Assessment and recommendations

Broadening the FDI boom and ensuring fiscal consolidation are key to improving economic performance

Important economic reforms have been implemented since the currency crisis of 1997, gradually improving conditions for doing business. Attracted by privatisation, tax incentives and prospects of EU accession, large amounts of foreign direct investment (FDI) have flowed in, helping to modernise the productive capacity. Nevertheless, the Czech economy has remained burdened for longer than other transition countries with a large number of poorly performing enterprises, suffering from weak corporate governance, which had been kept alive by soft loans from state-dominated banks. The major challenge in this context is to overcome the dualism between the prospering FDI sector and the still considerable part of Czech industry in need of further restructuring. Broadening the FDI boom requires the reallocation of resources – mainly labour – to more productive uses. In order to prevent unavoidable layoffs from turning into permanent withdrawals from the labour market, and to preserve the inherited high participation and employment rates, new reforms should improve the demand for labour and strengthen the incentives to take up work. This requires a market framework that facilitates large-scale reallocation of labour among firms and sectors through low hiring and firing costs. On the macroeconomic front, the Czech Republic faces the difficult task of rebalancing the policy mix so as to create conditions for greater financial stability and avoid a loss of external competitiveness through excessive wage increases and overshooting exchange rates. A substantial fiscal adjustment is needed, first of all to claw back the excessive fiscal loosening over the period 2002-03, but beyond that to deal with social-security spending pressures and to create room for tax cuts and growth-enhancing expenditure increases in areas like infrastructure investment, education and business-relevant public services. The probable Czech entry into the European Union next year will strengthen the framework for conducting broad ranging economic reforms, but also further increases the need to stay on such a reform path.

Recent macroeconomic performance was supported by fiscal stimulus

Output growth in 2002 decelerated less than in Western Europe in spite of the close links with key trading partners in the EU, in particular Germany. The real annual growth rate of 2½ per cent was to a large extent due to a massive fiscal stimulus during an election year. Growth in social transfers, housing subsidies and government wages, together with private sector wages benefiting from a tight labour market, as well as improved borrowing opportunities nurtured strong household consumption. The sharp increase in the nominal exchange rate in the first half of 2002 helped to achieve larger than expected disinflation, which further boosted real income, but had serious adverse consequences for parts of the business sector. Cost competitiveness and financial conditions rapidly deteriorated and investment and employment growth weakened. As a result of strong domestic consumption, deteriorating competitiveness and the exceptional late-summer floods, the external deficit increased in the second half of the year. However, this was tempered by improving terms of trade, partly reflecting lower prices of imported oil and gas. Consequently the current account deficit remained below 5 per cent of GDP for 2002 as a whole and was financed by FDI.

Although international recovery should contribute to a pick-up in growth in 2003-04, much depends on structural reforms

Recovering export markets should result in growth picking up again and exceeding 3 per cent in 2003 and 2004. Additional fiscal stimulus remains budgeted for 2003 – driven by further growth of public wages and transfers – but on a much smaller scale than in the previous year. The dynamism of recovery will have to be driven by private sector developments instead. While the current projection envisages a "traditional" recovery, which is broadening over the forecast horizon, considerable risks exist. If the exit of firms from low performance activities accelerates, but with incentives to take up work and to hire labour remaining insufficient, the economy may see its employment rate decline with consumer confidence and growth suffering. However, if the pursuit of structural reforms results in stronger incentives for labour demand and supply, together with improved business conditions, allowing rapid re-deployment of redundant workers, this would stimulate the economy and raise potential output growth over the medium term.

Inflation targets have been undershot as the currency has appreciated, and monetary conditions have become very tight

Monetary policy has switched to headline inflation targeting to increase transparency and credibility. Target bands have been determined up to December 2005 by the Central Bank in co-operation with the government. However, strong currency appreciation in the first half of 2002 in combination with other temporary factors led again to an undershooting of the inflation target and the pace of appreciation became the key concern of monetary policy as international competitiveness deteriorated. This motivated actions by the Central Bank, including currency market interventions, successive rate cuts and a more credible agreement with the government to slow down the conversion of foreign exchange receipts from privatisation. These efforts triggered a phase of stabilisation of both real interest and exchange rates from mid-2002, though monetary conditions have nevertheless remained tight by historic standards. While the present inflation targeting framework would seem to provide an effective instrument for stabilisation in the face of volatile market conditions, decisions will have to be made on how to adapt monetary and fiscal frameworks in order to allow for adequately timed ERM II and EMU participation after EU accession.

