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Highlights in this issue:

- **Social cohesion in the Czech Republic is remarkably strong**

- **Social transfers only partly explain the high level of Czech social cohesion**

- **However, their design can have significant economic effects, in particular on labour supply and fiscal sustainability**

Social cohesion in the Czech Republic: a blessing or a trap?

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Summary

When using indicators of inequality of income distribution and the at-risk-of-poverty rate, the Czech Republic has one of the highest levels of social cohesion in the EU, comparable to that of the Nordic countries. Though social transfers play a significant role in reducing the Czech poverty rate, it is the country's relatively equal distribution of primary income that contributes most to the level of social cohesion overall. This can be explained by several factors, in particular by the quality of education, the homogeneity of society, regulation of rental housing, the gradual nature of the transition process and other historical reasons. Economic theory and empirical evidence are not clear-cut on what the impact of social cohesion is on economic efficiency and growth. Though social cohesion can have a positive economic impact on growth, the tax-transfer system, if badly designed, may have harmful consequences for labour supply and for the sustainability of public finances as seems to be the Czech case.

Social cohesion in the Czech Republic: the facts

Social cohesion was acknowledged as a key objective of the European Union at the Lisbon European Council of March 2000. In the follow-up EU summit in Laeken in December 2001, the EU leaders agreed that inequality of income distribution and the poverty rate are important statistical indicators of social performance and since then they have been regularly published by Eurostat. These two indicators show that, at the moment of the EU accession, the Czech Republic had a very high level of social cohesion, comparable to that of the Nordic countries.

Inequality of income distribution and the poverty rate are among the lowest in the EU…

First, the Czech Republic displays a very low inequality of income distribution, which is defined as the ratio of total income received by the 20% of the population with the highest income (top quintile) to that received by the 20% of the population with the lowest income (bottom quintile).[1] As Chart 1 displays, the indicator for the Czech Republic is 3.4, only slightly above the minimum in the EU-15 (3.3 in Sweden). Among the recently acceded Member States (RAMS) only Slovenia and Hungary have a lower indicator (3.1 and 3.3, respectively). For the EU-25 as a whole, the average ratio is much higher (4.8).

Second, the Czech Republic displays the lowest poverty rate of all the EU Member States. The "at-risk-of-poverty rate" is an indicator which shows the share of households with an income below the risk-of-poverty threshold which is set at 60% of the national median income.[2] As indicated in Chart 1, only 8% of households in the Czech Republic lived below this relative poverty line in 2003. In the Nordic countries (Denmark, Finland and Sweden), which have traditionally had a high level of social cohesion, the share of poor households reaches some 11%. In the EU-25

as a whole, on average about 16% of households live below the relative poverty line.

As indicated in Chart 1, the Eurostat indicators on inequality of income distribution and on poverty are highly correlated: the lower the inequality of income distribution, the lower the poverty rate. In other words, when more households have income close to the median, it reduces the poverty rate, which is defined in relative terms.[3]

Chart 1: Social cohesion in the EU (2004 or the most recent data)
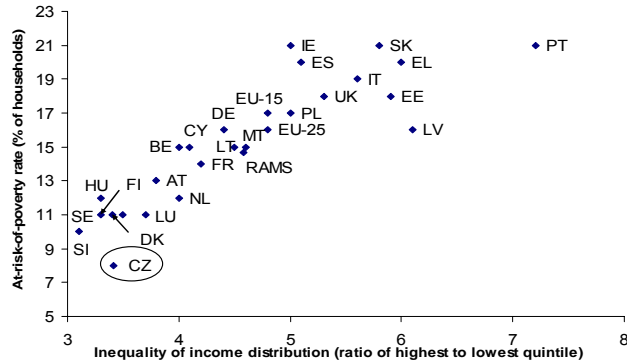
Note: Data for the Czech Republic, Estonia, Cyprus, Lithuania, Latvia, Hungary, the Netherlands, Poland, Slovenia and the United Kingdom are from 2003; for Malta from 2000
Source: Eurostat

Eurostat points out that, due to differences in the underlying sources, these data cannot be considered to be fully comparable among the countries. Nevertheless, OECD data lead to a similar conclusion (OECD, 2005): the Czech Republic seems to be a quite cohesive country from the social point of view, compared not only with the other RAMS, but also with the EU as a whole. Moreover, data on the poverty rate indicate that the Czech Republic already stood out as the country with the lowest poverty rates in the early and mid-1990s (Sainsbury and Morissens, 2002).

