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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of the Czech Republic were reviewed by the Committee on 19 March 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 2 April 2008.

The Secretariat's draft report was prepared for the Committee by Philip Hemmings, Zuzana Smidova and Alessandro Goglio under the supervision of Andreas Wörgötter.

The previous Survey of the Czech Republic was issued in June 2006.

BASIC STATISTICS OF THE CZECH REPUBLIC, 2006

LAND

Area (1 000 km^2)	79	Major cities, 31 Dec. (1 000 inhabitants)	
Agriculture (%)	54	Prague	1 188
Forest (%)	34	Brno	367
		Ostrava	337

PEOPLE

Population (1 000)	10 287	Employment (1 000)	4 811
Inhabitants per km^2	130	Agriculture (%)	4
Natural increase in population (1 000)	1	Industry (%)	40
Net immigration (1 000)	35	Services (%)	56

GOVERNMENT

Public consumption (% of GDP)	21	Chamber of Deputies, as at April 2006	Seats
General government total revenue (% of GDP)	41	Social Democratic Party	70
		Civic Democratic Party	57
General government deficit (% of GDP)	3	Communist Party	41
Public debt, Maastricht definition (% of GDP)	30	Christian Democratic Union	21
		Freedom Union	10
		Independent	1
		Total	200

PRODUCTION

GDP, current prices (billion CZK)	3 232	Origin of value added (%)	
GDP per capita (USD, current prices)	13 930	Agriculture	3
Gross fixed investment (% GDP)	25	Industry	38
		Services	59

FOREIGN TRADE

Exports of goods and services (% GDP)	76	Imports of goods and services (% GDP)	73
Main exports (% of total merchandise)		Main imports (% of total merchandise)	
Machinery and transport equipment	53	Machinery and transport equipment	43
Manufactures	31	Manufactures	32
Chemicals	6	Chemicals	11

CURRENCY

Monetary unit: Czech koruna		Currency units per euro	
Currency units per USD, 2007	21.35	Year 2007	28.15
		Feb. 2008	25.34

Executive 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.*
- **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.*

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Assessment and recommendations

The economy is growing rapidly…

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*.

… the inflationary risks are manageable

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.

The new government has many plans for reform, but is backed by only a thin parliamentary majority

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.

Ensuring fiscal sustainability is the main policy challenge…

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.

… deficit goals need to be more ambitious

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.*

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Deficit reduction should be helped by further reform of the budgeting system, but political commitment is crucial

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.

The tax reform is broadly welcome…

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.

… and the proposed healthcare reforms have potential

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.

A final decision on pension reform is still pending…

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.

… and more work is needed in other areas of public spending

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.

Raising labour supply and skill levels requires attention to general labour market policies…

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.

… but also policies specifically affecting parents and older cohorts…

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.*

… and education policy

The tighter labour market and the still considerable income gap relative to the EU average underscores 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.

Globalisation is playing a key role in the economy…

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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Chapter 1

Recent developments and policy challenges

This first chapter of the OECD's Economic Survey *of the* Czech Republic *looks at recent economic developments and policy challenges in sustaining a healthy pace of growth for the future. Growth has picked up significantly since the early 2000s and is improving catch up with other OECD economies. Manufactured exports and foreign direct investment are continuing to play a key role in the economy – this is followed-up in* Chapter 4, *which looks at the implications of globalisation for the* Czech *economy. So far, the rapid pace of economic activity has not raised underlying inflation. However, headline inflation is being hiked up by international market developments and policy measures, notably increases in indirect taxation. Even though last year's government deficit has turned out below the level needed for entry to the euro area, ensuring fiscal sustainability is nevertheless an important policy challenge, and is followed up in* Chapter 2. *The second main policy challenge is widening labour supply and deepening skills, which is examined further in* Chapter 3. *The final sections of this chapter update developments in business, competition and the environment policies.*

A strong pace of growth has emerged in the Czech Republic. This is accelerating catch-up in GDP *per capita* with other OECD economies and making fiscal deficit reduction easier. Nevertheless, there are challenges. Public-spending reform to ensure fiscal sustainability is still lagging. In particular, time is running out to put healthcare and pension systems in order to cope with the upcoming acceleration in population aging. In addition, spare labour resources are being rapidly absorbed, which could constrain economic growth. The government has recognised the need for reform, particularly as regards public financing. A wide-ranging fiscal package was passed by parliament in 2007 and a very broad range of reform initiatives is under development with different ministries. But, deficit ambitions are timid given recent growth developments and prospects. In addition, as for previous governments, the ruling coalition has a weak political mandate, making progress in reform difficult (Box 1.1).

Box 1.1. **The political situation**

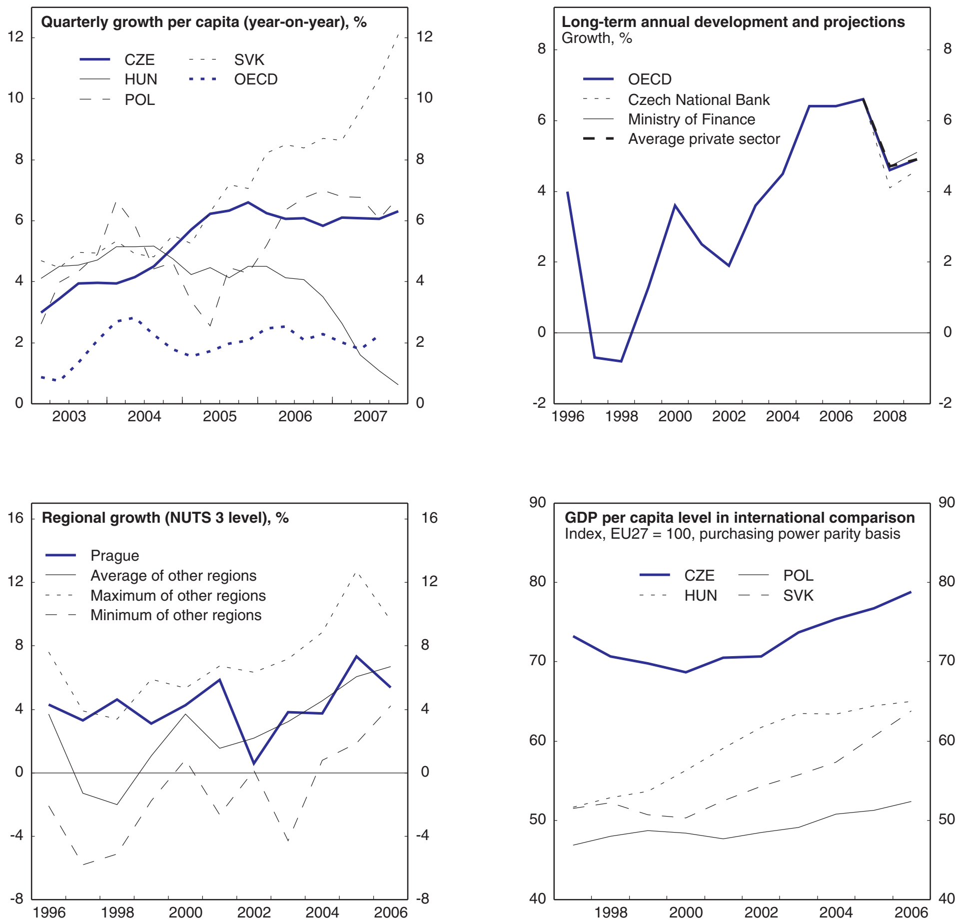
The general election of June 2006 was followed by political deadlock because the two main political groupings won exactly the same number of parliamentary seats. It was not until January 2007 that a government led by Mirek Topolánek of the centre-right Civic Democratic Party (ODS) was officially approved. The Christian Democratic Union – Czech People's Party (KDU-ČSL) and the Green Party are the junior partners. The centre-left Czech Socialist Democratic Party (ČSSD) has been put into opposition for the first time in eight years. The left-wing Communist Party of Bohemia and Moravia (KSČM) remains outside government. Similar to previous governments, the ruling coalition's mandate is weak. It does not have a majority in parliament, and either has to rely on the votes of two rebel ČSSD parliamentarians or seek wider support from the opposition parties. The next parliamentary elections have to be scheduled before mid-2010.

Presidential elections were held in February this year and Václav Klaus, who is aligned with the ODS, was re-elected for a second and last term. Elections of representatives in the fourteen regions and one third of Senate are scheduled for autumn and municipal elections will follow the next general election.

A rapid pace of growth has developed

Economic transition in the Czech Republic ran into difficulties in the late 1990s with a banking crisis, currency problems and economic recession. However, in recent years outturns have improved significantly. Annual real GDP growth turned out at 6.5 and 6.4 in 2005 and 2006, respectively, a marked improvement on the early 2000s (Figure 1.1). Growth in 2007 remained roughly flat, slightly below 6.5% (year-on-year) for the first three quarters. In the final quarter it was a marginally faster at 6.6%, but there were special factors.[1] The annual outcome was 6.5%, which is a good margin higher than that projected in the latest *Economic Outlook*, published in December last year (Table 1.1). Growth in GDP per capita has been of a similar magnitude to that in Poland and much higher than in

Figure 1.1. **Developments in real GDP**



StatLink http://dx.doi.org/10.1787/314557664456

Note: Data for 2007Q4 is preliminary (top left panel). There are fourteen Czech NUTS3 regions in total (bottom left panel).

Source: Eurostat; OECD, *Economic Outlook Database*, December 2007; Czech Ministry of Finance, *Macroeconomic Forecast*, January 2008; Czech National Bank, *Inflation Report*, February 2008; *Consensus Forecasts*, February 2008.

Hungary, but less impressive than that in Slovakia (Figure 1.1). Encouragingly, the recent phase of growth has been countrywide, given the large dichotomy between Prague and the rest of the country.[2] Even the slowest NUTS3-level regional growth rate in 2006 approached 4% (Figure 1.1). The strong pace of economic activity is feeding through to the labour market and household incomes. Since the second half of 2005, employment growth been around 2% (Figure 1.2), a relatively fast pace given that the working-age population has practically zero growth. Indeed, the labour market has tightened significantly.

Despite the tighter labour market, demand growth nevertheless appears to be primarily structural. Real GDP has been increasing faster than potential output growth, but not by much. The latest OECD projection puts potential growth a little over 5% for 2007 and a positive output gap of about 1¼% of GDP.[3] Prior to the recent update of quarterly growth, it seemed likely that that gap was already shrinking. It is less clear whether this is now the case. Nevertheless, growth is expected to dip below potential this year, mainly because a

Table 1.1. **Recent developments and projections (*Economic Outlook* No. 82, December 2007)**

	Current prices (CZK billion)	Percentage changes, volume (2000 prices)				
	2004	2005	2006	2007	2008	2009
Private consumption	1 417.2	2.5	4.4	6.7	4.0	4.1
Government consumption	624.2	2.3	1.1	0.6	0.0	0.1
Gross fixed capital formation	727.2	2.3	7.6	4.2	7.8	7.7
Final domestic demand	2 768.6	2.4	4.5	4.7	4.1	4.2
Stockbuilding[1]	48.2	–0.6	1.1	1.6	0.1	0.0
Total domestic demand	2 816.8	1.7	5.6	6.2	4.1	4.1
Exports of goods and services	1 967.6	12.0	16.6	12.6	10.9	11.4
Imports of goods and services	1 967.4	5.1	15.8	13.2	10.6	10.8
Net exports[1]	0.2	4.8	1.1	–0.1	0.7	1.0
GDP at market prices	2 817.0	6.5	6.4	6.1	4.6	4.9
GDP deflator	–	–0.2	1.1	3.5	3.8	2.7
Memorandum items						
Consumer price index	–	1.9	2.6	2.7	4.6	3.1
Private consumption deflator	–	0.9	1.6	1.7	4.4	3.1
Unemployment rate	–	8.0	7.2	5.4	5.0	4.7
General government financial balance[2]	–	–3.5	–2.9	–3.7	–3.1	–2.5
Current account balance[2]	–	–1.6	–3.1	–2.9	–1.5	–0.6

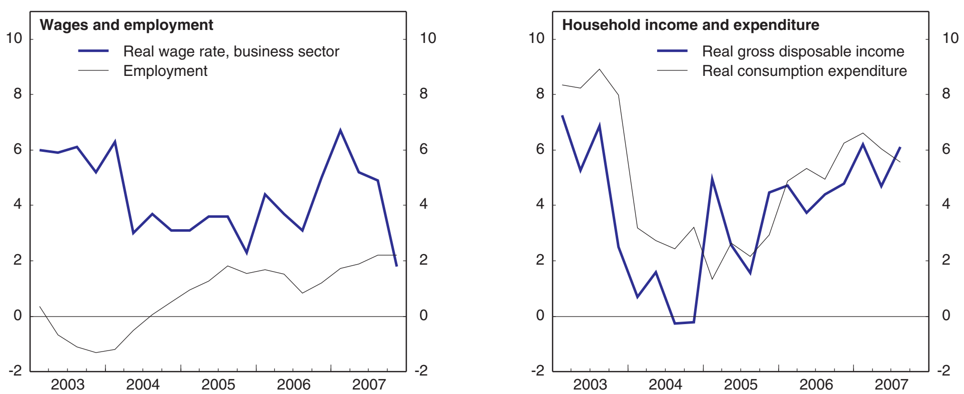
Note: National accounts are based on official chain-linked data. This introduce a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods, (*www.oecd.org/document/14/0,3343,en_2649_34573_1847822_1_1_1_1,00.html*).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: *OECD Economic Outlook 82 Database.*

Figure 1.2. **Developments in the household sector**

Year-on-year growth, %



StatLink http://dx.doi.org/10.1787/314627062287

Source: Czech National Bank, *ARAD Database*; Czech Statistical Office; OECD, *Main Economic Indicators Database*.

spike in inflation is temporarily damping household consumption (see below). The consensus among projections is for an annual outcome of around 4.5% (Figure 1.1).

For 2009, real GDP growth is expected to pick up and come in close to potential, which will still be around 5%. Such a growth rate implies a good pace of catch up with more advanced OECD economies since *per capita* GDP growth is roughly of the same magnitude. If it can be maintained for the longer term, the time taken to reach landmarks in catch-up will be significantly shortened. For example, GDP *per capita* is currently about 75% of the euro-area average on a purchasing-power-parity (PPP) basis. Assuming real GDP-*per capita* growth of 2% in the euro area and 5% in the Czech Republic, the gap could close within a decade.

The recent financial turmoil has not had any significant impact so far on the economy. There appears to be little risk of a crisis of domestic origin. According to available data, neither domestic banks nor the branches and subsidiaries of foreign banks operating the Czech Republic have substantial holdings of products contaminated by poor-quality loans.[4] As a result there has been no sign of mutual distrust and a credit crunch in domestic banking markets. However, international financial market developments are inevitably affecting the economy to some degree. At a minimum, the global re-pricing of credit is bound to raise borrowing costs for higher-risk Czech firms and households. Insofar as the parent companies of foreign banks operating in the Czech Republic suffer losses that reduce their available equity capital, their Czech subsidiaries might also curtail lending. Also, the Czech stock market has been influenced by swings in global markets. Finally, the global financial turmoil, and the international policy response to it, is affecting interest-rate differentials with foreign instruments. This, and other factors related to global events, are affecting exchange rate movements. Indeed, strong appreciation in the latter half of 2007 and the first months of 2008 is believed by the unwinding of carry trade.

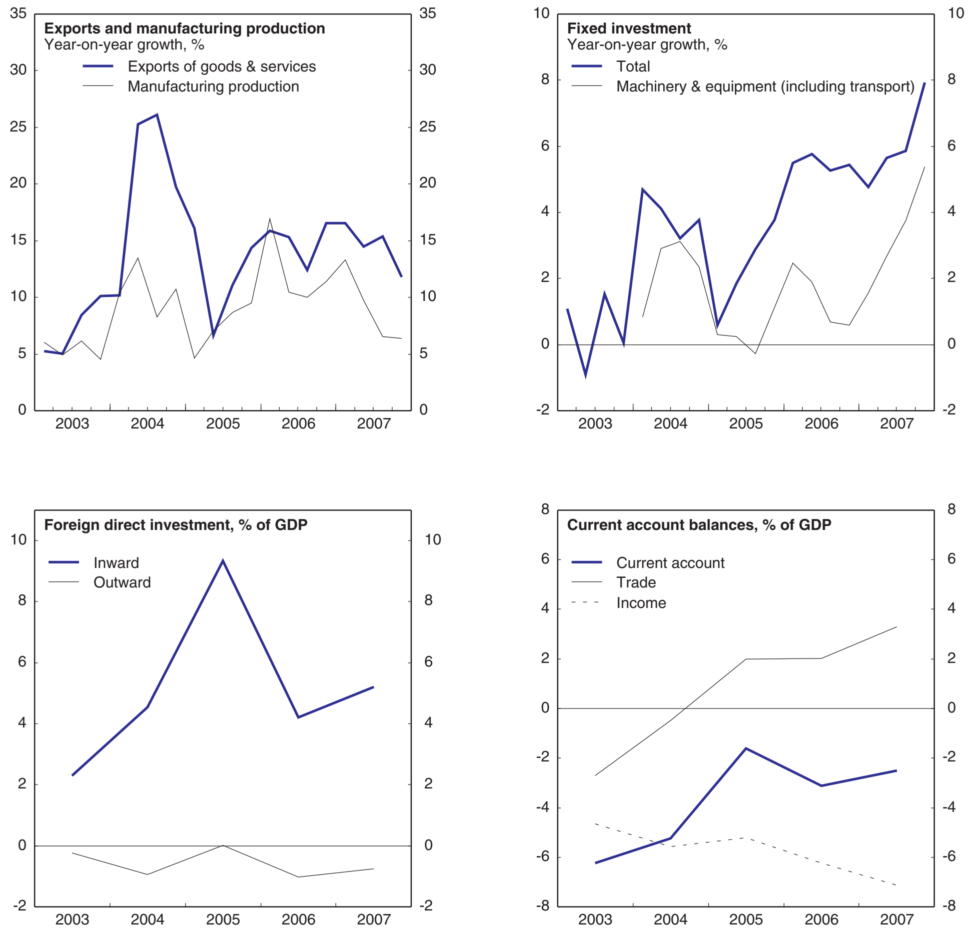
The economy is strongly linked to globalisation processes

Growth is being driven by a surge in export-oriented manufacturing that marks further deepening of the economy's involvement in international supply chains. This process has been a central feature of economic development since transition began in the early 1990s. Chapter 4 examines this further. International manufacturing is most obviously reflected in fast growth in exports and production and significant surges in fixed investment and foreign direct investment (Figure 1.3). Export manufacturing in the Czech Republic involves large cross border movements of goods in both directions. Indeed, imports are of the same magnitude as exports and the volume of trade is now about 50% larger than that of GDP. The most prominent sector is vehicle manufacture, and, linked to this, a significant share of trade is with Germany.

The very large trade flows associated with globalised manufacturing are having a positive impact on the current account – the trade-balance has been positive since 2005. In fact, the current account deficit has narrowed significantly since the early 2000s (Figure 1.3). At the same time, the manufacturing facilities generate outflows of re-invested earnings and dividends. These have a negative effect on the current account balance and largely explain the deficit in the income component.

Chapter 4 not only looks further at the pattern of trade in goods and production but also examines other impacts of globalisation on the Czech economy. As in other OECD countries, multinationals are changing the face of retailing and certain imported goods prices are lowering inflation. In addition, a tradable services sector is developing, though in the Czech case it is so far relatively small. The chapter also considers what policymakers should do to harness globalisation for the benefit of both households and businesses.

Figure 1.3. **Developments in exports, manufacturing, investment and the current account**



StatLink http://dx.doi.org/10.1787/314640811622

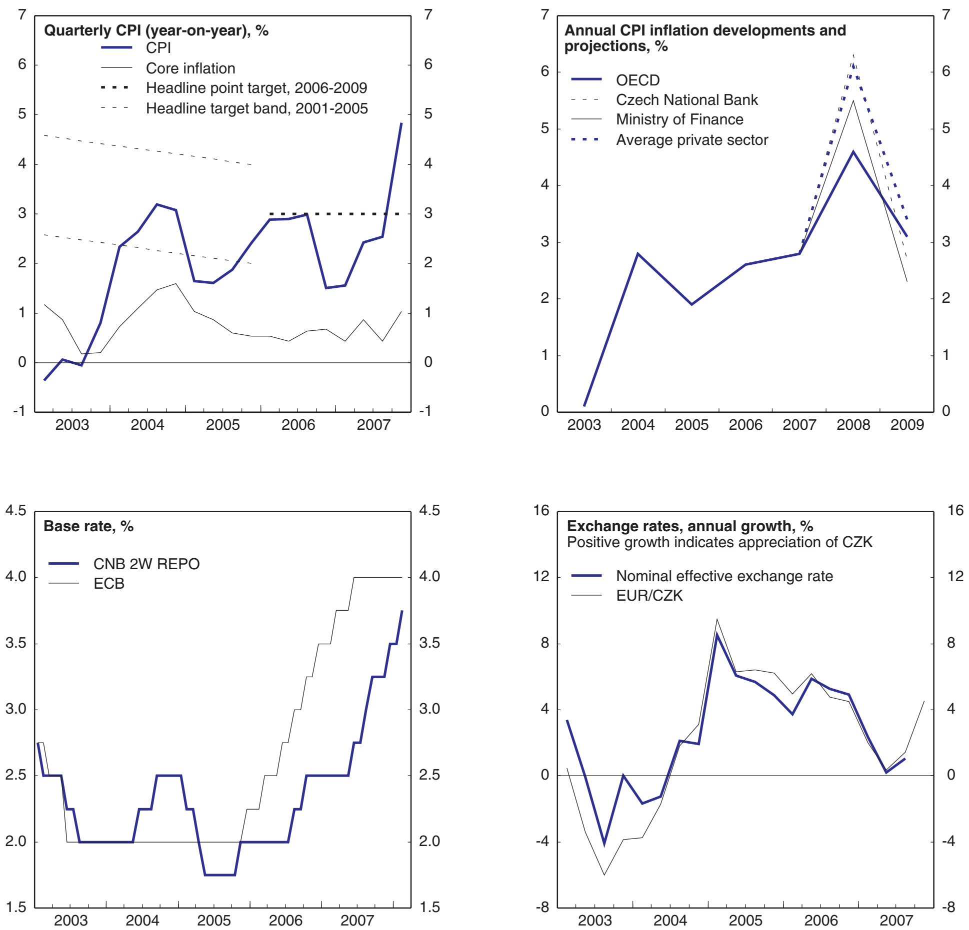
Note: Estimate for 2007 based on Q1-Q3. The high inflow of foreign direct investment in 2005 (bottom-left panel) was primarily due to the privatisation of Czech Telecom, Unipetrol and Vitkovice Steel.

Source: Czech National Bank; Czech Statistical Office; OECD, *National Accounts Database*.

There are some concerns about inflation

Until the final quarter of 2007, headline inflation had remained below the 3% central target that was introduced at the beginning of 2006 (Figure 1.4). Indeed, core inflation has remained benign and, as discussed above, although a positive output gap has developed, it is relatively small. However, recent developments raise some concerns. Headline CPI growth shot up to 4½% in the fourth quarter of 2007, mainly due to market-driven increases in food and oil prices. Furthermore, several policy-driven price hikes are currently increasing inflation. The biggest single impact on inflation is from increase in the lower rate of VAT, which includes some major items such as food, and which is part of a package of fiscal measures (see below). Prices are also being pushed up by large increases in excise duty on tobacco and in the regulated components of energy prices. Ongoing increases in regulated rents, new environmental taxes and the introduction of healthcare fees are further increasing current CPI outcomes. The combined effect of these measures

Figure 1.4. **Developments in prices, interest rates and exchange rates**



StatLink http://dx.doi.org/10.1787/314774263510

Note: The inflation rate is the growth in the consumer price index compared to the same quarter of the previous year. The core inflation used here is the Czech National Bank's adjusted inflation measure that excludes regulated prices, fuels and first-round impacts of changes to indirect taxes.

Source: Czech National Bank (CNB); Czech Statistical Office; European Central Bank (ECB); Czech Ministry of Finance, *Macroeconomic Forecast*, January 2008; Czech National Bank, *Inflation Report*, February 2008; *Consensus Forecasts*, February 2008; OECD, *Economic Outlook December* 2007.

is bringing a significant spike in inflation (Figure 1.4). The risk is that, although mainly driven by one-off effects, this may nevertheless feed into inflationary expectations and hence core inflation, particularly if food and energy price developments further fuel headline inflation.

Overall, although monetary policy faces challenges, there are no signs that the inflation-targeting regime itself needs substantial reform. The Central Bank began a series of rate increases in July 2007 (Figure 1.4) that raised the rate from 2.25 to 3.75% (as of February 2008). Partly these moves reflect a reaction to the risks described above. Changes in policy rates elsewhere are also affecting monetary policy because of a strong influence of exchange rate movements on consumer prices. In addition, a lowering of the inflation target is also becoming relevant. In March 2007, the Bank announced that, as of January 2010, the inflation target will be 2% expressed as annual price index growth with a tolerance band ±1 percentage point instead of 3% with the same ±1 tolerance band. Other adjustments to policy were announced, including the publication of an interest rate path (CNB, 2007).[5] Response lags mean rate setting is already taking account of the new target. The reasons for the lower target given in the Bank's official announcement are that: *i)* by 2010, upward pressure from changes in administrated prices currently in the pipeline will have finished; *ii)* upward pressure on inflation from real exchange rate appreciation effects will have weakened and the need to keep open positive inflation differential will gradually subside; *iii)* the new consumer basket introduced in January 2007 puts more weight on unregulated tradable commodities that has lowered CPI growth; and *iv)* the inflation expectations of financial market participants are anchored at low levels (just below the target at the three year horizon). In this situation the Central Bank views it as appropriate to move the inflation target to a lower level in line with practice with advanced countries. Aside from these technical arguments, the new rate clearly ties in more closely with the likely rate of inflation required to fulfil the Maastricht conditions for euro entry.

Conservative views on euro entry are being voiced

The target date for entering the euro area (2009-10) set in the original Euro Area Adoption Strategy of 2003 has already been missed. With hindsight, this could probably have been achieved if a concentrated policy effort had been made. Technically, the earliest possible year of entry is now 2012.[6] Although fulfilling the Maastricht criteria looks feasible by then, the present government has not committed to a target year. Moreover, leading policymakers are advocating a more conservative approach to entry compared with the previous administration. A common argument is that joining the euro should be held off until the economy is a lot more closely aligned with that of the euro-area and after reforms have been implemented. This shift in approach is reflected in a revised Strategy that was adopted by the government in August 2007. The document does not specify the target date and conditions the adoption of the euro on enhanced flexibility of the economy (especially of the labour market) and on consolidation of public finances.

In terms of real and nominal convergence the Czech economy indeed has some way to go; real GDP-*per capita*, as already mentioned, is currently about 75% the euro-area average and the average price level about 60%. In these circumstances, another consequence of entering the euro-area is that, with the loss of the exchange-rate channel, inflation has to do all the work in nominal convergence. Certainly in the past, this channel has been important, with the koruna typically appreciating against euro (Figure 1.4).[7] At the same time, delaying entry implies accumulating opportunity costs because it postpones the gains from adopting the euro (principally the removal of exchange rate risk). Uncertainty in the magnitude and dynamics of these costs and benefits means economic analysis cannot provide much precision on the optimal timing for entry, but it can nevertheless help guide decision making. In this regard, it is important that the annual report prepared jointly by Ministry of Finance and the CNB, and approved by the government (see Box 1.2) continues to provide an objective assessment of alignment and that the entry decision takes due account of the costs and benefits of entry.

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Box 1.2. **The Czech strategy for euro entry**

The Czech authorities consider that exchange-rate mechanism II (ERMII) membership should not extend much beyond the two-year minimum required. This implies that ERMII should not be joined unless the chances of passing the Maastricht criteria are good and that alignment is satisfactory. An annual assessment on the preparedness of the economy to join is published in a document prepared jointly by the Central Bank and the Ministry of Finance that contains a recommendation for the government on whether to join ERMII in the following calendar year. The first assessment was made in autumn 2004. The latest, published in late 2007, recommended not joining ERMII during 2008 (Ministry of Finance and Czech National Bank, 2007). According to the report, the main obstacles lie with public finances and low flexibility of the labour market. Indeed, the report concluded that it is necessary to continue with further reform efforts so that public finance deficits decline by at least 0.5% per year until they are well below the maximum level allowed under the Maastricht convergence criterion.

