APRIL 2010 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of the Czech Republic, 2010

Summary

The Czech economy was severely affected by the global downturn, owing to its high degree of openness and integration in global production chains. The fiscal position was also hit hard, prompting a rapid shift in policy from stimulus to consolidation. The medium-term challenges facing the country are principally concerned with creating conditions for rapid convergence with advanced OECD economies by restoring the sustainability of public finances and improving the business environment:

- **Executing an ambitious medium-term consolidation strategy.** The government should outline a clear medium-term plan to achieve a structural balance close to zero. Consolidation efforts will need to be underpinned by structural reforms and should aim at an appropriate balance between safeguarding the revenue base, exploiting the potential for efficiency savings in spending programmes and containing expenditure growth. This should form the cornerstone of a broader strategy to prepare the economy for entry into the euro area.
- **Addressing risk diversification in healthcare and pensions.** Further reforms in healthcare and pensions are needed to assure long-run fiscal sustainability in the face of spending pressures generated by population ageing. There have been promising starts on both but more needs to be done, particularly to diversify the sources of retirement income.

The tax and benefit systems have both undergone significant reforms in recent years. While many of these changes are to be welcomed, some policy challenges remain:

- **Shifting the tax burden onto less distorting taxes.** More can be done to move towards greater reliance on indirect taxes, particularly consumption, environmental and property taxes, rather than direct taxes on labour and capital income.
- **Better co-ordination of tax and benefit policies.** Undesirable interactions between tax and benefit systems sometimes arise because policies in the two domains are not well co-ordinated. More systematic analysis of such interactions could help avoid such problems.

This Policy Brief presents the assessment and recommendations of the 2010 OECD Economic Survey of the Czech Republic. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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- **Eliminating other distortions in the taxation of labour and capital.** Labour-market behaviour is distorted by the differential treatment of dependent employees and the self-employed, while investment patterns are affected by corporate income tax provisions that favour particular asset classes and sources of investment finance over others.

Steps to reduce the regulatory burden offer a way to reduce the cost of doing business – and thus relieve the pressure on the enterprise sector – at little or no fiscal cost:

- **Further reducing rigidities in product and labour markets.** Despite recent reforms, much remains to be done to reduce entry barriers in product markets, strengthen competition, particularly in network sectors, and relax labour-market regulation.
- **Pressing ahead with regulatory reform.** Efforts to relax labour- and product-market regulation should be underpinned by greater consistency in the implementation of regulatory policies, with particular emphasis on administrative simplification and effective regulatory impact assessment.
- **Further development of e-government initiatives.** Increased reliance on e-government methods could make a significant contribution to the achievement of these objectives. ■

How has the Czech economy weathered the crisis?

