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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of the Czech Republic were reviewed by the Committee on 14 October 2020. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 November 2020.

The Secretariat's draft report was prepared for the Committee by Urban Sila and Christine de la Maisonneuve under the supervision of Mame Fatou Diagne. The Survey also benefited from contributions by Adéla Kelnerová, Kass Forman, Carissa Munro and Emilie Cazenave. Statistical research assistance was provided by Corinne Chanteloup and editorial assistance by Sylvie Ricordeau.

The previous *Survey* of the Czech Republic was issued in July 2018. Information about the latest as well as previous Surveys and more information about how *Surveys* are prepared is available at http://www.oecd.org/eco/surveys

BASIC STATISTICS OF CZECH REPUBLIC, 2019

(Numbers in parentheses refer to the OECD average)*

BASIC STATISTICS OF CZECH REPUBLIC, 2019
(Numbers in parentheses refer to the OECD average)*

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	10.7		Population density per km²	137.9	(37.9)
Under 15 (%)	15.4	(17.7)	Life expectancy (years, 2018)	79.1	(80.6)
Over 65 (%)	20.2	(17.6)	Men	76.2	(78.0)
Foreign-born (%, 2012)	7.1		Women	82.0	(83.3)
Latest 5-year average growth (%)	0.3	(0.6)	Latest general election	October 2017	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	250.8		Primary sector	2.1	(2.4)
In current prices (billion CZK)	5 751.3		Industry including construction	34.8	(26.1)
Latest 5-year average real growth (%)	3.7	(2.2)	Services	63.0	(71.4)
Per capita (000 USD PPP)	43.3	(46.7)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure	41.3	(40.6)	Gross financial debt	37.7	(110.0)
Revenue	41.6	(37.6)	Net financial debt	7.7	(65.0)
EXTERNAL ACCOUNTS					
Exchange rate (CZK per USD)	22.93		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	12.44		Machinery and transport equipment	59.1	
In per cent of GDP			Manufactured goods	14.2	
Exports of goods and services	74.4	(54.2)	Miscellaneous manufactured articles	11.9	
Imports of goods and services	68.4	(50.6)	Main imports (% of total merchandise imports)		
Current account balance	-0.3	(0.3)	Machinery and transport equipment	48.3	
Net international investment position	-20.6		Manufactured goods	15.7	
			Miscellaneous manufactured articles	11.6	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate for 15-64 year-olds (%)	75.1	(68.7)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	2.0	(5.4)
Men	82.0	(76.2)	Youth (age 15-24, %)	5.6	(11.7)
Women	68.1	(61.3)	Long-term unemployed (1 year and over, %)	0.6	(1.4)
Participation rate for 15-64 year-olds (%)	76.7	(72.8)	Tertiary educational attainment 25-64 year-olds (%)	24.2	(38.0)
Average hours worked per year	1 788	(1 726)	Gross domestic expenditure on R&D (% of GDP, 2018)	1.9	(2.4)
ENVIRONMENT					
Total primary energy supply per capita (toe)	4.0	(3.9)	CO_2 emissions from fuel combustion per capita (tonnes)	9.0	(8.3)
Renewables (%)	10.7	(10.8)	Water abstractions per capita (1 000 m^3, 2018)	0.15	
Exposure to air pollution (more than 10 µg/m^3 of PM2.5, % of population, 2017)	99.9	(58.7)	Municipal waste per capita (tonnes, 2018)	0.35	(0.50)
SOCIETY					
Income inequality (Gini coefficient, 2017)	0.25	(0.31)	Education outcomes (PISA score, 2018)		
Relative poverty rate (%, 2017)	5.6	(11.5)	Reading	490	(487)
Median disposable household income (000 USD PPP, 2017)	19.6	(24.0)	Mathematics	499	(489)
Public and private spending (% of GDP)			Science	497	(489)
Health care	7.8	(8.8)	Share of women in parliament (%)	22.5	(30.7)
Pensions (2017)	8.3	(8.6)	Net official development assistance (% of GNI, 2017)	0.15	(0.37)
Education (primary, secondary, post sec. non tertiary, 2017)	2.7	(3.5)			

* Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, International Monetary Fund.

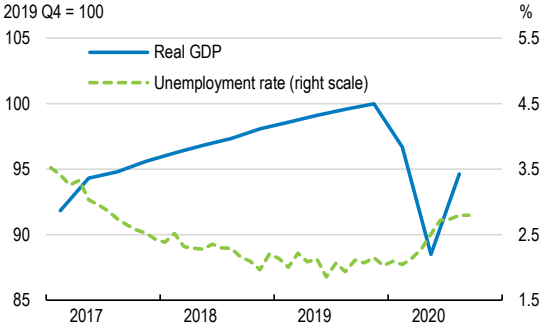
Executive Summary

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.

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
Growth 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.

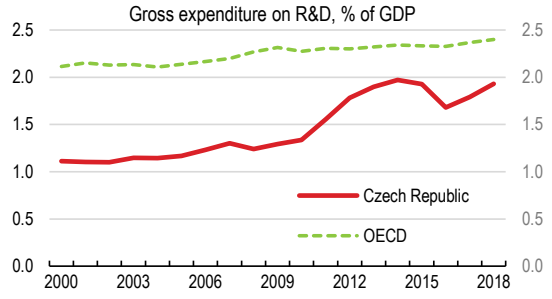
Lower taxes and social contributions for the self-employed reduce public revenues and adequacy of safety nets. Taxes and contributions of the self-employed remain lower than for employees, driving the high incidence of self-employment. The lower assessment base for social contributions creates issues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

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.

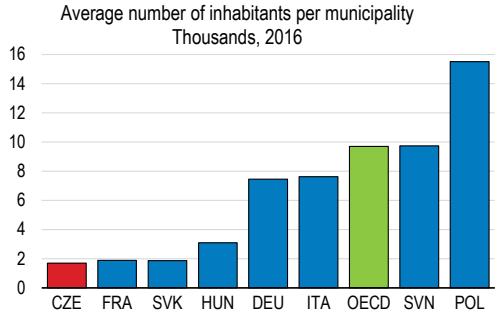
Higher public integrity and less fragmented local government

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.

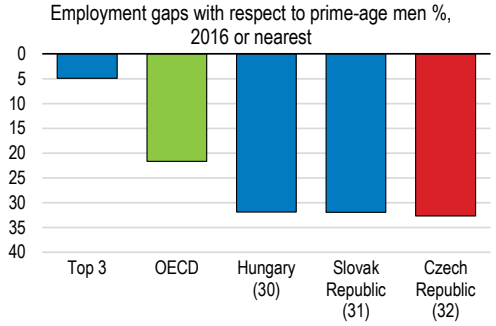
Bringing more mothers to the labour market and building skills

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.

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.

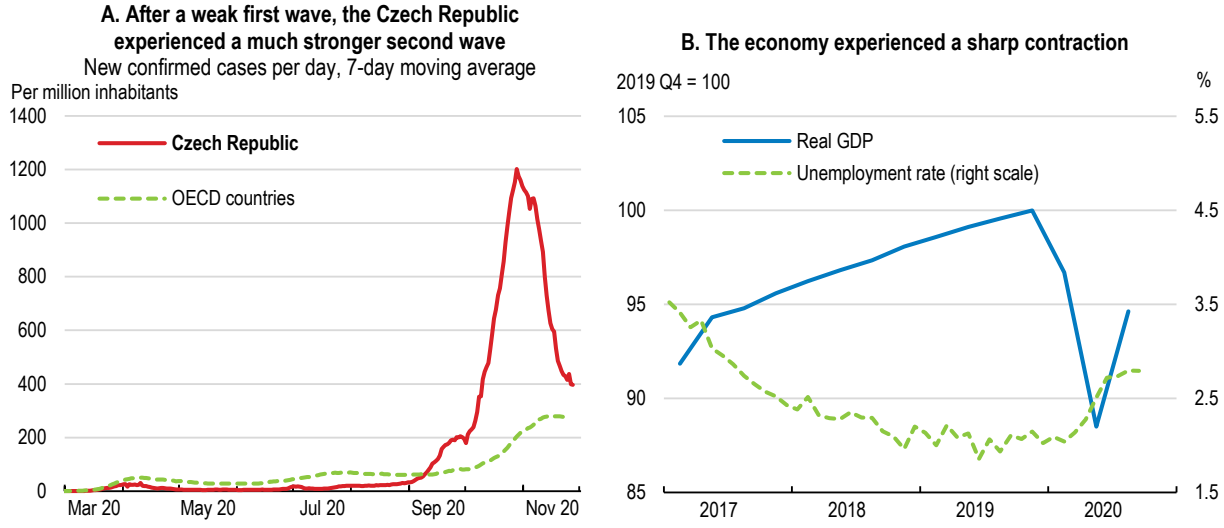
1 Key Policy Insights

Introduction

As most of the world, the Czech Republic is battling the social and economic consequences of the new coronavirus pandemic (Figure 1.1). The government reacted swiftly by introducing strict containment measures in March, and much of the social and economic activity – domestic as well as international – was brought to a halt during March and April. While the first wave of the outbreak was effectively contained, the Czech Republic is undergoing an even stronger second wave. Recovery, which started as soon as the initial lockdown was lifted in April, is now stalling due to a renewed lockdown and restrictions on certain activities. Uncertainty remains elevated and economic growth is expected to resume only slowly over the coming years.

The Czech Republic had ample policy space at the start of the crisis, and the authorities stepped in with bold monetary and fiscal easing to support employment, incomes and liquidity (Figure 1.2). Moreover, many of these support programmes have been extended amid the second wave and the reintroduction of new economic restrictions.

Figure 1.1. The Czech Republic is fighting the social and economic consequences of the pandemic

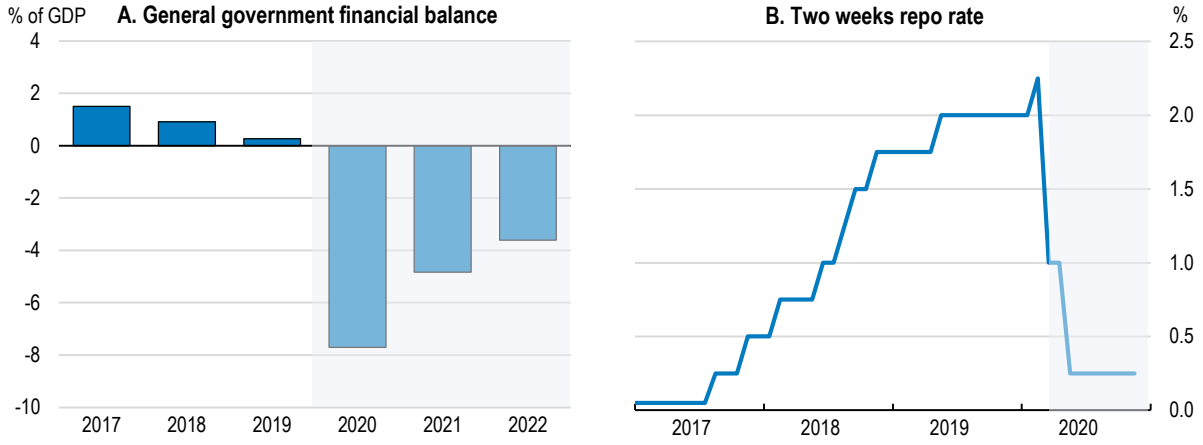


Source: OECD calculations based on European Centre for Disease Prevention and Control (ECDC); OECD Economic Outlook database; Czech Statistical Office.

Policy has helped preserve jobs and businesses, but some of them may no longer be viable after the economy restarts. A balance will need to be found between supporting viable jobs and companies on the one hand, and promoting resource reallocation across sectors and companies to restore productivity growth on the other. With relatively low public debt, the Czech Republic is in a good position to continue to provide fiscal support, if needed. Nevertheless, the crisis heightens the need to continue addressing

long-term challenges and resume structural reforms. Sustainable growth will raise living standards and help restore fiscal and monetary policy space.

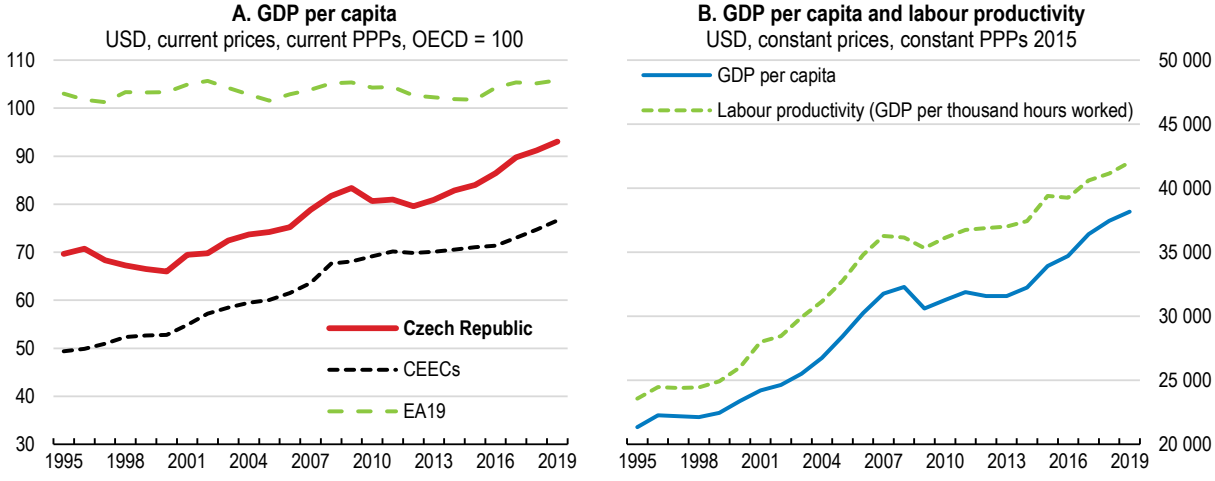
Figure 1.2. Fiscal and monetary policies stepped in to support the economy



Source: OECD Economic Outlook 108 database; Refinitiv.

The crisis struck after a long period of impressive convergence to the OECD average incomes (Figure 1.3), and rising living standards. Geographical location and openness to foreign direct investment, boosted by the accession to the EU and the single market, spurred integration to global value chains. Coupled with sound economic policies, this helped lift productivity, wages and the quality of life (Figure 1.4). The Czech Republic has also maintained one of the lowest inequality and poverty rates in the OECD, supported by high employment rates and comprehensive redistribution through taxes and transfers (Figure 1.5).

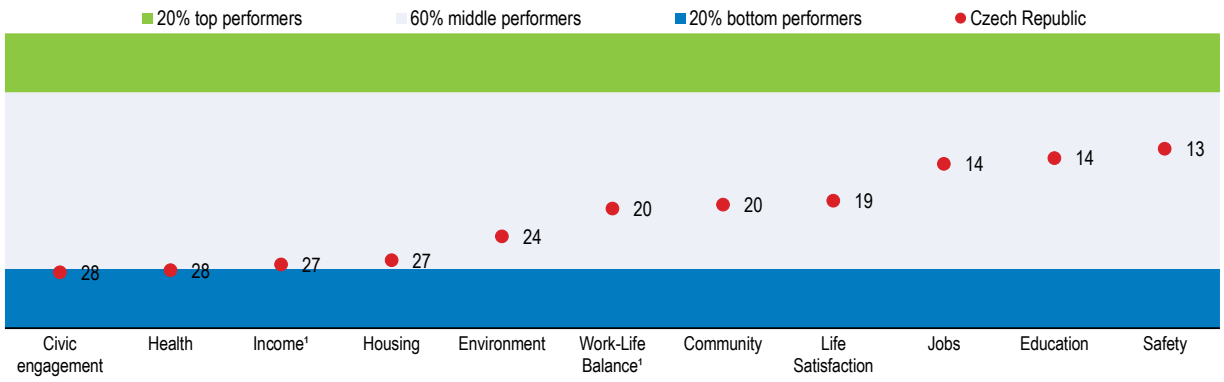
Figure 1.3. The Czech Republic was rapidly converging towards the OECD average



Note: CEECs include Hungary, Poland, Slovak Republic and Slovenia.
Source: OECD Productivity database.

Figure 1.4. Prior to the crisis, the Czech Republic performed well in many aspects of well-being

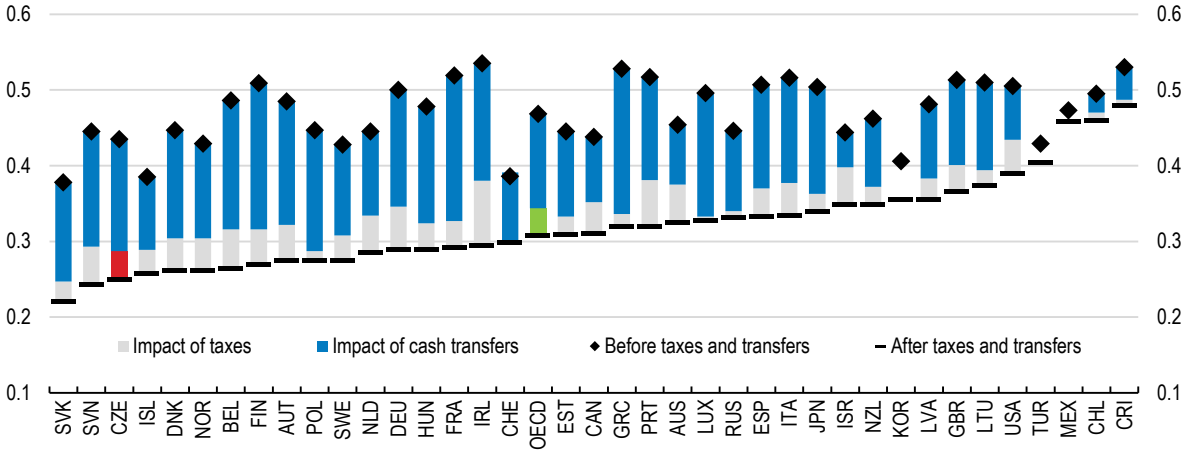
Rankings amongst OECD countries from 1 (best) to 37 (worst)[1], 2018 or latest available year



1. Each well-being dimension is measured by one to four indicators from the OECD Better Life Index set.
Source: OECD Better Life Index database.

Figure 1.5. Income inequality is one of the lowest in the OECD

Gini coefficient, scale from 0 "perfect equality" to 1 "perfect inequality", 2016 or latest available year



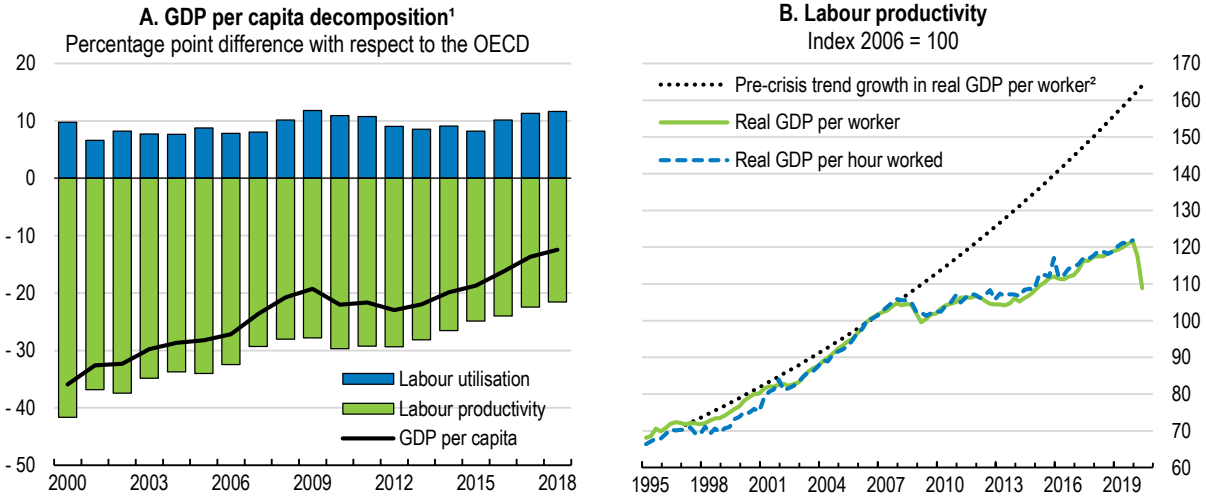
Source: OECD Income Distribution database (IDD).

Nevertheless, the Czech Republic faces long-term challenges that need to be addressed in order to sustain the rise in living standards once the economy recovers. Labour utilisation is high, raising GDP per capita, but labour productivity – while catching up - still lags behind markedly from the OECD average (Figure 1.6, panel A). After the global financial crisis, productivity growth slowed significantly (Figure 1.6, panel B), and remained firmly below pre-crisis trends for an extended period. Sharp cuts to output and trade during the coronavirus pandemic and heightened uncertainty may additionally hurt productivity-enhancing investment. In addition, shifting to higher value-added activities could be an opportunity to help reduce the high carbon dependency of the Czech economy.

The Czech population will age substantially over the coming decades (Figure 1.7), reducing employment rates and growth, but also raising age-related spending pressures. Before the coronavirus crisis, labour shortages were one of the main barriers to growth and labour market tensions resulted in high growth of wages and a record low unemployment rate. With the COVID-19 crisis, unemployment has started to rise,

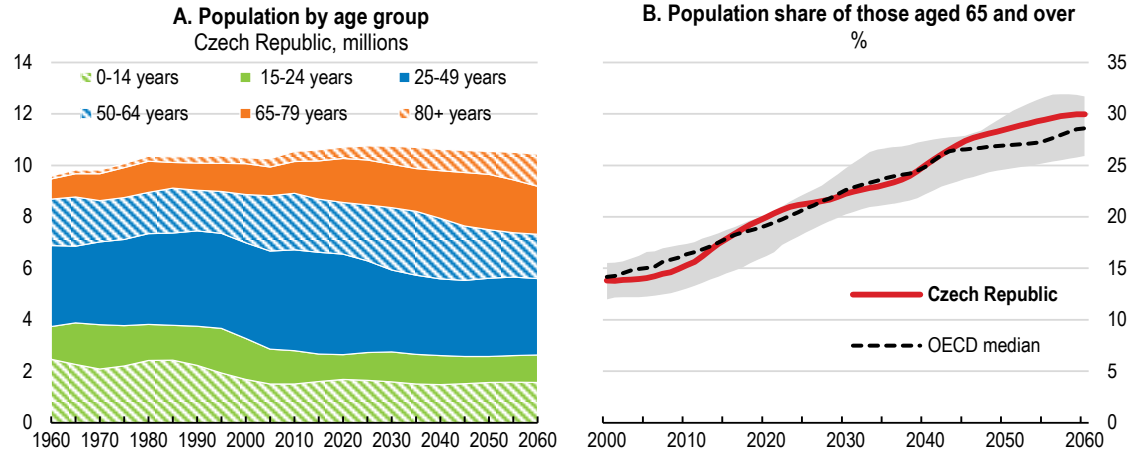
although it remains very low in international comparison. To support the recovery and future growth, it is essential to help jobseekers transition to new jobs and to raise labour participation of groups at the margins of the labour market, notably women with young children. Together with more equitable provision of education and effective lifelong learning, this could spur growth and productivity.

Figure 1.6. Labour productivity growth has stalled and remains below the OECD average



1. GDP is measured at current prices, current PPPs. Labour productivity is measured by GDP per hour worked and labour utilisation is the total number of hours worked divided by the population.
2. Pre-GFC trend growth in real GDP per worker is calculated from a linear trend between 1997 and 2006, and is projected from 2007Q1 onwards.
Source: OECD Economic Outlook database; OECD Productivity database.

Figure 1.7. The population is ageing rapidly



Note: In Panel A, youth are shown in green, 25-64 year-olds in blue and seniors in orange. After 2020, data are from the "medium variant" of UN scenarios. In Panel B, the shaded area denotes the 25th to 75th percentile range of available data for OECD countries.
Source: United Nations (2019), World Population Prospects: The 2019 Revision, Online Edition; OECD Economics Department Long-term Model.

Challenges related to lagging productivity, industrial pollution, ageing and obsolete skills are not the same across the Czech Republic. Despite overall low inequality, there is considerable regional variation in

incomes and poverty, and the gaps have grown over time. Certain regions suffer from declining and ageing population, low human capital, poor connectivity and restructuring economies. 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 head in the OECD. The resulting lack of capacity at the local level impacts the quality of public services and impedes the uptake of effective development projects.

Against this background, the main messages of this Survey are:

- Policy needs to continue to support households and businesses in the event of persistent economic weakness. It should nevertheless gradually shift from broad support towards facilitating resource reallocation and implementing well-targeted measures to avert scarring effects and multiple firm bankruptcies. This will also help reduce poverty and deprivation.
- Strong growth in incomes and living standards will require faster productivity growth, which can be fostered through further improvements in the business environment and higher and more effective R&D investment. Policies to reduce the reliance on coal, greenhouse gas emissions and air pollution would also boost well-being. Raising labour-market participation, notably of mothers with young children, and improving skills are also needed to lift incomes and economic growth, and make them more equitable.
- Less fragmented local government would help in effectively delivering public services such as education, health and public administration, and help reinvigorate local economies.

Box 1.1. The key long-term priorities of government's economic policy

The priority in 2020 has been to tackle the **coronavirus pandemic** and the associated social and economic crisis. The government aimed to ensure the safety and health of the population by steering the health system and other government services towards effective containment of the pandemic and treatment of those infected. Furthermore, the authorities provided ample income and liquidity support to the economy.

Other key priorities of the current government include the following areas:

Ageing – improving the long-term fiscal sustainability of the pension system; upholding the quality and the cost-effectiveness of the healthcare system in the long-term and adopting measures to fulfil the needs of healthcare personnel.

Digitalisation – keeping up to speed with the ongoing digital revolution; improving eGovernment services; developing high-speed internet and building new-generation networks.

Investment – promoting private investment; focusing investment incentives on higher value-added projects linked to R&D activities and the creation of higher-skill jobs; simplifying and streamlining the process of obtaining construction permits.

Labour market and gender equality – reducing the gender pay gap; supporting affordable, accessible and high-quality childcare services; facilitating labour migration from abroad and integration of foreigners.

Research, development and innovation – supporting R&D activities and innovation; providing support for cooperation between research and business sector and subsequent commercialisation of R&D results.

Transport infrastructure – aiming to complete the backbone transport infrastructure and improve connectivity of remote regions; implementing measures enabling the development of automated and autonomous mobility.

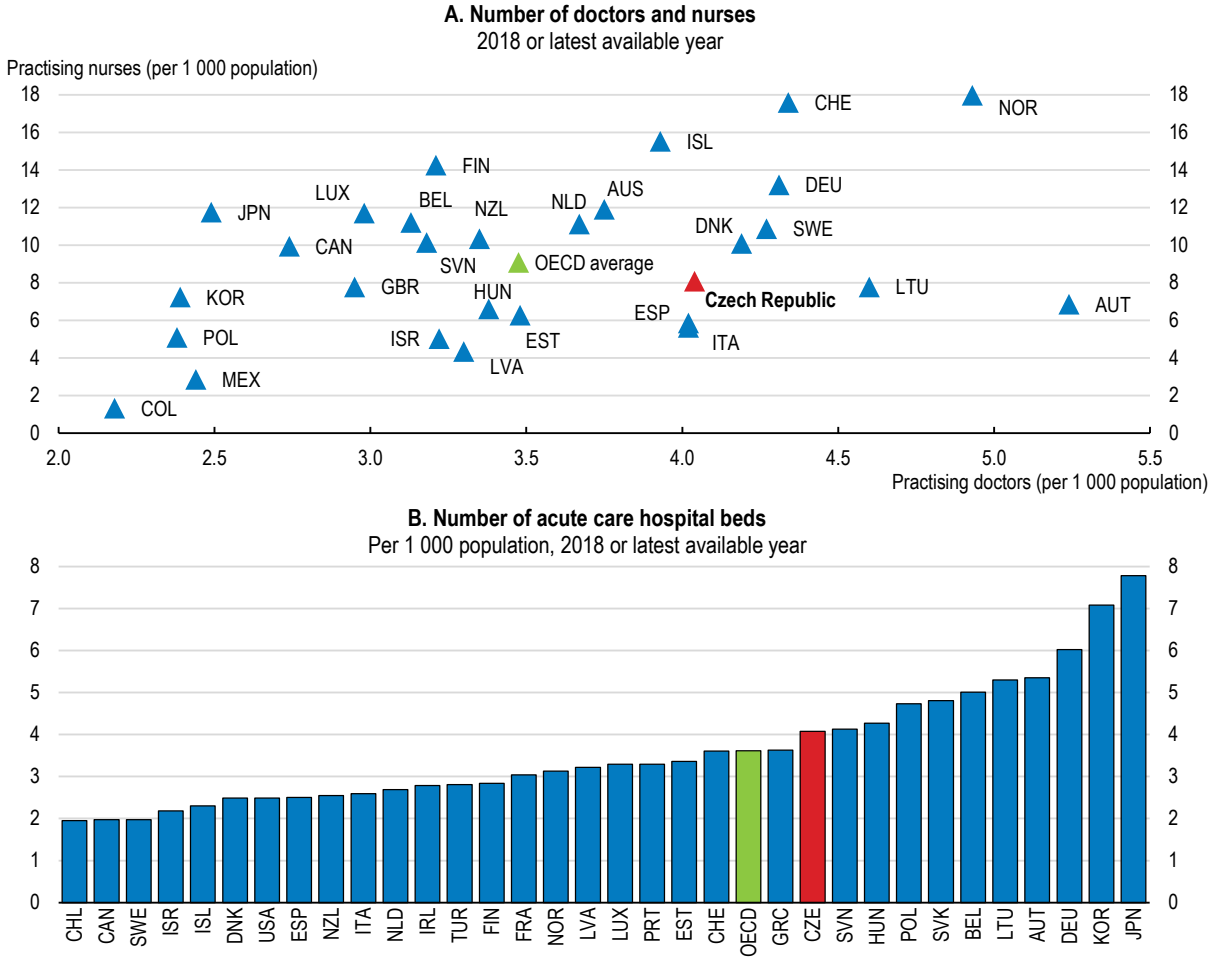
Housing – setting up conditions for more affordable housing.

The economy requires substantial macroeconomic policy support

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

The Czech health system - with close to universal coverage - was relatively well equipped to respond to the crisis, with the number of doctors and acute hospital beds above the OECD average (Figure 1.8). As the threat of the pandemic rose, additional resources were channelled to the health sector. Adjustments were made to raise capacity to treat COVID-19 patients, enhance testing capacity and boost the availability of personal protective equipment (PPE).

Figure 1.8. The Czech health system was relatively well equipped to respond to the crisis



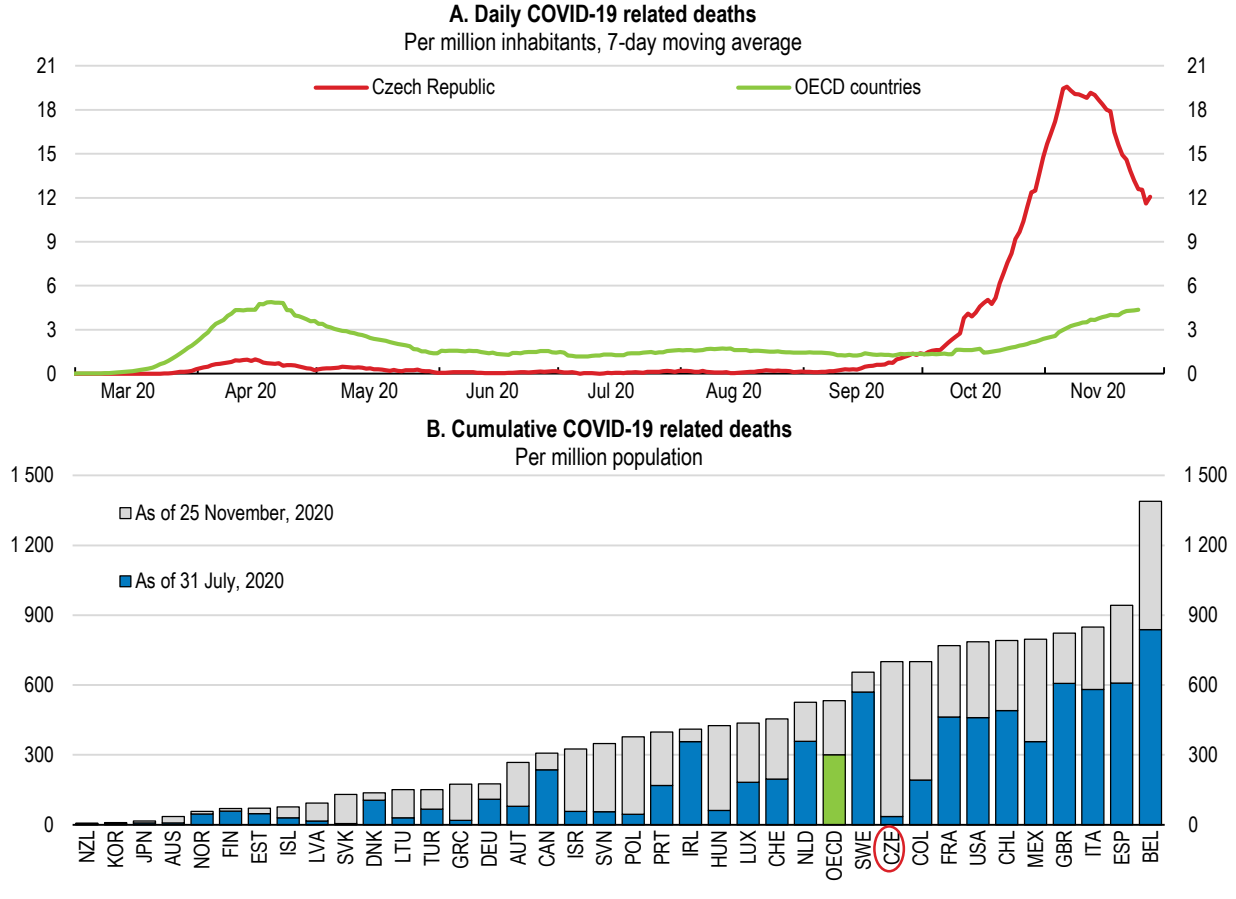
Note: In Austria, the number of nurses is underestimated as it only includes those working in hospitals. Acute care beds include not only beds in intensive care units, but also beds in acute care units (e.g. all surgical units, all gynaecological and obstetric services, as well as acute psychiatric care beds in about half the countries). France, Japan and Latvia exclude psychiatric care beds.
Source: OECD Health Statistics.

The coronavirus pandemic first started gathering pace after March 9, 2020, when the first infection of a person without travel history was confirmed. A state of emergency was proclaimed on March 12. Internal travel and gathering in groups were restricted and international travel banned. Restaurants, hotels and most stores were closed. Swift action bore fruit and the first wave was soon effectively contained. This allowed the government to commence a gradual lifting of restrictions on society and the economy in mid-

April and most restrictions were lifted by the end of June, after which only bans on large gatherings remained in place.

After the summer, however, the Czech Republic entered a strong second wave with the number of cases and deaths far exceeding the levels from the first wave (Figure 1.9). The government declared a state of emergency on September 30, and reintroduced a national lockdown on October 21, limiting the movements of people. Increasingly heavy restrictions were also imposed on economic activity, with bans on events and gatherings, the closure of education establishments and severe restrictions in the hospitality and retail sectors, among others. The number of new cases dropped significantly in November, albeit remaining elevated, and in December, the government started easing some containment measures. If the Czech Republic was one of the more successful countries in containing the pandemic during the first wave, it was hit hard in the second wave.

Figure 1.9. The Czech Republic is experiencing a strong second wave



Source: OECD calculations based on European Centre for Disease Prevention and Control (ECDC).

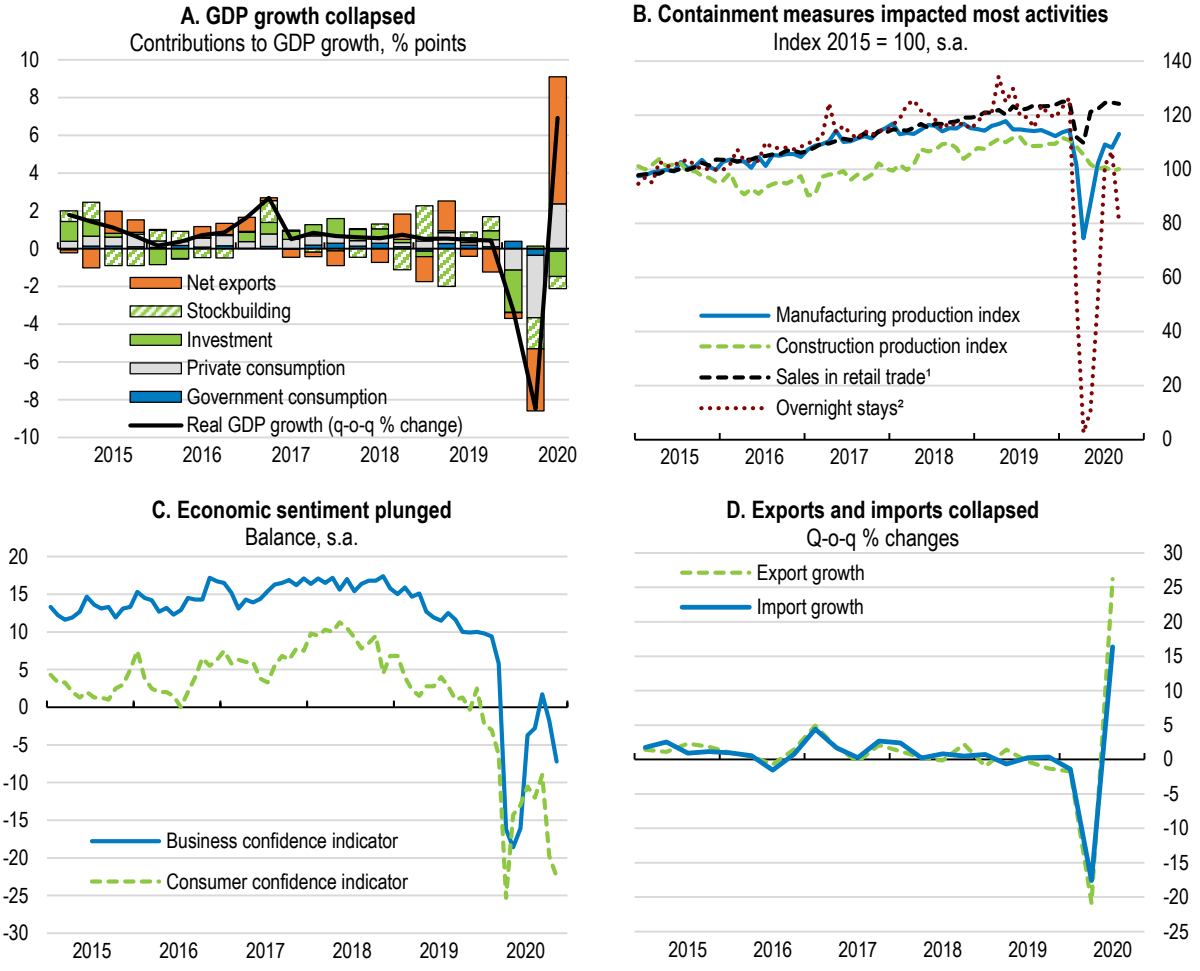
The economy contracted sharply

Before the coronavirus outbreak, the economy was growing at a robust pace, but already showed signs of slowing. Weak growth in trading partners, notably Germany, slowed industrial production and exports. The rise in uncertainty and softening sentiment in relation to international trade disputes and Brexit reduced private investment. On the other hand, household consumption remained strong, fuelled by high wage growth, underpinned by a very tight labour market. The labour market tightness also contributed to rising

inflation, together with rising food prices. In November 2019, inflation moved outside the 1-3% inflation tolerance band, and peaked at 3.7% in February 2020.

The coronavirus outbreak and the lockdown had an immediate strong negative impact on economic activity (Figure 1.10). Industrial production fell and economic sentiment plunged. In the first half of 2020, all components of GDP showed large drops, bar government consumption and investment. Apart from essential businesses, activity in some sectors was frozen temporarily by decree, while in others, companies reduced output of their own accord due to unfavourable conditions. The Czech National Bank (CNB) estimated that the spring containment measures affected about 40% of the Czech economy (Czech National Bank, 2020a). According to the Czech Statistical Office, trade, transport, accommodation and hospitality, and manufacturing were among the economic activities most negatively affected in the second quarter of 2020.

Figure 1.10. Economic developments

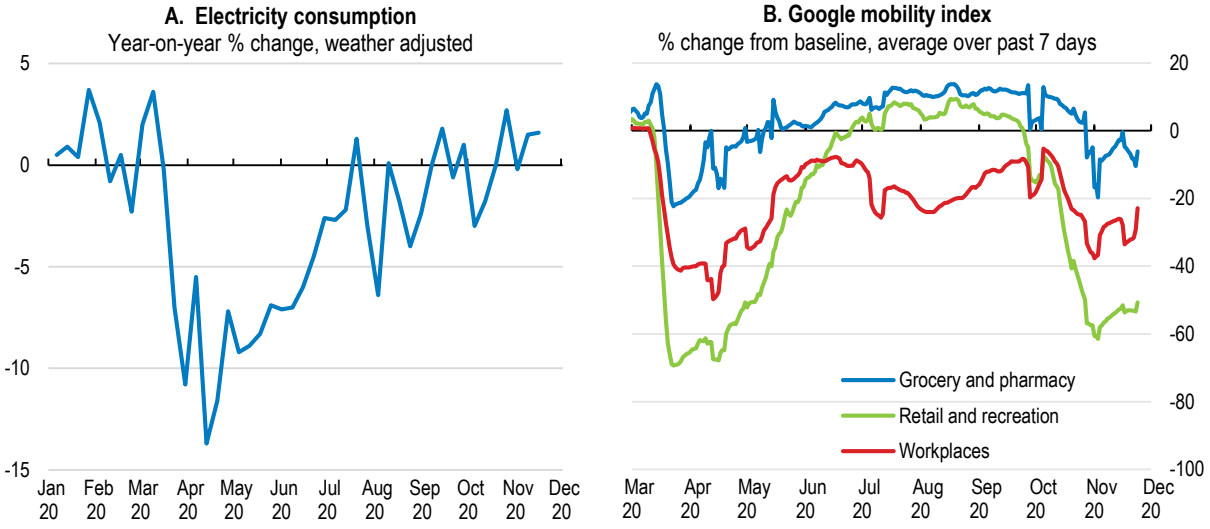


1. Sales in retail trade, except of motor vehicles, constant prices.
2. Number of overnight stays of guests in collective accommodation establishments.
Source: OECD Economic Outlook database; Czech Statistical Office.

