

Executive Summary

The coronavirus outbreak caused a sharp economic contraction

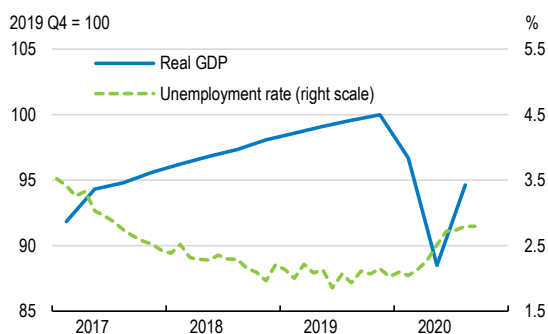
The Czech Republic is experiencing a strong second wave of the coronavirus pandemic.

The first wave was effectively contained in April, and the lockdown was soon lifted but the number of cases and deaths rose rapidly in autumn, much exceeding the magnitudes from the first wave. The government again declared a state of emergency and a lockdown was reintroduced, with restrictions on events, education and the retail and hospitality sectors.

The pandemic caused a sharp drop in GDP and recovery has stalled due to renewed containment measures.

In spring, activity dropped due to restrictions to mobility and private consumption. International trade dropped, too, and the economy's high reliance on external demand and integration in global value chains amplified the economic impact of the pandemic. Unemployment rose from low levels and wage growth subsided. Once the lockdown was lifted, economy rebounded, but the recovery in activity and sentiment have stalled since September, amid renewed restrictions and high uncertainty.

Figure 1. The economy contracted sharply



Source: OECD Economic Outlook database; Czech Statistical Office.

StatLink  <https://doi.org/10.1787/888934221009>

The recovery will be slow. GDP will grow modestly in 2021. Continued restrictions in some sectors, low sentiment and elevated uncertainty will hold back demand, notably investment. Withdrawal, albeit gradual, of government income and liquidity support will give way to increased bankruptcies and unemployment. Inflation will moderate towards the 2% target

level in 2021. Slack in the labour market and slower wage growth will hinder growth in private consumption. In 2022, economic growth is expected to pick up slightly, on the back of sustained rises in sentiment and domestic demand, once the pandemic is better controlled in the Czech Republic and globally.

Table 1. The recovery will be slow

Growth rates, unless specified	2020	2021	2022
Gross domestic product (GDP)	-6.8	1.5	3.3
Unemployment rate (% of labour force)	2.6	3.6	3.6
Consumer price index	3.3	2.2	2.0
General government net lending (% of GDP)	-7.7	-4.8	-3.6

Source: OECD Economic Outlook 108 database.

Policy space permits further support

The Czech National Bank (CNB) moved quickly to ease the monetary policy stance.

It reduced policy rates from 2.25% to 0.25% between March and May 2020. It also reduced the counter-cyclical capital buffer to support bank credit to the economy. The Act on the CNB was amended to pave the way for quantitative easing. The CNB took additional measures to support liquidity by broadening the range of eligible collateral and introducing liquidity-providing operations with longer maturities.

The government introduced broad emergency fiscal measures to support the economy.

Low public debt before the crisis gave ample fiscal space to extend assistance. The government introduced job retention schemes, benefit payments to the self-employed, income support for workers caring for children and tax deferrals. Moreover, a COVID loan and guarantee programme was launched to boost firm liquidity, notably for SMEs. Deferrals of rent and loan repayments have also been offered. The duration and scope of many of these programmes have been extended following the resurgence of cases and reintroduction of containment measures.

There remains room for continued fiscal policy support, if needed.

The medium-term expenditure framework has been amended to allow for extensive fiscal support. After 2021,

however, the framework requires a gradual fiscal consolidation by 2028. The plan for medium-term consolidation is appropriate, but it could be adjusted if the crisis lingers longer than expected.

Policy focus will need to shift towards facilitating workers' retraining and job search. Some sectors and firms will adapt rapidly to the new economic reality, while for others, restrictions and low demand may persist for longer. A key challenge will be to keep supporting viable firms and jobs, while allowing for necessary resource reallocation across sectors. The coronavirus job retention schemes are effective in preserving existing jobs, but cannot replace active labour market programmes and retraining for job seekers. These programmes currently receive little fiscal support and should be boosted to facilitate job reallocation. Effective insolvency procedures will also be crucial to minimise barriers to corporate restructuring and spur productivity-enhancing capital reallocation.

Ensuring long-term fiscal sustainability

The Czech Republic faces challenges from population ageing. Ageing-related costs will weigh heavily on public finances in the medium to long term. There is no automatic link between retirement age and life expectancy. Moreover, recent changes in the pension indexation rules and discretionary measures are pushing pension spending up further. Once the economic recovery is well established, addressing the challenges of the pension system's sustainability will become more important.

The Czech tax system can be reformed to become more growth-friendly. A heavy tax burden on labour - high social security contributions in particular - is not optimal. On the other hand, the use of environmental and real estate taxes, that are less distortive to growth, is low. There is also too much use of reduced VAT rates, which are shown to be poorly targeted to fight poverty.