Explaining the high level of social cohesion

High levels of social cohesion can be explained by a number of factors. In addition to redistribution through social transfers, other elements can also be important: for example labour market policy and institutions, market regulation, education and training systems, mechanisms to avoid child poverty, integration of people with disabilities, ethnic minorities and immigrants, etc. (OECD, 2005). Social cohesion is also usually linked to the level of economic development. It is beyond the scope of this analysis to consider all these factors and their interactions in a systematic manner. Only those arguments which seem to be particularly relevant for the Czech Republic are selected here.

Social policy

The role of social policy can be assessed when comparing the above Eurostat indicators which include social transfers with those which do not. Using gross (i.e. before-tax) annual earnings (i.e. without social transfers) in industry and services of the year 2002, Mittag (2006) shows that in the Czech Republic the 10% of the population with the highest income (top decile) earns three times as much as the 10% of the population with the lowest income (bottom decile). This is the lowest earning disparity among the RAMS. Of the old Member States, only the Nordic states (Finland, Denmark, Sweden; and, outside the EU, Norway) have a lower ratio. Low income disparity can also be derived from looking at the ratio of mean (average) to median gross annual earnings. This indicator for the Czech Republic is only 1.18, below the EU-25 average (1.20) and the lowest among the RAMS.[4] Therefore, social transfers and progressive income taxation do not significantly change the relative position of the Czech Republic in terms of income inequality.

… which is only partly due to social policy

However, as concerns the poverty rate, the 2006 Joint Report on Social Protection and Social Inclusion (European Commission, 2006) finds that the Czech social protection system (see Box below) decreases the poverty rate by three fourths or more (if pensions are included) or by almost two thirds (without pensions). This is the largest impact of all the EU Member States, and only the three Nordic countries

(Finland, Sweden and Denmark) reach comparable results. That said, the poverty rate in the Czech Republic is among the lowest even without social transfers. In 2001, the most recent year for which comparable data are available, the poverty rate before transfers was about 18% which was among the lowest in the EU (only three EU Member States – Hungary, Slovenia and Sweden – reached about the same level).

The social protection system in the Czech Republic

Social insurance covers situations of unemployment, in-work sickness, disability and old age. Contributions are defined as a percentage of gross earnings and are divided between the employee and the employer. Benefits are paid in relation to previous net income, but the formulae for calculating the benefits entail significant redistribution.

State social support addresses the financial needs connected with family life. Most of the benefits are income-tested. Support covers child benefits, allowances for parents taking full-time care of children, social family allowance for low-income families with children, housing allowance for low-income families and some other benefits.

Social assistance provides safety net income. If the income of the person or family concerned, including all other state support benefits, pensions or sickness insurance benefits, does not reach the state-defined minimum subsistence allowance (MSA), and eligibility conditions are met, the gap is usually bridged by social assistance. The MSA is constructed from two components, one setting the amount for the basic personal needs of each member of the household (personal needs) and the other setting the amount for the needs of the household as a whole (household needs).

Source: OECD (2004)

Primary income distribution seems more important

Though social transfers seem to be quite effective in combating poverty they do not explain the comparatively favourable position of the Czech Republic in the EU in terms of social cohesion. The poverty rate and income inequality are low even without taking account of transfers and taxes. The relatively equitable distribution of primary income seems to be more important than social transfers for social cohesion. The main factors explaining the equitable primary income distribution are mentioned below.

Education

Czech education has traditionally been of relatively good quality. Rates of secondary school participation and completion have been high and, at the same time, the share of degree-level attainment relatively low by international comparison (OECD, 2006). This narrows the gap between skilled and unskilled compared to other countries. This might explain why the earning disparities are so low in the Czech Republic.

