**The Czech Republic**

***Transitional Success:***

***USSR to EU***

Public finance policy issues during the political

economic transition from centrally planned socialist

economics to free market democratic capitalism.

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*November 20, 1996*

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**Table of Contents**

**I.** Introduction

**II.**  Political Summary: Restructuring for Transition

**III.** Transition to Market Economy: 1990 - 1991

**IV.** Problems of Transitional Monetary Policy and the Financial Sector: An Overview

**V.** Macro Economic Stability: 1993 - present

**VI.**  Monetary Policy: 1993

**VII.**  Intergovernmental Financial Relations

**VIII.** Budgetary Overview: 1993 - present

**IX.** Tax Reform

**X.** Current Political Economic Considerations: 1996

**XI.** The EU and NATO

**XII.**  Conclusions

**XIII.**  References

**Introduction**

In 1989, after nearly 40 years of Soviet control, Czechoslovakia once again became an independent nation, the Czech and Slovak Federalist Republic. This transition from Soviet socialism to democracy culminated throughout Central and Eastern Europe with the literal collapse of the Berlin Wall in East Germany, the heroic Gdansk Shipyard Strikes in Poland. The student and worker protests in Prague and Budapest were no less important.

The Czechoslovakian revolution took place peacefully and over a much longer period of time than events in other former Soviet Union or Warsaw Pact nations. Hints of major reform in Czechoslovakia began as early as 1968. Czechoslovakian officials, under Soviet power, moved incrementally to begin the long road towards decentralization and independent Czechoslovakian rule. Their increasingly effective efforts became known as the Prague Spring, a time of growth, change and development.

Success was, of course, neither immediate nor easy to achieve. The Cold War reached a pinnacle in the Eighties and the winds of change began to blow in Central and Eastern Europe. The CEE nations endured many hardships. Soviet oppression, though waning by this time, became largely unbearable. Change in Czechoslovakia came from the ground up; dissidents quietly began to return to popular power. The revolution gained momentum by 1989. ‘Revolutionists’ began to demand sweeping economic and political reform. They were backed by well organized and very timely strikes and protests. After a two hour general strike on November 27, 1989, proving the immediate and widespread power and cohesion of the revolution, the Soviet controlled authorities finally agreed to negotiate.

Through the negotiation process and threat of further massive general strikes, former dissidents assumed officially sanctioned ‘concessional’ positions. Within months, they gained near complete (and very real) control of the Federal Assembly. On December 29, 1989, Mr. Havel, a very famous and popular Czech dissident, became President of Czechoslovakia (renamed the Czech and Slovak Federalist Republic).

This initial political victory represents only half of the nation’s success. Within the first three years of self rule, harsh economic (and subsequent political) realities forced the nation to divide once again. The nation as a whole was unable to accommodate the vast discrepancies between the western Czech and eastern Slovak regions. Massive economic reforms brought this to the popular agenda as Slovakia suffered greatly while their Czech counterparts seemed to benefit from reform.

The government in Prague wished to move swiftly to further reform efforts. Slovakia hindered Czech success and in turn suffered greatly by this Czech-led reform. Slovakia simply could not move as rapidly toward a market economy due to the economic configuration left to them by years of Soviet planned economics.

**Political Overview: Restructuring for Transition**

In 1992, Vladimir Meciar, a very strong nationalist was elected prime minister of the Slovak Republic, while Vaclav Klaus, a moderate federalist, was elected in the Czech Republic. Unfortunately, these two leaders were unable to agree on common economic and political strategies to govern the CSFR. Klaus’s reform plans, now legendary, were simply inappropriate for the fledgling Slovak regions. Slovakians felt alienated from the government reform in Prague. Within a short time it was very clear that the Czech regions could not completely support their Slovak countrymen through the transition. The two leaders agreed to divide the Czech and Slovak Federalist Republic (CSFR) into the Czech and Slovak Republics on January 1, 1993.

Federal assets and liabilities were split between the two nations in a two to one ratio. The Czech Republic received the larger portions reflecting both size and population. Again, the split was achieved peacefully, without massive debate. The two countries agreed to form a customs union. They implemented identical foreign policies with respect to third countries, and forbid tariffs or ‘bans’ between themselves. They also formed a temporary monetary union, which collapsed within months as both countries unexpectedly experienced a massive drain on foreign reserves during this time. To more fully understand the current developments in the Czech Republic, one must examine the historical economic decisions made before the break-up in 1993 as outlined below.