The key policy challenges

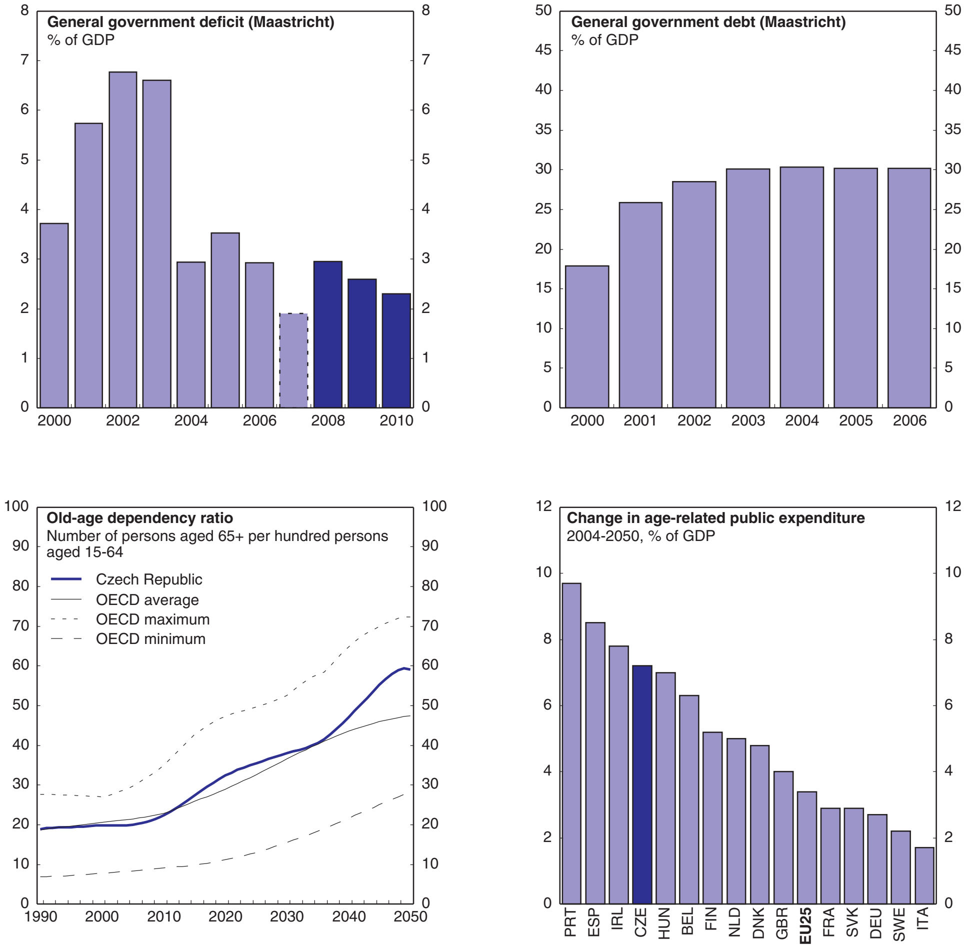
Ensuring fiscal sustainability

Fiscal sustainability has been a perennial challenge. Deficits have not been so high as to risk macroeconomic crisis. But, public spending includes transfer systems and services that are often inefficient. As a result, taxes are higher than they need be and more resources tied up in producing public services than is necessary. The fiscal position has been helped considerably by the strong pace of growth. Indeed, there have been large budgetary surprises. The 2007 budget experience provides a good example. The Ministry of Finance initially estimated the general government deficit at 4% of GDP, boosted by spending increases voted in by parliament in the run-up to the 2006 general election (several welfare benefits were increased substantially).[8] But, higher-than-expected revenues mean the outturn is now expected to be 1.6% of GDP and seems likely that the target of a 2.3% deficit in 2010 can be easily achieved (Figure 1.5).

The primary motivation for reforming public finances is that a period of rapid population aging is on the horizon and it will put large pressure on healthcare and pensions spending. The old-age dependency ratio is going to increase rapidly in the coming years (see Figure 1.5). According to UN population projections, Czech demography will have two phases of accelerated aging in the first half of this century, one will begin in the next few years and end in the early 2020's and the other will start in the mid 2030's and end around 2050 (Figure 1.5). Calculations made for the European Commission's report on the impact of ageing on public expenditure exemplify the possible fiscal consequences (European Commission, 2006). According to the report, the additional spending pressure will be equivalent to nearly 7% of GDP by 2050, based on assumptions about unchanged policy settings, and is one of the largest age-related fiscal pressures among European-Union countries (Figure 1.5). Coping with this will require not only reforms in ageing-related areas, but also efficiency gains in other areas of spending.

Despite the difficult political position (see Box 1.1), the current government made a positive start to its term of office with a fiscal package that includes wide-ranging tax and spending reforms, many of which are aimed as first steps in more ambitious reform. The package contained more tax measures than spending reforms but some of the latter were

Figure 1.5. **Fiscal developments and upcoming challenges**



StatLink http://dx.doi.org/10.1787/314864873202

Note: The deficit for 2007 is an estimate and for 2008 to 2010, government targets.

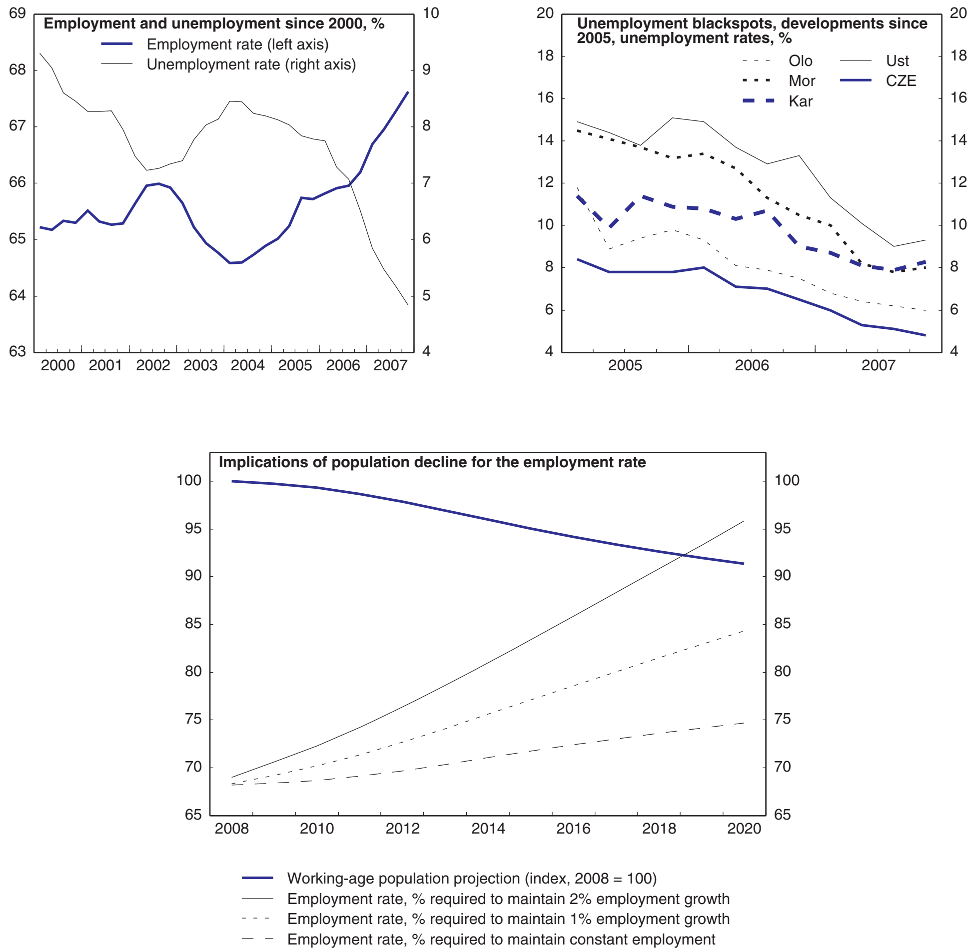
Source: European Commission (2006) "The impact of ageing on public expenditure", *Special Report* No. 1/2006; *OECD Economic Outlook Database*, December 2007; UN, *World Population Prospects: The 2006 Revision*, medium-variant population projections.

significant. For instance, in healthcare the package has introduced fees for some services. Chapter 2 of this *Survey* makes a detailed assessment of the achievements and plans in tax and spending reform.

Improving labour supply

A second set of challenges lie in raising potential labour supply and skill levels. Past *Surveys* have underscored the need for reform in education and for supply-side adjustments. In part, reforms have been required to deal with regionalised structural unemployment that emerged from industrial adjustment. Moreover, the Czech Republic has some way to go in reaching levels of educational attainment seen in many other OECD countries, particularly at the tertiary level. This, and other, issues in education policy were discussed by an in-depth review in the previous *Survey*.

Figure 1.6. **Trends in employment and unemployment**



StatLink http://dx.doi.org/10.1787/315022570421

Note: Employment rate is total employment divided by working-age population, quarterly data. Quarterly population is interpolated from annual and projected for 2007.

Regions: Olo-Olomoucký, Mor-Moravskoslezský, Kar-Karlovarský, Ust-Ústecký. The four regions shown are all the NUTS3 regions that had unemployment rates over 10% in Q1 2005. There are 14 NUTS3 regions in total.

Source: Czech Statistical Office; OECD, *Economic Outlook Database*; UN, *World Population Prospects: The 2006 Revision*, medium-variant population projections.

The increased pace of growth has had a significant impact on the labour market. The employment rate has increased by over two percentage points since 2005 and the unemployment rate has fallen substantially (Figure 1.6). Indeed, by the fourth quarter of 2007 the rate was below 5%. The good news is that, in line with regional GDP growth, labour market conditions have improved throughout the country. In fact, the problem of highly regionalised structural unemployment has been significantly reduced. Since 2005 there have been large drops in the unemployment rate in those regions that suffered large job losses in the 1990s (Figure 1.6). Linked to this, long-term unemployment has declined.[9]

Labour market conditions have improved so much that a problem of labour shortage has emerged. The start of a period of decline in the working age population within the next few years is going to amplify the problem. As a result, maintaining even a constant level of employment for the future implies substantial increase in the employment rate (Figure 1.6). Offsetting these developments requires not only continued attention to structural unemployment but also to policies that can bring more people into the labour force and improve the deepening of skills. These issues are discussed in Chapter 3. To some extent, immigration has already been helping fill gaps in the labour force. Indeed, population-register data show that the number of foreigners resident for more than 90 days has increased by 40% between 2005 and 2007, although immigrants remain a fairly small share of the total population.[10] Policy issues in migration are discussed in Chapter 4.

Update on other policy areas

Other policy areas of course play a role in creating a good environment for growth. As in many countries, innovation policy has received increased attention in recent years and was reviewed in the 2006 *Survey*. Red tape and legal issues for business as well as corruption have often been covered in past *Surveys*. Progress on these fronts, albeit rather slow, has been made. However, there is room for further improvement. In addition, past *Surveys* have typically reviewed developments in competition policy where, as for many OECD countries, the key challenge lies in bringing effective market competition in the network industries.

Innovation policy

The review in the 2006 *Survey* found the broad goals of policy commendable, namely to encourage more private-sector research and a more market-driven approach in public-sector research. But it did identify weaknesses in policy frameworks and implementation. The detailed recommendations notably suggested simplification through a reduction in the number of R&D related budget lines. Moreover, the review recommended better co-ordination and business representation in the administration of innovation policy. Plans to move away from institutional funding towards project-based funding were broadly welcomed. In addition, the review recommended monitoring the impact of recently introduced tax breaks for R&D spending and caution in plans for a state-backed venture capital scheme for SMEs.

There has been some progress along these lines. A positive shift towards project-based funding of R&D is underway; the share of project-based financing was 43% in 2005 and is expected to reach 53% this year. Moreover, a reform package is being developed that includes a reduction in the number of budget lines (from 22 to 10), further centralisation of policy and executive powers in the Research and Development Council, as well as overhaul of the administration of research grants. Further tax deductions on R&D expenditures are also being considered. The existing tax break has proved popular with private-sector spending on R&D apparently increasing by 20% between 2005 and 2006. But, the increase probably contains a degree of deadweight loss and creative accounting. Such risks should be taken into account in any further measures.

Business legislation, red tape and corruption issues

The long-awaited new bankruptcy legislation came into force in January. It is expected to strengthen creditor rights and speed up the resolution of bankruptcy claims, helping reduce the very long time taken to close businesses in the Czech Republic compared with other countries (see 2006 *Survey* for further detail).[11] Policy is currently focusing on further shortening of the judicial process through increased use of electronic communication and cuts in administration.

As regards red tape, a survey of administrative burdens across state bodies was published in 2006 (Government of the Czech Republic, 2006). The report includes estimates of the financial cost of burdens and concludes that the best way forward is to cut back information demands through better co-ordination between administrative bodies, simplification of requests and the abolition of redundant requests. Following this report, a broad goal for a 20% cut in administrative burdens by 2010 was set. In addition, a simplified business registration process for entrepreneurs has been running since mid 2006.

There is tentative evidence that the campaign against corruption is paying off. In both 2006 and 2007, there was improvement in the Czech Republic's score in Transparency International's corruption perception index. Unfortunately, high-profile cases continue to hit the headlines. Of particular concern are recent cases involving the 2004-06 EU budget, especially in light of the much larger allocations of the 2007-13 budget. In terms of recent measures, legislation on conflict of interest was enforced in January 2007 that includes making more categories of public officials subject to yearly property and income declarations. Furthermore, a pilot project involving an anti-corruption hotline is underway, legislation increasing punishment for corruption and money laundering and giving the police special powers in corruption is currently in parliament. Also, several ministries and regional governments have announced individual action plans to tackle corruption.[12]

Some policy actions in other areas are going to have positive spin-offs for the fight against corruption. As a part of an expansion of e-government, a network of 2 300 "Czechpoints" is being created, that will allow access to official databases and certification, such as the business and property registers. The system is expected to reduce bribes to speed-up applications. The introduction of user fees for doctor and specialist appointments is also likely to reduce undeclared cash payments (see Chapter 2).

Competition issues

Dominant incumbents in the network industries continue to present significant challenges for the Competition Office (*Úřad pro ochranu hospodářské soutěže* or ÚOHS) and industry regulators. In the *gas sector*, provider choice was opened up to domestic users in January 2007, six months ahead of the EU-directive deadline. While this is welcome, the incumbent, RWE, still has considerable influence throughout the supply chain. For instance, in autumn 2006 it was fined for increasing barriers for competitors in gas distribution (RWE has majority shareholdings in six of the eight distribution companies). Furthermore, RWE is obstructing access to gas storage facilities.[13] At present, there are no plans for ownership unbundling of the company's interests in transmission networks from its market services. Neither is a forced reduction in the incumbent's interests in other areas envisaged, such as in regional wholesale distribution.[14]

In the *electricity sector*, supplier choice for households was also implemented in January 2007. The grid has been separated from the incumbent, and is run as a state-run company. Nevertheless, ČEZ remains influential. The company controls over 70% of production capacity and 45% of distribution. Furthermore, ČEZ remains majority state owned, so links with the grid remain, albeit indirect. The government sold a small share of its holding in late 2007 but the move aimed to raise revenue and was not a prelude to full-scale privatisation. Arguably, it would be important to split up the company prior to privatisation in any event. In part, geo-political concerns are stalling further sell offs. But in addition, the dividend payouts often bring substantial revenues. For instance, in 2007 the dividend helped lower the state and general government deficits by about 0.4% of GDP.[15]

The price of *telecommunications* remains high compared with other OECD countries, and is contributing to a low take up of broadband Internet.[16] However, the consensus view is that legislation and oversight of the sector is sound and that competition is intensifying. There has been some fine-tuning of regulation. In particular, special rules that clouded the powers of the Competition Office in telecommunications markets were removed in 2007. Oversight of the sector needs to remain strong, with recent cases brought by the competition authority exemplifying active efforts by the dominant provider to limit competition.[17]

In other sectors, the Competition Office is putting a greater emphasis on public relations, transparency and advocacy (*i.e.* direct discussions with parties without the use of formal legal proceedings). There is an ongoing campaign to remove non-essential regulations in the liberal professions. Furthermore, the Office has provided welcome resistance to inappropriate proposals to protect suppliers to retail chains.[18] Furthermore, additional tools for tackling cartels are being developed. The Competition Office has set up a specialist cartel department and there is new leniency legislation that, for example, gives greater protection to parties who submit information about cartel activity. Suspicion of cartel activity in motorway construction has often been voiced in the press and there has been some research into the issue although no formal proceedings have been initiated.[19]

Environment policy

Several new measures to contain carbon-dioxide emissions have been introduced. EU directives have brought environmental taxes on energy suppliers and mandatory additions of biofuel to gas and diesel.[20] There are plans for more tax instruments though no action is anticipated before 2010. The main vehicle for encouraging renewable energy production continues to be the so-called "green bonus" scheme in which producers can choose a guaranteed final price, or receive a bonus on top of the market rate of electricity. As in similar schemes elsewhere, there is a risk that the subsidy is too high in relation to the supply possibilities, such that more public money than necessary is being used to attract producers.

Air pollution in urban areas continues to be a problem. An annual report on the state of the environment in 2006 underscored environmental problems from a combination of increasing traffic volumes, old vehicles and poor road surfaces (Ministry of Environment, 2006). This echoes concerns raised in the OECD's *Environmental Performance Review* (OECD, 2005). Residential heating units are also an important source of air pollution. Various parameters of annual road tax are being altered to encourage users to switch to more efficient vehicles, for instance incentives to replace old vehicles have been increased. There are also plans to encourage the public sector to use more environmentally friendly vehicles. As regards domestic heating units tighter controls are intended along with encouragement to use environmentally friendly fuels.

The modernisation of waste-water treatment is attracting policy attention. The main concern is that progress is too slow particularly in light of a 2010 deadline contained in an EU directive (Supreme Audit Office, 2007). Resolution of a dispute between the Czech authorities and the European Commission on which types of waste-water contract are eligible for EU funding has been one cause of delay.[21] In addition, some local authorities are reportedly facing difficulties in financing the required investment, despite the availability of EU funds.[22]

Notes

1. The fourth-quarter growth for 2007 of 6.6% (year-on-year, seasonally adjusted) was announced in early March. The Czech Central Statistical Office estimates that 0.6 percentage points of this figure was due to increased healthcare consumption in advance of the introduction of fees for prescriptions and some services. Hence, without these effects, GDP would have grown by 6%.
2. According to CZSO data, GDP per capita in Prague was already a little over 165% of the EU average in 2006 while it ranged between 60 and 75% in all other regions at the NUTS3 level.
3. The OECD's estimates of potential growth and output gaps for the Czech Republic are based on differences between outcomes and trends in inputs. The exact figures for 2007 are 5.3% potential output growth and 1.3% output gap. The January 2008 Ministry of Finance's forecast estimates an output gap of about 1.3% for 2007 (Ministry of Finance, 2008). The February 2008 projection by the Czech National Bank has quarterly output gaps of a similar magnitude and indicate that the gap has already begun to fall (CNB, 2008).
4. There is no evidence of an increase in non-performing loans among domestic businesses and households. Indeed, over recent months the shares have continued to fall, following a trend that has been apparent for several years. According to Czech National Bank, in December 2007 the share of non-performing loans was 7.2% in the business sector and 2.7% in the household sector.
5. The March 2007 statement of the CNB also announced, as of 2008: reduction in the frequency of monetary policy meetings from twelve to eight per year and publication of the full details of the votes by board members (previously only the number of votes was made public).
6. If the 2008 joint report by the CNB and the Ministry of Finance (see Box 1.2) recommends joining Exchange Rate Mechanism II (ERMII) within the following year, then the two-year minimum ERMII membership could start in early 2009 and end in early 2011. Allowing time for assessment and the various preparatory work needed to introduce the euro makes it very unlikely the currency could be introduced before 2012.
7. The depreciation of the koruna in 2003 shown in the lower right panel of Figure 1.4 was a temporary episode. Prior to this the currency had been appreciating steadily since the currency crisis of the late 1990s.
8. A number of these spending increases were proposed by individual members of parliament in the run up to the election, not the then government. In particular, there were large increases in some welfare payments. The 2007 *Convergence Programme* (Ministry of Finance, 2007) estimates the total additional spending to be equivalent to about 1% of GDP.
9. As of early 2008, data on the duration of unemployment were only available up to 2006. Nevertheless, these figures show a sharp drop in long-term as well as short term unemployment.
10. A total of about 392 000 foreigners were recorded as staying for more than 90 days in 2007 compared with about 278 000 in 2005. This represents roughly 3.8% of the total population in 2007.
11. According to the World Bank's Doing Business indicators for 2007 it takes about 9 years to close a business in the Czech Republic compared with 2, 3 and 4 years in Hungary, Poland and Slovakia, respectively (World Bank, 2007).
12. Earlier drafts of this legislation included provisions allowing the police to provoke corruption, for example by using undercover agents to offer bribes to suspects. Although such provisions have reportedly been successful in Slovakia and Poland, they were not included in the final draft. According to the current draft, undercover agents may be used to monitor corruption. Furthermore, for corruption investigation the tax authorities are no longer obliged to maintain secrecy.
13. Access to gas storage facilities is also being obstructed by inadequate regulation. The limited access to storage makes it difficult for competitors to offer services to segments which have varying demand, notably households.
14. One argument presented by the Czech authorities is that ownership unbundling of transmission would bring little benefit because of the very limited options for domestic production and outside supply; the vast majority of gas is imported from Russia.
15. The government's dividend from its ČEZ shareholding was CZK 14.8 billion in 2007. Under government accounting rules, dividend payments are counted as revenue. In theory future dividends are reflected in the share price, implying that the government would not "lose out" by further sell offs. However, privatisation receipts are not booked as revenues and so cannot directly help government deficits, though they are factored into debt (and so there is an indirect impact on the deficit *via* lower debt-servicing costs).

16. A comprehensive international comparison of telecommunications prices (as of 2006) is made in the latest *OECD Communications Outlook* (OECD, 2007). In all seven of the consumption baskets prices for fixed and mobile telephone use, the Czech Republic has among the highest prices of all OECD countries on a PPP basis. For instance, medium-usage residential fixed line communication costs at least 60% more than in the majority of OECD countries. The cost of broadband Internet access also ranks high as measured in the price per megabit per second. As of mid-2006 where were less than 10 broadband Internet subscribers per hundred inhabitants in the Czech Republic, compared with at least 15 subscribers in most other OECD countries.
17. For instance, in 2005 the incumbent (now *Telefónica O2 Czech Republic*, formerly *Czech Telecom*) was fined in CZK 205 million for abuse of dominance in the timing of its wholesale and resale price offers (Competition Office, 2006).
18. A bill introducing the concept of "economic dependency" was initially supported by the Office but then considered subsequent amendments made the legislation too stringent. The bill was later vetoed by the President on the advice of the Office. The Office has also fiercely opposed legislative proposals for banning pricing below cost.
19. One report conducted jointly by the Supreme Audit Office and its German counterpart compared construction costs on the German and Czech stretches of the Prague-Dresden motorway. For example, the cost of tunnels on the Czech side is found to be higher than that on the German side (Supreme Audit Office and Bundesrechungshof, 2006).
20. The new environmental taxes are levied on suppliers to end-users or operators of distribution or transmission systems. The tax is specified in Czech Korunas per unit of energy. For instance the tax is CZK 28.3 per megawatt-hour of electricity. The first regulations on biofuel additions came into force in September 2007 and the final round will be in January 2009 by which time diesel will have to contain 4.5% vegetable oil methyl ester and gas will have to contain 3.5% bioethanol. This is a part of an EU wide effort for more renewable energy use, targeting 20% renewable energy in total final consumption of energy in EU by 2020, including a 10% target for biofuel in fuels used for transport. As regards the EU's emission-trading system, the Czech authorities are disputing the quota given by the European Commission for the 2008-12 period. The quota it is nearly 15% lower than that initially applied for. Controversy over the allocation may recede if recent plans by the Commission for an EU-wide system of allocation go ahead.
21. Many local authorities have contracted out waste-water treatment and this raised questions of eligibility for EU funding. The issue has been resolved with an agreed eligibility depending on the length of contract.
22. The allocation for environment issues is nearly 20% of the 2007-13 EU budget and much of it is earmarked for investment in water treatment and supply.

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ANNEX 1.A1

Progress in structural reform

This table reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Past recommendations	Actions taken and current assessment
A. Ensuring fiscal sustainability: central-government budgeting	
In the Medium-Term Expenditure Framework, be vigilant against dilution of the spending ceilings, abuse of rules on cyclical spending and inappropriate use of windfall revenues.	No changes to the MTEF have been made but the current government has pledged a strong commitment to it. In the past, the expenditure ceilings were broken.
Bring more extra-budgetary funds into mainstream budgeting.	No significant action since the winding up of the National Property Fund and Czech Consolidation Agency.
Other measures not linked to recommendations:	A new system of reserve funds based on "rights to spend" accounts has been introduced.
B. Ensuring fiscal sustainability: public expenditure reform	
Pensions (in-depth review in 2006 Survey)	
The wide range of detailed reforms developed systematically in 2005 should be used as a basis for a final decision on pension reform.	No final decision has been made. However parametric changes have been submitted to parliament, notably further increases in the retirement age and changes to eligibility requirements. A voluntary defined-contribution carve out is being discussed.
Healthcare (in-depth review in 2003 Survey)	
The general goals of reform should be to:	
• Clarify and narrow down universal health services and allow private markets for complementary services to develop. • Make user fees play a greater role. • Step up monitoring of the output and quality of services. • Seek efficiency gains through more horizontal and vertical co-operation among providers. • Put more focus on preventative measures, such as public awareness programmes on lifestyle.	The 2007 fiscal package introduced a first phase of reform, notably bringing fees for some medical services. A second phase of reform is being prepared that includes substantial reform to the insurance system. A third phase of reform is envisaged. In principle these measures would address several previous recommendations.
Local and regional government (in-depth review in 2006 Survey)	
Exploit economies of scale through: • Financial incentives for municipality mergers. • Measures to encouraging co-operative provision. • Rationalisation of the networks of offices providing central-government services.	No significant action taken.
Improve financing and accountability through: • Tighter debt rules.	When debt servicing exceeds 30% there is now increased surveillance by the Ministry of Finance, but no effective sanctions are in place.
Wider auditing powers of the Supreme Audit Office and further development of the ARIS database. Some increase in discretionary taxation, notably real-estate taxation.	Local governments can now choose between five different rates of real-estate taxation.

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Past recommendations	Actions taken and current assessment
Incentives for sub-national governments to participate in benchmarking. Improvements to oversight and transparency in public procurement.	
C. The labour market: improving efficiency and the skills base	
Labour taxation	
Focus on cutting non-wage labour costs, particularly at the lower end of the labour market.	The 2007 fiscal package has brought a further shift away from direct to indirect taxation. A flat tax rate system on personal incomes has been introduced as well as a ceiling on social-security contributions.
Take further steps towards levelling the tax treatment between dependent and self-employment in order to reduce tax evasion.	The incentives for subcontracting may have increased as the 2008 tax reforms are expected to be advantageous to the self employed. Moreover, a ban combating pseudo self- employment has been abolished.
Welfare schemes and other transfers	
The plans to strengthen incentives for job search in the welfare system are welcome and the authorities should not hesitate to implement them.	A second, less generous, level of social benefit was introduced in 2007 that is, in principle, a sanction for those who do not fulfil job search and other commitments for eligibility for the standard welfare benefit.
Improve the system of sick pay.	Introduction of a new sick-pay scheme has been postponed. The scheme would make the employer responsible for paying the first two weeks of sick pay in exchange for a reduction in the employer's social contribution. In the interim, a three-day "waiting period" has been introduced.
Active labour market policy	
More systematic evaluation of programmes and a broad shift towards more activation schemes is needed.	Evaluation of active labour market policy has been made as part of monitoring under the EU-related Human Resource Development Operational Programme.
Consider introducing private placement systems.	No action.
Employment protection legislation	
Aim to lighten regulation in general but in particular consider linking notice period and severance pay to the length of service.	A new labour code was introduced in 2007. It allows for a wider scope of employment contracts because it takes an "anglo saxon" rather than "Napoleonic" legal form (see 2006 *Survey*). Specific provisions in the code notably include provisions for working time accounts. Some minor lightening of the code has been made subsequently and further reform is intended.
Education (in-depth review in 2006 Survey)	
In tertiary education, improve signals for students and providers by: • The introduction of tuition fees backed by publicly supported student loans. • Stronger linking of funding to output and quality indicators.	The government has stated that it will not bring in tuition fees during its current term of office but it is nevertheless promoting debate on fees. A "White book" is being prepared that covers introduction of tuition fees and proposals for linking output and quality indicators to funding.
In secondary education, improve effectiveness by: • Closer consultation with universities in setting the new state leaving exams. • Wider access to the general courses that provide options for tertiary education. • Phasing out streaming into elite publicly funded schools from age eleven.	There have been consultations, but diversity in secondary school curricular makes exam standardisation difficult. A two-level examination is currently being considered.
• Further development of assessment systems. • Improving morale in the teaching profession.	No action.
Promote lifelong learning through: • Better access to secondary and tertiary courses for adults. • A more systematic approach to funding mechanisms, quality assurance, information and guidance.	A new lifelong learning strategy was adopted in 2007 and is now in early stages of implementation.
Immigration (in-depth review in the 2004 Survey)	
Take a longer-run approach to immigration, for example by widening the avenues to permanent residence and citizenship to increase integration.	The authorities are working on a new "green card" scheme.

