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Czech Republic

Robert Jahoda
Ivan Malý
Tomáš Sirovátka



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Contact: Giulia Pagliani

E-mail: Giulia.PAGLIANI@ec.europa.eu

European Commission

B-1049 Brussels

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**ESPN Thematic Report on
Financing social protection**

Czech Republic

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Robert Jahoda, Ivan Malý, Tomáš Sirovátka, Masaryk University

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Summary

Compared to the EU average of 28.2% of GDP, Czech social expenditure was about one-third lower (18.9% of GDP) in 2016. The low level of expenditure was relatively stable between 2005 and 2016. In the long term, increasing expenditure on the old-age and sickness/health functions takes resources away from the other functions.

Funding of the social insurance system has been very stable over time in the Czech Republic. Almost three-quarters of social protection expenditure was financed from social security contributions in 2016; the fourth quarter was financed by the general government. Social security contributions are paid by employees and employers, the proportion of payments being approximately 1:3. The contribution rate payable by the self-employed corresponds to the sum of the rates payable by the employee and the employer. The payment of contributions has no floor, except for the self-employed. In 2008, ceilings on social security payments were introduced. The biggest part of social protection expenditure is connected with old-age pensions: their share increased from 37.3% of all social protection expenditure (2005) to 43.7% (2016). Old-age benefits are financed mainly from social contributions (82.5% in 2015). The healthcare insurance rate has been stable for a long time, despite the fact that the system regularly produces a structural imbalance between income and expenditure. Non-contributory benefits (family-related benefits and social assistance) are financed from tax revenues. In the Czech system, tax relief is an essential source of support for families with children. The most relevant development after 2008 has been an increase in the child tax credit.

Financing through social insurance contributions has a major impact on the tax costs of labour that increase the overall costs of labour. Fortunately, the Czech Republic is still a converging economy, with low labour costs. A strength is that this keeps the funding system transparent and deterministic: an increase in spending is only possible if revenue increases. This keeps most systems (structurally) balanced in the long run. One weakness is that a change in the system's revenues determines the amount of expenditure. The way in which pension benefits and healthcare standards are discussed in connection with changes in incomes due to the economic cycle can be instructive. Different tax expenditure has a mixed impact on the labour market. In the pension system, there is a mismatch between the relatively flat rate of the pension benefit and the contributory payments. The pension rights of workers in arduous and hazardous jobs have long failed to be adequately addressed. As regards the healthcare system, there are significant disparities between the average contributions of employees and the self-employed: the base for calculating the contributions of self-employed earners corresponds to only 50% of their profits. The state still pays too little for state-insured persons. The existing mix of financing options does not create any incentives for health promotion.

Our recommendations include:

- general recommendations: to start a national debate on the composition of funding sources for social protection; to limit the impact of economic performance on the (pro-cyclical) debate on the expenditure of the social system;
- taxation: to limit the impact of a growth of tax costs on total labour costs, with a primary focus on lower-income taxpayers; to periodically re-evaluate the child tax credit; to consider abolition of the low-income spouse tax credit and a tax rebate on a spouse and reallocate the amount of today's relief to other (benefit) instruments;
- pension system: to separate the financing of the pension system from the state budget; to consider rebalancing the calculation of the pension benefit, so that the flat basic amount is financed to a greater extent from general taxes; to address the issue of retirement of the group of workers in arduous or hazardous jobs, while having employers more financially involved in this change;
- healthcare: to increase patients' co-payments for routine and not very serious services; to reflect health-risk behaviour in the calculation of contribution rates; and

to devote, at least partly, some revenue from the Pigouvian 'corrective' taxes (mainly the tobacco tax) to fund payments for state-insured persons.

1 Current levels and past changes in financing social protection

1.1 Overall developments

The Czech Republic keeps social protection expenditure consistently low. Compared to the EU average of 28.2% of GDP in 2016, Czech social protection expenditure was about a third lower (18.9% of GDP). Net social protection expenditure is nearly identical to gross social expenditure: the level of net social protection expenditure was less than 0.1 percentage points (pp) lower in the years 2007-2015, while in the EU the difference was 2.2 pp in 2015.¹ The reason is that social protection benefits are not subject to taxation, except the highest pensions (this affects about 1-2% of pensioners).

The share of social protection expenditure in GDP is relatively stable over time. Between 2005 and 2016, the share of social protection expenditure in GDP increased by only 0.9 pp, while there was an increase of 2.2 pp, on average, in the EU (see Table 1). A more remarkable increase is, however, apparent between 2008 and 2010: from 17.9% to 20%. This increase is due to the financial and economic crisis, and is mainly an effect of the 4.8% negative GDP growth in 2009 (in consequence, the share of social expenditure automatically increased), and also of increased expenditure compensating for the impact of the crisis, such as increased numbers of the unemployed and early retirees.

Table 1. Social expenditure 2005-2016 (in constant prices and as a percentage of GDP, structure of social expenditure)

	2005	2008	2010	2016	EU-28 2005	EU-28 2016
Total in constant prices 2005=100	100	111	120.3	127.3	100	122.6
Total % GDP	18.0	17.9	20.0	18.9	26.0	28.2
of which (total = 100%)	100	100	100	100	100	100
sickness/health	34.3	31.9	31.1	32.4	28.5	29.5
old age	37.3	40.3	41.8	43.7	38.6	40.1
other:	28.3	27.8	27.1	23.9	32.7	30.4
- disability	7.6	7.9	7.5	6.4	8.0	7.4
- survivors	4.2	3.9	3.6	3.3	6.7	5.5
- family	10.0	11.4	10.3	8.8	8.4	8.7
- unemployment	3.5	3.4	4.0	2.6	5.8	4.6
- housing	0.4	0.3	0.6	1.4	2.0	2.2
- social exclusion	2.7	0.9	1.1	1.4	1.8	2.2
means-tested benefits in other (all items above)	5.3	2.0	1.9	2.7	10.3	12.1

Source: Spasova and Ward (2019), Annex ESSPROS tables.

If we look at the development of expenditure in constant prices, there was an 11 pp growth between 2005 and 2008, due to the increases in expenditure on the old-age function and improvements in family-related benefits, such as the increased parental benefit. Between 2008 and 2010, the growth of expenditure in constant prices was again 9 pp, due to demands for compensation resulting from impacts of the crisis (see above). Between 2010

¹ Statistical annex on financing social protection: levels and structure (2005-2016).