The fiscal loosening in 2002 should be reversed while containing social-security spending pressures through appropriate reforms…

The fiscal stance loosened significantly in the election year 2002, with a jump in general government expenditure of close to 3 per cent of GDP and an increase in the budget deficit of almost 2 per cent of GDP. According to preliminary estimates on the basis of cash transactions, the consolidated deficit for 2002 has reached 4½ per cent of GDP, excluding privatisation-related revenues and spending (the deficit reaches 7.3 per cent if the spending related to the losses of transformation institutions is included). Additional fiscal stimulus is budgeted for 2003 and future fiscal prospects remain worrying, as the spending liabilities of the pension and health systems – as currently legislated – will necessitate ever rising transfers from the budget, expected to double from less than 2 per cent of GDP in 2002 to 4 per cent in 2010, and to double again to 8 per cent by 2020. Reforms in these areas are needed to avoid risks to fiscal sustainability.

… and additional room is needed for tax cuts and growth enhancing spending

Expenditure reform is needed not only to establish fiscal sustainability, but also to make room for growth-enhancing measures. The Czech Republic is now a country with a heavy tax burden exceeding the average of the low-income OECD countries by more than 5 percentage points of GDP. High taxes, which are distorting economic choices and risk eroding business and work incentives, should therefore be lowered. Reducing the high taxes on labour is also important to foster the creation of new jobs. Additional fiscal efforts are necessary to improve the transport infrastructure, education outcomes, environmental performance, business relevant public services and other convergence related areas. The government is presently considering a wide-ranging public expenditure reform to address these issues, taking into account the public management reforms described in the 2001 *Economic Survey*. But current proposals may not be sufficiently ambitious to achieve the needed results; stronger structural measures, aimed at substantially reducing future spending on mandatory programs relative to current projections are therefore strongly recommended.

Pension reform is urgent

The pay-as-you-go (PAYG) pension system is the largest mandatory spending item, generating annual deficits that are projected to double from 1 to 2 per cent of GDP within the coming few years, and to rise further by 2030. The present value of the implicit pension debt is well above 100 per cent of GDP. The first step towards a scheduled pension reform would be a readjustment of key PAYG parameters. For example, the contemplated switch to inflation indexing might return the system to current balance by 2006 and result in slowly rising surpluses in subsequent years that would peak at 2 per cent of GDP in the mid-2020s. But, by itself, the corresponding decrease of replacement rates would not be socially sustainable for very long unless other forms of retirement income became available rapidly. The logic of this approach, therefore, would be to establish a second pension pillar to provide additional retirement income over time as the PAYG system shrinks. Other approaches may also be considered, drawing on the range of reform models implemented in other OECD member countries. The key feature of any sustainable system is that it provides appropriate incentives for older workers to remain in employment longer as their life expectancy increases. The Czech Republic has some margin of flexibility in ensuing pension reform insofar as privatisation receipts in the next few years would provide a financial buffer. But the essential point is that such margin be used to underpin a genuine reform, and not to finance temporarily a system that is unsustainable in the longer run.

Current policies risk unsustainable increases of public healthcare expenditure

The healthcare system is based on comprehensive publicly funded health insurance for the entire population. Private health payments account for an unusually low (8 per cent) share of total health spending. The system has helped to achieve a remarkable improvement in the health status of the population since the early years of transition, at a pace unmatched in the region with the exception of Slovenia. And fiscal costs have been contained to date despite little private co-financing. However, despite recent wage growth, health sector wages and prices still remain low in comparison to the rest of the economy and this cannot be sustained for long. With these pressures added to the effects of population ageing and new medical technology, a significant increase in the health bill is to be expected. With current policies, the deficit of the public health care system is projected to rise considerably. Dealing with these pressures will require both increasing the efficiency of public sector healthcare delivery, and some increased role for private payments. Experience from other OECD countries shows that this is possible without compromising unduly the principle of universal access to medically necessary services.

