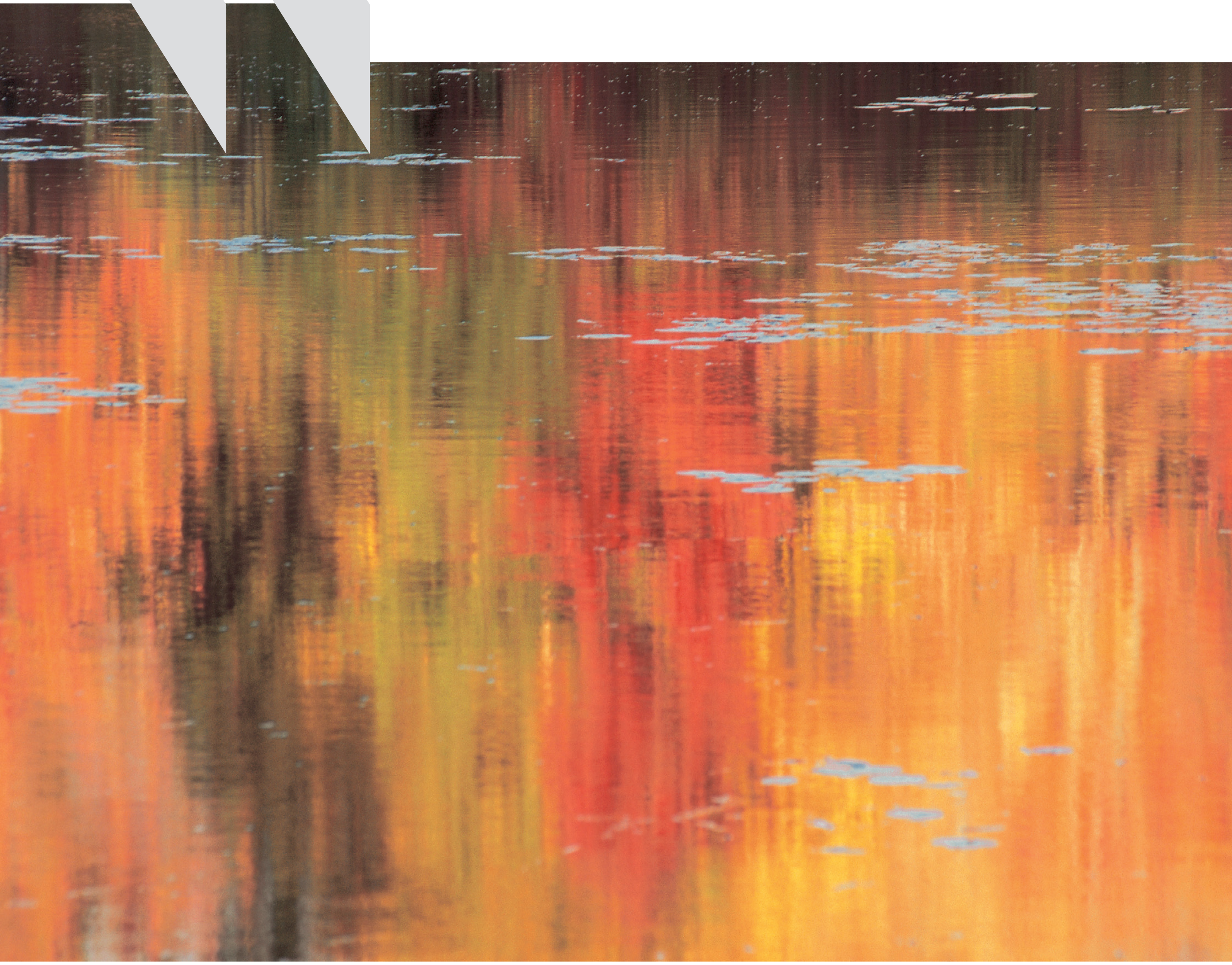
OECD Economic Surveys

CZECH REPUBLIC



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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 25 January 2010. 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 15 February 2010.

The Secretariat's draft report was prepared for the Committee by William Tompson, Zuzana Šmídová, Laura Vartia, Zdeněk Hrdlička and David Prušvic under the supervision of Andreas Wörgötter. Research assistance was provided by Margaret Morgan.

The previous Survey *of the Czech Republic was issued in April 2008.*

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BASIC STATISTICS OF THE CZECH REPUBLIC, 2008

LAND

Area (1 000 km^2)	79	Major cities (1 000 inhabitants)	
Agriculture (%)	54	Prague	1 225
Forest (%)	34	Brno	370
		Ostrava	308

PEOPLE

Population (1 000)	10 430	Employment (1 000)	4 986
Inhabitants per km^2	132	Agriculture (%)	3
Natural increase in population (1 000)	15	Industry (%)	41
Net immigration (1 000)	72	Services (%)	56

GOVERNMENT

Public consumption (% of GDP)	20	Chamber of Deputies, as at January 2010	Seats
General government total revenue (% of GDP)	41	Civic Democratic Party	78
General government deficit (% of GDP)	2	Social Democratic Party	70
Public debt, Maastricht definition (% of GDP)	30	Communist Party	26
		Independent	13
		Christian Democratic Union	9
		Green party	4
		Total	200

PRODUCTION

GDP, current prices (billion CZK)	3 689	Origin of value added (%)	
GDP per capita (USD, current prices)	20 719	Agriculture	3
Gross fixed investment (% GDP)	24	Industry	38
		Services	60

FOREIGN TRADE

Exports of goods and services (% GDP)	77	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	41
Manufactures	30	Manufactures	30
Chemicals	6	Chemicals	10

CURRENCY

Monetary unit: Czech koruna		Currency units per euro	
Currency units per USD, 2009	21.32	Year 2009	27.70
		Jan. 2010	25.94

Executive summary

The Czech economy was severely affected by the global downturn, owing to its high degree of openness and integration in global production chains. The fiscal position was also hit hard, prompting a rapid shift in policy from stimulus to consolidation. The medium-term challenges facing the country are principally concerned with creating conditions for rapid convergence with advanced OECD economies by restoring the sustainability of public finances and improving the business environment.

- **Executing an ambitious medium-term consolidation strategy.** *The government should outline a clear medium-term plan to achieve a structural balance close to zero. Consolidation efforts will need to be underpinned by structural reforms and should aim at an appropriate balance between safeguarding the revenue base, exploiting the potential for efficiency savings in spending programmes and containing expenditure growth. This should form the cornerstone of a broader strategy to prepare the economy for entry into the euro area.*
- **Addressing risk diversification in healthcare and pensions.** *Further reforms in healthcare and pensions are needed to assure long-run fiscal sustainability in the face of the spending pressures generated by population ageing. There have been promising starts on both but more needs to be done, particularly to diversify the sources of retirement income.*

The tax and benefit systems have both undergone significant reforms in recent years. While many of these changes are to be welcomed, some policy challenges remain:

- **Shifting the tax burden onto less distorting taxes.** *More can be done to move towards greater reliance on indirect taxes, particularly consumption, environmental and property taxes, rather than direct taxes on labour and capital income.*
- **Better co-ordination of tax and benefit policies.** *Undesirable interactions between tax and benefit systems sometimes arise because policies in the two domains are not well co-ordinated. More systematic analysis of such interactions could help avoid such problems.*
- **Eliminating other distortions in the taxation of labour and capital.** *Labour-market behaviour is distorted by the differential treatment of dependent employees and the self-employed, while investment patterns are affected by corporate income tax provisions that favour particular asset classes and sources of investment finance over others.*

Steps to reduce the regulatory burden offer a way to reduce the cost of doing business – and thus relieve the pressure on the enterprise sector – at little or no fiscal cost.

- **Further reducing rigidities in product and labour markets.** *Despite recent reforms, much remains to be done to reduce entry barriers in product markets, strengthen competition, particularly in network sectors, and relax labour-market regulation.*
- **Pressing ahead with regulatory reform.** *Efforts to relax labour- and product-market regulation should be underpinned by greater consistency in the implementation of regulatory policies, with particular emphasis on administrative simplification and effective regulatory impact assessment.*
- **Further development of e-government initiatives.** *Increased reliance on e-government methods could make a significant contribution to the achievement of these objectives.*

Assessment and recommendations

The collapse of external demand hit an already slowing economy hard…

After several years of growth averaging close to 6% *per annum*, the economy slowed markedly in 2008, entering a sharp recession in the fourth quarter. Real GDP is projected to have fallen by 4.3% in 2009. This reflected the collapse of world trade that followed the onset of the global financial crisis. The economy's integration in international supply chains, particularly its specialisation in the export of consumer durables and capital goods, made it vulnerable to such a global trade shock. The trade collapse quickly triggered a contraction in domestic demand, especially fixed investment. Private consumption growth turned negative in the third quarter of 2009, as households responded to rising unemployment and a sharp slowdown in wage growth. On the production side, most major sectors contracted, with tradables suffering the most. Manufacturing alone accounted for around half the total drop in gross value added, and service sectors linked to the cycle in manufacturing, like trade and transport, were also hit hard.

Real GDP turned around in the second quarter of 2009, driven by a slight pick-up in exports against a backdrop of falling imports and decelerating consumption. The export recovery seems to have owed much to the adoption of car-scrapping schemes and other measures to support the automobile sector in major export markets. Overall, the strength of the recovery will depend chiefly on the growth of world trade. Domestic demand will remain weak, with government consumption constrained by the need to bring down the budget deficit and private consumption growth depressed by rising unemployment, a bleak outlook for wage growth and the impact of fiscal consolidation measures.

Although growth has resumed, the consequences of the recession for employment and living standards are still unfolding. Unemployment surged in the first quarter of 2009, which saw the largest one-quarter increase in joblessness since the early 1990s, and reached 7.3% in the fourth quarter. It would probably have risen higher still but for widespread use of the unsubsidised and collectively agreed "partial unemployment" provisions introduced into the Labour Code in 2007 (essentially a short-time working regime). The evidence suggests that nominal wage flexibility also played a part in the labour-market adjustment. While the employment impact of the recession was and remains painful, the response so far suggests that the labour market has become more flexible in recent years.

The banking system has weathered the crisis relatively well

The banking sector appears to have come through the downturn in reasonably good shape, although bank portfolios are yet to feel the full impact of the financial consequences of the contraction. Credit conditions grew tighter, particularly for households and borrowers in struggling sectors like construction. While interest rates on new loans to households rose, the tightening of credit to non-financial firms appears to have taken the form of tougher non-interest conditions. Interest rates on new loans to business actually fell slightly, but the decline was far smaller than the drop in the Czech National Bank's (CNB) policy rate. Banks increased risk premia rather than passing on policy-rate cuts to borrowers. This helped them to recapitalise so as to cope with the growth of non-performing loans.

The resilience of the banking system reflected a number of factors, including prudent macroeconomic management and market structure. Low inflation and interest-rate spreads meant that there was little incentive to borrow in foreign currency. In addition, Czech banks had pursued fairly conservative strategies, reflecting both the lessons drawn from past banking crises and their ability to make healthy profits from "normal" banking business. Their net external investment position was and remains positive, with domestic lending financed by the domestic deposit base. Finally, as subsidiaries of foreign banks, most Czech banks did not invest in "toxic" assets, even if their foreign parents did so.

Monetary policy helped cushion the shock

With inflation falling and the koruna near historically high levels, the CNB began to ease monetary policy in August 2008, cutting its main policy rate in stages by a total of 275 basis points over sixteen months to a historic low of 1.0%. It also responded to the turmoil in international financial markets in the autumn of 2008 by introducing a new facility for providing liquidity to banks, with the option of using government bonds as collateral. In the end, this facility was little used, and no bank required any direct public support. A significant weakening of the koruna against other major currencies in late 2008 and early 2009 also provided some relief to the tradable sector, although it was by no means sufficient to offset the collapse in external demand. Moreover, for many firms, the currency's volatility in 2009 was more of an issue than its level.

Fiscal policy moved rapidly from stimulus to consolidation

In an effort to address the unfolding crisis, the government in late 2008 and early 2009 adopted a range of fiscal stimulus measures amounting to about 2.2% of 2008 GDP, spread across 2009-10. The failure to pursue fiscal consolidation more vigorously during the years of strong growth that preceded the crisis meant that there was no fiscal space for any larger stimulus. The authorities in any case recognised that, in such an open economy, using fiscal policy to stimulate aggregate demand would not be effective. The stimulus measures therefore primarily targeted the supply side. They were aimed at limiting employment losses by reducing non-wage labour costs, mitigating the investment contraction and supporting exports by providing guarantees, which were becoming increasingly unavailable due to dysfunctional global financial markets.

As the year unfolded, the budget balance deteriorated faster than had been anticipated. By the third quarter, the government was projecting deficits of 6.6% of GDP for 2009 and, if corrective action were not taken, over 7% for 2010. This raised the prospect of significant increases in the government's cost of borrowing and of a crowding-out effect that could inhibit the recovery of private investment. The government responded with a fiscal consolidation package ahead of the 2010 budget. On balance, the decision to withdraw from fiscal stimulus relatively early is to be welcomed. Domestic fiscal tightening is unlikely to be decisive with respect to the sustainability of the recovery, which depends chiefly on developments in external markets.

An ambitious medium-term consolidation strategy is needed

The consolidation package was largely limited to 2010, because the government in office was a caretaker cabinet appointed following the fall of the previous centre-right coalition. While the revenue measures adopted were of indefinite duration, changes on the expenditure side were confined to the coming year. *One of the most important challenges for the government in 2010 is to formulate a credible multi-year strategy for fiscal consolidation.* The measures for 2010, like past Czech consolidation efforts, were heavily weighted towards the revenue side, partly in an effort to make up the revenue losses experienced in the wake of the crisis. However, a good deal of cross-country empirical work suggests that consolidation is both more likely to be sustained and less likely to depress growth if it is based on spending restraint. There is also evidence to suggest that a substantial share of public spending in the Czech Republic is inefficient. *Consolidation plans for 2011 and beyond should thus place greater emphasis on the expenditure side of the budget.* Reducing the deficit from an estimated 6.6% of GDP in 2009 to a level below the Maastricht Treaty threshold of 3% of GDP, as required under the EU's Excessive Deficit Procedure, will be an important milestone but is not a sufficient goal for fiscal policy. *Ultimately, the government needs to aim for a structural balance close to zero to ensure long-run fiscal sustainability and retain the capacity to rely on discretionary fiscal measures or automatic stabilisers to offset future shocks. The adoption of a structural indicator of the budget balance would strengthen the current system of nominal expenditure ceilings and would also increase the transparency of fiscal policy.* The authorities may also wish to consider the examples of some other OECD member countries, which have adopted constitutionally entrenched fiscal rules.

While legislative change will be needed to bring about structural spending reductions in many areas, aspects of expenditure policy that are under the government's direct control can be addressed relatively quickly. *Reforms to the budgetary process, particularly as regards rigorous* ex ante *and* ex post *scrutiny of expenditure programmes, improvements in budgetary transparency and overhaul of public procurement practices are long overdue and could pay significant dividends in coming years. The speedy implementation of plans to shift to a treasury system of budgetary management should also be regarded as a very high priority.* The unified accounting and real-time financial management that the treasury system will bring should yield direct savings, by reducing debt-service costs and administrative overheads, and should also make it easier to identify where there may be scope for further streamlining of expenditure. Since social spending represents the largest share of non-discretionary expenditure it will also have to be addressed. *A review of social spending should be undertaken, with particular attention to whether some benefits that are not income-tested should be phased out at higher incomes. Some savings and revenue increases should also be generated by reforms of tax collection and further steps to improve tax compliance (see below).*

The prospect of euro entry could facilitate consolidation

In view of the fiscal situation, adoption of the euro can only be a medium-term prospect and will depend in part on economic and fiscal developments that are hard to predict at this point. The Czech Republic is unlikely to bring its deficit back below 3% before 2013, and the target date for entry will depend crucially on when this goal is reached. The previous government had planned to set a date in 2009, but domestic political developments and the economic crisis meant that this did not happen. As economic conditions normalise and the recovery takes hold, the next government should revisit the issue. After the policy zigzags, economic turmoil and exchange-rate volatility of the last two years, clarity about meeting the conditions for euro accession, even if it is a medium-term objective, would help reduce uncertainty for business. It would also help anchor expectations and mobilise political capital for a sustained fiscal consolidation effort and other structural reforms. *The authorities should therefore outline a clear strategy to put in place on a sustainable basis the conditions for euro area entry.*

The fiscal consequences of population ageing remain the principal long-term challenge

Ensuring long-term fiscal sustainability remains a serious challenge, owing chiefly to the fiscal consequences of rapid population ageing. The ratio of age-related spending to GDP is projected to rise by 6.4 percentage points over the period to 2060. In the absence of policy change, the Ministry of Finance estimated even before the crisis that this would push the public debt past 60% of GDP shortly after 2040, rising to 250% of GDP around 2060. Post-crisis debt dynamics look even worse. Two areas – healthcare and pensions – account for the largest part of this growth, with the latter by far the more important. Largely parametric reforms in these two areas have been initiated in recent years.

Recent legislation extending the increase in the retirement age will do much to fend off the threat of looming increases in pension spending, but on current projections pension expenditure is still set to rise from around 7.8% of GDP in 2007 to roughly 11 by 2060. Tackling this challenge without imposing large – and possibly unsustainable – increases in social security contributions or other taxes is likely to require a combination of both further parametric adjustments to the system and structural changes. *A first step would be to take the recent changes in the retirement age further by phasing out the differentiation of women's retirement ages. The possibility of instituting partial indexation of the retirement age to life expectancy should also be considered.* Increasing labour-force participation among groups with high benefit-recipiency rates, as well as policies to boost labour supply, such as migration policy, could also help to address this problem.

The previous government's pension reform plans envisaged the creation of a voluntary, fully funded, defined-contribution "second pillar" to the pension scheme, which would be financed by allowing individuals to divert a portion of their pension contributions from the "first pillar" – a public pay-as-you-go (PAYG) defined-benefit system – to private pension funds. They would be required to top up this "carve out" with further contributions of their own. These plans are currently stalled, and recent turmoil on financial markets may have made it politically harder to win public support for funded schemes. Nevertheless, the case for diversification of retirement income sources remains as strong as ever, and the introduction of the second pillar would be a welcome step in this direction. However, given the highly redistributive nature of the first pillar, a voluntary carve-out could undermine its financial sustainability. The better paid would face very strong incentives to take the carve-out option, because the first pillar offers them much lower returns on their contributions than it does the low paid. *The next government should resume work on the second pillar and should consider making it mandatory or, at the least, using "soft compulsion" by requiring individuals to opt out of it rather than into it. The regulatory framework will need to be designed so as to balance return considerations, income security and the need to minimise financial overheads.*

Ambitious plans for healthcare reform have largely stalled, following a political backlash against the introduction of small user fees for doctor consultations, prescriptions, emergency-room visits and hospital stays in 2008. There has been limited progress in respect of other aspects of healthcare reform, such as changes in price-setting for pharmaceuticals or liberalising the rules that govern negotiations between insurers and healthcare providers. The benefits of these measures have yet to be seen. Other planned changes, such as improvements in the definition of the basic healthcare package provided by the public system and increases in the diversity of insurance products on the market have not been adopted at all. *The government should revitalise the healthcare reform process, moving ahead with plans to redefine the basic publicly provided healthcare package and allow greater diversity of insurance products. It should also move to eliminate distortions in healthcare markets created by regional authorities'* ad hoc *tinkering with the system of user fees.*

More can be done to make the tax system less distortive

While fiscal consolidation efforts should focus more on the expenditure side than hitherto, it is likely that further revenue measures will also be required as part of the adjustment. It will be important, therefore, to identify the revenue sources that are least distorting and least damaging to growth. Setting out a clear path for tax policy, with well defined goals, would enhance the transparency and predictability of policy during this period. Given that the labour tax wedge is still relatively large and that the tax system overall still relies very heavily on the direct taxation of labour and capital income, *new revenue measures should focus on indirect taxes, particularly the taxation of consumption and property rather than income.*

- The Czech Republic relies less on the taxation of real property than any other OECD member. Yet property taxes are among the least distorting revenue sources available. They are also relatively difficult to evade and less cyclical than income taxes. *The real estate tax should be increased by raising tax rates and linking the tax base to actual market prices.*
- The two-tier VAT should also be reviewed. It creates market distortions and complicates administration. Yet as a means of helping those on low incomes it is extremely inefficient: households with median income or higher receive around 60% of the tax

benefits of the two-rate system. *VAT should be levied at a unified rate, with exceptions and exemptions reduced to a minimum. Distributional concerns should be addressed by direct transfers.*

- Finally, although the recent tax reform package marked a first step in environmental tax reform in the Czech Republic, considerable scope remains for more progress in this direction. *The next government should follow through with plans for further environmental tax reform, including the introduction of a greenhouse gas emissions tax and a transition from free allocation to auctioning emissions permits under the Emissions Trading Scheme.*

Distortions in capital taxation should be reduced

The steady reduction in the statutory rate of corporate income tax (CIT) has itself helped to reduce some of the distortions that exist in the system of capital taxation. However, the Czech CIT is still less neutral between forms of investment finance and asset types than many in the OECD. Specifically, it tends to favour debt-financed investment very heavily, as compared with investment financed by new equity, and the effective taxation of investment in new machinery tends to be unusually low compared to investments in most other assets. *The CIT and/or the dividend tax should be revised to reduce, if not eliminate, the disparities between the tax treatment of different sources of investment finance. At the same time, the neutrality of the CIT with respect to investment in different types of assets should also be increased. This may require revision of depreciation schedules and of targeted investment incentives now written into tax legislation.*

Interactions between the tax and benefit systems still create perverse incentives for some groups

While the tax changes of 2008 increased work incentives, the interaction of tax and benefit systems remains an issue. An analysis of tax-benefit interactions suggests that the Czech Republic has made considerable progress in addressing inactivity traps since 2006. However, some groups still face very high average effective rates of taxation, which discourage activation, or very high marginal effective rates, which reduce the incentives for individuals to increase their labour supply. *Where possible, the remaining spikes in marginal effective tax rates should be reduced or eliminated, by smoothing the withdrawal of some benefits as income rises, particularly unemployment benefit and living allowance, and by gradually withdrawing the spousal tax credit as the second earner increases earnings.* Family benefits are the area where tax-benefit interactions create the largest – and, in recent years, increasing – disincentives to work. Parental allowances and other benefits available to families with young children reflect the Czech authorities' preference for family-based childcare and are therefore heavily tilted towards de-activating parents for relatively long periods. *A comprehensive review of the tax and benefit system provisions as they apply to families with dependent children should be undertaken with a view to making it easier to combine work and family life and making the system more neutral with respect to parents' choices about how to do this.* Problematic tax-benefit interactions partly reflect the fragmentation of policymaking, with different ministries handling taxes and benefits. *At a minimum, tax and benefit policies should be systematically co-ordinated with one another. The government may want to consider using a tax-benefit model to analyse systematically the tax-benefit interactions that arise when policies change.*

Remaining distortions in labour taxation should be addressed

Some distortions in labour taxation still need to be addressed. Perhaps the most important concern the tax privileges enjoyed by self-employed persons. These create incentives for employers to declare many *de facto* dependent employees to be self-employed contractors. *Steps should be taken to reduce the disparities in the tax treatment of dependent workers and the self-employed*. Secondly, given that the fiscal situation limits the scope for further reductions in the labour tax wedge at present, priority should be given to reducing the tax wedge on the low paid, where the evidence suggests the employment effects of a reduction would be greatest. *Targeted reductions in social security contributions for low-wage jobs should be considered*. These could be financed in part by eliminating the current anomaly whereby individuals with earnings above the cap on social security contributions face steadily declining average effective rates of tax on personal income. This could be done either by eliminating the cap on social security contributions for very high earners or by introducing a higher-rate income-tax bracket for earnings above the cap. Although such a change would affect only a small number of people, it would eliminate an arrangement that is troubling in terms of equity and unlikely to have any impact on labour supply.

Tax compliance and administration can be simpler and cheaper

Tax reform would be incomplete if it did not address administration and compliance costs. There is considerable scope here for changes to benefit both taxpayers and the state. Since the complexity of the tax system arises chiefly from exceptions and exclusions in tax legislation, *a systematic accounting of tax expenditures would provide a basis on which to serve both simplification and equity goals while pursuing tax reform and fiscal consolidation*. The planned integration of collections into a single agency should lead to palpable savings for taxpayers and the budget. The gains from doing so will be all the greater if the integration and streamlining of tax administration is accompanied by greater harmonisation and simplification of tax bases and definitions. *The definitions and tax bases for the personal income tax and social security contributions should be further harmonised and simplified. Plans to integrate the collection of taxes, customs and social security contributions should be swiftly implemented*.

More can be done to eliminate rigidities in product and labour markets

The Czech Republic has recently made substantial progress in reducing start-up costs for both new companies and sole proprietors and simplifying a wide range of basic legal procedures, from property registration to insolvency. However, more can be done to streamline product-market regulation. In particular, although start-up procedures have become much faster, the costs remain comparatively high, owing largely to the relatively high level of minimum capital requirements for new companies. *The next government should consider lowering these amounts, while examining other aspects of the entry process to identify factors contributing to excessive fees*.

There are competition issues to be addressed in specific product markets. In electricity, gas and telecommunications, the evidence points to the need for continued vigilance against possible exploitation of market power by dominant players. In food retailing, the threat to competition comes from the Act on the Abuse of Significant Market Power in the Sale of Agricultural and Food Products adopted in 2009. Though ostensibly aimed at curbing the "buyer power" of supermarket chains *vis-à-vis* small agricultural producers, the act is likely to create legal confusion, distort competition and raise prices for consumers. Moreover, it may even have the perverse effect of deterring supermarkets from contracting with the small suppliers the act is meant to help. *The act should be repealed.*

As noted above, the labour market proved more flexible in the downturn than many had anticipated. However, a number of indicators, including persistent long-term unemployment and the widespread use of phoney self-employment to evade labour regulations, point to continuing rigidities arising from the Labour Code and other regulations. *At a minimum, notice period and severance pay arrangements ought to be linked to the length of service. The Code's provisions concerning fixed-term and other non-standard work contracts could be liberalised. Housing-market policies that create barriers to labour mobility should also be reconsidered.*

Regulatory policies need to be implemented more effectively on a whole-of-government basis

The government has adopted a range of regulatory reform policies in an effort to reduce the burden of regulation on businesses and households. Initiatives such as the drive to reduce administrative burdens using the Dutch Standard Cost Model and the introduction of regulatory impact analysis (RIA) are welcome. The Czech framework for RIA compares favourably with those of other OECD members, and many dimensions of regulatory reform are increasingly supported by a range of e-government initiatives now being introduced. However, implementation of regulatory reform – and of RIA, in particular – has been uneven. While a number of specific steps can be taken to strengthen the application of these, the main problem lies in the failure of many line ministries to implement the reforms. The vesting of responsibility for regulatory reform with a pair of line ministries is part of the problem: they are not well positioned to bring other ministries into line when non-compliance issues arise. *The government should consider establishing a strong institution at the centre of government to drive regulatory reform across the whole of the public administration.*

Further steps are needed to curb corruption

Evaluations of the business environment continue to highlight corruption as a major problem. While there has been some evidence of progress in recent years, not least in conjunction with increasing reliance on e-government methods, more needs to be done, particularly to address corruption in public procurement. *The next government should pursue further steps to enhance the transparency and competitiveness of public procurement procedures, while strengthening the mechanisms that allow bidders to challenge questionable procurement practices in a timely and efficient manner. The authorities should also institute liability of legal persons and explore ways to strengthen whistleblower protection.*

Institutional innovations could yield greater policy coherence

In recent years, policy in many domains seems to have been characterised by frequent changes of direction and by difficulty in ensuring a co-ordinated approach to policies that cut across the divisions between government ministries or between central, regional and municipal authorities. The independence of individual ministries and the lack of a strong institutional centre capable of ensuring unity in approach and consistency in implementation present a particular challenge when policy reform requires a whole-of-government approach, like regulatory reform or fiscal consolidation. These difficulties reflect such diverse factors as the country's administrative traditions, the nature of the political system and the constitution. However, they are not insoluble problems. OECD governments are structured in a wide variety of ways and they have likewise evolved a wide range of mechanisms for ensuring policy coherence and fiscal discipline. A number of member countries achieve these objectives even in environments characterised by complex political coalitions, minority cabinets and a centre of government with relatively limited authority. *Policymakers could profitably explore the potential for similar solutions to bring results by, for example, creating a fiscal council or similar institution to strengthen adherence to a rules-based framework for fiscal policy. In terms of structural policy, mechanisms to strengthen high-level communication and co-ordination across ministries are needed in order to establish greater stability and coherence in policy-making; here a council of chief economists, bringing together the top economists of the various ministries could have a role to play*. Changes in the internal organisation of ministries may be needed to facilitate such co-operation.

Chapter 1

The challenge of fiscal consolidation after the crisis

This chapter describes how the global crisis hit the economy and the channels through which the external shock made itself felt. It then examines the policy response to the crisis before proceeding to consider the major medium- and long-term challenges confronting the authorities during the recovery. The most important of these concern the state of public finances. First, there is an urgent need for a clear and credible strategy for medium-term fiscal consolidation that would bring the general government deficit down from its current unsustainable level. Secondly, the authorities should move ahead with the reforms needed to address the fiscal consequences of rapid population ageing. Previous Surveys have identified this as a major long-term challenge facing the country, but structural reforms in healthcare and pensions, the two areas of greatest concern, have largely stalled. The current crisis has in some respects made it harder to advance reforms in those areas, but it has done nothing to diminish the need for them.

After several years of strong growth, the Czech economy slowed markedly in 2008, entering a sharp recession in the fourth quarter. The severity of the contraction primarily reflected the collapse of world trade that followed the onset of the global financial crisis and the economy's integration in international supply chains. The second quarter of 2009 witnessed a return to growth, but the recovery remained weak and apparently fragile in subsequent quarters and is subject to significant downside risks. The consequences of the recession for employment, living standards and public finances are still unfolding. The policy response to the crisis encompassed fiscal, monetary and structural measures, but was complicated at key points by domestic political developments – chiefly, the fall of the governing coalition and its replacement by a caretaker government with a limited mandate (Box 1.1).

Box 1.1. **The political situation**

Since May 2009, the Czech Republic has been governed by an expert cabinet formed after the previous centre-right coalition lost its parliamentary majority and was defeated in a no-confidence vote in the Chamber of Deputies. The new government was formed following an agreement between the outgoing three-party coalition and the opposition Social Democrats, and was initially intended to remain in office until early elections could be held later in the year. Its mandate was extended in September, however, after the Constitutional Court found the early dissolution of the Chamber of Deputies unconstitutional because it had not been preceded by three attempts to form a new government, as prescribed in the constitution.

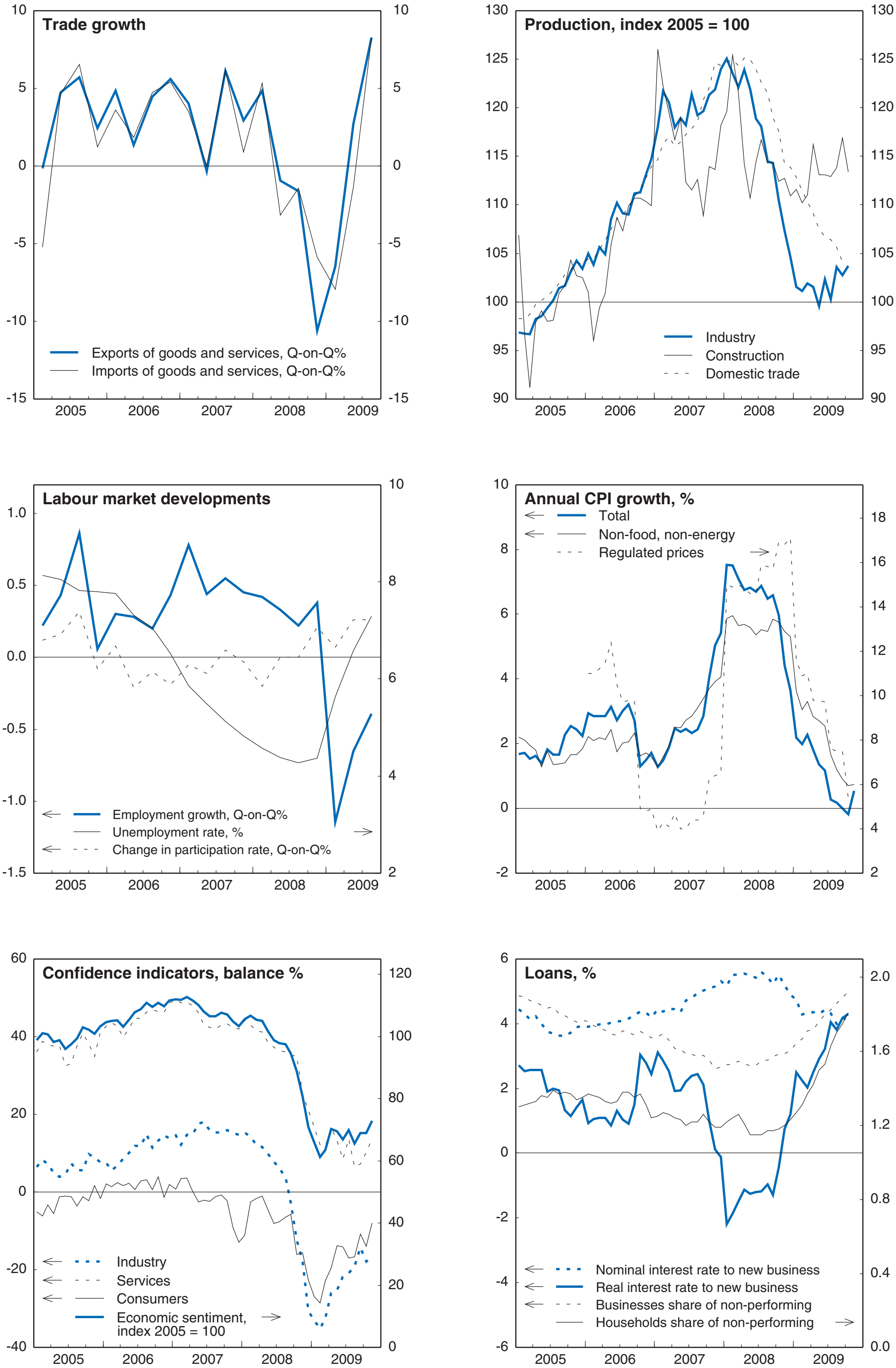
The government is thus set to remain in office until the next election, scheduled for 28-29 May 2010. The government secured passage of a fiscal consolidation package and, subsequently, parliamentary approval of the 2010 budget. The current government will also have to bring work on the 2011 budget to an advanced stage, because the elections will occur late in the second quarter and may be followed by an extended period of coalition negotiation, while the budget cycle already began in the first quarter. The technocratic character of the government may have reduced partisan conflict over some aspects of policy in the midst of the current downturn. However, its caretaker status makes it difficult to address major structural challenges.

A cyclical slowdown exacerbated by an imported crisis

The economy entered a severe downturn at the end of 2008

The economy appears to have passed a cyclical peak in early 2007, with real GDP growth moderating from the spring of that year until the final quarter of 2008, when it turned sharply negative. The contraction continued through the first quarter of 2009 and was broad-based, affecting all major sectors of the economy (Figure 1.1). It was driven in the first instance by falling exports and investment in response to weakening global

Figure 1.1. **Main economic developments**



Note: Production – domestic trade is wholesale and retail trade and repair of motor vehicles and motorcycles. Labour market data are from the Labour Force Survey. The change in the participation rate is shown in percentage points. The participation rate is here defined as the labour force as a percentage of population aged 15 to 64.

Source: Czech National Bank; Czech Statistical Office; European Commission; OECD, *Main Economic Indicators* and *National Accounts Databases*.

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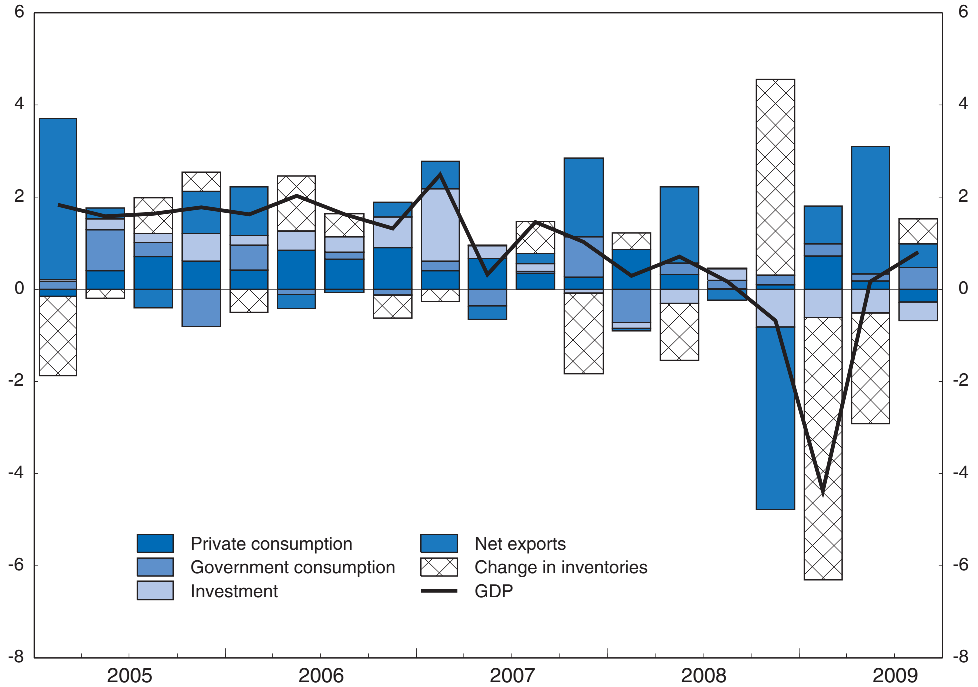
demand, and a dramatic fall in stocks, as firms under pressure struggled to maintain cash flow (Figure 1.2).[1] Overall, the downturn in the Czech Republic was somewhat more severe than the OECD average (Figure 1.3).[2]

Figure 1.2. **Quarterly contributions to growth**



Source: OECD, *National Accounts Database*.

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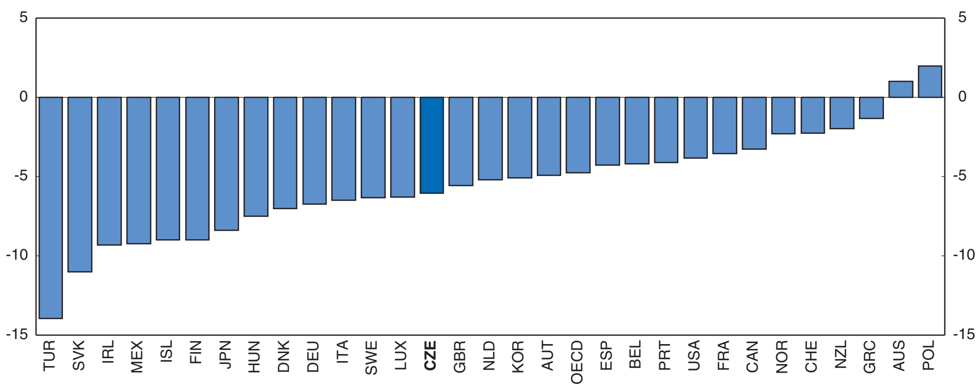
Figure 1.3. **Output losses, 2008-09**

As a % of maximum GDP, negative indicates loss



Note: Real GDP, seasonally adjusted, 2008Q1 to 2009Q2.

Source: OECD, *National Accounts Database*.

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Although growth was slowing throughout 2008 and significant policy challenges remained, the Czech economy prior to the crisis was characterised by relatively healthy external and fiscal balances, a flexible exchange rate, low inflation, sound banks and the absence of domestic financial bubbles. Both the business environment and the functioning of the labour market were improving. There was thus little reason to regard the country as particularly vulnerable to the on-going international financial turbulence.[3] Indeed, the Czech Republic held up better than most its regional peers during the early stages of the crisis. However, the contraction in the first quarter of 2009 was the fourth-largest in the OECD area. Other metrics for assessing the severity of the downturn, such as change in the estimated output gap through the crisis, also show the Czech Republic to have been hit harder than most.

Although growth resumed in the second quarter, real GDP is estimated to have fallen by 4.1% in 2009. Growth is projected at 2% in 2010 and 2.8% in 2011, largely driven by the continued recovery of world trade (Table 1.1). Domestic demand is expected to remain weak, as government consumption is constrained by the need to bring down the budget deficit and private consumption adjusts in response to rising unemployment and the pursuit of fiscal consolidation in 2010. Exports should continue to grow, albeit at a modest pace. The gradual recovery in 2010 and 2011 is expected to be driven by export demand and a consequent recovery of investment, while household consumption will slow the pace of recovery. Consumer price inflation slowed sharply in 2009, owing to weak domestic demand, slow nominal wage growth and falling employment. The weakness of the recovery should ensure that inflation remains subdued, although the planned VAT hikes in the fiscal consolidation package and expected increases in regulated prices will increase price levels in 2010 and 2011. This forecast is subject to significant risks due to uncertainty about developments in Germany and other major export markets, particularly as the car-scrapping schemes in other countries are phased out. On the domestic demand side, the main downside risk lies in a possible weakening of private consumption in response to the deteriorating labour market and the 2010 fiscal consolidation package.

Table 1.1. **Recent developments and projections**

Percentage changes from previous period, at constant prices, unless otherwise indicated

	2005	2006	2007	2008	2009	2010F	2011F
Private consumption	2.5	5.3	5.0	3.5	–0.2	–0.7	1.6
Government consumption	2.9	1.2	0.7	1.0	4.4	–0.9	0.6
Gross fixed capital formation	1.8	6.0	10.8	–1.5	–8.3	1.0	4.5
Public sector	3.3	7.0	–0.3	5.6	n.a.	6.4	2.2
Total domestic demand	1.8	5.6	5.2	1.1	–3.9	0.4	2.2
Exports of goods and services	11.8	16.2	15.0	5.7	–9.9	3.8	6.4
Imports of goods and services	5.2	14.7	14.2	4.3	–9.9	1.5	5.9
Gross domestic product	6.4	7.0	6.1	2.3	–4.1	2.0	2.8
Memorandum items:							
Consumer price index	1.9	2.6	3.0	6.3	1.0	1.4	2.0
Unemployment rate[1]	7.9	7.2	5.3	4.4	7.3	8.4	7.9
General government balance[2]	–3.6	–2.6	–0.7	–2.0	–5.7e	–5.6	–5.0
Current account balance[2]	–1.3	–2.5	–3.1	–3.0	–1.0	0.3	0.3

e: The general government balance for 2009 is an OECD estimate.
1. As a percentage of labour force.
2. As a percentage of GDP.
Source: Czech Statistical Office; OECD, *Economic Outlook,* No. 86, November 2009.

Policy would have to adjust in the event of a renewed contraction; in particular, it might be necessary to allow the automatic stabilisers to work in full and perhaps to postpone some discretionary fiscal tightening. However, policy-makers would need to take account of the financial markets' reaction to any relaxation of the fiscal stance. In the event of market concerns about fiscal weakening, rising interest rates could offset much of the stimulus effect of such a policy shift. The Czech authorities are well aware of this risk. The strategy for exit from the crisis that was approved by the government in early 2010 explicitly ruled out the possibility of further easing and focused instead on measures to support exports and growth at minimal cost to the budget, while increasing the efficiency of public expenditure and making the most of EU funds. It also envisaged steps to simplify the tax system.

The downturn was imported…

The international crisis hit the country primarily through the trade channel, although the external financial sector constituted a second, less important transmission channel. The economy's exceptionally high degree of globalisation meant that it felt the full effects of the collapse in world trade at the end of 2008.[4] The ratio of total trade turnover to GDP, at around 150% in recent years, is among the highest in the OECD, with total exports amounting to over 75% of GDP. Direct export sales account for over half of total sales in industry. With world trade falling at annualised rates in excess of 25% in the fourth quarter of 2008 and the first quarter of 2009, Czech exports dropped sharply (Figure 1.1). If the size of the export contraction in those two quarters is weighted by the export share of GDP, then only Finland, Slovakia, Belgium and Luxembourg suffered larger losses as a result of the trade shock, and Hungary was hit almost as hard as the Czech Republic. The drop in export demand, in turn, triggered the investment contraction, although private household demand initially held up fairly well.

The importance of external trade to Czech growth in recent years is difficult to exaggerate. Export-oriented sectors have consistently accounted for the largest share of value-added growth (Table 1.2) and have been the preferred sectors for FDI inflows. In recent years, export-oriented manufacturing has recorded among the highest rates of productivity growth and made the largest contribution to the growth of aggregate productivity (Table 1.3). In one respect, however, exporters continued to perform well. For many years prior to the crisis, they tended to gain market share during cyclical upturns but did not lose it during downturns. As a result, the country's share of total world exports of goods roughly quintupled from 1991 to 2008, albeit from a low base. This pattern held good during the contraction phase in 2008-09 – the Czech share of OECD exports, at least, increased.[5]

Table 1.2. **Supply side components of growth**

Contributions to growth in percentage points

	2002	2003	2004	2005	2006	2007	2008	2009[1]
Gross value added at basic prices	2.3	2.7	4.1	5.9	6.8	5.3	3.0	–4.3
Tradables	1.2	–0.2	3.6	3.1	3.4	1.8	2.4	–3.2
Construction	–0.1	0.1	0.3	–0.1	0.4	0.3	0.0	–0.1
Market services	0.7	2.2	0.3	2.6	2.8	3.3	0.8	–1.0
Non-market services and others	0.5	0.5	–0.2	0.2	0.3	–0.1	–0.2	0.2
GDP	**1.9**	**3.6**	**4.5**	**6.3**	**6.8**	**6.1**	**2.5**	**–4.6**

Note: There are five sectors in tradables: Agriculture, hunting and forestry, fishing, mining and quarrying, manufacturing, electricity, gas and water supply.

1. Average contribution.

Source: Czech Statistical Office; OECD, calculations.

Table 1.3. **Productivity performance of market sectors**

2000-08

	Average annual productivity growth	Average contribution to hourly productivity growth
Agriculture, forestry and fisheries	3.6	0.2
Mining and quarrying	0.5	0.0
Manufacturing	7.3	1.9
Electricity, gas and water supply	5.9	0.3
Construction	0.3	0.0
Wholesale and retail trade	8.1	1.0
Transport, storage and communications	5.2	0.4
Financial intermediation	5.8	0.1
Total activity[1]	***4.2***	***4.1***

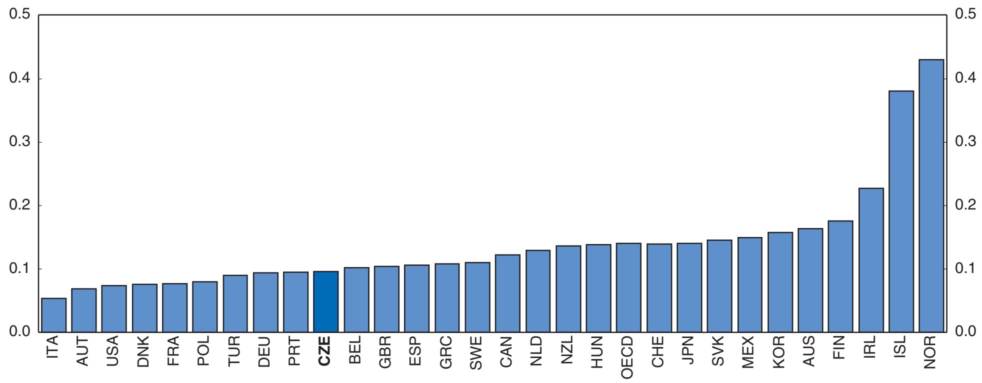
1. Includes non-market sectors not shown in the table.
Source: OECD, *STAN Database*.

The structure of Czech trade, and not merely its scale, may have added to the economy's vulnerability at the end of 2008. In general, the sectors most affected by the recession, like manufacturing and capital goods, account for a larger share of world trade – and of Czech output and exports – than of world output. This is in part due to vertical supply chains, which have changed the relationship between trade and income in recent decades (OECD, 2009a; Cheung and Guichard, 2009). Cheung and Guichard (2009) observe that the largest trade declines in the OECD area were recorded by countries with a relatively large share of vertical trade. The Czech Republic has the fourth-highest share of vertical trade in the OECD – around 48%, as against an OECD average of close to one-third (Miroudot and Ragoussis, 2009). Recent analyses by the CNB show that export activity has recently been significantly correlated with euro area *exports* rather than euro area GDP growth – a finding that would appear in large measure to reflect the large share of vertical trade in total foreign trade (CNB, 2008:7; OECD, 2008a:83-86). Altogether, manufacturing accounts for around 30% of total value added in the business sector, compared to an OECD average of 19%, and the share of goods in total exports is around 85%, as against an OECD average of 75%. It is precisely these sectors of the Czech economy which contracted most severely in early 2009. Manufacturing alone accounted for roughly half the contraction in gross value added in the first half of 2009.

The force with which the trade contraction of 2008-09 hit the economy has prompted concern that the Czech Republic's export profile may be too highly concentrated. In fact, as measured by Herfindahl-Hirschman indexes (HHI) based on both two- and three-digit classifications, export concentration seems to be slightly below the OECD average (Figure 1.4).[6] However, there may still be a challenge here, because a large share of exports, though belonging to different product groups, are based on manufacturing sectors that tend to be particularly cyclically sensitive, like autos, electrical equipment and machinery. These industries account for roughly 12% and 15% of business sector value added and employment, respectively. Thus, while the HHIs suggest that the Czech Republic is unlikely to be especially vulnerable to shocks in individual sectors, a global shock such as that which occurred at the end of 2008 will hit the economy particularly hard.

