DRIVERS OF GROWTH
ECFIN Country Workshop

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Executive summary

Convergence of the Czech Republic’s GDP per capita to the EU average was slower than expected twenty years ago. Moreover, net national disposable income, a proxy of living standards, has not improved relative to the EU-15 average. This presentation puts forward four elements that help explain these facts.

Firstly, growth in CZ as well as in other CEE countries was largely driven by foreign direct investments – an appropriate choice for countries that needed to recapitalise and catch up with the technological frontier. However, despite numerous success stories, the evidence that FDI helped improve the overall sophistication of production, which is the crux of long-term growth, is mixed. Secondly, this growth model produced impressively low unemployment. While this was an achievement envied by many, it perhaps also took away the pressure to continue with reforms. The Czech Republic started to lag behind on the quality of the institutional framework. Since institutions ultimately shape growth, this is a serious issue.

Zooming in on the post-crisis period, two additional factors account for the observed growth differentials between CZ and its regional peers: As the strong post-war cohort approached retirement, the Czech population of working age started to shrink. Projections suggest that demography is to become a permanent drag on growth. Finally, while fiscal consolidation was necessary and of broadly comparable magnitude e.g. with SK, the particular mix of the Czech fiscal adjustment resulted in a higher drop in GDP.

Based on this analysis, we draw a list of reforms that could strengthen domestic drivers of growth.
1989

“We will reach Austria in 10 years”

Valtr Komárek

economist and politician (1930-2013)
"In 2-3 years real GDP growth should be back at 4-5% again. We should reach the EU in about 20 years”

Zdeněk Tůma
former Governor of Czech National Bank

"We could get at the EU level in a medium-term horizon, in around 10-15 years”

Eva Zamrazilová
member of the CNB Bank Board
Reality: Not there yet

GDP/capita relative to EU-15, in %

Source: Eurostat
At this speed, convergence with EU-15?

GDP/capita vs. EU-15, in %

Source: 1995-2012 Eurostat
At this speed, convergence with EU-15?

GDP/capita vs. EU-15, in %

Source: 1995-2012 Eurostat

- EU-15
- Czech Republic
Looking at what really matters

Living standards
Net national disposable income in % of EU-15

Source: Eurostat
Only in CZ did convergence in living standards stall

Change in living standards 1995-2012
Net national disposable income in % of EU-15

Source: Eurostat
What happened?

1. FDI / export driven development
2. Institutional framework
3. Demographics & labour supply
4. Consolidation mix
CZ was highly attractive for FDI

CZ most attractive for foreign investment in CEE

UNCTAD, Inward FDI Potential Index, 1995
Today, FDI shape CZ economy...

- **PRODUCTION**
  - 1995: 7%
  - 2012: 43%

- **VALUE ADDED**
  - 1995: 5%
  - 2012: 31%

- **PROFITS**
  - 1995: 8%
  - 2012: 60%

Source: CzSO (2012)
...and induce large income transfers

Income transfers account for 7.5% in 2012

GDP and Gross National Income, in CZK 1000bn

Source: Eurostat
Know how transfers?
Shifting to knowledge-intensive output

Picture mixed

<table>
<thead>
<tr>
<th>Ranking of CZ among EU-28 Member States</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMPLOYMENT IN HIGH-TECH MANUFACTURING</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>18</td>
</tr>
<tr>
<td>PATENT APPLICATIONS</td>
</tr>
</tbody>
</table>

Source: Eurostat, Innovation Union 2013
CZ economy export-oriented
But exports highly concentrated in terms of geography and structure

WHERE DOES CZ EXPORT TO?

- DE (31%)
- EU (other) (40%)
- SK (10%)
- China (14%)
- Russia (4%)
- Other (1%)

WHAT DOES CZ EXPORT?

- Machinery (48%)
- Manufactured materials (20%)
- Crude materials (7%)
- Manuf. articles (12%)
- Chemicals (7%)
- Food (5%)

Source: CzSO
FDI/export model: What to expect

More FDIs?

More external demand for current products?

Shift in value added?
What happened?

1. FDI / export driven development
2. Institutional framework
3. Demographics & labour supply
4. Consolidation mix
CZ falling behind in governance...

CZ underperforms most EU countries in governance
Ranking of CZ vs. EU-28 MS, 2013

<table>
<thead>
<tr>
<th>KEY INDICATORS</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political Stability</td>
<td>7</td>
</tr>
<tr>
<td>Regulatory quality</td>
<td>16</td>
</tr>
<tr>
<td>Law</td>
<td>17</td>
</tr>
<tr>
<td>Government Effectiveness</td>
<td>18</td>
</tr>
<tr>
<td>Voice &amp; Accountability</td>
<td>20</td>
</tr>
<tr>
<td>Corruption</td>
<td>21</td>
</tr>
</tbody>
</table>

