

Economic Survey of the Czech Republic, 2004

Summary

Following accession to the European Union the big issue for the Czech Republic is to strengthen growth prospects. Growth potential at present is somewhat above 3 per cent, implying a moderate pace of catch-up to living standards in the EU and elsewhere. There is room for greater ambition in growth performance, and it is welcome to see this reflected in the programme of the new Czech government. This *Survey* underscores four main challenges. Fiscal consolidation is the dominant challenge for macroeconomic policy, and is not only necessary to cope with ageing and to bring down the tax burden but is also needed to fulfil euro-area entry conditions. A welcome programme of fiscal reform has begun, including proposals for a system of multi-year aggregate spending ceilings and significant expenditure cuts. However, to date, mainly revenue-raising measures have been implemented while the full impact of expenditure measures is yet to be realised. The attempt to secure broad political consensus on pension reform is commendable, but it must be underscored that whatever reform is finally implemented, it will have to bring considerable fiscal savings. Health-care reform also has to deliver savings, but concrete proposals have yet to be made. To facilitate assessment of the true fiscal position, extra-budgetary funds need to be more fully integrated in mainstream government budgeting procedures. Also, with the further decentralisation of public services, the need for good budgeting practices and accountability in regional and municipal governments is all the more important. The Central Bank and the Ministry of Finance have formulated a transparent strategy for entering the euro area, that foresees minimising the time spent in ERM II. Annual reports will assess the eco-

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This Policy Brief presents the assessment and recommendations of the 2004 OECD Economic Survey of the Czech Republic. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

economic conditions in relation to the Maastricht Criteria and a request to enter ERM II will only be made if the probability of a positive first assessment by the EU authorities is high. The choice of a 3 per cent inflation target for the run-up to euro entry is justifiable on medium-term grounds. However there may be some difficulty communicating the consistency of this target with the Maastricht criterion for price stability. The Czech authorities should therefore pay close attention to how the Maastricht criteria are interpreted and applied by the European Commission and the ECB and adjust their communication strategy accordingly. Most of the catch-up in living standards will have to come from boosting productivity growth. This means swifter re-allocation of resources across firms as well as stronger in-firm productivity growth. While the Czech Republic is a strong competitor for attracting foreign direct investment, policy towards poorly performing firms and business start-ups has problems, slowing down the exit and entry of firms. Bankruptcy procedures are cumbersome, often long and usually end up in liquidation, with asset stripping not uncommon. Reforms have long-since been planned, and it is welcome that new legislation looks finally set to go ahead. The legislation aims at strengthening the role of creditors, speeding up proceedings and allowing composition to play a bigger role. Likewise, efforts to streamline business registration are welcome and should be implemented as soon as possible. The general business climate is also damaged by issues in network-industry competition, as some services, notably internet, are expensive in international comparison. Mobility between jobs and regions is weak. Administrative extensions of collective wage agreements, strict employment protection legislation (EPL) on individual dismissals, rent control, severe poverty traps (particularly for families) and a high tax wedge have contributed to considerable long-term unemployment. The Roma population is hit especially hard in this respect. Migration is to some extent mitigating the labour-market rigidities with Slovaks filling skilled vacancies and other eastern Europeans (mainly Ukrainians) taking up unskilled jobs that are unattractive for locals. Tackling the unemployment problem requires measures across a wide front, but most notably social benefit reform is needed along with reduction in the tax wedge as well as easing of EPL. The widespread social and economic exclusion of the Roma needs more attention, particularly in the education system. A more open immigration policy is needed to address immediate issues such as the inconsistency between granting work permits as well as for better alignment of immigrants' skills with those needed on the Czech labour market. ■

What are the main challenges for the Czech economy?

Growth in the Czech Republic is projected by the OECD to be around 4 per cent, somewhat above potential, this year and next, marking substantial progress over past performance and reflecting the success of past reforms. Investment and exports are expanding rapidly, taking over from a period of strong increase in domestic consumption. This good performance needs to be sustained, and preferably bettered, for living standards to catch up with the OECD average at a reasonable pace. This means creating the right conditions for continued capital deepening, efficient utilisation of labour resources and the further development of relevant skills. In many areas, good policy has already created healthy conditions for growth. For some years now, inflation has been low and stable and membership of the EU has prompted further progress in structural reform. Indeed, institutions and policies now closely resemble those in many other OECD countries.