Two factors served to provide at least some sort of a buffer against the effects of the trade contraction. First, the country's terms of trade rose significantly in late 2008 and early 2009. In an economy as open as that of the Czech Republic, even a modest shift in the

Figure 1.4. **Export concentration of OECD economies**
Three-digit Herfindahl-Hirschman indexes for exports, 2005-07



Note: Indices were calculated as the sum of squares of the shares of each commodity as a proportion of total exports and normalised to the range 0 to 1. Data are SITC Revision 3 product categories at the 3-digit level.
Source: UN Comtrade Database; OECD calculations.

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terms of trade can have a substantial effect on the dynamics of real gross domestic *income* (RGDI).[7] Thus, the fall in RGDI during the two quarters of contraction was only about half as great as the drop in real GDP, though a slight fall in the terms of trade thereafter meant that the income effect of the growth recorded in the spring and summer was also partly offset by terms of trade shifts. Secondly, the exchange rate fell sharply from mid-2008, depreciating by some 23% from July to February 2009. This probably brought palpable, if limited, relief to the tradable sector. The Czech National Bank (CNB) estimates that the export contraction would have been 3-5 percentage points greater in year-on-year terms in the absence of an exchange-rate adjustment. However, the ability of exporters to profit from koruna depreciation was probably limited in the case of those that were "over-hedged".

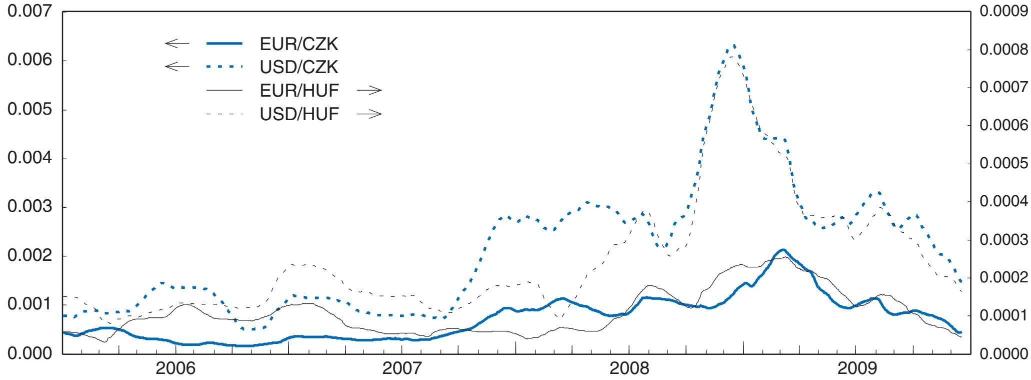
For many firms, the very high volatility of the currency during 2008-09 was itself a problem. After reaching a historic high of 23.0 CZK/EUR in July 2008, the koruna fell to a five-year low of 29.5 CZK/EUR in February 2009 before recovering. Since March 2009, it has more or less returned to its trend rate of real appreciation of around 3-4% *per annum*, thus remaining somewhat below its pre-crisis peak. However, the trend has not been smooth, as volatility remained high throughout most of the year (Figure 1.5). These large swings in exchange rates appear to be more related to global market sentiments than local fundamentals. It is therefore not surprising that representatives of export-oriented businesses, like the Confederation of Industry, strongly favour entry into the euro area to gain protection against revenue fluctuations stemming from exchange-rate movements.

... but quickly hit domestic demand for investment and consumer durables

The trade collapse quickly triggered a contraction in domestic investment, particularly in machinery and equipment. After surging in late 2006 and early 2007, fixed investment more or less stagnated for about a year before beginning to contract sharply in the last quarter of 2008. The contraction reflected weakening external demand, tighter credit conditions, deteriorating corporate profitability and growing uncertainty amid the crisis. Investment continued to fall through the first half of 2009. This slowdown encompassed

Figure 1.5. **Exchange-rate volatility**

Six-month moving standard deviation



Note: Moving standard deviation of the exchange rate over the current and 125 preceding business days.

Source: Datastream.

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both financial and non-financial firms, as well as household spending on durables. It was most evident in falling demand for transport equipment, machinery and other equipment, and in declining investment in buildings, particularly housing, as banks became more cautious in their lending and households in their borrowing. The growth of government investment remained narrowly positive. Private consumption, which was already slowing markedly in 2008, was very subdued in 2009, reflecting low consumer confidence, rising unemployment and a sharp slowdown in disposable income. Although private consumption growth remained weakly positive through the first half, it turned negative in the third quarter, as households responded to the deteriorating labour market situation. Fluctuations in the survey-based indicators of consumer and industrial confidence over the course of 2009 suggested that household and business confidence, though recovering from the lows of early 2009, remained fragile (Figure 1.1).

On the production side, most major market sectors contracted, with the exception of agriculture. As noted above, the greatest impact was on manufacturing, which experienced one of the sharpest output declines and which accounted for most of the drop in value added. Non-manufacturing industry – specifically, energy sectors – also contracted sharply. In services, the recession was slower to take hold and also less severe. Not surprisingly, the sharpest declines were recorded in sectors that were clearly linked to the cycle in the export-oriented industrial sector, like transport (–4.8% year-on-year in the first half of 2009) and trade (–5.4%). Value added in real estate and business services fell by 4.4% over the period, while hospitality (hotels and restaurants) barely dipped before recovering. Construction also held up relatively well, with both gross value added and output roughly flat in year-on-year terms during the first half, following a small decline in the last quarter of 2008. The composition of construction activity changed substantially, however, as building output fell by 8.5% year-on-year and civil engineering, financed chiefly from public funds, rose 21.9%. The slowdown in building construction reflected both the increased conservatism of banks' lending policies and the greater caution of firms and households with respect to their investment decisions.

The labour-market adjustment has been painful

The labour market responded rapidly to the contraction (Figure 1.1). Unemployment actually began rising in the fourth quarter of 2008, but the increase was initially quite gradual. In 2009, however, it jumped sharply, with the first quarter witnessing the largest one-quarter increase in unemployment since the beginning of the 1990s. The second quarter, however, saw a slowdown in the rate of increase of unemployment. At 7.3%, the fourth-quarter unemployment rate was still relatively low compared to most EU members. In general, dismissal patterns reflected the structure of the labour market, with temporary agency workers and those on fixed-term contracts let go first. The labour market response has to be seen in a context of the overheating observed in certain sectors shortly before the crisis. In the automotive and construction sectors, immigration served to fill the gaps created by a tightening labour-market and slowing labour-force growth. The sharpest drop in employment actually came in the second quarter, when employment in industry fell by around 9.3%. Job losses in manufacturing actually exceeded the decline in total employment economy-wide, as employment rose somewhat in services and construction. Average hours worked also fell, declining by 2.0% year-on-year, with full-time dependent employees accounting for the largest reductions. This may reflect a combination of severance costs and the fact that firms that only a short time earlier had faced shortages of skilled labour were reluctant to downsize if they could retain workers through the downturn by putting them onto short-time regimes.

Changes to the Labour Code that entered into force in 2007 may have played an important role here, since it is now possible for firms in certain circumstances to put workers on "partial unemployment" (or reduced working time). This provision was little used prior to the end of 2008, but during the first ten months of 2009, Labour Office approval for the introduction of such arrangements for at least some part of the year was granted to firms employing almost 120 000 workers (roughly 2% of the labour force). Since Labour Offices decide on such applications only if no trade union is present, these data primarily cover smaller firms. There are no comprehensive data on the use of short-time regimes by agreement between employers and trade unions, but such arrangements were agreed in many large companies, suggesting that a substantial part of the workforce was affected (Box 1.2).

As noted above, real wage growth slowed sharply but remained positive overall. In the private sector, year-on-year real wage growth in the first half of 2009 slowed to 0.9%, from 2.8% a year earlier, whereas in the public sector it averaged 2.6%. The latter sector had experienced declining real wages in 2008. Sectoral differences in wage growth reflected to some extent the differential impact of the crisis across sectors, with tradable sectors hit hardest. However, it is not possible to assess the degree of nominal flexibility or rigidity of wages from aggregate data. Aggregate figures published by the Czech Statistical Office show nominal wages stable or rising in all major sectors except mining, but since the newly unemployed were predominantly drawn from among less productive – and thus less well paid – workers, there was a composition effect at work.[8] Even if nominal wages stood still, or fell slightly, sectors with declining employment might well show rising average wages in aggregate. Data on a panel of firms and a pseudo-panel of employees (the match is not perfect) constructed for the Ministry of Labour and Social Affairs allow a comparison of monthly salaries in the enterprise sector in the first half of 2008 and the same period of 2009. They yield an index of 99.0% for the median salary on the pseudo-panel of employees. Moreover, this appears not to take account of the effects of the short-time

Box 1.2. "Partial unemployment" under the Czech Labour Code

Article 209 of the Labour Code allows an enterprise to introduce a reduction in working time and pay workers a compensatory wage well below their normal remuneration levels if it is unable to keep them employed for a full working week owing to a temporary drop in sales or demand. Known as "partial unemployment", this regime can last for up to one year. It can be applied in two ways, depending on the circumstances of the firm:

- If trade unions are active in the enterprise, the arrangement must be agreed with them. Unions and employers agree the level of the compensatory wage that employees will receive for the time not worked but it must be no lower than 60% of the average wage.
- If no trade unions are present, the employer must ask the Labour Office to decide whether there are sufficient grounds to apply partial unemployment. In this instance, employees automatically receive 60% of the average wage for the time not worked.

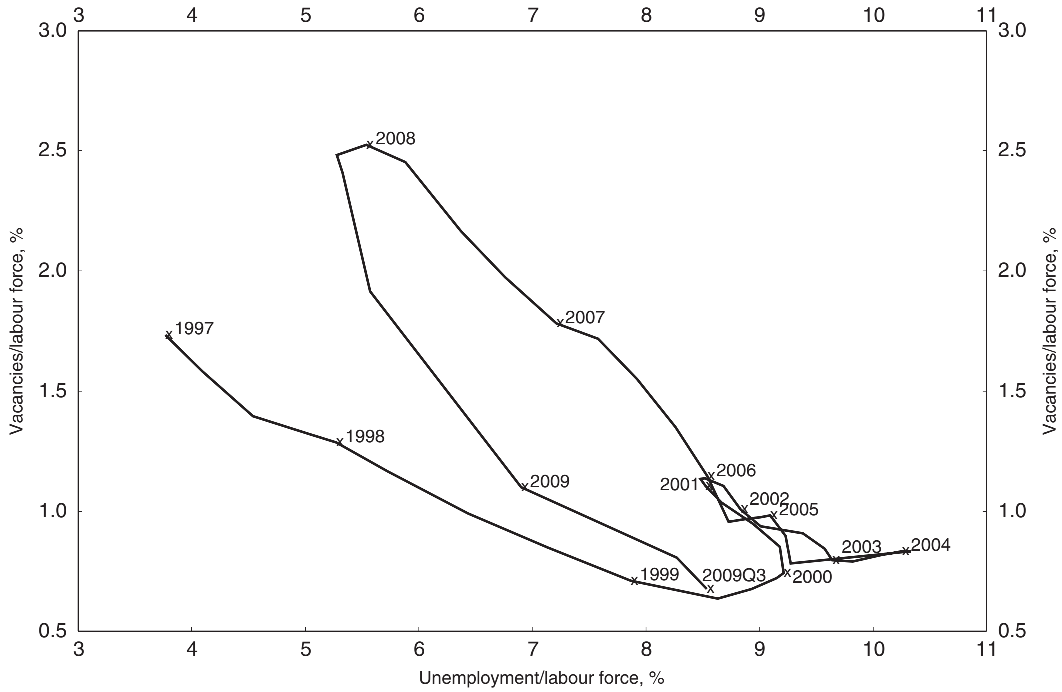
During January-October 2009, Labour Offices approved partial unemployment requests from more than 2 000 small and medium-sized firms. In addition, reductions in the working week were adopted after agreement with the trade unions at such companies as Škoda Auto (with over 24 000 employees), Hyundai, the Jablonex Group (a major glass and jewellery producer), Zetor Tractors, the rubber producer Gumotex Břeclav, the lorry producers Avia and Tatra Kopřivnice, and the auto components manufacturers Brano Group and Bosch Diesel.

Source: Ministry of Labour and Social Affairs.

working regimes described above.[9] Altogether, therefore, it is likely that nominal wages did play a role, albeit a limited one, in the labour-market adjustment. Other evidence reinforces this impression. Over 60% of firms responding to a survey by the Czech Confederation of Industry reported that they had reduced salaries for at least some employees, owing to reduced orders (ERM, 2009). In addition, many large employers did negotiate wage reductions with the unions, often in conjunction with a shift to shorter working time (Dolezelová, 2009).

Some other aspects of the labour-market response were at least modestly encouraging. The number of job applicants entering new jobs began rising again from the beginning of the second quarter. The Beveridge curve, which maps the relationship between unemployment and the vacancy ratio, may also have shifted slightly to the left, implying greater labour-market efficiency (Figure 1.6). It will not be possible to conclude whether a structural improvement has taken place until the employment recovery gets under way and it is possible to observe the vacancy-unemployment relationship across the cycle. However, the steep slope of the relationship for recent quarters, indicating a very rapid drop in the vacancy ratio relative to the rise in unemployment, suggests that the market has responded to the downturn relatively efficiently compared with the much flatter slope in the wake of the 1997 crisis. Finally, the participation rate fell very little and very briefly before ticking back up as the rate of job-destruction slowed (Figure 1.1). Initially at least, the rise in unemployment did not trigger a surge in withdrawals from the labour force via channels such as disability and early retirement (Figure 1.7). Owing to recent reforms, the sickness insurance scheme can no longer be easily used to mask *de facto* temporary unemployment (see Chapter 2), and entry into disability schemes fell. The pick-up in transitions into retirement seen in Figure 1.7 seems to have been too modest to attribute to a wave of early retirements in response to the deteriorating labour market. Cohort effects probably account

Figure 1.6. **The Beveridge curve, 1997-2009**



Note: Dates indicate the position of the first quarter of the year. Unemployment is registered. Data are seasonally adjusted.
Source: Ministry of Labour and Social Affairs via OECD, *Main Economic Indicators Database*.

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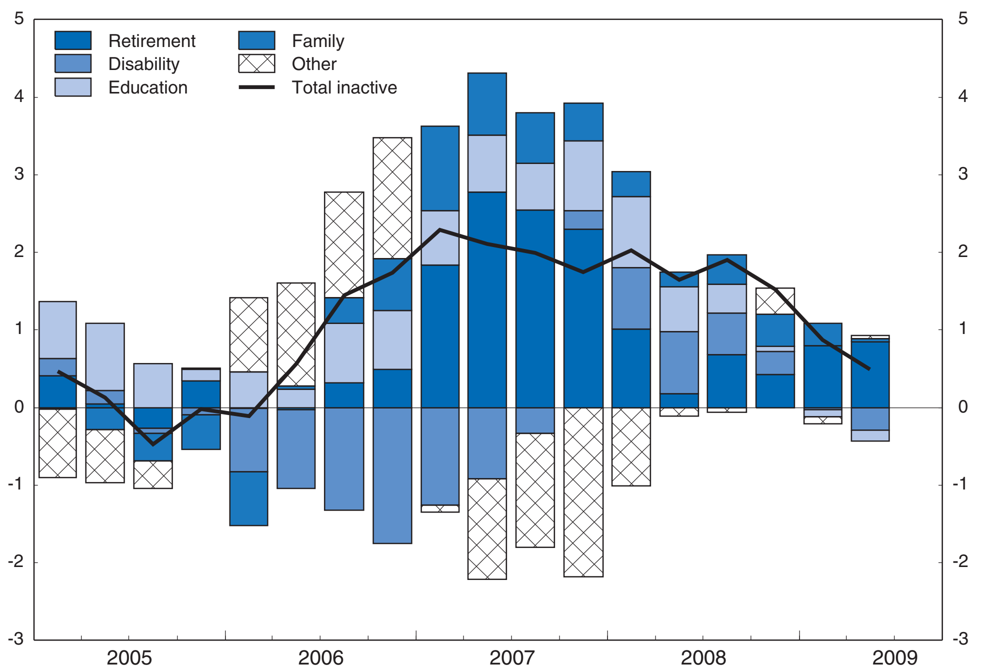
Figure 1.7. **Contributions to growth in the number of inactive working-age persons**

Contributions to annual growth of non-participants in labour force, %



Source: Ministry of Labour and Social Affairs; OECD calculations.

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for the increase in the number of new retirees in 2009.[10] Moreover, early retirement has recently become a less attractive option (see below), not least as a result of changes making it easier for "ordinary" retirees to supplement their pension incomes with work, something those who take early retirement are not allowed to do.

Nevertheless, the real challenges may well lie ahead. The experience of past recessions in OECD members suggests that, as unemployment rises and a growing proportion of the newly unemployed exhaust their entitlement to unemployment benefit, there will be mounting pressure to ease labour-market exit into early retirement, disability or other channels. Proposals to cut unemployment by reducing labour supply in this way should be strongly resisted, particularly in respect of the system of disability pensions, which is now being reformed (see Chapter 2). Individuals who withdraw from the workforce via long sick spells or disability tend to be very difficult to reactivate (OECD, 2009f).

It is still too early to assess the social impact of the recession, as data on such issues as income inequality and poverty will not be available for some time, and the consequences of the downturn for the labour market are still unfolding. However, there is little doubt that many households have been hard hit. The growth of real gross disposable income slowed from 3.8% in the final quarter of 2008 to roughly 1.3% year-on-year in the second quarter of 2009.[11] Real wages and salaries virtually stagnated, while property income and the mixed income of the self-employed fell. The only components of gross disposable income still rising in the second quarter were social benefit income, which rose at an annualised rate of 10%, and the contribution to disposable income resulting from the decline in tax payments and social security contributions. The growth of real household consumption expenditure fell from annualised rates of more than 6% in 2007 and 3-4% in 2008 to just about 1.6% in the first half of 2009.

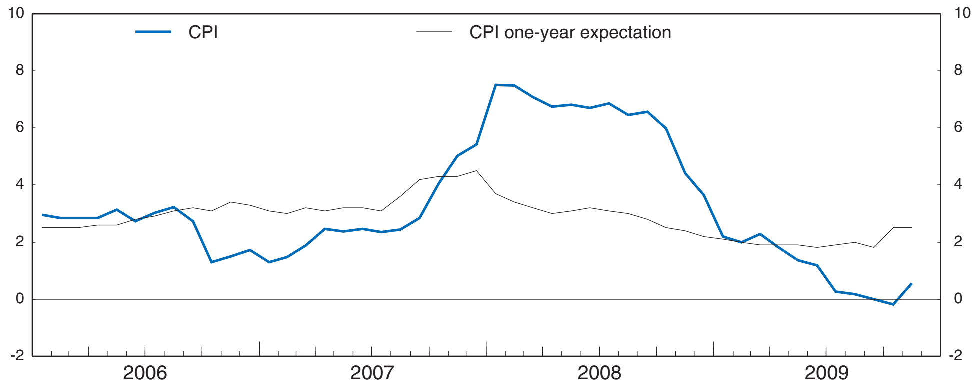
It is likely that, as unemployment continues to rise, the growth of real incomes will turn negative for a period before it finally starts to recover. This, in turn, could lead to further increases in household defaults on mortgages and other loans, but this risk should not be exaggerated. Overall, Czech households are not especially heavily indebted – domestic credit to households amounted to just about 20% of GDP prior to the slowdown, similar to the levels found in Poland and Hungary and well below those prevailing in countries like Latvia and Estonia, and virtually all of this debt was in local currency. The ratio of loan repayments to net money income was 4.6% at the end of 2008, roughly unchanged on a year earlier. However, the loan-to-value ratios of many mortgages issued in the later stages of the boom were in excess of 80%, suggesting a potential negative equity problem for some households. Moreover, the CNB estimates that around 40-60% of households with debt would find themselves in deficit if their nominal incomes fell by over 10%. It is this that underlies the expectation of a significant rise in household default rates over the coming two years (see below).

Inflation has fallen to historic lows

Following a temporary spike in last quarter of 2007, which resulted from policy driven measures such as increases in regulated prices and in both excise duties and the lower rate of VAT, inflation remained high during most of 2008, reaching 6.3% for the year. However, this was generally seen as a temporary aberration, caused by commodity-price rises and one-off policy changes, since the country has a long tradition of low inflation, and inflation expectations seem to have been little affected by the surge in price growth (Figure 1.8). CPI inflation began to fall as the economy slowed in late 2008 and dropped off sharply during the first months of 2009. By the fourth quarter, it had fallen to zero. The only major segment of the CPI still recording prices growth in the latter months of the year was regulated prices, namely rents and electricity. Fuel and food prices were falling, as was the measure of adjusted inflation that excludes those commodities. The expectation of further increases in regulated prices in 2010, as well as a rise in VAT rates, contributed to an uptick in inflationary expectations in late 2009.

Figure 1.8. **Inflation developments and inflation expectations**

Year-on-year



Note: Inflation expectations are those of financial market analysts as measured by a statistical survey of the Czech National Bank.

Source: Czech National Bank.

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The banking system has weathered the crisis fairly well

The financial system was the second major transmission channel through which the global crisis affected the Czech Republic. Financial turbulence abroad affected the country mainly through its impact on investor confidence – risk premia rose and foreign direct investment (FDI) inflows, which have played such an important role in fuelling growth in the past (OECD, 2008a:83-89), fell sharply. Stock market capitalisation fell by more than half between August 2008 and February 2009, before beginning to recover. The post-Lehman rise in risk premia for the Czech Republic was short-lived but there was a further very sharp spike at the start of 2009, amid a wave of speculation about the external vulnerabilities of various central and east European economies. This pressure largely abated as investors took stock of differences among the region's economies and recognised that the Czech economy was not exposed to many of the risks identified elsewhere. In any case, developments on financial markets, though by no means irrelevant, matter less in the Czech Republic than in most OECD countries, because the financial system is very bank-centred. The stock market is relatively small, with few issues actively traded, and firms rely overwhelmingly on banks rather than stock or bond markets for financing. It is thus the health of the banking system that is of primary concern.

The banking sector appears to have weathered the downturn in reasonably good shape (Box 1.3), though bank portfolios are yet to feel the full impact of the financial consequences of the contraction. The share of non-performing loans (NPLs), in particular, is likely to continue to grow through the early stages of the recovery. Data for the first three quarters of 2009 show a sharp slowdown in credit growth and a rise in NPLs (Figure 1.1), especially from corporates. Credit conditions grew markedly tighter, particularly for households and

Box 1.3. **The Czech banking sector and the crisis**

The banking sector has not always been seen as a source of strength for the economy. During the 1990s, Czech banks were locally owned, and a series of banking crises triggered by massive loan defaults required expensive state rescue operations. By the late 2000s, however, more than 85% of the sector was foreign-owned. The early years of the decade saw a marked improvement in prudential regulation, supervision and enforcement (OECD, 2003), as well as the gradual build up of provisions and reserves (Bárta and Singer, 2005).

The comparatively good health of the sector during the current downturn appears to reflect several factors. First, macroeconomic management has generally been prudent, with a well established inflation-targeting regime. Inflation has generally remained low, except in 2008, when tax changes and emerging capacity constraints combined to push it up. This meant that interest-rate spreads were low and there were thus no incentives to borrow in foreign currencies. Furthermore, Czech banks focus mainly on the domestic market. The share of foreign currency-denominated debt in the total debt of the non-financial private sector prior to the crisis was the second-lowest in the central and east European (CEE) region. Forex loans to households were all but unknown and they accounted for about 20% of borrowing by non-financial companies, also one of the lowest rates in the region.

Secondly, Czech banks generally pursued conservative strategies in the years before the crisis. In part, this reflected the lessons of the previous decade's crises. It also reflected the fact that Czech banks could make fairly healthy profits in "normal" banking business at home; they were not driven to take greater and greater risks in the search for yields. Rates of real domestic credit growth, though rapid, were lower than in many countries in the region. Given that faster lending growth tends to be associated, *ceteris paribus*, with a deterioration in portfolio quality, this was probably a good thing, particularly in view of recent evidence that weak banks in CEE expanded lending faster than strong ones during 2000-07 (Tamirisa and Igan, 2008). The country experienced no major domestic financial bubbles, and banks did not invest heavily in risky assets abroad. As of mid-2009, the CNB estimated the share of "toxic" assets in bank portfolios at less than 1%. This may in part reflect the sector's ownership structure. Most of the country's banks, including all the major ones, are foreign-owned, and in some instances their foreign parents were exposed to toxic assets on a large scale but the Czech subsidiaries were not. Nor were Czech banks dependent on foreign financing. Their net external investment position was and remains positive, a unique situation in the CEE region. Domestic lending is financed by the domestic deposit base. Deposit-loan ratios were around 120% prior to the crisis and remained at roughly that level through the first half of 2009.

So far, foreign ownership has not had the negative consequences that many feared when the crisis hit. Concerns that foreign owners of CEE banks would shore up their positions at home at the expense of their CEE subsidiaries have so far proved exaggerated. Indeed, Zumer *et al.* (2009) note that net foreign liabilities shrank most in the CEE banking sectors with the lowest share of foreign ownership. Parent banks with subsidiaries in the region generally remained committed to maintaining them, whereas many domestically owned CEE banks had difficulties obtaining or renewing syndicated loans abroad (see also ECB, 2009).

The CNB believes the new model of prudential supervision has helped it to manage the situation during the crisis, although no systematic evaluation has been done, owing to its relatively recent introduction. Since April 2006, supervision of all segments of the financial system has been vested with the CNB. Securities markets, small co-operative banks and insurers had previously been regulated separately. Since January 2008, the organisation of prudential supervision within the bank has been functional rather than sectoral. The move to integrated supervision was prompted by an awareness of the interdependence of different segments of the financial system. It was also intended to strengthen the links between micro-level supervision and lender-of-last-resort activities, on the one hand, and macroprudential concerns on the other. It is difficult to assess the weight of this factor in assuring the overall stability of the system, since many of the factors identified above pre-date it.

Box 1.3. **The Czech banking sector and the crisis** *(cont.)*

Finally, it is possible that the Czech preference for "relationship banking" has worked well for banks in the downturn, though it is less clear whether it has been as beneficial to firms. Czech firms rely heavily on relationship banking: in 2008, an estimated 85% of firms relied on a single lender, with a further 12% having just two lending relationships. The incidence of reliance on single lenders is thus about twice as high as in Germany, where relationship banking has long been recognised as the dominant model. In a recent study of Czech banks, Geršl and Jakubik (2009) find that the level of credit risk at bank level falls as the incidence in firms applying single relationship banking in its portfolio rises. Information asymmetries are reduced and monitoring costs are lower. Moreover, it appears that more creditworthy borrowers tend to concentrate their borrowing with a single dominant relationship lender, while less creditworthy firms and firms in cyclical industries tend to borrow from several banks.

borrowers in struggling sectors like construction. In the case of households, this tightening was reflected in rising interest rates on new loans, but the tightening of credit to the commercial sector appears to have taken the form of tougher screening of potential borrowers. While average interest rates on new loans to non-financial corporations actually fell somewhat, a majority of respondent firms in business surveys reported increasing difficulty with access to credit in early 2009, reflecting tougher non-interest conditions. The fall in interest rates on new loans was less than half the magnitude of the drop in policy rates administered by the CNB and it lagged the path of policy rates. In effect, banks increased risk premia rather than passing on policy-rate cuts to real-sector borrowers. This helped them to recapitalise ahead of the anticipated growth of NPLs: the sector's capital adequacy ratio, already above 12% before the crisis hit, rose by 1.4 percentage points in the first nine months of 2009. The ratio of highly liquid assets to total assets also rose, reducing the danger that banks would face sudden liquidity problems.[12]

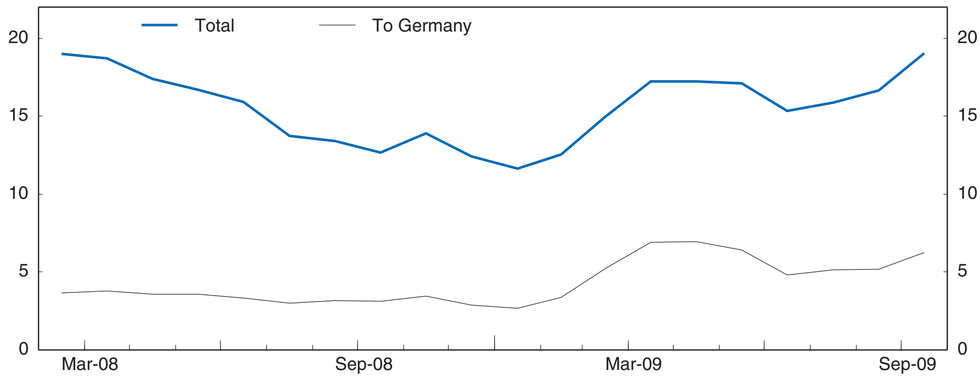
So far, the banking sector has not encountered significant liquidity problems, and no direct support has been required from the authorities. The CNB believes that the sector should remain stable and estimates its recapitalisation needs at well under 1% of GDP even in the most extreme scenarios. In July 2009, the CNB stress tested the banking system under its baseline forecast scenario[13] and under a protracted recession scenario.[14] Under the latter, the CNB results saw the corporate default rate peaking at about 15%, up from around 6% in mid-2009. Under the baseline scenario, the peak fell somewhat later and was also slightly lower (under 14%). The differences between scenarios were in fact far greater for households: a 5½-6% default rate in 2009-10 under the baseline scenario, as against a rate of around 10% in the protracted recession case. However, the CNB found that the banks were able to maintain capital adequacy comfortably in both cases.

A hesitant recovery began in the second quarter, driven largely by policy stimulus abroad

Real GDP edged up by 0.3% in the second quarter of 2009 and a further 0.8% in the third, driven by a slight pick-up in exports against a backdrop of falling imports and continued, albeit weak, private consumption growth. The export recovery seems to have owed much to the adoption of car-scrapping schemes and other measures to support the automobile sector in major export markets. The automobile industry accounted for around 16% of exports in 2007 and was hit hard from the beginning of the global slowdown in mid-2008. Exports of passenger vehicles, which were down more than 30% year-on-year in the first months of 2009, rose rapidly in the spring, with the fastest recoveries recorded in exports to markets with relatively generous scrapping schemes, like Germany and France. Indeed, in the second quarter, passenger car exports to Germany were up almost 80% year-on-year in value terms (Figure 1.9). Where scrapping schemes took effect later, the export boost was also delayed, and the recovery in car exports was weaker or non-existent in markets where such measures did not exist or were comparatively limited. Altogether, passenger car exports were down slightly in value terms over the first three quarters but up 7.1% in terms of the number of units sold. Trade data for the automotive sector as a whole also show evidence of recovery through the year, suggesting that such schemes provided a boost to auto parts manufacturers as well. Thus, while total exports of machinery and transport equipment were down by 18.2% in January-October, the biggest drops were in general industrial machinery and equipment and in office machines. Exports of all vehicles and "other transport equipment", by contrast, were up 3.2%.

Figure 1.9. **Monthly passenger car exports**

CZK bn, 3mma



Note: Data refer to SITC Revision 3, Code 7812, motor vehicles for the transport of persons.

Source: Czech Statistical Office.

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The Czech Republic was well positioned to benefit from scrappage schemes, since it produces a range of smaller, less expensive vehicles. This seems to have been a major factor behind the boost in sales to Germany, as many consumers taking advantage of the car-scrapping subsidies appear to have opted for less expensive models. Where the subsidies offered are set in absolute terms, they provide a greater incentive for buyers of cheaper cars. The first half of 2009 therefore witnessed a significant change in the structure of car exports: while total passenger vehicle exports were still falling as of May, the Czech Automotive Industry Association reported that exports of small cars were up 37%. Such support measures were temporary, however, raising the danger of a second slump for the industry as they were withdrawn. Indeed, the impulse given by such schemes often seems to abate even before they formally expire: data on exports to countries like Germany, France and Austria show a sharp pick-up in exports as support measures are introduced followed by a slowdown later on. However, there was no indication that export sales were falling back to the very low levels of late 2008 and early 2009, suggesting perhaps that the nascent global trade recovery was beginning to take hold and that Czech exporters were gaining market share.

As noted above, economic fundamentals were fairly strong just prior to the crisis. This raises the question of why the country was hit so hard and whether the downturn exposed sources of vulnerability that were not fully appreciated beforehand. The obvious explanation for the severity of the downturn is the one provided above – *viz*, the very high degree of dependence on foreign trade. It is unlikely that any conceivable domestic development or policy response could have offset such a sudden and extreme collapse in external demand. A comparison between the Czech Republic and Poland – one of two OECD economies to avoid recession in 2008-09 – suggests that this explanation is indeed valid but also casts light on other factors that affected relative performance (Box 1.4).

Box 1.4. **Polish growth and the Czech recession compared**

Poland entered the crisis in a position that was in many ways similar to that of the Czech Republic. Both countries had experienced strong growth for several years but were slowing from a cyclical peak. External and fiscal balances, though negative, did not look dangerously large, though fiscal policy does in hindsight appear to have been more pro-cyclical in both countries than was recognised during the upswing. Polish banks were also generally conservative in their practices and there was no financial or housing bubble. Like their Czech counterparts, the Polish authorities responded to the global shock with a combination of fiscal and monetary easing, while allowing the currency to weaken against the euro. In the Polish case, however, both the fiscal stimulus and the exchange-rate adjustment were substantially larger. Finally, both countries benefited from car-scrapping subsidies in major export markets.

Nevertheless, growth outcomes in the two economies have been very different. While the onset of the crisis brought a sharp slowdown in Poland, the economy continued to grow as its neighbours contracted. The magnitude of the trade shock does indeed appear to constitute a major difference between the Czech and Polish situations. The Polish economy is less exposed to trade, on both the import and export sides. Poland's total trade turnover was just under 84% of GDP in 2008, as against 149% for the Czech Republic, and its export-to-GDP ratio, at 39% in 2008, was just over half that of the Czech Republic. The fall-off in export demand thus had less impact on growth. At the same time, the złoty fell further, and recovered less, than the koruna. Between late July 2008 and mid-February 2009, the złoty lost roughly 35% of its value against the euro. It remained over 20% below its pre-crisis peak in the third quarter of the year. It is unclear to just what extent the złoty's fall mitigated the export contraction but it does seem to have contributed to significant import substitution (OECD, 2010).

Trade *composition* also seems to have played a role. Polish exports are less concentrated in investment goods and more in consumer goods than Czech exports – Poland's share of vertical trade is estimated at only about 28% – and the global trade contraction hit investment goods particularly hard. Poland's non-tradable sector, moreover, benefited from a number of significant stimuli, including infrastructure investment linked to EU transfers and the 2012 European football championship. A spike in residential investment, supported by a programme of subsidised mortgage interest rates for low-income households, also helped limit the fall in gross fixed investment. The lower share of imports in consumption may also have served to make Poland's fiscal stimulus more effective. Government spending multipliers are negatively correlated with openness, and the OECD estimate of the multiplier for Poland is indeed about 2.5 times that for the Czech Republic. Differences in the structure of consumption may also play a role here, albeit a modest one. Housing apart, Polish households devote a far larger share of consumption expenditure to basic necessities, which tend to have low income elasticities, than do their Czech counterparts. By contrast, Poles spend significantly less on recreation, culture, hospitality and catering, for which elasticities are relatively high. In short, Polish consumption is likely to be less cyclically responsive.

Box 1.4. **Polish growth and the Czech recession compared** *(cont.)*

Finally, although external financial turbulence did affect Poland, the country was relatively insulated from direct financial contagion. The share of forex-denominated loans in non-financial private sector debt, though higher than in the Czech Republic, was low by the standards of the region, and the burden of such debt was comparatively small, since Polish firms and households were less leveraged overall than their regional peers. The ratio of domestic credit to GDP in Poland was the lowest in the region and far lower than in the Baltic states or Germany, so the tightening of global credit conditions probably had less of an impact.

The policy response

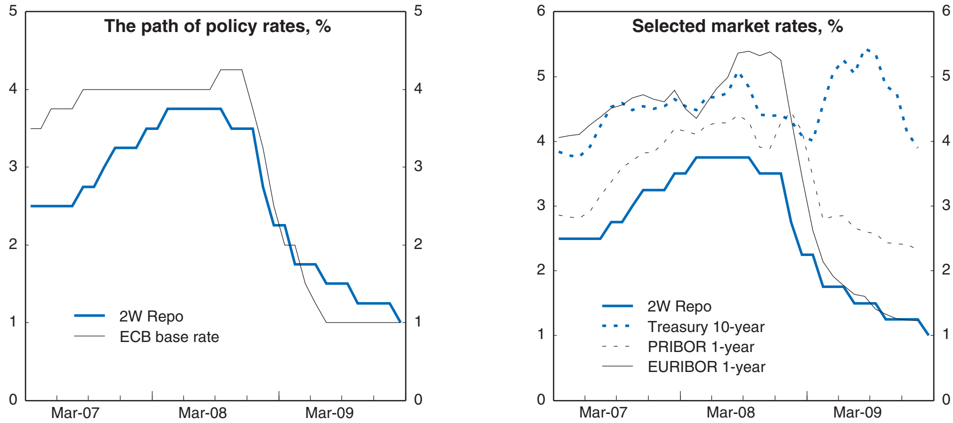
From the onset of the crisis, it was clear that the principal determinants of its impact on Czech growth were beyond the control of policymakers. The country entered the recession as a result of a sudden sharp drop in external demand, and its prospects for renewed growth depended principally on the recovery in export markets. Moreover, the government expenditure multiplier was estimated to be the lowest in the OECD area, largely owing to the high degree of openness of the economy.[15] This meant that the countercyclical impact of automatic stabilisers or discretionary fiscal measures was likely to be limited. Discretionary action was therefore aimed largely at cushioning the impact of the trade collapse on households and at helping firms to survive and to preserve employment until recovery took hold. Both fiscal and monetary policies were employed to these ends.

The central bank began easing in August 2008

Monetary easing actually began before the size of the downturn became fully apparent. With the inflation risks on the downside, the koruna at historically high levels, and the outlook abroad increasingly negative, the CNB first cut interest rates in August 2008. As the crisis unfolded and its impact on the domestic economy began to be felt, the bank continued to relax its stance in stages through December 2009 in an effort to contain the recession. There were seven cuts in the key policy rates in sixteen months, the biggest a 75-basis point cut in November 2008 (Figure 1.10). This sequence of cuts brought the two-week repo rate to a historic low of 1.0% in December 2009, down 275 basis points.

Prior to the financial crisis, the domestic financial sector was characterised by excess liquidity, heavy reliance on domestic deposits and a very small volume of foreign currency lending. However, when interbank markets around the world froze in the autumn of 2008 the Czech market was no exception. Market activity in October was very limited and confined largely to overnight operations. The CNB responded with a new liquidity-providing facility for banks (for either two weeks or three months), with the option of using government bonds as collateral in such operations. However, this facility was hardly used by any of the banks after the turbulent fourth quarter. Deposit insurance was also increased, but the authorities provided no universal guarantees or assurances. Finally, the CNB stepped up information-gathering by supervisors in an effort to spot emerging problems early; this extended to a requirement for more frequent reporting from the banks, including daily monitoring of some indicators.

Figure 1.10. **Interest rate developments**



Source: Czech National Bank; European Central Bank.

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The scope for further easing has to be considered in the context of the market's reaction to previous cuts and the effectiveness of the interest-rate channel. As noted above, the banks were slow to translate the reductions in policy rates into lower lending rates, and long-term rates tended to respond less to changes in policy rates than to the fiscal situation, which was deteriorating rapidly. By the end of 2009, there was growing scepticism about the ability of the CNB to move the yield curve much with further interest-rate cuts, and its two-week repo rate had converged with the ECB rate (Figure 1.10). Regulated price increases and tax changes in early 2010 will add some upward pressure on prices, but this will occur in a very low-inflation environment. It is likely that the new inflation target will be undershot for most of the year. The inflation outlook for the more distant future is closely connected to growth prospects. At the end of 2009, the principal risk here was that a combination of weak consumption growth and the phasing out of some stimulus measures abroad could temporarily weaken the nascent recovery. However, the space for further cuts in interest rates – or at least for keeping current low rates in place – will depend not only on growth and inflation data and exchange-rate movements, but also on progress with respect to fiscal consolidation.

A new, lower inflation target came into force in January 2010: the CNB is now targeting 2% annual CPI growth with a ±1 percentage point tolerance band. The previous target, in place since 2006, was 3% with the same tolerance band. The shift to a lower target was announced in March 2007, and due to time response lags (and given the 12- to 18-month monetary policy horizon), it has in fact been taken into account in CNB decision-making during the past year. The rationale for the change in the target is that many transition-related factors that previously contributed to higher inflation have receded. Moreover, the lower target should ensure that the Czech Republic can meet the price stability and inflation criteria for joining the euro area. The CNB expects that inflation will remain low but still positive in early 2010 but will then start increasing and will be just above the 2% inflation target at the end of the year.

Fiscal stimulus quickly gave way to consolidation

Late in 2008, the government adopted a range of measures to address the unfolding crisis as part of the 2009 budget. As it was based on an optimistic June 2008 forecast, the budget for 2009 was in any case thought to be rather expansionary. Some of the "anti-crisis" measures were already on the government's agenda anyway, such as reductions in both employer and employee social security contributions (SSCs) and increased infrastructure spending. Others were new and aimed at immediate relief for businesses. These included the abolition of advance payment of taxes and SSCs for small businesses (up to five employees), accelerated VAT refunds and an increase in funding for state guarantees for business credit through the Czech Export Bank and the Czech-Moravian Guarantee and Development Bank. A new National Economic Council of the Government (NERV), an *ad hoc* group of "wise men", was charged with preparing proposals for additional anti-crisis measures. In February 2009, the government unveiled its National Anti-crisis Plan, which likewise consisted of a mix of initiatives that were already on the agenda and new measures, including a temporary reduction in employers' SSCs, increases in expenditure on research and development (R&D) and the introduction for a limited period of faster depreciation for some investment items.

The authorities recognised that, in such an open economy, using fiscal policy to stimulate aggregate demand would risk fuelling import growth rather than demand for domestically produced goods and services. Stimulus measures were therefore aimed largely at the supply side. There were some exceptions to this rule, many of them added when the package was under consideration by parliament. Nevertheless, the overall emphasis remained on trying to limit employment losses by reducing non-wage labour costs and on trying to mitigate the investment contraction and support exports. Few of the measures were sector-specific in their targeting: most of the main measures affected all enterprises, apart from those focused on small firms or exporters. Support to the construction sector, in terms of infrastructure spending and the "PANEL" subsidy programme for the renovation of pre-fabricated apartment blocks was substantial, but the great bulk of this spending was already planned anyway, as was the increase in spending targeted at the agricultural sector. These measures were not initiated in response to the crisis, and their inclusion in the anti-crisis plan was thus a matter of presentation. A scrapping subsidy aimed at the auto industry was approved by parliament, but the government decided not to implement it. Czech automotive producers were in any case benefiting from scrapping schemes in neighbouring countries.

In terms of labour-market policies, the government tried to use the crisis as an opportunity to promote rapid re-activation and human capital development, using EU structural funds. Newly unemployed workers who accept training are offered higher replacement rates for unemployment benefit, and several new programmes have been introduced to encourage training and skills upgrading for those facing difficulties on the labour market. The "Restart" programme offers training and search assistance to employees facing redundancy, while two other programmes – "Training is a Chance" and "Train Yourself!" – allow employers outside Prague to benefit from public subsidies if they provide training to workers on short-time regimes. The programmes are broadly similar, but "Train Yourself!" is administered by the Ministry of Social and Labour Affairs and the Public Employment Service and emphasises general education. It targets workers who have accepted temporary lay-offs. "Training is a Chance", which is administered by the Ministry of Labour and Social Affairs and implemented by employers, is aimed at firms that have not introduced short-time working and prioritises projects involving a high proportion of employees under 25 or over 50 years of age, the two groups deemed to be most vulnerable in the downturn. These programmes cover the costs of education activities, a share of wage costs and other direct costs for successful applicant enterprises. Both measures are temporary. The evaluation of applications does not involve any assessment of the enterprises' viability or commitments by the enterprise to keep the workers involved employed for some set period after the training is completed. Thus, although the programmes are intended to slow the rate of job destruction in the short term and to help enterprises trying to preserve jobs during the worst of the downturn, they are aimed primarily at people rather than jobs. Altogether, the government expects to spend CZK 7 bn on the two training programmes, just under a half on "Training is a Chance". It is estimated that around 200 000 workers will be involved in one or the other programme in 2009-10.

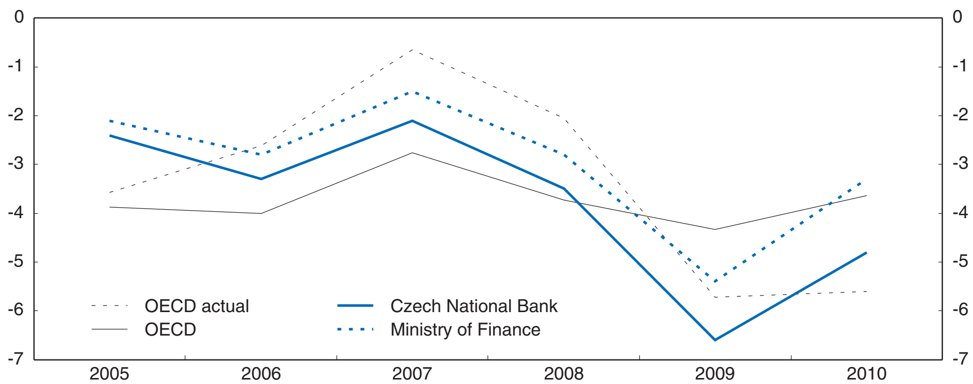
Although they are modest in scale, the character of these programmes is certainly commendable, not least because, as previous *Surveys* noted, there is a need to promote lifelong learning in the Czech Republic.[16] The country ranked 25th in the OECD in 2007 in terms of participation rates in full- or part-time education among those over 40 years old, and it was below average even among 20-39 year-olds. This is particularly a problem given the relatively low attainment rates in tertiary education among middle and older age groups. While a great deal clearly depends on the quality of the training provided, which cannot yet be evaluated, the new programmes could pay longer-term dividends, particularly in light of evidence suggesting that older Czechs' propensity to enter further (formal or non-formal) education is strongly and positively related to both educational attainment and past participation in further education. While some of this relationship reflects self-selection, entry into continuing education programmes does seem to increase the appetite for more (Rabušic, 2007; and Rabušicová and Rabušic, 2006).

Altogether, the fiscal stimulus measures adopted in late 2008 and early 2009 amounted to around 2.2% of 2008 GDP over 2009 and 2010, with most taking effect from mid-2009. There was little scope for any larger stimulus, given that the budget was in deficit even during the boom years before the crisis and the operation of the automatic stabilisers was expected to increase it considerably. In fact, the deterioration in the budget balance was far worse than anticipated, largely as a result of surprises on the revenue side. In the first-quarter, fiscal revenues fell almost 11% overall, driven by a 16% drop in personal and corporate income tax (PIT and CIT) revenues, a 14.5% decline in social security contributions (SSCs) and a 9.5% fall in revenues from indirect taxes. The unexpectedly sharp revenue drop reflected a number of factors, including changes in tax legislation (see Chapter 2), as well as the relaxation of advance payment requirements for small firms. However, it may also be the case that the Czech tax base is highly cyclically sensitive. The Czech Republic appears close to the average on OECD estimates of the cyclical elasticities of various taxes (Girouard and André, 2005), but its overall tax structure is more reliant than most on taxes with relatively high elasticities, such as the CIT. In principle, of course, a cyclically sensitive tax base could be an advantage, as it would act as an automatic stabiliser. However, this stabilising function requires the authorities to save surplus revenues in the upswings in order to offset shortfalls during downturns, something that failed to happen during the years of strong growth that preceded the crisis.

As the Ministry of Finance (2009) observes, it appears in hindsight that the earlier stimulus measures may have been designed without a full appreciation of the extent to which the operation of the automatic stabilisers would affect revenue and expenditure. Moreover, it appears that fiscal policy in the years of strong growth that preceded the crisis may have been looser than was realised. During 2000-06, the Czech Republic was one of only two OECD members with government revenues growing by more than 5% *per annum*. This revenue buoyancy rapidly fed through into higher spending: the country experienced the third-fastest growth of real per capita government spending in the OECD during this period. The expenditure ceilings set under the medium-term framework in the years prior to 2008 reflected the expectation that this trend would continue (MFCR, 2009). During the period of strong growth in 2005-07, the reduction in the structural deficit was modest. At the peak of the cycle in 2007, the general government balance was still in deficit (0.7% of GDP), while the structural deficit stood somewhere between 1.5 and 3% of GDP, depending on the method of calculation used (Figure 1.11). The failure to take full advantage of such a run of good years to pursue fiscal consolidation raises questions about the framework for budgetary policy, particularly about the procedures for setting – and adhering to – expenditure frameworks and the identification and treatment of windfall revenues. Given that the cyclical contribution to revenue growth was probably larger than previously thought, attention needs to be paid to structural indicators as well, in order to avoid unintentionally pro-cyclical policy, especially during the recovery now getting under way.