...and business environment

**WB Doing Business country rankings**

1 = best in the world, 189 = worst in the world, 89 = worst EU MS in 2014

- **SK**
- **HU**
- **PL**
- **Czech Republic**
- **Worst EU**

Source: WB Doing Business (2014)
Labour is heavily taxed

Taxes on labour higher compared to peers but also Germany
Implicit tax on labour, in %, 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>TAX (%)</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>BE</td>
<td>42.8%</td>
<td>1</td>
</tr>
<tr>
<td>IT</td>
<td>42.3%</td>
<td>2</td>
</tr>
<tr>
<td>CZ</td>
<td>39.0%</td>
<td>6</td>
</tr>
<tr>
<td>DE</td>
<td>37.1%</td>
<td>10</td>
</tr>
<tr>
<td>PL</td>
<td>32.2%</td>
<td>16</td>
</tr>
<tr>
<td>SK</td>
<td>31.9%</td>
<td>19</td>
</tr>
<tr>
<td>BG</td>
<td>24.6%</td>
<td>26</td>
</tr>
</tbody>
</table>

Source: Eurostat
Taxes affect employment status

Shares of self-employed increased in both CZ and SK but CZ self-employed made zero contribution to GDP growth.

Average contribution to GDP growth, in %, 1995-2012

Source: Eurostat
What happened?

1. FDI / export driven development
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Working age population is now shrinking

Number of people aged 15-64 years

Source: Eurostat
Ageing plays a role

1995

Working age population, 1995 (in ths)

2012

Working age population, 2012 (in ths)

Source: Eurostat
Utilisation of labour has been a strength

Gap to EU-15, average 1995-2012

<table>
<thead>
<tr>
<th></th>
<th>GDP/capita</th>
<th>Overall productivity</th>
<th>Labour utilisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>69%</td>
<td>57%</td>
<td>121%</td>
</tr>
<tr>
<td>SK</td>
<td>55%</td>
<td>56%</td>
<td>98%</td>
</tr>
<tr>
<td>HU</td>
<td>54%</td>
<td>48%</td>
<td>113%</td>
</tr>
<tr>
<td>PL</td>
<td>48%</td>
<td>44%</td>
<td>108%</td>
</tr>
<tr>
<td>EU-15</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Author's calculations based on AMECO data
Labour participation of young women much below EU-15

Underutilised potential in the labour market
Employed and unemployed on population, in %, 2012

Source: Eurostat LFS
Unprecedented expansion of higher education – but is the structure right?

CZ graduates by field, in ths

Source: Eurostat
Unused potential in primary education

Source: BuzzFeed (2014) based on OECD PISA 2012
What happened?

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### Fiscal effort 2010-2013

Cumulative discretionary measures, in % of GDP, 2010-2013

<table>
<thead>
<tr>
<th>TOTAL REVENUE MEASURES</th>
<th>CZ</th>
<th>SK</th>
<th>PL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect taxes</td>
<td>1,4</td>
<td>1,1</td>
<td>0,2</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>0,1</td>
<td>0,1</td>
<td>0,0</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>0,0</td>
<td>0,2</td>
<td>-0,3</td>
</tr>
<tr>
<td>Social security contributions</td>
<td>0,1</td>
<td>0,7</td>
<td>0,5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TOTAL EXPENDITURE MEASURES</th>
<th>CZ</th>
<th>SK</th>
<th>PL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediate consumption</td>
<td>0,6</td>
<td>1,2</td>
<td>0,5</td>
</tr>
<tr>
<td>Compensation of employees</td>
<td>0,4</td>
<td>0,5</td>
<td>0,4</td>
</tr>
<tr>
<td>Social benefits</td>
<td>0,1</td>
<td>0,0</td>
<td>0,8</td>
</tr>
<tr>
<td>Public investment</td>
<td>1,9</td>
<td>0,7</td>
<td>1,6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TOTAL DISCRETIONARY MEASURES</th>
<th>CZ</th>
<th>SK</th>
<th>PL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,7</td>
<td>4,6</td>
<td>3,7</td>
</tr>
</tbody>
</table>

Source: Author's calculations
Consolidation resulted in disproportionately higher drop in GDP

Cumulative loss in % of GDP, 2010-2013

Source: Author's calculations using QUEST model
Way forward:
Stimulate domestic drivers of growth

- HUMAN CAPITAL
- LABOUR POTENTIAL
- STRENGTHEN INSTITUTIONS
- GROWTH-FRIENDLY FISCAL POLICY

?
Way forward: Rebalance to domestic growth
(Detail based on 2013 Country-specific Recommendations)

**HUMAN CAPITAL**
- Improve quality of education (all levels)
- Support innovations

**STRENGTHEN INSTITUTIONS**
- Reduce tax compliance costs
- Address self-employed - reduce discrepancies
- Anticorruption strategies / improve administration

**UTILISE LABOUR POTENTIAL**
- Increase child-care facilities

**GROWTH FRIENDLY FISCAL POLICIES**
- Prioritize growth-enhancing expenditures (don't cut investments)
- Shift taxes away from labour
ADDITIONAL SLIDES
Unemployment rate remained relatively low in CZ

Unemployment rate 1995-2012 - average, min and max

Source: Eurostat
Income transfers in EU-28

Share of net income transfers on GDP for CZ third highest in EU-28

Source: Eurostat
References

