

5-1991

Investing in Czechoslovakia

Richard Sumann

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vjtl>



Part of the [European Law Commons](#), and the [Marketing Law Commons](#)

Recommended Citation

Richard Sumann, Investing in Czechoslovakia, 24 *Vanderbilt Law Review* 369 (2021)

Available at: <https://scholarship.law.vanderbilt.edu/vjtl/vol24/iss2/6>

This Symposium is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Journal of Transnational Law by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

Investing in Czechoslovakia

*Richard Sumann**

TABLE OF CONTENTS

I. INTRODUCTION.....	369
II. FACTS	370
III. REFORM MEASURES.....	370
A. <i>Price Liberalization</i>	370
B. <i>Limited Internal Convertibility of Czechoslovakia Koruna</i>	371
C. <i>Privatization</i>	371
IV. JOINT VENTURES.....	375
V. INVESTMENT AND BUSINESS OPPORTUNITIES: DEMAND OUTLOOK	376
VI. CONCLUSION.....	377

I. INTRODUCTION

Students once asked the famous British Professor John Maynard Keynes about the long-term effects of his regulatory policies. His answer was that in the long run, we are all dead. We have quite a different philosophy. In the long run, we want to be all better off. And we understand that to be better off, it means the introduction of a market economy and a free, democratic society. Converting the rigid, centrally planned economies of Central and Eastern Europe into flexible, efficient, motivated, market-oriented economies and societies may affect your future. In fact, it will affect Europe and the world at large, and it will touch the welfare and prosperity of us all.

There is no historical experience from which to learn in this process. Some of the measures that we take now in Czechoslovakia will later prove to be inadequate or even outright mistakes, but our basic orientation is that the government must introduce a market economy and do so as soon as possible.

* Executive Director, Federal Foreign Investment Agency, Federal Ministry of Economic Affairs, Prague, Czechoslovakia.

II. FACTS

The official name of Czechoslovakia is the Czech and Slovak Federal Republic. The country contains, as the name indicates, two fairly independent Republics, the Czech Republic and the Slovak Republic. Czechoslovakia has territory comparable to that of the State of Louisiana. It has 15.6 million inhabitants, which is roughly the population of the State of Texas. Although this division causes a little bit of trouble, I think we can manage through this difficult period, and Czechoslovakia will remain a federated republic in the future.

Our society has a long industrial and democratic tradition. In fact, Czechoslovakia, before the Second World War, was among the ten most developed industrial countries in the world. We were more developed than, for example, Germany at the time. So you can see what forty years or so of central planning and communist rule cost the country. Czechoslovakia must now go back to its roots: to the market economy, to the tradition of entrepreneurship, to industrial development, and to democracy.

III. REFORM MEASURES

After Czechoslovakia's "Velvet Revolution" in late 1989, the necessary preconditions for the introduction of a market economy existed. The following year was thus understandably dominated by political debate over the nature and pace of economic reform. Actual implementation of a broad range reform measures began on January 1, 1991. The most important measures include: price liberalization, limited internal convertibility of Czechoslovakia currency, and privatization of state assets.

A. *Price Liberalization*

Until recently prices were centrally controlled by the government. Needless to say, this policy led to enormous price distortions, which in turn required huge subsidies. This poses problems for investors coming to Czechoslovakia wanting to see balance sheets for our companies. As a result, balance sheets on our companies do not tell you anything. You will only be able to see which companies have a competitive advantage in Czechoslovakia after certain periods of price liberalization.

On January 1, 1991, price liberalization was introduced, and eighty-five percent of prices are now determined in the market. The tendency towards sharp price increases is mitigated by the creation of a competitive environment. Nevertheless, the Federal Ministry of Finance has the necessary authority to regulate prices to a certain extent if there is a serious threat of market disruption or elimination of competition. This

regulation may include even price freezes of six months for selected products.

B. *Limited Internal Convertibility of Czechoslovakia Koruna*

Limited convertibility of the koruna was introduced on January 1, 1991. Prior to this, companies that earned profits in Czechoslovakian currency were in a difficult position in converting their profits into freely converted currency. Now, they can officially exchange their profits made in Czechoslovak korunas for freely convertible currencies, and after paying taxes, take their profits out of the country. On the other hand, when they operate in the Czechoslovakia market in the form of joint ventures, they have to surrender their earnings in freely convertible currencies from their exports abroad and change these earnings into Czechoslovak korunas. This is the rule right now; however, there are pressures by foreign companies to have special accounts where they can keep their freely convertible currency. They argue that if they change their earnings into Czechoslovakian korunas and need it after half a year, they will suffer if there is a devaluation of Czechoslovakian currency. I do not know whether such accounts will be allowed or not.