At the same time, however, there are challenges related to the fiscal position, business conditions and the labour market. These will need to be addressed alongside the approaching challenges of euro entry and accelerated ageing of the population. The key policy issues can be summed up under four headings:

- *Fiscal consolidation.* Government spending has increased over the past few years, generating a high deficit and a large tax burden, notably a high tax wedge on labour. The high deficit needs to be brought down and budgetary reform has to deliver sustainable spending cuts so as to bring down the influence of taxes and transfers in household and business decision making. Particular attention is needed to reform health and pension systems as Czech demographic trends are set to bring a rapid rise in the old-age population in the next few years.
- *Successful entry to the euro area.* Monetary policy has to stay on course to reap the benefits of euro entry; difficult decisions have to be made regarding the best implementation of the strategy for entry so as to avoid untimely pressures on the real economy and exchange rates.
- *Improving policy towards business.* Increases in labour productivity have to do most of the work to catch up with levels of GDP per capita in more advanced OECD countries. Among the many

structural policies influencing the business environment, the administration and legislation for dealing with non-viable firms and relatively cumbersome business-start-up procedures are of particular concern.

- *Improving the labour market and increasing skills.* The labour market is not performing as well as it should and this is reflected in rising unemployment. The intention to reintroduce legal extensions in wage setting would risk reducing the flexibility of wage determination. Furthermore, the high-tax wedge damps both demand and supply and leads to grey-sector activity. In addition, employers face difficulties in applying the regulations for letting go underperforming or surplus workers. Poor performance has not only arisen from labour market inflexibilities but also poverty traps, particularly for unemployed families, and low mobility partly linked to problems in the rental market for housing. In terms of increasing skills, tertiary education programmes are lagging behind rapidly increasing enrolments and new curriculum demands. In addition, there are specific challenges in the education system for the Roma where unemployment rates are well above average. ■

Will the fiscal reform achieve sufficient deficit reduction?

The fiscal reform programme that began last year marks a positive commitment to consolidation. The programme has already resulted in economies in spending and revenue-raising measures. And, a proposed new budgeting framework has the capacity to harden spending constraints and force a longer-term outlook through its legally binding three-year spending ceilings. *Implementation of the fiscal programme should meet its objectives while avoiding any dilution of the expenditure ceilings.* It should, furthermore, stick to the agreement that windfall revenues will only be used for deficit reduction. While the new budgeting framework is set to be introduced as planned, pension reform has gone back to the drawing board, and concrete proposals for healthcare-system reform have yet to emerge. In addition, there has been a degree of compromise on some measures to increase VAT revenues. Though implementing fiscal reforms is difficult given the narrow majority of the coalition government, *every effort should be made to push through and communicate to the public reforms of both expenditure programmes and budgetary procedures.*

Earlier pension reform is starting to pay off and employment rates among older workers have been rising, in contrast to most other OECD countries. The recent relaxation of work restrictions on those getting pensions is a good move that should further boost rates. Furthermore, the possibility for the unemployed to get two years of early retirement pension has been removed and rules that allow invalidity pensions to be converted to unconditional early retirement pensions will be phased out. The Government has asked an expert commission to provide the inputs for a discussion among all parliamentary parties about the main direction of pension reform. Although the effort to seek political consensus is commendable, *further delays should be avoided. Moreover, fundamental public-pension reform, whether only through parametric change to the PAYG system or through the introduction of a new pension, has to generate savings for the budget and should be announced as soon as possible.* In health, even though regionalisation is to some extent hardening budget constraints and forcing economies in the hospital sector, a major health reform is still needed. *The reform should include fewer universal services and more private provision as well as greater use of fees, preventive measures and outcome-based resource allocation.*

Though the fiscal reform programme covers important bases, some issues are not tackled. *Despite substantial recent progress to increase transparency, some extra-budgetary funds continue to obscure the Government's true fiscal position and all of them should be more fully integrated in mainstream government budgeting procedures.* Increases in transparency are needed elsewhere too. In particular, *clearer distinction in communication on the different government accounts is needed, particularly regarding the Ministry of Finance's adjusted-cash account and the ESA95 account produced by the Central Statistical Office and reported to the European authorities.* In addition a permanent financing system for the regions needs to be finalised, following the decentralisation of responsibility for providing hospital services and secondary schooling. The decentralisation means good accounting practices in sub-national government matter all the more. In this regard, *debt developments in municipal government should be closely monitored following the removal of borrowing constraints. Decentralisation also raises the importance of diffusing best-practise in public spending to ensure outcome orientation and efficiency gains in provision.* ■

What is the strategy for entry to the euro area?

