The Czech Government´s Strategy for Reducing Inequality

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Abstract

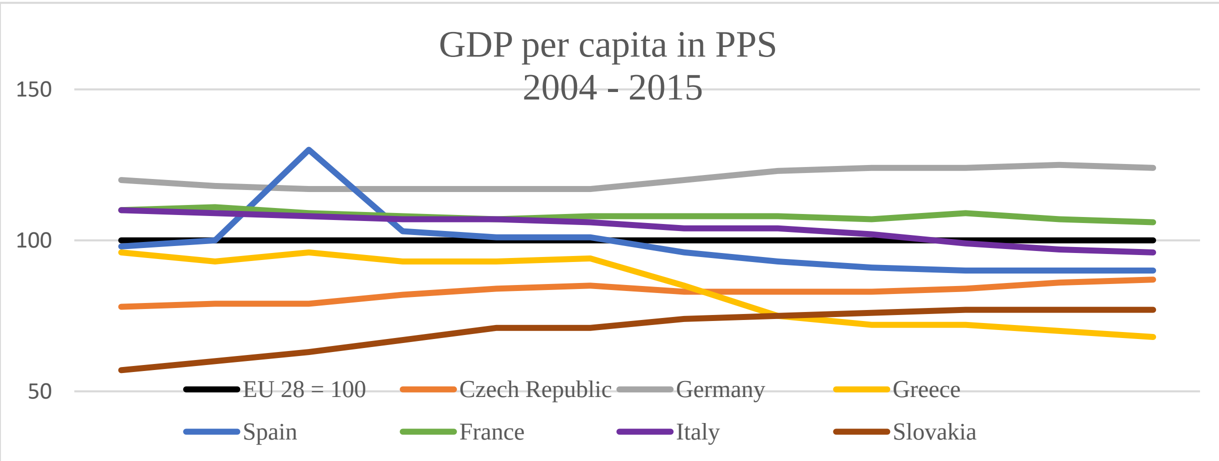
Inequality as measured by the distribution of income between rich and poor countries has narrowed globally. However, the story is less pleasing within individual countries. This paper analyses the situation in one post-communist transitional country. The aim of the paper is to answer whether the generally-accepted opinion about Czech society being egalitarian is true. We started with an analysis of wealth inequality within EU countries. The **first conclusion** based upon EUROSTAT and World Bank data shows the inequality between developed EU members and post-communist countries and the authors analyze some of the contributing factors. Next, we analyze inequality through the prism of three different methods to discover whether the commonly-proclaimed opinion about the egalitarian nature of Czech society is true or whether the reality is different. The first factor is **differentiation among workers**. The analyses clearly support the conclusion that inequality of workers in Central European post-communist countries will hardly reach the income level corresponding to their counterparts of groups in the A and B categories of workers in the developed economies of the EU. The second is the **growth of crony capitalism** (as measured by the crony capitalism index). A value of 12.53 indicates a high level of interaction between the government and rent seekers and requires the immediate implementation of appropriate measures. The third is **social and economic status**. Social status has been predominantly influenced by access to education, family structures, social capital (interaction with groups), and pre-existing income inequality. Access to inexpensive education represents the most important factor in reducing inequality, regardless of comparatively low government spending (within the EU). The paper's conclusions see the greatest inequality in pre-existing wealth (created by restitutions after the fall of the communist regime) and thereafter the possibility to participate on a free market of investments. Inequality has been growing despite the generally-accepted supposition that Czech society is egalitarian.

Keywords: Globalization, Solidarity, Inequality, Income, Crony Capitalism,

Introduction

Defenders of globalization often argue that whatever distress it may cause rich-world workers (Piketty, Capital in the 21st Century, 2014), it has been good for poor or less affluent countries. The data provided by the World Bank supports this opinion, though one of the most famous opponents of globalization, Joseph E. Stiglitz, does not agree with the argument used by neo-liberal economists: "*Big parts of population segments in highly-developed countries do not enjoy increased participation in profits created through globalization. In the U.S., the median salary of a fully-employed male worker adjusted for inflation is smaller than the corresponding income 42 years ago,"* (Handelsblatt, 2016, p. 46-47). Bernie Sanders used the same arguments *in INY Times* (INY Times, 2016. p. 12).

