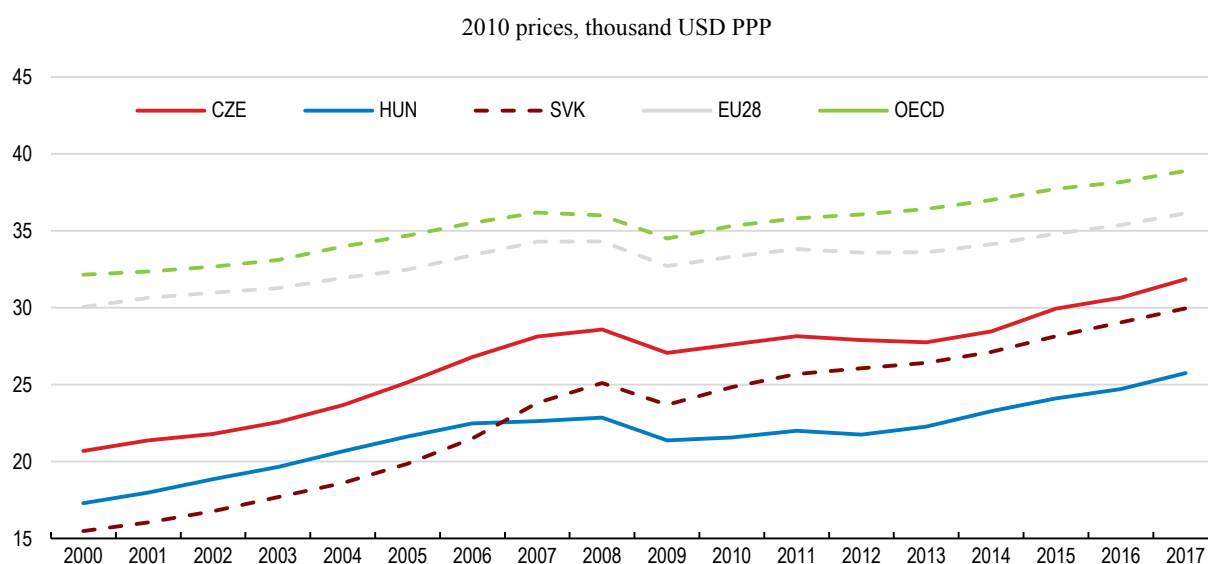


Key policy insights

Since the early 1990s, the Czech Republic has progressed successfully towards the average OECD incomes. Building on its geographical location and strong industrial base, the country has opened its markets and attracted foreign direct investments. Following the Velvet Revolution in 1989, the economy has become highly integrated in global value chains. Growth has been strong, though volatile. Following slow growth in the wake of the 2007 financial crisis, the Czech Republic has resumed its convergence towards OECD and EU average incomes. The economy is thriving, driven by internal and external demand. Per capita GDP reached 82% of the OECD average in 2017 or 88% of the EU average (Figure 1).

Figure 1. GDP per capita is converging to the OECD average



Source: OECD (2018), OECD Productivity (database).

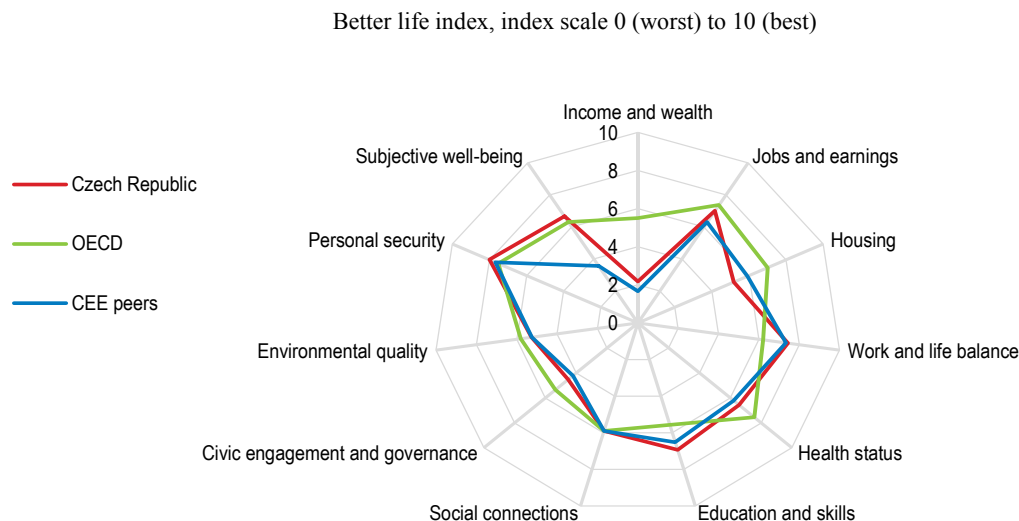
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The Czech Republic has adopted many best policy practices in macroeconomic and structural policy areas. A sound macroeconomic policy mix, in particular prudent debt policy, has laid the ground for strong institutions that contribute to high business and consumer confidence. As such, the country is an attractive location for investment. The Czech Republic shows continuous efforts to improve its business environment, for example, by implementing reforms towards broadening access and competition of its markets (as highlighted in Annex A).

To remain sustainable in the long term, economic growth should translate into an environment that creates opportunity for all parts of the population and where the benefits

of prosperity are distributed fairly across society. Relative to the OECD average, the Czech Republic improved on many aspects of well-being. In particular, indicators of overall personal security, environmental quality, work-life balance, and education and skills are high. Despite having low inequality, the Czech Republic lags behind the average OECD country in terms of income and wealth (Figure 2). Improvements are also needed in civic engagement and governance, and health. Further, the country is one of the most equal societies in the OECD in terms of disposable income (Figure 3).

Figure 2. Measures of well-being outperform the CEE peers, but lag behind the OECD average



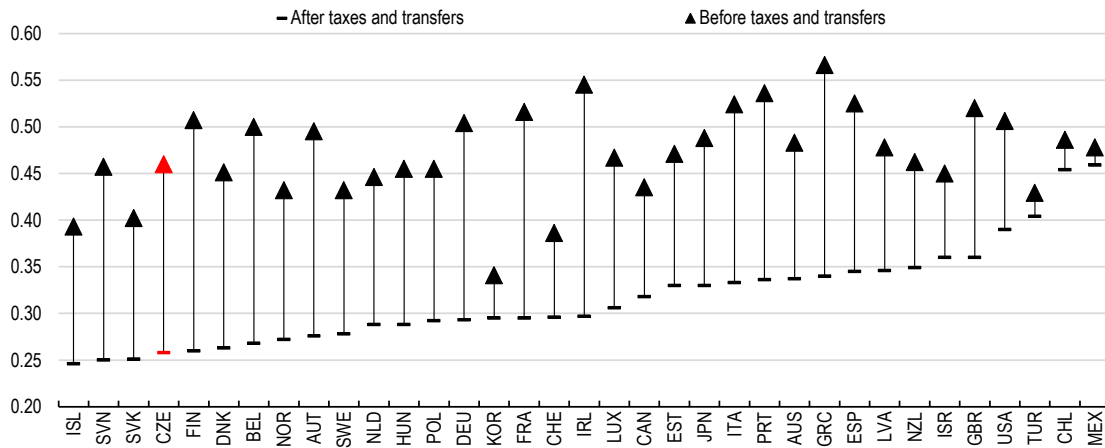
Note: For each dimension indicators are normalised according to the following formula: $(\text{indicator value} - \text{minimum}) / (\text{maximum} - \text{minimum}) \times 10$ and averaged. The OECD aggregate is population-weighted. CEE peers are Estonia, Hungary, Poland, the Slovak Republic and Slovenia. Note that the OECD does not officially rank countries in terms of their BLI performance.

Source: OECD (2017), OECD Better Life Index, www.oecdbetterlifeindex.org.

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Figure 3. Redistribution reduces inequalities

Gini coefficient, 2015 or latest year



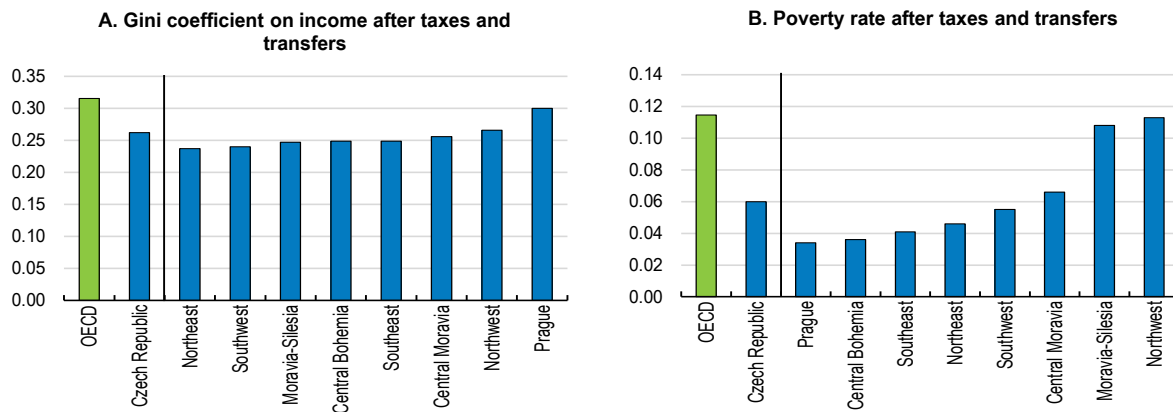
Source: OECD (2018), OECD Income Distribution (database).

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Inequality and poverty have stayed remarkably low in the last decade. However, there are large regional differences in poverty rates, which are high in the Northwest and Moravia-Silesia regions (Figure 4). Inequality is highest in Prague. As the poverty rate is relatively low, this reflects a high dispersion of wages due to differences in skills and productivity between sectors. At the same time, even low-income earners in Prague do better than those in more “peripheral” regions. In the Northwest, the higher poverty rates are driven by low wage/income for most workers.

Figure 4. Inequality and poverty are relatively low but vary across regions

Ratio, 2013



Note: The Gini coefficient is zero if everyone had the same income and is one if a single person had all the income. The poverty rate shows the share of the population with an income of less than 50% of the respective national median income. Income is after taxes and transfers, adjusted for differences in household size.

Source: OECD Regional Well-Being database, <http://dotstat.oecd.org/Index.aspx?DataSetCode=RWB> and OECD Income Distribution database.

StatLink <https://doi.org/10.1787/888933790334>

To sustain further improvements in living conditions, the Czech Republic will need to move up the value chain and improve the skills of its workforce. In the short run, it needs to respond to labour shortages, e.g. by increasing female workforce participation, while preparing for the impact of an ageing society in a longer-term perspective. The key messages of this *Economic Survey* are:

- The economy is booming, but growth needs to be more inclusive. Labour and skills shortages risk becoming main constraints to higher growth. Skilling is a win-win for more inclusive growth as apart from growth it would raise job quality, wages and well-being.
- The fiscal position is strong but spending related to ageing, such as pensions and health, will weigh on public finance. Restraining increases in pensions and other ageing-related spending in the long run is still necessary.
- The health sector works well but will be challenged by an ageing population. Efficiency and quality of service delivery have room to improve.

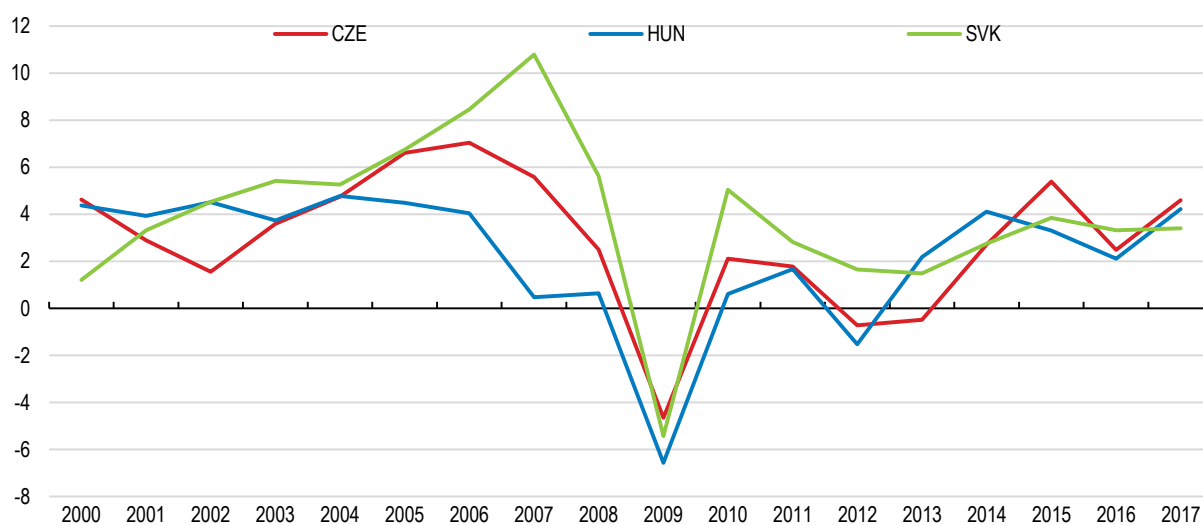
Recent macroeconomic developments and short-term prospects

Growth has picked up strongly

Since 2013 growth has accelerated (Figure 5). The main driver has been EU-financed public investment, especially in 2015. In 2016, growth slowed down to 2.6% as public investment slumped. By contrast, private investment became the engine of growth, supported by rising profits and credit, together with stronger household consumption boosted by rising wages and employment.

Figure 5. Growth is accelerating as in neighbouring countries

Real GDP growth, year-on-year per cent changes



Source: OECD (2018), OECD Economic Outlook (database).