The recovery has stalled amid elevated uncertainty and renewed containment measures. Activity showed signs of a partial recovery soon after the government lifted restrictions. Electricity consumption and mobility statistics quickly recovered from their troughs in April (Figure 1.11). Manufacturing production, retail sales

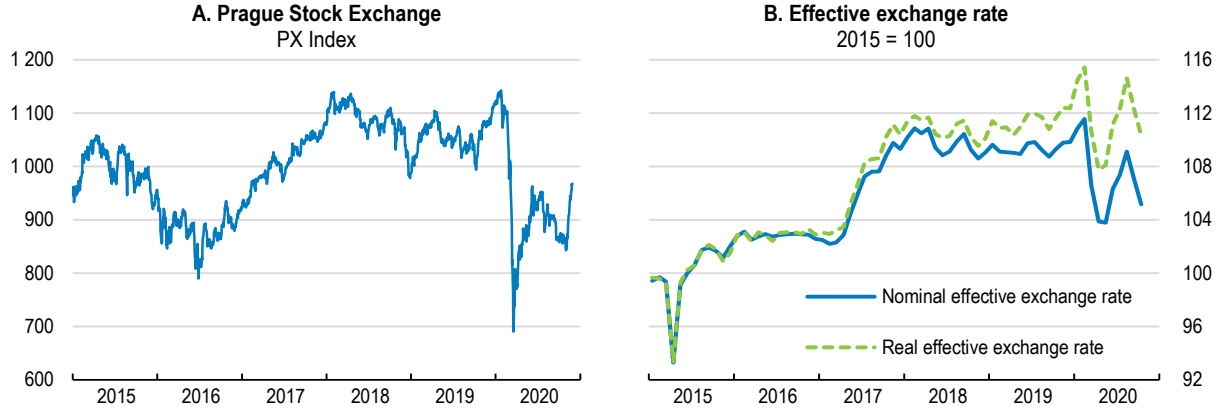
and tourism also bounced back after April and economic sentiment partly recovered (Figure 1.10). However, these rebounds have reversed since the end of the summer. The Prague stock exchange PX index and the koruna exchange rate, after regaining value over the summer, lost value from August to October (Figure 1.12).

Figure 1.11. The recovery stalled due to renewed containment measures and elevated uncertainty



Note for panel B: The level during the baseline period was established based on the median value of the volume of visits for each day of the week during the period January 3–February 6, 2020.
Source: OECD calculations based on Google Community Mobility Report; Central bank of the Czech Republic, https://www.cnb.cz/cs/o_cnb/cnblog/Prvni-odhad-dopadu-pandemie-COVID-19-na-ekonomiku-CR/#

Figure 1.12. The stock market and the exchange rate lost value after summer gains

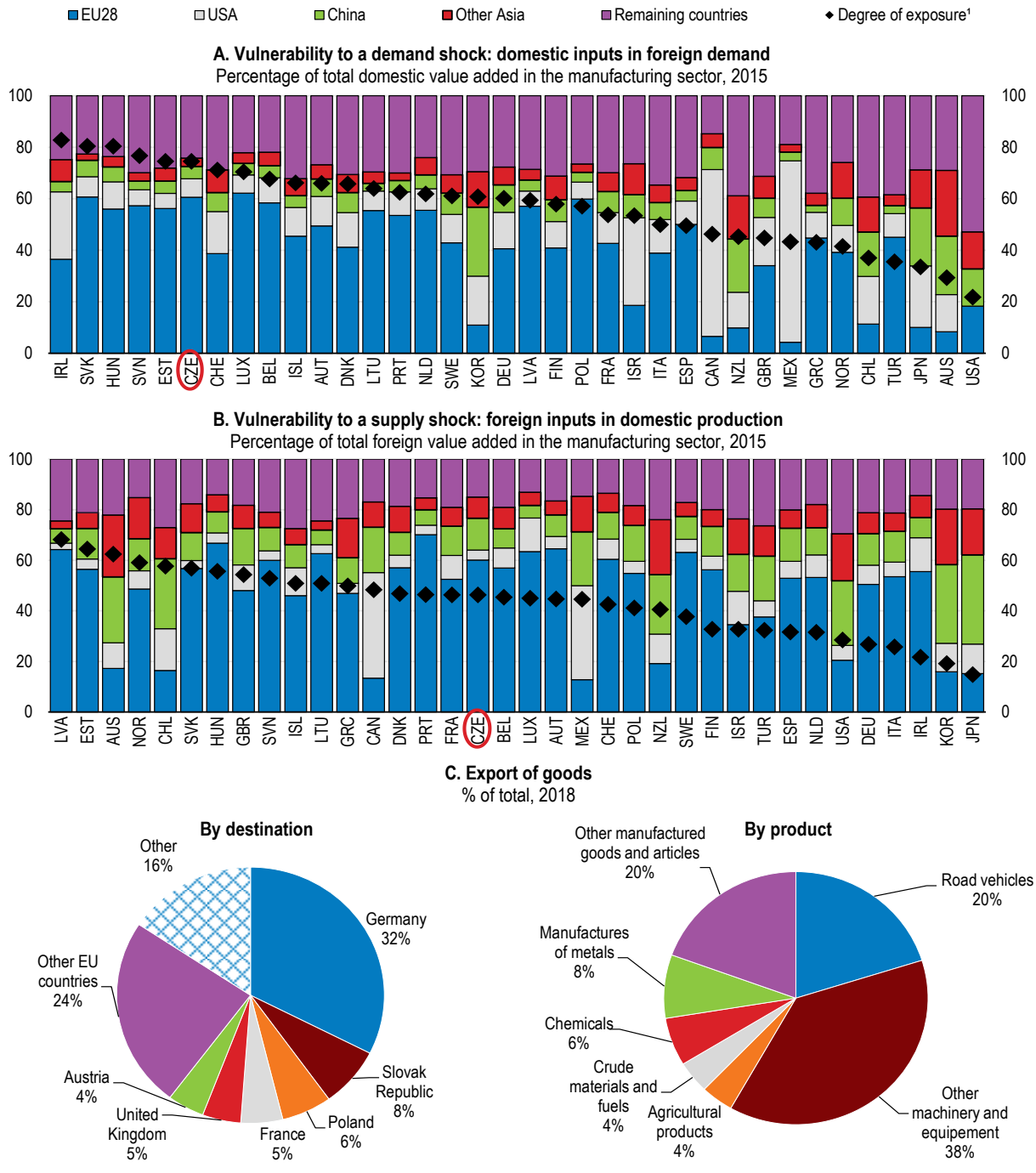


Source: Refinitiv.

The Czech Republic's economic openness and high level of integration in global value chains magnified the economic impact of the pandemic (Figure 1.13). Exports of goods and services fell strongly due to the drop in external demand and bans on international movements. Importantly, the automobile industry was forced to stop production for close to 30 working days (ACEA, 2020) due to international supply chain disruptions and lower demand, with repercussions for many domestic SMEs. This has added to difficulties of the automobile sector that had already been under pressure due to regulatory changes (CO2 emission

targets for new cars) and digital transformation requiring structural change and investment in new technology.

Figure 1.13. High integration in global value chains amplifies crisis impacts

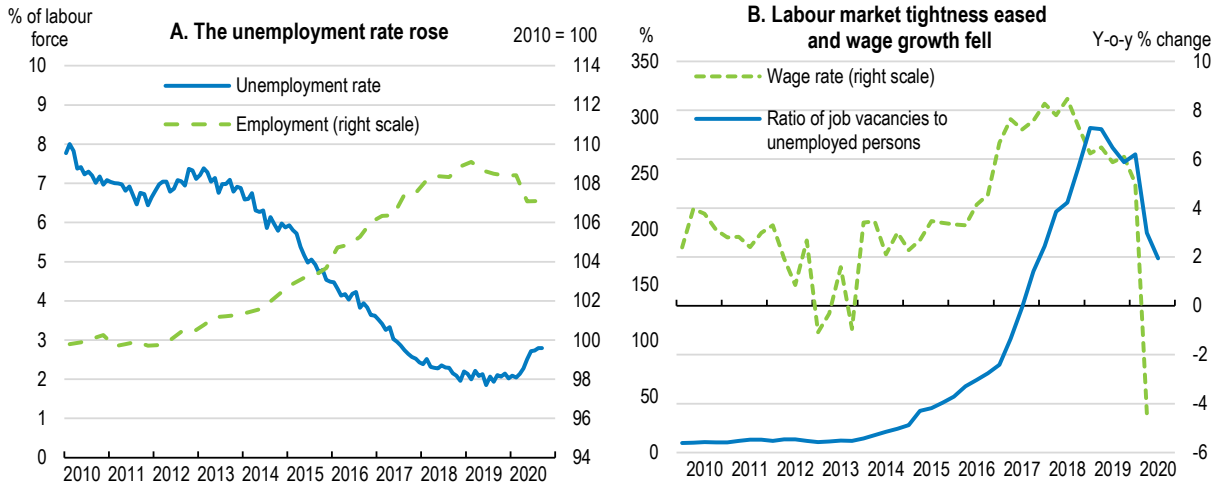


1. The degree of exposure to a supply shock is computed as a share of foreign value added in gross output of the manufacturing sector, while the degree of exposure to a demand shock is computed as a share of domestic value added in foreign final demand. Other Asia includes Japan, Korea, India and ASEAN countries.

Source: OECD Economic Outlook n.107, IMF DOTS Database; UN Comtrade Database.

Unemployment started to rise from low levels (Figure 1.14). The survey-based unemployment rate rose from 2.0% in February, to 2.8% in September 2020. Employment declined, and the number of average hours worked dropped in March–May, most notably among the self-employed, before rebounding in the summer. According to official estimates, job retention schemes ("Antivirus") helped support more than 790 000 employees by end-September from close to 58 000 firms (Ministry of Labour and Social Affairs, 2020a), reflecting increased slack in the labour market. Job vacancies started falling after staying at elevated levels for almost a year, and wage growth eased markedly.

Figure 1.14. Unemployment started to rise and wage growth slowed



Source: OECD Economic Outlook database; Eurostat database [jvs_q_nace2]; Czech Statistical Office; OECD National Accounts.

Inflation remained above the upper boundary of the tolerance band for most of 2020 (Figure 1.15), despite economic weakness. Rising slack in the labour market lowered pressures on wages and big drops in oil prices have had a dampening effect. However, koruna depreciation and increasing food and administered prices have put upward pressure on inflation. Increased costs for firms, due to supply restrictions and new sanitary requirements, also translated to higher prices for consumers (Czech National Bank, 2020c).

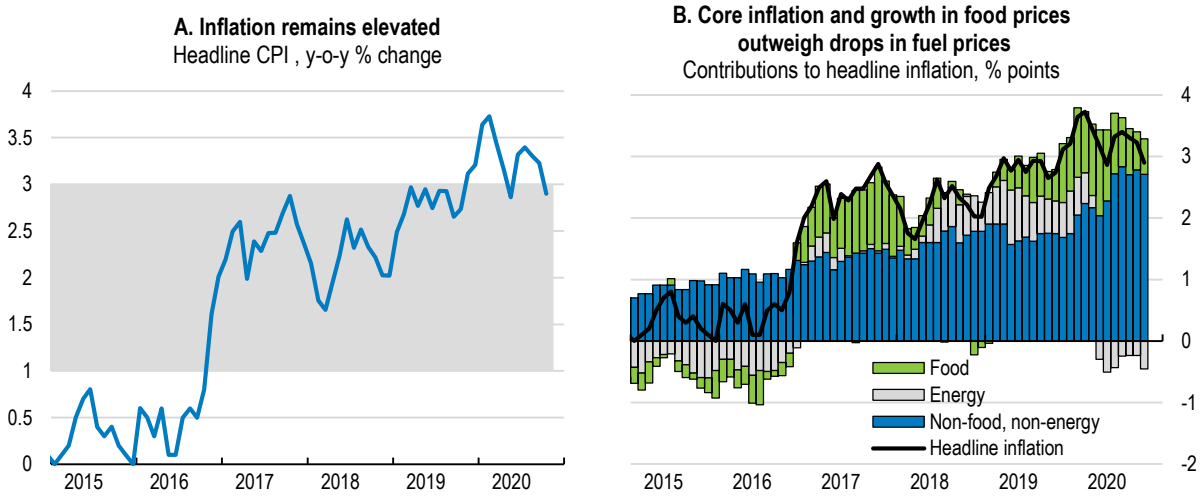
The recovery will take time and is shrouded by uncertainty

GDP is estimated to contract by an estimated 6.8% in 2020. It is projected to recover slowly, by 1.5%, in 2021, , and pick up to 3.3% in 2022. During 2021, the continuation of the pandemic outbreak, some remaining containment restrictions in most sensitive sectors, and weak foreign demand will delay and weaken the economic recovery. Vaccines are assumed to be widely deployed only in the latter half of 2021. Subdued activity and high uncertainty will dampen private consumption and business investment. Wages and prices will grow slowly and inflation is expected to slow towards the 2% target level. Firm bankruptcies are expected to rise in 2021 due to prolonged economic weakness and withdrawal of some support measures. The unemployment rate is expected to continue rising in the first half of 2021. Thereafter, once the pandemic is better controlled globally and locally, economic growth will gather pace on the back of improving sentiment and rising domestic demand. Trade will pick up, too.

Uncertainty remains high. In case of a more prolonged lockdown, private consumption, investment and trade will drop again to low levels. Protracted adversity would increase bankruptcies further, and the unemployment rate would surge. The unemployment duration would lengthen, too. The highly open Czech economy is exposed to persistent disruptions to international trade or new trade barriers. Potential further disruptions to the international automobile supply chain could be particularly damaging to the economy.

On the upside, the current substantial government support could have a stronger than expected positive effect. Notably, companies could resume their activities more quickly than expected thanks to job retention measures. Moreover, the deployment of vaccines could turn out to be swifter than expected, triggering a faster resumption of confidence and economic growth.

Figure 1.15. Inflation hovered above the upper boundary of the tolerance band for most of 2020



Note: Inflation target is 2% with a tolerance band of +/- 1% points.
Source: OECD Economic Outlook database.

Table 1.1. Macroeconomic indicators and projections

Annual percentage change, volume (2015 prices)

	2017 Current prices (billion CZK)	2018	2019	Projections 2020	2021	2022
Gross domestic product (GDP)	**5,117.4**	**3.2**	**2.3**	**-6.8**	**1.5**	**3.3**
Private consumption	2,422.0	3.5	3.0	-4.0	1.1	2.2
Government consumption	958.7	3.8	2.3	2.9	1.9	0.7
Gross fixed capital formation	1,275.7	10.0	2.1	-6.6	-1.6	9.1
Final domestic demand	4,656.4	5.3	2.6	-3.4	0.6	3.6
Stockbuilding[1]	73.1	-0.5	-0.2	-1.6	-0.6	0.0
Total domestic demand	4,729.5	4.7	2.4	-4.9	0.0	3.7
Exports of goods and services	4,048.4	3.7	1.2	-12.9	8.1	4.7
Imports of goods and services	3,660.5	5.8	1.3	-10.9	6.2	5.5
Net exports[1]	387.9	-1.2	0.0	-2.2	1.5	-0.2
Other indicators (growth rates, unless specified)						
Unemployment rate (% of labour force)	. .	2.2	2.0	2.6	3.6	3.6
GDP deflator	. .	2.6	3.9	3.7	1.7	1.8
Consumer price index	. .	2.1	2.8	3.3	2.2	2.0
Core consumer price index[2]	. .	2.4	2.5	3.6	2.5	2.0
Current account balance (% of GDP)	. .	0.4	-0.3	2.0	2.5	0.6
General government financial balance (% of GDP)	. .	0.9	0.3	-7.7	-4.8	-3.6
General government gross debt (Maastricht, % of GDP)	. .	32.0	30.2	38.2	42.6	45.2

1. Contribution to changes in real GDP.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 108.

Table 1.2. Low-probability events that could lead to major changes in the outlook

Shock	Possible impact
Limits on the free movement of goods and services after hard 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 and the world.
Rising protectionist pressures in trade and investment and geopolitical tensions in and around Europe	Tariff increases affecting intermediate goods for the manufacturing sector would have damaging impacts. A downturn in activity in Europe due to geopolitical tensions could jeopardise the economic recovery in the Czech Republic.
Major house price correction	Large correction in house prices would have a negative impact on household consumption and economic growth and could expose vulnerabilities in the financial system.
Accelerated structural changes in the automotive sector (demand for low-emision cars and drive for digitalised production methods)	Loss of demand for cars and car parts produced in the Czech Republic, with multiplying effects throughout the Czech economy, destroying jobs, incomes, large companies and SMEs.

Considerable policy space permits continued support if needed

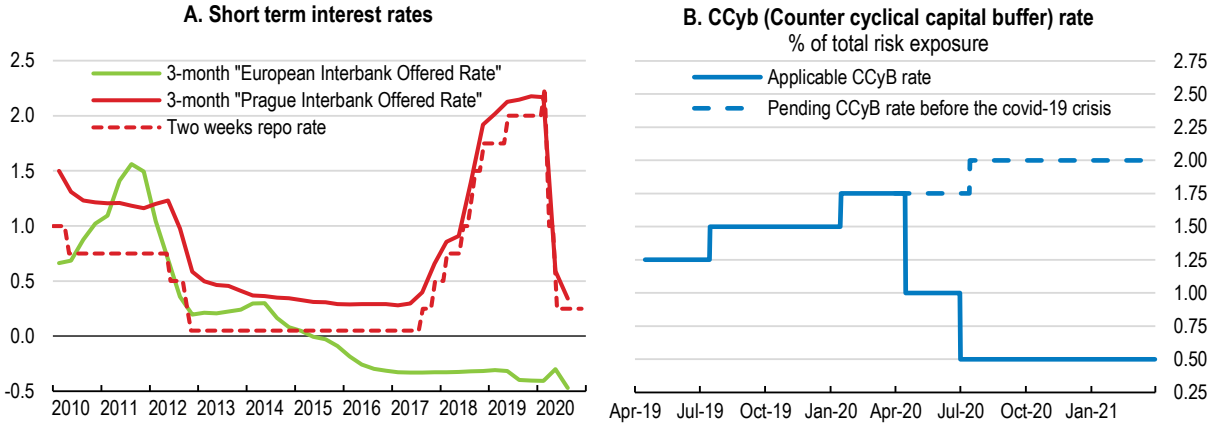
Monetary policy has room to ease further if needed

Monetary policy moved quickly to accommodate the drop in activity and support liquidity. Over the period from March to May 2020, the Czech National Bank (CNB) cut policy rates, from 2.25% to 0.25% (Figure 1.16), and communicated that it stood ready to do more, including koruna exchange rate support and quantitative easing. The Act on the CNB was amended, to temporarily allow (until the end of 2021) the CNB to trade instruments with maturities of more than one year, paving the way for quantitative easing. In addition, the CNB is now allowed to trade also with non-bank financial institutions, such as insurance and pension companies or with other institutional investors. The CNB took additional measures to support liquidity by broadening the range of eligible collateral and introducing liquidity-providing operations with longer maturities.

The CNB also relaxed credit ratio limits for new mortgages, relaxing the loan-to-value ratio and removing the debt-to-income ratio and debt-service-to-income ratio limits. These had been repeatedly tightened over previous years due to mounting risks in the housing markets. Some households are exposed to the risk of default. The CNB estimated apartment prices to be 15-25% overvalued in 2019 Q4 and affordability continued to deteriorate (CNB, 2020b). However, despite the crisis, there have been no significant corrections in house prices as of 2020 Q2. Moreover, a prolonged period of very low interest rates may trigger a build-up of imbalances and further rises in housing and other asset prices, calling for monitoring the associated risks.

To help banks extend credit, the CNB also lowered the counter-cyclical capital buffer (from 1.75% to 0.5%, Figure 1.16). Before the crisis, banks were well capitalised and highly profitable, earning high interest margins and profiting from negligible impairments losses (Czech National Bank, 2019b and 2019c). Ample capital and measures taken to cushion the impact on credit losses should buttress the banking sector. In particular, the government introduced a measure – in agreement with the CNB – where debtors are able to interrupt their repayments for a period of three or six months. In addition, liquidity was offered to struggling firms backed by government guarantees. The CNB's recent macro stress test confirmed the sector's resilience to shocks (Czech National Bank, 2020b). However, credit defaults are expected to increase after the end of the loan repayment moratorium, and peak in mid-2021 (Czech National Bank, 2020b). In a prolonged recession, the capital surplus held by banks would play a key role in keeping the sector's overall capital ratio above the regulatory threshold. The CNB has called for a prudent dividend policy.

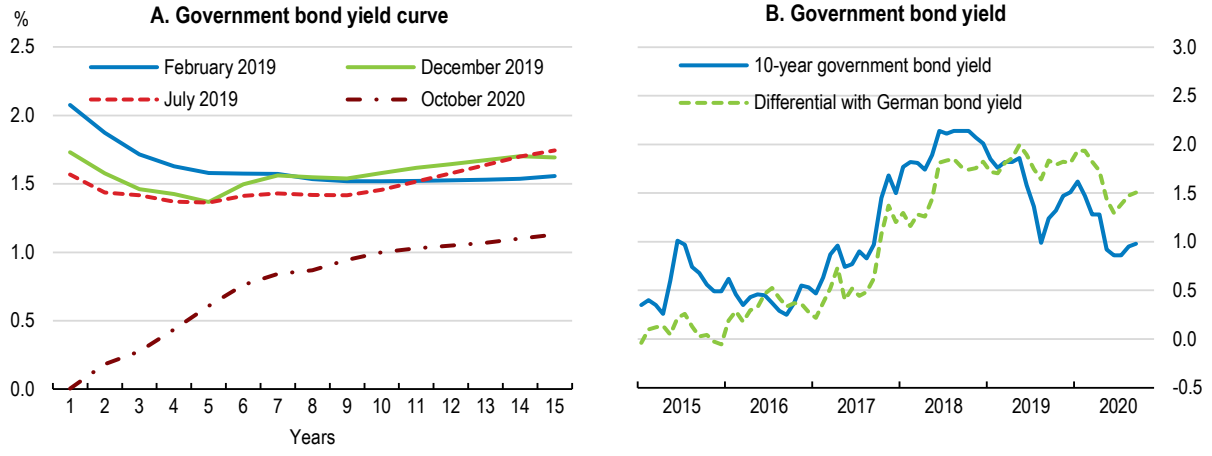
Figure 1.16. The central bank moved quickly to support the economy



Source: OECD Economic Outlook database; Refinitiv; Czech National Bank.

The monetary policy stance remains appropriately accommodative. However, the CNB should further scale up its support in the event of continued weakness in the economy, taking into account potential sizeable disinflationary (or even deflationary) effects, and their impact on its price stability mandate. At the policy interest rate of 0.25%, the room for conventional monetary policy is limited. The countercyclical capital buffer could be reduced further to allow more bank credit to the economy. Greater room – after the change to the Act on the CNB - to provide liquidity at longer maturities to the financial sector is welcome. The CNB could also undertake asset purchases (quantitative easing) to lower borrowing costs and ease financial conditions over the yield curve. This said, the yield curve has turned positive, reflecting lowering of interest rates at the short end, while long-term interest rates do not show signs of stress. The government bond yield and the spread with German Bunds have stayed within a limited range for the last two years (Figure 1.17).

Figure 1.17. Long-term interest rates do not show signs of stress



Source: OECD Main Economic Indicators database; Czech National Bank.

The accommodative stance, despite short-term supply disruptions, is unlikely to compromise the price stability objective in the medium-term due to subdued demand. If inflationary pressures on the other hand arise in a persistent way, some stimulus might need to be withdrawn. In the case of a prolonged recession, it will be more challenging to minimise financial stability risks, as bankruptcies will be much larger and

capital buffers of banks will likely be eroded. The Czech National Bank should continue to monitor risks in the banking sector, including that banks maintain a prudent dividend policy and refrain from other actions that might reduce their loss-bearing capacity.

Any further easing of prudential regulation should be done conditional on transparent disclosures of financial exposures and regular stress testing. Once recovery is fully under way, the needed easing of prudential regulation during the crisis will have to be gradually reversed to rebuild capital and liquidity buffers, and to restore policy space. A sound financial system will be key for future monetary policy transmission and resilience in a next downturn (OECD, 2020a). In addition, the CNB could be given full-fledged powers to use a wide array of instruments in tackling future crises, by more permanently amending the Act on CNB.

Box 1.2. Rules-based macroeconomic policy

Monetary Policy

According to the Czech Constitution and the Act on the Czech National Bank (CNB), the CNB's primary objective is to maintain price stability. Nevertheless, the CNB also supports the general economic policies of the Government leading to sustainable economic growth. As stipulated in the Act, the CNB has a high degree of independence from political structures when performing its functions.

The CNB's monetary regime can be characterised as "inflation targeting". An inflation target of 2 % currently applies (since January 2010) over the medium term, with a tolerance band of one percentage point in either direction. The CNB achieves its primary objective – price stability – by using its instruments, especially key interest rates. Occasionally, the CNB would use foreign exchange interventions to dampen excess market volatility or to help ease/tighten monetary policy.

Another main task of the CNB is to maintain financial stability. The CNB is required to set macroprudential policy by identifying, monitoring and assessing risks to the stability of the financial system and, in order to prevent or mitigate these risks, contribute to the resilience of the financial system and the maintenance of financial stability. In pursuing this mandate, the CNB performs financial sector supervision.

Fiscal policy

The Czech fiscal policy framework is bound by European and domestic legislation. In 2017, the Czech Republic strengthened further its fiscal framework, partly by translating EU fiscal rules into national legislation. Currently, however, due to extraordinary circumstances, fiscal policy deviates from the rules specified below, as the European Commission allowed members to activate the escape clause.

A debt rule stipulates that the general government sector debt (after the deduction of cash reserves) should not exceed 55 % of the nominal GDP. Acts on budgetary responsibility set the expenditure framework for the state budget and state fund budgets, compatible with a medium-term budgetary objective (MTO), to ensure long-term sustainability of public finances. The mandated MTO is expressed in terms of a "structural budget balance", adjusted for the cycle and one-off factors. Fiscal policy should reach the MTO or be heading towards it by adjusting the structural budgetary positions at a rate of 0.5% of GDP per year. The fiscal framework includes the rules for local governments, whereby the amount of debt of a local government unit cannot exceed 60% of its average revenue for the last four financial years.

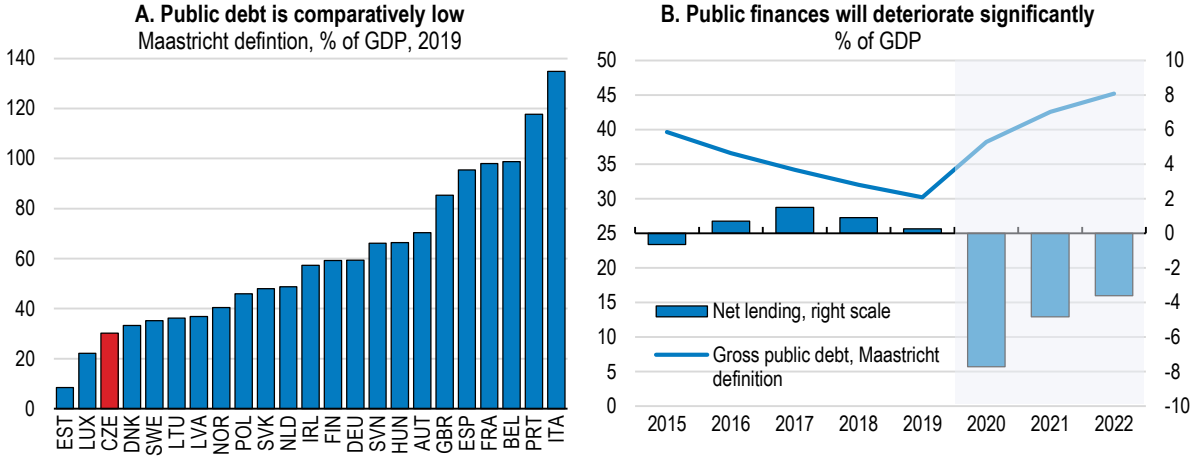
With the 2017 reform, two independent institutions have been put in place: i) the National Budgetary Council monitors the respect of fiscal rules and assesses the impact on long-term sustainability of public finances, and ii) the Committee for Budgetary Forecasts verifies the plausibility of macroeconomic and fiscal forecasts used in the budgetary process.

Further fiscal policy support is needed

The authorities have introduced a broad and generous package of fiscal measures to support employment and incomes of households, and to preserve the liquidity of companies. Some of the measures have been extended in duration and scope after the reintroduction of containment measures in autumn. Employment support schemes, benefit payments to the self-employed, income support to workers caring for children and tax-deferrals were introduced. Moreover, a COVID loan and guarantee programme was launched to boost firm liquidity, notably for SMEs. Further support has been offered through deferrals of rent and loan repayments (see Table 1.3 for details).The Ministry of Finance (2020a) estimated that the direct budget support and deferred taxes amounted to 4.4% of GDP in 2020. In addition, liquidity support and guarantees to businesses amounted to 16% of GDP.

Prudent policies before the crisis had kept debt levels low, but the emergency fiscal response will raise the deficit and contingent liabilities. The sharp drop in economic activity negatively impacted fiscal revenues. Meanwhile, growing social benefits together with emergency support measures boosted public expenditures, resulting in a steep deterioration in public finances. The state budget for 2020 was revised three times in the first half of 2020, going from an initially planned state budget deficit of CZK 40 billion (0.7% of GDP), to CZK 500 billion (9% of GDP). According to the OECD projections, the general government deficit will rise steeply (Figure 1.18) and public debt is projected to rise from around 30% in 2019 to 38% of GDP in 2021. In addition, the government's generous programme of guarantees could increase future burdens on public finances.

Figure 1.18. The public deficit and debt will rise from low levels



Source: OECD Economic Outlook 108 database

As a reaction to the COVID-19 crisis, the structural balance fiscal rule has been temporarily amended to allow fiscal support. In 2017, the Czech Republic strengthened its fiscal framework by introducing debt and expenditure rules, and establishing two independent institutions that monitor public finances. According to the debt rule, the general government sector debt (after the deduction of cash reserves) should not exceed 55% of GDP. Furthermore, acts on budgetary responsibility set the expenditure framework for the general government that needs to be compatible with a medium-term budgetary objective (budget balance adjusted for the cycle and one-off factors). In line with the European Commission's activation of the escape clause of the Stability and Growth Pact, following the crisis, the structural balance rule was amended for the new expenditure framework 2021-2028 (Ministry of Finance, 2020b). The amendment requires at least 0.5 percentage point improvements in the structurual budget balance per year between 2022 and 2028.

Table 1.3. Emergency fiscal measures to support the economy

Measure	Description	Total Amount (billion CZK)
Income support measures for individuals and households, excluding tax and contributions policy changes	Financial support for the self-employed and employees that stayed at home to take care of children aged 6 to 13 (due to schools closure). CZK 424 per day (up to CZK 13 144 per month) in March (later increased to CZK 500 per day) to all self-employed persons and 60% (later increased to 80%) of reduced assessment base to employees. The measure lasted from March 12 to June 30, 2020. Extended in October for the self-employed, with CZK 400 per day.	15.6
	Compensatory bonus to the self-employed persons and very small businesses of CZK 500 per day, where the activity performed is the principal activity and there is a proved sufficient drop in sales compared to a year before. Programme lasted from March 12 to June 8, 2020. The Government also approved a compensatory bonus to persons working on the employment agreement (or agreement on working activity) of CZK 350 per day for the same period. In October, the programme was extended, for both the self-employed and persons on employment agreements, with CZK 500 per day.	22.,2
	Increasing funds for salary bonuses of workers in the health sector and social services, for police, firefighters and taxmen.	7.0
	See also Antivirus programme below (under public sector subsidies to businesses)	
Deferral of taxes and social security contributions	Waiver of the advance payments (not the tax itself) for corporate and personal income tax in June. Road tax advances due in April and July can be paid until 15 October. Further extended in October.	22
	Waivers of any penalties and default interest for corporate and personal income tax payments up to 1 July. Deferral of the VAT. Further extended in October. Deferral of a continued rolling out of the electronic registration of sales for all subjects to the end of year 2020, and then further deferred to January 1st, 2023.	
Tax and contributions policy changes	A six-month waiver on the (minimum) payments of health and social insurance for the self-employed.	23.1
	Waiver of social security contributions paid by employers with a maximum of 50 employees (under certain conditions), between June and August 2020.	13.5
	Exemption of VAT on goods that are supplied free of charge (e.g. test kits and diagnostic test tools for COVID-19, protective clothing, thermometers, disinfectants and sterilisation products, other medical devices and medical supplies) and the products used to manufacture these goods. Further extended in October.	Not quantified
	Reduction in VAT rate from 15 to 10% for accommodation services, tickets for cultural and sporting events, admission fees to sports grounds, fare on ski lifts and admission fees to saunas and other similar facilities. A reduction to 25% of the road tax on lorries over 3.5 tonnes and shortening the refund time for the overpayment of excise duty on "green diesel".	4. 8
	Introduction of a loss-carry backward provision – the self-employed can offset CIT and PIT losses reported in 2020 from their tax bases in 2019 and 2018, thereby obtaining a refund from the Financial Administration.	18
Public sector subsidies to businesses	Job retention scheme (Antivirus programme) to compensate for all or part of salary costs for the time of the emergency measures. Employees will receive all or part of their wages, subsidised by the state, depending on the exact reason and situation of reduced activity. For example, employees ordered into quarantine will receive 60% of their salaries, while employees working in firms that had to stop operations by a government order will be compensated in full. In both cases, the government reimburses the employer 80% of the employee compensation (up to CZK 39 000 per employee). Employees in firms facing supply disruption in inputs or drop in sales, receive 60-100% of their salaries, with the state reimbursing 60% of the costs (up to CZK 29 000 per employee). Lasted from April (retroactive effect from 12 March to the end of October 2020. The Antivirus (renamed Antivirus Plus), for companies that need to shut down or restrict operations due to government decree or workers in quarantine job-retention scheme was extended in October, until the end of the year 2020. Support will increase as companies will be entitled to the entire sum of employee compensation (80% before). The maximum monthly limit is to be increased from CZK 39,000 to 50,000 per person. Antivirus for companies affected indirectly by the coronavirus crisis was also extended until the end of 2020.	22.9
	Other programmes include: COVID Technology Programme 19 (subsidy for projects directly linked to the fight against the further spread of coronavirus through the acquisition of new technological equipment and facilities, CZK 300 million in total); Czech Rise Up 1.0 and 2.0 Programmes (encourage the introduction of new solutions to fight the coronavirus crisis by supporting innovative companies, including start-ups, CZK 500 million in total). The 2020 Rural Development Programme, to help entrepreneurs in agriculture, food and forestry (CZK 3.3 billion). Subsidy of spas (CZK 1 billion). COVID Accommodation program, to subsidise accommodation facilities by contributing CZK 100 to 330 per room per night for the period when they had to close during the pandemic. COVID Cultural and Creative Industries of CZK 900 million (in October extended in duration and scope by CZK 750 million) to support small and medium-sized enterprises in the creative industries in the form of subsidies and creative vouchers. In October, additional programmes were announced. A COVID - Bus subsidy program, to compensate bus carriers fore their lost revenues has been introduced (CZK 1 billion). COVID – Sport II, to support professional sports and sports event organizers (CZK 500 million). Agrocovid Food industry - to support the food industry (CZK 3 billion). Additional funds for the State Fund of Cinematography (CZK 98 million) to help cinema operators, production and distribution companies (not covered by COVID- Culture programme). A Covid - Tourism Support programme (CZK 500 million), to support travel agencies and tourist guides.	11.8

Public sector loans and loan guarantees	COVID I loan program for the SMEs. A direct interest-free loan in the range of CZK 0.5 to 15m.	1
	Loans are granted for up to 90% of eligible expenditure with a maturity of 2 years including the possibility of deferred repayment for up to 12 months.	20
	COVID II program in the form of guarantees for loans (CZK 10k to 15m) from commercial banks (with annual deferral of repayments), where the Czech-Moravian Guarantee and Development Bank will be subsidising the interest rate.	1.5
	COVID Prague for Prague entrepreneurs and SMEs (Since COVID II is funded by the EU, it is not possible to support projects in Prague).	150
	COVID III program. The self-employed and companies with up to 250 workers can receive a 90% guarantee and companies with 250 to 500 employees an 80% guarantee on loans provided by the commercial banks. In October, extended until end-2021.	330
	COVID Plus programme for large companies with more than 250 workers can receive an 80% guarantee on loans in the range of CZK 5m to 2 billion.	1
	The Government increased funds for the Support and Guarantee Farm and Forestry Fund, to provide farmers and foresters with more liquidity (delay of loan repayments).	
Measures to promote burden-sharing within the private sector	COVID rent programme, whereby the government contributes half of the payment for commercial rent to entrepreneurs that had to close establishments, with the maximum amount of support at CZK 10m for the period from April to June (under the condition of 30% discount on the rent provided by the lessor). Individuals and companies affected by the coronavirus were also allowed to delay paying rents and there was a ban on evictions. In October, the COVID - Rent programme was extended and it is no longer conditional on a discount from the landlord.	8.0
	Government allowed moratoria on the payment of loans and mortgages. Debtors - individuals as well as companies – were able to interrupt their payments for a period of three or six months.	

Fiscal consolidation should not be rushed. A more protracted crisis than expected would warrant further support to the economy. Efforts should also be made to use fully the newly available recovery funds at the EU level. In any case, the temporary nature of the emergency measures in 2020 - and their gradual withdrawal – are likely to contribute to a quite significant consolidation in 2021. Depending on the strength of the economy, enough flexibility should be permitted to do less consolidation early and more later on, once recovery is well under way.

Providing effective support to labour and capital reallocation

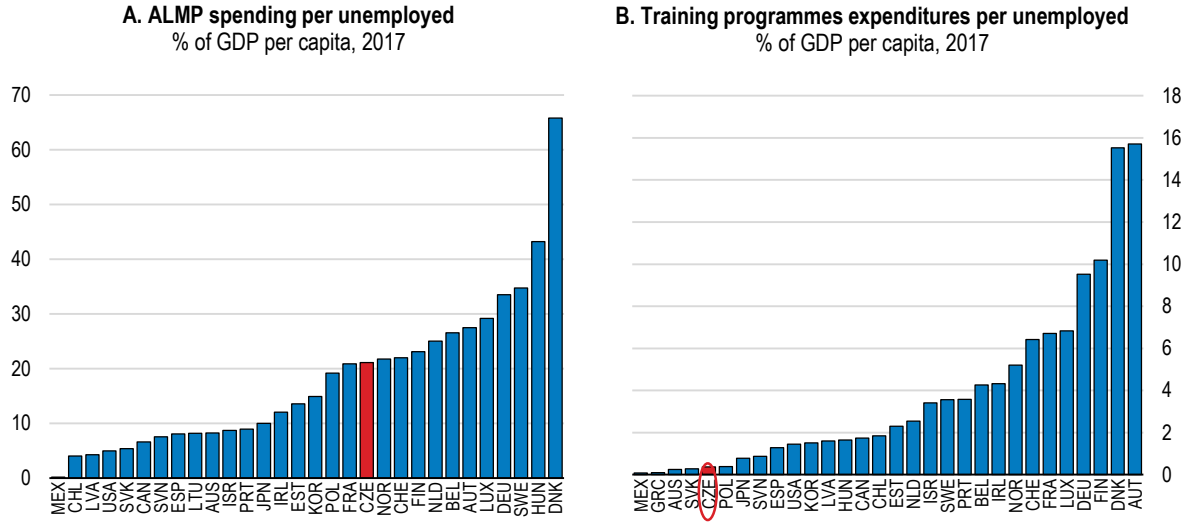
A key challenge is to identify viable jobs and companies in the near term to minimise long-term scarring, while allowing sufficient flexibility for necessary resource reallocation across sectors to support productivity growth (OECD, 2020a and 2020b). Restrictions of some non-essential activities (e.g. travel; hotels and restaurants; parts of the retail sector; recreational services) may persist for some time and consumer demand may take time to fully recover. In contrast, industries and firms with business models that are compatible with distancing may grow (e.g. e-commerce; courier, express and parcel services; parts of the health sector), suggesting that significant reallocation of resources is likely to occur (OECD, 2020b).

The “Antivirus” job retention programme has been effective in preserving existing jobs and valuable firm-specific human capital, but may hinder post-crisis adjustment across sectors. One policy option would be to gradually raise the financial contributions from employers in these schemes. This will encourage companies to self-select whether to continue participating or not, based on their assessment of the medium-term viability of the business. The government now aims to introduce a more permanent short-time working scheme, which could be triggered in future crises. Care should be taken to strike a balance between facilitating reallocation and preserving potentially unviable jobs.

Active labour market policies should be significantly boosted to facilitate job reallocation. The Czech Republic spends little money on active labour market programmes, partly a consequence of a history of a tight labour market (Figure 1.19). The OECD Priorities for Adult Learning Dashboard points to large gaps in providing adult learning to the unemployed. With rising unemployment and the gradual withdrawal of emergency measures, there is an opportunity to channel more resources into such programmes. Active labour market programmes should support the unemployed in their job search, and include training programmes and reskilling to facilitate employment in growing sectors, notably targeted to the low skilled, older workers and youth. The youth unemployment rate is likely to rise, as new entrants onto the labour

market will face meagre prospects of finding work. For instance, in the 2009 crisis, youth unemployment doubled and stayed elevated for a number of years.

Figure 1.19. There is room to boost active labour market policies



Source: OECD Labour Force Statistics; OECD Key Short-Term Economic Indicators; OECD Economic Outlook database.

Effective insolvency procedures will also be crucial to minimise barriers to corporate restructuring and spur productivity-enhancing capital reallocation (Adalet McGowan et al., 2017). The Czech Republic implemented reforms to insolvency procedures, and now scores high on the strength of insolvency framework index in the World Bank's Doing Business indicators. Still, this framework needs to be fully translated into effective practice. The recovery rate lags behind other advanced economies, and the whole procedure is costly and takes longer (World Bank, 2020). The number of insolvency cases will likely rise in the wake of the crisis and the system will need adequate resources to work effectively, including by recruiting and training staff.

