JUNE 2006 Policy Brief

OECD ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of the Czech Republic, 2006

Summary

The Czech Republic's economic growth performance has improved and now compares favourably with other catch-up countries in the region. Low inflation and interest rates have been a strong point of the economy for some time and policy is well prepared to meet the monetary challenges of euro entry which is aimed for in 2010. However, the next government will have to face up to considerable challenges in achieving fiscal sustainability. In addition, it must push ahead in improving the labour market and enhancing the business environment.

Recent deficits have been encouragingly low but driven by revenue surprises and deferred expenditure, rather than by spending cuts. **Containing deficit and debt in the long-run will be impossible without widespread public-spending and budgeting reform**, not least because of the need to co-finance EU funding opportunities and upcoming spending pressures due to ageing:

- In tackling ageing-related spending pressures some broadly agreed principles from the five pensions proposals made in 2005 provide a good basis for a final decision on reform; this ought to be high on the agenda of the next government along with the long-awaited reform of the healthcare system.
- One area of concern is regional and municipal spending. Measures must be taken to increase efficiency among the many very small municipalities. In addition, benchmarking cost and output in services needs to become more widespread. These considerations, plus the need for structural reforms in spending areas, mean caution is required in giving more revenue flexibility to sub national governments.

This Policy Brief presents the assessment and recommendations of the 2006 OECD Economic Survey of 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.

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In the labour market, there is persistent long-term unemployment and a general damping of employment from a large tax wedge that is difficult to cut back. While there is some progress with welcome initiatives to motivate job seekers and a better sick-pay system, the reform of the labour code has been more limited and efforts are required to improve paths to higher education. In-depth review of secondary and tertiary education reveals a need for more action to deal with the rapidly increasing demand for degree-level education:

- The difficulties of the public universities in coping with rising student numbers would best be resolved by the introduction of tuition fees, complemented by publicly supported student loans.
- Secondary school education needs to be better geared towards tertiary education through increased access to programmes that give options for university entrance. In addition, the early streaming of a minority of students into elite publicly funded schools should be phased-out.

Business conditions are being improved by new bankruptcy legislation and on-going efforts to reduce red tape and corruption but will require follow up. In-depth assessment of innovation policy reveals good intentions but much work remains:

- Clearer responsibilities and some tidying up of financial arrangements in innovation policy is required, notably a reduction in the large number of budget lines providing R&D support.
- The recently introduced tax incentives for R&D and plans for additional incentives should be carefully considered given the mixed international evidence on their cost-effectiveness. ■

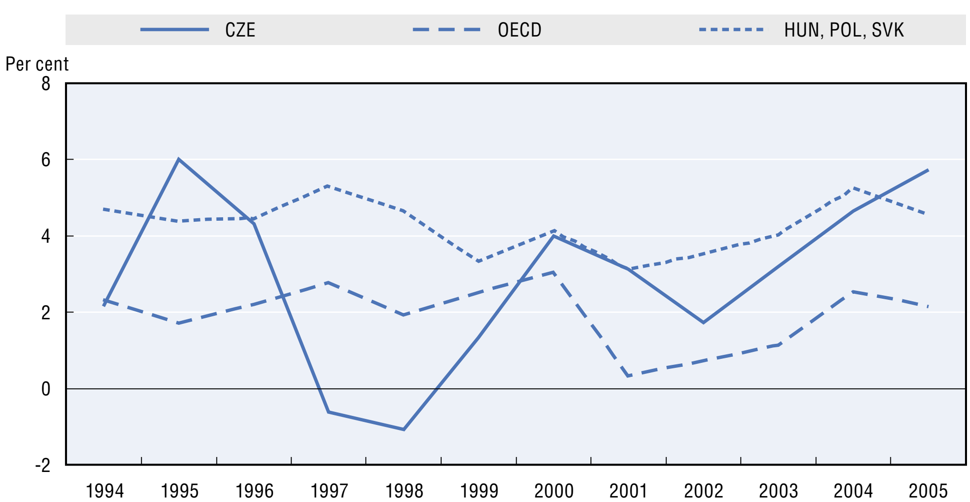
What prospects for GDP growth?