StatLink  <https://doi.org/10.1787/888933790353>

Table 1. Macroeconomic indicators and projections

Annual percentage change, volume (2010 prices)

	2014 Current prices (billion CZK)	2015	2016	2017	2018 (projected)	2019 (projected)
GDP¹	4,313	5.4	2.5	4.6	3.8	3.2
Private consumption	2,073	3.7	3.5	4.0	3.8	3.5
Government consumption	849	1.9	2.0	1.5	1.8	1.6
Gross fixed capital formation	1,083	10.4	-2.5	5.9	5.2	4.3
Housing	145	22.7	8.9	7.2	5.6	4.9
Final domestic demand	4,006	5.1	1.5	4.0	3.8	3.4
Stockbuilding ²	32	0.8	0.0	0.0	0.5	0.0
Total domestic demand	4,038	5.9	1.4	3.9	4.3	3.3
Exports of goods and services	3,559	6.2	4.3	6.9	5.3	5.4
Imports of goods and services	3,284	7.0	3.1	6.2	6.1	5.7
Net exports ²	274	-0.2	1.1	1.0	-0.2	0.1
Other indicators (growth rates, unless specified)						
Potential GDP	..	2.4	2.7	2.7	2.9	3.1
Output gap ³	..	0.4	0.2	2.0	2.9	3.1
Employment	..	1.4	1.9	1.6	0.8	0.3
Unemployment rate	..	5.0	3.9	2.9	2.4	2.3
Wage bill	..	4.8	5.8	8.3	7.0	5.8
Unit labour cost	..	-0.4	3.3	3.6	2.8	2.4
GDP deflator	..	1.2	1.2	1.4	1.2	1.4
Consumer price index	..	0.3	0.7	2.5	2.0	2.1
Core consumer prices	..	1.3	1.6	2.0	2.0	2.1
Household saving ratio, net ⁴	..	6.8	6.0	5.4	4.8	3.9
Current account balance ⁵	..	0.2	1.6	1.1	0.5	0.3
General government fiscal balance ⁵	..	-0.6	0.7	1.6	1.6	1.4
Gross government debt (Maastricht definition) ⁵	..	40.0	36.8	34.6	32.4	30.5
Three-month money market rate, average	..	0.3	0.3	0.4	0.9	1.4
Ten-year government bond yield, average	..	0.6	0.4	1.0	2.0	2.5

1. All GDP components are working day-adjusted.

2. Contributions to changes in real GDP, actual amount in the first column.

3. As a percentage of potential GDP.

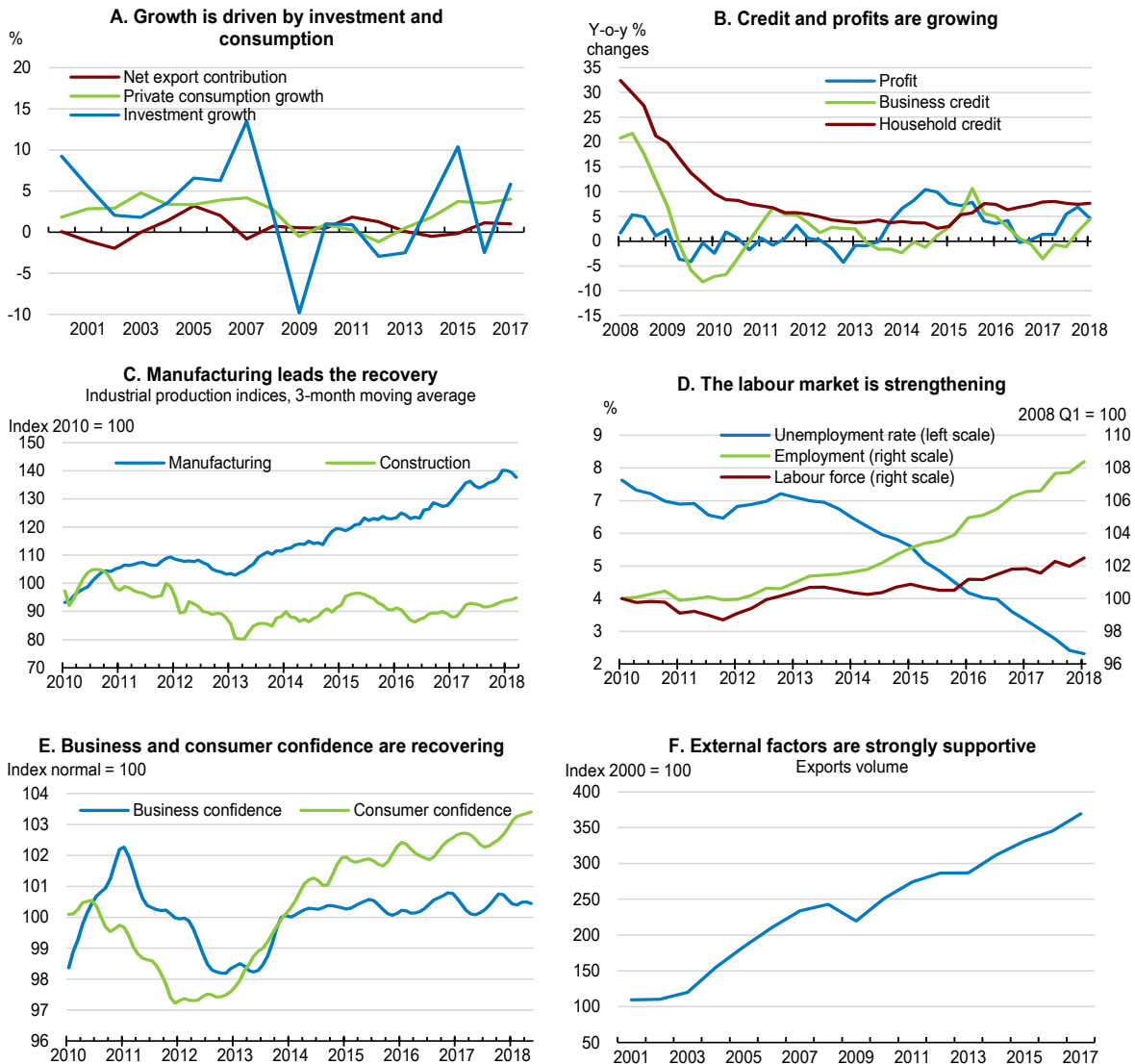
4. As a percentage of household disposable income.

5. As a percentage of GDP.

Source: OECD (2018), OECD Economic Outlook 103 (database).

The growth acceleration in 2017 to 4.6% was more balanced than in previous years. It was driven by both internal and external demand. Private consumption remained high in 2017 (Figure 6, Panel A) as household consumption was supported by income growth, declining savings rate as confidence went up and by rising credit (Figure 6, Panel B). Private investment also increased markedly, driven by manufacturing and ICT investment on the back of a continued recovery in profits (Figure 6, Panel B and C). Industrial production increased, particularly in the automotive sector, which benefited from both demand from abroad and domestic orders of machinery and equipment. Exports also kept their expansion in 2017 thanks to accelerating growth in trading partners. But imports were also strong due to the high import component of exports and investment.

Figure 6. Czech economic developments



Source: OECD (2018), OECD Economic Outlook (database); Czech National Bank; OECD (2018), OECD Quarterly National Accounts (database) and OECD Main Economic Indicators (database).

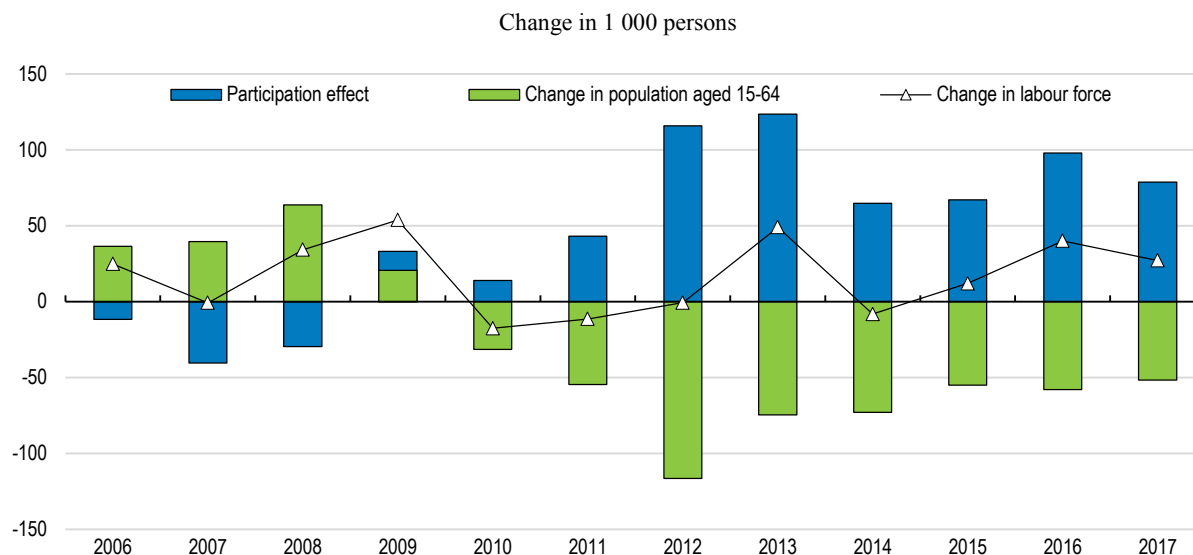
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The unemployment rate fell further in 2017 and at below 3% is among the lowest in the OECD (Figure 6, Panel D). Robust job creation pushed up wages by around 6% and the wage bill by 8.3% in 2017, helping to reduce inequalities. The wage bill has been growing strongly in the last three years and at a higher pace than GDP (Figure 10).

The lack of workers is becoming the main bottleneck to higher economic growth. Until recently, labour shortages driven by demographic changes and high employment were partly offset by higher economic activity rates. The ageing process has resulted in a continuous decline of the population aged 15-64 since 2010 (see Figure 7). Nevertheless, this negative effect on the labour force was mitigated in most years by a higher participation rate of persons that have not been economically active in the past, attracted

by job vacancies and growing earnings. However, the economy is facing constraints on the labour market and vacancies registered at employment offices increased more than seven folds, from 30 803 in December 2010 to almost 267 000 in April 2018.

Figure 7. Higher participation in the labour market has offset the effect of ageing



Source: OECD (2018), Labour Force Statistics (database).

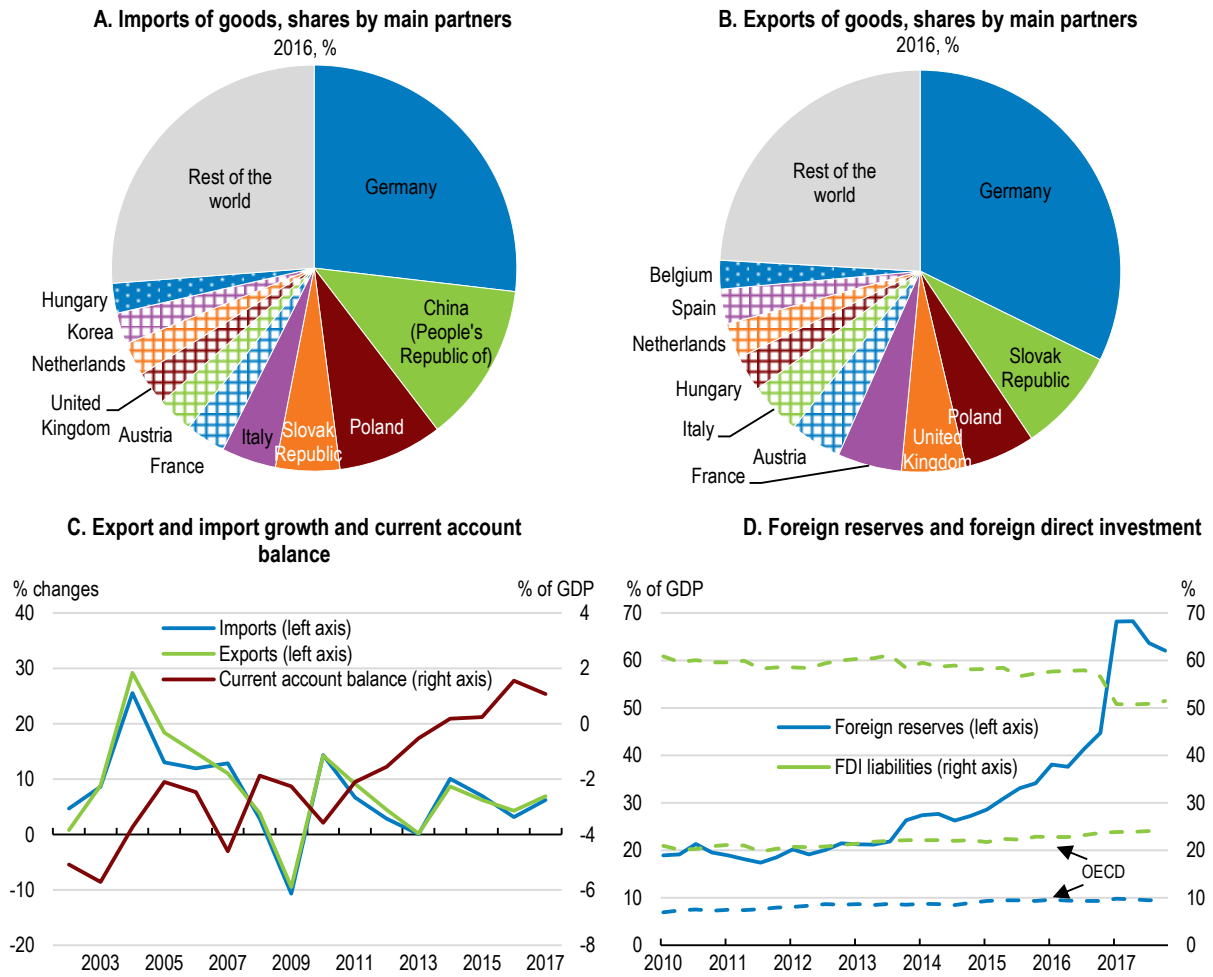
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At 3% in 2017, the growth rate of labour productivity is above the post-crisis trend but still below the pre-crisis trend (Figure 9). The level of labour productivity remains relatively low compared to advanced economies due to significant skills mismatches, a low transformation of R&D in innovation and the size of low-skilled intensive manufacturing industries (OECD, 2016^[1]).

Exports remain an important source of demand, growing by around 6% in 2017 (Figure 8). Much of this, however, can be thought of as re-exports of imported intermediate goods and ICT technology. Germany is the main partner in this two-way traffic as the Czech industry is closely integrated into German value chains (Figure 8, Panels A and B). The Czech industry is also well integrated into Central and Eastern European value chains.

The current account has been positive in the last four years (Figure 8, Panel C) contributing to foreign reserves accumulation. In addition, the Czech National Bank's exchange rate policy led to further accumulation of foreign reserves to prevent the koruna appreciation from 2013 to 2017. Following the exit from this exchange rate policy in April 2017, reserves started to decrease as a percentage of GDP and the koruna to appreciate.

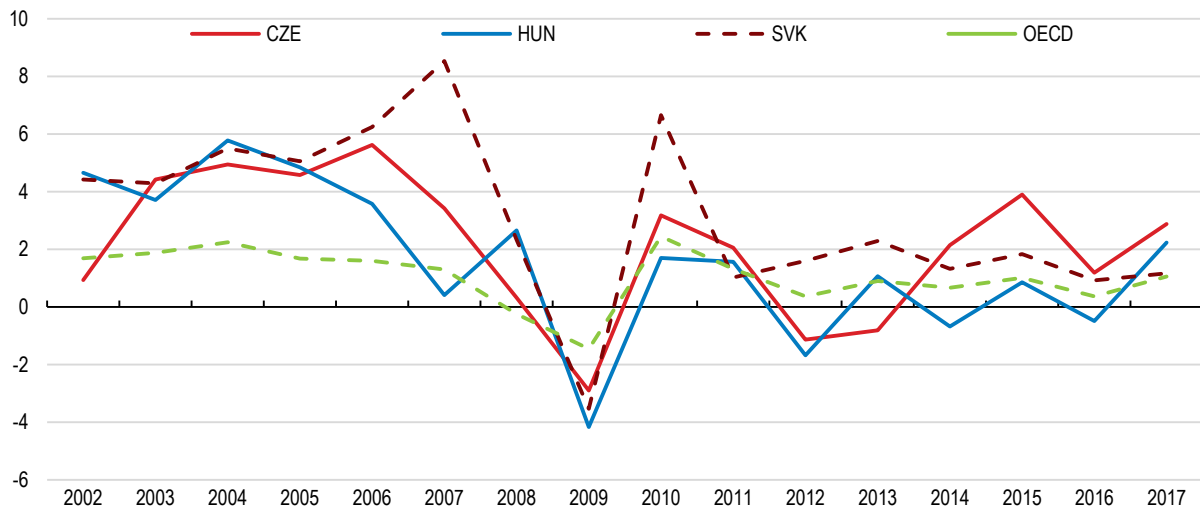
Figure 8. EU countries are the Czech Republic’s main trading partners



Source: OECD (2018), OECD International Trade by Commodity Statistics (database); OECD Economic Outlook (database) and OECD Resilience (database).