**Transition to Market Economy Overview: 1990-1991**

CSFR economic reformers went to work immediately following the collapse of Soviet rule. The reform package included near complete liberalization of prices, a complete reversal of former exchange and trade systems and an impressive preparation for massive and rapid privatization. These efforts were supported by financial policies including a “pegged” exchange rate, currency devaluations, and restrictive fiscal, monetary and wage policies.

*Monetary Policy*

Although monetary policy is discussed in a separate section, it needs to be briefly addressed here to understand the conditions in which the transition occurred. Monetary policy in the initial stages of transition ensured that inflation remained in control throughout currency devaluations and price liberalizations. The CSFR devalued its currency by 20 percent in 1991 after several smaller devaluations before hand. Taken as a whole, these devaluations reduced the value of the currency by half within six months. Generally, monetary policy remained tight throughout the entire period.

*Fiscal Policy*

Undoubtably, the goals of the CSFR economic reformers were to drastically reduce government spending. The former centrally-planned, output-driven economic policies were no longer effective for the new capitalist democracy. Restructuring government expenditures was a key component of reform. The main changes, aside from massive privatization discussed below, forced reduced subsidies wherever possible. Every sector of society, with the exception of health, welfare and education, saw an abrupt end to government subsidies. In 1991 alone, for example, officials reduced government spending by 12 percent to reach 47 percent of GDP. This trend continued throughout the transition. Massive government spending, a hallmark of socialism, ended virtually overnight.

Areas where government spending remained high would remain so throughout the reform process. Health and welfare for poor, elderly, unemployed and children is a very difficult situation in any government, especially one in transition. Reformers focused primarily on industry and energy in the initial stages, leaving the areas of greater uncertainty to be dealt with in a more stable political environment.

*Price Liberalization*

As an almost immediate measure, subsidies to foodstuffs and energy were reduced by nearly 50 percent. Retail prices for most household items increased by nearly 25 percent literally overnight. By the end of 1991, the Czech government controlled only 6 percent of prices in the country as compared with 85 percent in early 1990. Only basic necessities, oil, and agricultural products remained under state control. To offset some of these shocks, wages increased, though only slightly and not nearly enough to meet the increased cost of living. Politically powerful trade unions prevented the passage of even more drastic reform measures. Plans in 1991 to increase the price of electricity, heating oil and coal by nearly 400 percent and rent by 300 percent were delayed until 1992 and 1993.

*Foreign Trade and Investment*

After an initial currency devaluation of nearly 50 percent, the government adopted an adjusted exchange rate connected to a “basket” of convertible hard currencies. Internal convertibility of hard currencies was established in 1991. These two measures combined to foster trade and investment. Initially, the CSFR set a 20 percent surcharge on imports coupled with a 5 percent tariff. These obstacles soon ended as major provisions were passed to more actively encourage trade and investment. Initial steps toward private property rights and the dissemination of publicly owned lands further enhanced the investment environment.

*Privatization*

Privatization is by far the most critical and complicated development the CSFR had to address. Speed was critical. The ‘default mechanism’ ensured that current managers and persons of powers would assume control and create their own joint venture agreements with foreign entities.

State firms that were nearly completely vertically integrated needed to be desegregated by form and function. And the process had to be done well, for flailing industries would simply increase state expenditures. Failures did not decrease expenditures in compliance with the transitional reform strategy. The CSFR privatization plan was threefold. Small-scale privatization was the easiest. Retail stores, restaurants and small service or industrial workshops were sold to the highest bidders in weekly public auctions. Where no CSFR buyers were found, a second round of auctions allowed foreigners to bid.

Property restitution was more difficult. The government needed to equitably redistribute land that had been taken nearly 40 years earlier. This is a difficult and involved issue. CSFR citizens are allowed to claim land taken from them, though the burden of proof is on them. Where no proof exists, special arrangements can be made for state assistance. In areas of conflict, the issue will be brought to the courts. A large part of the country was not in private hands before Soviet rule. Some of this land can be used as an offering to parties where disputes over ownership exist. Also, lands that have been improved (shops, developments, houses, etc.) are sold at specially determined rates to the former property owners. Prices and possible alternative compensation for those owners who do not wish to purchase these ‘improvements’ are again settled by a special court arrangement.