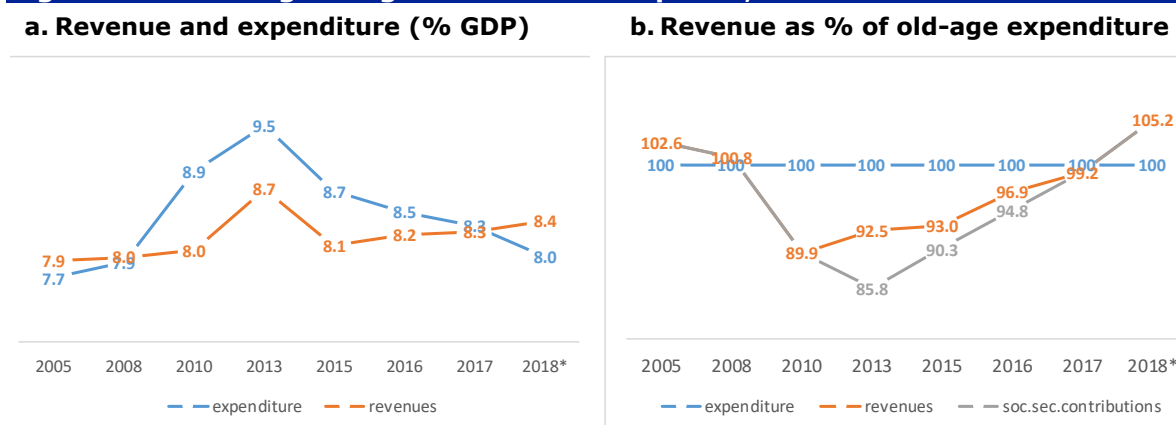
and 2013, expenditure in constant prices dropped slightly (by 0.9 pp), due to the effects of the austerity package implemented by the centre-right government with the aim of balancing the public budget under the Excessive Budget Procedure. From 2013, with the revival of the economy, there was again an increase in social protection expenditure in constant prices (of 8.7 pp) that lasted until 2016. All in all, between 2005 and 2016, social protection expenditure in constant prices increased significantly (by 27.3%, which is more than the EU average of 22.6% in the same period). On the other hand, as a share of GDP it increased by only 0.9 pp in this period, while in the EU the rise was 2.2 pp on average. This development mirrors, among other trends, faster GDP growth in the Czech Republic than the EU average.

When comparing expenditure on the three largest functions, we can see that the old-age and sickness/health functions represent a larger share than the average for the EU. The old-age function represented 43.7% of total expenditure in 2016, compared to 40.1% in the EU on average; and the sickness/health function represented 32.4%, compared to 29.5% in the EU on average. The remaining functions (other) represented only 23.9%, compared to an average of 30.4% in the EU.

1.2 Old age

Between 2005 and 2016, expenditure on the old-age function grew consistently, from 37.3% to 43.7%, due to the effect of growing numbers of pensioners and in spite of the increasing statutory pension age. The revenue from social security contributions almost covered the expenditure on old-age benefits, mainly in years when the economy grew. On the contrary, the economic downturn after 2008 was accompanied by an increase in the share of expenditure on GDP (the effect of a GDP decline and an increased number of early retirees). In these years, social security contributions were insufficient to finance the pension system expenditure. The revenue of the pension system was therefore supplemented by income from general taxes and from previous privatisation revenues (for more, see part 2). In addition, the cumulative pension system deficit between 2009 and 2017 was 4.7% of GDP.

Figure 1. Financing old age in the Czech Republic, 2005-2018



Notes: the data for 2018 are provisional and not fully consolidated yet throughout all public-sector institutions (army, police). The figure is based on national data. European System of Integrated Social Protection Statistics (ESSPROS) data show a slightly different picture of financing – in ESSPROS data, the government's share is approximately 7 pp higher.

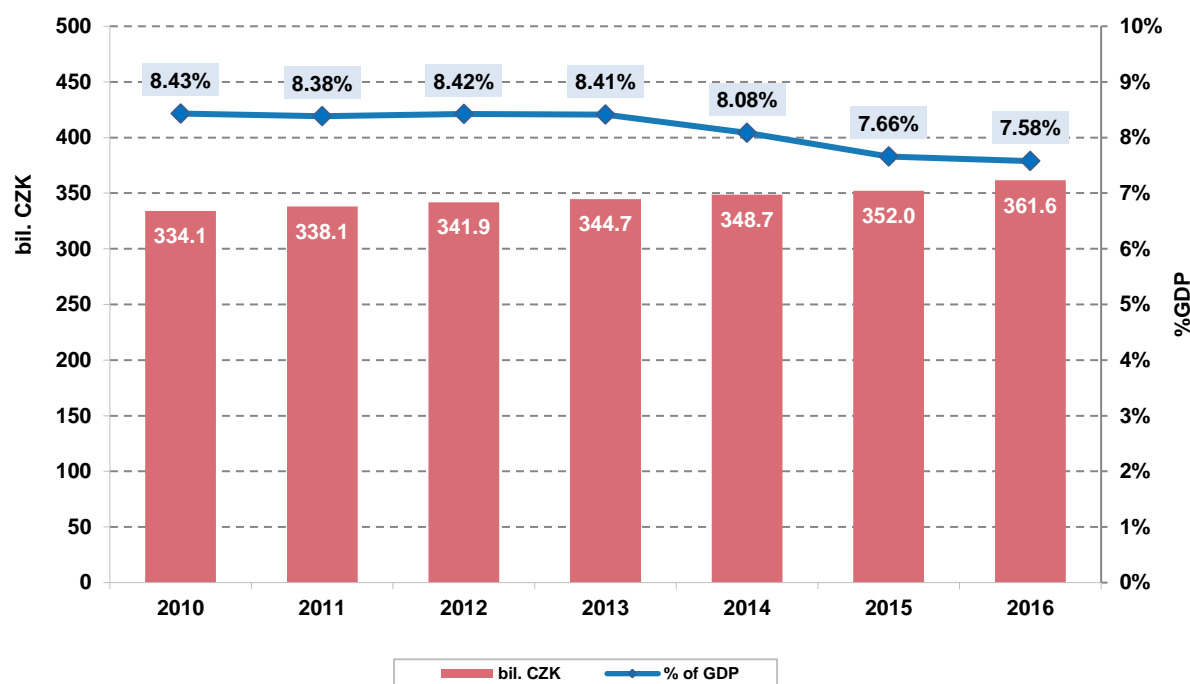
Source: Ministry of Finance (2007-2014), MPSV/MOLSA (2019a).

1.3 Healthcare/sickness

Expenditure on the sickness/health function first dropped, between 2005 and 2010, because of the reform of sickness benefit (a waiting period of three days with zero payment was implemented); it then increased after 2010. Overall, however, in the period 2005-2016 it fell from 34.3% to 32.4% of total social expenditure.