Past recommendations	Actions taken and current assessment
Monitor and adjust the pilot project for points based immigration ("Selection of Qualified Foreign Workers") with a view to expanding the scheme.	The pilot project is due to end in July 2008.
Make work permit policy less restrictive, for example through less narrowly defined job descriptions and more relaxed rules for foreign residents to get permits.	A new "green card" scheme is being developed.
Extend integration support (particularly for language courses) to cover "economic" migrants.	No recent actions.
Continue efforts to increase statistical information on immigration.	Transposition of an EU regulation on migration statistics is underway.
D. Improving the business environment	
The legal environment for business	
Priority should be given to reforming bankruptcy legislation.	New bankruptcy legislation was passed in early 2006 and came into force in 2008.
Further progress to ease business registration is needed.	Changes to legislation were introduced in 2005 that should speed up business registration. A project setting up central registration offices has been underway since late 2004 and a new information system for trade licences has been implemented.
General taxation and targeted support for business	
Make larger cuts in the corporation tax than those scheduled, rather other forms of tax-expenditure on firms.	The 2007 fiscal package scheduled further cuts in the corporate that reduce the rate from 24% in 2007 to 19% in 2010. *Ceteris paribus,* this will bring the rate much more in line with rates in peer countries.
A critical look at the cost-effectiveness of targeted financial support should be made.	Access to large-scale investment support has been broadened by lowering the minimum-investment requirement. At the same time it has cut the length of the tax holiday and further reform is planned. Some schemes for SMEs are to be changed in light of new channels of support *via* EU-supported schemes.
Competition issues	
In telecommunications markets the regulator needs to be more committed to creating stronger competition. In particular, local-loop unbundling has to become more widespread.	The competition authority has been closely tracking competition levels in the network industries. Though prices remain high in international comparison, it is widely believed the legal and institutional frameworks are appropriate and are helping intensify competition.
Vigilance has to be maintained towards monopoly tendencies in electricity markets.	Commitments under EU legislation to allow supplier choice for end-users were completed in 2007.
In the gas sector the impact of the 2004 Energy Act should be monitored with view to further steps if the level of competition continues to be weak.	No significant alteration to legislation or monitoring has been made, aside from commitments under EU legislation for allowing supplier choice for end users.
Innovation policy (in-depth review in 2006 Survey)	
Tighten responsibilities and tidy up financial arrangements. Notably, cut the large number of budget lines linked to innovation policy.	Reform planned.
Follow-through with plans to allocate a larger share of R&D support on a project, rather than institutional basis.	Reform planned.
More strongly link earnings to performance in public-sector research institutions.	Reform planned.
Evaluate the impact of tax breaks on R&D spending.	No action.
Improve the business skills of potential innovators and information bases by more business training in science and engineering courses, better information systems for intellectual property rights and development projects.	No action.
E. Environment (in-depth review in 2004 Survey)	
Climate change	
Use market signals, such as the EU's emission permit trading price, in setting the parameters of domestic abatement programmes.	No change since the setting up of the "green bonus" scheme. The fixed feed-in tariffs should be reviewed to avoid an uneconomic level of subsidy.
Introduce an excise duty on coal and other fossil fuels in the sectors that are not covered by the EU's emissions trading system.	Energy excise duties on coal, electricity and natural gas were introduced as of 2008. Additional duties were brought in for some sectors *via* the EU Emissions Trading Scheme.

Past recommendations	Actions taken and current assessment
Scale back programmes to promote renewable resources so that the extra costs (relative to investment in new less-polluting power stations) are in line with value of reduced air pollution externalities and reduced greenhouse gas emissions. One option would be through a reverse auction.	The renewable energy act implies a significant scaling up of the promotion of renewable resources.
Air pollution	
Make more use of emission charges in reducing air pollution.	No action.
Extend annual emission-based vehicle tax to non-commercial as well as commercial users.	As of 2008 road tax on certain vehicles for business are being taxed according to emission output as well as engine size and it is planned to widen this to other users in the future. There are plans to encourage the public sector to use more environmentally friendly vehicles.
Exploit data collected in in-vehicle truck monitoring to base taxation on vehicle use as well as type.	No action.
Consider introducing road pricing in the major cities.	No action.

ANNEX 1.A2

Topics covered in previous Surveys

2006

Chapter 1: *Policy challenges in sustaining catch-up*
Chapter 2: *Ensuring fiscal sustainability: assessing recent proposals for pension reform*
Chapter 3: *Ensuring fiscal sustainability: motivating regional and municipal governments*
Chapter 4: *Improving the labour market: getting education right for long-term growth*
Chapter 5: *Enhancing the business environment: policies to promote innovation*

2004

Chapter 1: *Economic conditions and policy challenges*
Chapter 2: *Fiscal policy and public-expenditure reform*
Chapter 3: *Policy for a smooth entry to the euro area*
Chapter 4: *Improving policy towards business*
Chapter 5: *Improving the reallocation of labour*
Chapter 6: *Immigration policy: addressing the needs of an ageing labour force*
Chapter 7: *Environmental issues for sustainable development*

2003

Chapter 1: *Recent economic developments*
Chapter 2: *Macroeconomic policy*
Chapter 3: *Making high quality healthcare fiscally sustainable*
Chapter 4: *Structural policies for a robust economic performance*

2001

Chapter 1: *Recent economic events*
Chapter 2: *Macroeconomic policy*
Chapter 3: *Improvingthe efficiency and sustainability of public expenditure*
Chapter 4: *Progress in structural reforms*

2000

Chapter 1: *Recent economic trends and prospects*
Chapter 2: *Macroeconomic management*
Chapter 3: *Progress in structural reform*
Chapter 4: *The tax system*

Note: Only the five most recent Surveys are listed, the first Survey for the Czech Republic was published in 1996.

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Chapter 2

Ensuring fiscal sustainability: assessing recent tax and public spending reforms

Public finance reform needs to remain a policy priority, particularly in light of upcoming fiscal challenges stemming from population ageing. This chapter examines the reform package enacted in 2007 that notably introduced a flat tax rate on personal incomes. In addition, it considers the initial steps and further reform plans in healthcare and the current state of play in the longstanding issue of pension reform. The chapter also looks at the challenges in accessing EU funds under the highly decentralised system for administering the allocations.

The fiscal reform package voted in by parliament in September 2007 brought significant changes to taxation and a range of reforms to public spending. In part, the package aimed to keep the deficit on track over the next two to three years, though the size of adjustment required turned out to be lower than expected and prompted additional spending. The package also made a number of structural reforms and there are wide-ranging plans for further measures. Subsequent sections show that the contents of the package and the other structural reforms made, or at least planned, by the current administration are broadly sound. Several measures are helping public finances directly and almost all of them are sensible structural improvements to taxation and public spending systems. The policy conclusions are summarised in Box 2.1.

Box 2.1. **Policy recommendations for ensuring fiscal sustainability**

Budgeting

Political commitment is essential for further improvement to targeting and budgeting processes. Deficit targeting should be more ambitious through commitment to use positive developments to adjust the consolidation path.

Also, reforms that help the MTEF drive the central-budgeting process should be considered. Most important, enhanced enforceability of the spending ceilings would help. Alternative formulations of the spending ceiling could also be considered.

A thorough overhaul of central-government budgeting is required, including:

- Deeper scrutiny of spending plans in the preparation phase of the budget.
- Greater transparency in the budget material submitted to parliament.
- Wider use of programme budgeting.
- There should be less opportunity *for* "*pork-barrel*" spending in the parliamentary phase.

Revenues

Further reduction in the gap between the VAT rates would be welcome and pressure to classify items at the lower rate should be resisted.

Cutback in support for home ownership and renovation should be put on the policy agenda.

Healthcare

In the already completed first phase of reform, the user-fees are particularly welcome. Dilution from exemptions should be avoided provided that access to needed care is not compromised.

As regards the planned second phase of reform, close attention is needed to the risk of undesirable behavioural reactions of the insurers as joint stock companies to increased competition and profit incentives. In particular:

- Attention to cream skimming as the incentives are likely to increase if insurers are more profit driven.

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Box 2.1. **Policy recommendations for ensuring fiscal sustainability** *(cont.)*

- Measures to avoid conflict of interest among the owners of the insurers when converted to joint stock companies.
- Clear signals that implicit guarantees for the insurers deficits and debts are off the agenda.
- Ground rules on insurance contracts that facilitate switching between insurers.
- Measures that grease the wheels of market forces. The opportunity for "stealth savings" should be limited by ensuring good information systems of provider performance.

Close monitoring of the reaction of providers to the reform is also needed. Providers may have local monopolies in a number of areas in which case incentivising insurers is unlikely to lead to successfully pressure providers to raise efficiency.

Further work on what is included in the basic package of healthcare services is required. The second phase of reform aims to better define the healthcare package but additional measures are needed to narrow it down or allow other sources of finance into the public system (for example by extending co-payments), in the context of population ageing and ever widening treatment possibilities.

Pensions

The parametric reforms drafted are welcome. It is very important that the further retirement age increases are implemented.

A final decision should be made soon on whether to remain with the PAYG pension or adopt a new approach. If the DC carve out reform currently being discussed is adopted, two issues need close attention in its design: the transition deficit and switching rules. Mandatory switching that would phase out the full PAYG pension should be considered instead of the current proposal for voluntary participation.

The regulations on private pension funds need an overhaul, and this should include measures that improve the rates of return, notably the restrictive regulation that annual returns to policyholders cannot be negative. The subsidy and tax breaks on voluntary private-sector pension savings should be critically assessed.

Other areas of public spending

Stronger efforts for efficiency gains through staff cuts in public administration should be made.

In sickness insurance, the 14-day scheme should not be postponed further.

While a period of discretionary indexation in welfare benefits can provide fiscal savings and allow erosion of generosity, the authorities should ultimately consider comprehensive automatic indexation.

EU funding

In broad terms, administration of the allocations needs to be simplified and decentralisation offset by stronger communication and the pooling of expertise in administration.

Recent deficit outcomes underscore a need for more ambitious targets

The story behind recent deficit outcomes and budget plans is complex. When the government came into office in early 2007 it was thought the 2007 deficit would be about 4% of GDP, implying a substantial consolidation effort to reach the targets for 2008-10 (see Box 2.2). This outlook, plus a desire to start structural reform programmes, gave birth to the

Box 2.2. **Fiscal targeting in the Czech Republic**

There are two main mechanisms of budgetary targeting: deficit targets expressed as a percentage of GDP and nominal spending ceilings.

General deficit targets as a percentage of GDP, expressed in ESA95 accounting term, are usually included in government proclamations when entering office. The current government announced targets of 2.95%, 2.6% and 2.3% for 2008, 2009 and 2010, respectively. The same targets are used in communication with EU bodies and are widely reported in the media. These deficit targets are used to derive the central government budget targets.

Since 2004, a medium-term expenditure framework (MTEF) is in place. It comprises three-year rolling nominal spending ceilings with a several sub-clauses to allow for their evolution over time. Adjustments are possible under the following circumstances: *i)* if inflation developments are significantly different from budget assumptions; *ii)* if there are changes in tax assignment between state and local government; *iii)* if EU fund allocations differ from those budgeted; and *iv)* in case of major unexpected events, such as natural catastrophes. According to budgetary rules the ceilings are set every spring and the government submits them to parliament together with the state budget in autumn. They are approved together with the state budget and thus become binding for planning for the following year's budget.

The goal of the MTEF is to let automatic stabilizers play their role over economic cycle. In case of better than expected GDP growth, the ceiling will translate to outcomes that are better than targeted deficit (in percentage of GDP). In case of adverse economic development, the deficit target will be worst than planned, unless the ceiling is lowered.

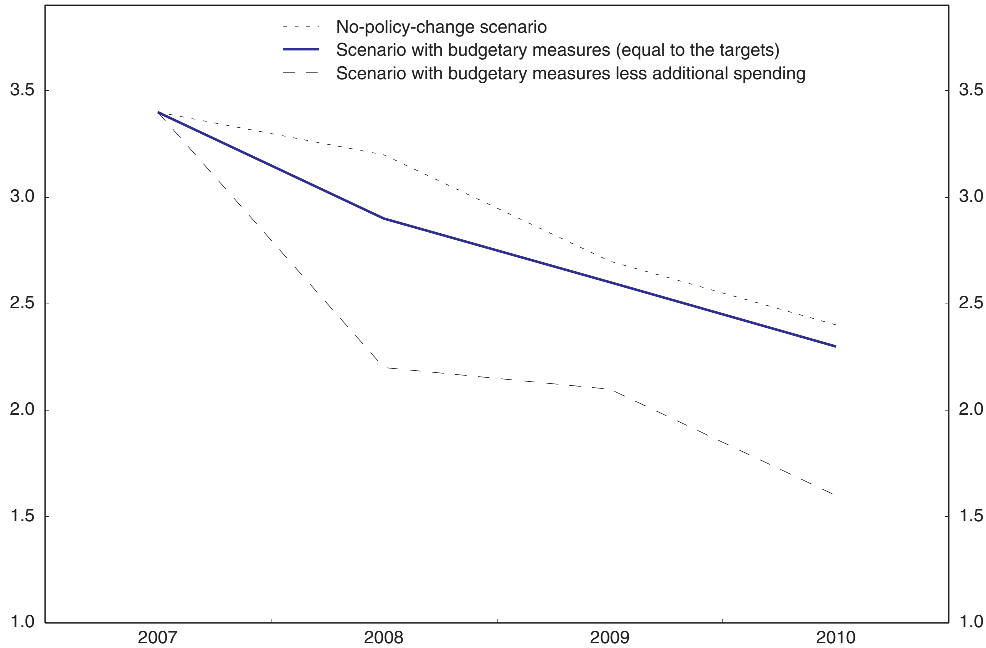
In theory, the MTEF is supposed to drive central government budgeting, thereby contributing to responsible fiscal policy. However, it can be argued that in the past the reverse was true. As discussed in the previous *Survey*, budget allocations have sometimes exceeded the ceiling even allowing for the "permissible adjustments". Moreover, the ceilings themselves have been raised somewhat generously. Effectively the rules of the MTEF were broken. Hence, the Framework was ineffective and the primary focus of attention was on the ESA deficit targets. Under the better-than-expected economic growth of recent years this has meant that although breaking the spending ceilings, the outturns have undershot the initial deficit targets expressed in percentage of GDP.

fiscal package. However, after the package was finalised it became clear that the deficit would be substantially lower, thus implying that the fiscal measures in the package would bring the deficit below target (shown in the "scenario with budgetary measures less additional spending" in Figure 2.1). Nevertheless, the government decided to stick to its original target, and consequently added some spending items to the 2008 budget. As a result, the combined impact of the fiscal package and the additional spending is small (Figure 2.1). This is seen by the gap between the "no-policy-change scenario" and the "scenario with budgetary measures" in Figure 2.1.

The deficit for 2008 is anyway likely to undershoot the target. The deficit for 2007 is now estimated to be 1.6% of GDP, about 1¾ percentage points below the benchmark used in formulating the 2008 budget. As a result, the outcome will probably be well below the current target (2.9%). Aside from the likelihood of reasonably strong growth in revenues again this year, the government's Medium Term Expenditure Framework is more strongly guiding the budget than has been the case in the past (see Box 2.2). In a welcome move, the

Figure 2.1. **Ministry of Finance deficit estimates as of October 2007**

General government deficit as % of GDP



StatLink http://dx.doi.org/10.1787/315024676243

Source: Ministry of Finance (2007), *Fiscal Outlook – Czech Republic*, October and OECD calculations.

government has actually lowered the ceilings in the latest MTEF (which covers the period 2008-10).

The experience of recent years suggests the budgeting system does not work as well as it could. Essentially the general-government deficit targets, the MTEF and the annual central-government budgeting process need to work more closely. There should be three priorities:

- More ambitious general-government deficit targeting at the political level that takes into account positive developments to adjust the consolidation path. Easy targets mean weaker pressures to conduct structural reform. Also, under certain conditions, weak targets can allow for "success" in budgeting even if the medium-term spending limits are broken (see Box 2.2).
- Ensuring the MTEF drives the central-government budgeting process. Although this government's commitment to the Framework is welcome, there have been no changes to its rules and the system remains vulnerable. As suggested in previous *Surveys*, some alterations should be considered. Most important, enhanced enforceability of the ceilings would help (for instance through more political and public scrutiny as well as sanctions for breaking the ceilings). Alternative formulations of the spending ceiling could also be considered. A ceiling that takes account of windfalls could be one way forward. Or, volatile items could be excluded from the ceiling.
- Improvements to the central-government annual budgeting process. This is discussed further below.

Avenues for improving central-government budgeting

A good quality central-government budgeting process helps effectiveness of the MTEF and is key to achieving the general-government deficit targets. Furthermore, central-government budgeting sets the distribution of spending and is therefore important to ensuring that envelopes set by the spending ceilings are allocated efficiently.

Several improvements have been made recently. There has been welcome progress in addressing problems with the reserve funds maintained by line ministries. Legislation passed in 2004 gave ministries more leeway to put unspent budget allocations into their reserve funds. End-of-year spending sprees have been reduced as a result, but control and predictability of budgetary outcomes have been weakened. In order to deal with this problem, temporary controls have been applied.[1] In addition, for 2008 and beyond, new unspent budget allocations will be put in special "right to spend" accounts, rather than reserve funds. Importantly, there is now explicit provision permitting the government to reduce the accumulated rights to spend. While the new approach is an improvement, it will mean that, temporarily, reserves will take two forms, complicating assessment of spending carryovers.

Some improvements have also been made to the "general treasury chapter" (*všeobecná pokladní správa*). In past, this aspect of the central budget has been criticised.[2] On the expenditure side it should only include general items that cannot be identified with a particular line ministry or were unknown at the moment of budgeting. The Supreme Audit Office (2007) has criticised the chapter for, in fact, including regular line ministries spending items and for a lack of detailed accounting. There has been some response. The 2008 budget saw transfer of several spending items to other chapters. And, there is legislation in the pipeline that prevents new items from being added to the chapter.

Finally, improvement in the communication of fiscal policy has been made with the launch of a biannual assessment of public finances by the Ministry of Finance. The first *Fiscal Outlook* was published in April 2007. The publications cover recent developments and medium-term prospects in public finances as well as in-depth topics. As with the inflation reports used by various central banks, high quality objective assessment is key to the effectiveness of such publications.

While the above moves are welcome, a more thorough overhaul of central-government budgeting is required. The main problem is in expenditure plans, where transparency and opportunity for detailed scrutiny are inadequate. The Ministry of Finance has only weak instruments for questioning and influencing the spending submissions of line ministries. Furthermore, chapter managers often overestimate spending requirements and make budget submissions based on an incremental approach, using criteria such as the size of previous budget increase, inflation and economic growth (Transparency International, 2006; and Ministry of Finance, 2007). Understandably, the Ministry of Finance does attempt to influence the spending submissions as much as possible. For instance, conservative revenue estimates and growth projections appear to be part of its strategy.[3] Overcoming this general problem in containing expenditure submissions should be tackled along three fronts:

- *Deeper scrutiny of spending plans in the preparation phase of the budget.* For example, a formal round of inter-ministry scrutiny of spending submissions in the preparation phase of the budget could be useful. Alternatively, the IMF (IMF, 2007) has suggested setting up an independent fiscal institution to monitor budgeting. Better scrutiny of spending allocations would help solve secondary problems. For instance, the Ministry of Finance

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is obliged to assume that ministries will spend exactly their budget allocation. Because there are cases of systematic under- or over-spending, the Ministry of Finance often knows its budget estimate is biased but cannot do anything about it. Improved scrutiny of the initial spending allocations would clearly help.

- *More transparency in the budget material submitted to parliament.* A recent report on budgeting by Transparency International underscores that budget material could be improved. Currently, there is no overview that outlines spending priorities. In general, there is undue complexity in presentation. Indeed, according to Transparency International, only a handful of experts who work in the Ministry of Finance have a comprehensive understanding of the budget documents (Transparency International, 2006).
- *Wider use of programme budgeting.* Programme budgeting (*i.e.* budgeting on the basis of activities, rather than entities) is being used in some areas. Intentions to widen its application should be fully implemented.[4]

Finally, there should be less opportunity for "pork-barrel" spending (in Czech, *porcování medvěda*, or "bear cutting") in the parliamentary phase. This spending occurs in the final phase of the budget reading in parliament. Proposals are typically made by individual MPs and often involve projects in their constituencies. At this stage in the budget process the overall spending envelopes have been set, so this spending has to be accommodated by cuts in the allocations to line ministries. But also, ministries probably factor some pork-barrel spending into their initial expenditure demands. The total value of the allocations varies considerably from year to year. For instance in 2006 and 2007 the change of budgetary allocation due to MPs proposals was quite high (CZK 9 and 10 billion respectively, roughly 0.3% GDP) while for the 2008 budget it was a modest CZK 2.9 billion.

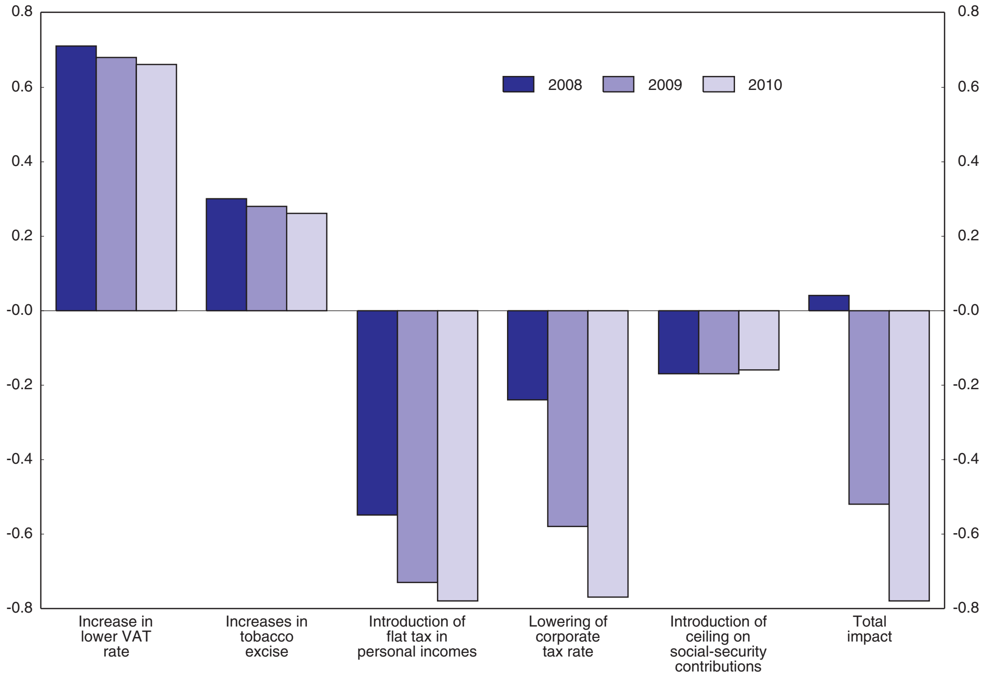
Reforms on the revenue side are substantial

The fiscal package contains wide-ranging changes to tax legislation. In terms of fiscal impact, there are revenue losses from the introduction of a flat tax rate on personal incomes and a ceiling on social contributions, as well as from a schedule of cuts in the corporate tax (Figure 2.2). These are countered by increases in the lower rate of VAT and excise duty. According to Ministry of Finance estimates, the net impact of these measures will be neutral for 2008 but negative for 2009 and 2010 due to further cuts in the corporate tax rate.

In structural terms, the most significant move is the simultaneous introduction of the flat tax rate and the social-contribution ceiling. This is discussed further below. The centrepiece of corporate tax reform is a schedule of further rate cuts that will bring the rate to 19% by 2010 (see Annex 2.A1). From a structural perspective, this brings the rate closer to peer countries, such as Slovakia and Hungary, which is welcome. The excise duty measure is a purely fiscal measure. In line with an EU directive, several large increases in excise on tobacco have to be made; the fiscal package simply brought the required increase forward. The increase in the lower rate of VAT (from 5 to 9%) clearly raises revenues. However, there is also a structural payoff as the move has narrowed the potentially distorting gap between the lower rate and standard rate of 19%. Further reduction in the gap would be welcome and pressure to classify items at the lower rate should be resisted.[5] Differences in VAT are often motivated by social concerns, but these are better addressed through the welfare system. Overall, the reforms reduce gaps between the headline rates of the main tax bases. Narrowing the gap between personal and corporate income tax rates, in principle, reduces biases in economic behaviour but there is no particular advantage in the value-added tax rate equalling rates on incomes.

Figure 2.2. **Impact on the budget of tax and social contribution measures in the fiscal package**

% of GDP



StatLink http://dx.doi.org/10.1787/315024787050

Source: Ministry of Finance (2007), *Fiscal Outlook – Czech Republic*, October.

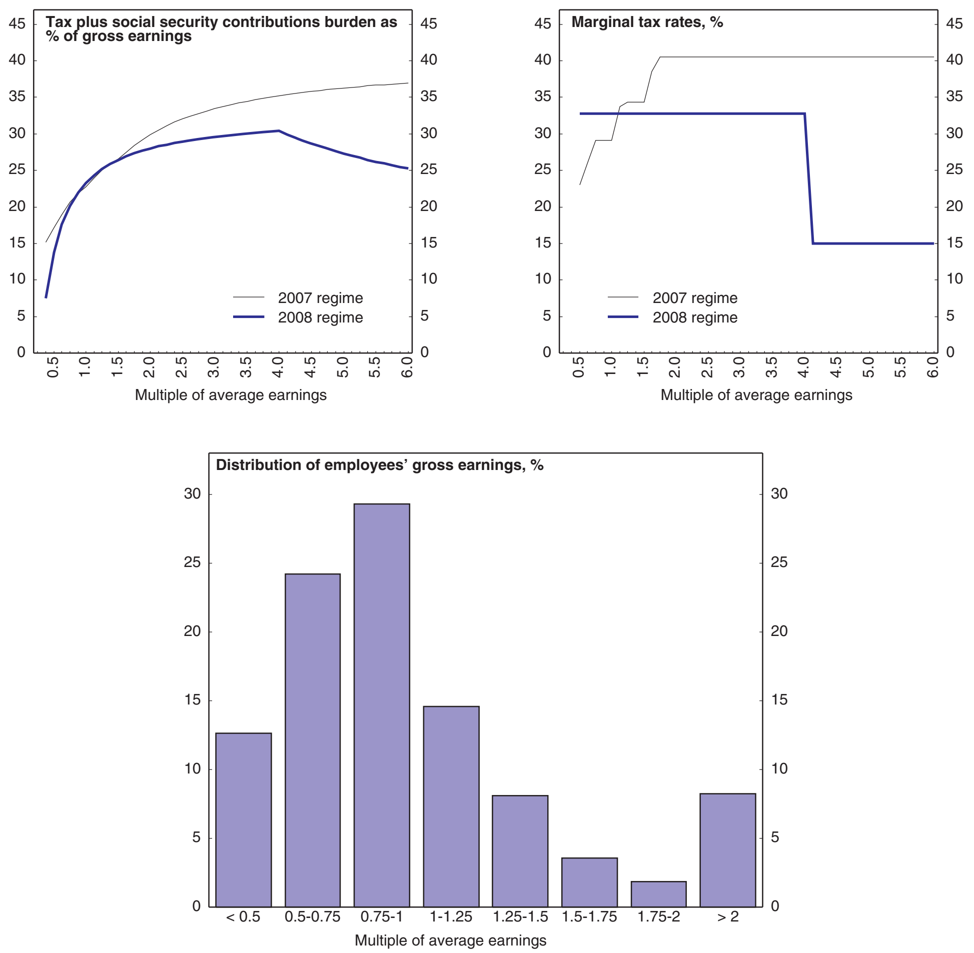
Implications of the flat tax rate on personal incomes and social-contribution cap

"Flat tax" was one of main election campaign promises of the leading coalition party and so there was strong commitment to follow through. The reform echoes those made in a number of other Central and Eastern European countries.[6] The centrepiece of this reform is a single rate of personal income taxation (PIT); the rate is 15% for 2008 and is scheduled to fall to 12.5% from 2009 onwards. The previous schedule comprised four rates of 12, 19, 25 and 32%. Comparison between the new and old systems is complicated because the base has been widened; the 15% rate is in fact equivalent to a 23% rate (see below). The single rate has been accompanied by a significant increase in the tax credit, which will be adjusted again to accommodate the 12.5% rate. Unlike other flat tax reforms, there has also been a significant widening of the tax base. PIT is now calculated on so-called "super-gross" earnings *i.e.* the base includes both employee and employer contributions (previously neither were included). More significant, a ceiling on both employee and employer social contribution assessment base at four times the average monthly wage has been introduced as part of the reform.[7]

The key implications for households are as follows:

- Little change to the average combined personal income tax and employee social-contribution burdens of most households. This is illustrated in Figure 2.3, which compares the combined tax and social-contribution burden in the 2008 with that in 2007 for a single-earner household with no children. In this example, the tax and social-contribution burden barely changes for those earning between about 0.75 and 1.75 times

Figure 2.3. **Impact of the new personal income tax: the case of a single person with standard deduction**



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Note: The distribution of employees earnings is based on 2006 data.

Source: Czech Statistical Office and OECD calculations.

the average wage. In terms of marginal rates, the reform brings a universal marginal tax and contribution rate of 33% that is above previous rates for some middle-income earners but below for others.

- Significant gains for high earners. Figure 2.3 shows that gains from the reform become non-trivial around twice average earnings (about 10% of employees earn more than this). And, there is a further boost from the ceiling on social contributions. The scenario in Figure 2.3, for example shows that at five times average earnings the reform boosts net earnings by about 15%. Moreover, high earners benefit in terms of marginal rates, again especially for those earning above the social contribution ceiling.
- Mixed implications for those at the bottom of the earnings distribution. In terms of the overall burden, the increase in the tax deduction more than offsets the increase in the tax rate and tax base. At the same time, the marginal rate of tax is increased.

- Gains for the self-employed. Social contributions are no longer tax deductible and the contribution ceiling (this was already in place for the self-employed) has increased. However, the minimum tax on self employment has been abolished. This, in combination with the lower tax rate and higher tax credit is expected to mean most self-employed will have a lighter tax and contribution burden.

The impact on the tax wedge, including social contributions, is similar to that for the tax burden because the employers' contribution is largely unaltered. Hence, wedges for a large majority of employees are practically unchanged. But, they are narrowed for those at the bottom of the earnings distribution in a very similar way to the tax burden. This being said, the wedge on employees earnings above the ceiling on social contributions is significantly narrowed because the ceiling applies to both employers' and employees' contributions.

The Czech government introduced the PIT reform with the aim of bringing structural benefits to economic behaviour. In principle, reduction of the tax wedge for earners in the bottom and top earnings deciles will improve labour supply and demand. Furthermore, a flat tax implies fewer behavioural distortions around the break points in rates. Nonetheless, the PIT reform does not resolve a problem that for low-earning family households, once cash benefits are included, the marginal effective tax rate is typically very high (see Chapter 3).