Large-scale privatization progressed swiftly. Some state-owned firms were sold outright to private interests while others remained under indirect state control until buyers were found, legal or economic concerns settled, or parliamentary debate resolved.

*Social Policy*

The strong tradition of labor unions and their political strength proved crucial to social security reforms throughout CEE. The CSFR was no exception. Labor unions were instrumental in keeping CSFR unemployment at very low levels and social safety net benefits quite high. Essentially the state guaranteed incomes at a minimal level to meet the ‘cost of living’ for the unemployed or the under-employed. Pensioners and parents of children received benefits adequately covering bare essentials. Further benefits for health care were distributed at the local level as the health system still remained under state control.

**Problems of Transitional Monetary Policy and the Financial Sector**

Since the introduction of reforms, monetary policy played a key role in the economic stability of the Czech Republic throughout the transition. Inflation remained surprisingly low (though relatively high in 1989 and 1990), exchange rates were relatively stable (after initial fluctuations), and external reserves stayed strong throughout the period (spurred by unusual and unexpected outside interest in the Czech Republic as the first reformer to prove its success).

What is perhaps most impressive are the obstacles Czech officials overcame in developing an effective monetary policy. First, the entire CMEA trading block was virtually dismantled. Reform and transition would be difficult even with stable trading partners. In the CMEA, all of the countries were experimenting with and adjusting prices, exchange rates and policies. It was very difficult to set monetary conditions correctly, in real or absolute terms.

Second, within just a few short years, the CSFR itself broke apart for economic and political reasons. This was largely unexpected and proved difficult in the policy making arena. As the break-up drew near, officials had a difficult time determining which policies should be enacted based upon which of many scenarios might occur in the CSFR.

Third, after finally establishing the terms of the CSFR split and negotiating a seemingly effective customs and monetary union between the two new countries, the monetary union failed miserably. Within a few months, the union caused significant drains on much needed foreign reserves in both countries and had to be abandoned.

Finally, the Czech tax system had to be completely overhauled. Additionally, the banking system needed massive reform. Large spreads in interest rates were common and overall the banks were simply reluctant to lend on any long term basis, a major impediment to domestic investment and growth.

All of these massive changes occurred within just a few years. Throughout these developments, monetary policy remained extremely tight. At the onset of the reform period, it was at its tightest, with a minor break late in 1991, once the political economic dust had settled. Otherwise, the next monetary reprieve didn’t occur until the second half of 1993. By 1994, broad money grew at 30 percent compared with growth of 15 percent a year earlier. More important than doubling growth figures is that the economy was able to withstand this growth by 1994!

Interest rates were high throughout the period, and continue to remain high by most western standards (over 9 percent). Interest rates were not directly controlled but were subject to central bank reserve requirements and discount rate announcements. Liquidity was further controlled through regular auctions of treasury bills.

Bank reform focused primarily on establishing the legal framework for transactions between the central bank and newly established commercial banks. Weaknesses still remain in reporting and accounting and the reluctancy for banks to lend. Several commercial banks have had to come back under government control to prevent major economic problems.

**Macro Economic Stability 1992 - present**

By 1992, the CSFR began to show significant signs of success. Though they were in fact more disadvantaged than many other countries in the CEE, they fared well. Their export market consisted almost entirely of former members of the Council for Mutual Economic Assistance (CMEA) who were in the same transitional position as the CSFR, impeding efficient trade. Fortunately, inflation on the whole in the CSFR remained remarkably low when compared to the rest of the CMEA, as did external debt. Inflation did jump just before the CSFR breakup into the Czech and Slovak Republics. Experts suggest this occurred in part due to the fear of instability during the breakup and in part due to an anticipated VAT. As expected, in 1993 (in the Czech Republic), inflation rose again after introduction of the VAT.

In 1993, free from its less advantaged Slovak counterpart, the Czech Republic better targeted its economic recovery plan. The plan encompassed three main elements:

1) A balanced state budget that encompassed sweeping tax reform;

2) A tight monetary policy to reduce the inflation caused by VAT and other lesser effects (which also improved its external position for trade and investment); and

3) Moderate wage increases (adjusted to inflation) and a stable exchange rate.

