

## VI. WORK AND PAY

In the 1998 version of this report, we paid much attention to the issue of the quantity and quality of human capital. We have concluded that while there is abundant quantity of human capital when measured using educational attainment of the population, especially at the secondary level, the quality of human capital is somewhat low in terms of the ability to actively use information in an analytical manner. (The latter finding was based on studies conducted by the Sociological Institute of the Czech Academy of Sciences.) Further, the relative lack of a college/university-educated work-

force and the over-stratification of the Czech vocational system have been singled out as potentially the most important problems of human capital creation. Finally, we have also investigated the sharply increasing wage returns to education as one of the most positive features of the wage structure development.

In this year's report we concentrate attention on other issues including the age structure of the population and its implications for the pension system, and we refer readers interested in human capital topics to the 1998 report.

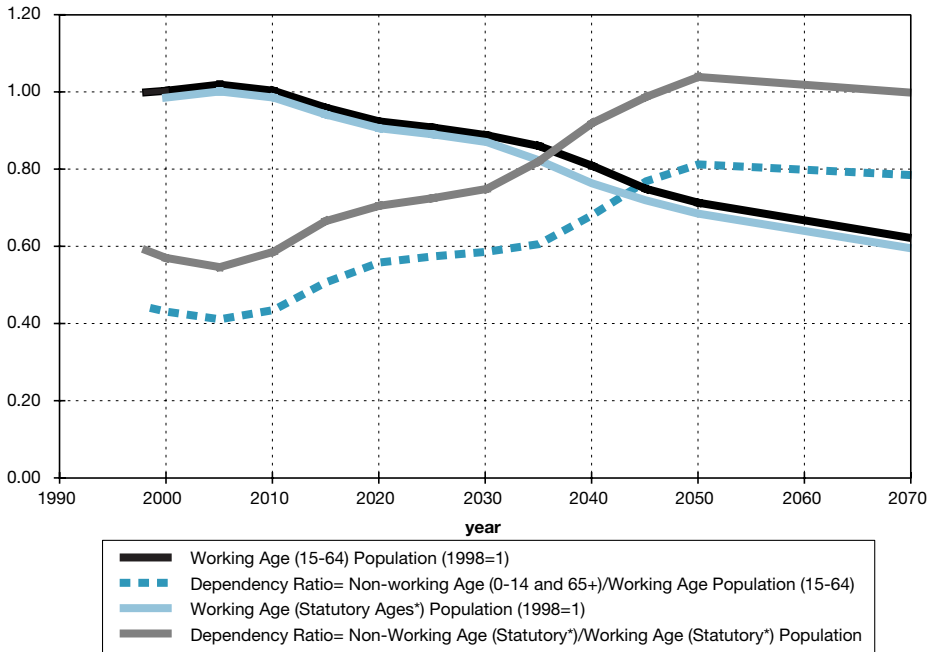
### VI.1 Age Structure and Trends

The age structure of the Czech population closely resembles that of developed Western countries rather than those of developing countries with a similar level of GDP per capita. Both the size and structure of the population has been relatively stable during the 1990s. The demographic age structure will, however, start changing rapidly around the year 2010, and the process will likely continue until the mid 21st century. The working-age population in 2030 is predicted to shrink to 89 per cent of its 1998 size, and it will be even lower in 2050 at 72 per cent. There are two main causes for this development. First, large cohorts of individuals born after World War II are

going to reach retirement age. Second, the cohorts born after 1989 are small due to a recent unprecedented decline in fertility rates. During the transition, annual live births declined by 30 per cent from 1990 to 1997. The gross birth rate in the country in the last two years reached the lowest point in the last two centuries and is one of the lowest in Europe and therefore in the world. It remains an open question to what extent this drop is a result of one generation delaying fertility decisions due to new career opportunities and whether fertility will increase in the future.