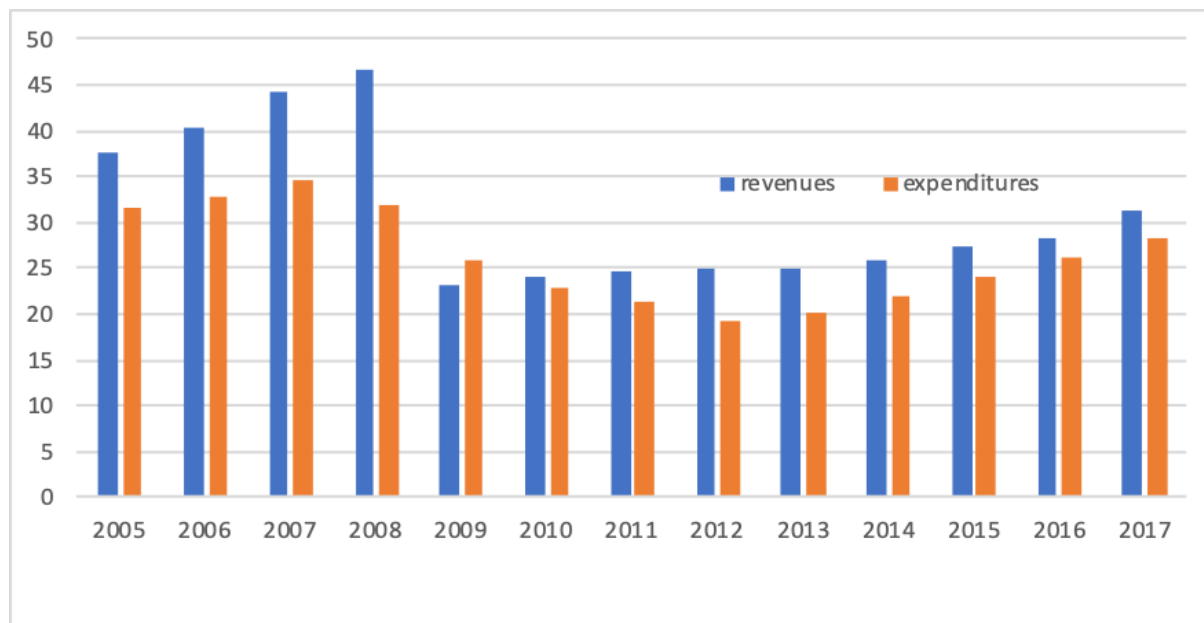
Healthcare expenditure (without sickness benefits) as a share of GDP remains relatively low in the Czech Republic, relative to other EU countries. In 2015, the country was ranked 18th (along with Hungary) among the EU countries. Average per capita expenditure increased from CZK 31,777/€1,231 in 2010 to CZK 34,230/€1,326 in 2016 (a 7.8% increase). While in nominal terms, expenditure increased by 1.33% year on year on average in 2010-2016, a year-on-year decline in the share of GDP first occurred in 2014. The downward trend continued in subsequent years, reaching 7.6% in 2016. In recent years, healthcare spending has grown more slowly than the whole Czech economy (see Figure 2).

Figure 2. Total expenditure on healthcare, 2010-2016 (in billion CZK; % of GDP)



Source: ČSÚ/CZSO (2018a).

The most dramatic changes in the level of revenues and expenditure on sickness insurance occurred in 2009. The new Act on Sickness Insurance No. 187/2006 Coll. noticeably reduced the amount of sickness insurance benefits. Sickness benefits are provided from only the 15th calendar day of temporary sick leave. During the first 14 calendar days, employees on sick leave receive wage compensation from their employer. For this reason, the employers' contribution rate was reduced, which led to a reduction in income (from CZK 46.7 billion/€1.8 billion in 2008 to CZK 23.0 billion/€0.9 billion in 2019 (see Figure 3). It is worth mentioning that expenditure exceeded revenue only in the first year of the change.

Figure 3. Revenue and expenditure of sickness insurance (billion CZK)

Note: CZK 10 = € 0.39.

Source: ČSÚ/CZSO (2018b).

1.4 Other functions

In contrast to pensions, expenditure on the 'other' social protection functions dropped from 28.3% to 23.9% of total social protection expenditure between 2005 and 2016.

A breakdown of the category 'other' into sub-functions shows that there was a continuous slight drop in expenditure in all the sub-functions between 2005 and 2016. The function disability dropped from 7.9% to 6.4% (mainly due to a stricter approach to disability assessment, in consequence of which the number of full disability pension recipients fell). The survivor function dropped from 4.2% to 3.6%, as also the number of recipients fell with increasing longevity.

The family function dropped from 10.0% to 8.8%, mainly due to the austerity package from 2008. The package restricted access to child benefits (only families with income over 2.4 times the subsistence minimum, instead of 3.0 times the subsistence minimum, were entitled to it; the birth grant was cut and eligibility was tightened; and supplementary social benefit was also cut and later cancelled). On the other hand, parental benefit nearly doubled in 2006.²

The unemployment function dropped from 3.5% to 2.6% between 2005 and 2016. In 2007, the duration of the benefit was cut by one month, and reforms were implemented in 2011 that brought restrictions in active labour market policies and public employment services expenditure. Lastly, the unemployment rate began to decrease in 2013.

The social exclusion function dropped from 2.7% to 1.4%, mainly due to the reform of social assistance in 2006. The reform of social assistance brought several restrictions: first, young people living in a flat or a house with their parents are now automatically considered to be part of the same household, and most of them have thus lost any entitlement to social assistance benefits. Second, greater stringency has been applied to assessing the entitlement to benefits. Only the existence minimum, which is less than two-thirds of the subsistence minimum, is provided in cases of insufficient individual effort to support oneself

² This benefit is paid to one of the parents after the maternity leave benefit expires (26 weeks); it may be paid until the child is 4 years old.

(such as effort to find a job). From 2007, the legislative guarantee that the level of the subsistence/existence minimums (and social assistance benefits) would be updated was cancelled, and the level of the allowance for living (which covers individual needs, including nutrition) was frozen from 2009.

Means-tested benefits

Expenditure on means-tested benefits dropped from 5.3% to 2.5% between 2005 and 2016, mainly due to the reform of social assistance (see the paragraph above). One exception is housing, where an increase from 0.4% to 1.4% is evident (expenditure on housing benefits tripled between 2010 and 2015, reaching approximately CZK 12 billion/€450 million, as a consequence of rising housing costs). All these sub-functions are below the EU average; only the family function is at the average EU level. In total, however, expenditure on means-tested benefits is much lower than in the EU, on average, where its share of GDP was 10.3% in 2005 and 12.1% in 2016.³

To sum up social protection expenditure, in the long term, the increasing expenditure on the old-age and sickness/health functions takes resources away from the other functions. This may be considered a problem, because of the already recognised or expected needs for increased support for social services, childcare, active labour market policies, social housing and social inclusion. Generally speaking, these items are connected with social investments or, in other words, new social risks, where a growing need for expenditure may be expected. The question remains of how this demand will evolve in the future and how it will coincide with the need for increased expenditure on the old-age and sickness/health functions as a consequence of ageing. Fortunately, social expenditure on sickness/health and old age is not so high in absolute terms. This is because social insurance benefits (pensions, sickness, unemployment, maternity) are based on low replacement rates provided to the middle- and higher-income brackets, which thus keeps social expenditure low. On the other hand, they are strongly redistributive in terms of effect and universal in terms of access, thus effectively protecting against poverty risks.

Tax relief financing family welfare and taxation of social benefits

Social benefits are not taxed in the Czech Republic. One exception involves pensions, but only pensioners with very high pensions are taxed.

Under the Income Tax Act, only annual pensions of more than 36 times the minimum (monthly) wage are taxed. In 2018, pensions were exempt from income tax up to CZK 36,600/€1,450 per month. The Czech Social Security Administration provides basic statistics on the monthly amount of pensions paid. The first income category contains monthly pensions exceeding €700, and these account for about 1.5% of retirees. With regard to the existence of ceilings on pension contributions, it is almost impossible to grant a new pension that is higher than the income tax threshold today.

Secondly, from 2015 economically active old-age pensioners are again entitled to the basic tax credit. This right was withdrawn by the previous government in the wake of the economic crisis, and this remained the state of affairs during the period 2013-2015. The Constitutional Court decided in 2014 that the withdrawal was unconstitutional.