In addition, the decision to bring in a ceiling on social contributions along with the flat tax rate is debatable. The question of whether to have ceilings has been long discussed in the Czech Republic. It is true that most countries have such limits. Upper bounds on contributions limit cross-subsidisation in social security and therefore make most sense when personal income taxation does a lot of work in redistribution.[8] Given the introduction of the flat tax rate, the case for the ceiling is therefore weakened. Moreover, ceilings bring discontinuity in the effective marginal tax schedule which is at odds with the goal of flatter and smoother schedules that flat tax regimes aim for. Nevertheless, even with a flat tax there may be sound reasons for a contribution ceiling. Ceilings cut the incentives for tax avoidance among high earners. And, softer treatment of high-end earners may be an effective means of tax competition as these workers are more internationally mobile.

The "super gross" base on personal income tax is extremely unusual. One advantage over a more conventional base is that a lower headline rate is possible whilst maintaining the same average and marginal tax and social-contribution burdens. In the Czech case, the rate would have to be 23% instead of 15% if employers' social contributions was not in the base and employees' contributions were tax deductible. From this perspective, the move is cosmetic, and it is doubtful whether there is any large impact in terms of improving the "competitiveness" of the tax profile. However, the Czech authorities argue the base improves transparency in the labour market because any change in employers' contribution rates will directly affect net wages. These issues aside, a super-gross base raises tricky issues. Fiscal estimation and projection become more complicated because changes to social contributions have immediate impact on tax revenues. In addition, taxing social contributions implies double taxation if payouts are already taxed, as well as other issues.[9]

Further tax reforms are planned. The fiscal package did not attempt a simplification in personal income tax (beyond the schedule) or in corporate income tax. Nevertheless, there are welcome plans to do so through a full re-write of the legislation. Several areas of corporate income tax are, in particular, overly complex. For instance, there are six different depreciation groups, which could be pooled into one. Simplification could be particularly beneficial in boosting tax compliance. There is also a case for stepping up the monitoring of household incomes and company behaviour in the wake of reform. Given the many changes that have been made to taxes and benefits in the past two years, an overall stocktaking of the implications for efficiency and distribution would be useful.[10]

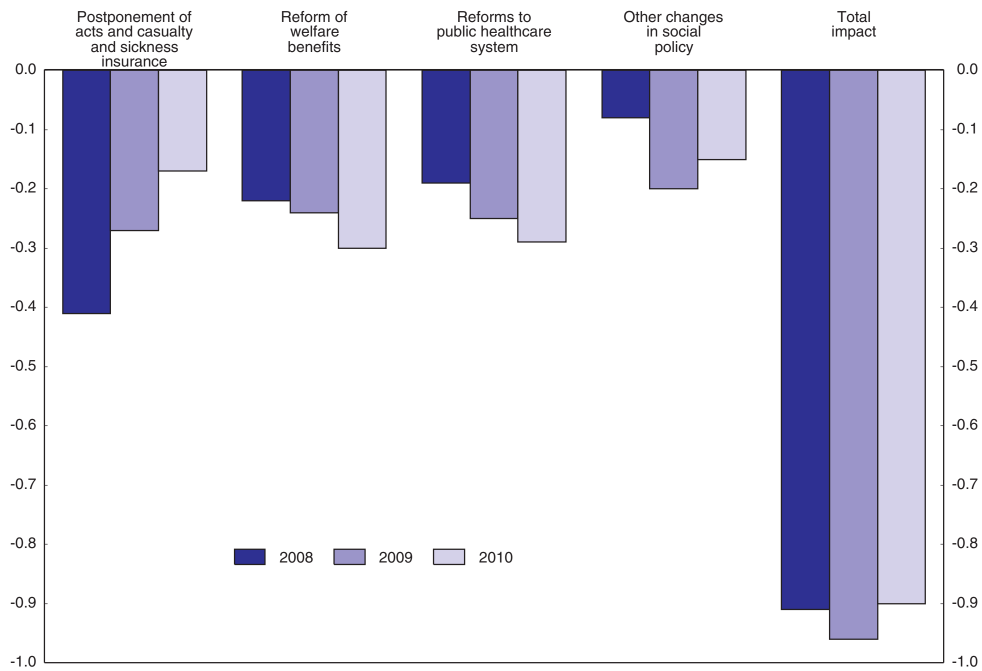
One issue that ought to be on the policy agenda is cutback in support for home ownership and renovation. Construction and renovation is effectively subject to the reduced VAT rate (see Annex 1.A2). In addition, there is a large tax deduction on mortgage interest; all mortgage interest up to CZK 300 000 per year can be deducted from the personal income tax base. Also, local property taxation is light.[11] And, capital gains from the sale of property are not taxed (if it is the principal residence). Furthermore, there are matching subsidies for savings towards house purchase or renovation. Savings in building societies (specialised construction savings societies) can be matched by up to CZK 3 000 per year in direct state subsidy (prior to 2004 it was CZK 4 500). And, interest from these savings is tax free. Fortunately, all these support measures have not yet fuelled a widespread property bubble in the Czech Republic. This is largely because full home ownership is already high and the amount of mortgage lending is relatively small, although growing rapidly (Czech National Bank, 2007).

Some progress and ambitious plans in public-spending reform

There were several public-spending measures in the fiscal package and many additional reforms are in the pipeline, or are at least planned. Most of the immediate fiscal savings come from altered policy on sickness insurance and workplace injury insurance, welfare benefit reform and steps in healthcare (Figure 2.4). The most substantial structural

Figure 2.4. **Net impact of public finance reform on spending**

% of GDP (negative means deficit-reducing)



StatLink http://dx.doi.org/10.1787/315087513528

Source: Ministry of Finance (2007), *Fiscal Outlook – Czech Republic*, October.

elements are in healthcare where fundamental changes to the insurance system are planned. Progress is also being made in pension reform. The insurance and welfare reforms have some structural implications. Furthermore, there are efforts at making public administration more efficient.

Healthcare

Current government policies aim at making the insurance-based healthcare system more efficient by strengthening regulated competition. In such arrangements, competition for clients in insurance markets is subject to government-set rules to ensure access and avoid insurers selecting good risks. Under the textbook model, individual insurers would be able to contract selectively with providers on the basis of price (and possibly on the quality of care as well). Savings through this process would permit the insurers to lower insurance premia and offer better quality care, thereby attracting more clients.

In practice, insurance-based healthcare policy does not go this far in value-based competition and, until recently, the Czech approach was no exception. For a start, there is a single contribution rate for health insurance, so there is no price competition for clients among insurers.[12] Furthermore, motivation for the selection of good risks remains because the risk-adjustment system across insurers is mainly based the on age and sex of the insured.[13] Moreover, government support for the deficits of insurers, together with little incentive for the management of insurance funds to behave efficiently, has meant that there is little pressure on insurers to search for cost savings. Finally, about 60% of the population is insured with the "incumbent", the *Všeobecná zdravotní pojišťovna* (VZP), which is explicitly backed by the State.[14]

As regards provider market competition, the government is involved in the negotiation between insurers and providers on service reimbursement and even, for example, used to set hospital reimbursement rates. In addition, state and regional governments typically own and run hospitals, so that reductions in excess supply (a problem underscored in past OECD recommendations) have been successfully resisted for political reasons for a while. This being said, several regions have recently been selling off hospital facilities or bringing in private-sector management. As a result, the issue of excess capacity is probably being dealt with to some extent.

A first phase of reform has already been completed (most of its measures were part of the fiscal package), including:

- The introduction of small user fees. As of January this year, there are nominal user fees for doctor consultations, drug prescriptions and hospital stays. To address concerns about affordability, a ceiling has been imposed on the total amount of selected fees and drug co-payments individuals pay.[15]
- Changes in the setting of drug prices. The procedure for setting prices for new drugs has been tightened. Notably, international price benchmarks will have a greater weight.[16] In addition, following criticism by the Constitutional Court and European Commission, price setting and reimbursement to the pharmaceutical companies have been made more transparent through a new administrative process and the introduction of an appeal clause.
- Easing of rules on the negotiation between insurers and providers. Until January this year, many parameters of service provision were set in a compulsory directive. As a

result, there was little scope to negotiate payment mechanisms and prices. Contracts can now depart from the directive, which will only apply if parties fail to agree.

A second phase of reform has been drafted by the Ministry of Health. The focus is on the insurance system and is inspired by recent measures in the Netherlands. The main elements are:

- Improved definition of the basic package of healthcare services. The spotlight will be on better definition of services; significant cutback in coverage is not envisaged.
- More diversity in insurance products. Currently insurers can only offer one product; access to the basic healthcare package across all providers. Under the reform, insurers would be able to offer two new types of insurance. One will be so-called "managed healthcare access" (*i.e.* the individual has access only to a specific list of providers). The other will allow the insurer to offer the choice of co-payments within the basic package in exchange for larger cash-back payments (see below). These measures will be accompanied by greater flexibility in the payment of supplementary treatment – *i.e.* care not included in the basic package.[17]
- Clarification of the legal status of the insurance funds. Currently the funds have a special legal status that is similar to that of public non-profit organisations. The reform aims to convert the funds into joint stock companies under standard business law. Safeguards will include an independent (state run) supervisor and new rules governing the activities of insurers offering the basic package of mandatory health insurance.
- A profit-sharing ("cash back") mechanism will operate to increase market forces in the interaction between insurers and insurees. Insurers will be allowed a certain level of operating profit but a share of additional returns will have to be paid back to the insurees.

There are several auxiliary measures in the proposals. In particular, a restructuring of the state-run teaching and research hospitals is envisaged. The goal is to concentrate teaching and research in specified hospitals and to strengthen governance by the state and the universities.

The steps taken in the first phase of reform are welcome. Indeed, the measures and plans address several previous OECD recommendations (OECD, 2003a). Even small user fees can help cut healthcare consumption. Dilution of exemptions should be avoided provided that access to needed care is not compromised. Also, the efforts to benchmark pharmaceutical prices should help contain costs.

The impact of the second phase of reform could be significant in strengthening competition on the quality and cost of services. Bringing profit motivation to the insurance funds by transforming them to joint-stock companies is likely to meet opposition but is central to the reform. In theory, it will strengthen profit motives and induce more vigorous negotiation on the cost and quality of services. These incentives will, to a degree, be influenced by the extent of profit sharing. The measure will anyway improve transparency and increase the responsibility and accountability of the boards of directors.

The reform is one way forward but success is not assured. The measures will bring increased choice on health insurance options, which is positive. In terms of efficiency gains, experience in other countries with this type of reform is limited. A reform quite similar to the Czech proposal has been made in the Netherlands (OECD, 2008). So far, there are no signs of large efficiency gains but it is early days to gauge the full impact of the new system. Switzerland also has a multiple insurer model but comparison is difficult because healthcare operates at the canton level (OECD, 2006a). Therefore, it remains to be seen whether free contracting between insurers and providers in the Czech case will lead to cost savings and improved fiscal sustainability over the longer haul.

Success in the second phase of reform will require close attention to the risk of undesirable behavioural reactions of the insurers to increased competition and profit incentives. In particular:

- *Attention to cream skimming* as the incentives for this are likely to increase if insurers are more profit driven. Although a new redistribution formula was phased in between 2003 and 2006, further adjustment under the proposed reform may be required.
- *Measures to avoid conflict of interest among the owners of the joint-stock insurance companies*. In particular, the government will almost certainly be ascribed ownership of the VZP. Given the risk of compromised profit motives, it should signal intention to sell off its stake. It is not yet clear who will be assigned ownership of the other insurers, which were originally set up by large employers or industry sectors.
- *Clear signals that implicit guarantees of insurer's deficits and debts are off the agenda*. One risk of the reform is that the insurers' management will use information advantages over shareholders and policyholders to bury profits in costs (including generous pay packages) and then pressure the state to provide additional funds.
- *Ground rules on insurance contracts that facilitate switching accounts between insurers*. Competition needs to be encouraged by low barriers for customers in switching insurance companies. One complication in the proposal is how to transfer the "cash back" between insurers.
- *Measures that grease the wheels of market forces*. Under a competitive environment, insurers may seek savings in provision that compromise the quality of care in ways that are not apparent to consumers. Therefore, the opportunity for such "stealth savings" should be limited by ensuring good information systems of provider performance. In addition, assistance in technical areas of administration, such as the development of diagnostic reference group systems, and in the analysis of healthcare demand should be provided.

Close monitoring of the reaction of providers to the reform is also needed. In particular, providers may have local monopolies in a number of areas in which case motivating insurers is unlikely to lead to increased efficiency. Indeed, OECD experience suggests that provider monopolies are a barrier to efficiency gains from market-based reform.

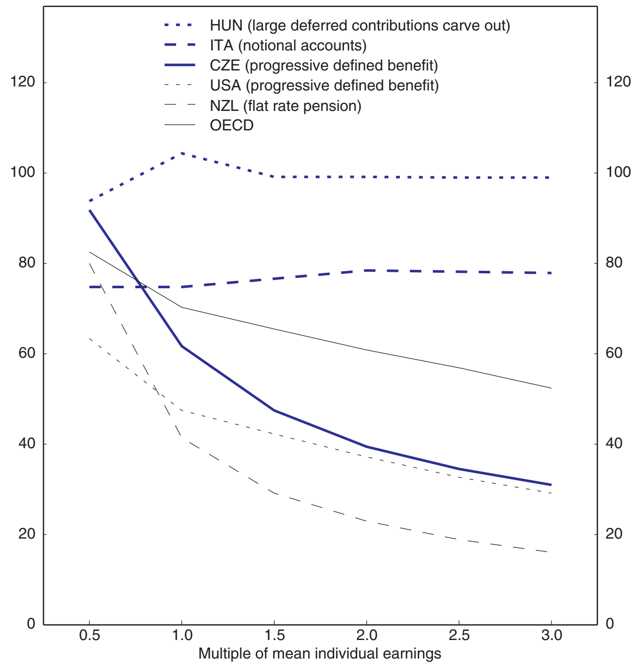
Finally, although the second phase of reform will better define the health insurance package, further work is required to narrow the package or allow other sources of finance into the public system. The immediate issue is whether there is scope for narrowing down the basic package without compromising welfare concerns. Related to this is a need for a system that allows the package to evolve over time in the context of ever widening treatment possibilities. The authorities intend to begin addressing these issues in a third phase of reform. A cross-party committee has been set up but no progress is likely to be made within the current government's term of office. One option under discussion is to combine adjustment of coverage with conversion of the "cash back" mechanism to a personal health account system approach in which accumulated savings could be used for uninsured treatment or comfort services.

Pension reform

The public pension

The public pension is provided through an insurance-based pay-as-you-go system. It is highly redistributive because the payout formula is strongly progressive. This is illustrated in Figure 2.5, which compares the profile of net replacement rates over a range of earnings with those of selected pension systems in other OECD countries. In this context, the Czech pension resembles a generous version of New Zealand's flat rate pension.

Figure 2.5. **Net replacement rates by earnings**



StatLink http://dx.doi.org/10.1787/315142131516

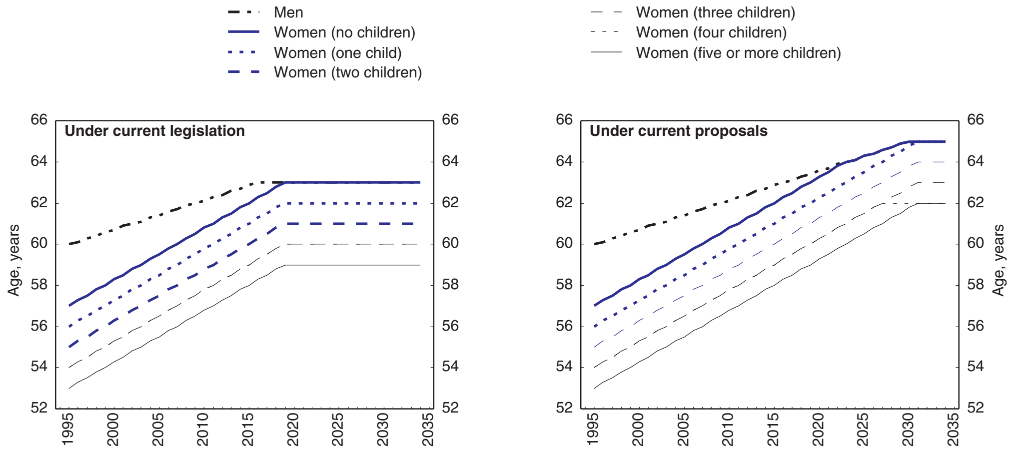
Note: The net replacement rate is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking account of personal income taxes and social contributions paid by workers and pensioners.

Source: OECD, *Pensions at a Glance* (2007).

The most pressing issue is the retirement age. Current legislation will bring the retirement age to 63 years for men and between 59 and 63 years for women by the late 2010s (Figure 2.6). In a welcome move, legislation as part of a first phase of pension reform has been drafted that extends the increases. Under the proposal, the retirement age for all will increase to 65 years by the early 2030s, except for women who have had two or more children where it will continue to be lower. The first phase of pension reform also aims to tighten eligibility conditions, notably through increasing the minimum number of contribution years from 25 to 35 and exclusion of years spent in higher education. The parametric reforms drafted are welcome; it is very important that further retirement age increases are implemented. As regards the current proposal, it would be preferable if the differentiation of women's retirement age were removed entirely, but otherwise the pace of increase is reasonable. A second phase of pension reform is planned that will focus on the legislative framework of private pensions, with a view to improving incentives for

Figure 2.6. **Retirement age scheduled in recent legislation**

Years



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Source: Actuarial Report on Social Insurance, 2006.

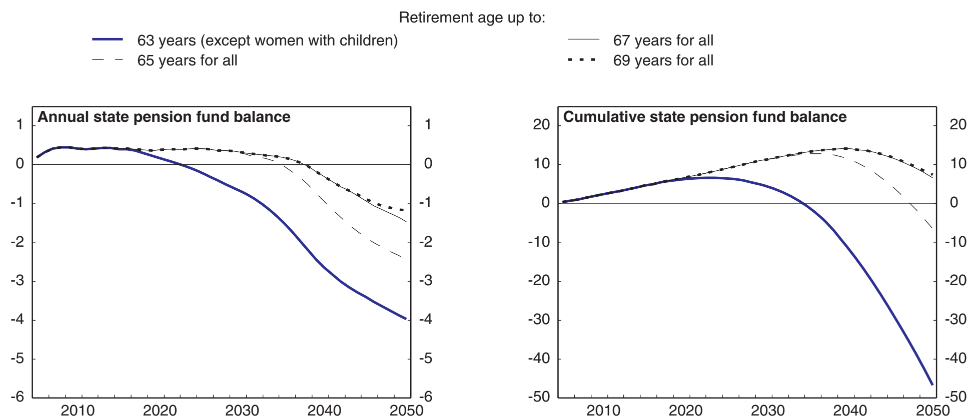
voluntary saving and as a preliminary step towards introducing mandatory second pillar pensions (see below).

With appropriate parametric changes, such as those described above, the current pension is sustainable as a means of providing an essentially "safety net" pension:

- The prolongation of retirement-age increases will go a long way towards heading off an excessive fiscal burden solving the looming pension-fund deficit problem (Figure 2.7).

Figure 2.7. **Fiscal implications of continuing retirement age increases under the current pension system**

% of GDP

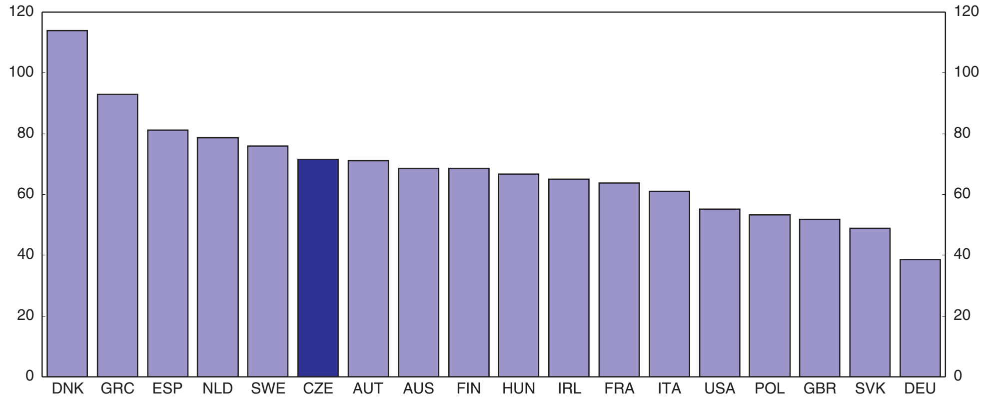


StatLink http://dx.doi.org/10.1787/315154708234

Source: Ministry of Labour and Social Affairs.

- The risk of poverty among pensioners will remain low. This is illustrated in Figure 2.8, which shows the future pensions replacement rates faced by those currently aged 25, assuming lifetime earnings remain at half of the average. In the Czech case, the replacement rate is about 70%, which is relatively high in international comparison.

Figure 2.8. **Gross replacement rates for entry at age 25 at half average earnings**



StatLink http://dx.doi.org/10.1787/315174440041

Note: The gross replacement rate is gross pension entitlement divided by gross pre-retirement earnings.

Source: OECD (2007), *Pensions at a Glance*.

A final decision should be made soon on whether to remain with the PAYG pension in its current form or adopt a new approach. This has been discussed for many years. Indeed, the previous *Survey* reviewed five proposals developed by a special cross-party committee in 2005. Whether and how change is made is essentially a question of political economy. Arguably, the current system has been "sold" as an insurance-based pension and individuals therefore think the link between contributions and pension payout ought to be substantial. The fact that the link is weak means there is an inherent tension in the system. If this has to be resolved then there is a case for change. There are two ways forward:

- Continue with a strongly redistributive pension but be more transparent about it. For example, a flat-rate pension funded from general tax revenues would be one solution.
- Bring in a stronger link between pensions and payout, for example by mandatory contributions to funded accounts (*i.e.* a second pillar).

Which of these routes is best depends on the relative merits of strong pensions-earnings links. There are two inter-related questions. First is the degree to which the state ought to require individuals to save for their retirement because they are myopic and, left to their own devices, would make inadequate provision. Second, is the degree to which pension entitlements should relate to earnings when in work.

Cross-party discussions are currently favouring a defined-contribution (DC) carve out, *i.e.* a share of the pension contribution would be channelled into private-pension funds chosen by the pension holder and the payout on the PAYG pension correspondingly lowered. A DC carve out strengthens the link between pensions and earnings without increasing total contributions. This is beneficial if the current level of mandated saving is considered satisfactory. Moreover, as with other "second-pillar" pensions, a carve out diversifies the mandatory pension savings into the private sector. And, in the long run, a carve out reduces the size of the PAYG pension commitment and lowers the fiscal burden of the pension. However, two issues require close attention in designing a DC carve out:

- *The implications of the transition deficit need to be considered.* DC carve outs bring a phase of extra fiscal burden because contributions fall immediately but savings on the payout side do not begin until the first pensioners on the new scheme begin to retire. The

Czechs aim to ring-fence privatisation receipts to cover this cost.[18] The transition deficit potentially raises issues in the European Commission's excessive deficit procedure and, therefore, euro entry. In particular, if the carve out is voluntary (as currently proposed), special consideration would not be given to the transition deficit.[19]

- *Also, so-called "switching rules" are critical to the fiscal and microeconomic implications of DC carve outs.*[20] There are two dimensions: the rules on who can (or must) switch into the carve-out scheme and the design of the carve out itself.
  - The DC carve out scheme under discussion would allow all generations a one-time choice, *i.e.* the old and new pensions would run parallel. This implies a political economy risk; if payouts differ substantially there is likely to be pressure on the state to bridge the gap. DC carve out reforms typically phase out the old pension by making the new pension compulsory for those below a certain age, thus limiting this risk to a transitory period. Mandatory switching that would phase out the full PAYG pension should be considered.
  - Carve out design**.** When the public-pension is highly re-distributive, as is the case currently, the carve out rules are difficult to design. A straightforward carve out (*i.e.* the whole carve out is re-directed to second pillar funds, irrespective of earnings) makes the pension less redistributive. If combined with opt-outs in the switching rules, reform can be expensive because higher earners are more likely to switch than lower income earners.

Policy on voluntary private-pensions

About half the eligible population makes voluntary savings in private pension funds but the savings per contributor are low. This is due to a combination of direct subsidy and tax incentive that makes saving attractive but only up to a limited amount.[21] The returns to the funds themselves are very low; according to a recent World Bank report, the average real rate of return is only about 0.5% (World Bank, 2007). A regulation that funds cannot deliver negative annual returns to contributors is partly to blame. In addition, regulations do not allow separation of shareholders' and contributors' assets. As a result, the funds are almost entirely invested in low-return fixed interest assets. The World Bank report also underscores problems in transparency and oversight. In sum, the regulations on private pension funds need an overhaul, and this should include measures that improve the rates of return.

The second stage of pension reform aims to address these problems. This is clearly of added importance given the plans for the DC carve out. The subsidy and tax breaks on voluntary private-sector pension savings should also be critically assessed. A first best solution would be for better regulation to make voluntary saving attractive without support. If support is maintained, wide coverage and minimal deadweight loss should be the priority. In this respect, matching contributions are advantageous over tax breaks in that support is usually more evenly distributed across income groups, which may boost the participation of low and middle-income groups (Antolin and Lopez Ponton, 2008).

Developments in sickness and workplace injury insurance

Abuse of sickness insurance has, at least in the past, been high. Primarily this is because the state covered employees throughout the period of sickness, so employers had little incentive to check the authenticity of leave. Furthermore, the benefits are generous. There has already been some reform. In particular, in 2004 benefit was halved for the first three days of sickness. More substantial reform was due in January this year with implementation of legislation that was voted in under the previous government. Under the scheme, employers would be responsible for the first 14 days of sick leave in exchange for a reduction in the social contribution.

The current government has not favoured the 14-day scheme; one criticism being that it exposes small companies to excessive risk, another that it would be expensive. As a result, implementation of the legislation has been postponed to 2009 and adjustments to the existing scheme have been made. As of January this year, a “waiting period” has been introduced; the insurance benefit is not be paid for the first three days of illness and employers’ can decide on whether to pay individuals during this time. In addition, the payout has been lowered for illnesses lasting less than a month but increased for long-term illness.

The waiting period is welcome and will help cut back abuse. However, many other OECD countries have quite long mandatory employer-paid periods (sometimes coupled with a waiting period). For instance, the employer-paid period is typically two weeks in Nordic countries and several months in Austria and Switzerland (OECD, 2003b). Clearly, many countries find it advantageous to put considerable responsibility on the employers for sick pay. Presumably, this is because employers then have little incentive to abuse the system themselves and, furthermore, provide effective control of most sickness claims by employees. Therefore, the 14-day scheme should not be postponed further. Concerns for small enterprises could be addressed by ensuring there are no barriers to the creation of private insurance markets to cover employers for when they are responsible for sick pay.

Implementation of an act on workplace-injury insurance has also been postponed. At present, employers pay fees to one of two insurers that are entrusted under the Labour Code. This duopoly has been criticized by the EU and the previous government’s response was to legislate a system with a state-run single insurer. The current government was opposed to the move, preferring a multi-insurer model, and has bought time to re-open the debate by postponing implementation of the legislation.

Other reforms

The fiscal package contains a number of reforms to the welfare system. Notably, the package decoupled many benefits from the minimum-living standard (MLS), expressing them in cash amounts, rather than multiples of the MLS. The aim is to generate savings by allowing increases in the MLS but, generally, not among the de-coupled benefits.[22] This will partially claw back the large benefit increases that were voted in prior to the 2006 general election. Whether decoupling is a good move for the longer term is debatable. Some benefits may get more attention than others for political, rather than economic, reasons resulting in imbalances between benefit levels. In addition, regulation on the MLS and subsistence minimum (see Chapter 3) itself is light. In this instance increases are set by governmental decree, though when inflation is above 5% the MLS must be increased by at least the rate of inflation. Hence, there is little to guide decision making. While a period of discretionary indexation can provide fiscal savings and allow erosion of generosity, the authorities should ultimately consider comprehensive automatic indexation. Other reforms to the welfare system are discussed in Chapter 3.

There have also been some efforts to streamline central-government employment. The government aimed for wage-bill allocations to grow by 1.5% each year from 2008 to 2010, implying that higher wage increases would have to be coupled with job cuts.[23] In fact, many wage bill allocations in the 2008 budget exceeded this limit. Even where it has applied, job cuts will probably be avoided. Stronger efforts for efficiency gains through staff cuts in public administration should be made in the future, especially as lay-offs can be easily absorbed given current labour market conditions.

In a welcome move, privatisation plans are being accelerated, notably regarding Czech Airlines, Prague airport, *Budvar* (a beer producer), Czech Post and the freight division of Czech railways. However, the majority stake in the electricity company ČEZ, which is the largest of the government's remaining assets (see Chapter 1) remains. There was a small sale of shares in late 2007 but its objective was to generate funds for infrastructure projects, and was not a first step in further privatisation.

EU funding: challenges in ensuring absorption

Absorption of EU funds is lagging. As of September 2007, only about 45% of the funds allocated in the EU's 2004-06 budget had been taken up.[24] This is one of the lowest absorption rates among new member states (European Commission, 2007). The "n + 2" rule, that allows funds to be drawn up to two years after the allocation year, means the authorities have only until the end of 2008 to absorb the rest.[25] In addition, administrators are dealing with the much larger 2007-13 EU budget allocation. The allocation is € 26.7 billion (excluding direct farm subsidies), equivalent to about 2.5% of GDP per year and is the highest *per capita* allocation among the new member states when measured on a purchasing-power parity basis.

Several factors make accessing the 2007-13 allocations a challenge, aside from the sheer increase in volume. First, the political stalemate following the general election in 2006 delayed submission of the National Strategic Reference Framework (NSRF) that details the structure and content of operational programmes. In addition, the subsequent approval process has been protracted. As a result, significant inflows will only begin this year.