The only positive albeit so far minor factor affecting the size of the Czech work

## Working Age Population and Dependency Ratios



\* Under the current scheme, retirement ages have been increasing over time since 1996 and will be until the year 2007: In the case of men, the retirement age will increase to 61 years. In the case of women with 2 children it will be 58 years.

Source: Burcin and Kučera, *Demography Forecasts*, Demography Department of the Charles University.

force is foreign employment. According to some estimates the total size of foreign employment is 3 to 5.5 per cent of the domestic labour force (including about 65,000 Slovaks in 1998). The country has accommodated at least 50,000 migrants

from other countries during the last five years, but recently laws limiting employment of foreigners to 3 years have been enacted. (Certain exemptions to high skill workers and academicians apply.)

### **A Ticking Bomb: Pensions**

*The ageing of the population discussed in this section has frightening implications for the fiscal sustainability of the existing pay-as-you-go pension scheme and therefore directly affects the state budget (see Section III.5) and the size of the payroll tax burden. The state-guaranteed pay-as-you-go system inherited from the communist era is the major source of old-age pensions. The current pension payment formulas are extremely egalitarian as individual pensions depend little on the amount of individual lifetime contributions. Payroll pension contributions are mandatory and the system is in permanent deficit, notoriously covered by the state budget.*

*This deficit will become unsustainable given the current pension scheme once the dependency ratio of non-working to working population starts rising in 2005 (see Section VI. 1). Raising payroll contributions (taxes) are hardly a solution as they are already very high (see Section III.5). Unless a fundamental pension reform is enacted, the retirement age will have to increase dramatically and the pension amounts will likely suffer as well.*

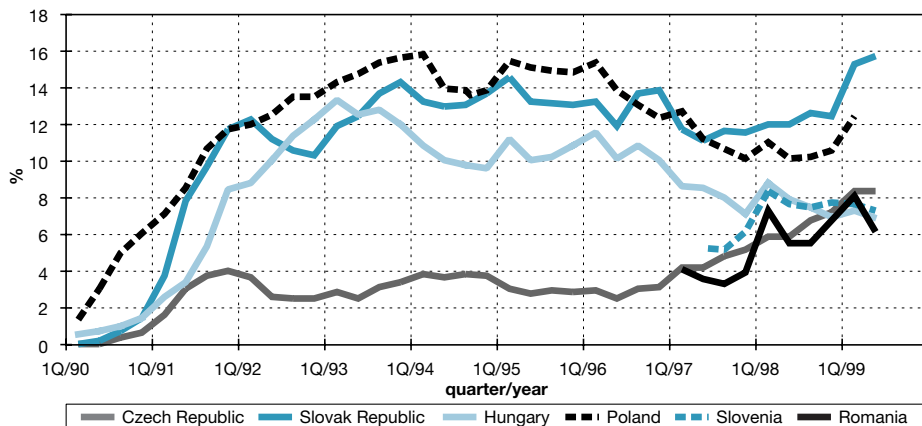
*The statutory retirement age for both sexes has already been increased and will continue to be raised until 2007. This gradual increase has been adopted in 1996 against much opposition accompanied by the widening of early retirement possibilities. By 1999, the annual number of early retirees had increased by a factor of six so that they constituted half of all old-age retirees. The added fiscal burden of early retirements more than outweighed the expected benefits of extending the statutory retirement age. Early retirements could become even more important.*

*A fundamental pension reform (a move towards private defined-contribution pensions) has been advocated by independent experts and shrugged off by the government for many years now. The current government's plan includes partial adjustments of the existing pay-as-you-go system and of the so far minor private supplementary pension insurance. Enlarging employer involvement is also considered in these plans and the goal is to maintain the public-pension/net-wage ratio of about 55-60 per cent.*