Figure 1.11. **Actual and cyclically adjusted general government balances**

% of potential GDP



Note: OECD unadjusted data are used for the actual balance as % of GDP. Projections for 2009 and 2010. Balances are revenue minus expenditure.

Source: Czech National Bank; Ministry of Finance; OECD, *Analytical Database*.

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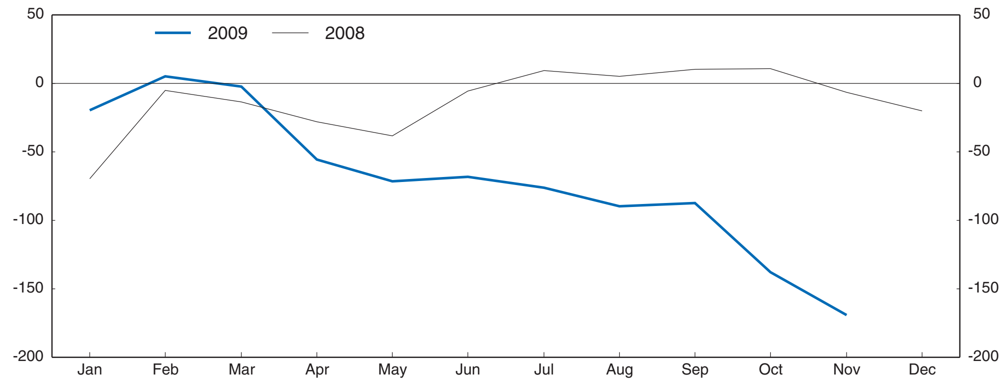
As the budget balance continued to deteriorate over the course of the year (Figure 1.12), the Ministry of Finance raised the official deficit forecast for 2009 to 6.6%, 2 percentage points higher than in the spring. The ministry projected that, in the absence of a change in fiscal policy, the general government deficit would exceed 7% of GDP in 2010. The focus of policy thus shifted rapidly from stimulus to consolidation. Prior to presenting its draft 2010 budget to parliament, the government secured adoption of a package of fiscal consolidation measures that was supported by both the labour unions and employers' representatives. The revenue-raising measures in the package were of indefinite duration but the spending cuts were limited to 2010 (Table 1.4), because the government, as an interim cabinet, had no mandate beyond the coming elections. The consolidation package

Figure 1.12. **Cumulative fiscal balances, 2008 and 2009**

Central budget, CZK bn



Note: Balance is revenue minus expenditure.

Source: Ministry of Finance, *Government Financial Statistics*.

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Table 1.4. **Fiscal consolidation package for 2010**

Measures for 2010	Estimated budgetary impact (2010) in CZK bn		
	Revenue	Expenditure	Difference
Raising the ceiling on income subject to social security contributions, postponing cut in employers' contributions and cancellation of reduction in employers' contributions	32.6		**32.6**
Increase in basic and reduced VAT rates (1 p.p. each)	17.8		**17.8**
Increase in excise taxes	11.1		**11.1**
Doubling of real estate tax rates (except for agricultural land)	2.8		**2.8**
Income taxes (taxing MPs and other constitutional officials)	1.5		
Temporary decrease of sickness benefits		–4.4	**4.4**
Maintaining employers' 50% refund for sickness benefit (connected to postponement of contributions decrease)		2.2	**–2.2**
Decrease in public sector pay (elimination of unfilled positions)		–2.0	**2.0**
Pensions non-increase (opposed to original budget draft)		–6.9	**6.9**
Total	**65.8**	**–11.1**	**76.9**
As a % of projected 2009 GDP			**2.0**

Source: Ministry of Finance.

aimed to reduce the general government deficit by around two percentage points of GDP. It included cuts in government wage expenditure and social benefits, and increases in value-added tax (VAT) rates. The package was altered somewhat in parliament during the final stages of work on the 2010 budget, as parliamentarians voted to reverse around CZK 12 bn in cuts in public-sector wages, agriculture spending and social expenditure. The government, which strongly opposed these late amendments, undertook to find savings elsewhere in order to hold the deficit to planned levels. Since such cuts must be made in areas that are within the competence of the government and require no legislative action, they are to target ministries' operational expenditures.

On balance, the decision to withdraw from fiscal stimulus relatively early is to be welcomed. Given the low government spending multiplier, the impact of stimulus measures was always likely to be modest. While this will be a short-term drag on domestic demand in general and consumer spending in particular, the domestic fiscal adjustment is unlikely to be decisive with respect to the sustainability of the recovery. In any case, large inflows of EU structural funds over the coming years should provide considerable stimulus. Inflows of structural and cohesion funds reached 1.2% of GDP in 2009, and the allocation available over 2007-13 (excluding farming subsidies) is € 26.7 billion. This amounts to an estimated 2% of GDP per year when assuming full absorption and taking account of the n+2 rule that allows spending to be carried over for up to two years beyond the designated period. The greater threat to growth may lie in the possible synchronisation of consolidation abroad: withdrawal of stimulus in major export markets could hurt Czech exporters more than the changes in the domestic fiscal stance. Any short-term benefits of further stimulus must be set against the medium-term risks exposed by the unexpectedly rapid deterioration in the budgetary position. Failure to take action on the deficit would have risked confronting the government with significant increases in the cost of borrowing. A recent analysis of the *dynamics* rather than the levels of interest-rate spreads in Europe suggests that the threat is real. Boone (2009) finds that in the euro area the markets' heightened sensitivity to rising public debt has amplified the impact of fiscal deterioration on sovereign spreads.[17] Indeed, this threat was probably all the greater, since the Czech Republic is a relatively small economy with a fairly small market for government debt, and fear of rising debt-service costs was the main motivation behind the authorities' rapid shift from stimulus to consolidation.

The government's decision to pursue fiscal consolidation underscores a number of policy challenges. First, the speed with which policy shifted from stimulus to consolidation will have created uncertainty; some stimulus measures were withdrawn before they entered into force, raising questions about the predictability of policy. Secondly, the limited nature of the government's mandate (Box 1.1) meant that the initial consolidation package was focused solely on 2010, and many of the measures adopted were clearly of an *ad hoc* character. This is perhaps unavoidable – the government has no mandate to pursue far-reaching reforms into 2011 and beyond – but it makes for a high degree of uncertainty for firms and households. Thirdly, the initial consolidation plan relies chiefly on new revenue measures. The spending cuts involved are limited and do not extend beyond 2010.

Medium-term consolidation efforts should aim at fiscal balance over the cycle

One of the first challenges facing the next government will be to establish a credible, multi-year strategy for fiscal consolidation. The pace of consolidation and the immediate target have already been defined under the Stability and Growth Pact's excessive deficit procedure: the Czech Republic is to bring the general government deficit below 3% of GDP by 2013 and to ensure a structural annual average adjustment of 1% of GDP. Achievement of these targets will mark an important milestone but cannot be seen as a sufficient goal for fiscal policy. Under the Stability and Growth Pact, the country is committed to a deficit no greater than 1% of GDP as a medium-term objective; this should be seen as the more important fiscal target. CNB (2008) argues that such a target is needed in order to leave room for the automatic stabilisers to function or for discretionary fiscal stimulus in response to any future downturn. The European Commission's (2009) long-term projections suggest that a primary structural balance of 0.7% GDP would be needed to stabilise the public debt at around 30% of GDP – prior to including projected ageing costs. Even before to the crisis, IMF (2007) estimated that stabilising the debt-to-GDP ratio at 40% over the long term would require a primary balance averaging between –1 and +0.2% of GDP, depending on the growth scenario. These considerations point to a need for more ambitious fiscal adjustment. Ultimately, the government needs to aim for a structural balance close to zero, so that it is ready for future challenges, such as population ageing or external shocks. That may necessitate supplementing a more robust set of expenditure ceilings with an explicit structural budget-balance target.

A clear medium-term strategy for achieving structural balance would strengthen confidence in the sustainability of public finances, with potential benefits for output in the short term. Such effects should reduce the direct output costs of consolidation, particularly given the low fiscal multipliers. The economy may already be reaping the benefits of the shift from stimulus to consolidation: government bond yields, which serve as a benchmark for private-sector credit, fell after the consolidation package was adopted (Figure 1.10). This could in due course allow for cheaper private-sector borrowing.

The focus of medium-term consolidation efforts needs to shift from revenue to expenditure to ensure fiscal sustainability. Past Czech consolidation efforts, like the fiscal package adopted in advance of the 2010 budget, have tended to focus heavily on the revenue side, but a considerable body of research suggests that consolidation has a greater chance of being sustained if based on spending restraint, particularly with respect to government consumption and transfers.[18] A focus on expenditure is more likely to correct the biases that led to the deterioration in the fiscal position in the first place (Von Hagen *et al.*, 2002). Policy and long-term interest rates are also more likely to fall when consolidation involves structural spending cuts, which may be why Giudice *et al.* (2004) find that consolidation episodes based on expenditure restraint have generally been associated with better growth performance than those relying chiefly on revenue increases. Yet the fiscal elements of the exit strategy approved by the government in early 2010 were heavily tilted towards further revenue measures. It will be important for the next government to redress this balance with a greater focus on expenditure.

Czech fiscal policymaking is in principle driven by the medium-term expenditure framework (MTEF), which was introduced in 2004. This marked an important step towards strengthening fiscal discipline: a growing body of empirical work suggests that fiscal rules can – if properly designed – support fiscal consolidation (IMF, 2009; Guichard *et al.*, 2007; Von Hagen, 2006; Kennedy *et al.*, 2001). However, as previous *Surveys* have observed, the authorities have not always adhered to the MTEF: the ceilings were broken in 2006 and 2007. Moreover, in the last years before the crisis, they appear in hindsight to have been set at increasingly generous levels in the belief that the strong growth the country was then experiencing would continue. In any case, fiscal policy is in reality driven by deficit targets rather than expenditure ceilings, which would seem to strengthen the case for adopting an explicit, cyclically adjusted deficit target to complement the MTEF. Recent research points to the potential benefits of this combination. In an analysis of 85 consolidation episodes in 24 countries during 1978-2005, Guichard *et al.* (2007) find that budget-balance rules generally work better when combined with nominal expenditure rules; IMF (2009) reaches a similar conclusion. The case for complementing an enhanced MTEF with an explicit budget-balance rule thus appears quite strong. At a minimum, the presentation of those ceilings should be accompanied by analyses of the location of the economy in the cycle and estimates of the structural balance.

Such a framework is only likely to work to the extent that elected politicians "take ownership" of these rules. Some countries have sought to discipline politicians by adopting constitutionally entrenched fiscal rules (Box 1.5). However, Ljungman (2008) finds that

Box 1.5. **Constitutionally entrenched fiscal rules: the Swiss and German examples**

Switzerland's debt-brake rule, adopted in 2003, targets a structurally balanced budget on an annual basis by annually setting cyclically adjusted expenditure ceilings and seeks to contain the accumulation of public debt by correcting future expenditures for past overruns. The accurate assessment of potential output and revenue projections is therefore critical to avoiding unexpected deficits. Unforeseen discrepancies from the budget are addressed through an adjustment account, which needs to be balanced over the longer term. If the account has a deficit above 6% of the previous year's spending, it has to be corrected over the next three years. During the four years after the rule was adopted, the ratio of federal debt to GDP declined by 8 percentage points.

Germany has long had a fiscal rule enshrined in its constitution, but it proved ineffective at checking the growth of public debt, and in June 2009, the rule was revised. With effect from January 2011, a new rule will take effect, with a transition to 2016 for the federal government and until 2020 for the *Länder*. The amendment limits the structural federal deficit to 0.35% of GDP and requires the *Länder* to achieve structural balance, on the basis of the European Commission methodology for calculating cyclically adjusted balances. Positive or negative deviations from these limits are "stored" in a notional adjustment account during the following year. If this account registers a negative balance in excess of 1.5% of GDP, the Constitution requires an adjustment. Parliament may vote for larger deficits than allowed by the rule, in response to natural disasters or other emergencies, but a proposal for higher deficits must be accompanied by an amortisation plan. Finally, a Stability Council is to be established to monitor public finances and issue early warnings.

rules need not be enshrined in law to be effective, provided there is real political commitment to them. Moreover he finds that, in the absence of political support, the legislative status of a rule cannot ensure its effectiveness. The need to allow for some flexibility in policy means that even a constitutional device must allow for exceptional circumstances, which politicians can exploit if they so choose.[19] Giving the fiscal rule a higher legislative status is thus more likely to be a way for politicians to signal their commitment to fiscal discipline than a real mechanism for binding themselves in future. The crucial challenge is therefore to establish broad and enduring support for a stable, transparent and effective fiscal framework.

Mechanisms that increase the political costs of breaching the rules can help a great deal and merit further development. Both Guichard *et al.* (2007) and IMF (2009) emphasise the need for rules to be simple and transparent, so as to facilitate public and media monitoring, as well as assessment by independent authorities. These considerations point to two reasons for retaining, in a strengthened form, the MTEF. First, spending caps can allow individual spending ministers to be held accountable for breaches, something the Czech authorities may wish to consider in future. Secondly, nominal expenditure ceilings are arguably more transparent – and thus easier to explain and to monitor – than all but the simplest unadjusted balanced-budget rules (which are likely to be too crude to be desirable). At the other extreme, a very sophisticated option, like the Swiss debt-brake regime, might make monitoring and public discussion more difficult. The Swedish budgetary framework, which has proved very successful, is simpler and might present a good model for the Czech Republic.[20] This framework is *not* anchored in legislation. It is founded on a political commitment, reinforced by strong expectations from outside observers (Ljungman, 2008).

The experience of the last Czech excessive deficit procedure suggests that the government should be particularly vigilant if growth turns out to be better than expected. During 2003-08, higher-than-projected growth made fulfilling the deficit targets relatively easy, but, as a result, this period of strong growth was not fully exploited as an opportunity to put public finances on a sound footing. Debrun *et al.* (2008) find that policy tends to be less pro-cyclical where spending rules explicitly address the macroeconomic stabilisation function of fiscal policy, as well as debt/deficit management. However, this requires that spending caps be set with counter-cyclical aims in mind, leaving the automatic stabilisers to operate on the revenue side. Guichard *et al.* (2007) and IMF (2009) observe that the fiscal frameworks in many successful consolidation episodes built prudent macroeconomic assumptions into the budgetary process. If growth surprises on the upside in the coming years, this should be treated as an opportunity to accelerate the process of fiscal consolidation, rather than an occasion for relaxing fiscal discipline. The danger of such relaxation became apparent at the end of 2009, when last-minute spending increases included in the 2010 budget were justified in part by the expectation that growth in 2010 would be better than previously forecast. Maintaining discipline in this respect will be important in 2010, especially as a number of new spending proposals had already been submitted to the parliament at the end of last year, and the outlook for revenues is becoming brighter again just as the country is approaching parliamentary and then municipal elections.

One of the major challenges on the spending side stems from the fact that half of budgetary spending is of a mandatory nature: curbing it requires changes to legislation, which have been difficult in the past, partly because governments for more than a decade have either been minority cabinets or have relied on very small, and sometimes unstable, parliamentary majorities. However, aspects of fiscal policy under the direct control of the government warrant closer scrutiny. Some immediate albeit limited savings could be realised by further reforming the budgetary process, in particular:

- Closer scrutiny of expenditure proposals is needed in the budgetary process. As the previous *Survey* argued, a better budgetary process could help to contain expenditures at an early stage. Currently, there is no centralised scrutiny of spending submissions in the budgetary process. The Ministry of Finance has no power to question the expenditure submissions of other line ministries. When cuts are required, as in the 2010 budget, these have tended to be executed across the board, in a top-down approach that targets operational expenditures in the absence of any real analysis of spending. Yet recent experience suggests that line ministries' requests are often "padded". In 2004, line ministries were allowed to set aside unspent resources for the following year. This resulted in the creation of reserve funds equal to 1% of GDP (about 3% of budgetary expenditure) during the first year. These reserves reached 2.8% of GDP in 2007. Since 2008, such unspent funds have been held in the form of a "virtual right to spend" rather than as real allocations from the Finance Ministry to the spending ministries. This has made for better debt-management and better monitoring of the use of such funds.[21] The government, however, is authorised to reduce the overall amount of such allocations that can be spent or to change the designated use of such carry-over funds. Apart from obvious carry-overs resulting from delays to investment projects or the disbursement of EU funds, they cast doubt on the accuracy and necessity of line ministries' initial spending submissions. Moreover, the prospect that decisions on the use of unspent funds could lead to *de facto* revision of expenditure ceilings targets constitutes a risk to the fiscal stance. Vigilance will be needed to ensure that the restrictions on ministries' right to carry reserves over into the following year does not bring a renewal of the end-of-year expenditure rushes seen prior to 2004.

- Efficiency analyses of individual spending programmes should be conducted and basic performance-oriented indicators implemented. The Czech budgetary process is based on an incremental approach, which assumes the current year's budget as a baseline for most spending and then adds to it. There is very little analysis of the efficiency of expenditure programmes. As the Supreme Audit Office (SAO) pointed out in a recent report, the investment incentives programme, which has run since 1993 and involves numerous specific initiatives extending across a number of line ministries, has never been properly assessed (SAO, 2008). Even the overall cost of the programme cannot be specified with precision. Allocations for training grants and other expenditure have been of the order of CZK 8 bn, but the programme has relied far more on tax breaks than direct expenditure, and the value of the tax expenditures involved is unknown. Only a handful of analyses are available even for individual ministries' spending programmes. The Czech Republic has hitherto been the only OECD member that has no system for the development of performance information in the budgetary process. Neither performance targets nor evaluation reports have been used in budget discussions between the finance ministry and spending ministries (OECD, 2009d:93). Past attempts to introduce a more sophisticated approach through so-called "programme budgeting" have yielded only meagre results, as only 5.8% of total expenditure was actually covered. A renewed effort was initiated in 2008, with those responsible for spending chapters asked to set overall goals, including two-year projections and indicators for evaluating the achievement of the goals set. These new requirements took effect in 2009, but they remained voluntary for the first year. As a result, only five of the roughly 40 chapters comprising the budget included such targets for 2010. It is thus too soon to draw conclusions at present, but implementation in the coming years will be important.
- Public procurement practices need to be reformed. Allocation of public expenditures through public procurement is exceptionally high. In 2006, it reached some 25% of GDP on OECD estimates (OECD, 2009d:111). Pavel (2008) puts the figure at 17%, still a relatively high level by OECD standards. Difficulties in public procurement are believed to extend across the whole public administration, and a number of independent institutions have repeatedly pointed to problems in this sphere. At the central level, reports issued by the SAO describe ineffective and wasteful use of public resources, especially in bigger investment projects (SAO, 2008). The anti-monopoly office has sanctioned a number of ministries, municipalities or state companies (including the forestry concern Lesy, the railways monopoly České Dráhy and the post office Česká Pošta) for breaking public procurement laws. This often concerns splitting up big projects in order to use the lighter regulations applied to smaller projects for the selection of contractors, which in effect means less competition. Pavel (2008) finds in a case study of 62 infrastructure projects that each additional participant in a tender brings the price down by an average of 4.4%. Greater competition in public procurement should bring savings to already stretched budgets, at local and central levels. Yet Pavel (2008) also finds that many tenders are structured in such a way as to discourage competition. This phenomenon appears to be

related to the problem of corruption in public procurement, which is explored in Chapter 3 of this *Survey*.

One of the major obstacles to deeper scrutiny of budget is the lack of detailed information on spending by individual line ministries. That should finally be overcome when a new state treasury is fully operational. The shift to a treasury system of budgetary execution, which is intended to minimise debt-service costs and improve public budget management, has been on the Ministry of Finance's agenda since 2002. It will introduce unified accounting and a real-time treasury management system that should streamline management of public resources and should bring savings of its own, as well as making it easier to identify other potential savings. There were significant steps forward in 2009, and its first phase was launched in January. The data collection phase is currently planned for 2012. Such an opportunity for more analysis of individual budget chapters should not be missed. Indeed, implementation of the treasury project, which has hitherto been subject to repeated delays, could be speeded up and should become a priority across all ministries. The next government should implement the treasury system swiftly, ensuring that no further delays occur.

As the previous *Survey* argued, there is also a need for greater timeliness and transparency in presentation of budget material. A good deal of cross-national research points to the benefits of transparency in terms of fiscal discipline and accountability. Cross-national empirical work confirms that countries with more transparent budgetary procedures tend to achieve lower deficit and debt levels (Von Hagen and Harden, 1994; Alt and Lessen, 2006). Greater transparency with respect to government accounts and fiscal policy plans has also been shown to reduce borrowing costs, increase accountability, reduce uncertainty and strengthen policy discipline under fiscal regimes involving deficit or expenditure targets.[22] At present, the year-end report is prepared within six months of the end of fiscal year, as recommended in OECD (2002), but it is approved by parliament and published only after a considerable delay: at the end of 2009, only the 2007 report was available on the finance ministry's web site; the audited accounts for 2008 had yet to appear. Delay means that analysis of the previous year's spending can have virtually no impact on discussion of the budget for the coming year. The inclusion of a report on tax expenditures in the material accompanying the draft budget is another OECD recommendation that could strengthen the budgetary process. At present, there is no systematic analysis of tax expenditures, despite the fact that the tax system includes a substantial number of special rates and other exceptions (see Chapter 2). An assessment of the costs and benefits of existing tax allowances, deductions and incentives would help identify possible revenue sources that could be tapped while also reducing the distortions created by the tax system.

Extra-budgetary funds also warrant further attention. A number of such funds and vehicles have been wound up over the years, but seven state funds remain.[23] Though they are organised as stand-alone entities independent of the budget, these funds rely increasingly on subsidies from the state budget and, with few exceptions, they cover regular line ministries' spending programmes. Their existence reduces budgetary transparency and complicates management. The rationale for their separation from the budget has largely disappeared, and the next government should consider integrating them into it.

Social security spending, including pensions and social benefits, accounts for the largest share of mandatory expenditure. Despite some important recent reforms in this area, any comprehensive public finance reform will have to explore the scope for further changes here. Recent reforms of sickness insurance have already led to substantial savings, and the on-going reform of disability pensions should reduce the incentives to use disability schemes as a mechanism for workforce adjustment (see Chapter 2). However, recent developments in respect of care for people who are dependent on the assistance of another due to disability or poor health have tended to move in the opposite direction. In 2008, a new law on social services resulted in a 60% year-on-year increase in the volume of benefits claimed, which has since stabilised at around CZK 18 bn. The law shifted the payment of care allowances from caregivers to the dependents themselves. This was intended to allow them to choose the form of care they preferred, be it individual or institutional. There are some 350 000 people covered and on top of the care benefit, the state budget subsidises provision of social services by CZK 6 bn. The authorities believe that there is some scope for adjustment, especially in the benefits provided to those with lower degrees of dependency.[24] Comprehensive assessment of the existing system and connected services, such as medical evaluation, is needed.

Particular attention should be given to those elements of the social support system that are available to individuals and households on relatively high incomes – both benefits that are not income tested, such as the birth grant or parental allowance, and some tax breaks (Table 1.5). Given the fiscal situation, the next government should consider whether benefits that are not income tested ought to be phased out at higher incomes. The scope for reform of some other areas of social expenditure that are comparatively generous by OECD standards is examined in Chapter 2.

Table 1.5. **Selected social insurance and social support benefits, 2005-08**

CZK bn

Benefit	2005	2006	2007	2008
Sickness benefit	27.1	27.8	28.8	25.6
Maternity benefit	4.6	4.9	5.9	6.3
Child allowance	11.2	11.0	10.3	6.3
Social supplement	4.8	4.4	4.6	3.2
Birth grant	0.9	1.6	2.1	1.6
Parental allowance	12.6	13.5	28.7	28.3
Foster-care allowance	0.5	0.6	0.8	0.8
Burial grant	0.5	0.5	0.5	0.1
Housing supplement	2.5	2.3	1.6	1.6

Source: Ministry of Labour and Social Affairs.

Fiscal consolidation will require addressing challenges at sub-national as well as national levels. The Czech Republic has fourteen regions and more than 6 200 municipalities, which together account for over 30% of general government spending, including a large share of expenditure on healthcare, primary and secondary education, roads and social care. Apart from 2007 and 2008, when revenues were particularly buoyant and number of municipalities profited from substantial asset sales, the regions and municipalities have been consistently in deficit in recent years: the balance of consolidated sub-national budgets averaged about –0.4% of GDP over 2000-06. They are now under mounting financial strain and will also face tighter budgetary constraints in the years ahead. This points to the need to address the reform of sub-national government. As previous *Surveys* have pointed out, municipal government is too fragmented to be efficient – there are too many municipalities and most of them are too small. Some 80% have fewer than 1 000 inhabitants, and 60% have fewer than 500. Earlier attempts to encourage mergers in recent years have had only limited impact. On the contrary, most recent amendments in the formula for tax allocation meant higher growth in revenues for small municipalities. The Czech constitution makes it difficult for central government to reform the municipalities unilaterally, but OECD (2006a) outlines a number of steps that could be taken to increase fiscal efficiency and transparency at regional and local levels. These include strengthening incentives for municipalities to merge, or at least to collaborate more in service provision; rationalising the networks of offices providing central-government services; tightening debt rules on municipalities and regions; and extending the powers of the SAO to allow full audits of municipalities. Many of these steps have been resisted by sub-national authorities in the past, but increasing financial pressure may make it harder for them to oppose reform now. Changes to public procurement practices should also pay dividends in terms of regional and local finances.

Although there is considerable scope for expenditure-side adjustment, no strategy for the consolidation of public finances is likely to rely entirely on spending restraint. To the extent that further revenue increases are needed, it will be important to identify the revenue sources that are least distorting and least damaging to growth prospects. Arnold (2008) finds that the economic cost of raising revenue by increasing taxes on labour income to be several times greater than that of raising the same amount from higher indirect taxes. This should be carefully considered, especially in the case of the Czech Republic, where the labour tax wedge is relatively large. Chapter 2 of this *Survey* explores the scope for further shifting the tax burden away from direct taxes on labour and for relying more on less distorting taxes, including real estate, environmental and consumption taxes.

Preparing for the fiscal consequences of population ageing

Medium-term consolidation must clearly rank high among the next government's policy priorities, but meeting the targets set out under the excessive deficit procedure should be seen as a first step. Even if these are achieved, long-term fiscal sustainability will remain a formidable challenge. As previous *Surveys* have shown, the longer-term problem stems from rapid population ageing and the related, but distinct, problem of rapidly rising healthcare and long-term care spending. The ratio of age-related spending to GDP is projected to rise by 6.4 percentage points over the period to 2060, reaching 23.4% on the basis of estimates done prior to the downturn (Table 1.6). In the absence of policy change, the Ministry of Finance projected before the crisis that increased age-related spending,

Table 1.6. **Projected change in age-related public expenditures, 2010 to 2060**

% of GDP

	2010	2060
Pensions	7.1	11.1
Healthcare	6.4	8.4
Long-term care	0.2	0.6
Education and unemployment benefits	3.3	3.3
Total	***17.0***	***23.4***

Source: European Commission, *Sustainability Report 2009*.

particularly on pensions and healthcare, would push public debt past the 60% of GDP enshrined in the Maastricht Treaty shortly after 2040, rising to 250% GDP in 2060. The outlook is still worse today: the ministry now expects, as a result of the crisis and the ensuing growth in public deficits, that the public debt will rise from 30% of GDP in 2008 to more than 44% by 2012; before the crisis, it had forecast a decline the debt-to-GDP ratio over the medium term, to roughly 25-26% by 2011-12.

Increases in the retirement age have improved the pensions outlook…

Pensions represent by far the largest share of the age-related expenditure increase and there has been a long-running debate about structural pension reform (OECD, 2006a, Chapter 2). While the parametric changes adopted in recent years have been quite substantial, the basic structure of the existing defined-benefit (DB), pay-as-you-go (PAYG) public system has remained untouched. This system provides an effective safety-net pension, as the formula used for calculating benefits is highly redistributive. Replacement rates are very high for those with low earnings but decline rapidly as income rises. This makes the system very effective at preventing old-age poverty, but it will, in the absence of further reform, face rapidly rising expenditure from around 2030. To date, the measure that has done most to check the growth of pension spending was the increase in the statutory retirement age. Previously, the adjustment of retirement ages had been set to culminate in a standard age of 63, applying to men from 2016 and to childless women from 2019. Women with children were to remain eligible for retirement up to three years earlier, depending on the number of children they had raised. Under legislation adopted in 2008, this process has been extended: retirement ages will continue to rise by 2 months per year until they reach 65 for men and childless women in the early 2030s. The retirement age for women will vary between 62 and 65, depending on the number of children raised.

In addition to extending the increase in the retirement age, the legislation will increase the minimum contribution period (MCP) from the current 25 years to an eventual 35 over a ten-year period. There will also be a reduction in the credits allowed for certain non-contributory periods, such as time spent in higher education, which will be excluded entirely from calculation of the MCP. The bonus for later retirement is to be increased and the provision restricting pensioners to one year contracts if they continue in work has been abolished. In general, it has become easier for ordinary pensioners to combine pension receipt with some labour income. The rules for drawing a pension while continuing to work have been altered. If an individual combines work with a full pension, the earnings-related component of the pension can be increased by 0.4% for every year of SSCs paid on the pensioner's salary. For those who work and draw only half their pension while they are in employment, the corresponding increase is 1.5% for every 180 days. This reduces the disincentives for older cohorts to remain in the labour market. At the same time, early retirement provisions have been changed. Currently, an individual may take early retirement three years before reaching the statutory age, provided that he or she has a full (35-year) contribution history. As the retirement age is increased, the period in which early retirement is permitted will also be increased, so that the age at which early retirement may be taken will not change. When the statutory retirement age reaches 65, early retirement will be available five years prior to that. However, the penalty for early retirement is set to increase as the duration of the period of eligibility for early retirement is extended. Prior to 2010, those taking early retirement suffered a reduction in benefits of 3.6% per year. This will rise to 6% per year when it becomes possible to retire five years early. Moreover, the provisions allowing ordinary pensioners to combine pension benefits and labour income do not apply to early retirees.

… But more must be done to assure long-term sustainability

The Ministry of Labour and Social Affairs estimates that the two-year increase in the retirement age adopted in 2008 should reduce projected spending by around 1% of GDP in 2060. Nevertheless, it is clear that more will have to be done if the financial soundness of the system is to be assured without imposing enormous – and possibly unsustainable – increases in social security contributions or other taxes, squeezing non-pension spending. At a minimum, the current differentiation of the retirement age should be phased out altogether. The pension system already credits women for periods spent caring for children, so they are not penalised in this way. Other policies that make it easier to combine work and family life would also help increase pension equity, as women's income profiles would suffer less if they chose to have children. To strengthen the system's long-term sustainability and avoid the need for further periodic adjustments to the retirement age, the next government could also consider the possibility of instituting a partial indexation of the retirement age to increases in life expectancy.

The current government has created a successor to the cross-party commission on pension reform that reported in 2005. This time, however, the experts involved do not necessarily represent specific political parties. The current group, which serves as an advisory body for both the Minister of Finance and the Minister of Social and Labour Affairs, is yet again looking at reform options and their potential financial implications. It is to report before June 2010 and, unlike the earlier commission, it is to issue explicit recommendations. The previous commission analysed the political parties' proposals but was not charged with the task of presenting a single plan of its own. Since then, it has proved impossible to overcome the divide between the center-left parties' support for retaining a defined-benefit PAYG system and the center-right's desire for a structural reform introducing a defined-contribution pillar that would involve greater private savings.

The previous government envisaged the parametric changes described above as only the first phase of a wider pension reform. The first phase also established a separate reserve account for pension reform within the state budget, which was supposed to receive revenues from selected privatisations and any annual surpluses from the state pension system. This was meant to accumulate the resources needed to finance the transitional costs arising from the second, structural phase of pension reform. However, the fund remains relatively small; at the end of 2009, it held about CZK 21 bn (around 0.7% of GDP). Previously, the authorities were aiming to accumulate CZK 40 bn by the end of 2010. However given the weaker labour-market outlook, which implies less revenue for the pension system and therefore also smaller prospects for a surplus in the medium term, and the fact that a large share of privatisation income tends to be channelled into infrastructure spending, it is difficult to see the fund emerging in the near term as a serious source of finance for any structural pension reform.

A subsequent phase of the reform was to involve the creation of a second, fully funded, defined contribution (DC) pillar of the pension system via a voluntary "carve out", under which individuals would be allowed to channel a portion of their pension contributions (equivalent to 4% of gross wages, as against total pension contributions of 28%) into private pension funds of their choosing. This would be contingent on an individual's readiness to supplement the diverted contributions with additional contributions amounting to at least 2% of his pension contribution base. Payouts under the first pillar would be correspondingly lowered. The existing voluntary private pension fund system – the so-called "third pillar" – plays only a limited role in retirement income provision, providing just over 10% of individual pension income. Currently, assets equivalent to some 4.7% GDP are managed by ten pension funds with heavily bond-dominated portfolios. Although about 45% of the working population participates in the third pillar, it is used more as a modest but tax-efficient savings scheme than a serious form of pension provision. Contributions are low – on average just about 2.5% of earnings. The system is heavily subsidised by the state, through both tax allowances and direct subsidies, and contributions are generally set at a level that maximises the public subsidy. Returns tend to be very low, in part due to extremely strict regulation of their activities, and benefits are usually withdrawn as lump sums rather than annuities.

Although the focus of policy has shifted to more immediate problems, the crisis has done nothing to reduce the risks from rapid population ageing. Indeed, the current fragile fiscal situation only highlights future spending pressures. While in many OECD countries, a great deal of attention has focused on the impact of the crisis on defined-contribution schemes, the next government should bear in mind the impact of the crisis on both funded (DC) and PAYG (DB) pension schemes:

- As a result of the worldwide fall in equity and property prices in 2008, pension funds across the OECD lost 23% of their portfolio value, although some of that value has been recovered in 2009 (OECD, 2009e). The situation in the Czech Republic was not so dramatic. There was no decrease in pension funds assets in 2008-09, for the simple reason that the legislation governing the third pillar prohibits pension funds from showing negative end-year results. Otherwise they have to draw on their own capital to make good their clients' balances, as indeed happened in 2008 in the amount of CZK 6 bn. This makes their investment strategies both extremely conservative and also rather short-term; low-return fixed-interest assets predominate in their portfolios.
- While the recent financial crisis will probably make it harder to win public support for greater reliance on funded DC pension schemes than would have been the case when financial markets were booming, the fact remains that the crisis has reduced the rates of return on contributions to the PAYG pillar as well, even if the decline has been less visible. The rate of return in the first pillar is linked to the growth of the contribution base and thus depends on labour-market and productivity performance. Now, with higher unemployment and slower wage growth, PAYG systems are taking in less income than expected, and it is likely that performance will continue to be affected by the crisis for some time to come. In addition, the prospect of negative labour-force growth means that, over the long term, the returns to contributions to the first pillar will depend ever more on productivity performance.

The case for diversified sources of retirement income as the best way to deliver income security in old age thus remains strong. The introduction of a second pillar would therefore be a welcome step. Both pillars would be subject to common aggregate shocks, but in combination they would provide some hedge against those risks more likely to affect one or the other. For example, the PAYG pillar is likely to be more susceptible to political bargaining, population ageing and poor labour-market outcomes, while the funded pillar would be more exposed to the risks of inflation and financial market volatility.

However, concrete rules and economic conditions play a crucial role here. Weaker growth and the deterioration in public finances mean that it will be harder to create the fiscal space to finance the initial costs of any major reform. In particular, a DC carve-out would entail a transitional deficit. Revenues flowing into the first pillar would fall immediately, as future retirees diverted a portion of SSCs to private accounts, while the savings to the first pillar resulting from lower payouts would be realised only when the first pensioners in the new scheme began to retire. Much depends on how the large the carve-out would be. There is also a question of compulsion. In principle, a mandatory second pillar, involving both a carve-out and additional contributions, prevents myopic behaviour and under-saving. It would also compel future pensioners to diversify the risk to which their pension prospects were subject. However, a mandatory second pillar might force some groups to over-save. This could happen if, for example, such resources were diverted from amounts needed to raise and educate children. Furthermore, pension plans are not the only form of wealth accumulation for retirement.

The original Czech plan, and one of the options that the revived commission will examine, was for a voluntary carve out. Individuals were to make a one-time choice, within a limited period of their entry to the labour market, whether to stay exclusively with the first pillar or to participate in the second. However, keeping the carve-out option open to all newcomers to the labour market could prove tricky. It is very difficult to make a decision about lifetime career earnings at an early stage of one's career, and individual choices may be disproportionately influenced by pension fund performance at the time the decision is taken. Moreover, as highlighted in the previous *Survey*, there might be pressure on the state should the pay-outs of those who opted for carve-outs and those who did not differ substantially: a major exogenous shock to one pillar or the other could result in political pressure for *ex post* revision of the rules. If participation in the second pillar were made mandatory for younger cohorts, this risk would affect only the transition generation. The other risk, in a system as redistributive as the first pillar scheme, is that only high earners would be inclined to opt for carve-outs if the second pillar were voluntary. This would only add to the first pillar's sustainability problems. Indeed, rough estimates by the Ministry of Labour and Social Affairs suggest that a voluntary carve-out taken up by the top half of the earning distribution would result in a deterioration in the balance of the first pillar of around 0.5% of GDP until the middle of the century, following which it would begin to improve. The introduction of a compulsory DC scheme, rather than a voluntary one, ought therefore to be given serious consideration. The government should at least consider "soft compulsion". In effect, this would imply automatic enrolment in a funded scheme, while allowing the individual to opt out. Whatever option is chosen, it is unlikely that a carve-out will in itself resolve the issue of long-term sustainability. This implies that other facets of pension reform, such as the further adjustments to the retirement age discussed above, will remain on the policy agenda.

The specific details of the carve-out constitute only one of the issues to be addressed in the design of the second pillar. The experience of other OECD countries in creating funded systems suggests that careful attention should be paid to the regulatory framework, so as to strike a proper balance between ensuring adequate rates of return and avoiding unacceptable levels of risk, as well as holding down transaction and administration costs. Ensuring robust competition among pension funds can also be a challenge: larger funds are likely to be better able to manage diversified portfolios and realise economies of scale, but if there are too few funds, competition will be weak.

Moreover, regulators may have difficulty finding a balance between transparency for consumers and over-regulation. If funds are given too much freedom to design products – defining their terms and conditions, and setting their fees, in a wide variety of ways – customers may find it very difficult to compare the performance of different funds. However, if funds are given too little freedom to design their own products, competition will be limited to a very few parameters. Recent experience with the design and operation of DC systems in other OECD members, including regional peers like Poland and Slovakia, highlights both the opportunities and pitfalls involved in designing such systems.

Healthcare reform has stalled

The other major age-related fiscal challenge will come from healthcare. The impact of population ageing on health spending will be compounded by the impact of rising incomes on healthcare consumption, which tends to rise as a share of total expenditure as income increases. Further pressure on healthcare spending comes from the on-going adjustment of the traditionally low pay of healthcare workers, an over-sized hospital sector and the absence of a well defined basic package of healthcare services.[25] Ambitious plans for healthcare reform introduced by the previous government aimed at strengthening regulated competition in the current insurance-based system, but these have largely stalled. Small nominal user fees (CZK 30-90) for doctor consultations, emergency-room visits, prescriptions and hospital stays, which were introduced in January 2008, have already been substantially adjusted. The original reform legislation capped annual out-of-pocket expenditures on healthcare at CZK 5 000 per individual. This has since been halved for those under 18 or over 65. More importantly, the introduction of fees proved a major issue in the regional elections held in the autumn of 2008, and a number of newly elected regional authorities began "reimbursing" various fees in early 2009. This includes reimbursement of fees paid to healthcare providers run by the regions, which account for one-third of the country's 192 hospitals. Such policies create distortions in the healthcare market, not least because the system of reimbursements varies across regions and is thus somewhat chaotic. It also creates an unnecessary layer of bureaucracy. With regional budgets already coming under increasing pressure as a result of falling tax revenues, it is difficult to see how such policies can be sustained. In any case, the central authorities have warned regional administrations that such actions violate current legislation.

The adjustment to the ceilings on out-of-pocket expenditure need not be seen as a dilution of the system, since the original ceilings were set administratively, without benefit of serious analysis. However, social concerns should be addressed primarily through the welfare system rather than *ad hoc* interventions by regional authorities. Despite their unpopularity, user fees do appear to have generated real benefits. According to Ministry of Health estimates, the fees generated some CZK 10 bn in savings for the healthcare system in 2008, both in terms of direct collections and falling demand for some services and products. Perhaps the largest drop occurred in ambulatory-care visits outside office hours, which fell by 36% year-on-year without triggering any increase in the use of emergency services. Declines in other areas in 2008 were modest (*e.g.* 17% for doctors' visits and 5% for hospital visits, despite an increase in the number of patients hospitalised). Data for 2009 are not yet available, but monitoring of healthcare consumption and outcomes should continue.

There has been only limited progress so far in respect of other aspects of healthcare reform, such as changes in price-setting for pharmaceuticals or liberalising the rules that govern negotiations between insurers and healthcare providers. Other planned changes, such as improvements in the definition of the basic healthcare package provided by the public system and increases in the diversity of insurance products on the market, which were to have been critical elements of the planned reform, have not been adopted at all. These plans should go ahead, as they are an essential precondition to any serious attempt to deal with future rising costs of the system.

Fortunately, understanding of the fiscal challenge of healthcare financing has increased across the political spectrum. The debate over user fees increased public awareness of this issue, but much of the change has come about as a result of a cross-party project concerned with modelling long-term healthcare costs. A special working group, the Roundtable on the Future of Healthcare, was established with the participation of experts from all but one of the main political parties. It has since published a number of reports on the Czech healthcare system, the most notable of which models long-term healthcare costs under a number of different assumptions about future demographic, economic and healthcare developments. The model itself has also been made publicly available. As the regional elections of 2008 demonstrate, the Roundtable has hardly removed healthcare from partisan politics or produced a consensus on reform. However, it has established a broad cross-party understanding on the nature of the challenges that lie ahead. In this, it may resemble the 2005 commission on pension reform, which did not in the end generate a consensus on structural pension reform but which did deepen the understanding of pension reform issues among political elites and the public.

Other policy challenges

The next government should set out a clear strategy for euro entry

In view of the fiscal situation, adoption of the euro is a realistic prospect only in the medium term. While the Czech Republic falls well below the Maastricht Treaty's 60% public debt criterion and should, if prudent policies are maintained, be able to meet the inflation and interest-rate criteria, it is unlikely to bring its deficit back under the 3% Maastricht Treaty threshold before 2013. The country currently has no timetable for joining ERM II or adopting the euro. This is not necessarily a problem. The immediate costs of being outside the euro are not as great as they are for some other countries in the region. Although the budget deficit needs to be brought down over the coming years, the macroeconomic framework is basically sound. Spreads between Czech and euro-area interest rates have generally been small in recent years – they were at or near zero for most of 2002-08[26] – inflation has generally been low, and exchange-rate flexibility was in some respects an advantage during the trade contraction at the end of 2008. A further argument against hasty pursuit of euro entry is that the convergence of nominal price levels, which still has some way to go, would have to come about through the inflation channel after euro adoption, rather than via a combination of nominal appreciation and inflation differentials, as at present. This consideration, however, is of declining importance. Recent strong growth put the Czech Republic at 75% of euro area GDP per capita and 68% of the average price level, one of the highest among its regional peers.

That said, the Czech Republic stands to benefit from euro accession, particularly given the very high share of its trade that is with the euro area and the consequent costs that exchange-rate volatility can impose on firms in the tradable sector. These costs can be substantial, as indeed they were during 2008-09, when the koruna proved unusually volatile. Hedging against currency movements can entail significant costs, which must be set against the benefits of exchange-rate flexibility. Moreover, as Pisani-Ferry *et al.* (2008) observe, the costs of hedging are typically greater for small and medium-sized firms than for large ones, and SMEs count for a large share of Czech exports.[27] Of course, a lot of hedging by Czech firms is "natural" – imports are priced in foreign exchange – but financial hedging is also an issue. Thus, the Czech Confederation of Industry and other business groups have been calling for a clear timetable for euro accession.

In present circumstances, the target date for entry will depend largely on the speed with which the next government brings the deficit back under the Maastricht threshold. The authorities do not wish to extend membership of the Exchange Rate Mechanism II (ERM II) much beyond the two-year minimum required by the criteria, so the country is unlikely to enter the mechanism unless and until the government is confident that the country can meet the Maastricht criteria and that the Czech economy is sufficiently aligned with that of the euro area. As far as the deficit criterion is concerned, that points to ERM II entry towards the end of the adjustment required under the excessive deficit procedure. The question of alignment depends on the judgement of the government. Since 2003, the Ministry of Finance and the CNB have produced annual assessments of the readiness of the Czech economy to join ERM II the following year, as a prelude to entering the euro area. Hitherto, these assessments have not recommended ERM II entry, insisting instead on the need for further fiscal adjustment and structural reform. At present, the Czech business cycle is better synchronised with that of the euro area than before, but it is not clear for the moment to what extent this simply reflects the current crisis, as opposed to a structural shift.

The previous government had planned to set a date in 2009, but domestic political developments and the economic crisis meant that this did not happen. However, as economic conditions normalise and the recovery takes hold, the next government should revisit the issue. Greater clarity about euro entry would help to anchor expectations and mobilise political capital for a sustained fiscal consolidation effort and other structural reforms. However, a new entry timetable should not be adopted unless and until there is sufficient political support, underpinned by a clear, credible strategy for meeting the relevant deadlines. The stabilising effect of such a commitment depends on its credibility; progress will be more difficult if this is in doubt. Moreover, the credibility of economic policy overall would suffer if the government were, for a second time, to set and then abandon a target date for euro adoption.

In addition to putting public finances on a sustainable footing – which the country needs to do regardless of its euro entry ambitions – the Czech Republic needs to use the run-up to euro adoption to pursue further structural reforms. The loss of an independent monetary policy and of exchange-rate flexibility will place greater demands on other adjustment mechanisms as and when shocks occur. This constitutes a further argument for a fiscal consolidation strategy that goes well beyond meeting the Maastricht deficit criterion. It will also be important to address the remaining structural rigidities in labour and product markets, which will also need to be more flexible once the country adopts the euro. While the current downturn provides some evidence that the labour-market is not as rigid as many believed, there are further steps to be taken, not least to increase regional labour mobility, which remains low. These are explored in Chapter 3.

The recent experience of countries like Ireland, Spain or some current ERM II members points to a need to avoid the risk of lending booms fuelled by lower nominal interest rates in the euro area and higher domestic inflation. This will require a strong macro-prudential framework and fiscal discipline both before and after euro adoption. There are also sector-specific policies that can raise or lower the risk of credit bubbles, particularly in connection with construction and housing markets. These include eliminating fiscal incentives for home ownership (which would also increase labour mobility), imposing market value-based real estate taxation (see Chapter 2) and smoothing intertemporal consumption by pursuing pension reforms that will encourage higher savings.

Better institutions may facilitate both fiscal discipline and reform

One of the themes that emerges from the foregoing and that is also apparent in the discussions of tax, benefit and regulatory policies that follow in Chapters 2 and 3 is the need for greater policy coherence and stability.[28] Policy in many domains seems to be characterised by frequent changes of direction[29] and by difficulty in ensuring a co-ordinated approach to policies that cut across the divisions between government ministries or levels of government.[30] This lack of co-ordination is one of the factors that underlie the country's persistent problems in ensuring fiscal discipline. The independence of individual ministries and the lack of a strong institutional centre capable of ensuring fiscal discipline aggravate the free-rider problem that undermines fiscal discipline in many countries: individual policymakers may favour fiscal adjustment in principle and yet thwart it by working to protect their own spending priorities against any cuts. Line ministers in spending ministries, after all, reap the chief political benefit for new spending for which they are responsible, without being singled out for blame if the overall deficit is too high. A similar problem arises in connection with, for example, deregulation: even if every policymaker votes to reduce the regulatory burden on business, individual ministries and departments may prove reluctant to relax their own regulation.

These problems are not unique to the Czech Republic, of course, but they may well be particularly acute there. First, the Czech cabinet is unusually decentralised by OECD standards. Traditionally, the office of the prime minister has not been as powerful as the centres of government in many other member states and, as noted above, the finance ministry, unlike its counterparts in many OECD countries, has little real power over spending ministries. It is essentially another line ministry. Secondly, for over a decade, the country has faced a particular political economy problem: intense bipolar competition with limited coalition options. Political competition has centred since 1996 on two major parties, one centre-right and one centre-left. Elections have been fairly close,[31] and governments have generally been minority cabinets or have commanded very small majorities in the Chamber of Deputies. Research suggests that such closely balanced bipolar competition can create reform logjams for extended periods. It can increase the short-term political risks facing a government that attempts to implement reforms even when there is broad agreement on the need for them, because a shift in the voting preferences of a relatively small number of people can mean the difference between winning and losing office.[32]

In some policy domains, it may be that greater coherence and co-ordination could be achieved by strengthening the centre of government – the experience of many OECD countries points to the advantages creating a strong, specialised institution at the centre of government that is capable of driving regulatory reform across the whole of the public administration, and this possibility is considered in Chapter 3. The fundamental character of Czech cabinets, however, is unlikely to change. Nor need it do so. OECD executives are structured in a wide variety ways and they have likewise evolved a wide range of mechanisms for ensuring policy coherence and fiscal discipline. A number of OECD countries achieve these objectives even in environments characterised by complex coalitions and a centre of government with relatively limited authority (OECD, 2009b). Czech policymakers could profitably explore similar solutions.