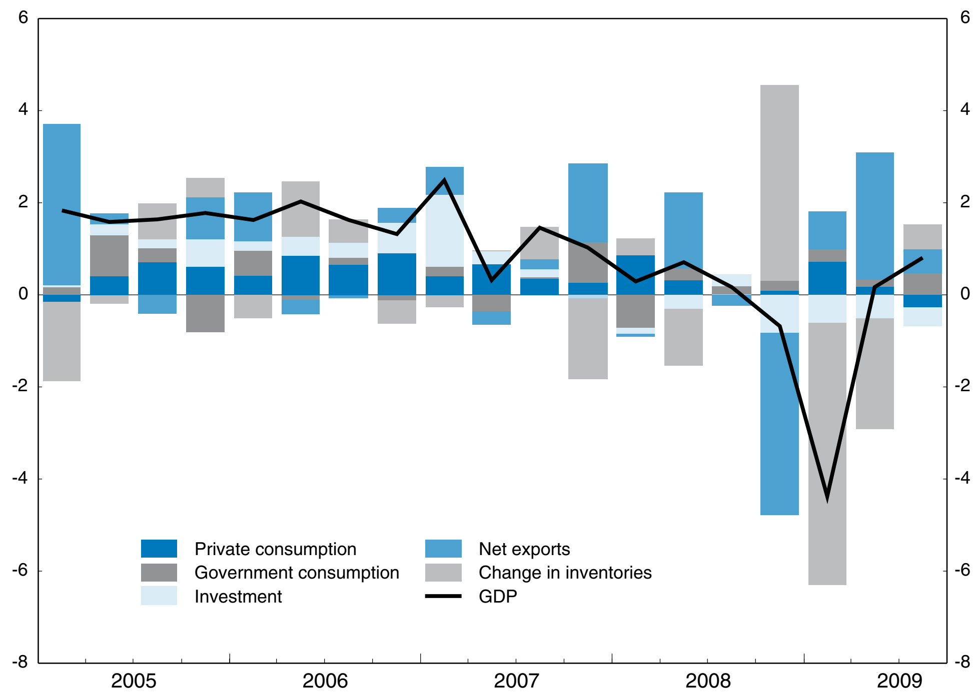
After several years of growth averaging close to 6% *per annum*, the economy slowed markedly in 2008, entering a sharp recession in the fourth quarter. Real GDP is projected to have fallen by 4.1% in 2009. This reflected the collapse of world trade that followed the onset of the global financial crisis. The economy's integration in international supply chains, particularly its specialisation in the export of consumer durables and capital goods, made it vulnerable to such a global trade shock. The trade collapse quickly triggered a contraction in domestic demand, especially fixed investment. Private consumption growth turned negative in the third quarter of 2009, as households responded to rising unemployment and a sharp slowdown in wage growth. On the production side, most major sectors contracted, with tradables suffering the most. Manufacturing alone accounted for around half the total drop in gross value added, and service sectors linked to the cycle in manufacturing, like trade and transport, were also hit hard.

Real GDP turned around in the second quarter of 2009, driven by a slight pick-up in exports against a backdrop of falling imports and decelerating consumption. The export recovery seems to have owed much to the adoption of car-scrapping schemes and other measures to support the automobile sector in major export markets. Overall, the strength of the recovery will depend chiefly on the growth of world trade. Domestic demand will remain weak, with government consumption constrained by the need to bring down the budget deficit and private consumption growth depressed by rising unemployment, a bleak outlook for wage growth and the impact of fiscal consolidation measures.

Although growth has resumed, the consequences of the recession for employment and living standards are still unfolding. Unemployment surged in the first quarter of 2009, which saw the largest one-quarter increase in joblessness since the early 1990s, and reached 7.3% in the fourth quarter. It would probably have risen higher still but for widespread use of the unsubsidised and collectively agreed "partial

Figure 1.

QUARTERLY CONTRIBUTIONS TO GROWTH



Source: OECD, *National Accounts Database*.

unemployment" provisions introduced into the Labour Code in 2007 (essentially a short-time working regime). The evidence suggests that nominal wage flexibility also played a part in the labour-market adjustment. While the employment impact of the recession was and remains painful, the response so far suggests that the labour market has become more flexible in recent years.

The banking sector appears to have come through the downturn in reasonably good shape, although bank portfolios are yet to feel the full impact of the financial consequences of the contraction. Credit conditions grew tighter, particularly for households and borrowers in struggling sectors like construction. While interest rates on new loans to households rose, the tightening of credit to non-financial firms appears to have taken the form of tougher non-interest conditions. Interest rates on new loans to business actually fell slightly, but the decline was far smaller than the drop in the Czech National Bank's (CNB) policy rate. Banks increased risk premia rather than passing on policy-rate cuts to borrowers. This helped them to recapitalise so as to cope with the growth of non-performing loans.

The resilience of the banking system reflected a number of factors, including prudent macroeconomic management and market structure. Low inflation and interest-rate spreads meant that there was little incentive to borrow in foreign currency. In addition, Czech banks had pursued fairly conservative strategies, reflecting both the lessons drawn from past banking crises and their ability to make healthy profits from "normal" banking business. Their net external investment position was and remains positive, with domestic lending financed by the domestic deposit base. Finally, as subsidiaries of foreign banks, most Czech banks did not invest in "toxic" assets, even if their foreign parents did so.