Strong secondary education also helps to explain the very low poverty rates. The only group with disproportionately high poverty rates are the Roma who also have a significant gap in education and skills, mainly due to their social and economic exclusion. However, the Czech society has a high degree of ethnic homogeneity as the Roma population is estimated to be less numerous in the Czech Republic than in other central and eastern European countries, and this may also partly explain the low level of poverty.[5]

Regulation of rental housing

Among policies, education and regulation of rents seem to play a significant role for social cohesion in the Czech Republic…

The relatively high degree of social cohesion in the Czech Republic might also be due to regulation of rental housing. Regulation of rents is a form of indirect redistribution of income from the relatively rich (landlords) to the relatively poor (tenants).

The specific characteristics of the Czech transition

Forty years spent under communist rule where the state guaranteed social assistance "from cradle to grave" may also have contributed to the high degree of social cohesion and egalitarianism in the Czech Republic. However, this argument does not explain why the Czech Republic differs so much from the other RAMS. The specifics of the Czech transition process are more telling here. The Czech Republic effected privatisation through a large-scale voucher scheme. A majority of people transferred their vouchers into investment funds, which obtained significant stakes in many privatised companies. The biggest of these funds were owned by the major domestic banks, in which the Czech state retained a controlling or majority stake. The funds did not have incentives to push for the closure of unprofitable firms and to

force the banks to write down the loans they had made to these firms. This privatisation policy was combined with sound macroeconomic management (the 1990 decision to devalue the currency by as much as 50 per cent, followed by very rapid economic growth between 1993 and 1996), ensuring that Czech unemployment rates in the first years of transition remained among the lowest of all the transition countries.

Nevertheless, the specific features of the transition should not be seen as exogenous. They can be partly explained by the fact that the need for draconian reforms was not as pressing in the Czech Republic as in other countries, thanks partly to the low degree of macroeconomic imbalances at the end of the 1980s and to the relatively high income level – similar conditions to those prevailing in Slovenia which, unsurprisingly, is almost as socially cohesive as the Czech Republic.

Historical legacy

… but historical and cultural reasons are relevant as well

Strong social cohesion is more generally linked to the Czech Republic's egalitarian culture, which has deep historical roots. The Czechs re-emerged as a nation in the 19th century without having a strong native aristocracy (unlike the Poles or the Hungarians for instance). Czechoslovakia between the wars had a relatively compact society of skilled workers, minor officials, small businesspeople, prosperous middling farmers and intellectuals (Hanley, 1999). As a former part of the Austrian empire, Czechoslovakia belonged to the class of corporatist states with a strong bureaucracy and one of the most generous welfare systems in the world, based on Bismarckian traditions (Večerník, 2004).

Impact of social cohesion on growth, employment and fiscal sustainability

Economic growth

Economic theory is ambiguous on the impact of social cohesion on economic growth. Some theories say that higher social cohesion helps economic growth; other claim the opposite (Barro, 2000).

There are at least three arguments why lower income inequality could enhance a country's economic performance and why social cohesion can be viewed as a productive factor. First, where access to credit largely depends on individuals' income and wealth, poor households tend to forego human-capital investment. Redistribution from rich to poor may in this case raise investment and the average rate of return. Second, a higher degree of social cohesion may cause higher economic growth by contributing to the stability of political institutions and a reduction in crime, riots and other disruptive activities by the poor. And third, a poverty protection system can motivate people to engage in risky but profitable economic activities, which they would probably not undertake otherwise (Sinn, 1996).

Social cohesion can have either a positive or a negative impact on economic growth

The opposite theories, those postulating of a negative relationship between social cohesion and economic growth, go back to Keynes' assumption that the propensity to save increases with income. If this is the case, a redistribution of income from rich to poor will reduce the aggregate rate of saving in the economy. More advanced theories assume that high rates of return can be achieved only after some minimum degree of capital accumulation (high set-up costs). In that case, economic growth would be supported by higher concentration of asset ownership (i.e. less social cohesion). If a high degree of social cohesion is achieved through high taxation (including social contributions), combating social inequalities may also distort economic decisions. The high cost of financing social spending may crowd out other growth-enhancing expenditures, like investment. Furthermore, levies on labour income may discourage labour effort and diminish labour supply and investment, with a resulting decline in economic growth.

In an extensive empirical study with cross-country and time-series data, Arjona *et al.* (2001) note that, while evidence tends to suggest that a wider income distribution is good for growth, the estimates as a whole explained little of the differences in growth rates and nothing, in fact, could be safely concluded.