Improving fiscal sustainability over the long term

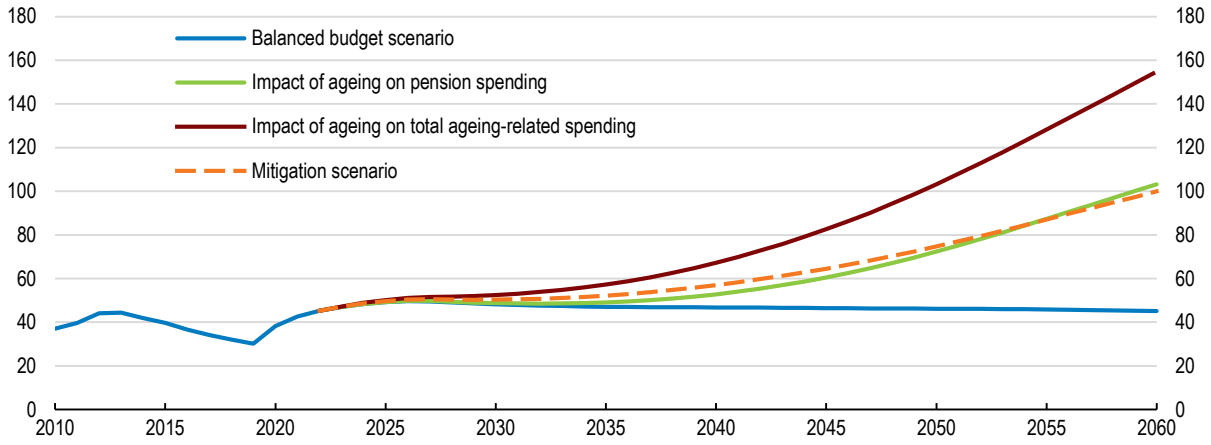
Czech authorities have ample fiscal space to support the economy in the short-term should economic weakness continue. Once the economy recovers from the current crisis, fiscal policy should once again focus on long-term challenges and deal with ageing pressures while reducing tax distortions.

Ageing threatens fiscal sustainability

Population ageing and the corresponding rises in public expenditure threaten long-term fiscal sustainability (Figure 1.20). Additional pressures will arise due to a reduction in tax revenues, notably from labour taxes (Colin and Brys, 2019). According to recent European projections, the old-age dependency ratio in the Czech Republic will rise from 30% in 2019 to 49% in 2070, with a peak at 54% in 2060 (Figure 1.21), albeit less than in some other Central and Eastern European countries (CEECs). Population ageing will strongly affect public finances, with rises in pension, health and long-term care spending. In the scenario with no reform to the pension system and financing of additional pension expenditure by a government deficit, the public debt-to-GDP ratio is set to rise to about 95% by 2060. Moreover, taking into account also rises in age-related public expenditures in healthcare and long-term care, public debt would reach staggering 155% of GDP (Figure 1.20).

Figure 1.20. Ageing-related expenditures put strong pressures on fiscal sustainability

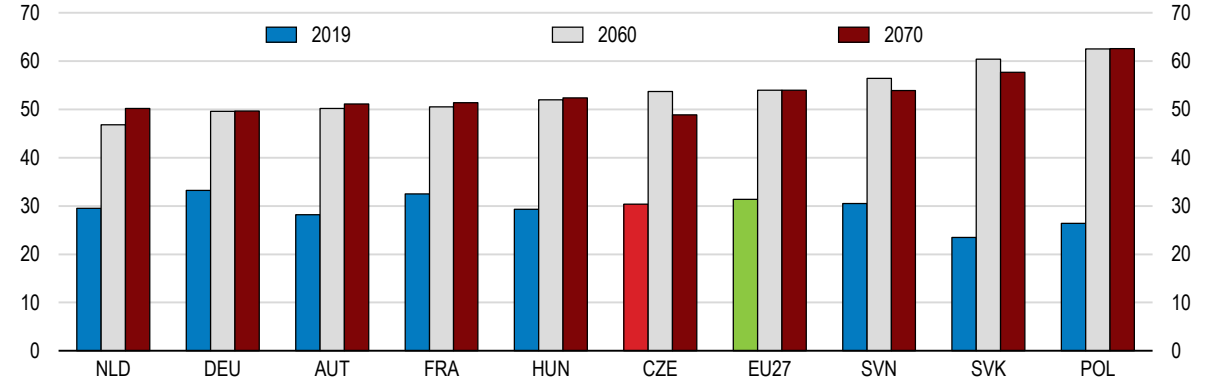
General government debt, Maastricht definition, as a percentage of GDP[1]



1. Scenarios consist of projections for the Economic Outlook until 2021, after which the economy is assumed to grow as projected in the OECD Long-term model. In the Balanced budget scenario, the primary balance is assumed to reach a balance in 2028 and remain at zero thereafter. The "impact of ageing on pension spending" scenario assumes that increases in pension spending are financed through deficits. The "impact of ageing on total ageing-related spending" scenario adds together the impact of ageing on pensions, health and long-term care. These scenarios are based on the 2018 Ageing Report by the European Commission combined with the economic developments in the OECD Long-term model. The "mitigation" scenario assumes that half of the ageing-related spending is financed by increasing revenues and limiting spending increases.
Source: Calculations based on the 2018 Ageing Report of the European Commission, the OECD Long-term model and OECD Economic Outlook database.

Figure 1.21. The old-age dependency ratio is set to rise significantly

In percentage



Note: This indicator is the ratio between the projected number of persons aged 65 and over (age when they are generally economically inactive) and the projected number of persons aged between 15 and 64. The value is expressed per 100 persons of working age (15-64).
Source: Eurostat; EUROPOP2019 population projections.

The old-age pension scheme will bring the greatest burden on public finances (Table 1.4). While pension spending is projected to be stable as a share of GDP over the next decade, it is expected to rise steeply after that, and go from 6.8% of GDP in 2030 to 10.2% of GDP in 2060. Yet, policy steps in recent years have made the system less sustainable.

Table 1.4. Public 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
Scenario (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).

Recent changes in the pension indexation rule and discretionary measures are raising pension spending. Since the start of 2018, pensions are indexed to a combination of the consumer price index (or pensioners' cost of living index, whichever is higher) and half of the real wage growth. Moreover, if according to the standard formula the growth of pensions were to be less than 2.7%, the government has the discretion to raise pensions by as much as 2.7% in nominal terms. In 2019, the government decided, beyond the standard indexation, to increase the flat-rate component of pension benefit from 9% to 10% of average wage, resulting in an overall increase of an average monthly pension by CZK 900 in 2020. Moreover, the government decided to give an additional CZK 1000 per month to all pensioners over the age of 85 (Ministry of Finance, 2019a) and to give a lump sum of CZK 5 000 to all pensioners as a solidarity assistance during the coronavirus crisis. The new indexation rule and discretionary increases are meant to help prevent old age poverty, but these measures add to the projected steep spending increases.

The adequacy of pensions of high income earners could be improved. The main pillar is a mandatory defined benefit pay-as-you-go public system. Overall, the pension replacement rate for average earners is close to the OECD average (Figure 1.22, panel A). It is quite generous for low-income earners but low for high-income earners (Figure 1.22, panel B). Overall, disposable income levels of people aged over 65 compared to the rest of the population are relatively low in international comparison, but relative poverty is low too, due to strong redistribution within the pension system (OECD, 2020d).

Box 1.3. Potential impact of reforms

Structural reforms can boost economic growth and incomes. The OECD has estimated the relationship between reforms and total factor productivity, capital deepening and the employment rate for a sample of OECD and major non-OECD countries (Égert, 2017). The analysis suggests that if the Czech Republic implemented the selected set of reforms (see below), per capita income could increase by 1.3% in two years, supporting the recovery, and by 6% in 10 years. The estimates are illustrative.

Table 1.5. Potential impact of structural reforms on per capita GDP

	2 years	10 years
Better target R&D support to small and young dynamic firms.	0.1%	0.9%
Improve the business environment.	0.6%	2.6%
Boost active labour market policies.	0.1%	0.2%
Link retirement age to life expectancy.	0.2%	1.0%
Keep expanding the supply of affordable and high-quality childcare facilities.	0.3%	1.4%
Shift taxation from labour towards real estate, consumption and environmental taxes.	-	0.9%
Total	**1.3%**	**7.0%**

Note*: The framework relies on a production function approach. A no policy change scenario is used as the baseline. The following changes in policy/outcomes are assumed. Business expenditure on R&D will reach OECD average as % of GDP. The cost of starting a business will go to zero and the difference in the cost of contract enforcement between the Czech Republic and the OECD average will be halved. Spending on active labour market policies as % of GDP will reach OECD average. Effective retirement age of men will reach EU-28 level. Family benefits in kind as a % of GDP will reach OECD average. Tax reform assumes a tax neutral shift from income taxes to consumption and property taxes.*
Source: OECD calculations based on (Égert, 2017). For tax reform, the source is Arnold (2008).

The following estimates quantify the direct fiscal impact of selected recommendations included in the Survey. The estimates are illustrative.

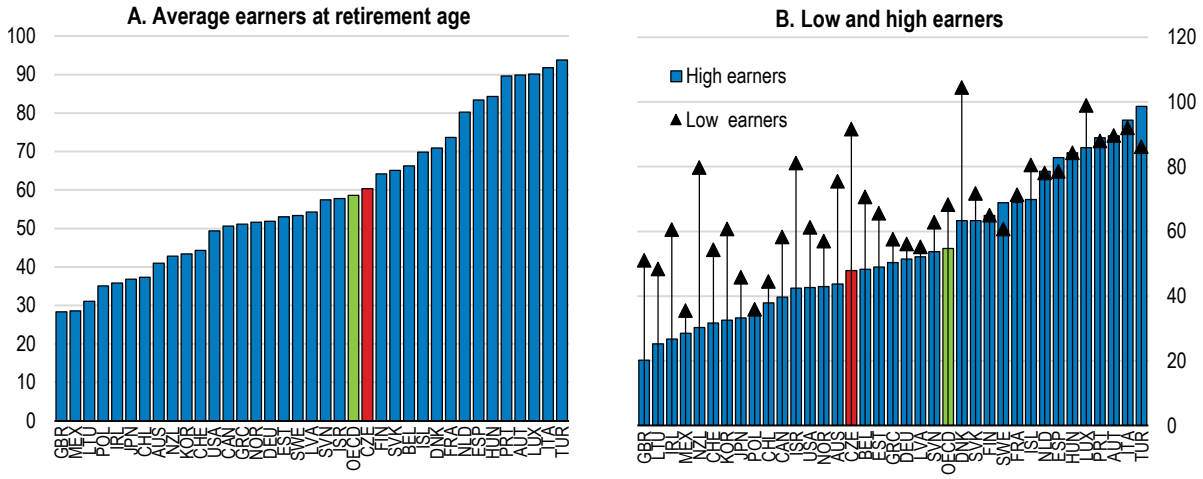
Table 1.6. Illustrative direct fiscal impact of selected recommended reforms

Reform	Fiscal impact (savings (+)/ costs (-)) (% of GDP)
Better target R&D support to small and young dynamic firms.	Fiscally neutral
Improve the business environment.	Negligible
Boost active labour market policies.	-1.0%
Link retirement age to life expectancy.	+1.6% by 2060
Keep expanding the supply of affordable and high-quality childcare facilities.	-0.3%
Shift taxation from labour towards real estate, consumption and environmental taxes.	Fiscally neutral
Fiscal savings from higher efficiency of public expenditure and from streamlined subnational government.	Offsetting other costs (+1.3%)

Note: The following changes in policy/outcomes are assumed. Spending on active labour market policies as % of GDP will reach OECD average. Family benefits in kind as a % of GDP will reach OECD average. The estimated fiscal saving of linking the retirement age to life expectancy is based on the estimate by the Ministry of Finance about the cost of keeping the retirement age ceiling at 65 until 2060.
Source: Ministry of Finance and OECD Secretariat.

Figure 1.22. The adequacy of pensions could be improved

Net pension replacement rates, %

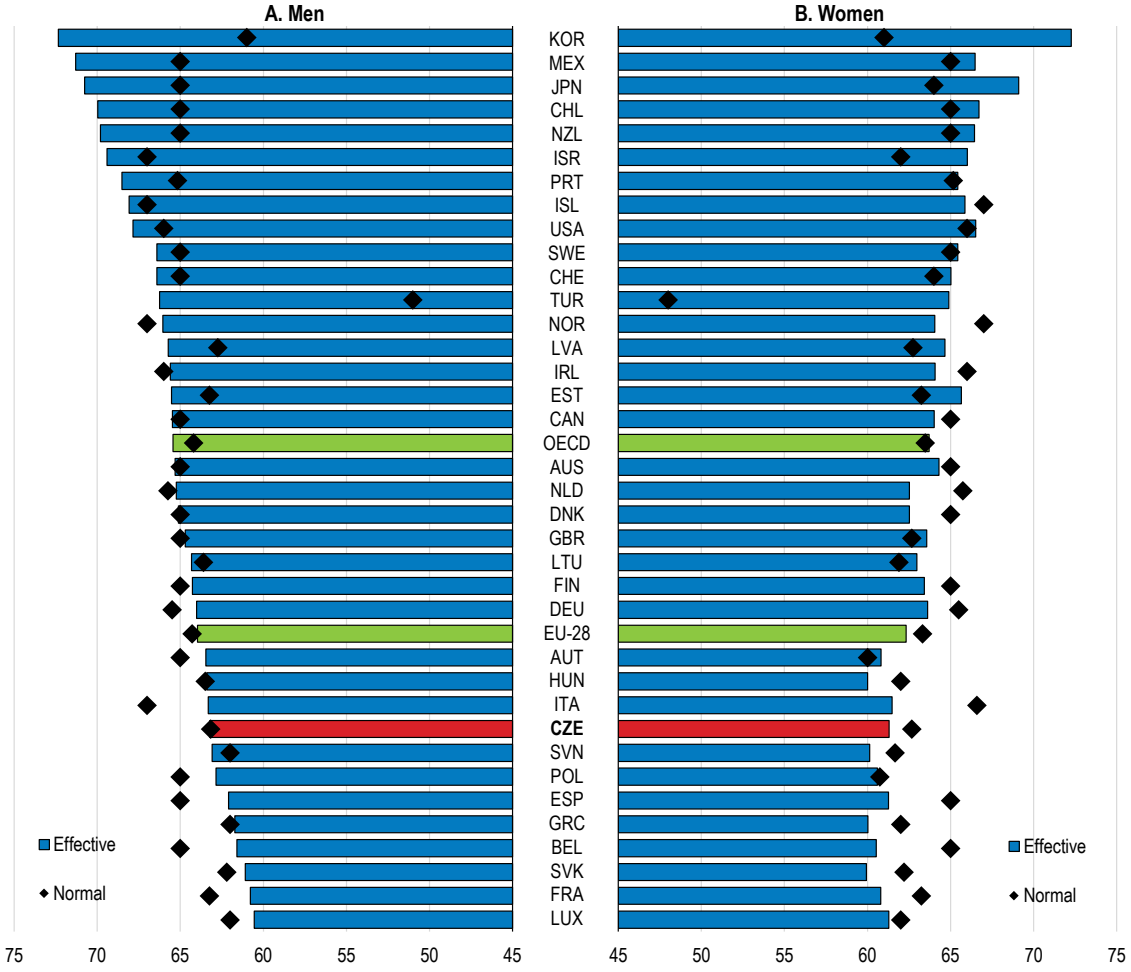


Source: OECD (2019), Pensions at a Glance 2019: OECD and G20 Indicators.

Czech workers retire early (Figure 1.23) and adjusting the retirement age is key. In 2017, the automatic mechanism for increasing the statutory retirement age was withdrawn and a ceiling at the age of 65 was introduced. Keeping the retirement age ceiling at 65 is estimated to increase pension expenditures by 1.6 percentage points of GDP by 2060 (Ministry of Finance, 2017). Every five years, the Ministry of Labour and Social Affairs is tasked to prepare a report on life expectancy and to suggest a shift in the statutory retirement age, provided that on average everyone spends a quarter of their life in retirement. The first report, prepared in 2019, proposed delaying further rises in retirement age to the next round of the revision process scheduled for 2024. No change was therefore instituted. Under this mechanism, the change in the retirement age is dependent on recurring government initiative, which brings about the risk that retirement age might not be increased in a timely manner or sufficiently to curtail the long-term spending pressures. As planned in many OECD countries, the Czech Republic should introduce a tight and automatic link between retirement age and life expectancy. This will limit the increase of pension spending and help maintain adequacy of pensions.

Figure 1.23. Effective age of retirement is low

Average effective age of labour-market exit and normal retirement age, 2018



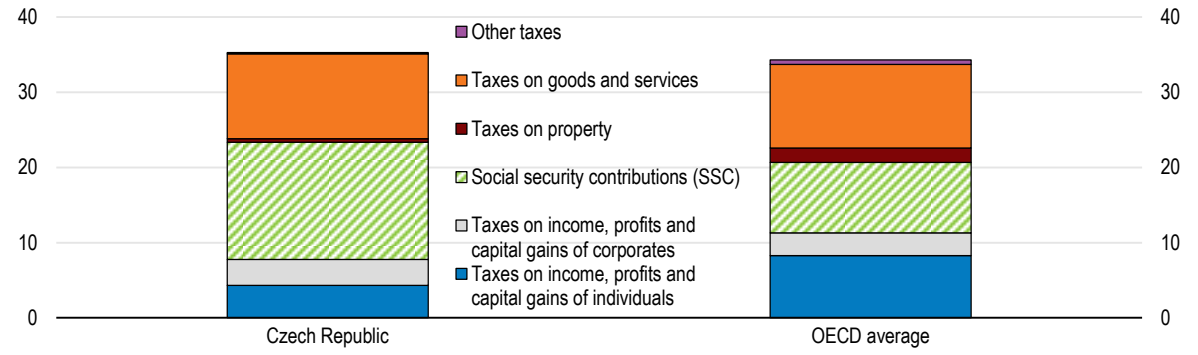
Note: Effective retirement age shown is for five-year period 2013-18. Normal retirement age is shown for individuals retiring in 2018 and assuming labour market entry at age 22.
Source: OECD (2019), Pensions at a Glance 2019.

Reforming the tax system to better support the recovery and future growth

The Czech tax system relies heavily on labour taxes (personal income tax and social security contributions), raising costs to companies and slowing growth. Personal income taxes are low, and there is very little progressivity. The PIT is a flat tax, with a solidarity surcharge of 7% for very high incomes. Social security contributions on the other hand represent a significantly higher share of tax revenues than in the OECD on average (Figure 1.24). This results in a high average tax wedge – a gap between the take-home pay of workers and their costs to employers. For most types of households, the average tax wedge in the Czech Republic is higher than the OECD average (Figure 1.25).

Figure 1.24. Tax revenues rely heavily on social security contributions

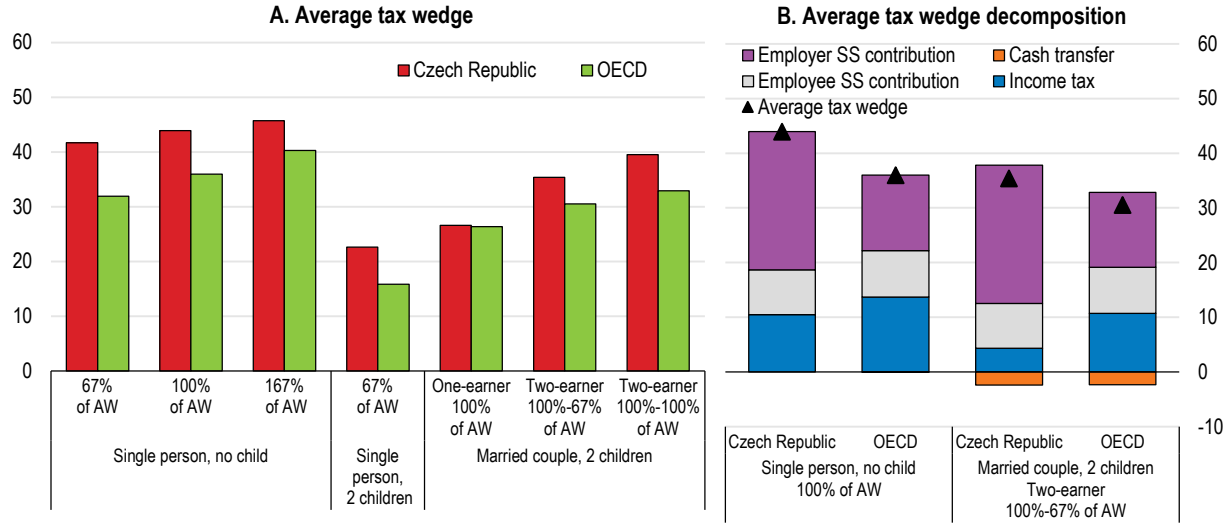
General government tax revenues, % of GDP, 2018



Source: OECD Revenue Statistics database.

Figure 1.25. The average tax wedge is high

Average tax wedge, % labour costs, 2019



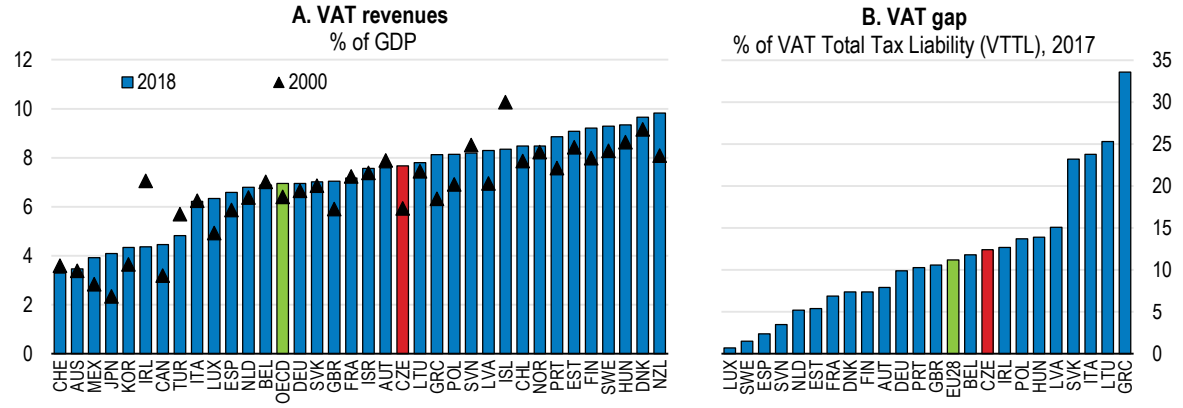
Note: AW refers to average earnings.
Source: OECD Revenue Statistics database.

The Czech Republic could reform its tax system in a revenue-neutral way, to reduce tax distortions and boost growth, which would in turn help restore fiscal sustainability. Taxes on production factors (personal income taxes and corporate income taxes) are most harmful to growth. The tax burden could hence be shifted away from labour in the Czech Republic. In particular, high social security contributions could be reduced and the PIT made more progressive. More revenue can also be raised from taxes on real estate property, which are the least distortive to growth, followed by consumption taxes (Arnold et al., 2011).

Efforts to strengthen VAT collection should be continued and VAT exemptions and reductions granted in recent years should be reversed, once the recovery is fully underway, not to add additional burden on sectors in distress. Receipts from VAT were rising strongly before the COVID-19 crisis (Figure 1.26) thanks to efforts to reduce tax evasion, including through the introduction of the electronic registration of sales

(rolling out of which has been partly postponed due to the COVID-19 crisis). Tax evasion, as measured by the VAT compliance gap, is estimated to have declined to close to the EU average levels (European Commission, 2020a). However, there is extensive use of the reduced VAT rate. For instance, the reduced VAT rate applies to public land and water transport since 2019, and to labour-intensive services, water and sewerage services, catering and beverage services, rental of printed materials and heat and cold supply since 2020 (Ministry of Finance, 2019a). Moreover, as an emergency measure to help sectors particularly affected by the coronavirus, the government lowered the VAT rate for accommodation services and admission to sports and culture events. VAT reduced rates raise complexity and tax compliance costs and, due to poor targeting, are not an effective means of increasing equity or giving support (OECD, 2019e).

Figure 1.26. There remains scope to increase receipts from VAT



Source: OECD Revenue Statistics database; CASE, Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report, https://ec.europa.eu/taxation_customs/sites/taxation/files/vat-gap-full-report-2019_en.pdf.

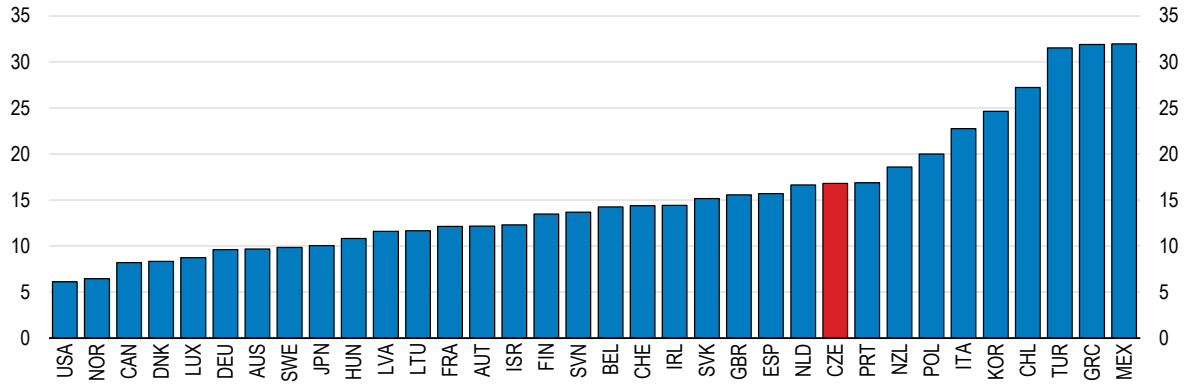
The Czech Republic is increasing its use of excise duties, notably by raising tax rates on tobacco products and alcohol (Ministry of Finance, 2019a), which is a step in the right direction. However, with respect to environmental taxes and a carbon tax, progress is slow (see below). The total revenue from the property tax in terms of GDP is one of the lowest in the OECD. The calculation of the tax is based on the size of the property rather than its value. Raising this tax could also help raising the tax autonomy of municipalities, which could in turn increase efficiency in providing public services (see Chapter 2). To avoid adverse consequences for vulnerable households, targeted means-tested exemptions and cash transfers could be introduced.

Taxes on the self-employed remain lower than for employees. The assessment base for social security contributions is set at 50% of net income, effectively lowering the overall contributions of self-employed workers compared to employees. In addition, a revenue threshold under which a flat rate deduction (instead of expenditures) can be used to lower the tax base is quite generous, reducing the personal income tax. The incidence of self-employment is relatively high (Figure 1.27), much of it being quasi-dependent employment and driven by the benefits from the advantageous fiscal position (OECD, 2018a).

The lower assessment base for social contributions for the self-employed creates issues of fairness, adequacy and sustainability. The self-employed enjoy the same rights from the health care system as employees, but they contribute significantly less. They also contribute less towards pensions, but in this case, lower contributions will result in markedly lower pension rights (albeit with a relatively high replacement rate), potentially leading to poverty. This could also increase the burden on public finances through future social transfers to fight poverty in old age (OECD, 2018a). In 2018, the government lowered the revenue threshold for the flat rate deduction of expenses, but this was retracted in 2019 back to CZK 2 million (EUR 80 000), demonstrating the political economy difficulties with this reform.

Figure 1.27. There are many self-employed

Self-employment, % of total employment, 2019 or latest available year



Source: OECD Annual Labour Force Statistics database.

Table 1.7. Past recommendations on strengthening the tax mix and fiscal sustainability

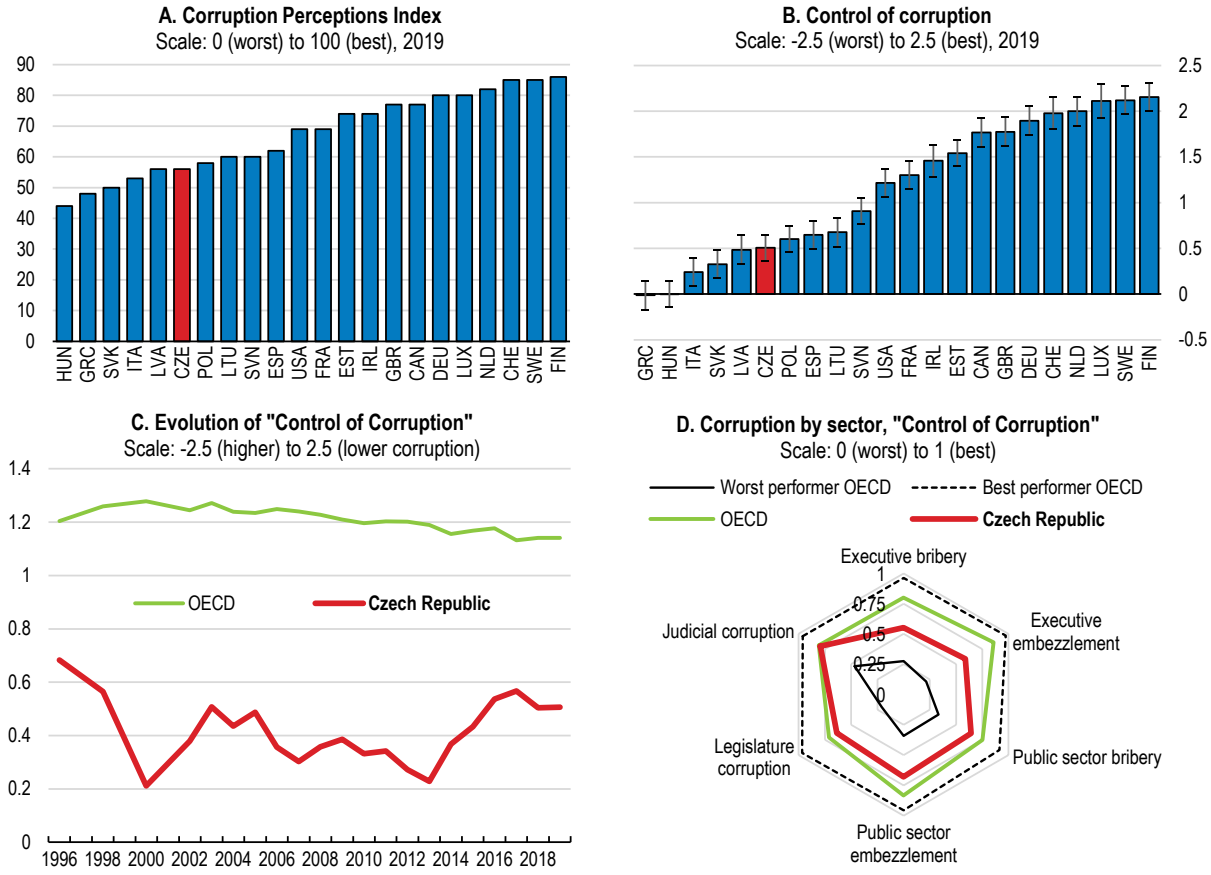
Recommendations in previous Surveys	Action taken
Rebalance tax revenues by reducing social security contributions and raising indirect taxes (VAT compliance and environmental taxes).	A 0.2 pp reduction in the sickness insurance rate. This involves compensation for costs incurred by employers in connection with the obligation to pay employees for the first three days of their incapacity for work, effective from 1 July 2019 (Act No. 32/2019 Coll.). Excise duties on tobacco products and alcohol were increased with effect from 1 January 2020 (as well as rates of gambling tax). Phasing in the electronic registration of sales for the remaining sectors (e.g. liberal professions, transport, agriculture, crafts and manufacturing activities, etc.), improving VAT collection.
Reduce the advantages of self-employment in terms of social contributions and personal income tax.	No action taken. (From January 2018, a 50% reduction on the flat-rate expenditure limit (to CZK 1 million) was introduced for the self-employed. However, this reform was retracted in January 2019.)
Use a multi-pronged approach to secure fiscal sustainability: Take steps to secure an increasing effective retirement age. Link tightly retirement age to life expectancy. Continue to ensure that the indexation of pensions does not lead to old-age poverty problems. Consider options for diversifying income sources for pensioners.	No action taken. Government has recently taken steps to improve the adequacy of pensions (by raising the flat rate component of pensions and by making the indexation of pensions more generous) but without addressing sustainability concerns. Government is supposed to discuss every five years whether to raise the statutory pension age (which is currently gradually rising to reach 65 in 2030, when it will also be equalised for both men and women). In 2019, the government decided not to raise the statutory retirement age and to discuss the issue again in five years.
Broaden the financing of health care and long-term care by expanding the base of contributions to all types of income.	No action taken.

Addressing corruption to raise the effectiveness of public spending

Improving governance and fighting corruption can improve the effectiveness of government spending and value-for-money. Fighting corruption successfully can also boost economic growth, including by maintaining the Czech Republic's attractiveness as a destination for foreign direct investment (OECD, 2016c; Blundell-Wignall and Roulet, 2017). Indicators of public sector governance are mixed. On the one hand, indicators of control and perceived risks of corruption in the public sector suggest that the Czech Republic performs poorly compared to most OECD countries (Figure 1.28). Control of corruption improved from 2012 onwards, but this progress has recently stalled (Figure, 1.28, Panel C). According to a survey by the European Commission (2017a), 84% of Czech citizens think that corruption is widespread, significantly above the EU average (68%), and they point to officials awarding public tenders, political

parties and politicians at all level of government as the most corrupt. They further believe that there are not enough successful prosecutions to deter corruption and the majority perceives government efforts to combat corruption as ineffective. On the other hand, the share of Czech businesses that reported corruption as a problem when doing business dropped from 51% in 2017 to 32% in 2019, slightly below the EU average (European Commission, 2017b and 2019b).

Figure 1.28. Czech Republic performs poorly in control and perceived risk of corruption



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.

Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Institute; University of Gothenburg; and University of Notre Dame.

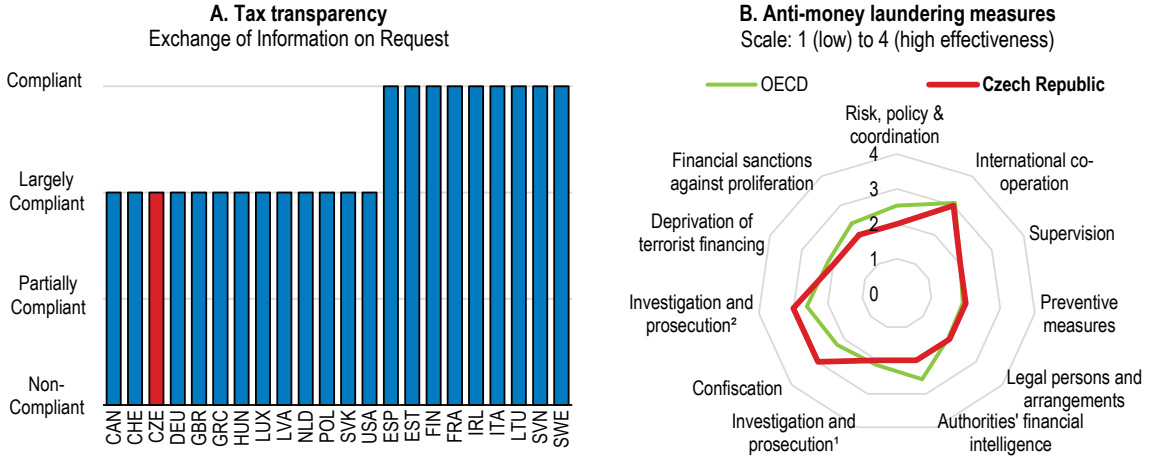
Corruption and weak anti-corruption measures have been noted in particular in relation to the management of EU funds, public procurement and other interactions between businesses and the public sector (GRECO, 2016). Elected high-level officials have been involved in criminal proceedings or recurring controversies because of integrity issues, consistent with the negative perception of politicians and political parties. Recent reforms to boost public integrity, such as new rules on election finance and political parties and improved access to information measures, have been introduced to increase resilience to fraud and corruption risks. Ensuring that these measures are implemented is critical, but more is needed to address public integrity across all branches of government.

In its fourth evaluation round, the Council of Europe anti-corruption body, the Group of States against Corruption (GRECO, 2016), listed fourteen recommendations to improve public integrity in the Czech Republic. However, in the follow-up report two years later (GRECO, 2018) it found the level of compliance

with the recommendations as “globally unsatisfactory”. Several recommendations aimed at improving integrity for members of parliament. These included improving transparency in parliamentary committee meetings and implementing a written code of conduct for members of parliament. Moreover, measures were proposed to ensure that members of parliament disclose conflicts of interest and activities, gifts and sources of income. Measures to strengthen the management and prevention of conflict of interest in the executive, as well as improve integrity and transparency in lobbying, should be adopted. The government could also consider reviewing its internal controls and integrity risk management framework to ensure robust measures are in place to prevent mismanagement of public funds. Effective implementation of such measures will improve transparency of government decisions, prevent misallocation of resources, and promote confidence in the economy.

Efforts to tackle bribery of foreign public officials in international business transactions should also be stepped up by implementing the OECD Anti-Bribery Convention (Figure 1.29). The Czech Republic is highly export-oriented and its exports include high-risk sectors for bribery, such as machinery and defence materials (OECD, 2017e). The country is now prosecuting its first case of foreign bribery, which represents a positive development (OECD, 2019g). Furthermore, efforts are underway to enhance detection of foreign bribery through certain key government agencies, in particular the Financial Intelligence Unit (FAU). The OECD Working Group on Bribery also welcomes the publication of comprehensive guidance by the Supreme Public Prosecutor’s Office (SPPO) on corporate liability. On the other hand, further efforts are needed to guarantee greater independence to prosecutors so that political factors are not taken into account in foreign bribery investigations and prosecutions. Another area of concern is the lack of appropriate protection from discriminatory or disciplinary action of whistleblowers, both in the public and private sector (Dell and McDevitt, 2018; OECD, 2019g). A law has been drafted in light of the new European Union (EU) standards on whistleblower protection, which is positive, but the adoption process is in very early stages.

Figure 1.29. There is scope to strengthen Czech Republic's anti-bribery enforcement across borders



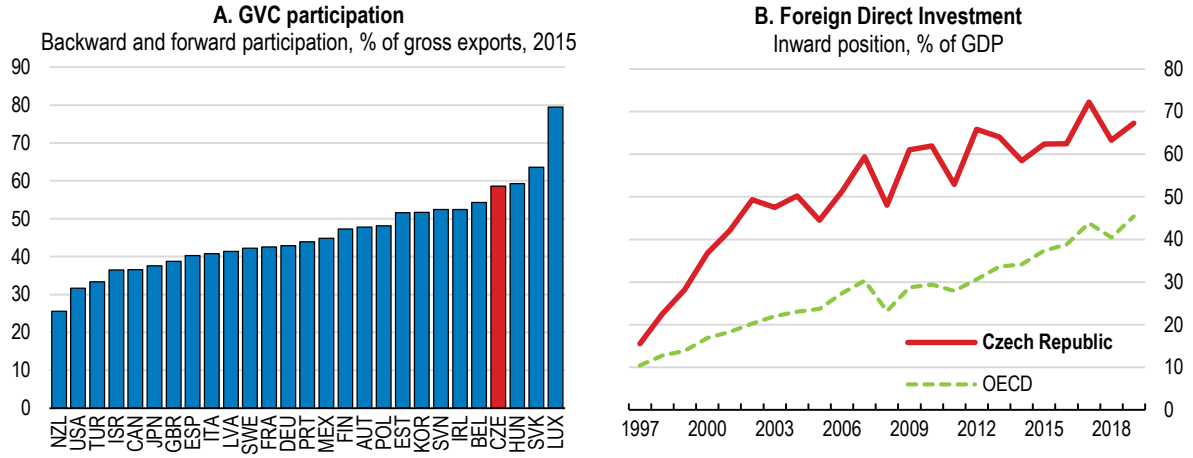
Note: Panel A summarises the overall assessment on the exchange of information in practice, from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows first round results; a second round is ongoing. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution1" refers to money laundering. "Investigation and prosecution2" refers to terrorist financing.
Source: OECD Secretariat’s own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

Policies to raise productivity and restart investment

Fostering R&D, innovation and improving the business environment

The Czech Republic is well integrated in Global Value Chains (GVCs). With its openness and stable macroeconomic environment, it has attracted a significant amount of FDI (Figure 1.30). A number of international companies have set up production in the country, and local SMEs represent an important element of the supply chain. SMEs are a notable employer and they directly or indirectly support exporting activity by supplying larger firms (OECD, 2019c).

Figure 1.30. Integration in Global Value Chains (GVCs) is high and there have been substantial FDI inflows

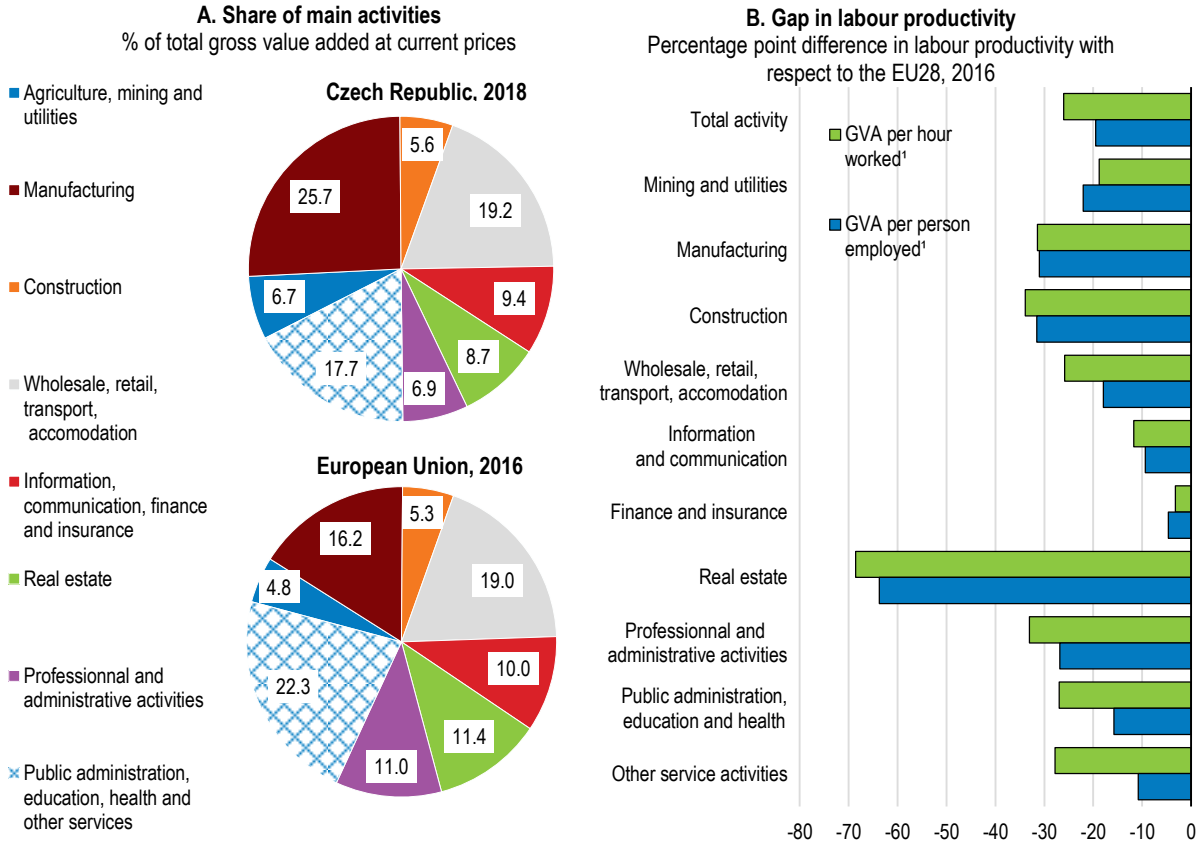


Source: OECD Trade in Value Added (TiVA) database; OECD International Direct Investment Statistics database.