Tax relief is essential in the Czech system for families with children. Between 2005 and 2007, there was joint taxation of spouses, but the most important relief is the child tax credit. The previous child tax allowance (1993-2004) was replaced with a non-wastable child tax credit (2005-), which effectively functions as a negative income tax. The non-wastable child tax credit is the only instrument that makes it possible to calculate a negative tax liability. Generally, the application of tax deductions in a progressive tax system means greater effective support for taxpayers on higher incomes. While the application of child tax credit reduces the tax liability equally for everyone, entitlement to

³ Statistical annex on financing social protection: levels and structure (2005-2016).

the tax bonus is limited to those families whose annual income from economic activity is at least six times the level of the minimum wage. In terms of family policy, the most relevant development since 2008 has been the increase in the child tax credit. A more detailed overview of this is described in Table 2. The overall outcomes are presented in Figure 4.

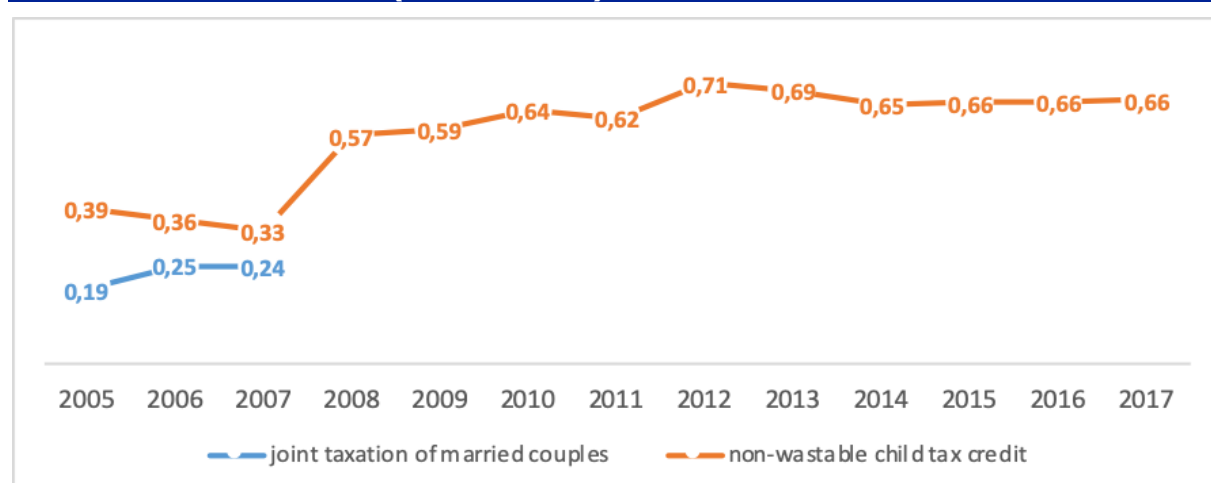
Since 2014, a new tax credit related to the cost of placing a child in a facility of early education and care was introduced (the 'kindergarten' tax credit). Its annual amount is established on the basis of the cost actually incurred in connection with placing the dependent child in an early childcare centre. The amount of the tax credit is capped at the minimum wage level.

Table 2. Development of tax relief for families with children in the Czech Republic between 2005 and 2017 (in CZK, yearly)

Year	Child tax credit			Max. tax bonus
	Amount:	amount in €	For:	
2005-2007	6,000	240	each child	30,000
2008-2009	10,680	427	each child	52,200
2010-2011	11,604	464	each child	52,200
2012-2014	13,404	536	each child	60,300
2015	13,404	536	1 st child	60,300
	15,804	632	2 nd child	
	17,004	680	3 rd + child	
2016	13,404	536	1 st child	60,300
	17,004	680	2 nd child	
	20,604	824	3 rd + child	
2017	13,404	536	1 st child	60,300
	19,404	776	2 nd child	
	24,204		3 rd + child	

Source: Act No. 586/1992 Coll. on Income Taxes.

Figure 4. Development of the structure of tax expenditures towards families with children since 2005 (as % of GDP)



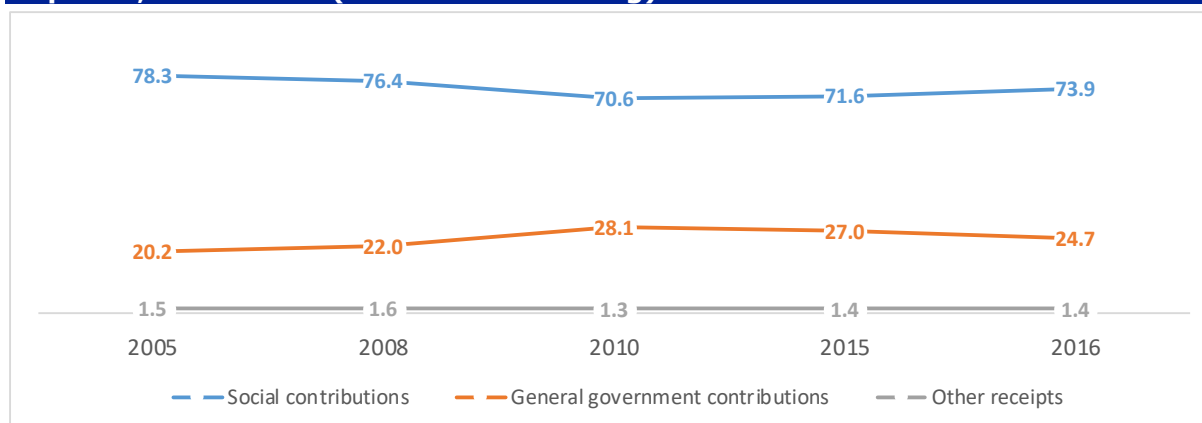
Source: Authors' calculations based on EU-SILC data.

2 Current mix and past changes in the sources of financing social protection

2.1 General overview

Financing for social protection relies mainly on social contributions in the Czech Republic. Moreover, as shown in Figure 5, the proportions of the main funding sources have been stable over time. The growth in the general government contribution share after 2008 is due to the economic downturn and the subsequent decline in social contributions.

Figure 5. Division of financing for social protection by main source in the Czech Republic, 2005-2016 (% of total financing)



Source: Spasova and Ward (2019), Annex ESSPROS tables.

As already mentioned, social benefits are not taxed in the Czech Republic. The only exception is old-age pension, which is taxed only if the annual amount of pension exceeds 36 times the minimum (monthly) wage. There are no statistics on the number of taxed pensions, but we estimate it to be only a few thousand. ESSPROS data show that the difference between gross and net social protection expenditure was 0.08% of GDP in 2015. Although this figure is very low, we believe that the tax revenue from pensions is even lower.

As we can see from the Table 3, the funding of the social insurance system has been very stable over time in the Czech Republic. The simplified table describes in detail its main aspects.

Contributions are paid by employees and employers, the proportion of their payments being approximately 1:3. The basis for payment is the monthly gross wage of the employee. In the case of the self-employed, it is one-twelfth of the annual assessment base (determined as 50% of yearly profits). At the same time, the contribution rate payable by the self-employed corresponds to the sum of the rates payable by the employee and the employer.

Contribution payments have no floor, except for the self-employed, where the minimum assessment base is given by a percentage of the average wage in the economy (25% for social insurance, 50% for healthcare insurance). A second exception is health insurance, where the minimum wage is the natural floor for payments. In 2008, ceilings on social security payments were introduced. Social security contributions are not paid on income that exceeds a particular multiple of the average wage. The reference period starts with the beginning of each calendar year. The ceiling is applied to approximately 1% of employees on the highest wages. There are currently no official estimates of the relief value. We estimate it at 0.1% of GDP.