Between 2002 and 2005, annual growth in GDP per capita has risen from a little under 2% to 6%, and shifted above the average for other east-European OECD countries. Past reforms and accession to the European Union are contributing to further expansion of export-driven manufacturing, backed by foreign-direct investment. Indeed, the trade balance has become positive. Nevertheless, catch-up with more advanced economies is some way off and maintaining this performance will require continued reform. Entry to the euro area is aimed for in 2010 and this may provide an additional fillip to growth. In addition, the current government has published a blueprint for reform, the *Economic Growth Strategy*. It contains a large number of detailed proposals, many of which echo past and present OECD recommendations, and should be used as a catalyst for change. The most important measures have to be taken in fiscal policy; it is very important that the next government faces up to the considerable challenge of putting deficits on a sustainable track through public-spending reform. Policy will also have to push ahead in making improvements to the labour market, including the skills base, and with measures to enhance the business environment.

Inflation and interest rates remain low and a commendable annual assessment process is in place to guide the timing of euro entry. Real convergence in GDP per capita has been accompanied for several years by low and stable inflation. In the early 2000s growth in the consumer-price index actually undershot the target band of the Central Bank's inflation targeting regime. However, inflation has since recovered and, as of early 2006, was well within the 3 +/– 1% target band. Interest rates are correspondingly low and similar to those in the euro area. Despite these favourable conditions, there are risks in reaching the inflation and exchange rate criteria for euro entry. To reduce these and other risks of euro entry, a special annual assessment process on the preparedness of the economy for euro adoption has been set up. The assessments look not only at conditions in relation to the Maastricht

Figure 1.

GROWTH IN GDP PER CAPITA[1]
Per cent



1. Growth in Hungary, Poland and Slovakia is a simple average and that for the OECD in 2005 is an estimate.

Source: OECD, Annual and Quarterly National Accounts Databases.

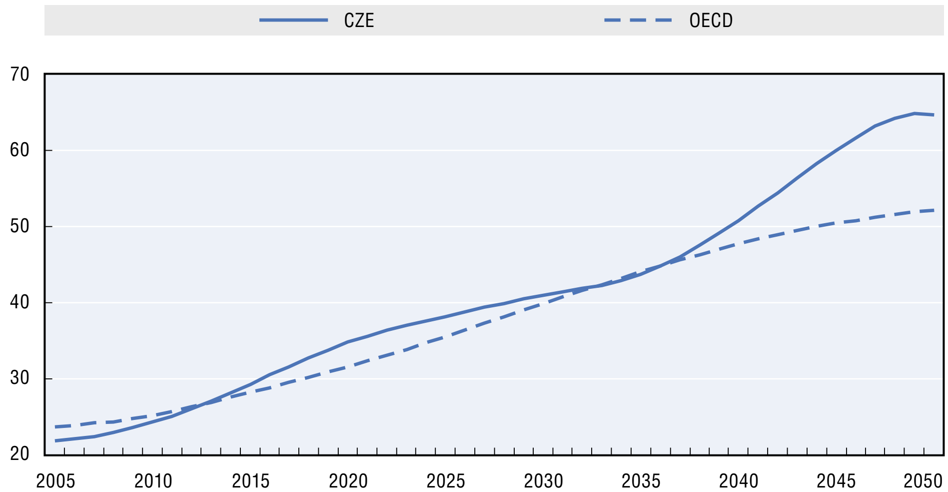
criteria but also at the alignment of the economy with the euro area and the flexibility of domestic markets. This process and the inflation-targeting regime are providing a good framework for euro entry and neither warrants major reform. ■

What progress on fiscal sustainability?

