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Public Spending Efficiency  
in the Czech Republic:  
Fiscal Policy Framework  
and the Main Spending  
Areas of Pensions and  
Healthcare

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**ECONOMICS DEPARTMENT**

**PUBLIC SPENDING EFFICIENCY IN THE CZECH REPUBLIC: FISCAL POLICY FRAMEWORK  
AND THE MAIN SPENDING AREAS OF PENSIONS AND HEALTHCARE**

**ECONOMICS DEPARTMENT WORKING PAPERS No. 922**

**by Zuzana Smidova**

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## ABSTRACT/RÉSUMÉ

**Public spending efficiency in the Czech Republic: Fiscal policy framework and the main spending areas of pensions and healthcare**

The Czech fiscal position is generally sound and policy making is prudent. However, the fiscal framework was not strong enough to contain spending in the upturn and it would benefit from independent budget oversight. An anchor for the fiscal policy would be helpful, in the form of an explicit debt target coupled with corresponding spending ceilings and deficit targets.

The ongoing fiscal consolidation, spending pressures and an already relatively high average tax burden necessitate public sector efficiency improvements. There is scope for improvement in the management of government spending, mainly by enhancing transparency, introducing performance-oriented budget indicators at both central and local levels, improving the management of state-owned enterprises and developing the procurement practices of the public sector.

Legislated increases in the retirement age will improve pension system sustainability. A new defined contribution tier is being introduced which should help to diversify future retirement income. At the same time, there is uncertainty about the number of participants who will decide to divert their contribution to the new tier and hence about the implications for revenues in the existing defined benefit pension tier. Also, attention should be taken regarding administrative costs of the new tier, since these can have a significant impact on future replacement rates and therefore public support for it. With more emphasis on private savings, the financial literacy of the population also needs to be stepped up.

In healthcare the authorities plan to continue improving the multi-insurer model through incremental reforms such as limiting pharmaceutical costs and improving provider-payment system. The potential for efficiency improvement in healthcare network planning and better care management should be explored, while ensuring that insurers and health providers are given the correct incentives.

This working paper relates to the *2011 Economic Survey of the Czech Republic*, [www.oecd.org/eco/surveys/czech](http://www.oecd.org/eco/surveys/czech).

**Keywords:** Czech republic; public finance; fiscal framework; budget; pensions; local government; healthcare

**JEL classification:** H51; H55; H57; H61; H72

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**Efficiency des dépenses publiques en République tchèque: cadre de politique budgétaire et principales zones de dépenses dans le domaine des retraites et des soins de santé**

La situation des finances publiques tchèques est globalement saine et la politique budgétaire est prudente. Cependant, le cadre budgétaire n'a pas permis de contenir les dépenses durant la phase ascendante du cycle et il pourrait être renforcé par une meilleure application des plafonds de dépenses à moyen terme et par la mise en place d'un mécanisme indépendant de supervision des finances publiques. La politique budgétaire gagnerait à avoir un point d'ancrage sous la forme d'un objectif d'endettement explicite assorti des objectifs de déficit et plafonds de dépenses correspondants.

L'effort d'assainissement budgétaire en cours, la pression des dépenses et une charge fiscale moyenne déjà relativement lourde sont autant de facteurs qui nécessitent une amélioration de l'efficacité du secteur public. Il est possible d'améliorer la gestion des dépenses publiques, principalement en favorisant une plus grande transparence, en adoptant des indicateurs budgétaires axés sur les résultats au niveau central et au niveau local, en renforçant la gouvernance des entreprises publiques et en perfectionnant les procédures de passation des marchés publics.

Le relèvement programmé de l'âge de la retraite améliorera la viabilité du système de retraite. Le nouveau régime à cotisations définies qui va être mis en place devrait permettre de diversifier les sources de revenu des futurs retraités. En même temps, il est difficile de dire combien de personnes décideront de transférer une partie de leurs cotisations vers le nouveau régime et quelles retombées cela aura sur les recettes du régime à prestations définies. Par ailleurs, il faudrait faire attention aux frais administratifs du nouveau régime, car ces charges peuvent avoir une incidence non négligeable sur les taux futurs de remplacement et donc sur l'adhésion du public. Compte tenu du rôle accru dévolu à l'épargne-retraite privée, il faut aussi améliorer les connaissances financières de la population.

Dans le domaine de la santé, les autorités ont l'intention de continuer à améliorer graduellement le modèle à assureurs multiples, avec des mesures progressives visant par exemple à limiter les dépenses en médicaments et à perfectionner le système de paiement des prestataires. Il faudrait explorer les possibilités de gains d'efficacité dans la planification du réseau de santé et dans la gestion des soins, tout en veillant à offrir aux assureurs et aux prestataires de soins les incitations qui conviennent.

Ce document de travail se rapporte à l'*Étude économique de l'OCDE sur la République tchèque 2011*, [www.oecd.org/eco/etudes/tcheque](http://www.oecd.org/eco/etudes/tcheque).

**Mots clés:** République tchèque; finances publiques; cadre budgétaire; budget; retraites; collectivités locales ; soins de santé

**Classification JEL:** H51; H55; H57; H61; H72

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## Public spending efficiency in the Czech Republic: Fiscal Policy framework and the main spending areas of pensions and healthcare

By Zuzana Smidova<sup>1</sup>

Fiscal consolidation, spending pressures and an average tax burden necessitate public sector efficiency improvements in the Czech Republic. Diminishing importance of real economic convergence and an ageing of population is likely to slow the economic growth in the medium- to long-term and so containing the burden of the public sector on the real economy becomes even more essential. The fiscal policy goal is to reach a balanced budget by 2016 and to set the debt ratio on a decreasing trajectory as of 2013, conditional upon sustained economic growth. The total tax burden (measured as total tax revenue as a share of GDP) prior to the downturn was already at or just above that of high-income countries such as Germany, Spain and the United Kingdom. Under the existing consolidation plan a substantial effort is planned on expenditure side of the budget (Convergence Programme, 2011). Unlike the past consolidation episodes in 2004 and 2007, efficiency savings form a significant share of the current consolidation effort at 0.7 and 0.8% of GDP in 2012 and 2013, respectively. Long-term expected increases of public spending linked to ageing, estimated at 6.4% of GDP by 2060<sup>2</sup> (European Commission, 2009), provide an even stronger need for expenditure control. Given public expectations of a continued improvement in the quality of public sector service provision, containing spending growth can be achieved primarily through spending efficiency gains.

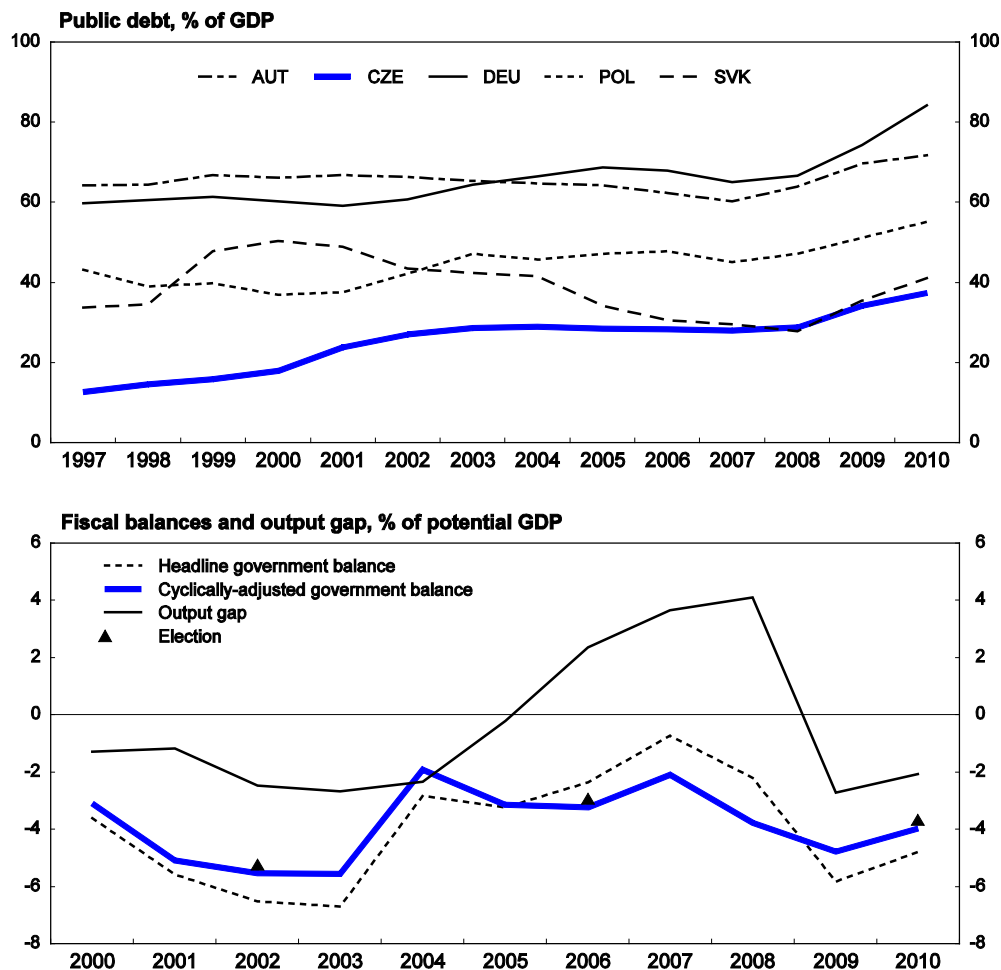
This paper examines ways to raise public spending efficiency. The first section looks at the macroeconomic fiscal policy framework and its ability to contain aggregate spending growth and ensure macroeconomic stability. The second section assesses the budgetary management framework that is essential for ensuring microeconomic efficiency. The third and fourth sections analyse the scope for improvement in two sectors that are key for containing spending pressures: pensions and health care. These are the two largest public spending categories, and they will be most affected by ageing pressures. Moreover, substantial reforms in both sectors are in the pipelines.

- 
1. Zuzana Smidova is an Economist in the Economics Department of the OECD. This paper was originally produced for the *2011 OECD Economic Survey of the Czech Republic* and published in November 2011 under the authority of the Economic and Development Review Committee (EDRC) of the OECD. The author would like to thank to Andrew Dean, Bob Ford, Andreas Wörgötter, Artur Radziwill and members of the EDRC for valuable comments and discussions, as well as the Czech authorities. She would also like to thank Margaret Morgan for research assistance and Josiane Gutierrez and Pascal Halim for secretarial assistance.
  2. The European Commission is currently updating long-term projections of member states' pension systems. Estimations including the newly legislated changes should be available during the first half of 2012.

### The fiscal policy framework is largely sound but can be further improved

The fiscal policy framework and the fiscal position came out of the downturn in a reasonable shape. This year, the budget deficit target is 3.7% and debt at 40.5% of GDP (Maastricht definition) – favourable figures when compared to regional peers (Figure 1.1). Fiscal policy-making is, in principle, governed by medium-term nominal expenditure ceilings and a medium-term objective of a deficit of 1% of GDP in structural terms. Three year rolling expenditure ceilings have been in place since 2004. They are set every spring and discussed by the parliament in the autumn as a part of the state budget approval. In theory, such a framework allows the automatic stabilisers to work through the revenue side and results in a variable deficit fluctuating inversely with actual growth developments. With a focus on annual nominal spending, such a framework should be effective in controlling government expenditures and thereby also conducive to debt reduction and consolidation efforts.

Figure 1.1. Fiscal policy has been generally sound



Note: Public debt is gross, Maastricht criterion. The government balance is revenue minus expenditure; headline is percent of GDP. The output gap is actual minus potential GDP.

Source: OECD, *Economic Outlook Database*.

However, this framework was not strong enough to contain spending in the upturn. While average GDP growth over the period 2000-09 of 3.4%, the annual real percentage change of government expenditures was 4.1%. A balanced budget was not achieved even during the period of strong growth prior to the crisis. Unlike Slovakia, which used the opportunity of rapid economic growth to reduce the debt burden in the decade prior to the downturn by 25 percentage points of GDP, the Czech Republic increased its debt burden by 10 percentage points of GDP, although it remains relatively low (Figure 1.1). Nevertheless, while the policy may be characterised as somewhat loose prior to the downturn, it was not strongly pro-cyclical, and the overall election cycle does not seem to have had a strong impact. Czech fiscal policy can therefore be characterised by prudence in bad times but only a weak ability to contain spending in good times, suggesting gains to adopting a stronger rules-based fiscal framework (Kopits, 2011).

***There have been challenges in the framework, mainly in implementation and adherence***

The recent track-record of the fiscal framework has been mixed, reflecting the fact that it has encountered teething problems. Firstly, the achievement of the medium term objective has usually remained beyond a government's term in office (Convergence programme, 2004, 2007), which suggests that it had only a low political priority. Also, the political cost of diverging from the framework is low. The expenditure ceilings were increased when deficit targets under the EU's excessive deficit procedure were easier to meet during high growth period, as deficits became the key policy focus. The attention shifted away from the nominal expenditure ceilings as an anchor for policy-making. This was the case in 2005 and 2006, when there were substantial revisions of the ceilings for the outer years (Ministry of Finance, 2007). On the other hand, in 2007 there was countercyclical tightening, and in 2009 pro-cyclical tightening, of the ceilings.