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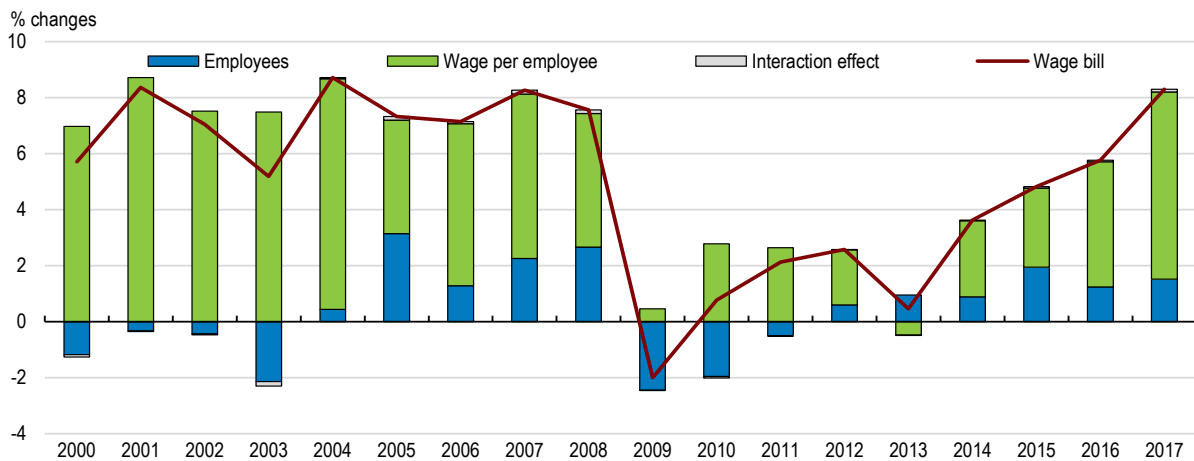
Figure 9. Labour productivity is picking up
Year-on-year per cent changes



Source: OECD (2018), OECD Economic Outlook (database).

StatLink  <https://doi.org/10.1787/888933790429>

Figure 10. The wage bill is rising
Decomposition of wage bill growth



Source: OECD (2018), OECD Economic Outlook (database).

StatLink  <https://doi.org/10.1787/888933790448>

Inflation picked up strongly in 2017 reaching on average 2.5% after three years of being around 0.5% (Figure 11). On the supply side, low unemployment combined with high job vacancies led to an acceleration of wage growth, which in turn prompted increases in unit labour cost. In addition, increasing oil prices contributed to inflation. On the demand side, strong household consumption drove up inflation. Food and non-alcoholic beverage prices are the key contributors to inflation.

Prospects and risks

Economic growth is projected to slow in 2018 mainly due to labour supply constraints. However, even at 3.8%, growth will be hovering above its estimated potential (Table 1). Increasing wages and employment will keep household consumption and internal demand high. The increase in public sector wages by 10% on average in 2018 will contribute to higher demand. Private investment is also projected to increase thanks to favourable credit conditions, and greater withdrawal of European Structural and Investment Funds. Moreover, the relative higher cost of labour than capital should stimulate physical capital investment. Also, high housing demand and prices will continue to drive housing investment. The net contribution of the external sector to growth should be more limited as imports and exports grow in parallel. Growing wages and strong household consumption are expected to keep annual inflation slightly above the 2% target of the Central Bank in 2018.

Risks stem equally from internal and external factors. Labour market developments could limit growth or even drive a bigger slowdown of growth than expected. First, the unemployment rate is hitting a floor as the seasonally adjusted unemployment rate in the age group 15–64 declined to 2.3% in April 2018 (CZSO, 2018_[2]). The number of job vacancies exceeds 267 000 in April despite increases in participation rates. Also the rise in inflation and wages and slower appreciation of exchange rate may lead to a normalisation of interest rates at a speedier pace than anticipated, increasing the gap with the euro area's rates. That would accelerate the appreciation of the koruna and impact negatively exports and growth (Table 1). The rapid rise in house prices poses a further risk.

Also, there are signs of overheating as the economy is growing above potential, wages are increasing rapidly and the labour market is tight. These dynamics pose a risk of inflation picking up strongly and calling for early interventions of the Central Bank and stronger appreciations of the exchange rate than expected.

On the external side, the Czech economy is particularly exposed to trade disruptions given its high inclusion in global value chains (Table 2, Box 2). Exports in value added terms contribute to around 45% of GDP (OECD, 2017_[3]). The United States and the United Kingdom are the second and third destinations respectively in terms of value added exports of the Czech Republic. Therefore, escalation in import tariff hikes would be damaging for growth. As well, a disorderly Brexit would hit the growth prospects.

Table 2. Potential vulnerabilities of the Czech economy

Shock	Potential impact
Limits on the free movement of goods and services after Brexit.	The Czech economy is landlocked and very integrated into European value chains and would be struck by major changes affecting the flow of goods and services across Europe.
Rising protectionist pressures in trade and investment	Tariff increases affecting intermediate goods for the manufacturing sector would have damaging impacts.

Monetary, financial and fiscal policies to promote stability and well-being

Monetary policy and exchange rate developments

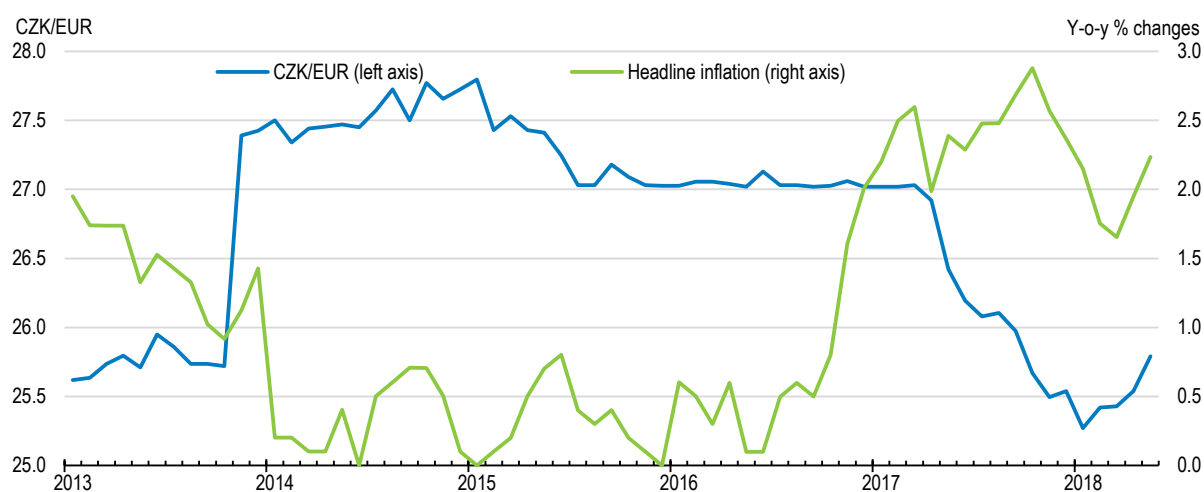
The Czech National Bank (CNB) is committed to an inflation-targeting framework and a floating exchange rate. Confronted with a persistent deflationary risk, in November 2013

the CNB used the exchange rate as a further policy instrument within its inflation-targeting strategy. In particular, the CNB intervened in the foreign exchange market to maintain the koruna above a floor set at CZK 27 to the euro, accumulating foreign reserves (70% GDP in April 2017). In April 2017, the CNB announced the exit from the exchange rate floor policy. In the following months the koruna gradually and continuously appreciated, reaching CZK 25.5 to the euro by the end of 2017. The exit from the exchange rate floor policy is a welcomed development.

As inflation rebounded strongly over the course of 2017, the CNB raised interest rates for the first time in five years in August 2017. Two more hikes followed afterwards, setting the base rate at 0.75% (March 2018). The increase of the interest rate is needed to prevent increasing inflation.

As wages and inflation are rising, monetary policy should raise interest rates further at a gradual pace as inflation remains within the neighbourhood of the target and monitor closely the inflation impact of the developments in the labour market. Should the economy show inflationary signs of overheating, the CNB should stand ready to raise rates accordingly. A faster pace of rising interest rates in the Czech Republic will increase the gap vis-à-vis euro area interest rates and contribute to the appreciation of the koruna. However, an appreciating exchange rate will tend to dampen economic activity and temper inflationary pressures, particularly for imported goods and services (Figure 11).

Figure 11. The exchange rate is appreciating and inflation is around the target



Source: Calculations based on OECD (2018), OECD Economic outlook (database) and Thomson Reuters Datastream (database).

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Financial sector vulnerability

The financial sector is benefiting from the economic boom. Its robustness and resilience have increased throughout 2017 despite increasing exposure to the housing sector. Indeed, the profits of banks, which represent 80% of the financial sector, have been increasing. The return on assets stands at 1.1% compared to 0.5% in the European Union (Czech National Bank, 2017_[4]).

The good profits of the banking sector are driven by increasing loans to households at a comfortable interest rate margin (Figure 12). In particular, the margin for consumer loans at 8.6 percentage points remains high. Moreover, non-performing loans have receded markedly in all categories, to 3% of the total in 2017 (Figure 12). The structure of banks' finance appears robust as the ratio of loans to deposit remains low and overall indebtedness is low compared to most OECD countries. Liquidity ratios do not show high exposure risk in the short run as bank assets are high (Figure 12).

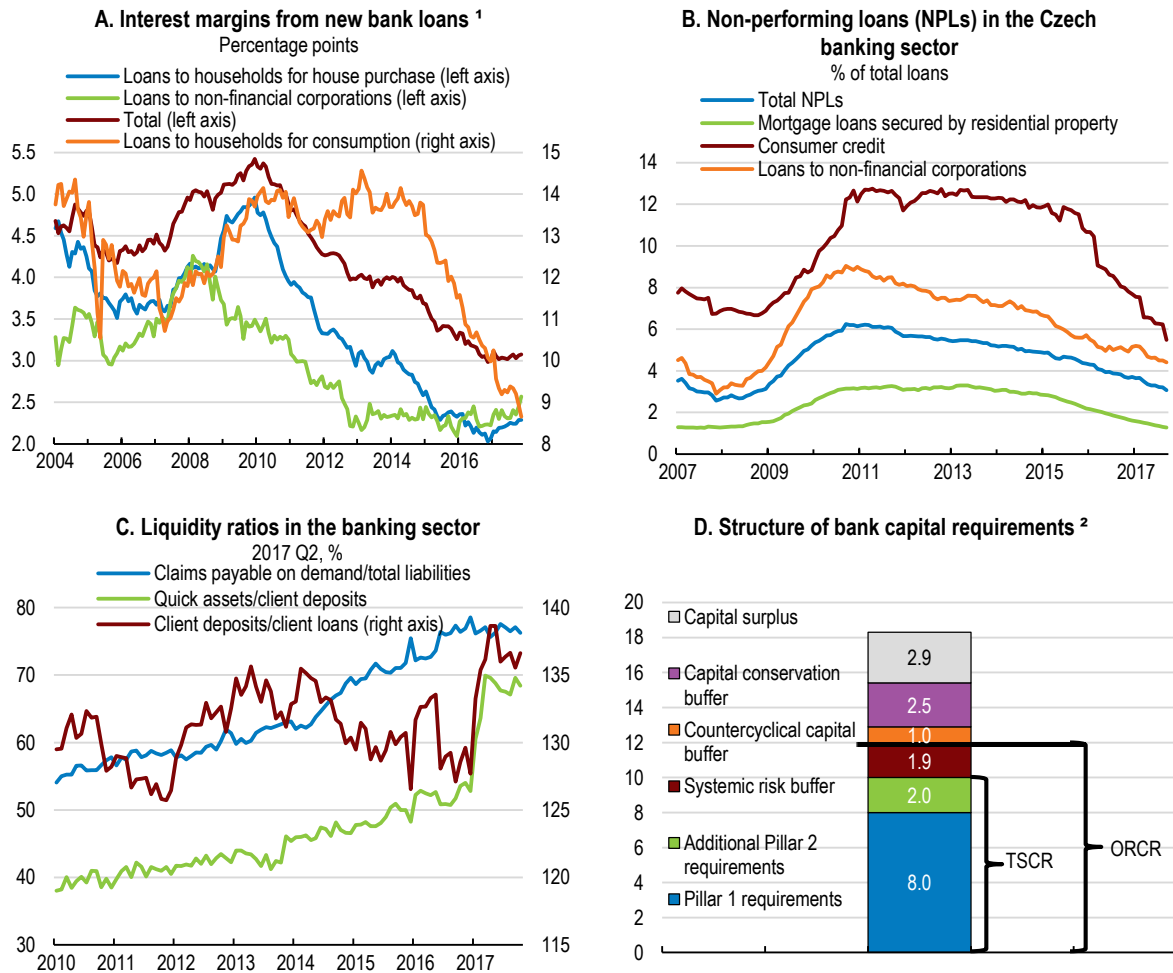
Banks also have strong buffers compared to capitalisation requirements. In addition to the overall capital requirements, the Czech National Bank added two more capital requirements: the capital conservation buffer and the counter-cyclical capital buffer. Banks in the Czech Republic exceeded these requirements by 2.9 percentage points by the end 2017 (Figure 12, Panel D). As the cost of risk remains low due to low interest rates and credit is increasing rapidly, the CNB introduced in January 2017 a 0.5% counter-cyclical buffer. The cyclical component of systemic risk posed by rising credit is persistent, as such the announced increase in the counter-cyclical capital buffers to 1.5% effective from 1 July 2018 appears necessary. Moreover, the counter-cyclical buffer is not affecting so far the availability of credit or the cost of capital. These prudential rules are in line with best practices in OECD countries.

Housing market developments are of some concern. Low interest rates combined with improving economic prospects and rising incomes have resulted in increasing demand for houses. The loans for house purchases have accelerated in the last two years (Figure 13, Panel A) and are reaching historically high levels. The increases in the loan growth rate and supply constraints are mirrored in rising housing prices. The housing sector experienced the highest price growth rate among EU countries in 2017 (Figure 13, Panel C). Moreover, housing prices are growing at a faster pace than wages, though they decelerated moderately in the first quarter of 2018. Therefore, household indebtedness is increasing and banks are exposed to a reversal in household income progress.

Increasing house prices are also the result of constraints on the supply side. Regulatory burdens to receive a construction permit are high and requires on average the fulfilment of 21 procedures compared to about 12.5 across OECD countries (World Bank, 2018^[5]). As such, time between planning and finalising a construction project may take several years (OECD, 2017^[6]).

To limit banks' exposure to the housing market and ensure that borrowers are creditworthy, the CNB introduced in 2015 and 2017 various prudential measures, in particular loan-to-value (LTV) ratios. For instance, it is recommended that the LTV ratio of no retail loan secured by residential property exceeds 90%. Banks are also encouraged to limit loans that have an LTV ratio between 80-90% at 15% of their portfolio on a quarterly basis. Banks and loan providers are also recommended to prudently assess the loan request of clients whose debt-to-income ratio exceeds eight or whose debt (service)-to-income ratio exceeds 40%. From October 2018, debt should not exceed nine times the net annual income of borrowers and the debt service-to-income ratio should not exceed 45%. These prudential ratios are only recommendations and are not binding, limiting their effectiveness. The CNB can only use the aggregate prudential instruments, in particular additional capital requirements, to influence banks' lending behaviours.

Figure 12. Exposure to financial vulnerabilities is low



1. Interest margin is the difference between the borrowing and lending rates of banks.

2. TSCR is for Total Supervisory Review and Evaluation Process Capital Requirement or Total SREP Capital requirements. "Overall capital requirements" is the sum of TSCR and all buffers. ORCR means "Other relevant capital requirements" and is the sum of the TSCR and the systemic risk buffer.

