



Economic Survey of the Czech Republic, 2008

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Summary

The strong growth that has emerged in recent years is encouraging and the risks to underlying inflation are manageable. However, there are policy challenges. Most important is a need to ensure fiscal sustainability through public-finance reform to put the economy in a better shape to cope with population ageing. Reforms should entail:

- **More ambitious deficit targeting** backed by improvements to central government budgeting and to the Medium Term Expenditure Framework.
- **Further work in healthcare reform.** The planned measures are one way forward but require additional attention. Reform needs ultimately to address the tricky issue of the coverage of public healthcare in the context of ever expanding treatment possibilities.
- **Increasing the retirement age further** and making a final decision on deeper pension reform.
- **Following-up the recent tax reform.** Plans for simplification of tax legislation should be followed through. A reduction in tax preferences and other support for home ownership needs to be put on the policy agenda.

The increased pace of growth is diminishing longstanding problems of structural unemployment. Indeed, it has raised a risk that labour supply constraints will limit economic development. Policy needs to improve incentives to work and accumulate human capital through a broad range of measures:

- **Improving general labour market conditions**, notably through further shifts in the tax mix to lighten the high burden on labour and reform of notice and severance pay regulations. Part-time and other non-standard types of employment should be facilitated primarily by removing barriers. Direct subsidies should be used sparingly.

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of the Czech Republic. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

- **Helping parents combine work and family.** Parental leave should be cut back, more resources should be put into supporting childcare services and improvements should be made to tax-benefit incentives for family households.
- **Encouraging older cohorts to work longer,** not only by increasing the standard age of retirement but also through further adjustment of early and late retirement regulation.
- **Further reforming the education system.** In secondary schools, there should be wider access to courses that provide options for tertiary courses as well as more benchmarking of schools and students. Tuition fees in tertiary education should be considered.

Rapid growth in export-based manufacturing is a key feature of Czech economic development. Harnessing globalisation largely requires tackling the same issues as those that help economic growth in general. However, there should be some specific priorities addressing bottlenecks and market failures:

- **Ensuring investment incentives** are economically justifiable through careful monitoring and adjustment of existing schemes.
- **Reforming migration policy to tap into the opportunities** created by increased international labour mobility, to help overcome emerging shortages.
- **Ensuring good transport infrastructure** through effective use of EU-funds, public-private partnerships and the removal of entry barriers into the rail freight market more effectively.
- **Supporting “growth poles”** by tackling local and regional infrastructure bottlenecks, particularly in the Prague region. ■

Does the fast pace of growth risk overheating?

The economy is benefiting from a significant pick-up in growth – on average, real GDP increased by over 6% between 2005 and 2007 and the labour market has tightened significantly. The recent global financial turmoil has so far not affected the economy although weaker growth elsewhere may have some impact. A spike in inflation is currently denting real consumption spending, nevertheless, GDP growth is expected to be about 4½% in 2008 and then to rise close to potential of around 5% in 2009. The improved economic performance is being driven by export-oriented manufacturing, reflecting further deepening of the economy's involvement in international production chains. The implications of globalisation for the Czech economy are the subject of an in-depth review in this *Survey*.

There is little sign of overheating so far; underlying inflation has remained moderate and the output gap is modest. However, headline inflation is currently being lifted by several policy measures, including an increase in the lower rate of VAT and tobacco excise duty. As in other countries, developments in food and oil markets have also been increasing consumer prices. Concern that these policy and market pressures will feed through to core inflation has contributed to a phase of policy rate increases by the Central Bank since mid 2007. In addition, interest rate developments elsewhere have influenced monetary policy because exchange rate movements strongly influence Czech consumer prices. Reduction of the inflation target by one percentage point to 2% with a tolerance band of ±1 percentage point as of January 2010 is also becoming relevant for rate setting and helping to stabilise inflation expectations.

The new inflation target ties in more closely with the likely rate of inflation required to fulfil the Maastricht conditions for euro entry. The target date for entry was missed under the previous government and the current government has not set a new one. The earliest possible year of entry is now 2012. While fulfilment of the Maastricht criteria on this calendar looks feasible, leading policymakers are advocating that much deeper alignment with the euro area and further reforms are required before entry. The pros and cons of this argument are difficult to assess. But it is important that the annual report prepared jointly by the Czech Ministry of Finance and the Central Bank and approved by the government continues to provide an objective assessment of alignment and that the entry decision takes due account of the profiles of costs and benefits over time. ■

What is the government doing to ensure fiscal sustainability?