In respect of fiscal policy, recent Czech history highlights the limitations on the ability of fiscal rules to bind policymakers. A nominal expenditure cap is no protection against optimistic planning. That requires institutionalising cautious assumptions, especially in respect of highly cyclical revenue sources, and a readiness to save surpluses. The evidence suggests that such arrangements can help prevent unintentional pro-cyclical drift (Guichard *et al.*, 2007; IMF, 2009). In the Netherlands, for example, cyclically adjusted budget-balance and expenditure rules were combined with deliberately cautious macroeconomic assumptions, while incentives and cost-benefit analysis were used for controlling, managing and reorganising public expenditures. A similar approach could bring significant benefits in the Czech Republic, provided that the macroeconomic assumptions that underlay fiscal planning were insulated from political pressure. This could be achieved by assigning the task to an independent and authoritative body with a reputation for both economic expertise and political impartiality, like the CPB Netherlands Bureau for Economic Policy Analysis in the Dutch case.

Recent years have witnessed growing interest in "fiscal councils" or other non-partisan agencies that perform at least some of the technocratic functions in the budget process, often in the context of implementing a fiscal rule (assessing macroeconomic assumptions, estimating long-run revenue elasticities and potential growth rates). These can be devices to signal government commitment, as well as forces for discipline in their own right. For example, the fiscal policy council in Sweden assesses whether fiscal policy objectives, including long-run sustainability, the budget target, the expenditure ceiling and counter-cyclicality (or at least avoidance of pro-cyclicality) are met.[33] An analysis by the European Commission (ECFIN, 2006) found that fiscal performance was better – primary surpluses were larger and public debt fell faster – in countries with at least one national institution other than government and parliament providing inputs into the fiscal policy process such as forecasts, analyses or recommendations. Although in no case was the government formally obliged to heed the views of such bodies, ECFIN (2006) concluded that they were effective in influencing policy where their visibility and credibility were sufficient to increase the reputation costs to the government of unsound policies. Delegation of forecasting responsibilities also seems to have helped correct optimistic biases in the projections underlying public budgets. Debrun and Kumar (2007) likewise find a strong relationship between the *de jure* influence exerted by non-partisan agencies ("fiscal councils") and their impact on fiscal performance, especially where there are formal guarantees of independence. The presence of fiscal councils appears to contribute both to the emergence of fiscal rules and to their effective enforcement.

The creation of such a council would not remove control of fiscal policy from elected politicians. First, the council would be appointed by, and accountable to, elected officials, though its independence would be enhanced if its members were appointed for relatively long terms and if parliamentary confirmation required a "heavy" majority, so that the selection would not just rest with the government of the day. Secondly, parliament and the government would still determine the size of the public sector and the distribution of taxes and spending. The council's task would be to act as the "watchdog" for a rules-based framework for policy by providing an independent assessment of the assumptions and methodologies used to determine the targets, producing updated long-term projections at regular intervals and refining estimation methodologies to allow for early action if the impact of demographic or other changes. In view of past difficulties in ensuring strict observance of fiscal rules, the Czech authorities should consider the creation of such a council as a means of strengthening the framework for fiscal policy.

Given the need for far-reaching fiscal reforms that will affect the entire public administration and will have to be implemented across all ministries and government departments, some strengthening of expert advice and inter-ministerial co-ordination would be desirable. The authorities may want to consider the possibility of creating a "council of chief economists" of ministries, or some similar body bringing together senior economic experts from across the government on a regular basis. More could also be done to strengthen the integration of economic analysis and advice in the policy process. At present, this tends to be unsystematic outside the core economic ministries; even within them, it tends to be compartmentalised, with units inside each ministry looking after specific activities, such as macroeconomic forecasting or the preparation of budget projections. There is relatively little contact between them. There are a number of research institutes outside government, linked either to social partners or academic institutions, and government departments sometimes solicit advice from these bodies. In general, however, their analytical work is tailored to the incentives corresponding to their institutional situation – producing publishable academic papers or underpinning the point of view of a political party or a social partner. From time to time government establishes *ad hoc* expert groups with specific mandates, such as the commission on pension reform in 2005, the Roundtable on future of healthcare or the *ad hoc* group of "wise men" who constituted the NERV. A common feature of such *ad hoc* bodies is that they lack permanent staff and often have to rely either on the members' contacts or affiliated institutions for support. This approach to integrating economic analysis into policymaking contrasts with the practices of many OECD members (Box 1.6). Given the policy challenges facing the country, the Czech authorities might wish to consider investing in mechanisms and institutions similar to those found in some other OECD members, with a view to making the provision of high-quality economic analysis an integral part of the policy process.

Box 1.6. **Economic analysis and policymaking in selected OECD members**

A number of OECD governments maintain state bodies with a legal mandate to analyse economic issues, make recommendations to government and evaluate and assess government programmes.

- Sweden's Fiscal Policy Council (*Finanspolitiska rådet*) is an independent agency. Its eight members are appointed by the government for three years. They are mostly academic economists but also include former policy-makers. The council typically reports to government once a year during pre-budget discussions. It focuses on: *i)* the degree to which the government's budget proposals are consistent with long-term fiscal sustainability, the budget surplus target and the multi-annual expenditure ceiling; *ii)* alignment of policy objectives; *iii)* how well budget documents explain and justify the fiscal policy stance; and *iv)* the quality of forecasts and the models used to generate them.

Box 1.6. **Economic analysis and policymaking in selected OECD members** *(cont.)*

- In the United States, the Council of Economic Advisers functions as an agency within the Executive Office of the President, charged with offering objective economic advice on the formulation of both domestic and international economic policy. Also associated with the Office of the President is the Office of Management and Budget (OMB). Its predominant mission is to assist the President in overseeing the preparation of the federal budget and to supervise its administration. In that capacity, OMB evaluates the effectiveness of agency programs, policies, and procedures, assesses competing funding demands among agencies, and sets funding priorities. It also oversees and co-ordinates the administration's procurement, financial management, information, and regulatory policies. The non-partisan Congressional Budget Office (CBO) performs similar functions for the Senate and the House of Representatives. The well staffed and well resourced CBO is an important voice in the policy process and could be relevant for a country like the Czech Republic, in which the legislature plays a very active role in shaping economic policy. In respect of tax policy, the Joint Committee on Taxation, a non-partisan House-Senate Committee, plays a critical role, employing a substantial staff of lawyers, accountants, economists, information technology specialists, and administrative support personnel.
- The *CPB Netherlands Bureau for Economic Policy Analysis* (CPB) is independent with respect to content but formally part of the central government, funded from the budget of the Ministry of Economic Affairs. It works for both government and opposition, and is able to identify areas for research on its own. Its major activity is macroeconomic modelling of the Dutch economy and the potential effects of institutional reforms. The CPB maintains its non-partisan reputation by focusing on empirical work and refraining from making direct policy proposals or normative statements. One of the more striking aspects of the its role is that it is employed by political parties of all stripes to "cost" their platforms ahead of general elections; during post-election coalition negotiations, it may also provide data and simulations to the parties involved to help them assess the implications of possible decisions. Intense interaction with the academic community help the CPB maintain a reputation in science that reinforces its reputation and credibility in the political sphere. CPB research often informs the deliberations of the *Social and Economic Council* (SER), a tripartite body, comprising representatives of the crown, the employers' bodies and the trade unions. Dutch governments tend to ask the advice of the SER on all important planned socio-economic measures. The government is not obliged to heed this advice, but it is generally reluctant to go against a unanimous SER recommendation. Discussions in the SER tend to reflect a strong commitment to evidence-based policy and are often informed by the reports of special commissions and expert bodies, as well as research provided by the CPB and other research bodies.
- The Productivity Commission (PC) is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues. Its role is to help governments make better policies in the long term interest of the Australian community. It is a part of public service and its core activities include the conduct of public inquiries and studies commissioned by the government. Findings are reported to the government and made accessible to the public. Although the PC remains accountable to elected politicians, its reputation and visibility give it a good deal of independent political weight – not only because its work is often the focus of much public debate but also because attempts to marginalise it from the policy process in respect of particular issues have sometimes generated sharp criticism.

Box 1.6. **Economic analysis and policymaking in selected OECD members** *(cont.)*

In some countries, the more typical approach involves the informal pooling of experts in research institutes affiliated to the social partners. In Austria, for example, the Council for Economic and Social Issues was set up on the basis of an informal agreement among social partners. Like the system for organising the social partners as a whole in Austria, it runs on a voluntary, informal basis. This model depends on the ability and willingness of the social partners to invest in very substantial analytical capacities of their own. In Austria, the Council was most influential when the social partners were the main driving forces behind policy formation and their institutions ran big economics departments. Finally, it should be observed that some countries relying largely on *ad hoc* commissions and working groups nevertheless do so in a more structured way than is typical of Czech policymaking. In Sweden, for example, temporary expert committees differ in their mandates, objectives and operations from what is often found elsewhere. Minority governments have long been the norm, making it all the more important for the government to search for legitimacy for each policy decision, and commissions are often employed to this end. What makes the Swedish case unusual is the tendency to use such bodies not merely to discuss concrete proposals but to deal with general and long-term challenges to the economy and the welfare state. They sometimes work for much longer periods than is typical elsewhere. The reports issued by these groups, known collectively as SOUs (*Statens Offentliga Untreningar*), played a major role in shaping public debates and providing guidance to policymakers during the welfare state and budgetary reforms of the 1990s.

Box 1.7 summarises the policy recommendations for the transition from recovery to sustainable growth.

Box 1.7. **Policy recommendations for the transition from recovery to sustainable growth**

Devising an ambitious, credible strategy for medium-term fiscal consolidation

Deficit reduction plans need to be underpinned by a concrete medium-term consolidation strategy, ultimately aiming at a more or less balanced budget over the cycle.

- Consolidation efforts should focus primarily on the expenditure side. This is likely to make for a more sustainable fiscal adjustment.
- The central government should exploit in full the opportunities for savings that are directly within its power. This can be done by introducing tighter scrutiny of spending proposals in the budgetary process, implementing performance indicators and carrying out efficiency analyses of individual spending programmes, while also improving public procurement practices.
- Implementation of plans to create a state treasury should be accelerated and should become a priority across all ministries.
- More transparent presentation of budgetary information could help increase understanding of fiscal policy and thus also pressure for fiscal discipline. This could include the institution of a regular tax expenditure report.
- The next government should consider integrating the remaining extra-budgetary funds into the budget.

Box 1.7. **Policy recommendations for the transition from recovery to sustainable growth** *(cont.)*

- The existing medium-term budgetary framework should be underpinned by cyclical indicators, with a view to ensuring that fiscal policy is not allowed to drift in a pro-cyclical direction during upswings.
- Social expenditures, including tax expenditures (like the child tax credit), should be reviewed, with particular attention paid to benefits that are not income-tested.
- Revenue-side measures should focus on consumption, property and environmental taxes. Increases in direct taxation, particularly of labour, should be kept to a minimum, as the tax wedge on labour is already very large.

Addressing the long-term fiscal challenges posed by population ageing

- The next government should proceed with plans to diversify retirement income provision by creating a defined-contribution funded second pillar in the pension system. The second-pillar scheme should be designed with due attention to its impact on both the redistribution that takes place within the existing PAYG system and on the financial sustainability of that system. The regulatory framework will need to be designed so as to balance return considerations, income security and the need to minimise financial overheads.
- The differentiation of retirement ages among women on the basis of their reproductive careers should be phased out.
- Partial indexation of the retirement age to life expectancy should be considered.
- In healthcare, the authorities need to eliminate various distortions in the user fees and proceed with definition of the basic healthcare package as planned. As with pensions, it is important to allow for diversification of resources by introducing diversity in insurance products.

Strengthening the coherence and predictability of economic policy

- The next government should aim to set out a clear, credible strategy for euro entry.
- Establishment of a fiscal council with responsibility for monitoring fiscal sustainability and adherence to fiscal rules should be considered.
- The creation of a body bringing together the top economic experts of ministries and other first-tier government bodies should be considered as a means of strengthening the provision of economic analysis and advice in policy formulation and ensuring greater co-ordination of policy across the government.

Notes

1. The huge negative contribution of the change in stocks, which actually accounted for most of the decline in the first half of 2009, raises some questions. A substantial negative contribution of changes in stocks is not in itself surprising in the circumstances, but the scale of apparent destocking is so large as to raise questions. Subsequent revisions of the data may attribute some of this to other components of demand.
2. Singer (2009) finds the contraction to have been slightly *less* severe than average for the OECD. This is based on cumulative quarter-on-quarter growth rates from the third quarter of 2008 through the second quarter of 2009. Figure 1.3 is based on the fall in output levels from the highest quarter to the lowest.
3. It is noteworthy that the consensus forecast for the Czech Republic for 2009 remained positive even in January of that year, turning negative only in February.

4. Indeed, the residual for the Czech Republic in a regression of the peak-to-trough fall in real GDP on openness (here measured as the ratio of total trade turnover to GDP) is close to zero, indicating that the output decline is in line with what could be expected from the experiences of other OECD countries.
5. Data on world, as opposed to OECD, exports for the period are not yet available.
6. It is worth noting this type of concentration indicator tends to be quite sensitive to cyclical fluctuations in relative prices. Commodity price rises thus make commodity exporters look as though their export profiles are rapidly becoming narrower. However, Czech exports are not generally in sectors subject to such large short-term price movements as those which affect primary commodities.
7. The CNB estimates that RGDI grew faster than real GDP during 1996-2008, by an average of 0.5 percentage points per year – cumulatively, a non-trivial contribution to real income convergence.
8. The Czech Statistical Office noted the existence of this effect – which is apparent from the fact that the employment fell far faster than the wage bill – in its commentaries on wage data but did not estimate its size.
9. This is because the pay of those on such regimes is recorded as an indemnity (*náhrada*) rather than wage (*mzda*).
10. The cohorts born in 1946-48 were about 30% larger than those that immediately proceeded them. The Ministry of Labour and Social Affairs also reports that observes no increase in early retirements in 2009.
11. Using the deflator for private consumption; real income growth was even slower, just over 1% year-on-year, when deflated by the CPI.
12. The CNB defines highly liquid or "quick" assets as cash on hand, balances with central banks, sight liabilities with credit institutions, and bonds and notes issued by governments or central banks (including those used in repo operations).
13. Based at that time on projections of real GDP growth of –3.8% in 2009 and 0.8% in 2010.
14. Involving real GDP growth of –5.2 and –1.1% for 2009 and 2010, respectively.
15. For the estimates and a discussion of the inverse relationship between fiscal multipliers and international openness, see OECD (2009c:115). CNB (2008:6) also notes the low effectiveness of the automatic stabilisers in the Czech Republic.
16. See, in particular, OECD (2006a:112-114) and OECD (2008a:35). Some recent initiatives have recently been adopted with a view to widening opportunities for obtaining adult qualifications and a new lifelong learning strategy was adopted in 2007.
17. The analysis in Boone (2009) is confined to the euro area but there is no reason to expect that non-euro countries would be less affected by this heightened sensitivity to public debt dynamics. If anything, one would expect just the opposite.
18. See, for examples, Alesina and Perotti (1996); Alesina and Ardagna (1998); Von Hagen *et al.* (2002); Ahrend *et al.* (2006); Guichard *et al.* (2007).
19. Indeed, it could be argued that the higher the rule's legal status, the more important it is to include provisions allowing for flexibility in emergencies.
20. Beginning in the mid-1990s, Sweden engineered an improvement in the cyclically adjusted budget balance of around 11.7% of GDP over seven years; the gross public debt-to-GDP ratio (Maastricht definition) fell by almost 35 percentage points over a decade (Guichard *et al.*, 2007). For a description of the Swedish experience of expenditure ceilings, see Brusewitz and Lindh (2005).
21. The debt-management benefits stem from the fact that the finance ministry no longer issues debt to cover the cost of transferring to other ministries funds which then remain there, unspent.
22. On the benefits of transparency for fiscal policy, see Alesina and Perotti (1996); Hemming and Kell (2001); Horvath and Szekely (2001); Petrie (2003); and Fabrizio and Mody (2006).
23. These are the State for Transport Infrastructure, the Land Fund, the Cinematographic Development Fund, the State Fund for Culture, the State Fund for Agricultural Intervention, the State Fund for Housing Development and the State Fund for the Environment.
24. The allowances range from CZK 2 000 to CZK 12 000, depending on the age and degree of dependency of the recipient.

25. These factors are discussed in OECD (2003).
26. CNB (2008:32-33). This included three-month interbank rates and rates on five- and ten-year government bonds.
27. According to data from the Czech Statistical Office, firms employing fewer than 500 people accounted for 36% of export sales in 2008.
28. Policy coherence is defined by OECD (2009d) as the systematic promotion of mutually reinforcing policy actions across government departments and agencies creating synergies towards achieving the agreed objectives.
29. See, for examples, the discussions of fiscal stimulus/consolidation and healthcare reform above, as well as the "treadmill" of tax and benefit changes in recent years, which is described in Chapter 2.
30. *E.g.* the uneven implementation of regulatory impact analysis and the plan to cut administrative burdens described in Chapter 3 or the lack of co-ordination between tax and benefit policies analysed in Chapter 2.
31. Since the mid-1990s, swings of just 1.5 to 2.8% of the electorate have been sufficient to reverse the major players' electoral positions.
32. Even if its methods and goals differ little from those of the rival bloc, the government may find that a controversial reform upsets enough floating voters (or mobilises enough previously inactive ones) to damage its re-election prospects. The opposition in such a situation has strong incentives to emphasise whatever differences exist between its positions and government policies, even on issues where there is substantial overlap between their positions. See Schludi (2003); and OECD (2009b).
33. For an extended discussion of the potential of fiscal policy councils, see Eichengreen *et al.* (1999).

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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
Ensuring fiscal sustainability	
Central-government budgeting	
In the Medium-Term Expenditure Framework, be vigilant against dilution of spending ceilings, abuse of rules on cyclical spending and inappropriate use of windfall revenues. Be more ambitious in deficit targeting through commitment to use positive developments to adjust the consolidation path.	No changes to the MTEF have been made, but the government has pledged a commitment to it.
Bring more extra-budgetary funds into mainstream budgeting.	No significant action taken.
An overhaul of central-government budgeting:	
Deeper scrutiny of spending plans in the preparation phase of the budget.	No significant action taken. Reserve funds of individual ministries used in response to deteriorating deficit situation. More scrutiny of EU funded programmes.
Greater transparency in budget material submitted to parliament.	No significant action taken.
Wider use of programme budgeting.	Renewed effort in 2008, requiring line ministries to introduce targets and indicators for evaluation of their fulfilment as of 2010.
Less opportunity for "pork-barrel" spending.	Parliament avoided "pork-barrel" proposals in the 2010 budget.
Stronger efforts for efficiency gains through staff cuts in public administration.	Some staff cuts (via failure to replace departing staff) included in fiscal response to the crisis.
Revenues	
Further reduction in the gap between the VAT rates.	The gap between rates was reduced in 2008 but the coverage of the lower rate was expanded.
Cutback in support for home ownership and renovation.	No significant action taken.
Pensions (in-depth review in 2006 *Survey*)	
A final decision should be made on whether to remain with the PAYG defined-benefit pension system or adopt a new approach.	The previous government approved a blueprint for introduction of a voluntary carve-out to create a second, defined-contribution pillar. However, reform has been stalled since the government fell.
The regulations on private pension funds need an overhaul.	Proposals submitted to parliament in conjunction with the creation of a second pillar would create a new legal framework for existing pension funds.
Assess the subsidy and tax breaks on voluntary private-sector pension savings.	No significant action taken.
Healthcare (in depth review in 2003 *Survey*)	
Reform of financing health care with a view to: clarifying and narrowing the range of down universal health services and allowing private markets for complementary services to develop; making user fees play a greater role; seeking efficiency gains through more horizontal and vertical co-operation among providers.	The 2007 fiscal package introduced a first phase of reform, notably small user fees for some medical services and changes in drug-price setting and negotiation procedure between insurers and healthcare providers. Further reform stalled, including re-definition of the coverage of universal healthcare services. See Chapter 1 for details.

Past recommendations	Actions taken and current assessment
Exemptions in user-fees should be avoided, save where necessary ensure that access to needed care is not compromised.	Original ceiling for user fees halved for children and pensioners. Significant dilution during 2009, as many regional administrations reimbursed fees in facilities owned by the regional governments.
Increase competition, profit incentives and reduce risk of undesirable behavioural reactions of insurers:	No action, planned reform on hold.
Introduction of the "14-day scheme" in sickness insurance (see Chapter 2 for details).	Introduced. A sharp fall in sickness absences and sickness insurance spending follows.
EU funding	
Simplifying the administration of the allocations and decentralisation.	The speed of drawing EU funds has significantly increased. Moreover, in line with EU regulations on ESF and ERDF, simplification of rules should come into force in spring 2010.
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 and rationalisation of the networks of offices providing centralgovernment services.	Amendments to the allocation formula for revenue sharing with sub-national governments, adopted in 2007, move in the opposite direction, increasing the formula's generosity to very small municipalities.
Improve accountability through tighter debt rules, wider auditing powers of the Supreme Audit Office, incentives for sub-national governments to participate in benchmarking and improved oversight and transparency in public procurement.	When debt servicing exceeds 30% there is now increased surveillance by the Ministry of Finance, but no effective sanctions are in place. New system for monitoring the financial situation of municipalities put in place in 2008.
Strengthen financing through some increase in discretionary taxation, notably real-estate taxation.	Local governments can now choose between five different rates of real-estate taxation.
The Labour market: Improving efficiency and the skills base, tackling shortages	
General labour market conditions	
Further shifting of the burden away from labour taxation to indirect taxation.	The 2008 tax reform package and the 2009 consolidation package shift the tax burden in this direction. See Chapter 2 for details.
More deregulation of the labour code. At minimum, notice period and severance pay arrangements ought to be linked to the length of service.	Reform proposals prepared but not submitted to parliament.
Full liberalisation of the housing rental market.	Full liberalisation of rents effective as of 2010 except in the largest cities, where it will take place only in 2012.
Take a longer-run approach to immigration, for example by widening the avenues to permanent residence and citizenship to increase integration.	Green card system introduced in January 2009. Due to the crisis and the short period of implementation, no serious assessment of its operation is yet possible.
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.	No significant action taken.
Younger cohorts	
Introduction of the tuition fees in tertiary education accompanied by publicly guaranteed student loans.	2009 White paper on tertiary education proposes a new system of student support that should precede eventual introduction of tuition fees. It has not yet been turned into legislation.
Avoiding elitism in secondary education. A need for more benchmarking of schools and students.	No significant action taken.
Plans to support student jobs.	No significant action taken.
Prime-age women	
Decrease of the span of a combined maternity and parental leave to at least two years.	In 2008, three possible regimes of parental leave, lasting two, three or four years, were been introduced. See Chapter 2 for details.
Widen the options for fathers to take leave for childcare.	An amendment to the legislation that would allow this has been submitted to parliament but is unlikely to be adopted due to fiscal constraints.
Bigger efforts to encourage childcare services:	Introduction of a home-based group childcare and incentives for companies to set up on-site child care facilities submitted to the parliament.
A comprehensive review of families' tax-benefit burdens.	Aspects of the system under review in connection with proposals for new "Family Support Plan" currently in parliament, but stalled for the moment owing to the political situation.
A system that precisely defines the calculation of the housing costs for the housing benefit should be considered.	No significant action taken.

Past recommendations	Actions taken and current assessment
Older cohorts	
Further increasing the retirement age to raise the employment rates of older cohorts.	Further linear increase of the statutory retirement age legislated. See Chapter 1 for details.
Further adjustment of the rules on working beyond the standard age of retirement, particularly the treatment of pension contributions.	New measures from January 2010 increase incentives to postpone retirement or combine work with pension receipt. See Chapter 1 for details.
Pushing the pension reductions for early retirement above neutrality.	Penalties for early retirement to rise significantly over coming decades but early retirement gradually extended to five years before retirement age rather than three. See Chapter 1 for details.
Take further steps to level the tax treatment between dependent and self-employment.	No significant action taken. Bans on the use of self-employment contracts in place.
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 2009 white paper envisages the introduction of a new system of student support and the eventual introduction of tuition fees. Repayment of student loans and fees would be income-contingent, and part of the repayment of fees to institutions would be deferred, so as to link their income to labour-market outcomes. The formula for funding would be modified to strengthen the role of output criteria and to diversify the tertiary system. The white paper's proposals have not yet been translated into legislation.
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. Further development of assessment systems. Improving morale in the teaching profession.	The introduction of the unified state leaving exam has been postponed to 2011. No significant action taken on other recommendations.
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.	New lifelong learning strategy adopted in 2007 but little concrete action prior to the crisis. Introduction of new general education and training programmes aimed at adults as part of policy response to deteriorating labour market in 2009. See Chapter 1 for details.
Improving the business environment	
The legal environment for business	
Priority should be given to reforming bankruptcy legislation.	New bankruptcy legislation into force in 2008, amended in 2009 to make alternatives to liquidation easier to pursue.
Further progress to ease business registration is needed.	Implementation of "Czech Points" initiative and other reforms reduce estimated registration times by 40% over two years.
Competition issues	
In telecommunications markets the regulator needs to be more committed to creating stronger competition.	The competition authority has been closely tracking competition in telecommunications and has undertaken an investigation into claims of abuse of dominant position in the broadband market. See Chapter 3 for details.
Environmental policy (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 significant action taken.
Introduce an excise duty on coal and other fossil fuels in the sectors that are not covered by the EU's emissions trading system.	Excise duties on electricity, natural gas and solid fuels introduced from 2008, in compliance with the European Energy Taxation Directive. Rates and revenues are low.
Globalisation and the Czech economy	
Trade policy	
Further liberalisation of the services sector to allow international competition.	Adoption of the Act on Free Movement of Services, implementing the EU services directive. See Chapter 3 for details.

Past recommendations	Actions taken and current assessment
Investment support	
Overall stocktaking of the investment incentive schemes, backed by more effective monitoring of firms.	No significant action taken, 2007 amendment enhanced monitoring measures.
The subsidies and concessions (*e.g.* public infrastructure) that are often negotiated between local authorities and investors should be held in check.	No significant action taken.
Any further reduction in the minimum eligibility requirements for investment support needs to avoid duplication and excessive support for SMEs.	Support of SMEs stemming from widening the investment incentive schemes internally not found duplicate by the authorities.
Support schemes for export-oriented SMEs	
Further development of support schemes for export-oriented SME based on continuous programme evaluation. Enhancement of the services for exporting SMEs.	National Anti-crisis Plan (2009) includes increased funds for loan guarantees and support for SME credit, a one-off increase in capital of the Czech Export Bank, an increase in coverage of the Export Guarantee and Insurance Corporation and a change in the law on state-supported export insurance to make it easier to access.
The coherence of SME programmes should be checked.	Annual evaluation of programmes within the Ministry of Industry and Trade's remit takes place.
Further widening of the responsibilities of CzechInvest should be considered (a case for merger with CzechTrade).	A number of offices of the two agencies abroad have been merged.
Policies to improve transport linkages	
Take steps to increase the efficiency and transparency of public procurement in transport investment.	Amendments to the Public Procurement Act have been adopted in order to implement EU legislation.
Public-private partnerships (PPPs) should be designed and implemented with appropriate sharing of financing and risk with the private sector.	The Ministry of Finance has adopted methodological guidelines for preparing PPPs and concessions and provided training to central and municipal government officials. As of mid-2009, eight major PPP projects were in various – mainly early – stages of realisation.
More attention to reduce entry barriers in rail freight is needed to ensure competition between providers and to achieve an efficient balance between road and rail.	No significant reform of the regulatory framework but the competition authority in 2009 fined Czech Railways for abuse of its dominant position in rail freight.
Creating a global role for Prague	
Maintaining the Prague economic area as a magnet for growth should remain a priority.	No significant action taken.
Stronger policy responses are needed to ensure a good regional transport system.	No significant action taken.

Chapter 2

Further advancing pro-growth tax and benefit reform

In 2008, the government implemented a major overhaul of the personal income tax (PIT), replacing the previous progressive rate schedule with a single 15% rate levied on an enlarged base. This was accompanied by significant changes to the corporate income tax (CIT) and an increase in the concessionary rate of value added tax (VAT) applied to many goods and services. The reform made the tax system more transparent and was broadly consistent with OECD recommendations concerning pro-growth tax reform. These tax changes followed the adoption of significant changes to the benefit system, particularly housing and social assistance benefits, in 2006-07. This chapter describes the main elements of these tax and benefit reforms and provides an initial assessment of their impact, with particular emphasis on changes in the effective tax rates of workers and firms. It begins with an overview of the systems and a summary of recent changes. This is followed by an evaluation of those reforms. A final section explores the scope for further reforms in future.

The Czech tax system

The tax system relies heavily on direct taxes, due chiefly to very high social security contributions

The tax/GDP ratio in the Czech Republic prior to the reform package introduced in 2008 was fairly stable at around 37%, somewhat lower than the EU15 but slightly above the OECD average and higher than in Poland and Slovakia. In 2008, the ratio fell only slightly, to 36%, since the tax reform had been designed in such a way as to limit the immediate revenue losses. The Finance Ministry actually estimated the revenue impact of the changes to be slightly positive in 2008, although it was expected to reduce tax revenues by around 0.5% of GDP in 2009 and 0.8% in 2010.[1] The fiscal squeeze that accompanied the recession, however, prompted postponement of some tax reform measures as the government sought to shore up its revenue base.

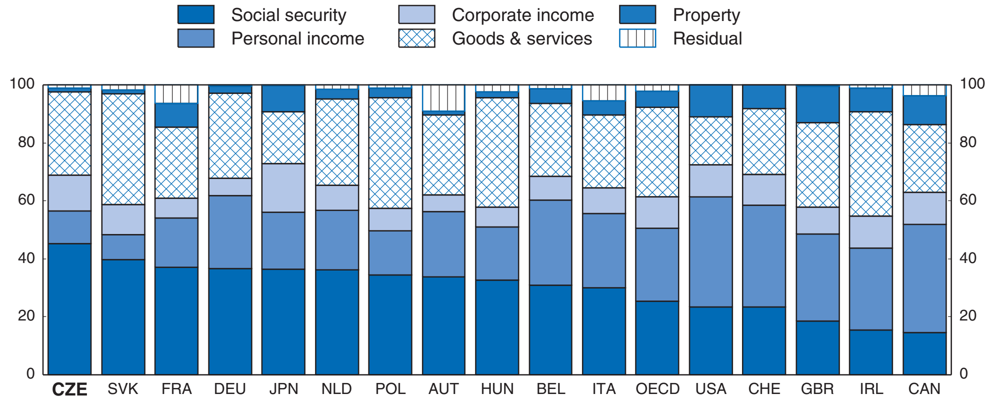
Czech tax policy in recent years has in many respects followed broader trends in the OECD. In many countries, there has been a "flattening" of income-tax schedules. Though only a handful of OECD members have moved towards flat-rate PITs, many have cut top statutory rates, sometimes quite dramatically. Corporate income tax (CIT) rates in many countries have also been cut, usually financed in part by base broadening, and top marginal rates on dividends have decreased, mainly as a result of the reductions in CIT rates. The share of consumption taxes in total revenues has declined gradually, with the mix of taxes on goods and services evolving towards greater reliance on general consumption taxes (mainly VAT) and away from taxes on specific goods and services (Johansson *et al.*, 2008).

Nevertheless, the structure of tax revenues in the Czech Republic is unusual, by the standards of both the OECD and regional peers, in several respects (Figure 2.1):

- The shares of both personal income taxes (PIT) and property taxes in total tax revenues are unusually low. PIT revenues accounted for about 10.8% of tax revenues in 2008, well below the averages for the OECD (24.9% in 2006) and EU15 (25.2%). Property taxes provided just 1.2% of tax revenues that year, compared to an OECD average of 5.7% for 2006 (EU15: 5.6%).
- Social security contributions (SSCs), by contrast, account for a larger share of total tax revenues than in any other OECD member – just over 45% in 2008,[2] as against an unweighted OECD average of 25.3% in 2006 and 28.2% for the EU15. The Czech figure is also well above the corresponding figures for Poland (36%), Hungary (32%) and Slovakia (40%). This partly reflects the fact that the overall take from other taxes is lower in the Czech Republic than in many other OECD countries but it is also the case that SSC rates are among the highest in the OECD, relative to both GDP and labour costs.[3] Employers pay 34% of gross earnings for each employee and employees 11% on earnings up to six times the average wage; self-employed persons pay 42.7% (44.1% if they opt to participate in the public sickness insurance scheme). In 2008, SSCs amounted to 16.2% of GDP, as against an OECD average of just under 10%.

Figure 2.1. **Tax mix**

% of total revenue



Note: Data refer to 2008 for the Czech Republic and 2007 for other countries.

Source: Ministry of Finance of the Czech Republic, *Fiscal Outlook*, October 2009; OECD (2009) *Revenue Statistics*; OECD calculations.

StatLink http://dx.doi.org/10.1787/816802266378

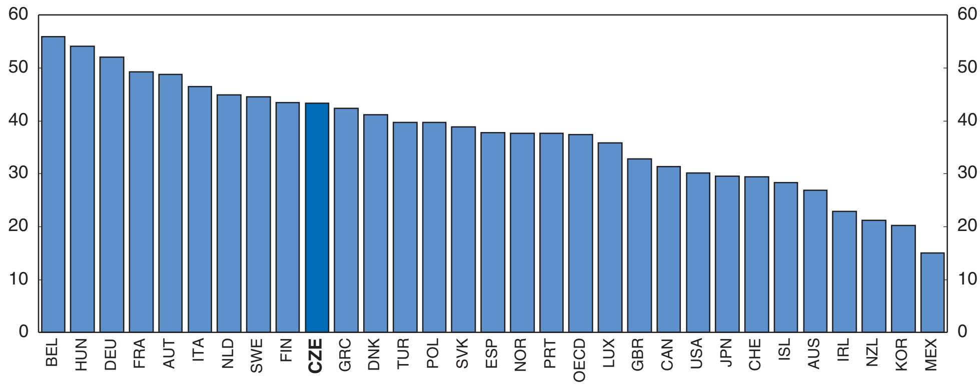
- Reliance on the CIT, which generated about 13% of tax revenues in 2008, is also high in comparison with the averages for the OECD (10.9% in 2006) and EU15 (9.0%). The Czech Republic in recent years has consistently ranked fifth in the OECD in terms of the ratio of CIT revenues to GDP. However, the statutory CIT rate is low by OECD standards and not out of line with those of regional peers. Reliance on CIT revenues is largely the product of economic structure: the corporate sector's share in value added is among the highest in the OECD area, a reflection of the concentration of activity in sectors like manufacturing, where the corporate form of business organisation predominates.[4] CIT revenues have changed little relative to GDP or total tax revenues in recent years, despite a series of reductions in the rate of CIT, although they are projected to drop sharply in 2009, owing to the recession.

The share of consumption taxes in total tax revenues, at 28.9% in 2008, is fairly close to the averages both for the OECD (31.6% in 2006) and the EU15 (30.1%).

Despite a relatively low, flat rate of PIT, the total tax wedge on labour is still above the OECD average, thanks chiefly to the burden of large SSCs (Figure 2.2). However, even more striking than the average wedge are differences in the tax wedges confronting different household types in different situations. The OECD calculates the combined burden of PIT and employee and employer SSCs across eight different household types, less the value of tax credits and other tax breaks to which each specific family-type is entitled. In 2008, the Czech Republic stood out for the size of the gap between childless and child-rearing households in otherwise similar situations: for both singles and couples, the degree of tax and benefit relief granted to those with dependent children is among the most generous in the OECD. For all categories of childless household, the wedge in the Czech Republic was well above the OECD average (Table 2.1). It was slightly above average for two-earner households with children, but the wedge for single-earner households with children was substantially below average (OECD, 2008c). As will be seen, however, although this system provides considerable support for families, it often confronts the second earner in such a household with very high average effective tax rates.

Figure 2.2. **Labour tax wedge, 2008**

Income tax plus employees' and employers' social security contributions as % of labour costs



Note: Data refer to a single individual without children at the income level of the average worker.

Source: OECD, *Taxing Wages 2008*.

StatLink http://dx.doi.org/10.1787/816858038258

Table 2.1. **Tax wedges for different household types in the Czech Republic**

Income tax plus employee and employer contributions less cash benefits (as % of labour costs), 2008

Household type	*No children*		*Two children*		*Difference in tax wedge between childless households and those with children*	
Wage level (% average wage):	Single 67	Married 100 + 33[1]	Single 67	Married 100 + 33[1]	*Single 67*	*Married 100 + 33[1]*
Czech Republic	**40.0**	**41.3**	**14.8**	**30.4**	***25.3***	***10.9***
Germany	47.3	47.2	34.8	41.4	*12.5*	*5.8*
Hungary	46.7	50.4	29.8	42.8	*16.9*	*7.6*
Poland	38.7	38.7	33.7	34.4	*5.0*	*4.2*
Slovak Republic	36.1	36.1	24.2	30.1	*11.9*	*5.9*
OECD[2]	33.5	34.3	18.4	29.4	*15.2*	*4.9*

1. Two-earner family, one earning the average wage (AW) and the other earning 33% of the AW.
2. Unweighted average.

Source: OECD, *Taxing Wages 2008*.

A major tax reform was implemented in 2008

A series of tax changes took effect at the beginning of 2008. The most important concerned the overhaul of the PIT and the introduction of a cap on income subject to SSCs at four times the average wage (CZK 90 764 per month in 2008). In late 2009, this ceiling was raised to six times the average wage from 2010, as part of the government's fiscal consolidation package. Most other major taxes were also affected by the 2008 reform in one way or another. The main aim of the reform was to promote growth and employment by simplifying the tax system, lowering tax rates while broadening tax bases, and gradually shifting towards greater reliance on indirect taxes. The government argued that the changes would strengthen the incentives for labour-market activation. It was also hoped that the flat-rate PIT would encourage human capital formation, since the returns on investment in human capital would be taxed less heavily. The changes to capital taxation arising from both the PIT reform and the reduction in the CIT rate were meant to boost investment and also make the allocation of capital more efficient.

The PIT reform introduced a flat-rate system based on direct labour costs (often referred to as "super-gross" earnings), with a fixed rate of 15% to replace the previous progressive scale, which comprised 12, 19, 25 and 32% brackets. The so-called "super-gross" tax base for employees comprises the gross salary and the employer's health and social insurance contributions, which are equivalent to 35% of gross salary. The 15% rate levied on this base is roughly equivalent to a rate of about 23% for dependent employees under the pre-reform PIT. The 15% headline rate was to have fallen to 12.5% from 2009, but in late 2008, the PIT rate cut was set aside in favour of a 2.5 percentage-point reduction in social security contributions adopted as part of the government's response to the economic crisis.[5] The reform significantly increased various credits, including the personal tax credit,[6] the tax credit for a non-earning spouse and the tax credit for children. These changes were intended to avoid any increase in the tax burden on those previously taxed at rates below 23%. The relatively high basic tax-exempt income threshold also allowed some progressivity in the average tax rate to be retained: even a single earner with no children enters the PIT net only at about 45% of the average wage. For many earners, PIT liabilities first bite at still higher levels: for a single earner with two children, the basic tax-exempt income threshold rises to 130% of the average wage. The joint taxation of couples with children was abolished – there is little advantage to joint taxation under a flat-rate PIT – but an increased tax credit for a dependent spouse is reckoned to compensate those who might nevertheless have lost out as a result of the change. Other changes included greater tax relief for students and holders of medical disability cards, and changes in the tax-exemption rules applying to the sale of securities.

The position of self-employed persons is somewhat more complicated than that of dependent employees, owing to other changes. Like dependent employees, the self-employed benefit from a lower tax rate and a larger personal credit, but under the super-gross system, they are no longer able to deduct their social and health insurance contributions from their tax base. On balance, the new system offers them relief, because they pay lower SSCs and are thus less affected by the adoption of the new larger base. Moreover, the minimum tax for the self-employed was abolished. Self-employed persons already benefited from a cap on earnings subject to SSCs, and the reform raised this cap to the level of that introduced for dependent employees.

The reform also cut the statutory CIT rate from 24% in 2007 to 21% in 2008 and 20% in 2009, continuing a trend that began in 2000, when the rate fell from 35 to 31%.[7] All withholding taxes on capital returns were unified at a 15% rate, the minimum allowed under EU regulations. These rate reductions were accompanied by some broadening of the tax base, most notably the tightening of thin capitalisation rules and limitations on financial expenditure. The CIT fell to 19% in January 2010, though this will affect cash flows only in 2011.

The preferential rate of VAT applied to a range of basic goods and services rose from 5 to 9%. The increase in the concessionary rate of VAT served to offset the revenue losses arising as a result of the changes to the PIT and CIT. However, while reducing the gap between the two rates, the reform expanded the reduced-VAT group to include certain environmental fuels (*e.g.* biofuels) and technologies in an effort to stimulate demand for more environmentally friendly products. Both the standard and lower VAT rates were raised by one percentage point in 2010, as part of the government's fiscal consolidation efforts.

Changes to other taxes were modest:

- Municipalities have been empowered to exempt farm land from the real-estate tax, though they can then withdraw the exemption if the land is close to a built-up area or is designated for construction. At the same time, they have been given the right to choose between four different tax rates for the real estate tax on buildings and non-agricultural land. The latter measure was intended to allow municipalities to offset revenue losses arising should they choose to exempt farmland. The reform also initiated the phase-out of the previous exemption of newly constructed buildings from the real estate tax for 15 years.
- New environmental taxes on electricity, coal and other solid fuels, and natural gas were introduced in compliance with the European Energy Taxation Directive (2003/96/EC). These reinforce the shift towards greater reliance on indirect taxes. Excise taxes were also revised to meet EU obligations, including higher rates on tobacco products. In 2008, mineral oils and tobacco products accounted for around 90% of revenues from these taxes, with liquor, beer and wine bringing in most of the rest. Taxes on electricity, gas and coal generated little revenue.
- Exemptions on gift and inheritance taxes were widened.

Altogether, the reform package shifted the total tax burden slightly from direct to indirect taxation: the share of indirect taxes in total tax revenues rose by about 0.8 percentage points in 2008. This, however, followed an increase in the share of *direct* taxes of roughly 2.4 percentage points over the decade to 2007. There is thus considerable scope for further shifting towards greater reliance on indirect taxes.

The benefit system has undergone many changes

Recent tax changes must be assessed alongside the numerous adjustments to the benefit system that have been made in recent years. The Czech Republic's three-pillar system of social protection (Box 2.1) is relatively extensive and is widely regarded as effective in reducing poverty and inequality. Like many small, highly open economies, the Czech Republic relies on relatively generous social protection to mitigate the adjustment costs that trade openness and product-market liberalisation sometimes entail.[8] Yet if the openness of the Czech economy constitutes an argument for a fairly extensive benefit system, it also underscores the importance of designing benefit policies so as to encourage work and avoid benefit traps. Over the long run, the sustainability of such systems of social protection depends on maintaining the high levels of employment needed to finance them. Ensuring that work pays has therefore been one of the main aims of benefit policy in recent years. Nevertheless, the numerous reforms adopted in recent years have not been entirely consistent.[9] Some tended to increase and others to curtail the generosity of various benefits. In particular, many benefit increases adopted in 2006 tended to increase incomes of those not in work, thereby reducing their incentives to activate. Yet subsequent reforms aimed at clawing back some of these increases actually reduced the incentives to work even further, since they withdrew many benefits at lower incomes than before rather than cutting them across the board. This sequence of expansion and retrenchment thus highlighted the tension between limiting benefit expenditure, by effectively targeting those most in need, and encouraging activation, by ensuring that benefit withdrawal does not confront those entering employment or increasing hours worked with excessive average or marginal effective tax rates.

Box 2.1. **The system of social protection**

The Czech system of social protection rests on three major pillars, a social insurance pillar financed from dedicated social security contributions and two non-contributory benefit systems financed from the state budget:

- The **social insurance** system, as its name implies, covers contributory benefits, including unemployment benefit, sickness insurance, and disability and old-age pensions. Contributions are defined as a percentage of gross earnings and are divided between employer and employee. Since benefits are paid in relation to previous net income, there is some relationship between contributions and benefits, but the formulae for computation of most benefits entail significant redistribution.
- **State social support** focuses on the needs of families with dependent children; the system covers child benefits, parental allowances, birth and death allowances, housing allowances, foster-care allowances and social supplements. Social support benefits are not means-tested but child allowances, housing allowances and social supplements are income-tested.
- The system of **assistance in material need** (hereafter simply "social assistance"), which underwent a major overhaul in 2007, provides safety-net income to individuals or families who meet certain eligibility requirements and whose income, including all other state support benefits, pensions or sickness insurance benefits, is insufficient to allow them to meet what are accepted to be basic living requirements. This is aimed at preventing poverty and social exclusion, especially of children. Benefits in this system are means tested (property and income). The system gives preferential treatment to recipients who are working or actively seeking work, though certain groups (pensioners, parents caring for children, etc.) are not required to seek employment. The level of benefit is determined by the living minima established for each member of the household: these minima depend on the ages of the recipients and the composition of the household.*

* For example, the minimum for an adult living alone is higher than for an adult in a multi-member household; the minimum is higher for the first adult in the household than for other adults, and lower minima are defined for children and young people.

The run-up to the 2006 general election witnessed some very large increases in benefits available under state social support, with little accompanying reform. Parental allowance – the largest benefit paid under state social support – more than doubled in 2007, from CZK 3 696 to CZK 7 582 per month. Aggregate expenditure on parental allowance thus jumped from CZK 13.5 bn to CZK 28.7 bn. Expenditure on birth grants, which were also increased, rose by around one-third, and child allowances were also increased. In 2008, some of these changes were reversed. The birth grant was cut, and the child allowance was simplified, while eligibility was reduced. Previously, it had been paid at three levels, depending on household income, up to a threshold of three times the "Minimum Living Standard" (MLS, see below) defined for the household. Now there is only a single rate of benefit paid, which is available to households with incomes up to 2.4 times their MLS. At the same time, parental allowance was revised to allow parents the option to receive it over two, three or four years, albeit at different rates, so that the overall value of the benefit is roughly the same. The allowance now has three payout options: CZK 11 400 per month for two years; CZK 7 600 per month for three years; or CZK 7 600 per month until the child is 21 months old and then CZK 3 800 until he/she is 48 months old.

Only around 5% of new parents have opted for the two-year parental leave option, with 42% opting for the extended, four-year arrangement. In 2009, the child allowance was increased again as a temporary measure, in an effort to mitigate the impact of the economic downturn on families with children, while eligibility was marginally relaxed.[10]

One of the most potentially far-reaching changes introduced in 2007, and one that affected a range of benefit calculations, was the revision of the formula for calculating the MLS, which was meant to reflect the cost of living. This was used in calculating most benefits, which were typically stated in multiples of the MLS. Previously, the MLS was calculated in two parts: a personal MLS for each member of the household (there was a single value for all adults and a scale of four values for children, depending on their ages) and a household MLS, based on the number of persons in a household and intended to reflect housing expenses, in particular. The MLS for a household thus depended on the number of members and the value of the personal MLS of each member. Under the new system, however, there is only a single MLS calculation based on the number of persons in the household and their status: there are now just three age brackets for children, but the amount for the second and further adults in a household is lower than for the first; there is also a separately defined MLS for single-member households. In addition to the revised MLS, the authorities introduced a new "subsistence minimum" of CZK 2 020 per month – well below the MLS for an adult – which replaces the MLS when calculating social assistance benefits for unemployed individuals who do not co-operate with efforts to find them employment or otherwise improve their situations. Overall, the new MLS formula is less generous than the old, but the impact of this change was initially offset by adjusting the formulae for calculating some benefits so as to offset the effect of a lower MLS.[11]

Subsequently, a number of benefits were effectively "decoupled" from the MLS, being stated in cash amounts instead. This change affected the birth grant, the parental allowance, child allowances and housing allowance. The MLS remained the basis for social assistance payments aimed at the lowest-income households, but less targeted benefits were de-linked from it. The purpose of the change was to hold down the expenditure increases associated with increases in the MLS and thus to reverse some of the large benefit increases adopted prior to the 2006 general election (OECD, 2008a:73-74). The long-term implications of this shift are unclear. As the previous *Survey* suggested, there is a danger that some benefits may get more attention than others for political reasons, and regulations concerning indexation of the MLS and subsistence minima are in any case very light: increases are set by government decree, although the MLS must be increased at least in line with the CPI when inflation exceeds 5%. While a period of discretionary indexation can provide fiscal savings, the authorities should ultimately consider a return to comprehensive automatic indexation on the basis of a formula that is transparent and fiscally sustainable.

In the case of housing allowance paid under state social support, decoupling from the MLS came in the context of a shift towards defining housing benefits in relation to housing costs. Until 2007, housing benefit was defined purely in terms of the relationship between households' net income and the various components of their MLS. Under the new formula, housing benefit covers the gap between prescriptive housing costs, defined according to family size, type of accommodation and location, and 30% of household income (35% in Prague). The cost estimates, set by government decree, are reckoned to be fairly conservative. At the same time, a new housing supplement was introduced under social assistance in order to provide additional support to households whose total net income, including housing allowance and living allowance, is still lower than the MLS. The combined effect of the two changes has been to increase the generosity of housing benefits overall but also to improve the relative position of the lowest-income groups, who appear to have benefited most from the changes (OECD, 2008a).