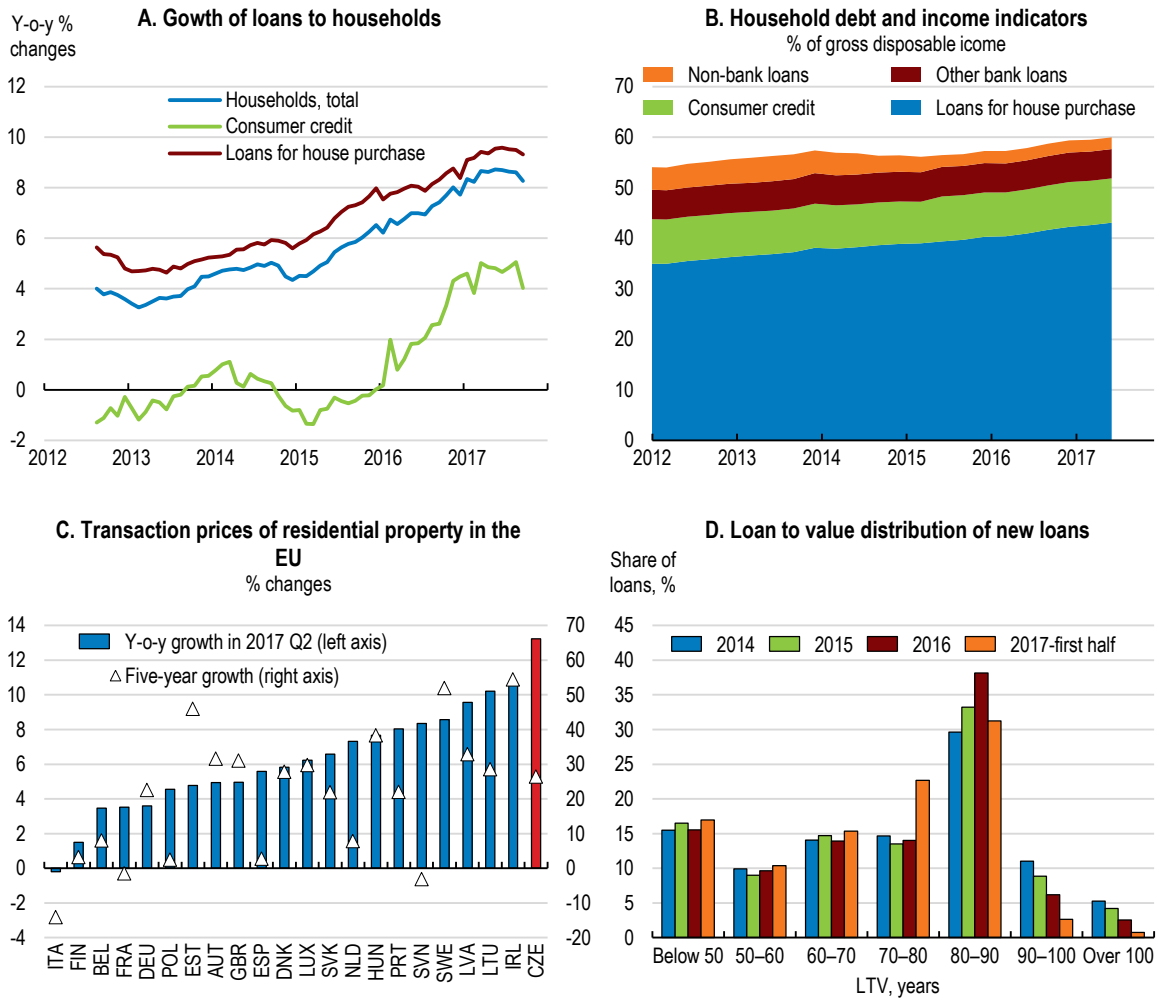
Source: Czech National Bank.

StatLink  <https://doi.org/10.1787/888933790486>

So far, banks are not fully compliant with these recommendations. The share of loans with LTVs of 80-90% stood at 31% in the first half of 2017, and almost 3% of the loans provided had LTVs of over 90% (Figure 13, Panel D), though in June 2017 the compliance significantly improved. Moreover, the valuation of collateral tends to be higher to respect the LTV norm (Czech National Bank, 2017_[4]), which is increasing banks' exposure to changes in the economic situation of borrowers.

The CNB could be given the power to set prudential rules applicable to individual loans. However, to avoid overly restricting credit to individuals, the borrowing limits should be judged with regard to borrowers' capacities, in particular their level of income.

Figure 13. Credit and housing market developments raise some concerns



Source: Czech National Bank; Czech Statistical Office and Eurostat.

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Fiscal policy

The fiscal position is strong but will be challenged by an ageing population. At 2.3% of GDP in 2017, the primary balance increased compared to 2016 and has been in surplus for three years in a row. Therefore, debt-to-GDP is decreasing rapidly and is one of the lowest in the OECD in 2017 at 35% (Maastricht definition). The primary balance is expected to remain positive in the next two years, further bringing government debt down. At below 30% of GDP, gross debt is considered sustainable for the Czech Republic (Fournier and Fall, 2015^[7]). Moreover, fiscal buffers needed to cushion adverse shocks are estimated at 10% of GDP (Fall et al., 2015^[8]).

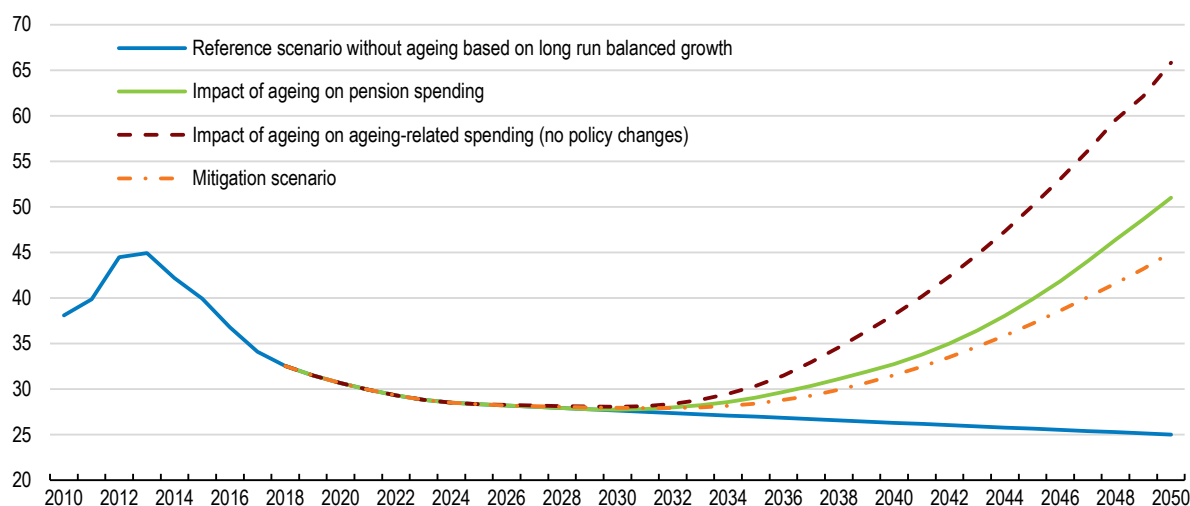
However, ageing will weigh on public finances in a longer-term perspective. If pension policy is not adjusted to cushion the impact of ageing, the debt-to-GDP ratio will increase by more than 20 percentage points by 2050 (Figure 14). Moreover, if no action is taken in

any ageing-related spending domain, the debt-to-GDP ratio would double by 2050 and further deteriorate by 2059 – the peak year of ageing impacts on spending.

The Czech Republic is committed to strengthening its fiscal framework to guarantee sustainability in the long run. In line with European Union and past OECD recommendations, fiscal institutions are being set up (Table 3).

Figure 14. Some fiscal space is available to address future needs

General government gross debt, Maastricht definition, in per cent of GDP



Note: The baseline consists of projections for the Economic Outlook until 2019. Thereafter, assumptions are: real GDP grows progressively closing the output gap and from 2025 growing by 2.5%; a balanced budget from 2025; and an average real effective interest rate converging to 2% by 2025. The “impact of ageing on pension spending” scenario assumes increases on pension spending are financed through the deficit which reaches 2.6% of GDP in 2050. The “impact of ageing on ageing-related spending” scenario adds together the impact of ageing on pensions, health and long-term care and assumes the deficit reaches 4% of GDP in 2050. The “mitigation” scenario assumes that half of the ageing-related spending is financed by increasing revenues and limiting spending increases.

Source: Calculations based on OECD (2018), OECD Economic Outlook (database).

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Table 3. Past recommendations to strengthen the fiscal framework

Recommendations in previous Surveys	Action taken
Implement the new fiscal framework and the fiscal council.	Acts on budgetary responsibility entered into force in February 2017. A medium-term budgetary objective is set to ensure long-term sustainability of public finances. Two independent institutions are put in place to monitor the respect of fiscal rules: <ul style="list-style-type: none"> National Budgetary Council (members appointed on 25 January 2018): surveillance of the respect of fiscal rules and assess the impact of governmental actions on long-term sustainability of public finances Committee for Budgetary Forecasts (members appointed on 30 April 2018): verify the plausibility of macroeconomic and fiscal forecasts used in the budgetary process.
Reduce the advantages of self-employment in terms of social contributions and personal income tax.	Since January 2018 there has been a 50% reduction of the flat-rate expenditure limit (to CZK 1 million) for entrepreneurs. This measure reduces the fictitious reporting of employment as a self-employment activity and approximates the level of taxation of self-employed to workers.

The stance of fiscal policy has been restrictive for the last two years (Table 4). While more public spending would have contributed to maintain growth momentum in 2016 and push inflation up, the fiscal stance was appropriate in 2017 in the context of strong growth and inflation. As there are signs of overheating, fiscal policy should avoid being procyclical. Public investment has fallen from the peak of 5.1% of GDP in 2015 to around 3.3% of GDP in 2016 and 2017. Public investment should increase again in 2018 with the acceleration of the EU funds withdrawal. Government spending, though stable relative to GDP (Table 4), is increasing in volume at a pace slightly higher than GDP. Government spending increased by 5% in 2017 and is expected to grow by 6% in 2018.

The main drivers of increases in government spending are:

- Pension benefits, which went up by 4% partly due to the changes in the indexation formula.
- Benefits for people with disabilities and long-term care.
- Benefits for families with children in particular to support the return of mothers to the labour market and for introducing paternity leave.
- The salary scale of civil servants, which will increase by 10%, excluding teachers, whose scales increased by 15% from November 2017, and health care workers whose scales have increased by 10% as of January 2018. The government wage bill should increase by at least 7% in 2018 (Ministry of Finance, 2018_[9]).

These measures are partly in line with past OECD recommendations to help women with children to further participate in the labour market by increasing family benefits. They also confirm that public expenditure is tilted towards social spending and less in investment in infrastructure, R&D and education. The dynamics of public investment remains closely driven by investment co-financed with EU resources, which implies high volatility and can delay investment in important infrastructure such as highways and railways. Future increases of public sector wages should be linked to labour productivity growth in the economy.

Table 4. The fiscal situation is robust

Per cent of GDP

	2015	2016	2017 ¹	2018 ¹	2019 ¹
Spending and revenue					
Total revenue	41.1	40.2	40.3	40.2	39.8
Total expenditure	41.7	39.4	38.8	38.6	38.4
Net interest payments	0.9	0.8	0.6	0.6	0.5
Budget balance					
Fiscal balance	-0.6	0.7	1.6	1.6	1.4
Cyclically adjusted fiscal balance ²	-0.8	0.7	0.8	0.4	0.1
Underlying fiscal balance ²	-0.6	0.7	0.8	0.4	0.1
Underlying primary fiscal balance ²	0.4	1.4	1.4	1.0	0.7
Public debt					
Gross debt	52.0	47.7	43.9	41.7	39.8
Gross debt (Maastricht definition)	40.0	36.8	34.6	32.4	30.5
Net debt	20.0	17.2	12.2	10.0	8.1

1. Projection

2. As a percentage of potential GDP

Source: OECD (2018), OECD Economic Outlook 103 (database).

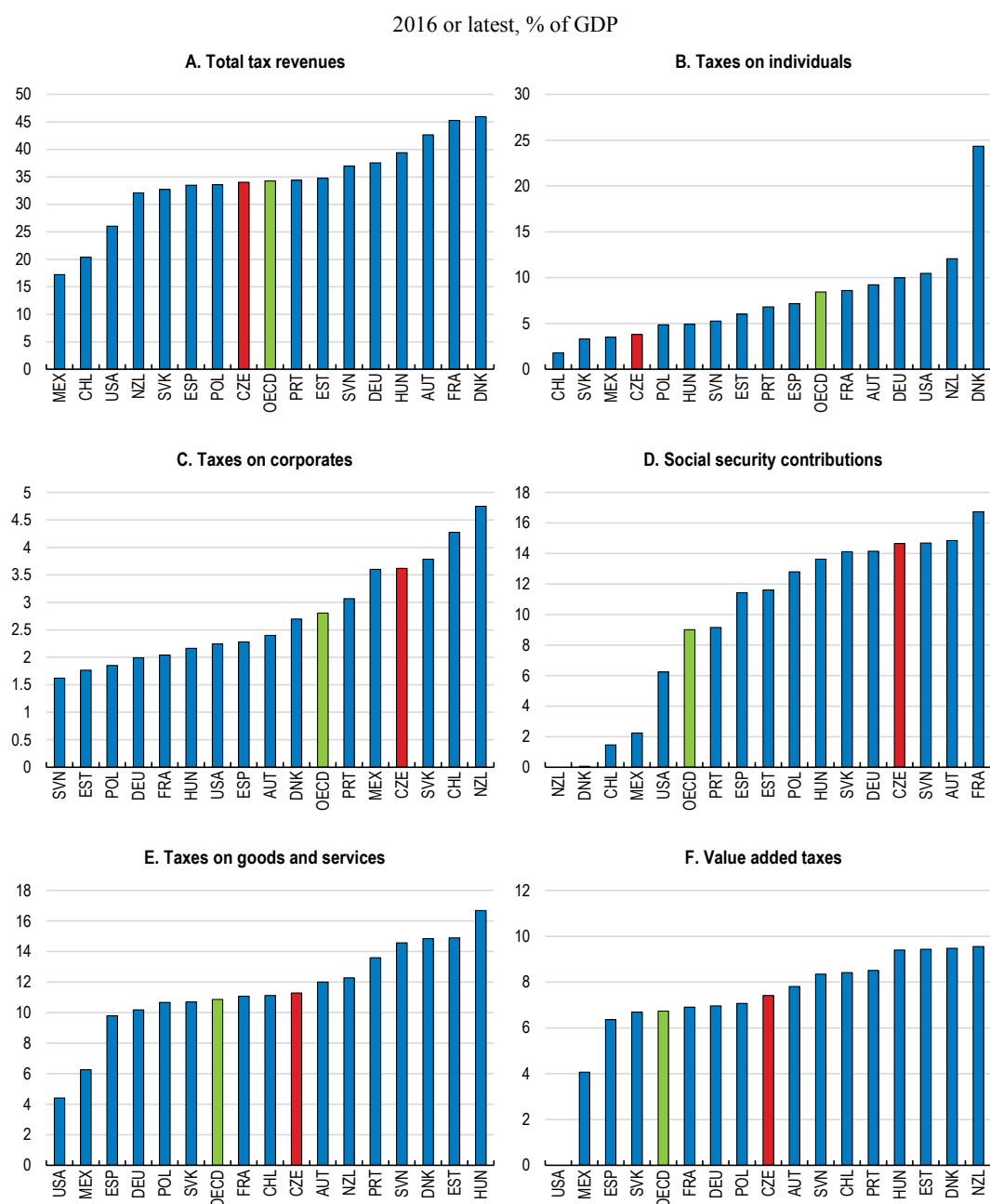
Government revenue is booming thanks to the expanding economy. Revenue collection increased by 6.5% in 2017 compared to 1.5% in 2016 (Ministry of Finance, 2018_[10]) and is projected to remain high in 2018. Increasing household consumption and the introduction of electronic recording of sales and VAT declarations are boosting VAT revenues, which increased by 9.5% in 2017. This has also started to have an effect on VAT evasion, which has decreased recently (European Commission, 2018_[11]). Revenues from personal income tax and social contributions have increased notably in 2017 and are projected to remain high in 2018, driven by growing employment and wages.