Lower taxes and social contributions for the self-employed reduce public revenues and adequacy of safety nets. Taxes and contributions of the self-employed remain lower than for employees, driving the high incidence of

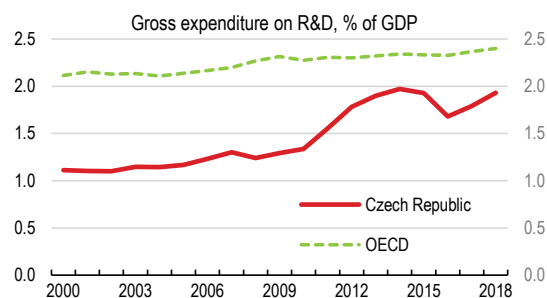
self-employment. The lower assessment base for social contributions creates issues of fairness, adequacy and sustainability. While enjoying the same rights from the health care system as employees, the self-employed contribute significantly less. Lower contributions to pensions, on the other hand, result in lower pension rights, leading to poverty in old age.

Raising R&D investment and improving the business environment

Strong economic performance before the crisis spurred convergence in incomes and living standards, but productivity still lags markedly behind the OECD average. Czech companies, particularly SMEs, invest comparatively less in R&D, and innovation activity is moderate. Much of the R&D activity is done by foreign multinationals. There is scope to make R&D support better targeted to young dynamic firms.

The burdensome aspects of the business environment impede investment and creation of new firms. The process of obtaining construction permits is one of the lengthiest in the OECD, slowing investment and construction. Also, opening a company is more cumbersome than in most OECD countries. Reducing red tape would help restart investment after the crisis and help unleash the entrepreneurial potential.

Figure 2. R&D expenditure lags behind OECD peers



Source: OECD Main Science and Technology Indicators database. StatLink  <https://doi.org/10.1787/888934221028>

Resources and investment should shift to less polluting and more energy-efficient activities. Energy and carbon dependence are high. Certain areas suffer from high air pollution.

The Czech Republic does not have a carbon tax and there are numerous exemptions for excise taxes applied to different uses of fuel. In the road sector, tax on diesel is lower than on gasoline, sending mixed signals to the market. Investment support should target transport and energy projects that help improve energy efficiency and reduce carbon emissions and air pollution.

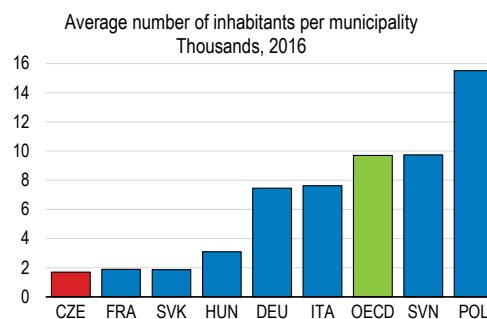
Higher public integrity and less fragmented local government

Strengthening governance and public integrity will improve the effectiveness of government spending. While the Czech Republic has made progress, further strengthening public integrity of members of Parliament and government officials will improve transparency and prevent mismanagement of funds. In addition, The Czech Republic is highly export-oriented and its exports include high-risk sectors for foreign bribery. In light of this, efforts to guarantee greater independence to prosecutors in foreign bribery investigations and prosecutions should be continued.

The small size of municipalities and the highly fragmented local government impede effective provision of public services and investment. The Czech Republic exhibits significant regional variation in incomes and poverty, and the gaps have grown over time. This is not helped by the fact that the Czech Republic suffers from a highly fragmented subnational government with the highest number of municipalities per capita in the OECD, making coordination difficult. The resulting lack of capacity at the local level and the lack of economies of scale compromise service quality.

Municipal cooperation is common, but lacks stability in administration and funding. Inter-municipal associations depend heavily on the willingness of the existing municipal administration to cooperate, and they primarily rely on external sources of funding. Mandating inter-municipal co-operation over a legally defined set of public services can be an effective way of improving efficiency and the quality of service delivery. Furthermore, small municipalities should be incentivised to merge.

Figure 3. Czech municipalities are very small



Source: OECD Subnational Government Structure and Finance database.

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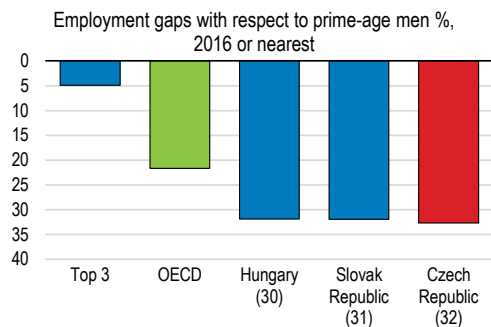
Bringing more mothers to the labour market and building skills

Low labour market participation of mothers constrains growth, incomes and equity. Childbirth has a large impact on labour market participation of women, with consequences for later careers. The gender pay gap is relatively high, and the risk of poverty in old age is higher for women than for men.