The centre-right coalition came into office in early 2007 following several months of political deadlock after the 2006 general election. To-date, its main achievement in economic policy has been a reform package that was voted in last year and there are many plans for further growth enhancing reforms. As for previous Czech governments, getting agreement on proposals can be slow within the coalition. In addition, putting legislation through parliament is an uphill struggle because the coalition itself has a thin majority. As

a result, many of these further reforms are uncertain even though their implementation would improve Czech economic performance over the longer term.

The main policy challenge is to ensure fiscal sustainability through reform-driven deficit reduction. Budget processes need attention to improve spending efficiency and discipline. In addition, the healthcare and pension systems require reform in the light of upcoming spending pressures from population aging. According to UN population projections, Czech demography will have two phases of accelerated aging in the first half of this century. One will begin as soon as 2012 and end in the early 2020's and the other will start in the mid 2030's, ending around 2050. Calculations made by the European Commission suggest that, with unchanged policies, the additional spending pressure would be equivalent to nearly 7% of GDP by 2050, one of the largest age-related fiscal pressures among European-Union countries. Coping with these medium and long-term challenges will require not only reforms in ageing-related areas, but also efficiency gains in other areas of spending. A number of the government measures make a start on this challenge.

Rapid growth has presented a golden opportunity for deficit reduction and structural reform but neither the previous nor current governments have fully exploited it. The general-government deficit targets (expressed as a percentage of GDP) are not providing strong enough support for responsible fiscal policy. Indeed, the current government has so far been sticking to the targets set when growth prospects were weaker. There is a medium-term expenditure framework comprising nominal spending ceilings that, in principle, drives budgeting. In this respect, if the government adheres to the current ceilings, deficits well below the targets are likely (although there are risks from scheduled cuts in direct tax rates in 2009 and 2010). The risk is that, as has happened in the past, policymakers choose to ignore the Framework and focus only on reaching the relatively easy deficit targets. *Therefore, deficit targeting needs to be more ambitious through commitment to use positive economic developments to adjust the consolidation path, rather than to dissipate the gains on additional spending.*

To its credit, the government is working on difficulties for budget control posed by large reserve funds that are partly under the control of line Ministries and which have accumulated through liberal rules on the carry-over of unspent budgetary allocations. An innovative publication, the *Fiscal Outlook*, is helping communicate policy and technical issues. In addition, improvements have been made to the general account that is supposed to cover only miscellaneous items (the "general treasury chapter"). Political commitment is essential for further improvement to central-government budgeting. This should translate concretely into further reforms:

- *Most important, there should be deeper scrutiny of spending plans in the preparation phase, greater transparency in the budget material submitted to parliament and*

wider use of programme budgeting. And there should be less opportunity for “pork-barrel” spending in the parliamentary phase of the budget process.

- *Improvement to the Medium Term Expenditure Framework ought to be considered.* The experience with this system of three-year rolling spending ceilings since its introduction in 2004 suggests there is scope for improvement. Most important, enhanced enforceability of the spending ceilings would help, for instance through more political and public scrutiny and sanctions for breaking the ceilings. Alternative formulations of the spending ceiling could also be considered.

A flat rate of personal-income tax of 15% (equivalent to 23% under a typical base, see below) has been in place since January this year, replacing a schedule of four rates (which ranged from 12 to 32%). As would be expected, high earners have gained the most. Low earners have benefited in terms of average tax burdens because of a large increase in the universal tax credit. The Czech government introduced the flat tax with the aim of bringing about structural benefits to economic behaviour by smoothing effective tax schedules. Two elements of the revenue reforms raise questions:

- The reform included the introduction of a ceiling on the social contribution assessment base, set at four times the average salary. This has further boosted the benefits of the tax reform to high income earners. Although ceilings are common internationally, the case for imposing them in a flat tax rate context is weaker because they introduce discontinuity in the marginal tax schedule that such systems aim to avoid.
- In an effort to make the headline rate low, the tax base has been widened as it now includes both employers' and employees' social contributions. This “super-gross” base is unusual. Indeed, no other OECD country has such a system. In theory, it does not create significant distortions but neither are there large advantages.