Payment of social security contributions is mandatory on a uniform basis for all economically active persons, with some minor exceptions. The system described above has been in force in the Czech Republic since 1 January 1993, when the new tax system was

put in place. The reform in 1993 abolished the post-socialist tax system and replaced it with a tax system that is in line with market principles. There are minor exceptions to the system described above, the most important of which are discussed in the following subsections.

Table 3. Evolution of social security contributions in the Czech Republic – rates (in %) and ceilings (as a multiple of the national average wage)

	2004	5	6	7	8	9	10	11	12	13	14	15	16	17	18	2019
Pension insurance – employee	6.5			3.5+(3.0+2.0*)						6.5						
Pension insurance – employer	21.5															
<i>Pension insurance – ceiling</i>	-			48			72			48						
Unemployment ins. – employee	0.4									0.0						
Unemployment ins. – employer	1.2															
<i>Unemployment ins. – ceiling</i>	-			48			72			48						
Sickness insurance – employee	1.1									0.0						
Sickness insurance – employer	3.3									2.3						
Sickness ins. – self-employed	4.4			48			1.4			2.3						
<i>Sickness insurance – ceiling</i>				48			72			48						
Healthcare insurance – employee	4.5															
Healthcare insurance – employer	9.0															
<i>Healthcare insurance – ceiling</i>	-			48			72			-						

Notes: (*) the changes in the rate of employee pension contribution in 2013-2015 relate to the introduction (2013) and abolition (2015) of the second pension pillar (funded, defined contribution).

Source: Czech legislation, OECD Taxing Wages, MPSV/MOLSA (2013: 18).

2.2 Pension system

The first pillar of the Czech pension system is based on the pay-as-you-go (PAYG) principle. If it were funded only by social security contributions, the contribution rate would have to be adjusted regularly. Contributions are paid by employees, employers and the self-employed. Since 2004, the contribution rate has been 28%, split between employees (6.5%) and employers (21.5%). However, as shown in the figure 1, the pension system was, for most of the time, in a moderate deficit, financed by the state budget. If we compare the system's balance sheet with the business cycle, we can see that the pension system suffers from a small structural deficit.

The second, statutorily funded, pillar was established in 2013 and abolished at the end of 2015. Any individual could partly opt out of the first pillar – in that case, his/her contribution rate of 6.5% was split into 3.5% (PAYG pillar) and 3% (second pillar). At the same time, a participant in the second pillar had to increase the contribution rate by 2% to a total of 8.5%. The increased contribution rate was one of the many reasons why the participation rate was so low (only around 85,000 individuals out of a 5 million workforce took part). When the government abolished the second pillar, the contribution rate returned to 6.5%. The reform did not influence the employers' rate. As a result of the reform, CZK 3.4 billion/€126 million of contributions were diverted from the first pillar (the contributions were returned to the participants at the end of 2016). The government had originally assumed greater citizen involvement, and had therefore decided that 7.2% of VAT revenue would be earmarked to finance benefits from the first pillar. This measure was in place in 2012-2014. The negative impact of the economic crisis on first-pillar fund was further cushioned by the transfer of funds that had been accumulated over previous years from the privatisation of state property. These funds (created between 1996 and 2007) were intended to support the start of the pension reform.

The introduction of the ceilings on social insurance payments from 2008 has had only a marginal effect on the financing of the Czech pension system. As these ceilings only affect the payments of individuals whose yearly gross income is over 48 times the average wage, they affect less than 1% of the workforce.

2.3 Unemployment insurance

As regards unemployment insurance funding, the Czech system has been stable for a long time. Since unemployment contribution payments were always higher than the system costs, the 1.6% contribution rate was reduced to 1.2% in 2009. Unemployment insurance contributions are paid only by the employer. However, ESSPROS data indicate that unemployment benefits are only two-thirds financed by social contributions (see Table 4). This would be true only if unemployment benefits expenditure contained expenditure on active labour market policy.

Table 4. Division of financing of unemployment benefits by main source, 2005-2015 (% of total financing)

		CZ	EU
2005	Social contr.	71.5	56.8
	Govt revenue	28.4	33.5
	Other receipts	0.1	9.7
2008	Social contr.	68.1	54.4
	Govt revenue	31.9	35.4
	Other receipts	0	10.2
2010	Social contr.	69.9	49.3
	Govt revenue	30.1	39.8
	Other receipts	0.1	11
2015	Social contr.	67.7	55.4
	Govt revenue	32.2	35.8
	Other receipts	0.1	8.8

Source: ESSPROS database.

2.4 Healthcare and sickness insurance

The structure of the main sources of financing for healthcare and sickness expenditure was quite stable in 2005-2015. ESSPROS data suggest only a slight decrease in the share of social contributions (80.1% of total financing in 2005; 76.9% in 2015), due to a slightly increased share of government revenues.

This is the case mainly in the area of financing healthcare provision (i.e. without sickness insurance), where the state covers the contributions for roughly 60% of those insured. So-called 'state-insured' persons include pensioners, children until they finish their education, registered unemployed persons, women on maternity leave, persons with disabilities, parents caring for small children, prisoners, etc. (we take a closer look at the role and development of this below). Using local data (ČSU/CZSO, 2018a) we can see that total healthcare spending increased by CZK 9.6 billion/€370 million (this represents a 2.7% year-on-year increase) in 2016. The increase was brought about by an almost identical increase in funding from health insurance and by direct payments for care from the state budget. The expenditure of health insurance companies grew by CZK 3.2 billion/€120 million (1.4%) year on year, and expenditure from the state budget by CZK 3.3 billion/€130 million (6.2%). It ought to be noted that direct payments by households (patients) – the third main source of healthcare financing in the Czech Republic – increased by CZK 1.9 billion/€70 million year on year (3.8%). However, ESSPROS methodology does not include any direct payments made by beneficiaries in the cost of social benefits in kind by way of cost-sharing, and so there is no relation of these payments to the 'other receipts' category in Table 5.

Table 5. Division of financing of healthcare expenditure and sickness benefits by main source, 2005-2015 (% of total financing)

		CZ	EU
2005	Social contr.	80.1	38.5
	Govt revenue	17.1	51.4
	Other receipts	2.8	10.1
2008	Social contr.	77.8	41.9
	Govt revenue	19.1	48.1
	Other receipts	3.1	10.1
2010	Social contr.	76.2	42.2
	Govt revenue	21.9	47.7
	Other receipts	1.9	10.1
2015	Social contr.	76.9	40.6
	Govt revenue	21.7	49.9
	Other receipts	1.4	9.5

Source: ESSPROS database.

The share of the three major sub-categories of social contributions financing healthcare and sickness benefits was also more or less stable.

Table 6. Breakdown of the financing of healthcare and sickness benefits by sub-category of social contributions, 2005-2015 (% of total financing)

Year	Employers	Employees	Self-employed
2005	50.8	22.5	6.8
2008	48.9	22.1	6.9
2010	49.1	20.0	7.1
2015	49.5	20.0	7.3

Source: ESSPROS database.