The move to limited internal convertibility is accompanied by the imposition of a twenty percent extra tariff on imports of consumer goods. Limited internal convertibility is seen as a major step towards creating a competitive environment on the home market and breaking up the existing monopolies of uncompetitive local producers. The introduction of limited convertibility was accompanied by the establishment of a single exchange rate for the koruna and its substantial devaluation.

C. *Privatization*

Privatization is viewed as the most important legal issue of the reform because private ownership of the means of production is one of the fundamentals of a well-functioning market economy. It is also very important from the point of view of foreign investors. Foreign investors can come to Czechoslovakia basically under two laws and two regulations. One is the joint venture law discussed below. Another very important law, adopted in early March, is the law on privatization of state property.

In Czechoslovakian industry, practically ninety-seven percent of the property is state-owned. The remaining three percent is privately owned through cooperatives. Therefore, the cake is very huge, and it is of interest to foreign investors.

Privatization, it was decided, will take place in the following way.

Every single case of privatization must start with a so-called "privatization project." Existing state enterprises will prepare a privatization project. Even if they are unwilling, they can be asked by the respective ministry to prepare such a project. It is not up to them to decide whether they want to privatize or not. A great deal of state-owned property will be privatized with only a few infrastructural operations to remain with the state. The privatization will be near complete privatization.

The privatization project consists of the following very important information. It must have a description of the enterprise and its activity. It must state the current legal form of the enterprise, *i.e.*, a joint stock company, a company limited by shares, or other form. The privatization project must contain a clear ownership statement by the state or a list of potential claims for ownership of assets. Investors who come to Czechoslovakia right now must be very careful about property rights. We have several types of property right now: state property, private property, and certain property where the status is not very clear.

We have a law on restituting property to former owners after forty years. The former owner, if he can prove that he was the owner, can ask the present owner to hand the property back to him within sixty days. If the present owner is not willing to hand the property back, they can, within a one year period, go to court and ask for a court decision.

In certain cases, it is very difficult to decide what type of property it is. You have to be very careful, first, to get to know what is exactly the status of the property you are interested in. Increasingly, you can find property, which was given back to former owners, and here the status is quite clear. Also, you may have a state enterprise, which was established after nationalization, so there can be no claims on the side of former owners making the status of that property very clear. It is, nevertheless, very important to study the ownership statement in the privatization project.

Another very important point of the privatization project is the method by which the privatization will be effected. We have two basic approaches towards privatization from two groups of economists in Czechoslovakia.

One group of economists favors privatizations through vouchers. They argue that in Czechoslovakia we do not have enough capital, our own local capital, to take an active part in privatization. And if we let only foreign companies in, it means that much of the national property will be sold out to foreigners. This group of economists invented a so-called voucher scheme entitling every Czechoslovakian citizen, with a permanent address in Czechoslovakia, to a certain amount of investment coupons. These investment coupons can be exchanged within a certain pe-

riod of time for shares of state enterprises, which will be privatized through this coupon or voucher scheme. The idea is to create approximately seven and a half million instant capitalists in Czechoslovakia through this process.

There is another group of economists who say this approach is totally wrong because it does not raise capital. They favor an auction or sale of state assets. Capital is badly needed for the modernization of enterprises in the economy. In the privatization project, it is up to the state enterprise to propose the approach to most privatizations, which may be a compromise of these two approaches. Therefore, fifty percent may be privatized under the voucher scheme, fifty percent may be sold on the open market.

The privatization project must also contain the future legal form of the privatized company. It may be a joint stock company, general commercial partnership, or whatever is allowed by Czechoslovakia law.

A very important point is that the privatization project must contain a valuation of the property, a valuation of the assets. In Czechoslovakia, we do not know how to value assets in the Western sense of the word. We do not have corresponding accounting methods in Czechoslovakia. That is why Czechoslovakia state enterprises usually use foreign companies, specialized in these matters, for the valuation. The privatization project must also contain a time plan for privatization and a statement whether foreign investment is required in that very state enterprise.

After preparing the privatization project, it must be discussed with the trade unions. It is not very clear from the law that was adopted what the rights of the trade union are exactly. The law mentions only that the trade union must be notified about the privatization project. Whether they will have a veto right or not is not known. Perhaps the law will be supplemented later in this respect.