The upshot of the foregoing is that both tax and benefit systems have undergone numerous changes in recent years, some of them quite substantial and not all of them entirely consistent with one another (Table 2.2). While governments since 2006 have taken steps to reverse some of the benefit increases adopted prior to the general election that year, they have also increased the generosity of other benefits. Moreover, in a number of instances, they have accelerated benefit withdrawal rates rather than reversing benefit increases overall. This means that benefits are arguably better targeted at those most in need, but, as will be seen, it also increases the marginal and average effective tax rates faced by many non-working individuals should they enter employment.

Table 2.2. **Major changes in tax and benefit systems, 2004-09**

	Measure
2004	Increase in unemployment benefit after three months raised to 45% of previous net wage Differentiation of duration of unemployment benefit entitlement according to age (15-50, 50-55 and 55+)
2005	Introduction of joint taxation of married couples with children Replacement of tax deductions for children by a payable tax credit for children
2006	Reduction in the basic rate for the first two PIT brackets Increase in the ceiling for the lowest PIT bracket
2007	Change in the calculation of the minimum living standard (MLS); introduction of a lower "subsistence minimum" as a sanction for those not co-operating with labour offices Introduction of new form of housing allowance, based on the relationship between household income and "prescriptive" housing costs, which are linked to municipality size[1] Extensive reform of assistance in material need, introduction of a new living allowance and a housing supplement New maximum for unemployment benefit set at 0.58 times the average wage for the first three quarters of the calendar year preceding the year in which the application for unemployment benefit is made
2008	Introduction of single flat rate for personal income tax, based on "super-gross" income, expansion of basic tax credits Abolition of joint taxation of married couples with children Introduction of a ceiling on income subject to social security contributions (SSCs) for dependent employees, increase in the SSC ceiling applied to the self-employed to match the new ceiling for employees Reform of parental allowance, allowing parents to choose the period over which it is drawn down (2-4 years) Revision to child allowance, payable in fixed amounts to families up to 2.4 times the living minimum, with simplification and reduction of eligibility
2009	Reduction in social security contributions paid by employers (1 p.p.) and employees (1.5 p.p.), the former to be phased out in 2010[2] Increase in tax credit for children Increase in child allowance (valid until end-2009 only) Replacement rate for unemployment benefit to be raised to 80% for the first two months and 55% thereafter, as from 1 November 2009 (never implemented)[3] Introduction of a three-day waiting period for receipt of sickness insurance benefits and employer responsibility for sick pay from the fourth through the fourteenth day of a sickness spell

1. If actual housing costs are lower than "prescriptive" costs, then allowances are based on actual costs.
2. The phasing out of the temporary reduction in employer SSCs was accelerated as part of the fiscal consolidation package adopted in the autumn of 2009.
3. Legislation adopted prior to the crisis would have reduced benefit duration by one month while raising replacement rates; the government's anti-crisis package raised replacement rates further and restored the extra month to the duration of the benefit. This was reversed again, however, by the fiscal consolidation package, which returned to the less generous policy settings.

Source: Pavel (2009); and Ministry of Finance (2009).

Labour taxation, the benefit system and labour supply

This section considers the implications of recent changes in the tax and benefit system, particularly in terms of their impact on work incentives. It looks first at the impact of the changes to the PIT, SSCs and social benefits on households, particularly their labour-supply decisions. The impact of both tax and benefit reforms can be assessed by analysing average and marginal effective tax rates (AETRs and METRs). The interaction of the tax and benefit systems can create high effective rates for certain groups, affecting labour-force participation, working hours and employment. The importance of work incentives is likely to increase in the near future. Labour-market outcomes have worsened considerably in the current economic downturn. The experience of past recessions suggests that there is a high risk that many newly unemployed individuals will either become long-term unemployed or will simply withdraw from the labour force. Current policies need to aim at supporting unemployed individuals in such a way as to facilitate their speedy return to employment. This being the case, the benefit and tax systems and the incentives created by their interaction may become more important in shaping labour-market developments and will have important fiscal consequences. For example, although the duration of unemployment benefits is relatively short (five months for those under 50 years of age, eight months between 50 and 55, and eleven months for workers above 55), the interaction of the benefit and tax systems will be crucial in avoiding the creation of unemployment traps.

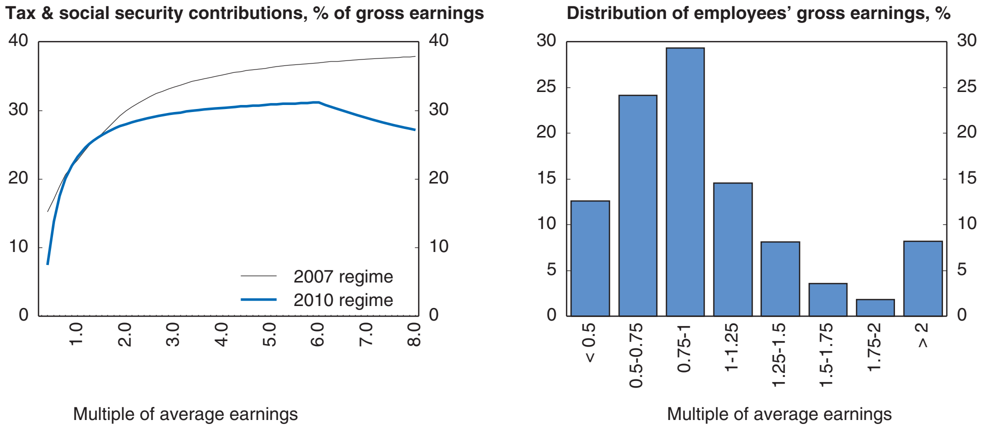
The PIT reform and the cap on SSCs had a limited effect on the tax wedge

A large body of research suggests that tax changes can have a significant impact at the margin on the labour supply of specific groups, even if their aggregate impact is limited. While hours of work are relatively inelastic for men overall, some recent work suggests that the participation rates of low-skilled men may be more responsive to changes in incentives than previously thought (Meghir and Phillips, 2008). It is widely accepted that the participation of married women and single parents can be quite sensitive to taxation, though once active, their effort, in terms of hours worked, appears to be only slightly more responsive to taxes than that of main breadwinners. For highly skilled men, participation rates appear to be unresponsive but higher marginal rates seem to discourage effort. Finally, the self-employed appear to be more responsive to taxes than dependent employees.[12] This result is consistent with OECD work suggesting that high marginal tax rates discourage entrepreneurship and, by extension, may dampen productivity growth (Johansson *et al.*, 2008; and Vartia, 2008). The results reported by Bičáková *et al.* (2008) in a study of Czech labour supply are broadly congruent with these findings from studies elsewhere. Overall, the Czech Republic conforms to the general rule that high participation rates are inversely related to the wage sensitivity of labour supply: Czech participation rates are high and wage elasticities are generally low. However, the elasticities for low-wage men are about six times the average for all men. Women's elasticities are about triple those of men, on average, and vary little with income. These findings point to some initial expectations about the likely impact of the recent Czech tax reforms.

Taken together, the reform of the PIT and SSCs brought little change in the tax wedge for most dependent employees but did result in significant reductions for those well above average earnings and those at the very bottom of the wage distribution (Figure 2.3). On its own, the reduction in the wedge for low earners constitutes an incentive to seek and accept vacancies. However, as will be seen, the real impact of this change on the low-paid depends

Figure 2.3. **Impact of the new personal income tax**

PIT plus SSCs as a percentage of gross earnings



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

Source: Czech Statistical Office; OECD calculations.

StatLink http://dx.doi.org/10.1787/817010587585

on its interaction with the benefit system: many low earners may face steep rises in their marginal effective tax rates (METRs), even if their average effective tax rates (AETRs) have fallen. Moreover, benefit changes in some cases result in increased AETRs for households that gained from the PIT reform. The drop at higher incomes is partly the result of the PIT reform but mainly, at very high incomes, a product of the cap on SSCs, which affected roughly the top 1.8% of earners in 2008; the new, higher cap in effect from 2010 will affect still fewer. The ceiling is unlikely to have a big impact on labour supply, since the affected groups are already in work, by definition, and research suggests that their marginal supply is fairly insensitive to tax changes (Meghir and Phillips, 2008).

The SSC ceiling was not, strictly speaking, part of the tax reform package at all: it was adopted separately. Its principal rationale was to reflect the fact that pensions and other social security benefits are subject to maximum levels, regardless of contribution history. Since these systems are meant to operate as social insurance rather than forms of social assistance, it was argued that a ceiling on income subject to SSCs would strengthen the link between contributions and benefits. Such caps on SSCs are a feature of many OECD tax systems. They are typically aimed at limiting the degree of cross-subsidy in pension and social insurance systems and at strengthening the link between contributions and benefits. However, most countries with an SSC ceiling also have PIT systems with progressive rate schedules. The combination of the SSC ceiling and the flat PIT is thus unusual, though not unique, in the OECD. The sharp drop in the METR at such a high level of income, and the fact that it implies steadily declining *average* effective tax rates for high earners has prompted criticism on grounds of equity.

It is important to set the equity implications of the reform in context. First, income distribution in the Czech Republic is unusually compressed by OECD standards and the incidence of poverty is lower than in almost any other OECD country. Secondly, questions of equity are better assessed in terms of the tax and benefit system as a whole. Thirdly, any assessment of the system's equity needs to look not only at the degree of redistribution that it effects but also at its impact on labour-market incentives and opportunities. A more "generous" or "progressive" system may seem more equitable at first glance, but if it creates inactivity traps or disincentives to increase earnings, then its claim to equity is open to question. It could, moreover, be argued that the SSC ceiling will benefit the whole economy, as it represents a form of tax competition for the most internationally mobile workers, and that, at least at the margins, it reduces incentives for tax evasion. It might also generate some positive externalities by increasing incentives to invest in human capital or engage in entrepreneurship (OECD, 2008a, Johansson *et al*., 2008). Nevertheless, even bearing these considerations in mind, the SSC ceiling looks like an anomaly. Since it affects fewer than 1% of earners, it would also be difficult to argue that it does much to strengthen the contributions-benefits link in the social insurance system or that its impact on labour-market incentives is very great. It introduces a marked discontinuity in the effective marginal tax schedule. This contrasts starkly with the steeply rising METRs faced by many on low incomes and is at odds with the goal of flatter and smoother schedules. Finally, it leaves a very small minority of very high earners with lower AETRs than those affecting less well off income groups. The current ceiling on SSCs is difficult to defend on equity grounds and unlikely to have much impact on labour-supply decisions. It has already been raised once since its introduction, and the government should consider eliminating it altogether.

The impact of the tax changes on labour supply depends on their interaction with the benefit system

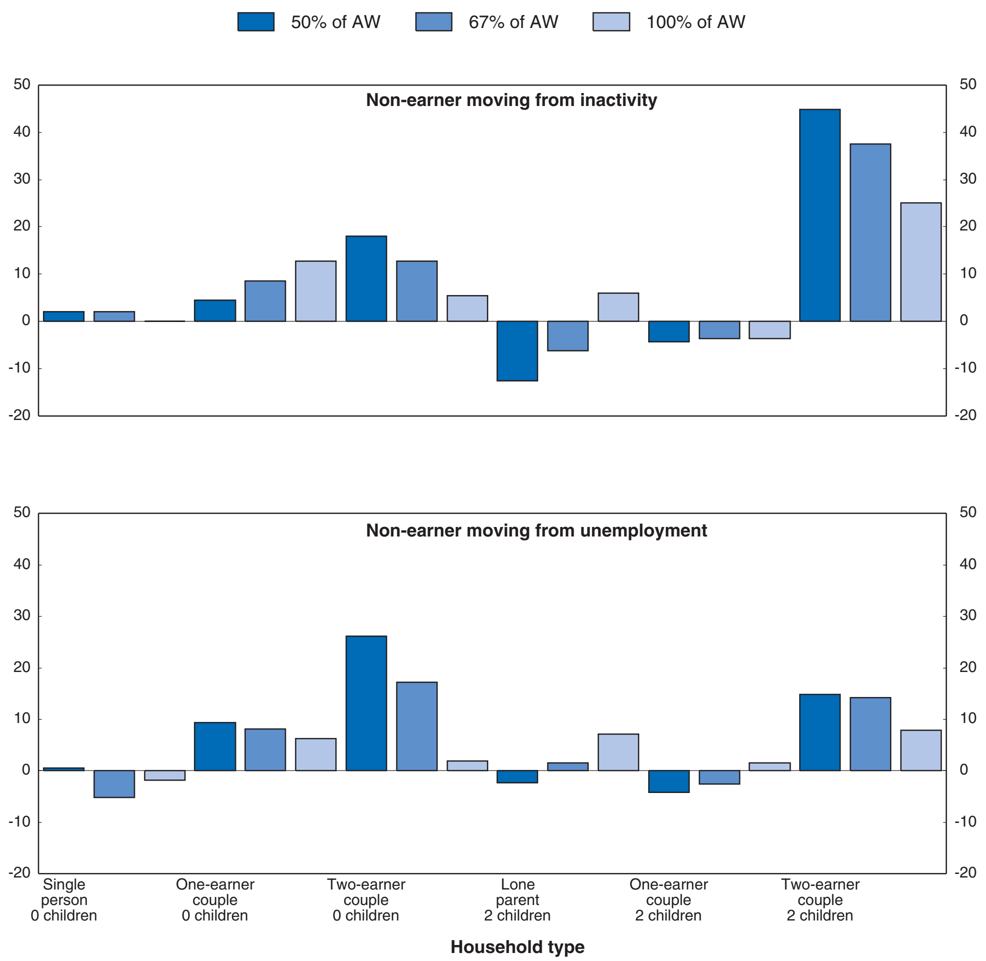
In principle, the impact of tax and benefit reforms on labour-market behaviour should depend on the path of average effective tax rates (AETRs), which primarily influence the decision to *enter* the labour market, as well as changes in marginal effective tax rates (METRs), which mainly influence the incentives to work one hour/one unit more (Carone *et al*., 2004). The analysis presented here uses a modified version of the OECD's *Tax and Benefit Model* to assess the impact on households of the numerous changes to the tax and benefit systems adopted in recent years.[13] The *Tax and Benefit Model*, despite some limitations, offers perhaps the best available basis for an initial assessment, since the detailed data needed for an empirical analysis of household behaviour in response to the most recent reforms do not yet exist.[14] Moreover, since there have been more or less continuous changes to the system in recent years (Table 2.2), it would be extraordinarily difficult to assess the behavioural response even to some less recent reform measures, and it would be hard to distinguish between the impact of the current economic situation and the impact of the reforms. The analysis that follows looks first at changes in AETRs under the recent reforms, before turning to an analysis of the reforms' impact on the METR profile facing different sorts of households as they move up the earnings scale. It should be noted at the outset that the model does not cover disability pensions or sickness insurance, both of which have likewise been the subject of important recent reforms; these are discussed separately below.

Overall, the model suggests that the most significant changes in the tax and benefit system include the introduction of a higher standard tax credit (2008), the change in housing allowance and the social assistance supplement for housing (2007), the changes in family benefits (2007-08), the reform of the MLS and the introduction of the single PIT rate. The first four of these reforms apply primarily to households with earnings below the average wage (AW). Since the evidence suggests that low-income workers are more responsive to financial incentives, they are arguably well targeted to achieve a labour-supply response. The flat PIT rate, by contrast, has its greatest impact on households earning more than 160% of the AW. The cap on SSCs is not captured in the analysis, since the model focuses on wage levels up to 200% of the AW, well below the level at which the cap takes effect.

Average effective tax rates are above the OECD average for many household types

The AETR reflects the tax and benefit incentives to participate in the labour market and to take up a job, as it measures the part of any additional gross earnings that are "taxed away" when moving from inactivity or unemployment to full-time employment. Overall, it seems that the AETRs facing individuals moving into low-wage jobs are somewhat higher than the OECD average for most household types (Figure 2.4). However, most of the differences are fairly small; the larger ones concern two-earner families with and without children. The AETRs for these groups suggest that there may be disincentives for second

Figure 2.4. **AETR: Czech Republic minus OECD average**



Note: In a one-earner household the base case earnings are 67% of the average wage (AW). The graph shows the average effective tax rate (AETR) when an individual in the base case household moves to full-time employment at 50%, 67% and 100% of AW. Simulations refer to the systems in 2008 and 2007 for the Czech Republic and OECD respectively. Twenty-four members are included in the reported OECD average.

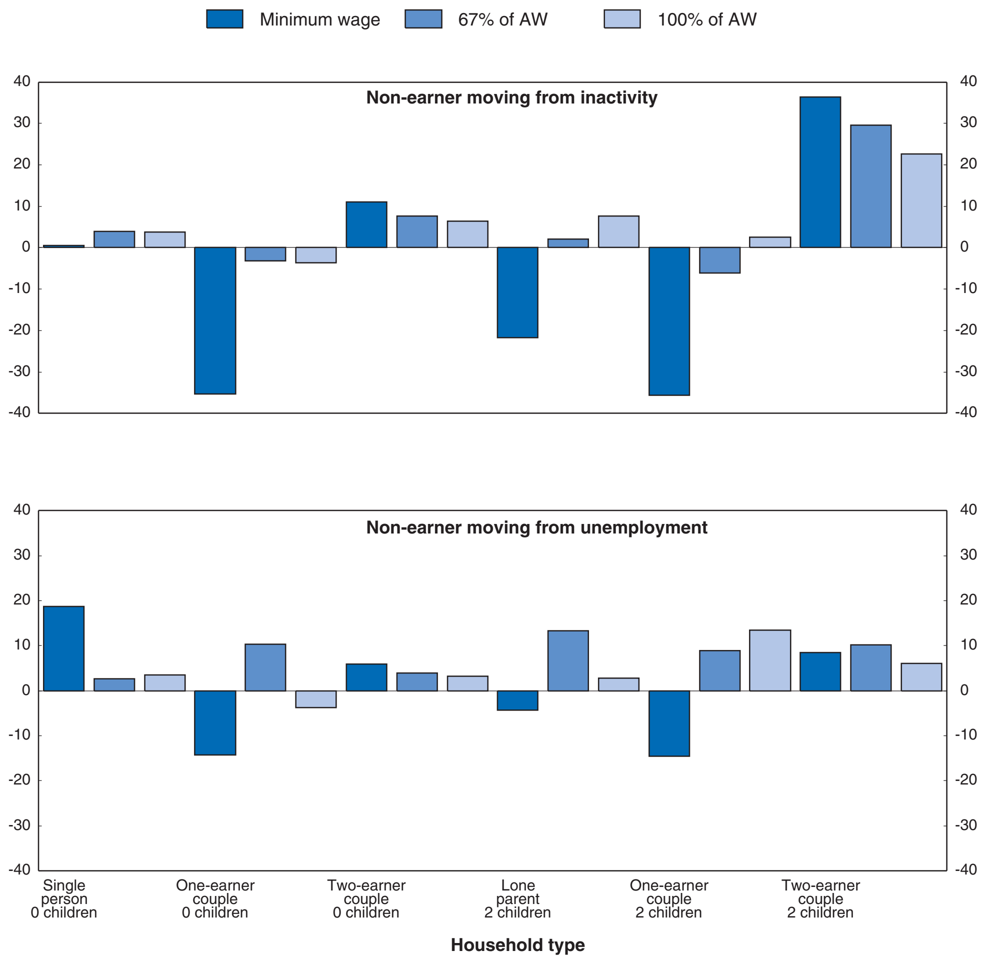
Source: Ministry of Finance; Ministry of Labour and Social Affairs; and OECD, *Tax and Benefit Model.*

StatLink http://dx.doi.org/10.1787/817018837308

earners to work. Furthermore, the AETRs are comparatively high not only at low income levels but also at the level of the average wage. As in many countries, the incentives to work in the Czech Republic are lower for households entitled to unemployment benefits (Figure 2.5), although the limited duration of those benefits for most workers means that this probably matters less than in many other OECD economies. The relatively high AETRs on labour supply are matched to some extent by factors that tend to depress demand for low-skilled labour, such as high severance costs and employer-paid social charges (CNB, 2008).

Figure 2.5. **Changes in AETRs for different household types, 2006 and 2008**

Percentage points, AETR in 2008 minus AETR in 2006



Note: In a two-earner household the second spouse is assumed to have full-time earnings equal to 67% of the average wage (AW). The graph shows the average effective tax rate (AETR) when an individual moves to full-time employment at the minimum wage, 67% of AW and 100% of AW. Simulations refer to the systems in 2006 and 2008.

Source: Ministry of Finance; Ministry of Labour and Social Affairs; and OECD, *Tax and Benefit Model*.

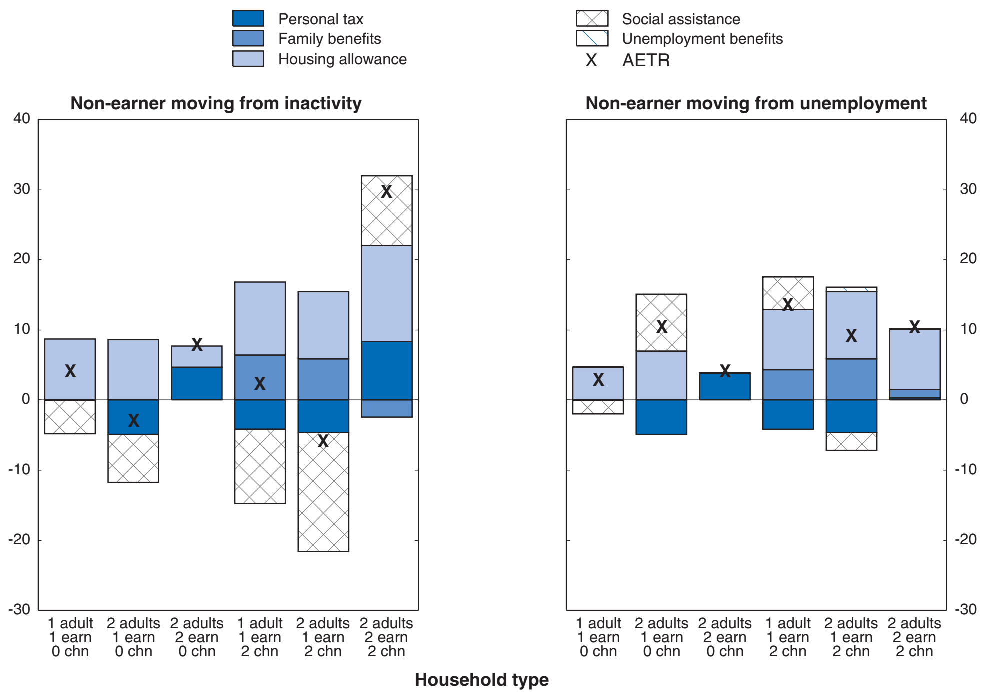
StatLink http://dx.doi.org/10.1787/817138005774

The impact of the reforms on AETRs has been limited

Given the relatively low estimates for the wage elasticity of labour supply in the Czech Republic, the size of most of the changes in Figure 2.5 above suggests that the tax and benefit reforms adopted in 2006-08 had little impact on the overall incentives to move from inactivity/unemployment to full-time employment for most households, except for couples with children and some minimum-wage workers. The changes in the personal income tax system in 2008 have clearly had a smaller impact on AETRs than the changes to the benefit system. Moving to the flat tax rate system with increased tax credits reduced the AETR for most households, though it increased slightly for certain households whose tax liability exceeded the tax credits but whose income was too low to benefit from the flat rate – *i.e.* their pre-reform tax rate was lower than the flat rate equivalent of 23% (Figure 2.3 above). However, the reforms give a particularly beneficial treatment to households with children, making the work incentives relatively low for the second earner in the household.[15] Family benefits, including both child allowance and social allowance, have become more generous at low income levels for households with children (Figure 2.6). This increases the second earner's AETR and thus reduces incentives to activate. Furthermore, the withdrawal of family benefits takes place at a lower income level than previously, which is likely to increase AETRs when moving from inactivity or unemployment to full-time employment.

Figure 2.6. **Changes in the AETR and its components, 2006-08**

Percentage points, 2008 minus 2006



Note: In a two-earner household the second spouse is assumed to have full-time earnings equal to 67% of the average wage (AW). The graph shows the change from 2006 to 2008, in the effect of an individual in the base case household moving to full-time employment at 67% of AW. Personal tax is income tax and social security contributions.

Source: Ministry of Finance; Ministry of Labour and Social Affairs, and OECD, *Tax and Benefit Model*.

StatLink http://dx.doi.org/10.1787/817178380265

The 2007 reform of social assistance implied changes in the living allowance, but it also included the introduction of the housing supplement – a new component of social assistance. In general, the post-reform living allowance is less generous at low income levels, but eligibility for the allowance was extended to higher income levels – in other words, it is withdrawn less quickly. In addition, the housing supplement partly compensates for the lower living allowance. The comparison of the impact of these reforms on AETRs at different income levels shows that the level of social assistance for an inactive single person or a single-earner household with zero gross income is lower after the benefit reform, whereas there is no change in the benefit level at an income of 67% of the average wage: at this level, the household was not and is not eligible for social assistance. The lower AETRs faced by households at 67% of the average wage thus reflect a reduction in net income when inactive. The reform of social assistance also reduced the AETRs of single-earner households with children. For households with two earners and no children, the benefit situation remained the same: they are not eligible for the benefit. However, the new social assistance system gives more favourable treatment to low-income couples with children: under the pre-reform system, such households were not eligible for social assistance, but under the current system they are covered by social assistance at low income levels. The new housing allowance scheme, which was reformed to reflect housing costs, is more generous for all households with income levels eligible for this benefit.[16] However, the increase in the housing allowance was relatively higher for lower income households. Thus, the reform implies higher AETRs for households moving from inactivity to full-time work. In particular, the allowance increased AETRs of households with children.

Marginal effective tax schedules have become flatter for most household types

This section assesses the impact of the reform on *marginal* effective tax rates (METRs) for different types of households at different points in the income distribution (Figure 2.7). Attention is focused on those spikes in METRs that fall at or above the minimum wage, which is about 30% of the average wage: discontinuities in METRs below this level would affect incentives only for part-time workers, which is an issue that will be discussed separately. The METR takes into account not only the nominal marginal rate of tax but also any loss of welfare entitlement that an individual may experience as result of increased earnings. It thus reflects the share of an additional unit of income that the individual can expect to keep. Overall, the results show that the tax and benefit reforms have made the METR schedule somewhat flatter, which is to be welcomed, although the ceiling on income subject to SSCs introduced a very large discontinuity at four (from 2010, six) times the average wage, with the METR falling sharply. The flattening of METR schedules is particularly evident in respect of households without children and those on higher incomes. Both the profile of the METR schedule and the extent to which it has changed in recent years depend not only on income level but also on the type of a household.

Disincentives to work exist for certain groups and in some cases have been reinforced

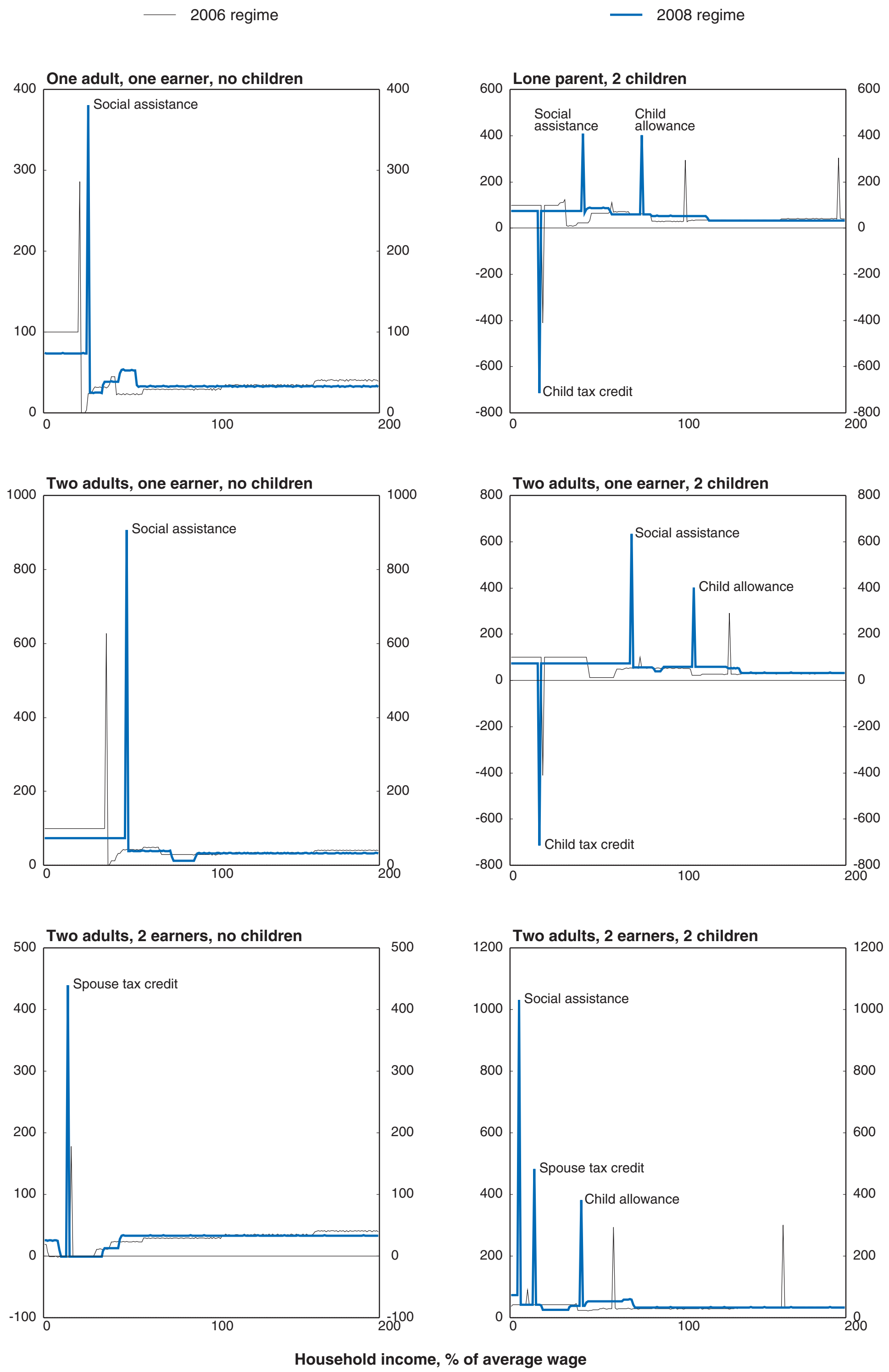
An assessment of changes in the tax and benefit system over 2006-08 reveals no simple picture of the effects of successive reforms. On the one hand, the 2008 PIT reform has made the METR profile flatter for most household types, although they do face larger stepwise jumps in marginal rates, due to the combination of an expanded standard tax credit and an effective flat PIT rate that is higher than were the lower brackets under the old system. On the other hand, the benefit system continues to create discontinuities in METR schedules and substantial changes in net income (Figure 2.7). In a number of cases, the "spikes" in the METR profile, reflecting a fall in net income, have simply been shifted along the wage scale: family benefits are withdrawn at a lower income level in the post-reform system, whereas social assistance is withdrawn at a higher level. Similarly, stepwise jumps in the METR profile have also moved up the wage scale, as the standard tax credit has been enlarged and the housing allowance is now withdrawn at higher income levels than before.

In general, the benefit and tax reforms have strengthened the incentives to increase work effort for most household types at very low wage levels. In 2006, virtually all single-earner households encountered METRs of 100% or more at very low income levels, implying that working another additional unit would not have increased the net income of these households. This disincentive to work was partly due to the way the living minimum was defined and used in the calculation of social assistance. Since the reform in 2007 changed the definition and the calculation of social assistance, this disincentive has been reduced. However, for two-earner households, the situation is different: the reformed benefit system discourages the second earner from working at low income levels, even on a part-time basis. At higher income levels, the introduction of the flat-rate PIT in 2008 reduced METRs, thereby increasing work incentives.

As is clear from Figure 2.7, the most apparent difference in impact concerns the relative positions of households with and without children. For households without children, the reforms brought little change, although single-person households face somewhat higher METRs at wage levels between 43% and 106% of the average wage than they did in 2006. For households with children, the METR profile is characterised by numerous ups and downs, and it is hard to generalise about the reform's impact on their work incentives. The benefit reforms in 2008 simplified the calculation and the withdrawal of the child allowance and thus reduced the number of "spikes" in the METR profile. However, this reform had little impact on the difference in net income (the AETR) in and out of work or METRs at other income levels. In terms of net income, the impact of the reform of social assistance, *i.e.* living allowance and the housing supplement, was considerably larger. Households with children confront considerable peaks in the METR profile and drops in net income due to benefit withdrawal, implying that the reforms may have reduced the incentives to increase working hours. For example, the withdrawal of social assistance at the 43% of the average wage has a significant negative effect on the net income of lone-parent households. They have to increase earnings by around 50% in order to obtain the same net income as before the withdrawal. Two-adult households face similar drops in net income due to the withdrawal of social allowance. The second earner, in particular, is discouraged from increasing hours worked. Another disincentive to work for the second earner is the abrupt loss of the spouse tax credit once the spouse earns more than a half of minimum wage, *i.e.* 16% of the average wage.

Another benefit withdrawal that creates a spike in the METR profile and a substantial drop in net income is the withdrawal of unemployment benefit, which is lost once a beneficiary begins earning more than half of the minimum wage. Hitherto, this has affected a relatively small number of households, because there are very few part-time workers, and the duration of unemployment benefits is only six to eleven months. In the years prior to the crisis, roughly half or more of the unemployed in the Czech Republic at any given time were long-term unemployed (over one year) and roughly 70% had been unemployed for over six months, so the benefit withdrawal disincentive would have affected only a minority of unemployed persons, even assuming that all those unemployed for less than six months were eligible for unemployment benefits. However, this may become a larger problem as a result of the surge in unemployment since late 2008.

Figure 2.7. **METRs for different household types, 2006 and 2008**



Note: In a two-earner household the second spouse is assumed to have full-time earnings equal to 67% of the average wage (AW). The graph shows the marginal effective tax rate (METR) as an individual increases earnings to 200% of the AW. Individuals are assumed to have no entitlement to unemployment benefits. Social assistance is living allowance and housing supplement.

Source: Ministry of Finance; Ministry of Labour and Social Affairs; OECD, *Tax and Benefit Model*.

StatLink http://dx.doi.org/10.1787/817201024108

Overall, the reformed tax system increases work incentives at the margin, due to the flat rate, although once the standard tax credit is fully exploited, the METR increases. At certain wage levels, this confronts households with much higher METRs than previously. On the other hand, the benefit system still creates disincentives, as many benefits are withdrawn abruptly. Although these disincentives may concern only a specific group, such as second earners and single parents at low income levels, smoothing the withdrawal of social assistance and the spouse tax credit, in particular, could improve employment possibilities and widen the choice of employment for different household types. Also helpful are activation measures that reinforce a mutual-obligations approach to social protection, such as the new programme allowing social assistance recipients to increase their benefits by doing work for municipalities.

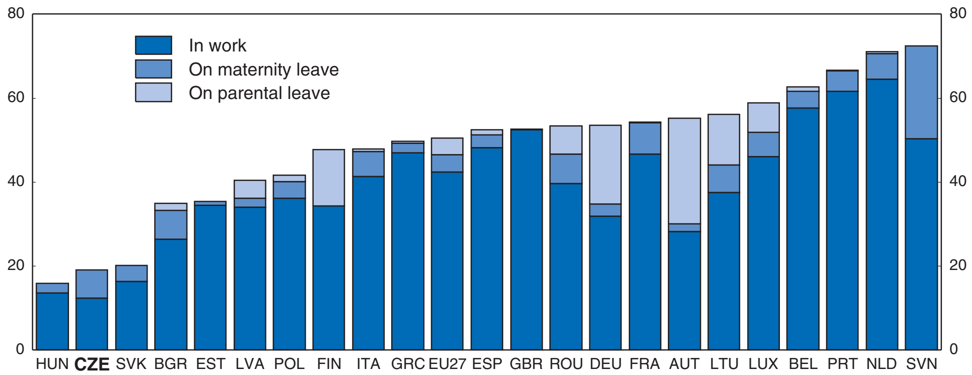
Since many of the biggest spikes in the METRs occur at very low gross earnings, fully realising the potential to increase the labour supply of second earners and others who are inactive is likely to require reducing other barriers to part-time work. Part-time employment accounted for only about 3.5% of total employment in 2008, the third-lowest level in the OECD and far below the OECD average of 15.5%.[17] The actual incidence of part-time work in the Czech Republic may in fact be somewhat higher – some research suggests that a significant proportion of those registered as "self-employed" are in fact dependent workers, many of them part-timers (Baštýř and Vlach, 2007; and Hála, 2007). Nevertheless, this only accounts for a part of the differential: part-time employment is still much rarer in the Czech Republic than in most other OECD members. A number of factors appear to underlie this phenomenon. Relatively low real incomes mean that both partners in most two-earner couples work full-time, and the relative under-development of the services sector, where part-time employment tends to be more common than in industry, probably contributes to low demand for part-timers. However, the causal relationship here may run on both directions: making part-time work easier and more attractive could facilitate service-sector growth. Part-time work is also discouraged by the obligation of employees earning less than the minimum wage to pay health insurance contributions based on the minimum wage for full-time workers, unless they are unemployed, taking care of children or receiving living allowance.[18] This increases the SSC burden on part-time employment disproportionately. Furthermore, the employer pays only that portion of the employer's contribution which corresponds to actual pay. The employee is obliged to pay the difference between the employer's share based on the actual wage and the employer contribution due for a full-time minimum-wage worker. The requirement to pay a minimum social security charge even in the case of part-time, low-wage work should be abolished for social assistance recipients and others on very low incomes.

Policies encouraging new parents to exit the workforce should be reconsidered

This chapter's conclusions concerning the exceptionally large work disincentives for second earners, particularly in families with children, find confirmation elsewhere, including in analyses conducted by the Czech authorities (CNB, 2008:89; Galuščák and Pavel, 2007; Pavel, 2009). Data on employment rates among women in the Czech Republic are congruent with these findings. Although the overall employment rate for prime-age women (25-54) has consistently been above the OECD average, it is in fact well below average up to about age 35 and well above for older cohorts. This appears to reflect the tendency of Czech women to spend several years out of the labour force when they have children.[19] The apparent connection between child-bearing and employment rates looks still stronger when female employment rates are broken down according to maternity status. In 2003, the gap between the employment rates of prime-age (20-49) women with children under twelve and those without children, at just under 32 percentage points, was by far the largest in the EU. The employment rate for childless women was the highest in the Union and that for mothers was second lowest.[20] Moreover, most of the difference arises in respect of women with very small children, suggesting that the parental leave and other benefit arrangements affecting new parents are indeed at work. In 2006, the country had the eighth-lowest employment rate in the OECD for women with children under 16, as against the fourth-lowest among those with children under two. A woman with children under three was less likely to be working in the Czech Republic than in any other OECD country (Figure 2.8).[21]

Figure 2.8. **Employment/leave status of mothers with children under 3**

% of all women with children under 3 years of age



Note: Data refer to 2006. Concepts differ across countries. For example, some countries include persons on child-related leave as employed and others do not. See *www.oecd.org/els/social/family/database* for details.

Source: OECD, *Family Database*.

StatLink http://dx.doi.org/10.1787/817218308102

Such sharp differences in female employment according to the age of the youngest child suggest that benefit disincentives do play a role, but other policy settings reinforce this tendency. First, there are no statutory provisions allowing the use of parental leave on a part-time basis. Secondly, municipalities are responsible for pre-school childcare, but they receive central funding for this purpose only for staff salaries, and they are not subject to mandatory service obligations for children under five, apart from health and safety standards. Here, too, the extent and quality of municipal services are probably negatively affected by the existence of far too many very small municipalities, as discussed in Chapter 1. Access rates for children under three in licensed early childhood education and care (ECEC) are the lowest among the OECD members for which data are available (OECD, 2006b:86). Moreover, since parental allowance is aimed at enabling new parents to stay home with their children, parents in receipt of it are allowed only up to five days per month of public childcare for children under three and up to four hours a day for children above that age. Returning to work with the aid of public childcare effectively means forfeiting the allowance. This severely constrains the ability of parents to make best choices for themselves when balancing work and family life, especially when compared with countries that combine relatively generous parental leave provisions with high-quality provision of ECEC services.

Further steps could be taken to make it easier for mothers to return to work via some period of part-time employment. In a number of OECD, countries, part-time work is very common for women with children and enables them to avoid total absence from the labour market for long periods while still leaving time for family responsibilities. Its availability is also associated with considerable increases in the employment rates of older cohorts. Yet, as noted above, the availability of part-time work is limited, and there are significant disincentives to taking it up. In 2007, the Czech Republic had the second-lowest incidence of part-time employment among women in the OECD. There are concerns that part-time jobs may marginalise women in the labour market, especially when such jobs are characterised by poor wages and benefits, weak security of tenure and few opportunities for training or advancement. Increasing the availability of affordable childcare can help mitigate this risk by making it easier for women to return to more promising full-time jobs if they wish. A number of countries also grant parents greater rights to change working hours (including the right to work part-time for a period before resuming full-time employment) for an extended period after a child is born (Jaumotte, 2003; OECD, 2007a).

It could, of course, be argued that current policies reflect a deliberate choice to encourage mothers to devote at least three years to full-time parental childcare following the birth of a child and that such a policy facilitates healthier child development, stronger families or other positive social externalities. It is also the case that gains from the activation of women now engaged in full-time unpaid childcare might be partly illusory. Women currently doing unpaid work would "outsource" that work in the formal economy and move into employment, so a part of the increase in recorded value added would simply reflect the transformation of non-market into market work. Recorded real GDP per capita would thus rise more than actual living standards, at least in the short run, even if both would be expected to increase. Over the long term, however, encouraging such a shift should raise both per capita GDP *and* living standards, because an economy in which women's labour-market entry decisions are biased towards unpaid work at home will operate inside its production frontier, with unused scope for further division and specialisation of labour. This productivity effect is distinct from the impact of additional labour utilisation on GDP per capita. As the population of the Czech Republic ages and labour-force growth turns negative, moreover, increasing productivity, not least via greater investment in human capital, will be a key factor in the country's ability to converge relatively rapidly with the levels of per capita income characteristic of the more advanced OECD members. The long-term consequences of policies that inhibit the growth of human capital for a large segment of the population thus merit serious consideration.

There are also important issues of gender equity at stake, since the potential productivity gains that are forfeited when such policies are in place also impose significant costs on the women involved. These costs go far beyond the wages forgone at the time. The evidence suggests that long periods outside the workforce result in lower wages over the rest of the working life.[22] Human capital deteriorates during such spells, while opportunities for advancement are missed. The prospect of lower lifetime earnings, in turn, tends to depress the returns to investment in human capital and may thus encourage women to invest in skills less than they otherwise would.[23] Long absences from the labour force may also explain why the Czech Republic – a country with some of the highest estimated returns to tertiary education in the OECD – has the third-largest gap between men and women in the economic returns from investment in tertiary education among the 20 OECD members for which data are available. As a share of average earnings, this gap is about 1.7 times the OECD average.[24] There is also evidence from many countries that women may self-select into occupations where entry and exit are easier and part-time or flexible working-time arrangements are more common; typically, such occupations pay lower wages and offer fewer opportunities for advancement or human-capital development (Cleveland and Krashinsky, 2003). Moreover, the spouse who takes time out to care for a child full-time is likely to be at a permanent financial disadvantage in the event of divorce, unless child support and other transfers from the former partner are extremely generous (Lundberg, 2002). The situation may be mitigated by income assistance for single parents, but this merely shifts some of the risk onto the taxpayer. Thus, while some period of paid leave helps to maintain labour-market attachment, too long a leave raises the risk of skills degradation, damaging future earnings and career trajectories (Jaumotte, 2003; OECD, 2007a).

Viewed from a child-welfare perspective, the issues are less clear-cut, but the three-year parental leave norm looks questionable and should at least be reviewed. As regards questions of early childhood development, OECD (2007a) finds that an infant needs full-time personal care for at least 6-12 months and cites evidence that cognitive development benefits from good-quality formal care and interaction with peers from around two years of age. Some studies point to significant and lasting benefits even where children enter childcare during the second year of life (Andersson, 1992). Investment in early childhood education also generates significant social returns, and the evidence strongly suggests that the more disadvantaged the child's home environment, the greater the advantages of good-quality early childhood education and care for his/her cognitive development.[25] Nevertheless, it must be acknowledged there is ongoing debate about the virtues of institutional childcare for children between 1 and 3 years of age.[26] That said, if childcare provision and attendance leads to higher permanent family income, some or all of the possible early negative effects on the child may be offset. In any case, the uncertainty surrounding these issues reinforces the case for making the benefit system more neutral, so as to give parents greater freedom to make the choices they think best for their own welfare and that of their children.

Consideration of all the issues involved – labour supply, gender equity, child welfare and work/family balance – suggests that the three-year norm is too long and that combined maternity and parental leave should be reduced to two years. Even this may need to be taken more flexibly than at present, and the possibility of replacing some child benefit expenditures with childcare subsidies should also be considered, perhaps targeting the former to low-income families and making the latter contingent on employment or at least on active job search. At a minimum the current practice of withdrawing childcare benefits if working mothers use childcare facilities should be scrapped. The cross-country empirical evidence shows that childcare subsidies do increase female labour supply, particularly full-time supply (Powell, 1998; Jaumotte, 2003). To the extent possible, these measures should be focused on low-skilled women, who are likely to face the largest distortions to their labour-supply decisions. Such changes to leave and benefit arrangements could, in tandem with steps to reduce the barriers to part-time employment, lead to less fragmented careers for women who have children.

The problem, it should be emphasised, is not the use of the tax and benefit system to promote higher levels of fertility; there are good reasons why policies are in place in many

OECD countries to reduce the economic burden associated with bearing and raising children. What is at issue is rather the way in which benefits in the Czech case are structured to favour labour-force withdrawal; many OECD members attempt the opposite, using the tax and benefit systems to make it easier to combine work and family life. The issue is not a choice between policies promoting high fertility and low employment or low fertility and high employment: policy can be structured so as to favour both high fertility and high employment. Indeed, whereas there was a broadly negative relationship between female employment and fertility in OECD countries in 1980, by the mid-2000s the relationship was positive, suggesting that women are likely to have more children where structures are in place to support combining family and work rather than forcing a choice between them (OECD, 2007). Allowing parents to choose between benefits for full-time care and, for example, childcare subsidies, could go a long way towards making the system more neutral in respect of the choices that families make. It is also important to recognise that pro-fertility/pro-family policies are not concerned solely with women's working conditions. It would also be advisable to move ahead with more flexible arrangements for fathers, such as proposals for paternity leave and related benefits.

Of course, any shift towards a more neutral approach will take time, as it will require substantial investment in good-quality childcare. A woman wishing to combine child-rearing and a career will consider not only the direct tax and benefit implications of her choice but also the availability of good-quality, licensed and affordable ECEC services. This is a very important part of the whole picture, as ECEC services can too easily be viewed as an adjunct to labour-market policies rather than an investment in the children's future. Yet research suggests that over the long run, such investment is likely to yield substantial returns for the children involved, their families and the society as a whole (Cunha *et al.*, 2005; Masse and Barnett, 2002). The government should move ahead with the development of existing proposals for more family-friendly policies, including expansion in the scale and variety of ECEC services available, more flexibility in arrangements for maternity and parental (including paternity) leave, and measures to promote greater opportunities for jobs with flexible hours.

The tax treatment of the self-employed needs to be reconsidered

The relatively favourable position of the self-employed with respect to the PIT and SSCs has long been debated in the Czech Republic, and government policies have alternated over the years between tougher and more generous treatment of this group. Many tax systems include special provisions applying to small firms and the self-employed, for a number of reasons. First, the fixed costs involved in paying and collecting taxes mean that the costs of compliance are relatively greater for small firms and unincorporated entrepreneurs, while the tax authorities find collecting from them to be expensive relative to the revenue raised. In the Czech case, one recent assessment estimated the cost of collecting PIT revenues from the self-employed at up to one-third of the revenue collected (Vítek and Pavel, 2008). Secondly, there is considerable empirical evidence that the self-employed in many countries are more prone to tax evasion than wage earners.[27] Thus, simpler, less burdensome tax schemes for them may improve small business compliance by both reducing incentives to evade and making enforcement easier (OECD, 2008e:22). However, preferential schemes can also *encourage* evasion, if they encourage false self-employment. They may also create other distortions, if they tend to bias incentives towards self-employment activities or discourage small business growth.

The evidence suggests that the tax system and other factors are indeed encouraging false self-employment, but the scale of the problem is hard to assess. Although the incidence of self-employment is somewhat above the OECD average, the difference is not enormous and the country is not an outlier in the OECD area or the region. In 2008, the self-employed accounted for about 19.2% of total employment, as against an OECD average of 16.6%.[28] Though above the levels recorded in Slovakia and Hungary, the Czech share was far lower than the Polish figure and also relatively low by comparison with some Mediterranean countries, where self-employment rates are very high.[29] Nevertheless, research in the Czech Republic suggests that a substantial proportion of those declaring themselves to be self-employed are *de facto* dependent employees: recent estimates vary between 13 and 25%.[30] Moreover, trends in self-employment seem to have been sensitive to changes in tax and regulatory policies. The introduction in 2004 of a minimum tax for the self-employed, along with legislation aimed at restricting opportunities to treat *de facto* employees as independent contractors, led to a decline in the number of self-employed. In a number of sectors, this decline was matched by growth in dependent employment of similar magnitudes.[31] The growth of self-employment resumed in 2007, when the legislation was repealed, and picked up further in 2008 when the minimum tax was abolished.