The Czech Republic has made significant efforts to increase the collection of VAT. Estimates of the VAT Gap conducted for all EU Member States show a downtrend of revenue losses in the Czech Republic during the last 4 consecutive years. However, the estimates have to be interpreted carefully with respect to VAT fraud and tax evasion. While the VAT Gap presents a measure of VAT revenue losses from fraud and non-compliance expressed as the difference between the amount of VAT revenue actually collected and the theoretical amount that is expected to be collected, it can also be influenced by bankruptcies and tax arrears, as well as reporting problems in national accounts. However, the Czech Republic's VAT Gap (at 16.48%) remains above the EU average (12.77%), and continued vigilance and efforts to further reduce this gap are therefore warranted. Consideration should notably be given to further reducing possible complexities from rate differentiation and exemptions, as these are generally known to have a negative impact on compliance.

The Czech Republic is also advised to carefully target anti-fraud measures at the sectors and taxpayer profiles that present the highest risk, in accordance with modern compliance risk management strategies, and to avoid that such measures create undue compliance burden for bona fide business. Moreover, regular changes to the tax system are creating uncertainties and compliance costs. The tax system should move towards more simplicity and fewer exemptions or reduced rates and more stability.

The structure of government revenues is unbalanced, with a heavy reliance on social security contributions. While government tax revenues were almost 35% of GDP in 2016, social security contributions were 14% of GDP (Figure 15). In terms of collected social security contributions, the Czech Republic ranks among the highest countries across the OECD. At the same time, personal income tax revenues are low (Figure 15, Panel B). VAT revenues are above the OECD average, but the revenues on goods and services are more similar to the OECD average, indicating that the Czech Republic raises relatively fewer excise duties (possibly on fuels, environmentally related taxes).

Imbalances in the structure of government revenues contribute to relatively high cost of labour. The tax wedge is the 6th highest across the OECD and the average rate of employers' social contributions is the second highest (Figure 16). Up to now, this has not been detrimental to labour market performance, in particular to employment, only because the average wage is low compared to other EU countries. Indeed, the Czech Republic has built its comparative advantage by holding wages low to attract foreign direct investment, in particular in manufacturing industries.

Figure 15. Government fiscal revenues rely heavily on social contributions

Source: OECD (2017), Revenue Statistics (database).

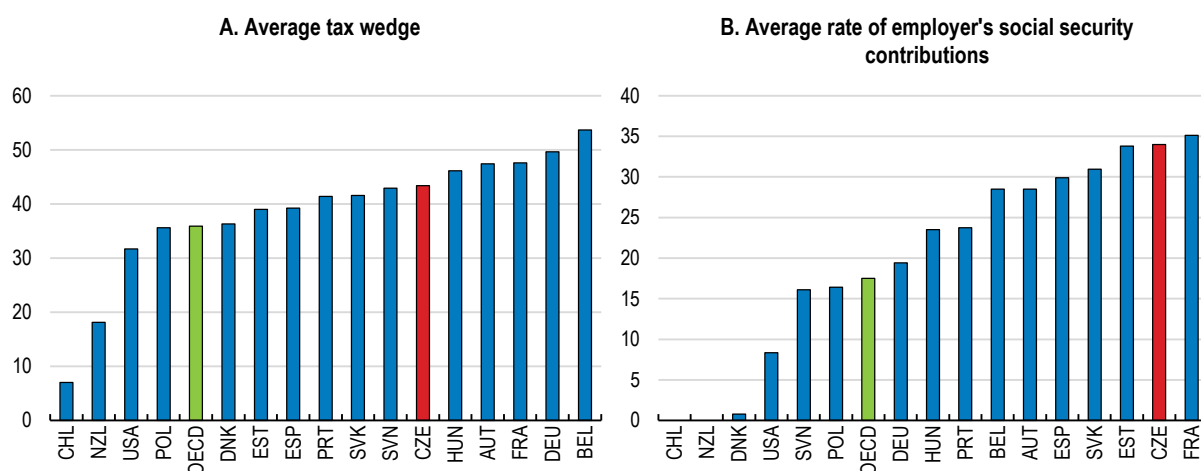
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However, as wage convergence towards OECD and EU averages is continuing and given the recent acceleration of wage growth, the high level of wage taxation could become burdensome. To maintain wage competitiveness, the government should consider shifting part of the financing of social protection from wages towards taxes on goods and services or on all kinds of income (e.g. capital and property income) and environmental taxes. For instance, there is room to shift one percentage point of GDP of social contributions

collected towards VAT revenues and/or environmental taxes (Table 5). Also, indirect taxes are less harmful for growth than taxes on wages.

Figure 16. The fiscal burden on labour could be lowered

2017, percentage



Note: The tax wedge is the sum of personal income tax and employee plus employer social security contributions together with any payroll tax less cash transfers, expressed as a percentage of labour costs for a single person on average earnings.

Source: OECD (2018), "Taxing Wages: Comparative tables", OECD Tax Statistics (database).

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Table 5. Scenarios of VAT rates to offset lowering social security contributions

VAT rates to offset a decrease of one percentage point of GDP of social contributions collected.

	Actual	Scenario 1	Scenario 2	Scenario 3	Scenario 4
basic %	21	25	24	24	21
reduced %	15	15	18	15	21
2nd reduced %	10	10	13	15	21

Note: Based on 2016 GDP and VAT collected from the different rates. These simulations do not take behavioural responses to tax rate changes into account.

Source: OECD calculation.

Table 6. Financial assessment of fiscal recommendations

Fiscal recommendations	Impacts on fiscal balance
Shift 1 percentage point of GDP of social contributions collected towards indirect taxes and/or environmentally related taxes.	Neutral almost
Keep expanding the supply of affordable childcare facilities by redirecting funds from family related transfers	Direct 0.8 pp of GDP from the 3.3% of GDP family benefits spending.
Favour higher participation of inactive persons through special training and vocational training.	-0.7% of GDP
Link retirement age to life expectancy	+0.2 pp of GDP in 2030 and +0.7 pp in 2040

Source: OECD

Taxes on self-employed remain lower than for employees creating loopholes in the tax system. The Czech Republic has a large number of self-employed compared to OECD countries due to incentives created by the tax system. The assessment base for social contributions is set at 50% of profits, effectively lowering the overall contributions of self-employed people compared to employees. However, recent reforms of self-employed taxation in addition to high job creations and strong wage growth may have contributed to the small decline in the number of self-employed. Some self-employed people have shifted towards limited liability companies or became secondary self-employed (meaning their business activity is not the primary source of income, they have other sources of income). Indeed, a cap on the use of lump-sum expenses has already been tightened over the past few years. The cap was further reduced since January 2018. However, for self-employed people with revenues up to CZK 1 million (around EUR 40 000) the tax system remains advantageous.

The lower assessment base for social contributions for self-employed has direct consequences on the contribution of self-employed to health care and pension schemes and their benefits. While self-employed benefits from the health care system are the same as for employees, their pensions are on average about 13% lower (Šatava, 2017_[12]). The risk of falling below the poverty line is higher for retired self-employed individuals, which would increase the burden on public finances through future social transfers.

The current framework incentivises self-employed to under-declare their income. For example, health care contributions of self-employed are defined as the maximum between the minimum contribution level and 13.5% of half of their profits. The marginal effective tax rate for those who declare an income above the minimum contribution level jumps from 0 to 6.75%. Therefore, self-employed are incentivised to declare a revenue so that they contribute the minimum contribution level, which about 90% of self-employed people do. Different options could be considered to raise the contributions of self-employed:

- The government could consider gradually increasing the assessment base for health contributions for self-employed or the minimum contribution level.
- In addition to increasing the minimum contribution level, self-employed would pay a lower contribution rate on their revenues above the threshold. While such design would not increase their health care benefits, it would imply higher pensions in the future as an incentive.

Addressing longer-run challenges to well-being

Sharing growth benefits and convergence

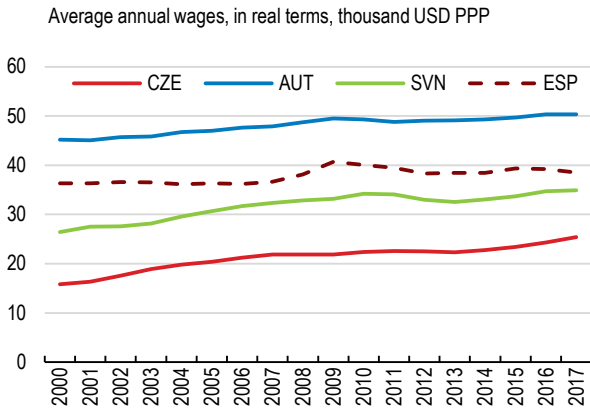
As discussed above, GDP per capita is converging towards the OECD average (Figure 1). However, the convergence in terms of household income is lagging behind (Figure 17). Indeed, compensation of employees represents 41% of GDP compared to 45% for most advanced economies and 51% in Germany (Figure 17, Panel C). Moreover the share of wages and salaries in value added is only 34% compared to 42% in Spain and the Netherlands and 46% in Germany (Figure 17, Panel D).

Low labour shares are influenced by the gap between GDP per capita and gross national income, which is among the highest in OECD countries (Figure 17, Panel B). It is the result of large profit outflows related to foreign direct investments that has benefited the economy and its insertion in global and regional value chains. However, it also means

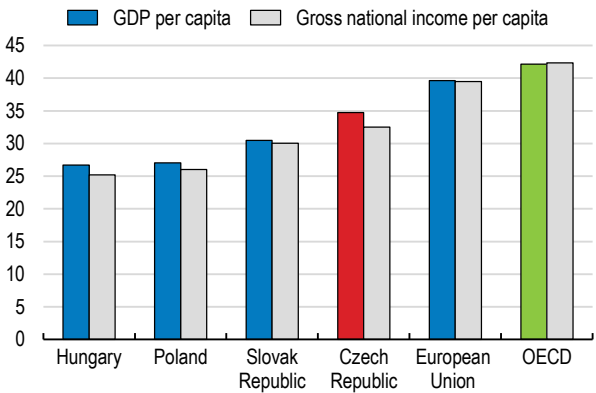
that there is room to improve the sharing of value added to foster a greater convergence to OECD standards (OECD, 2015_[13]).

Figure 17. Czech wage levels are not converging to OECD standards

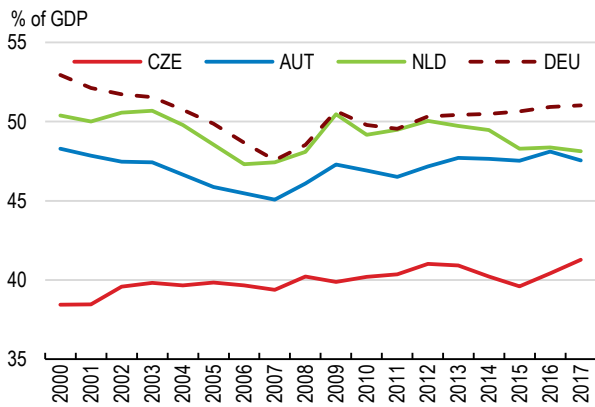
A. The Czech wage level is low compared to advanced OECD countries



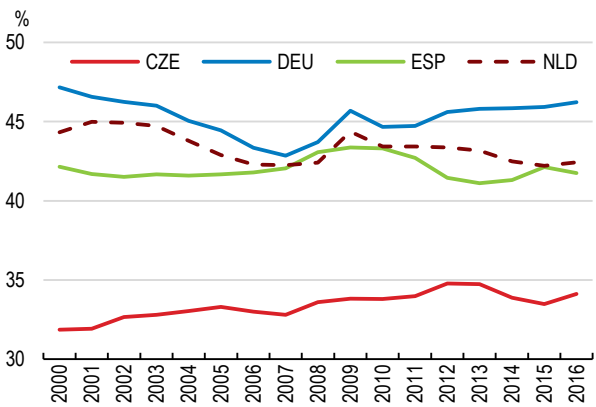
B. GDP and gross national income, Thousand USD PPP per capita, 2016



C. Compensation of employees



D. Share of wages and salaries in gross value added



Source: OECD (2018), OECD Labour Force Statistics (database); OECD Economic Outlook (database) and OECD National Accounts (database).

StatLink  <https://doi.org/10.1787/888933790581> (figure 17)

Box 1. Simulations of the potential impact of structural reforms

Simulations based on historical relationships between reforms and growth in OECD countries allow gauging the impact of structural reforms recommended in this Survey (Table 1). The estimates assume swift and full implementation of reforms. Reforms include a reduction in social security contributions, an increase in training spending and other measures to increase labour supply, notably childcare. Results in Table 7 are not fully comparable to results presented in Table 6 due to differences in methodology.

Table 7. Potential impact of structural reforms on GDP per capita after 10 years

Structural policy	Policy change		Total effect on GDP per capita
	2018	After reform	
Fiscal policy			
A. Reduce social security contributions	34%	31%	1.3%
Labour market policies¹			
B. Increase spending on activation/Training (2)	7%	14%	0.8%
C. Increase family benefits in kind	0.7%	1.0%	2.1%
D. Increase family benefits in kind (3)	0.7	1.5	5.6%
Total			
A+B+C:			4.2%
A+B+D:			7.7%

1. Table 2 presents the detailed measures.
2. Percentage of GDP per capita
3. Percentage points.

Source: OECD calculations based on Balázs and Gal (2016_[14]), "The quantification of structural reforms in OECD countries: A new framework", OECD Journal: Economic Studies, Vol. 2016/1 and Balázs (2017_[15]), "The quantification of structural reforms: taking stock of the results for OECD and non-OECD countries", OECD Economics Department Working Papers, forthcoming.

Table 8. Type of reforms used in the structural reform simulations

Structural policy	Structural policy changes
Fiscal policy	
Reduce social security contributions	Reduce social security contributions, which fund pensions, health care and unemployment benefits, from 34% of gross wages to 31%.
Labour market policies	
Increase spending on vocational training and activation.	Increase expenditure per unemployed as a percentage of GDP per capita.
Increase family benefits in kind	Increase family benefits in kind, such as childcare services, from 0.7% of GDP to 1% or 1.5% by shifting family cash benefits.

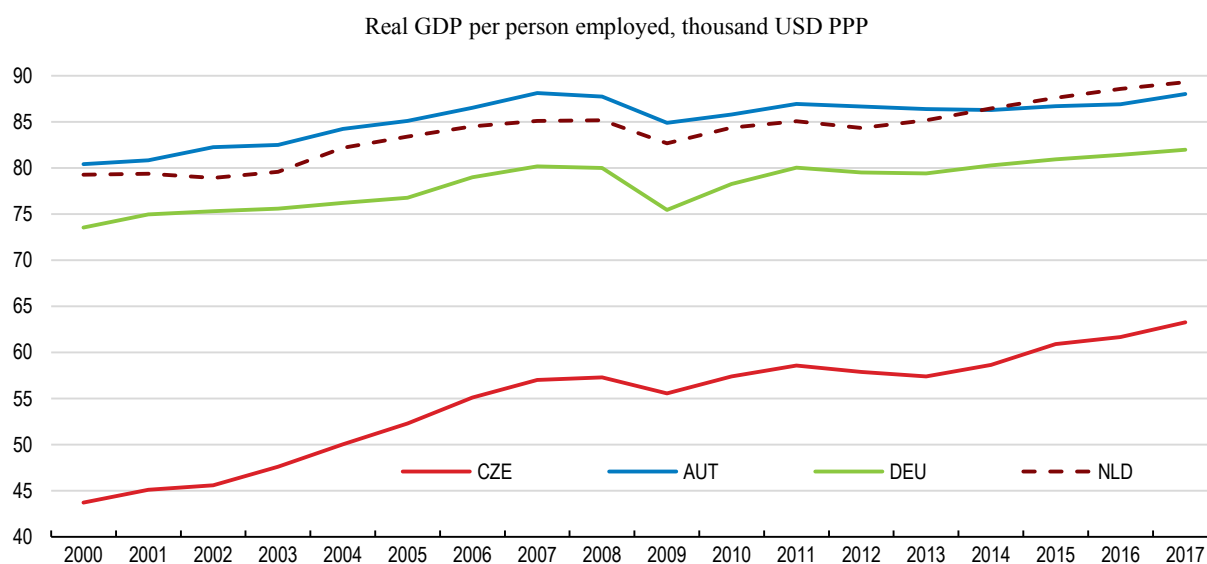
The low level of labour productivity explains the differences in wage levels compared with advanced OECD economies, which, however, allows for an increase in wages without immediately hurting firms' competitiveness (Figure 18). Over the past two decades, low labour costs have contributed to a large inflow of FDI, which has been fundamental for the Czech integration in European production networks (Pavlínek and Ženka, 2015_[16]). Recent wage developments are welcomed, but further increases should be backed by corresponding labour productivity growth. To boost productivity and provide a basis for sustainable wage growth, the economy should better leverage its

integration in global value chains (GVCs) and move up the value chain towards knowledge and technology-intensive activities (Box 2).