*However, simulations conducted at CERGE-EI have suggested that moving from a pay-as-you-go public pension system to a fully private system incorporating debt financing of the obligations to current workers would increase the growth rate of the Czech economy by between 0.5 and 1 per cent per year every year for at least the next two decades. Surprisingly, due to the greater savings generated by the pension reform, these simulations show that interest rates would fall despite the added debt needed to provide benefits for current workers and retirees. The positive effects of pension reform have to do with their ability to allow for massive amounts of capital investment which will be needed to achieve high growth rates. Given the problems of the stock markets and the current state of the financial systems in the region, it is doubtful that sufficient capital will come from external sources.*

## VI.2 Unemployment

## Unemployment in Central Europe



Sources: 1990-1991 *Unemployment in Transition Countries: Transient or Persistent?*, OECD, 1994  
1992-1999 *Statistical Bulletins of the CSO*

Our rather grim unemployment rate predictions published in the 1998 edition of this report turned out to be very accurate. The Czech unemployment rate continued to rise steadily during 1998 and is now at a level typical for many other transition economies. Both the ongoing economic downturn and the long-delayed restructuring of large enterprises, which up to recently relied on a soft budget constraint to stay afloat, are to blame for this protracted growth of unemployment. Our time-series unemployment model predicts that the unemployment rate will approach 11 per cent by the end of 2000.

The Central European transition countries now form two groups in terms of their unemployment levels. Poland and Slovakia seem to follow a high unemployment equilibrium path (12-16 per cent), while Hungary and Slovenia apparently converge to lower un-

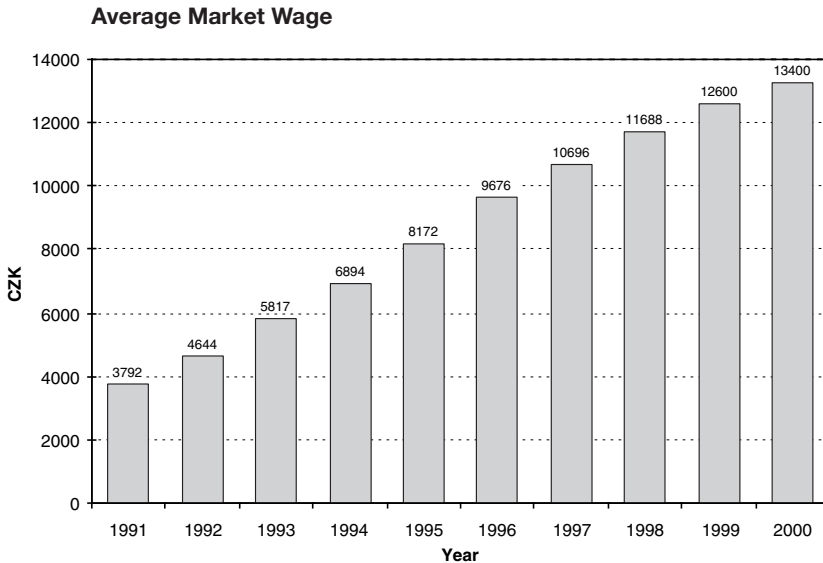
employment levels (7-9 per cent). Whether the Czech economy will leave the low-unemployment group and join Poland and Slovakia is not clear. One could expect that the end of the current recession will bring somewhat lower unemployment figures, but few expect the rate of joblessness to return to its 1996 levels, partly because many unemployed might get caught in the welfare trap (see Section VI.4 of the 1998 report).