Once the privatization project is ready, having been prepared by the state enterprise or by outside specialists, it is passed to the founding ministry of the state enterprise depending on the respective sector of the economy. This ministry is supposed to know the enterprise and will discuss the attitudes, approaches, future organization, production activities of the state enterprise, and so forth. After discussing this project with the founding ministry, the project is sent for final approval to the Ministry for Privatization. The Ministry for Privatization again discusses the project from the point of view of general privatization attitudes, practices, and regulations. When the project is approved by the Ministry for Privatization, the public can be informed about privatization project. This is a very important moment, because it is exactly the moment when foreign investors may get to know that a given state enterprise is ready for priva-

tization and any designated conditions.

The government is now preparing the technical aspects of privatization. All of these ministries and institutions on privatization must be established, staffed, and sworn. Theoretically, the first cases may be ready by late summer. Perhaps this is too optimistic, and the first companies will be privatized autumn of this year. The first cases will be practical experiments where we will learn all the pitfalls of the process of privatization. Massive privatization will likely take place next year. I am not as optimistic as some Czechoslovakian economists who think that we can privatize eighty percent of the property in two or three years. I think that privatization will be a lengthy process.

I think it is up to foreign companies, American and others, to come to Czechoslovakia right now to help Czechoslovakia companies to prepare their privatization projects. These companies who are active already now will be in a much better position, because they will know what state enterprises, in what stage or preparation for privatization that very state enterprise is. They will have contacts with the state enterprise, and maybe they can even influence the decision a little bit.

Practical privatization will be effected in the following way. The founding ministry will wind up the activity of the state enterprise. But before that, the state enterprise will be converted into a joint stock company where the state will be the sole owner of the stock. After winding up the stock, the assets of this state enterprise will be transferred to a "National Assets Fund." This is a necessary technical measure because, between winding up and privatization, there is a certain time period.

The National Assets Fund is an institution which will carry out the privatization program. These National Assets Funds are not supposed to engage in entrepreneurial activities. Because Czechoslovakia is a federal republic, there are Czech, Slovak, and federal ministries and funds. This means that there is a complicated scheme in determining which respective ministry or fund is responsible.

The National Assets Fund will carry out the privatization under the voucher scheme, open-bidding process, or any compromise approach. The law foresees also the possibility that there may be settlement. In a special case, you, as an investor, may deal directly with the National Assets Fund and the state enterprise without any auction. But usually, as a rule, it will be auctions, and the property will be offered through the open market.

We want to privatize the process of privatization. We do not foresee a big role for the state in the process and would prefer that banks organize the process including foreign investment banks, because foreign investment banks have a lot of clients who might be interested in buying part

of the property. We understand that the valuation of the property is a theoretical valuation and that the price will be the price of the market. Even if we have a certain valuation and certain price tag on the property, it will depend on whether we can find somebody who is interested in the property or not. That will determine the real price of the property.

IV. JOINT VENTURES

For the time being, the most practical way to invest in Czechoslovakia is through joint ventures. The joint ventures law was created one year ago to help foreign capital come to Czechoslovakia. The law is quite liberal (*e.g.*, both corporations and individuals can enter into joint venture arrangements). Foreign participation may be up to one hundred percent. Joint ventures may be established in all sectors of the economy with the exception of those considered important to defense and security. The authorization proceedings are concentrated into the Federal Ministry of Finance in agreement with the two republican Ministries of Finance. Permits for banking joint ventures are issued by the state bank.

The income tax for joint ventures is fifty-five percent of assessable income if the share of the foreign partner is less than thirty percent and the annual income is higher than two hundred thousand Czechoslovakian korunas. Companies with foreign participation of thirty percent or more are taxed at twenty percent on the first two hundred thousand korunas and forty percent on any further taxable income. Therefore, foreign investors are advised to have at least a thirty percent share in the venture. Two year tax holidays starting from the commencement of business are negotiable, but are rare. Joint venture companies must pay into a reserve fund at least five percent of each year's profits.

The joint venture must also pay a wage-level tax. This tax is fifty percent of total annual wages paid in a joint venture operation. A reduced rate can be obtained if the operation is in the service sector where the wage component is important to the expenditures of the enterprise.

Finally, a withholding tax of twenty-five percent applies to profits taken out of the country by foreign investors. Withholding tax is subject to relevant double taxation treaties. Czechoslovakia has such treaties with most major developed market economy countries. Under those treaties the tax rates applied to dividends range from zero to fifteen percent.