In the Czech Republic, product and process upgrading prevail (Antal, De Castro and Vlčková, 2015^[17]; Pavlinek and Zenka, 2011^[18]). To achieve economic upgrading, the Czech economy has to shift from low-skilled activities to higher-skilled activities (Barrientos, Gereffi and Rossi, 2011^[19]), increasing the value added that is created and improving the position of firms in GVCs (Humphrey and Schmitz, 2002^[20]). To facilitate functional and chain upgrading, innovation capabilities have to be strengthened, and a wide range of knowledge-based capital including superior managerial know-how has to be built up to identify new profitable products (OECD, 2013^[21]; OECD, 2016^[1]). Endowing workers with the right skill sets – through education and lifelong learning – is also crucial.

Benefits from economic upgrading could encompass spillover effects into the local economy extending beyond firms participating in GVCs. For example, local firms can increase productivity by learning about advanced technologies or good organisational and managerial practices even when not taking part in GVCs (Saia, Andrews and Albrizio, 2015^[22]). For local firms to be able to benefit from knowledge diffusion and technological adaptation, the workforce has to be equipped with the right skill-set (OECD, 2017^[23]; Morrison, Pietrobelli and Rabellotti, 2008^[24]; OECD, 2015^[25]). These measures could support more inclusive growth.

Figure 18. The gap between the Czech productivity level and that of advanced economies remains large



Source: OECD (2018), OECD Productivity (database).

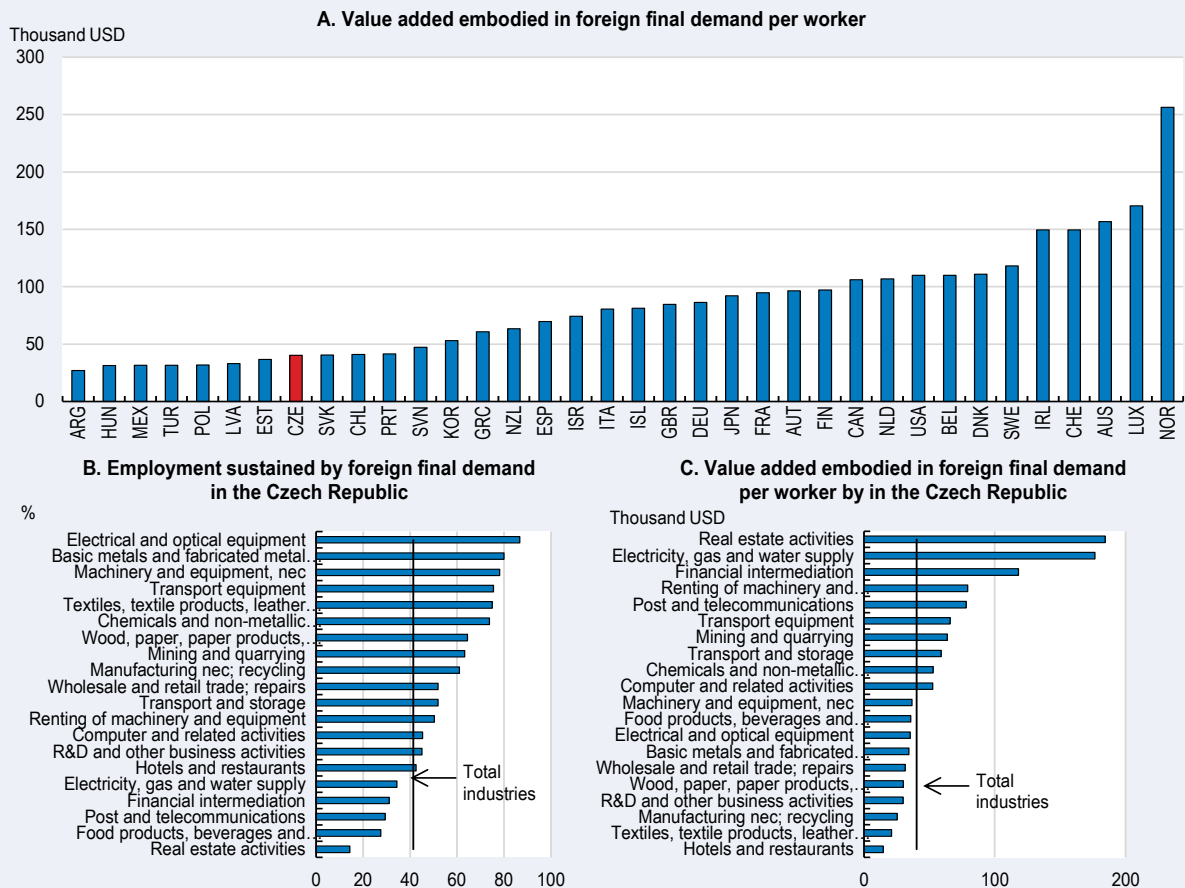
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Box 2. Economic upgrading through integration in Global Value Chains (GVCs)

Geographic proximity to Western European markets and significantly lower labour costs, a well-developed supplier base and increasing agglomeration economies have contributed to Czech Republic’s high integration in GVCs over the last two decades (Pavlínek, 2015_[26]). More than 40% of all jobs are generated through participation in GVCs (Figure 19, Panel B). In some manufacturing industries - e.g. electrical and optical, machinery and transport equipment, textiles - participation in GVCs sustains more than 75% of jobs. Despite the high integration in GVCs, the value-added resulting from this participation is low and most jobs are in less knowledge-intensive sectors (e.g. mass assembly in the automotive industry). Thus, in industries where a large share of jobs is sustained by participation in GVCs, the value added per worker is comparatively low.

Figure 19. Benefits from participating in GVCs are moderate

2011 or latest available



Source: OECD (2018), OECD STAN (database) and OECD TiVa (database).

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The amount of value created has a direct effect on the economy in terms of employment, income and also economic growth. Value added varies across the different stages of the production process, with most of it added at the beginning or the final stages. The fabrication process tends to add the least value to the product.

There are several ways to realise higher value added from GVC participation. Humphrey and Schmitz (2002_[20]) distinguish four basic types of upgrading, which have been documented in vast number of case studies (OECD, 2013_[27]):

- Process upgrading: undertaking tasks with significantly greater efficiency and lower defect rates, and process more complex orders.
- Product upgrading: supplying higher value-added products owing to their superior technological sophistication and quality, and also introducing novel products faster.
- Functional upgrading: starting to supply competitive products or services in value chain activities which are associated with higher value added.
- Chain upgrading: participating in new GVCs that produce higher value-added goods or services, often leveraging the knowledge and skill acquired from the current participation in GVCs.

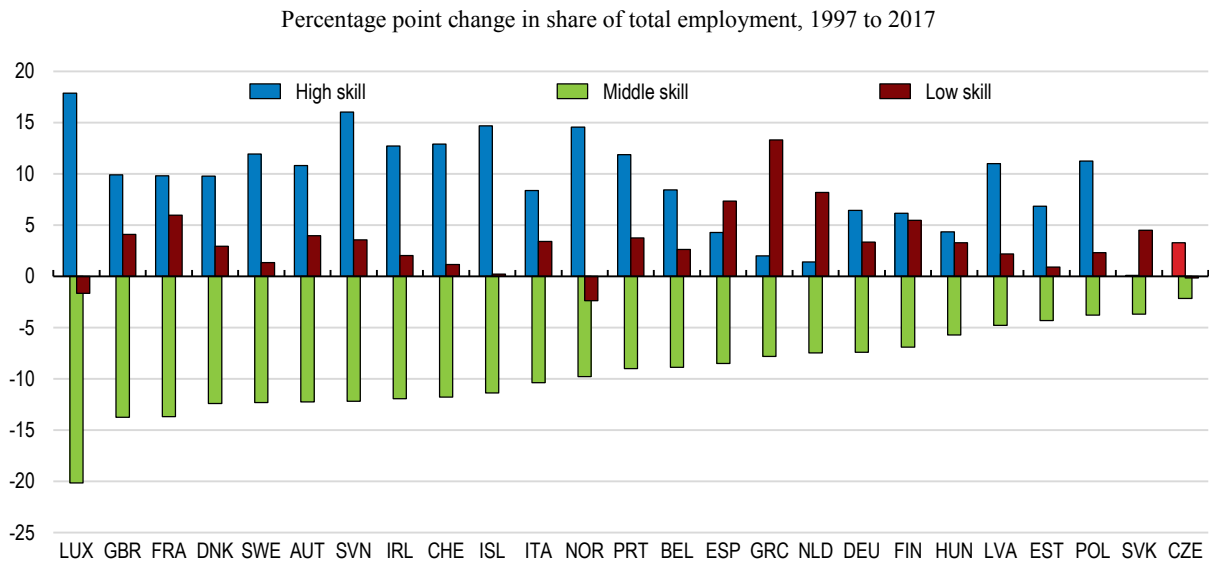
Source: Based on OECD (2017_[28]), *Employment Outlook 2017*; OECD (2017_[23]), *Skills Outlook 2017: Skills and Global Value Chains*.

Addressing labour market challenges

Structural changes in the labour market require adjustments of skills

The Czech labour market is shifting towards higher-skilled employment. Since transitioning from central planning, the service sector has expanded and manufacturing has become tightly integrated into global value chains, changing more and more the skill set that was needed in the labour market (OECD, 2014_[29]). From 1997 to 2017, employment shifted from medium-skilled towards high-skilled jobs (Figure 20). Over this period, technology adoption measured as the level of ICT capital services per hour worked has grown by about 300% (OECD, 2017_[23]). The increase in computerisation and automation not only led to a change of job profiles, but also to a loss of non-cognitive routine jobs due to automation.

Sectors such as manufacturing, IT and business services will continue expanding, creating new jobs in these sectors. Employment projections from CEDEFOP (Figure 21) suggest that the need for high-skilled workers will increase, whereas the demand will decrease in low and middle-skilled employment. Similar results are found by Antal et al. (2015_[17]) who showed that low-skilled jobs are at the greatest risk. By contrast, the demand for highly skilled workers, especially those with a technical education, is found to increase. Providing workers with the right skill set and training to adapt to a changing environment will also increase the resilience towards automation. Estimates suggest that about 10% of jobs are at high risk of being automated within the next 10 to 20 years, and another 36% are at risk of significant change (Arntz, Gregory and Zierahn, 2016_[30]).

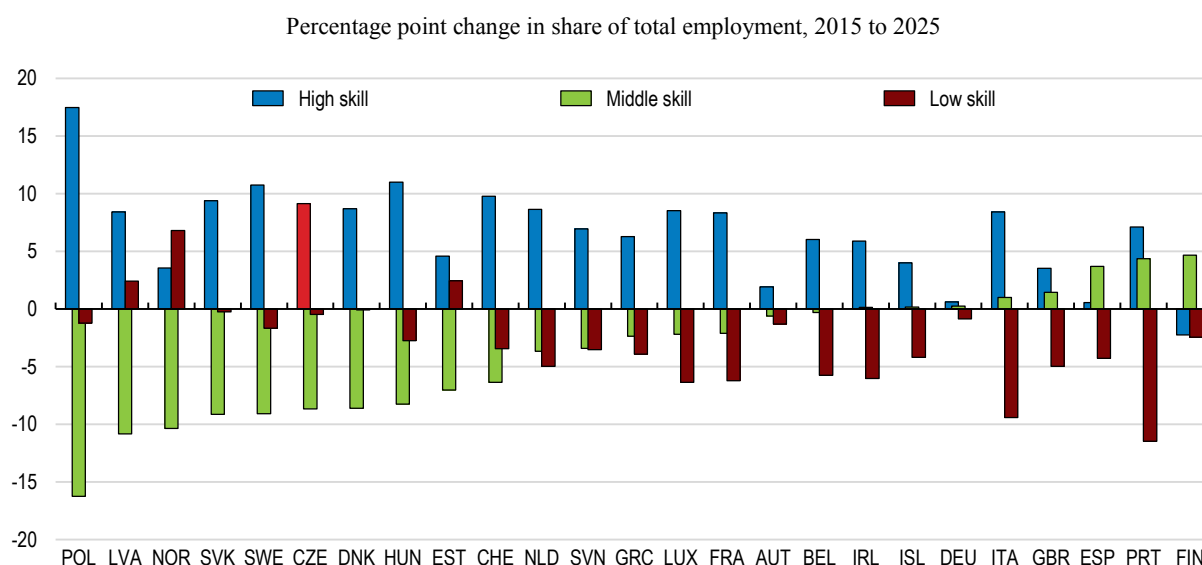
Figure 20. The labour market has shifted from medium towards high-skilled employment

Note: High-skill occupations include jobs classified under the ISCO-88 major groups 1, 2, and 3. That is, legislators, senior officials, and managers (group 1), professionals (group 2), and technicians and associate professionals (group 3). Middle-skill occupations include jobs classified under the ISCO-88 major groups 4, 7, and 8. That is, clerks (group 4), craft and related trades workers (group 7), and plant and machine operators and assemblers (group 8). Low-skill occupations include jobs classified under the ISCO-88 major groups 5 and 9. That is, service workers and shop and market sales workers (group 5), and elementary occupations (group 9). As agricultural, fishery and mining industries were not included in the analysis, those occupations within ISCO-88 group 6 (agricultural and fisheries workers) were likewise excluded. The above chart includes 15 of the 18 listed industries. The excluded industries are the following: Agriculture, hunting, forestry and fishing (1), mining and quarrying (2), and community, social and personal services (18). As a result of unavailable data for 1997, a different starting year was used for some countries. Latvia and the Slovak Republic used 1998.

Source: Eurostat.

StatLink  <http://dx.doi.org/10.1787/888933790638>

Preparing the labour market for technological change is high on the political agenda. Significant support is currently devoted to the area of digital competences as well as preparing the economy and society for the next industrial revolution. A key policy of the Industry 4.0 strategy is to upgrade data and information infrastructure to facilitate knowledge diffusion and adoption of technological change. This is expected to increase competitiveness through more efficient manufacturing, meaning faster, cheaper and resource-effective production and to enhance the ability of Czech companies to be involved in GVCs (European Commission, 2017_[31]). The implementation of the Industry 4.0 strategy should be accelerated and a funding strategy for participating projects needs to be developed. Furthermore, policy actions that foster productivity and innovation as highlighted in the last survey (OECD, 2016_[1]) have to follow.