Secondly, monitoring of adherence to the ceiling is cumbersome. Budgetary rules permit adjustments for a variety of factors: inflation developments that are significantly different from initial assumptions, changes in tax assignments between central and local governments, developments of EU fund allocations and major unexpected events. In practice, technical adjustments happen twice a year. The experience so far shows that there was only little public scrutiny when the ceilings were increased. Overall, absence of an independent systematic evaluation of the framework seems to contribute to its weak political weight and perceived credibility.

Thirdly, the framework does not pay much attention to the initial cyclical position of the economy. In their initial years, ceilings were based on assumptions of continued revenue growth that with hindsight did not correctly identify the temporary revenue gains of the boom years. The 2005 and 2006 revision of the ceilings for the outer years was a result of a belief that stronger revenue growth was of a structural nature. As pointed out in earlier *Surveys*, the framework does not specify procedures for assessing developments in revenue and spending to determine whether a structural or cyclical interpretation is appropriate (OECD, 2006, 2008). In fact, it seems that only a little analysis of the economy's cyclical position feeds into the setting of the ceilings. There is an element of cyclical assessment in the budgetary process, as under the Stability and Growth Pact the country should strive to achieve the medium-term structural deficit target of 1% of GDP. But so far, it has rarely been much of an anchor in budgetary discussions. For example, corporate and personal income cuts between 2006 and 2008 were not fully accounted for by revenue increasing or expenditure-decreasing measures, particularly in the later years of the outlook, widening the gap with the medium-term structural deficit target (Ministry of Finance, 2007, 2008).



***Further improvement of the framework is on the agenda...***

A weak ability to reduce debt in good times suggests gains that could be achieved by improving the rules-based fiscal framework. The authorities have pledged to introduce “a fiscal constitution” and are currently discussing various proposals. The government manifesto foresees introducing a new fiscal rule into the constitution and the creation of a budgetary council. Both measures would be welcome, as they could help to address the shortcomings described above. A number of OECD countries are considering the introduction of a fiscal rule, while others like Germany and Switzerland, have already done so, entrenching them in their constitutions.

There is a growing literature on the pros and cons of various types of rules. Clearly, there is no one-size-fits all approach for fiscal rules given various types of fiscal problems faced by countries and nature of the economies (OECD, 2011a). Fiscal rules can set targets for budget balances, spending and less commonly taxation. Beyond their intended direct effect, rules also have a role to play in communicating with the public and as such should be relatively simple to perform this role. But in their simplest form, deficit rules can be pro-cyclical and typically require consolidation when an economy is already in a weak state (Guichard, 2007).

Meanwhile, multi-year expenditure based rules, when based on accurate structural assumptions, can see through the cycle and avoid a boom and bust in government spending. Moreover, public expenditure is more directly under the control of authorities than revenues, which are more cyclically autonomous (Atkinson and van den Noord, 2001). Therefore, in principle the Czech Republic already has a good base in place. However, multiple rules are often used and past empirical analysis found that countries using a suite of rules have managed to sustain fiscal consolidation more successfully than others relying on a single rule (Guichard *et al.*, 2007; IMF, 2009). With a hindsight, had a target of decreasing public debt complemented introduction of expenditure ceilings back in 2004, fiscal policies would have been tighter in the period of strong upswing, leaving more fiscal space to deal with consequences of global financial crisis.

On-going discussions about a fiscal rule have not yet come to a final conclusion. One of the recent proposals from the National Economic Council of Government (NECG), an advisory body to the government, has involved a debt targeting rule. An explicit formula would set the annual primary balance target according to a desired debt level. The primary balance would be adjusted annually in line with developments in potential and actual growth rates and it would also reflect a correction to address past overruns and deviations from an appropriate fiscal policy path. Such a proposal has merit, though the complexity in the setting and monitoring of the debt-targeting rule is likely to present a challenge. Past experience with respect to the expenditure ceilings shows that low understanding and awareness, together with the complex adjustment mechanisms in place, have made public monitoring difficult. Even the most elaborate numerical formula will not foresee all possible economic developments and shocks. Economic circumstances can thus result in breaking such a rule, undermining its credibility. Also, there is a considerable degree of uncertainty involved in calculations of variables such as potential output. These concerns are particularly relevant since the Czech government plans to enshrine a fiscal rule into the constitution.

A more robust approach would be to refer in the constitution to a high-level principle, such as requiring the government to issue a debt-target for its period in office. The principle should then be translated into multi-annual expenditure ceilings and deficit targets. There are a number of approaches to setting a desirable debt level depending on overreaching policy goals, which can aim at convergence of debt to its initial (arbitrary) level, avoiding excessive debt accumulation or indeed a more ambitious approach of including funding of future government liabilities (Price, 2010). Once the fundamental approach is decided, the existing nominal expenditure ceilings should then serve as an operational

commitment to budget prudence. The budget mechanism should hold spending ministers directly accountable for their actions by specifying clear spending envelopes and *ex post* accounting of performance. Moreover, such a framework needs to account for tax expenditures in order to avoid the temptation of pro-cyclical fiscal loosening during times of cyclical revenue upswings. It should also explicitly include sub-central levels of government in order to ensure that local fiscal policy is in line with the overall national goals (see below).

***... and should include an independent fiscal institution***

Efforts to strengthen fiscal frameworks across OECD countries often include setting up an independent fiscal institution (Box 1.1). A number of OECD countries have independent fiscal councils with an advisory function, either from a normative or positive perspective (Hageman, 2010). Such an institution has already been recommended to the Czech authorities as a complement to the existing fiscal framework, in order to address the identified weaknesses of the expenditure ceilings process (OECD, 2010a). By monitoring the application of the medium-term expenditure ceilings and regularly reporting to the parliament and the general public, such an independent body could increase transparency, establish a political cost for breaking the framework and reduce the perceived partisanship of the Czech budgetary process. It could also decisively strengthen the analysis of cyclical position of the economy that is crucial for setting appropriate structural assumptions underlying the medium-term framework. A budgetary council that is currently planned, would assess only fiscal costs of new legislation, and would be located in the prime minister's office. This body should help in ensuring the budgetary costs of new legislative proposals are appropriately reflected in budgets, even if the Ministry of Finance is already well placed to verify cost estimates from line ministries. However, another body with a more comprehensive mandate as described above would help to enhance the quality of fiscal policy making in the Czech Republic.

**Box 1.1. Recently established fiscal councils**

**UK Office for Budget Responsibility** – Set up in 2010 to “provide independent and authoritative analysis of UK’s public finances” under the HM Treasury. It is led by a three member board of economists and has a staff of 16 civil servants. There is also an Oversight Board and Advisory Panel in place. The Office produces short- and medium-term forecasts that are used for budget formulation, assesses progress towards the government’s fiscal targets (both cyclical balance and debt target) and the long-term sustainability of public finances. It also scrutinises the Treasury’s costing of Budget measures. There is a Memorandum of Understanding that sets out the working conditions and interactions with the rest of the administration and its analytical independence is set in law (Charter of Budgetary Responsibility). The Chancellor nominates members to the board of the Office, but they have to be approved by the Treasury Select Committee of the House of Commons.

**Irish Fiscal Council** – Established in June 2011, the institution has 5 independent members appointed by the Minister of Finance and a permanent secretariat of staff of 4. Two of the councillors are from Ireland and the rest are international experts, including from the OECD, which should help to broaden the range of independent perspectives. The Council will report three times a year, pre- and post-Budget and after issuance of the Stability programme, to the Minister of Finance, who is obliged to submit these reports to the parliament within 24 hours. The main focus of the reports will be to monitor compliance with fiscal rules and evaluate consistency and adequacy of the government’s medium-term target with prudent fiscal and economic management. It will also assess the forecasts and assumptions underlying the medium term government plans. The council will provide normative judgements and recommendations about fiscal policy.

Source: OECD Economic Survey of Ireland (OECD, 2011b), UK Office for Budget Responsibility’s website.

## **Budgetary management and control to promote efficiency**

Improvements in budget management and control are essential to maintain spending efficiency. This section reviews a number of areas of possible improvement, including the increased transparency of budgetary documentation, the use of performance indicators, the monitoring of tax expenditures, ensuring the quality of public procurement, reforming sub-national fiscal relations and strengthening the governance of state owned enterprises. The authorities are already undertaking several initiatives in these areas.

### ***Increased budgetary transparency but only limited progress in performance indicators***

Greater transparency in budgetary procedures tends to be associated with lower deficit and debt levels (von Hagen and Harden, 1994; Alt and Lessen, 2006), but most importantly should make it easier to assess quality and effectiveness of spending. The budget is the government's key fiscal policy document, where policy objectives are reconciled and implemented in concrete terms. Therefore, it is essential that it is comprehensive, encompassing all government revenue and expenditure, so that trade-offs between different policy options can be assessed (*OECD Best Practices for Budget Transparency*, 2002). While a number of *OECD Best Practices* are already applied in the Czech budgetary process, scope for improvement remains.

There has been long-standing criticism that the budgetary documents are complex and lack comprehensiveness (Transparency International, 2006). Some progress has already been achieved in this area and renewed effort to increase the transparency of public expenditures has been launched under the *Competitiveness Strategy*, recently adopted by the government (Annex A2). One of the priorities of this strategy is to make the state budget and the overview of its individual spending programmes accessible on the internet. It is already possible to download the budget proposal from an electronic database of planned legislation at the Office of the Government and *ex post* overviews of the main individual chapters are available from the Ministry of Finance website. Moreover, a database of some state subsidies is accessible on the Ministry of Finance's website as well as indicators on municipal indebtedness (see further). A number of line ministries publish their budgets and/or end of year reports on their website and a recent court ruling clarified that remuneration of civil servants should also be made publically available information. *IMF Manual on Fiscal Transparency* (2007) calls for a publication of a citizens' guide to the budget, an easy-to-understand summary of main features of the annual budget. Although only a small number of countries currently publish such guides, it has been identified as a good practice in international fiscal transparency initiatives (OECD, 2010a). Further improvements in the available documentation and, potentially, the publication of an overall assessment of the budget by an independent fiscal institution, would be helpful in enhancing transparency and accountability.

The Czech budgetary process is one of the very few in the OECD not to use any performance indicators (OECD, 2011c). Such indicators offer an understanding of how the goals of various governmental policies and spending programmes are being achieved and could be used to assess spending effectiveness. Such information would also be an important input into the formation of new budget proposals, which for the moment are based mainly on incremental increases from the previous year. This inhibits expenditure prioritisation, which will be particularly important during a period of fiscal consolidation. There have been some efforts in the past to introduce performance-based budgeting, but only on a voluntary basis and with limited impact. In reality, some performance indicators are being used at the individual ministerial level, but no systematic approach is in place. Information about performance indicators is not an explicit part of the budget documentation, nor is it used as evaluation criteria during the budget preparation phase.

The Czech authorities could draw on OECD countries' experience in constructing their own performance indicators (Boyle, 2009). Irish Departments (ministries) produce annual output statements, which set out information on expenditure and services on a programme basis. They also include output information alongside expenditure allocations in the state budget. Australia's Productivity Commission publishes an annual review of government programmes that is used in budgetary formation process. Similar, measurable performance indicators could be developed for individual spending programmes in the Czech budgetary process, complemented by wider use of *ex ante* and *ex post* cost benefit analysis.

A new treasury system has been under implementation for three years. The overall aim of is an upgrade of the current monitoring and budgetary management system and a streamlining of the state's cash management across levels of government. The project is reportedly occupying all available development capacities of the budgetary staff. Although these are no doubt useful measures *per se*, the treasury system does not include evaluation of individual spending programs. Once the technical implementation is over and human resources are freed, the authorities should focus on performance oriented indicators and budgeting.

### ***Tax expenditures need to be disclosed regularly***

Tax expenditures matter for the effectiveness of the fiscal framework and their regular reporting is necessary (Anderson and Minarik, 2006). Tax expenditures are the estimated lost-revenue costs of preferential treatment for specific activities and should be disclosed as supplementary information in the budget (OECD, 2002). They undermine the benefits of spending and affect the fiscal stance. For example, increases in tax deductible costs for the self-employed contributed to the economic boom prior to the downturn. Fortunately, a broadening of tax bases has received more attention under the current consolidation programme and a first overview of tax expenditures was prepared last year (Jareš, 2010). It identified some 57 tax expenditures at an estimated cost of CZK 120 billion in 2008, or 3.1% of GDP, addressing other public policy areas (Table 1.1). Tax expenditure reporting, possibly including an analysis of related distortions to the allocation of resources in the economy, should become a regular and integral part of the budget proposal. As experience from other OECD countries shows, such reporting can be delegated to an outside independent institution, especially when uncertainty about the size of tax expenditures is large. For example, in France the estimate of tax expenditures by the independent court of audit is almost three times as high as the estimate by the Ministry of Finance (OECD, 2011d).

**Table 1.1. Estimates of main tax expenditure categories**

|   | Estimated cost (bn CZK) |
|---|-------------------------|
| Total, including  | 120                     |
| Preferential VAT rate   | 54                      |
| Tax exempt rent income  | 29                      |
| Tax exemptions on lotteries   | 8                       |
| Personal income tax exemption on employer-provided meals            | 6                       |
| Tax deductible mortgage interest                                    | 5                       |
| Personal income tax exemption on employer-provided public transport | 2                       |
| Investment tax incentives within corporate income tax               | 2                       |

Source: Jareš (2010).