With inflation falling and the koruna near historically high levels, the CNB began to ease monetary policy in August 2008, cutting its main policy rate in stages by a total of 275 basis points over sixteen months to a historic low of 1.0%. It also responded to the turmoil in international financial markets in the autumn of 2008 by introducing a new facility for providing liquidity to banks, with the option of using government bonds as collateral. In the end, this facility was little used, and no bank required any direct public support. A significant weakening of the koruna against other major currencies in late 2008 and early 2009 also provided some relief to the tradable sector, although it was by no means sufficient to offset the collapse in external demand. Moreover, for many firms, the currency's volatility in 2009 was more of an issue than its level. ■

How to achieve fiscal sustainability?

In an effort to address the unfolding crisis, the government in late 2008 and early 2009 adopted a range of fiscal stimulus measures amounting to about 2.2% of 2008 GDP, spread across 2009-10. The failure to pursue fiscal consolidation more vigorously during the years of strong growth that preceded the crisis meant that there was no fiscal space for any larger stimulus. The authorities in any case recognised that, in such an open economy, using fiscal policy to stimulate aggregate demand would not be effective. The stimulus measures therefore primarily targeted the supply side. They were aimed at limiting employment losses by reducing non-wage labour costs, mitigating the investment contraction and supporting exports by providing guarantees, which were becoming increasingly unavailable due to dysfunctional global financial markets.

As the year unfolded, the budget balance deteriorated faster than had been anticipated. By the third quarter, the government was projecting deficits of 6.6% for 2009 and, if corrective action were not taken, over 7% for 2010. This raised the prospect of significant increases in the government's cost of borrowing and of a crowding-out effect that could inhibit the recovery of private investment. The government responded with a fiscal consolidation package ahead of the 2010 budget. On balance, the decision to withdraw from fiscal stimulus relatively early is to be welcomed. Domestic fiscal tightening is unlikely to be decisive with respect to the sustainability of the recovery, which depends chiefly on developments in external markets.

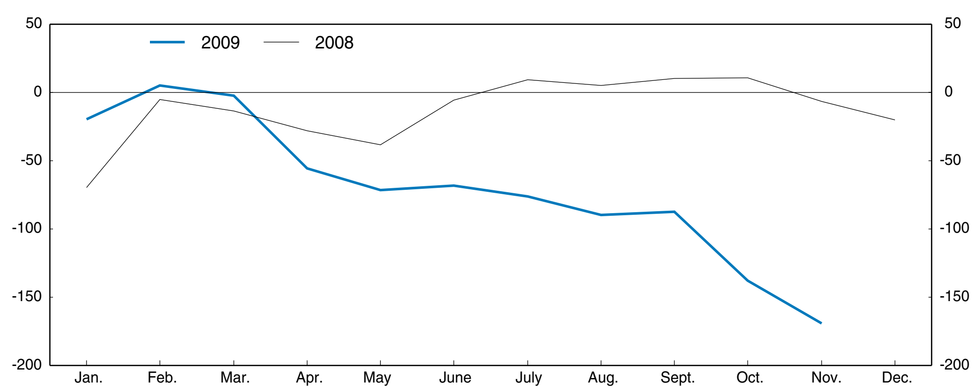
The consolidation package was largely limited to 2010, because the government in office was a caretaker cabinet appointed following the fall of the previous centre-right coalition. While the revenue measures adopted were of indefinite duration, changes on the expenditure side were confined to the coming year. One of the most important challenges for the government in 2010 is to formulate a credible multi-year strategy for fiscal consolidation. The measures for 2010, like past Czech consolidation efforts, were heavily weighted towards the revenue side, partly in an effort to make up the revenue losses experienced in the wake of the crisis. However, a good deal of cross-country empirical work suggests that consolidation is both more likely to be sustained and less likely to depress growth if it is based on spending restraint. There is also evidence to suggest that a substantial share of public spending in the Czech Republic is inefficient. Consolidation plans for 2011 and beyond should thus place greater emphasis on the expenditure side of the budget. Reducing the deficit from an estimated 6.6% of GDP in 2009 to a level below the Maastricht Treaty threshold of 3% of GDP as required under the EU's Excessive Deficit Procedure will be an important milestone but is not a sufficient goal for fiscal policy. Ultimately, the government needs to aim for a structural balance close to zero to ensure long-run fiscal sustainability and retain the capacity to rely on discretionary fiscal measures or automatic stabilisers to offset future shocks. The adoption of a structural indicator of the budget balance would strengthen the current system of nominal expenditure ceilings and would also increase the transparency of fiscal policy. The authorities may also wish to consider the examples of some other OECD member countries, which have adopted constitutionally entrenched fiscal rules.