This reform policy was backed by an IMF “stand by” arrangement as a precautionary measure. The IMF would assist if the Czech Republic needed financial assistance. This happened once early in 1993 and Czech officials repaid the loan before it came due (much to the delight of the IMF).

Unemployment remained remarkably low in the Czech Republic at 3 percent in 1993, while Poland’s figures (another major success story in CEE) *still* remain in double digits. Low, virtually non-existent unemployment certainly contributes to greater political and popular acceptance of the above fiscal and monetary policies.

Many attribute a major setback in the Polish “Shock Therapy” reform efforts to the political demands of the labor unions. The Polish President, Lech Walesa, understood the need to keep wages low to implement the reform. But he feared for his political power and caved in to labor pressures by granting wage increases. By doing so he nearly destroyed the entire economic reform process. He claimed that had he not, the entire political reform process would have crumbled.

Czech officials didn’t face this obstacle as unemployment throughout the transition remained low. The political reform process was slightly segregated from the economic reform process. The small Czech population (roughly 10 million) was easier to organize than Poland’s 40 million. Regional differences were less and political factions less pronounced. Regardless, by 1993, the Czech Republic had a very cohesive popular political support base which facilitated the economic reforms.

By 1994, foreign trade increased substantially, with much of the growth occurring between EU member nations. Tourism in Prague, now a “must see” on any European vacation, contributed to increased trade to maintain a strong balance of payments and a surplus in the current account. Though FDI by 1994 had decreased (after very high initial investments in 1992 and 1993), the

capital account maintained high inputs due to the rise in borrowing of Czech firms (which proved even better for Czech long term economic success).

GDP began to rise slightly after a period of decline from 1991-1993 of nearly 20 percent. Privatization entered its second round in 1994 for enterprises being privatized through voucher programs. The first wave of privatization is considered a remarkable success (a model to be used farther east). As this first wave ended in 1993, the Prague stock exchange began trading and the banking system went though increased and improved reforms. The Czech Republic was a leader in the CEE in trade and investment. Economic reform efforts, coupled with the above mentioned political support, put the Czechs at the forefront of CEE success.

*Industry*

Industrial output by 1993 declined by nearly 21 percent compared with 1991 figures. This can partially be explained by increases in the service sector, as investment soared in service sectors and dropped dramatically in the industrial sector. Also, the industrial sector was the most inefficient sector in the former centrally planned economy and much of those inefficiencies were corrected with the introduction of market reform. Most industries produced less as consumption dropped. And they did so more efficiently as output based economic plans were no longer used.

It is significant to note that the Czech Republic does not have an industrial policy. They feel the state does not have enough information or resources and thus it is most efficient to allow the private sector complete control. Government could assist with exemptions and subventions, but the market should determine winners and losers.

However, the Czech government continued, through 1994, to bail out state-owned enterprises, mostly due to their economic (employment) and political leverage. In essence, this hurts struggling smaller, private, firms that are unable to compete with giants, let alone subsidized giants. These large industrial subsidies are all but gone in most industries today, however they still exist for politically sensitive or economically vital industries. In some cases the government reluctantly returned to subsidies as not all of the initial privatization efforts proved successful. Some large enterprises were not effectively dismantled and the resulting giant enterprises were simply too large and inefficient for the new market economy. It took several years, in some cases, to learn this lesson.

*Prices*

Consumer price inflation by 1993, after the initial shocks of the VAT, stabilized at 18 percent. Experts estimate the VAT added 7 percent to inflation during 1993 and an additional 2 percent can be attributed to government administered price regulations. Price regulations remained mostly in the utilities sector. Adjustments from 1994-1995 increased prices in several key areas including gas, oil, transportation, medicine and telecommunication tariffs.

*Wages*

Wage restraints through a “tax based income policy” was an important feature of the CSFR. Wage restraints ended in 1993, but had to be brought back by the end of the year by the Czech government. The rational behind bringing the restraints back was that market forces were not yet adequate to control wage increases. Wage increases had to remain close to increases in consumer prices to avoid inflationary difficulties. Therefore, as late as 1995, up to 100 percent tax rates were applied to wage increases over allowable limits, effectively keeping wages at desired rates.