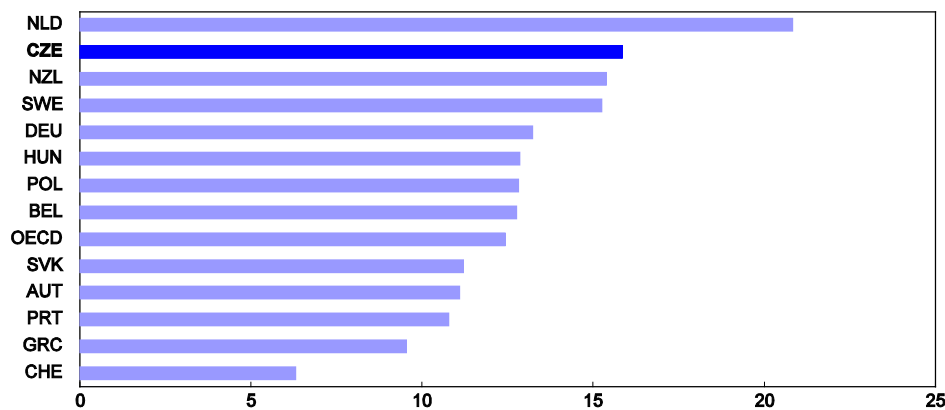
### ***Public procurement offers significant scope for improvements***

Public procurement spending represents a large share of governmental spending and the authorities are hoping to achieve significant efficiency gains from improving current practices (Convergence Programme, 2011). The procurement of general government amounts to 17% of GDP and Czech public procurement ranks at the top of the OECD, only behind the Netherlands (Figure 1.2). The figure is even

higher, when procurement by state owned utilities is also included. Non-transparent procurement practices are vulnerable to waste, fraud and corruption, given their complexity and close interaction between the public and private sector (OECD, 2011c). Such risks are present in the Czech Republic and there has been a growing discontent with the public tendering procedures. According to Eurostat, only 20% of public tenders get advertised in the Official Journal of the EU, compared to 45% in Estonia, the EU top performer. Anecdotal evidence and comparative analysis of large infrastructure projects point to overpriced programmes (Palguta, 2010). Also, there has been a practice of breaking-up public tenders into smaller parts to avoid tighter requirements for public procurement projects (NECG, 2011a).

**Figure 1.2. The importance of public procurement is high**

Government purchase as a % of GDP, 2008



Note: Procurement is the purchase by general government of goods, services and works. OECD is the average of available shares.  
Source: OECD, *Government at a Glance*, 2011, and *National Accounts Database*.

A major overhaul of tendering legislation is in the pipelines and the authorities expect to make significant savings as a result of improved procurement practices. They have estimated that some 15% of the current costs of general government procurement, amounting to around 2.5% of GDP, could be saved. The comprehensive *Anti-corruption Strategy* that has been adopted at the beginning of the year includes an ambitious amendment to the procurement bill, which is currently debated in the parliament. The amendment proposes a lowering of the limits for public tenders, obliges the publication of more *ex ante* and *ex post* information about procurements, including the final price paid, tightens conditions for using simplified procurement practices and introduces an economic analysis for significant public tenders (above CZK 100 and 200 million). At the same time, the authorities are working on a national electronic system for public procurement, templates for tenders to be used across the public sector and centralizing government purchases of services. A report on the public procurement market in the Czech Republic will be published annually. All these steps are welcome, but enforcement is also important. Notably, there is room for more effective enforcement of corrective actions taken against entities in breach of the rules and regulations by the Anti-monopoly Office and Supreme Audit Office (Pavel, 2009).

### ***Reaping economies of scale among sub-central governments...***

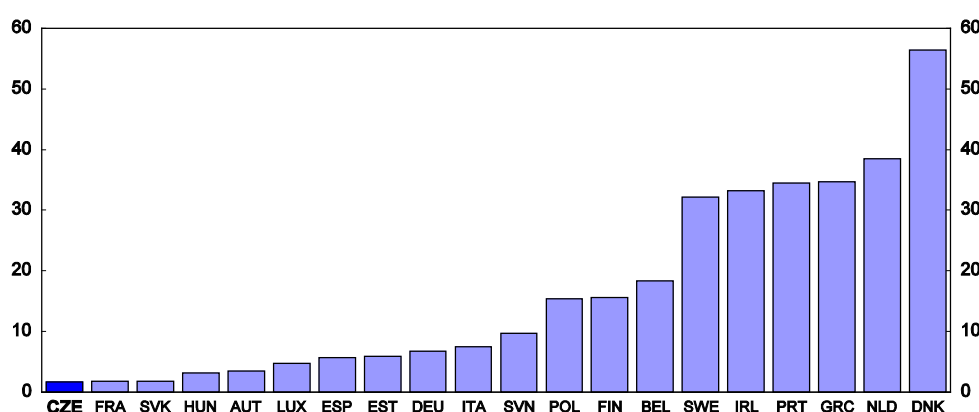
No indicators are available about the cost and quality of public service provision across municipalities and regions, although such indicators would contribute to enhancing the efficiency and effectiveness of sub-central service delivery, and a number of countries compile them for this purpose (Mizel, 2008). For instance, Norway and Australia regularly publish such information. Some municipalities in the Czech Republic have taken independent initiatives to benchmark their costs for the provision of certain services, but these data are not generally available. Compiling cost and efficiency indicators on sub-central

governments at the central level would help to assess the municipal performance in providing public services and identify potential for efficiency improvements across the country.

Nevertheless, the Czech Republic stands out among OECD countries in terms of the number of sub-central governments, many of which are therefore likely too small for the efficient provision of public services. With a population of 10 million, the country has two sub-central levels with directly elected officials – 14 regions and 6 245 municipalities. While there is no conclusive evidence on the ideal size of a municipality, the average size of Czech local governments, at just over 1 600 inhabitants, is extremely small by international comparison (Figure 1.3). Among the OECD countries, only France has a similar set-up, but it is currently on course to mandate inter-municipal co-ordination by 2013. A number of other countries have undertaken reforms to increase the average size of municipalities over the past decades. Denmark, with average municipal population of 55 000 following such a reform, is at the other end of the scale.

**Figure 1.3. Municipality size is very small**

Average number of inhabitants per municipality, 2009-10, thousands



Source: CEMR (The Council of European Municipalities and Regions)-Dexia, *EU Subnational Governments*, 2010/2011 edition.

### Box 1.2. Sub-central government expenditure and financing

Just over a quarter of general government expenditure is spent at the sub-central levels in the Czech Republic. The regions, which came into effective existence in 2002, are in charge of general hospitals, upper secondary education, public roads and transport and some social policies for disadvantaged groups. Municipalities run pre-school, primary, and lower secondary education, social care services, local roads, water and energy supply and waste collection and treatment facilities.

Sub-central governments are financed from two basic sources: tax revenues (from tax sharing arrangement and assigned own taxes), and various forms of transfers from the state budget (transfers, grants and subsidies). Tax revenues are at the full discretion of sub-central governments, while transfers and grants that cover education spending, together with subsidies for selected health providers and for the provision of some public administration services, are fully earmarked. In the case of municipalities, about a third of their revenues come currently from earmarked transfers and two thirds from tax revenues and other incomes. Shared taxes include part of personal and corporate income tax as well as value added tax, while property tax revenues go fully to the municipalities. For regional administrations the ratio of earmarked transfers and shared tax revenues is inverse.

An earlier *Survey* (OECD, 2006) argued that incentives for small municipalities to merge were fairly limited. In the past, there was a progression in the shared-tax revenue per capita linked to the population size thresholds. However, this did not produce desired mergers and recent reforms have reduced the merging incentives further. Under the current financing arrangement, should municipalities merge and as a result of that fall into a bigger population category, their shared tax revenue will not actually increase that much. There is a modest bias in favour of the smallest municipalities and six cities above 100 000 inhabitants including the capital of Prague, which is also a region on its own. The current redistribution of shared tax revenues to local municipalities is based on centrally determined

coefficients that have been set for various municipal sizes, primarily based on historical revenues and population. Another criterion, albeit with a very small weight for formula, is municipal surface area. The authorities are discussing a revision of the revenue sharing scheme this and next year, but it does not provide any significant incentives for the consolidation of the smallest municipalities. Planned changes would slightly flatten the distribution of shared revenues, mainly by withdrawing disproportionately higher revenues of larger municipalities in favour of the middle-sized ones. The formula will also include the number of pupils in schools and pre-school institutions, while an earmarked transfer from the Ministry of Finance will be eliminated.

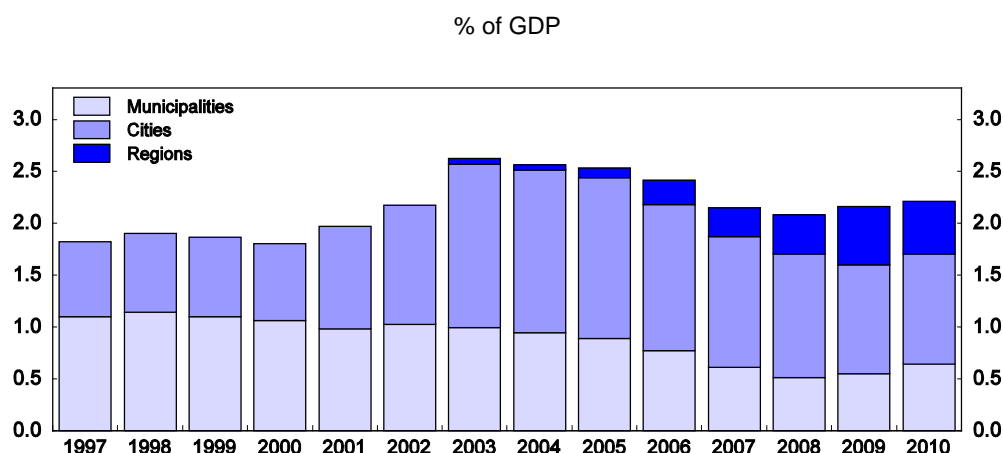
Assigning greater tax raising powers and spending autonomy to the sub-central governments could make municipalities more accountable to their electorates and hence increase pressure for spending efficiency. Firstly, non-earmarked grants are usually more efficient instruments and give incentives to economise on administration, so moving away from earmarked transfers is welcome. Secondly, a formula-based on coefficients is not a very transparent mean of redistributing public revenues. The tax potential of a particular local government and how much it receives as a result of national equalisation are not obvious. A number of countries, in particular the Nordics, use a model in which these two parts of the revenues are separated, opening the way for an analysis of cross-subsidisation and its underlying causes, including inefficiencies. Also, the existing tax-sharing arrangement provides only little incentives for broadening tax bases, since revenues from the shared taxes are redistributed.

One of the main sources of sub-central governments' autonomy is property taxation, which is already fully assigned to the municipalities in the Czech Republic. However, property taxation is currently differentiated only according to size of the municipality and the basis for it is set in monetary terms (*e.g.* CZK 2 per square meter for a residential building). The central government introduced brackets to allow the differentiation of the coefficients that determine the effective property tax rates further. Local governments have used this opportunity to increase the coefficients and thereby rates in 2009 and 2010. Moreover, there was a general increase in the property tax as a consolidation measure in 2010. However, property taxation still represents only a modest revenue source at 1.2% of total government tax revenues in 2007 and according to the latest Ministry of Finance estimates, real estate tax revenues represented over 6% of total municipal tax revenues. This suggests further scope for increase, for instance by reflecting the value of the property in the tax. The authorities foresee the introduction of so-called price maps, in which the value of real estate would be reflected in and serve as a basis for the real estate tax.

### ***... and including them in the fiscal framework***

Czech sub-central governments are covered by the existing budgetary rules and should aim for balanced budgets, but there is no effective restriction on borrowing. The overall budgetary position of the sub-central governments is generally sound, with debt at CZK 80 billion in 2009, *i.e.* 2.1% of GDP. As recommended in an earlier *Survey* (OECD, 2006), the Ministry of Finance has stepped up its monitoring of local budgets and is now compiling a number of indicators on the financial situation and indebtedness. According to these numbers, the four biggest cities have accumulated the most debt, some CZK 40 billion in 2010, *i.e.* half of the overall municipal indebtedness and almost 70% of their annual tax revenue. About a half of municipalities use some debt instruments and 62 have reached according to the authorities a higher rates of risk, involving among other criteria re-payment obligations above 25% of their total assets. Use of external financing has increased as a result of pre-financing needs for drawing of EU's structural funds (Ministry of Finance, 2010). The budgetary situation of the municipalities has recently stabilised, though regional governments experienced a 40% increase in debt in 2009, albeit from a very low level (Figure 1.4).

Figure 1.4. Debt across sub-central governments is low but on the rise



Note: Cities are the four largest.

Source: Ministry of Finance.

While providing more fiscal autonomy, a number of OECD countries also apply borrowing restrictions to sub-central governments. There has been a general move away from a micro-management based on a prior approval system on a case-by-case basis towards aggregate and numerical targets across the OECD (Sutherland *et al.*, 2006). The Czech authorities are discussing imposing a limit on sub-central borrowing or on deficit, with explicit requirements for municipalities in breach of the limit (such as to appoint financial advisor from the Ministry of Finance) and specific arrangements for insolvency (including a centrally appointed administrator, *správce*). Balanced budget or debt rules risk becoming pro-cyclical the more stringent they are and the shorter their horizon. For example, Danish municipalities that are highly restricted in borrowing achieve consumption smoothing through adjustments in investment activity. Moreover, as local governments may own or control local enterprises (such as public transport companies), it is important that contingent liabilities are taken into account. Some progress is being made on this front as, according to legislative amendments currently in the parliament, the Supreme Audit Office will have new powers to review municipalities and regions. To strengthen the fiscal responsibility of sub-central governments further while respecting their constitutional independence, the authorities should introduce an internal stability pact' that sets borrowing limits on local budgets and ensures that local fiscal policy is in line with the overall national goals. Also, publishing indicators on the indebtedness of individual local governments can serve as a means for benchmarking and increasing their electorates' awareness of the local public finances.