While legislative change will be needed to bring about structural spending reductions in many areas, aspects of expenditure policy that are under the government's direct control can be addressed relatively quickly. Reforms to the budgetary process, particularly as regards rigorous *ex ante* and *ex post* scrutiny of

Figure 2.

CUMULATIVE FISCAL BALANCES, 2008 AND 2009

Central budget, CZK bn



Note: Balance is revenue minus expenditure.

Source: Ministry of Finance, Government Financial Statistics.

expenditure programmes, improvements in budgetary transparency and overhaul of public procurement practices are long overdue and could pay significant dividends in coming years. The speedy implementation of plans to shift to a treasury system of budgetary management should also be regarded as a very high priority. The unified accounting and real-time financial management that the treasury system will bring should yield direct savings, by reducing debt-service costs and administrative overheads, and should also make it easier to identify where there may be scope for further streamlining of expenditure. Since social spending represents the largest share of non-discretionary expenditure it will also have to be addressed. A review of social spending should be undertaken, with particular attention to whether some benefits that are not income-tested should be phased out at higher incomes. Some savings and revenue increases should also be generated by reforms of tax collection and further steps to improve tax compliance (see below).

In view of the fiscal situation, adoption of the euro can only be a medium-term prospect and will depend in part on economic and fiscal developments that are hard to predict at this point. The Czech Republic is unlikely to bring its deficit back below 3% before 2013, and the target date for entry will depend crucially on when this goal is reached. The previous government had planned to set a date in 2009, but domestic political developments and the economic crisis meant that this did not happen. As economic conditions normalise and the recovery takes hold, the next government should revisit the issue. After the policy zigzags, economic turmoil and exchange-rate volatility of the last two years, clarity about meeting the conditions for euro accession, even if it is a medium-term objective, would help reduce uncertainty for business. It would also help anchor expectations and mobilise political capital for a sustained fiscal consolidation effort and other structural reforms. The authorities should therefore outline a clear strategy to put in place on a sustainable basis the conditions for euro area entry. ■

What can be done to address the long-term fiscal consequences of population ageing?

Ensuring long-term fiscal sustainability remains a serious challenge, owing chiefly to the fiscal consequences of rapid population ageing. The ratio of age-related spending to GDP is projected to rise by 6.4 percentage points over the period to 2060. In the absence of policy change, the Ministry of Finance estimated even before the crisis that this would push the public debt past 60% of GDP shortly after 2040, rising to 250% of GDP around 2060. Post-crisis debt dynamics look even worse. Two areas – healthcare and pensions – account for the largest part of this growth, with the latter by far the more important. Largely parametric reforms in these two areas have been initiated in recent years.

Recent legislation extending the increase in the retirement age will do much to fend off the threat of looming increases in pension spending, but on current projections pension expenditure is still set to rise from around 7.8% of GDP in 2007 to roughly 11% by 2060. Tackling this challenge without imposing large – and possibly unsustainable – increases in social security contributions or other taxes is likely to require a combination of both further parametric adjustments to the system and structural changes. A first step would be to take the recent changes in the retirement age further by phasing out the differentiation of women's retirement ages. The possibility of instituting partial indexation of the retirement age to life expectancy should also be considered. Increasing labour-force participation among groups with high benefit-recipiency rates, as well as policies to boost labour supply, such as migration policy, could also help to address this problem.