The general-government deficit for 2005 is currently estimated at 2.6% of GDP on an accrual basis following 2.9% in 2004. These outcomes are a marked improvement on preceding years, even taking into account special factors in the accrual accounts. However, the outcomes partly reflect continued strong growth in revenues. In addition, spending was lower than budgeted because of the transfer of spending allocations into reserve funds. Nevertheless, there is no sign of a permanent downward shift in public spending when expressed as a percentage of GDP. Furthermore, the 2006 budget has seen relaxation in spending discipline on several fronts. In particular, the ceilings of the Medium Term Expenditure Framework have been raised, reflecting the expectation of structural revenue increases. There is some concern about the justification of these ceiling increases. *Indeed, additional rules are needed in the Framework to deal with revenue and expenditure windfalls*. Within the next few years, fiscal challenges lie in creating budgetary room for co-financing the much larger project funds that will become available in the EU's 2007-13 budget, many of which are important for infrastructure development. The co-financing needed to make full use of EU funds will rise from about a ¼ of a per cent of GDP currently to about ¾ of a per cent of GDP. *Generating room for these and other necessary infrastructure investment makes all the stronger the case for tighter spending controls elsewhere, so as not to put at risk a steady approach of the budget toward a balanced position, which is necessary to prepare for spending pressures due to population ageing that are set to accelerate*. In sum, improving on the deficit outcomes in the lead-up to euro entry, and beyond, will be impossible without permanent savings through public-spending reform and would be helped by better budgeting processes. ■

Figure 2.

THE OLD-AGE DEPENDENCY RATIO[1]



1. The old-age dependency ratio is calculated as 100(population 65+)/(population 20-64).

Source: Secretariat estimates based on United Nations – World Population Prospects 1950-2050 (The 2002 Revision).

How do the proposals for pension reform compare?

A welcome effort to establish consensus on pension reform has been made. Five proposals (one by each of the main political parties) were developed by a special working group on pensions in 2005, a process which helped considerably in ensuring that the proposals were detailed on a comparable basis. Indeed, this transparent approach has much to recommend it for an issue as fundamental to society as a whole as pension reform. *A wide range of options is covered and the proposals should be used as a basis for the final decision on pension reform that ought to be high on the agenda of the next government.*
One proposal introduces a system of notional accounts, a second keeps a pay-as-you-go pension but carves out a defined-contribution pillar from it, a third reform proposes only parametric changes to the current pay-as-you-go pension while a fourth proposes a flat-rate pension. The fifth proposal is similar to the third but adds a defined-contribution component to a pay-as-you-go pension.

Some aspects of the reform proposals could be improved without undermining the core approach embodied in each of them. In particular, in terms of financial stability the proposals could be strengthened by an automatic, rather than a discretionary, procedure for adjusting pensions in payment.

Other aspects of the proposed pension systems are however inherent to their design, most importantly the strength of the pensions-earnings link and the extent of public provision for retirement. The proposal for a defined-contribution add-on and the notional-accounts scheme have the greatest emphasis on the pensions-earning link by ensuring a high pension replacement rate at all levels of previous earnings. The key issue in deciding on the appropriate strength of the link is the degree to which the state should require individuals to save for their retirement because they are myopic and, left to their own devices, would make inadequate provision. Proponents of a stronger link between pensions and earnings also argue that it increases incentives to work and to contribute to pension savings (because contributions are seen less as an implicit tax). These advantages however have to be weighed up against the fact that, as crafted, these proposals entail high contribution rates and a large government involvement, while not fully addressing social safety net issues.

The tax treatment of pensions and welfare payments were not covered by the 2005 working group. However, these issues needs to be addressed, particularly the system of subsidies and tax allowances on voluntary contributions to private pension funds, which currently generates little saving. *Reform needs to take into account the growing international evidence that tax incentives are often costly and ineffective in inducing more saving.*

Progress in other elements of public-sector reform has been uneven. Though plans for major healthcare reform have been drawn up by successive ministers, none have been implemented. As a result, little progress along the lines suggested in past OECD *Surveys* has been made. General economies in public spending have also been limited, notably a drive for staff cuts in government ministries has stalled.