Figure 1: EU Wealth Inequality



(Source: Own adjustment based on Eurostat data)

Wealth inequality between states is clearly demonstrated in figure 1. It shows that regardless of the steady long-term performance of the Czech economy, wealth inequality between the EU's founding developed countries and transitional accession countries expressed in PPP shows a considerable gap of 71.5% to Germany. An even more distressing picture was given in the latest statement from the WEF in Davos: the private wealth of the three richest men in the world is greater than the wealth of the 58 poorest nations in the world. Though the analysis of factors behind this data would partly explain some causes of inequality among countries, we intend to look at inequality within a single country: the Czech Republic.

Why is the issue of income inequality considered so important? To answer this question, we have to go back into history. A large portion of the

Czech population grew up influenced by communist ideology, which was firmly entrenched even before the communist takeover in 1948. The Velvet Revolution of 1989 opened the door to implement western-style democracy in the form of democratic capitalism.

The first wave of inequality began with restitution processes that transferred a massive amount of wealth, especially in land and real estate, to individuals. The second wave came in the form of privatization of former state-owned companies. This offered opportunities to investors, either from neighboring western countries, or to communist party members that managed the companies before the revolution. The third factor relates to the generation born in the 1950s that earned a low income in state-owned communist factories and entered retirement with low pensions that corresponded to their salaries; a group that currently represents about 20 % of the population. These three factors created a base for inequality, particularly in terms of equal opportunity to participate in profitable businesses.

Democratic capitalism can be described as an economic system characterized by freedom of thought, private property rights, economic justice, profit motives, free competition, and social cooperation. The principle of solidarity is thus incorporated into the philosophy of democracy. Most importantly, it requires social cohesion in order to tackle the biggest challenges of globalization that threaten all western democracies: climate change, low birth rates combined with rising life expectancy, and increasing migration and technological change.

All of these factors have influenced the political and social atmosphere, which can be described as very intolerant and explosive. In this atmosphere, the implementation of measures leading to greater solidarity are among the governmental policies with the highest priority.

We first analyzed the reasons for the wealth gap between developed EU members and post-communist transitional countries using per capita GDP and Gini´s coefficient and then examined factors specific to the Czech Republic. We used: 1. Differentiation among workers and their participation on the income of the companies they work for (chiefly owned by foreign entities); 2. The crony capitalism index, which shows the role of rent-seeking tycoons; and 3. Social and economic status. Once we perform these analyses, we should be able to answer our hypothesis: ***"Is Czech society as egalitarian as is commonly believed?"***

1. Globalization and its Measurable Consequences on Societies

1.1. Gini Coefficient of Inequality

Inequality as measured by the distribution of income between rich and poor countries has narrowed. However, the story is less pleasing within individual countries. Globalization in fact resulted in a faster widening of inequality in many poorer countries. The Gini coefficient is the most commonly-used measure of inequality. It varies between 0, which reflects perfect equality, and 1, which indicates perfect inequality. Graphically, the Gini coefficient can be easily represented by the area between the Lorenz curve and the line of equality.

Gini Coefficient of Inequality

$$G = \frac{\sum_{i=1}^{n}\sum_{j=1}^{n}|x_i - x_j|}{2n^2\bar{x}} \qquad (1)$$

- Where x is an observed value, n is the number of values observed and x bar is the mean value.

Table 1: Gini coefficient (disposable income after taxes and transfers) for selected Central European countries and the USA, 2012

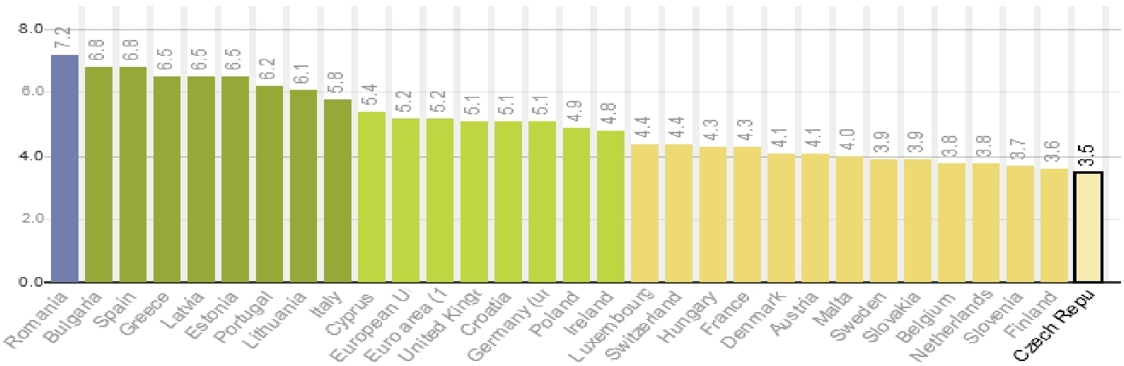
Country	Gini coefficient	Palma ratio
Austria	0.276	0.96
Czech Republic	0.256	0.89
Hungary	0.29	1.03
Poland	0.298	1.08
Slovakia	0.25	0.83
USA	0.389	1.74