The healthcare insurance contribution rate has been stable for a long time. For economically active payers, it is universally determined by law (13.5% – i.e. 9.0% paid by the employer and 4.5% by the employee). The self-employed pay the same total percentage (13.5%), but the base is only 50% of their profits. There are significant disparities between the average contributions of employees and self-employed persons.

The state pays the healthcare contributions⁴ of half the Czech Republic's population (children, mothers on maternity and parental leave, students, pensioners and prisoners) from the state budget. The contribution rate for state-insured persons is determined by the government and serves, in effect, as a tool to regulate the volume of funding in the public health insurance scheme. Since 1992, the revenue generated from contributions paid for state-insured persons has ranged from 20% to 27% of total revenue in the public

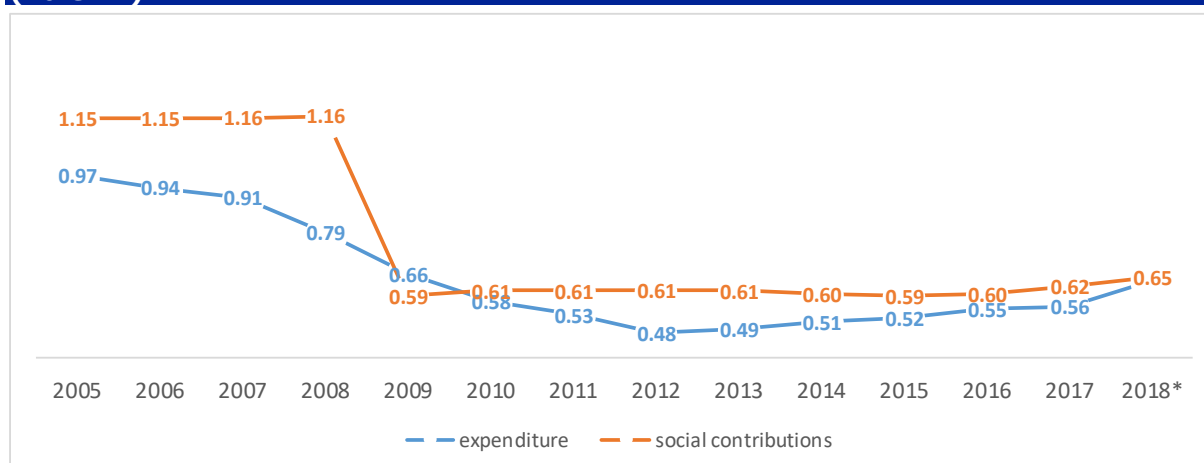
⁴ This is shown in the 'government revenue' columns in Table 5.

health insurance scheme.⁵ The government currently pays CZK 969/€37.90 a month for each state-insured person. This contribution is far below the lowest level paid by 'non-state-insured' persons (the level equals the contributions paid by 'insured persons without earnings', who are supposed to contribute CZK 1,647/€64.40 per month, which stands at 13.5% of the minimum wage). Therefore, in the case of fiscal imbalances, an ad hoc adjustment of the assessment base of these state-insured persons (and thus increased payments by the state) can restore the financial balance within the system. In the past, when these changes to the assessment base failed to balance the healthcare budget, the state subsidised the system directly (for example, by purchasing bad debts from healthcare insurance companies at a disadvantageous price to the state). In 2017, the cabinet redesigned the way in which the contribution rate for state-insured persons will be set until 2020, in order to create a more predictable environment for healthcare providers and payers. It has thus ensured an increase in the total amount of contributions of CZK 3.5 billion/€134 million annually.⁶

2.5 Sickness insurance

Figure 6 shows the development of revenue and expenditure in the sickness insurance system (see also Figure 3) and their balance. The system encountered a radical change in 2009, when new anti-abuse elements were introduced to the payment of benefits. These take the form of a waiting period (the first three days of illness) and payments by the employer replacing wages at the beginning of an illness. Initially, employers had to pay wage replacement for the first 14 days of work incapacity. This period was extended to 21 days from 2011, and then reverted to 14 days from 2014. The wage-replacement system was accompanied by the sickness contribution rate adjustment. Employees were exempted from paying sickness insurance contributions. The contribution rate was lowered from 4.4% to 2.3% for employers. The self-employed experienced the biggest reduction in the rate – from 4.4% to 1.4%. From 2011, the system of wage replacement was mitigated for employers with fewer than 26 employees. They can opt to sign up for a higher sickness insurance contribution rate (3.3%, rather than the normal 2.3%), in return for which half the wage compensation paid to employees is reimbursed. Since 1994, the self-employed may decide to opt out of the whole system.

Figure 6. Financing of sickness insurance in the Czech Republic, 2005-2018 (% GDP)



Note: (*) data for 2018 are provisional.

Source: Ministry of Finance (2007-2014), MPSV/MOLSA (2019a).

⁵ In 2017, it represented CZK 65 billion/€2.5 billion in total.

⁶ For a recent analysis of payments for state-insured persons, see Gajdošová and Maaytová (2018).

In 2012, the range of sickness-insured persons was expanded to include employees working under a non-standard work contract.⁷ The obligation to pay sickness insurance arises if the person earns more than CZK 10,000/€400 in a calendar month.

2.6 Non-contributory benefits (family benefits, housing and social assistance benefits)

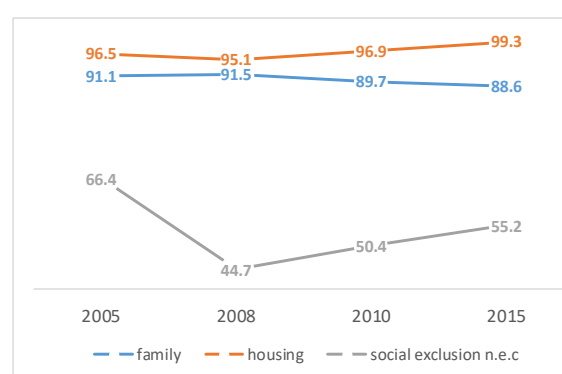
Family benefits are organised under the system of State Social Support. They are completely financed from general tax revenues, as are social assistance benefits. ESSPROS data suggest (see Figure 7) that the government does not fully finance this expenditure from general government revenue. According to us, these systems are funded exclusively from general taxes (although the differences are likely to be negligible, given the proportion of this expenditure in GDP).

Figure 7. Financing family benefits and social assistance benefits in the Czech Republic, 2005-2018

a. Expenditure (% GDP)



b. Government revenue as % of total financing



Source: Spasova and Ward (2019), Annex ESSPROS tables.

These benefits are income tested and target the poorest part of Czech society (47% of the non-contributory family-related benefits in 2015). Two exceptions to this are the mostly universal parental benefit (47% of these benefits) and foster care benefits (6%). At the same time, taxes are levied mostly from the part of society with higher income (progressive taxation). The combination of focused benefits with progressive taxation leads to significant redistribution in the system as a whole.

2.7 Accidents at work and occupational diseases

Insurance contribution varies according to risk (between 0.2% and 1.2% of gross earnings). It is paid by the employer for jobs which may be connected with the existence of such a risk.