The use of fictitious self-employment status is often encouraged (or even imposed) by employers, as it relieves them of the burden of both SSCs (34% of the gross wage) and compliance with the Labour Code.[32] This makes employing the self-employed both cheaper and more flexible. For the individuals concerned, the tax advantages of self-employment stem chiefly from the fact that they pay social security contributions on only half their taxable income. The implicit assumption underlying this provision is that the mixed income of a self-employed individual is split 50/50 between capital and labour components, which is probably rather generous to small self-employed craftsmen and professionals in labour-intensive sectors. The self-employed also benefit from the availability of large lump sum deductions for "expenses" that need not be documented when calculating their PIT and SSC bases (Table 2.3). These deductions run from 40% for the independent professions to 60% for most other trades and 80% for workers in agriculture and the craft trades.[33] These arrangements enable many of the self-employed to declare minimal incomes and, as a consequence, to avoid much higher tax bills. Finally, participation in the sickness insurance system is voluntary for the self-employed, which means that their total SSC rate may be 2.3 percentage points below that of the combined employer and employee contributions for a dependent worker.

Table 2.3. **Lump-sum deductions available to the self-employed**

As a % of gross earnings

Sector	1993-2005	2006-08	2009	2010
Agriculture	50	80	80	80
Crafts	50	60	80	80
Other trades	25	50	80	60
Independent professions	25	40	60	40

Source: Ministry of Finance.

This state of affairs not only makes for immediate revenue losses to the budget, it also means that a significant part of the workforce are not making sufficient pension contributions to ensure themselves an adequate income in retirement. Since it is unlikely that any government will wish to leave a large group of pensioners in poverty, this could constitute a large additional strain on public finances in the future. Previous *Surveys* have pointed to the need for steps to level the tax treatment of the self-employed and dependent employees, but the 2008 reforms seem to have increased the incentives for to declare self-employment. Clearly, reductions in the tax wedge on employees and greater flexibility in the Labour Code would both reduce such incentives, but tax policy has a role to play. Differences in the tax treatment of dependent employees and the self-employed should be reduced. Possible steps might include making participation in the sickness insurance system mandatory for the self-employed, gradually lowering the share of income that can be deducted as expenses without providing documentation or a phased increase in the share of income included in the SSC base. Some form of simple minimum tax might be reintroduced for those on very low incomes.

Initial results of disability pension and sickness insurance reforms are promising

Sick pay and disability pensions are not included in the OECD's *Tax and Benefit Model*, because entitlement depends on specific contingencies that must be assessed on a case-by-case basis, and benefit calculations are highly individualised, depending on contribution history. Overall spending on sickness and disability programmes, which was running at about 2.1% of GDP prior to the downturn, is not far from the OECD average, but some other indicators have pointed to problems with these programmes in the past:

- In 2007, just over 11% of the labour force was in receipt of full or partial disability benefits, among the highest rates of disability in the OECD. This is partly a statistical artefact. Many of these persons would be on old-age pensions if they did not receive disability benefits, because individuals awarded disability pensions continue to receive them after they reach retirement age; in future, full disability pensions are to be converted into old-age pensions of the same amount when the recipients reach 65. However, this explains only part of the gap between the Czech Republic and the OECD average. In 2006-07, roughly 7% of the working-age population were in receipt of disability benefits, ranking sixth among the 24 OECD economies for which data are available. Inflows into disability have remained substantial and, in the case of partial disability, they have grown especially rapidly. The Czech Republic in 2005 had the highest rate of unemployment among the disabled among the 27 OECD economies for which data were available.
- Sickness absences have also been a problem, though the situation has recently improved considerably. In the mid-2000s, the Czech Republic recorded the highest rates of sickness absence in the OECD area, with over 6.5% of the workforce reporting sick on an average day. This has since fallen sharply, in large measure thanks to recent reforms (see below), but the sickness absence rate in 2009, at 4.9%, was still well above the OECD average.

The Czech experience with disability pensions is typical of many OECD countries, which have seen disability recipiency rates rise as the numbers receiving unemployment benefits have fallen – often in roughly similar proportions (OECD, 2009b; Prinz and Tompson, 2009). The evidence suggests that in many countries there is considerable substitution between the two benefits. Unemployment policy in much of the OECD over the past two decades has been driven by an activation agenda, with increasingly strict participation and job-search requirements and, in some countries, stricter limits on eligibility for and duration of unemployment benefits. Yet until recently, most countries adopted no such approach to disability benefits, which therefore came under increasing pressure as "benefits of last resort". This was particularly common where – as in the Czech Republic – unemployment benefits were not particularly generous (OECD, 2009f). Over the last decade, however, many OECD countries, including the Czech Republic, have moved to rectify this, tightening access to disability schemes and strengthening support for rehabilitation and reactivation (OECD, 2006c, 2007b, 2008b).

In an effort to tighten access to partial disability pensions, the authorities have approved the transition to a three-category definition of disability to replace the current distinction between full and partial disability. This is a key step, given that partial disability has accounted for most of the growth in the incidence of disability pensions in recent years. The reform will allow the introduction of a single disability benefit linked to the level of actual disability. The current full disability pension (at least a 66% loss of work capacity) will be re-designated as a disability pension for third-level disability and will be awarded henceforth only to those with an assessed loss of work capacity of 70%. The current partial disability pension will be seen as a disability pension for second-level disability, if the individual's assessed earning capacity has been reduced by at least 50%. Where the capacity loss is assessed at less than 50% but more than 35%, a smaller disability pension for a first-level disability will be paid. The assessment of work capacity was also tightened and greater consideration is to be given to the potential for rehabilitation and retraining.[34] There will be no elimination of eligibility for disability pensions that have been paid hitherto but some individuals may experience a change in the percentage amount of the pension paid. New inflows into the disability pension scheme should be curtailed, largely because of the tougher screening and the lower benefits available to first-tier disabled persons. The finance ministry estimates that around 75% of those currently categorised as partly disabled would fall into this first tier under the new criteria. For many of them, disability pensions are likely to cease to be an attractive option for labour-market exit.

The picture with respect to sickness insurance (SI) is also promising, as a result of recent reforms. As noted above, the rate of sickness absences fell sharply in 2008. In 2009, a combination of further reforms and the economic downturn pushed this figure still lower: the number of sickness spells fell by over 30% year-on-year in 2009. Two major reforms of SI were initiated in 2008.

- SI benefits for the first three days of a sickness spell were eliminated: this measure was overturned by the Constitutional Court in mid-2008 but reinstated in a constitutionally acceptable fashion as from 1 January 2009. There is some concern that this may go too far. A waiting day is a common feature of SI schemes, but three days is a comparatively long waiting period. While it doubtless discourages workers from taking fraudulent short sick spells, it may prompt some workers to continue working when they should not do so, with negative consequences for their health and, in the case of infectious conditions, for that of their colleagues. This is particularly a risk in respect of the low-paid, whose replacement rates are higher[35] and for whom the loss of three days' sick pay would be harder to bear. A very long waiting period may also encourage unnecessary prolongation of sick spells, since workers face significant losses if they return to work prematurely and suffer a relapse (Johansson and Palme, 2002).
- Responsibility for sick pay for the first 14 calendar days of a sickness spell was transferred to employers. Sickness benefits are paid from the public SI scheme only from day 15. This should strengthen employers' incentives both to try to keep employees

healthy, and to crack down on fraudulent sickness claims. It should also eliminate any incentive for them to use SI for short-term adjustment of their workforces. SI was indeed used in this way in the past, but employers in 2009 became both less do so and much more aggressive in policing unwarranted sickness absences on the part of workers.

The issue is now of increasing importance as a result of sharply rising unemployment. OECD (2009c) highlights the tendency of governments in past downturns to open up sickness and disability schemes to newly unemployed individuals whose health problems or disabilities would not otherwise have warranted such assistance. This can create precedents that are very difficult to overturn, even when economic conditions improve. Moreover, the individuals channelled into such schemes tend to be very difficult to reactivate. Careful screening of new disability pension recipients will therefore be important in ensuring that the short-term impact of the crisis on the labour market does not turn into a long-term reduction in labour-supply. It is important for the authorities to sustain the recent reform of the SI system and to resist pressures to relax access to disability pensions.

Taxation of capital income

There is little scope for further reductions in corporate tax rates

In analysing the impact of recent changes on capital formation, it is important to distinguish between the implications of reform for the *level* of capital formation and its impact on the *allocation* of capital and hence capital productivity. The level of investment is likely to be affected chiefly by the change in the overall tax burden on capital. Recent OECD work shows that high corporate taxes have a negative effect on the level of domestic investment. Moreover, the evidence suggests that lowering statutory CIT rates can lead to particularly large productivity gains in firms that are dynamic and profitable (Johansson *et al.*, 2008). However, the implications of reform for capital allocation depend more on the degree to which the changes make the tax system more or less neutral with respect to returns on investments financed by debt, equity or retained earnings, as well as with respect to different asset types. Furthermore, international allocation of capital and productivity may be influenced by tax incentives on FDI, although the evidence suggests that labour taxes are even more important than the CIT in influencing FDI flows (Hájková *et al.*, 2006).

There are thus reasons to expect that the CIT reforms of recent years will serve to boost investment, though it is not so much the most recent changes that matter as the secular trend: the most recent cut represents the culmination of a process that has reduced the statutory CIT rate by 15 percentage points over the course of the decade. The current statutory rate of 19% is well below the (unweighted) euro area average of 25.7% and comparable to those of regional peers, including Poland (19%), the Slovak Republic (19%) and Hungary (20%, comprising the CIT and the Solidarity Surtax for companies). However, to capture the full impact of the CIT and other corporate taxes, it is useful to look at broader measures than the statutory rate. Average and marginal effective corporate tax rates (ECTRs) take into account both the tax rate at which corporate profits and capital income are taxed and the tax base to which they are applied (Box 2.2). ECTRs may thus better capture the overall impact of corporate tax reforms on capital formation and productivity. Indeed, recent OECD work finds that average ECTRs do have an impact on productivity (Johansson *et al.*, 2008; Vartia, 2008).

Box 2.2. **Calculating effective corporate tax rates**

Effective tax rate computations are based on investment models in which firms maximise the after-tax net present value of their investment projects given the tax system. A marginal effective tax rate (METR) is applied to incremental investment earning the minimum required rate of return, whereas an average effective tax rate (AETR) is applied to discrete investment projects earning some economic rent. The effective tax rates analysed in this section are based on a Centre for European Economic Research (ZEW) project financed by the European Commission. The focus is on two main elements of corporate tax codes: depreciation allowances and the statutory corporate tax rates. In addition, the effective rates take into account the tax deductibility of interest paid, shareholder taxation in the form of dividend and capital gains taxes, and taxes on interest income. In the Czech Republic dividends are taxed under a modified imputation system and are subject to a final 15% withholding tax paid at a company level. Capital gains from the sale of securities held for more than six months are exempt from the personal income tax.

Source: Devereux *et al.* (2008).

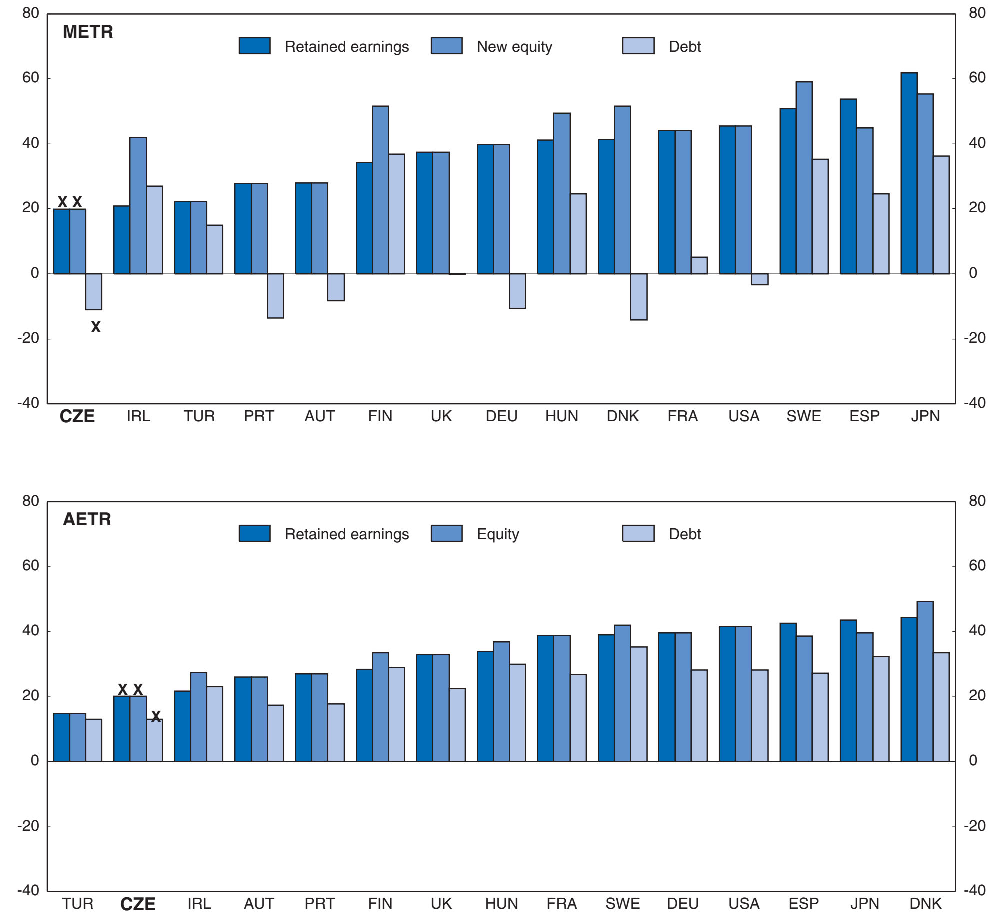
Czech AETRs and METRs for companies are relatively low by international standards, and the recent cuts in the statutory rate, which now stands at 19%, have further reduced effective rates (Figure 2.9).[36] Furthermore, the effective rates are below those of the Czech Republic's regional peers, which may matter if foreign investors compare countries within regional groups when making their investment decisions. Overall, effective corporate taxation in 2010 appears to be relatively low. Thus, any further cuts in the statutory rate of CIT would not bring about a significant change in the tax position compared to other countries and they would result in revenue losses to the budget.

The preferential tax treatment of investment in machinery should be reconsidered

As in other OECD countries, there are differences in the tax treatment of assets and types of financing in the Czech Republic. Looking at the asset-specific AETRs and METRs, investments in intangible assets or in machinery bear the lowest effective tax rates in many OECD countries. The highest rates apply to investments in financial assets. The differences in these rates mainly reflect variation in the generosity of depreciation allowances. Financial assets do not receive any capital allowances for tax purposes, since there is no account for economic depreciation. AETRs are lowest for machinery and intangibles, since for these two assets the depreciation allowances for tax purposes over-compensate the actual economic depreciation rate in most countries. While accounting conventions may make some differences in asset-specific AETRs and METRs unavoidable, the Czech CIT is rather extreme in the case of machinery, a fact that reflects in part the specific tax incentives used to encourage investment in new machinery.[37] The estimated METR for investment in machinery in the Czech Republic in 2007 was less than 70% of the average across all categories of asset, while in other EU countries this ratio was typically around 90%. This may encourage overinvestment in machinery at the expense of other assets (Elschner and Vanborren, 2009). As noted in Chapter 1, the Czech economy is relatively concentrated in manufacturing industries that are likely to be characterised as heavy investors in machinery. CIT distortions that favour such investment may tend to foster over-specialisation in these sectors. The previous *Survey* also pointed to signs that

Figure 2.9. **Effective corporate tax rates**

%



Note: The marginal effective tax rate (METR) is defined as the difference between cost of capital and post-tax real rate of return. The average effective tax rate (AETR) is a measure of the present value of taxes paid, expressed as a proportion of the net present value of the income stream. For further details see Devereux *et al.* (2008). The METR applies to a marginal investment which earns zero economic rent, whereas the AETR applies to a discrete investment with economic rent. The graph shows effective rates based on the assumption of a non-qualified zero-rate shareholder. Rates are simple averages over the different types of assets. Simulations refer to the system in 2009 and 2007 (symbol X) for the Czech Republic and 2007 otherwise. Ranking is by retained earnings.

Source: Project for the EU Commission, TAXUD/2005/DE/3 10, Centre for European Economic Research (ZEW).

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this specialisation had indeed been reinforced by particular investment-support policies (OECD, 2008a:97). Making the tax system more neutral in its treatment of different asset types could facilitate progress towards a more diversified economic structure. Investment incentives that promote investment in new machinery, in particular, should be reconsidered.

Differences in the tax treatment of forms of financing create significant distortions

Another distortive element of the tax system is the differential treatment of types of financing. In the Czech Republic, as in most other OECD countries, investment financed by debt is taxed at lower effective rate than investment financed from retained earnings.

Financing through new equity faces the highest effective tax rates of all. This may render companies more prone to insolvency and discriminate against small companies and start-ups that have limited access to, and less favourable terms for, debt financing. In addition, corporations that own intangible or very specific assets, against which it is difficult to borrow, are placed at a relative disadvantage by the favourable tax treatment of debt-financed investment (OECD, 2007). Moreover, the current financial crisis must in any case raise questions about the wisdom of tax-encouraged increases in leverage. This distortion in the CIT arises in most countries, because interest payments for debt-financed investments are often fully deductible from the tax base; only the residual income is taxed at the corporate level. In the case of equity-financed investments, such a deduction is not generally available, although some countries, such as Belgium, do allow for a notional interest deduction in order to achieve neutrality with respect to the source of finance.[38] Furthermore, if companies are expected to maximise the after-tax income of their shareholders, personal income taxes faced by shareholders should be included in the effective tax rates for equity-financed investment. In this case, the higher effective rates on new equity-financed investment reflect taxes on dividends, interest income and capital gains.[39]

Overall, the preferential tax treatment of debt-financed investment is comparatively important in the Czech Republic. For example, the METR applied to debt-financed investment is less than 50% of the average METR for all forms of finance, whereas the EU-wide average is 75%. The METR for debt-financed investment is slightly more than one-quarter that for equity financing. That said, the situation has improved recently, as a result of reductions in the statutory CIT rate. Other things being equal, the difference in the effective rates between debt- and equity-financed investment decreases as the statutory corporate tax rate is reduced, because a lower statutory tax rate reduces the impact of interest deductibility. Thus, cuts in the statutory rate of CIT over the last decade have reduced this distortion, but it still remains unusually large. In this context, the recent decision to reverse substantially the tightening of “thin capitalisation” rules that was adopted as part of the tax reform package must be seen as a step backwards. Under the reform legislation implemented in 2008, interest and other financial costs on loans in excess of six times a company’s equity were treated as non-deductible for purposes of the CIT. Deductible financial costs for loans from related parties were reduced. The new limit was three times equity in the case of related-party loans from banks and insurance companies, rather than six times equity, as before. The limit for related-party loans from other companies was lowered from four times equity to just two times.[40] The business community and tax professionals viewed this change negatively, and in early 2009, the thin capitalisation rules were revised and the limits returned to the levels prevailing before 2008. The application of the rules to transactions involving unrelated parties was cancelled, though the cost of loans from unrelated lenders may still be partly non-deductible if a related entity has provided security.

The neutrality of the tax treatment of different sources of investment finance could be enhanced by the introduction of a notional interest deduction for equity-financed investment, as in Belgium. However, this would require careful consideration of the interest rate employed, which should correspond as closely as possible to the actual cost of financing. The simpler and more attractive possibility would be to phase out altogether the interest-payment deductibility of debt-financed investment or to allow deduction of dividends at company level, taxing them only as income to shareholders. Whatever, the chosen mechanism, the key priority must be to make the CIT as neutral as possible between sources of investment finance. At a minimum, the tighter thin capitalisation rules adopted in 2008 should be reinstated. This would increase the tax burden of debt-financed investment, but such a move need not depress investment levels overall if other CIT provisions, which apply equally to all forms of investment finance, were relaxed.

Pro-growth tax reform in the wake of the crisis

Clearly, prospects and opportunities for new tax reforms are constrained by the need to tackle a fiscal sustainability problem that has grown markedly worse as a result of the downturn. Any substantial reduction of the tax burden in general, or the tax wedge on labour in particular, will require structural cuts in government spending, which, in order to be sustainable, are likely to depend on reform progress in respect of healthcare, pensions and other fields of government expenditure. This implies that, for some time to come, any new tax reforms will have to be self-financing. The principal concern at present, therefore, should be to shift the tax system still further in the direction of recent reforms – towards greater reliance on less distortive taxes, increased simplification and a broadening of tax bases to allow lower tax rates. As noted above, the 2008 reforms shifted the balance between indirect and direct taxes only slightly; the weight of direct taxes in the Czech tax mix after the reform was still well above the OECD average and slightly greater than it was in the 1990s.[41] The discussion that follows is devoted to exploring ways to do shift this balance further. At the same time, changes to the benefit system and adjustments to the tax system should be considered in tandem, to ensure that they do not operate at cross purposes. Indeed, one of the major priorities for further reform should be to ensure that policies in respect of taxes, SSCs and benefits are better co-ordinated. Such co-ordination should apply not merely to the setting of tax rates or the determination of benefit levels. There is also significant scope for harmonising definitions, tax bases and collections in a manner that would reduce both compliance costs for taxpayers and administration costs for the authorities. These are addressed in Chapter 3.

The tax burden could shift further from labour taxes…

As noted above, the labour tax wedge in the Czech Republic is fairly large, chiefly because SSCs constitute an extraordinarily large part of total revenues. There is no reason in theory why such a large tax wedge should necessarily reduce labour demand. In a well functioning market with no distortions, labour should earn its marginal product. A rise or fall in the tax wedge should result in changes in take-home pay rather than increases or decreases in employers' labour costs. However, the tax wedge in such a situation will still affect employment to the extent that workers respond to reductions in their take-home pay by reducing labour supply. Moreover, where rigidities exist, the tax wedge may also affect labour demand. The impact of the wedge on demand depends on the degree to which the tax is "shifted forward" onto producers' labour costs. If workers demand wage increases in response to a rise in taxes on their income, or resist wage cuts in response to an employer tax, the tax will increase labour costs and thus reduce demand. Since the elasticity of demand for labour is generally reckoned to be greater than the supply elasticity, the employment effects of the tax wedge are likely to result primarily from forward shifting. There is now substantial empirical evidence of a link between high tax wedges and low employment, and there is good evidence that this relationship is particularly strong in the case of the low paid.[42]

Forward shifting, in turn, is likely to be inversely related to labour-market flexibility. The more rigid the labour market, the more negative the employment effects of the tax wedge. In general, the Czech labour market is reasonably flexible, apart from restrictions on individual dismissals of regular workers, which are among the highest in the OECD. This flexibility may be one reason for the speedy labour-market response to the downturn, which was faster than has been observed in previous contractions, and it would suggest that forward-shifting might be less of an issue there than elsewhere. At or near the minimum wage, however, the tax wedge on labour cannot but reduce labour demand, since employers cannot push wages below the statutory minimum. Since very low-skilled workers make up the largest share of the long-term unemployed in the Czech Republic and their unemployment rates were, even prior to the crisis, relatively high, this is a real problem. Thus, while an overall reduction in the labour tax wedge would probably be a desirable long-term goal, the first step in that direction might well be targeted reductions in SSCs for low-income workers. This would maximise the employment benefits of the tax change at lower fiscal cost, since (formal sector) labour supply tends to be more elastic in the vicinity of the minimum wage than at higher wages (Brook and Leibfritz, 2005). Such reductions should apply to employers' contributions, since for workers at or close to the minimum wage, changes in payroll taxes appear to have greater effects on employment than changes in wage taxes and are thus more likely to induce an increase in labour demand.[43]

The Czech Republic is one of the few OECD countries where even very low wages are normally subject to full SSCs (from both employer and employee). Indeed, in some instances low-wage workers are liable to more than the normal level of SSCs: as noted above, the minimum contribution for health insurance is equivalent to the health insurance contributions due for a full-time minimum-wage employee. Targeted cuts in labour taxes for low earners have been implemented in a number of other OECD economies, with apparently positive results for the employment of low-skilled workers.[44] The fiscal costs of such a reduction could be financed, at least in part, by eliminating the SSC ceiling. The lower tax wedge should in any case be at least partly self-financing, through higher output and higher employment. If the change triggered some shifting of informal employment into the formal sector, especially in personal services, then VAT revenues would also increase.

There remains, nevertheless, the broader challenge of reducing the burden of SSCs further up the wage distribution. At its heart, this problem is directly linked to the need for structural pension reform and further reform of the healthcare system. Otherwise, very high SSCs will be needed to finance steadily rising expenditures in these two areas. That said, one way to reduce SSCs in the near term would be to transfer onto the state budget the financing of the pension and health funds' obligation to provide minimum benefits for persons who have not contributed sufficiently to the funds. The cost to the budget could be financed by increases in indirect taxation to offset the revenue foregone as a result of lowering the SSCs. This would also make the system more insurance-based which could also increase incentives to contribute to the funds, as the contributions would be more clearly linked to benefit entitlements.

... To taxes on consumption...

One of the main OECD tax recommendations for many member states in recent years has been to move towards greater reliance on indirect taxes, particularly consumption taxes, because they are less distortive. The increase in the lower rate of VAT in 2008 and the 1 percentage-point increases in both the standard and reduced rates in 2010 were steps in this direction, albeit measures motivated chiefly by the need to offset the revenue losses rather than on structural grounds. The Czech VAT is currently levied at a standard rate of 20%, with a reduced rate of 10% applied to foodstuffs, water supply, pharmaceuticals, books and newspapers, certain medical equipment, special equipment for disabled persons, children's car seats, certain live plants, firewood, regular domestic passenger transport, admission to cultural and sporting events, hotel accommodation, medical care and social services (unless they are exempt), cleaning in private households, domestic care services, funeral services, the construction and transfer of social housing,[45] and renovation and alteration of housing.

The principal argument in favour of such a two–tiered VAT is that differentiated consumption taxes can help reduce poverty, via exemptions and zero or very low ratings on certain goods and services, such as staple foods and other necessities. However, direct transfers to low-income households, depending only on their socio-economic characteristics, are likely to be better for both equity and efficiency than complex VAT arrangements, because higher-income households consume more low-taxed goods and therefore benefit more from the lower rates than low-income households (Deaton and Stern, 1986; Ebrill *et al.*, 2001). This clearly appears to be the case in the Czech Republic. The lower rate of VAT covers around 41% of consumption of goods and services subject to VAT, and there is only limited variation in the share of such goods in the consumption baskets of households across the different income deciles (Table 2.4). Consequently, the reduced rate of VAT saves the average individual in the top income decile about 2.5 times as much as the average consumer in the bottom income decile. Altogether, those with incomes above the median consume about 60% of VAT tax expenditures. This is an expensive and inefficient way to protect those on low incomes; if it were an expenditure programme, rather than a form of tax expenditure, it would be difficult to defend on the grounds of equity or poverty alleviation.

Table 2.4. **Allocation of tax expenditures on low-rate VAT**

Per cent, unless otherwise indicated

	Income deciles										
	1	2	3	4	5	6	7	8	9	10	Avg.
Share of low-rated goods and services in consumption basket	46.6	42.8	44.2	42.6	42.4	41.5	41.0	37.3	36.7	37.0	41.2
Estimated tax expenditure on low-rate VAT, CZK bn	2 473	2 867	3 268	3 384	3 610	3 667	4 146	4 022	4 600	6 111	n.a.
Share of aggregate tax expenditures on low-rate VAT	6.5	7.5	8.6	8.9	9.5	9.6	10.9	10.5	12.1	16.0	n.a.
Effective rate of VAT	14.3	14.7	14.6	14.7	14.8	14.8	14.9	15.3	15.3	15.3	14.9

Source: Ministry of Finance; OECD calculations.

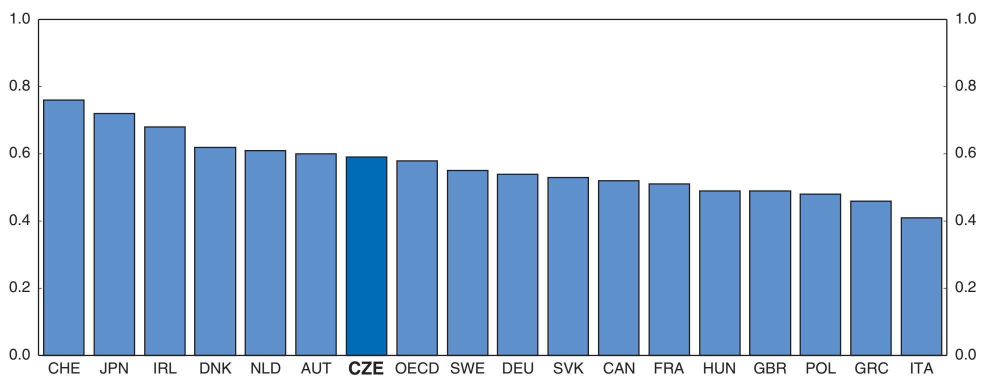
The other argument in favour of differentiated consumption taxes is that they can be used to penalise the production and consumption of "bads", while generating revenues that can offset reductions in other taxes, such as direct taxation of labour and capital income. They might also be used to encourage the consumption of goods and services thought to generate positive externalities. This, in essence, is the logic behind the inclusion of certain fuels and technologies in the lower VAT band on environmental grounds. A similar argument is often made for "bads" that affect consumers' health and have potential externalities, such as tobacco or alcohol. However, to the extent that the tax system is used to address such externalities, it is likely to be administratively simpler to achieve such ends by relying on excise taxes on specific products rather than a complex structure of VAT rates.[46] Unifying the VAT rates would reduce distortions and simplify VAT administration, although progress in this direction must be gradual, as the authorities are already concerned about the potential impact of recent VAT increases on household consumption.

It is well known that VAT does not distort markets or incentives in the way that taxes on labour and capital can do. Under a VAT, it makes no difference what factors of production are employed to produce a good, how many times it is traded, how the production chain is organised or where the good is produced. However, there is a further argument for greater reliance on VAT in an economy as open to trade as that of the Czech Republic. VAT applies to all goods and services sold in the country, whereas direct taxes are levied only on domestic producers. A cut in direct taxation (in SSCs, for example) reduces domestic producers' costs relative to those of their foreign competitors. Thus, a cut in direct taxes financed by an increase in VAT could actually be revenue-neutral and yet still improve the competitive position of the tradables sector. To be sure, the improvement would be a one-off: a change in the *level* of VAT would not affect the dynamics of real exchange rate appreciation or Czech producers' productivity performance. The case for shifting to greater reliance on VAT thus rests chiefly on other arguments. Nevertheless, the one-time relief provided to tradables producers as a result of such a change could be an added bonus.

Moreover, the VAT is a relatively efficient source of revenues. To assess the impact of the VAT reform on the efficiency of revenue collection, one may examine the so-called VAT revenue ratio (VRR).[47] This ratio is defined as VAT revenues relative to the tax base, consumption,[48] divided by the standard VAT rate. It measures the efficiency of the VAT system in respect to the breadth of the tax base and lower rates as well as in respect to the level of compliance and tax administration. The higher the value of the ratio the more efficient the tax system is in collecting revenues. In international comparison, the Czech Republic has a relatively efficient VAT tax system measured by the VAT revenue ratio. This ratio is around the OECD average and well above those of regional peers (Figure 2.10).

Figure 2.10. **VAT Revenue Ratio**

Ratio 0 to 1 indicating increasing efficiency



Note: Data refers to 2008 for the Czech Republic and 2005 for other countries.

Source: Ministry of Finance; OECD, *Consumption Tax Trends* 2008; OECD calculations.

StatLink http://dx.doi.org/10.1787/817242541341

… GHG emissions and other environmental "bads"…

As noted above, the 2008 tax reforms included a range of new environmental taxes introduced in compliance with the European Energy Taxation Directive. Fiscal neutrality was one of the basic principles underlying this reform: direct taxes on labour (in the form of social security charges) were reduced to offset the rise in energy taxes. The sums involved in the 2008 reforms were in any case relatively modest, owing to the wide range of exemptions from environmental taxes allowed under the law. Total income from all environmental taxes fell in real terms in 2008, and the revenues raised by the new taxes on electricity, gas and solid fuels amounted to just under 0.07% of GDP. In line with EU directives, electricity is exempt when used for electrolytic, metallurgical or mineralogical processes. This compromises the environmental impact of the tax, but it prevents the tax from doing what is regarded as excessive damage to the competitiveness of energy-intensive industries. It also avoids punishing firms for investments undertaken under previous policies. Energy products used in the production of electricity are also generally exempt, to avoid double taxation.[49] From an environmental perspective, it would make more sense to tax the fuels rather than the electricity, so as to reflect better the emissions impact of different fuels. This could, however, complicate cross-border trade in electricity, as well as efforts to administer the rules exempting certain electricity consumers from the tax. In both cases, it would be necessary to identify the precise fuel composition behind the electricity supplied.[50]

The 2008 reform was originally envisaged as the first step in a larger environmental tax reform process, but progress has largely stalled for the moment, owing to the political situation. Yet there is more to be done in this area and it is important that environmental tax reforms continue, including the introduction of a tax on greenhouse gas (GHG) emissions and changes to the administration of the Czech allocations under the EU's Emissions Trading Scheme (ETS). Phasing in such changes will be important, given the country's heavily industrial economic structure, but further reform is needed, particularly if the Czech Republic is to meet its international environmental obligations at least cost. At present, the country ranks near the top of the EU in terms of CO_2 emissions per capita and per unit of GDP.[51]

Like all EU members, the Czech Republic participates in the ETS, which covers large emitters of GHGs in power and heat generation and in selected energy-intensive industrial sectors. Member states have considerable freedom to decide how to allocate their emissions allowances under the national quotas fixed by the European Commission. The method of allocation of permits is of great importance in terms of both equity and efficiency. Broadly speaking, auctioning permits to the polluters covered by the system is preferable to distributing them free of charge to existing polluters ("grandfathering"). Auctions raise revenues that, depending on the circumstances, can be used to lower distortionary taxes or finance public expenditure, and they limit the realisation of windfall profits by the polluters who receive the initial credits. Moreover, OECD (2009e) concludes that permit auctions also stimulate environmentally friendly innovation more effectively than trading schemes with free allocations.[52] "Grandfathering" permits, which is often adopted under pressure from industry lobbies, is meant to alleviate concerns about the impact on industrial competitiveness of auctioning permits. However, it is the opportunity cost of permits (*i.e.* the price at which they could be sold) that determines their impact on production costs and hence competitiveness. Thus, the method of permit allocation should not make any difference to competitiveness, at least in the absence of market failures.[53]

Hitherto, the Czech authorities have opted for a grandfathering scheme: under the National Allocation Plan (NAP) for 2008-12, allowances are distributed free of charge, except for unused allowances left in the reserve for new entrants, which will be sold at auction at the end of the second trading period.[54] The government should consider moving away from grandfathering emission allocations in the next NAP. At a minimum, the free allocation should be substantially reduced, with the balance being auctioned. This would be consistent with EU policy, which holds that buying permits should gradually become the norm. By signalling such a policy change now, well before the 2013-17 NAP comes into force, the government would give firms ample time to prepare for the new arrangement.

Even allowing for the further extension of emissions trading schemes – European or national – to other firms and sectors, some sort of emissions taxes are likely to be needed to ensure adequate incentives for emission reductions in areas where cap-and-trade schemes cannot realistically be applied, such as waste, agriculture and transportation. The next government should press ahead with plans for a tax on GHG emissions. In order to avoid undermining the competitiveness of Czech firms, some other tax relief may be warranted. However, the authorities should be wary of exemptions, rebates or other mechanisms for addressing competitiveness concerns that would undermine the environmental impact of the tax, such as exemptions or lower rates for more energy intensive production methods. This does not mean that a very heavy emissions tax must be imposed all at once: in designing the tax, the authorities should bear in mind that its environmental impact will depend on the tax paid on *marginal* emissions, not the average tax per unit emitted. There may thus be some scope for phasing the tax in or designing it in such a way as to avoid unduly penalising investment decisions made before it was adopted.[55]

Although most recent discussion of environmental taxation has focused on climate change issues, there is also a need to review the current system of environmental levies applied to various forms of water use, waste collection and disposal, air pollution (other than GHGs), freon use, forestry and mineral extraction. The system comprises a large number of relatively small charges administered by different agencies or levels of government. They are largely unco-ordinated with one another or with the tax system as a whole, and administration costs appear to be exceptionally high as a share of net revenues raised. High administration costs are to be expected where some environmental taxes are concerned – their object is to deter environmentally damaging behaviour rather than to raise income, so they functioning more like fines, with correspondingly high ratios of administration costs to net revenues. However, the very high relative administration costs in the Czech Republic mainly reflect the fact that charges are very low – often too low to influence polluter behaviour (Pavel and Vítek, 2007). A recent European Environment Agency (EEA) assessment of the charges levied for aggregate raw materials (stone, sand and gravel) highlights the problems that exist in respect of many environmental taxes and charges. The charges, introduced in 2002, vary with local conditions and environmental impact, but they appear to have been set too low to affect extraction activities or to influence recycling rates. Since the charges only apply to designated "reserved" deposits, simply raising them might trigger a shift to extraction from non-reserved sites (EEA, 2008). Raising the aggregate charges modestly, while extending them to cover all extraction, could provide needed additional revenues for municipalities. At the same time, it would be desirable to change the current complex formulae for calculating mining charges. The government should consider a systematic rationalisation and streamlining of the system of environmental levies, with a view to simplifying the system, reducing administration costs and increasing environmental impact. Here, as elsewhere, it is important to bear in mind not merely the costs of environmental taxes and charges or their direct impact on polluting behaviour but also their potential to stimulate "eco-innovation". As OECD (2009e) makes clear, any assessment of the costs and benefits of environmental tax reform that ignores innovation is incomplete.

... And real property

Another OECD recommendation is to increase reliance on the taxation of real property. The advantage of taxes on land and buildings is that they have relatively little effect on the allocation of resources in the economy, because they do not affect the decisions of economic agents to supply labour, to invest in human or other capital, to produce or to innovate to the same extent as some other taxes (Johansson *et al.*, 2008). Another advantage of property taxes is that the tax revenue they generate is more predictable than the revenues obtained from labour and corporate taxes, partly due to less cyclical fluctuation in property values (Joumard and Kongsrud, 2003). Also, as real estate and land are highly visible and immobile these taxes are more difficult to evade. The immobile nature of the tax base may be particularly appealing at a time when the bases of other taxes are becoming increasingly internationally mobile. If well designed, property taxes may also encourage greater accountability on the part of government, particularly where they are used to finance local government. For this reason, the authorities might wish to consider increasing municipalities' freedom to adjust property tax rates as part of any larger property tax reform.

As noted above, taxes on real property are unusually low in the Czech Republic. The real estate tax, which provides the revenue base for municipalities, consists of two parts – a tax on land and a tax on buildings – and has many deductions. The tax base for buildings is defined in physical units (square metres), using the surface of the buildings as the basis for measurement. Tax rates are defined in monetary terms (CZK) and depend on the use of the buildings: residential and agricultural structures, for example, are taxed less than other buildings. In the case of residential buildings, the tax depends also on their location: it is higher in Prague and other major cities than elsewhere. The tax base for land is measured in physical units (square metres), except for agricultural land, and it, too, depends on the designated use of the land – whether it is built area, a building plot or another type of land. The location of the land also matters, as in the case of residential property. The basic rates are multiplied by coefficients ranging from 1.0 to 4.5, depending on the size of the municipality. Municipal authorities have limited discretion to adjust this coefficient and also to exempt farmland from the tax altogether. However, neither the tax on land nor the tax on buildings reflects actual market values. For example, in the current tax system, the real estate tax for residential buildings in the Prague area is CZK 4.5 per square metre, and for built land it is CZK 0.45 per square metre. Given current prices per square metre in Prague, this corresponds to an effective tax rate of roughly 0.013%. Eliminating the under-taxation of real estate may also reduce the pro-cyclicality of property taxes and reduce housing price cycles (Muellbauer, 2005).[56] The tax mix in the Czech Republic should be shifted towards greater reliance on the taxation of real property by increasing the tax rates, by linking the tax to actual market prices or some combination of the two. It would also be desirable to limit those provisions that link property tax rates to designated use: the tax rate on an asset should not, as a general rule, depend on the use to which it is put.

Nonetheless, there are two practical drawbacks to a significant shift towards greater taxation of real property. First, these taxes are very unpopular in many countries, at least in part because of their visibility and because they are less obviously linked to ability to pay than are most other taxes. The latter consideration makes them particularly vulnerable to criticism on equity grounds. In some respects, however, taxes on real property offer advantages in terms of equity. First, they tap into the economic rents that may accrue to asset owners for reasons unrelated to their activities. Secondly, they can help to recoup the cost of infrastructure investment from its principal beneficiaries. Their unpopularity could in any case be reduced by the use of up-to-date valuations and provisions to deal with the situations of people with low incomes and illiquid assets. In the case of pensioners, one option would be to capitalise the property tax and take it from their estates, on death. However, it would not necessarily be desirable to do too much in this regard, since policies aimed at keeping house-rich but income-poor individuals in their current homes create distortions in the housing market that can impose (sometimes hidden) costs on other groups. The second practical drawback is that, as in most OECD countries, property tax revenues belong to local governments and so a shift towards property taxes would require some changes to revenue-sharing arrangements. However, this difficulty should not be over-estimated, as in most OECD countries local governments receive some income tax revenues, which could be substituted by property tax revenues, and/or substantial grants from higher levels of governments, which could be reduced as property tax revenues increased.

Box 2.3. **Tax and benefit policy recommendations to enhance growth**

The tax system should become less reliant overall on distortive tax sources

Recent tax reforms have already helped shift the tax burden towards reliance on less distortive forms of taxation but there is much more that can and should be done:

- The tax burden should be shifted further from direct to indirect taxes, specifically from the taxation of labour and capital income towards taxation of consumption and real estate.
- Reducing the labour tax wedge and, in particular, very high social security contributions, should remain a particular long-term priority.
- The trend towards lower tax rates and broader tax bases should continue, albeit with due consideration for the need to ensure that changes do not undermine the sustainability of public finances.

Labour taxation and the benefit systems should be made more growth-enhancing by boosting labour supply and demand

While the tax changes of 2008 helped increase work incentives, the interaction of tax and benefit systems means many groups still face very high average effective rates of taxation, which discourage activation, or very high marginal effective rates, which reduce the incentives for working individuals to increase their labour supply.

- Tax and benefit policies should be systematically co-ordinated. The authorities may want to consider constructing a tax-benefit model to analyse the tax-benefit interactions that arise when policies change.

Box 2.3. **Tax and benefit policy recommendations to enhance growth** *(cont.)*

- Where possible, the remaining spikes in marginal effective tax rates should be reduced or eliminated, by smoothing the withdrawal of some benefits, particularly unemployment benefit and living allowance, and by gradually withdrawing the spousal tax credit as the second earner increases earnings.
- The anomaly created by the combination of a flat-rate PIT and a cap on SSCs at high incomes should be corrected by eliminating the cap.
- A comprehensive review of the tax and benefit system provisions as they apply to families with dependent children should be undertaken with a view to reducing the disincentives for second earners to take up work by reducing the very high average effective tax rates they may face.
- Steps should be taken to reduce the disparities in the tax treatment of dependent workers and the self-employed.
- Targeted reductions in social security contributions for low-wage jobs should be considered. In particular, the requirement for workers earning less than the equivalent of the full-time minimum wage to pay the minimum social contribution should be relaxed.
- Consideration should be given to a return to comprehensive automatic indexation of tax and benefit parameters on the basis of a formula that is transparent and fiscally sustainable.

Distortions in capital taxation should be further reduced

The steady reduction in the statutory rate of corporate income tax (CIT) has itself helped to reduce some of the distortions that exist in the system of capital taxation. However, the system is still less neutral between forms of finance and asset types than many in the OECD.

- Some revision of the CIT and/or the taxation of dividends should be adopted so as to reduce the disparities between the tax treatment of different sources of investment finance. At the very least, thin capitalisation rules should be tightened.
- The neutrality of the CIT with respect to investment in different types of assets should also be increased. This may require revision of depreciation schedules and of targeted investment incentives now written into tax legislation.

Further steps to reform consumption taxation should be considered

- VAT should be levied at a single rate, with the number of exceptions and exemptions reduced to a minimum.
- Increased excise taxes on, for example, highly polluting fuels, should be considered where the government wishes to use consumption taxation to address environmental objectives or curb other social bads.
- A GHG emissions tax should be adopted.
- The next National Action Plan under the European Union's Emissions Trading Scheme should move away from the current practice of allocating emissions allowances to polluters free of charge.
- The system of environmental levies and charges should be rationalised and streamlined with a view to simplifying the rules, lowering administration costs and setting rates at levels that will influence polluter behaviour. Ways should be sought to reduce the sometimes excessively high compliance costs for the public administration and private taxpayers.

Box 2.3. **Tax and benefit policy recommendations to enhance growth** *(cont.)*

Taxes on real property should be both overhauled and increased

- The real estate tax should be increased by raising tax rates and linking the tax to actual market prices.

Follow-through in implementing recent reforms through the downturn will be important

- Implementation of recent reforms to disability pensions and sickness insurance should be monitored closely. Pressure to relax access to disability schemes or to compromise recent sickness insurance reforms as unemployment rises should be resisted.

Notes

1. When the tax package was adopted in 2007, the finance ministry expected that the net impact of these measures would be neutral for 2008 but negative for 2009 and 2010, due to further cuts in the CIT rate; see OECD (2008a:45-46) for details.
2. The figure for 2008 was little changed from the 44-45% recorded in previous years, despite the introduction of the 2008 tax reforms.
3. Relative to labour costs, Czech SSCs are estimated to have been the fourth highest in the OECD in 2008 (they exceed one-third of total labour costs); as a share of GDP, they ranked third in 2006.
4. In 2007, the Czech Republic ranked fifth in the OECD in terms of the corporate share of value added, behind Luxembourg, Norway, Switzerland and the Netherlands. Of course, the question of economic structure is not entirely exogenous: the tax system itself influences choices about forms of business organisation, but the evidence does not suggest that this is a major factor underlying the relatively large size of the corporate sector in the Czech Republic.
5. The rate was reduced by 1.5 points for employees and by 1 point for employers. In fact, some reduction in SSCs was already under discussion, but the crisis gave the issue new urgency.
6. The reform increased the personal tax credit from CZK 600 per month to CZK 2 070 (just over 8% of the average monthly wage) in 2008. This was scheduled to fall in 2009, when the PIT rate was cut, but the reduction in the credit was set aside along with the rate cut.
7. The rate was reduced to 28% in 2004, 26% in 2005 and 24% in 2006.
8. On the relationship between social protection and globalisation, see, *inter alia*, Katzenstein (1985); Hays *et al.* (2005); Mares (2005); and Kim (2007).
9. This section focuses on changes to social support and social assistance; reforms to sickness insurance and disability pensions are treated separately below.
10. From 1 July to 31 December 2009, child allowance was paid to families with an income of less than 2.5 times the MLS and the monthly amounts of the allowance are increased by CZK 50, to CZK 550 for a child under 6, CZK 660 from 6 to 15 years of age, and CZK 750 from 15 to 26 years (provided the child remains in full-time education or vocational training, or is disabled).
11. For example, the most generous level of child benefit was previously 0.32 times the child's MLS for households with income below 1.1 times the MLS for the household; in 2007, this changed to 0.36 times the child's MLS up to a threshold of 1.5 times the household's MLS. Similar adjustments were made in respect of the calculation of other levels of child benefit, of the "social supplement" paid under social assistance, and so on.
12. See Meghir and Phillips (2008). In the Russian case, Duncan and Sabirianova-Peter (2009) find that the flat-rate PIT introduced in 2001 does appear to have had a small but statistically significant impact on male hours of work, with implied elasticities with respect to tax rates that are in line with other estimates of male labour-supply elasticities. Simulations of the introduction of a flat-rate PIT in Belgium point to a similar conclusion. See Decoster *et al.* (2008); and Paulus and Peichl (2009).
13. The model and the adjustments made to it for this analysis are described in Annex 2.A1 below.

