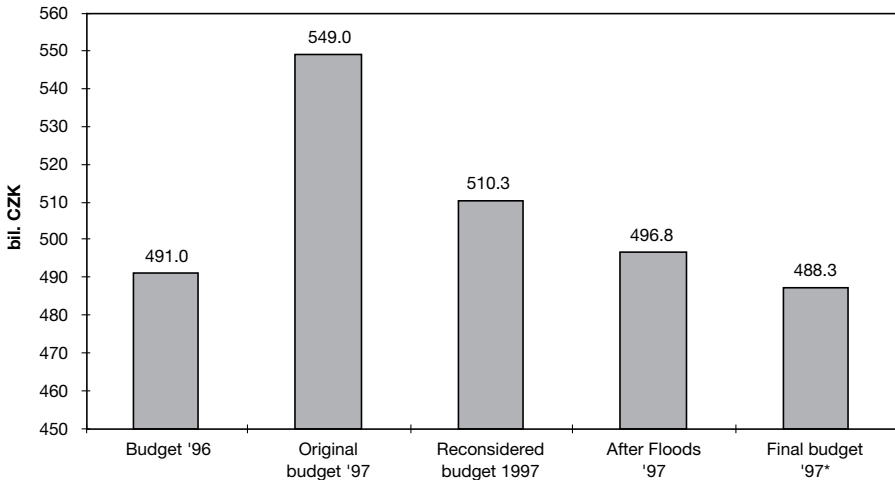


VI. PUBLIC ECONOMY

VI.1 State Budget

State Budget - Plans and Reality



* Governmental prediction in December 1997
Source: Parliamentary report, MF CR

Although the revenues of the 1997 state budget approved at the end of 1996 were in the same time considered as underestimated, there were some indications, at the beginning of 1997, that the tax revenues and the mandatory social insurance contributions will be smaller than previously expected. The substantial decline in economic growth at the beginning of 1997 and the political and economic crisis during spring 1997 led the government to reconsider its previous expenditures and attempt to re-balance the budget. State revenues and expenditures were reconsidered twice, once in April and again in June 1997. In addition, disastrous

floods in July brought unexpected budgetary expenditures and have also had further impact on the amount of state budget revenues.

Balance of Public Budgets (estimates)

Public Budgets, bil.CZK	1997	1998
State Budget	-9.1	0.0
Municipal budgets	-6.0	-8.3
State Financial Assets	-9.4	-4.0
State Funds	0.0	0.0
National Property Fund	6.0	0.0
Allotment Fund	-1.0	-1.5
Health Insurance Companies	-1.0	0.0
Total deficit	-20.5	-13.8

Source: Budgetary Committee of the Lower House of the Parliament

Flooding in the Czech Republic

Even though a slow-down in economic growth and currency devaluation was expected by certain independent experts at the beginning of 1997, the overall economic growth was influenced by disastrous floods in the Czech Republic. The official estimates of the flood damage are about 60 bil. CZK (USD 1.8 bil.). This damage did not directly affect economic growth; however, the economic losses due to disrupted production and the slight shift in household and firm demand towards different commodities in the flooded areas temporarily reduced growth, mainly in the third quarter and also partly in the fourth quarter of 1997.