Some progress has been made in improving the budgeting system. Various measures to tighten accountability are underway and cuts in the number of off-budget accounts have been made. New rules allowing ministries more freedom to carry over spending have reduced wasteful expenditure but are proving problematic in terms of overall spending control. *An adjustment to the rules should be sought that preserves the advantages of this provision, especially for capital spending and EU programmes, while allowing the Finance Ministry to retain control over spending. One avenue that should be exploited is to link carry-over spending with progress in output performance budgeting.* Use of public-private partnerships to help public finances remains limited, though legislation currently in the parliamentary process aims at paving the way to much greater use in the future. *Such partnerships can help financing but need expertise and careful structuring to avoid undesirable long-term liabilities.* ■

How to motivate local government in public-spending reform?

Successful public-spending reform requires concerted efforts by central-government ministries and agencies but also by municipal and regional governments. Policy has to work on three fronts to ensure that sub-national government delivers efficiency improvements: economies of scale, financing systems and accountability.

- There are over 6 200 municipalities in the Czech Republic and international evidence on the minimum-efficient scale of local government suggests a large number of them are too small from an economic perspective. Therefore, opportunities to encourage greater economies of scale have to be fully exploited. *One route is to strengthen financial incentives for mergers through further steepening of the tax allocation schedule, one-off compensation for the costs of mergers and the removal of biases in grant formulae that favour small-scale government operations. The authorities should also seek ways of encouraging more co-operation in the provision of services.* On this front, a proposal to alter tax allocation rules to benefit municipalities who sign comprehensive co-operation agreements looks promising. In addition, there is potential for rationalising the networks of offices providing central-government services.
- *In sub-national government financing, the broad thrust of policy should be towards giving more flexibility*, in particular by switching from earmarked grants to block grants or increased tax allocation. However, caution is needed because some spending areas are due to undergo system-wide reform and central-government leverage through earmarked grants may be important to successful implementation. In addition, cost and output indicators are not yet widely used, so the tools for the local population to oversee revenue use are not fully in place. At the same time, greater room for regions and municipalities in discretionary taxation is warranted, for example through widening of the statutory limits on real-estate taxation.
- *In the budgeting system some tightening of the debt rules is needed*: the sanctions are rather soft and the inclusion of debt repayment in "debt servicing" is problematic. *Various measures should also be taken to improve transparency.* In particular, there should be further development of the public database of regional and municipal accounts and wider powers for the Supreme Audit Office to audit municipalities.

- *In terms of accountability, additional incentives to participate in cost and output benchmarking projects are required if they are to become comprehensive nationwide systems*. Oversight and transparency in public procurement also need improvement. The lead taken by Prague's municipal authority in publishing details of all its procurement contracts on line should be followed. In e-government, the set-up cost for users of electronic signatures needs to be brought down and better co-ordination of public databases would reduce red tape for businesses. ■

What labour and education reforms are needed?

While the most powerful long-term driver of catching-up has to be rising productivity, catch-up in GDP-per-capita can also be fostered through greater use of labour resources. Recent labour-market outcomes have been encouraging but fundamental problems remain, notably long-term unemployment. About half of the unemployed have been out of work for at least a year and they are strongly concentrated in certain regions of the country. Employment creation – in particular for groups with a low labour market attachment – is hampered by the high tax wedge and strict employment protection legislation on regular employment. As regards future productivity growth, the skills base is of crucial importance. Though the education system is performing reasonably well on some fronts, further reforms are needed to cater to the rapidly expanding demand for tertiary-level education. Secondary-school attainment has traditionally been high, but in the working-population as a whole the Czech Republic has one of the lowest shares of degree-level attainment in the OECD. However, change is underway due to a rapid rise in the tertiary enrolment rate among school leavers. This is only partially offset by population decline in young cohorts and overall demand for tertiary education courses is expected to continue growing for some time.

Stepping up labour utilisation requires a range of measures raising both the supply and demand for labour aimed at improving incentives and encouraging greater flexibility in the labour market.