Publicly funded healthcare is employing too many resources and capacity downsizing is necessary

A key feature of the healthcare system is the exceptional density of the publicly funded hospital and physician networks, and the extent of pharmaceutical reimbursements, which go far beyond OECD averages. Healthcare capacity is neither fully utilised nor completely targeted at medical necessities. Many reimbursed drugs are over-the-counter products, which are paid out-of-pocket in most other OECD countries. Medical needs should be defined more narrowly and according to standards prevailing in advanced OECD countries. Overall, excessive installed capacity, in a wide spectrum of areas ranging from acute care beds to ambulatory specialists' offices, has been identified and the Czech government is currently preparing adjustments. There is no alternative to such reduction of publicly funded health capacity and a co-ordinated approach should be preferred to *ad-hoc* cuts enforced by short-term budgetary constraints.

More scope for privately sponsored healthcare could help to ease the burden of capacity downsizing

At the same time, there is no provision today for market-oriented hospital and physician services that can be funded by payments from users or private insurers. To preserve the homogeneity of the supply network and enforce formal equity of access (although rationing exists in many areas and is sometimes solved with the aid of illegal but effective side payments), such market developments have been banned more stringently than in most other OECD countries. As a consequence, no market for complementary health insurance has developed. Hence, markets should be liberalised in non-core activities, both to respond to private demands for diversified and comfort services, and to open activity avenues to health professionals and facilities made redundant in the publicly funded sector. Private insurance can be made available in such peripheral areas and contribute to the desirable increase in the share of private payments. More means testing associated with access to full public funding – such as in long-term care and some pharmaceutical prescriptions – can also help. Furthermore a general introduction of private co-payments in a socially acceptable and appropriate way should be considered as a partial alternative to health insurance contributions. However, even if some adjustments are made to the use of public funding and assuming also that productivity gains can be achieved in the provision of health services, the social and political priority for strong, high quality and collectively available health care will nevertheless mean that health spending will increase over time. Room will have to be found for this through budget savings in other areas which would be eased by medium-term spending discipline and higher economic growth.

The trend growth rate of the economy is below the regional average, weighed down by low productivity in the domestic business sector

The estimates of the potential growth rate of the economy – currently clustering between 2½ and 3 per cent – show a clear lag relative to other countries in the region. While these estimates are based on a variety of different methodologies, they all associate low potential with ineffective utilisation of inputs. This peculiarity, which has sustained high labour force participation and employment rates, reflects the rapid pace of ineffective industrial investment in the first decade of transition under government-sponsored banking and weak corporate governance and low subsequent exit of unprofitable firms. Consequently a large segment of the labour force is employed in enterprises and activities that are not sufficiently productive to meet domestic and international competition. This problem will intensify with an expansion of the highly productive FDI sector, which contributes to further real wage growth and currency appreciation. The size of the "vulnerable" component of the industrial sector is estimated at between 5 and 10 per cent of dependent employment, with recent signs of an increase due to the worsening competitiveness.

Higher potential growth will require overcoming the emerging dualism between domestic and FDI firms

The level and growth rate of productivity remain comparatively low, in spite of the remarkable impulse coming from the surging FDI sector where Czech plants' productivity approaches levels in the investors' home countries. The future performance of the economy will depend importantly on overcoming the emerging dualism in the business sector, and the quality and pace of interaction and productivity diffusion between international and domestic firms. Corporate restructuring in this context will be shaped by the microeconomic and institutional environment for external take-overs, downsizing, mergers and consolidations, and the extent to which they facilitate the shifting of human and capital resources to better uses. In order to help restructuring firms grow, policymakers should remove obstacles to stock market listings and investment by further strengthening the credibility of financial market supervision, reporting and corporate governance. This will help to overcome the public disenchantment with the outcomes of voucher privatisation in the 1990s.