### ***Governance of public enterprises can be strengthened***

There are still over 100 state-owned or controlled enterprises (SOE), including the post office, railways, airports, an airline, energy producer and national forestry manager. These companies employ over 160 000 employees, over 3% of total workforce (OECD, 2011e). As one indication of their importance for overall public spending, procurement of state owned utilities alone corresponds to 9% of GDP, more than half of public sector procurement. As SOEs are vulnerable to the risk of soft budget controls and inefficiencies, ensuring accountability and the quality of corporate governance among the remaining SOEs is crucial (OECD, 2011f). One way to achieve this goal is a partial privatisation and listing on the stock exchange, as recently suggested by the NECG. But also full privatisation, alongside with adequate regulation where necessary to protect consumers, needs to be considered. Careful consideration should also be given to the oversight of SOEs within the public sector. The National Property Fund, a main vehicle for privatisation and state ownership established at the beginning of the transition



period in the 1990s, was finally dismantled in 2006 and its role was taken over by the Ministry of Finance. Currently a dual model of ownership is in place, whereby sectoral ministries nominate directors of SOEs and hold their shares, with the Ministry of Finance in charge of operational performance (OECD, 2011f). Although such a dual model has long been prevalent in OECD countries, more recently there has been a trend towards a centralised ownership structure, either under one co-ordination ministry or a separate entity. For example, the UK's Shareholder Executive implements unified guidelines regarding disclosure, board nomination and executive nomination. Centralisation is also conducive to aggregate financial reporting on state ownership and unified implementation of the ownership policy. The authorities should thus consider consolidating all corporate state holdings and stakes under one roof with a professional management to improve their accountability and establish an arm's length principle relationship. Similar institutions have been in place in Finland, Germany, Austria and recently established in Slovenia.

### The pension system is undergoing major reform

The Czech Republic spends some 8% of GDP on pensions, a little above the OECD average. The current retirement income provision is dominated by a universal and compulsory public defined benefit (DB) scheme, with only a minor role played by private provision. Currently, the retirement age is around 62 (the exact age depends on an individual's date of birth, women are able to retire earlier based on a number of children raised) and is to increase gradually to 65 by 2030. Moreover, it will be united for both genders by reaching 66 years and 8 months in 2041. The benefits from the public DB tier consists of a basic and an earnings-related component, with the basic flat part equivalent to approximately 9% of the average wage. The overall contribution rate is high: employees and employers together contribute 28% of gross earnings. Only a few countries (Hungary, Italy and Spain) have higher rates, while the OECD average was 19.6% in 2010.

The Czech population is ageing fast, which will strain on the public finances. Absent of any reform the pension spending is projected to rise by some 4 percentage points GDP by 2060 (EU, 2009).<sup>3</sup> Updated national projections show that the system is projected to post annual deficits above 4% of GDP starting from 2030 onwards. There is little effective retirement income diversification since, as noted earlier, current retirement income is dominated by the public tier. In response, the government continues to implement measures to improve the overall pension system performance and to prevent future increases in the contribution rates. In particular, important parametric changes to the existing scheme were recently legislated and a more fundamental reform is under parliamentary approval. The following section reviews the current, reformed, and newly proposed retirement income system against five basic criteria outlined in a previous *Survey* (OECD, 2006): the strength of the safety net, *i.e.* poverty prevention, the benefit/contributions link, diversification, fiscal sustainability and retirement incentives. The summary assessment is provided in Table 1.2.

**Table 1.2. Assessment of evolution of the pension provision system**

|  | Poverty prevention | Benefit/Contributions link | Retirement incentives | Retirement income diversification | Fiscal sustainability |
|--|--------------------|----------------------------|-----------------------|-----------------------------------|-----------------------|
| Current public DB                          | xxx                | x                          | xx                    | x                                 | x                     |
| Parametric changes of the DB               | xxx                | xx                         | xx                    | x                                 | xxx                   |
| DB with an added DC carve-out <sup>1</sup> | xxx                | xxx                        | xxx                   | xx                                | xx                    |

1. Note that fiscal sustainability assessment does not include extra revenues from VAT and other sources that have been identified to finance the immediate fall-out of social contributions.

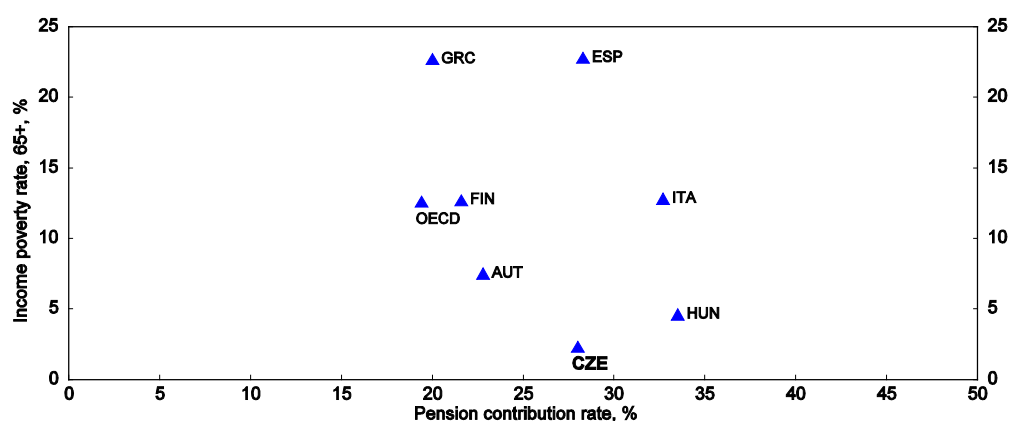
3. *Ibid.*

***The pension system is efficient in providing a safety net but less so in other areas***

The public pension tier provides an adequate safety net and is therefore efficient in terms of preventing old age poverty. The Czech Republic has one of the lowest proportions of impoverished pensioners (Figure 1.5). Just over 2% of those aged 65 and more live with an income less than a half of the median household disposable income, while the average in the OECD is 13.5%. Also, a Gini coefficient of pension entitlements, which measures the inequality in pensions, is among the lowest in the OECD. This is ensured by a significant redistribution within the benefit formula: workers with a half of the average wage have a net replacement rate of over 90%, whereas those earning one and a half times the average get only a half of that. However, tension about the redistributive nature of the system has been growing, as earnings dispersion in the economy is widening. This tension had been highlighted by the constitutional court ruling recently, which has decided that the public scheme does not provide adequate pensions for higher income earners given the size of their contributions.

The current set-up offers good financial incentives for working longer, as described in previous *Surveys* (OECD, 2008, 2010). Currently, a worker can retire up to three years earlier if he has a required contributory history of 25 years and this will be extended to five years (together with an extension in the required contributory history) as the pensionable age reaches 65. The reduction in benefits for retiring early is achieved via a decrease in the accrual factor. In effect, this results in a reduction in the pension level of 5.6% per year of early retirement for a full-career worker, which is close to actuarial neutrality. At the same time the scheme offers substantial incentives for continuing to work beyond the statutory age of retirement and indeed there has been a gradual pick up in the participation rates of the older workers (OECD, 2011g). While employment rates in the Czech Republic are generally higher than the OECD average, they had been lower for older workers. In the age group of 60-64, employment has been increasing steadily, reaching a peak of 39% in 2008, but that was still some 10 percentage points below OECD average.

**Figure 1.5. The pension system protects well against poverty**



*Note:* The income poverty rate, 65+ is the percentage of persons aged 65 and over with incomes less than 50% of the national median household disposable income in the mid-2000s. The pension contribution rate is pension contributions (by employer and employee) as a per cent of employee gross earnings in 2009. Selected countries have similar contribution rates to the Czech Republic. OECD is the average of the 21 members for which data is available.

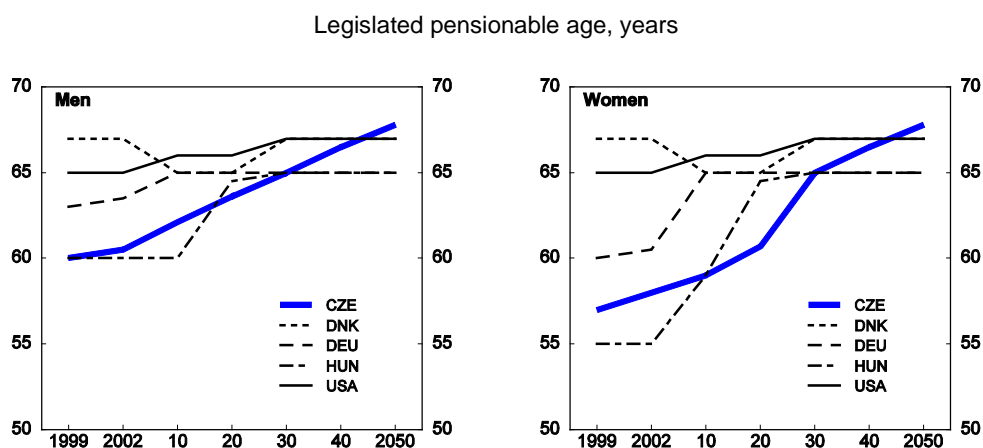
*Source:* OECD, *Pensions at a Glance*, 2011.

### *Parametric changes continue to improve long term sustainability*

A set of parametric changes modifying the public DB part of the pension system has entered into force in September, addressing the following issues:

- *Increasing statutory retirement age.* Once the statutory retirement age reaches 65 in 2030 it will continue to increase by two months per year (Figure 1.6). Moreover, the differentiated and lower statutory pensionable age for women will be phased out by accelerating the ongoing increases in the pensionable age for women will be accelerated. This will result in the age being unified for men and women by 2041 at over 66 years. The new legislation also smoothes the penalisation formula for early retirement.
- *Changes in the benefit formula.* To accommodate the Constitutional court ruling, the authorities have somewhat decreased the degree of redistribution. Effectively, there are now two thresholds for the calculation for the earning-related component of pension benefit. Up to 44% of the average wage, 100% of earnings are replaced; above that, earnings up to a ceiling of four times the average wage are replaced at 26%. This should result in the same replacement rate for the lowest income decile, a 25% increase for the top income decile and 3% decrease on average for the remainder. Furthermore, as opposed to the past practice of annual adjustment by the Ministry of Social and Labour Affairs, the thresholds are now set as a percentage of the average wage. Also, a cap on social security contributions, which includes pensions contributions, has been lowered from 6 times to 4 times the average wage. All this scales back the redistributive features of the system without reducing old-age poverty prevention.
- *Extension of earnings' covered by the benefit formula.* The minimum of 25 years' earnings coverage is being extended to 35 by 2018. Gradually, it will be extended to cover a pensioner's full earnings history. In principle, such a measure decreases somewhat the level of pension benefits, because earnings increase over working life. At the same time, it increases incentives for overall labour market attachment and contribution compliance.

**Figure 1.6. Statutory retirement age will increase fast**



*Note:* Pensionable age is defined as the age at which people can first draw full age-pension benefits (that is, without actuarial reduction for early retirement). The definition is designed to be comparable across countries and may be below the pension age set in national legislation. Refer to the source for more details. Selected countries have broadly similar life expectancy to the Czech Republic.

*Source:* OECD, *Pensions at a Glance*, 2011.

- *Automatic indexation of pensions.* Currently, pensions are indexed yearly by inflation plus one-third of real wage growth, but the actual increases have been frequently higher. As of September 2011, indexation will be automatically carried out by a ministerial decree, based on the above-specified minimum, and will not require government approval. The authorities are hoping to limit the scope for higher-than-minimum indexation this way, thereby contributing to improved fiscal sustainability. These changes go a long way towards improving the fiscal sustainability of the public scheme, especially the increases in the statutory retirement age. The authorities estimate that the long-term spending increase will be significantly reduced. The DB tier's annual deficits are projected in the magnitude of 0.5% of GDP, with a maximum of just over 2% between 2046 and 2066, when the impact of population ageing is projected to be the strongest. Moreover, given future demographic developments, the authorities estimate that the planned increases in the retirement age would also keep remaining life expectancy at the pensionable age broadly constant at around 20 years. It should be remembered, however, that the announced path might need adjustment if developments in life expectancy change. For instance, Denmark has linked its pensionable age to life expectancy developments after it reaches threshold of 67 in 2020. Also, the Netherlands is on course to implement such feature. Around a half of OECD countries have mechanisms providing an automatic link between pension benefit and a change in life expectancy in their mandatory retirement income provision. At the same time, it is important to supplement increasing retirement age with policies tackling barriers to working longer, such as high labour costs, ageist attitudes and seniority-pay schemes (OECD, 2011g).

Legislation introducing a new defined contribution (DC) second tier pension is currently before the parliament and should come into force in 2013. It would represent the most fundamental reform in the system since the mid-1990s. After the reform, people will have the option to divert 3 percentage points of the current 28% pension contribution rate into a funded pension plan that will be managed by a pension fund manager (*i.e.* pension company) of their own choosing (Box 1.3). The diversion will be conditional upon adding 2 percentage points on top of the existing contribution, bringing the contributions rate to the second tier to 5% and the overall contribution rate to 30%. Current employees over the age of 35 will have to decide during the first half of 2013. Employees below that age and new labour market entrants can decide on their participation before reaching the age of 35 or within 6 months of making their first social contribution. Under these conditions, such a decision will be open to all labour market participants at the time of the reform, but will be irrevocable in the future. For those participating in the second tier, the pension from the first DB tier will be lowered accordingly: the earnings-related component of the pension benefit will be calculated from a reduced contribution rate of 25%.