**Monetary Policy: 1993**

By 1993, Czech monetary policy began to stabilize in conjunction with political and economic indications of success. The basic aims of monetary policy at this point were simply to maintain internal and external currency stability. Officials kept the Czech crown pegged to stable European currencies and prevented inflation from rising above 10 percent. In a somewhat disguised blessing, foreign capital flowed into the Czech Republic at high rates in 1994 causing officials to raise reserve requirements from 9 to 12 percent to insure inflationary stability. The banking system, though still flawed, was able to withstand the pressures. The economy certainly welcomed the increased capital.

By 1993 and even more so by 1994, monetary policy was less of a political tool in the reform process. Stability in many respects had been achieved. The nature of further reform and continued stability relied almost entirely upon fiscal decision-making. To fully understand and appreciate the political economics of reform from 1993 onward, both fiscal and monetary, an examination of the Czech budget is helpful. Defining the role of the state in the new market oriented economy is critical. Two main issues must be examined, the resources and informational capabilities of the state. Both are limited and both are not independently effective. The budget and the political issues surrounding its passage are important in understanding the Czech approach to stability now that much of the transition has been rather successfully completed.

**Intergovernmental Financial Relations**

Before the budget analysis, a brief overview of intergovernmental financial relations may be helpful. The Department of Finance makes budgetary estimates for the Ministry of Economy. They regulate spending and essentially decide which organizations and institutions receive the much sought after government subsidies. They are also responsible for government accounting, financial management and regulation of wages. The Department of Finance is classified under the Ministry’s “Administration and Finance” section.

The Foreign Economic Relations Department, the European Affairs Department and the Economic and Social Policy Department are all included under the Ministry’s “Economic Policy.” They all report to the Ministry and are essentially charged with the difficult task of improving and encouraging economic development both home and abroad. The Ministry also supports a wide variety of business development departments; Small Business, Business Promotions, Tourism, etc. Though their interactions, cooperation and communication are limited, they all follow somewhat coordinated general policy initiatives of the Ministry.

**The 1993 Budget**

The following budget summary is based on the 1993 budget because that was the first budget elaborated as the independent Czech Republic. Before the transition, Czech had one of the more state dominated economies in the CEE. The state controlled almost all economic activity with government expenditures reaching as high as 65 percent of GDP in 1989.

The 1993 budget focused on a more developed private sector. The budget is fundamentally influenced by tax reform which will be discussed in the following chapter.

*Revenues*

The 1993 budget is based on three main revenues: the value added and excise taxes (36.9 percent), income tax from legal entities (25 percent) and social insurance (28.5 percent). The new tax system (and total restructuring of public finance to benefit local budgets) reshaped the revenue system and forced budget developers to complete more in-depth estimates of revenue flows. They were forced to make more accurate revenue predictions.

Total revenues in 1993 reached 419 billion crowns (26 Kc per $1USD), of which 343 billion went to the state, 41 billion to local districts and 35 billion to health insurance. Revenue growth was 13.4 percent and local budgets rose 35.2 percent in 1993

*Expenditures*

A large part of the expenditures for the Republic encompassed transfers to the people. The largest programs are pensions, family allowances and sickness insurance. Social transfers were increased in 1993 to create reserves for expected increases in unemployment. Expenditures on branches of government like health care, for example, increased by 50 percent in 1993, simply responding to demand. A move to create the National Health Fund was instituted out of a revamped payroll tax and transfers from the central budget to care for the non-working public. The health fund reduced local spending on health care thereby reducing local transfers. Expenditures on education and culture also increased by a third over 1992 levels. These additional expenditures were partially offset by a new wage tax targeting employers and a combination of the following:

1) Savings in compensatory income support and sickness benefits by a new means tested model;

2) A freeze on subsidies to agriculture, transportation and mining; and

3) Large cutbacks in real investment, including a public housing plan begun in 1992.