The new bankruptcy law should be enacted and the re-sale of non-performing loans swiftly continued

The environment for doing business depends on transparent legislation and competent public administration. The bankruptcy, exit and take-over of non-viable enterprises is cumbersome and currently takes too long. The physical and enterprise-specific human capital, as well as other intangible assets of defaulting firms, are often trapped in dead-end situations under entrenched management. The bankruptcy law, amended 19 times since 1993, is frequently interpreted by the judiciary in favour of incumbents, often for short-term employment protection reasons. Creditors and new owners are discouraged from rehabilitating faltering firms and therefore opt for and try to obtain liquidations rather than compositions. A new draft bankruptcy act is being currently prepared to clarify and enforce all parties' rights and responsibilities in distressed firms. Its adoption should be hastened and the courts trained and equipped for its rapid implementation. The non-performing loans which are in the portfolio of the Czech Consolidation Agency, concerning 7 000 non-financial firms, 500 housing and 600 small agricultural co-operatives, covering claims with a face value close to 15 per cent of GDP, should continue to be auctioned off to the market. The early experience with the initial sales, in spite of unnecessarily long delays in realisation, is encouraging with some restructuring activities having been apparently triggered successfully. As regards corruption, Czech authorities have stepped up efforts to bring more cases to court, which is likely to increase public awareness and have a detrimental effect on shady practices.

Wage determination in general is quite flexible but employment protection is high and labour turnover low…

Wage bargaining between employers and employees takes place in a form that, in principle, reflects firm circumstances. Sectoral wage negotiations with unions representing 30 per cent of the labour force result in collective agreements, which are not binding for non-unionised enterprises. However, the government makes regular use of the right of legal extension in some sectors like construction, textiles and metalworking – in order to prevent wage dumping. This policy is having adverse consequences for smaller vulnerable firms and is hampering the reallocation of the labour force to more profitable firms by distorting wage signals. Laws and regulations pertaining to employment are rigid and especially the procedures governing mass layoffs are cumbersome and demanding. Legal reforms to reduce the costs of employment protection and to provide a suitable framework for part-time and temporary work are necessary, as the present *ad hoc* system risks making the elimination of overstaffing in either vulnerable private firms or public enterprises with excessive employment very costly.

… and labour supply incentives are weakened by the tax-benefits system…

Exit opportunities are available for redundant workers in the form of recently tightened but still generous early retirement and welfare benefits. A widely abused sick leave system also socialises part of the redundancy costs in declining firms. Overall, income replacement rates by the welfare system are high, notably for low-skilled and low-income workers.

First-time entrants to the labour force also benefit from these transfers, with unwelcome consequences for work motivation. The high expectations and the high reservation wages of the unemployed are revealed by the growing wedge between *registered* (9½ per cent) and *survey* (7 per cent) unemployment rates – insofar as the latter measure more accurately captures *involuntary* unemployment. Widespread recourse to registered and unregistered immigrant workers, who reportedly account for 2-4 per cent of the labour force, including in low-skilled jobs where official unemployment is high, is another indicator of a poorly functioning labour market. Skill mismatches and regional labour market imbalances are also widely documented. In order to reduce unemployment traps it is recommended that the social transfer system shifts from passive maintenance with prohibitive marginal benefit withdrawal rates to in-work benefits. Given the high share of long-term unemployed, special initiatives to activate welfare recipients are necessary. Poor incentives to take up work should be improved by strictly enforcing the job-search requirements mandated by the law.

… while hiring incentives are also hindered by high non-wage labour costs

Hiring incentives of employers are weakened by excessively high non-wage labour costs. The Czech Republic relies more than other countries on taxing wages, with payroll taxes accounting for 17 per cent of GDP and their contribution to total tax revenues reaching 44 per cent. Non-wage costs represent about one-third of the labour costs of low-skilled and low-income workers, which reduces the demand for such workers by creating a distorting wedge between their income on the one hand, and their required productivity to cover the costs of employment on the other. Hence, the chances for re-employment of workers losing their jobs are significantly reduced, especially under present competitiveness pressures. If non-wage labour costs were lower and part-time and temporary work arrangements less cumbersome, greater demand could develop for low-skilled labour, including in service sectors.

The education system should be made more responsive to skill mismatches

Recent OECD and other international comparisons indicate that outcomes of the Czech primary education system are good, although no longer appearing superior as in earlier investigations measuring traditional skills. However, many labour-market relevant skills of secondary and post-secondary school graduates are unsatisfactory, especially from the point of view of the most demanding parts of the FDI sector, requiring the command of foreign languages and computer skills. Lack of shorter and suitable college-type courses rather than long academic programmes at universities appears to be particularly relevant. Due to inadequate capacity, post-secondary enrolment is low despite nominally free access and public funding of the current college and university system. Therefore, higher total investment and more diversity in the education system are needed, which could be financed by relying more on fee-based college and university programmes. Equity objectives could be preserved with the aid of a national scholarship and student loans scheme.