2.8 Financing from self-employed and other non-standard work

In the Czech Republic, non-standard forms of employment include mainly self-employment (17.3% of total employment) and, to a lesser extent, fixed-term contracts (8.5%), part-time work (6.7%) and marginal categories of agreement to perform work (*dohoda o pracovní činnosti*) and agreement to complete a task (*dohoda o provedení práce*). The Czech social security system is, in principle, uniform for employees, self-employed people and other non-standard labour categories. The *agreement to complete a task* establishes participation in social insurance schemes only in those months in which the employee

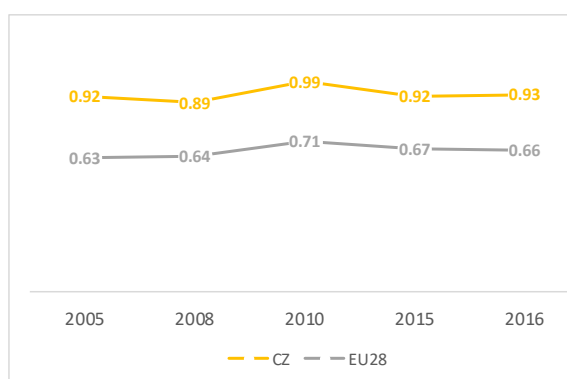
⁷ These other forms are agreement to perform work (*dohoda o pracovní činnosti*), which is work outside one's main regular contract, not exceeding 20 hours per week; agreement to complete a job (*dohoda o provedení práce*), which covers work not exceeding 300 hours per calendar year for one employer.

reaches an assessable income of more than CZK 10,000/€400. A similar principle applies to *agreements to perform work*, where assessable income must amount to at least CZK 2,500/€100. These categories are, however, only marginal: they are typically concluded in parallel with another employment contract.

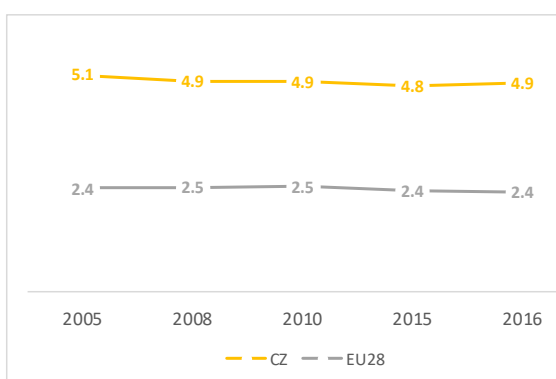
As for self-employed persons, the amount of the contribution payment is derived from the assessment base, which equals 50% of the average monthly income, after deducting expenses. A basic overview of the social protection funding by self-employed earners is shown in Figure 8 below. Even though the share is higher than the EU-28 average, the funds that the self-employed generate are lower than their share of expenditure on social protection.

Figure 8. Financing social protection by self-employed earners in the Czech Republic, 2005-2018

a. Contribution (% GDP)



b. Contribution as % of total financing



Source: Spasova and Ward (2019), Annex ESSPROS tables.

Consequently, since the earnings-related pension component forms the biggest part of the old-age pension, some self-employed people can expect very low pensions. There has been a long-standing debate in the Czech Republic on whether the self-employed contribute an adequate share to the social system. If we compare a model employee with a monthly wage of CZK 25,000/€1,000 (approx. 90% of the average national wage in 2017) and a self-employed person whose income equals the employee's labour costs, we can say that the net income of the self-employed person is 154%, the payment of the pension insurance is 27%, and the expected pension is 56% of the corresponding employee's figures. The tax advantage of the self-employed dates back to the 1990s. It aimed to stimulate an area that had been practically non-existent in the socialist economy. Although tax adjustments have been made since then, differences in tax payments with employees remain.

3 Strengths and weaknesses of the existing mix of financing options and potential future sources of financing – national debate on the topic

3.1 Social security through labour taxes – main strengths and weaknesses

Social protection is financed mainly from social insurance contributions (almost 74% in 2016, compared to the average of 55% in the EU as a whole). Financing through social insurance contributions has a major impact on the tax costs of labour, increasing the overall costs of labour. High labour costs may, theoretically, affect the demand for labour and lead to unemployment. The issue of high labour costs was already tackled once by the Country Specific Recommendations of the European Council to the Czech Convergence Programme 2015 (*'Reduce the high level of taxation levied on low-income earners, by shifting taxation to other areas'* – see European Commission, 2015). The government has long recognised the need to reduce labour taxation, as this aspect is reflected in every tax policy discussion. However, since the real impact of high labour taxation is negligible (the unemployment rate is the lowest in the EU-28), the government has not taken any real steps to reduce labour taxation.

The following Table 7 shows the average rate of labour taxation, using the tax wedge indicator for OECD countries and three model taxpayers (always a single person without a spouse and without dependent children, with income shown as a percentage of the national average wage). OECD countries (36 countries, 22 of which are currently EU members) are ranked according to the indicator, from the highest tax wedge to the lowest. As the table shows, the position of the Czech Republic has remained unchanged for a long time – or has even deteriorated slightly in recent years.

Table 7. Tax wedge for selected individuals (wage as % of average national wage); the Czech Republic's ranking among OECD countries

	67% AW	100% AW	167% AW
CR ranking 2005	9	10	12
CR ranking 2010	9	11	12
CR ranking 2015	9	8	13
CR ranking 2017	8	7	12
CR tax wedge 2017	40.8%	43.4%	45.5%
OECD average tax wedge 2017	32.1%	35.9%	40.3%
Germany tax wedge 2017	45.5%	49.7%	51.4%
CR marginal tax wedge 2017	48.6%	48.6%	48.6%
CR ranking 2017 (marginal tax wedge)	9	13	17

Notes: (1) Tax wedge includes personal income tax and social security contributions (paid by employees and by employers). (2) The lower the number in the ranking, the higher the tax wedge in the Czech Republic compared to other OECD countries. (3) A marginal tax wedge measures the proportion of additional labour taxes from a marginal increase in gross wage.

Source: OECD (2019).

We can connect high labour taxation with three aspects of a single weakness:

- Funding social protection mainly through social insurance contributions may affect labour demand in the future (when labour costs are comparable to those in Germany).
- Although there has been no reform in the last 10 years, the position of the Czech Republic is deteriorating slightly (in terms of tax wedge – the ranking of the Czech Republic is worsening (moving to a higher rank) compared to other countries. Among

other factors, this is due to the fixed value of the standard tax credit. It was 9.2% of the average wage in 2008, but by 2018 it was 6.8% (due to wage increases).

- Social insurance contributions are of great importance in the labour taxation system. There is a flat rate for personal income tax and also for social insurance contributions (see Table 3), and so the marginal tax wedge is the same for all taxpayers listed in Table 7 (some exceptions apply to the top 1% of wage earners). The potential negative impact of the high average tax wedge is therefore more pronounced for low-income taxpayers.

Why does high labour taxation not then lead to a higher unemployment rate? And instead, why does the Czech Republic have the lowest values of the EU countries? The Czech Republic is still a converging economy, with low labour costs. Accession to the EU has deepened its economic ties to Germany. According to Eurostat, unit labour costs are lower in the Czech Republic (€11.30 in 2017) than in Germany (€34.10 in 2017). At the same time, the labour productivity of selected enterprises is the same as in Germany (e.g. the automotive industry). This difference in unit labour costs has a more significant impact on labour demand than the tax wedge values or possible shortcomings of Czech economic policy.