The previous government's pension reform plans envisaged the creation of a voluntary, fully funded, defined-contribution "second pillar" to the pension scheme, which would be financed by allowing individuals to divert a portion of their pension contributions from the "first pillar" – a public pay-as-you-go (PAYG) defined-benefit system – to private pension funds. They would be required to top up this "carve out" with further contributions of their own. These plans are currently stalled, and recent turmoil on financial markets may have made it politically harder to win public support for funded schemes. Nevertheless, the case for diversification of retirement income sources remains as strong as ever, and the introduction of the second pillar would be a welcome step in this direction. However, given the highly redistributive nature of the first pillar, a voluntary carve-out could undermine its financial sustainability. The better paid would face very strong incentives to take the carve-out option, because the first pillar offers them much lower returns on their contributions than it does the low paid. The next government should resume work on the second pillar and should consider making it mandatory or, at the least, using "soft compulsion" by requiring individuals to opt out of it rather than into it. The regulatory framework will need to be designed so as to balance return considerations, income security and the need to minimise financial overheads.

Ambitious plans for healthcare reform have largely stalled, following a political backlash against the introduction of small user fees for doctor consultations, prescriptions, emergency-room visits and hospital stays in 2008. There has been limited progress in respect of other aspects of healthcare reform, such as changes in price-setting for pharmaceuticals or liberalising the rules that govern negotiations between insurers and healthcare providers. The benefits of these measures have yet to be seen. Other planned changes, such as improvements in the definition of the basic healthcare package provided by the public system and increases in the diversity of insurance products on the market have not been adopted at all. The government should revitalise the healthcare reform process, moving ahead with plans to redefine the basic publicly provided healthcare package and allow greater diversity of insurance products. It should also move to eliminate distortions in healthcare markets created by regional authorities' *ad hoc* tinkering with the system of user fees. ■

What should be the main priorities for pro-growth tax reform?

While fiscal consolidation efforts should focus more on the expenditure side than hitherto, it is likely that further revenue measures will also be required as part of the adjustment. It will be important, therefore, to identify the revenue sources that are least distorting and least damaging to growth. Setting out a clear path for tax policy, with well defined goals, would enhance the transparency and predictability of policy during this period. Given that the labour tax wedge is still relatively large and that the tax system overall still relies very heavily on the direct taxation of labour and capital income, new revenue measures should focus on indirect taxes, particularly the taxation of consumption and property rather than income.

- The Czech Republic relies less on the taxation of real property than any other OECD member. Yet property taxes are among the least distorting revenue sources available. They are also relatively difficult to evade and less cyclical than income taxes. The real estate tax should be increased by raising tax rates and linking the tax base to actual market prices.
- The two-tier VAT should also be reviewed. It creates market distortions and complicates administration. Yet as a means of helping those on low incomes it is extremely inefficient: households with median income or higher receive around

60% of the tax benefits of the two-rate system. VAT should be levied at a unified rate, with exceptions and exemptions reduced to a minimum. Distributional concerns should be addressed by direct transfers.

- Finally, although the recent tax reform package marked a first step in environmental tax reform in the Czech Republic, considerable scope remains for more progress in this direction. The next government should follow through with plans for further environmental tax reform, including the introduction of a greenhouse gas emissions tax and a transition from free allocation to auctioning emissions permits under the Emissions Trading Scheme.

The steady reduction in the statutory rate of corporate income tax (CIT) has itself helped to reduce some of the distortions that exist in the system of capital taxation. However, the Czech CIT is still less neutral between forms of investment finance and asset types than many in the OECD. Specifically, it tends to favour debt-financed investment very heavily, as compared with investment financed by new equity, and the effective taxation of investment in new machinery tends to be unusually low compared to investments in most other assets. The CIT and/or the dividend tax should be revised to reduce, if not eliminate, the disparities between the tax treatment of different sources of investment finance. At the same time, the neutrality of the CIT with respect to investment in different types of assets should also be increased. This may require revision of depreciation schedules and of targeted investment incentives now written into tax legislation. ■

How to eliminate perverse interactions between taxes and benefits, and other distortions in labour taxation?