- A number of measures have been taken to make the welfare system more work-oriented. In particular, as of January 2007, a new job-search bonus will be introduced, in-work benefits strengthened and sick pay arrangements improved. In addition, agreement has finally been reached on a schedule for removing rent control in housing, which should help labour mobility. Some progress towards more flexible labour legislation and wage setting has been made. The new labour code, if approved, will bring wider contractual freedom through modernisation of the legislation. Among the specific provisions in the code, legislation on working time accounts in particular should help flexibility. *However, further lightening of rules on dismissal for those on permanent contracts is still required.*
- In wage setting, large increases in the minimum wage have been granted in the first half of this year, continuing an upward trend seen since the late 1990s that has already been detrimental to international competitiveness and job creation.

- *Reduction in the large tax wedge on labour needs to remain a broad policy priority as this is damping employment throughout the labour market*. The resources for doing this are, however, limited by the need for fiscal consolidation and by competing priorities on spending and revenue reduction. Cuts in the wedge may therefore have to focus on reducing non-wage labour costs at the low end of the labour market.

The rapid expansion of tertiary education requires more resources and better incentives for both students and higher education institutions. The universities have been responding somewhat to the changing environment, notably new 3-year vocationally oriented degrees are being introduced. *The introduction of tuition fees for students in public universities that at least partially reflect the cost of tertiary courses would make for better decision making by students and faster reaction of universities to changing demands. If tuition fees are introduced they should be accompanied by publicly supported student loans in which repayments are conditional on graduate income*. This diversification of funding for tertiary education would also help universities cope with further rises in student numbers. *Any increase in funding has to be linked to output quality monitoring and evaluation*.

Secondary schools enjoy a good reputation and benefit from a well established institutional tradition. However, further changes in focus and flexibility in the system are required to better cope with changing skill requirements in the labour market.

- In secondary education, a new system of common national leaving exams in some subject areas is being gradually introduced, bringing welcome reduction in the diversity of final exam tests. The new system will make exam results more useful input for prospective employers. In addition, the system ought to play a bigger role in university entrance by cutting back the need for university-specific entrance exams that not only make the admission process cumbersome but also add to social segregation in tertiary education. *However, less reliance on entrance exams requires closer consultation with universities to ensure secondary school leaving exam results are a useful input for assessing prospective students*.
- Wider access is needed to the general courses in secondary schools that provide options for entering tertiary education. *This could be achieved by making these courses more widely available in the secondary technical schools and by equalising the quality standards with those of the four year gymnasia. More generally, choices could be broadened if upper secondary school curricula were differentiated among broad subject-based streams and if students were allowed to transfer both between and within schools more easily. In addition, the streaming of a minority of students into elite publicly funded schools from age eleven should be phased out, as already outlined in strategic documents by the Ministry of Education*.
- Further decentralisation of responsibility for schooling since the early 2000s has raised the importance of output measurement and benchmarking. *A recently introduced assessment system has merits but its effectiveness needs to be raised, in particular by allowing the publication of results and by giving the inspectorate more scope in information gathering. The assessment and evaluation*

system should be expanded to cover schools, types of school, regions and the entire school system. This should in particular assess how graduates are prepared for employment and further education.

- In the teaching profession, motivation is widely reported as low. Encouraging greater use of financial rewards for good performance is part of the solution. *In addition, more in-service training would ensure that teachers adapt to change in the secondary school system, particularly if students' access to general education is widened, and should also increase job satisfaction.*

It is necessary to boost the participation of middle and older age groups in education; in particular motivating those with low education and qualification is important. The education system is too rigidly geared towards standard pathways of learning. Access to education, notably for adults who want to take either secondary or tertiary level courses, needs to be increased and a greater range of programmes is needed. *This requires a more systematic approach to continuing education that establishes funding mechanisms, quality assurance, information and guidance as well as making changes to current arrangements in the framework of qualifications.* ■

What progress in the business environment and innovation policy?

The business sector has to play a key role in closing the gap in GDP per capita with other OECD countries. As discussed above, the financial environment for business is quite good with low inflation and borrowing costs. However, the slow progress in reforms to labour regulation is damping business development. On other policy fronts, challenges remain in improving administrative process, overcoming weakness in specific areas of business legislation and in dealing with corruption. In addition, there are challenges in ensuring that taxation and business support achieve policy objectives efficiently, particularly in the area of innovation policy.