Figure 21. The shift towards high-skilled employment is expected to continue

Note: High-skill occupations include jobs classified under the ISCO-88 major groups 1, 2, and 3. That is, legislators, senior officials, and managers (group 1), professionals (group 2), and technicians and associate professionals (group 3). Middle-skill occupations include jobs classified under the ISCO-88 major groups 4, 7, and 8. That is, clerks (group 4), craft and related trades workers (group 7), and plant and machine operators and assemblers (group 8). Low-skill occupations include jobs classified under the ISCO-88 major groups 5 and 9. That is, service workers and shop and market sales workers (group 5), and elementary occupations (group 9). As agricultural, fishery and mining industries were not included in the analysis, those occupations within ISCO-88 group 6 (agricultural and fisheries workers) were likewise excluded. The above chart includes 15 of the 18 listed industries. The excluded industries are the following: Agriculture, hunting, forestry and fishing (1), mining and quarrying (2), and community, social and personal services (18). As a result of unavailable data for 1996, a different starting year was used for some countries. Finland, Sweden and the Czech Republic used 1997, while the Slovak Republic used 1998.

Source: European Centre for the Development of Vocational Training (Cedefop) (2017), Forecasting skill demand and supply, <http://www.cedefop.europa.eu/en/events-and-projects/projects/forecasting-skill-demand-and-supply/>.

StatLink  <http://dx.doi.org/10.1787/888933790657>

Identifying skill needs and preparing the workforce for the future

The relation of workers graduated in a field to the number of jobs in that respective field, indicates a lack of graduates in mathematics, science and statistics, health and welfare, but also in services such as finance and insurance (Montt, 2015_[32]). Current developments suggest that the stock of skills in the labour force may not suffice to address emerging shortages in certain sectors, such as health and the IT (European Centre for the Development of Vocational Training, 2017_[33]). Although the share of the population with tertiary education has been increasing from 23% in 2010 to 33% in 2016, students do not graduate in fields that are in high demand of firms. For example, in 2015 only 4% of tertiary graduates had studied information and communication technologies, and 10% health and welfare (OECD, 2017_[34]). Moreover, this trend is expected to continue as the share of tertiary students currently enrolled in IT or health care does not indicate a significant change in the short to medium term. About 5% of students in 2015 were enrolled in information and communication technologies, and 12% in health care (OECD, 2017_[34]).

To guide career decisions and assess potential skill gaps, the Czech Republic is aiming to make labour market forecasts with a focus on emerging skill needs within the framework of the KOMPAS project. Providing effective, up-to-date and tailored information, advice and guidance is one crucial element in developing strategies to address emerging skill gaps. In combination with high-quality initial education and training, this assessment forms the basis for setting incentives for individuals to invest in those skills most needed and to raise educational capacities in the relevant institutions to address the skill gap in the long term (OECD, 2017_[35]). Such initiatives should further be part of a sustainable framework and could be directly linked with actual labour market policies and trainings.

Long-term strategies need to be complemented by short- and medium-term solutions focusing on skill upgrading of the existing workforce. As shifting the skill composition of the labour force through new entrants takes time, the current labour force should be provided with adequate training options to adapt to new skill demands. Vocational education should be further developed to play a significant role in overcoming skill mismatch through the involvement of employers to supply workers with the needed skill set. Support for vocational education is provided through projects that aim to increase the professional skills of employees, such as “Support for Vocational Training for Employees II” (POVEZ II) and “Education and Skills for the labour market II” (VDPT II). Retraining should encompass solutions for all skill ranges based on modern systems of lifelong learning that help workers to adapt and update their skills over the course of their career. In particular, specific programmes should be developed for old-aged workers to ensure that they are equipped to adapt and participate in the changing economy.

Changes in the occupational structure evoked by digitalisation and automation require a holistic policy framework to contain the risk of increasing inequality. The social security system needs to adapt to new forms of employment and ensure adequate coverage for workers on non-standard work contracts (OECD, 2017_[35]). For example, rather than linking entitlements to the employment history, they should be linked to the individual and therefore allowing greater labour mobility. Moreover, new forms of employment which do not fit easily with the standard definition of employment need to be covered by the tax system and require solutions with respect to the minimum wage, employment protection legislation, working time regulations and regulations to safeguard occupational health and safety (OECD, 2017_[35]). As such, labour market and skills policies as well as tax and benefit schemes will need to be adjusted to promote skill adaptation and labour mobility. At the same time, it needs to be ensured that even low-paying work provides a sufficient income to avoid poverty.

Mobilising domestic labour

To ensure economic growth, all potential sources of labour supply need to be mobilised. The increasing shortage in the labour market has already led to a decline in the employment gap of traditionally disadvantaged groups, such as the young (15-29-year-olds), non-native, old age, people with disabilities and mothers of young children (OECD, 2017_[28]). Despite the slight improvements, further advances have to be made as the labour market misses out on talent (Table 9). Participation to the labour market of inactive persons could be favoured through special training and adaptation programmes.

Though participation of Czech women in the labour market is high, available skills of women are not utilised fully in the labour market. Women are increasingly investing in their education and over the past few years, more women than men graduated from tertiary education (63% of first-time graduates in 2015 were female). While men tend to

be overrepresented in most STEM fields, female graduates form the majority in mathematics and natural sciences (59.6%) and health and welfare studies (83.5%). Although these skills are in high demand, they are not available to the labour market as one out of three women aged 25 to 34 that graduated in a STEM field with a tertiary degree reported being inactive in 2016 (OECD, 2018_[36]). For the ones aged 35 to 44, still 15% reported being inactive. By contrast, less than 7% of men having graduated with a STEM field reported being inactive in both age groups combined.

Despite recent efforts, reconciling career and family choices continues to be a problem for women in the Czech Republic. As already highlighted in last surveys (OECD, 2016_[1]; OECD, 2014_[29]), female labour force participation tends to fall with childbirth contributing to gender inequality over the subsequent career path. While the employment rate between men and childless women differs only slightly, female labour force participation drops once women have children (Eurostat, 2017_[37]). The difference between the employment rate of women aged 25-49 without children and with children under the age of 6 in 2016 exceeds 40 percentage points (see Figure 22). This places the Czech Republic among the three EU countries (together with Slovakia and Hungary) with the most sizeable consequences of childbirth on mothers' employment. The break in the employment history of mothers further translates into gender gaps in the overall employment rate and lower average earnings.

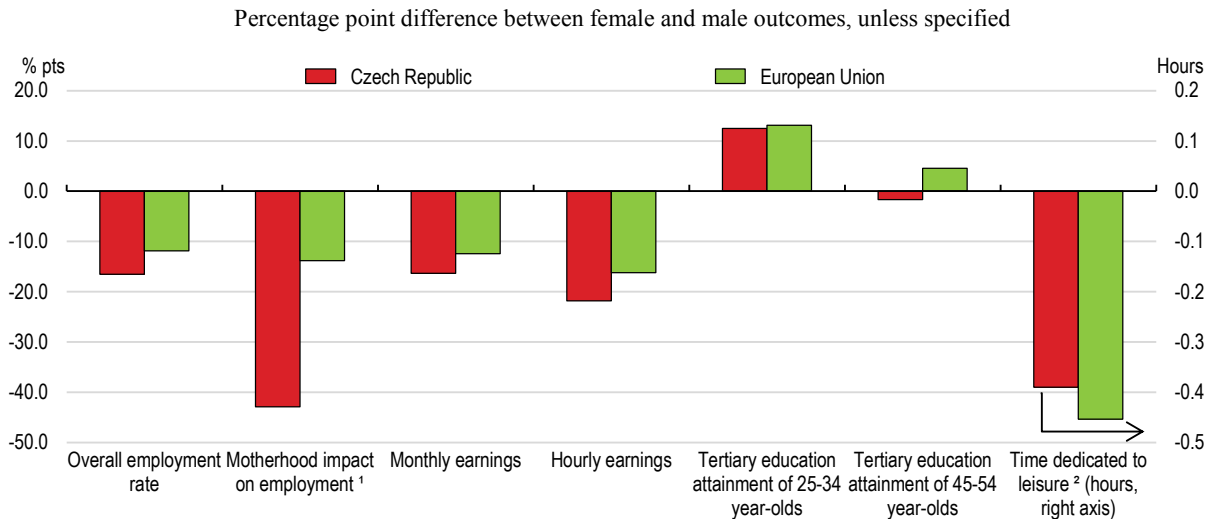
The long break in young mothers' employment is partly due to parental leave rules, which do not incentivise resuming work. Spending on maternity and parental leave is the highest among OECD countries, reflecting a public policy preference for home care over formal childcare. The Czech Republic offers up to 216 weeks of maternity and parental leave, which is significantly higher than the OECD average of about 85 weeks (19.1 weeks of maternity and 65.7 weeks of parental leave in 2016) (OECD, 2018_[38]). However, the total amount of parental allowance can already be drawn in six months of parental leave. Furthermore, take-up rates are among the highest in the EU. While parental leave can be shared between the parents, mothers tend to be the principal user. In 2015, only about 2% of men used any kind of parental leave (OECD, 2016_[39]). Moreover, from 2018 the government is increasing pro-family spending by CZK 5 billion to introduce paternity leave and increase social benefits. As highlighted in the last survey, conditional on the expansion of affordable and quality childcare, the maximum duration of parental leave should be reduced as planned. Fathers should be encouraged to take some of the parental leave. Child care facilities should be further developed by redirecting funds from family transfers towards OECD average.

Long maternity leaves are also due to a lack of accessible and affordable childcare services for young children. In 2014, only 5.6% of children aged two years or less were enrolled in formal childcare services and pre-school facilities. As such, the rate is significantly lower than the EU average (31%) and OECD-28 average (34%) (OECD, 2016_[40]). As the maximum length of entitlement for parental allowance is until the child is aged up to 4 years, enrolment rates of children aged 3 to 5 in pre-primary and primary education are much higher at around 80%. However, participation rates for three-year-olds are with 68% far lower than those for the five-year-olds (89%), indicating a shortage of child-care facilities. Thus, out of the approximately 20% of respondents with unmet need for formal childcare services, about 28.5% declared as main reason that no child care places were available or that the opening hours were unsuitable (Eurostat, 2018_[41]).

The Czech government has introduced new measures to expand access to child-care facilities. Following an amendment to the education act of 2016, public kindergartens are

in the process of being scaled up, guaranteeing a place for children older than 4 years since September 2017. From 2018, there will be guaranteed places for all children older than three years and from 2020 for all children older than 2 years. In addition, firms are incentivised to provide children groups for children of their employees. By 2017, firms, NGO's and others provided 431 children groups accommodating 5 530 children (Ministry of Labour and Social Affairs). These developments are in line with previous recommendations regarding the expansion of child care and should be continued.

Figure 22. Gender gaps in the labour market are large



1. Difference in employment rates of women aged 20-49 with children up to 6 years old and those without children.

2. The number of hours per day that, on average, full-time employed people spend on leisure and on personal care activities. This is one component of work-life balance dimension of the OECD Better life index 2017.

Source: OECD (2018), OECD Labour Force Statistics (database); Eurostat; OECD Earnings (database), OECD (2018), Education at a Glance (database); and OECD (2017), Better Life Index 2017.

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Childbirth and long maternity leave affect the career opportunities of women. The unemployment rate of women with children is twice as much as that of childless women. Re-entering the labour market after taking parental leave seems to be especially difficult. About 60% of unemployed women with children up to 6 years became unemployed immediately after their parental leave. Returning to work is partly hindered by inflexible work arrangements. In 2016, only 9.8% of working women in the 20-64 age group worked part-time, most of them mothers with children of up to 6 years. The EU average of women working part-time was significantly higher with 31.4% (Eurostat, 2018^[42]). Increasing the flexibility of jobs by providing and enforcing existing rights for part-time work, flexible teleworking arrangements and shared jobs can support the re-entering of skilled female labour into the market.

Attracting skilled labour and integrating migrant workers

To compensate for labour shortages in the context of an ageing society, policies can attract skilled labour into the Czech Republic. However, attracting foreign workers from outside the EU faces several challenges, including language barriers and current migration policies. By 2015, most newly arrived migrants were from Eastern Europe, i.e.

from the Slovak Republic, Ukraine and Russia. In November 2015, a special migration procedure was introduced for high-skilled workers from Ukraine. This project “Special Procedures for Highly Qualified Workers from Ukraine” gave participants priority access to embassies when applying for the Employee Card. In August 2016, a similar project, “Special treatment for qualified workers from Ukraine”, was launched, with a capacity of 3 800 specialised workers per year. As there were high interest and uptake, the capacity was increased in February 2017 and in January 2018. Moreover, new programmes were launched for workers from Mongolia and the Philippines in 2018.

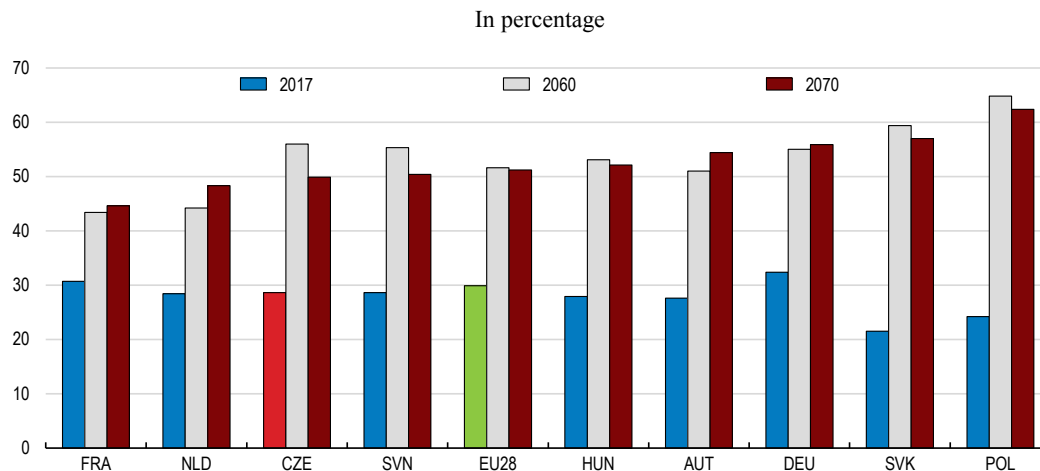
Migration policies should be reconsidered to attract skilled workers from countries other than Ukraine and Eastern Europe. Easy accessible information about educational degree verification, work opportunities and the availability of language courses could raise awareness among skilled workers to consider the Czech Republic as a destination. Already, a network of 13 regional integration support centres to co-ordinate the efforts of local authorities, NGOs and other stakeholders has been set up to provide information, advice, and integration courses and co-ordinate the development of local integration projects co-funded by the European Social Fund. These efforts should be scaled up to facilitate the integration of workers and their families.

Table 9. Past recommendations for improving innovation and skills mismatch

Recommendations in previous Surveys	Action taken
Remove the barriers to the mobility of workers to reduce skill mismatch by improving the functioning of the private rental market, lowering the cost of closing a business and easing the stringency of employment protection legislation.	In 2016, a financial contribution for jobseekers who, due to regional disparities (of a structural and qualification nature), have to commute for work outside their place of residence was introduced. The allowance is provided monthly, for a 12-month period, at a flat rate based on the commuting distance. Also, an allowance to change place of residence because of employment was introduced. This financial subsidy of CZK 50 000 can be provided to an applicant who moved house for the above-mentioned reasons within the territory of the Czech Republic.
Accelerate the creation of funds and guarantee programmes to support SMEs and innovation.	In progress. Example of policy initiatives: <ul style="list-style-type: none"> • In 2017, 2142 SMEs were provided support amounting to EUR 156.2 million within the framework of the program Guarantee 2015-2023. • During 2017 the first programs supporting venture capital were in co-operation with European Investment Fund (EIF). In January 2017 the Fund of funds managed by EIF was created, combining EUR 40 million from OP EIC (program Venture Capital) and 10 million from EIF RCR mandate.

Ageing will weigh on public finance

The Czech population is ageing more rapidly than in most European countries. According to recent European projections, the demographic old-age dependency ratio in the European Union is about to rise from the current 29.6% to 51.2% in 2070 (European Commission, 2018_[43]). The Czech situation follows this average trend with projections going from 28.1% in 2016 to 49.7% in 2070 with a peak at 56.1% in 2058 (Figure 23). This peak is higher than the average for the EU and is caused mainly by large generations born in the 1970s and the drop in the turn of millennia, which was connected to the change of lifestyle after the Velvet Revolution.