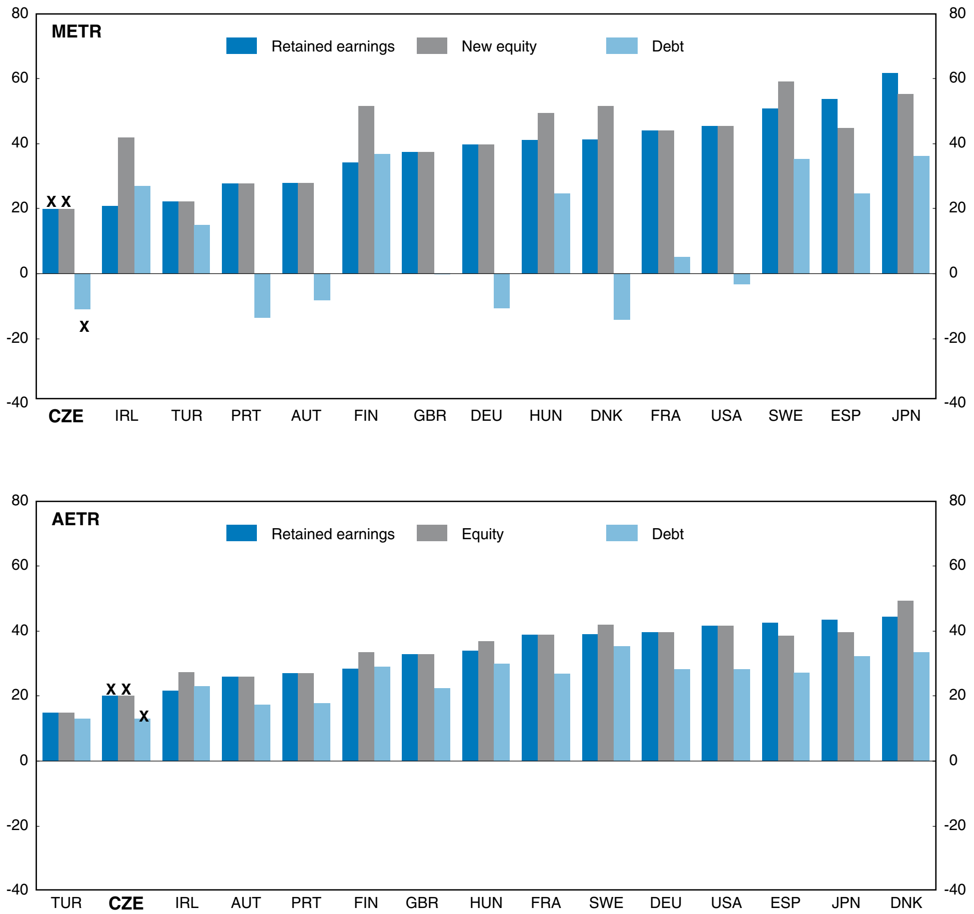
While the tax changes of 2008 increased work incentives, the interaction of tax and benefit systems remains an issue. An analysis of tax-benefit interactions suggests that the Czech Republic has made considerable progress in addressing inactivity traps since 2006. However, some groups still face very high average effective rates of taxation, which discourage activation, or very high marginal effective rates, which reduce the incentives for individuals to increase their labour supply. Where possible, the remaining spikes in marginal effective tax rates should be reduced or eliminated, by smoothing the withdrawal of some benefits as income rises, particularly unemployment benefit and living allowance, and by gradually withdrawing the spousal tax credit as the second earner increases earnings. Family benefits are the area where tax-benefit interactions create the largest – and, in recent years, increasing – disincentives to work. Parental allowances and other benefits available to families with young children reflect the Czech authorities' preference for family-based childcare and are therefore heavily tilted towards de-activating parents for relatively long periods. A comprehensive review of the tax and benefit system provisions as they apply to families with dependent children should be undertaken with a view to making it easier to combine work and family life, and making the system more neutral with respect to parents' choices about how to do this. Problematic tax-benefit interactions partly reflect the fragmentation of policy making, with different ministries handling taxes and benefits. At a minimum, tax and benefit policies should be systematically co-ordinated with one another. The government may want to consider using a tax-benefit model to analyse systematically the tax-benefit interactions that arise when policies change.