#### Predicted Unemployment Rate in the Czech Republic in 2000

Month	Unemployment Rate [%]
March	9.8
June	9.8
August	10.6
December	11.1

Source: CERGE-EI unemployment model

### VI.3 Wages



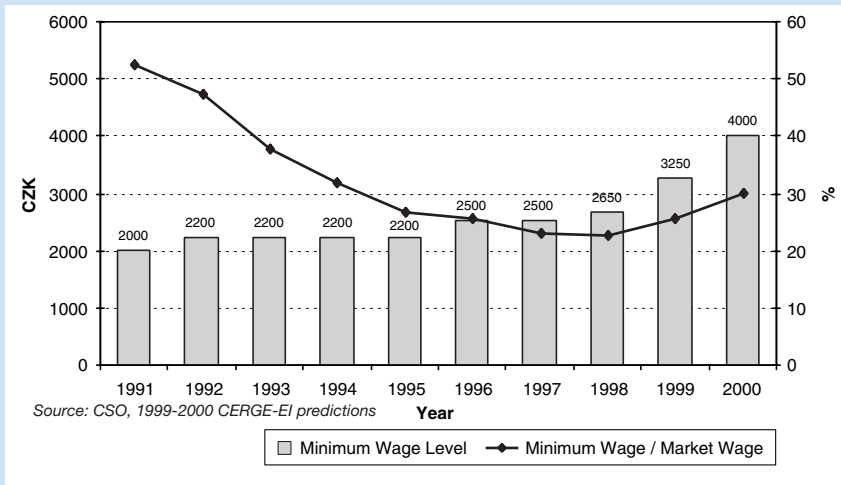
Source: CSO, 1999-2000 CERGE-EI predictions

Real wage growth in 1999 apparently again surpassed productivity. A similar development in the mid 1990s helped to put the economy out of balance and spur the ongoing economic recession. Subsequently, real wages ceased to grow in 1998, and inflation started to decline. Few expected the slowdown of 1999 to happen so rapidly. Wage bargaining relied on over-valued estimates of inflation and set the nominal wage growth too high. The annual wage growth (as of the third quarter of 1999) was almost

9 per cent, while inflation stayed under 2 per cent. Government contributed to this wage surge by increasing budget-sector wages by over 13 per cent (following little or no increase in public wages during previous years). The real wage growth reached 7 per cent while GDP stagnated and employment decreased by almost 5 per cent. The real wage growth appears to be way above the productivity increase, in spite of large employment reductions. However, it stands at about 3 per cent in mid 1999.

## Changes in Minimum Wages and the Work Act

### Legal Minimum Wage



The Czech government sets a legally binding minimum wage which does not vary across regions or education. Until recently its value has played little role compared to average wages during the transition. In the past, collective agreements of employers and trade unions typically stipulated minimum wages at about 20 per cent above the officially binding level. A 12-tariff minimum-wage bracket system was also part of about 25 per cent of the collective agreements reached in 1998. Even though the minimum wage has been increased in January 1999 from 2650 CZK to 3250 CZK, its level was still only about 30 per cent of the average monthly salary at that time. However, in mid 1999, the minimum wage level reached 3600 CZK, and it will equal 4000 CZK (about 110 EUR) by January 2000. Even at this level, the minimum wage is unlikely to have much impact on labor demand. It is also unlikely to improve labor supply as it typically remains below the official minimum subsistence levels guaranteed by welfare payments. Therefore, social benefits serve as the effective wage floor.

The government has also proposed many changes to the basic law governing the labor market, the Work Act, which will align Czech legislation with the EU. In these proposals, standard clauses are introduced aimed at reducing gender pay discrimination – for example, the policy of comparable worth. The Czech gender pay gap is about 25-30 per cent even after accounting for differences in worker characteristics (such as education) across genders. Further, the guaranteed vacation length will increase from 3 to 4 weeks if the new legislation is enacted during the next year.

### **Did Wage Grids Survive the Transition?**

*(Based on Münich, D., Švejnár, J., and Terrell, K.: Returns to Human Capital under the Communist Wage Grid and during the Transition to a Market Economy. CERGE-EI Discussion Paper 1999-29)*

*The centrally planned economic system in the Czech Republic remained intact until the very end of the communist regime. Under communism, most workers had their wages set according to a centrally-determined wage grid.*

*A recent study conducted at CERGE-EI shows that the communist system succeeded in using the wage grid to set and maintain for decades extremely small wage differentials. Indeed, the estimated rate of return on education was very small and constant for decades during the communist rule. At the level of individual and household incomes, the effects of the wage grid translated into the most egalitarian distribution of income in the world.*