Bankruptcy legislation has long been criticised as hampering the efficient use of capital in the Czech Republic. Following several previous attempts, new bankruptcy legislation passed in early 2006 aims to strengthen the position of creditors in various ways, including the introduction of a "re-organisation" option. Also welcome are legal changes that aim to reduce the administrative tasks of judges, lighten checking procedures in legal processes and shorten the maximum time allowed for registration of a file with the courts. Business registration forms have also been standardised. *However, both the new bankruptcy legislation and the steps to cut red tape are likely to need some follow-up action; hence careful monitoring of the impact of these new systems is required.* The reduced administrative burden for businesses should also discourage corruption arising from attempts to short-cut processes. The campaign against corruption is also being helped by an increasingly open recognition of the problem and by on-going efforts to introduce new measures to increase accountability, such as the recent proposed legislation that would increase financial disclosure requirements for politicians and public administrators. *However, the fight against corruption is by no means over and pressure through new measures to enhance accountability has to be maintained, along with further reductions in the opportunities for corruption through simpler administrative processes.*

Research and development spending is equivalent to about 1% of GDP in the Czech Republic; this level is relatively low compared with the OECD average, but somewhat higher than in the other east European OECD economies. As in a number of other OECD countries, Czech innovation policy broadly aims to encourage both more private-sector research and a more market-driven approach to research by public-sector research institutions and universities.

- Some tightening of responsibilities and tidying up of financial arrangements is needed in the innovation policy system. *It is important that plans reducing the large number of R&D-related budgetary lines are followed through. In addition, the responsibilities of the state administration in innovation need to be reformulated so as to orient innovation policy more clearly towards research that develops commercial applications or provides academic groundwork with potential for commercial application*. In the case of the umbrella organisation for R&D, the Research and Development Council, this could be dealt with, for example, by greater business-sector representation. In addition, problems of overlap between the Council and the Ministry for Education and Sports need to be resolved and better co-ordination is required between the five ministries involved in R&D policy.

- The majority of public support for R&D is allocated on an institutional rather than a project-specific basis with a split of roughly 60-40% and one of the main policy goals is to change this split to 40-60%. *Changes to the assessment criteria used for awarding grants are also needed*. Less weight should be given to academically oriented indicators of the whole research institution (or department) and more to the characteristics of the team that will carry out the research. A system of periodic "research assessment exercises" should also be considered.

- As in many other countries, the authorities are trying to boost market-oriented research by encouraging stronger public-private links. *To make the labour market for researchers more integrated, more performance-related pay in public-sector research positions could be envisaged*. As well as strengthening industry-science ties, these measures could also help attract back Czech researchers from abroad. Public-private links could also be strengthened by raising the importance of joint work with business in evaluating research activities.

- Tax-based measures are also being used to encourage R&D. A 100% tax allowance on R&D expenditure was introduced in 2005. *While such allowances are in place in several other OECD countries, evidence on their effectiveness is mixed and so the focus should be on impact evaluation both in terms of research activity and cost*. There is also a proposal in a recent policy document to set up a scheme similar to the Hungarian Innovation Fund. The potential gains of this approach need to be evaluated against the downsides of increased complication of the business tax environment and additional administration costs. In addition, sunset clauses should be considered for such programmes.

- Access to finance is one of the key constraints for innovative SMEs in the Czech Republic, largely because the investment proposals are typically too small to attract venture capitalists. There are plans to address this with a government-sponsored risk capital fund. *This scheme should be carefully planned and monitored to ensure good targeting and cost effectiveness*. Indeed, there may be less costly ways of helping innovative SMEs access finance, for example, through changes to investment regulations on pension funds.
- *Czech innovators often lack key skills and information needed to successfully launch an enterprise and more policy action is needed*. One route is for universities to include more business training in courses for science and engineering, including coverage of patenting law and application processes. Improving the information and administrative systems for intellectual property rights would also help. In addition, innovative SMEs would benefit from the introduction of an information system on current and upcoming development projects in regions and municipalities so that they can more easily keep abreast, for example, of places available in technology parks. ■

For further information

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