Currently, the industry sector is the primary employer in the Czech Republic, with a share of 29.1% of total employment (the indicator `nama_10_a10_e`). This is the largest share of all EU countries. While it fell from 19.3% (2000) to 15.3% (2017) in the EU-28, it has remained almost constant in the Czech Republic over the past 20 years. The Czech Republic may be expected to converge with the EU in terms of the sector structure of the economy, with an impact on labour costs. In any case, technological progress, combined with the elimination of differences in labour costs, will also influence the change in the Czech labour market over time and will move the Czech Republic towards a post-industrial economy. We can also expect that non-traditional forms of work – for example, part-time work or temporary work – will expand. In particular, the changes will hit a low-skilled labour force where the Czech Republic competes by offering low prices. Not only the rise in labour costs, but also the development of digitisation and robotisation will reduce the share of unskilled, semi-skilled and routine labour (the digital divide). These trends will then further affect social protection funding. With the continuous wiping out of economic disparities, the Czech Republic will have to reconsider the composition of social protection funding and, in particular, its distribution among different social groups.

The largest expenditures of the Czech social protection schemes are linked to the social insurance system (almost 89% of social protection expenditure in 2016). Social insurance is mainly funded by the contributions of economically active persons, as described above. From the viewpoint of the financial balance of each sub-system, this has its strengths and its weaknesses.

One strength is that this keeps the funding system transparent and deterministic: an increase in spending is only possible if revenue increases. This keeps most systems (structurally) balanced in the long run.

A weakness is that a change in system revenue determines the amount of expenditure. The way in which pension benefits and healthcare standards are discussed in connection with changes in incomes due to the economic cycle is instructive. We may compare this situation to the inadequate attention paid to the new social risks (social investments) – see Table 1 in section 1; these are also framed within the current economic situation rather than within a needs analysis. This may be considered a problem because of the already recognised or anticipated need to increase support for social services, childcare, active labour market policies, social housing and social inclusion.

Based on the above, we formulate the following recommendations for Czech social policy:

- (1) to initiate and develop a national debate on the composition of funding sources for social protection, in order to prepare for a situation where rising labour costs start to have a greater impact on labour demand,

(2) to limit the impact of the economy on the (pro-cyclical) debate on the expenditure of the social system,

(3) to limit the impact of a growth of tax costs on total labour costs, with a primary focus on lower-income taxpayers. Indexation of the basic tax credit seems to be a convenient tool, as it should closely follow year-to-year changes in the average wage.

3.2 Fiscal welfare through tax expenditure – main strengths and weaknesses

Tax expenditure plays the role of a hidden redistribution tool in Czech social policy. It significantly affects the income of some groups (families with children, individuals financing their housing through a mortgage). In other cases, the role of this instrument is only indirect or minor. For example, tax relief on supplementary pension savings affects savings (participation in the scheme and the amount of savings), but the collected funds are mostly not used to purchase a lifetime (or long-term) annuity. Different tax expenditure has a different impact on the labour market. For example, we claim that the child tax credit motivates single parents to enter the labour market. Contrariwise, we see the labour market impact of the low-income spouse tax credit as negative. Therefore, we give the following two recommendations:

(4) to periodically re-evaluate the child tax credit, so that it does not lose its value due to a growth in the average wage, and to consider the importance of the tax bonus ceiling at the same time,

(5) to consider abolition of the low-income spouse tax credit and, at the same time, reallocate the amount of today's relief to other (benefit) instruments that do not affect incentives to work (child allowance, care allowance).

3.3 Pension protection – main strengths and weaknesses

The Czech pension system is an insurance system (the benefit should be in proportion to previous income). At the same time, it is substantially redistributive. This discrepancy was addressed by a Constitutional Court finding in 2011, which ruled the pension calculation formula unconstitutional. In response, a set of parametric changes to the pension system was approved. Although these reforms have slightly strengthened the merit principle, there has been no major change. On the contrary, by strengthening the basic amount of pension from 9% to 10% of the average wage, from 2018 onwards, the merit principle of pensions will be further weakened. So, there is again a mismatch between the relatively flat rate of the pension benefit and the contributory payments under the pension system.

In 2019, a new Pension Reform Committee was set up, which will come up with a solution that *'defines a standard for blanket security in old age relying on the principle of solidarity [and] reinforces the principle of merit'* (Government, 2018). A secondary objective will then be *'to start looking for additional financial resources for the pension system that, in the long run, may face financial imbalances with ongoing labour market changes and the ageing of the population'* (MPSV/MOLSA, 2019b). The Commission seeks a retirement benefit calculation that will better define the flat rate standard and, at the same time, strengthen the merit principle. This should be accompanied by a search for additional resources for the pension system. These requirements may be reconciled by strengthening the universal basic amount of pension and, at the same time, increasing the funding for this universal component from general taxes. Thus, the principle of merit underlying the percentage-based component of the pension would simultaneously be reinforced.

The pension rights of workers in arduous and hazardous jobs (WAHJ) have long failed to be adequately addressed. The discussion is whether early retirement should be allowed at the expense of the rest of society (as is today the case with miners), or whether employers should be obliged to finance these workers' improved pension entitlements. However, this

solution increases labour costs, with all the negative implications of that for the labour market.

Based on the above, we offer the following recommendations:

- (6) to separate the financing of the pension system from the state budget,
- (7) to consider rebalancing the calculation of the pension benefit, so that the percentage-based component better reflects income during economic activity and the flat basic amount is financed to a greater extent from general taxation. Such a solution should help to reduce the tax costs of labour,
- (8) to address the issue of retirement of the WAHJ group, so that it is entitled to a more equitable benefit, while having employers more financially involved in this change.

3.4 Healthcare/sickness – main strengths and weaknesses

The main strength of the system is that both the healthcare and sickness insurance systems are relatively stable and generate sufficient resources to finance expenditure.

The following may be considered to be the main weaknesses:

- From the point of view of fairness and solidarity, differences in the effective rate of health insurance contributions between employees and self-employed people have often been mentioned as an issue. The contribution rate for all economically active payers is universally determined by law (13.5%, i.e. 9.0% paid by the employer and 4.5% by the employee). The self-employed pay the same total percentage (13.5%) as employees, but the base is only 50% of their profits. There are significant disparities between the average contributions of employees and the self-employed.
- The state still pays too little for state-insured persons. As we noted above, the government currently pays a contribution that is less than 60% of the lowest level paid by 'non-state-insured' persons.
- The existing mix of financing options does not create any incentives for health promotion. On the contrary, we are witnessing moral-hazard behaviour in the field of healthcare (*'I have paid a lot – I am entitled – I deserve a lot'*).

In this respect, we recommend establishing a special working group (similar to the recently created Expert Working Group on Pensions) that would seek long-term improvement in terms of solidarity, long-term sustainability, promotion of healthier behaviour in the population and cost-effectiveness. At least three changes should be seriously considered here:

- (9) A partial increase in patients' co-payments for routine and not very serious services, in order to generate extra funds for inevitable and expensive care.
- (10) Reflect health-risk behaviour in the calculation of healthcare contributions (introduce a system of bonuses/malus) or, more generally, get back to the idea discussed in 2007-2008 of allowing health insurance companies to provide different health plans for their clients, some of them based on the concept of 'managed care'.
- (11) Devote part of the revenue from the Pigouvian 'corrective' taxes (mainly the tobacco tax) to fund an increase in payments for state-insured persons.

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