Compared to its EU peers, the Czech Republic's economy remains significantly more dependent on manufacturing (Figure 1.31), of which the automotive sector is the most important part. Yet, despite this specialisation, manufacturing shows the third largest gap in labour productivity, more than 30% below the EU average (Figure 1.31), reflecting a more downstream position in the global production chain. The overall productivity gap is also sizeable.

The R&D intensity remains significantly below the OECD average, although it rose over time (Figure 1.32). The share of Business R&D (BERD) is also low in international comparison (Figure 1.32), impairing development and diffusion of new technologies (OECD, 2018g). Innovation performance is moderate (European Commission, 2019a, 2020a) and the number of patents is low (Figure 1.32). Czech firms are also slow to adopt more sophisticated technologies, holding back their digital transformation. ICT task intensity and the share of non-routine employment are relatively low, in particular in manufacturing (Figure 1.33).

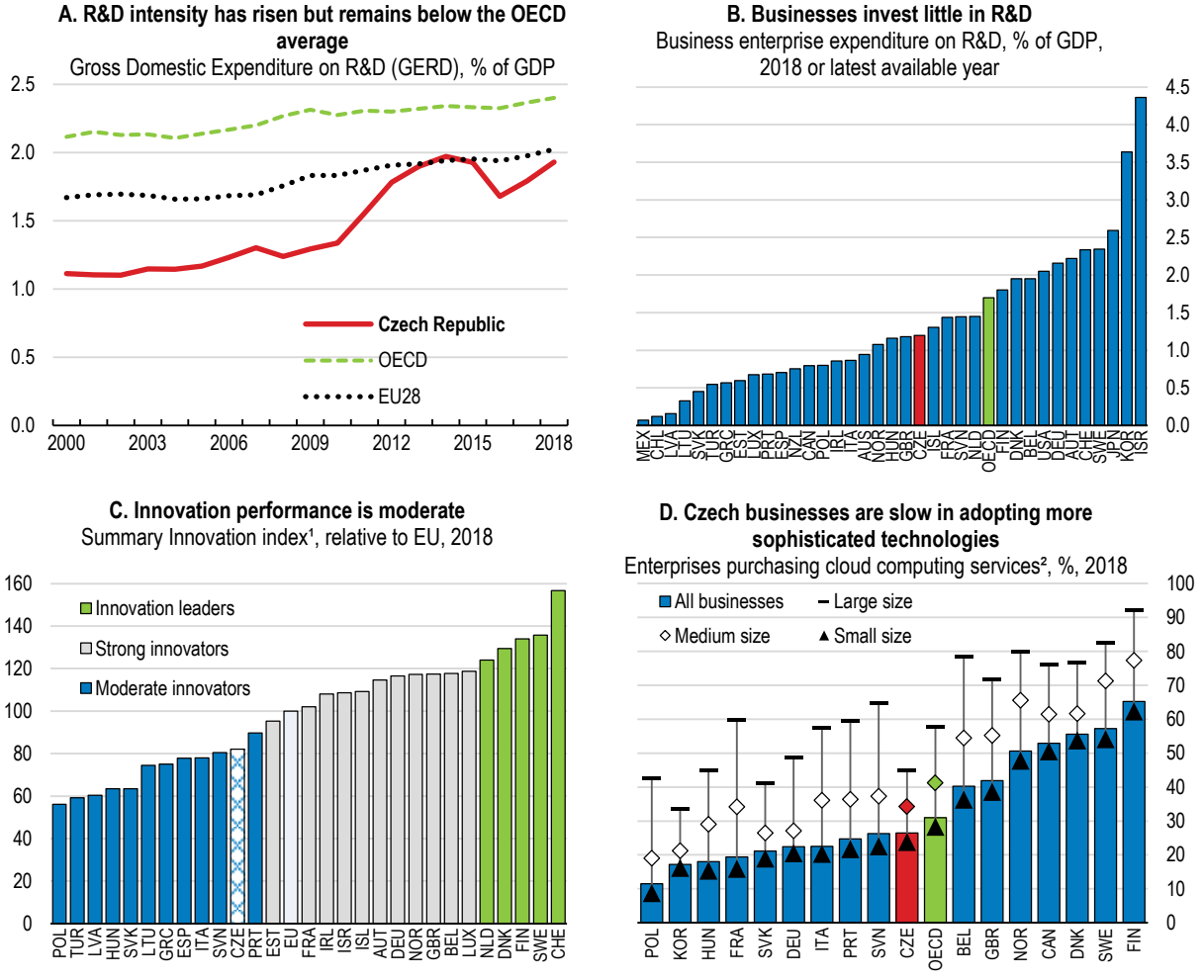
Figure 1.31. The Czech Republic specialises in manufacturing, but gaps in productivity remain



1. Gross Value Added (GVA) is measured in current USD PPPs.
Source: OECD National Accounts Statistics.

Czech SMEs in particular have low productivity and invest little in R&D (Figure 1.34). Moreover, the gap in productivity between large and small firms has grown over time (Figure 1.34). Many SMEs seem to specialise in lower value-added activities in manufacturing, supplying larger multinational companies, or serving the domestic market. SMEs in the Czech Republic invest significantly less in R&D and represent a relatively lower share of innovating firms than in many other advanced economies (Figure 1.34). A major share of the R&D investment comes from business investment from abroad, primarily through domestic subsidiaries of international companies (Figure 1.35, OECD, 2017d).

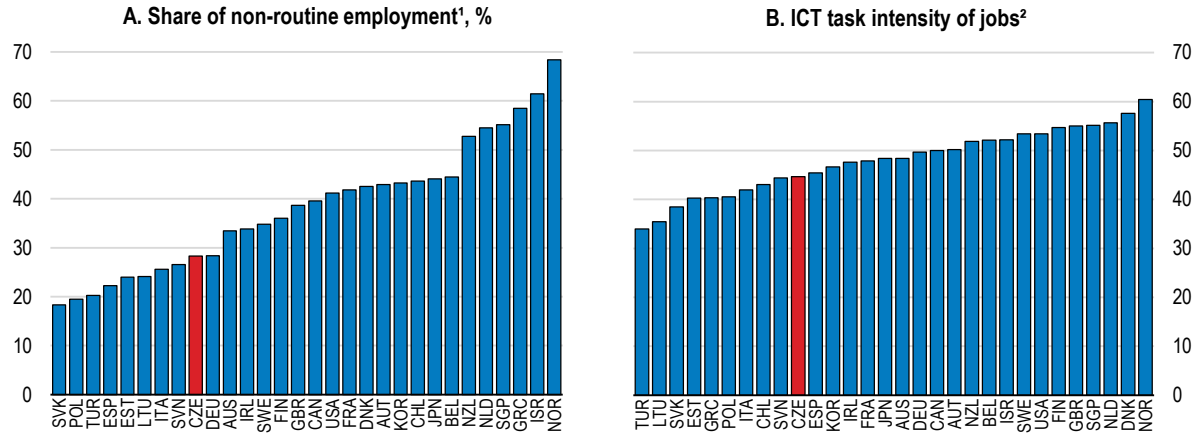
Figure 1.32. R&D intensity and innovation performance are low, and adoption of new technologies is slow



1. The colours show normalised performance in 2018 relative to that of the EU in 2018: green above 120%; grey: between 90% and 120%; blue: between 50 and 90%.
2. Cloud computing refers to ICT services used over the Internet as a set of computing resources to access software, computing power, storage capacity and so on. Data refer to manufacturing and non-financial market services enterprises with ten or more persons employed, unless otherwise stated. Size classes are defined as: small (10-49 persons employed), medium (50-249) and large (250 and more). OECD data are based on a simple average of the available countries.
Source: OECD Main Science and Technology Indicators database; European Commission, European Innovation Scoreboard 2019; OECD ICT Access and Usage by Businesses database.

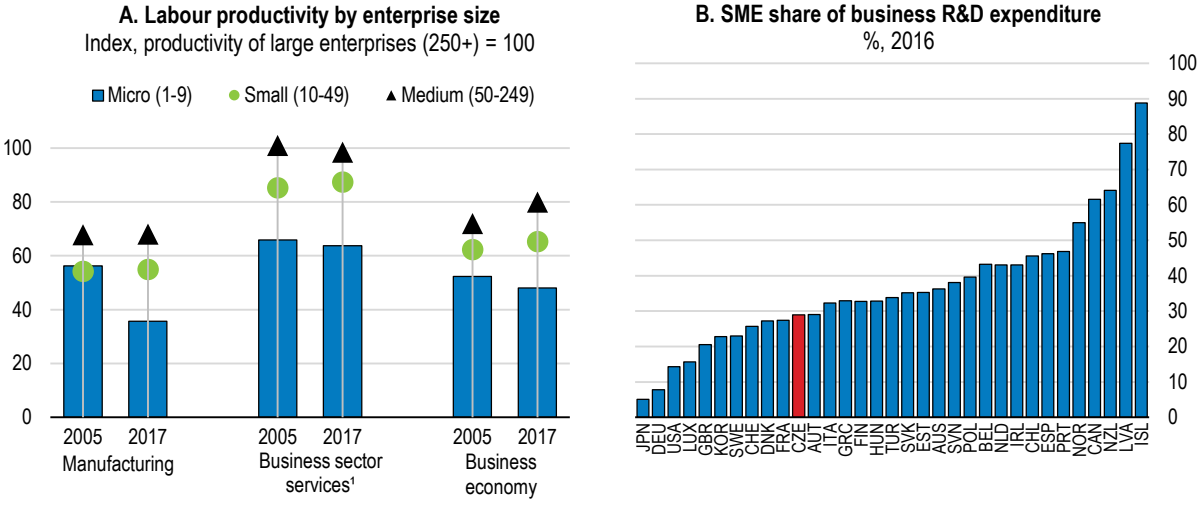
Figure 1.33. ICT task intensity and share of non-routine employment are relatively low in manufacturing

Average manufacturing industry, 2012 or 2015



1. The share of non-routine employment represents the proportion of the industry's total employment accounted for by the 3-digit occupations found to be intensive in non-routine tasks. Occupations are ranked in terms of their intensity in routine tasks following the methodology detailed in Marcolin et al. (2015). Routine-intensive occupations are those ranking above the median in terms of the routine intensity of the tasks performed on the job; non-routine occupations score below the median.
2. The index of the ICT task intensity of jobs relies on exploratory state-of-the-art factor analysis and captures the use of ICT on the job. It relies on 11 items of the OECD Survey of Adult Skills (PIAAC) ranging from simple use of the Internet, to the use of Word or Excel software or a programming language. The detailed methodology can be found in Grundke et al. (2017). Intensities have been rescaled from the 0-1 to the 0-100 interval.
Note: Manufacturing covers mining; food and beverages; textiles, apparel and leather; wood, paper and publishing; basic and fabricated metals; chemicals, rubber, plastics and other non-metallic mineral products; machinery and equipment n.e.c; electronic, optical, and computing equipment; transportation equipment; manufacturing n.e.c.
Source: OECD (2017), OECD Science, Technology and Industry Scoreboard 2017.

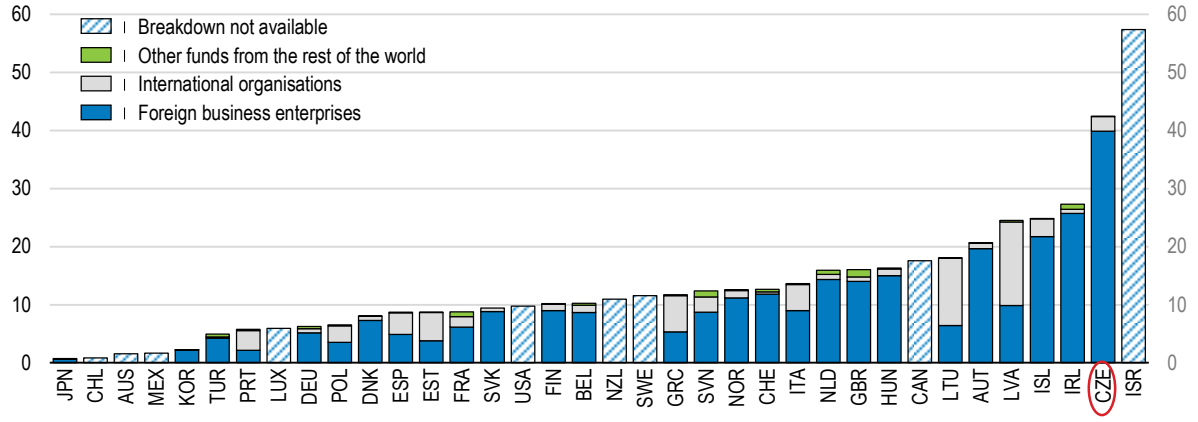
Figure 1.34. Czech SMEs have low productivity and they invest relatively little in R&D



1. Except financial and insurance activities.
Source: OECD Structural and Demographic Business Statistics Database; OECD SME and Entrepreneurship Outlook 2019.

Figure 1.35. A major share of the R&D investment comes from business investment from abroad

Business R&D funded from abroad, by source of funds, % of business enterprise expenditure on R&D, 2018 or latest available year

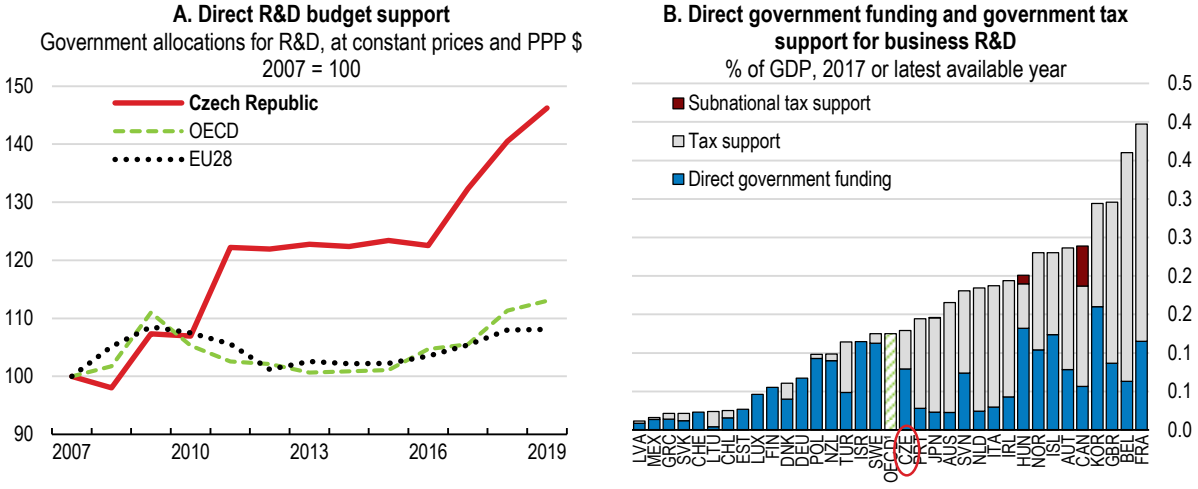


Source: OECD Research and Development Statistics database.

Better targeting support for R&D and innovation

Over time, numerous strategies, support programmes and institutions, with different and overlapping goals (support of R&D and innovation, SMEs, exports, energy efficiency, digitalisation, etc.) have emerged, making support overly fragmented, as already discussed in a previous Survey (OECD, 2016a). Recognising the weak performance in R&D and innovation (RDI), the government has set the support of science, research and innovation as a major priority. Government financial support of R&D has risen over time (Figure 1.36), and further increases are planned in the state budget (Government of the Czech Republic, 2019), with financing coming from national resources and from the EU. The government has also recently prepared the Innovation Strategy of the Czech Republic 2019-2030 with very ambitious goals (Government Council for Research, Development and Innovation, 2019). Steps towards unifying the design, assessment and coordination of RDI policies are welcome, and follow past OECD recommendations (OECD, 2016a).

Figure 1.36. Government financial support of R&D has risen over the last decade



1. Median of available OECD countries.
Source: OECD Main Science and Technology Indicators database; OECD R&D Tax Incentives database.

Efforts to further boost business RDI and to target it better should continue, in view of the fact that most RDI investment is done by international firms. Government support for business R&D spending is offered through direct funding and through tax incentives, the total of which is close to the OECD median (Figure 1.36). International evidence shows that government support – either through direct funding or through tax incentives - tends to significantly boost R&D spending by companies (Appelt et al., 2020). Direct grants are also an opportunity for governments to exert greater control and to ensure that R&D spending follows set strategic priorities. Direct grants to businesses can be effectively targeted towards the needs of SMEs and young and dynamic companies in particular, and the Ministry of Industry and Trade and the Technology Agency of the Czech Republic offer numerous programmes with specific support for the RDI activities in these types of firms.

The importance of tax incentives in total government support has been on the rise, as in many other OECD countries. The 2019 reform of the Tax Incentives Act further simplified the procedure for companies. The R&D tax allowance is based on volume of the qualifying R&D expenditure, and additional incentives are given to firms with growing R&D spending through the incremental tax allowance, but the effect of this is small. Firms with insufficient tax liability in a given year can carry forward unused allowances for three years. OECD simulations show that marginal tax subsidies are above the OECD median for large firms, both, profit making and loss making. For loss-making SMEs, on the other hand, the marginal subsidy rate is below the OECD median (OECD, 2019d and 2018c).

Given the particular lack of RDI activity among Czech SMEs, tax incentives could be better targeted to support dynamic young firms. This could be particularly effective, as small or young firms are shown to react more strongly to R&D tax incentives than large firms (Appelt et al., 2016). SMEs are also less likely to shift their profits abroad to avoid taxes.

In the Czech Republic, a possible way of offering stronger support for smaller firms would be to impose a ceiling on the amount of eligible R&D that is subsidised or a threshold for eligible R&D beyond which the subsidy rates become lower. Such upper limits on the amount of qualifying R&D exist in most other OECD countries.

Table 1.8. Past recommendations on R&D and innovation

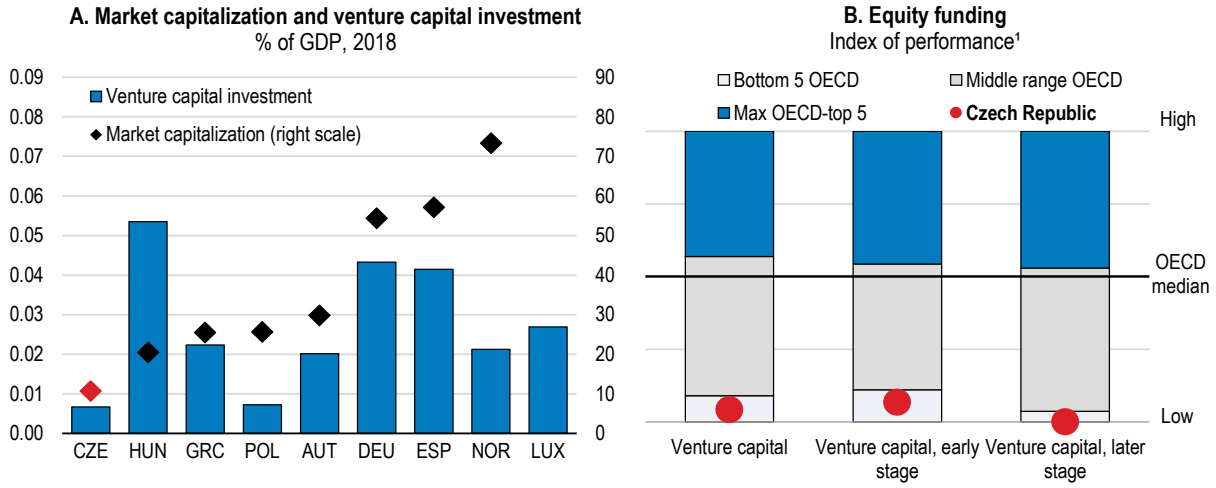
Recommendations in previous Surveys	Action taken
Accelerate the creation of funds and guarantee programmes to support SMEs and innovation.	For 2020, 8 support programs are planned with the total amount of CZK 24.6 billion.
Develop government co-financing schemes to complement grants and increase fiscal incentives for business R&D spending.	Since April 2019, the change in R&D tax allowance came into effect. Under the new legislation, the taxpayer has to notify the tax administrator only of his intention to claim an R&D allowance. R&D project must then be prepared at the date of filling the tax return. (Companies will no longer be at risk of rejection of the R&D tax allowance due to insufficiently elaborated R&D project in advance.)
Use public procurement contracts to initiate innovative solutions in strategic areas with societal benefits.	On 21 January 2019, the government approved an update of action plan "Public Procurement Digitisation Strategy for 2016–2020", In 2019, measures such as the monitoring of foreign best practices in the field of digitisation of public procurement, including the assessment of the possible implementation of the best solutions in the legislative environment of the Czech Republic, were continuously implemented.

More funding and less red tape to foster firm entry and investment

Start-ups and young SMEs often play a leading role in the introduction of advances in products, processes, organisational methods and marketing techniques, pushing the economy toward the technological frontier. Fostering entry of new innovative firms could raise productivity and help restart growth after the crisis.

Young and dynamic Czech firms lack sufficient sources of funding suited to their needs. Bank credit is readily available to SMEs and financing conditions are not significantly worse than for large companies (OECD, 2019c), but capital markets are underdeveloped. Venture capital is essentially non-existent (Figure 1.37), creating a financing gap for early-stage innovative companies. To help remedy the lack of venture capital, the government has concluded agreements with various funds (European Investment Fund, Central Europe Fund of Funds), that would invest in Czech innovative start-ups and emerging growth-oriented companies seeking capital for their further development. The Czech-Moravian Guarantee and Development Bank also provides guarantees for SMEs and innovative projects. Such efforts and broader efforts to better develop capital markets should be pursued further.

Figure 1.37. Capital market is underdeveloped and very little venture capital is available

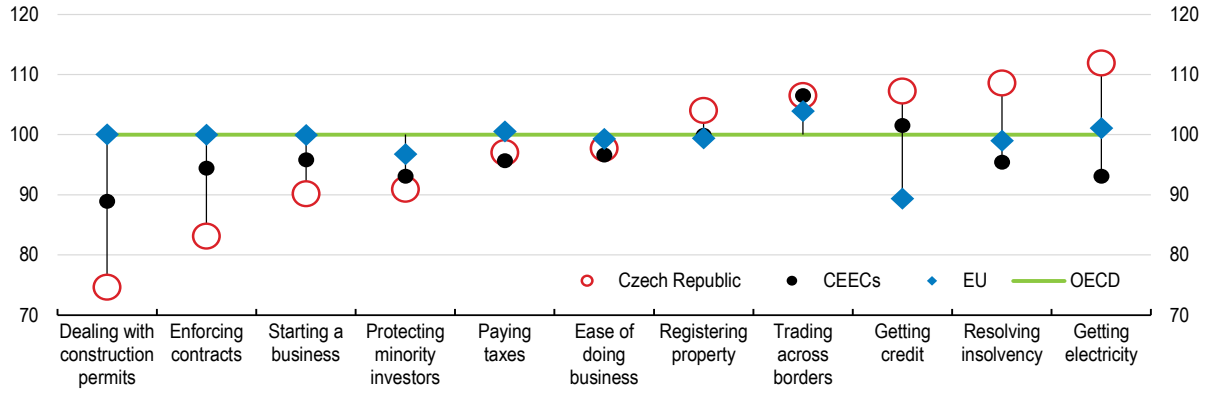


1. Index of benchmark (OECD median = 100), from lower resource availability or accessibility (low) to higher resource availability or accessibility (high).
Source: OECD Entrepreneurship Financing Database; FESE database; OECD SME and Entrepreneurship Outlook 2019.

A lower regulatory burden could also unleash the entrepreneurial potential and boost investment, helping with the recovery. The World Bank Doing Business indicators (World Bank, 2020) show a number of weaknesses (Figure 1.38). Procedures for starting a business are more burdensome and time consuming than in most other OECD economies. Resolving commercial disputes ("enforcing contracts") takes longer than on average in the OECD, and is more costly to businesses. Most notably, the process for obtaining construction permits is one of the slowest and most cumbersome in the OECD and among CEEC peers. To build a warehouse, 21 different procedures are required and the process takes about 8 months, three months longer than in the OECD on average (World Bank, 2020). Such delays in planning and issuing permits have repercussions for the wider economy, as they slow down infrastructure investment and contribute to rising house prices by limiting the supply of residential housing. The government is preparing a comprehensive overhaul of the legislation and regulation around construction permits, with the aim to speed up and streamline the process.

Figure 1.38. The Czech Republic ranks low on a number of Doing business indicators

Doing Business indicators 2020, Ease of doing business scores, from low to high, OECD average = 100



Note: CEECs is an unweighted average of Hungary, Poland, Slovak Republic and Slovenia. EU is an unweighted average of EU countries that are members of the OECD.
Source: World Bank Doing Business indicators 2020.

Accelerating green growth

The Czech Republic has made significant progress in decoupling environmental pressures from economic activity. It nevertheless remains highly energy and carbon dependent (Figure 1.39). Power generation still relies heavily on coal, although it is being gradually replaced by nuclear power. The share of renewable sources in primary energy supply however has been on the rise. Emissions from road transport are increasing and reliance on fossil fuels for residential housing is high. Together they are primary sources of local air pollution, to which the Czech population has one of the highest exposures in the OECD.

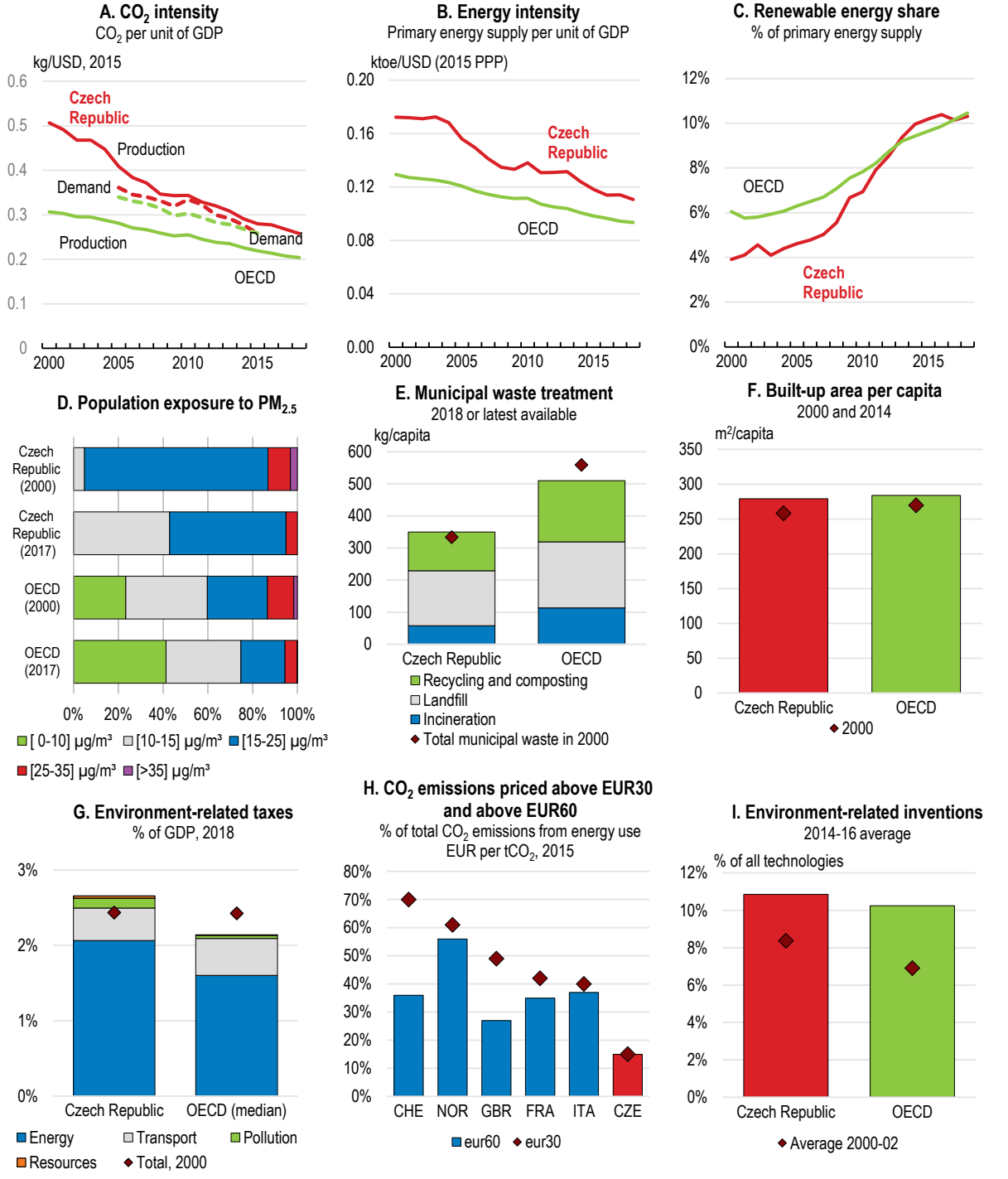
Strengthening political commitment to a low-carbon economy and ensuring that the long-term targets of the State Energy Policy are compatible with the Paris Agreement objectives are key priorities. Despite these commitments, the Czech Republic has not increased its ambitions in the 2019 National Energy and Climate Plan. Achieving mid- and long-term targets will require further progress in energy savings. Public investment during the crisis recovery could prioritise investment spending favouring the greening of the economy, notably by targeting transport and energy projects that help improve energy efficiency and reduce air pollution. The EC's recovery plan with the bulk of resources to support public investment for green and digital transformation and key structural reforms provide opportunities in this regard.

Pricing carbon will help in tackling climate change and air pollution cost-effectively. Revenues from environmental taxes are above the OECD average, but this is primarily driven by high energy and fuel consumption rather than high tax rates that would reflect the estimated environmental costs of fuel and energy use. The Czech Republic does not have an explicit carbon tax. OECD (2018e) estimates that the carbon pricing gap, which compares actual carbon prices and real climate costs (EUR 30 per tonne of CO2) and takes into account taxes as well as pricing of emission permits, stood at 70% in 2015. This is one of the highest gaps in the OECD. Hence, carbon price signals remain insufficient even when considering the impact of the EU Emissions Trading System (ETS).

The 2018 OECD Environmental Performance Review of the Czech Republic (OECD, 2018d) analyses the potential for a review of the tax structure to better align economic and environmental objectives. The one sector with meaningful effective carbon taxation is the road sector (OECD, 2019f) and yet, taxes on diesel are lower than on gasoline, despite the former's higher carbon and air pollutant emissions. Taxes on natural gas, coal and other solid fuels and electricity are low and are not adjusted for inflation. Several tax exemptions applied to various fuel uses decrease end-use prices and reduce incentives to save energy or

to switch to cleaner fuels. Exemptions apply for example for residential heating or in agriculture. In its recent National Energy and Climate Plan 2019, the Czech Republic has not defined a roadmap to phase out fossil fuel subsidies.

Figure 1.39. Green growth indicators



Source: OECD (2020), Green Growth Indicators, OECD Environment Statistics (database); OECD National Accounts (database); IEA (2020), IEA World Energy Statistics and Balances (database); OECD (2020), Exposure to air pollution, OECD Environment Statistics (database); OECD (2020), Land cover, OECD Environment Statistics (database); OECD (2018), Effective Carbon Rates 2018; OECD (2020), Municipal waste, OECD Environment Statistics (database); OECD (2020), Environmental policy: Environmental policy instruments, OECD Environment Statistics (database).

The Review (OECD, 2018d) further suggests that to promote investment in low-carbon technology, the Czech Republic should increase more rapidly the share of permits auctioned in the power sector under the EU ETS, instead of free allocation. It should also set a stable support framework for development of renewables. Domestic energy generation from renewable sources faces technical and legal obstacles and changes to policy and financial support have created uncertainty and resulted in higher capital costs (European Commission, 2019a). In the road sector, tightening the environmental criteria of vehicle taxes would promote fleet renewal towards cleaner vehicles and extending distance-based charging would help address air pollution and congestion (OECD, 2018d).

Table 1.9. Past recommendations on green growth and achieving efficiency in the energy system

Recommendations in previous Surveys	Action taken
Introduce a carbon component in energy taxation for carbon emissions outside the EU system.	No action taken.
Realign the excise tax rate on all fossil energy sources and products, based on their carbon content and other environmental externalities, notably by increasing the relative taxation of diesel. Remove several excise tax reliefs on fuel use.	No action taken.
Develop traffic management in urban areas, including traffic restrictions in city centres, parking fees and incentives to commute by public transport. Strengthen control of emissions from older vehicles and stimulate the renewal of vehicles through adequate carbon pricing.	National Action Plan on Clean Mobility, approved by the Government in April 2020, is based on Directive 2014/94/EU on the deployment of alternative fuels infrastructure which in the case of electro mobility and natural gas (also hydrogen) obliges Member states to develop the relevant charging and refuelling infrastructure. The action plan sets requirements for the construction of charging stations with a time horizon between 2020 and 2030.

Countering the adverse environmental impacts of urban sprawl

Measures are needed to counter urban sprawl while addressing the vulnerabilities of densely populated cities, highlighted also by the COVID-19 crisis. The Czech Republic has experienced a process of suburbanisation, in particular in Prague and Brno. As population is moving from rural areas and small cities to Prague, its outer zone built-up areas are growing and car traffic volume is increasing, exacerbating air and noise pollution. Land use changes due to urbanisation can also have environmental effects, including on the risk of flooding. Evidence suggests that, while cities bring growth through agglomeration effects (Bartolini, 2015; Ahrend et al., 2014; OECD, 2015a), in the long run, compact cities are more resilient and have better environmental outcomes, such as lower energy consumption, for example (OECD, 2018d and 2018f).

Greater and more stable municipal cooperation is needed to tackle urban sprawl and the negative impact on the environment. The three Czech metropolitan areas – Prague, Brno and Ostrava – extend across a high number of municipalities and are among the most fragmented in the OECD (OECD, 2016a). While core cities comprise of one or two municipalities only, outer areas contain a large number of small municipalities that did not merge with the core once cities grew beyond historic limits. This fragmentation rises the cost of policy coordination, slows urban planning and transport investment. It is common for municipalities to cooperate in service delivery and investment projects, partly overcoming the problems of fragmentation. Evidence shows that a large portion of inter-municipal cooperation is happening in Central Bohemia, around Prague, and in South Moravia, around Brno (OECD, 2016a). However, these inter-municipal associations are ad hoc, often rely on temporary external funding and are dependent on a specific mayor and its local administration.

Metropolitan-area planning is needed that covers developments outside the city core. Prague's intensive suburbanisation suggests that its land use planning system is highly permissive and its commuting zone is characterised by dispersed development. Prague's latest land use plan – the Metropolitan Plan – aims

to control sprawl and protect green areas, but due to legal restrictions the Metropolitan Plan does not cover the entire metropolitan area. In general, cities' development plans lack a properly integrated approach to urban development that would link housing, transport and land use policies involving all municipalities in the functional urban area. Such planning should prioritise low-carbon urban infrastructure (OECD, 2020c). While many city cores enjoy good public urban transport, connections to the suburbs are more limited, intensifying car use. Furthermore, green mobility options are largely underdeveloped. While cities' building regulations promote better and more sustainable urbanisation, the lengthy approval process hinders their effectiveness (OECD, 2018d).

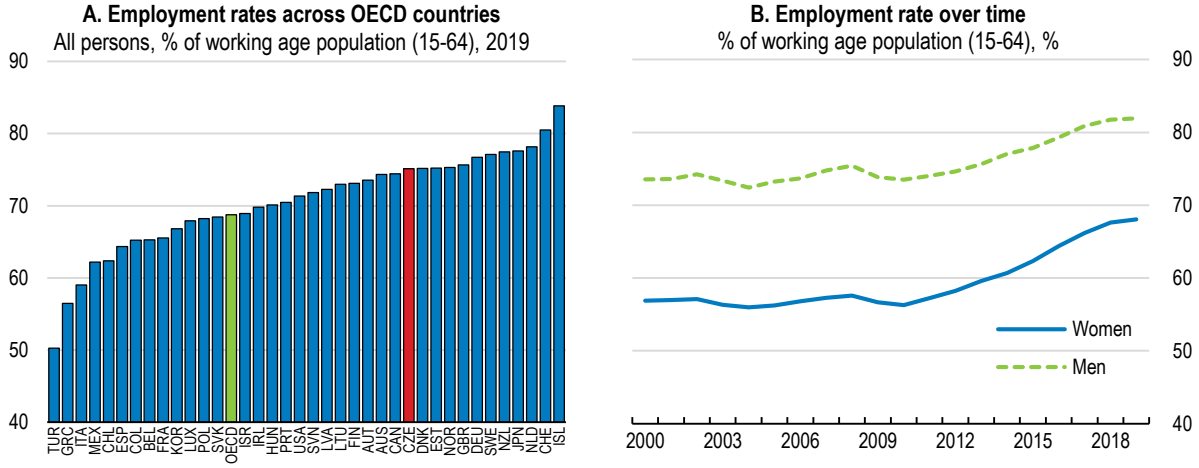
Fragmentation and obstacles to policy coordination could be tackled by using a functional rather than administrative approach in delimiting metropolitan areas. Also, metropolitan governance bodies could be created. They are increasingly being used in other OECD countries to offset municipal fragmentation. In the Czech case, the focus should be on improving co-ordination of land use planning to address urban sprawl. In the case of Prague, the reach of the Prague Institute for Planning and Development could be extended to cover the entire metropolitan area (OECD, 2018d and 2016a). Czech cities could also rely more on fiscal instruments to encourage density and on a mixture of congestion charges, vehicles taxes and parking charges to address congestion and pollution.

Increasing labour market participation and building skills

Bringing more mothers to the labour market

The employment rate in the Czech Republic is above the OECD average and it has shown a rising trend prior to the crisis (Figure 1.40). Nevertheless, the employment rates of the young (15-29-year olds), older persons, people with disabilities and mothers of young children still record significant gaps to those of prime age men (Figure 1.41). Before the coronavirus outbreak, labour shortages were a major barrier to growth, but these abated because of the crisis. Still, over the long-term horizon, demographic constraints to growth in labour utilisation are set to drag down GDP per capita growth. The Czech economy would therefore benefit from bringing marginal groups more effectively to the labour market. In the short to medium run, the recent drop in economic output, the rise in the unemployment rate and disruptions to childcare provision pose additional challenges for facilitating labour transitions among groups at the margins of the labour market.

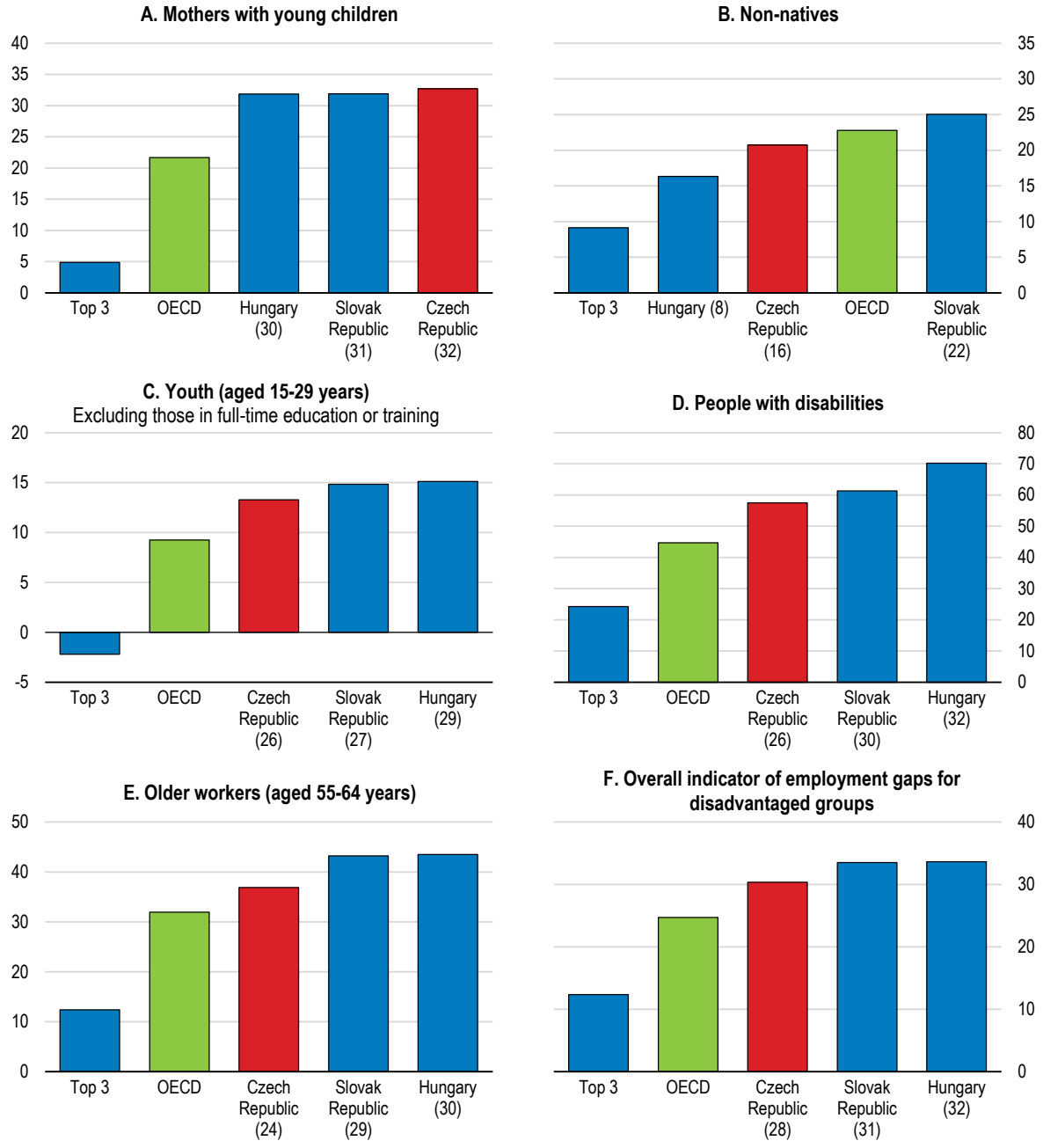
Figure 1.40.Employment rate is high and has risen over time



Source: OECD Labour Force Statistics.