Barriers to the regional mobility of capital have diminished somewhat but labour mobility remains too low

Investment incentives are inversely proportional to local income levels and thus benefit all regions except Prague, which already enjoys a per capita GDP exceeding the EU average. Consequently, investment generated by incentives is highest in lower income regions. Nevertheless, two large pockets of permanently high unemployment remain in the northern regions of Bohemia (Usti) and Moravia (Ostrava), notably because poor road access discourages potential investors and skill mismatches reduce employability of the labour force. The continued imposition of rent control by the government at artificially low levels, ignoring a Constitutional Court's decision that regulated rents must be based on market prices, has paralysed the residential rental market. This is reducing labour mobility because tenants in high-unemployment areas cannot find affordable housing in more dynamic regions. The experience of OECD countries suggests that labour mobility will not improve unless the residential rental market is allowed to function properly. Therefore, the government ought to either abolish rent control or elaborate a regulatory mechanism that is consistent with market pricing along the lines acceptable to the Constitutional Court. Furthermore regional labour market programs should focus on providing labour market relevant skills.

Privatisation of network industries should continue and public utility reforms should be fully implemented

The Republic's openness to FDI is very positive and the willingness to fully privatise network industries is particularly welcome. However, the government needs to avoid entrenching private monopolies. In spite of the gradually improved functioning of the independent energy and telecom regulators, energy and telecommunication prices remain comparatively high. Therefore, network industries should be opened to full competition as soon as possible. Obstacles to internet diffusion, which remain significant, notably in terms of access prices, ought to be remedied through availability of reasonably priced untimed access and rules allowing for rapid entry and strong competition among internet service providers.

Transport infrastructure should be developed in a more effective and cost-efficient manner

Public infrastructure spending has been maintained at levels fluctuating between 3 and 3½ per cent of GDP but there are strong signs of allocative and technical inefficiencies. The government's emphasis on construction of new motorways and railway corridors has resulted in inadequate maintenance of the existing networks. Reports of the Auditor General emphasise systemic shortcomings, including routine violations of public procurement rules, poor project management and inadequate choice of priorities, which contributes to the persistence of regional mobility barriers. The authorities are introducing the first steps of programme evaluation and are encouraged to fully implement the corresponding recommendations of the 2001 *Economic Survey*. They should also consider the specific suggestions provided in recent reports on transport infrastructure by the Auditor General which would result in better infrastructure investment at lower cost.

Summary

Microeconomic reforms and a massive fiscal stimulus have allowed the Czech economy to achieve annual growth of around 3 per cent over the past couple of years together with price stability and falling unemployment. Sweeping privatisation initiatives and generous investment incentives have made the Czech Republic the leading recipient of FDI among European transition economies, pushing up real wages and the exchange rate with a consequent competitiveness problem for the backward parts of domestic industry. A rebalancing of the macroeconomic policy mix, with the restoration of more appropriate monetary conditions, will only be possible if fiscal consolidation reverses the excessive fiscal loosening. Public deficits should be reduced via sustainable expenditure cuts arising from lasting reforms. The government intends to implement the 2001 *Economic Survey* recommendations on public expenditure management in order to address this issue, but greater ambition is warranted to bring down mandatory spending over time.

Pension reform should not be delayed further and requires fundamental rather than palliative changes. Parametric changes to make the PAYG system more fiscally sustainable – in particular through a switch to price indexation – would have to be accompanied by the development of a second pillar counteracting the decline of replacement rates in the PAYG system. Also health policies are not fiscally sustainable in the medium term and it is necessary to focus on medical necessities, increase the privately funded share of expenditures and allow the emergence of a private health market to absorb current over-capacities. Pushing ahead with microeconomic reforms is urgently needed to facilitate the resource reallocation, which is necessary to overcome the emerging divide between the booming FDI sector and domestic industry. The growth-enhancing exit of chronically loss-making firms requires strengthening of bankruptcy procedures, and reforms of the tax-benefit system are necessary to improve incentives to hire labour and take up work. Progress on all these scores should allow the Czech economy to increase its trend growth rate, preserve social cohesion and facilitate a smooth accession with a steady convergence towards the higher living standards in the EU.