### *The proposed reform is welcome in principle...*

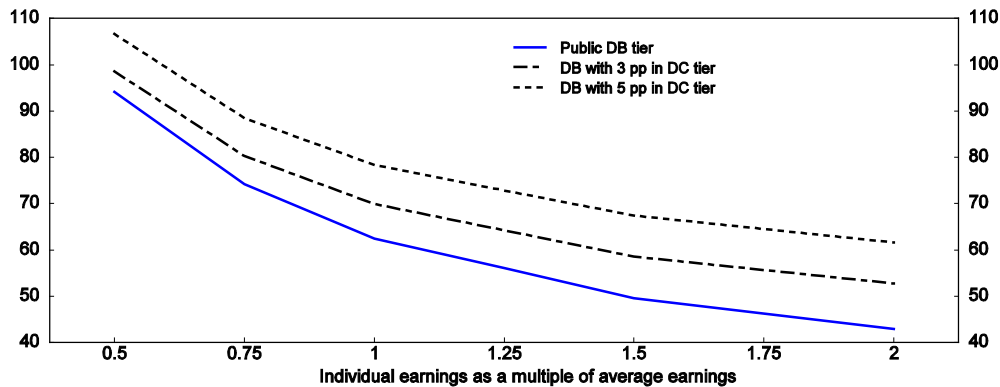
The reform in its current design improves the prospects for pension provision in many aspects, but also raises some questions. The DC tier effectively raises contribution rates, which means that those participating in it will be saving more for their retirement. It strengthens the earnings-related link of future pensions and thereby improves expected replacement rates and pension adequacy across income profiles (Figure 1.7). Poverty prevention features should not be significantly affected, provided that revenue loss does not lead to a change in the benefit formula. Although the DB tier will still remain the dominant of retirement-income, the DC tier will introduce more diversification of pension provision. Based on model calculations, a 40 year contribution period with 5% of the wage being saved, as will be the case for the DC tier, can yield a 30% replacement rate (OECD, 2011f).<sup>4</sup> There are also macroeconomic benefits from

4. OECD DAF model calculations for Insurance and Private Pensions Committee. Contribution and replacement rates when assets are invested in a portfolio comprising 60% equities and 40% fixed income, assuming a nominal rate of return of 7%, a nominal discount rate of 4.5%, and a life expectancy of 20 years at age 65.

generating more savings in the economy, such as a deepening of local capital markets, adopted by the authorities. However, switching rates might prove higher than expected, as has been the case in several other countries.

**Figure 1.7. Model replacement rates of the pension systems**

Individual net pension entitlement as a % of net pre-retirement earnings



Note: DC refers to defined contributions; DB is defined benefits; pp is percentage points. Calculations used the average gross monthly nominal wage per full-time equivalent employee in 2010 multiplied by 12. Assumptions of the calculations are described in detail in *Pensions at a Glance*, 2011 and include notably 2% annual real earnings growth and annual real rate of return of the DC tier of 3.5%.

Source: OECD pension models calculations.

The introduction of the DC tier requires generating additional revenues to cover transitional deficit of the DB tier. The lower contribution rates for the DB tier of those switching could also have an impact on ability to maintain the current redistributive features of the system. The size of the financing gap depends on the number of people who decide to join the DC tier but the authorities currently estimate it at 0.5% of GDP (CZK 20 billion) and plan offset it by dividends from state assets and increased VAT revenues. However, the switching incentives of the reform are not very clear. The authorities estimate that the internal rate of return for an average wage earner in the DB tier is currently around 5.5% and will be decreasing in future. Given the redistributive features of the system, anyone below that wage threshold has a higher return, while those above it face lower rates of return. The switching incentive therefore depends on the expected real rate of return from the DC pension plans. Should it be higher than 5.5%, switching would be favourable for those with earnings above the average wage and this is the assumption adopted by the authorities. However, switching rates might prove higher than expected, as has been the case in several other countries.

#### Box 1.3. Design of a new defined-contribution tier

Pension fund managers will be obliged to run four investment pension plans with the composition of the portfolio reflecting various degrees of risk. The four pension accumulation plans will have the following investment restrictions:

**Sovereign bonds fund.** The majority of the portfolio must be invested in sovereign bonds, with 70% in the Czech bonds and the rest in OECD and EU countries' bonds with top ratings, and those issued by other international organisations (such as IMF, EFSF, etc.). The average weighted maturity of these must be below 5 years.

**Conservative fund.** This is in principle a money-market fund that should serve a purpose for the pay-out phase. On top of the sovereign bonds, it can invest up to 30% in corporate bonds, money market instruments and shares of money market funds, all with the top five grades of ratings.

**Balanced fund.** Up to 40% of the portfolio of this fund can be invested in stocks and shares. Bonds must have a rating of at least A–.

*Dynamic fund.* Up to 80% of the portfolio can be invested in stocks and shares, bonds must have a rating of at least BBB–.

A participant can choose to diversify his assets into several pension accumulation plans or choose a life-cycle accumulation plan. An element of a life-cycle strategy is foreseen, as accumulated assets will by default be gradually transferred into a more conservative investment plan, starting 10 years prior to the statutory retirement age, leading to an increasing share of assets in the conservative fund. A choice between life-time annuity, an annuity with an option of a three years survivors' benefit or a programmed 20-year withdrawal permitting bequest will be possible.

While the contributions will be collected by a public Single Collection Point (also a tax collection agency), there will be individual accounts and direct contracts between the participants and fund managers. Ceilings on fees have been set between 0.3% of average yearly assets for the most conservative fund to 0.6% for the dynamic fund. On top of that, all but the sovereign bond fund can charge a fee on returns of up to 10%. There will also be a limit on acquisition fees for attracting new clients at 3.5% of the average monthly wage, *i.e.* around CZK 840 (EUR 33).

The retirement income generated in DC plans is subject to uncertainty as a result of different market conditions throughout the saving phase and at the time of retirement. This is why policy-makers across the OECD area use various measures to decrease such risk, in particular appropriate default investment strategies, while a few also use minimum income guarantees. Minimum income guarantees ensure that the amount of accumulated savings at retirement does not fall below a certain value. They are most useful where DC plans provide a large part of the overall retirement income and where membership of such plans is mandatory. However, they tend to be relatively costly, both in terms of fees and their impact on investment strategies. The Czech third voluntary tier, where such a guarantee exists in the form of a non-negative annual results, has experienced low returns on investments, as pension fund managers have opted for very conservative investment strategies.

Life-cycle strategies are increasingly being used to reduce pension benefit volatility. According to such investment strategy savings are invested into riskier assets at the beginning of the plan and gradually one's portfolio shifts towards less risky assets with pay-out phase approaching and as people get closer to retirement. Recent OECD work illustrates that life-cycle investment strategies set as a default provide protection against negative equity market shocks (OECD, 2011h). In the newly established second tier, the pension fund managers will be obliged to offer life-cycle investment strategies and accumulated assets will be, by default, transferred gradually to more conservative fund 10 years prior to reaching retirement age. However, the design of the DC tier should maximize the likelihood that individuals make decisions consistent with their long-term interests. Therefore, investment in higher-return assets in the early pension saving phase should be encouraged by making the life-cycle strategies an explicit default option.

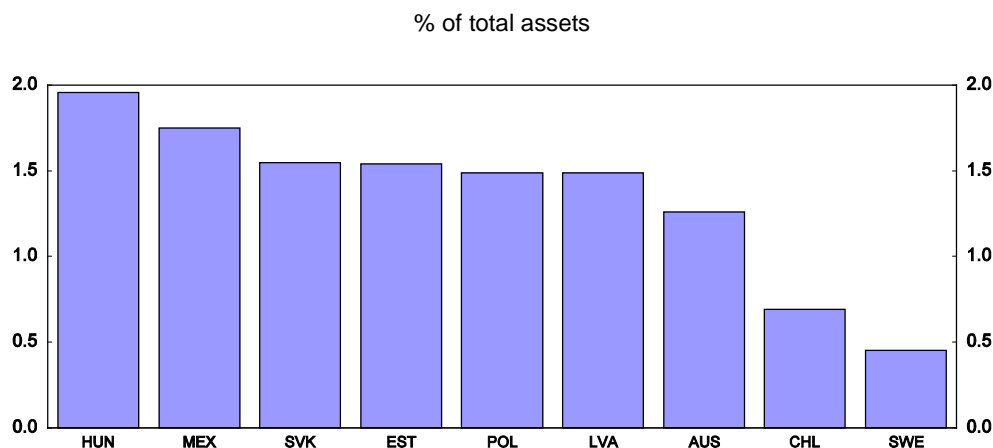
### *... but can be still improved to avoid excessive fees*

High administrative costs of individual DC schemes can reduce retirement income significantly. Fees themselves are influenced by a number of factors such as the size and maturity of the system, market structure, competition, investment strategy and regulation. The authorities have decided to regulate the fees and disclosure requirements to ensure that plan members receive timely and comparable information on the fees they pay. Pricing regulations allow for a single charge structure and set ceilings on the fees. However, such an approach might not be the most effective. Pricing regulation does not necessarily lead to cost reduction and greater efficiency in the industry (OECD, 2011h). Although the ceilings currently proposed sound broadly appropriate (Box 1.3), there are risks that they could prove too low, resulting in difficulties for the pension companies in recovering costs, or too high, and therefore ineffective. In particular, fee ceilings can limit price competition in the short-term, inducing implicit collusion among market players. Moreover, survey evidence from Chile and Poland suggests that the majority of the population does not know what fees are paid to pension companies (Martinez and Sahm, 2005). Financial literacy in the Czech

Republic is also low (CNB and Ministry of Finance, 2010), which suggests that a disclosure approach might have a limited impact.

International experience shows that there are clear cost advantages to centralised institutions as opposed to direct individual contracts between pension plan managers and participants (Figure 1.8). Such institutions can be in charge of either delivering various pension services and/or negotiating fees on behalf of individual plan members. Among OECD countries, the Swedish system, where there are no limits on fees but a centralised agency, has the lowest fees in the mandatory DC tier – under 0.5% of assets under management (Tapia and Yermo, 2008). The Swedish Pensions Agency acts as a single accounts administrator and as a reporting interface with plan members. Also, it negotiates rebates with the asset managers chosen by the plan members. The UK will introduce a system of a publicly managed default fund from 2012 (National Employment Savings Trust) to keep administrative costs down, while Mexico and New Zealand have similar projects in preparation. In the Czech DC scheme, a new revenue collection agency (Single Collection Point) will be created as of 2013 collecting also the DC contributions. The authorities should explore the possibility of using the Single Collection Point to administer and negotiate fees for DC plan holders, as in Sweden.

**Figure 1.8. Fees in mandatory DC pension systems**



*Note:* Data refer to administrative fees in private pension systems in 2007 or 2006.

*Source:* OECD, Private Pensions Outlook, 2008.

One of the main pension provision goals is to protect people from outliving their own resources. In DB systems the longevity risk is borne by the public sector, while in DC schemes this is borne by individuals themselves, unless they use pension assets to purchase annuities. As mentioned above, in the Czech DC tier there will be a choice between a life-time annuity, an annuity with the possibility for a survivors' benefit in the following three years, and a programmed 20-year withdrawal which permits bequests. Life-annuities are generally not very popular as they involve "giving away" large sums of money for a future stream of small payments. However, this attitude is largely explained by widespread evidence that most people underestimate their life expectancy. Hence, if the main motivation for the reform is to diversification of old age income, the annuity option should be made a default for the pay-out phase.

### ***The existing voluntary third tier is also undergoing changes***

The existing third tier, where voluntary private pension savings are already possible, will be closed in its current format as part of the pension reform, reflecting its governance challenges (Box 1.4). Its functions will be taken over by pension fund managers, who can also operate the newly established second

tier. They will be obliged to offer one conservative fund, while setting other funds is optional. Current plan-holders will be offered the choice of transferring to a new plan or maintaining the current conditions in a specific “transformation fund”, which will be managed by reformed pension fund managers. The state will continue to offer public support both in terms of matching subsidies and tax expenditures, but it will target higher monthly contributions. As the support for the existing third tier was among the most generous in the OECD (Figure 1.9), the authorities should consider scaling it back. Moreover, tax incentives need a careful design to ensure that gains do not accrue mainly to middle and upper income earners (Yoo and de Serres, 2004).