The minimum authorized capital of a company is one hundred thousand korunas. The full nominal capital must be paid within one year of company formation. Foreign companies and individuals cannot own land. Joint ventures with foreign participation can own land necessary to fulfill the venture's corporate needs. Dividends and profits of foreign in-

vestors can be, in accordance with limited convertibility scheme, freely converted into foreign currency and transferred abroad.

Although the formation of joint ventures got off to a slow start, they number more than 1500 at present. The most popular sector is tourism; a majority of joint ventures concentrate in hotel construction. Roughly half of all foreign investors in Czechoslovakia come from Germany and Austria.

V. INVESTMENT AND BUSINESS OPPORTUNITIES: DEMAND OUTLOOK

There are several opportunities for western investment in Czechoslovakia. There are two types of investment priorities in Czechoslovakia. One is called governmental priorities. Usually, the problem is that governmental priorities are usually not priorities of foreign investors. There is some conflict of interests because what foreign investors prefer usually are not priorities of the government.

One government priority is the conversion of the defense industry to civilian production. We have cut down production on arms and armaments in Czechoslovakia causing serious problems in the regions. Because this armament production was concentrated in Slovakia, the region is hard hit by this decision. We want to find new programs and new export markets for the industry, and so on.

Another government priority is reduction of energy consumption. Czechoslovakia consumes a lot of energy and is a superpower in this respect. A related priority is the diversification of oil and gas imports from the Soviet Union and other countries. All of our pipelines for oil and gas imports come from the Soviet Union. We have to construct new pipelines which will connect us with the Western European network.

Another priority is the reduction of steel consumption in the economy, and a reduction of the steel industry as such. Currently, we produce approximately 15.5 million tons of steel, which is quite a lot for a small country. We are determined to reduce this production to eight, maybe ten million tons of steel per year. The steel mills that will remain in operation will have to be modernized thoroughly, and for that, we need some assistance.

Another priority is the introduction of a digital public telephone network. This is a very popular sector with American companies, and American companies are already there in Czechoslovakia. And I do not think that they will let too many other competitors interfere in this sector. Other priorities include the construction of motorways, the modernization of Prague Airport, introduction of metal recycling technologies, and the production of bio-gas stations.

A good investment possibility relates to the privatization of Czechoslovakia industry, infrastructure, and services. This privatization will mean the creation of a lot of small hotels, restaurants, and shops. They will need refrigeration equipment, kitchen equipment, and storage facilities. I can foresee an enormous market in these products in Czechoslovakia. This will be a market where the owners of these facilities will have money to invest in this type of equipment.

The tourist industry in Czechoslovakia also presents opportunities. Czechoslovakia was last year visited by more than twenty-four million foreign tourists. This is a lot, and the facilities are not up to the standard. We need to modernize our hotels, contract new hotels, motels, and motorways, which are connected with this tourist industry.

Another very good sphere for investment is traditional Czechoslovakian production of glass, cut glass, ceramics, porcelain, and products of this type. The Czechoslovakia textile industry is quite extensive. It will be slightly modernized. We have to find new markets because it was very much dependent on the Soviet market until now.

Of course, our integration into the world community and the market economy will mean that there is an enormous need in Czechoslovakia for consultancy services, banking services, and financial services. I am visited by investors from many countries, and it is the Americans and the British who are specialized in the service sector. For example, you cannot find a consulting company in Czechoslovakia from France. There are dozens and dozens from the United States and Great Britain.

VI. CONCLUSION

I think that when you want to come to Czechoslovakia, you have, as in other countries, to think about long-term return. I warn you that you cannot expect that you will have big profits in the first or second year. It is a strategic decision, and you have to think about the long-term effect of your investment in Czechoslovakia. Czechoslovakia needs not only money, but what we need more is managerial experience. New technologies, marketing skills, accounting skills are things that will make the economy work.

Usually, when you want to come, you also have to offer certain financial solutions because the financial situation of Czechoslovakia enterprises is very difficult right now. If you do not find a way to help them survive this difficult period of transformation, it will be very difficult to do business with them.

My basic message is that any foreign investor who comes to Czechoslovakia must decide one basic question: whether to come to Czechoslovakia now or later. We understand that the legal structure is not perfect

and that the legal structure is not very transparent for the time being, but competition is not very keen as yet. It is also much cheaper to come to Czechoslovakia than to come to Germany, for example, or to France. The investor may decide to wait for two or three years and come to Czechoslovakia later. After two or three years our legal system will be perfect, and everything will be in place, but the competition will be much higher, and it will be much more difficult to come into the country. That is the basic decision that you have to face when deciding upon your investment in Czechoslovakia.