Glossary

AUT	Austria
AUS	Australia
BEL	Belgium
CAN	Canada
CHE	Switzerland
CEZ	Czech Power Company
CKA	Czech Consolidation Agency
CNB	Czech National Bank
CSO	Czech Statistical Office
CZE	Czech Republic
CZK	Czech koruna
DEU	Germany
DNK	Denmark
ESP	Spain
EUR	Euro
FDI	Foreign Direct Investment
GBR	United Kingdom
GFS	Government Finance Statistics
GRC	Greece
FIN	Finland
FRA	France
HUN	Hungary
HIF	Health Insurance Fund
IMF	International Monetary Fund
IRL	Ireland
ISL	Island
ITA	Italy
JPN	Japan
KCP	Czech Securities Commission
KOR	Korea
LUX	Luxembourg
MEX	Mexico
MoF	Ministry of Finance
NOR	Norway
NLD	Netherlands
NZL	New Zealand
POL	Poland
PRT	Portugal
SNA	System of National Accounts

SVK	Slovakia
SWE	Sweden
TUR	Turkey
USA	United States
VZP	General Health Insurance Fund of the Czech Republic

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BASIC STATISTICS OF THE CZECH REPUBLIC[1]

THE LAND

Area (sq. km)	78 864	Population of major cities (thousands) (1.1.2000)	
Arable land (sq. km)	42 798	Prague	1 186.9
		Brno	383.6
		Ostrava	321.2
		Plzeň	167.5

THE PEOPLE

Population (thousands, 31 December 2001)	10 206	Civilian employment by sector	
Number of inhabitants per sq. km	129.4	(% of total, 2001)	
Annual population growth, 1996-2001 (%)	–0.02	Agriculture	4.8
Employment (thousands, 2001)	4 707	Industry	40.4
		Services	54.8

THE PARLIAMENT

Chamber of Deputies, as at March 2003 (number of seats)

Social Democratic Party	70	Freedom Union/Christian Democratic Union	31
Civic Democratic Party	58	and People's Party Coalition	
Communist Party	41	Total	200

THE PUBLIC SECTOR[2]

% of GDP, 2002

Current receipts	40.9	Total expenditure excluding net lending	46.2
Direct taxes	9.8	Government consumption	21.7
Indirect taxes	10.3	Subsidies to enterprises	2.4
Social security contributions	16.1	Social security benefits	13.5

PRODUCTION

GDP ($ million, 2001)	56 754	Structure of production (% of GDP, 2001)	
GDP per capita ($, 2001)	5 561	Agriculture	4.2
Gross fixed investment (% of GDP, 2001)	28.3	Industry	40.0
		Services	55.8

FOREIGN TRADE

Exports of goods and services (2001)		Imports of goods and services (2001)	
($ billion)	40.5	($ billion)	42.0
(per cent of GDP)	64.9	(per cent of GDP)	68.2
Main merchandise exports (% of total, 2001)		Main merchandise imports (% of total, 2001)	
Machinery and transport equipment	47.4	Machinery and transport equipment	42.2
Manufactures	24.3	Manufactures	20.2
Chemicals	6.4	Chemicals	10.9
Other	21.9	Petroleum products	9.1
		Other	17.6

THE CURRENCY

Monetary unit: Czech koruna		Currency units per $	
		Year 2001	38.0
		Year 2002	32.7
		Feb. 2003	29.4

1. An international comparison of certain basic statistics is given in an annex table.
2. Data are based on the OECD-adjusted general government accounts which differ from but are based upon the Czech Ministry of Finance data produced in accordance with the IMF's Government Financial Statistics.

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.*

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The economic situation and policies of the Czech Republic *were reviewed by the* Committee *on* 27 *January* 2003. *The draft report was then revised in the light of the discussions and given final approval as the agreed report by the whole* Committee *on* 17 February 2003.

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The Secretariat's draft report was prepared for the Committee *by* Rauf Gönenç *and* Jaromir Cekota *under the supervision of* Andreas Wörgötter.

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The previous Survey of the Czech Republic *was issued in* July 2001.

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