Generous cash benefits and limited childcare places discourage mothers' return to work. Family benefits are generous, mostly in the form of cash benefits to families with young children, and parental leave lasts until the child's age of three. At the same time, childcare availability, while growing in recent years, is limited.

Socio-economic factors and variation in school quality play a strong role in student performance and educational attainment. Small schools in remote and disadvantaged areas can find it challenging to provide high quality education. A recent funding reform has partly addressed the problem of lack of resources for these schools, but disadvantage could be more explicitly targeted. Further efforts to consolidate the school network and incentives for highly competent teachers to work in remote areas could raise quality.

Figure 4. The employment gap of mothers with young children is very high



Note: Number in parenthesis indicates the OECD rank.

Source: OECD (2018), Good Jobs for All in a Changing World of Work: The OECD Jobs Strategy.

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Lifelong learning should be better targeted to the low skilled. The Czech Republic has already experienced a rise in the share of high-skilled jobs. These trends are set to continue and may be accelerated by the distancing requirements during the coronavirus outbreak. Low-skilled workers rarely take part in adult education programmes and the VET sector should be better adapted to delivering education to adults, by developing short and flexible courses.

MAIN FINDINGS	KEY RECOMMENDATIONS
Supporting the economy to exit the crisis	
The economy has contracted sharply and the recovery is likely to be slow. Monetary policy reacted swiftly, but remaining room for conventional monetary policy is limited.	If weakness persists in the economy and inflation pressures are low, further reduce interest rates and the countercyclical capital buffer to facilitate credit to the economy. Consider undertaking asset purchases to lower borrowing costs and to ease financial conditions over the yield curve.
Some fiscal space is still available to continue supporting the economy and alleviating hardship while the crisis continues.	Be ready to provide further fiscal support until the economic recovery fully sets in. Pursue planned fiscal consolidation while allowing for flexibility given economic conditions.
The policy focus needs to shift from the initial broad support towards facilitating necessary resource reallocation across sectors to restore productivity growth.	Boost well-targeted active labour market policies to facilitate employment transitions while phasing out job retention schemes in a timely manner.
Ensuring long-term fiscal sustainability and raising public integrity	
The Czech population is ageing rapidly and age-related spending will rise steeply over the coming decades.	Continue to raise the retirement age and link it more tightly to increases in longevity.
Tax revenue relies heavily on labour taxation (social security contributions in particular) and real estate taxes are low. There is extensive use of the reduced VAT rate.	Shift taxation from labour towards real estate, consumption and environmental taxes.
The self-employed benefit from tax advantages vis-à-vis employees, resulting in significantly lower social security contributions and potentially inadequate pensions.	Reduce tax advantages for the self-employed, including by increasing the assessment base for social security contributions.
Public integrity could be improved further.	Adopt measures to strengthen the management and prevention of conflict of interest in the Parliament and the executive. Improve integrity and transparency in lobbying.
Raising productivity and restarting investment	
R&D intensity is low, and R&D and innovation activity of SMEs is below par.	Better target R&D support to small and young dynamic firms.
Procedures to obtain construction permits and to start a business are cumbersome and lengthy.	Adopt the new Building Act and reduce the time and number of procedures for starting a business.
Carbon dependence and air pollution are high. Several tax exemptions reduce incentives to save energy or to switch to cleaner fuels.	Promote investment to facilitate the transition to low-emission technologies and increase energy efficiency.
Increasing labour market participation and enhancing skills for higher growth	
Childbirth has a large impact on the labour market activity of mothers and the gender wage gap is sizable. Family cash benefits and tax breaks are generous while public childcare support is low, particularly for children under age three.	Keep expanding the supply of affordable and high-quality childcare facilities. Reduce the maximum duration of parental leave and incentivise fathers to take more of the parental leave.
Socio-economic factors have a large impact on student performance and attainment. Much of the inequality stems from variation between schools. Many schools are too small to provide education effectively.	Introduce explicit and objective criteria in the funding formula of schools to further address inequities and disadvantage. Consolidate the school network to ensure quality of education in all schools and encourage small schools to cooperate and share administrative resources.
The recovery from the crisis and technological change will require flexibility and reskilling by workers. Low skilled workers rarely take part in adult learning.	Foster flexible courses for adult education, in particular targeted at low-skilled workers.
Tackling inefficiencies due to fragmented local government	
Czech municipalities are the smallest in the OECD. High fragmentation poses challenges to efficiency and the quality of services. Inter-municipal co-operation is common, but lacks stability and often relies on external, temporary sources of financing.	Introduce financial and non-financial incentives for municipal mergers. Make inter-municipal co-operation mandatory and multi-purpose at the level of micro-regions with clearly specified tasks. Encourage self-funding of inter-municipal co-operation (from own tax sources and by member municipalities).
Indicators about the cost and quality of public service provision across municipalities and regions are missing.	Gather information on the quality of services provided at the local level to increase understanding of best practices and allow the use of benchmarking.



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