*The transition to a market system resulted in a major gradual increase in the rates of return to education, with the rates of return already reaching West European levels by 1996. This increase is found in all ownership categories of firms. Hence, in the face of the reduced subsidies to state-owned enterprises (SOEs) and the opening of the economy to world competition, the new wage grid used by SOEs, public administration and privatized SOEs did not cause these firms to deviate substantially in terms of returns to education from the de novo private firms.*

*The effect of the number of years of an individual worker's labor market experience on earnings indicate that men's wage-experience profile was concave in both regimes and did not change from the communist to the transition period. These results imply that the experience-wage grid used by planners to set starting wages was maintained during the entire communist period and was not substantially altered during the first six years of the transition. However, the de novo private firms now have a more concave profile than SOEs and public administration, and they pay a higher experience return than both SOEs and public administration to recent entrants in the labor market.*

*Contrary to earlier studies that found the inter-industry wage structure to be stable and similar in market and centrally planned economies, inter-industry wage structure changed substantially between 1989 and 1996 as the economy switched from central planning to a nascent market system. In particular, employees working in mining and quarrying lost much of their former wage premium, while those in trade, transport and telecommunications, light manufacturing, and "other" activities gained significantly.*

## VI.4 Welfare

The state social assistance scheme is still based on a two-income household model. It provides transfers to increase households' income to guarantee an official minimum standard of living. The standard is indexed to inflation and changes whenever inflation (CPI) rises by more than 5 per cent since the previous adjustment period. The level of the minimum standard of living reflects the household size and the age of the household members. Some benefits (child allowances, social allowances, housing contribution, and transport contribution) are provided conditionally depending on household income,

while others are not (parental allowances, birth or funeral bonuses, etc.) In particular, state support of maternity care has a long tradition in this country and has persisting public support. The system is not well targeted to individuals and households in need. For instance, approximately 75-85 per cent of all households with dependent children in the country receive child allowances. Equally importantly, the system creates strong work disincentives for large families (see the 1998 report for a detailed discussion of this issue).

### Earnings and Social Welfare

Unemployment Benefits Rules	50%(40%) of previous wage during first (second) 3 months of unemployment
Average Unemployment Benefit (June 1999, CZK)	2,513 CZK
Sickness Insurance Rule	50% of wage during first 3 days, 69% for next days up to 468CZK per day including weekends; not taxed; state budget payments.
Sickness Expenditures (1998, CZK)	20.4 bil.CZK
<b>Guaranteed Minimum Living Standard</b>	
a) household 1 adult, 1 child (11 years of age)	5,880 CZK
b) household 2 adults, 2 children (11, 17)	10,670 CZK
Minimum Wage (effective January 2000)	4,000 CZK
Average Wage (2nd Q.1999, gross)	11,366 CZK in commerce, 10,149 in public sector.
Average Elderly Pension (2nd Q. 1999)	5,506 CZK, not subject to taxation.