#### Box 1.4. Governance problems of the existing voluntary tier

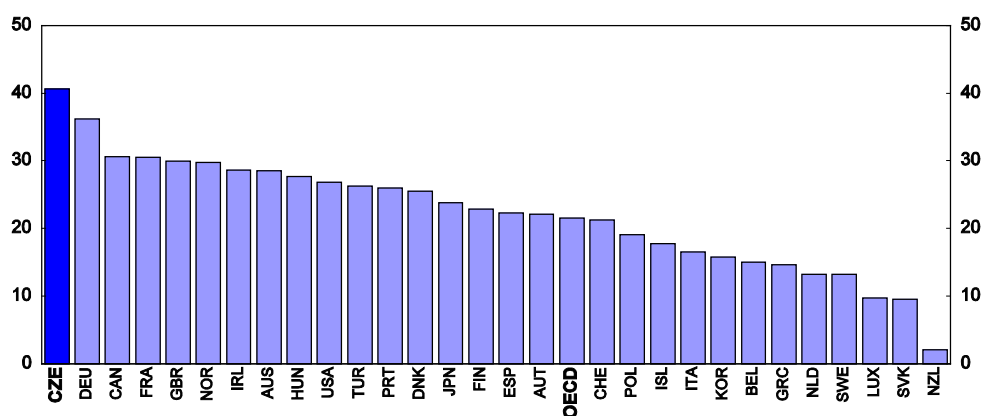
As a result of legal framework and regulation the third tier is currently a hybrid corporate structure with features of both banks and life-insurance companies that has been challenged elsewhere (World Bank, 2007). Most notably, there is no separation of shareholders assets from those of the plan holders and sales commissions have significantly escalated over time.\* Another specific feature of the system is that the regulatory framework prevents negative returns from the pension funds on an annual basis. While on its own this might not be an undesirable feature, it has resulted in very conservative investment strategies, with 85% of assets invested in government bonds and thus low returns.

A diagnostic review by the World Bank along the lines of the *OECD Guidelines for Pension Fund Governance* has identified a number of governance weaknesses that leave this tier of pension provision vulnerable to problems of opacity, poor actuarial control, inadequate solvency and inequity among different generations of plan-holders. Although some improvements in the oversight of the sector, carried out by the Czech National Bank, have been achieved since the review, the existing tier was considered as inappropriate for taking on the increased role of the DC tier under the current set-up.

\* In some cases, sales commissions have risen to 100% of first year contributions (World Bank, 2007) while Hlavac and Schneider (2011) calculated that acquisition costs have increased from 1% of total assets in 2000 to over 3% in 2009 in the system as a whole.

Source: World Bank, 2007.

Figure 1.9. Public incentives for private pension voluntary savings



Source: OECD, *Pensions at a Glance 2011*.

#### *Financial literacy is important for ensuring adequate savings for retirement income*

Action to improve financial literacy and awareness among the population matters for adequate pension provision: the experience from several OECD countries shows that people tend to under-save with respect to their future retirement income expectations. A national strategy for financial literacy has been



approved in 2010 and subsequently the authorities commissioned a financial literacy survey the same year. The results indeed demonstrated a low awareness of financial issues among the population, which is the case in many countries in fact, and the authorities are committed to improvement of financial literacy of the general public. They are addressing the issue with a systematic approach. While seminars for teachers have been organised since 2008, new curricula and textbooks for schools have been developed in co-ordination with the Ministry of Education, the Ministry of Finance and the central bank. The Czech Republic is participating in OECD/International Network for Financial Education financial literacy pilot project and also PISA 2012 financial literacy option. An appropriate public campaign explaining the DC tier to the public will also be crucial and related activities have already been started by the authorities. The authorities should ensure regular plain-language reporting of projected pension benefits for individual participants from the DC tier, based on their current contributions, as well as continue with actuarial reports on the public DB tier and its future developments.

### **The efficiency of health spending**

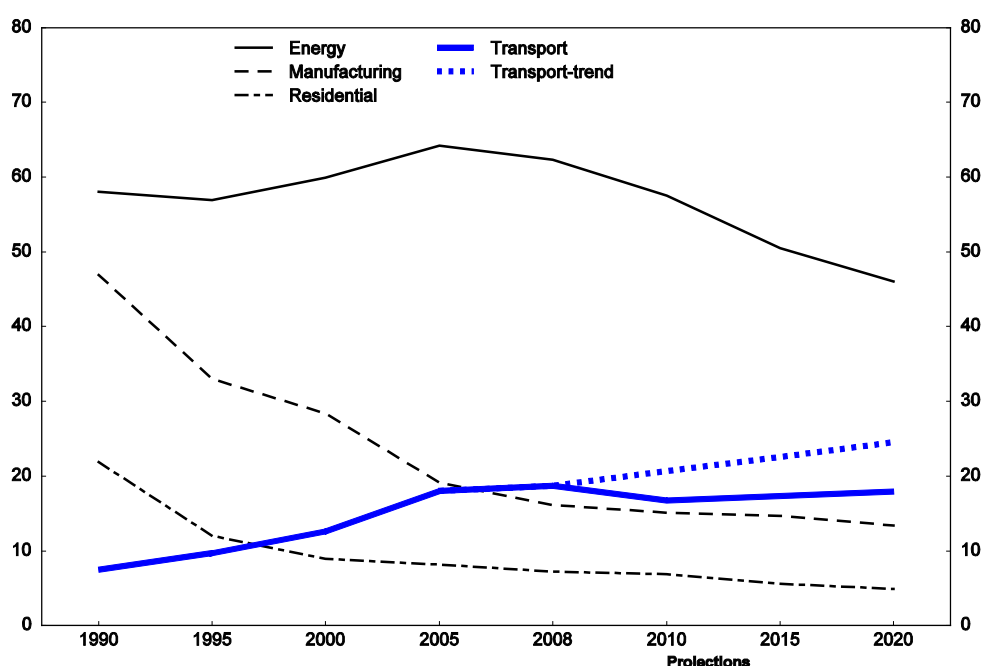
The Czech Republic, as most other OECD countries, is facing spending pressures in the healthcare sector, even though the health expenditure is still relatively low on per capita basis (Figure 1.10). As a share of GDP, at just over 8% according to the OECD Health Data, total health care expenditures are still lower than the OECD average, but have been rising over the past 10 years. In the long term, ageing is expected to increase health spending by 2 percentage points of GDP by 2060 (EU projections, 2009).<sup>5</sup> In the shorter-to-medium term, pressures are associated with increasing demand for health care, linked to wage pressures, rising income levels, an upgrading of the health system and technological progress.

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5. The European Commission is currently updating long-term projections of member states' pension systems. Estimations including the newly legislated changes should be available during the first half of 2012.

**Figure 1.10. Public health expenditure and GDP per capita, 2009**

Thousand USD at 2009 purchasing power parity

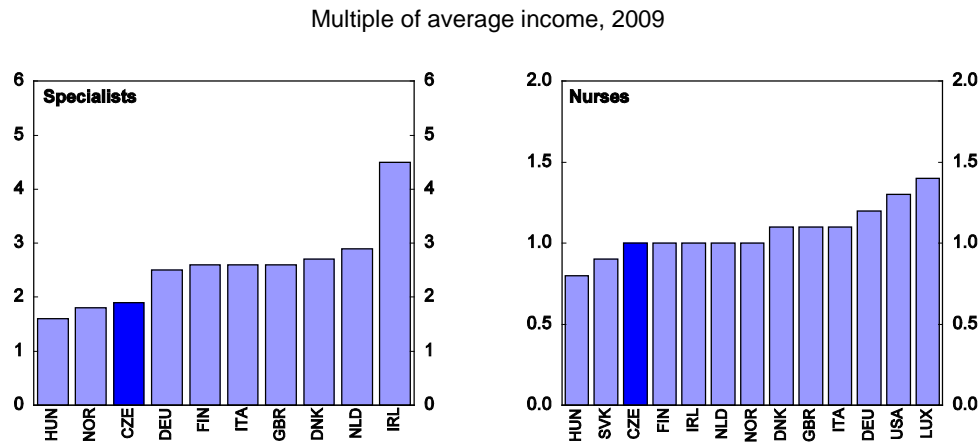


Note: Public healthcare expenditure is current expenditure by general government. Refer to source for details of concepts and comparability.

Source: OECD, *Health Database*.

The Czech health care system is characterised by a mandatory universal coverage, under which health care is funded by a part of the social security contributions levied on wages and state contributions for those insured but inactive such as children and pensioners. There is a wide consumer choice as patients are free to choose both provider and insurer (*OECD Survey*, 2003). There are currently ten insurance funds operating on a non-for-profit basis, financed from the social security contributions and redistributed according to their clients base and risk-sharing formula accounting for age and gender. The hospital network is by and large owned by the public sector, be it central authorities or local governments, while GPs have mostly individual practice. Specialists tend to be salaried or concentrated around health centres (so-called polyclinics) in private practices. Potential deficits in the health insurance system are implicitly backed by the state, mainly through increased state payments for those insured but inactive, channelled primarily through the VZP, the incumbent and the biggest insurer.

Current arrangements have resulted in financial tensions over the years in the health care, which intensified recently due to disputes about the remuneration of salaried medical staff. Relatively low rates of remuneration (Figure 1.11) had helped to keep overall health spending below the OECD average. With the opening of the labour market in neighbouring Germany and Austria in the spring of 2011, which lifted the remaining restrictions on the free movement of labour, some 3 800 doctors threatened to walk out of the Czech hospitals in search of better wage opportunities. An agreement between the authorities and the doctors' association, signed at the beginning of the year, stipulates wage increases for salaried doctors and nurses through to 2013. This includes a particular 10% pay increase for doctors and an unspecified increase for all medical staff in 2012 and an agreement that by 2013 salaried doctors' pay will range between 1.5-3 times the average wage depending on qualification. This is conditional upon achieving efficiency gains in the healthcare system.

**Figure 1.11. Remuneration of health professionals is moderate**

Note: Data refers to salary for year indicated or an adjoining year except for Germany which is for 2006. Refer to source for details of concepts and comparability.

Source: OECD, *Health Database*.

Achieving efficiency savings within the system to free up resources for increasing wages and to contain medium-term spending increases without sacrificing the quality of health services are key goals of the authorities. The opportunities for efficiency improvement are substantial. While the system scores well in comparison with many regional peers in terms of life expectancy, a recent OECD analysis points to significant potential gains, especially when measured by amenable mortality (*i.e.* premature deaths that should not occur in the presence of effective and timely care). If the Czech health system moved to the OECD efficiency frontier, life expectancy at birth could be increased by over 3 years and amenable mortality decreased by almost 40% without having to increase resources (Annex 1.A1). Exploiting potential efficiency gains would also help contain public spending and result in large savings, estimated for the Czech Republic at around 1.5% of GDP by 2017 (Joumard *et al.*, 2010).

Efficiency-seeking involves changes in providers' network, their pay system, steering patients' demand and managing care. As the Czech central authorities have less control over public health spending than in a single insurer system of healthcare, emphasis needs to be put also on getting the underlying incentives of the system right. The following section looks at possible improvements in these areas. It starts with a description of measures already in the legislative process and then discusses further steps that should be considered in the medium term.

### ***Reform aims at incremental improvements of the existing system***

The authorities are seeking to achieve incremental improvements within the existing multi-insurer model. Indeed, more fundamental reform does not seem warranted, as OECD countries employ various models of health care and efficiency analysis shows that no broad type performs systematically better than another in improving the population health status in a cost-effective manner (Joumard *et al.*, 2010). Meanwhile, a multi-insurer model is becoming more popular among OECD countries as competition features are being implemented in similar systems such as in the Netherlands, Germany or Switzerland, while preventing undesired side effects by regulatory oversight. The following incremental changes that continue direction of the reform adopted by the Ministry of Health in 2007 are currently debated in the parliament and are planned to take effect in 2012:

- *Improving drugs price setting and re-imbursement* to contain the growth in pharmaceutical spending, which have been consistently outpacing the growth in total health expenditure in the last decade. A reference basket for new drugs price setting will be extended from 8 to 18 countries and the maximum ceiling will be calculated based on the three lowest ones. Re-calculation of the re-imbursement price of drugs will be due whenever the exchange rate or foreign reference price changes result in substantial savings, set at a threshold of CZK 30 million (EUR 1.2 million). Over-the-counter drugs will be excluded from the basic insurance package. Also, a faster 30-day procedure will be established for the introduction of generic drugs into the market. The authorities plan to introduce a positive list of reimbursed drugs for which electronic auctions will be organised.
- *Streamlining of private co-payments* that were introduced to control overconsumption of health services – the Czech health care system has the second highest doctor consultations per capita, at 12.6 compared to an OECD average of 6.8. The co-payment for a hospital stay will increase from EUR 2.4 to EUR 4 per day (CZK 60 to 100) while drug co-payments will be now applied per prescription, rather than per individual items. Private household expenditures for health care are still moderate, and as there are differentiated ceilings and exceptions in place, co-payments would not pose a significant social burden (see Box 1.5).
- *Explicit rules for mergers of the insurers* to help reap economies of scale in the sector. The insurance market has already been consolidating, as 27 insurers have been reduced to ten funds, with the three biggest covering some 80% of the population. Although the overall administrative costs of the healthcare system are below the OECD average, the scope for further reduction through economies of scale should be exploited. In particular, a merger of the health insurer for the army (*Vojenská zdravotní pojišťovna*) and for the Ministry of Interior (*Zdravotní pojišťovna ministerstva vnitra*), each with a rather small client base, seems warranted.
- *Refining a standard benefits package* to open way for its further streamlining. The first stage of reform introduces the terms “standard” and “above-standard” care into legislation.
- *Improving the legislative framework* to codify patients’ and providers’ rights and obligations. This guarantees patients free choice of care provider and includes sanctions when rules are broken. New legislation on rescue services and other specific healthcare services (such as *in vitro* fertilisation treatments, abortion, gender change, etc.) is in preparation.