Figure 1.41. Employment gaps of certain groups are large

Employment gaps with respect to prime-age men for selected groups, %, 2016 or nearest

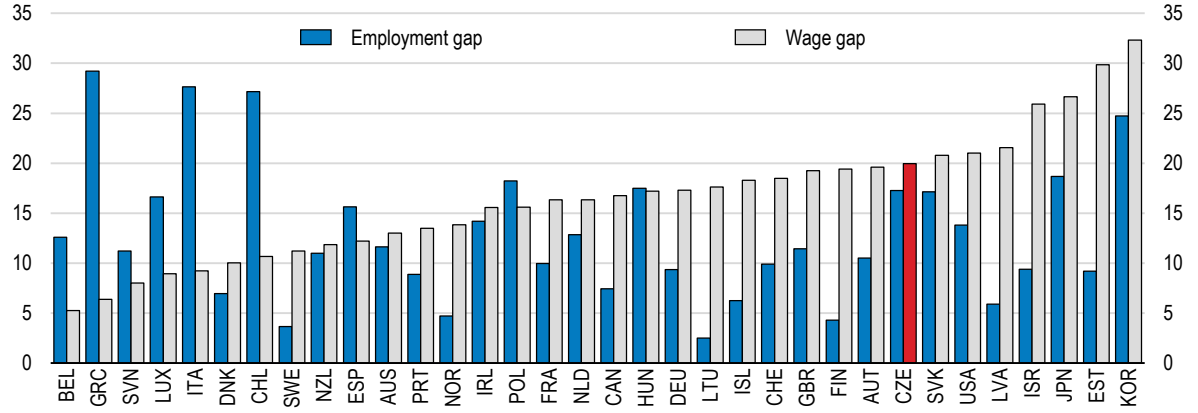


Note: Countries are sorted in ascending order of the employment gap (i.e. from best to worst performing). Number in parenthesis indicates the rank from best performing. For each group, the employment gap is the difference between the employment rate of prime-age men (aged 25-54 years) and that of the group, expressed as a percentage of the employment rate of prime-age men. Panel A: Mothers with young children refer to working-age mothers with at least one child aged 0 to 14 years. Panel B: Data refer to all foreign-born people with no regards to nationality. Panel C: In the case of youth, those that are in full-time education are excluded from the denominator of the employment rate. Panel D: Data refer to 2011. Panel F: The overall indicator is a weighted average of the employment gaps for each group.
Source: OECD (2018), Good Jobs for All in a Changing World of Work: The OECD Jobs Strategy, https://doi.org/10.1787/9789264308817-en.

The employment gap of mothers with young children is particularly large and progress has been slow. The gender gaps in wages of full-time employees and in employment rates are sizeable in comparison to similar countries (Figure 1.42), although the overall employment rate of women is above the OECD average. Motherhood has a large negative effect on labour market activity (Figure 1.43), and women stay inactive for a relatively long time after childbirth. This in turn has consequences for wage and career progression over the women's lifetime. It is also reflected in marked differences in average old-age pension between men and women and higher risk of poverty in old age for women. Nevertheless, due to strong redistributive features of the pension system, the gender gap in pensions is low in international comparison (OECD, 2019j). In view of the fact that female educational attainment has been on the rise, higher activation of women and mothers would not only be beneficial for women but for the economy and society at large. The Czech government is pushing for progress on gender equality and reconciliation of work and family life by implementing the Strategy for Gender Equality in the Czech Republic for 2014-2020.

Figure 1.42. Gender gap in employment and wages is higher than in many peers

Gender gap, %, 18-64 years, 2018 or latest available year

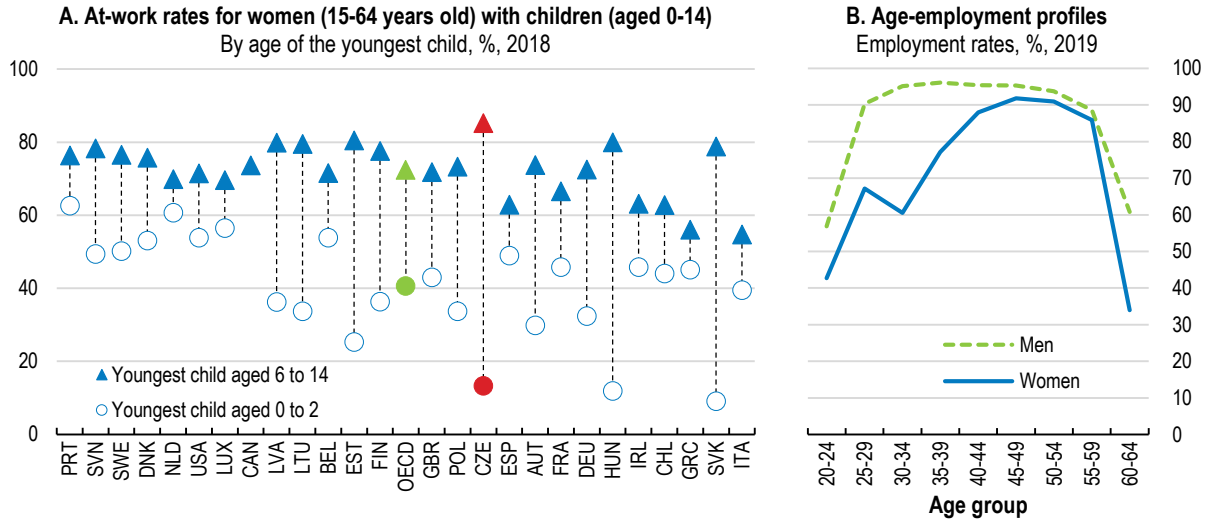


Note: The gender gap is computed as the difference of the relevant indicator for men and women expressed as a percentage of that of men. Wage gap is for full-time employees.
Source: OECD calculations based on the OECD Employment database.

Generous parental leave rules and child cash benefits contribute to gender differences in the labour market, as they discourage Czech women from resuming work after childbirth. One parent – which is almost exclusively the mother - can stay at home while receiving a parental allowance until the child reaches three years of age without losing reintegration rights at their employer. The receipt of benefits is not linked to parents' employment status and is not targeted towards families in hardship.

Public spending is tilted towards generous cash benefits for families with young children (Figure 1.44). Public spending on services – childcare provision and support and early childhood education – on the other hand, is low. The government has recently increased the generosity of family cash benefits even further (Box 1.4). Total cash benefits accruing to families with young children - relative to average wage - are the highest in the OECD (Figure 1.44).

Figure 1.43. Motherhood has a big effect on labour market activity



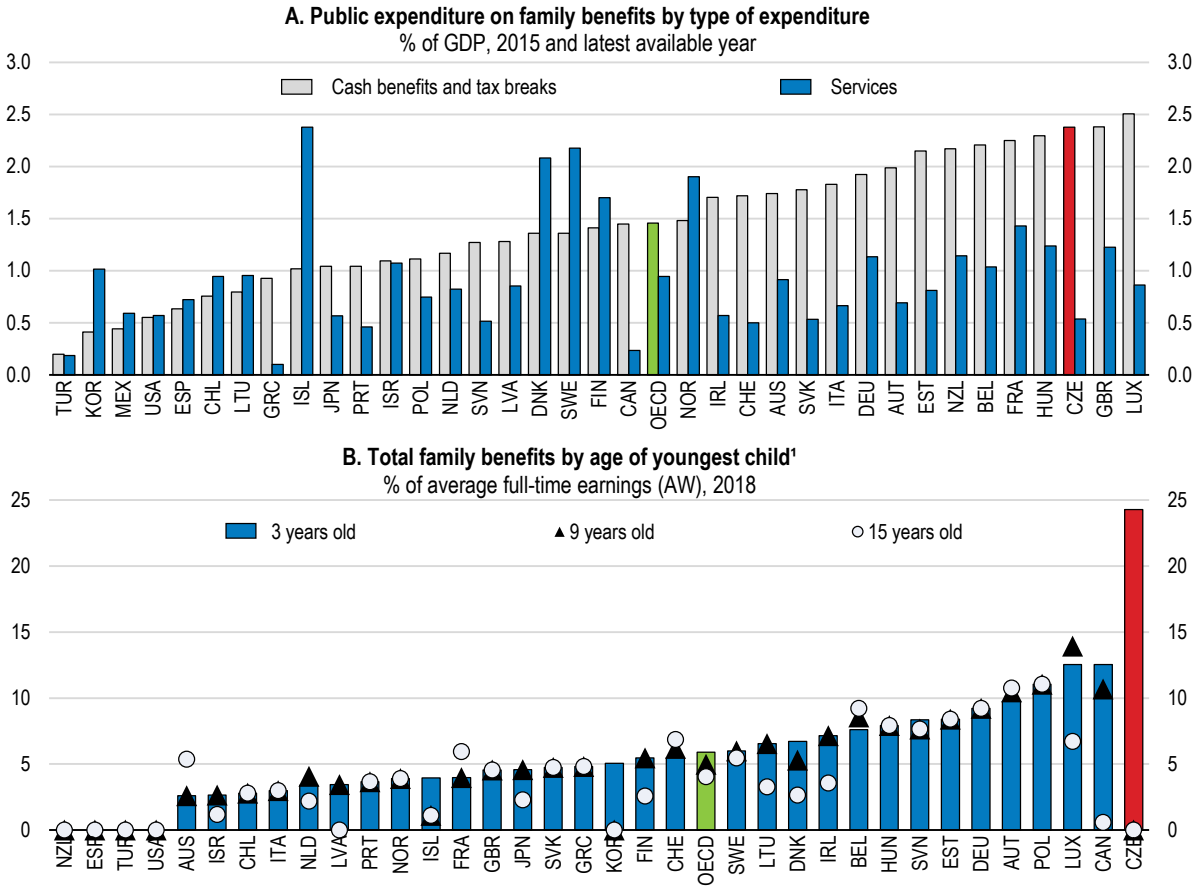
Note for Panel A: Data for Chile refer to 2017. The 'at-work' rate includes only those who did any work (at least one hour) for pay or profit during the survey reference week. It differs from the employment rate in that it excludes those who are employed but absent from work during the survey reference week – that is, those that have a job or business from which they were temporarily absent, and who did not do any work for pay or profit during the survey reference week – regardless of the reason for absence.

Source: OECD estimates based on the European Union Labour Force Survey, https://ec.europa.eu/eurostat/web/microdata/european-union-labour-force-survey, the Canadian Labour Force Survey, https://www.statcan.gc.ca/eng/survey/household/3701, the Chilean Encuesta de Caracterización Socioeconómica Nacional (CASEN), http://observatorio.ministeriodesarrollosocial.gob.cl/index.php, and the U.S. Current Population Survey, https://www.census.gov/programs-surveys/cps.html; OECD Labour Force Statistics database.

The government is more actively encouraging men to take larger portion of parental leave. In 2018, paternity leave was introduced to encourage fathers to engage in childcare from an early stage. To encourage mothers with young children to take up work, the maximum monthly number of hours a child can spend in childcare facilities while parents draw the parental allowance was doubled to 92 hours. At the same time, the government is aiming to introduce “shared jobs” that would allow mothers with small children to work part-time in a flexible way. Higher flexibility of jobs, better enforcement of rights for part-time work and flexible teleworking arrangements can support the re-entering of female labour into the market.

The choice of mothers to resume work is however limited by the scarce supply of childcare. In 2017/2018 there was an estimated unmet demand for childcare of 14,000 children below 3 years of age (European Commission, 2019a) and more than 33,000 applications for admission to nursery schools were rejected, close to one-fifth of all applications (Office of the Government of the Czech Republic, 2018). Enrolment of children under three in early childhood education and care is among the lowest in the OECD (Figure 1.45).

Figure 1.44. Family cash benefits and tax breaks are generous



1. Estimates based on a two-parent, two-earner, two-child family, with one parent working full-time (40 hours per week) and one parent working part-time (20 hours per week), both on wages at the median of the full-time earnings distribution. The two children are aged three years apart, with the youngest child at the given age.
Source: OECD Social Expenditure Database, http://www.oecd.org/social/expenditure.htm; OECD Family database, http://www.oecd.org/social/family/database.htm.

Supporting affordable, accessible and high-quality early childhood education and care services is one of the priorities for the government and significant progress has been made in the number of available places. The Ministry of Labour and Social Affairs continues to support "children's groups" for children from one year of age to the start of compulsory education (5 years of age). Currently, the Ministry registered 1040 "children's groups" with approximately 13 650 places for children (Ministry of Labour and Social Affairs, 2020b). Micro-nurseries offer care for small children, from six months to three years of age in small groups of up to four children, and currently, there are 98 micro-nurseries (#mikrojesle, 2020). There are plans for further expansion in both types of facilities. Public kindergartens for children from the age of three to primary school are also under expansion. These developments are in line with previous OECD recommendations (OECD 2018a, 2016a) and should be continued. One possible way to finance the further expansion of childcare places and to lower disincentives to return to work would be by reducing the cash benefits and shortening the maximum duration of parental leave.

Box 1.4. Child related benefits in the Czech Republic

Maternity benefit is received by a parent who takes care of a newborn child. It is given for 28 weeks (37 weeks in case of twins or more children). The mother can start maternity benefit 8 – 6 weeks before the expected date of birth. For the first six weeks after childbirth, the maternity benefit belongs exclusively to the mother. After that point, up to 22 weeks can be transferred to the father. Participation in the sickness insurance scheme is a condition for entitlement. The benefit is close to 70% of the gross wage, up to a maximum.

Paternity benefit is received by fathers who help care for a newborn child. It came into effect in February 2018. It is given for seven calendar days and can be used within six weeks from the date of birth. Participation in the sickness insurance scheme is a condition for entitlement. Payment and benefit amounts are the same as for the maternity benefit.

Parental allowance is received by a parent who cares for a child of up to 4 years of age. In January 2020, the total amount of this allowance was increased by 80,000 CZK to 300,000 CZK (also for parents who had already stared parental leave before that date). Every family receives the same total amount for a child, regardless of their employment status or income. Typically, parents start receiving the benefit after the end of the maternity benefit. It is paid in monthly payments and the receiving parent may choose the duration of the drawdown period, which determines the monthly amount. Only one parent can receive the benefit at any one time, but every three months the receiving parent and the chosen length of the receiving period can be changed. Since January 2020, the government has doubled the maximum hours per month (to 92 hours) that a child under two can spend in nursery or other pre-school facilities, without the family losing the benefit. By law, previously employed parents are guaranteed a job with the same employer (but not necessarily the same position) for the duration of parental leave until the child reaches three years of age.

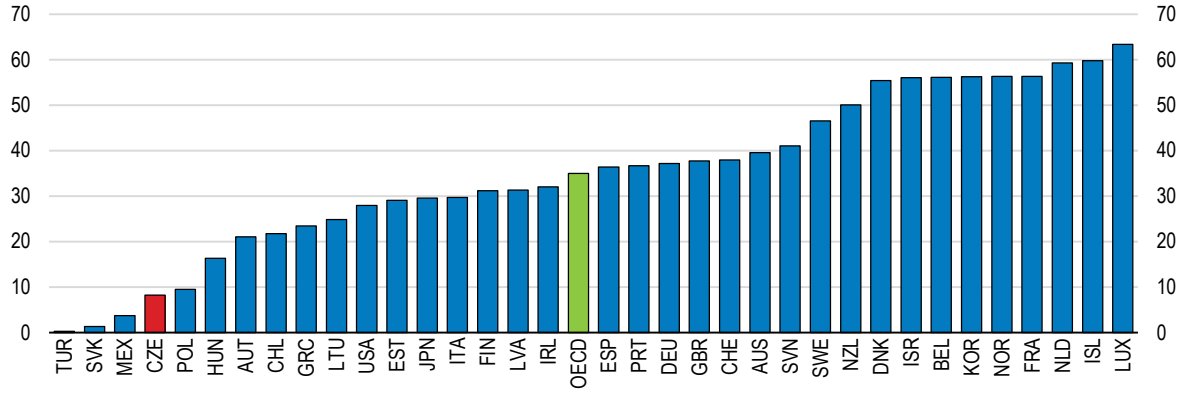
Other benefits:

- The *pregnancy and maternity compensatory benefit* is received by pregnant women and mothers of newborn children to compensate for lost earnings if they are reassigned to a lower-paid position because of pregnancy or maternity.
- The *child allowance* is a long-term benefit for low-income families that helps them to cover the costs of raising and supporting dependent children. Eligibility is means-tested on the family's total income.
- The *tax credit for child placement in a pre-school facility* (*non-refundable*) can be used by parents, based on actual provable expenses incurred for each child's stay in a pre-school facility or children's group. The tax credit is non-refundable, and subject to an annual limit per child, which is 14,600 CZK for 2020 (equal to a monthly minimum wage).
- The *tax credit for children* (*refundable*) can be used by parents with dependent children in the household (children up to 18 years, full-time students up to 26 years, and doctoral students up to 28 years). The tax credit for the first child amounts to 15,204 CZK, for the second child 19,404 CZK and for the third and every other child 24,204 CZK. The amounts have been in force since 2018. When the tax liability is lower than the tax credit for children, the amount of tax credit exceeding the tax liability is paid to the taxpayer, but with a maximum limit of 60,300 CZK. Only one of the parents is entitled for this tax credit.

Besides a higher number of places in early childhood education and care, it is also important to ensure quality. Evidence shows that early childhood education and care provides a crucial foundation for future learning and is important for success later in life, but much of the benefit crucially depends on the quality (OECD, 2018b; 2017a). This is perhaps even more important in the Czech Republic, where socio-economic factors have a strong effect on student performance and educational attainment (OECD, 2019a).

Figure 1.45. Enrolment of children under three in early childhood education and care is among the lowest

Children enrolled in early childhood education and care services, 0 to 2-year-olds, %, 2017 or latest available year



Note: Data generally include children enrolled in early childhood education services (ISCED 2011 level 0) and other registered ECEC services.
Source: OECD Family database, http://www.oecd.org/social/family/database.htm

Growing numbers of early childhood education and care providers of different types can become a challenge with respect to ensuring quality. Furthermore, different parts of the sector fall under different ministries, adding to complexity. The authorities should ensure effective coordination and monitoring to safeguard quality across different providers, including by making sure that children benefit from equal learning and development opportunities across various types of settings. For now, kindergartens offer education, while children's groups solely offer child-care. A further boost to the sector could be achieved by requiring a qualified workforce, while offering opportunities for professional development and career progression and adequate salaries, to ensure quality and job satisfaction (OECD, 2019h and 2019k).

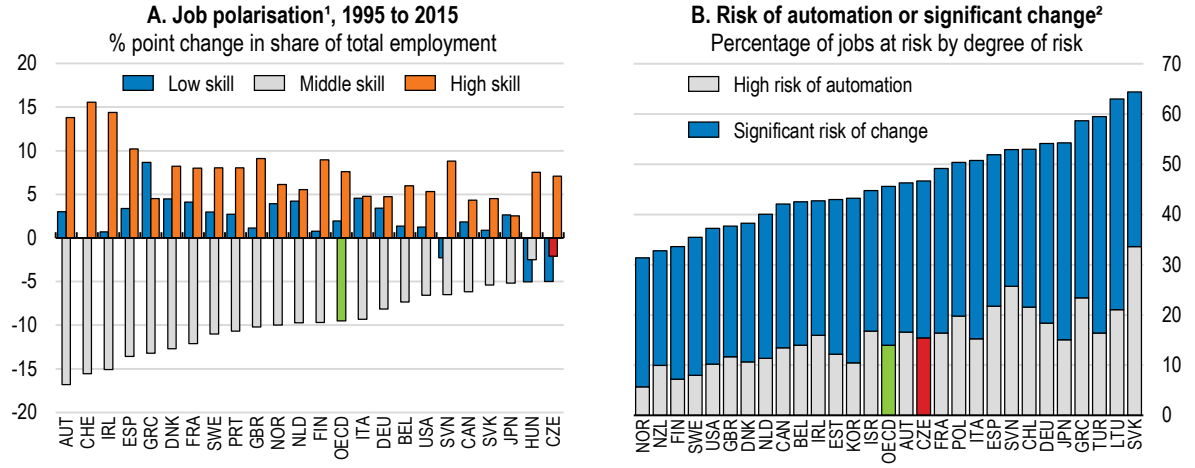
Table 1.10. Past recommendations on higher labour utilisation

Recommendations in previous Surveys	Action taken
Keep expanding the supply of affordable childcare facilities.	It is one of Government's priorities. • Since the school year 2017/2018, the compulsory participation in pre-school facilities for children aged 5 years was introduced. • The Ministry of Labour and Social Affairs continues to support the implementation of children's groups for children from one year of age to the start of their compulsory education. • The Ministry of Labour and Social Affairs continues with a project for Implementation and pilot testing of childcare service for children from six months to four years of age in "micro-nurseries". • Since 2019, an amendment of the Act on Children's group has been in the legislative process, it aims to improve quality of the services provided, legislative anchoring of a care service for the youngest children (micro-nurseries) and provide a system of national funding for these facilities.
Reduce the maximum duration of parental leave as planned and incentivise fathers to take some of the parental leave.	Limited progress. The duration of parental leave remains the same. Since January 2020, the total amount has increased by 80 000 CZK, to 300 000 CZK. Nevertheless, the maximum number of hours in a month during which a child up to 2 years of age can attend a pre-school facility has been increased from 46 hours per month to 92 hours, without the parent losing parental allowance.
Increase the flexibility of jobs by better enforcement of rights for part-time work, flexible teleworking and shared jobs.	Job sharing was introduced in legislation in June 2020 to increase flexibility.

Making education and skills more inclusive and better adapted to a changing labour market

Technological change, globalisation, and the ensuing changes in the labour market and in demands for skills present significant opportunities and challenges (OECD 2019b and 2017b). These trends are set to continue and may be accelerated by the economic disruption and the distancing requirements triggered by the coronavirus outbreak. Over the past decades, the Czech Republic has already experienced a rise in the share of high-skilled jobs at the expense of low-skilled jobs (Figure 1.46). OECD estimated that close to half of current jobs (Figure 1.46) would face a high risk of automation or would be significantly changed by technology (Nedelkoska and Quintini, 2018). With the exception of some relatively low-skilled jobs – notably, personal care workers – rising routinisation and further expansion of ICT applications will increase demand for skills that are complementary to technology. Occupations will increasingly require professional training and/or tertiary education.

Figure 1.46. High-skilled jobs are replacing low-skilled jobs and many jobs will be changed by technology



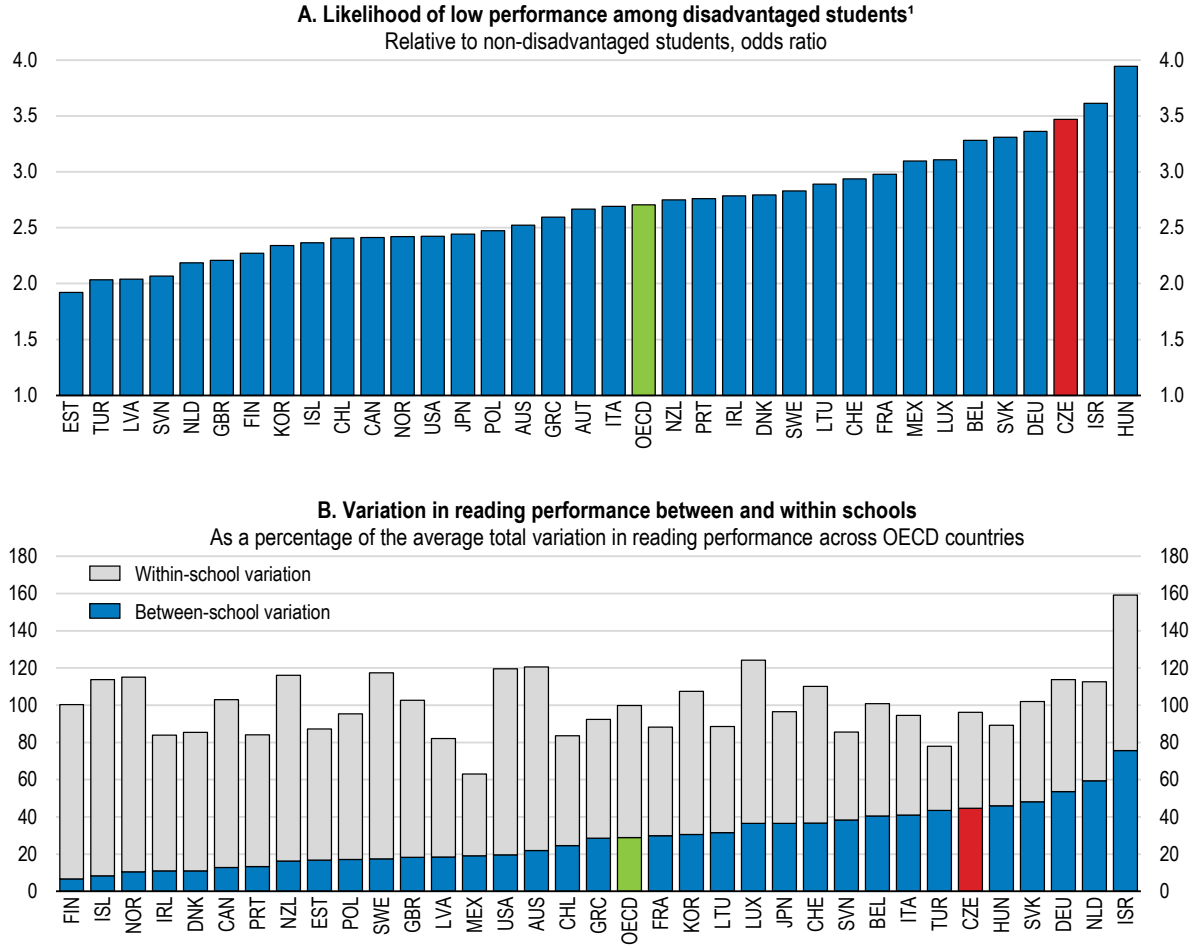
1. High-skilled occupations include jobs classified under the ISCO-88 major groups 1, 2, and 3., that is, legislators, senior officials, and managers (group 1), professionals (group 2), and technicians and associate professionals (group 3). Middle-skilled occupations include jobs classified under the 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-skilled 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).
2. Jobs are at high risk of automation if the likelihood of their job being automated is at least 70%. Jobs at risk of significant change are those with the likelihood of their job being automated estimated at between 50 and 70%.
Source: OECD Employment Outlook 2019.

Moreover, the world of work is changing and working lives are getting longer. Over the span of their careers, Czech workers will likely change jobs and employers, and will need to reskill. Strong core skills such as information processing, problem solving and communication – and not only ICT specialist skills - can ensure that individuals are able to adapt more easily and become resilient to change (OECD, 2017c and 2016b). Endowing workers with the right skill sets – through education and lifelong learning – is therefore crucial. Resilient skills – and easy access to learning - will also help workers more easily transition to new jobs and sectors following economic shocks.

More inclusive schools

The Czech education system can be improved by better delivering core competencies to everyone. PISA results – which measure proficiency of 15 year-olds in reading, mathematics and science -, are above the OECD average for mathematics and science and at the OECD average for reading. According to the PIAAC Survey of adult skills, Czech adults also have above-average skills in literacy and numeracy, and they show good computer skills. On the other hand, there are persistent inequalities (Figure 1.47) and much of the gap in performance stems from differences between schools (OECD, 2019a), pointing to variation in school quality. Resources for education are among the lowest in the OECD. Attractiveness of the teaching profession is low with very low teacher salaries and limited career progression (OECD, 2019i, Shewbridge et al., 2016). The Czech Republic also lags behind in tertiary education attainment, despite increases over time.

Figure 1.47. Socio economic status has a strong impact on student performance and schools differ in quality



1. A socio-economically disadvantaged student is a student in the bottom quarter of ESCS (PISA index of economic, social and cultural status) in his or her own country/economy.
Source: OECD (2019), PISA 2018 Results (Volume II): Where All Students Can Succeed, PISA, OECD Publishing, Paris, https://doi.org/10.1787/b5fd1b8f-en.

The Government's Strategy for Education Policy 2020 sets reducing inequalities as a priority. A compulsory participation in pre-primary education for one year prior to primary school has been introduced, and more resources have been dedicated to teacher salaries.

Inequalities could be further addressed by reducing differences in quality between schools that are partly related to high regional disparities (Shewbridge et al., 2016). Recent changes to funding of schools (primary and secondary) goes some way towards this goal, within the constraints of a highly fragmented territorial administration that encourages the existence of many small schools. The previous system of per-student funding – which favoured schools in urban areas and left some rural schools starved of resources – has been replaced by funding for the actual extent of education in a school. In this way, small schools with fewer children will not be penalised with lower funding. Yet, further consolidation of the school network is needed and could raise efficiency and quality. Many localities face a declining school-aged population and it has become increasingly difficult to create school units of appropriate "size efficiency". To consolidate the school network the government could establish a set of guiding principles, rules and even target quotas for capacity at different key stages of schooling (Shewbridge et al., 2016). Moreover, small schools could be encouraged to cooperate by sharing resources and common services. Clusters of schools could be formed, that would come under the umbrella of common school leadership and a shared pool of administrative stuff.

Adding explicit and objective criteria in the funding formula for schools to target economic and other disadvantages could further help address the inequities. After a recent reform in Australia, funding is based on a "standard" which comprises a base funding amount for every student plus six additional "loadings" that provide extra funding for disadvantage (disability, low English proficiency, Aboriginal and Torres Strait Islanders, socio-educational disadvantage, school location and school size). The criteria and specific loadings can then evolve in step with strategic priorities of the government.

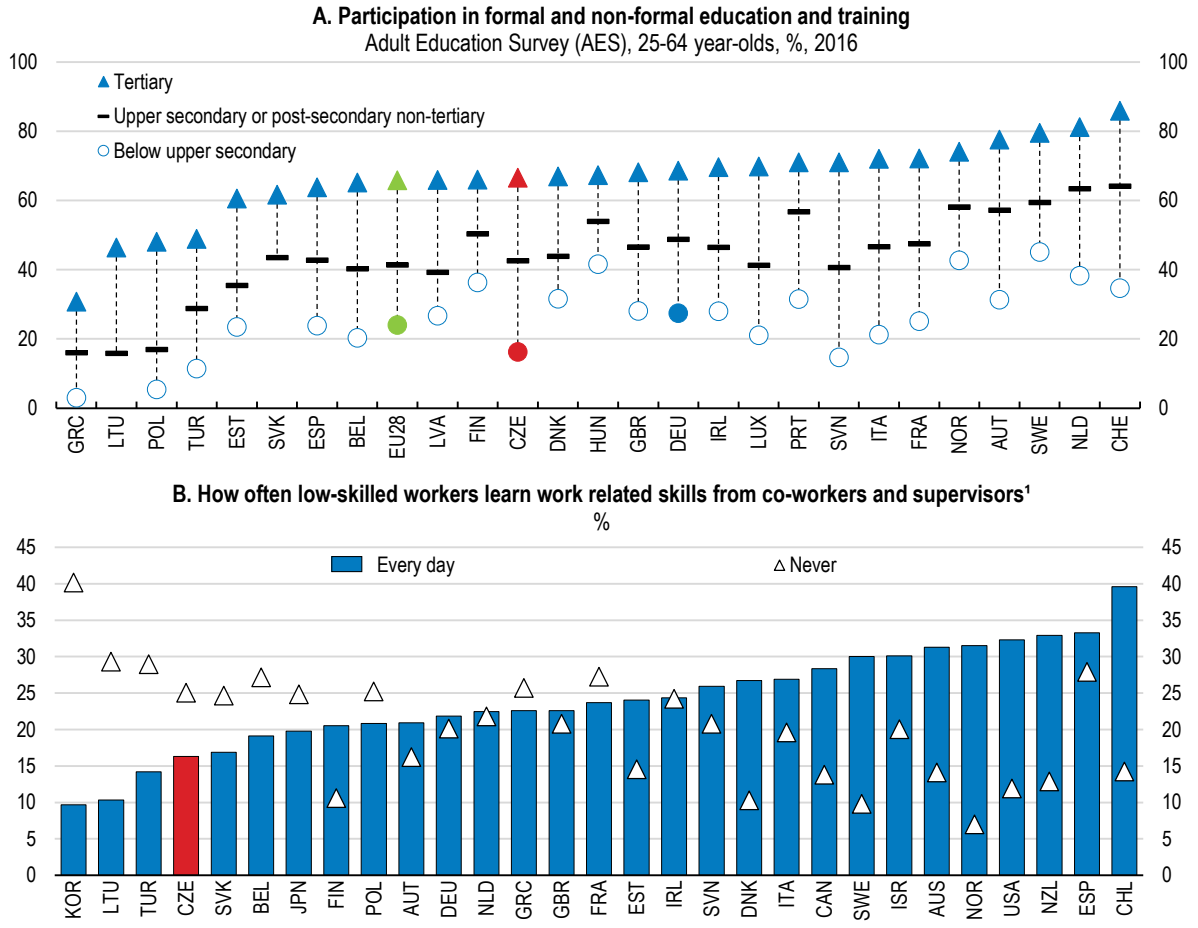
Improving information on skills demands and boosting lifelong learning

High-quality information (data and analysis) on current and future labour market demand, trends and earning potential can help governments as well as students in making choices. This can help the education sector and skill providers keep up to speed with shifts in skill demand, and can help tune public education funding to labour-market developments. The Czech Republic is aiming to make labour market forecasts with a focus on emerging skill needs within the framework of the KOMPAS project. There is room for upgrading the information on employment prospects in different sectors and linking it to education choices of students, which could direct them towards study pathways where large labour demand is expected. It is good practice to develop a centralised online platform, such as in New Zealand, that provides information about careers and education pathways, and their employment outcomes, for both higher education and VET courses.

Adult training could also be better developed, notably by better targeting low-skilled and older workers. In the Czech Republic, low skilled workers rarely take part in adult education programmes and most of them rarely learn from their peers at the workplace (Figure 1.48). The Czech Republic scores poorly in the inclusiveness dimension of the OECD Priorities for Adult Learning Dashboard, with large gaps in adult learning for older workers, women and the unemployed. Financial support to employers for retraining their workers with formal courses is offered via the "Support for Vocational Training for Employees II" (POVEZ II) programme. Support should be directed at sectors and courses with the largest needs for reskilling and upskilling. More generally, the vocational sector should be able to adapt to delivering education to (full-time employed) adults, by developing short and flexible courses (OECD, 2019l).

Recognising and validating various courses and informally acquired skills can encourage workers to undertake learning and help to facilitate job mobility by reducing uncertainty for employers. The Czech Republic is developing a National Register of Qualifications that allows candidates to obtain a nationally recognized certificate of their professional qualification. Workers can also obtain recognition for non-formal education and informal learning (Government of the Czech Republic, 2019).

Figure 1.48. Adult education for low-skilled workers should be strengthened



1. The white triangles stand for the % of low-skilled workers who report to never learn from others. Bars show the % of low-skilled workers reporting learning every day from colleagues. Data for United Kingdom refer to England and for Belgium to Flanders.
Source: Eurostat database [trng_aes_102]; OECD (2017), Building Skills for All in Australia, Policy Insights from the Survey of Adult Skills.

Table 1.11. Past recommendations on education and skills

Recommendations in previous Surveys	Action taken
Increase resources to education, skilling, reskilling and upskilling.	Limited progress. Public funding for education has increased in absolute numbers, as well as in terms of GDP, both thanks to increases in salaries of pedagogical and non-pedagogical staff and thanks to the targeted support of the higher number of lessons taught (division of classes to smaller groups, overlaps of the kindergarten teachers, longer hours of kindergarten service, etc.). From 01/01/2020, funding of education is changed fundamentally. The per capita funding was replaced by a normative (amount) for one educational worker. Schools will receive money according to the number of lessons taught.
Encourage the participation of managers and workers in training and further education to increase the productivity of staff.	The Ministry of Labour and Social Affairs is preparing an "employment package" consisting, among other measures, of a support for those employees who are threatened by job losses by the introduction of new technologies or manufacturing processes. The project POVEZ II for the support of vocational training of employees is still ongoing (since 1/12/2015).
Increase the flexibility of jobs by better enforcement of rights for part-time work, flexible teleworking and shared jobs.	Since 2019, the institute of shared jobs has been in a legislative process (parameters of this measure are still under discussion).

Table 1.12. Recommendations

MAIN FINDINGS	RECOMMENDATIONS (key recommendations in bold)
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.** Further easing of prudential regulations should be done conditional on transparent disclosures of financial exposures and regular stress testing. Once the recovery is fully under way, the easing of prudential regulations during the crisis should be reversed.
The Act on the CNB was partially amended to extend the CNB's authority to trade on the financial market in terms of possible instruments, their maturities and counterparties, but only with temporary effect until the end of 2021.	Adopt a comprehensive amendment to the Act on the CNB to expand its monetary policy and financial stability instruments beyond 2021.
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 tax is 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.**
The Czech Republic is highly export-oriented and its exports include high-risk sectors for foreign bribery, such as machinery and defence materials. Only one case of foreign bribery has been prosecuted so far.	Continue efforts to guarantee greater independence to prosecutors so that political factors are not taken into account in foreign bribery investigations and prosecutions.
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.**
The Czech capital markets are underdeveloped and young and dynamic firms lack sufficient sources of funding suited to their needs.	Continue efforts to develop capital markets.
Increasing labour market participation and enhancing skills for higher growth	
Childbirth has a large impact on 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 urban sprawl to counter environmental pressures	
Ongoing suburbanisation and urban sprawl are putting pressures on the environment. Territorially fragmented cities hinder effective policy coordination, urban planning and investment.	Strengthen the governance system across the functional metropolitan areas and consider creating metropolitan governance bodies to coordinate investment on transport and energy infrastructure.

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2 Enhancing administrative and fiscal decentralisation

Introduction

Incomes and poverty vary significantly across regions in the Czech Republic and inter-regional gaps have grown over time. The population is ageing and declining in many rural areas, reducing the school-aged population and increasing the demand for public ervices such as health and long-term care, while at the same time putting pressures on resources to deliver them. The highly fragmented territorial administration of the Czech Republic does not help in this regard. There is a very high number of municipalities, which makes coordination difficult. In addition, the small size of many municipalities results in low capacity at the local level and a lack of economies of scale that compromise service quality and raise costs.

After the COVID-19 crisis, the need to ensure long-term fiscal sustainability will put the efficient use of resources more strongly to the fore. Subnational governments showed healthy fiscal balances for many years, but a drop in revenues during the crisis puts pressures on local budgets. In this context, enhancing access to high-quality services across regions and municipalities is needed to address economic and social challenges in the wake of the COVID-19 pandemic and to ensure that vulnerable people and areas are not left behind. In this regard, a well-resourced local administration can help to accelerate economic recovery, notably by effectively undertaking productive investment projects.

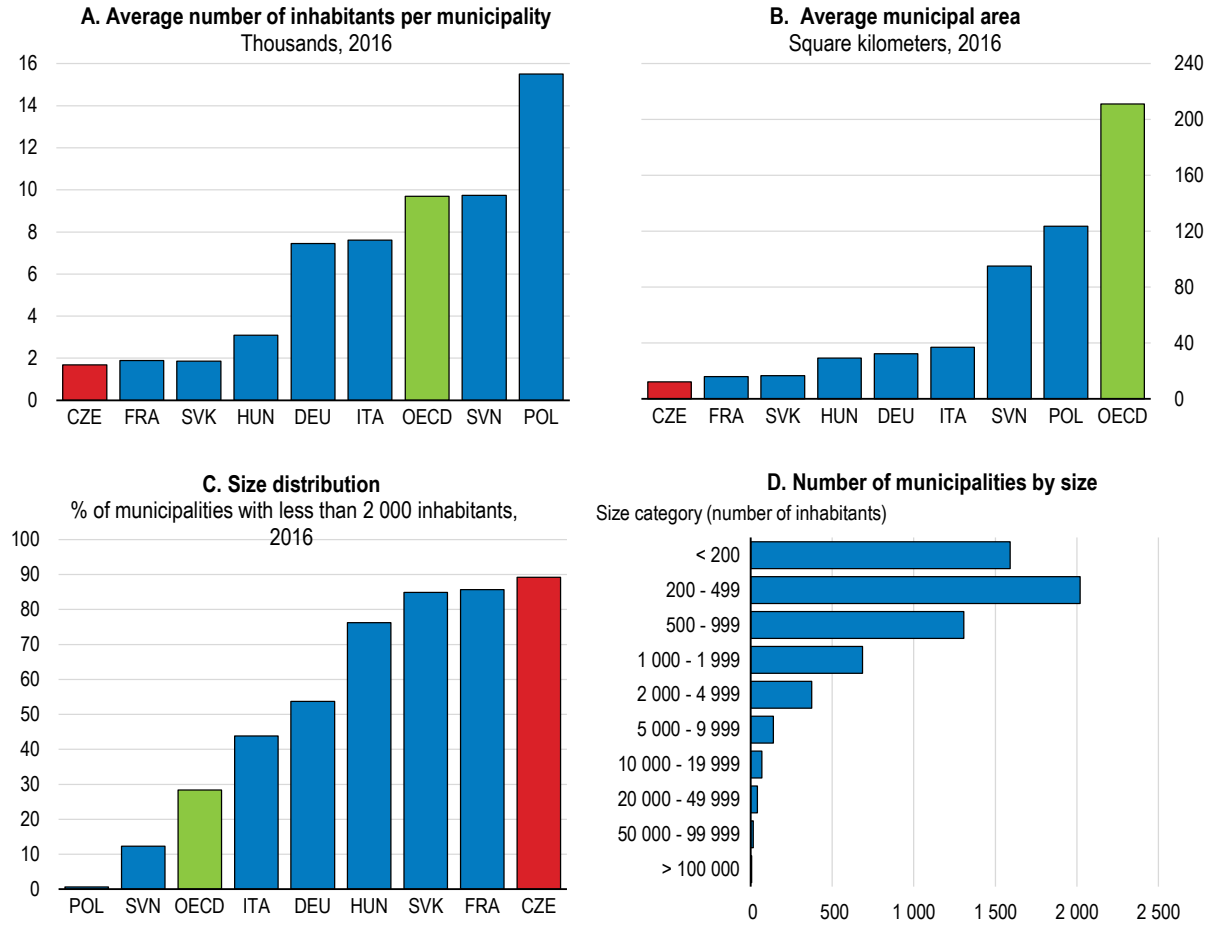
This chapter addresses the challenges faced by Czech subnational governments and proposes reforms to enhance their effectiveness. The first section describes the basic features of the territorial division and distribution of responsibilities among different levels of government. The second section discusses challenges that arise from the fragmented territorial division. The section that follows reviews inter-municipal co-operation and suggests ways to improve the system. Section four discusses the impact of the COVID-19 crisis on fiscal balances, fiscal arrangements and the level of fiscal autonomy of Czech subnational governments. The last two sections discuss the delivery of education and health and long-term care services at the local level, under demographic pressures.