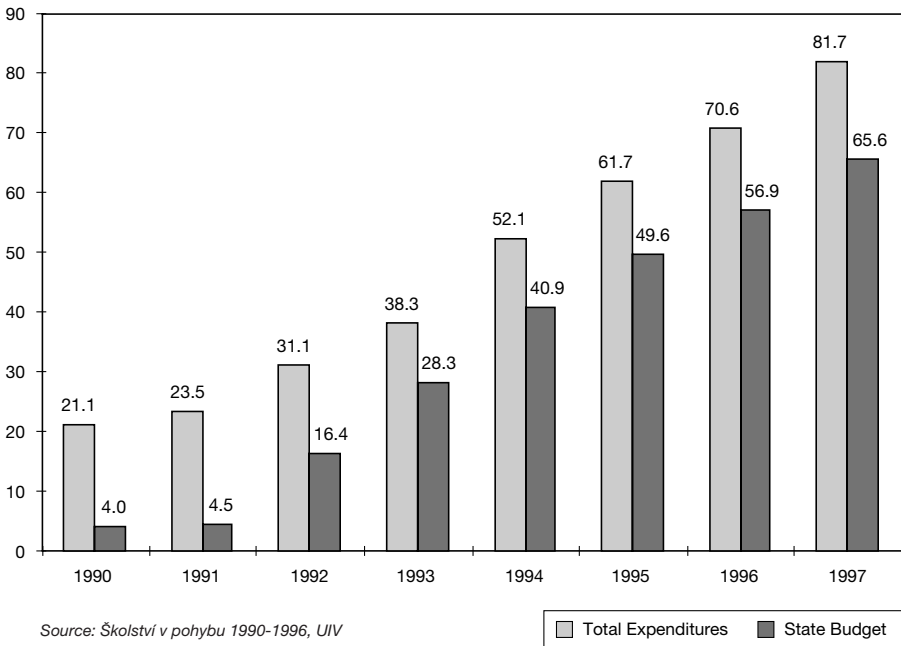
Well organized producers like Škoda, Automobilová a.s., or Barum Continental Otrokovice (which was almost washed away) are expected to cover their losses caused by flooding by the end of the year. Smaller but profitable enterprises might be harmed a little bit more, but their viability is not directly endangered by the consequences of the floods. However, firms which were in trouble before the floods were not able to survive the disaster. Enterprises which were not located in the area of havoc might even profit from the disruption of their competitors' supply if their competitors are located in the flooded areas of Moravia and North-East Bohemia.

Since properties were heavily damaged in certain areas, there has been unambiguous growth in demand within the construction industry which seems to have replaced the previous construction stagnation. The central government has severely reduced its spending because of the dramatic reduction of governmental revenues even prior to the floods (so-called Package 1 and Package 2 amounted to about a 40 bil. CZK cut) and has been able to reduce the growing deficit from 14 bil. CZK in May of 1997 to 2 bil. CZK in November. However, after the floods the government decided to issue "Flood Bonds" with a total value of 5 bil. CZK. Regardless of the severe situation after the floods, this action actually represents a change in the government's policy in terms of a balanced budget.

The five-year maturity "Flood Bonds" are an excellent risk-free opportunity for small investors since their yield floats with inflation plus an extra 2% to cover taxes on bond revenues. The first two materialized tranches of 1 bil. CZK each intended for small investors and the general public were sold almost immediately since their real net revenue is zero and thus better than most commercial savings interest rates. The bonds were designed as suitable for framing and the governmental campaign regarding the bonds was carried out in an American-like patriotic style. However, the tradability of these bonds is almost zero because of the well known problems of the Prague Stock Exchange. Also, the third immaterialized tranche of 3 bil. CZK for large investors seems not to be selling, since large investors are able to make more than inflation through their other investment actions and the "Flood Bonds" thus represent a net loss for them.

VI.2 Public Expenditures on Schooling

Expenditures on Schooling, bil. CZK



Since 1990 the educational system in the Czech Republic has undergone many changes. Although during the first four years of the transformation, there was a decline in the gross domestic product, the expenditures on schooling increased substantially by almost 26% in real terms during 1990-1995. The share of expenditures out of GDP have remained at 6% for the last three years, which is a level comparable to the OECD average of 6.1%. The growth of expenditures was followed by substantial structural changes. The flow of expenditures for expanding secondary schooling grew 2.3 times in real terms while

the funds flowing to rigid state universities only followed the inflation rate.

Share of Expenditures on Schooling out of GDP (1994)

Austria	5.4
Czech Republic ¹⁾	6.2
Finland (EU max)	7.3
France	6.1
Germany	5.9
Hungary	6.6
Italy (EU min)	5.1

1) In 1996.