Transfers from federal accounts to the Czech government totaled 90 billion crowns, one fifth connected with expiring credits granted abroad and debts owed by the former Czechoslovakian and CSFR government. Debt service is a major component of the 1993 budget. The debt reached 115 billion crowns by 1993. 40 billion crowns were transferred liabilities of the Czechoslovakian Commercial Bank from operations of the so-called ‘central foreign currency resources’. Total expenditures on debt service reached 23 billion crowns in 1993. Due to its size and proportion of the entire budget, some of those payments were deferred. Eight billion crowns, the total Czech share of the 1992 debt, was financed through state bonds and money from the national property fund. Old debt principals were deferred for a year until 1994.

**Tax Reform**

The main elements of the systems prior to 1993 included taxes on enterprise surpluses, payroll and turnover. Wage or income taxes existed but were largely insignificant. The main function of the taxes were to transfer enterprise surpluses to the state budget and to sustain the administratively determined price structures. Tax incentives played no role in the economic system.

Sweeping tax reforms dominated the budget for the 1993 year. They included new indirect, direct and property taxes and modification to the payroll tax including a shift in the tax burden from corporate incomes to wage incomes. From 1992 to 1994, relative to GDP, the share of wage based taxes rose while the share of corporate income tax fell and indirect taxes remained unchanged.

These new direct taxes eliminated earlier distinctions for taxation of businesses based on forms of ownership and employment status. The new system of VAT and excise taxes expanded the coverage of indirect taxes to services. It also mitigated the falling implicit rate in the earlier turnover tax and condensed the range of standard tax rates.

The reforms promoted investment by lowering the cost of capital to businesses. This reform featured a significant reduction in the statutory rate of taxation, standardization and acceleration of allowed depreciation and a 10 percent credit on investment in selected equipment which reduced the dispersion in effective taxes on investment activities. This is how the cost of capital was lowered. The tax allowed the rate of taxation on enterprise profits to drop from 55 to 45 percent.

A personal income tax was also introduced to replace the previous network (maze?) of taxes on wages of large enterprises, the incomes of artists and authors, and the various forms of income derived from the emerging private sector. The new tax had all wage and self employed income taxes on a progressive scale with marginal rates from 15 to 47 percent, standard deductions and additional deductions allowed for social insurance contributions, children, transportation to work, etc. Interest, dividends and capital gains were subjected to 15 to 25 percent, encouraging investment only slightly. Social security and health taxes on wages of 36 percent from the employer and 13.5 percent employee replaced the old payroll tax of differential rates. Net taxes on gifts, inheritance and motor vehicles were implemented and the import surcharge was eliminated. Although the system went through amazing changes as outlined above, much of these changes were to no avail.

*Tax evasion and avoidance*

The problem with this system is that these any tax structures are still relatively easy to get around if one is willing to operate in the shadows. In the first quarter of 1994, the (23% rate) VAT yield was 30 percent below initial expectations. The corporate and VAT combined barely yield 80 percent of original estimations (one suspects that estimate is high...). Overall, Czech shadow economic activity, though low, is still significant. Estimate suggest anywhere between 15 and 25 percent of the economy works in the shadows.

Police claim it is almost impossible to investigate and prosecute tax violations. The criminal codes do not allow for them to effectively investigate such activities, and no other effective mechanisms yet exist. Change in codes and regulations are too complex and far too frequent. The Ministry of Finance claims that between 1993 and 1994 there was a change in the tax codes at least every 4 days. An example is the modification in 1994 of the corporate income tax from 45 percent to 42 percent, a reduction in the highest marginal personal income tax rates from 47 to 44, and an increase in allowable expenses. These simple changes required major modification in software and procedure for the Ministry’s clerks to keep up with the changes. The Ministry coordinates 12,000 employees in hundreds of local offices that constantly need to register and update databases with the latest tax changes.

Due to all the confusion, police estimate they can only catch roughly 10 percent of tax related crimes. A 1994 law adds to the difficulties by allowing businesses to keep their records secret. Employees can be sworn to secrecy regarding certain administrative procedures in firms, like tax issues. The criminal code states that banks can only be forced to reveal tax information *after* initial evidence from a formal investigation. With no information to go on, investigations rarely reach formal status. Additionally, a great deal of business transactions are still conducted on cash basis due to the ease and tradition. This opens very easy avenues for tax evasion and avoidance as cash is barely trackable.