Some distortions in labour taxation still need to be addressed. Perhaps the most important concern the tax privileges enjoyed by self-employed persons. These create incentives for employers to declare many *de facto* dependent employees to be self-employed contractors. Steps should be taken to reduce the disparities in the tax treatment of dependent workers and the self-employed. Secondly, given that the fiscal situation limits the scope for further reductions in the labour tax wedge at present, priority should be given to reducing the tax wedge on the low paid, where the evidence suggests the employment effects of a reduction would be greatest. Targeted reductions in social security contributions for low-wage jobs should be considered. These could be financed in part by eliminating the current anomaly whereby individuals with earnings above the cap on social security contributions face steadily declining average effective rates of tax on personal income. This could be done either by eliminating the cap on social security contributions for very high earners or by introducing a higher-rate income-tax bracket for earnings above the cap. Although such a change would affect only a small number of people, it would eliminate an arrangement that is troubling in terms of equity and unlikely to have any impact on labour supply. ■

Figure 3.

EFFECTIVE CORPORATE TAX RATES

%



Note: The marginal effective tax rate (METR) is defined as the difference between cost of capital and post-tax real rate of return. The average effective tax rate (AETR) is a measure of the present value of taxes paid, expressed as a proportion of the net present value of the income stream. For further details see Devereux *et al.* (2008). The METR applies to a marginal investment which earns zero economic rent, whereas the AETR applies to a discrete investment with economic rent. The graph shows effective rates based on the assumption of a non-qualified zero-rate shareholder. Rates are simple averages over the different types of assets. Simulations refer to the system in 2009 and 2007 (symbol X) for the Czech Republic, and 2007 otherwise. Ranking is by retained earnings.

Source: Project for the EU Commission, TAXUD/2005/DE/3 10, Centre for European Economic Research (ZEW).

What can be done to improve the business environment as the recovery takes hold?

Tax reform would be incomplete if it did not address administration and compliance costs. There is considerable scope here for changes to benefit both taxpayers and the state. Since the complexity of the tax system arises chiefly from exceptions and exclusions in tax legislation, a systematic accounting of tax expenditures would provide a basis on which to serve both simplification and equity goals while pursuing tax reform and fiscal consolidation. The planned integration of collections into a single agency should lead to palpable savings for taxpayers and the budget. The gains from doing so will be all the greater if the integration and streamlining of tax administration is accompanied by greater harmonisation and simplification of tax bases and definitions. The definitions and tax bases for the personal income tax and social security contributions should be further harmonised and simplified. Plans to integrate the collection of taxes, customs and social security contributions should be swiftly implemented.

The Czech Republic has recently made substantial progress in reducing start-up costs for both new companies and sole proprietors, and simplifying a wide range of basic legal procedures, from property registration to insolvency. However, more can be done to streamline product-market regulation. In particular, although start-up procedures have become much faster, the costs remain comparatively high, owing largely to the relatively high level of minimum capital requirements for new companies. The next government should consider lowering these amounts, while examining other aspects of the entry process to identify factors contributing to excessive fees.

There are competition issues to be addressed in specific product markets. In electricity, gas and telecommunications, the evidence points to the need for continued vigilance against possible exploitation of market power by dominant players. In food retailing, the threat to competition comes from the Act on the Abuse of Significant Market Power in the Sale of Agricultural and Food Products adopted in 2009. Though ostensibly aimed at curbing the "buyer power" of supermarket chains *vis-à-vis* small agricultural producers, the Act is likely to create legal confusion, distort competition and raise prices for consumers. Moreover, it may even have the perverse effect of deterring supermarkets from contracting with the small suppliers the Act is meant to help. The Act should be repealed.

As noted above, the labour market proved more flexible in the downturn than many had anticipated. However, a number of indicators, including persistent long-term unemployment and the widespread use of phoney self-employment to evade labour regulations, point to continuing rigidities arising from the Labour Code and other regulations. At a minimum, notice period and severance pay arrangements ought to be linked to the length of service. The Code's provisions concerning fixed-term and other non-standard work contracts could also be liberalised. Housing-market policies that create barriers to labour mobility should also be reconsidered.