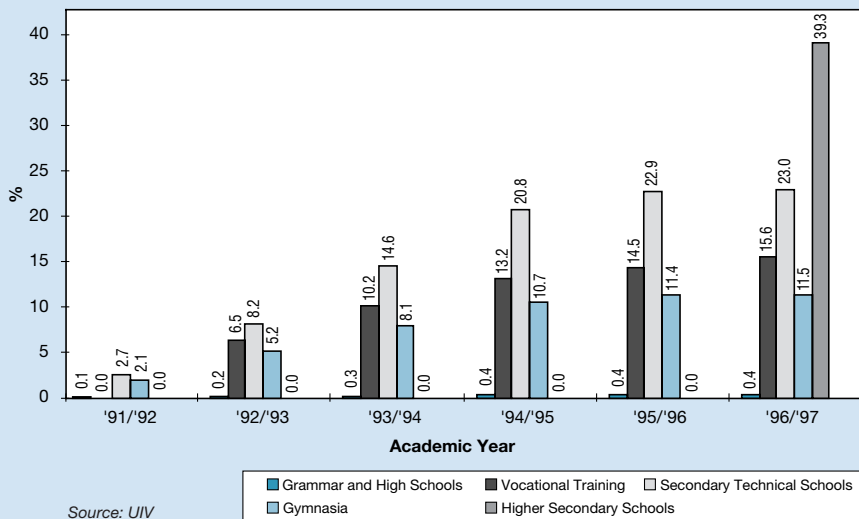
Source: Education at a Glance, OECD Indicators, OECD 1996, Paris

Birth of Private Schooling

In 1990 the secondary schooling system entered an major transition period. New types of schools were established, and the number of non-state secondary schools mushroomed with the support of state funds. A new funding scheme was introduced in 1992, allocating funds mainly according to the number of students. The scheme was quite close to the scheme of schooling vouchers. Although there are problems with the uncertain legal framework, limited information availability, and the lack of credibility of private schools, newly established private schools increased the supply of much-in-demand secondary education and encouraged competition between private and public schools.

The current period has been characterized by the settling down of the legal environment and of a gain in experience and credibility on the part of private schools. The greatest rigidities prevail at the university level. Strong interest groups on the side of state university management and political discontent have prevented the existence of non-state universities and the introduction of tuition for universities. The new law, repeatedly reconsidered since 1995, was finally approved by the government in fall 1997 but it is uncertain whether it will be discussed by the Parliament after the government resigned in November 1997. The new law is expected to allow for the existence of non-state universities and tuition.

Share of Students in Non-state Schools

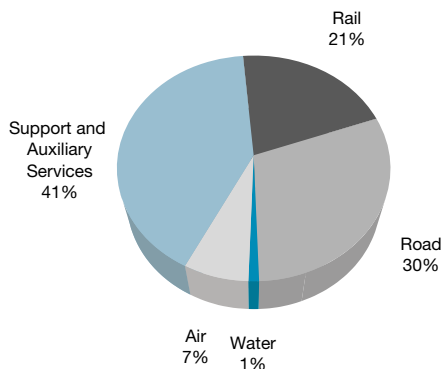


VI.3 Public Expenditures on Transport

The total length of railroad track is more than 9,400 km while the total length of roads and highways approached 56,000 km in 1996. The total combined length of both track and roads has been stable during the transition period. However, the length of highways is rapidly increasing as the demand for public and private transportation increases. For example, the number of passenger cars is steadily increasing, and in spite of improvements in the highway network, traffic intensity is rising dramatically.

In 1996, the average number of inhabitants per one passenger car was 3.1, compared to 4.5, 4.8 and 5.1 in Hungary, Poland and Slovakia, respectively.

Transport Revenues 1996



Source: CSO

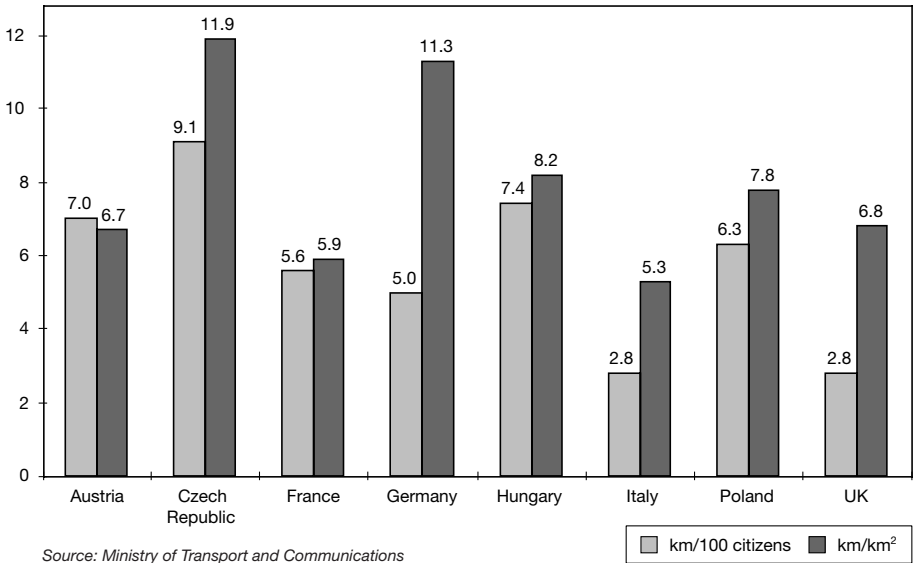
Road Infrastructure Investment Financed by the State, in thousands of CZK