Figure 23. The old-age dependency ratio is projected to peak around 2060

Note: Old-age dependency ratio is the ratio of population aged 65 and more to the working-age population aged 15-64.

Source: Eurostat.

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Population ageing will affect public finances. Not only will spending on pensions increase, but also spending on health and long-term care. It is, however, the old-age pension scheme that brings the biggest burden on public finance in the context of ageing (Table 10).

The main pillar is a mandatory defined benefit pay-as-you go public system. A second pillar was introduced in 2013 and abolished in 2016. It was an attempt to set up a voluntary defined contribution funded scheme providing complimentary pensions, which would have allowed discharging the public scheme partially. A third pillar exists and allows voluntary savings in a fully funded, defined contribution scheme. Although the number of participants is high, the savings are low.

Pension spending in terms of GDP ratios are projected to be stable over the next 15 years. However, a steep rise is expected to occur over the 20 years after 2030, accounting for more than 2.5 percentage points of GDP. In 2017, the Czech government withdrew the automatic mechanism of increasing statutory retirement age and put a ceiling at the age of 65 (Table 11). However, every five years, the Ministry of Labour and Social Affairs will prepare a report on life expectancy and suggest a shift of statutory retirement age to assure that on average everyone spends a quarter of his life in retirement. Under this mechanism, the change of retirement age is dependent on government decision and prone to non-compliance.

The recently introduced ceiling on retirement age is worsening the effect of pension spending on public finances. As in many OECD countries, the Czech Republic should follow the strict and tight linking of retirement age with life expectancy, which would limit the increase of pension spending (Table 10).

Also, the recent changes in the pension indexation rule are pushing up pension spending along the projection horizon. Currently, pensions are indexed to a combination of the consumer price index (or pensioners' cost of living index, whichever is higher) and real wage growth (half of the growth). Moreover, if the growth of pensions were to be less

than 2.7% according to the standard formula, the government has the discretion to raise pensions by as much as 2.7%. Before, it was the sum of inflation and one third of real wage growth. This new rule makes the expenditure approximately 0.3 percentage points higher at the projection horizon compared to the previous indexation rule (Ministry of Finance, 2017_[44]). The new indexation rule should help prevent old age poverty by targeting an average replacement rate at around 40%.

Table 10. Pension expenditure projections

	Percentage of GDP							
	2016	2020	2030	2040	2050	2060	2070	Peak year
Total public pensions	8.2	8.1	8.2	9.2	10.8	11.6	10.9	2059
of which								
old-age pensions	6.8	6.7	6.8	7.7	9.4	10.2	9.5	2059
disability pensions	0.9	0.8	0.8	0.8	0.8	0.7	0.8	2016
survivor pensions	0.5	0.6	0.6	0.7	0.7	0.7	0.7	2062
linked to life expectancy	8.2	8.1	8.0	8.5	9.7	10.2	9.3	2059

Note: The baseline scenario is computed with the fixed ceiling on statutory retirement age. The last row represents a scenario linking the statutory retirement age to the life expectancy.

Source: Ministry of Finance (2017_[44]).

Table 11. Past recommendations on pension reforms

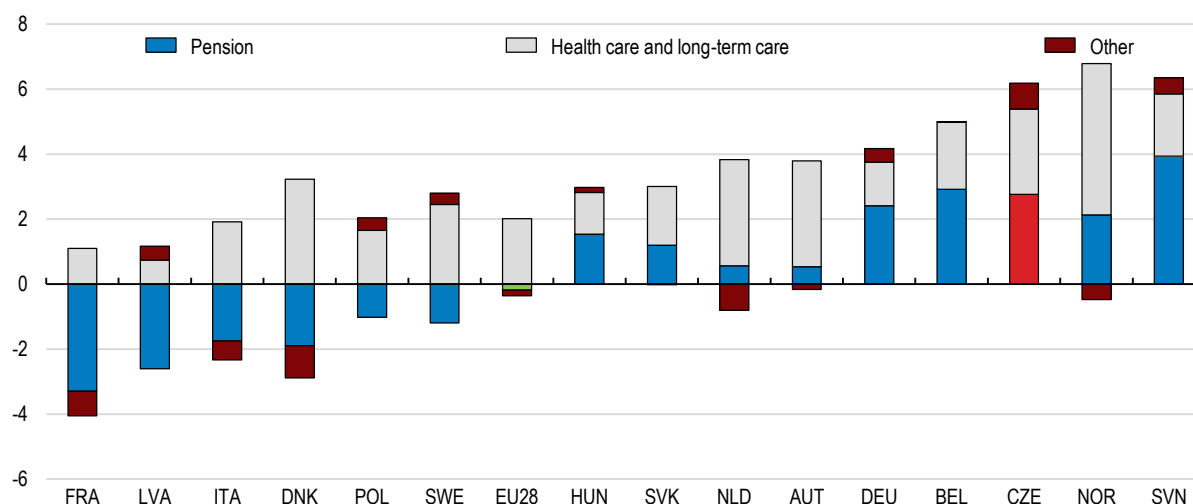
Recommendations in previous Surveys	Action taken
Take steps to secure an increasing effective retirement age.	Pension indexation changes introduced in 2017 are more generous to protect the purchasing power of pensions.
Continue to ensure that the indexation of pensions does not lead to old-age poverty problems.	Retirement age increases have been capped at 65 years of age for both men and women.
Consider options for diversifying income sources for pensioners.	
An additional measure could be to bring forward the increases in the statutory retirement age.	

Health care and long-term care expenditures are also projected to rise in the upcoming decades. In comparison with other EU countries, the Czech Republic is going to face above average increases as share of GDP (Figure 24). Since this comparison is based on AWG reference scenarios (European Commission, 2018_[43]), it disregards the non-demographic aspects and considers mainly the effect of ageing. The actual increase is thus likely to be even higher (see Chapter 1).

Financing pensions, health care and long-term care currently requires more than 43% of the government budget and the requirements will rise substantially in the coming decades. While keeping the size of the budget in relation to GDP constant (around 35%), the projected social expenditures in 2060 would take more than 75% of the budget (Table 12). Thus, it would mean either serious crowding out of other expenditures (wages in public administration and education, investments, etc.), or an expansion of the government budget by an increase of the tax burden. Linking tightly retirement age to life expectancy will limit the impact of ageing on public finances. More efficiency in health care delivery will also help limit the impact of aging on health spending (see Chapter 1).

Figure 24. Ageing will have a substantial impact on public finances

Change in gross public expenditure between 2016 and 2070 in percentage points of GDP



Note: Other expenditure covers education and unemployment benefits. Baseline scenarios are used for pensions, education and unemployment benefits, and AWG reference scenarios for health care and long-term care.

Source: EC (2018), Ageing Report: Economic and budgetary projections for the 28 Member States (2016-2070) and Ministry of Finance of the Czech Republic (2017), Pension projections of the Czech Republic, October 2017.

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Table 12. Expenditure projections as shares of the government budget

	to GDP		to govt. budget	
	2017	2060	2017	2060
Pensions	8.2	11.6	32.4	45.7
Old age pensions	6.8	10.2	26.8	40.2
Health care	6.2	9.6		
financed by employees, employers and self-employed	4.1	3.3		
financed by the government budget	2.1	6.3	8.4	24.7
Social long-term care	0.7	1.4	2.8	5.5

Note: The share of health care financed by the government budget is only approximated. It is not possible to get it directly from the budget, as it is decomposed in various items, not only direct payments to health insurance funds, but partly also in other social transfers and transfers to regional budgets. Projections to 2060 are estimated assuming fixed ratio of the budget to GDP. Long-term care does not cover health long-term care which is included in health care expenditures. Total government expenditures accounted for CZK 1 279.8 billion in 2017. Pensions covered 414.7 billion (32.4%), from which 343.4 billion went particularly in old-age pensions. Health care was financed mostly through direct contributions of employees, employers and self-employed to health insurance funds, which is not recorded in the government budget. The government expenditure is thus approximated subtracting these contributions from the total public health expenditures, assuming that the rest must be covered by the public budgets. The share in 2060 is estimated with an assumption of a fixed burden on one person in terms of GDP ratio. The decreasing ratio is a result of shrinking working age population. Health spending increases include non-demographic factors and correspond to OECD estimates.

Source: EC (2018), Ageing Report: Economic and budgetary projections for the 28 Member States (2016-2070), OECD projections for health spending.

Greening growth and addressing environmental issues

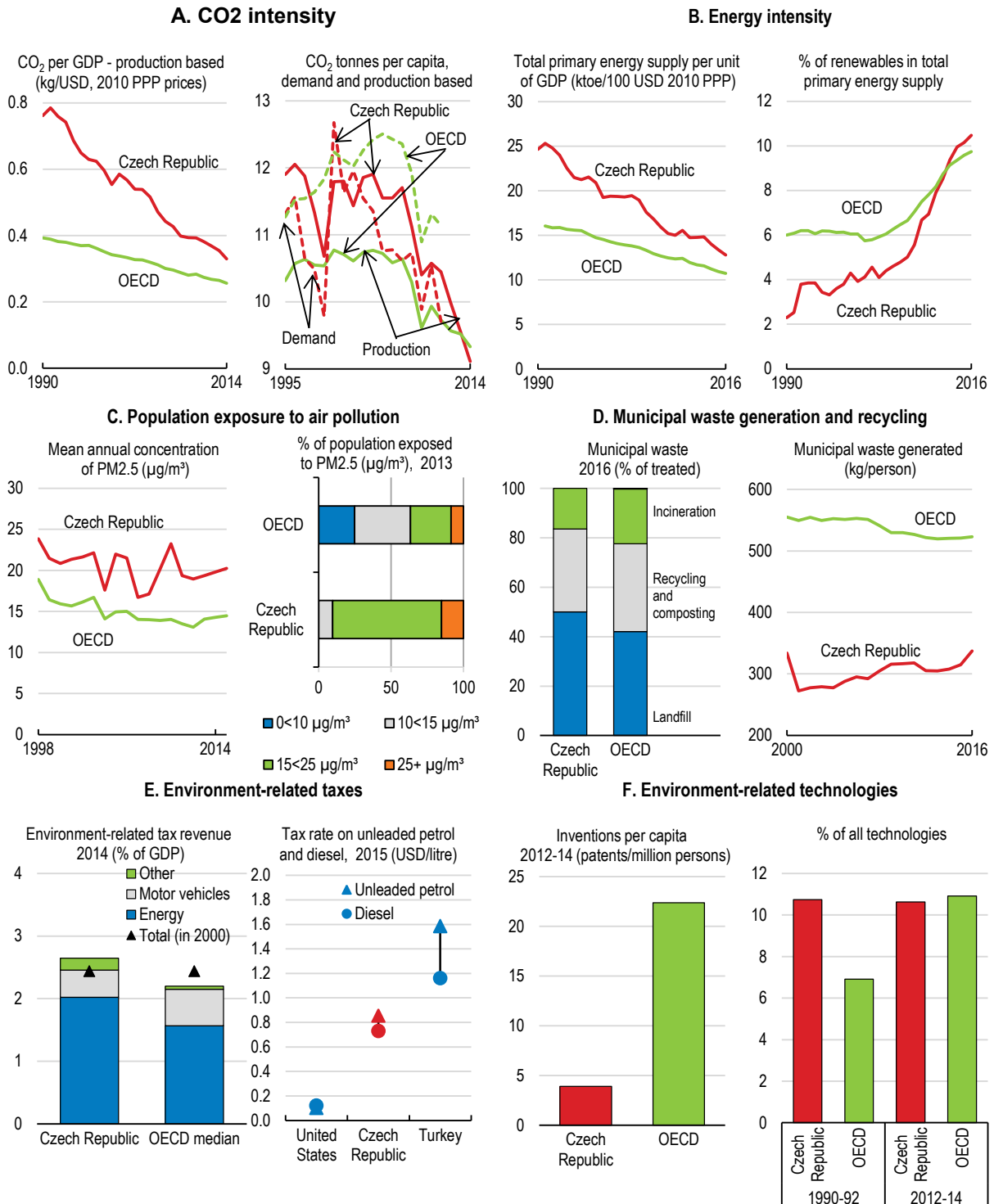
The 2018 OECD Environmental Performance Review of the Czech Republic finds that the country performs well on a number of Sustainable Development Goals such as poverty, water and biodiversity. The 2017 “Czech Republic 2030” strategy defines priorities for implementing the 2030 Agenda. However, the economy remains among the most energy- and carbon-intensive in the OECD, and the population is exposed to high levels of air pollution due to reliance on coal (Figure 25).

Strengthening political commitment to a low-carbon economy and aligning the State Energy Policy with the Paris Agreement objectives are key priorities. The Review analyses the potential for a review of the tax structure to better align economic and environmental objectives. Pricing carbon will help in tackling climate change and air pollution cost-effectively. It could contribute to improving energy affordability.

The Czech Republic has progressed in increasing the use of environmental and regulatory impact assessments, as well as strategic environmental assessments of policies. But it could go further in greater use of cost-benefit analysis and in ex-post analysis of policy impacts and efficiency. Public participation in environmental decision making and access to information have improved, but on issues including the liability regime and access to environmental justice, current practices need upgrading.

In considering particular policy areas, the Czech Republic made progress in waste recovery but continues to rely on landfilling (Figure 25, Panel D). The Review sees the need for promptly adopting the pending new Waste Act and harmonising the national waste management information. It also reviews how compact city policies can help the future urban structure produce a better balance between affordable housing with adequate mobility and low air pollution.

Figure 25. Green growth indicators: Czech Republic



Source: OECD (2018), Green Growth Indicators.

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Box 3. Recommendations of the 2018 OECD Environmental Performance Review

The Review makes a wide range of specific recommendations, of which the following is a non-exhaustive summary.

Many specific policy recommendations highlight that policy coherence and adequate price signals are key to progress towards green growth:

- Strengthen political commitment to a low-carbon economy: develop an integrated energy and climate plan to reach the 2030 and 2050 GHG reduction targets.
- Introduce a carbon component in energy taxation for carbon emissions outside the EU ETS and provide a stronger and more consistent price signal across the economy.
- Consider recycling part of revenue from higher taxes on heating fuels and electricity to vulnerable households using an income-tested cash transfer.
- Raise the excise tax on diesel to at least match that on petrol, and index the taxes on both fuels to inflation.
- Extend distance-based charging to address air pollution and congestion and tighten environmental criteria of vehicle taxes to promote fleet renewal towards cleaner vehicles.
- Review waste-related taxation in line with the waste hierarchy and ensure full cost recovery for municipal waste service provision.
- Reduce agricultural pollution by reducing fertiliser and pesticide use, including through taxation.
- Apply water user charges that allow sustainable cost recovery. Ensure that groundwater abstraction charges reflect resource scarcity and remove exemptions that are not justified on environmental grounds.
- Consider establishing a green tax commission, possibly as part of the National Budgetary Council, to review the environmental effects of fiscal instruments.

In some cases, environmental governance and management could be strengthened to improve co-ordination, efficiency and enforcement. For example:

- Enhance collaboration among municipalities to make use of economies of scale and co-ordination in service provision, e.g. waste treatment and disposal, water supply and treatment.
- Improve vertical co-ordination by strengthening guidance from the Ministry of Environment to regional and local authorities.
- Use more cost-benefit analysis for assessing environmental policies, and expand ex post evaluation.
- Establish and enforce strict (independent of faults) liability for environmental damage by removing exemptions for compliance with

environmental permits.

- Ensure that the public and NGOs have a right to go to court if the competent authority fails to act in response to non-compliance.

Source: OECD (2018), Environmental Performance Review of the Czech Republic.

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