A fragmented and complex territorial division

The Czech Republic's administrative organisation is fragmented with a high number of very small municipalities, potentially reducing economies of scale and compromising service quality. With 6 254 municipalities (not counting military districts), the average municipality size is the lowest among OECD countries in terms of both population and area (Figure 2.1, panels A and B). Almost 90% of municipalities have fewer than 2 000 inhabitants and close to one quarter of municipalities have a population below 200 (Figure 2.1, panel B and C). The median size of a municipality is 426 inhabitants (Ministry of the Interior, 2018).

Contrary to experience in many other OECD countries, fragmentation has increased over the past decades, partly due to historical reasons. After the 1989 "Velvet Revolution", the centralised system was abolished and municipal self-government was restored. This resulted in a steep rise in the number of municipalities: there were 4 100 municipalities in 1990, 6 097 in 1992 and 6 230 in 1994. Growth in the number of municipalities eventually stopped in 2000, after a requirement of at least 1 000 inhabitants for the creation of a new municipality was introduced.

Figure 2.1. Municipalities are very small



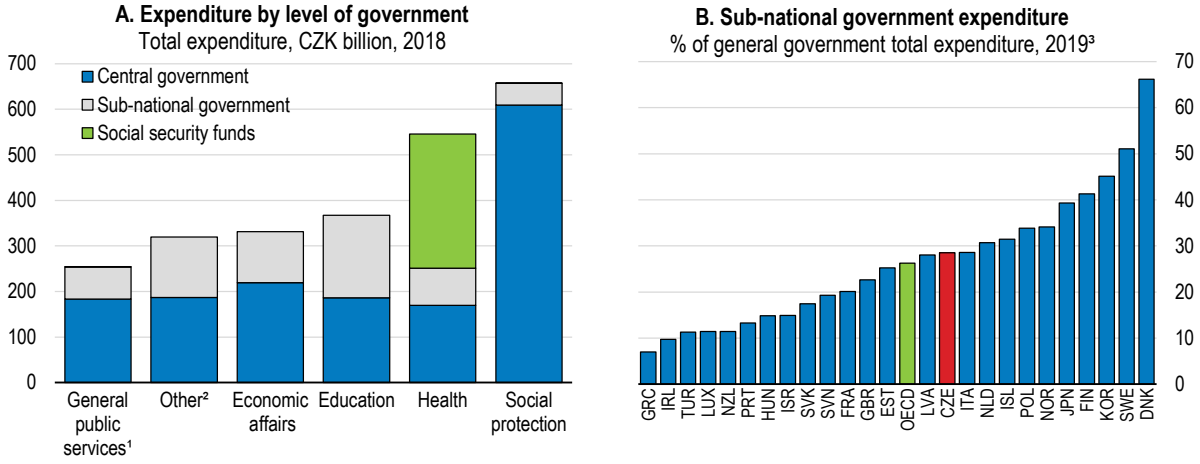
Source: OECD Subnational Government Structure and Finance database; Ministry of the Interior of the Czech Republic.

There are fourteen administrative regions in the Czech Republic (including the capital city of Prague, which has a special status as a region and municipality), which are also small by international standards. Most of the regions are not big enough to qualify as NUTS2 regions for EU-regional funding purposes. Only three regions are stand-alone EU-funding units. Consequently, combinations of regions have been formed for this purpose, adding a layer of complexity to regional administration and policymaking.

Overall, sub-national spending accounts for about one-quarter of general government expenditure, close to the average for OECD unitary countries (Figure 2.2, panel B). However, even in cases where much of the funding is covered by the state or social funds, local governments are often responsible for setting up, investing and managing the delivery of services. Autonomy and discretion in service delivery of local governments varies across sectors in terms of responsibilities and autonomy over revenues (Table 2.1).

Czech local governments are responsible for the delivery of many key services. Key spending items at the local level include education, economic affairs (transport), and other spending such as waste and wastewater treatment (Figure 2.2, panel A). Municipalities have greater spending responsibilities than regions. They are responsible for education up to lower secondary school, social services including housing, energy, water infrastructure and waste services. In health care, spending is largely covered by social security funds, but regions are responsible for hospitals and municipalities for health centres and small hospitals.

Figure 2.2. Subnational governments spending is comparable to the OECD average



Note: OECD refers to an unweighted average of available OECD unitary countries.
1. Executive and legislative organs, financial, fiscal, external affairs, foreign economic aid, general services, basic research, R&D related to general public services, public debt transactions and transfers of a general character between different levels of government.
2. Public order and safety, defence, environment protection, housing and community amenities, recreation, culture and religion.
3. Or latest available year.
Source: OECD National Accounts database.

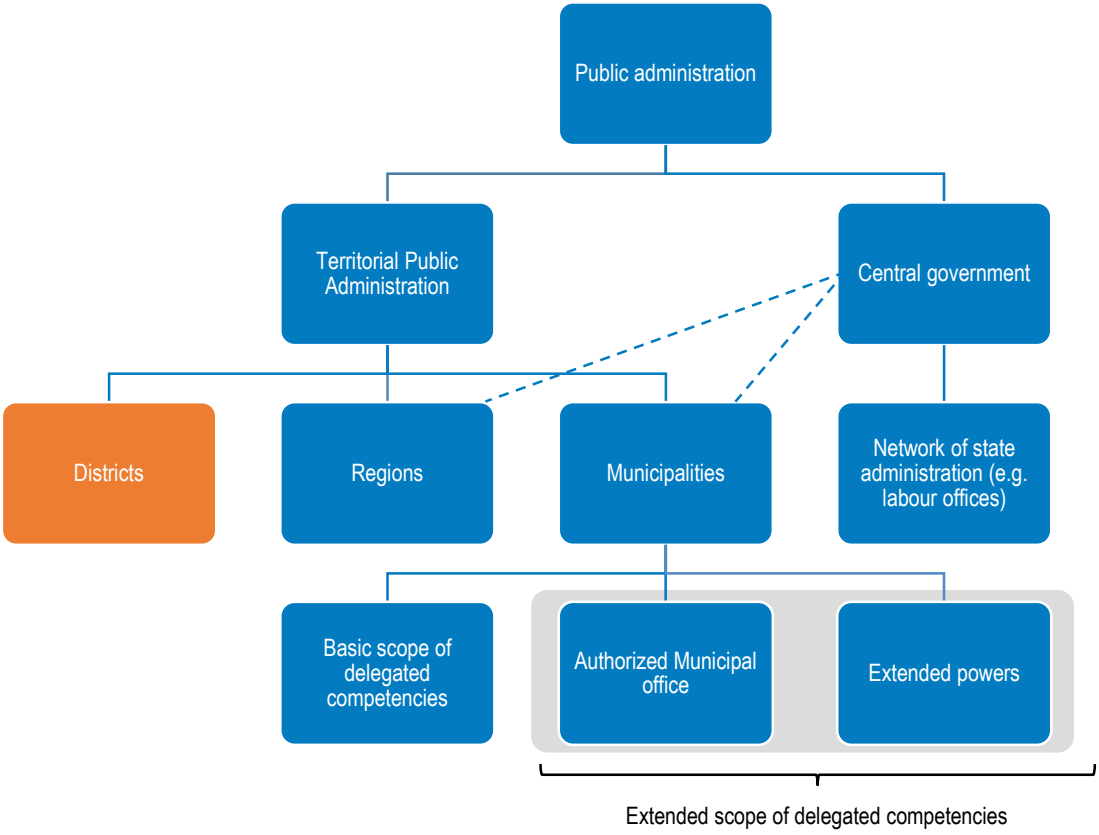
Table 2.1. Main responsibilities at the municipal, regional and central levels

Own responsibilities	Central government responsibilities	Autonomy over revenues
Education		
Provision of early childhood education (municipalities) Primary schools (municipalities) Secondary schools (regions). Some aspects of human resources but most is delegated to schools	Sets national education strategy, per capita financing and standardised tests Provides building grants	School financing is based mainly on the number of lessons taught. Tax revenue of municipalities received via the tax sharing formula includes the number of pupils in kindergartens and primary schools with a weight of 9 %. There are no user charges.
Health		
Opening and closing of hospitals (regions) Opening health centres (municipalities) Staffing levels	Determines treatment covered and the cost to insurance funds Provides investment grants Sets nation-wide pay	Funding is from the health insurance scheme and earmarked investment grants There are some small user charges.
Economic affairs		
Secondary (regions) and local roads (municipalities). Public transport	Sets technical standards for roads and prices for public transport	Funding comes from the sub-national government (SNG) resources and from tax revenues via the tax sharing formula. State provides some earmarked investment grants. Control over public transport fares is constrained by centrally set ranges.
Social protection		
Administration of social benefits on behalf of central government (municipalities) Level and quality of public housing (municipalities)	Sets parameters for social benefits There is no national definition of social housing but a national policy is planned	Transfers are received for costs of administering benefits and not earmarked. There are limited user charges. Housing investment grants are earmarked.
Utilities		
Water and waste management (municipalities with extended powers)	Sets standards following EU requirements Sets part of water price	User charges are an important source of revenue.

Source: Updated version of table 2.4 in OECD (2016a).

Municipalities and regions also perform public administration functions delegated to them by the state (Figure 2.3). The varying degrees to which state administration is delegated to different types of municipalities adds complexity. All municipalities perform a basic scope of delegated competencies on the area of the municipality (type I), but there are two more categories of municipalities, depending on the degree of transfer of state administration: type II – "Municipalities with authorized office" (338) and type III – "Municipalities with extended powers (MEPs)" (205). The latter form the so-called micro-regions and carry out a selected list of delegated competencies also for other municipalities in their respective micro-region (Box 2.1).

Figure 2.3. The structure of public administration is complex



Note: Dotted lines are for delegated competencies. Districts have been replaced by municipalities with extended power but in practice remain. Municipalities with an Authorized Municipal Office carry out fewer delegated competencies.
Source: Ministry of the Interior of the Czech Republic (Ministry of the Interior, 2018).

An efficient allocation of delegated power is impeded by the excessive fragmentation of municipalities in the Czech Republic. The allocation of delegated powers could be changed so that they are exercised only by municipalities of the second and third types, which have sufficient personnel and financial capacity to perform those functions. The new government strategic document, "Client's oriented public administration 2030" (Government Resolution no. 562/2020), includes a plan to transfer some of the competencies of delegated powers to the type II municipalities, which would be a step in the right direction.

State administration tasks that were previously performed by district offices were mostly transferred to the municipalities with extended powers after the 2002 decentralisation reform. However, districts have not been fully abolished, adding to the overlaying and complicated territorial structure. In 2020 an Act

on Territorial Division of the State was passed by the parliament to complete the transition from districts to municipalities in order to streamline the system and raise efficiency, effective from January 1st, 2021.

Box 2.1. Delegated and independent competencies of municipalities

Municipalities' delegated competencies depend on the size and capacities of municipalities. They form 3 types of municipalities. In parentheses, the number of municipalities concerned.

Delegated competencies

Type I : Basic delegated power (6254)

- Dealing with offenses (e.g.: minor disorderly conduct, traffic);
- Ensuring elections;
- Population records;
- Water management;
- Road authority.

Type II : Municipalities with authorized office (388)

Type I competencies plus

- Building authority (e.g.: delivery of building permits) (some are also located in Type I municipalities);
- Registry office (some are also located in Type I municipalities);
- Selected agenda on environment and agriculture;
- Social work/assistance;
- Administering war graves.

Type III : Municipalities with extended powers (205)

Type I + II competencies plus

- Issuance of ID cards, travel documents, driving licenses, trade licenses;
- Management of the register of motor vehicles and the population register;
- Coordination of the provision of social services.

Independent competencies (6254)

- Management of the municipality and the municipal office;
- Issuance of generally binding decrees;
- Territorial and regulatory plan of the municipality;
- Setting local fees;
- Establishment and management of nursery, elementary and basic art schools;
- Inter-municipal co-operation.

Source: Ministry of the Interior, 2018.

Administrative fragmentation increases costs, constrains the quality of services and reduces capacity at the local level

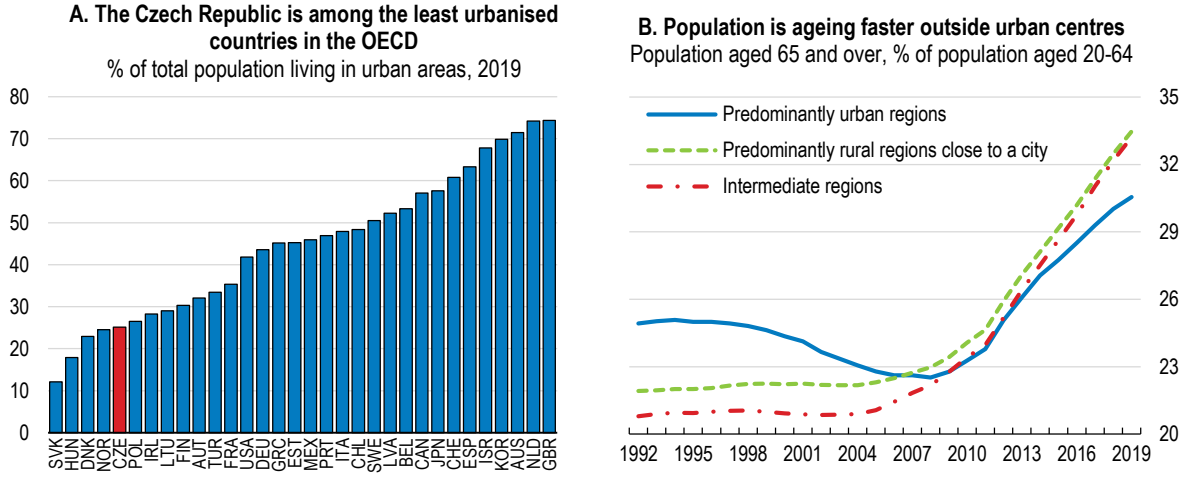
Small units of government make it more difficult to exploit economies of scale in public administration and service provision. A high number of territorial units and overlaying administrative structures make coordination of policies more difficult. It is also difficult for small municipalities to attract and pay sufficiently skilled staff to undertake more complex procurement and investment projects. These factors contribute to the overall below average public spending efficiency in the Czech Republic, in particular in the domain of general public services (Dutu and Sicari, 2016).

International evidence suggests a U-shaped relationship between the costs of service provision and the size of municipalities. Municipalities with more than 250 000 inhabitants or with fewer than 20 000 - 25 000 (well beyond the size of most Czech municipalities) appear less efficient (Holzer et al., 2009; McKinlay Douglas Limited, 2006). Very small size brings additional costs. In Spain, per capita total expenditure has been estimated to be 20% higher in municipalities with 1000 inhabitants compared to those with 5000 inhabitants (Solé-Ollé and Bosch, 2003). In Switzerland, costs have been found higher and service quality lower in municipalities with less than 500 residents (Ladner and Steiner, 2003).

The nature of economies of scale differs for different services. Small municipalities face a loss of economies of scale especially in capital-intensive services. Labour-intensive services such as police, fire and education, on the other hand, can be efficient also in smaller governments (Holzer et al., 2009).

The cost of public service provision also increases in remote and more sparsely populated areas (OECD, 2017a; OECD, 2018a). Sparsity was found to be associated with higher service delivery costs in rural areas in the United Kingdom (Ranasinghe, 2014). The Czech Republic is among the least urbanised of OECD countries (Figure 2.4, panel A), and many Czech municipalities with a small number of residents are remote and sparsely populated, raising costs. In addition, population tends to be older in rural areas compared to cities (Figure 2.4, panel B), requiring different and potentially more expensive public services. This is set to worsen over time as remote and rural areas will experience further depopulation and ageing.

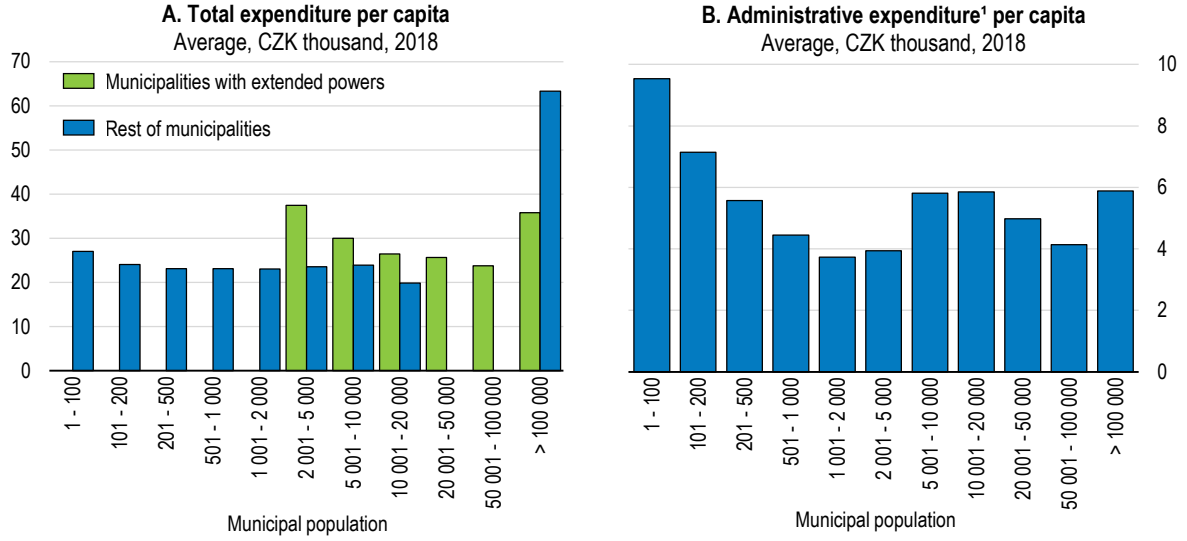
Figure 2.4. Share of urbanisation is low and population is ageing faster in rural areas



Source: OECD Regional Statistics database.

In the Czech Republic, total municipal expenditure per capita shows a slight U-shape pattern (Figure 2.5, panel A). However, making comparisons is difficult, as big cities tend to provide a full range of services, while very small municipalities simply do not provide some services. Comparisons of total expenditure are further complicated by the fact that different types of municipalities cover different ranges of delegated public administration functions. In this regard, it is telling that municipalities with extended powers, which in the domain of delegated state functions provide the same basket of services, also show a U-pattern in expenditure per capita. Narrowing the focus on administrative expenditures only, the U-shape pattern described above becomes more pronounced (Figure 2.5, panel B), with a decline in the cost per capita up to the population of 1000 – 2000. Overhead costs therefore affect the efficiency of very small municipalities and leave them with smaller financial resources for other services.

Figure 2.5. Expenditure per capita is higher in small municipalities



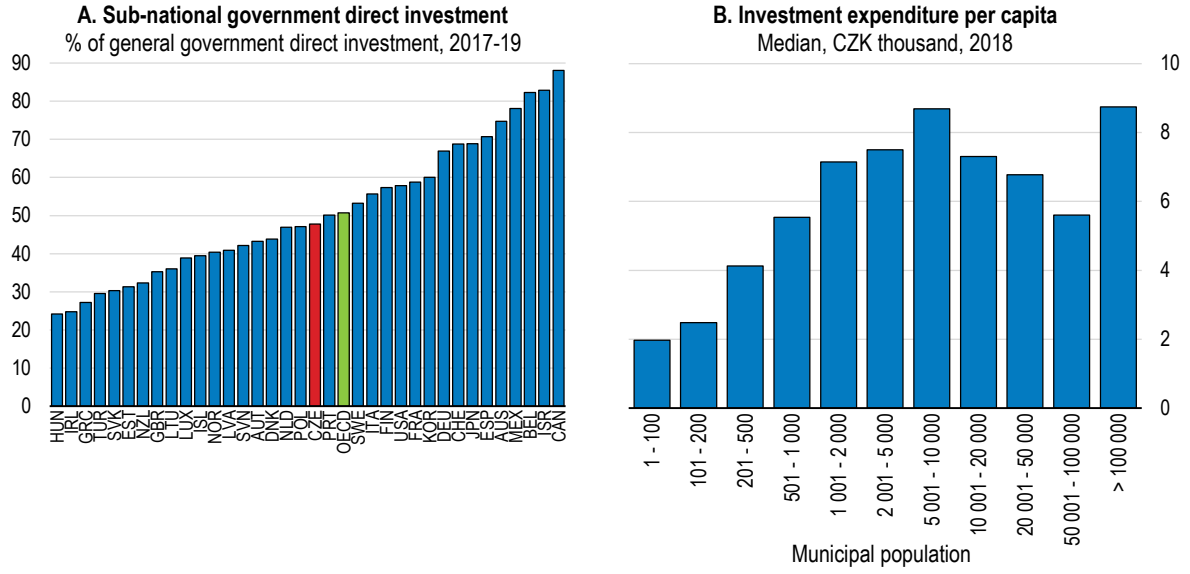
1. Data refer to sectorial expenditure in state power, state administration, local government and political parties.
Source: Ministry of Finance.

The small size of municipalities also brings problems of low capacity. The lack of adequate skills and low administrative capacity in small municipalities is particularly acute when dealing with specialised areas such as investment projects and procurement, contributing to the lower number and lower quality of projects. Sub-national governments in the OECD on average perform about half of all public investment (figure 2.6, panel A). They invest in roads, energy supply, water management, schools and hospitals, among others. Yet, evidence shows that in the Czech Republic, investment per capita in small municipalities (with less than 500 inhabitants) is less than half of investment per capita in mid-size (5 000 – 10 000 inhabitants) or large municipalities (over 100 000 inhabitants) (Figure 2.6, panel B).

There are no indicators about the cost and quality of public service provision across Czech municipalities and regions. Such indicators would contribute to enhancing the efficiency and effectiveness of local service delivery by helping the central government to assess performance, allow benchmarking and identify potential for efficiency improvements across the country. Some OECD countries such as Australia, Denmark, Italy and Norway compile and publish such indicators (Mizell, 2008 and Fadic et al., 2019). For example, in Norway, the KOSTRA system has brought several benefits to Norwegian municipalities. It has provided municipalities with a tool for internal planning, budgeting, and benchmarking. It has also helped the central government to assess if municipalities are complying with national standards and regulations (OECD, 2010a). In Italy, an online portal, OpenCivitas, has been

set up to collect public administration efficiency indicators, and it provides a large number of detailed data on the performance of local governments (municipalities, provinces and regions) based on actual expenditures and public services provided. The collection of this data is legally mandated at regular intervals (Fadic et al., 2019).

Figure 2.6. SNGs are important investors, but small municipalities invest comparatively less per capita

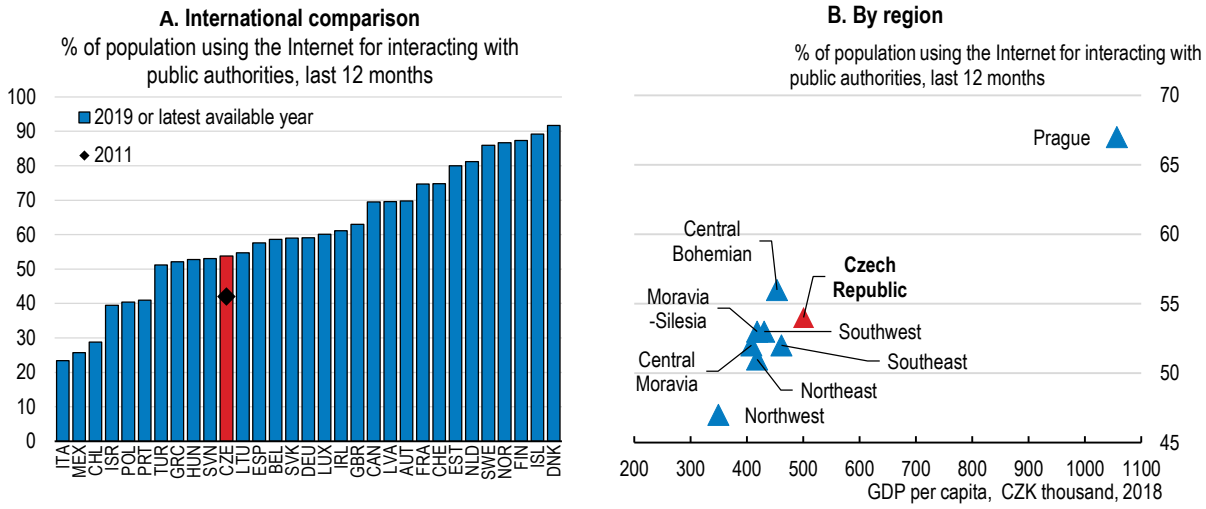


Note: Direct investment includes gross capital formation and acquisitions, less disposals of non-financial non-produced assets. OECD refers to an unweighted average for available OECD countries.
Source: Ministry of Finance; OECD National Accounts database.

The Ministry of the Interior has supported various pilot projects on collecting detailed cost and output data on state administration and other public services at the sub-national level, as reported in previous Surveys (OECD, 2006 and 2011). However, these benchmarking projects have had limited participation and the indicator database has not been made public. The government should introduce further incentives for participation and step up efforts to make the systematic collection of cost and output data of public service delivery at sub-national level a comprehensive nationwide system. Yet, this could be a high burden for very small municipalities, and difficult to manage due to the very high number of municipalities. It is nevertheless important to improve transparency, enhance data collection and strengthen performance monitoring. More systematic benchmarking could therefore be done at the level of regions and municipalities with extended powers.

Capacity at the local level and quality of public administration can be strengthened by higher skills-building among local employees, and greater use of digital technologies and e-government, which can be especially beneficial for more sparsely populated areas. In recent years, the government launched two initiatives to promote the development of e-government: the Strategic Framework of the Development of Public Administration in the Czech Republic followed by Digital Czechia. The latter aims to provide user-friendly and efficient online services for citizens and businesses, increase staff capacities and competencies in public administration and provide an efficient and centrally coordinated Information and Communication Technology (ICT) system for public administration (European Commission, 2019). However, the use of the internet to communicate with public authorities has room for improvement, especially in certain regions (Figure 2.7). Access to internet broadband connection is unequal across regions and cities, impeding the use of e-government by a higher number of residents.

Figure 2.7. The use of e-government could be increased



Source: OECD ICT Access and Usage by Households and Individuals database; Eurostat database [isoc_r_gov_i]; OECD Regional database.

Administrative capacity can be raised also through lifelong training and higher professionalism of local administrative staff. Reinforcing the expertise of public officials and institutions has been shown to foster public investment at the local level (OECD, 2014a). A recent OECD review on Making decentralisation work (OECD, 2019a), lists a number of measures through which the central government can support capacity building at the subnational level. The central government should assess capacity challenges in different regions on a regular basis, adapting policies to the needs of various territories. The aim should be to reinforce the capacities of public officials and institutions in a systemic and sustainable way, rather than offering technical assistance on a case-by-case basis. Open, competitive hiring and merit-based promotion, as well as offering competitive salaries, could also help raise professionalism of local staff.

Encouraging mergers and mandating inter-municipal co-operation to tackle fragmentation

Merging small municipalities is an obvious solution to administrative fragmentation, but can be politically challenging. Inter-municipal co-operation is another way of overcoming fragmentation and is common in the Czech Republic. However, inter-municipal co-operation is unstable, relies on external funding and mostly focuses on one-time investment projects rather than effective delivery of recurring public services. Mandating inter-municipal co-operation over a legally defined set of public services - in the area of micro-regions - can be an effective way of improving efficiency and the quality of service delivery. Eventually, this can be accomplished more durably by transferring competencies for service delivery to a higher level of territorial administration (municipalities of extended powers and their micro-regions), effectively introducing an intermediate layer of subnational government.

Mergers of municipalities should be encouraged

Many OECD countries have reformed their fragmented territorial administration, by successfully merging municipalities, despite initial political resistance (Box 2.2). Mergers can be politically difficult as they are seen as weakening local democracy and accountability and potentially threatening public jobs. In Nordic countries, especially Denmark, Norway and Sweden, successive waves of mergers have drastically reduced the number of municipalities (OECD, 2014b). In the Netherlands and Switzerland,

municipal mergers have been more of a gradual process. Mergers can be made mandatory as in Denmark, Greece, Japan and New Zealand or voluntary as they were in France and Norway. Some countries encouraged mergers by keeping the former municipal administration with a sub-municipal status, like in Korea, the United Kingdom, New Zealand, Ireland and Portugal or in France with the delegate mayors (OECD, 2017b).

Box 2.2. Experience of municipalities' mergers in selected OECD countries

Municipal mergers have been considered or implemented in most OECD countries over the past 15 years to, inter alia, generate economies of scale and scope, generate cost savings and internalise spillovers in the provision of local public services; to adapt to demographic change and to increase municipal administrative capacities.

Compulsory approach:

Mergers were made mandatory in Japan (1953-1999), New Zealand (1989), Denmark (2007), Greece (2011) and Turkey (2008 and 2012). Forced mergers were implemented either through strict pre-determined plans and targets (for instance, a determined targeted number of municipalities after the reform) or with more flexible objectives.

Japan (up to 1999): Strict pre-determined targets were used. Several waves of mergers drastically reduced the number of municipalities, from 9 868 in 1953 to 1 741 in 2017-2018 (OECD, 2018b).

New-Zealand: Strict pre-determined targets were used. Before the consolidation process, the local government sector was characterised by high fragmentation and wide disparities in size and activities, both at regional and local levels. An independent commission, the Local Government Commission, had the responsibility to supervise the reform process.

Denmark: The approach was characterised by some level of flexibility. Realigned responsibilities and financing changes drove a bottom-up process of amalgamation. A lower size limit of 20 000 was imposed. Local authorities were free to choose the neighbouring municipalities with which to merge. The central government gave municipalities six months to prepare their merger plans, with the implicit threat of intervening and imposing mergers in cases of non compliance. The number of municipalities fell from 271 to 98 in 2007. At the same time, 13 counties were replaced by 5 regions.

Greece: More competencies and resources were given to the new municipalities. The number of municipalities was reduced from 1033 to 325. Also, 54 departments were replaced by 13 regions, including two metropolitan regions.

Voluntary approach:

Norway, Iceland, Luxembourg, Netherlands, Finland ("PARAS" reform) and Japan (after 1999) chose the voluntary approach, relying on various incentives. However, in Japan and Finland, mergers based on voluntary approaches did not achieve their objectives.

Japan (after 1999): Mergers were pursued to raise cost-efficiency and address the weak fiscal situation of many small towns and villages. Many rural municipalities were also still considered below the critical size to provide public goods efficiently. The government used different financial incentives (grants and tax advantages) available until 2006. Moreover, "special amalgamation bonds" were introduced to fund projects related to amalgamations. Measures to mitigate the resistance to mergers were also taken, such as the guarantee to maintain the seats of local assembly members, a local tax "freeze" and the use of new organisational structures to enhance local representation. While the aim of the reform was to reduce the number of municipalities to around 1 000 (from 3 232), the goal has not yet been reached. In 2017-2018, the number of municipalities was 1 741 (OECD, 2018b).

Finland: Enacted in 2005 and 2007, the PARAS reform aimed to strengthen municipal and service structures, improve productivity, slow down the growth of local government spending and create a sound basis for local service provision. Municipalities were free to choose whether to merge or not and to select their merging partners. Financial incentives were implemented to promote mergers, in particular, grants were offered to merging municipalities. Other incentives were proposed (organisation and consultations tools, including local referendums). Only 67 mergers took place between 2007 and 2013, most mergers involving two municipalities. The number of municipalities declined from 431 in 2006 to 320 in 2013. A large-scale merger plan was introduced in 2011 and abandoned in 2015 because of strong resistance and the risk of being unconstitutional.

France: A voluntary process started in 2010. Financial incentives were provided for municipal mergers (cut in transfers for non-merging municipalities, see Box 2.4) and for transferring powers to "communities of municipalities". Since 2016, the number of municipalities has been reduced from 36 700 to 34 970.

Source: OECD (2017b), OECD (2016a) and OECD (2014b).

Czech municipalities are the smallest in the OECD, and mergers of small municipalities should be strongly encouraged, in particular as in many areas population's decline is set to continue. This was discussed at length in previous Surveys (OECD, 2016a and 2006). To make municipal mergers mandatory, a law would need to be passed by parliament, but political support for such legislation seems currently limited. Alternatively, mergers can be encouraged on a voluntary basis, using financial and non-financial incentives as has been done in other countries.

Municipal co-operation is common but it lacks stability

Inter-municipal co-operation is common in the Czech Republic and has a long history. Ninety per cent of municipalities are involved in some form of co-operation (Swiandiwicz, 2010). Different types of co-operation exist and there is some overlap in the functions carried out by each association as no overarching legislative rules and recommendations are in place (Ministry of the Interior, 2020). This can create inefficiencies and makes monitoring difficult. Furthermore, many associations lack stability. They depend on the willingness to cooperate by the current municipal administrations. In fact, in most cases inter-municipal co-operation is not aimed at the exercise of recurrent public services (e.g. strategic planning, education, social care), but at optional independent tasks (e.g. promotion of tourism, support for the construction of cycle paths, etc.). Inter-municipal co-operations also often importantly rely on external, temporary sources of financing, such as from the state budget or EU funds, rather than funding provided by member municipalities or own revenues from service provision.

The most common way of inter-municipal co-operation is via the Voluntary association of municipalities (VAM). As reported in the previous OECD Survey (OECD, 2016a), VAMs vary in nature, purpose and membership. As regards the scope of the activities, VAMs can be divided into single-purpose and multi-purpose VAMs. While the multi-purpose VAMs cover several functions, mostly in order to help with strategic development of its members, the activities of single-purpose VAMs are most often related to infrastructure and transportation (OECD, 2016a; Sedmihradská, 2010). They can have a one-time single purpose (e.g. an investment project) or ongoing provision of a service (e.g. waste removal). They can be established as joint stock companies (which can invest in another body alongside private companies) or public bodies.

Examples of such co-operation include a transfer of water infrastructure to a VAM (by a large number of municipalities) that also became the main shareholder in the water management company. Another example was a more modest VAM that was formed for connection of three small municipalities to the gas supply network. This VAM had no employees and individual municipalities carried out most of the functions for the project while the largest municipality managed accounting (OECD, 2016a).

Inter-municipal co-operation can also take the form of contracts for performing certain functions (Sedmihradská, 2010). In such cases, contracts are used to delegate some services that municipalities are required to provide, typically to the municipality with extended powers. Responsibilities transferred include administration, but also services such as education.

Co-operation is also taking place at the regional level. Groupings of regions were created with the main purpose of receiving EU structural funds, as most of the administrative regions are too small to be eligible for EU funds alone. The Association of Regions was established in 2001, a year after the creation of regions, and has gradually developed into a formal institutional structure comprising representatives from all regions. It facilitates co-operation, accumulation of expertise and trust, and dialogue with the national government.

The funding of VAMs can come from membership fees, user charges, or grants and subsidies from EU funds, regional authorities and selected state funds (e.g. state fund for transport infrastructure). Funds received from the EU and the state budget represent roughly 1/5 of total revenues of VAMs (Table 2.2). In fact, attracting grants or subsidies from the EU and state budget often requires co-operation, which has been an important driver of VAMs. Main expenditure items are capital expenditure, purchase of goods and services and salaries. Yet, VAMs can even be established without funding, as seen in the example above.

High reliance on external sources of funding can be a problem. External grants are project-based, hence temporary in nature. The lack of own funds and the reliance on external sources often drives the thematic focus of inter-municipal associations, which are not always aligned with local and regional priorities (Ministry of the Interior, 2020). Furthermore, receiving EU or state budget grants requires financing participation, for which inter-municipal associations lack own revenue-raising powers. With the expected relative trend decline in the inflow of EU funds to the Czech Republic, these sources of financing will gradually decrease over time. To ensure continued operations, member municipalities as well as the two associations of municipalities and the state should think of alternative sources of funding in the short term. Over time, municipalities should boost their own financing participation in inter-municipal associations to sustain stability. In the past, many municipalities accumulated budget surpluses that could be directed for these purposes.

Co-operation is common and flexible, but it can be associated with drawbacks and does not solve all the problems of fragmented governance that can result in lower quality or lack of certain services at the local level. There are costs associated with the formation of associations. While the voluntary basis of co-operation can result in such co-operation being well-targeted to the needs of participating municipalities, it may be costly to search for partner municipalities across a range of needs. This can be especially significant for small municipalities, which are the most in need of co-operation. Moreover, where VAMs involve participation of a large number of small municipalities, coordination costs can be high. Some VAMs do not include adjacent municipalities, likely leaving out places where the benefits of co-operation could be large (OECD, 2016a and Sedmihradská, 2010). There may be political costs linked to co-operation and the sustainability of an association or agreement usually depends on the current mayor or local administration. Finally, inter-municipal co-operation may suffer from a degree of democratic deficit as representatives of inter-municipal co-operation structures are not directly elected, potentially leading to accountability problems (OECD, 2019a and 2017b).

Mandating inter-municipal co-operation and increasing the role of municipalities with extended powers

Municipal co-operation exists in many OECD countries. It is particularly popular in Nordic countries (Finland, Sweden, Norway and Denmark) but also in Italy, Spain, Poland and France, where it is mandatory for all municipalities (OECD, 2019b and OECD, 2014b). Inter-municipal co-operation arrangements are very diverse, varying in the degree of co-operation (Figure 2.8), from the loosest

(single or multi-purpose cooperative agreements) to the strongest form of integration (supra-municipal authorities with delegated functions and even taxing powers). The financing varies considerably by country, over time and even by service sector. While, for instance, the Nordic countries have mostly relied on the member municipalities to fund the associations, other countries such as France have relied more on direct central government financing of subnational co-operation. In addition, the French public establishments for inter-communal co-operation (EPCI or établissement public de coopération intercommunale) have their own sources of tax revenue (OECD, 2019b, 2017b).

Table 2.2. Revenue and expenditure of Voluntary Associations of Municipalities

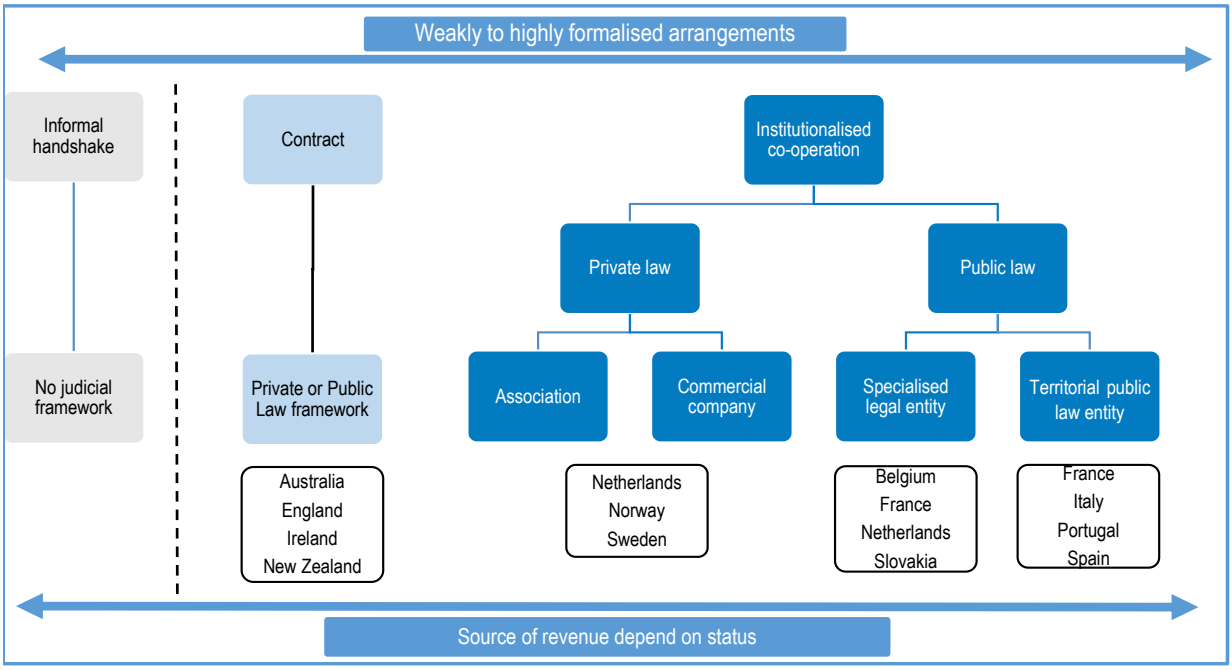
	2019
Revenues (millions CZK)	
Tax revenues	..
Non-tax revenues	**1429.2**
Of which:	
Income from own activities	321.4
Proceeds from letting property	892
Capital revenues	**18.5**
Transfers	**2678.0**
Current transfers	**1193.3**
Of which:	
From municipalities	478.2
From regions	66.9
From central government and the EU	200.5
Capital transfers	**1484.6**
Of which:	
From municipalities	702.4
From regions	152.3
From central government and the EU	622.5
Total revenues	**4125.7**
Expenditures (millions CZK)	
Current expenditure	**1445.2**
Of which:	
Salaries	368.9
Purchase of goods and services	838.3
Capital expenditure	**2303.4**
Total expenditure	**3748.7**
As a percentage of total public spending	0.2

Source: Ministry of Finance.

There is a number of "multi-purpose VAMs" in the Czech Republic that include most of the municipalities from their functional micro-region (administrative unit of the municipality with extended powers). They facilitate coordination among municipalities across a wide range of different activities, many of which are known to benefit from economies of scale. These include: strategic planning and development; co-operation in provision of selected services (education, social services, telecommunications, waste management, care for public greenery); support for the development of social, cultural and leisure activities, and for tourism development; landscape management and prevention of the consequences of climate change; and administrative support for member municipalities (e.g. public procurement assistance, and sharing experiences and best practices). In their function, these multipurpose VAMs within micro-regions come closer to the strong forms of sub-governmental integration mentioned above - the supra-municipal authorities with delegated functions stipulated by law. The Ministry of the Interior

sees the multipurpose VAMs as role models on which to base progress towards greater integration (Ministry of the Interior, 2020). However, as with other VAMs, their set up does not guarantee stability and their sources of funding are highly uncertain. They receive funds from their members, but mayors are reluctant to raise membership fees sufficiently to ensure adequate financing (Ministry of the Interior, 2020).