The strategy on euro entry has much to commend it. The risks of Exchange-Rate Mechanism II (ERM II) membership are to be minimised by only entering when conditions look set for the fulfilment of the Maastricht criteria. Also, commitment to euro entry a long way in advance is being avoided through annual assessment and decision on whether conditions are right to join ERM II. Credibility of the strategy has been heightened by a process of dialogue and explicit agreement between the Government and the Central Bank.

The choice of a 3 per cent inflation target for the run-up to euro entry is justifiable on medium-term grounds. However there may be some difficulty communicating the consistency of this target with the Maastricht criterion for price stability. The Czech authorities should therefore pay *close attention to how the Maastricht criteria are interpreted and applied by the European Commission and the European Central Bank and adjust their communication strategy accordingly.* ■

What are the main challenges for business policy?

Positive organisational changes have been made in business policy. A deputy prime minister position has been created to enhance the co-ordination of growth policy. Also the administration of business policy has been put under one umbrella organisation – the Business and Investment Development Agency (CzechInvest) and co-ordination and cross-fertilisation in policymaking will also be enhanced by a newly formed advisory council. As in many other countries there is a host of programmes to attract FDI, support small-and-medium enterprise and encourage R&D and the use of new technologies. *The enhanced facilities for co-ordination in business policy should be complemented with regular evaluation of the composition and cost effectiveness across general and targeted financial support schemes for businesses.* More generally, *reform to regulatory frameworks should get high priority.* In terms of specific issues:

- The *corporate tax rate* of 28 per cent is to be cut back to 24 per cent by 2006 and targeted tax advantages mean the effective tax rate is much lower than this. However, targeted tax breaks are distorting and less visible. For this reason, the

efficiency of the tax system could be improved through reduction in targeted tax breaks, creating room for tax cuts.

- In regulatory reform, the most significant developments are taking place in *bankruptcy legislation*. Productivity growth has long since been hampered by a system that allows too many poorly performing firms to continue operating and does not adequately prevent asset stripping. And, even when operations cease, assets can be tied up in long legal proceedings. In addition to a pending amendment to strengthen the position of creditors a new act on bankruptcy legislation looks set to be implemented that should cut back incentives to delay application for bankruptcy and increase the possibilities to salvage viable parts of businesses through a “reorganisation” procedure. *The implementation of reform to bankruptcy legislation should no longer be delayed.*
- The Czech Republic ranks rather poorly in international indicators of the administrative requirements to set up a business, and this detracts in particular from the incentives to set up small enterprises. Entry on the *commercial register* is the most widely criticised aspect of the administrative process, involving extensive paperwork and often taking several weeks to complete. *The prospect of speeding-up business registration, as contained in pending legislation, is therefore welcome and further delays of reform should be avoided.*
- A reputation for *corruption* is also weakening the business profile of the Czech Republic and the development of countermeasures needs to continue. Plans to introduce “integrity testing” for civil servants should help dissuade corrupt arrangements between the public sector and business and plans for a “crown witness” programme should help successful prosecution in corruption as well as other illegal business practices. In addition most ministries have introduced hotlines to allow the public to report suspicions about corruption. *Cutbacks in regulation and red tape would also help reduce opportunities and incentives to engage in corruption.*

Competition issues remain in some network industries and are also a mark against the business environment. In telecommunications, despite the progress in reform, dominance of previously state-run Cesky telecom is a concern. Prices for some telecommunication services are, on average, high and delay in infrastructure and market development has slowed the spread

of high-speed internet. It is intended that this issue, along with others, including the efficiency of the regulator, will be dealt with in a new telecommunications act. Strong market dominance is also an issue in the energy sector. The state-owned gas company was sold entirely to the German company RWE and competition remains weak. In *electricity*, vertical and horizontal unbundling has to be completed and the incumbent, CEZ, still has significant interests across production, distribution and sales. *Across the network industries, unbundling is an important instrument to enhance competition and should be implemented wherever appropriate.* ■

How to make the labour market work better?