Project	1996	1997
Road Maintenance	400,000	440,000
Construction of Free-ways	1,757,765	1,565,755
Improvement of Internatl. Roads (E-Roads)	23,700	70,300
Construction of State Roads	2,189,938	3,233,302
Construction of Municipal Roads	1,029,297	1,512,643
D5 Praha-Rozvadov	3,013,562	2,923,663
D8 Praha-Ústí n.L.-border	783,983	927,346
R35 Hradec Králové-Lipník n.B.	592,870	823,214
D47 Vyškov-Ostrava-border	81,000	147,490
D11 Praha-Hradec K.-border	36,200	203,464
D3 Praha-Tábor-České Budějovice-border	27,500	76,100
Prague Ring Road	32,400	475,410
D1 Prague-Brno-border Upgrade	305,658	355,214
Maintenance of Existing Highways	506,827	676,809
Total	10,780,700	13,430,710

Note: D or R means highway

Source: State Budget Proposal 1996, The Parliament

Density of Railway Networks in Europe



The Czech railways are a state monopoly operating on a very dense but obsolete network. The management control remains highly centralized and inefficient. The trade union is quite powerful and opposes restructuring. The lack of improvements in the quality of services, the expansion of alternative road traffic for both cargo and public transport, and fare increases which have not kept pace with inflation have led to continuous economic losses. The railways employ almost 2%

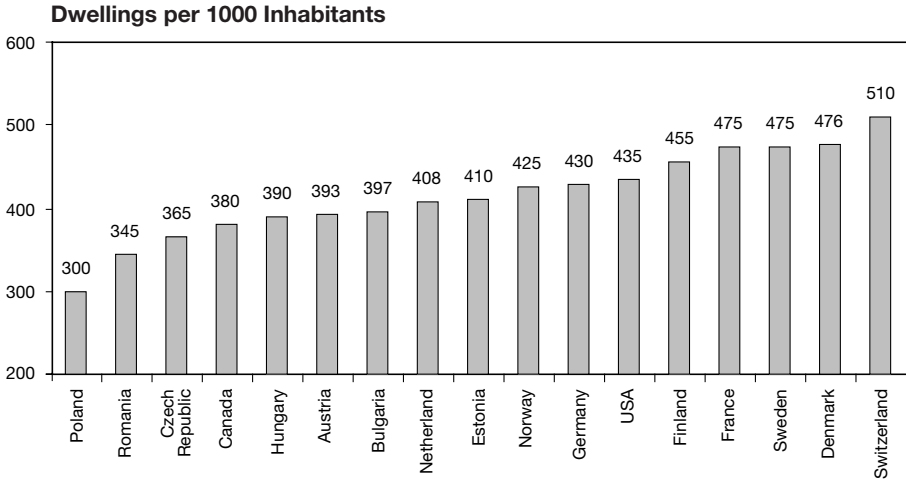
of the total labor force. A reconstruction plan was approved by the government in 1997, including the following steps: substantial reduction of employment accompanied by investment in control systems, privatization or abrogation of regional routes, a substantial increase in fares, separation of the route maintenance management from the route operation and transport management, and entry of private carriers.