Figure 2.8. From soft agreements to more formalised forms of co-operation in the OECD



Source: OECD (2019), Making decentralisation work: a handbook for policy-makers.

In order to support a wider use of multi-purpose associations in the Czech Republic, it would be necessary to enshrine in law the selected mandatory tasks that municipalities must perform either independently (if they are large enough) or through inter-municipal co-operation. A clear definition by law of mandatory tasks to be performed by local self-government is missing in the Czech Republic. Exercising independent competencies and joining inter-municipal associations are all on voluntary basis.The case of multipurpose inter-municipal co-operations in Germany with clear co-operation structure and well-defined tasks supported by law (Box 2.3) is a good example for raising the stability of co-operation.

Inter-municipal co-operation could be made mandatory at the level of micro-regions. Like the Czech Republic, France has a high degree of administrative fragmentation, and also a long history of inter-municipal co-operation that developed to counter fragmentation. Since 1992, France promoted inter-municipal co-operation as integrated territorial projects - “communities of municipalities” - with own taxation powers. Due to the high complexity of inter-municipal organisation, this was further streamlined in 2014, by setting a minimum threshold for inter-municipal co-operation structures (15 000 inhabitants instead of 5 000), as experience showed that a sufficiently large population threshold was needed to form effective “communities of municipalities”. The reform resulted in a decrease in the number of inter-municipal co-operation (IMC) structures with own-source tax, from 2 456 in 2013 to 1 258 in January 2019. Today, all French municipalities are part of an IMC with own-source tax, ranging in size from 21 metropolises (greater than 400 000 inhabitants), 13 “urban communities”, 223 “agglomeration communities” and 1 001 “communities of municipalities” in rural areas (as of January 2019). With their

own taxing powers, these structures form another quasi-layer of subnational level of government (Box 2.4, OECD/UCLG, 2019). Creating communities of municipalities around MEPs in the Czech Republic can be a way to boost efficiency and quality of local public services, without undermining the sense of local independence.

Box 2.3. Multipurpose (mandatory) associations of municipalities – example of Germany

There are four basic models of inter-municipal co-operation around large cities in Germany. The highest degree are unions of municipalities that are legally equal to territorial self-governing units. The second model are multi-purpose associations of municipalities ("Zweckverband"), while the third model are single-purpose associations (dealing with, for example, regional planning). The fourth type are inter-municipal co-operations using forms of co-operation based on private law, such as the joint creation of companies by several territorial units.

The second model - multi-purpose associations of municipalities – is interesting from the perspective of making inter-municipal co-operation more stable in the Czech Republic. The second model in Germany has three typical foundations: 1) on the basis of an agreement of its members to perform optional tasks, 2) on the basis of an agreement of its members to perform mandatory tasks established by law and 3) by special law, which directly determines the scope of obligatory, or alternatively voluntary tasks of the co-operation (e.g. Regional association for the greater Braunschweig area 2017).

Source: Schliesky, Utz: Stadt-Umland-Verbände, pages. 874 - 899, in: Handbuch der kommunalen Wissenschaft und Praxis.

Box 2.4. Inter-municipal co-operation and mergers: the experience of France

France is a unitary country with three tiers of local government: regions, "departments" (départements) and municipalities (communes). In January 2019, there were 18 regions, 101 departments, and 34 970 municipalities. France also has a fourth subnational quasi-level composed of 1 258 inter-municipal co-operation structures, having their own sources of tax revenues. This complex structure is the result of different waves of decentralisation.

Objectives of the municipal and inter-municipal reforms

France is a country with one of the highest number of municipalities in the OECD. The objective of the different reforms has been to reduce municipal fragmentation in order to reach economies of scale and greater efficiency.

In the past, as reforms encouraging mergers failed to generate a substantial reduction in the number of municipalities, policies have encouraged inter-municipal co-operation. However, despite the numerous positive outcomes of inter-municipal co-operation, the way it was implemented resulted in the creation of a dual municipal layer, generating an unnecessary proliferation of inter-municipal structures and duplication of services and staff.

Since 2010, and even more since 2015, the perception of municipal mergers has evolved and thus the objective of the government has been: i) to reduce the number of inter-municipal co-operation structures while reinforcing their responsibilities; ii) to favour municipal mergers by improving the *Commune Nouvelle* legislative framework adopted in 2010.

Characteristics of the municipal and inter-municipal reforms

In March 2015, a law was passed which aims at promoting voluntary municipal mergers. Under this framework, the status of “associated municipalities” allows merged municipalities to remain and retain some

particularities such as a delegate mayor, a town hall, an advisory council, etc. The rules for the creation of new (merged) municipalities have been relaxed and strong financial incentives for small municipalities creating communes nouvelles were introduced. Financial incentives took the form of the safeguarding of transfers from the central government in a context of large cuts in transfers to non-merging municipalities. Associated municipalities were also guaranteed to receive the sum of the main transfer from the central government (Dotation Globale de Fonctionnement, DGF) of all former municipalities. Moreover, for merged municipalities of greater sizes, the DGF has been enhanced over three years ("Financial Pact").

Simultaneously, the government aimed at strengthening the powers of inter-municipal co-operations (IMCs) while decreasing their number. The minimum population threshold for IMCs went from 5 000 to 15 000 inhabitants, to be attained before 1 January 2017. All municipalities had to integrate an inter-municipal co-operation structure, on a compulsory basis. The number of inter-municipal syndicates (single or multi-purpose and without taxing power) had to be reduced. Inter-municipal co-operation was strengthened, as municipalities have the obligation to transfer some additional responsibilities to their IMC structure - community of municipalities. These responsibilities include water provision and sanitation, waste, tourism, commercial activities, and other optional responsibilities (e.g. creation of public services centres). In addition, provisions for pooling services and personnel were improved by law to avoid duplication.

The reform has had some success, as since 2015, the number of municipalities decreased from around 36 700 in 2015 to 34 970 in 2019 (Ministère de la cohésion des territoires et des relations avec les collectivités territoriales, 2019). The number of communities of municipalities decreased by almost 1 200.

Source: OECD (2017b), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, OECD Multi-level Governance Studies, OECD Publishing, Paris.

A longer-term solution to stabilise funding and improve efficiency, but currently not constitutionally feasible, would be to increase the role of MEPs as an intermediate level of subnational government, with independent competencies over their respective micro-regions. Certain municipal competencies could thus be moved to the level of MEPs - those especially prone to economies of scale or those that are effectively done over larger areas and populations, such as public transport, spatial planning and environment, to name a few. MEPs already provide delegated public administration functions for other municipalities and in some cases smaller municipalities outsource to them the provision of other services, so this will be a natural step. The staff and functions of the existing inter-municipal co-operation structures could eventually be integrated with the MEP administration. To ensure stability and effective provision of services this would also require changing the division of competencies among different layers of government, and should involve greater revenue-raising capacities (taxing powers) of MEPs.

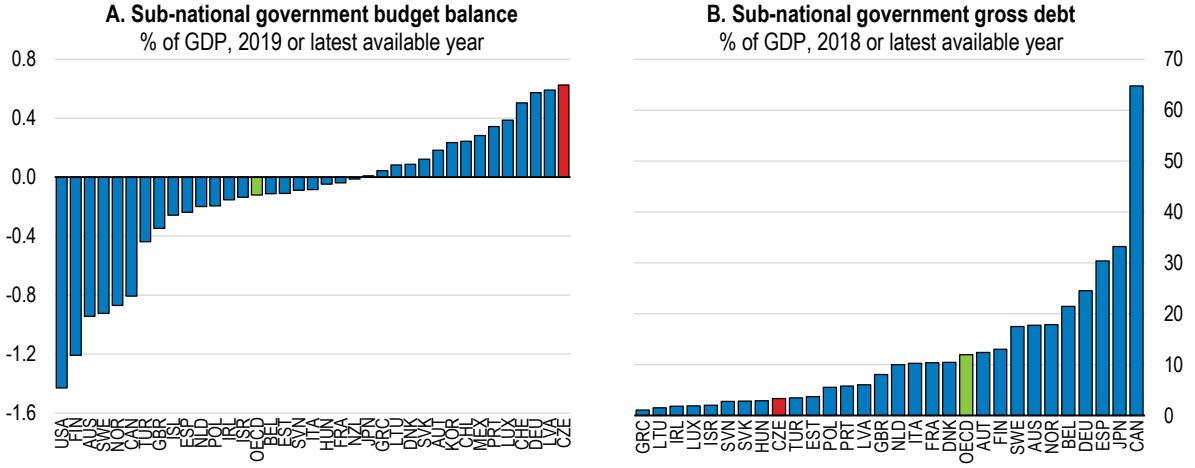
Fiscal arrangements to improve efficiency

Overall, the fiscal position of local governments is sound but the COVID-19 shock will pose challenges

Overall, the budgetary situation of subnational governments (SNGs) before the crisis was sound. Debt as a share of GDP was among the lowest in OECD countries while their fiscal balance was positive (Figure 2.9). But the large drop in economic activity and the reduction in fiscal revenues during the crisis will have a significant impact on subnational government fiscal balances. It is common in crises that subnational governments struggle with a "scissors effect", of decreasing tax revenues and rising expenditure (Bloechliger et al., 2010). Czech SNG fiscal balances appear quite sensitive to the economic cycle (Figure 2.10, panel A). Notably, through a tax sharing formula (more on this below), Czech regions and municipalities are exposed to cyclical variation in tax revenues. During the 2009 global financial crisis, fiscal balances of Czech subnational governments quickly deteriorated from

surpluses to deficits (Figure 2.10, panel B), before returning to surpluses in the following years. The effect in the current situation can be expected to be similar.

Figure 2.9. Local government finances were sound before the COVID-19 crisis



Note: OECD refers to a simple average of available OECD countries. Gross debt is based on the SNA 2008 and includes the following liabilities: currency and deposits, debt securities, loans, insurance pension and standardised guarantees and other accounts payable.
Source: OECD National Accounts database.

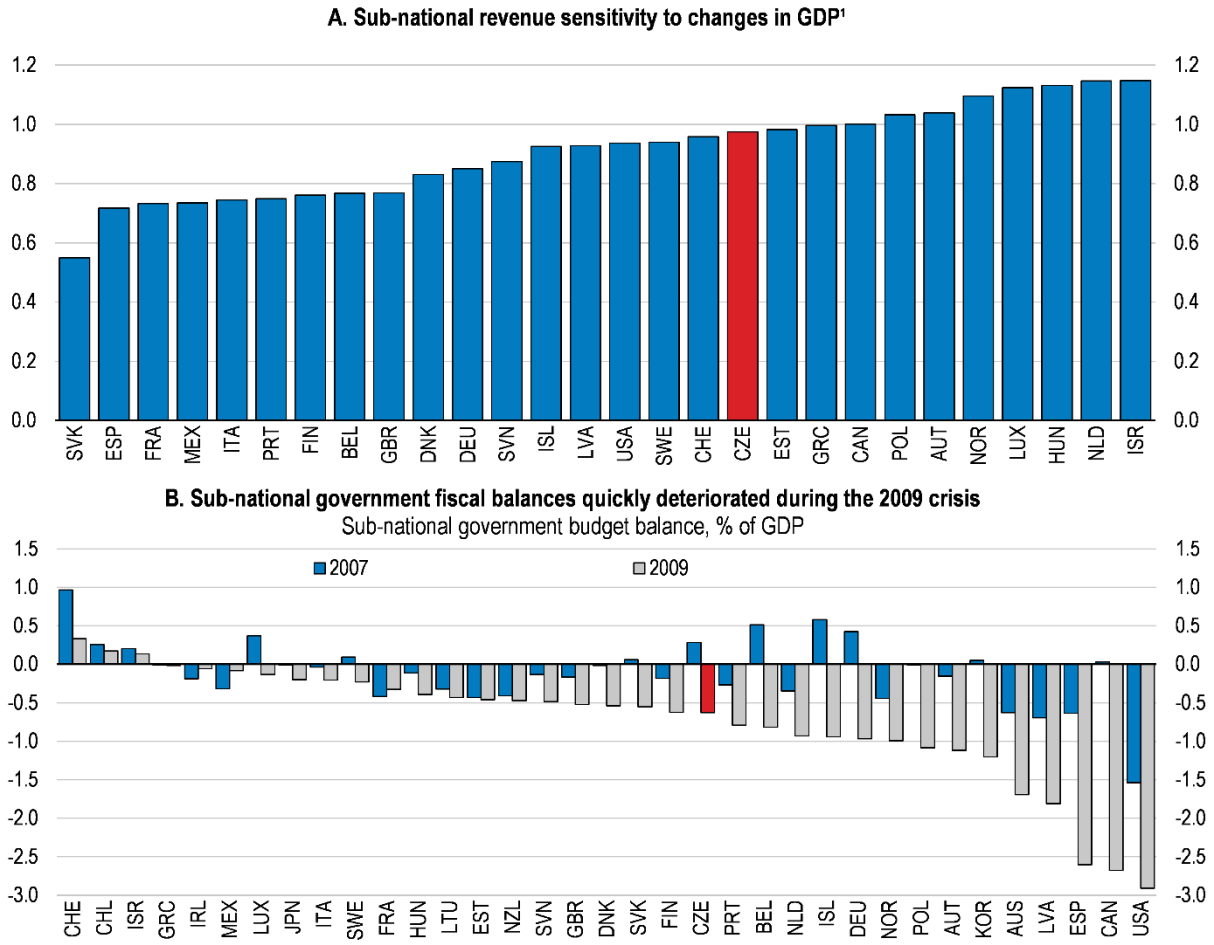
Municipalities' limited ability to raise their own taxes and, for small municipalities, to borrow money, result in only limited room for discretion. This can lead to large pro-cyclical cuts to local expenditures, notably investment, that could be important for post-crisis recovery. It is generally accepted good practice to assign less pro-cyclical tax sources to sub-central governments, such as property taxes, in order to avoid large sub-central government budget fluctuations and pro-cyclical effects (Kim and Vammalle, 2012). The central government – with its strong fiscal positon and ability to borrow - is better able to bear the burden of economic fluctuations and emergency fiscal measures, without causing strong pro-cyclical contraction in other expenditures.

To help the economy during the COVID-19 contraction, a number of emergency fiscal measures were instituted through the tax system, putting additional pressures on budget revenues of the Czech subnational governments through the tax sharing formula. In particular, the support to the self-employed (compensatory bonus) was introduced through the personal income tax, and deferrals were introduced on personal income tax advances and corporate income tax advances by companies. Sharing the additional burden of the emergency measures with Czech municipalities makes their revenues even more pro-cyclical in a time of crisis. This was indeed controversial at the time, and the Czech National Budget Council (2020) argued against it. In the end, the central government compensated the municipalities, by allocating them non-earmarked grants, and by allocating more funding for repairs to local schools and kindergartens and other buildings owned by municipalities. Moreover, due to concerns about the impact of the COVID-19 crisis and the additional burden of emergency measures on the municipal investment projects, the central government also invited the Union of Towns and Municipalities of the Czech Republic to review the status of various investment projects. The central government committed to support those for which funding was missing (Ministry of Finance, 2020).

To counteract the pro-cyclical impact of deteriorating SNG budgets on local public expenditures during the COVID-19 crisis, many other central governments across the OECD – Finland, Italy, Norway, Spain and the United States - stepped in to extend support to local budgets with discretionary grants. This has been done with a view that SNGs expenditures, notably investment expenditures, will be important for

the recovery. SNGs form an important part of public investment, including in the Czech Republic. As said earlier, budget positions of Czech SNGs were strong before the crisis, and many of them had built substantial cash reserves. It is therefore difficult to assess from the outset how much support – if any – is warranted.

Figure 2.10. Sub-national fiscal balances in the Czech Republic are highly sensitive to changes in GDP

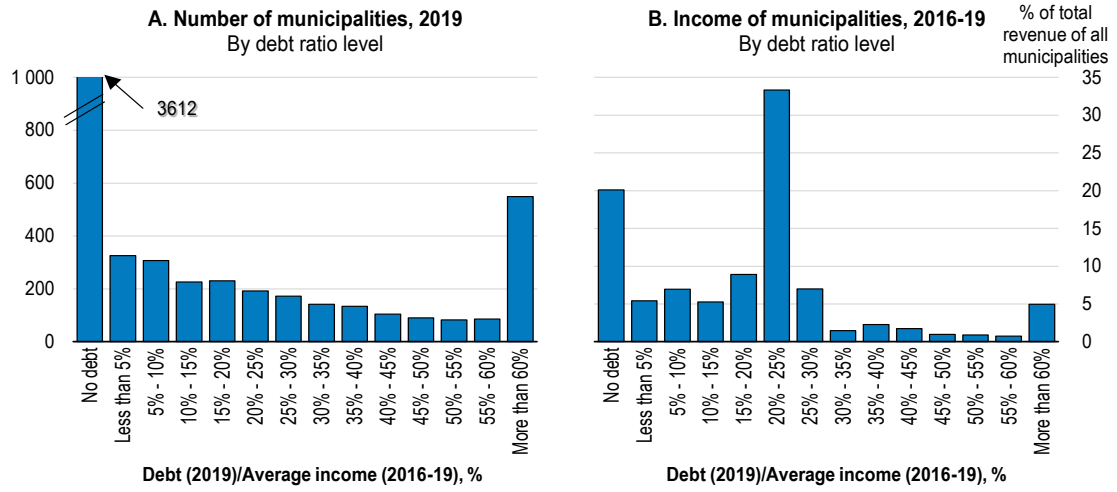


1. The responsiveness elasticity is calculated as the coefficient of a log-log regression that regresses overall SNG revenue on GDP (including different types of own-source taxes and intergovernmental transfers). Years considered: from 1995 to latest available year (varies among countries). Only countries with regression R2 higher than 75% are presented.
Source: OECD National Accounts database; OECD (2020), COVID-19 and fiscal relations across levels of government, https://read.oecd-ilibrary.org/view/?ref=129_129940-barx72laqm&title=COVID-19-and-Fiscal-Relations-across-Levels-of-Government

To avoid pro-cyclical effects, it is also possible to relax fiscal rules, as has been temporarily done for the general government sector. In the wake of the COVID-19 crisis, Spain, France and Germany, for example, relaxed fiscal rules for their SNGs (OECD, 2020a and 2020b). This said, there are no strict fiscal rules pertaining to municipal expenditure in the Czech Republic, as long as they can finance them from reserves or by borrowing money. The latter might be a constraint for small municipalities. But, due to low debt in most municipalities, the debt rule (maximum 60% of the average revenue over the past four years, beyond which municipalities need to gradually repay the debt) is binding only for a minority of municipalities (Figure 2.11).

Once the crisis subsides, the SNGs will nevertheless need to contribute to the consolidation efforts to restore fiscal space and to get on the path of sustainable public finances of the general government. To effectively support the economic recovery and credibly commit to fiscal consolidation, efficient provision of public services at the local level and increased capacity to undertake productive investment projects will become even more important.

Figure 2.11. Not many municipalities would reach the 60% debt limit



Source: Ministry of Finance.

Distribution of tax revenues favours small municipalities

In the Czech Republic, SNGs' revenue comes mostly from shared taxes and from grants and transfers from the central government (Tables 2.3 and 2.4). The mix of revenue categories is in fact close to the OECD average (Figure 2.12). However, as already discussed in a previous Survey (OECD, 2016a), Czech SNGs have comparatively very little autonomy over revenues. They raise a very small proportion of total taxes (Figure 2.13) and a large part of tax revenue is distributed via a tax sharing formula. Moreover, grants from the central government are generally earmarked and often do not require cofinancing (matched funding) by the SNG receiving the grant possibly reducing efficiency (Bergvall et al., 2006).

Total tax revenue is shared among different levels of governments (state, regions, municipalities, and the state fund for traffic infrastructure) according to coefficients stipulated by law (Table 2.5). Recently, the share of SNGs has been increased for several taxes, including VAT. These revenues are then further distributed between regions and municipalities. For regions, the coefficients for redistribution were set in 2005 and roughly followed the estimated level of costs associated with delivering delegated services and functions. As the situation has evolved since then, including diverging population trends, there is growing pressure for a change to a horizontal distribution of revenues among regions.

Table 2.3. Revenue and expenditure of regions and municipalities

As a % of total, 2019

	State	Regions	Municipalities[1]
Revenues (% of total revenue)			
Tax revenues	**86.4**	**31.4**	**67.3**
Of which:			
PIT (person income tax)	10.8	8.8	16.8
CIT (corporate income tax)	8.1	7.0	14.6
VAT (value added tax)	19.1	15.6	28.1
Social security contributions	36.2	0.0	0.0
Other tax revenues	12.1	0.1	7.7
Non-tax revenues	**1.4**	**2.8**	**9.8**
Capital revenues	**1.2**	**0.2**	**1.9**
Transfers (consolidated)	**11.0**	**65.6**	**21.1**
Current transfers	6.6	60.7	14.7
Capital transfers	4.4	4.9	6.4
Total revenues	**100.0**	**100.0**	**100.0**
Expenditures (% of total expenditures)			
Current expenditures (consolidated)	**91.0**	**86.1**	**72.1**
Capital expenditures	**9.0**	**13.9**	**27.9**
Total expenditures (consolidated)	**100.0**	**100.0**	**100.0**

1. Including capital city Prague and Voluntary associations of municipalities.
Source: Ministry of Finance, "Monitor Státní pokladna – Analytical part of portal Monitor".

Table 2.4. Revenue and expenditure of regions and municipalities

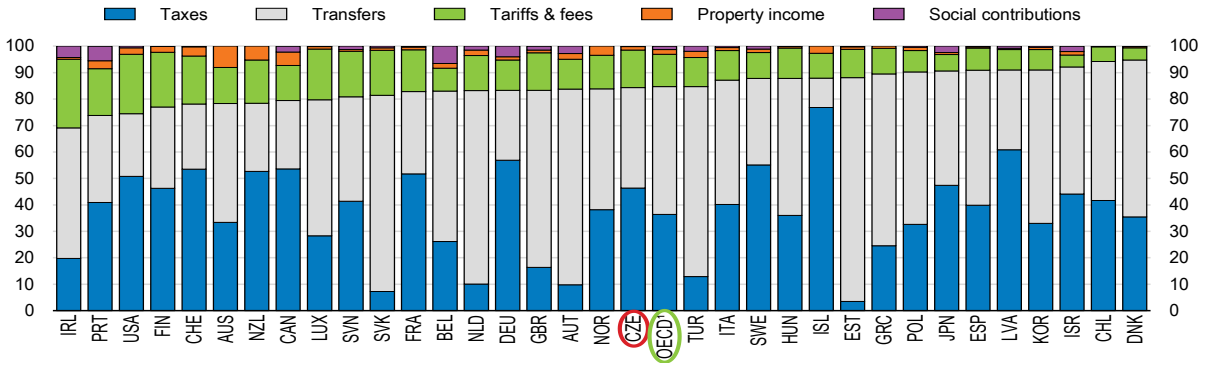
In billions CZK, 2019

	State	Regions	Municipalities[1]
Revenues			
Tax revenues	**1 315.7**	**75.0**	**245.2**
Of which:			
PIT (person income tax)	164.5	21.0	61.2
CIT (corporate income tax)	123.5	16.8	53.2
VAT (value added tax)	291.3	37.1	102.5
Social security contributions	551.7	0.0	0.0
Other tax revenues	184.7	0.1	17.3
Non-tax revenues	**21.5**	**6.7**	**35.6**
Capital revenues	**18.7**	**0.4**	**6.8**
Transfers (consolidated)	167.3	156.5	77.0
Current transfers	101.0	144.8	53.8
Capital transfers	66.3	11.7	23.3
Total revenues	**1 523.2**	**238.5**	**364.6**
Expenditures			
Current expenditures (consolidated)	**1 412.6**	**200.4**	**244.2**
Capital expenditures	**139.1**	**32.3**	**94.5**
Total expenditures (consolidated)	**1 551.7**	**232.7**	**338.7**

1. Including capital city Prague and Voluntary associations of municipalities.
Source: Ministry of Finance, "Monitor Státní pokladna – Analytical part of portal Monitor".

Figure 2.12. Sub-national governments' revenues come mainly from shared taxes and transfers

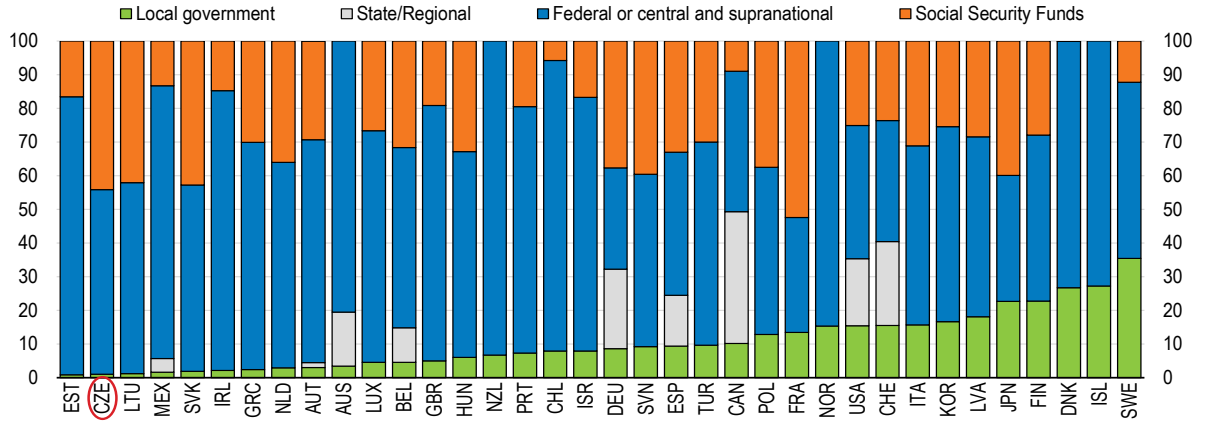
Subnational government revenue by type, % of total revenue, 2016



1. Unweighted average.
Source: OECD Subnational Government Structure and Finance database.

Figure 2.13. Tax revenue levied at the local level is very low

Tax revenues of sub-sectors of general government as % of total tax revenues, 2018 or latest available year



Note: Compulsory social security contributions paid to general government are also treated as taxes.
Source: OECD Revenue Statistics.

For municipalities, the tax sharing formula is more complex, and it implicitly encourages very small municipalities to remain small. The formula takes into account population size (88%, following a formula), number of children in nursery schools and primary schools (9%) and the size of the cadastral area (3%). On top of this, a small share of PIT that is levied on wages, is distributed according to the number of employees across municipalities. Over the past years, the tax sharing system was changed in favour of larger municipalities by introducing a cap on the cadastral area component and increasing the weight of the component on the number of children in kindergartens and primary schools. However, as the density of population increases with the population size of a municipality, the cadastral area component matters especially for small municipalities (Figure 2.14, panel A). Hence, the average tax revenue per inhabitant follows a U-shape curve (Figure 2.14, panel B and Table 2.A.1) and very small municipalities on average receive significantly more tax revenue per inhabitant. It is understandable that the tax sharing system compensates for higher costs of service delivery in scarcely populated areas. However, in the Czech case where the number of municipalities is taken to the extreme, the tax sharing formula should be made more neutral for small municipalities, say for municipalities with population of fewer than 1 000 inhabitants.

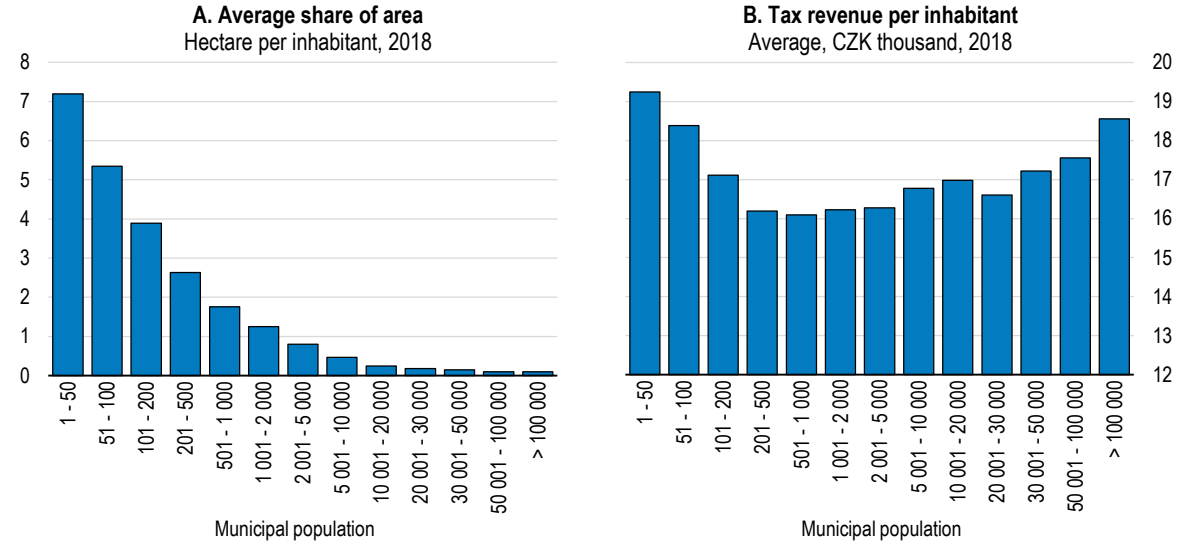
Table 2.5. Tax sharing arrangement in the Czech Republic, 2018

	State	Regions	Municipalities	State fund[1]
Tax revenue distributed via tax sharing formula				
Value added tax	67.5	8.92	23.58	0
Corporate income tax	67.5	8.92	23.58	0
Personal income tax				
Tax on interest and dividends	67.5	8.92	23.58	0
Tax of unincorporated individuals	80.5	5.352	14.148	0
Tax on wages and salaries	66.0	8.92	25.08 (1.5 % is redistributed according to the location of employees)	0
Gambling tax				
Technical games[2]	35.0	0	65.0	0
Other games	70.0	0	30.0	0
Real property transfer tax	100.0	0	0	0
Excise duty on mineral oils	90.9	0	0	9.1
Other excise duties	100.0	0	0	0
Tax revenue distributed directly to sub-national governments or state fund[3]				
Income tax paid by municipalities[4]	0	0	100.0	0
Income tax paid by regions[4]	0	100.0	0	0
Real estate tax[5]	0	0	100.0	0
Road tax	0	0	0	100.0

1. State fund of traffic infrastructure.
2. Tax revenue is shared according to the information on permits issued for the placement of gaming space.
3. The real property transfer tax is state budget income.
4. Income tax paid by municipalities or regions is the income of the same municipalities or regions.
5. Tax is redistributed according to the location of the estate.

Source: Act No. 243/2000 Coll. on Budgetary Tax Determination.

Figure 2.14. The tax sharing system favours small municipalities



Note: Brno, Ostrava, Plzeň and Prague are not included.

Source: Ministry of Finance.

The tax sharing formula also results in strong implicit redistributive flows between municipalities, as the amount of tax revenue received is little related to the tax base in each municipality. However, the formula-based system does not make clear how much a municipality receives from its own tax base, and how much it receives through redistribution.

A model with two parts of revenues, one from own tax base and another for fiscal equalisation (as in many OECD countries) could make redistribution flows more transparent, while at the same time incentivising SNGs to develop their tax base. Explicit fiscal equalisation has an important role in various OECD countries, notably in those with high fiscal autonomy of SNGs, as higher autonomy can raise equity concerns due to uneven distribution of tax raising capacity (Blöchliger and Petzold, 2009). In the Czech Republic, it would be however important to design the equalisation system in a way that promotes tax and development efforts of subnational governments (Blöchliger et al., 2007).

Apart from the implicit redistribution through the tax sharing formula, the Czech Republic attempts to resolve imbalances at the level of municipalities or regions also through transfers dedicated to special programs for structurally affected areas (such as RE:START to support the coal mining regions). Explicit fiscal equalisation would make it easier to pursue explicit politically agreed goals in terms of closing persistent gaps in living standards across regions.

Giving local governments more tax autonomy

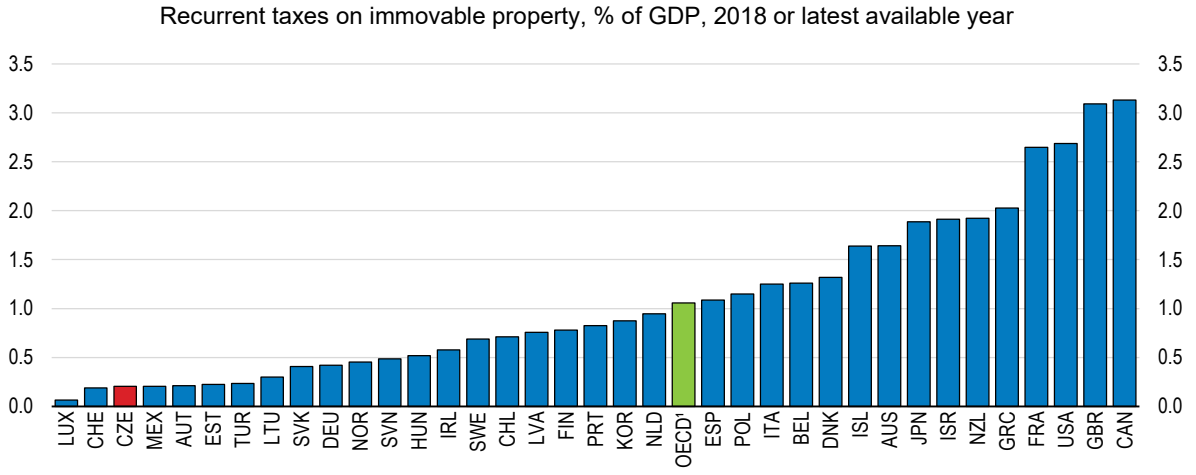
Tax revenue directly levied at the local level represents only 1% of total tax revenue, which is among the lowest level across OECD countries. Apart from income taxes paid by municipalities and regions, the property tax is the only tax that belongs directly to municipalities. Municipalities thus directly raise only 8.3% of their own tax revenue, whereas for regions this is as low as 0.4%. Municipalities (and regions to a lesser degree) additionally receive some revenue from their own sources such as user charges and property income (Table 2.4 and 2.5).

Czech regions and municipalities are quite heavily reliant on shared taxes and revenue from the central government, through grants and transfers. The system has its strengths. The advantages come from lower uncertainty and higher stability, especially for small municipalities. Taxes are determined centrally, and the Ministry of Finance regularly provides projections of expected tax revenues, making budgeting at the local level easier. However, this also reduces the efficiency and accountability benefits of decentralisation (Dougherty et al, 2019). Indeed, international evidence shows that subnational governments are more efficient when local residents self-finance local services through local taxes and charges (Geys, Heinemann and Kalb, 2010; Blöchliger and Kim, 2016). This encourages local residents to assess the costs and benefits of local service provision, and compare them with neighbouring jurisdictions (OECD, 2019b). It also increases the accountability of SNGs.

However, from a practical point of view, it can be difficult to achieve a meaningful level of self-financing and corresponding accountability in the Czech case. Most Czech municipalities due to their small size are not optimal taxing units. Encouraging mergers or moving to a system where larger subnational units (such as micro-regions) play a bigger role should therefore be undertaken in combination with financing reforms to promote greater fiscal autonomy at the subnational level. In fact, giving municipalities greater tax autonomy once merged could be used as an incentive for administrative consolidation.

A first step towards increasing the fiscal autonomy of Czech municipalities would be to encourage SNG to raise more revenue from the property tax. Total revenue from the property tax in terms of GDP is one of the lowest in the OECD (Figure 2.15), and represents only 5% of municipalities' tax revenue, despite the fact that this tax is among the least distortive for growth. In addition, property tax provides relatively stable revenues, which is good for local governments that have largely non-cyclical spending (Blöchliger, 2015).

Figure 2.15. Revenue from property tax is low



1. Unweighted average.
Source: OECD Revenue Statistics.

In the Czech Republic, the property tax comprises a land tax and a tax on buildings, and the calculation of the tax is based on the size of property rather than its value. The base rate is set centrally, but municipalities can raise the rate up to five times the minimum threshold amount. Yet, most municipalities tend to set their local property tax rate at the low level, and only 7% of municipalities have made use of the possibility to increase tax rates. Moreover, municipalities can set exemptions and the number of exemptions and of properties excluded from taxation is high (Radvan, 2019). The tax evaluation should be based on regularly updated estimates of property value, such as in Denmark, Estonia, Spain, United Kingdom among others, rather than size as is currently the case. To avoid resistance to the tax and unintended consequences for vulnerable households, targeted means-tested exemptions could be introduced (Blöchliger, 2015).

The local tax autonomy could be raised also by encouraging local governments to develop their tax base. The tax sharing formula could be tweaked to raise the weight of factors linked to economic activity (number of employees) and income. Alternatively, additional taxes could be designated as own-source taxes, such as the municipal income tax as in Finland and Sweden. In case of a transition towards "communities of municipalities" within micro-regions, they could be given their own tax source to finance the new responsibilities (in a tax neutral way, not to raise the overall tax burden).

Using grants and transfers to boost efficiency

In addition to their own competencies, municipalities and regions are also responsible for the performance of delegated state administration functions. Those competencies are mainly financed by transfers from the central government (and also by administration fees and partly shared tax revenue). In principle, the distribution of transfers is based on a formula set by the Ministry of the Interior taking into account the population of the municipality and the scope of delegated competencies of state administration. Municipalities with extended powers receive an additional transfer that corresponds to their extended responsibilities. However, the link between the cost of service provision and the transfers made for the provisions of these services is small. A past Survey (OECD, 2016a) reported that there was no allowance for economies of scope even in services such as a population register.

Reducing earmarking is needed to encourage spending efficiency. Grants and transfers received by municipalities and regions are predominantly earmarked (91% of total grants were non-matching earmarked grants in 2010 (OECD fiscal decentralisation database), both current and capital. These are

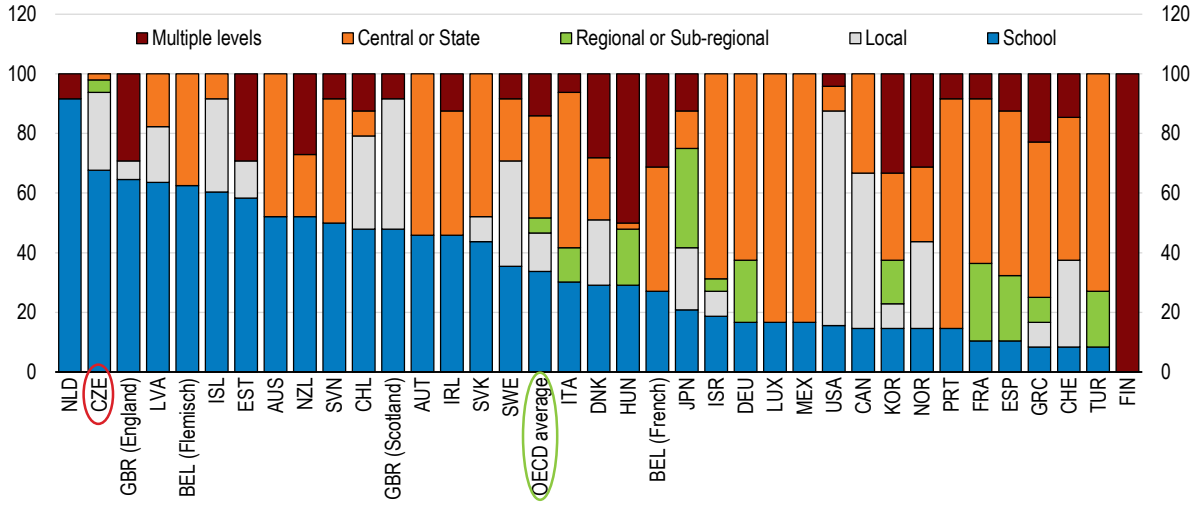
for example used to finance education, specific development programmes or infrastructure maintenance. Municipalities may also receive subsidies from regions, both within the independent competence of the region (e.g. programs announced by individual regions) and by redistribution of some types of subsidies received from the state budget (e.g. salaries of teachers). Still, earmarked grants are associated with lower efficiency, in particular when they do not require matched funding (cofinancing by the SNG receiving the grant) (Bergvall et al, 2006). The Czech Republic could therefore make more use of non-earmarked grants that require matched funding or to move to block grants, which are les constraining, as in Denmark and Norway. This could boost innovation and efficiency.

Making delivery of education more equitable across the country

In the Czech Republic, the education system is highly decentralised (Figure 2.16). Roughly, two thirds of the decisions are taken at the school level. Schools can tailor their educational programmes and other activities to the needs of their students and community. Schools are also responsible for the professional development and performance of their staff. This said, the majority of school-level decisions are taken within a framework set by the Ministry of Education, Youth and Sports (Table 2.6). For example, for curricular issues, schools have substantial autonomy through the development of School Educational Programmes (SEP) as long as they are in line with national Framework Education Programmes (OECD, 2018c and Shewbridge et al, 2016a).

Figure 2.16. The education system is highly decentralised

Percentage of decisions taken at each level of government in public lower secondary education, 2017



Source: OECD (2018), Education at a Glance 2018: OECD Indicators.

Responsibilities are also split between different levels of government. While the Ministry of Education, Youth and Sports (the Ministry) establishes the legal framework for the school system, municipalities are responsible for the delivery of pre-primary, primary and the majority of lower secondary education and regions for organising upper secondary education. The founders of schools (regions, municipalities or associations of municipalities) finance the operating costs and capital expenditure. The state budget, via the Ministry, on the other hand covers wages and social security contributions of teaching staff, expenditure on teaching aids, the training of teachers, and special-interest activities.

Table 2.6. Decisions taken at the school level in public lower secondary education, %, 2018

	Czech Republic		OECD average		
	In full autonomy	Within framework set by a higher authority	In full autonomy	Within framework set by a higher authority	Other
Organisation of instruction	33.3	66.7	19.4	38.7	7.2
Personnel management	33.3	58.3	13.3	22.3	7.4
Planning and structures	0.0	83.3	0.5	37.4	1.8
Resource management	50.0	50.0	26.7	18.2	6.8

Source: Education at a glance, 2018.

There are advantages to the Czech system of decentralised responsibility, but there are risks of regional disparities in service quality. A previous OECD Review (Shewbridge et al., 2016a) noted that such a high level of decentralisation should be combined with a more adequate system of checks and balances. Monitoring of the quality of teaching and learning could be improved and a persistent lack of relevant information makes it difficult to conduct policy based on evidence. Furthermore, there are important gaps in information to monitor equity, including comparative information across regions and basic indicators of socio-economic factors, despite this being a strategic priority. In recognition of these problems, the Czech authorities plan to address the issue of information gaps and lack of monitoring in the future as stipulated in the 2030+ Education Strategy, and some progress has already been made. Notably also, the Czech School Inspectorate launched the Complex System of Evaluation project (2017-22) for the evaluation of the quality of education services and facilities with the aim to support the monitoring of the school system and help identify, among others, the impact of socio-economic and territorial factors in education outcomes (OECD, 2019c).The analysis in this section draws on the findings in previous OECD Reviews of the Czech education system, most notably the OECD Reviews of School Resources: Czech Republic (Shewbridge et al., 2016a).