Second, retaining experts on EU funds has proved difficult. Ministries and other government bodies often face stiff competition for staff from the private sector. For instance, following the 2006 election a large number of experts on EU funding in the Ministry of Regional Development (MRD) departed, many to the private sector. Indeed, staff losses were so significant that at one point during negotiations on the NSRF, the Commission asked for proof of sufficient administrative capacity (Ministry of Regional Development, 2007). Frequent changes at the top of the MRD have also not helped.

Finally, and most importantly, the structure for allocating and managing the funds remains highly decentralised, raising concerns about efficiency and co-ordination. There are 24 operational programmes with responsibility spread throughout government (Table 2.1). Many elements of the system used for the 2004-06 allocation have been carried over. The MRD remains in charge of the whole process but line ministries and regional councils play a major role in managing the funds (they are the "managing authorities"). Significant inefficiencies may emerge because economies of scale in administration and expertise are not fully exploited. In addition, decentralisation makes the MRD's job of co-ordination and monitoring harder and makes communication with potential applicants for EU funds more difficult.

Some issues are already being tackled. A special decree was made in 2007 allowing bonuses for experts on EU funding (worth up to 20% of the monthly wage). And from 2006, EU funds have been integrated in the state budget. As a result, the managing authorities

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Table 2.1. **Operational Programmes for absorbing the 2007-13 EU budget allocations**

Operational Programme	Managing Authority	Allocation available (€ billion)
Transport	Ministry of Transport	5.76
Regional (7) and special Prague Programmes (2)	Regional Councils	5.08
Environment	Ministry of Environment	4.92
Enterprise and innovation	Ministry of Trade and Industry	3.04
Research and development for innovation	Ministry of Education	2.07
Education for competitiveness	Ministry of Education	1.81
Human resources and employment	Ministry of Social Affairs	1.81
Integrated operational programme	Ministry of Regional Development	1.55
Cross-border programmes (5), interregional and transnational (2)	Ministry of Regional Development	0.39
Technical assistance	Ministry of Regional Development	0.26

Source: Ministry of Regional Development.

have more flexibility in making advanced payments thus helping recipients obtain funds without delay.

More adjustments will be required. In broad terms, administrative processes should be simplified and decentralisation offset by stronger communication and the pooling of expertise in administration. If the decentralised structure proves too cumbersome, the authorities should consider using EU regulations that allow for alteration to the structure of operational programmes during the budget period.[26]

Co-financing requirements pose a challenge. The value of co-financing, if funds are fully absorbed, is estimated at € 4.7 billion over the whole of the budgeting period. This is roughly equivalent to 0.4% of GDP *per annum* between 2007 and 2013. Furthermore, these co-financing demands will vary considerably from one year to another. For instance, the amount is likely to be particularly high in 2013.[27] Overall, therefore, there is a risk that fiscal budgets in some years will have to cope with significant co-financing demands (Ministry of Finance, 2006).

Notes

1. These temporary controls are in the form of government decrees. In 2006, there were rules about the net growth in reserve funds over the year. For 2007, Ministries had to seek prior government approval to access their reserves and the government unilaterally took money out of the reserves to fund other areas of spending. For 2008, the spending of non-EU related reserves must be discussed with the minister of Finance and be approved by the Prime Minister. This applies to about one third of total resources in the reserve funds.
2. In the general treasury chapter the revenue side serves as a vehicle for processing about 60% of general tax revenues. About 20% of total expenditure is covered by the chapter. Components of the budget are divided into *kapitola* which translates to chapter. Each line ministry has its own chapter and there are additional chapters, such as the general treasury chapter.
3. In the period of 2003-06 the Ministry of Finance growth forecast used when drafting the budget was on average 0.3 percentage point below the consensus projection. The consensus projection itself was 1.3% below the outcome on average over this period.
4. There are almost 200 programmes carried out on a basis of programme budgeting, but they cover only 10 per cent of the expenditures and are mainly focused on property renovation.
5. Czech policy on this front has not always been positive. Due to EU regulations, a preferential VAT rate can now only be applied for the construction and renovation of “social housing”. In light of this, regulations were altered so that for VAT purposes “social housing” now includes any apartment with a surface of less than 120 square metres and any house less than 350 square metres.

6. Flat tax reforms were introduced in the 1990s in Estonia, Lithuania and Latvia. In the 2000s Georgia, Macedonia, Montenegro, Romania, Russia, Serbia, Slovakia and the Ukraine have made flat tax reforms. For an overview of most of these reforms see Keen *et al.* (2006).
7. The ceiling on social contributions operates on an annual basis. In other words, contributions are made over the year until the annual assessment base reaches 48 times the monthly average wage.
8. Social security or insurance systems where the payout (in cash or in kind) is uniform (such as universal healthcare) obviously imply strong cross subsidy when contributions are proportional to earnings. Even in areas where there are links between contributions and payout, such as unemployment insurance or pensions, the payout formulae are usually progressive, again implying a degree of cross subsidy.
9. In this context, the tax treatment of PAYG pensions is interesting. Prior to the new PIT system, the pension was not taxed at the contribution stage but was officially taxed at the payout phase. However, because of a special deduction for pension income (equivalent to about 75% of the average wage), pensions are effectively not taxed in payout. Therefore, although the new PIT in theory implies double taxation it in fact introduces single taxation. Double taxation is not the only issue raised by taxation of contributions. For instance, if there are economic rents in the payouts from social contributions (*i.e.* rates of return above a benchmark, such as the government's cost of borrowing) then taxing only at the contribution stage implies the economic rents are not taxed. In this situation, an exempt-taxed system is preferable to a taxed-exempt system.
10. As useful start on this has been made by researchers at the CNB and Ministry of Finance. Galuščák and Pavel (2007) use a micro-simulation of the tax-benefit system to examine the impact of benefit changes on households and this work is being extended to examine more recent reforms.
11. Details of the VAT treatment of construction and renovation are shown in Annex 1.A2. Property taxation is levied according to surface. The typical charge in Prague, which has the highest rates, is only CZK 600 per year for a 100 square metre apartment. Recent changes in legislation on property taxation however allows local authorities to increase the charge substantially. For instance, in the preceding example a ceiling of CZK 2 700 per year has been set.
12. The employees' healthcare contribution is 4.5% of gross wages and the employers' contribution is 9%.
13. Other measures to contain cream skimming include legislation that prevents insurers from refusing clients and a system of partial compensation of expensive cases.
14. To cover these deficits there have been large increases in the payments the government makes on behalf of non-contributors (such as children and pensioners). In the past, the state has also pumped money into the funds by paying off the funds' debts (through a state agency for bad loans, the CKA).
15. The fees have been set at CZK 30 for appointments with doctors and each drugs prescription, CZK 60 a day for a hospital stay and CZK 90 for an emergency room visit. The ceiling is CZK 5 000 per year (this is equivalent to about 5% of annual gross earnings at the minimum wage). It is estimated the fees will bring an additional CZK 4 billion to healthcare providers this year. The ceiling only applies to drug co-payments, drug prescription fees and doctor appointments.
16. It is expected that some pharmaceutical companies will ask for the new drugs pricing procedure to apply to existing drugs, because it would show their products to be the cheapest available.
17. Currently, if patients want treatment (with, say, a total hip replacement) not included in the basic insurance package, the only option is to pay for the whole procedure. Not only do patients have to pay for the full procedure but can only get the treatment at a medical facility that is not covered by their insurer. According to the draft, patients will only pay the additional cost.
18. In January this year, a separate reserve account to cover such costs was created with an initial sum of CZK 1.1 billion. Surpluses from the PAYG pension fund will be channelled into the account and there is discussion of putting privatisation receipts into it as well. The Ministry of Social and Labour Affairs expects that by 2010 some CZK 40 billion will have accumulated in the account but this partly depends on the size of upcoming pension increases. The Ministry also plans on putting dividends from assets in network industries into the fund.
19. The revised Stability and Growth Pact acknowledges transition costs of pension reform as mitigating a factor if the deficit is above the 3% Maastricht criterion. The new Code of Conduct says that consideration to the net cost of the pension reform can be given for the initial five years after a Member State has introduced a mandatory fully-funded system. However, the share of the net cost considered will be reduced over time (100% in the first year but 80, 60, 40 and then 20% in the following four years, respectively). Also, the rules state that consideration will only be given if the

deficit is close to 3% of GDP and is only temporarily above the reference value. Furthermore, if the Czech's introduce an optional defined-contribution carve out then consideration might not be given because the scheme is not mandatory.

20. See Mattil and Whitehouse (2008) for an international perspective on switching issues in DC-carve out reforms.

21. There is a tax break for pension contributions over CZK 6 000 per year. They can be deducted from the personal income tax base up to a total deduction limit of CZK 12 000 per year. There are also matching subsidies with a maximum of CZK 150 per month. Moreover a deduction up to CZK 12 000 can be made for life insurance contributions.

22. The decoupling implies that parliament votes on increases in the benefit amounts. Increases in the MLS are set by governmental decree.

23. Initially, the government aimed to apply this cap across the whole public sector, including such groups as teachers and nurses. However, it later became narrowed to apply to areas of public administration only. Indeed, for example teachers have been granted a wage rise of 3%. Assessing the scale of genuine streamlining is anyway complicated because in many areas of public administration new staff have been taken on to deal with the country's 2009 EU presidency and to administer the 2007-13 EU budget allocation.

24. The fund allocation figure represents the percentage of funds that were certified by the paying authority.

25. Expenditure on all projects in this allocation have to be made before the end of 2008. The deadline for certification by the authorities is 15 months later.

26. Article 33 of EC Regulation 1083/2006 says that following implementation difficulties, operational programmes may be re-examined and revised.

27. Up to 2010 a temporary "n + 3" rule will apply but will revert to an "n + 2" in 2011. Assuming that fund applications will bunch up at the end of the permissible period for a given year's allocation, this implies particularly high absorption and co-financing demands in 2013, because allocations from both 2010 and 2011 will have to be absorbed by 2013.

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ANNEX 2.A1

Selected details of tax measures in the 2007 reform package

Personal income tax

- Introduction of a flat rate system with a rate of 15% in 2008 and 12.5% from 2009 onwards with a base of "super-gross" earnings for employees.
- Changes in deductions. For example, the standard allowance (in monthly amounts) has been increased from CZK 600 in 2007 to CZK 2 070 in 2008 and will be reduced to CZK 1 380 in 2009, reflecting reduction in the flat tax rate.
- For self-employed, abolition of the current minimum tax base.
- Abolition of the option of joint taxation of married couples but the tax relief for dependent spouses is increased by making it the same as standard allowance.
- Increased tax relief for students and holders of medical disability cards.
- Alteration to tax-exemption rules from the sale of securities.

Corporate income tax

- Reduction in the rate of corporate income tax from the 2007 rate of 24% to 21, 20 and 19% in 2008, 2009 and 2010, respectively.
- All withholding taxes on capital returns unified at a 15% rate.
- Base broadening. Notably thin capitalization rules and limitation of financial expenditure will be stricter.
- Exemption of corporate tax on the gains from the sale of shares of a subsidiary. This only applies to subsidiaries in the EU and countries with which there is a double taxation treaty. There is also a condition that the shares must have be held for at least 12 months.
- Dividends received by a Czech parent firm or a branch of an EU company from subsidiaries residing in non-EU countries will be tax exempt as long as a double tax treaty has been signed. In addition, the tax rate in the home country of the subsidiary must be at least 12%.
- Abolition of limitations on the "acquisition price" for passenger motor cars.
- Introduction of binding rulings of the tax authority with regard to the treatment of some costs.

Value-added tax

- Increase in the preferential rate of VAT from 5 to 9% as of January 2008. The preferential rate is notably applied to foodstuffs, renovation of housing, construction of “social housing” accommodation and the passenger transport. Note that for VAT purposes “social housing” is defined as an apartment of no more than 120 square meters and a house of no more than 350 square meters.
- Transfer of some environmental fuels (*e.g.* wood pellets) in the reduced VAT rate group.

Other measures

- Exemptions on gift and inheritance taxes have been widened.
- Municipalities can decide to make farmland exempt from real-estate taxation. Municipalities can withdraw the exemption if the land is close to a built-up area or if it is designated for construction. At the same time, municipalities have been given the right to choose between four different tax rates for all real-estate subject to tax.
- New environmental taxes on energy suppliers as part of commitments from EU directives were included in the fiscal package.

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Chapter 3

Tackling labour and skill shortages

The fast pace of growth has moved the spotlight in labour market issues. In the past, the chief concern was with regionalised long-term structural unemployment. This problem is receding and a new challenge of ensuring labour supply has emerged. Unemployment rates hit an 11-year low at 4.9% in the last quarter of 2007 and the share of the working age population will start shrinking soon. To prevent labour supply becoming a constraint to growth, it is crucial that additional attention is paid to activating the remaining reserves of labour. This chapter looks at where possible reserves may lie and how policies could help bring them into employment. For young cohorts, education policy is the key issue. In other groups, comparison with other OECD countries shows there are sizeable reserves among prime age women and older cohorts, which link to family policy and early retirement incentives.

Until recently, highly regionalised structural unemployment was the primary concern of labour market policy in the Czech Republic. The brisk pace of recent economic growth is eroding this problem. Indeed, there is a risk that labour shortages will hamper future economic growth. This chapter focuses on how to deepen skills and increase employment rates among domestic labour – options for strengthening labour supply through migration policy are considered in Chapter 4. The chapter first looks at how policy can improve general labour market conditions and then examines the specific policy issues for young, prime-age and older cohorts. The policy conclusions are summarised in Box 3.1.

Box 3.1. **Policy recommendations for tackling labour and skill shortages**

General labour market conditions

Further progress in shifting the burden of away from labour taxation to indirect taxation should be sought.

Though widening the scope for using the sanction level of benefit is welcome, the creation of an underclass of de-motivated beneficiaries should be avoided. Those sanctioned still ought to get help from activation policy.

The removal of some restrictions in the labour code is welcome but more deregulation needs to be considered. At a minimum, notice period and severance pay arrangements ought to be linked to the length of service.

While the current schedule of regulated rent increases is helpful, full liberalisation of the rental market should be considered.

Non-standard 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.

Younger cohorts

As recommended before, tuition fees in tertiary education should be introduced. This should be accompanied by publicly guaranteed student loans in which repayments are conditional on earnings after graduation.

Elitism in secondary education should be tackled by less streaming of students and wider access to courses that provide options for tertiary education. In addition, there is a need for more benchmarking of schools and students.

Given the other measures being discussed to support part-time work, the plan to support student jobs may be unnecessary.

Prime-age women

The three-year leave system is too long: a combined maternity and parental leave of two years, or less, should be aimed for. The plans to widen the options for fathers to take leave for childcare are promising and should be developed further.

Box 3.1. **Policy recommendations for tackling labour and skill shortages** *(cont.)*

Much bigger efforts to encourage childcare services are required. The following avenues should be considered in addition to the planned measures:

- For pre-kindergarten care, consider boosting services through the existing channels, *i.e.* give municipalities bigger incentives to offer childcare. Alternatively, the parental allowance could be partially, or fully, replaced by vouchers that can be spent in both public and private services.
- If the current shortage of places does not ease off quickly then additional support for kindergartens should be considered.

A comprehensive review of families' tax-benefit burdens is required to increase the incentives to take up work. In particular, despite the new three-speed system, the parental allowance is overly generous. In addition, a system that precisely defines the calculation of the housing costs for the housing benefit should be considered.

Older cohorts

Further increasing the retirement age is crucial to raising the employment rates of older cohorts.

Further adjustment of the rules on working beyond the standard age of retirement should be considered, particularly the treatment of pension contributions.

Consideration could be given to pushing the pension reductions for early retirement above neutrality.

The proposed first phase of pension reform makes progress on all three of these fronts and its implementation is therefore important.

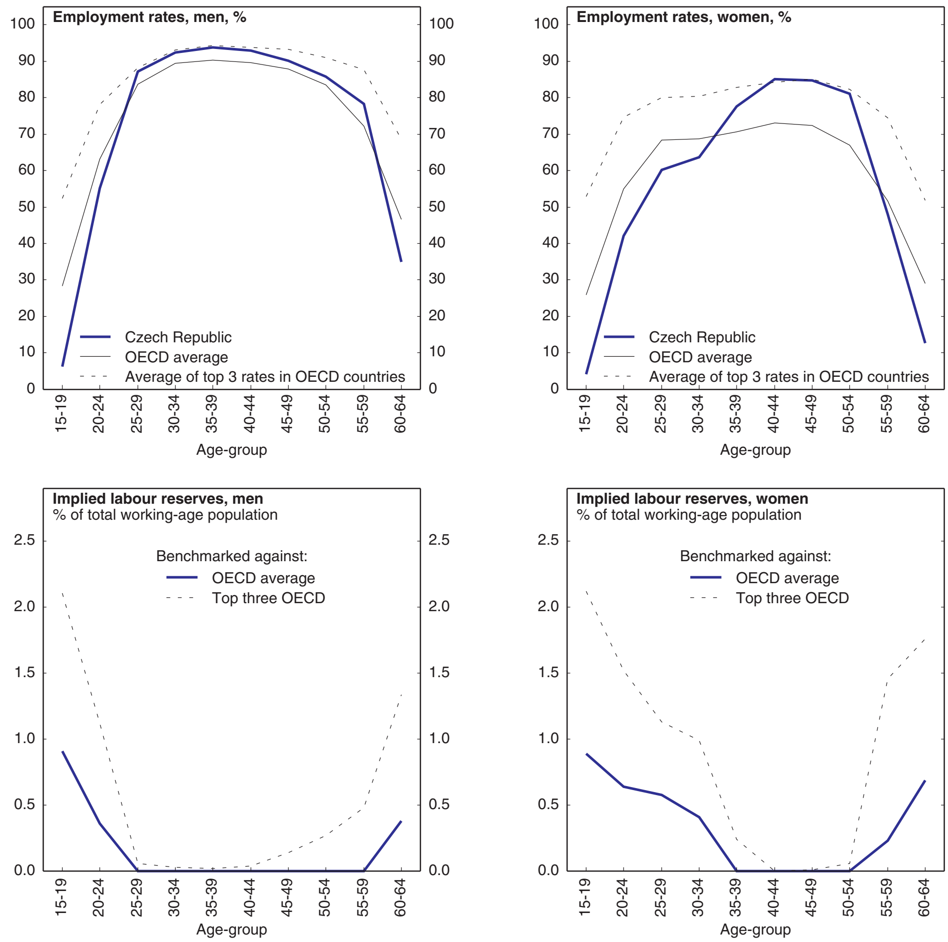
Where are the reserves of domestic labour?

International comparison of employment rates suggests the remaining reserves of labour in the Czech Republic are principally among young cohorts, some groups of prime-age women and older cohorts. Figure 3.1 compares Czech employment rates with the overall OECD average and an average of the top three rates. For both men and women aged 15-24, the Czech rates fall well below these benchmarks. This is also the case for those aged 55 to 64. Among prime-age women, while the employment rates among 40 to 54 year-olds are among the highest in the OECD, the rates for those aged 25 to 39 are below average. To gauge the size of the reserves, the bottom panels of Figure 3.1 use population data to calculate the size of groups implied by the gaps in the employment rates. For instance, the difference between the employment rate among 60-64 year-old men and that of top-ranking countries implies a reserve equivalent to a little below 1.5% of the total working-age population.

In the case of young cohorts, the benchmarking exercise should be treated with caution. *Prima facie*, it seems in many other OECD countries youth employment rates are much higher, despite typically having equivalent or higher enrolment rates in tertiary education.[1] However, the Czech Statistical Office suspects that many students with jobs do not report they are working in the Labour Force Survey. A special survey of Czech students conducted for Eurostat's *Eurostudent* project suggests this is indeed the case as its results show that a large share of student incomes come from own earnings.

The reserves of labour include, of course, those who are actively seeking work (*i.e.* the unemployed) but a majority is not working for other reasons. As shown in the left-hand

Figure 3.1. **Czech employment rates in international comparison**



StatLink http://dx.doi.org/10.1787/315286573488

Note: The employment rate is the number employed as a percentage of the population of the same age and gender. Implied labour reserves are the additional employed needed to equate the Czech employment rate with the benchmark employment rate. Data refer to 2006. Working-age is 15-64 years.

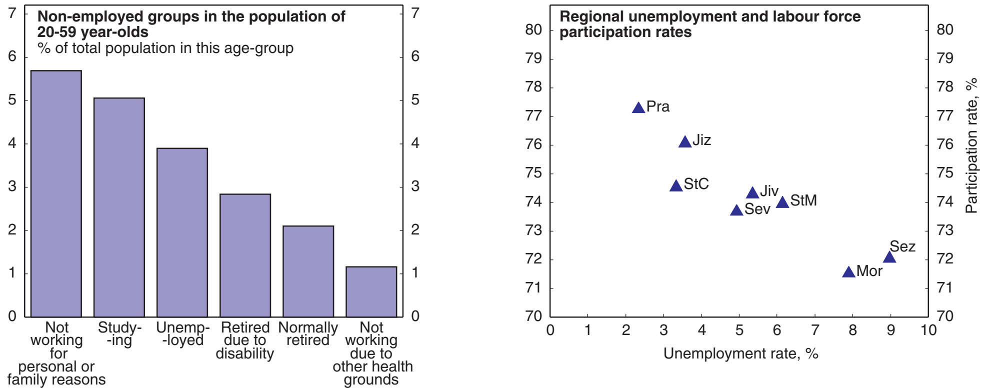
Source: OECD calculations based on OECD (2007), *OECD Employment Outlook*.

panel of Figure 3.2, there are far more 20 to 59 year olds who are either studying, retired, or not employed for personal or family reasons than there are unemployed. However, labour market conditions are influencing these activities, as can be seen in the negative relationship between regional unemployment and participation rates in the right-hand panel of Figure 3.2. That is good news for policymakers because it confirms a fair degree of "hidden" unemployment.

Progress in improving general labour market conditions

Increasing the potential for higher employment rates requires attention to several policy areas. Lowering taxes and social contributions on labour is one avenue. Depending on household circumstances, the Czech tax wedge is typically well below the highest in the OECD area, but above the average. For instance, OECD calculations show that, as of 2007, the average tax wedge across eight household types was 50% in the Czech Republic

Figure 3.2. **Other aspects of Czech labour reserves**



StatLink http://dx.doi.org/10.1787/315312804228

Note: Non-employed groups reflect the responses given by survey respondents on why they are not in paid employment.

Unemployment and participation rates are for each of the eight NUTS2 regions:

Pra	Praha	Sev	Severovýchod
StC	Střední Čechy	Jiv	Jihovýchod
Jiz	Jihozápad	StM	Střední Morava
Sez	Severozápad	Mor	Moravskoslezsko

Source: Czech Statistical Office (2007), *Labour Force Survey*, 3rd Quarter 2007.

compared with over 60% in some countries and an OECD average of 46%.[2] The tax measures discussed in Chapter 2 head broadly in the right direction, shifting the burden away from labour taxation to indirect taxation. Further progress in this direction should be sought. As Chapter 2 suggests, further narrowing of the gap between the preferential and standard rate of value added tax could be one way of funding cuts in the wedge.

Furthermore, general improvements to the labour market through reforms to unemployment and welfare benefits, as well as labour market regulation are part of the answer to building capacity in labour utilisation. As regards welfare benefits, previous *Surveys* have criticised the minimum-living standard (MLS) system (or system of "assistance in material need") that provides a floor to household incomes through top-up payments. The chief problem is that the floors can dissuade employment in some instances. In January 2007, a second, less generous floor (called the *existenční minimum*, or subsistence minimum) was introduced as a sanction for those not co-operating with labour offices.[3] There is intention to widen the scope of these sanctions. For example, there are proposals to remove individuals from the labour register if they refuse job offers or training programmes. Removal from the register implies not only losing eligibility for the subsistence minimum but also access to several in kind benefits. In addition, there are plans to make labour offices take more concrete activation steps. In particular, one aim is for all those who are still unemployed when their insurance benefit expires to be offered training courses or public-works jobs. Though widening the scope for using the sanction level of benefit is welcome, the creation of an underclass of de-motivated beneficiaries should be avoided. Those sanctioned still ought to get help from activation policy. For instance, even if clients loose access to benefits, they should still be subject to targeted activation measures.

Moreover, there are plans to make unemployment benefit more front loaded through shortening the maximum duration by one month to five months and alteration of the payout schedule. Under the current system, benefit is 50% of the previous earnings for the first three months and 45% for the following three months. The plan is for a payout of 65% of previous earnings for the first two months, 50% for the third and fourth months and 45% for the fifth month. A cap on the benefit amount will remain. The changes to the sickness pay system discussed in Chapter 2 are also likely to improve effective labour utilisation by cutting back on days lost due to illness.

As regards labour market regulation, the previous government's new labour code has been operating since January 2007. The leading coalition partner has always been critical of this legislation and several minor liberalising adjustments were made in autumn 2007. These include greater flexibility in the organisation and bonus payments for weekend and shift work. In addition, there is now more scope for employers to alter working hours without consulting employees and overtime restrictions for junior managerial positions have been removed.[4]

The lightening of the labour code is welcome but more deregulation needs to be considered. Major reform is mooted but no details are yet available. At a minimum, notice period and severance pay arrangements ought to be linked with the length of service. Currently, the notice period is always two months and severance pay three months, no matter how long the person has been in the job concerned. Compared with other countries, these settings are modest for long-serving employees but relatively generous for those who have been employed a short time. Indeed, it is these aspects of labour regulation that make the OECD's indicator of employment protection legislation for the Czech Republic high in international comparison. Newly hired workers should only gradually acquire these entitlements as their length of service increases.

The strong regionalisation of Czech unemployment suggests there may be barriers to the mobility of labour, a topic often discussed in previous *Surveys*. Home ownership is very common and one factor constraining labour mobility. A large number of apartments were transferred to occupants at favourable prices as part of economic transition. Furthermore, home ownership is fuelled by generous tax treatment and subsidies. Hence, the recommendation for reducing support made in Chapter 2 would also help in the context of labour mobility. The development of rental markets is hampered, not only by the strong ownership incentives, but by rent regulation too. A schedule of large increases in the ceilings on rents is underway and due to end in 2010. The goal is for regulated rents to be roughly equivalent to five per cent of the value of property. While this should be helpful, full liberalisation of the rental market should be considered.

Encouraging non-standard jobs

Increasing labour utilisation is likely to involve the creation of more "non-standard" jobs, such as part-time work, temporary work and teleworking, because the remaining reserves of labour largely comprise groups with priorities that can make full-time, year round work difficult. Non-standard work arrangements have been relatively uncommon to date. For instance, less than 5% of employees are part-time in the Czech Republic compared with over 15% in many OECD countries. This is partly due to economic conditions. Income levels in the Czech Republic mean that fewer households are willing to consider part-time employment compared with countries where the real earnings are higher. In addition, on the demand side, the relatively low share of service-sector jobs probably limits the market for part-time work.

But at the same time, some policies are stifling non-standard work. In particular, there is a minimum healthcare contribution equal to the contribution on a full-time minimum-

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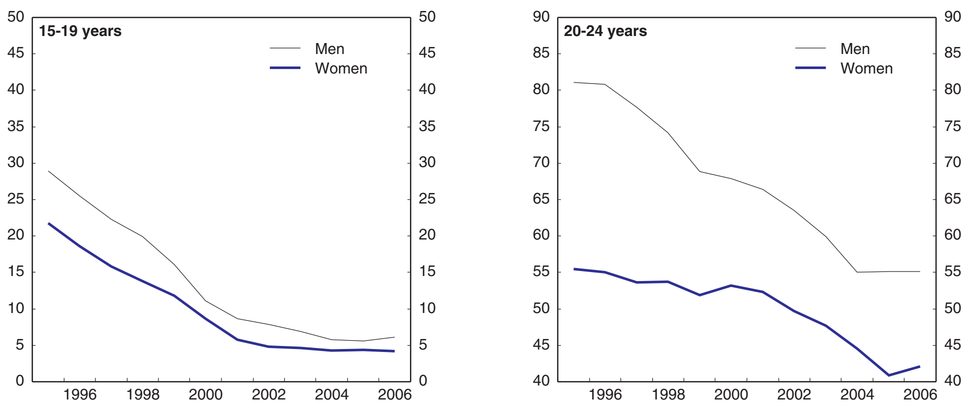
wage job. There are exemptions for students, parents (under certain circumstances) and those working beyond the standard age of retirement. Nevertheless, the rule strongly dissuades the creation of part-time work in the rest of the labour market, particularly for jobs paying low hourly rates. There are plans for direct subsidy of part-time work through lump sum reduction of the employer's social contribution for unemployed persons who take up jobs involving less than 75% of standard working hours. The spirit of the move is welcome. However, removal of the barrier created by the minimum social contribution, and any other impediments to part-time work, should take priority over direct subsidies. There can be tricky aspects to such reform. In particular, minimum-contributions are often in place to tackle under-declaration of earnings and tax evasion and so removing them may have to be accompanied by measures that deal with these issues in other ways.

Younger cohorts: encouraging the right balance between work and study

As in other OECD countries, employment rates among young cohorts have trended downwards; though probably by less than is shown in Figure 3.3 because of the underreporting of work by students (see previous discussion). Broadly speaking, this is of course a positive development because it reflects longer periods in full time education, which in principle filter through to workforce skills and growth potential. However, spending more time in education underscores the need for the right kind of learning at the right pace in schools and tertiary institutions.

Figure 3.3. **Employment rates of young cohorts, %**



StatLink http://dx.doi.org/10.1787/315325833406

Note: The employment rate is the number employed as a percentage of the population of the same age and gender.

Source: OECD (2007), *OECD Employment Outlook*.