Source: *Sociální politika*

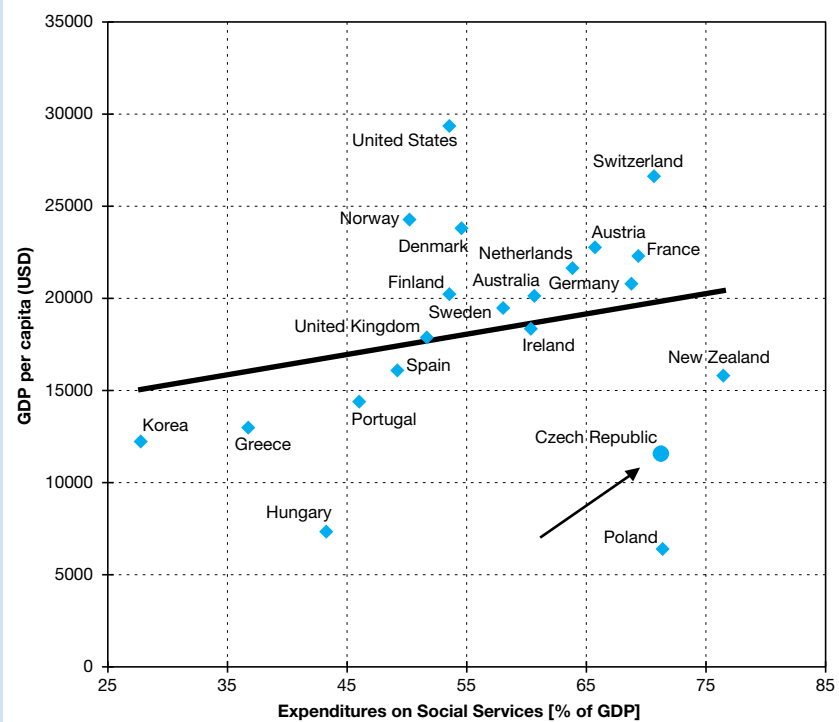
## **Not Rich Enough for Our Generous Welfare System**

*To properly understand the current set of Czech social policies – a loosely defined mix of government programs, laws, and regulations touching almost every aspect of life – we should remember that communism left the country with policies that were inappropriate for a free market. The communist social policies were implemented directly, not using financial aid, but through a centralized system providing housing, education, health, and other services of low quality for nominally low prices or by using some system of rationing. The price system was therefore distorted and income policies were extremely egalitarian. Although this system guaranteed a certain welfare minimum for everyone, it was enacted at the expense of civic and economic liberties. The only part of the old social system surviving almost completely intact during the emergence of the market, deregulation, price liberalization, and privatization is the pension scheme, currently subject to demographic pressures (see Section VI. 1). New schemes had to be introduced from scratch, such as unemployment insurance and legal minimum wage stipulations.*

*Both the population age structure and the generous system of social assistance which the country inherited, resembled their counterparts in many EU countries. Further, the newly introduced social policies mimicked to a great extent policies already established in the EU. Ten years after the collapse of communism, the Czech Republic implements social policies which are comparable in terms of their relative costs to those operating in EU member states, where the average GDP level is about 2-3 times higher. This similarity of social policies is a disadvantage, rather than a success which should be applauded. The cost of social policies is too high given the relative level of development (see the figure and the discussion below). The current social assistance formulas introduce strong work disincentives (see the 1998 report for a description of the social benefits welfare trap), further adding to the high cost of the system. Finally, the economic and social impact and especially the efficiency of these social policies is subject to very little empirical analysis and independent expert scrutiny.*

*The welfare state commitments inherited from the communist era resulted in what was formerly termed by Janos Kornai as a “premature welfare state.” The portion of output produced by a Czech worker which is taken by the government through social security contributions and income taxes is much higher than the less than 30 per cent tax in the US and UK, the less than 20 per cent in Japan and Australia and the less than 5 per cent in Korea. Total tax rates in the rapidly developing countries in Asia and Latin America that have set the standard for growth in recent decades are similarly much lower. Indeed, in recorded history it is impossible to find an example of a country that has achieved sustained rapid growth with tax rates anywhere*

### Expenditures on Social Services [% of GDP] and GDP per Capita at PPP [USD]



Source: The World Bank Development Report 1999

approaching those found in many of the transition economies today. The post-war German “economic miracle” occurred in a largely unregulated, low-tax environment. The magnitude of the relationship between growth rates and tax burdens is a matter of some dispute among economists, but the unambiguous conclusion is that the correlation is negative. It is unlikely that the Czech economy will find a way to repeal the economic law connecting tax and growth rates even if its initial conditions differ sharply from those of the typically less developed countries. To build a dynamic and growing labor market, the goal of the government should be to reduce the tax on labor earnings from its current high levels to substantially below the OECD average of 34 per cent.