The flat rate tax and social-contribution ceiling have been accompanied by more cuts in corporate taxation. By 2010 the rate will be 19% which is five percentage points below the current level. The revenue losses from these measures are being offset by an increase in the lower rate of value-added tax and a large hike in excise duty on cigarettes. As regards future plans, there is the welcome intention to remove unnecessary clutter in taxation through a complete re-write of legislation. *A phased cut back in support for home ownership and also for renovation ought to be added to this agenda;* at every possible juncture there is either very light taxation or substantial subsidy. In overall terms, the tax reform has brought a welcome narrowing of the gaps between taxation on personal and corporate income and a shift from direct to indirect taxation. *Indeed, further reduction in the gap between the VAT rates could be considered, allowing greater adjustment in the tax mix.* Currently, as in many other OECD member countries, differences in VAT taxation are motivated by social concerns. However, these are better addressed through

the welfare system. Given that many changes have been made to taxes and benefits simultaneously, the impact on efficiency and distribution should be closely monitored. ■

Is progress in healthcare and pensions reform adequate?

Getting healthcare on track to cope with population aging is a key hurdle to ensuring fiscal sustainability. Small user fees have been introduced in a first phase of reform, a move that was recommended in previous OECD assessment and should help curb healthcare consumption. In principle, a multiple-insurer system aims at generating efficient provision through negotiation on the cost and quality of services between health insurers and providers. A second phase of reform is currently under discussion in the governing coalition which moves in this direction. Central to the reform is a proposal to bring profit motivation to the insurance funds by converting them into joint-stock companies, thereby strengthening their incentives to seek cost effective provision. This would be accompanied by several measures: improved definition of the basic package of healthcare services, establishment of an industry regulator, widening of options for insurance products and a “cash back” mechanism that would channel some of the insurers’ profits back to their clients. The impact of the second phase of reform could be significant in strengthening competition on the quality and cost of services. However, OECD experience is limited so far in this type of reform. Particular attention is needed to the following:

- *Undesirable reaction of the insurers.* Attention to cream skimming is required as the incentives for this may well increase under the reform. Furthermore, measures to facilitate switching between insurers are important. Conflict of interest among the owners of the joint-stock companies will need to be avoided.
- *Close monitoring of the reaction of providers to the reform.* Providers may have local monopolies in a number of areas in which case incentivising insurers is unlikely to generate significant efficiency gains. Regulators will also need to ensure that intensified provider-market competition does not reduce the quality of care. This, in turn, will require better information systems on provider performance.
- *Further work on what is included in the basic package of healthcare services.* The second phase of reform aims to better define the healthcare package. But, further work is needed to narrow the package or allow other sources of finances into the public system (for example, by extending co-payments), particularly in the context of population ageing and ever growing treatment possibilities.

Another major issue in fiscal sustainability is ensuring the pension system can cope with population aging. The immediate problem is the age of retirement. A schedule of retirement age increases is underway but will end in the late 2010s when men’s retirement age reaches 63 years and women’s between 59 and 63 years (depending on the number of children they have

raised). Under all plausible demographic projections, remaining at this retirement age implies large deficits in the public pension fund. It is *therefore very important that the draft parametric reforms that include extending retirement-age increases are implemented.*

A final decision should be made soon about further old-age pension reform. The current pay-as-you-go (PAYG) system focuses on providing a safety net pension through a highly redistributive payout formula. It is sustainable as long as appropriate parametric adjustments are made, in particular to the retirement age. However, there is a case for reform especially if it is believed a stronger link between contributions and payouts is required. One way forward, currently under discussion, is a defined contribution (DC) carve out, i.e. a share of the pension contribution would be channelled into private pension funds, as it is already the case in Slovakia, Hungary and Poland. The implications of the transition deficit need to be considered. A DC carve-out brings fiscal complications because contributions fall immediately but savings on the payout side do not begin until the first pensioners on the new scheme retire. Also, the “switching rules” are critical to the fiscal and microeconomic implications of DC carve outs. Mandatory switching that would phase out the “full” PAYG pension should be considered, rather than the current proposal that would allow all future generations to choose between the two systems. Providing a permanent choice risks additional public expense because net contributors are likely to switch whilst net beneficiaries will stay with the full PAYG pension.