14. Where cross-national comparisons are presented, the standard model is employed; the rest of the discussion, focused only on the Czech Republic, uses the extended model, which presents a more detailed picture of the Czech system.
15. CNB (2008:89) also draws attention to the very high net replacement rates for families with children, whether recently unemployed or long-term unemployed.
16. The reform also implied that eligibility for the scheme was extended to higher household income levels.
17. These figures are taken from OECD data using a common definition and thus differ from estimates derived from national sources and based on national definitions.
18. The employee pays the normal contribution 12.5% of her/his wage and on top of this health insurance contribution for the difference between the minimum wage and her/his wage.
19. OECD (2008:72-74) notes that employment rates for the 25-29 age group have been rising, while those for the 30-34 age group have fallen, which may reflect a tendency for women to begin their reproductive careers somewhat later than in the past.
20. The EU25 average differential was just 14.7 percentage points, and second-largest and in only five countries did it exceed 20 points.
21. The difference between the country's position on the latter two indicators is instructive: while two-year leaves are not uncommon in the OECD, the three-year norm leaves the Czech Republic at the extreme end of the OECD distribution.
22. See, *inter alia*, Joshi (1990); Joshi and Davies (1992); Gray and Chapman (2001); Joshi and Davies (2002); Davies and Pierre (2005).
23. Note that the cost of education is the same for women and men; where tertiary education involves tuition fees, lower earnings make it harder for women to pay off loans taken out to finance their studies.
24. See OECD (2009b). Several other countries with very large gaps between men's and women's returns to education also exhibit a pattern of women leaving the labour force for long periods after childbirth.
25. The expectation of net social returns from investment in all children already underlies the provision of free schooling, but here, too, it is likely the less well off who benefit most, as long as quality education is provided. See, in addition to OECD (2007a), OECD (2006a); Heckman (2005); Cleveland and Krashinsky (2003); OECD (2001a); and Datta Gupta *et al.* (2007).
26. There is a strong consensus that it is beneficial for cognitive development above that age.
27. For an overview of this evidence, see Annex 2.A1 of OECD (2008e).
28. OECD data; the Czech Statistical Office estimate is 18.1%.
29. The Czech Republic's heavy concentration in manufacturing makes the level of self-employment puzzling, since self-employment is typically far more common in services and relatively rare in manufacturing.
30. See Baštýř and Vlach (2007); Hála (2007); Doleželová (2008); and Novák and Doleželová (2009).
31. During the period of the ban, the number of own-account workers in construction fell by 15 200 and the number of employees rose by 15 500. For details, see OECD (2008e:58).
32. Self-employed workers' contracts fall under the commercial code rather than the Labour Code, so employers are free of obligations in respect of such things severance rights, paid holiday, etc.
33. Legislation raising the thresholds for many groups was adopted in late 2009, with retroactive effect from the beginning of that year. However, the increases were mostly clawed back as from 2010 in the fiscal consolidation package.
34. The previous implementation and assessment guide was 15 years old and was updated to take account of changes in technology and medical knowledge.
35. Limits on the level of SI benefits mean that replacement rates are far higher at low wages.
36. This finding is in line with the evidence presented in Dalsgaard (2008) on the effective tax rates.
37. Companies may deduct 10-15% of the cost of new machinery and technology, provided they are the first owners or leaseholder. There are also VAT exceptions for the purchase of new machinery. See OECD (2008a:96-97).

38. This system is fairly unique although some countries have incorporated some elements of the system into their tax codes (Austria, Italy, Ireland, Luxembourg and Switzerland) and some countries have had such a system in place OECD (2009d).
39. For further detail on the effective rates, see Devereux *et al.* (2008) and Elschner and Vanborren (2009).
40. These limits also applied to loans from unrelated parties that were secured by a related entity.
41. Data for 2009 are likely to show a greater effect, because of the large crisis-induced drops in PIT, CIT and SSCs; VAT revenues have held up better through the downturn.
42. See OECD (2003, 2009); Daveri and Tabellini (2000); Nickell (2003); Carey (2003); and De Haan *et al.* (2003). With respect specifically to the eight new EU entrants in Central and Eastern Europe, World Bank (2005) finds that, for a given GDP growth rate, each percentage point increase in the tax wedge is associated with a decrease in employment growth of 0.5-0.8 percentage points. This finding, though suggestive, should be viewed with caution, however, owing to data limitations.
43. An increase in wage taxes over the lowest segment of the earnings distribution has no impact on employment because the minimum wage rate is still higher than the wage rate that would equate labour supply and labour demand; see Carey (2003).
44. See, for examples, the experiences of France (OECD, 2005), Belgium (Carey, 2003) and the United Kingdom (Brook and Leibfritz, 2005).
45. For VAT purposes, "social housing" is defined as an apartment of no more than 120 m^2 or a house of no more than 350 m^2.
46. For more on the rationale for using special excise taxes or subsidies rather than VAT to address such externalities, see Ebrill *et al.* (2001).
47. For more details on the VRR, see *Consumption Tax Trends 2008*.
48. The tax base is measured by the national accounts definition of final consumption and does not fully match with the actual VAT base.
49. These fuel sources are also exempt when not used as fuel or to produce heat; here the logic is simply that they need not be taxed on environmental grounds if they are not burned.
50. The question of taxing electricity at all is open to debate, because electricity generation is covered by the EU ETS. Cross-border trade within the EU is no problem here, because it is measured emissions at power plants that form the basis of the ETS. The tax on electricity consumption therefore does not contribute to a reduction in EU-wide CO_2 emissions: these are governed directly by the "cap". Instead, the electricity tax helps lower permit prices, benefitting emitters in other sectors covered by the ETS and (rather perversely) the electricity generators with the largest relative CO_2 emissions – coal-based generators.
51. DG Env (2009) reports that in 2006 it ranked fourth among the EU25.
52. Grandfathered permits are identified as one of the *least* effective mechanisms for stimulating innovation.
53. Ekins and Salmons (2009). In practice, there is likely to be an impact on competitiveness, owing to imperfections in financial markets and the competitive structures of permit and product markets. The arguments for auctioning over grandfathering are canvassed at greater length in OECD (1995); OECD (2001a); OECD (2008f); and Ekins and Salmon (2009).
54. The reserve for new entrants is equivalent to about 1.49% of the total quota.
55. OECD (2005:68-69) describes the attempt to introduce such a tax in France.
56. In particular, it may limit the ability of households betting on a rising market to take on excessive mortgages, even if there are willing lenders available. If the tax on a property is too high relative to income, both borrower and lender will think twice about the transaction, even if it looks like a good speculative bet.

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ANNEX 2.A1

Effective tax rates on labour – methodology and assumptions

The analysis of effective tax rates in this chapter closely follows the methodology used in the OECD *Tax and Benefit Model*, which is available for all OECD members and some non-OECD economies. However, due to its wide coverage and the necessity of employing some non-country-specific assumptions, the model does not fully capture the details of the Czech tax and benefit system. The analysis presented here is therefore drawn from a modified version of the model for the Czech Republic, which has been augmented with additional information on the Czech system. Information on the overall methodology used in the OECD *Tax and Benefit Model* can be found in OECD (2007c).

The OECD *Tax and Benefit Model*

Effective tax rates

The analysis focuses on average and marginal effective tax rates (AETR and METR). They are calculated to measure the extent to which tax and benefit systems distort work incentives. The METR measures the share of one unit additional earnings that is "taxed away" through the combined effect of changes in taxes and benefits. Instead of measuring the impact of a one-unit change in earnings, the AETR captures the share of additional earnings that are "taxed away" due to changes in taxes and benefits as an individual moves from unemployment or inactivity to full-time employment. The METR and AETR are defined as follows:

$$METR = 1 - \frac{\Delta y_{net}}{\Delta y_{gross}} \qquad \text{(A.1)}$$

$$AETR = 1 - \frac{y_{netIW} - y_{netOW}}{y_{grossIW} - y_{grossOW}} \qquad \text{(A.2)}$$

where y refers to income and Δ to a one-unit change in income. Sub-indices *net* and *gross* indicate net and gross income and IW and OW indicate employment status – full-time employment ("in work") and inactivity or unemployment ("out of work"), respectively.

Income definitions

Gross income is defined as labour earnings before taxes and benefits. Only cash incomes are considered in the model. Net income is gross income minus income taxes and employee social security contributions plus cash benefits. Any taxes or contributions not paid directly by or to the wage earner or benefit recipient are not included in the income definitions.

Labour earnings are measured as a percentage of the earnings of the average worker (AW) and are expressed on an annualised basis. The annual AW wage in the Czech Republic in 2008 was around CZK 271 257. Average earnings are calculated for the business sector, that is, industries C to K of the United Nations International Standard Industry Classification (ISIC Rev. 3.1) and relate to the whole country.

Time period

All income measures are based on the tax-benefit rules and laws in force in a given year. For the Czech Republic the analysis focuses on 2006 and 2008. In international comparisons, the year of analysis is 2008 for the Czech Republic and 2007 for other countries.[1] Since the focus is on a given year, any time-lags delaying the assessment of entitlement or payment of benefits and taxes are ignored. For example, in the case where means-tested benefits depend on the previous year's income, these benefits are modelled on the basis of a household's current income situation.

Household types and related assumptions

Effective tax rates are computed for the following household types: single adult, one-earner married couple and two-earner married couple. All the three types are considered with two children and without children. Household adults (both male and female) are assumed to be 40 years old and children are assumed to be four and six years old.

In this analysis, effective tax rates are calculated for several different earnings levels. The AETRs focus on the earnings level of the minimum wage (8 000 CZK per month) and at 67% and 100% of the AW. Where the other spouse is also working, her/his earnings are assumed to be either 67% or 100% of the AW. METRs are calculated for all wage levels below 200% of the AW. The levels above this wage are not considered, as at such wage levels tax and benefit systems are unlikely to distort work incentives.

Benefits

Since only cash income is considered, all benefits "in-kind" are excluded from the model. In addition, benefits directly related to the purchase or reduced prices of particular goods and services (other than housing and child care) are excluded. The benefits included in the OECD model are unemployment insurance, unemployment assistance, social assistance, family benefits and lone-parent benefits, housing benefits, child allowance and employment-conditional "in-work" benefits. The model disregards, *inter alia*, old-age cash benefits, early retirement benefits, childcare benefits for parents with children in externally provided childcare, sickness, invalidity and occupational injury benefits, and benefits related to active labour market policies, as well as severance pay. A detailed description of the assumptions used in the model may be found in OECD (2007c). For the analysis of the Czech system, the relevant benefits include unemployment benefit, housing allowance, child and social allowance (family benefits), as well as living allowance and housing supplement (social assistance).[2]

Taxes

The calculation of taxes and social security contributions (SSCs) are based on the OECD Taxing Wages models. Only personal income taxes (PIT) on labour and SSCs payable by the wage earner are included. The analysis incorporates only standard tax reliefs which are unrelated to actual expenditures incurred by the taxpayer and are automatically available to taxpayers who fulfil the eligibility criteria. Non-standard tax reliefs excluded from the analysis are, *inter alia*, those related to cost of owner-occupied housing, mortgage interest payments and insurance premiums, contributions to saving or pension schemes and charitable donations. In the case of the Czech Republic, the relevant tax reliefs consist of the standards tax credit, spouse and child tax credit.

Modifications to the OECD *Tax and Benefit Model* for the purposes of this analysis

The main differences between the current analysis and the results yielded by the standard *Tax and Benefit Model* are related to the assumptions concerning housing costs for the purpose of calculating housing allowance, the income definition used in benefit calculations, entitlement to the child tax credit and payment of SSCs below the minimum wage. In addition, the housing supplement is included in the category of housing benefits in the *Tax and Benefit Model*, whereas in the current analysis, it is considered as a part of social assistance. This is because it is, together with living allowance, the final source of support in the benefit system and is included in the system of social assistance in material need.

Housing costs

The *Tax and Benefit Model* applies a simple assumption concerning the level of housing costs for the housing allowance calculations. These costs are assumed to be 20% of gross earnings of the average worker for all household types and all income levels. The current analysis incorporates more detailed assumptions of housing costs for benefit calculations by using the prescriptive housing costs set by law every year and used as the basis for calculating housing allowances.[3] Table 2.A1.1 below presents the prescriptive costs for 2008. The cost used in the model for each family size consisted of a weighted average of the prescriptive cost for that family size, with the weights reflecting the distribution of that family type across the range of municipalities. Thus, the analysis allows, *e.g.* different housing costs for a single person and for a couple with two children.

Table 2.A1.1. **Prescriptive monthly housing costs, 2008**

Number in household	Prague	Population				Weighted average for household type
		100 000+	50 000-99 999	10 000-49 999	< 10 000	
1	4 182	3 383	3 155	2 895	2 747	3 131.4
2	6 091	4 998	4 686	4 331	4 128	4 534.2
3	8 401	6 971	6 563	6 099	5 834	6 518.3
4+	10 549	8 824	8 332	7 772	7 453	8 029.4

Source: Ministry of Labour and Social Affairs, OECD calculations.

Income definition used in benefit calculations

Both eligibility for and the level of many benefits depend on family income. Thus, it is important to use the "right" income definition as a basis for benefit calculations. The OECD *Tax and Benefit Model* uses the basic net income definition as the income basis for calculation of the benefit entitlement and level, *i.e.* gross income after taxes and benefits. However, according to the Czech benefit system rules, the child tax bonus (a negative tax liability) is not included in the income definition. This lowers the net income used in the benefit calculations and thus makes the system more generous in eligibility and benefits levels. The current analysis incorporates this into the income definition. A second difference is that social assistance is not included in the income definition. Thirdly, individual benefits are included or excluded from the income definition depending on the benefit. These changes bring the definition of income used in the modified version of the model closer to the rules applied in the Czech system when assessing benefit eligibility and level. For example, only child allowance is included in the income definition when social and housing allowances, as well as the housing supplement, are calculated. Living allowance calculations include only taxes and social security contributions in the income definition. These differences in the definition of income lead to some differences in the effective tax rate calculations between the current analysis and the standard OECD model.

Table 2.A1.2. **Income definitions used for specific benefits**

System	Benefits	Income included
Social insurance	Unemployment benefit	Gross income less PIT and SSCs
State social support	Child allowance	Gross income less PIT and SSCs plus unemployment benefit
	Social allowance	Gross income less PIT and SSCs plus unemployment benefit and child allowance
	Housing allowance	Gross income less PIT and SSCs plus unemployment benefit and child allowance

Source: Ministry of Labour and Social Affairs; Ministry of Finance.

Entitlement to the child tax credit

The current analysis also takes account of the fact that a household with children is eligible for the child tax credit only if at least one adult in the household is earning more than half of the minimum wage (CZK 4 000 per month). The standard model does not incorporate this rule.

Payment of social security contributions

The rate of employee SSCs is 12.5% of gross earnings in the OECD model.[4] This rate is applied to all income levels. However, at incomes below the minimum wage, employees are obliged to pay both employees' and employers' part of the health insurance contribution due for a full-time minimum wage worker, unless they are unemployed, engaged in full-time childcare or entitled to living allowance.

Notes

1. At the time of writing, updates for other OECD countries were not available.
2. Parental allowance is not included, as families are entitled to this benefit only when children are under three years old and the assumption of the age of the children more than three years (four and six).
3. Both the current analysis and the OECD *Tax and Benefit Model* assume that housing costs are entirely rental costs.
4. This has since fallen to 11.0%, but the analysis was conducted using policy settings for 2008.

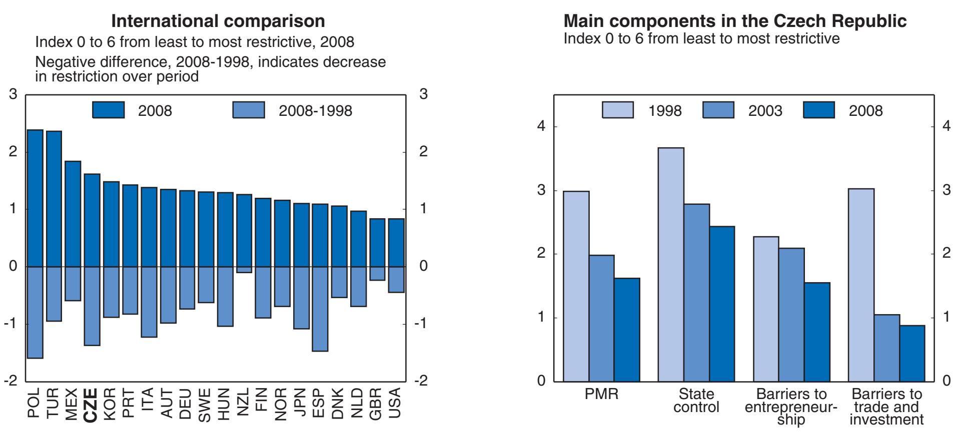
Chapter 3

Improving the business environment

This chapter assesses recent regulatory reforms and considers the scope for future initiatives in this area. It begins with a look at the substance of product- and labour-market regulation before turning to the questions of regulatory policy per se*, particularly simplification and impact analysis. Both substance and process are important, since recent OECD and academic research suggests that less burdensome product- and labour-market regulation and better regulatory management systems are both associated with better performance in terms of output, employment and productivity. A final section looks at the contribution that e-government is making to these efforts and at the areas where the authorities could do more to use e-government methods to enhance the business environment.*

Despite significant recent reforms, the business environment in the Czech Republic appears in most international comparisons to be characterised by a comparatively high level of regulation (Figure 3.1). This reality finds reflection not only in above-average scores on the OECD's indicators of product-market regulation (PMR) but also in the country's consistently mid-range ranking in the World Bank's "Doing Business" indicators, which cover a related but distinct set of regulatory issues, and in the results of business surveys conducted by such bodies as the World Economic Forum and the Council on Czech Competitiveness. In fact, the country has made considerable progress in relaxing regulation. As is clear from Figure 3.1, the Czech Republic saw one of the most significant reductions in the PMR burden in the OECD area during 1998-2009. The "Doing Business" indicators also point to improvements in many domains. However, other countries are also reforming, so a certain pace of improvement may be needed for a country simply to maintain its competitive position. Thus, the Czech Republic continues to rank among the most heavily regulated OECD economies, and its overall ranking on the World Bank's "Ease of Doing Business" indicator fell steadily from 2006 through 2010.[1]

Figure 3.1. **Product-market regulation**



Note: For details on concepts and calculations, refer to Wölfl, A. *et al.* (2009), Ten years of product market reform in OECD Countries – Insights from a revised PMR indicator, *OECD Economics Department Working Papers*, No. 695.

Source: OECD, "Indicators of economy-wide regulation", OECD webpage.

StatLink http://dx.doi.org/10.1787/817268866866

Steps to reduce the still heavy regulatory burden on business would be desirable at any time and could, in the wake of the crisis, offer a way to reduce the cost of doing business – and thus relieve the pressure on the enterprise sector – at little or no cost to the budget. Cross-country empirical studies suggest that more open and competitive product markets are associated with faster productivity growth and that a reduction in the regulatory burden would also foster entrepreneurship and employment growth during the recovery.[2] These findings reflect not only the direct compliance costs involved in heavier regulation but also the impact on incentives to invest and innovate of regulations that inhibit entry.[3] Some work also points to regulation as a deterrent to foreign direct investment (Dewit *et al.*, 2009), a particularly important consideration for the Czech Republic. The government itself has recognised this and has committed itself to a major drive to reduce the cost of regulation; indeed, it has identified administrative simplification as an important element of its response to the governance challenges raised by the current downturn (OECD, 2009d:45).

To a great extent, the policy challenges explored in this chapter share a common feature with those issues examined in Chapters 1 and 2: the need for greater co-ordination across the public administration. In a number of domains, policy settings are moving in the right directions, but implementation is uneven, because the institutions driving policy lack the capacity to ensure a whole-of-government approach. Further measures are needed to strengthen institutions and mechanisms for assuring consistent, coherent implementation of regulatory policies.

Reducing impediments to entry, exit and competition

Starting a business has become faster but remains relatively expensive

Previous *Surveys* have drawn attention to the cumbersome and expensive regulation of business start-ups for both sole proprietors and new companies.[4] This has changed substantially in recent years. On-line registration has been introduced, and the full activation of a network of administrative "one-stop shops" (the so-called "Czech Points" discussed below) has made it possible to gather the necessary data and documents without visiting a host of different state institutions. This has greatly reduced the time required for start-up. Simplified and standardised forms for registration have been introduced and time limits have been established for regional commercial courts to take a decision on registration (otherwise, a "silence is consent" rule applies). For sole traders, the licensing regime was also simplified via a reduction in the number of specific trade licences that are issued. These measures cut the estimated time required to register both new companies and individual enterprises by almost 40% between 2007 and 2009, and the country is now close to the OECD average as regards the speed of registration. The cost of registering companies has also fallen but remains about double the OECD average when measured as a proportion of average per capita income (the situation for sole proprietors is more favourable). This chiefly reflects the minimum capital requirements in force (CZK 200 000 for a limited liability company, CZK 2 m for a joint-stock company). These requirements, in turn, affect another major registration cost – notary fees are related in part to the amount of the company's registered capital. The next government should consider lowering the minimum capital required for new limited liability and joint-stock companies. Entry barriers for notaries should also be examined with a view to identifying factors that may contribute to excessive fees.

The streamlining of registration processes has coincided with steps to simplify and accelerate a number of other activities that had proved unusually time-consuming or expensive, particularly for smaller firms. The issuing of construction permits has become substantially faster as a result of reductions in the time allowed for the bureaucracy to process the registration of new plots. This has cut the estimated time required to obtain such permits by around one third; it is now just below the OECD average. Property registration has likewise been streamlined and with similar results. While very long waits are still reported in Prague, in most of the country the estimated time required is down by just over one-third, thanks to reorganisation and greater use of information and communications technologies at the Cadastral Office (World Bank, 2009). The continuing development of on-going e-government initiatives (see below) should result in further improvements. That said, recent assessments of the ease with which businesses can navigate regulatory processes suggest that the drive for lighter regulation has had less effect at local level in many areas: the processes that provoke the most complaints are often those handled by municipalities. The administration of zoning and other local regulations appears to be very uneven.

The new insolvency law appears to be accelerating bankruptcy processes

The economic crisis has provided a stringent test of the new bankruptcy law, which came into force in January 2008, following years of debate. The new law was aimed at increasing the transparency of bankruptcy processes, strengthening the role of creditors and speeding up the resolution of insolvency cases. These have tended to be extremely long in the Czech Republic. As previous *Surveys* have noted, the weaknesses of the legal framework for insolvency have been among the reasons why winding up a business was so time-consuming and so costly.[5] The new legislation limits judges' role in decision-making on valuation and other commercial issues, gives creditors greater authority *vis-à-vis* insolvency administrators and introduces a re-organisation option that in some respects resembles US Chapter 11 proceedings. Under this procedure, a judge can, if certain conditions are met, impose a schedule for the partial repayment of debt which, if successfully completed, means that the remainder of debt is written off. In some cases, reorganisation can commence even without the creditors' consent, though a qualified majority of creditors can stop such a reorganisation. This gives distressed debtors more incentive to file for bankruptcy rather than "gambling on resurrection" or asset-stripping (OECD, 2006a:30-31). In an effort to increase the transparency of judicial processes, the law also introduced an electronic insolvency register, accessible free of charge. Finally, the new law reintroduces the balance-sheet insolvency test into Czech law (Richter, 2006). Under the balance-sheet test, a debtor whose assets are worth less than its debts must disclose this fact by commencing insolvency proceedings, bringing the balance sheet back into balance via the issue of new equity or a debt-for-equity conversion, or merging with a financially sound business.[6] This provision is intended to identify debtors whose assets are insufficient to cover all debts even before their insolvency begins to show in an inability to pay debts as they fall due. It provides some protection against managers running a distressed firm deeper into debt without acknowledging its problems, since some claims taken on after the debtor was insolvent but before this fact was disclosed may be challenged.

So far, the law appears to be working well, with a large number of cases being resolved in accordance with the new options permitted by the law (Richter, 2009). The provisions for individual insolvency also seem to be working. Amendments to the law adopted in 2009 as part of the government's response to the crisis further increased the scope for alternatives to liquidation, in an effort to preserve businesses in trouble during the crisis, and also increased the protections afforded to an insolvent debtor's employees. The estimated time for winding up a business in the Czech Republic has fallen by almost one-third and recovery rates have increased somewhat (World Bank, 2009). Moreover, the greater transparency permitted by the creation of an electronic insolvency register appears to have brought benefits of its own: by reducing the risks stemming from asymmetric information between debtors and creditors, or among different creditors of a single debtor, the register has allowed insolvency proceedings to move faster, while also making it easier for creditors and debtors to negotiate. This can contribute to both increased scope for agreeing on reorganisation and increased recovery rates in the event of liquidation (Mejstřík and Chvalovská, 2009). Despite these improvements, however, the estimated average length of bankruptcy proceedings is still about four times the OECD average. The next government should consider further revisions to the bankruptcy regime with a view to speeding up insolvency proceedings; this should involve not only further amendment of the legislation but also further efforts to train judges and administrators. The current government has recognised this need, and further training of judges handling insolvency cases is among the measures included in the draft strategy for exit from the crisis adopted by the government in early 2010; it will be important for the next cabinet to take this initiative forward.

While the new bankruptcy regime is clearly an important step forward, it highlights a broader problem with the judicial system. Various assessments of the Czech business environment highlight the high costs, in terms of both time and money, of recourse to the judicial system for contract enforcement, investor protection or liquidation (World Bank, 2009; WEF, 2009; CCC, 2009). Surveys of businesspeople and ordinary citizens reinforce this impression. The legislative framework for business is generally well regarded and the judicial system scores relatively highly on indicators of probity, but it is also reckoned to be slow and expensive.[7] World Bank (2009) estimates the cost of contract enforcement, in terms of both time and money, to be high compared with the levels found in neighbouring countries like Poland, Slovakia and Hungary, or in most of the EU (see also CCC, 2009).

Competition issues remain to be addressed in gas and telecommunications

One way a government with limited scope for fiscal manoeuvre can bring relief to a tradable sector under pressure is to address barriers to competition in non-tradables, particularly infrastructure and network sectors.[8] The inefficiency of these sectors can represent a competitive handicap to the exposed tradable sectors that rely on them for services and other inputs (Conway and Nicoletti, 2006). Indeed, previous research on the Czech Republic has found a positive relationship between services-sector reforms and the performance of domestic firms in downstream manufacturing sectors (Arnold *et al.*, 2006). This is an area in which the Czech Republic has already made considerable progress, as it has opened up its major infrastructure sectors in line with European legislation, so there is no longer much “low-hanging fruit” to be picked. Reform challenges remain, however, in power, gas and telecommunications.

In the power sector, the authorities have sought to assure competition via vertical unbundling of ownership, with the grid owned and operated by a separate, state-owned company. However, market dominance remains an issue. The majority state-owned ČEZ continues to control around 73% of generation and 45% of distribution. At the same time, it exports almost 20% of its electricity, while independent traders supply imported power to domestic customers. In late 2009, the European Commission initiated an anti-trust investigation of ČEZ and the privately owned power-sector holding company EPH, following allegations of anti-competitive conduct and abuse of dominance. The results of the investigation are not yet known, and the companies involved have emphatically denied any anti-competitive or collusive activity. Although price movements are increasingly determined by market forces, the episode highlights the difficulty of ensuring robust competition in a sector where one actor dominates both up- and downstream activities and the need for the competition authority and the sectoral regulator to remain extremely vigilant in monitoring any potential anti-competitive behaviour.

The gas sector is dominated by single, private player, RWE, which is the largest supplier and also owns, via subsidiaries, the transport network and 75% of storage capacity. Its subsidiary Transgas handles about 85% of gas imports, and its share of supplies to final customers was 69% in 2008. A third-party access (TPA) regime is meant to ensure smaller suppliers' access to the pipeline network, but access to storage facilities must be negotiated. Neither arrangement has worked smoothly. The Office for the Protection of Competition (OPC) has found that RWE failed to allow competitors fair access to regional distribution networks. Even with precise rules, accounting separation and legal unbundling (the pipelines are operated by a separate RWE subsidiary), information asymmetries and the incentive to discriminate remain. Yet challenging RWE is costly and difficult, and risks antagonising the dominant actor in the sector. The situation as regards storage is more serious. Access to storage capacity matters relatively little for supplying the largest customers, but it is essential for supplying households and small and medium-sized commercial customers (OECD, 2008c:45). The potential significance of this dominant position in gas storage became especially evident during the disruption of gas supplies that occurred in early 2009 as a result of the Russo-Ukrainian dispute over gas supply and transit tariffs. Following an investigation by the OPC, RWE undertook to make 10% of its storage capacity available to rival suppliers by the end of 2011 and 20% by the end of 2013. While this is a step forward, the next government should at the very least explore ways to strengthen the third-party access regime in transport and to move towards regulated, rather than negotiated, third-party access in storage. Should this prove insufficient to ensure fair competition, the government should explore the options for fuller vertical separation via ownership unbundling, including voluntary separations, such as have recently been seen in Germany.

The prices of the vast majority of fixed-line and mobile telephone services remain exceptionally high in the Czech Republic compared with other OECD countries, although prices for mobile services have been coming down. In some market segments, Czech telephone tariffs are the highest in the OECD area and are up to four times higher than in the lowest-priced markets.[9] Such high prices are both an anomaly and a significant burden on businesses in every major sector, as well as on households. The situation with respect to broadband is more complex, as much depends on the availability of different platforms. Cable prices, for example, tend to be relatively low in international comparison, whereas the lowest DSL tariffs on offer are comparatively high.[10] Overall, entry-level prices for medium- and high-speed connections are now quite low by OECD standards, although very high-speed connections are close to the median for the OECD. The level and movement of broadband prices are critical, for, as the previous *Survey* observed, they contribute to a low take-up of broadband Internet. With an estimated 17.2 broadband subscribers per 100 inhabitants, the Czech Republic ranked 23rd in the OECD in terms of broadband penetration in December 2008 (OECD, 2009c).

It is not clear why the Czech Republic continues to stand out in this respect, but the structure and history of the sector suggest that weak competition is an issue. The fixed-line sector is still heavily dominated by the former state-owned monopoly Telefónica, and the three GSM operators have significant market power in the more dynamic mobile sector.

The powers of the OPC over the sector were strengthened in 2007, when parliament repealed a provision of the telecommunications law that had effectively prohibited the OPC from taking action where the sectoral regulator had the power to set fines or regulate conduct. On the whole, the OPC has tended to act more vigorously than the sectoral regulator, which was criticised by some for having allegedly undergone "regulatory capture".[11] Whether such allegations are warranted or not, resistance from the industry to a larger role for the OPC suggests a fear in some quarters of more vigorous enforcement of competition law in the sector. Moreover, as OECD (2008c:42) observes, commitments made in conjunction with the OPC decisions have not always been honoured in practice.

OPC officials state that they find no evidence of abuse of dominance or of collusion in the voice services market, although fixed and mobile telephone tariffs remain high. Broadband access is another matter. The competition authority has undertaken a major investigation into claims that Telefónica, which accounts for over 85% of the DSL market, has abused its dominant position in broadband. The definition of the "relevant market" has taken on great importance here, since Telefónica argues that it faces more intense competition from Wi-Fi and cable than do its counterparts elsewhere. Telefónica has also pressed for revision of the regulated access regime that governs its rivals' access to the physical infrastructure that it owns, again arguing that technological change implies a need to redefine the relevant market. With the fixed-line penetration rate one of the lowest in Europe (31%) and Wi-Fi growing rapidly, it is argued that dominance on fixed wires matters little. Inter-platform competition is indeed an important feature of the market. However, not all platforms are everywhere available, and alternative operators have complained that the incumbent's control of the infrastructure is making it increasingly difficult to compete with Telefónica's bundled offers.[12] The question, in any case, is not merely what the market share of a given company in a given market (however defined) may be, but what conditions may give it the ability to exercise market power. Given the importance of ICT for businesses in every other sector, ensuring robust competition here is a key priority. The regulatory and enforcement authorities should make every effort to promote greater competition in the sector and act quickly in response to any evidence of abusive practices, collusion or other sources of market power.

Parliament has moved to curb competition in food retailing

Despite increased licensing requirements, the liberalisation of retail markets in the Czech Republic has generally been successful. Food retailing has increasingly been consolidated around eight or nine major chains. The OPC takes the view that this is a sufficient number of players for robust competition, while their size is great enough to allow consumers to benefit from scale economies. Recently, however, there has been growing pressure to limit price competition in the sector, which is seen as damaging to agricultural producers and domestic food processors. The autumn of 2009 witnessed a significant retrograde step in this area, as parliament overrode both the objections of the government and a presidential veto to adopt a law aimed at curbing the abuse of market power by large food retailers ("O významné tržní síle", 2009). The ostensible purpose of the law was to protect small suppliers of food and other agricultural products against the "buyer power" of large supermarket chains. In the end, it was extended to all entities with turnover in excess of CZK 5 bn (€ 192 m), which are required to adhere to a code of fair business practices for dealing with suppliers. The law rests on a fundamental confusion between bargaining power (the strength a buyer has *vis-à-vis* suppliers) and monopsony power (the ability of a buyer to drive the price up/down by purchasing more/less). Bargaining power tends to benefit downstream consumers, especially if there is competition downstream, while monopsony usually results in higher prices downstream (OECD, 2009e). While many elements of the code simply repeat provisions set out elsewhere in Czech legislation, others involve significant deviation from normal principles of private law and some are regarded by legal practitioners as overly vague (Uřičař, 2009). Apart from restricting competition and, in all likelihood, raising prices for consumers, the law may well damage those it is intended to protect. Faced with the sometimes unclear requirements of the law, many retailers may prefer to avoid potential problems by minimising their dealings with small suppliers and sourcing supplies from large organisations. The Act on the Abuse of Significant Market Power in the Sale of Agricultural and Food Products should be repealed.

Services liberalisation has moved forward

The Act on the Free Movement of Services, which implements Council Directive No. 2006/123/EC on services, entered into force on 28 December 2009. This represents an important further step in the completion of the EU Internal Market. The directive requires member states to abolish restrictions that hinder service providers from entering markets in other member states. In each state, uniform single contact points ("one-stop shops") are to be established, allowing business entities from the Czech Republic and other member states to obtain the information needed to commence business activity and to process the necessary formalities. This should significantly reduce the administrative burden associated with entry into new national markets. The directive and the act introduce the principle of "tacit approval" in this sphere: if the relevant regulatory body does not grant or deny permission to provide a service within a given period of time, approval will be deemed to have been granted. Neither the directive nor the act covers audiovisual services, healthcare and social services, transportation services, services provided by employment or security agencies, financial services or electronic communication services. The scope of the act also excludes some basic infrastructure and network sectors, although the Czech authorities support further sectoral initiatives at EU level to liberalise activities such as healthcare and financial services.[13]

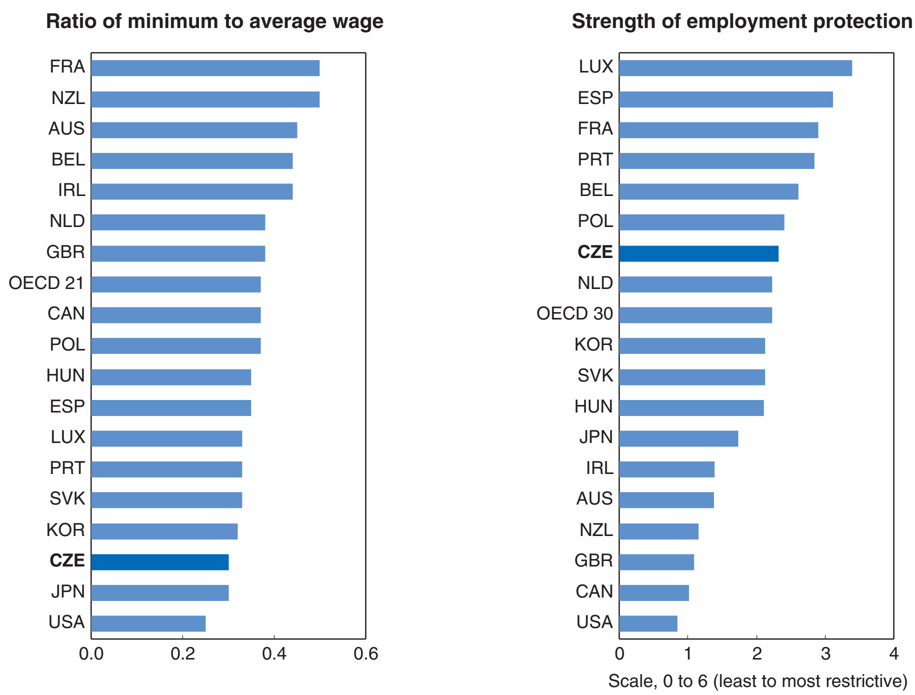
Overall, implementation of the directive should make services sectors in the Czech Republic more competitive, while opening up new opportunities for services-sector firms to operate in other EU markets. As a relatively small country with a skilled workforce and comparatively low labour costs, the country is well positioned to benefit from market opening. Liberalisation of trade in intermediate services can boost manufacturing competitiveness by reducing transaction costs and the costs of entering new markets (Nordås, 2009). The government could, indeed, go further, reducing domestic barriers to entry in services and opening up sectors not covered by the directive. Arnold *et al.* (2009) estimate that a bold liberalisation package in services could raise labour productivity for the average EU country by around 10% over a decade. The Czech economy, in particular, should stand to gain much from such a move, as the OECD PMR indicators for 2007 show that the country has tighter restrictions on entry into many professional services than most OECD members. Now that the directive opens up those services to cross-border provision, such restrictions will lose much of their force but they may handicap local providers. The government should review entry barriers in professional services with a view to using implementation of the EU directive as an occasion to go even further in opening up these markets. It should also be ready to open up the many important service sectors not covered by the directive.

Making labour markets more flexible

The labour market has shown flexibility in response to the crisis but rigidities remain

Assessments of the Czech labour market generally place it somewhat better than the OECD average in terms of flexibility. The minimum wage is low relative to average wages,[14] and the country's scores on OECD indicators of the rigidity of employment protection legislation (EPL) are close to, or even slightly below, the average in most areas, indicating above-average flexibility (Figure 3.2). The major exception is the indicator for the protection of regular workers against dismissal, which is discussed further below. As Chapter 1 shows, the labour market's response to the crisis confirms the impression of a reasonably flexible labour market. Employment, working time and even nominal wages all adjusted in varying degrees, and they did so more rapidly than many had anticipated. Though economically and socially painful, this adjustment suggests that the labour market is reasonably flexible and efficient. This bodes well for the long term. Nevertheless, there are still clear indications that the market could be more flexible. The persistence of long-term unemployment is one indicator of rigidity. Long-term unemployment accounted for over half of all unemployment during 2000-08 and only began to decline in the years of very fast growth just before the crisis. A second indicator is the widespread tendency of

Figure 3.2. **Labour-market regulation, 2008**



Note: The OECD indicators of employment protection are synthetic indicators of the strictness of regulation on dismissals and the use of temporary contracts. For more information and full methodology, see *www.oecd.org/employment/protection*.

Source: OECD, *Earnings and Indicators of Employment Protection Databases*.

StatLink http://dx.doi.org/10.1787/817332244050

firms to use fictitious self-employment,[15] temporary agency work and fixed-term contracts in order to gain more flexibility than would be possible with standard contracts under the Labour Code. Finally, significant and persistent regional disparities in unemployment rates point to mobility barriers that remain to be addressed.[16] These phenomena raise the risk of increasing labour-market dualism. Certain regulatory rigidities add to business costs and may limit employment growth. Some barriers to the creation of "non-standard" jobs, arising from the tax and benefit system, are addressed in Chapter 2. This section looks specifically at regulatory policies that undermine labour-market performance.

More can be done to reduce hiring costs and encourage labour mobility

As noted in the previous *Survey*, several minor reforms aimed at liberalising elements of the 2007 Labour Code were adopted in autumn 2007. These granted employers greater flexibility in the organisation of working time and introduced the arrangements governing short-time working regimes that are discussed in Chapter 1. However, a number of changes could allow for still greater flexibility. Further relaxation of some aspects of EPL, in particular, would be welcome. While EPL has no clear impact on the overall employment rate, the evidence suggests that it slows the rate of job creation and adversely affects the entry of younger workers and women to the labour market (Bassanini and Duval, 2006; European Commission, 2006a). At the very least, notice period and severance pay arrangements ought to be linked to tenure. Currently, the notice period for redundancy is two months, with severance pay equivalent to three months' wages. Compared to other OECD members, these provisions are modest for long-serving workers but very generous to those only recently employed. Newly hired workers should acquire normal severance rights gradually once their probationary period is completed, as their length of service increases. EPL reforms tend to be very difficult to adopt in a context of rising unemployment, as the value of protection rises in a weak labour market. However, preparation for such changes now should pay dividends during the recovery, when encouraging job creation will be a key priority. The experience of a number of OECD countries suggests that labour-market reforms can be harder to pass in the midst of downturns, but implementation tends to be easier in a strengthening labour market (OECD, 2009b).

Greater flexibility of contracting should also reduce employers' incentives to use bogus self-employment arrangements with their workers, particularly if adopted in tandem with tax changes that make false self-employment less attractive to employer and employee alike (see Chapter 2). Studies of the false self-employment issue suggest that, in addition to tax avoidance, phoney self-employment is used to circumvent restrictions on the use of fixed-term contracts, which cannot be extended beyond two years except in specified circumstances, as well as regulations concerning working-time and overtime arrangements. The government should explore options for the further relaxation of the rules regarding fixed-term and other non-standard contracts. Finally, previous *Surveys* have highlighted large and persistent differences in regional unemployment rates, linking these to possible barriers to mobility, particularly in connection with the housing market (OECD, 2004, 2006a, 2008a). As noted in Chapter 2, VAT on construction and renovation is levied at the reduced rate, mortgage interest deductions are large relative to incomes and the real estate tax is minimal. Capital gains from the sale of one's principal residence are not taxed. At the same time, the rental market continues to be regulated, although this is being phased out. Gradual, centrally capped increases in regulated rents have been under way since 2007, and from 2010 owners should be able to set rents freely, except in large cities, where the ceiling on increases will continue till 2012. Nevertheless, some observers believe that, thanks to recent rises in the ceilings on rents, rent regulation remains a real constraint only in Prague. The next government should work to reduce the favourable tax treatment of home ownership.

Reducing the burden of regulation while improving its quality

A major drive to reduce administrative burdens is under way

In 2005, the government undertook a survey of administrative burdens across state bodies, using the Standard Cost Model (SCM) developed in the Netherlands and subsequently used by many OECD members to measure and reduce unnecessary administrative burdens on business (Box 3.1). The survey was necessarily selective, focusing on those pieces of primary and secondary legislation thought likely to involve the heaviest administrative burdens. Most ministries and state bodies performed their own evaluations, so it was to some extent a self-assessment exercise. Moreover, the survey report explicitly acknowledged that some ministries had failed to account for aspects of the administrative burden for which they were responsible. Overall, therefore, the 2005 evaluation may be regarded as having produced a lower-bound estimate of the administrative burden.[17] Nevertheless, the exercise identified an estimated CZK 86.4 bn in administrative costs, equivalent to roughly 3% of GDP (Table 3.1). Roughly 24% of this total was reckoned to result in whole or in part from the transposition of EU legislation into Czech law; the rest was fully within the competence of the responsible national bodies ("Analysis", 2006). The burdens associated with the Ministry of Labour and Social Affairs (MLSA), the Ministry of Health and the Ministry of Finance were chiefly associated with the handling of social security contributions, health insurance and tax legislation, respectively. For the Ministry of Agriculture, the major burdens arose primarily in connection with the regulation of tobacco and foodstuffs, while for the Ministry of Environment, the burden was spread across roughly a dozen regulations (ten statutes and two decrees). The major burdens in the case of the Ministry of Industry and Trade stemmed from the Trade Act and the application of technical requirements for some products.

Box 3.1. **The Standard Cost Model**

The Standard Cost Model (SCM) is a quantitative method for providing consistent estimates of the administrative costs generated by laws and regulations. It does not assess the policy objectives of a regulation or the substantive cost of compliance (such as the cost to a firm of upgrading production to meet an environmental standard). Thus, it is by no means a cost-benefit evaluation. It focuses instead on the information obligations, data requirements and administrative activities associated with regulatory compliance. That is, it measures the administrative burden, not the regulatory burden. While it can help draw attention to clumsy or outdated regulations, its chief value may be in highlighting the ways in which necessary or desirable rules may be made less burdensome. The SCM can be used to assess individual laws and rules or substantial bodies of legislation, and it can provide a basis for evaluating proposed new legislation, as well as measuring the potential impact of simplification proposals. A key strength of the SCM is that it uses a high degree of detail in the measurement of administrative costs, down to the level of individual activities.

Source: International SCM Network (2005).

Table 3.1. **Estimated administrative burdens by origin of obligation, 2005**

Authority	Total administrative burden		Origins of obligation (%)		
	CZK m	% of total	A[1]	B[1]	C[1]
Ministry of Finance[2]	7 265.1	8.4	0	1	99
Ministry of Labour and Social Affairs	20 141.9	23.3	0	0	100
Ministry of Health[2]	17 318.7	20.0	4	12	84
Ministry of Justice	2 113.6	2.4	0	0	100
Ministry of Industry and Trade	6 517.3	7.5	56	1	43
Ministry of Agriculture	18 851.5	21.8	30	19	51
Ministry of Transport	4 298.5	5.0	2	73	25
Ministry of Environment	6 656.9	7.7	0	0	100
Other bodies[2]	3 216.1	3.7	14	45	41
Total	**86 379.6**	**100**	**12**	**12**	**76**

1. *A – obligation arises entirely from transposition of EC/EU legislation; B – obligation arises from transposition of EC/EU legislation but implementation is in the competence of national bodies; C – obligation is in the competence of national bodies.*
2. Incomplete data were provided by the Ministry of Finance, the Ministry of Health, the Ministry of the Interior, the Ministry of Culture, the Ministry of Education, Youth and Sports and the Ministry for Regional Development.

Source: "Analysis" (2006), Annex 6.

In early 2008, the government adopted a plan to reduce that total by 20% in the period to end-2010 as part of a wide-ranging regulatory reform effort that equated broadly to the EU's "Better Regulation" policy (European Commission, 2006b). Similar burden-reduction exercises have been undertaken by a large number of OECD members in recent years, many of them initiated under the EU action programme on reducing administrative burdens in Europe.[18] Several dozen state bodies were to explore the scope for abolishing redundant administrative requirements, to simplify those that remained and to make the forwarding of information to state bodies easier. At the same time, they were charged with monitoring the additional administrative burden associated with new primary or secondary legislation and with identifying offsetting reductions to compensate for any new burdens imposed. The Ministry of Industry and Trade (MIT) is responsible for overseeing this effort and monitoring plan fulfilment. By the end of 2009, the ministry estimated that about 70% of the target – a reduction of 14% in the administrative burden – had been achieved. However, the political situation (Box 1.1) stalled much further progress after early 2009. Some 70-80% of the administrative burden identified in 2005 originated in primary rather than secondary legislation.[19] This meant that parliament would have to approve many of the changes needed to meet the 20% target. With a caretaker government in office since May 2009 and elections approaching in May 2010, the process was therefore stalled at the end of 2009, though work continued in many ministries on the amendments that would be needed to move forward after the elections. The government should seek to act rapidly on these proposals in 2010.

MIT officials have complained of non-co-operation by some ministries. As noted above, some did not provide full information during the original audit of the burden, and others have been slow to cut back on information obligations. In some cases, state bodies reportedly sought to "achieve" their targets in part by revising their methodologies rather than their regulations. Unfortunately, precise evaluation of the basis for these claims is difficult, because the evaluation of progress towards meeting the targets is entirely in the hands of the ministries and departments themselves. Unlike the initial report on administrative burdens issued in 2006, the interim assessment issued at the end of 2008 contained no independent evaluation of the measures reported ("Zpráva", 2009). The authorities should ensure that actions taken by ministries and departments in the context of burden-reduction efforts and similar regulatory reforms are subject to independent assessment, ideally by a regulatory reform unit close to the centre of government.

Implementation of regulatory impact assessment is uneven

If the benefits of administrative burden reduction are to be sustained, they need to be integrated with other regulatory policies and instruments. Significant tensions can arise from contradictory pressures, particularly between the desire to reduce administrative burdens on the one hand and the on-going demand for new regulation on the other, a significant (though by no means the largest) part of which is required by international commitments or supranational institutions (OECD, 2009d). Addressing this challenge requires ensuring that there is rigorous *ex ante* impact assessment of new regulations as they are developed and that such assessments are conducted with due regard for the goal of avoiding unnecessary administrative burdens on citizens and firms. Recent years have seen the elaboration of an increasingly sophisticated system of *ex ante* regulatory impact assessment (RIA) in the Czech Republic. RIA is an important element of the "Better Regulation" policy in place since 2005. A well designed and executed RIA system can provide policymakers with detailed information about the potential effects of regulatory measures on the economy, environment and social arrangements, including administration and compliance costs. Well developed RIA processes provide for exploring alternatives to traditional regulation and for *ex post* evaluation of regulations. Undertaken as part of the deliberative policymaking process, RIA can also contribute to improving policy coherence and inter-ministerial communication.

Formally, at least, the Czech Republic has such a system in place. RIAs have been required by the Legislative Rules of Government since 1998, though this requirement really became effective in November 2007. In some respects, the RIA system is now relatively well elaborated.[20] The RIA guidelines adopted in August 2007 explicitly require clear specification of policy aims and objectives, statement of impacts (gender, business and environmental), and consideration of alternatives to regulation. They also specify the use of the SCM for assessing administrative burdens. They do not, however, require specification of any measures for *ex post* evaluation. Quality control of RIAs is assigned to an inter-ministerial Committee on Quality Control of Regulatory Impact Assessment (RIA Standing Committee). When a proposal is submitted by a given ministry or other drafting authority for inclusion on the government's agenda, the committee examines the proposal and its accompanying RIA statement.[21] If the RIA is found to be inadequate, the committee may recommend that the government return the proposal to the drafting authority with instructions to complete the RIA or it may find that the proposal should be rejected by the government on account of the regulatory burden it would impose.