Finding the "right" balance between economic efficiency and income equality is thus a big challenge for every country (Buti *et al.* 1999). In the case of the Czech

Republic, particular attention should be paid to social transfers. Though the Czech social protection system seems quite efficient (mainly in combating poverty) and social spending is currently not excessive given the level of economic development (see Chart 2), ensuring that it does not have a negative impact on either the labour market or the long-term sustainability of public finances is the key to maintaining social cohesion in the Czech Republic in the future.

Chart 2: Social transfers and income level
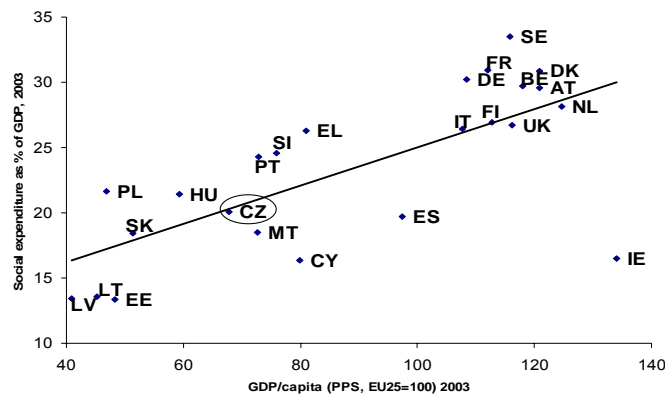
Source: Eurostat

Employment

Social transfers and taxation affect the behaviour of individuals. However, the empirical literature on the interactions between taxes and transfers and their impact on labour supply in the Czech Republic is very thin. In one of the few contributions, Galuščák and Pavel (2005) find that the Czech tax-transfer system seriously distorts labour supply, especially for some groups (principally low-paid employees with a working spouse). They also find that the tax-benefit system attenuates the search effort of unemployed individuals with a non-employed spouse. Those are the groups most vulnerable to poverty. The labour market is also negatively affected by the regulation of rental housing which benefits tenants who rented their housing under socialist rule, and therefore disadvantages mainly young people and those who would be willing to move to take up a job, which hinders work-related migration.

Combating negative effects on labour supply and unsustainable social spending while maintaining social cohesion are the main challenges in the Czech Republic

The tax-transfer system thus appears to have a negative impact on employment which is itself a vehicle to combat poverty and an important factor of economic growth. A start has been made in tackling these shortcomings, with several changes introduced in 2004 and 2005 (mainly to reduce personal income taxation).

Fiscal sustainability

When considered in a dynamic long-term perspective, the financing of the Czech social protection system in its current design does not appear to be sustainable. This is mainly due to an explosive increase in age-related expenditures as the Czech Republic has not yet sufficiently adjusted its pension and healthcare system to the expected process of very rapid population ageing (Mora, 2005). In the Council Opinion on the December 2005 update of the convergence programme, the Czech Republic was classified as being at high risk as regards the long-term sustainability of public finances, together with five other Member States.

Concluding remarks

The Czech Republic displays very low income inequality and the lowest poverty rate in the EU. Though the latter has been largely achieved through an effective use of social transfers, the high level of social cohesion is mainly due to relatively equal primary income distribution. This can be explained by several factors including a good-quality yet egalitarian education system and regulation of rental housing. It is also a result of the specific features of the Czech transition, and of deeper historical and cultural causes. Although welfare programmes fostering social cohesion can have both positive and negative repercussions on economic growth, the design of the Czech tax-transfer system creates disincentives for labour supply and endangers the sustainability of public finances. Taking further steps to tackle these

shortcomings without compromising the high level of social cohesion is the main challenge the Czech Republic faces in the field.

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[1] This refers to equivalised disposable income. "Equivalised" means that it takes account of the size and composition of a household. The first adult has a weight of 1.0, each additional adult 0.5, and each child 0.3, thus reflecting a household's economies of scale. "Disposable" means that it is net (after-tax) and includes all incomes of a household: earnings, social transfers, property income, etc.

[2] Also here this refers to net equivalised disposable income (see endnote 1).

[3] Median income divides the population into two halves: 50% of population earns more than the median income and 50% earn less.

[4] The higher the ratio, the larger the difference between the mean and median income, and therefore, the more people who earn less than the average income.

[5] Between 1 and 2% of total population, though no precise estimates exist.