Voluntary pension saving (i.e. third-pillar pensions) is common but saving per contributor is low. This is because a combination of direct subsidy and tax incentive makes some saving attractive, but beyond this returns are low. *The regulations on private pension funds need an overhaul, notably the restrictive regulation that annual returns to policyholders cannot be negative. In addition, the subsidy and tax breaks ought to be critically assessed. The first best solution would be if the regulatory overhaul makes saving attractive without support.*

The government's public-spending reform extends beyond healthcare and pensions. Economies in welfare benefits are being made, in part, to claw back some large increases that were voted in the run-up to the 2006 general election. This has partly involved bringing more discretion in the indexation of welfare benefits. Although this indeed creates possibilities for fiscal savings, it brings no reduction to the risks of political pressures for unwarranted increases. *On balance, an appropriate system of comprehensive automatic indexation should ultimately be considered.* Saving has also been made by postponing the implementation of acts on workplace injury insurance and sickness insurance. The act on sickness insurance makes employers responsible for the first 14 days of sick pay in exchange for a reduction in social contributions. Although a three-day “waiting period” has been introduced in the interim, *the 14-day scheme should not be postponed further because a period of employer responsibility would help considerably in tackling abuse of the sick pay system.*

As regards public administration, more is needed to encourage efficiency gains via job cuts, especially as lay-offs can easily be absorbed given current labour-market conditions. The recent attempt to induce savings by limiting wage-bill allocations for 2008-10 is encouraging but it is too early to assess its results. In addition, given the significant opportunities in EU-funding, administration of the allocations needs to be simplified and decentralisation offset by stronger communication and the pooling of expertise in administration. ■

How to improve incentives for labour supply?

Improving the supply potential and skills base of the working age population remains the second key challenge for enhancing growth potential. The rapid pace of growth is reducing a longstanding problem of highly regionalised structural unemployment. However, it is creating a new challenge; ensuring labour supply and skills can support a higher pace of economic development. Policy primarily needs to provide the right conditions for the labour market in general. As highlighted earlier, the tax reforms head broadly in the right direction, shifting the burden away from labour taxation to indirect taxation. Also there are plans to strengthen activation in the social security system and to reform the unemployment benefit. On other fronts:

- *The removal of some restrictions in the labour code is welcome and more deregulation needs to be considered.* At a minimum, notice period and severance pay arrangements ought to be linked to the length of service such that these regulations are lighter for those with short job tenure.
- *Consider full liberalisation of the rental market.* Regulatory settings are still restricting rental accommodation and this has contributed to weak labour mobility within the country. Full liberalisation would have a greater impact than the current schedule of regulated rent increases.

With falling structural unemployment and a period of decline in the working-age population imminent, even modest increases in employment imply tapping into additional reserves of labour. The largest of these are among parents with young children and older cohorts:

- *Deeper reform is required to help parents combine work and family.* The revision to the cash parental allowance, with the option of three durations of payout, gives more scope for choice. Also, there are plans to encourage home-based private sector childcare services. However, further reforms should be made. *International evidence suggests that long periods out of work damage parents' careers and family incomes, and through this route can harm child development. On this basis, the combined length of maternity and parental leave should be cut back from three to two years, or less.* However, the Czech Government has indicated that it is unlikely to act on this recommendation because it considers that the current system reflects societal preferences for family-based childcare. *In any case there should be further steps to increase childcare provision.* One option is to give municipalities greater incentives

to offer childcare services. Alternatively, the parental allowance could be replaced partially (or fully) by vouchers for public and private childcare services. Finally, the recent tax reform does not sufficiently tackle a problem of high effective marginal tax rates for low-income family households, once cash benefits are included; a comprehensive review of this issue is required.

- As regards older cohorts, a further increase in the retirement age is crucial to raising employment rates. And, attention is needed on post-retirement incentives to work. At present, working pensioners make pension contributions but there is no corresponding adjustment of the payout. Some consideration could be given to pushing the pension reductions for early retirement above neutrality. Measures on both these fronts are part of the proposed parametric adjustments. Indeed, given that the current PAYG pension closely resembles a flat-rate pension, there is a case for phasing out early retirement options altogether. Improvement to disability pensions is underway and needs to continue.
- These, and other, non-working groups often have priorities and commitments that better suit part-time jobs. Removal of the barrier created by the minimum social contribution and any other impediments to non-standard work should take priority over direct subsidies.