The government has adopted a range of regulatory reform policies in an effort to reduce the burden of regulation on businesses and households. Initiatives such as the drive to reduce administrative burdens using the Dutch Standard Cost Model and the introduction of regulatory impact analysis (RIA) are welcome. The Czech framework for RIA compares favourably with those of other OECD members, and many dimensions of regulatory reform are increasingly supported by a range of e-government initiatives now being introduced. However, implementation of regulatory reform – and of RIA, in particular – has been uneven. While a number of specific steps can be taken to strengthen the application of these, the main problem lies in failure of many line ministries to implement the reforms. The vesting of responsibility for regulatory reform with a pair of line ministries is part of the problem: they are not well positioned to bring other ministries into line when non-compliance issues arise. The government should consider establishing a strong institution at the centre of government to drive regulatory reform across the whole of the public administration.

Evaluations of the business environment continue to highlight corruption as a major problem. While there has been some evidence of progress in recent years, not least in conjunction with increasing reliance on e-government methods, more needs to be done, particularly to address corruption in public procurement. The next government should pursue further steps to enhance the transparency and competitiveness of public procurement procedures, while strengthening the mechanisms that allow bidders to challenge questionable procurement practices in a timely and efficient manner. The authorities should also institute liability of legal persons and explore ways to strengthen whistleblower protection. ■

How to increase policy coherence?

In recent years, policy in many domains seems to have been characterised by frequent changes of direction and by difficulty in ensuring a co-ordinated approach to policies that cut across the divisions between government ministries or between central, regional and municipal authorities. The independence of individual ministries and the lack of a strong institutional centre capable of ensuring unity in approach and consistency in implementation present a particular challenge when policy reform requires a whole-of-government approach, like regulatory reform or fiscal consolidation. These difficulties reflect such diverse factors as the country's administrative traditions, the nature of the political system and the constitution. However, they are not insoluble problems. OECD governments are structured in a wide variety of ways and they have likewise evolved a wide range of mechanisms for ensuring policy coherence and fiscal discipline. A number of member countries achieve these objectives even in environments characterised by complex political coalitions, minority cabinets and a centre of government with relatively limited authority. Policy makers could profitably explore the potential for similar solutions to bring results by, for example, creating a fiscal council or similar institution to strengthen adherence to a rules-based framework for fiscal policy. In terms of structural policy, mechanisms to strengthen high-level communication and co-ordination across ministries are needed in order to establish greater stability and coherence in policy making; here a council of chief economists, bringing together the top economists of the various ministries could have a role to play. Changes in the internal organisation of ministries may be needed to facilitate such co-operation. ■

For further information

For further information regarding this *Policy Brief*, please contact:
William Tompson, e-mail: william.tompson@oecd.org, tel.: +33 1 45 24 15 76; or
Zuzana Šmídová, e-mail: zuzana.smidova@oecd.org, tel.: +33 1 45 24 87 23; or
Andreas Wörgötter, e-mail: andreas.woergoetter@oecd.org, tel.: +33 1 45 25 87 20; or
see *www.oecd.org/czech*.

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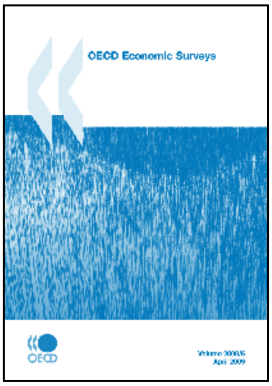

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Where to contact us?

OECD HEADQUARTERS
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: *www.oecd.org*

GERMANY
OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail: berlin.centre@oecd.org
Internet: *www.oecd.org/berlin*

JAPAN
OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: *www.oecdtokyo.org*

MEXICO
OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail: mexico.contact@oecd.org
Internet: *www.oecd.org/centrodemexico*

UNITED STATES
OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail: washington.contact@oecd.org
Internet: *www.oecdwash.org*
Toll free: (1-800) 456 6323

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