In wage setting, an otherwise flexible system could be challenged by administrative extensions and there are worrying intentions to widen the scope of legislation to include more sectors of the economy. Widening the extensions would bring even more sectors of the economy under the risk of excluding low skill workers from employment. *This should be an important consideration in proposals to introduce discretionary extensions of sectoral collective agreements.*

The system of state subsidy of sick-pay has contributed to high, and rising, levels of sick leave. Employers have little incentive to check the authenticity of sick leave and, reportedly, sick leave is often encouraged when business is slack so as to cut back on labour costs. Cuts in the state payouts made this year should ease the problem. *Plans to make employers entirely responsible for the first two weeks of sick-pay and to increase the strictness on medical certificates would also be positive steps. Provisions to successfully prevent abuse are, however, weak and should be strengthened together with the implementation of the planned reform.*

Unemployment is highly regionalised, partly because of wide geographic diversity in structural change and economic growth, but also because of weak labour mobility. Problems in the rental market for housing are an important factor constraining mobility. More than one quarter of households live in rent controlled apartments and account for most of the rental market. These households remain effectively protected by old rent-control rules that cap rents and are reluctant to terminate the contracts; this contributes to high prices and limited turnover in the open market. In addition, the subsidised mortgages increase the transaction

costs of moving house. *Final steps to liberalise the rental market need to be taken. Welfare issues caused by rising rent costs for poorer households should be dealt with through compensatory measures in state benefits. At the same time, support for home ownership should be reduced.*

Stringent employment-protection legislation is weakening demand for labour. Employers wanting to dismiss individual workers face a cumbersome process to prove unsatisfactory performance that strongly protects the employee and instead will typically justify dismissal on the basis of re-organisation, even though this means paying redundancy. Czech redundancy rules require the same payout no matter how long the worker's tenure – making dismissal costs a significant share of labour costs when employment is short. *The rules on redundancy payments should be brought in line with typical practice elsewhere, with payments linked to tenure. More generally, the legislation on dismissals for those on standard contracts should be eased.* Such measures could, for example, be incorporated in the Government's intended new labour code.

Unlike developments in some other countries, the strict rules protecting workers on standard contracts have not brought widespread use of temporary contracts, despite light regulation. Instead, employers find a variety of other arrangements preferable. Most notable is a practise of subcontracting with “self employed” workers, which not only avoids dismissal regulation but typically entails lower tax and social-security costs for both the employer and employee. The recently adopted employment act offers better opportunities for employers to hire from temporary work agencies and is a welcome development. In addition, the draft labour code aims at lighter rules on standard contracts and tightening up on abuse of alternative arrangements, better aligning social contributions across the different types of contract.

The use of subcontracting arrangements reflects strong incentives to evade paying the tax wedge on labour; fiscal revenue demands combined with pressures for competitive corporate taxation mean personal-income tax and both employee and employer social contributions bear a heavy burden. This is particularly hampering formal employment at the low end of the labour market, where social benefits limit wage flexibility and poverty traps are widespread. In addition, grey sector activities are increasing – partly in response to the high tax wedge – and are further diminishing the tax base. *Therefore cutting back the*

wedge should be a general priority for the Government in the process of fiscal consolidation. Opportunities and scope for such cuts could be created by more fully exploiting under-utilised tax bases – properly designed property and environmental taxation in particular. The recent introduction of caps on social security contributions has cut the tax wedge for better-paid workers. However, given the concentration of unemployment among the low-skilled, cuts at the lower-end of the labour market are more urgently needed in order to reduce poverty traps.

The welfare system has long since given financial support to the non-employed, particularly to families, that is generous in relation to earnings prospects and often given without strict application of eligibility conditions, allowing distorting grey-sector activity. The Government should not hesitate in implementing plans to use variation in the social assistance system to strengthen implementation of entitlement criteria. The introduction of joint income taxation would increase the incentives to take up work in families that do not have any earned income. However, in designing the tax schedule for joint income taxation the authorities should ensure that it does not create disincentives for second earners to take up work in particular through interaction with the transfer system. As a general strategy, the gap between the average wage and the minimum subsistence amount should be allowed to widen over time. Such a move could be made more effective by strengthening activation measures, in particular by putting more weight on placement services. ■

What could be done to increase the benefits from immigration?