Many of these tax reforms will become obsolete as the Czech Republic bids for EU membership. Czech will have to compete with EU tax codes, one example entails small breweries. Parliament passed a law on EU guidelines that allows a larger consumption tax on alcoholic beverages to be granted only to small, independent breweries. Breweries producing less than 200,000 hectoliters per year will be eligible for consumer tax cuts of up to 50 percent. The law sets a progressive rate up to the minimum margin limit.

Though it may seem straight forward, experts are unsure whether this brings the tax code closer to EU standards or drives them farther away. Are they protecting small business, providing tax shelters to favored companies, or preparing for entrance into the EU? Currently no one knows. The tax reform process is slow. Though much has been accomplished on the books, no one is really sure what the final outcomes will be. One suspects, as with many recent development in the Czech Republic, change will gravitate toward EU standards wherever possible. As the potential for EU membership draws near, one can expect many of these seemingly confusing tax issues to be clarified immediately as the Czech Republic attempts to do business with one of the most developed and powerful economic forces in the world.

**Current Political Economic Considerations: 1996**

Perhaps the most exciting chapter of the Czech political and economic transition is still to come. In November 1995, the Czech Republic signed a membership agreement with the Organization for Economic Cooperation and Development. The Czech Republic is the first CEE country to enter the ‘rich boys club.’ The Czechs furthered their status by recently declaring that they were now considering themselves a ‘developed’ economy. Though perhaps a bit premature and self-serving, OECD membership certainly entitles them to make such a claim. Many more economic issues still need to be addressed however, before transition can *truly* be considered complete.

The Czech Republic should reach growth levels of 7 percent this year. That growth needs to be achieved for the next ten years to simply double their income, and even then they will remain far behind their western neighbors. Current GDP in the Czech Republic is only about $3500, which according to the World Bank, ranks them near Malaysia. Fortunately, unemployment is practically non-existent at about 3.2 percent, the lowest rate in all of Europe. And the Czech trade deficit runs about 5-7 percent of GDP. Some experts suggest that rapid appreciation of the crown in recent times is to blame.

Furthermore, wages are a problem. Though they remain low, they are rising very quickly even with governmental controls. To stay competitive Czech business must increase productivity. This tends to be very difficult without cheaper capital. Though tax designs are in place to ‘cheapen’ capital, it is not immediate nor as effective as necessary. Finally, average savings rates throughout the CEE are about 18 percent, which is just half of the very successful East Asian Tigers (and two to three times that of developed economies). Czech needs to decide how fast and how much more they will grow in the near future. Regardless of some of these more negative indicators, Czech has made a significant transition. The numbers above simply indicate that their journey is not yet complete.

OECD membership is just a small step toward the Czech’s ultimate goal of EU membership. The Czech Republic is revamping their policies in order to comply wherever possible to EU regulations, guidelines and policies in order to facilitate their membership bid. Some of these changes include a decrease in the number of income tax brackets, decreases in the VAT from 22 percent to below 20, and the end to all tariffs with EU countries by 1997 (excluding “sensitive products”). These changes are helpful to the Czech economy but slightly premature. Experts claim they are done solely to impress the EU application reviewers.

**The EU and NATO**

EU membership is inextricably tied to NATO membership. It is important to understand the similarities and differences between these two organizations, especially as they concern the Czech Republic and the continuation or completion of the transition. The transition is both economic and political and therefore should be examined in terms of both EU and NATO powers. The EU and NATO are arguably the most advance powers economically and politically in the world. NATO includes the US, while the EU, of course does not. It is interesting, then, that many claim EU membership is virtually predicated on NATO membership. This creates an interesting foreign policy situation for the Czechs. It is not contradictory, but perhaps a bit dispersed in terms of goals and objectives.

Originally, NATO was created as a response to the communist threat. Recent discussions between NATO and Russia *suggest* this threat no longer exists. So what is NATO’s role today? For the time being, NATO has a very powerful, though perhaps indirect role in the continuation of EU expansion. EU membership would bring long term economic and political stability to the CEE (a NATO objective as well). NATO must continue to work in association with the EU to bring stability throughout the region to insure that the “communist threat” is indeed diffused indefinitely. It is not out of the question that massive economic and political upheaval in the FSU could result in some nationalist power rising up and posing a serious threat to European interests. It is in this sense that NATO and EU have a very common, and perhaps final goal.