#### **Box 1.5. Level of private participation and evolution of out-of-pocket payments**

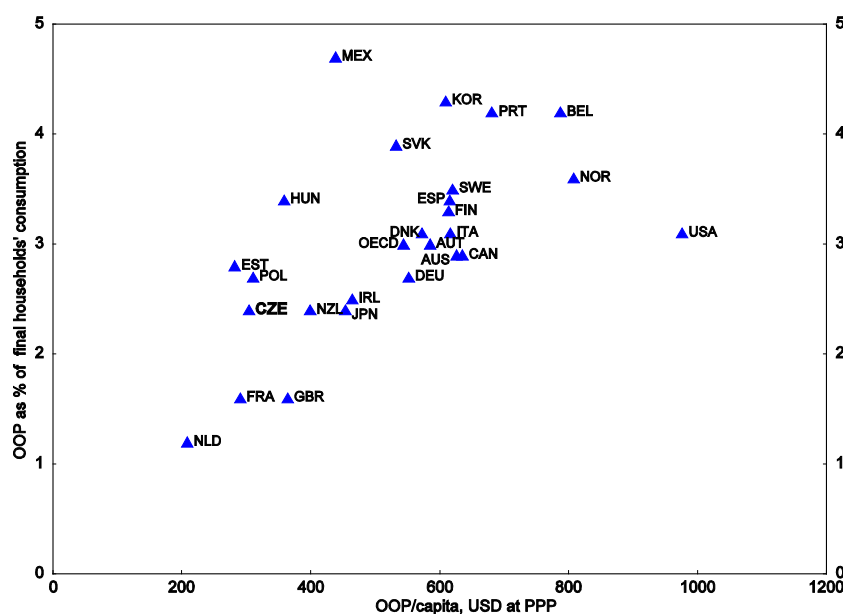
Private expenditures in the Czech health care remain relatively modest despite significant increases in recent years (Figure 1.12). Survey data by the Czech Statistical Office show that between 2000 and 2009, overall household expenditures on health care tripled with about a half of that increase being spent on pharmaceuticals. Private expenditures now represent some 16% of total health expenditures while the EU average is 23.5%. The biggest change was introduced in 2008, when out-of-pocket payments (OOP) were implemented with a considerable political cost. For some time they were reimbursed by certain regional administrations run by the opposition that claimed that OOPs were introduced in an unconstitutional way. By now the legal ambiguity has been cleared and there are no systematic reimbursements from regional authorities available.

The underlying motivation in the Czech case was to introduce price signals, curb excessive consultations and thereby improve the system's efficiency (Bryndova *et al.*, 2009). An impact on healthcare demand was indeed observed, but mainly in the first year of introduction. The use of emergency services declined by 36%, the number of prescriptions by 23% and ambulatory care consultations by 17% year-on-year in 2008 when the OOPs were introduced. Also, the rate of decline in the number of hospitalisation days increased. However, the growth in demand for most health care services recovered in 2009, albeit at a somewhat slower pace than previously, which is consistent

with experience from other countries. The authorities explain the pick-up in health demand by a low nominal level of the payments.

Out-of-pocket payments are usually regressive and thus the least equitable way to finance health care. However, the low level of co-payments (for example a standard copayment for a consultation is CZK 30 or EUR 1.25), several exemptions and a ceiling reduce the burden. Persons receiving subsistence benefits, the institutionalised disabled and income-poor elderly in care-homes are exempt. Moreover, there are differentiated ceilings on OOPs. For children under 18 years and elderly above 65 years the ceiling is set at CZK 2 500 (EUR 104) annually. For the rest of the population the ceiling is CZK 5 000 (EUR 208), which corresponds to 5.2% of the minimum wage. In 2009, under 280 000 people reached the ceiling, rising to 415 thousand in 2010.

**Figure 1.12. Households' direct payments for health care in OECD countries, 2009**



Note: OOP refers to out-of-pocket and PPP to purchasing power parity. Data is for 2009 or latest available. Refer to the *OECD Health Database* for details of concepts and comparability.

Source: OECD Reviews of Health Systems: *Switzerland 2011*.

Other planned measures are aimed at increasing the transparency of the corporate governance of the health insurance funds and establishing a level playing field among the funds. Health insurance funds are currently governed according to a specific legal framework and report to the parliament both in terms of financial results and annual business plans. In case of the VZP, the incumbent insurer, the supervisory board composition usually reflects political situation: two-thirds of its members are appointed by the parliament and one-third by the central authorities; in case of other insurers, the board composition represents tripartite agreements. More standardised reporting, accounting principles and increased liability of board members are planned. Other measures include setting up an independent Office of Health Insurers that will serve as an administrator of the system, primarily being in charge of the redistribution of funds based on risk formula. For the moment this is done by the VZP.

While these measures bring desirable improvements of the system, they are insufficient neither to generate large immediate efficiency savings nor to decisively limit future health spending growth. There is a scope to look for more efficiency savings in the network, procurement and care management. Also, other

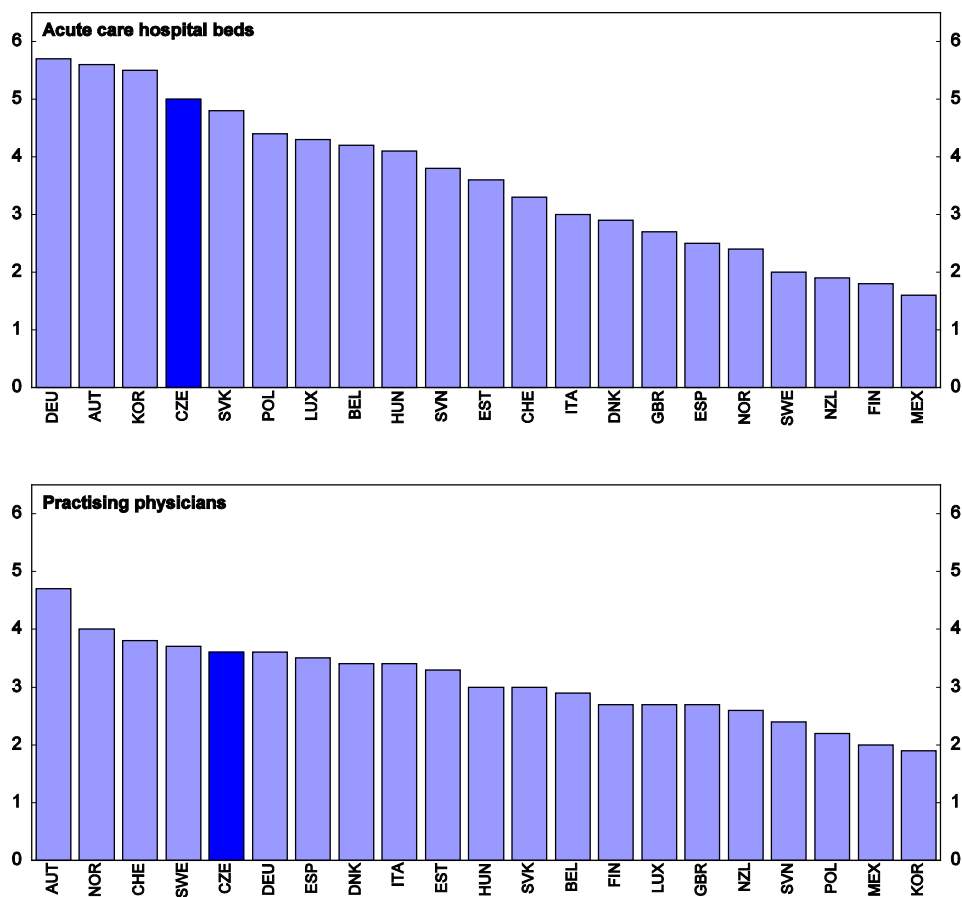
core features of the system, such as risk-equalisation and providers' pay, need to be addressed to avoid that undesirable behaviour by various stakeholders.

***Potential for network streamlining should be seized***

Substantial scope for efficiency exists in the providers' network. Although there has been a 15% decline in hospital beds since mid-1990s, the Czech Republic still stands out in terms of bed capacity, in particular for acute care (Figure 1.13). With an overall 7.3 beds per 1 000 population, it ranks well above the EU and OECD averages of 5.8 and 3.8 respectively. At the same time, the occupancy rate is lower than the OECD average, while the number and average length of stays are high. Moreover, hospital discharges, that measure the number of people who stay in a hospital each year, is high. Hospital discharge, together with average length of stay are important indicators of hospital activities and countries that have greater number of hospital beds also tend to have higher discharge rates (OECD, 2010e). Given that a large share of hospitals are owned by local governments, the reduction of capacity or closing down of wards is often a politically difficult issue. The structure of remuneration of providers also plays a role in maintaining an excessive healthcare network. Up to 1997, hospital services were remunerated via a points-based fee-for-service with *per diem*, which led to a considerable growth in services provided and longer hospital stays (Bryndova *et al.*, 2009). While hospitals are currently paid by a combination of mechanisms that include regressive *per diems*, case payments based on DRG, global budgets and capped fee-for-service for hospital out-patient care, historical volumes and medium-term framework contracts play a decisive role, slowing down adjustment in capacity.

**Figure 1.13. The existing network offers scope for streamlining**

Number per 1 000 population, 2009



*Note:* Practising physicians are university graduates in medicine who provide services directly to patients. Data refers to year indicated or an adjacent year. Refer to source for details of concepts and comparability.

Source: OECD, *Health Database*.

The Ministry of Health can play a bigger role in co-ordinating and planning the network of providers, in particular in relation to the local authorities, who implicitly have large stakes in the network. The ministry should work closely with the insurers, who have data on quantity and quality of providers across the country. Part of the agreement for wage increases in the hospital sector includes the co-operation of stakeholders in reviewing the existing bed capacities at a national level. The authorities have launched a co-operation project with the region of South Moravia looking into bed capacity planning, with the aim of eventual reductions. With just over a million inhabitants, the region has almost 9 000 beds, a half of which are allocated in hospitals managed by the Ministry of Health and by the Ministry of Defence, and a half in hospitals owned and run by the regional administration and municipalities. The first results of the project revealed that over 6% of beds could be eliminated, most of them for acute care. This suggests that a comprehensive review of the national bed capacity would be very useful. Based on its results, the authorities should create a national capacity plan, in particular for the inpatient sector, in co-operation with other stakeholders. Such a plan would be very timely, as the medium-term framework contracts between providers and insurers expire next year and new contracts could be based on the new plan. Furthermore, to stimulate capacity adjustment, part of the remuneration of the hospitals could be linked to compliance with the plan. One way forward that the authorities are hoping to explore is to turn spare capacity into long-term care. Cost efficiency of such change should be carefully examined, as part of preparation of a comprehensive strategy of long-term provision. The population is ageing and residential long-term care has been one bottleneck in the system, resulting in extensive informal home care provision (Ministry of Health, 2010). Moreover, because of traditionally long waiting lists for residential long-term care facilities, hospitals offer expensive long-term in-patient care beyond medical necessity (Bryndova *et al.*, 2009). As a result, there are currently two, to some extent overlapping, types of long-term care in place with differing levels of private participation. There are user charges for every day of hospitalisation, while in the social sector the provider can charge up to 85% of the income, *e.g.* pension of the client. Responsibility for long-term care is split between health insurance and social welfare, each falling under a different ministry, and co-ordination between these ministries, sub-national governments, insurers and providers has been an issue. Therefore, a new concept of long-term care is currently under discussion and can draw on experience of other OECD countries (Box 1.6).

In response to anecdotal evidence of overpriced and unco-ordinated purchases of technical equipment in hospitals, the authorities plan to publish on the internet all purchases above CZK 50 000 (EUR 2 000) and require ministerial approval for purchases over a million CZK (EUR 40 000). This is welcome, but should not apply only to the providers owned by the ministry, which have a relatively small share of the hospitals sector. Such practice needs to be followed thoroughly and extended to the whole sector as a best practice, while providing benchmarks for purchasing managers. Moreover, new equipment needs and resources in the hospital sector could be pooled nationally and linked to the bed capacity plan, once it is agreed by the stakeholders. Efforts to improve the public procurement practices and their transparency, part of *Anti-corruption Strategy*, should have beneficial effects in the health care sector too.



### Box 1.6. Long-term health provision in OECD countries

Population ageing, combined with a trend towards reduced family care in high-income countries and increasing quality expectations, leads to a higher utilisation of long-term formal care in OECD countries. Although the formal sector is still relatively small as a share of GDP across the OECD, its costs are on the rise. In the past decade, long-term care costs have increased in per capita terms at an annual average of over 7% in real terms across 22 OECD countries, which is almost double that of average health spending (OECD, 2010).

Various models are applied, with three broad country clusters identified: a universal coverage model with a single programme; mixed systems and means-tested safety net schemes. As in health care as a whole, what matters is eligibility to coverage, type of benefits provided and the source of financing, as well as cost-sharing arrangements. For example, Germany set up long-term care insurance funds in 1995 that are financed from payroll and income-related contributions. Labour taxation, including social security contributions, is already high in the Czech Republic, so other means of financing would be preferable. Other countries finance long-term care from health insurance or general taxation. While some means-tested approaches have been called into question, in universal schemes, the range of services covered and the level of private participation have been subject to scrutiny. One common trend across the OECD is that countries are shifting in terms of coverage to universal systems, as well as increasing targeting benefits according to income levels and care-need assessments. At the same time, consumer choice and flexibility as to how the benefits are spent have become important policy goals in long-term care.

Source: *Help Wanted? Providing and Paying for Long-Term Care*, OECD, 2011i.