Economic Performance of Czech Railways

	1993	1994	1995	1996	1997*
Subsidies, mil.CZK	6050	5771	5248	5150	5263
Loss, mil.CZK	3180	2701	3093	4744	5100
Loss and Subsidies as %	2.68	2.26	1.93	2.11	2.12
Share of the State Budget					

* CERGE estimates
Source: Ministry of Transport and Communications

VI.4 Deregulation: Housing and Utilities



Source: Ministry of Regional Development

The majority of prices were liberalized in early 1991. However, the housing market still remains over-regulated. Although only about one quarter of housing is in state or municipal possession, price ceilings are also imposed on private rental housing. Strict regulations of landlord-tenant rights still prevail. Rents, however, represents only a portion of total housing costs. Other housing costs which include heating and water supplies and other services not subjected to such strong central regulation have increased substantially during the last few years. In 1998, the prices of electricity and gas are expected to jump as a consequence of the deregulation schedule.

Controlled step-wise deregulation of rents was initiated in summer 1997. The government allowed rents to increase by as much as 100% in selected locations. Further lift-

ing of rental ceilings in 1998 are contingent on political agreements.

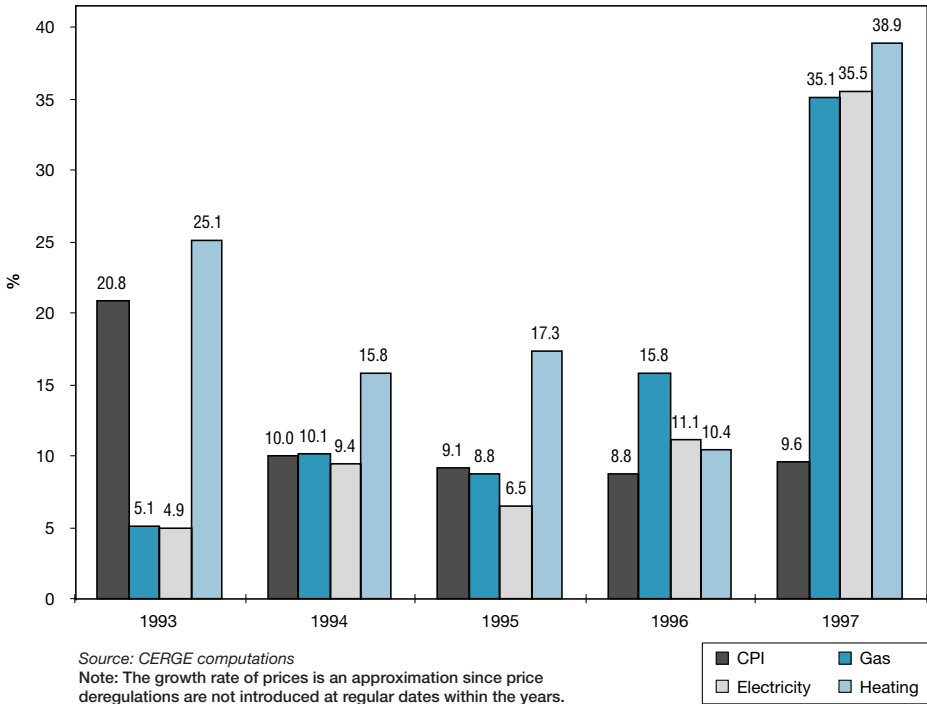
Stringent housing market regulations and their uncertain prospect have caused a long-lasting huge surplus of demand for housing, especially in large cities where municipal housing dominates. In a time when unemployment has been growing steadily, housing market rigidities contribute to the difficulties unemployed workers have in finding housing in areas where employment is offered. It is likely that these rigidities will further increase the regional differences.

Ownership of Housing (%)

State	4
Municipal	23
Co-ops	20
Private	53

Source: Ministry of Regional Development

Deregulation of Prices for Households



The prices of energy for households remained subject to price ceilings set by the government while the prices for firms have been subject to much weaker governmental regulation. As a result, at the beginning of 1997, firms paid higher prices for energy than households: 55% more for electricity, and 23% more for gas. The deregulation schedule aims to equalize distorted prices for households through stepped increases of the price ceilings. The deregulation plans also assume an increase in VAT on energy, from 5% to 22%, which will further increase energy prices. All deregulation steps, including in the areas of housing, railways, and telecommu-

nications, will represent more than 4 points of the CPI in 1997.

Price Deregulation Contribution to CPI '97

Rents	1.29
Electricity	0.88
Gas	0.35
Heating	1.50
Solid Fuels	0.10
Telecommunications	0.11
Post Services	0.04
Railways Fare	0.10
Total	4.37

Source: CERGE estimates