Demand for tertiary education has been expanding rapidly with an increasing share of school leavers wanting to continue education before entering the labour market. This has presented challenges for the tertiary sector, particularly the universities, which have traditionally focused on providing long and strongly academic courses. There has been some response, notably new three-year vocationally oriented degrees are being brought in. However, deeper reform is needed. As recommended in an in-depth review on education in the 2006 *Survey*, tuition fees in tertiary education should be introduced. Such a move would help the tertiary sector become less supply driven by improving market signals between students, providers and the labour market. So as not to deter students, especially those from low-income families, the fee system should be accompanied by publicly guaranteed student loans in which repayments are conditional on earnings after graduation.

Although Czech secondary education has a good reputation, it has an elitist approach that does not suit preparing the much larger share of students heading for higher education. Recommendations to deal with this made in the 2006 *Survey* still hold. In particular, there should be less streaming of students and wider access to courses that provide options for tertiary education. The need for more benchmarking of schools and students recommended in the *Survey* also still holds.

There appears to be greater support for reforms along these lines in the current government, though it is uncertain how much concrete progress will be made. Indeed, the government's declaration made at the beginning of its term explicitly ruled out introducing tuition fees to accommodate the views of junior coalition partners. Nevertheless, there are plans to submit proposals by mid-2009 that are likely to pave the way to fees. In secondary education, some of the weaknesses, in principle, will be resolved by a reform of curricula and teaching methods that aims for less rote learning and more focus on key skills. This programme, underway since 2004, is now largely in place and the key question is now whether teachers will respond to the new system as intended. Unfortunately, the introduction of common national school-leaving exams, which would bring welcome comparability in testing and results, has been postponed. According to the authorities this is because the curricula remain too diverse. There are ambitions for other measures in secondary education, but these remain very much at the planning stage. These include dividing the final state exam into two levels.

The Ministry of Education plans to submit a bill that would bring active subsidy of student jobs. The aim is to design a special form of short-term work contract in which social and healthcare contributions are either reduced or eliminated. Given the other measures being discussed to support part-time work (see above), such a heavily targeted measure may be unnecessary.

Prime-age women: getting incentives right for combining work and family

Czech family policy encourages mothers to be full time carers and not to work until their children are old enough to attend kindergarten through long parental leave provisions backed by cash benefits and very limited subsidy of day-care for young children. Thus, women typically spend several years out of the labour force when they have children (men take parental leave only in a very small share of households). This accounts for the relatively low employment rates among women aged 25 to 39 and contributes to the gender wage gap. The employment rates among 25-29 year olds have picked up in recent years but those for 30-39 year olds have continued on a downward path (Figure 3.4), which possibly reflects increases in the average age when women start a family.

Some progress in making leave and financial support more flexible

The system of leave allowances and cash benefits comprises of support for the first years of parenthood and long-term support that continues until children are in their late teens or early twenties:

- For working women, maternity leave usually starts one and a half months before birth with a maximum duration of typically 28 weeks (see Table 3.1). During this time, financial support comprises an earnings-related insurance benefit (maternity benefit)

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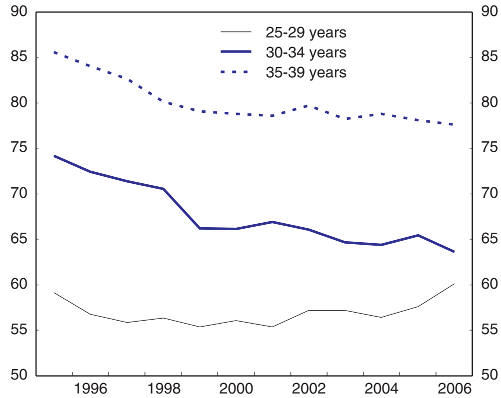
Figure 3.4. **Employment rates among prime age women, %**



StatLink http://dx.doi.org/10.1787/315334187886

Note: The employment rate is the number employed as a percentage of the population of the same age and gender.

Source: OECD (2007), *OECD Employment Outlook*.

and a universal one-off "birth grant". After that, the mother or father can use parental leave to remain off work until the child is three years old. This is backed by a cash parental allowance that is available until the child is four years old. Non-working women also receive the birth grant and are eligible for the parental allowance from when the baby is born. It is important to note that the allowance can be received while working but access to group childcare services is limited. Notably, for children less than three years old, services can be used no more than 5 days per month (see Table 3.1).

- Most families get some form of long-term financial support. There is a family tax credit on earned income. Furthermore, the "minimum-living standard" (MLS) and subsistence minimum schemes provide a floor to family income. In addition, there are two types of child benefit and a housing allowance that families can get even if their income is above the MLS.

Some large benefit increases were made in the run-up to the 2006 election. The measures were politically motivated and not part of a systematic reform. As of January 2007, the parental allowance and child benefit almost doubled (see below) and there was substantial increase in the birth grant. A new system of housing allowances also came into force in 2007. Under this system housing costs are no longer included in the MLS calculation. Simulations by Galuščák and Pavel (2007) show that the increase in the parental allowance significantly boosted incomes. The combined effect of the other changes introduced in 2007 varies according to the type of household. However, the analysis does reveal that the housing allowances have become more generous. Some of these measures are being reversed. The birth grant has been reduced as of 2008 and most family benefits are now decoupled from the MLS (see Table 3.1 and Chapter 2) which will permit the erosion of the real value of benefit levels over time.

In addition, a "three-speed" parental allowance system has been introduced this year. In 2007, the parental allowance doubled to CZK 7 582 per month. As of January this year, parents choose between getting two, three or four years of allowance. The two and three-year options have monthly payouts of CZK 11 400 and CZK 7 600, respectively while the four-year option pays CZK 7 600 until the child reaches 21 months and then pays CZK 3 800. Only those with previous earnings above twice the minimum wage can choose the two-year

Table 3.1. **Leave and financial support for families**

Scheme	Key features	Benefit amounts in 2008 (monthly amounts unless otherwise stated)
Birth grant *(Porodné)*	One off payment at birth of each child.	CZK 13 000; reduced from 2007 and no longer linked to the MLS.
Maternity leave and benefit *(Mateřská dovolená a peněžitá pomoc v mateřství)*	Maternity leave is 28 weeks (37 in the case of multiple births) and is covered by an insurance-based benefit. A minimum of 14 weeks must be taken.	The benefit is 69% of previous earnings but with a cap of CZK 14 849.
Parental leave and parental allowance *(Rodičovský příspěvek)*	Employees have right to three years parental leave. The parental allowance can be paid for up to four years. In 2007, it was increased substantially and in 2008, a new "three-speed" system was introduced.	The parental allowance has three monthly payout options: CZK 11 400 (two years), CZK 7 600 (three years). For the four-year allowance the payout is CZK 7 600 until the child is 21 months old and then CZK 3 800. The two-year option is decided on the end of maternity leave and is conditional on previous earnings. The four-year option is decided on when the child is 21 months.
	Whilst receiving the allowance, for children less than three years, access to group childcare is restricted to no more than 5 days per month. For children over three years access is restricted to now more than full 5 days a month or four hours per day.	Payout is reduced by the amount of maternity or sickness benefit received (this effectively means an insured mothers will typically not receive the allowance whilst getting maternity benefit). Indexation no longer linked to the MLS.
Child benefits (*Přídavek na dítě*)	Per-child benefits (up to age 26) paid to households with income up to 2.4 times the MLS. The benefit schedule was altered in 2007 and 2008.	From CZK 500 to CZK 700 depending on the age of child. Indexation no longer linked to the MLS.
Social contribution (*Sociální příplatek*)	Effectively a second child benefit. Families are eligible if their income is less than 2 times the MLS but in this case, the income calculation has to include child benefit and parental allowance. Evaluated on a quarterly basis.	Benefit depends on family income and age of child. It ranges from CZK 50 for a child under six in a family with income close to the MLS to CZK 1 228 for a child aged 15-26 in a family on the MLS. This benefit remains linked to the MLS.
Welfare top-up payments *(*MLS and subsistence minimum, or *Životní a existenční minimum)*	Top-up payments based on a "minimum-living standard" and subsistence minimum calculation. The housing costs are not included in the calculation of income for the top-up.	The MLS is calculated by adding up values for each family member. Values range from CZK 1 600 for children aged under 6 to CZK 2 880 for the first adult. For instance, the MLS for a two-parent household with 2 children aged under 6 is CZK 8 680 per month.
Housing benefit (*Příspěvek na bydlení*)	A payment covering the gap between housing cost estimates and 30% of household income (35% in Prague). The cost estimates are made by a governmental decree on the advice of the Ministry of Labour and Social Affairs.	For homeowners, the housing cost estimates (the housing "normative") ranges from CZK 2 653 for a one-person household to CZK 7 385 for a family of four. There are common rates throughout the country. Indexation is no longer linked to the MLS.
Tax deduction for children (*Sleva na dani na dítě*)	Reduction of the household tax bill for each child.	CZK 10 440 for each child – increased from 2007 as part of the personal income tax reform.
Memorandum		Minimum wage in 2008: CZK 8 000. Average wage in 2008 (estimate): CZK 23 000.

option. It is hard to predict how parents will respond to this system. Because the allowance can be received whilst in work, the options do not necessarily have to connect with leave choices. Also, the total value of the allowance does not differ much between the three options.[5] However, for instance, some may choose the two-year option because this would enable them to freely access childcare services when their child turns two.

Other changes to leave and financial support have been made. Maternity leave has been made the same for single and married parents. Also, there is a plan to introduce one-week paternity leave with an earnings-related allowance. Furthermore, the postponed sickness legislation (see Chapter 2) introduces an option for fathers to take over the maternity leave after the baby is seven weeks old. In this case, the maternity allowance would be based on the father's salary.

Public childcare for young children remains sparse

Public childcare for pre-kindergarten age children have shrunk to a point where they are practically not an option for most parents because there are no facilities nearby home or workplaces. There are less than 50 dedicated public childcare centres for those aged under three years, compared with over 1 000 in the early 1990s. Some kindergartens offer places to under threes but only about 6% of children in this age group attend any form of public childcare.

The dramatic cutback in services came about partly due to demographic developments but also because policy settings have limited demand and supply. On the supply side, public pre-kindergarten childcare is legally the responsibility of municipalities. However, the central government does not provide any additional funding, nor set any service obligations (aside from health and safety standards). Hence, municipalities have free range in choosing service levels and fees. In theory, local democratic process should ensure the right level of services but in practice, the lack of central-government support is likely to mean many municipalities under-provide.[6]

Policy settings on the demand side have also contributed to the fall in childcare services for young children. As mentioned above, parents receiving the parental allowance have restricted access to group childcare. Therefore, the only way, in theory, parents can use group childcare and return to work is to forego the parental allowance. This increases the implicit price on childcare services significantly. Hence, most parents take the parental allowance and either go on leave or arrange childcare through family or friends.[7]

The kindergarten system has been under strain recently and is adding to parents' difficulties in combining work and family. In theory, kindergartens cater for three to six year olds. But, there is a shortage of places, boosted by a mini baby boom. For example in the 2006-07 school year, reportedly, a large share of the applications for 3 to 4 year olds were rejected – by law kindergarten must offer places to 5 year olds. Therefore, there is a potentially a serious gap in family support in which parents are neither getting leave allowances nor a guaranteed place in schools.

The Ministry of Labour and Social Affairs is working on a new strategy for family support. This includes an innovative proposal for home-based group childcare. In the scheme, subject to registration, parents would be able to offer services from their home for up to four children (including their own). Linked to this, there are plans to cut out unnecessary health and safety regulations for childcare services.

Radical reform should be considered

While the various steps taken recently and the proposed measures are welcome, they do not go far enough in helping parents combine work and family. The main problem is the focus on encouraging a three-year period of full-time parental childcare. According to the latest OECD *Babies and Bosses* report (OECD, 2007a), from a purely labour market perspective, the optimal length of leave is around four to six months. From a child development perspective, the report underscores strong evidence that long periods out of work damage parents' careers and family incomes and through this route can be harmful. The report also investigates the large literature on the impact of different types of care on child development. It concludes that development is negatively affected when he or she does not receive full-time personal care for the first 6 to 12 months. For children older than this but under about two years the report finds no consensus on the relative merits of personal *versus* formal care. From age 2-3 years, the report suggests that cognitive development benefits from good quality formal care (and interaction with peers).

On balance, even taking child development considerations into account, the three-year leave system is too long. A combined maternity and parental leave of two years, or less, should be aimed for. Cuts in parental leave seem for the moment unlikely because the current Czech government considers that the system reflects societal preferences for family based childcare. It is believed these preferences partly reflect negative experience with collective care prior to 1989. In addition, the authorities emphasise the research that advocates personal childcare.

Cutting back on parental leave and profiting from the cognitive benefits of formal childcare means that much bigger efforts to encourage childcare services would be required. The proposed reforms mentioned above are promising but other avenues should be explored:

- For pre-kindergarten care, consider boosting services through the existing channels, *i.e.* give municipalities bigger incentives to offer childcare. Alternatively, the parental allowance could be replaced, partially or fully, by vouchers that can be spent in both public and private childcare centres.
- If the current shortage of places does not ease off quickly then additional support for kindergartens should be considered.
- Enabling fathers to assist with childcare allows mothers to strengthen their labour market attachment. In this regard, the plans to widen the options for fathers to take leave for childcare are promising and should be developed further.

A comprehensive review of families' tax-benefit burdens is required to increase the incentives to take up work. The measures to undo the distortions created by the 2007 benefit hikes are welcome. Nevertheless, more should be done. In particular, despite the new three-speed system, the parental allowance is overly generous. Moreover, the PIT reform does not resolve a problem that for low-earning family households, once cash benefits are included, the marginal effective tax rate is typically very high. This problem is principally due to phase-out schedules in housing and child benefits and has been aggravated by the 2007 benefit increases. Recent simulations by the IMF suggest that these welfare increases, while lowering the average tax rate (with adjustment for transfers) pushed the marginal rate above 70% for low-income households (IMF, 2008). In addition, the new housing benefit should be assessed. There appears to be room for discretion in the estimation of housing cost increases by the Ministry of Labour and Social Affairs that makes the system open to abuse. A system that precisely defines the calculation of the housing costs should be considered.

Older cohorts: a need to press on with reform to pensions

The reserve of labour among older cohorts is almost certainly the largest. Employment rates within this group remained flat or even declined a little until the early 2000s. The rates have since increased for women aged 55-59 and men aged 60-64, while the rate for women aged 60-64 has remained flat (Figure 3.5). Demand-side factors have influenced these trends, notably the macroeconomic downturn in the late 1990s which damped employment rates throughout the labour market. Policy has also been playing a role; parameter changes in old-age pensions and reforms in channels to early retirement are raising the effective age of retirement.

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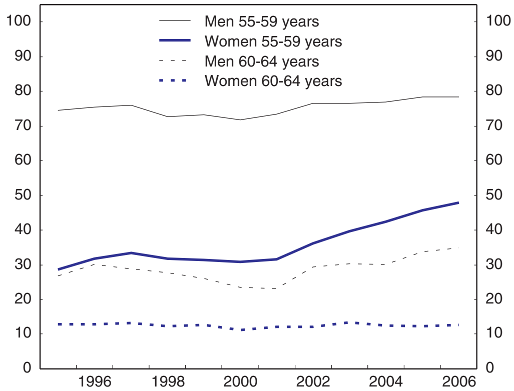
Figure 3.5. **Employment rates among older people, %**



StatLink http://dx.doi.org/10.1787/315366636402

Note: The employment rate is the number employed as a percentage of the population of the same age and gender.

Source: OECD (2007), *OECD Employment Outlook*.

The old-age pension has a key influence on the employment rates among older cohorts. Despite ongoing increases, the statutory age of retirement is low compared with many OECD countries; it is currently just under 62 years for men and ranges between 56 and 60 years for women. Current legislation will only bring the retirement age to 63 years for men and to between 59 and 63 years for women. Chapter 2 stresses the need for further increase in order to reduce the fiscal burden of the pension system. However, it is clear that further increase in the retirement age is also crucial to raising the employment rates of older cohorts.

The role of the old-age pension in retirement decisions

Early retirement options mean that the effective age of retirement is typically well below the statutory age. There have been welcome changes in recent years:

- Cancellation of various schemes and options now means there is only one early retirement route, which allows up to three years early retirement with permanent reduction in the pension payout (Table 3.2). Previously, for instance, there was a scheme that only entailed temporary reduction in the pension. Furthermore, in the early 2000s the payout reductions were increased. The new formula is close to being actuarially neutral; *i.e.* based on unisex life tables, the total pension payout is reduced by the value of pension contributions lost from retiring early.
- Options for postponing retirement beyond the statutory age have been widened. Deferment of the pension with a corresponding increase in the pension payout is already in place (Table 3.2). From 2004, those above the standard retirement age have been able to simultaneously work and pick up their pension (without earnings limit), thus providing a second option to those continuing work. This is thought to have prompted more people to work beyond retirement age and might account for the notching up of the employment rate among 60-64 year-old men in 2004 (Figure 3.5).

These moves are helpful but more could be done. Further adjustment of the rules on working beyond the standard age of retirement ought to be considered, particularly the treatment of pension contributions. Those who work when receiving an old-age pension continue to pay pension contributions but these are not factored into pension payouts – *i.e.* there is no “return” on them to individuals. The first phase of pension reform that is

Table 3.2. **Early retirement and deferral options in the old-age pension system**

	Features
Early retirement options	
Permanently reduced pension	Allows retirement up to three years before standard retirement age, conditional on 25 years contribution period.
	Prior to the reform in the early 2000s, the pension was reduced by 0.6% of the assessment base for every three-month period prior to the statutory retirement age. Following the reform, the reduction has been 0.9%. Reforms proposed in 2008 increase this to 1.5% for first year if retiring three-years early. Individuals cannot work while in early retirement.
Deferral options and related issues	
Deferred pension	Assessment base increased by 1.5% for every three months worked above the statutory retirement age.
Special conditions on post-retirement work	From 2004, individuals can work and receive old-age pension with no limit on earnings.
	Employment contracts cannot exceed one year (but can be renewed). There is a plan to abolish this condition.
	Sickness pay insurance is limited to no more than 81 days per year.
	Pension contributions are made but these are not factored into the pension payout.

currently being discussed in parliament addresses this issue. Under the proposal individuals can draw half of their pension and get an increase in the assessment base of 1.5% for every six months of work as for a deferred pension, a lower increase would apply if the full pension is drawn while working.

In addition, consideration could be given to pushing the pension reductions for early retirement above neutrality. Actuarial neutrality in early-retirement options is an appealing approach and is followed, or at least aimed for, in many OECD countries. Nevertheless, there are catches. First, neutrality is calculated according to unisex life tables. Because of the substantial gender gap in life expectancy, this means the "neutral" reductions are neither neutral for men or women. Second, at actuarially neutral discount rates, international evidence shows that most households choose to retire as soon as possible, the implication being that their personal discount rates are higher than the pension reduction. Given these issues, and if raising the employment rate among older cohorts has high priority, then deductions above neutrality could be a way forward. It is interesting to note that the first phase of pension reform does propose increasing the assessment-base reduction (see Table 3.2). Indeed, given the current pension closely resembles a flat-rate pension, there is a case for phasing out early retirement options altogether.

Disability pensions

As in a number of countries, the disability pension has become a conduit for early retirement with coverage expanding beyond that originally intended and therefore deserves attention. The problem in the Czech Republic is not as severe as in some member States. Nevertheless, a sizeable share of the non-employed aged 20 to 59 is on disability pensions (Figure 3.2) and the ongoing retirement-age increases may be prompting more people to exploit the disability system.

There are currently two disability pension schemes – "full" or "partial" depending on classification of the individual's reduction in work capacity (see Table 3.3). The full disability pension is calculated in a similar way to the old-age pension and but the payout is generally higher. The key aspect of the partial disability pension is that there are no restrictions on working; the payout is, on average, about 55% of the full-disability pension.[8] The system has already been tightened somewhat. As of 2007, classification as partially disabled no longer entitles the person to take up the old-age pension two years early with only a temporary reduction in the pension payout (instead of the permanent reduction in the standard early retirement option in the old-age pension).

Welcome further changes to disability pensions are planned as part of the first phase of pension reforms (see Chapter 2). The key proposal is for the introduction of an additional, less generous, partial disability pension (Table 3.3) along with minor alteration to the cut-off points for eligibility. The new pension will apply to those with a 35 to 50% incapacity rating and would cover a large share of disability pensioners; about three quarters of the currently partially disabled fall into this range. The goal of these changes is to better differentiate disability and corresponding payouts. Evaluation of work capacity has been based on an assessment of abilities to perform work in general, not only the person's previous occupation, since the mid 1990's. In this sense, the assessment process already follows good practice. An update of the regulations for assessing the degree of reduced working capacity has been drafted to accommodate developments in treatment possibilities and changes in the work environment. However, as in other OECD countries, further work will probably be required to avoid "passive" benefit payments through vocational rehabilitation both prior to granting disability pensions as well as to pension recipients.[9]

Table 3.3. **Current and proposed eligibility conditions for disability pensions**

	Current system	System in current proposals
Full disability	• At least 66% work incapacity. • For those aged over 28 years at least five years of insurance are required for eligibility. Lighter insurance requirements apply to younger applicants. • Payout calculated in the same way as the old-age pension. • Can only work up to one third of standard full-time working hours.	• At least 70% work incapacity. • Same conditions, except there is no option to remain permanently on the disability pension after the standard age of retirement.
Partial disability	• 33-65% work incapacity. • Same insurance conditions as full disability pension. • Payout calculated in a similar way to the old-age pension except with less generous parameter settings. • No restrictions on paid employment.	• 50-69% work incapacity. • Otherwise same conditions as current partial disability pension.
Proposed new partial disability pension		• 35-50% work incapacity. • Lower pension payout that partial disability pension. • Otherwise same conditions as partial disability.

Notes

1. The top-ranking employment rates among young cohorts are in countries such as Australia, Denmark, the Netherlands and New Zealand.
2. These figures are calculated from the latest edition of the OECD's *Taxing Wages* (OECD, 2008). The calculations use wedges that include income tax, employee and employer social contributions, and adjustment for cash benefits.
3. The minimum living standard (MLS) for a single person is currently CZK 3 126 a month, while the equivalent subsistence minimum is CZK 2 020, *i.e.* roughly 65% of the MLS.
4. The adjustments to the labour code made in autumn 2007 also include removal of a rule preventing parents with children less than one year old from working overtime and removal of a limit of 30 working hours per week for those aged 16 to 18 (the general limit of *average* 40 hours per week will apply).

5. Mothers not eligible for maternity benefit (*e.g.* because they were not working previously), must take the four-year parental allowance option. In this case the total value of benefit is CZK 262 000. For mothers eligible for maternity benefit, the length of parental allowance is reduced by 5 months in each case. This makes the total value of the allowances CZK 216 600, CZK 235 600 and CZK 224 200 for the two, three and four-year options, respectively.
6. There are no precise data on how much municipalities charge. However, Kuchařová and Svobodová (2006) report that fees range from CZK 2 000 to CZK 7 500 per month across both public and private providers and it is likely that municipalities typically charge towards the bottom end of this range.
7. Indeed, following the large increase in the allowance in 2007 the implicit price of public childcare is substantial. For instance, taking the parental allowance under the three-year option (CZK 7 600 per month) and assuming fees for public childcare of CZK 2 000 per month, gives an implicit price that is a good margin above the minimum wage (CZK 8 000 per month).
8. Ministry of Labour and Social Affairs (2006) estimates the average value of newly granted full disability pensions in 2005 at CZK 8 396 per month in 2005 compared with CZK 4 809 for the partial disability pension.
9. The OECD is currently conducting a series of reviews on disability policies. The latest review covered Australia, Luxembourg, Spain and the United Kingdom (OECD, 2007). A review covering Denmark Finland, Ireland and The Netherlands is forthcoming and a synthesis paper is planned.

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Chapter 4

Globalisation and the Czech economy: how should policy respond?

Favourable location and low labour costs have resulted in large inflows of greenfield investment and export-oriented manufacturing is playing a key role in the Czech Republic's robust growth. This chapter looks at this process in depth and examines other influences of globalisation on the economy, such as changes in retail markets and the development of tradable services. The chapter also considers the policy implications. In general, the policies required to harness globalisation are the same as those needed to help overall economic growth. However, some specific areas require particular attention: investment incentives, support for small and medium enterprises, transport and urban infrastructure, and immigration policy.

The Czech economy is deeply involved in globalisation. Trade flows are very large, reflecting the movement of inputs and outputs from production plants that are often part of global supply chains. The country has an advantageous geographic location and, with recent extension of the Schengen agreement, all its borders can be passed without any controls. It is likely that labour cost considerations are also high on the checklist of firms setting up businesses in the country. As elsewhere, consumers have been benefitting from low-cost manufacturing imports, channelled into the country by competitive retail chains. However, there are challenges in harnessing the benefits of globalisation and the policy recommendations for overcoming these are summed up in Box 4.1.

Box 4.1. **Policy recommendations concerning globalisation**

Framework conditions

To harness the benefits of globalisation ensure healthy framework conditions for growth in general. Prudent fiscal policies and stable inflation matter alongside structural policies that affect the business environment, such as business regulation, corporate and labour taxation, education and innovation policies.

Trade policy

Further liberalisation of the services sector is needed to allow international competition.

Investment support

There should be overall stocktaking of the investment incentive schemes. This should be backed by more effective monitoring of firms that have been given support. The authorities should proceed in line with the results of programme evaluations with any further cuts in support. In addition, further eligibility criteria that enhance the focus of support could be considered.

The subsidies and concessions (*e.g.* public infrastructure) that are often negotiated between local authorities and investors should be held in check.

Any further reduction in the minimum eligibility requirements for investment support should be assessed in relation to targeted SME programmes, to avoid duplication and excessive support for SMEs.

Support schemes for export-oriented SMEs

Further development of support schemes for export-oriented SMEs should be based on continuous programme evaluation.

Services for exporting SMEs should be enhanced through the publication of case studies, training courses and good information on available support.

The coherence of SME programmes should be checked. For instance, support for globalisation ought to dovetail with support for innovation, technology parks, integrated clusters of firms, business incubators, and technology transfer centres.

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Box 4.1. **Policy recommendations concerning globalisation** *(cont.)*

Further widening of the responsibilities of *CzechInvest* should be considered. In particular there is a case for merger with *CzechTrade*.

Policies to improve transport linkages

The much larger EU funding opportunities underscore the need for efficient public procurement in transport investment.

Public-private partnerships should be designed and implemented with appropriate sharing of financing and risk with the private sector. In addition, there be should strict and detailed guidelines on the project's criteria and performance contracting should be considered.

In rail transport, more attention to reduce entry barriers in the freight sector is needed to ensure competition between providers and to achieve an efficient balance between road and rail.

Creating a global role for Prague

Maintaining the Prague economic area as a magnet for growth should remain a priority.

Stronger policy responses are needed to ensure a good regional transport system in the face of growing (and changing) demand from commuting, tourism and business activities.

Globalisation and employment

The proposal for a "green card" system is welcome. Experience with the pilot programme and successful programmes in other OECD countries ought to guide design of the scheme.

If acute labour market shocks do occur, the authorities should focus on adjusting existing universal programmes (such as unemployment benefits).

A balanced package of largely familiar policies is also required. In particular flexible labour markets, activation of the unemployed and effective lifelong learning policy.

What role is globalisation playing in the Czech economy?

Large volumes of trade and foreign-direct investment

The Czech economy is highly integrated in world trade and investment patterns. The volume of trade is very high in relation to size (as proxied by population, Figure 4.1). Expressed as a percentage of GDP, trade in goods and services (exports plus imports) is equivalent to about 150% of GDP, one of the highest shares among OECD countries and of a similar magnitude to Hungary and Slovakia. Export market shares have grown steadily over the past decade or so (Figure 4.2). Moreover, during cyclical upturns Czech exporters appear to gain market share, which is not lost when there is a downturn.

Goods dominate Czech trade, accounting for about 80% of the total (Figure 4.3). Much of it is due to export-driven manufacturing. This activity largely explains the fairly high degree of correlation between exports and imports (Figure 4.2) as production involves bringing in significant volumes of raw materials and semi-finished products. It also explains why there is a large share of intra-industry trade, particularly in the case of trade with Germany (Table 4.1).

Flows of foreign direct investment (FDI) have been substantial. Foreign interests have historically featured strongly in Czech economic development (Box 4.2). Indeed, currently the stock of FDI is equivalent to about 40% of GDP, a comparatively high share

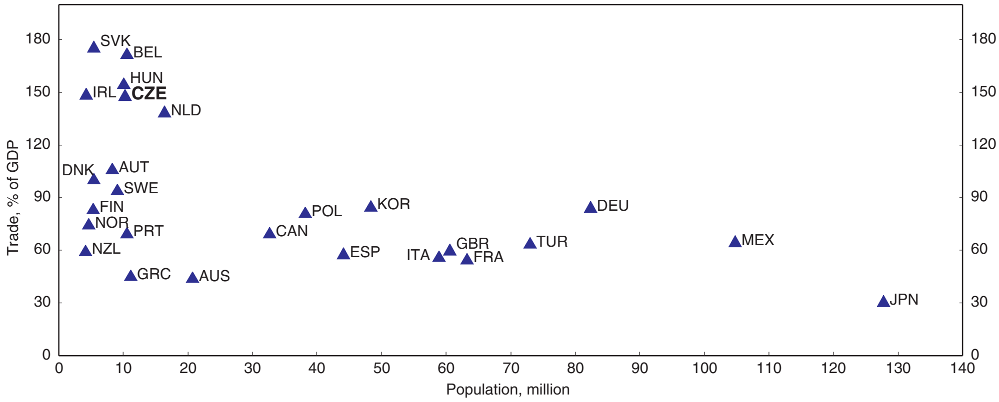
Figure 4.1. **Trade in goods and services and investment patterns**[1]

StatLink http://dx.doi.org/10.1787/315372674776

1. Trade is exports plus imports of goods and services. Data refers to 2006.

Source: OECD, *National Accounts Database*.