Unfortunately, although the design of the Czech RIA system is commendable, the practice remains very uneven. In a comparative analysis of RIAs in five central and east European Countries, Staroňová (2009) finds that in 2008, the first full year in which the practice of RIAs was really mandatory in the Czech Republic, a small number of very high-quality RIAs were produced to accompany bills being considered by the government. These generally included consideration of alternative approaches and utilised consultation processes in the preparation of the draft legislation. However, virtually all of these RIAs were prepared by the ministries most directly involved in driving the RIA reform – most notably the Ministry of the Interior and the Ministry of Finance. Elsewhere, Staroňová finds the practice of RIA to have been largely formalistic, an impression the interior ministry's own assessment confirms (MVD, 2009). In practice, the Standing Committee rarely refers proposals back to ministries on account of inadequate RIAs, though it did require amendments and explanations in a significant number of cases in 2008. It also granted numerous exemptions. Exemptions are allowed in exceptional cases, to avoid slowing the policy process unnecessarily or imposing excessive burdens on the public administration. However, in 2008, exemptions were granted in respect of 54% of the proposals considered by the Standing Committee (MVD, 2009, Figure 5). Many of the RIAs that did go through were incomplete. The requirement for public consultation, in particular, tends to be poorly observed; Czech officials privately admit that ministries and departments are often reluctant to consult other state bodies on legislative proposals they are preparing (though they are required to do so), let alone the public. This may soon begin to change. The Ministry of the Interior has developed a methodology for consultation that, if made mandatory and implemented effectively, would ensure that such consultations took place and would also do more to make primary and secondary legislation more visible to outsiders while it was being developed. The draft methodology for public consultations should be adopted and every effort made to implement it effectively.

To some extent, the formalistic character of most RIAs may reflect a delayed process of institutional learning, inasmuch as many line ministries did not participate in the pilot project that took place during 2005-06; they may therefore have lacked the necessary skills and capacities when RIAs became mandatory. While the interior ministry made a good deal of information available on its website during the run-up to 2008, relatively few officials were trained in RIA methods. This hypothesis finds partial confirmation in the fact that a significant minority of the exemptions granted in 2008 were allowed in conjunction with the transition period for the introduction of RIA.[22] Such exemptions have become rarer over time.[23] However, there is also resistance to the practice in some quarters, where it is seen as a time-consuming burden and an obstacle to decision-making or legislative work. This is despite the fact that the new regime provides for both "big" and "small" RIAs. The latter are less elaborate and are undertaken when a measure is not expected to have broad impact or when even the expectation of broad impacts is not thought to warrant a full RIA.[24] In 2008, "big" RIAs were performed in respect of only 10.3% of the legislative proposals that came before the Standing Committee; "small" RIAs were done for a further 29%.

If the RIA system is to be effective, the screening of RIAs before proposals are considered by the government should become more stringent. The criteria under which exemptions are granted should be clarified and tightened, and the proportion of cases in which exemptions are allowed should be carefully monitored. In order to avoid making the process excessively burdensome and slowing down government decision-making, the authorities might also build on the distinction between "big" and "small" RIAs by designing a two-tier process for reviewing draft assessments. Only RIAs for draft proposals likely to have a significant impact on the economy as a whole would be reviewed by a body close to the centre of government. Quality control of "small" impact assessments could be decentralised somewhat, provided there were mechanisms in place to allow some external monitoring of these processes (*e.g.* via spot checks). Such arrangements could be effective, provided that they had "teeth": the central body responsible for ensuring that decentralised quality-control arrangements were effective and not merely formalistic would need both the means and the incentives to take effective action. The practice of RIA could be further strengthened by extending it to the parliamentary phase of lawmaking. Many proposals undergo substantial revision in parliament, but there is little or no assessment of the impact of amendments added to bills at this stage. The authorities should consider creating a mechanism for ensuring mandatory assessment of the impact of parliamentary proposals. Of course, such a mechanism could not restrict parliament's legislative prerogatives, but it would increase the transparency of the legislative process, making the likely consequences of legislative proposals clearer to both the public and the deputies themselves.

Regulatory policy needs stronger high-level backing

Lack of co-operation from parts of the bureaucracy has hampered progress in respect of both the drive to reduce administrative burdens and the implementation of RIA, particularly the latter. In order to realise their full potential, both these policy priorities need to be pursued across the whole of the administration. However, the Ministry of the Interior, being a line ministry itself, is not well positioned to discipline other ministries for non-compliance. Recently, this has led to proposals to decentralise the RIA process, making individual ministers responsible for their ministries' RIAs. Such proposals should be rejected. While greater accountability of ministers for impact assessments performed under their authority would be welcome, simple decentralisation would effectively turn the RIA process into a voluntary self-assessment exercise. Efforts to improve compliance with RIA requirements should, on the contrary, be used as an opportunity to foster a whole-of-government approach to policymaking.

OECD experience suggests that such co-ordination across the government can be achieved in a variety of ways, depending on the institutional and political context. Single-purpose agencies may be created to drive specific elements of regulatory reform; civil service ministries or regulatory reform agencies may be assigned specific functions; or special committees may be established by the government, often comprising a majority of non-governmental representatives. No single institutional configuration is appropriate for all countries. However, a growing number of countries have opted for a model in which regulatory reform is driven by the centre of government – often a special unit or department attached to the prime minister's office or its equivalent (OECD, 2008f). This was in fact the Czech model until late 2006, when the regulatory reform unit attached to the Office of the Prime Minister was transferred to the Ministry of the Interior, and responsibility for aspects of regulatory reform was divided between that ministry and the MIT. Given the difficulties these ministries have had when faced with resistance from other departments, the next government should consider establishing a strong institution at the centre of government to drive the regulatory reform agenda and to implement, or at least review, RIAs. Such an institution would require both considerable authority and sufficient independence to work effectively with line ministries; for that reason, it would also be critical to specify its objectives clearly and to ensure its political accountability to the government. The importance of a top-level commitment to regulatory reform is difficult to exaggerate. In her study of RIAs in Central and Eastern Europe, Staroňová (2009:18) concludes, that "absent a strong executive centre, the legislative oversight body may make civil servants comply formally, but not substantively, with RIA requirements".

Simplification of tax compliance and administration

Further simplification of tax bases could save money for both taxpayers and the state

This section explores an aspect of tax reform not examined in detail in Chapter 2: the scope for reducing the administrative costs to the state and the compliance costs to taxpayers by reducing the complexity of the tax system. Assessments of the administrative burden using the SCM discussed above suggest that compliance with the PIT, the CIT and SSCs accounted for around 30% of the total administrative burden on business, with SSCs accounting for roughly 78% of the tax compliance burden ("Analysis", 2006). The SCM assessment was based on data from 2005 and covers only the information obligations arising from legal regulations and the cost to businesses of meeting these obligations.[25] Moreover, data on the burdens associated with some pieces of tax legislation was incomplete ("Analysis", 2006). It thus represents a lower-bound estimate of the cost of tax compliance.[26] More recently, Vítek and Pavel (2008) calculated the cost of tax compliance for entrepreneurs in 2007 at about 3.9% of all revenue, equivalent to almost 1.3% of 2007 GDP (Table 3.2). This burden, moreover, is regressive, falling disproportionately on small businesses, in part because there are fixed costs associated with tax compliance[27] and in part because around three-quarters of entrepreneurs with annual turnover below CZK 1 m (around € 40 000), as well as a large minority of those in the CZK 1-5 m range, report that they would not keep a full set of books were it not for tax liability. The Vítek and Pavel estimate, though higher than that based on the SCM, may be still be regarded as quite conservative, as it values entrepreneurs' time at the average wage. In fact, the average reported income of those participating in the survey was closer to triple the average wage.

Table 3.2. **Estimated compliance burden by tax, 2007**

Tax	Net revenue (CZK bn)	Compliance cost CZK bn	Compliance costs as a share of net revenue %
Corporate income tax	135.0	7.5	5.5
VAT	234.3	10.6	4.5
Personal income tax from dependent employment	125.0	3.8	3.0
Personal income tax from self-employment	23.1	6.7	34.4
Health insurance contributions	151.9	5.3	3.5
Social insurance contributions	366.2	5.4	1.5
Road tax	5.8	1.0	16.4
Real estate tax	5.0	0.4	8.1
Total	**1 046.3**	**40.7**	**3.9**

Source: Vítek and Pavel (2008).

It is difficult to evaluate these compliance cost estimates in a comparative context. Individual studies done at national level vary as to what is included or excluded in the calculations.[28] Cross-national studies of tax compliance costs are rare, and it is not always clear to what extent they really compare like with like. The best known set of cross-country estimates is in the World Bank's "Doing Business" indicators, which in 2009 ranked the Czech Republic 121st in terms of ease of paying taxes, chiefly because of the time involved. The validity of this indicator has been challenged, particularly its estimate of the time spent paying taxes.[29] Yet even if the "Doing Business" estimates are open to question, there is little doubt that the time demands of tax compliance are considerable for firms. The employer is responsible for calculating and paying PIT, social insurance contributions and health insurance contributions for employees, and for the *ex post* reconciliation that occurs at the end of the tax year. Given that the same income received by the same employee may be classified as taxable for some of the relevant levies but not others, this is a complex task.[30] Strictly speaking, the employer also has an obligation to explain these payments to individuals, potentially one of the most time-intensive activities that payroll administrators have to perform in most companies.[31] In addition, VAT returns are more complex than those of many jurisdictions, and the complexity of depreciation schedules and rules concerning the deductibility of expenses makes CIT returns time-consuming. That said, there have been important changes recently: electronic filing of returns has become easier and the flat-rate PIT has somewhat simplified firms' task in respect of labour taxes. On the World Bank estimates, the time devoted to tax compliance thus fell by around 30% in 2008-09. Further progress in the application of e-government methods to tax should allow this figure to fall further still.

Nevertheless, the evidence suggests that much could be done to lower compliance costs by further simplifying the tax system itself. Even in the wake of recent tax reforms, the legislation concerning taxes on labour income, in particular – the PIT and SSCs – remains long and complex, with numerous exceptions and exclusions. The 2008 reforms did not bring about much simplification of the PIT (beyond the schedule of rates), and there was no simplification of SSCs or the CIT. Much more could be done to eliminate exceptions and simplify definitions and rules. Recent work on tax avoidance and tax evasion in the Czech Republic has highlighted the growing complexity of the legislation concerning direct taxes on labour and income, in particular, which nearly tripled in length in the decade prior to the 2008 reform. Especially significant was the steady increase in the number of exceptions granted over the period: the number of clauses setting out exceptions to general norms nearly doubled (Hanousek and Palda, 2007). While the PIT legislation implemented in 2008 simplified the schedule of tax rates, the length of income tax law continued to grow – by the end of 2008, the legislation on the PIT, CIT and SSCs exceeded 90 000 words and contained more than 170 clauses involving various exceptions. While the legislation is far shorter than, say, the comparable US legislation, it is rather long by the standards of some of the country's regional peers, including Slovakia and Estonia. Roughly 70% of the clauses stipulating exceptions fall in the chapter dealing with SSCs, which are far more complex than the PIT or even the CIT.

Previous *Surveys* have also observed that some areas of the CIT, such as the system of depreciation schedules, are also overly complex and could be simplified. There are six depreciation categories, as compared with just two employed in jurisdictions like Ireland, and in many instances firms face further choices about how to apply the schedules within each category. Frequent rule changes, many of them applied retroactively, add to this burden. Recent examples include the reversal of many stimulus measures discussed in Chapter 1 or the policy zigzags with respect to thin capitalisation rules and lump-sum deductions for the self-employed described in Chapter 2.

PIT and SSC bases could be harmonised to a greater degree than at present

There is, at the same time, scope for harmonising the PIT and SSCs to a greater extent than at present. The PIT and the various components of SSCs (social insurance contributions and health insurance contributions) are all related to the level of wages in the case of employees or the level of profits in the case of self-employed persons. The PIT is, in principle, imposed on all income not otherwise taxed.[32] Its base consists of five elements (see Box 3.2). The base for SSCs is even more complex. Although all forms of insurance financed from SSCs are mandatory, with the exception of sickness insurance for the self-employed, certain income subject to the PIT is excluded from the SSC base,[33] and there are also differences in SSC liability linked to different forms of work contracts. In certain instances, the same income may or may not be subject to SSCs depending on the modalities of the labour relationship (particularly but not only in respect of the self-employed). In addition, SSCs are, as noted in Chapter 2, subject to minimum as well as maximum limits for the tax base. SSC calculations also become extremely complicated when, as often occurs, an individual earns income both as an employee and as a self-employed person, or when he is in receipt of social insurance payments (students, women on maternity leave, pensioners, etc.).

Box 3.2. **The personal income tax base**

The tax base for the personal income tax (PIT) comprises 1) income from dependent activity and office-holders' emoluments; 2) income from business activity and other independent gainful activity, subject to the deduction of permitted expenses; 3) income accruing from capital, subject to some exceptions; 4) net rental income; and 5) other income. Income from the sale of one's primary dwelling is exempt, as are social insurance benefits,* and some revenue from the sale of shares and other securities. Individuals may deduct charitable donations up to 10% of the tax base. Interest paid on mortgages or loans provided from housing savings schemes are deductible up to a ceiling of CZK 300 000 per household per year (about 110% of the 2008 average annual wage), provided that they are used to finance primary housing needs, as are up to CZK 12 000 per year each in private life insurance premia and contributions to supplementary private pension schemes. A taxpayer may claim a personal tax credit, as well as a credit for a cohabiting spouse with an income of less than CZK 38 040, equivalent to about 1.7 times the average monthly wage. Additional allowances are granted to families with children, students up to age 26 (28 for doctoral studies), recipients of disability pensions, and those with physical disabilities who require an escort.

* Since social security contributions are not tax-deductible, taxing benefits would amount to double taxation.

Merging the PIT and SSC bases might well be the simplest way to reduce administrative and compliance costs, but total harmonisation of the tax bases would violate the principle of social insurance, which is meant to maintain a link between contributions and benefits.[34] Tax revenues are used to finance public services and, where necessary, redistribution of funds, whereas social insurances (with the exception of health insurance) are intended to provide benefits to the contributor when he is unable to work or has retired. These insurances therefore cover incomes related to work and, although considerable redistribution is involved, they are intended to link contributions to benefits. In the case of the PIT, therefore, ability to pay is a primary consideration in allocating the tax burden and it makes sense to use a very broad definition of income. This is not so obviously the case with respect to SSCs, other than health insurance contributions. Health insurance premia could certainly be treated more like the PIT, with a very broad base, since the healthcare system is not intended to ensure a link between the level of contributions and the level of benefits. It might indeed make sense to combine health insurance premia with the PIT and finance healthcare via the tax system.

Yet even if the various tax bases cannot be harmonised completely, they could be brought much closer together by reducing the range of exemptions applied to SSCs. The PIT could be simplified by consolidating the five partial tax bases into just three, since it can be difficult and time-consuming to match different types of income to the "proper" partial tax base. Rental income could thus be classed as business income and income accruing from capital could simply be included as "other income". This, in turn, would make it easy to define a relatively broad, and simple, SSC base consisting of a partial base of dependent activity and a partial base of business income, even if the government opts to retain some maximum threshold for income subject to SSCs. It might also make sense to impose SSCs on "other income", a good deal of which in practice is related to work. However, this option could involve additional administrative burdens for both taxpayers and tax collectors. Whatever the solution, it should be borne in mind that many of the above considerations matter chiefly (though not exclusively) in respect of taxation of the self-employed: reducing the differentiation in the tax treatment of the self-employed and dependent employees, as recommended in Chapter 2, should make the simplification of tax bases for the PIT and SSCs easier.

Tax administration should be centralised and streamlined

Greater harmonisation of bases would also facilitate the pursuit of another important policy priority: modernising and streamlining revenue collections. At present, taxes, excise duties, social insurance contributions and health insurance contributions are all collected by different agencies. This fragmentation adds to the compliance burden discussed above, since taxpayers cannot file a single return or deal with a single institution across the whole range of taxes and duties. It also raises the administrative costs incurred by the state, which in 2007 were estimated at around 1.3% of net revenue – substantially down on the figure of 2.1% recorded five years earlier, but still somewhat above the OECD average of just under 1% and far above the administrative costs incurred by the best performers.[35] Of course, many of the OECD members with the lowest ratios of administrative costs to net revenues are also comparatively high-tax jurisdictions, reflecting the fixed costs involved in tax administration. However, as OECD (2009a) shows, the Czech Republic's performance is not exceptional even when revenue-to-GDP ratios are taken into account; a number of comparatively low-tax jurisdictions, like the United States, Korea and Switzerland have achieved very low administrative costs per unit of revenue, by streamlining and rationalising the agencies involved and making greater use of IT.

The need for streamlining is clear. The system at present is labour-intensive and fragmented. In 2007, the Czech Tax Administration (CTA) employed almost 16 000 people, making for a ratio of registered personal income tax payers to tax officials of roughly 240 to one – less than one-third of the OECD average and the third lowest ratio in the OECD area – despite the fact that the vast majority of Czechs do not file individual returns. While no data exist that would allow the ratio to be assessed in terms of "effective filers" (combining corporates, the self-employed and other individuals who must file), the ratio of VAT-registered entities to tax officials in 2007 was just above 32, as against an OECD average of 218. Yet even these figures fail to tell the whole story, since they do not include those employed by the customs agency, the social security agency or the health insurance institutions.

The Czech authorities are well aware of these problems and committed to addressing them. In November 2008, the government adopted a resolution on the creation of a single integrated revenue agency by 2014. This move follows a trend elsewhere in the region, as a number of countries have moved towards unifying collections in this fashion.[36] While SSCs are sometimes distinguished from taxes on account of the connection between contribution and benefit implied by a social insurance scheme, they have many of the features of an income tax, albeit one with a very specific purpose, and collecting them requires many of the same basic processes. There are very large overlaps in taxpayer coverage and tax bases, as SSC collections are strongly aligned with those of employee withholding taxes, in particular. The experience of countries that have already integrated revenue collection suggests that a single revenue agency can reduce both administration and compliance costs, and increase collection rates. The cost of expanding the responsibilities of the core tax administration is marginal, especially when compared with the economies of scale and scope that can be realised via successful integration of staff, infrastructure and IT systems (Barrand *et al.*, 2004). For taxpayers, unification of collections should reduce paper work, as a result of the use of common forms and record-keeping systems, as well as a common audit programme. However, realising these benefits in practice will require closer inter-agency co-operation and consultation, particularly between the tax administration and the pension institution. The importance of this challenge should not be underestimated, particularly in view of the evidence presented throughout this draft *Survey* that policy coherence and co-ordination across the whole of government are often difficult to achieve.

In the Czech case, the planned reform also offers an opportunity to modernise the CTA, streamlining its network of regional and local offices – there are currently over 200, which is far too many for such a small country. This reorganisation will coincide with two other major changes:

- The first is a push to increase reliance on e-government methods in structuring interactions between taxpayers and the state. Although the possibility of electronic filing has existed for some time now, e-filing has remained relatively rare; most interaction between taxpayers and the tax authorities has been on paper. However, the implementation of new legislation on so-called "data boxes" (see below) will lead to a rapid increase in e-filing. Indeed, although official data are not available, PricewaterhouseCoopers estimates that almost 8% of tax returns filed in the first three quarters of 2009 were electronic, roughly double the rate of the year before. This increase preceded the full implementation of the data box legislation, but the rolling out of that reform may have prompted many firms to start availing themselves of opportunities for electronic interaction with the tax authorities.
- The second involves the shift from geographical to functional organisation of the tax administration, including the creation of a special department for dealing with very large taxpayers. In addition to reducing the amount of time taxpayers spend interacting with tax officials (more and more contact between them will be electronic), the move from a geographical to a functional structure should allow for the centralisation of more specialised, high-competence functions and for greater consistency in the application of tax rules across the country. One of the persistent complaints of Czech businesses in recent years has been the perceived inconsistency with which tax regulations are applied by different tax offices (World Bank, 2009:7). This can create considerable uncertainty for entrepreneurs.

The 2008 reform went some way to addressing the problem of uncertainty in respect of the CIT, at least. It defined five new areas in which taxpayers could, on payment of a fee of CZK 10 000 per ruling, obtain binding rulings from the competent tax authorities on issues where questions of interpretation could materially affect tax liabilities if the authorities were to adopt interpretations *ex post* that were at variance with those used by the taxpayer *ex ante*. These included:

- the allocation method to be applied to expenses linked to both taxable and non-taxable income;
- the determination of the allocation of expenses related to the operation of real estate that is used partly for business activities and party for private activities;
- the distinction between technical improvements, for which costs can be capitalised as capital improvements, and repair/maintenance of property, which can be expensed as such;
- the definition of which expenses incurred in research and development are deductible; and
- guidelines for determining whether a taxable supply is subject to standard or reduced VAT.

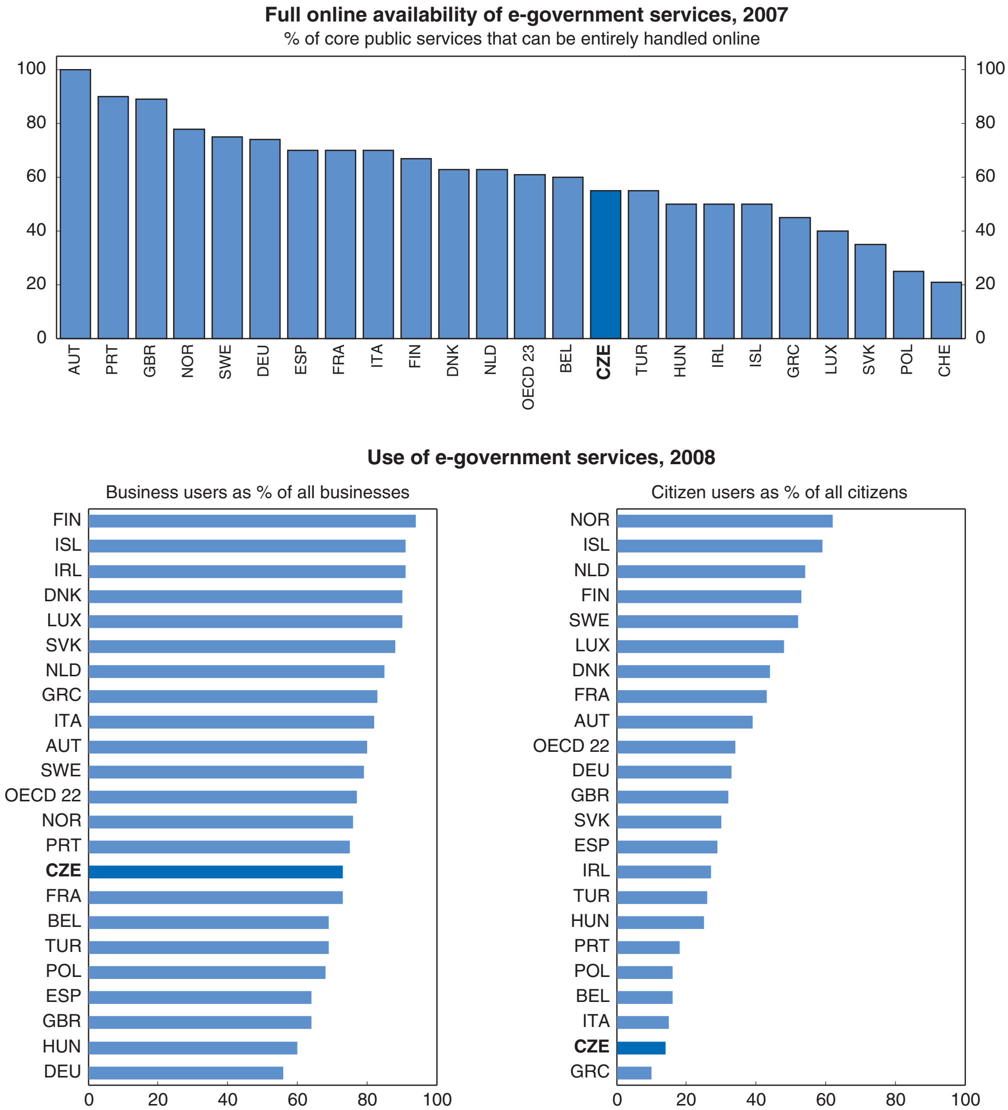
This should help to reduce the administrative burden and the uncertainty facing firms, but a simpler body of tax law and a more consistent system of administration should reduce the demand for such rulings.

Extending e-government services

The government has launched a trio of ambitious e-government reforms

Over the last decade or so, OECD members have been working to make an increasing range of public services for citizens and businesses fully available online. Such initiatives have formed an increasingly important part of the Czech authorities' Better Regulation policy. The potential benefits of moving towards increasingly electronic governance include lower administrative burdens on citizens and firms – a very large share of the reduction of administrative burdens in 2008 resulted from the application of e-government methods ("Zpráva", 2009) – as well as potential efficiency gains in the functioning of public bureaucracies themselves. The latter stem from the fact that developing and implementing integrated e-government services often requires the standardisation of internal processes and data in order to integrate back-office functions across the public sector. Moreover, in a number of fields, there is good evidence that greater reliance on electronic interaction between public officials and private agents reduces corruption by standardising processes, making procedures more transparent and limiting the opportunities for citizens or officials to make irregular proposals. Particularly in fields like public procurement, direct contact between suppliers and officials is best limited.[37] Hitherto, the Czech Republic has not stood out as an e-government pioneer, though it has been close to the OECD average in terms of the extent and sophistication of e-government services offered (Figure 3.3). When compared to the availability of e-government services, take-up has been low, among both firms and especially citizens, in part because of limited access to broadband. This may soon change, however, as the government is now implementing three of the country's biggest e-government initiatives to date, funded mainly from EU resources.[38]

Figure 3.3. **E-government services in selected OECD countries**



Note: The full online availability indicator covers the number of public services for which citizens or businesses can submit completed forms or payments online, in addition to finding information about the service. Businesses are those with 10 or more employees. Citizens are counted as individuals aged 16-74. Refer to the source for more details.

Source: OECD, *Government at a Glance 2009*, based on data from Eurostat and EC DGISM.

StatLink http://dx.doi.org/10.1787/817348333625

"Czech Points" have reduced the cost of start-ups and simplified many procedures

In April 2007, the government launched a pilot programme to create a network of administrative "one-stop shops" called Czech Points,[39] where citizens could access a range of public records and registries. The pilot was extended to the entire country in January 2008, and by late 2009, the Czech Point network comprised over 3 500 contact points. Most are located in municipal offices, but they are also operated by notary practices, post offices and the Chamber of Commerce, among other institutions. For entrepreneurs, in particular, the Czech Point network offers a means of accessing information from a wide range of public bodies and obtaining extracts from official registers without having to visit a large number of different institutions.[40] Among the registers covered are the insolvency register, the real estate cadastre, the companies register, the trades register and the crime register. The range of Czech Point functions is gradually being extended to include more and more official information sources. Czech Points have helped reduce the time required to start up new businesses and register property transactions, among other things (World Bank, 2009b). There are plans in future to make the network accessible via the Internet, though the existing contact points are to be retained, so that citizens who lack Internet access or the necessary IT skills can still benefit from the service.

There has been little independent evaluation of the Czech Points so far, but initial assessments have generally been favourable, although there have continued to be problems with some services arising from faulty communication between public administration databases. Špaček (2009) finds that only about 12% of citizens actually used Czech Points in 2008 – fewer than one in five reported having had any electronic interaction with the authorities at all – and observes that surveys suggest many Czechs still prefer to deal with officialdom face to face. However, for those – such as entrepreneurs – who need to gather a range of official documents from different sources, the network has proved valuable and Špaček (2009) also points to indications that the implementation of the Czech Points initiative has improved "back office" co-ordination among state institutions and municipalities, which should generate benefits even for those who do not avail themselves of Czech Point services when dealing with the authorities.

A great deal of communication with the public sector must now be conducted online

Under legislation adopted in August 2008 and effective as of 1 November 2009, communications between legal persons and the public authorities must take place through dedicated electronic mailboxes known as data boxes (*datové schránky*). They are also to be used for communication between public-sector bodies. Hitherto, most such communication has been in paper form, with electronic communications accepted only if they bore guaranteed electronic signatures. During the summer of 2009, the Ministry of the Interior created data boxes for all public bodies and all legal persons registered in the Commercial Register.[41] Boxes are to be set up for newly incorporated entities once the ministry receives notification of their inclusion in the register. Data boxes remain optional for natural persons, although in 2012 they are to become mandatory for those engaged in certain professional activities, such as tax law or insolvency administration. Initially, data boxes were only for use in communications with or among public-sector entities, but from 1 January 2010 individuals and corporations may opt to use them when communicating with each other. The Act also regulates the "authorised conversion of documents", *i.e.* conversion of written instruments into electronic format and *vice versa*, to ensure that the result of the conversion has legal features identical to an authenticated copy. In contrast to the pre-existing system for electronic tax filing operated by the tax administration, filings via data boxes do not usually require electronic signatures.

The data box legislation is unusual in the extent to which the government chose to force public-sector bodies, companies and other legal entities to interact online. This contrasts with the approach taken in some other OECD members, like neighbouring Austria, which have allowed companies to determine for themselves the extent to which they wish to interact with the authorities electronically. Such a decisive push to shift official business online should pay dividends over the long term. The immediate cost savings are expected to be substantial, but the greater benefits may stem from speeding up official business and compelling those public institutions that are lagging in terms of e-government development to increase the range and sophistication of their own e-government services and infrastructure ("eGovernment", 2009).

This is particularly important in respect of regional and municipal authorities, the level of government with which many citizens have their most direct dealings. Most important central services for citizens and businesses are already developed to the point where they allow use of online services not only for information or one-way interaction (such as downloading forms) but also two-way interaction (*e.g.* submission of forms on line) and, in many instances, online transaction (full electronic case handling).[42] However, the situation regarding services provided by sub-national authorities is very uneven. In many localities, such basic transactions as vehicle registration and applications for zoning or building permits cannot be handled online ("eGovernment", 2009). The operation of the Czech Point network is likewise still relatively uneven across the country (Špaček, 2009). This is only partially a problem of e-government policy: to some extent, it arises from the fragmented structure of local government described in Chapter 1. One solution may be to encourage co-operation among municipal authorities: larger municipalities in a given region could provide methodological, technical or administrative help with e-government implementation under contract to their smaller neighbours. The data box and Czech Point initiatives should be supported by efforts to promote improvements in the provision of e-government services, particularly at sub-national level. To achieve economies of scale, small municipalities should be encouraged to outsource some e-government functions to larger ones.

"Key registers" should reduce administrative burdens and raise public-sector efficiency

The second major new e-government initiative is the Act on Key Registers adopted in early 2009. The law provides for the creation of four main electronic information registers that should be used by public authorities seeking the relevant data:

- a population register, covering all citizens and foreign residents in the Czech Republic;
- a register of economic entities, covering legal and natural persons conducting business in the country, as well as public-sector bodies;
- a register of territorial identification, addresses and real estate administered by the Czech Cadastral Office; and
- a register of the rights and responsibilities of authorities, companies and citizens administered by the Ministry of the Interior.

This will involve bringing together several dozen central, regional and local information systems.[43] The establishment of the registers should ensure that citizens and firms do not have to provide the same data repeatedly to different authorities and will make it easier to ensure that basic information contained in public registers is consistent and up to date. State institutions will be able to extract needed data directly from the registers, rather than requiring firms or individuals to provide it. This will not only save time for citizens and companies dealing with officialdom, it will also reduce the "burden of proof" on them. At present, it is often up to the private-sector agent to provide whatever supporting documentation or evidence is needed to prove that the data submitted to a public-sector body are correct. In future, the state will take responsibility for the accuracy of the information in the registers, which public bodies will have to accept as valid. It is also intended that citizens and firms would have instant access to the data in the registers. Together with the system of data boxes, the key registers should also provide an important tool for further improvements in public management.

Combating corruption

Evaluations of the Czech business environment continue to highlight corruption as a major problem. While it is clearly not possible to measure the scale of corrupt activity with precision, the evidence that is available gives grounds for concern. The country ranked 52nd of 180 in Transparency International's 2009 Corruption Perceptions Index, somewhat down on its scores for the preceding years and below such regional peers as Poland and Hungary but above Slovakia. In the World Bank's indicators of the quality of governance, the Czech Republic consistently ranks in the top fifth of countries in terms of voice and accountability, regulatory quality and government effectiveness but hovers around the 66th percentile when it comes to control of corruption. Corruption also ranks high among the concerns of businesspeople in surveys like those conducted by the World Economic Forum and the Council on Czech Competitiveness.[44] To be sure, assessments based on *perceptions* of corruption should not be confused with direct evidence of its extent, although perceptions alone can have an impact on investor sentiment. Perception indexes can be a misleading indicator of corruption levels (as, for example, when a single high-profile case has a big impact on outsiders' perceptions), but only up to a point. Countries with a reputation for corruption generally do have serious problems with it.[45] This view finds some confirmation in the survey conducted for the 2009 Global Corruption Barometer, which suggests that around one household in ten had paid a bribe in the preceding 12 months. This is higher than all but four of the 19 European countries surveyed and roughly double the unweighted European average.[46] Czech respondents identified civilian public officials, rather than politicians, judges or the police, as the group most affected by corruption, and fewer than one in ten thought the government's anti-corruption efforts were effective.

That said, there has been some evidence of progress in recent years. The most recent OECD assessment of Czech implementation of the anti-bribery convention, in December 2008, found that the country had implemented in whole or in part the great majority of the recommendations made at the time of its October 2006 review. As noted above, recent e-government initiatives have helped to reduce the opportunities for corruption in some spheres, and the outsourcing of the "anti-corruption hotline" created in 2008 led to an upsurge in calls to report corruption allegations. Whistleblower protection, virtually unknown in 2006, has been considerably strengthened.[47] Legislation concerning the requirement for banks to report suspicious transactions in an effort to combat money laundering was also tightened in 2008; in some respects, it is now unusually tight – the reporting threshold, in particular, is very low. Finally, the government presented a new anti-corruption package to parliament in early 2010. While it contained some welcome measures, including steps to tighten up the conduct of public tenders, its overall emphasis was on law-enforcement measures, like the introduction of anti-corruption agents in the police and greater scope for the use of wire-tapping during investigations, rather than on changes in the way public bureaucracies work that might reduce the incentives to engage in corrupt activities.

There is thus more to do, particularly in terms of reducing the opportunities and incentives for corruption. The available evidence suggests that a great deal of corrupt activity is concentrated in the field of public procurements, particularly at local level. This is widely recognised to be a field with considerable corruption potential in most countries (OECD, 2005, 2007). Public works, in particular, are sensitive. Very large sums are often involved, and the nature of the projects often means that they tend to involve complex contracting arrangements and are essentially *sui generis*, making comparison and external evaluation difficult. In a pair of projects involving large numbers of elite interviews with officials and businesspeople in the Czech Republic in the early to mid 2000s, Grødeland (2005a, 2009) finds that the great majority report informal contacts to be critical in public procurements, with information sharing and other favours extremely common. Often, groups can be advantaged by the manipulation of tender conditions. Pavel (2008) finds a direct relationship between the relative weight of price in the terms of a tender and the level of competition: the more complex (and less price-centric) the terms, the more agents conclude – whether rightly or not – that it is being arranged for someone in particular. If price is central, the tender is perceived as competitive, and agents bid.

The experience of other OECD countries suggests a number of steps that can be taken to reduce corruption in public procurements. In addition to effective accounting, auditing and reporting, steps to make procurement processes more transparent and competitive should reduce the scope for corruption even as they increase the efficiency of public expenditure. Greater reliance on e-procurement systems has also been found effective in reducing corruption,[48] which constitutes a further reason to welcome the increasing computerisation of the Czech state. Other measures include effective sanctions, including denial of access to bidding, which may necessitate creating a form of liability for legal persons (see below), and effective recourse mechanisms. These can be difficult to design, owing to the need to prevent the procurement process from becoming too cumbersome, but many OECD members provide mechanisms to allow bidders who have grounds to suspect that they have suffered discrimination as a result of corrupt practices to challenge the process (OECD, 2007). The next government could draw on the examples of the public procurement mechanisms in countries like Austria, Germany, Hungary, Poland and the Slovak Republic to design an efficient, independent complaint and review system.[49]

A further issue to address concerns the liability of legal, as opposed to physical, persons. At present, no such liability exists under Czech law, though successive governments have worked on reform of this provision in recent years. There are several reasons why a regime for imposing liability on legal persons would be desirable. First, the increasingly complex and diffuse nature of corporate decision-making may make it difficult to identify the specific individuals responsible. Secondly, while the liability of legal persons should be without prejudice to the liability of natural persons involved in a corrupt undertaking,[50] proceedings against a legal entity may be fairer and more convenient than prosecuting an agent or low-level employee who may have acted under pressure from above. Finally, the absence of corporate liability makes it difficult, for example, to "blacklist" or otherwise penalise companies, even when their employees are found to have behaved corruptly. The next government should institute the liability of legal persons, paving the way for the imposition sanctions that are effective, proportionate and dissuasive where corrupt practices are exposed. Critics insist that whistleblower protection is still too weak. Some argue in particular for preserving the anonymity of "insiders" who report corruption in their institutions. Around 40% of OECD members allow whistleblowers anonymity, but the issue is a difficult one in many countries and it may be problematic where anonymous denunciations of others for alleged wrongdoing are associated with the abuses of past authoritarian regimes.[51]

Box 3.3. **Policy recommendations for enhancing the business environment**

Reducing impediments to entry, exit and competition

- The next government should follow up recent simplification of start-up procedures by reducing the minimum capital required for new companies.
- The authorities should consider further steps to increase the speed and reduce the cost of judicial proceedings, particularly in respect of contract enforcement and bankruptcy.
- Third-party access rights in respect of natural gas distribution should be strengthened. It would also be desirable to move towards regulated third-party access for gas storage. If these measures prove insufficient to prevent abuse of dominance and ensure robust competition, then further unbundling of the dominant firm in the gas market should be considered.
- Competition-promotion efforts in electricity and telecommunications should be stepped up. The role of the competition authority in addressing collusion, abusive practices and other sources of market power in these sectors could be strengthened, particularly in the rapidly expanding broadband segment of the telecommunications market.
- The Act on Abuse of Significant Market Power in the Sale of Agricultural and Food Products should be repealed.
- The next government should exploit the opportunity created by implementation of the EU services directive to further open up entry in services.

Making labour markets more flexible

- The Labour Code should be amended to allow notice period and severance pay obligations to be phased in according to length of service.
- The scope for further relaxing Labour Code provisions regulating the use of fixed-term and other non-standard contracts should also be explored, with a view to reducing the risk of increasing labour-market dualism.
- The current very favourable tax treatment of home ownership should be phased out.

Reducing the burden of regulation while improving its quality

- Once a new parliament is elected, the authorities should move rapidly on legislative amendments prepared in the context of the programme for reducing administrative burdens.
- The government should ensure that actions taken by ministries and departments in the context of burden-reduction efforts and similar regulatory reforms are subject to independent assessment, ideally by a regulatory reform unit close to the centre of government.
- The draft methodology for public consultations in connection with regulatory impact assessment (RIA) should be adopted and implemented.
- The mechanisms for screening RIAs when legislative proposals are considered need to be strengthened. Proposals to decentralise responsibility for RIAs to individual ministries should be resisted.
- The authorities should explore the potential for creating an effective mechanism for rigorously assessing the impact of regulatory and legal changes introduced during the parliamentary phase of the policy process.

Box 3.3. **Policy recommendations for enhancing the business environment** *(cont.)*

- Co-ordination of both RIA and regulatory burden reduction efforts across the whole of government needs to be enhanced. The next government may want to consider establishing a strong institution at the centre of government to drive regulatory reform. Such a body should be charged with providing independent assessments of actions taken by ministries and departments in the context of regulatory reform.

Simplifying tax compliance and administration

The planned integration of collections into a single agency and greater harmonisation of tax bases should lead to palpable savings for both taxpayers and the state. The gains from so doing will be all the greater if the integration and streamlining of tax administration is accompanied by greater harmonisation and simplification of tax bases and definitions:

- The definitions and tax bases for the personal income tax (PIT) and social security contributions (SSCs) should be further harmonised and simplified.
- The number of exemptions and exceptions to the PIT and SSCs should be reduced.
- A single declaration covering all labour taxes should be introduced to reduce the compliance burden on employers and the self-employed.

Extending e-government services

- The authorities should continue to expand the range of services offered by Czech Points and of the means by which they may be accessed.
- More needs to be done to ensure adequate support for the development of e-government services at regional and municipal levels and to facilitate co-operation among municipalities to realise economies of scale.
- The government should exploit in full the potential of data boxes and "key registers" to strengthen co-ordination among public bodies, to evaluate their performance and to identify areas for further cost-saving measures or changes in administrative practice.

Combating corruption

- Further steps are needed to make public procurement more transparent and more competitive. There is also a need for arrangements enabling bidders to challenge questionable procurement decisions in a fair, efficient and timely manner.
- Liability of legal persons should be instituted, as required by the OECD Anti-Bribery Convention.
- The government should explore ways to strengthen whistleblower protection and corporate compliance measures, as called for by the OECD's 2009 Anti-Bribery Recommendation.

Notes

1. OECD (2006a, 2008a); Wölfl *et al.* (2009). See also the findings of the World Bank's "Doing Business" project since 2004 at *www.doingbusiness.org*; WEF (2009); and CCC (2009).
2. For recent work on regulation and entrepreneurship, see Ardagna and Lusardi (2009); on unemployment, see Feldmann (2009) and the research surveyed in Box 1 of Wölfl *et al.* (2009).
3. For a concise overview of the evidence, see Wölfl *et al.* (2009), Box 1. See also Conway, *et al.* (2005, 2006); Craft (2006); Bassanini and Duval (2006); Arnold *et al.* (2008); OECD (2008d) and Eifert (2009).
4. OECD (2006a, 2008a); this indicator has also been one of the consistent weak points for the Czech Republic in the World Bank's "Doing Business" indicators.

5. See OECD (2006a, 2008a). According to the World Bank's "Doing Business", prior to the law's entry into force it took about 9 years to close a business in the Czech Republic compared with 2, 3 and 4 years in Hungary, Poland and Slovakia, respectively.
6. The reasoning here is that the shareholders in such a debtor enterprise have effectively been wiped out in economic terms, and general creditors are thus in the position of shareholders – instead of a fixed investment (debt), they hold claims that have become residual and thus riskier investments (like equity). The management of such a firm is legally liable if it fails to disclose the new nature of creditors' claims.
7. See TI (2009a) on the issue of probity: the TI survey of citizen perceptions finds the courts to be the public institution that is reckoned to be least affected by corruption. Interestingly, Grødeland (2005b) finds that elite perceptions of the judiciary are similar: respondents in elite interviews reported that the judiciary was more law-abiding than other sectors. On speed and efficiency, see CCC (2009).
8. See *e.g.* the studies of Australia and Sweden during the recessions of the early 1990s in OECD (2009b).
9. OECD (2009c) finds that in 2008,the Czech Republic had among the highest prices of all OECD countries (on a PPP basis) across all of the consumption baskets prices for fixed and mobile telephone use.
10. Price data for October 2009; OECD Directorate for Science, Technology and Industry calculations.
11. See OECD (2008c) for examples.
12. European Commission (2009:37). "Bundled offers" are those combining fixed-voice telephony with other services, such as broadband or television.
13. These include postal service, the distribution of electricity, gas and water, public transport, the operation of ports and airports, and waste treatment and disposal
14. The minimum wage rose from 27.3% of the average wage in 2000 to almost 34% in 2006, before falling back to about 30% in 2008. These figures were near the low end of the distribution in the OECD. The Czech ratio was also below the average for the Visegrad countries throughout the period.
15. Strictly speaking, fictitious self-employment is illegal; a relationship that is in substance one of dependent employment must be registered as such. However, the collusive nature of such arrangements makes enforcement extremely difficult.
16. OECD (2006a, 2008a); see also CNB (2008). It is at this level that national minimum wages, even if they are low, may have an impact: Fialová and Mysíková (2009) find that rises in the minimum wage relative to regional average wages are associated with increased regional unemployment rates.
17. In part, this was because no additional resources were made available to finance the exercise, so there was little scope for drawing consultants or other outsiders into the process.
18. For details of such burden-reduction efforts in a large number of OECD countries, see OECD (2006b, 2008b, 2009d). In January 2007, the Commission launched the action programme for measuring and reducing administrative costs, and in March of that year the Council agreed to a joint reduction target of 25% and invited member states to set national targets of "comparable ambition".
19. Government of the Czech Republic (2009) estimates that just ten statutes account for the bulk of the burden – around CZK 55 bn.
20. For a comparison of five Central and Eastern European countries, see Staroňová (2009).
21. The work of the Board is supported by an advisory body, the Permanent Committee for Regulatory Impact Assessments which examines submitted impact assessments and written opinions to them elaborated by the secretariat of the Board.
22. The full RIA obligation was only imposed on drafts where preparatory work was launched after 1 November 2007. This means that some major new legislative initiatives, including the new Civil Code and the new Commercial Code, are exempt from the RIA requirement.
23. See MVD (2009:12-15), especially Figures 6 and 10.
24. *E.g.* adjustments to regulated prices, changes in tax rates or adjustment of benefit levels.

25. For example, the finance ministry did not include in the measurement of the administrative burden such things as the issue of tax documents, price labelling, etc. This means that the administrative burden arising from the regulations within the ministry's competence was definitely in excess of that presented in the data.
26. The estimate of VAT compliance in the analysis is negligible – just CZK 64 m – but Czech officials privately acknowledged that the VAT burden was likely to be significantly understated, owing to methodological problems; OECD (2008b).
27. OTPR (2002) suggests that businesses' tax compliance costs relative to size fall dramatically as they grow, meaning that the regressive impact of compliance costs is heaviest on start-ups and very small enterprises.
28. See, for examples, Tax Foundation (2001) and Treasury (2002). Many such studies are prepared by business lobbies or tax pressure groups and may therefore be biased in some of their assessments.
29. Since the indicator rests on expert assessments of the number of hours devoted to preparing and filing returns and paying taxes, it is not clear that experts in all countries are including the same range of activities in their assessments. The World Bank results may be contrasted to some extent with the survey-based findings of Vítek, Pavel and Pubal (2003) and Vítek and Pavel (2008), but since these are not cross-country studies and the methodologies of the two approaches differ, it is hard to assess the extent, if any, to which the "Doing Business" indicators disadvantage the Czech Republic.
30. The "Doing Business" data attribute roughly half the time spent on tax compliance to labour taxes alone.
31. Anecdotal evidence suggests that many either do not perform this function or do so in a largely formalistic way, but it is included in the "Doing Business" estimates on the assumption of full compliance. This is a major reason for the very high estimate of time reported in the "Doing Business" series.
32. Income from some sources, such as loans and inheritances, is already subject to specific taxes.
33. For example, SSCs apply to income from dependent activity and office-holders' emoluments, as defined by the PIT, but are not levied on compensation for damage according to the labour code, gratuities, rewards after the end of appointment or remuneration according to the law on inventions.
34. Given the high degree of redistribution that takes place within the Czech social insurance system, it might be argued that little or no harm would result from compromising the principle of social insurance and treating SSCs as just another tax. However, an alternative approach would be to shift the burden of benefits for non-contributors onto the budget, financing them from general taxation, while strengthening the insurance principle in the system and lowering SSCs somewhat.
35. The lowest ratios of administrative costs to net revenues in 2007 were found in Switzerland (0.28), Sweden (0.45), the United States (0.45) and Denmark (0.62). See the data in OECD (2009a), Table 11.
36. Recent reformers in this field include Hungary, Croatia, Estonia, Latvia, Russia, Serbia and Slovenia, among others. See Barrand *et al.* (2004) for more background on this trend.
37. See OECD (2005, 2007). In the Czech case, Transparency International reports that the computerisation of land cadastres has reduced the opportunities for "street-level" officials to extract bribes from citizens.
38. Altogether, just over € 500 m has been allocated to the e-government axis of the Czech Integrated Operational Programme; see Špaček (2009).
39. "Point" is an acronym of the Czech words meaning "submitting verifying informational national terminal".
40. The official aim of the project is to make the data, rather than the citizens, run around.
41. Data boxes are obligatory for all incorporated businesses, legal persons and branches of foreign entities registered in the Commercial Register. They are not obligatory for unincorporated entities registered as enterprises for the purposes of the VAT Act.
42. In respect of citizen services, this applies to PIT declarations, job-search services, many social security benefits and reimbursement of medical costs. For firms, these basic services comprise such things as payment of taxes, duties and social contributions, company registration, submission of data to the Czech Statistical Office, customs declarations, environmental permits and public procurement.

43. Under the legislation, a pilot is to begin on 30 June 2010, with the system of registers to be fully operational after 30 June 2011. Some Czech officials suggest privately that the latter date could, if necessary, be postponed until 2012 but they are confident that the system will be fully operational by then.
44. WEF (2009); CCC (2009). See also Aghion *et al.* (2009:34) for data suggesting that Czechs are more likely to perceive an increase in corruption since 1989 than the citizens of most new EU member states.
45. See Olken (2009) for a recent overview of this literature; see also Mocan (2004).
46. The reported incidence of bribes was higher in Lithuania (30%), Greece (18%), Romania (14%) and Hungary (14%) than in the Czech Republic (11%). The figures for Bulgaria and Poland were 5% and 4% respectively, with most other countries falling in the 1-3% range.
47. OECD (2006b) notes that the only protection a whistleblower enjoyed at that time was provided by the Labour Code provision concerning grounds for dismissal. Legal protections have since been instituted.
48. OECD (2005:12) draws particular attention to the experiences of Mexico and the Republic of Korea.
49. For a description of these countries' systems and of the design issues involved in creating such mechanisms, see OECD (2007).
50. The Council of Europe and UN Conventions on corruption both stipulate that the liability of legal persons should not preclude proceedings against natural persons who are perpetrators, instigators or accessories to corrupt acts. See OECD (2008e:67).
51. This issue is explored in OECD (2006b).

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