### *Improving care management...*

Another route for addressing efficiencies in the sector is to manage health care demand by introducing care co-ordination. The Czech system highly values freedom of choice. This has clear benefits but does not necessarily promote efficiency (Pearson, 2011). In the absence of any gate-keeping function the number of consultations in the Czech Republic is high: in 2007 only Japan had a higher number of doctors' consultations per person among the OECD countries (OECD, 2010e). While the Czech authorities see a potential for care-co-ordination by the insurers - once a legislative basis is established - OECD countries apply various forms of gate-keeping, mainly centred on the general physicians (GP), to encourage the appropriate use of health services and to guarantee a good follow-up of patients. Gate-keeping is used in single insurer health systems, but it exists also for instance in the Dutch multi-insurance system. Other countries, including Germany, France and Belgium, have introduced "soft" gate-keeping mechanisms, such as financial incentives for referrals, in which for example the re-imbursement rate for a doctor consultation without a referral is lower, thus effectively increasing the patient's co-payment. Special provisions can remove concerns about limiting access in certain situations. Care management does not need to apply to all specialists. For instance, in France certain specialties, such as ophthalmology and gynaecology, are excluded from the referral obligation (Dourgnon *et al.*, 2009).

The current disease burden of the Czech population suggests potential gains can be made from improved care management with focus on prevention. A large share of the disease burden is a result of preventable causes and unhealthy life-styles. Circulatory system disease and malignant neoplasms are two main causes of death (Bryndova *et al.*, 2009). Better chronic disease management is one of recommendations of the NECG's working group on healthcare. Better care management and an increased role of GPs, both in terms of prevention and adequate follow-up, can help to alleviate the disease burden. In theory, prevention should be in the interest of insurers and to some extent this is the case, but it seems that the current risk equalisation in place might not be very conducive to prevention, since insurers receive additional reimbursement for above average cost cases. More broadly, returns on many prevention programmes materialise only in the long term and, since patients can switch insurers, this makes for weaker investment in keeping the insured population base healthy. A gate-keeping system can allow for better prevention programmes management if remuneration of GPs is adequately set, since they would be actively incentivised to keep their patients healthy. For instance, pay-for-performance programmes in the

US and the UK indicate that payment policies linked to quality indicators can strongly influence delivery of healthcare (OECD, 2009).

Implementation of centralised ICT systems, including electronic record keeping and sharing, can significantly improve care management (OECD, 2010c). It has been on the agenda for some quite time now in the Czech Republic, but often becomes a victim of inappropriate tender and technical specifications. Recently, a working group on health care of the NECG proposed the wide ranging use of ICT technologies that should bring efficiency savings, for instance the sharing of patients' electronic documentation in an e-Health system as a condition for providers' pay. Such steps are welcome and could go a long way towards addressing existing inefficiencies, in particular duplicate and unnecessary examinations, provided that adequate security of such information sharing and appropriate resources for implementation are ensured.

### ***... and lower pharmaceutical expenditures to bring further efficiency savings***

While Czechs currently spend around 1.5% of GDP on pharmaceuticals, which is slightly below the EU average of 1.7% of GDP, average annual spending growth on pharmaceuticals outpaced the growth of total health expenditure in the period of 1998-2008 and in a number of OECD countries it has been the fastest growing item. The authorities are therefore rightly planning additional structural reforms to contain increases in pharmaceutical expenses:

- Prescription by international non-proprietary name (active substance) is an emerging best-practice in reducing pharmaceutical costs. Some countries, such as Spain go even further, making generic prescription mandatory. Generic substitution has been allowed in Czech pharmacies since 2008 and currently the authorities plan to introduce positive lists of pharmaceuticals (list of drugs eligible for reimbursement or public funding), determined by insurers' tenders for wholesale suppliers. Such measures should bring savings in the pharmaceuticals' expenditures. However, to contain also out-of-pocket expenditures of households, mandatory active substance prescription should be introduced, subject to tight medical justification in case of deviation.
- An electronic prescription system is planned to improve monitoring of consumed pharmaceuticals. Estonia implemented e-Prescription last year as part of an overall digitalisation of the health care sector. By obliging the pharmacies to dispense generic drugs, which can be easily verified in such system, the e-Prescription aims to decrease spending on costly pharmaceuticals. The electronic prescription system in Sweden contributed to a reduction in call backs and clarifications by the pharmacies to the physicians, a decrease in pharmacy waiting times and greater convenience for patients in terms of centralised overview of their drugs use. However, successful implementation requires a considerable stakeholder backing, technical and security expertise and needs to be clearly identified as a policy priority (OECD, 2010).

### ***Improving insurance funds' incentives by better risk adjustment and payments system***

Among ten European countries with a multi-insurer system, only Germany, the Netherlands, Slovakia and Switzerland have such a wide consumer choice as in the Czech Republic, *i.e.* that population can choose both the insurer and the provider of care. However, unlike in the other countries (except for Slovakia), there is no competition on the premiums and only limited competition in contracting among the providers, although the underlying assumption under a multi-insurer setup is that such competition will be conducive to increasing productivity, reducing costs and improving quality of care. The authorities are therefore striving, despite considerable resistance from various stakeholders, to gradually strengthen competition, while improving regulation aimed at protecting patients' rights.

The experience of other OECD countries shows that regulated competition among insurers does not necessarily promote spending efficiency and achieve cost control (Rosenau *et al.*, 2006). Moreover, Schut (2011) concludes from the reformed Dutch healthcare system that effectiveness of the purchaser competition depend crucially on the success of ongoing efforts to improve performance indicators, product classification and the risk equalisation scheme. Even in the current system, it is important to ensure that proper regulation prevents competition based on risk profile. A risk adjustment mechanism, according to which money is redistributed to the insurers to offset insurance risks, is therefore of crucial importance. The current formula, which covers all revenues collected, is based on 36 age and gender categories. In addition, there is *ex ante* and partial *ex post* compensation for costly care, amounting to 85% of the costs above the average annual client expenditure. Various studies in other countries have shown that gender and age explain only a very small percentage of expenditure variation (Holly *et al.*, 2004; Beck, 2004) and this is also the case in the Czech Republic, where there have been some signs of risk selection (Chalupka, 2009). Hence, it may be highly profitable for insurers to engage in cream-skimming, *i.e.* competing for members with the best risk profile. The Czech authorities plan to improve the risk adjustment mechanism by introducing pharmaceutical cost groups, which is an indicator for out-patient morbidity based on prior use of prescribed drugs. Such a system is applied for example in the Netherlands, where it is complemented by a diagnosis cost group system. Together these two risk adjusters explain more than 20% of the overall variation in annual spending among individuals, although insurers still have a number of tools for risk selection (OECD, 2011j).

Another example of a more sophisticated risk-adjustment formula is to be found in Germany (see Box 1.7). A system of provider remuneration is important for ensuring cost reducing competition in contracting health-care services, and in the German system, remuneration is based on morbidity, in order to channel financial resources in a patient centred way. Diagnosis-related groups (DRGs) have been used since 2004 for in-patient care and standard service volumes are now used for out-patient treatment. The Czech authorities have been implementing DRG for some time now, but so far with limited success, as only 7% of the in-patient care has been contracted this way.

#### Box 1.7. Risk-equalisation

The risk equalisation transfer mechanism was reformed in Germany in 2009 by taking morbidities into account and switching to a prospective system (*i.e.* a payment system under which a provider receives a fixed payment to cover an episode of care during a period of time). In addition to 20 age and 2 gender categories as well as 6 levels of invalidity benefit payments, the burden of 80 diseases is considered, which translates into 106 so-called “hierarchical morbidity groups”. Selection criteria for these were cost-intense chronic diseases or diseases with difficult progress causing above average costs. Doctors, rather than insurers, undertake the morbidity coding. Importantly, patient data with morbidity codes is made anonymous before being sent to a Health Fund, which pools the financial resources and from where risk-adjusted payments are made to the insurers.

An initial assessment of the impacts of the new risk equalisation mechanism is positive overall: incentives for risk selection are likely to have been reduced, as the transfer volume across sickness funds changed tremendously. The newly calculated transfer payments for the sick substantially reduce the financial gap in relation to the full costs. As a result, the sick are no longer only “bad risks”. However, the healthy are still the most profitable members as standardised expenditure transfers are still above their expected health costs. Preventive health care activities pay off, as an insurance fund gains if a member is healthier than the year before.

Source: OECD Health Review of Switzerland, OECD (2011j) (forthcoming).

There is now a renewed effort to extend DRG use, shifting towards prospective payments. The main instrument the authorities have is a so-called reimbursement directive issued annually by the Ministry, which for 2012 will set DGR as the only form of payment for acute care. At the same time, there will be a three-year transitional adjustment period to prevent too sudden changes in the level of resources, under which a provider can lose or gain a maximum of 20% compared with the previous year. The authorities see

implementation of the DRG and emphasis on more competitive contracting by insurers as a cornerstone for reaping efficiency savings in the system. The DRG payment system should indeed be extended throughout the various forms of health care as it can improve incentives for more efficient care provision. However, efforts should be made to prevent up-coding that happens in DGR-based systems, especially in existing cases of vertical integration or alliances between providers and insurers. Maintaining global budgets will be also important since the experience from other OECD countries shows that introduction of DRG has lead to increase in volumes, as hospitals tried to recoup lower payments per case.

### ***Setting the stage for streamlining the basic benefits package***

The authorities plan to exclude some health care services and above-standard services from the basic insurance package as an important step towards clarifying entitlements and containing health-care expenditure increases. Benefits in the Czech system are currently rationed via a negative list of services, a positive list of approved pharmaceuticals and medical and dental aids, a fees schedule (known as list of health services) and an annual negotiation process between the providers and insurers (Bryndova *et al.*, 2009). However, the legislation contains a vague formula about patients having access to the best medical treatment available, so treatments excluded from the positive lists may still be reimbursed depending on individual need. As a result, if an expensive treatment is prescribed, it is covered in full by the public insurance. On the other hand, informal rationing of care and waiting lists are common.

Definition and implementation of the basic benefit package will require systematic analytical work. A recent OECD *Survey* of health care systems shows that most countries guarantee a high level of coverage for acute in-patient care and medical services, as well as for laboratory tests and diagnostic imaging (OECD, 2010d). Dental care and eye products are excluded from the basic benefit package in a number of OECD countries. However, for primary care services, four countries have a level of coverage below 75%: France, Ireland, Korea and New Zealand. In France, the typical share of costs covered for physicians' outpatient services is 60%, while a complementary health insurance, held by 92% of the population, covers virtually all of this cost-sharing. In the medium term, the introduction of partial coverage in the form of standard and above-standard benefits packages in the Czech Republic should also be accompanied by the development of a private health insurance market, to cover private costs for such expenses.

Eventually, since the Czech authorities have opted for a multi-insurer model, there is also a plan to introduce competition on nominal premiums, which has been recommended by the healthcare working group of the NECG. The premiums would consist of two components: a basic one (a percentage of salary) covering public benefits, and a variable one (a fixed nominal fee) covering above-standard services. However, this reform is rather longer term and beyond the horizon of the current government. Moreover, so far there is no clear empirical evidence that competition of this form brings significant and undisputable improvements in terms of patient benefits, efficiency improvements and healthcare cost containment (Roseanu *et al.*, 2006; Frank *et al.*, 2009).

**Box 1.8. Recommendations for improving public spending efficiency**

**Strengthening fiscal framework**

- Establish the responsibility for government to announce a debt target that should be translated into medium term expenditure ceilings and broken down to individual ministries' targets.
- Adopt an independent fiscal institution to increase the credibility of the existing framework. The institution should assess the budget in light of the cyclical position and medium-term fiscal objectives.

**Promoting spending efficiency through budgetary management and control**

- Improve transparency of budgetary documentation. Introduce performance oriented budgeting for the state budget, extending such an approach eventually also to sub-central governments. Promote wider use of *ex ante* and *ex post* cost benefit analysis. Include a regular tax expenditures report in the annual draft budget proposal in order to increase transparency and evaluation of public spending.
- Given constitutional independence of the municipalities, further initiatives to foster inter-municipal co-operation and joint provision of services should be actively promoted. Consider introduction of an "internal stability pact" that sets borrowing limits on local budgets. Publish cost and efficiency indicators on sub-central governments and benchmark their performance.
- Implement plans for substantial changes to the public procurement law and establish a central purchasing authority.
- Improve corporate standards and transparency of state owned enterprises, considering partial privatisation and listing, or consolidating all corporate state holdings under one roof with a professional management.

**Reforming pension system**

- The pace of retirement age increases should be kept in line with changes in life expectancy.
- Consider a centralised clearing house for pension plans to keep the administrative costs down of the proposed defined contribution tier. Make life-cycle investment strategy a default plan for participants. Offer annuities as the default in the pay-out phase. Consider scaling back support for the third pillar.
- Improve financial literacy and awareness of the population. Prepare regular reports on pension prospects to inform the public about their future retirement incomes.

**Improving health spending efficiency**

- Implement a diagnosis-related group payment system to strengthen cost-consciousness among providers.
- Conduct a national review of in-patient capacity and prepare a national capacity plan that would guide medium-term contracts with providers, as well investments and equipment purchases.
- Introduce compulsory active substances prescription as well as an electronic prescription system to reduce drug expenditures. Stimulate co-ordinated purchases and auctions of drugs and other supplies.
- Introduce soft gate-keeping to improve care management.
- Implement plans for e-Health while ensuring adequate security and resources for implementation.
- Improve risk-adjustment formula among insurers by implementing pharmaceutical drug groups.
- In the medium term, work towards a definition of the basic package of health care paid for by public system, while developing a private insurance market to cover expenditures outside the basic package.

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