Alongside the high rate of structural unemployment, there are substantial shortages of labour in some regions and occupations, further underscoring the problems in the labour market. Immigration has partially relieved these labour shortages. Higher-skilled vacancies tend to be filled by Slovaks while low-skilled jobs that Czech workers find unattractive are taken mostly by other Central and Eastern Europeans. While gains from labour migration have already been realised from the special agreement on the free movement of labour with Slovakia, the policy approach to other potential source countries, such as the Ukraine, has to-date been rather restrictive. The Czech Republic has gradually become an immigration country since 1990, but legal immigration from countries other

than Slovakia is still low in international comparison, though, as elsewhere, actual immigration is higher because of undocumented migrants. The recent pilot project that facilitates the granting of permanent residence using a points system is a positive sign of new thinking in immigration policy. A more open and long-run approach to standard legal immigration could help formalise labour inflows and increase the integration of foreigners and thus go towards easing problems created by the rapidly ageing Czech population. One step would be to widen the avenues to permanent residence and citizenship. A less restrictive system of work permits, including the use of less precisely defined permits would complement such measures and be beneficial in fiscal terms, as more activities would be declared. At the same time, the trade licensing system for foreigners should be aligned to the work permit system, as it has become abused as a means of legal entry. Information to develop immigration policy needs to be improved. In particular, more statistics are needed on the number and activities of immigrants to help develop policy. ■

How to increase tertiary-education attainment?

Results of the OECD's PISA survey suggest the Czech workforce has good levels of basic education, and this is a plus for the business profile of the country. However, beyond basic levels, the education system has not evolved rapidly enough to match changing labour market demands. The system is geared towards vocational qualifications and the share of those with non-degree level, post-secondary education is above the EU-15 average. However vocational qualifications have not always kept pace with changing demand. In addition, the tertiary enrolment rate for degree-level courses has only recently risen to a level comparable with other OECD countries and attainment in the population as a whole is very low in international comparison. Though the rise in tertiary enrolment is encouraging, the system does not encourage a rapid enough reaction of students and public universities to changing opportunities and returns in the labour market from different degree-level courses. Resource allocation within the public university system entails a large element of supply side flexibility, but demand prospects for future skill requirements have insufficient weight in programme development. The introduction of tuition fees for students in public universities that at least partially reflect the cost of tertiary courses would make for better

decision making by students and faster reaction of universities to changing vocational demands. If fees are introduced a system of income-contingent student loans should be considered so as to ensure accessibility to tertiary education. ■

What are the problems for Roma integration?

As in other countries, widespread social exclusion prevents the Roma population from accumulating labour market relevant skills and contributes significantly to very high unemployment and low incomes among this ethnic minority. Better education needs to be a key element of a long-term comprehensive strategy to cope with this challenge. *A draft school act proposes to take a positive step by eliminating the system of special schools that the majority of Roma children attend.* The special schools are not in fact aimed at catering for the Roma and have contributed to poor education outcomes and weak integration into mainstream Czech society. With the closure of the special schools, *more special teaching assistance and adaptation of curricula and teaching methods is needed to make primary education more inclusive for Roma children.* *Inclusion and education prospects would also be helped if more Roma children went to kindergarten and the Government proposal for one year of compulsory pre-school is therefore welcome.* The scheme of financial support for Roma going to secondary school has been reasonably successful at encouraging enrolment and similar support should be considered in tertiary education. In terms of general support to the Roma, the development of policy is often hindered by a lack of information. In particular, census data on individual ethnic background is not representative. *One possible solution is a “mapping” of Roma communities (as opposed to individuals) similar to that carried out in Slovakia* though the Czech Republic’s relatively dispersed Roma population may require adjustment of survey techniques. This would

assist in providing the much-needed deepening of targeted inclusion policies for the Roma. ■

What are the main challenges in further improving climate and air quality?

The Kyoto target on greenhouse-gas emissions should be reached comfortably and emission reduction will be helped by membership of the EU emission trading scheme. However, intentions to give away all permits for free will imply windfall gains for past polluters. *Emission trading should be accompanied by an excise duty on household coal to dissuade households from using coal-fired heating which is not subject to the permit system.* In addition, *plans for new brown-coal power plants and relaxation of environmental regulation for mining brown coal should be reconsidered*, both for environmental and cost reasons. More generally, artificially low prices are encouraging energy consumption and *the policy of bringing retail energy prices to market levels should be completed.* *State spending on renewable energy is too high in relation to the estimated gains from lower air pollution and reduced greenhouse-gas emissions and should be cut back to economic levels.* Though air pollution has been reduced significantly, levels remain relatively high. More cost-effective instruments need to be used in bringing levels down further. In this regard, *the introduction of emission-related taxes on commercial vehicles is welcome and should be extended to all vehicles.* *The introduction of road pricing in urban areas should also be considered.* ■

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- **Economic Outlook No. 75**, June 2004. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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