The tighter labour market and the still considerable income gap relative to the EU average underscore the need for good education policy to increase human capital. Skill deepening can also accelerate structural change in the economy, for example by strengthening innovation. Two issues in particular need to be addressed:

- The Czech Republic follows the central European tradition of early streaming in secondary education. Consequently only a small part of the population holds academic degrees. This elitism should be tackled by less streaming of students and wider access to courses that provide options for tertiary education. In addition, benchmarking of schools and students should be strengthened.
- As recommended in previous Surveys, tuition fees in tertiary education should be introduced both to provide extra resources and to improve efficiency in the sector. This should be accompanied by publicly supported student loans in which repayments are conditional on earnings after graduation. ■

How to continue benefitting from globalisation?

The Czech economy is very open. The volume of trade is large, about 50% more than GDP, and much of this reflects the cross-border movement of goods in international production chains. A significant share of trade is with Germany and, linked to this, the largest single sector is vehicle manufacture. A favourable location and relatively low labour costs are the core attractions. The setting up of international production plants has accounted for a large share of the Czech Republic's substantial foreign-direct investment. Globalisation is affecting the economy in other ways; multinationals now

play an important role in retailing, a tradable services sector is emerging and the increasing international mobility of labour is also presenting challenges and opportunities.

Ensuring the economy continues to benefit from globalisation largely implies focussing on the same issues as those that help economic growth in general: namely healthy macroeconomic conditions and attention to structural policies that affect the business environment such as simplification of business legislation, corporate and labour taxation, education policy and innovation policy. This being said, there are some specific issues. *Prima facie*, trade policy would be one area of potential importance but this is now largely governed by decision making at the EU level. Nevertheless, there are areas where government can play a direct role. The priorities should be as follows:

- *Ensure greenfield investment incentives and other business support linked to globalisation are economically justifiable, for example because of market failures or spillover effects.* Eligibility for the incentives has been widened, while simultaneously the length of the tax holiday has been halved. This seems sensible, though further alteration in investment incentives should be guided by a stocktaking of the incentives and more monitoring of supported firms. In addition, the subsidies (e.g. public infrastructure) and concessions that are often negotiated between local authorities and investors should be held in check and the support schemes for export-oriented small-and-medium enterprises (SMEs) also closely monitored. Further widening of the responsibilities of *CzechInvest* ought to be considered. In particular, there is a case for merger with *CzechTrade*.
- *Reform migration policy* to tap into the opportunities created by the increased international labour mobility brought by globalisation. Slovakia has traditionally been the main source of immigrants. And, EU membership has widened the pool of labour able to enter without restrictions. However, policy actions are needed to tap into labour from elsewhere. The plan for a “green card” programme is potentially welcome. Experience with the current points-based pilot programme and successful immigration programmes for skilled immigrants in other countries ought to guide design of the scheme.
- *Ensure good transport infrastructure* as this is one of the few key factors in firms’ location decisions where policy plays a direct role. Given the sizeable funds allocated in the 2007-13 EU budget for transport projects, priorities and implementation mechanisms require careful evaluation. In particular, increased attention needs to be paid to the efficiency of public procurement. Public-private partnerships ought to be considered but care is needed in their design. Further attention to the rail freight sector is required to bring more inter-modal competition and a better balance between road and rail transport.
- *Enhance the pulling power of “growth poles”.* In the Czech case, Prague is the most important magnet for business and has the potential to play a much

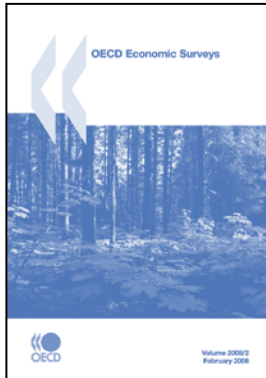
bigger role in central and eastern Europe. Factors limiting the expansion of the metropolitan area need to be addressed, notably emerging transport bottlenecks and housing issues. ■

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Economic Outlook No. 82, December 2007.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2008 edition.

More information about this publication can be found on the OECD's website at www.oecd.org/growth/goingforgrowth2008.

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