Consolidating the school network would raise quality and efficiency

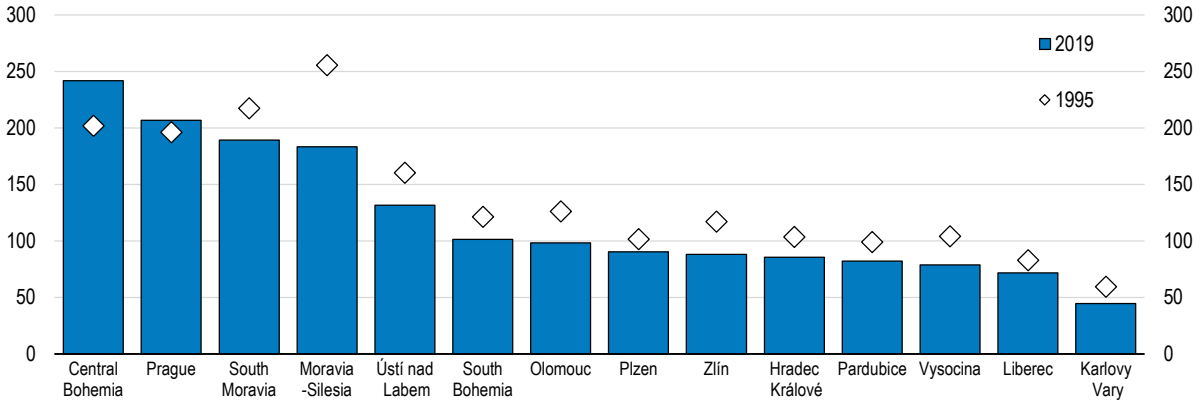
While education is a basic and essential service at the local level, territorial fragmentation can heighten organisational challenges as well as affect the quality of education provided. Many municipalities are too small to effectively operate schools. At the same time, municipalities tend to be highly attached to the schools in their area – even if small and of low quality - making closing or merging schools unacceptable from a political point of view. Previous OECD Reviews (Santiago, 2012) found that widespread opposition to consolidate the school network in the Czech Republic reduces the willingness to monitor education quality and can hinder improvements, even in schools identified by the system itself as underperforming. In recognising this, the National education strategy of the Czech Republic for the period 2030+ goes some way towards supporting consolidation of school network.

Many rural areas face severe demographic pressures and declines in school-age population (Figures 2.17 and 2.18), making it increasingly difficult to keep schools of appropriate “size efficiency” (Shewbridge et al., 2016a). The number of schools in basic education is now lower than it was in 2005, but recently the number has started rising again (CZSO database). The proportion of small schools (with less than 200 students) has been on the rise. The per-student funding system helped to initiate some school consolidation in basic education (Shewbridge et al, 2016a), as the declining number of students translated into lower grants from the state for local schools, exacerbating resource constraints in local schools that did not consolidate. At the same time, however, it resulted in major regional

differences in the amount of funding received for similar activities (Ministry of Finance, 2020) and thus intensified equity concerns.

Figure 2.17. Declines in school-age population put pressures on the school system

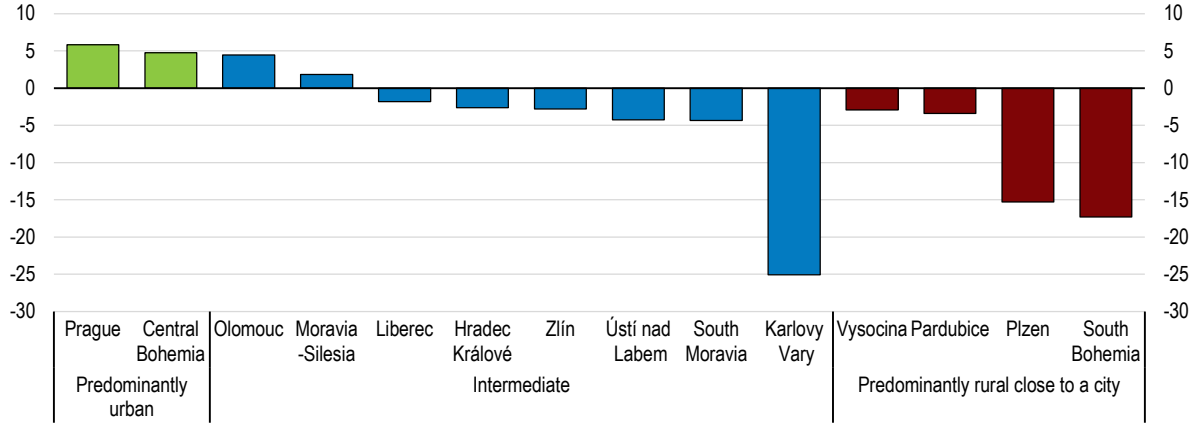
Number of children under the age of 15, thousands



Source: OECD Regional database.

Figure 2.18. The population in rural areas will decrease further

Projected population growth, 2015-2060, % change



Source: Batista e Silva et al. (2016) Regionalisation of demographic and economic projections. Joint Research Centre, European Commission.

The 2020 reform to school funding (primary and secondary) goes some way towards addressing the problem of declining resources in small schools. The system of per-student funding that implicitly favoured schools in urban areas has been replaced by funding for the actual number of lessons taught in a school, loosening the link with the number of students. Funding for direct costs will now be more closely linked to the real financial needs of schools (i.e. for salaries of the required teaching staff and costs of teaching aids) to effectively deliver their teaching load, adjusted for other aspects, such as the class size and the number of students with special needs.

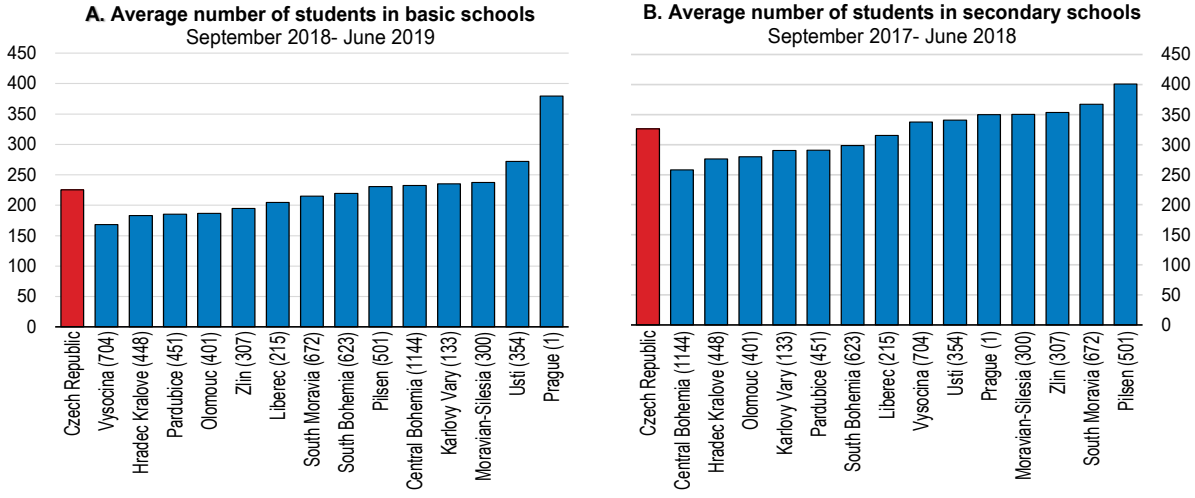
Further consolidation of the school network should be pursued to raise efficiency and quality. Many small schools could benefit from merging with schools in neighbouring areas and in regions with a low

average size of basic schools there is room to further reduce the number of municipalities with schools (Figure 2.19).

Although school network consolidation is a sensitive national and local issue, international experience suggests that national frameworks and assistance can spur school network consolidation through municipality co-operation or mergers. For instance, in England, during the 1980s and 1990s, many rural schools were closed because of demographic changes and a strong push from the government for reform. Some smaller schools started collaborating and sharing resources, by, for example, using common ICT and catering services, and common provision of specialised teaching. Other schools chose to merge, which in some cases proved to help recruit and retain qualified teachers and even helped raise the total number of pupils (OECD, 2010a). In Finland, the project to restructure local government and services (PARAS), launched by the government in 2005, set minimum population targets for a number of activities (e.g. 50 000 for vocational basic education) and it was then up to municipalities whether they would reach the goals by mergers or co-operation (OECD, 2017b). In Lithuania, a large drop in school-aged population triggered a large reorganisation of the school network, with the number of municipal schools reduced by almost one fourth, between 2005 and 2015. The government introduced initiatives to assist municipalities with school consolidation, including expansion of transport for students (Shewbridge et al., 2016b and OECD, 2017c).

To consolidate the school network the Czech government should establish a set of guiding principles, rules and even target quotas for capacity (minimum school size) at different stages of schooling (Shewbridge et al., 2016a). As in other countries, small schools could be encouraged to cooperate by sharing resources and common services. Clusters of schools could be formed, that would come under the umbrella of common school leadership and a shared pool of administrative stuff. Finally, good demographic data and projections at the regional level and a strong school registry with comprehensive information on educational fields and capacity across the country are needed so that policy is built on objective and reliable information.

Figure 2.19. Some regions have many small schools



Note: The numbers in parentheses refer to the total number of municipalities by region.
Source: Czech Statistical Office.

Collaboration between central, regional and municipal levels is important to build trust and steer policy but this is challenging given the fragmentation. Incidentally, the recent funding reform made a move towards greater centralisation. Before the reform, regions were tasked with reallocating the national

funding for direct costs to municipalities, which impaired efficiency and created a systemic conflict of interest where regions had a tendency to provide preferential treatment to schools under their direct operating responsibility (secondary and special education). The reform has separated the funds for schools founded by municipalities from those for schools founded by the region and funding goes from the Ministry directly to municipalities.

More direct links between the Ministry and municipalities can act as a useful policy tool that enables the Ministry to better understand the challenges of the education system at the school level (Shewbridge et al., 2016a). In turn, it can help steer policy more effectively towards strategic objectives, including on the consolidation of the school network. However, for this to work well municipalities need to have sufficient capacity to run schools effectively and to engage in a policy dialogue with the Ministry, which is a challenge with the current fragmented local government. For instance, many municipalities only have one school or no school at all. Setting minimum population targets for different levels of education could therefore go hand in hand with shifting the competency for primary and lower secondary education - and the flow of education grants - from municipalities to municipalities with extended powers (MEP). This would also simplify policy coordination between the Ministry and a high number of municipalities.

Nevertheless, moving towards a consolidated network of schools has to be accompanied by reforms in other policy domains. To address economic and other disadvantages, more explicit and objective criteria in the funding formula for schools could further help address the inequities in education. In Australia, for example, after a recent reform, funding is based on a base funding amount for every student plus six additional loadings that provide extra funding for disadvantaged groups (loadings for disability, low English proficiency, Aboriginal and Torres Strait Islanders, socio-educational disadvantage, school location and school size). The criteria and specific loadings can then evolve in step with strategic priorities of the government.

Greater distances to schools in remote areas would also require integrated policy that would include infrastructure and transportation. For the moment, there are no legal requirements for schools or local governments to provide free transportation to students when the distance between school and their residence goes beyond a certain threshold (although in 2018 transport discounts for pupils and students were introduced). This partly stems from the fact that currently the school network is quite dense. However, without adequate provision of transportation of pupils to schools, consolidation of the school network could result in raising barriers to attend schools, which can have detrimental effect on disadvantaged groups. Comprehensive investment and provision of transportation services can significantly reduce the cost savings of school network consolidation (OECD, 2010b). However, it is important to preserve access while improving the quality of schooling in remote areas.

Improving the quality of teaching by expanding incentives for teachers to work in remote areas

In the Czech Republic, the attractiveness of the teaching profession is low with relatively low salaries (OECD, 2019d; OECD, 2020c) and limited career progression. This results in low diversity, with teachers being quite old on average and predominantly female. The OECD Review (Shewbridge et al., 2016a) found that the Ministry's capacity to monitor and plan teacher supply according to needs is lacking. One key issue in the planning and distribution of teachers is whether the best teachers are working where they are needed most, especially in disadvantaged schools. International evidence shows that disadvantaged schools are more likely to have staff shortages and they more often employ the least experienced teachers, intensifying the disadvantage. This is often even more pronounced in remote and rural settings (OECD, 2012).

The uneven distribution of qualified teachers across schools is a concern in the Czech Republic. Disadvantaged schools are more likely than advantaged schools to report shortages of qualified or competent teachers (Shewbridge et al., 2016a; Schleicher, 2014). The Czech Republic does not have

targeted programmes or incentives to motivate teachers to work in remote or regional areas (Shewbridge et al., 2016a).

The Ministry should increase incentives for highly qualified teachers to work in remote areas to help reduce disparities in the quality of schooling. Both financial and non-financial factors are important in motivating teachers. Professional factors matter, such as opportunities to take on extra responsibilities and positions of influence, reforms and innovation, and developing strong leadership and collegiality in professional development (Mourshed, Chijioke and Barber, 2010; OECD, 2012; Rice, 2010). The Ministry should help create an environment where disadvantaged schools are in position to attract the best teachers by offering meaningful careers, good working conditions and opportunities for rewards. The overall reform to the career system of teachers would be helpful and consistent with this approach. It is actually also part of the government education strategy 2020 and has been recommended by the OECD on previous occasions (Shewbridge et al., 2016a; OECD, 2014c, Santiago et al., 2012).

Improving the delivery of health and long-term care for an ageing population

Addressing ageing-related challenges will require efficiency gains at all government levels. Together with ensuring the adequacy and sustainability of the pension system, expanding access to health and long-term care services are key challenges. Meeting increased demand for these services while improving value-for-money to manage fiscal costs and ensuring quality will require better coordination between levels of government and healthcare and long-term care providers. The COVID-19 crisis also highlighted the key role of local governments and regional providers of health care services.

Healthcare outcomes are unequal across the country

Regions and municipalities are to a large extent responsible for the management of health and long-term care. Funding of health care and social services is predominantly by the central government and social security funds. The Central government (Ministry of Health) has a supervisory role and the direct administration of some care institutions and bodies. It owns and runs university hospitals. Within their independent authorities, regions are responsible for the establishment of regional health facilities, monitoring the quality of care of private health care providers and the preparation and implementation of subsidy programmes, such as capital investments or operational costs (Table 2.7). In addition, the regions are responsible for a set of delegated authorities from the state administration, such as authorisation and registration of health services, inspection and quality control as well as the provision of emergency services. The regional authorities own emergency units, long-term care institutions, some primary care facilities and medical spa facilities. Provision of health services through smaller hospitals are often under the responsibility of municipalities, which also manage services provided by private doctors.

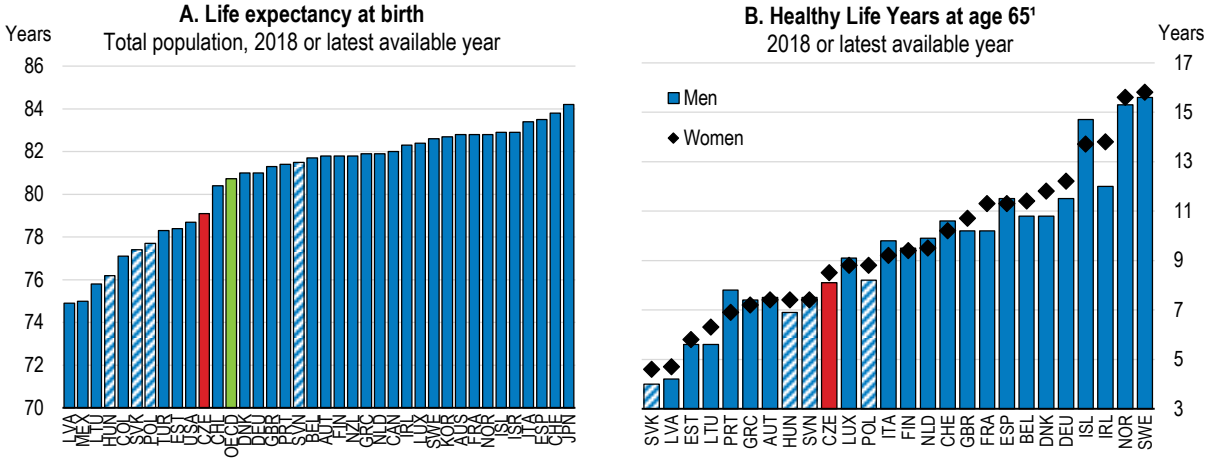
Health status of the population varies across regions. Life expectancy compares favourably with other Central and Eastern European (CEE) countries (Figure 2.20). It has risen in all regions over the last decade, but large disparities remain (Figure 2.21). There are also marked differences across regions in age-adjusted mortality rates (Figure 2.22). Disparities in health outcomes persist, despite the fact that gaps in physician density between urban and rural areas are not particularly large by international standards (Figure 2.23), and there is a wide network of hospitals across the country. Evidence nevertheless shows, that while health outcomes are closely associated with socio-economic factors (Figure 2.24) and behavioural risk factors that vary across regions, they also reflect variations in the access (Figure 2.25) and the quality of health care services (OECD, 2018d).

Table 2.7. Responsibility for health care by level of government in the Czech Republic

National responsibility (Ministry of Health)	Regional responsibility	Municipal responsibility
– Health care – Management of large hospitals	– Establishment and management of hospitals	– Health services, through both municipal hospitals and private doctors
– Public health protection, health research activities and directly controlled health facilities	– Nursing homes	
– Ensuring the safety, quality and rational use of pharmaceutical and medicinal products, precursors and additives; approving, licensing and monitoring pharmaceuticals and medical aids	– Facilities for physically and mentally disabled adults and children	
– The search for, protection and use of natural medicinal sources, natural spas and mineral water resources, medicinal products and technical equipment for prevention, diagnostics and treating people	– Monitoring the quality of health care delivery of private providers, jointly with professional medical chambers; monitoring refers to a minimum set of criteria for material and technical equipment, as well as qualification of medical staff which are set by the Ministry of Health	
– Health insurance and health information systems	– Ensuring that non-state providers comply with a variety of laws and directives that define the technical, staffing and hygienic requirements before registering and thereby allowing them to offer health services	
– The use of biocide preparations and introduction of biocide preparations and agents to the market		

Source: OECD (2018c).

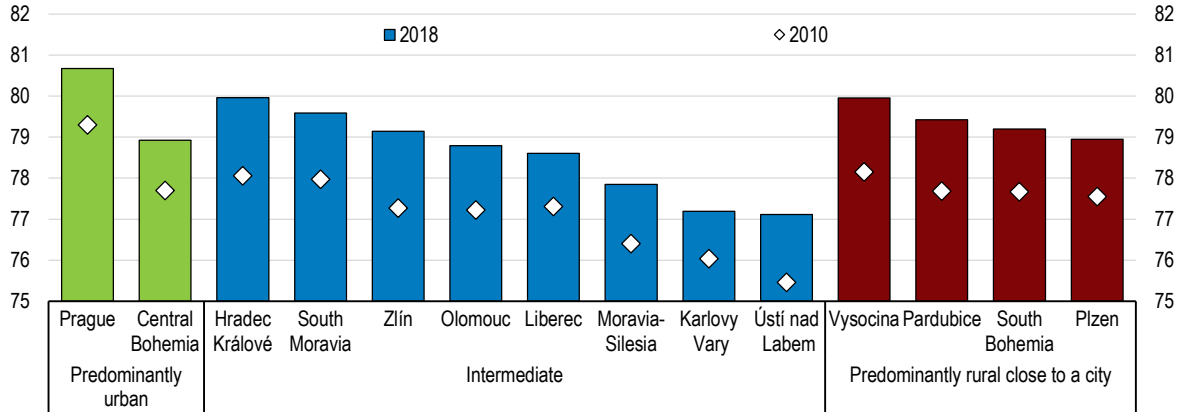
Figure 2.20. Life expectancy compares favourably with other CEE countries



1. The indicator Healthy Life Years (HLY) at age 65 measures the number of years that a person at age 65 is still expected to live in a healthy condition.
Source: OECD Health Statistics; Eurostat database.

Figure 2.21. Life expectancy has increased in all regions but disparities remain

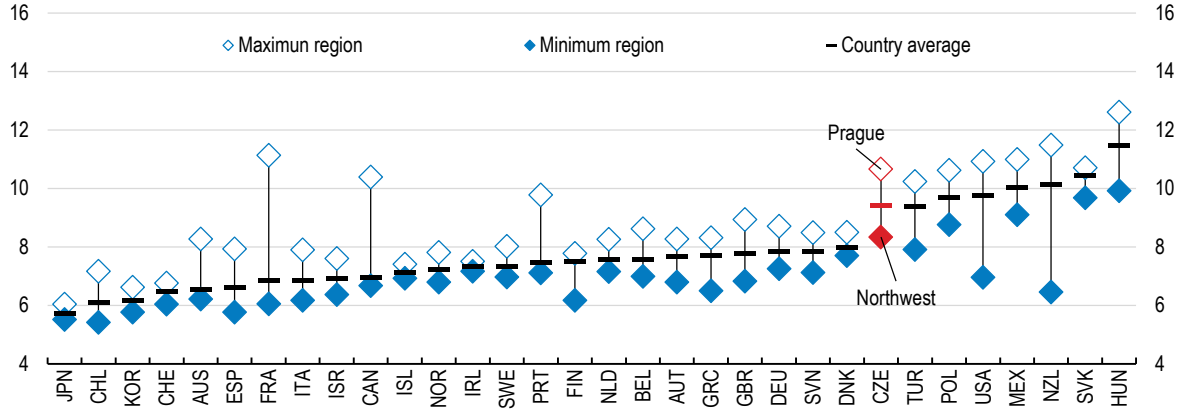
Life expectancy at birth, total population, years



Note: The OECD has classified TL3 regions as predominantly urban (PU), intermediate (IN), or predominantly rural (PR) regions. This typology is based on the percentage of regional population living in rural communities, combined with the existence of urban centres where at least one-quarter of the regional population reside. An extended regional typology has been adopted to distinguish between rural regions that are located
close to larger urban centres and those that are not. See (OECD, 2016b) for more details.
Source: OECD Regional Database.

Figure 2.22. Differences in mortality rates across regions are high in international comparison

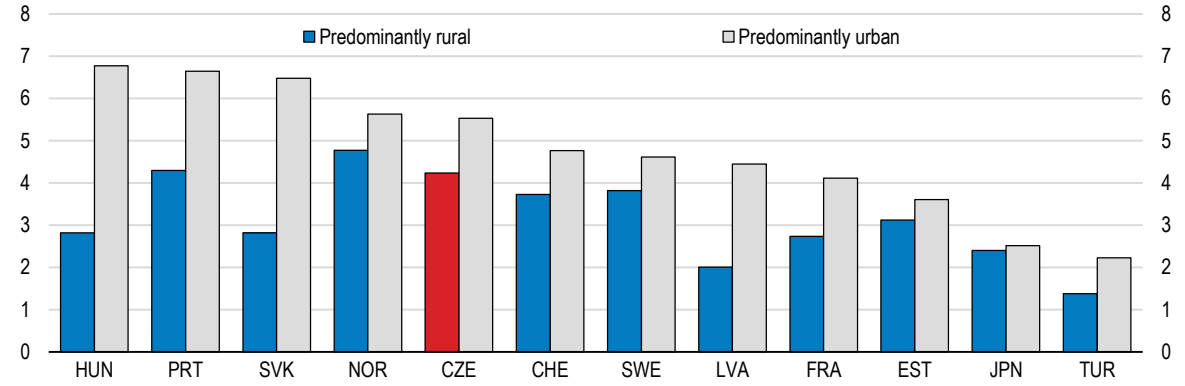
Age-adjusted mortality rate, by large region (TL2), deaths for 1000 population, 2017 or latest available year



Source: OECD Regional database.

Figure 2.23. The gap in physician density between urban and rural areas is not large

Physician density, per thousand population, 2018 or latest available year



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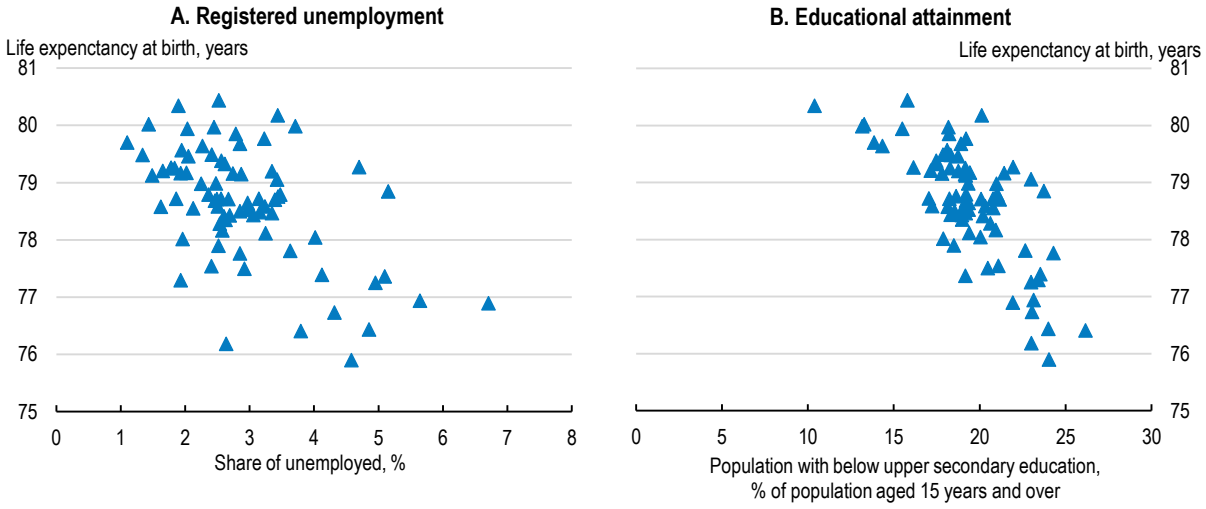
Source: OECD Regional Statistics database.

Figure 2.24. Life expectancy is lower in disadvantaged districts



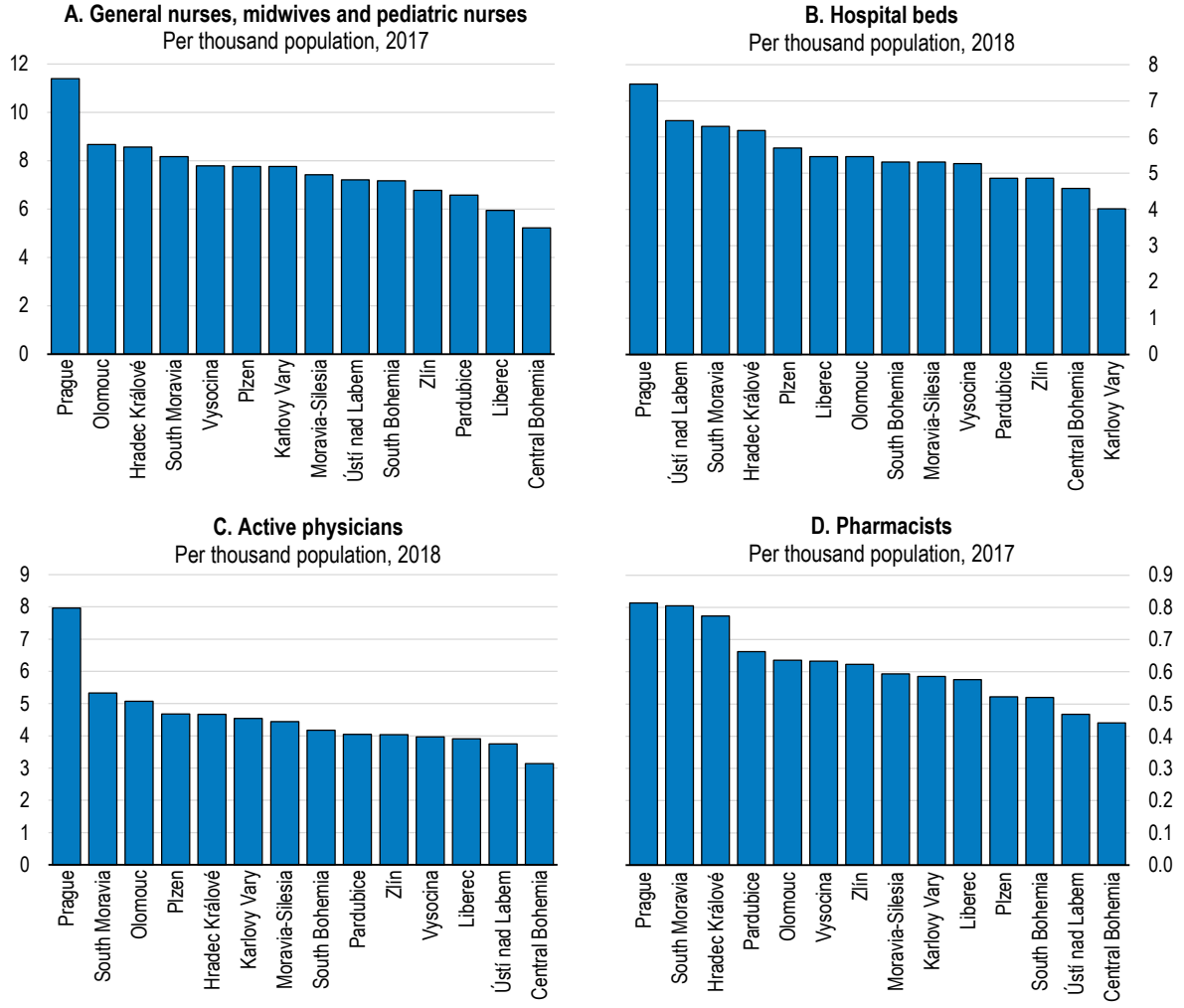
Note: Data refer to 2018 for life expectancy, to December 2019 for unemployment and to 2011 for educational attainment.
Source: OECD calculations based on data from Czech Statistical Office.

The number of hospital beds is above the OECD average. There are 4.1 acute care hospital beds in the Czech Republic per 1000 population, compared to 3.6 in the OECD on average (OECD, 2019f). A high number of beds - and appropriate equipment - can be helpful in the event of a health crisis such as an infectious virus outbreak, but this should not preclude an assessment of potential inefficiencies in the use of hospital resources (OECD, 2018d). In 2017, the occupancy rate was lower than the OECD average and it had been on a downward trend (OECD, 2019f). Where possible, shifting towards day-care, instead of inpatient care, can help save resources (OECD, 2018d). Better co-ordination of neighbouring municipalities and regional hospitals by merging and regrouping some services could enhance the efficiency of the hospital sector. However, to ensure that relying more on same-day surgeries reduces costs – and does not jeopardise health outcomes - it should go hand in hand with

improvements to post-acute care and strengthened primary health care at the local level, to ensure uncompromised recovery. This requires coordination between the hospital sector and primary care.

The hospital network could be reorganised to improve efficiency and raise quality of care. This could be facilitated by a simultaneous overall reorganisation of the fragmented subnational government. In Denmark, a 2007 reform of public administration and push for a reduction in the number of municipalities (see Box 2.3) included reforms to the hospital sector. The reform centralised specialised care in fewer hospitals and reduced the number of acute care hospitals, by merging some of them. The reform was successful in that hospital productivity increased while costs were kept stable (Christiansen and Vrangbaek, 2018).

Figure 2.25. Health resources vary across regions



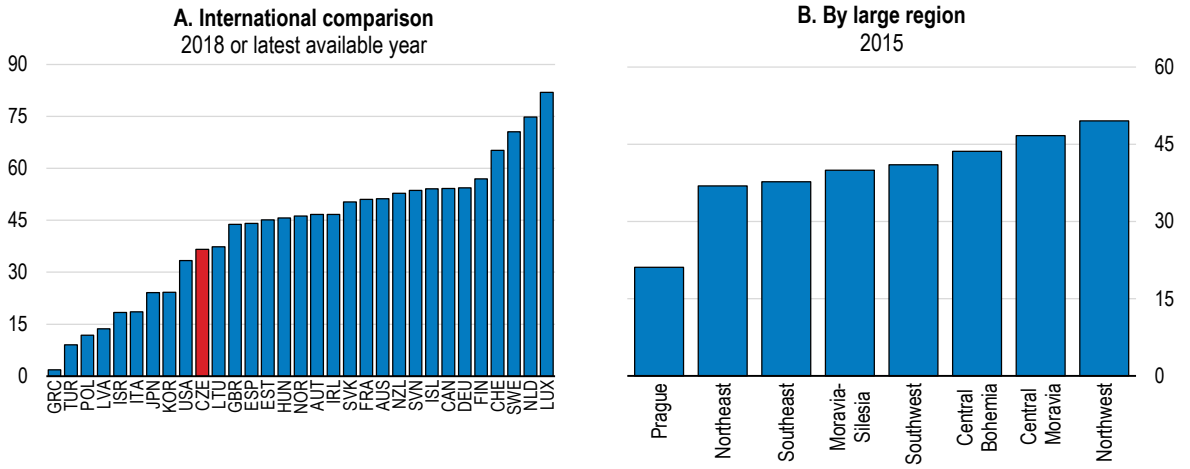
Source: OECD Regional database; Czech Statistical Office; Czech Health Statistics 2017.

Sharing activities and consolidation of hospital facilities could help raise the overall quality of services and address the needs of remote areas. Co-operation and consolidation already happen in some regions where different hospitals focus on different specialisation areas. Meanwhile, highly specialised care could be concentrated in designated centres. On the other hand, the reform should be accompanied by a reorganisation of the emergency services as planned in the Strategic Framework for Health 2030 (Ministry of Health, 2019), to ensure continued provision of emergency services close to

the population, even in the remote areas. The Strategic Framework for Health 2030 aims at reforming primary care and building an even network of emergency services across the country. The authorities also plan to convert some small municipal and regional hospitals to long-term care (LTC) centres, addressing the relative lack of beds in residential LTC facilities (Figure 2.26).

Figure 2.26. There are few beds in long-term care facilities

Beds in residential long-term care facilities, per 1 000 population aged 65 years old and over



Source: OECD Health Statistics; Eurostat database [hlth_rs_bdsns].

Quality of care in remote areas should be monitored more systematically. The lack of comparable data at the local level makes it difficult to assess the quality of primary care. The same applies to small local hospitals. Currently, as funding is weakly linked to performance, there is no incentive for hospitals to provide information that would allow benchmarking. With the greater shift to the use of diagnosis related groups (DRG) system to measure hospital activity planned for 2020 and 2021, benchmarking will be possible. The DRG system can also be used for setting the prices of hospital services but also to provide incentives to underperforming hospitals based on best-performing hospitals.

Access to General Practitioners (GPs) varies less across regions than in many other OECD countries, but policies could reduce the variation further, notably to improve access in remote areas. The lack of GPs in remote areas has led to high use of emergency services. In 2011-2013, 52% of patients went to an emergency service because primary care was not available, the second highest share in the EU (OECD/EU, 2016). A subsidy programme has been designed that covers the cost of setting up a new medical clinic. In addition, in certain rural or remote areas, GPs may be compensated with a higher capitation if the number of registered patients is significantly below the national average (more than 30% below). These programmes should be closely monitored and regularly evaluated to adjust to emerging needs (OECD, 2018d). Better coordination of primary care between GPs, specialists and outpatient hospital care, with a greater role for GPs, would help release some burden from hospitals and support their refocussing on complex and intense treatments.

Improving access to long-term care services

Different levels of government share the responsibilities for the provision and financing of LTC. Financing is provided by the health insurance (for healthcare facilities providing long-term inpatient care), under the supervision of the Health Ministry. Social services and residential LTC facilities are financed by the central, regional or municipal budgets, under the supervision of the Ministry of Labour

and Social Affairs. Recipients of social services receive a care allowance, and clients' fees represent a major funding resource for social services, accounting for nearly half of total costs (European Commission, 2018). Co-operation across levels of government and between the two ministries is important to avoid perverse incentives in the use of hospital facilities, where people who need social care are hospitalised. Local authorities should be incentivised to ensure that enough long-term care institutions exist within their borders, taking into account future needs.

Home care should be developed further at the local level. With high quality support at home, either through family and other informal care, professional care workers, or a combination, older people can enjoy a higher quality of life than in a traditional care facility (OECD, 2019e). Furthermore, for persons with less intensive care needs, home care can also be more cost-efficient than institutional care (OECD, 2017d). However, quality assurance, a trained workforce and support for informal workers are lacking in many areas. The European Commission (2018) reports that in the Czech Republic, in some regions, there is an absence of support services for families caring for their members. Moreover, the quality of care is difficult to assess. There is no systematic monitoring and the quality assurance system could be improved.

International experience shows that local governments, social care centres and primary care have important roles in developing effective home care for the elderly. In Japan, an Integrated Community Care System, organised at the municipal level, has been a pillar of the government's strategy to improve support for older populations. Most importantly, the system provides close coordination between medical treatment and long-term care, but also provides prevention services and other support (OECD, 2019e, Morikawa, 2014). In Sweden, reforms introduced in 2018 attempted to better integrate primary care into care planning processes, to raise the quality of care at home. To smooth the transition between hospital and home, hospitals are required to notify the patient's municipality and primary care clinic within one day of admission, to ensure that community services have enough time to prepare for any transition and care co-ordination needs (OECD, 2019e).

Table 2.8. Recommendations on enhancing administrative and fiscal decentralisation

Main findings	Recommendations (key recommendations bolded)
Streamlining and enhancing the effectiveness of local administration	
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).
	Increase the role of municipalities with extended powers by transferring to them selected independent competencies and giving them more taxing power.
	Transfer all delegated competencies (public administration services) to larger municipalities with sufficient personnel and financial capacity (type II and type III municipalities).
Upgrading capacity and the quality of public services at the local level	
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.**
Capacity at the local level is low and maintaining the quality of public services can be a challenge, particularly in remote and sparsely populated areas.	Continue the rolling out of eGovernment and offer training to local public officials.
Improving fiscal efficiency	
The tax-sharing system tends to favour small municipalities.	Adjust the tax sharing formula so that it does not encourage very small municipalities to stay small, by reducing the weight of the cadastral area.
Fiscal autonomy is low and the link between received tax revenues and the tax base is weak, reducing incentives to grow local economies. Having said that, most Czech municipalities are not optimal taxing unit due to their small size.	Encourage municipalities, of appropriate size or once merged, to develop their tax base, by raising the weight of factors linked to economic activity in the tax sharing formula. Make fiscal equalisation flows explicit.
Grants are generally earmarked and do not require matched funding, reducing efficiency	Favour non-earmarked grants with required co-financing by SNGs to raise cost efficiency.
Raising equity in education across the country	
The new funding system is fairer but does not correct for economic disparities across regions.	**Introduce explicit and objective criteria in the funding formula of schools to further address inequities and disadvantage.**
The number of small schools is high and many of them are not of an efficient size, lowering quality. Municipalities often do not have sufficient capacity to run schools effectively.	**Consolidate the school network to ensure quality of education in all schools and encourage small schools to cooperate and share administrative resources.** Introduce legal requirements for provision of transportation to schools. Shift education competencies – and the flow of education grants – to the municipalities with extended powers.
Disadvantaged schools are more likely to have staff shortages and they employ the least experienced teachers. This is even more pronounced in remote and rural settings.	Offer better career paths to teachers and increase incentives for high quality teachers to work in remote areas.
Improving the delivery of health and long-term care services at the local level	
The number of small hospitals is high reducing efficiency in health care delivery	Spatially redistribute healthcare services. Concentrate highly specialised care in fewer centres. Extend the network of primary care provision and emergency centres.
Provision and financing of LTC is fragmented and under pressure from population ageing	Facilitate provision of long-term care services at home, by integrating social and health care services at the local level. Strengthen quality assurance and support and training for LTC workers, including for those providing care at home.

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Annex 1.A. Average tax revenue per capita is higher in small municipalities, 2018

Table 1.A.1. Average tax revenue per capita is higher in small municipalities, 2018

	Total population	Number of municipalities	Average population per municipalities	Number of pupils in municipal schools	Share of tax revenue	Average tax revenue per inhabitant (thousands CZK)	Aprox. cadastral area (ha)	Average share of area per inhabitant (ha)
1-50	2 922	71	41	0	0.0%	19.3	21 008	7.2
51-100	29 340	376	78	444	0.2%	18.4	156 771	5.3
101-200	147 265	987	149	1 046	1.1%	17.1	573 543	3.9
201-500	652 060	1 991	328	24 033	4.6%	16.2	1 717 451	2.6
501-1000	975 337	1 377	708	91 230	6.9%	16.1	1 718 246	1.8
1001-2000	1 053 794	754	1 398	139 493	7.5%	16.2	1 318 423	1.3
2001-5000	1 284 242	425	3 022	178 533	9.2%	16.3	1 034 287	0.8
5001-10000	979 575	143	6 850	140 675	7.3%	16.8	460 769	0.5
10001-20000	957 946	68	14 087	135 690	7.2%	17.0	234 011	0.2
20001-30000	609 580	26	23 445	78 795	4.5%	16.6	109 992	0.2
30001-50000	707 564	18	39 309	92 688	5.4%	17.2	105 611	0.1
50001-100000	870 531	12	72 544	107 747	6.8%	17.6	88 423	0.1
100001 and more	204 473	2	102 237	25 131	1.7%	18.6	20 942	0.1
Brno, Ostrava, Plzeň	840 913	3	280 304	92 281	10.5%	28.3	58 208	0.1
Prague	1 294 513	1	1 294 513	137 257	27.0%	47.2	49 621	0.0

Source: Ministry of Finance.

OECD Economic Surveys

CZECH REPUBLIC

After a long period of impressive convergence to the OECD average incomes, the Czech Republic is now battling the social and economic consequences of the COVID-19 pandemic. The economy contracted due to strict containment measures, but the authorities extended generous support to maintain incomes, employment and liquidity. The economic recovery is expected to be gradual. The crisis heightens the need to continue addressing long-term challenges with disappointing productivity growth, low labour participation of mothers, pressures due to population ageing and high energy and carbon dependence. Sustainable growth will raise living standards and help restore fiscal and monetary policy space. In addition, despite overall low inequality, there is considerable regional variation in incomes and poverty, and the gaps have grown over time. The Czech Republic suffers from a highly fragmented subnational government with the highest number of municipalities per head in the OECD. The resulting lack of capacity at the local level impacts the quality of public services and impedes the uptake of effective development projects.

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