Figure 4.2. **Trade and population**[1]



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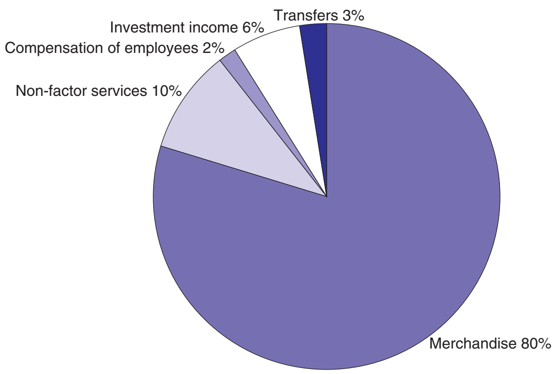
1. FDI is the stock of inward foreign direct investment; reinvested earnings and other capital are excluded in 1995 and 1996. Export markets are a weighted average of imports by the rest of the world (*i.e.* existing and potential exports from the Czech Republic). Weights are calculated as shares in goods and services trade flows in 2000. Domestic demand is private and government consumption and gross fixed capital formation.

Source: Czech National Bank; OECD, *OECD Economic Outlook* and *National Accounts Databases*.

Figure 4.3. **The breakdown of current account turnover, 2006**



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Source: Czech National Bank.

Table 4.1. **Intra-industry trade for total manufacturing**

As of 2005, as % of total manufacturing trade

	Germany	EU15	EU_new12	Asia	Total
Czech Republic	69	59	49	13	71
Austria	75	65	51	19	79
Belgium	72	60	32	33	82
Hungary	67	55	43	11	73
Ireland	38	29	20	23	43
Slovak Republic	53	44	49	11	61
Germany	–	59	57	27	74

Source: OECD calculations, based on SITC 4 digit disaggregation.

Box 4.2. An economy with strong entrepreneurial tradition

To put the issues discussed in this chapter in historical perspective, it is important to note that before the Second World War the Czechoslovak GDP *per capita* was comparable to that of Austria. This economic success was driven by a dynamic entrepreneurial sector (Dyba, 2008), that fully participated in the delayed industrialisation of the Habsburg empire. Between the two World Wars, Czechoslovakia was among the world's top ten producers of manufacturing products, particularly industrial machineries, mostly based in Czech territories. Already at the time, Czech producers were strongly integrated in trade with western Europe; a good part of the country's financial and industrial assets were foreign owned, especially by British and French companies. This underscores that developments since the early 1990s should more appropriately be referred to as a re-entry of the Czech Republic into global production, rather than an entry *tout court*.

(OECD, 2007a). The equivalent figures for Hungary, Slovakia and Poland are 35%, 30% and 25%, respectively.[1] While brownfield investments (privatisations, mergers and acquisitions) dominated in the 1990s, recently greenfield investments have since become more important. As Chapter 1 points out, FDI activity is affecting the balance of payments. The deficit in the income balance of the current account has been widening since 2000, reflecting increases in profit repatriation and reinvested earnings by the affiliates of foreign multinationals. This balance more than offsets the combined surpluses of the trade and service balances.

Multinational manufacturers are playing a key role

Currently, multinationals are responsible for about half of total value added in manufacturing. This is one of the highest shares in the EU, though lower than in Hungary and Slovakia (OECD, 2007a). In employment, the proportion is smaller, reflecting relatively high productivity. Foreign affiliates also account for a comparatively high proportion of R&D spending.

Production by multinationals has altered the structure of trade. In particular, exports have become more concentrated in certain sectors (see Table 4.1). For instance, the six largest 4-digit SITC industries (there are about 1 000 categories in this classification) account for about 25% of total merchandise exports, compared with 16% in 1999 (Table 4.2). Rapid growth of trade in automotive and electronic products, including parts, accessories and components, largely explains for this. Some sectors have grown very rapidly. Notably, digital processing units (now third ranking in exports) was in 172nd position in 1999, while television receivers (now ranked fifth) occupied the 80th position.

The geographical breakdown of trade differs radically from that in place at the beginning of the 1990s. In particular, falling trade barriers have brought two major structural changes (Figure 4.4):

- Dramatic expansion in manufacturing trade with the European Union. Germany, in particular, stands out as the largest trading partner of the Czech Republic in virtually all of the most important export categories, as well as in several top import categories.
- Growing imports from Asia. Trade with the Asian countries is particularly intense in parts and accessories for specialised industrial machines, as well as telecommunication equipment and semiconductors. For these products China, Taiwan and Malaysia are the main trading partners, with which the Czech Republic registers a wide trade deficit.

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Table 4.2. **Main export and import categories**

Top-6 export categories (ranked in order of share in exports)	4-digit SITC classification code	2006 percentage share in total exports	Percentage share in total exports (cumulative)	1999 percentage share in total exports	Percentage share in total exports (cumulative)	Ranking position in 1999
1) Motor vehicles	7 812	8.9	8.9	8.1	8.1	1
2) Parts and accessories for motor vehicles	7 843	6.7	15.7	5.2	13.3	2
3) Digital processing units	7 523	3.2	18.9	0.1	13.4	172
4) Wire, cable and electrical conductors	7 731	2.2	21.1	2.0	15.5	3
5) Television receivers	7 611	2.1	23.1	0.3	15.7	80
6) Parts and accessories for specialised machines	7 599	1.6	24.8	0.5	16.2	35

Top-6 import categories (ranked in order of share in imports)	4-digit SITC classification code	2006 percentage share in total imports	Percentage share in total imports (cumulative)	1999 percentage share in total imports	Percentage share in total imports (cumulative)	Ranking position in 1999
1) Parts and accessories for motor vehicles	7 843	4.4	4.4	3.5	3.5	1
2) Parts and accessories for specialised machineries	7 599	3.2	7.6	0.8	4.3	15
3) Motor vehicles	7 812	2.4	9.9	2.4	6.7	2
4) Parts and accessories for telecommunications equipment	7 649	2.0	11.9	0.8	7.6	13
5) Electronic integrated circuits and micro-assemblies	7 764	1.9	13.8	0.8	8.4	16
6) Pharmaceuticals	5 429	1.6	15.4	1.6	10.0	5

Source: Czech Statistical Office.

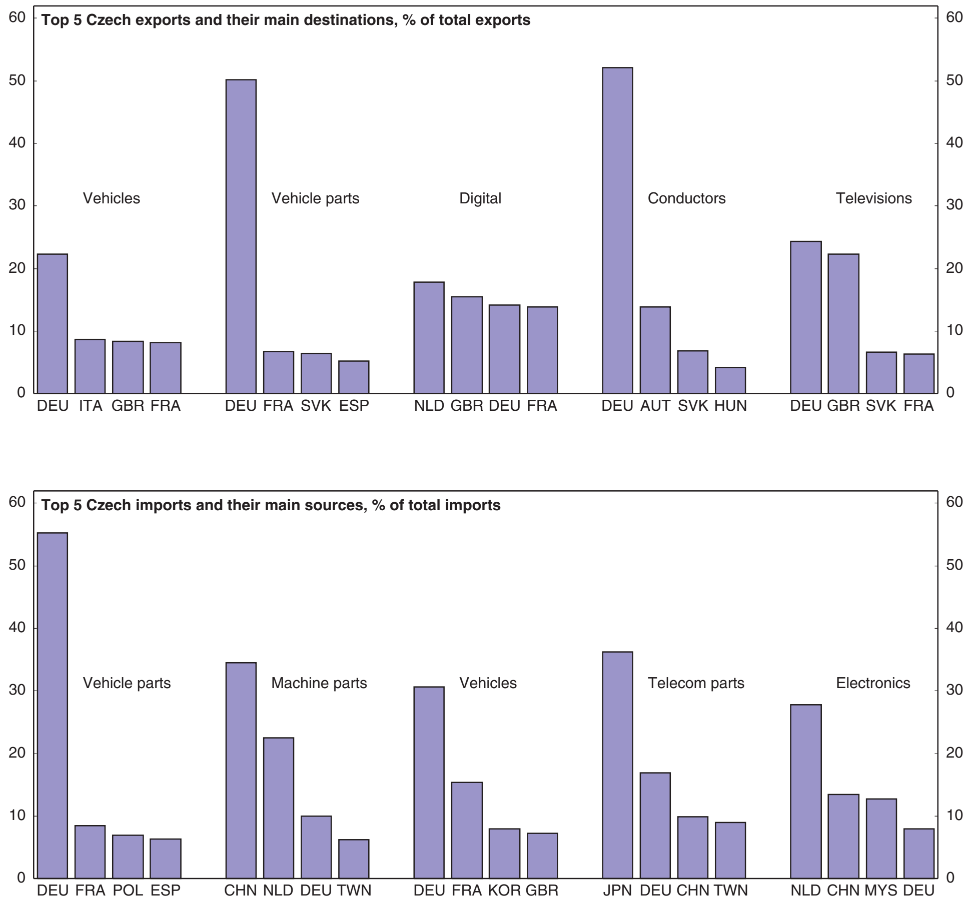
Foreign firms have been consistently more profitable and productive than domestic firms so far. This is not surprising given that, compared with Czech firms, multinationals are often working with higher levels of technology, have stronger capital investment capabilities and in many cases use more advanced business as well as management models. This being said, the performance gap between foreign and domestic enterprises is reckoned to be smaller in the Czech Republic than in the other central and eastern-European countries of the OECD, and narrowing over time.

The way in which foreign multinationals interact with the local producers and service providers is important. There almost certainly are positive spillovers through the transfer of business and technical know-how. However, there are numerous channels for these spillovers to operate and it is hard to gauge whether, overall, they have a big impact on domestic firms' productivity. Several papers are sceptical about the size of these effects in the Czech context (for instance Djankov and Hoekman, 2006; and Damijan *et al.*, 2003). Other research claims the impacts are significant (for instance Sabirianova *et al.*, 2005; Ayyagari and Kosova, 2006; and Kosova, 2006).[2] Interestingly, this latter research underscores that positive spillovers typically take some time to materialise. For example, work by Hoekman and Javorcik (2004) finds evidence that, initially, multinationals tend to rely on imports for the purchase of their intermediate inputs but then gradually increase use of domestic producers and service providers. Nevertheless, it is tough for domestic firms to compete because contract manufacturing and services provision for "headline" producers have themselves become globalised businesses in many areas (see Box 4.3).

Among services, globalisation has mainly boosted demand in traditional sectors

In services, the highest proportion of exports come through tourism, much of this relating to Prague. However, other service sectors have undergone important changes over

Figure 4.4. **Top export and import categories by main trade partners**[1]



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1. Export products, from left (top export) to right, are Motor vehicles (7 812), Parts and accessories for motor vehicles (7 843), Digital processing units (7 523), Wire, cable and electrical conductors (7 731), Television receivers (7 611). For example the top Czech export in 2006 was motor vehicles and 22% of them went to Germany. Numbers in brackets are the SITC Revision 3 codes at the 4-digit level, which capture a product category. Import products, from left (top import) to right, are Parts and accessories for motor vehicles (7 843), Parts and accessories for specialised machineries (7 599), Motor vehicles (7 812), Parts and accessories for telecommunication equipment (7 649), Electronic integrated circuits and microassemblies (7 764). Data refer to 2006. See Glossary for country codes.

Source: Czech Statistical Office.

the recent past. Some have been pulled along with the rapid growth in manufacturing. In particular, the share of transport services in total trade transactions has expanded by more than one third between 2000 and 2006, reaching about a quarter of total credits (Figure 4.5). This is mainly due to strong growth in road freight transport. The volume of rail freight and "combined" transport remains relatively small (see below).

Some non-tradable sectors have been strongly affected by globalisation due to the entry of multinationals in markets. A case in point is retailing. Measures taken over the past years to increase competition in retail distribution, including very liberal shop opening hours regulations, have led to better exploitation of economies of scale and scope. In turn, this is reckoned to have boosted overall productivity growth (Arnold *et al.*, 2007). The arrival of large supermarket chains has played a crucial role in these developments,

Box 4.3. **Contract manufacturing in the Czech Republic**

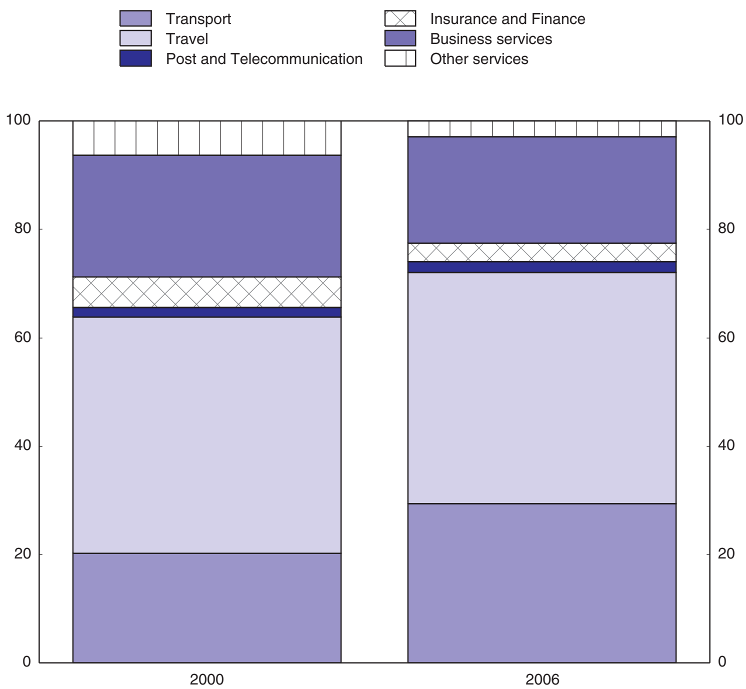
In addition to the household names such as *Bosch*, *Honeywell*, *Panasonic*, *Procter and Gamble*, *Siemens* and *Toyota*, a lot of contract manufacturing is located in the Czech Republic. This is often performed by medium-sized firms that participate in the supply-chain of the big players through production or assembly operations. But, some contract manufacturers are themselves large international enterprises.

Contract manufacturing is particularly widespread in electronics. For example, the Czech Republic manufactures more than 40% of all computers sold in Europe and a significant share of game consoles and personal-music systems. Many Taiwanese contract manufacturers have chosen the country as their European base (Czech Focus, 2007a). The largest among such companies, *Foxconn*, produces desktop computers and notebooks for *Hewlett Packard*, and *Dell*, along with *Microsoft* game consoles. By 2006, *Foxconn* employed 4 000 people; it has recently announced plans to expand further (by about 5 000 new jobs).

Contract manufacturing is not limited to the electronic industry or to foreign players. For example, *AERO Vodochody*, a Czech company, provides high value added parts and kits for airplanes, including the Boeing 757 and 767. Another aircraft company, *Jihlavan*, manufactures parts for *Saab*, *Airbus* and *GE Aircraft Engines*. There is also a significant amount of contract manufacturers for the automotive industry. Furthermore, contract manufacturing acts as a catalyst to many service businesses, as computer and software design.

Figure 4.5. **The changing structure of service exports**

% of total service exports



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Source: Czech National Bank.

altering the structure of consumer markets and supply. At present, all top ten retailers are foreign companies. These players are from Germany (*Kaufland*, *Rewe*, *Globus*, and *Tengelmann*), the Netherlands (*Makro Cash and Carry* and *Ahold*) and the UK (*Tesco* and *Spar*).

As regards tradable services, the pattern of recent FDI investment deals suggests the Czech Republic is becoming a European platform in some areas. For instance, many prominent international companies have opened information technology operations and business process outsourcing (Box 4.4). Linked to this, trade in computer and information services has strengthened in recent years, though from a low base.

Box 4.4. **The growing importance of business-service centres**

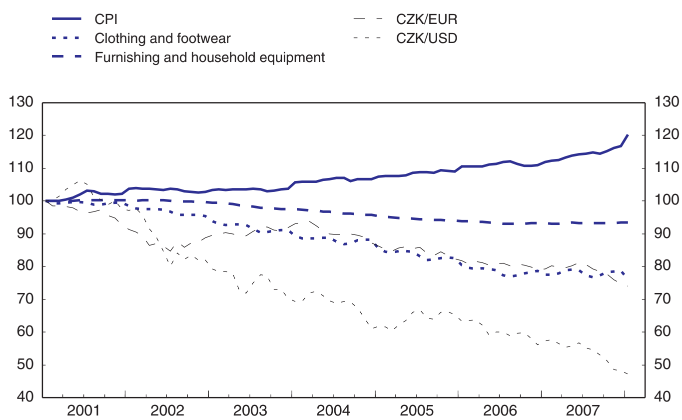
The first business support service centres were established in the early 2000s (Czech Focus, 2007b). Currently, there are about 15 800 employees in this sector. *IBM* was among the first, choosing Brno's Technology Park as the location for its global services delivery centre. The centre initially had 70 employees but now employs more than 2 000 workers. *Accenture* set up back-office accounting operations in Prague and Brno. There are 1 700 employees working in some 20 languages. *DHL*, a large logistics company, created in Prague its European IT service centre (1 300 employees). *Lufthansa* (400 employees) has a support centre in the Czech Republic, especially devoted to serve central and eastern European customers. It also has a logistics centre for managing air freight.

Globalisation is reducing prices for many consumer durables

Recent OECD and IMF analysis underscores globalisation and trade openness typically damps the price of consumer durables (IMF, 2006; and Pain *et al.*, 2006). Indeed, Czech households appear to be benefitting quite strongly from this aspect of globalisation. There have been particularly pronounced long run declines in some components of the consumer price index, such as clothing and footwear, furnishings and household equipments. In addition, recent declines in these prices have been influenced by the trend appreciation of the koruna relative to the euro and particularly the dollar (Figure 4.6). The importance of globalisation and international trade for consumer-price inflation in the new EU member

Figure 4.6. **Consumer price developments in selected tradable goods**

Index, Jan. 2001 = 100



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Source: Czech National Bank and Czech Statistical Office.

states has been analysed in a recent IMF study (Allard, 2007), which found that globalisation is estimated to have lowered domestic prices by between ½ and 1 percentage point per year since the middle of the 1990s, on the back of lower import prices and lower mark-ups. In other words, increased access of foreign producers has intensified competition, inducing local producers to lower their own margins and forcing the exit of the less efficient local suppliers.

Globalisation is supported by favourable labour costs and an advantageous location

Labour costs are a crucial factor in attracting business to the Czech Republic. For instance, Table 4.3 shows that the cost of labour at the average wage is significantly below the OECD area average. This is coupled with strong middle-level skills. In particular, the Czech Republic has one of the highest upper-secondary school completion rates in the OECD and secondary school students perform well in international comparison based on test scores of study achievements in mathematics and science for 15-year-pupils. Moreover, workforce language capabilities as well as skills in information and communication technologies are strong.[3] For instance, scores in the Test of English as a Foreign Language are fairly high (OECD, 2006a). This being said, as Chapter 3 underscores, although tertiary-level enrolment is rapidly catching up with other countries, it will be some time before the share of the working age population with degree-level education reaches that of more advanced OECD economies.

The relationship between greenfield foreign direct investment and skill development is complex. While there is no doubt that FDI has had a positive impact on growth and employment overall, there is evidence that the production processes used in FDI plants involve a form of "de-skilling". For instance, Bruno *et al.* (2004) examine the impact of increasing inflows of foreign investment on wage inequality and on the composition of labour demand between skilled and unskilled workers in three eastern European countries: Poland, Hungary and the Czech Republic. Panel data estimates show that the substitution elasticity between skilled and unskilled labour increases in the presence of foreign companies, suggesting that FDI is not skill neutral, but using technologies which allow the switch of (more expensive) skilled labour for (relatively cheaper) unskilled labour. This finding is broadly corroborated by Geishecker (2004) and Crinò (2005).[4] Whether this de-skilling is a negative process is unclear. It might simply reflect the evolution of skill requirements in modern production methods, and this comes through in FDI-based production because it tends to be technologically advanced.

Geography has an important influence on the country's integration in globalised production too. Many studies have explored the link between market proximity and the expansion of trade. One key conclusion is that by reducing transport costs, proximity widens the opportunity for countries to concentrate production in activities where they have a comparative advantage. The Czech Republic is located at the heart of Europe according to conventional distance indicators (Figure 4.7). This places the country in a strategic position, not just as a partner to western Europe but also as a gateway to the eastern and southern parts of the continent. Recent OECD work has quantified the contribution of geography to economic growth (OECD, 2007b). The Czech Republic is not part of the study, however neighbouring Austria is found to have benefited from favourable access to markets, though the impact is not very pronounced.[5]

Table 4.3. **Productivity and cost indicators**

Highest level among OECD countries = 100

	2000	2006
Productivity[1]		
Czech Republic	39	45
Hungary	42	48
Poland	37	40
Slovak Republic	42	51
Unweighted average:		
OECD		76
EU15		88
EU19		81
Labour costs[1]		
Czech Republic	34	40
Hungary	30	36
Poland	36	35
Slovak Republic	28	31
Unweighted average:		
OECD	67	69
EU15	69	71
EU19	78	80
Total tax wedge[2]		
Czech Republic	43	43
Hungary	55	51
Poland	43	44
Slovak Republic	42	39
Unweighted average:		
OECD	38	38
EU15	43	43
EU19	44	43
Corporate income tax rate[3]		
Czech Republic	31	24
Hungary	18	16
Poland	30	19
Slovak Republic	29	19
Unweighted average:		
OECD	34	28
EU15	33	27
EU19	37	31

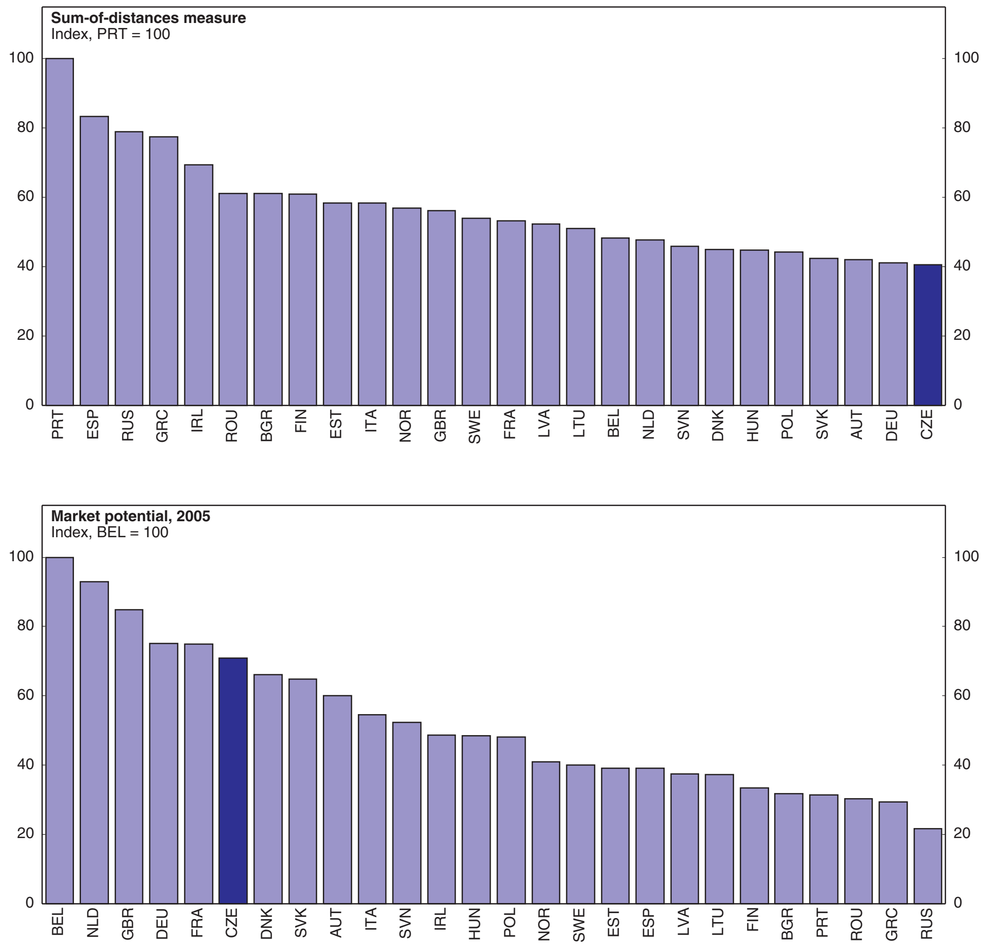
1. Based on values in dollars with equal purchasing power. Highest level among OECD countries = 100. The USA was the productivity leader country in both 2000 and 2006. Germany was the country with the highest labour costs in 2000; for 2006, it was the UK.
2. Single individual without children at the income level of the average worker.
3. Basic combined central and sub-central (statutory) corporate income tax rate.

Source: OECD.Stat and OECD, *Taxing wages*.

Looking forward, external competitiveness is under pressure from four areas:

- *On labour costs, the advantage of the Czech Republic* vis-à-vis *the OECD average is shrinking.* For instance, labour costs have risen from nearly 34% of the highest labour cost in the OECD area in 2000 to nearly 40% in 2006 (Table 4.3). In part, a narrowing of labour cost differentials naturally follows as part of the process of catch-up in GDP per capita. Nevertheless, as Chapters 1 and 3 emphasise, policy can to some extent offset this process by maximising potential labour supply and by deepening and re-shaping skills through education policy.

Figure 4.7. **Indicators of market distance and potential**[1]



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1. The sum-of-distances measure sums the distance of each country to the other 25 countries. The indicator is normalised so that the most distant country (Portugal) is equal to 100. The market potential measure is the sum of all countries' GDP weighted by the inverse of the bilateral distance. The distance measure combines capital-to-capital distance between countries and a measure of internal distance based on the surface area. The indicator is normalised so that the country with the highest market potential (Belgium) is equal to 100. See Glossary for country codes.

Source: OECD calculations based on data from Centre d'Études Prospectives et d'Informations Internationales (CEPII).

- *Adding to this, the total tax wedge is higher than the OECD average, though not out of line with the European average*. A particularly high wedge is found for workers at two thirds of the average wage, which may be restricting the labour market for low wage earners. On business taxation, the Czech Republic has had a relatively high corporate income tax rate in the past. A schedule of reductions legislated in the government's fiscal package is narrowing differences with peer countries. The rate has been cut to 21% (effective from 2008) from 24% and will be cut further to 20% and 19% in 2009 and 2010, respectively. By the end of this process the rate will be the same as Polish and Slovak rates (assuming these remain unchanged from current levels) but still higher than the Hungarian rate.[6]

- *The prices of some services are also relatively high.* Cost efficiency in all areas of services, many of which are non-traded internationally, matters for external competitiveness because such services are regularly purchased by the companies that operate in the tradable sectors (Arnold *et al.*, 2007). Most notably, as Chapter 1 discusses, communication prices are high both relative to peers and the European average.
- *Emigration may increase once remaining barriers for labour mobility within the European Union are removed.* Currently, the Czech Republic's "old" European Union neighbours (Austria and Germany) maintain some barriers for the access of job seekers from new EU member states. These may be containing labour force emigration and imminent removal of them could aggravate labour market bottlenecks.

However, there are more general concerns about the impact of globalisation on Czech economy and, linked to this, growth prospects for the future. As discussed above, the evidence on the size of positive spillovers from FDI is mixed. More broadly, Myant (2007), for example, argues that the post-1989 economic transformation in the Czech Republic has created a market economy acceptable for EU membership but there is limited potential for autonomous and innovative growth. In addition, Rae and Sollie (2007) assess which EU countries are most exposed to globalisation using, among other indicators, measures of revealed comparative advantage. Former Communist countries, like the Czech Republic, are found to be particularly exposed to future transition threats, because of a legacy of heavy product market regulations, inflexible labour markets, relatively low tertiary attainment and an inefficient innovation framework.

Making the best of globalisation: how should policy adjust?

Globalisation raises several issues for policy makers. In broad terms, policy needs to provide an environment that improves the gains for business and households, while minimising potential downside effects. In many respects, what is good for growth in general is also good for harnessing globalisation. These framework conditions necessarily include prudent fiscal policies and stable inflation. A strong macroeconomic framework helps to encourage greenfield investment as well as research into more innovative products and production processes. For instance, Kay (2007) argues that the large increase in foreign investment following the 1997-98 recession was helped by the shift towards more predictable economic conditions and improved inflation expectations.[7] In addition, strong macroeconomic conditions also help create fiscal room for lowering tax burdens. Interestingly, some researchers stress a reverse causality between globalisation and macroeconomic policies, *i.e.* globalisation fosters macroeconomic stability because it disciplines monetary and fiscal policies (Box 4.5).

Sound macroeconomic policies are not the only framework conditions that help harness globalisation. In particular, as implied by the preceding discussion, policies that improve the functioning of the labour market and education outcomes are important. Among other areas of structural policy, efforts to lighten red tape for businesses and provide a good environment for innovation can also directly improve growth potential.

Globalisation also underscores several specific policy issues. For businesses, it puts trade policy, taxation and targeted support under the spotlight. For labour, there are questions of international migration and transfers to households. Globalisation also raises the importance of having a well functioning transport and communication infrastructure.