Recently while in Detroit campaigning, President Clinton set a date for NATO expansion. He did not specifically mention which countries he was referring to, however, he did say that ‘their’ inclusion into NATO is expected by 1999 (by ‘their’ most experts assume, Poland, Czech and Hungary). If the Czech Republic becomes a NATO member by the year 2000, EU membership could come as early as 2003 or 2004.

Therefore, politically, the Czech Republic needs to satisfy the goals of both EU and NATO. Economically, they need to address the EU a bit more thoroughly then the US as the EU will be their main trading partner, but the US will remain a powerful ally, investor and trade partner. Although membership in either of these prestigious world powers would be remarkable for a country just a decade after socialist rule, the Czechs need to proceed carefully.

In joining the EU, the Czech Republic will face a somewhat unpleasant reality. After years of being the political and economic leader of the transitional Warsaw Pact countries, they would be immediately subverted to the lowest status in EU member countries, lower than Portugal. Though this would enable them to receive EU assistance, both technical and financial, it would also require them to adapt possibly painful domestic policies involving increased environmental standards, increased costs and drastically high competition in terms of quality and markets. It would also find them having to compete with Hungary and perhaps the most important country from the EU perspective, Poland. If Czech is forced to split benefits and favors with Poland and its huge 40 million person markets, they will indeed have their work cut out for them. Another major problem are the EU legal requirements for issues like consumer protection.

The benefits to EU membership, of course are many. The Czech Republic currently meets four of the five requirements for EU membership under the recent Maastricht Treaty. The Czechs reached EU membership levels for currency stability, interest rates, debt as a percentage of GDP and public expenditures as a GDP percentage. They still fall short on the inflation determinant. 1996 inflation is still at 9.1 percent. This would have to be lowered to 3.8 percent to conform to EU standards, a daunting task. The country will continue to reduce taxes wherever possible to stimulate the economy, but this is increasingly difficult as the Czechs are now in a relatively comfortable position where increased reductions in taxes would seriously hurt social benefits.

The EU is currently in the process of implementing their monetary union. Though this is a fantastic goal for the Czech Republic, they are not yet in a position to completely abandon their own monetary policy and rely entirely on fiscal policy. Even though they could not be permitted to join the EMU upon their EU membership (it has much stricter requirements than general membership), it would be strange for the Czech Republic to enter the EU knowing that they are a far cry from EMU membership. This is not to say it is inadvisable. The Czechs must join the EU at almost any cost. It is simply a concern worthy of mention. As the EU expands, the core states will be able to continue a favored status or elite power center, revolving around EMU involvement and not simply EU membership. This could be an important strategic leveraging issue for the core states (and a major point of contention for the Czech Republic as a new member).

There are many concerns and areas for excitement both politically and economically for the Czech Republic. They are in a very good position to come out far ahead of anyone’s expectations. Perhaps even their own. EU and NATO membership will both be achieved within the next 5-10 years, no matter what difficulties are faced along the way.

**Conclusions**

In just seven years, the Czech Republic transformed itself from a socialist, Soviet-controlled industrial-based economy to an increasingly service oriented OECD member and number one contender for the next wave of EU and NATO expansion in the region.

The Czech Republic’s success can be largely attributed to its small size and population and its relative ethnic and religious homogeneity. More important, however, is the Czech determination and persistence in meeting the challenges of transition. The transition that began in 1989 entailed a great many hardships. Not all of the CEE countries made it through the transition so successfully. The Czechs succeeded because they were able to stick to their plan when most other countries were forced to abandon for political reasons and popular discontent.

When the reform package became difficult, the Czechs didn’t revolt, they didn’t strike and they didn’t complain. They showed remarkable foresight in taking early steps to revamp their tax system and banks, keep inflation and unemployment and wage increases low, and keep their currency at stable levels. These were not all easily accomplished. They survived the difficult times and came out on top of the CEE as the only country to make it through the transition virtually unscathed. This smooth transition earned their revolt the nickname, “the Velvet Revolution.”

The Czech Republic is now poised to embark upon a greater challenge, that of becoming one of the world’s power core with EU and NATO membership. It will entail further difficulties, but compared with the accomplishments of the past and their ability to overcome Soviet oppression and transition from central planning, there is little doubt that the Czech Republic will succeed in their final step toward complete transition from the USSR to the EU.

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