Box 4.5. **Globalisation: a disciplining effect on macroeconomic policy?**

Several academic papers have focussed on the effects of globalisation on macroeconomic policymaking. For instance, research by Rogoff (2003 and 2006), Tytell and Wei (2004) and Romer (1993) stress the disciplining effects on monetary and fiscal policies. The main argument is that an accommodative monetary stance and/or the protracted lack of fiscal discipline amplify inflationary risks, which are likely to damage competitiveness and put off foreign investors. Recent empirical analysis of Razin and Loungani (2005) and Razin and Binyamini (2007) underscore that trade and financial openness encourages policymakers to become more aggressive on inflation variability and correspondingly less focussed on the output gap. Looking forward, however, the damping effects of globalisation on inflation *via* consumer durable prices seem set to diminish as the share of imported goods in the consumer basket stabilises around levels seen in other OECD countries. In addition, recently developments in international food and commodity prices are pushing up inflation.

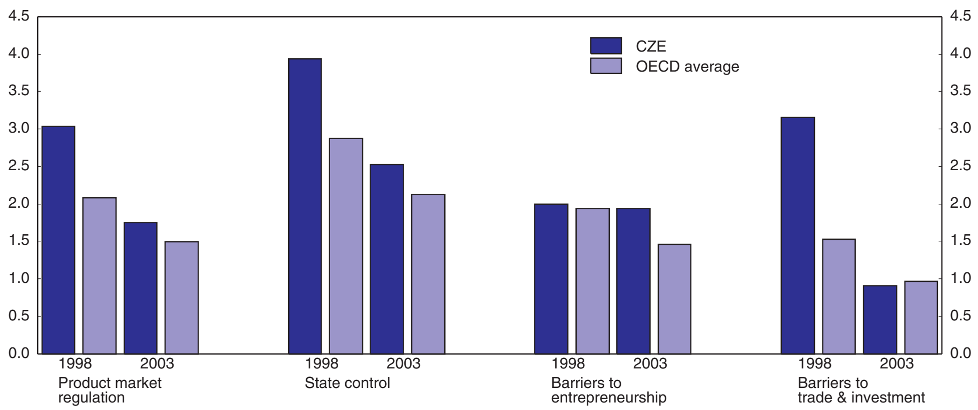
The role of Prague as a pole of attraction for foreign investors willing to expand in the Czech Republic is another important issue.

Issues in trade policy

Trade barriers have been reduced substantially in the process of economic transition. For instance, according to the OECD's product market regulation index, the Czech Republic had the third most restrictive regulation among member countries in 1998 but by 2003 regulatory reforms had brought the index close to the OECD average. Furthermore, regulatory barriers to trade and investment had come down from the second most restrictive to below OECD average, as illustrated by Figure 4.8. A forthcoming update of the indicator is likely to show further improvement. Some of the reform was domestically driven but it has partly been prompted by supra-national trading policies. Trade policy has

Figure 4.8. **Product market regulation restrictiveness**

Indicator range 0 to 6, least to most restrictive



StatLink http://dx.doi.org/10.1787/315515707536

Source: OECD, Indicators of product market regulation database described in Conway, P., V. Janod and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003", *Economics Department Working Paper*, No. 419, OECD, Paris.

indeed become increasingly exogenous as the country is now subject to EU trade decisions as well as the General Agreement on Trade in Services of the World Trade Organisation.

Nevertheless, there is some room for domestic policy to directly widen trade. In particular, the government should reform services regulation further to allow international competition. Swift implementation of the EU services directive would have a positive effect on cross-border trade in this area. More effective openness to trade and investment in services can compensate for relatively shallow local markets and contribute to a more competitive economy. Indeed, OECD estimates suggest that if all member countries introduced OECD best practice combined with mutual recognition of regulation, trade in services could increase by about 80% on average, raising GDP per capita by about 2% (Kox and Nordås, 2007). The Czech Republic would be among the countries that could gain the most from such a scenario with an estimated increase in services trade of about 110%, which could raise the level of GDP per capita by about 1.5%.

Business policies related to globalisation

Issues in investment support

Initially, investment support focussed on attracting foreign manufacturing companies in light of competition from other east-European countries and emerging markets more generally. There are currently two programmes of investment incentives, one covers manufacturing and the other targets various services (Table 4.4). The programmes combine direct and indirect incentives. The manufacturing scheme comprises of various forms of tax relief, job creation grants, financial support for training and site support. Eligibility crucially requires a minimum investment amount. The support for services targets high-value adding tradable activities and provides subsidies on the wage bill and for training. Here, there are requirements on the number of jobs created. Most resources have so far gone into manufacturing support; it accounts for over 90% of spending. Typically, the parameters of the schemes run up to the limits set by EU rules on state aid, which vary according to the level of regional economic development. The maximum EU ceiling (which applies to most of the country) has recently been lowered to 40% (effective from 2007).[8]

As Table 4.4 implies, the investment incentives are strongly rule based, *i.e.* there is no discretion on what is offered to firms in the programmes themselves. Such a system should lead to non-discriminatory administration, insulated from political interference. Clarity should increase certainty and predictability, facilitating investment decisions. That predictability is undermined, though, and a degree of discretion is reintroduced, by a common practice of bilateral negotiation between applicants and local authorities about infrastructure.

The relative merits of the investment-incentive schemes have been increasingly debated in the Czech Republic. Empirical work for the OECD countries underscores that it is difficult to get a precise picture of how far incentives succeed in attracting more and better quality investment (Box 4.6) and the Czech Republic is no exception. There are several doubts being raised about the system:

- It is difficult to prove that the investments would not have taken place in the absence of the incentive. A study by Mallya *et al.* (2004) argues the manufacturing incentive scheme is fiscally expensive and bringing in only a small fraction of additional investment. However, large international companies, such as car manufacturers, for instance, say

Table 4.4. **Overview of state investment incentives programmes**

Act on investment incentives	Programme for support of technology centres and business support
Target sector(s)	
Launch of new /expansion of existing production in manufacturing.	Launch of new /expansion of existing production in certain services: Technology centers for development and innovation. Business Support Services: customer contact, shared services, ICT expert solutions, software development, hi-tech repair centers.
Forms of incentives	
Tax incentives: corporate tax relief for up to five years for new companies; partial tax relief for up to 5 years for existing companies. Companies may also deduct 10-15% of the cost of new machinery and technology from their tax base, provided that they are the first owner and leaseholders. There is also VAT exception on the purchase of new machinery.	*Subsidy to business activity*: covering payroll costs according to the state aid map.
Job-creation grants: financial support for creation of new jobs in regions with high unemployment (CZK 200 000 per employee).	*Training/retraining grants*: under 100 new jobs created, 35% of 3 year training costs; above 100 new jobs created, 35% of 5 year training costs.
Training/retraining grants: financial support for training and retraining of new employees in regions with high unemployment (35% of training costs).	
Site support: Provision for low-cost land and/or infrastructure.	
Eligibility criteria	
Minimum investment: CZK 50-100 million depending on the regions' unemployment rate. Half of the minimum investment must be financed by the equity of the investor.	Minimum investment CZK 10 million
60% of total investment must go into machinery. Machinery can be already used but cannot be older than 2 years.	Minimum number of newly created jobs: 20 jobs for software development/expert solutions centres; 30 jobs for technology centers; 50 jobs for high-tech repair/shared services centres; 100 jobs for call centres.
The total amount of investment incentives (with the exception of training and retraining) must not exceed 40% of the eligible costs. However, aid is increased by 10% for medium-sized enterprises and by 20% for small enterprises.	All support is conditional on keeping the centre for a minimum of 5 years.
The total amount of training and retraining grants must not exceed 35% of the eligible costs (45% in case of SME).	
All support is conditional on keeping the investment in the country for a minimum of 5 years.	

Source: CzechInvest.

that although the incentives do not cover a large share of financing costs they make a difference at the margin on their decisions.

- Although not intended, support has turned out to be highly concentrated. Of the almost 400 projects that have received support in the years to 2006, over 40% were given to car producers. It appears therefore that the programme is largely unsuccessful in bringing product diversification.
- The minimum investment requirement means that, in effect, the system is biased in favour of foreign investors. Indeed, foreign companies have counted for about fourth-fifths of the cumulative incentives allocated between 1998 and 2006.
- Finally, the results available on the overall economic effects of the incentives are rather inconclusive. Assessment by the consultancy companies *Deloitte* and *Patria*, suggest there are positive fiscal returns to support because the stream of extra tax revenues is greater than the outgoings in support in direct subsidy plus tax expenditures. In contrast other research (notably, Mallya *et al.*, 2004; and Schwarz, 2007), concludes the fiscal returns have typically been negative. The risk of low returns to investment support are

Box 4.6. **International evidence on the effectiveness of investment incentives**

Some studies conclude that investment incentives have an impact on inward investment, albeit small. Hubert and Pain (2002), test for structural change in the geographical patterns of FDI in Europe, using a panel data set on outward investment by German companies. Controlling for other industry- and country-specific factors that are known to affect location choices, they find evidence that support has a positive impact on the level of inward FDI. However, the direct marginal impact on the level of investment is small compared with other factors. More recently, Chung and Fields (2007) divide US states into two groups, namely economically "advantaged" (those in desirable locations with ample infrastructures) and "disadvantaged" (rural and less prosperous states). The study finds that economically disadvantaged states tend to offer more types of investment incentives than relatively advantaged states. It concludes that this extra effort does help offset their lower attractiveness, but only marginally.

Other research is more sceptical. Cannari *et al.* (2006) use data from a self-reporting survey of several thousand businesses in Italy to investigate the effects of investment subsidies on the investment decisions. The study finds that three quarters of subsidised firms claim they would have made the same amount of investment at the same date. And, most of the remaining firms say they would have made the same amount of investment at a future date. A study of the French experience with investment incentives that are allocated through regional policies (Crozet *et al.*, 2003) finds very little evidence of positive effects on location choices.

clearly the greatest when the incoming plants or service centres import inputs to production. For instance the large new Hyundai plant, which is currently under construction and expected to employ some 3 000 workers, is located close to the border with Slovakia and Poland. Particularly in light of recent labour market tightening, a substantial share of employees may be foreign frontier workers who would commute on a daily basis. If this is the case, the direct positive effects on the Czech economy – private consumption gains, spillover effects to the local industrial sector, along with any extra tax revenues – may not be very pronounced.

There has been some adjustment to the investment incentives, partly in response to these concerns, partly because of the lower support ceiling allowed in EU state-aid rules:

- Most importantly, the length of corporate tax relief, which has been reduced recently from 10 to 5 years (effective from mid-2007) – a decision largely aimed at reducing generosity.
- The ceiling for applying to an investment grant has been lowered from CZK 200 million to 100 million (corresponding to about € 3.6 million), while for high unemployment regions a special ceiling of CZK 50 million (€ 1.8 million) will apply. This will probably give more scope to domestic players in accessing the scheme, thus reducing the bias in favour of foreign investors. Reportedly, this move has indeed already attracted more domestic companies.
- Rules on the machinery content of investment have been tightened. In particular, machinery has to account for at least 60% of the total value of the investment (up from the previous level of 40%) and has to be less than two years old. These changes should bring welcome quality improvements to manufacturing investment.

Further steps should be taken. There ought to be stronger stocktaking of the investment incentive schemes, backed by more monitoring (and possible sanctions) of firms that have been given support. Whether the generosity of support needs to be cut even further is at present a sensitive policy issue. Better evaluation would help in this regard. And, any additional widening of the scheme by reduction in the minimum eligibility requirements should be assessed in relation to targeted SME programmes. This would avoid overlap and the risk of excessive support for SMEs. In addition, further eligibility criteria that enhance the focus of support could be considered. Finally, the subsidies and concessions (*e.g.* public infrastructure) that are often negotiated between local authorities and investors should be held in check. It is important to ensure that these local negotiations do not end up with agreements to unjustifiable level of subsidy.[9]

Support schemes for export-oriented SMEs

Public support for SMEs comes through a wide range of financial and non-financial schemes, and some of these specifically aim to help businesses tap into globalisation.[10] In particular, some direct subsidies are provided by *CzechTrade*, the national trade promotion agency that operates under the Ministry of Industry and Trade. For instance, there is a programme (*Marketing*) that aims to strengthen international competitiveness of SMEs by supporting participation in trade fairs. Welcome attention is being paid to support services for SME exporters. Training programmes are being run for SMEs entering export markets. And, there is a plan to make sector specific export surveys in collaboration with Czech embassies. Furthermore, *CzechInvest* (see below), compiles publicly accessible databases of local suppliers. For example, the *General Database* includes about 2 000 profiles of Czech suppliers. In addition, there are specialised databases, *e.g.* the *Automotive Supplier Database* and the *Aerospace Supplier Database* and there are plans to introduce more of these.

Development of programmes for exporting SMEs should be based on continuous programme evaluation but also draw on international evidence. As regards the latter, a joint study by the OECD and the Asia Pacific Economic Cooperation provides interesting insights (OECD-APEC, 2006). The study is based on a cross-country survey of almost 8 000 SMEs and identifies several key barriers to globalisation:

- Lack of international business skills. For instance, the publication of case studies of SMEs that have succeeded in global markets should be considered thereby helping firms better understand the challenges in exporting.
- Lack of information concerning foreign markets. Training of export oriented SMEs should focus on providing practical tools for increasing market knowledge (evaluation of the growth potential of specific markets, identification of potential international partners, and so on).
- Limited knowledge of the range of support services available. The authorities need to ensure publicity is effective and transparent in order to help firms select the most appropriate programmes.
- Complementarities with other areas of SMEs policies. The coherence of SMEs support should be checked. For instance, support for globalisation ought to dovetail with support for innovation, technology parks, integrated clusters of firms, business incubators, and technology transfer centres.

Getting the right marketing pitch to businesses

CzechInvest (CI) is the investment and business agency of the Czech Republic and serves as a first source of information for foreign companies wishing to find partners and suppliers in the country. It has played a major role in the integration of the Czech Republic into the global economy by building an attractive investment framework, and by marketing the country to foreign companies (World Bank, 2005). CI was launched in 1993, at this time its immediate task was to attract greenfield manufacturing activities to offset the adverse employment effects of heavy restructuring. Though a government agency, CI has a private sector approach and this is a widely recognised as important to its success. The agency has generally been kept at arms length from politics and well staffed. Further widening the responsibilities of CI should be considered. It has been merged with CzechIndustry (since 2003) and the Czech Energy Agency (since 2008). There is a case for now combining CzechInvest with CzechTrade which would help co-ordinate support and allow more comprehensive packages to be developed.

Ensuring the provision of efficient infrastructures

National policies to improve transport linkages

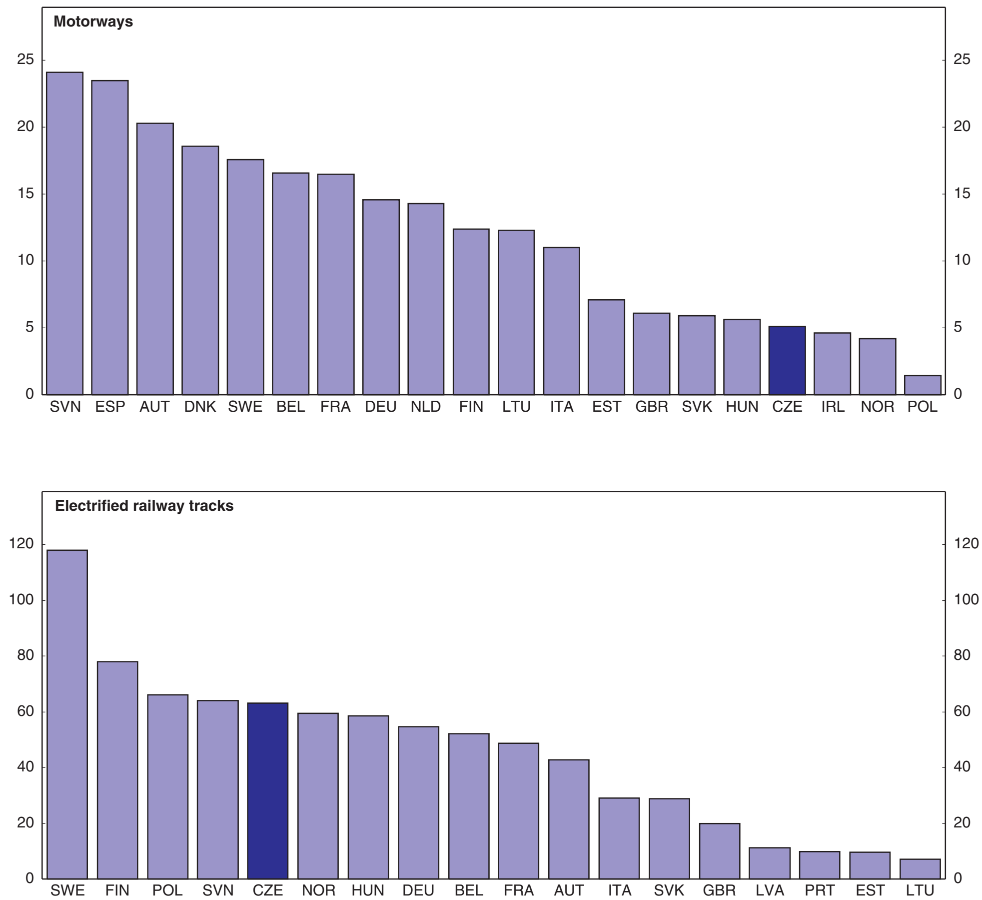
The coverage and quality of road and rail networks undoubtedly play a role in many firms' location decisions. An effective and efficient transport infrastructure not only helps to exploit the opportunities opened up by a favourable geographic location but also supports employment through boosting labour force mobility. In addition, transport networks can, to some extent, be used to encourage business to locate in particular areas such as unemployment black spots.

The *road system* compares well with the other catch-up countries in the region. In particular, the motorway network is growing rapidly. Its length increased by nearly 30% in the period 2000 to 2006, stimulated by increasing trade with European markets. For instance, 2006 saw improved links with the German motorway system, resulting in better connection to Munich, Dresden and Berlin. Despite this progress, however, motorway density (as calculated by scaling the size of the network by population) still remains well below the EU average (Figure 4.9). Recent development of the *rail system* has been relatively modest and mainly confined to some major lines (much of it to prepare for high speed *Pendolino* trains). However, although, the Czech Republic ranks relatively high in terms of railway density (Figure 4.9), there has been little restructuring of local line networks and capacity utilisation varies widely.

In response to these issues, the latest General Plan of Transport Infrastructure Development (Government of the Czech Republic, 2006), sets out clearer transport infrastructure priorities and proposes new approaches to allocate funding. In road transport, investment will focus on the construction and maintenance of the "core" motorways network (*e.g.* the Czech section of the Trans European Network), ensuring the related road connections, and on boosting quality (*e.g.* the removal of local defects in order to increase road safety). As to the rail infrastructure, investment will continue to concentrate on incorporating the Czech network into the European corridors and renewal of several major rail junctions. The opportunities for enhancing transport networks are indeed significant given the much larger allocations available under the 2007-13 budget. The Operational Programme for Transport, has been allotted about 22% of the

Figure 4.9. **Transport network densities for European countries**[1]

Kilometres per hundred thousand population



StatLink http://dx.doi.org/10.1787/315520814486

1. See Glossary for country codes. In the upper panel, according to Czech data, the score is currently higher than that shown at 9.8 under a broad definition that includes expressways that have the same parameters as motorways. This is not yet reflected in official Eurostat data.

Source: OECD calculations based on Eurostat data.

2007-13 EU budget allocation, an amount several times larger than that available under the 2004-06 EU budget.

The much larger EU funding opportunities underscore the need for efficient public procurement in transport investment. In this regard, the cost of motorway construction has often been questioned. For instance, recent assessment of 17 road construction and renovation projects by the Supreme Audit Office is very critical. According to the Office, many of the projects lacked adequate cost-benefit analysis and project processing was excessively long.[11] Processing difficulties arise in particular because of lengthy settlement of property rights issues and appeals.

A cautious approach is being taken to public private partnership contracts (PPPs) in transport networks, which is welcome. Furthermore, legislation addressing PPPs has been adopted that regulates design and budgeting. PPP financing is attractive because, in principle, it can be fiscally advantageous. But success depends heavily on getting the design of the PPP right: poorly set up partnerships can backfire badly. Thus understandably, the government is following a prudent approach with a pilot project for a 30 kilometres section of motorway. Widening the use of PPPs in transport infrastructure should take into account the following (OECD/ITF, 2008):

- PPPs projects should be designed and implemented with appropriate sharing of financing and risk with the private sector. The projects often create long-term financial commitments for governments, which generate risks that need to be minimised. It is particularly important to signal to potential applicants the full life-cycle costs have to be taken into account in the PPP project.
- There should be strict and detailed guidelines on the project's criteria (for instance, availability, physical, and safety requirements) so as to avoid compromises on quality and other issues.
- Performance contracting should be considered, rewarding above standard achievements, while at the same time penalising poor delivery.

Furthermore, in rail transport, more attention to reduce entry barriers in the freight sector is needed to ensure competition between providers and to achieve an efficient balance between road and rail. Currently, only about one quarter of freight is by rail; the aim is to increase the share to 40%. Completion of the rail link to the European corridor will help but it is unlikely to be sufficient. Measures boosting competition across transport modes will also need to be considered (OECD, 2007c). In particular, there is scope for greater competition within rail transport to help the competitiveness of combined transport relative to direct road transport (European Conference of Ministers of Transport, 2004). Finally, the strategy for scaling back uneconomic parts of the rail network should be more ambitious. One way forward would be for the government to make access by the local authorities to EU-funding of rail infrastructure projects contingent upon meeting a minimum closure threshold.

Creating a global role for Prague

Prague is the key "growth pole" in the geography of Czech development and, arguably, it has the potential to become a truly global economic centre. Maintaining Prague and its environs as a magnet for growth should remain a priority. Aside from its unique cultural heritage, Prague is the main centre of higher education in the Czech Republic, attracting both domestic and foreign students and researchers. Recent empirical work shows that synergies between such innovative groups are not only appropriated by the city in which they live but also filter through to the rest of the country (Glaeser, 2005; Glaeser and Gottlieb, 2006).

The potential of Prague is confirmed by several studies. For instance, *Globalisation and World Cities*, a network specialised in the economics of cities, identifies 122 "world cities" based on the intensity of their international transactions and the availability of advanced services (accounting, finance, law, advertising, and so on). In this study Prague is part of a middle group, ranking on a par with, for example Amsterdam, Boston, Geneva and Washington.[12] A recent survey by the European Commission comparing 75 cities ranks Prague as one of the most attractive cities in Europe, based on quality of life criteria (European Commission, 2007).

Nevertheless, there are challenges. In particular, policy needs to ensure a good transport system in the face of growing (and changing) demand from commuting, tourism

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and business activities. The accessibility of Prague has seen significant improvement over the past decade, with the tripled capacity of the airport and the creation of new road facilities that have reinforced the links with the European corridor. Also, urban transport has been improved through modernisation and better co-ordination. Services have now been put under the same logistic and timetable framework and there is also a common system of tariffs. However, in order to allow Prague's potential to be fully developed, more work will be required to cope with the expansion of suburban populations. The most important priority being completion of the ring road around Prague. Other plans include the extension of the metro network to reach Prague's international airport and to connect the southern part of the city to the centre.

Globalisation and employment

Immigration policies can alleviate skill bottlenecks

As discussed in Chapters 1 and 3, the reserves of Czech labour are being absorbed rapidly. To some extent, immigration has already helped alleviate excessive pressure in the labour market by relieving specific skill shortages. The Czech authorities are using this opportunity, albeit somewhat cautiously. A pilot points-based scheme (similar to those used in Australia, Canada and New Zealand) has been under way since 2003 and is due to end in July this year. Its aim has been to test policy settings for permanent migration. About 800 workers have entered under the scheme. In-depth assessment of migration issues in the 2005 *Survey* suggested the scheme would need some fine tuning if it were adopted as a mainstream policy.

The current government is considering a *green card* system to help employers with difficulties in hiring. In principle, this is a welcome move, however much depends on the details of the scheme. One advantage of the system is that it will accelerate the process of obtaining residence and work permits. According to the current plan, labour offices will have to provide some evidence that a native person is not available to do the job concerned. Specifically, according to the draft proposal, the respective labour office will have to prove that no Czech person has shown an interest in the post for a period of 30 days. Experience with the pilot programme and successful programmes in other OECD countries ought to guide design of the scheme.

The 2005 *Survey* also identified some weaknesses in the permit systems. For instance the system of "social checks" for residence permits was seen as excessively strict and a source of high administrative costs. Since this review there has been welcome progress. In particular, legislative amendments have made the extension of permits easier. Under the old system permits could not be extended, they had to be requested *ex novo*. Now, the employer can apply for extensions more easily and deal with the labour office directly. Measures allowing more regional mobility of foreign workers are also being considered. Furthermore, in the case of a job loss the government is considering to allow a longer job search period, from 30 to 60 days, without loss of visa entitlements. Other plans include a welcome proposal to automatically grant work permits to foreign students graduating from Czech secondary schools and universities.

Labour market policies

Another aspect of globalisation, particularly where production has become more specialised, is an increased risk of sectoral labour market shocks, which could echo the problems of regionalised structural unemployment generated in the 1990s. So far policymakers have not set up targeted programmes in anticipation of such risks and this is consistent with OECD assessment that there is little justification for such policies (Martin, 2006). If acute labour market shocks do occur, the authorities should focus on adjusting existing universal programmes (such as unemployment benefits). Indeed, what is required is a balanced package of largely familiar policies: flexible labour and product markets; activation of the unemployed; effective lifelong learning policies; and, again, a good macroeconomic framework.

Notes

1. All shares are calculated using cumulative FDI inflows data for the period 1997-2006. The figures for the Czech Republic differ from what is shown in Figure 4.1 because the sources are different.
2. This is in line with recent research about the role of European multinationals on productivity growth (Geishecker *et al.*, 2007). Using firm-level data, this study shows that in general multinational companies contribute more than domestic firms to enhance economy wide productivity growth.
3. Interestingly, *AT Kearney* (2004) derives an "Offshore Location Attractiveness Index" for 25 locations for back-office work. The Czech Republic is fourth in the ranking, following three Asian countries (India, China and Malaysia).
4. Geishecker (2004) finds that FDI is biased against medium-skilled workers. Crinò (2005) observes that FDI is correlated with the skill premium, but negatively with demand for skilled labour. In particular, this study finds Czech metallurgic sector has become progressively more unskilled-labour intensive.
5. The econometric analysis in OECD (2007b) suggests Austria's geographic location boosted GDP per capita by an estimated 2% between 1970 and the early 2000s. However, the effect for Austria is considerably smaller than for Belgium and the Netherlands, where the impact is around 6%.
6. Effective tax rates ought to be the benchmark for comparison here. However, there are no standardised comparative data here due to complexities in business taxation. It is anyway likely that the headline rates are used as a basic indicator by businesses.
7. Several other studies have underscored the link between macroeconomic conditions and foreign direct investment, for example, Brada *et al.* (2004) and Kral (2004).
8. In the relatively more prosperous south-west regions the ceiling is 36% and will be reduced to 30% in 2014. In Prague the ceiling is 10%.
9. The subsidies and concessions negotiated at local level have to be submitted along with other support for screening by the European Commission. Therefore, this activity does do not imply breaking EU rules on state aid. Nevertheless, such additional support may be unjustifiable when assessed on economic grounds in the context of domestic policy.
10. See OECD (2006b) for a discussion of direct support schemes for innovative SMEs.
11. The report of the Supreme Audit Office, issued in October 2007, underscores that delays of 6 to 8 years are common and that large budget overruns are frequent. The report also criticises the quality of cost-benefit analysis in the decisions to build sections of roads.
12. The study scores cities from 1 to 12. All these cities cited in the main text received a rating of 6. The highest rating is attributed to four cities (London, New York, Paris and Tokyo). In another study, *Mercer*, a consulting resource firm, scores Prague as the most liveable city in Central and Eastern Europe.

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Glossary

APEC	Asia Pacific Economic Co-operation
BPO	Business process outsourcing
CI	CzechInvest
CPI	Consumer Price Index
SSD	Czech Socialist Democratic Party
CT	Czech Trade
DC	Defined contribution
ERMII	Exchange-rate mechanism II
FDI	Foreign direct investment
GaWC	Global and world cities
GDP	Gross domestic product
ICT	Information and communication technology
IT	Information technology
KDU-ČSL	Christian Democratic Union-Czech People's Party
KSČM)	Communist Party of Bohemia and Moravia
MLS	Minimum living standard
MRD	Ministry of Regional Development
MTEF	Medium-Term Expenditure Framework
NUTS3	Nomenclature of territorial units for statistics 3
ODS	Civic Democratic Government
PAYG	Pay-as-you-go
PIT	Personal income tax
PPP	Public-private partnership contracts
PPP	Purchasing power parity
R&D	Research and development
SAO	Supreme Audit Office
SITC	Standard International Trade Classification
SME	Small and medium sized enterprises
TOEFL	Test of English as a Foreign Language
VAT	Value-added tax
VZP	Všeobecná zdravotní pojišťovna
WTO	World Trade Organisation

ISO Codes

AUS	Australia
AUT	Austria
BEL	Belgium
BGR	Bulgaria

CAN	Canada
CHN	China
TWN	Chinese Taipei
CZE	Czech Republic
DNK	Denmark
EST	Estonia
FIN	Finland
FRA	France
DEU	Germany
GRC	Greece
HUN	Hungary
ISL	Iceland
IRL	Ireland
ITA	Italy
JPN	Japan
KOR	Korea
LVA	Latvia
LTU	Lithuania
LUX	Luxembourg
MYS	Malaysia
MEX	Mexico
NLD	Netherlands
NZL	New Zealand
NOR	Norway
POL	Poland
PRT	Portugal
ROU	Romania
RUS	Russian Federation
SVK	Slovak Republic
SVN	Slovenia
ESP	Spain
SWE	Sweden
CHE	Switzerland
TUR	Turkey
GBR	United Kingdom
USA	United States

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