(Source: Own adjustment based on OECD and World Bank data)

1.2. Eurostat Uses the Income Quintile Share Ratio (S80/S20 ratio)

The Gini coefficient is a measure of the inequality of income distribution. It is calculated as the ratio of total income received by the 20% of the population with the highest income (the top quintile) to that received by the bottom 20% of the population (the bottom quintile). More generally, income ratios can be computed for different ‘quantiles,’ a generic term that refers to any specific population proportion. For example, income ratios may be computed on the basis of deciles (1/10 of the population ranked by income), quartiles (one quarter of the population), etc.

Figure 2: Eurostat Income Quintile Share Ratio (S80/S20)



(Source: Eurostat)

In the period of 2004-2014, income inequality in the Czech Republic remained at the same level: 3.5. We conclude that if this level is compared with GDP growth rates and increases to the Czech average salary in 2004 to 2014, then inequality in fact increased. The average monthly salary in the Czech Republic has grown steadily since 2014 and reached CZK 31,646 (€1,246 according to the current exchange rate) in 2017, but two-thirds of employees did not reach that level. Therefore, the more correct measure would be the median at CZK 27,320 (€1,075).

Palma Ratio: The Palma ratio is defined as the ratio of the richest 10% of the population's share of gross national income divided by the poorest 40%'s share. It is based on the work of Chilean economist Gabriel Palma, who found that middle class incomes almost always represent about half the gross national income while the other half is split between the richest 10% and the poorest 40%, but the share of those two groups varies considerably across countries. The Palma ratio addresses the Gini coefficient's over-sensitivity to changes in the middle part of the distribution and insensitivity to changes at the top and bottom, and therefore more accurately reflects income inequality's economic impacts on society as a whole. Palma has suggested that distributional politics mainly pertain to the struggle between the rich and poor and who the middle classes side with. The situation in pre-election campaigns in the USA and the position of the middle class in China and other countries support the use of the Palma ratio rather than the Gini coefficient, which shows how much wealth is accumulated by the top 10% of billionaires in a given country. (Palma, 2006)

Professional publications on income inequality describe two major schools of thought: the American and Chinese. The Chinese view perceives inequality corresponding to characteristics of high power-distance countries. The greatest divide in both income and opportunity is between rural and urban areas. The Gini coefficient in China has risen to almost 0.7 (FT, 2016). The American approach says income inequality is not as important as social and economic mobility. If everyone has the opportunity to make more money and increase their own income and social standing, then your income in relation to others will only be as limited as you let it be, and large gaps are okay because the meritocracy punishes those who do not work hard enough.

One of the perceived ways to fix inequality is through government and legislation. Many of the ways America supports social mobility is through legislation banning unequal hiring practices and discrimination. The capitalist system is supposed to combat inequality as a functioning meritocracy and the ideology does not count for racism or sexism, meaning theoretically those who do the best work should be the ones actually doing it and nothing else should be considered. However, this becomes complicated when wealthier individuals can spend more money on better schools, acquiring more skills to be better in their jobs. It’s this situation that consequently creates inequality, promoting individual families and communities and building dynasties. An article in *The Economist* entitled *"Mobility, measured"* (The Economist, 2014) stated five barriers to social mobility that need to be addressed in order to properly combat inequality: residential segregation, quality of schooling, family structure, "social capital" (interaction with groups), and inequality (pre-existing income inequality). The conflicting argument is the general European point of view that says income inequality should be addressed. The rich should only be allowed to be so rich and the poor should only be allowed to be so poor in order to maintain the social balance. This argument is much more straightforward and easier to address in socially-oriented societies. The main tool to combat this kind of inequality is taxation, i.e. taking money from the richest and giving it to the poorest in order to keep income inequality at a minimum. However, this causes issues with incentives. What is the point of enriching oneself if the government will take more and more of your money? It also creates an issue when you are free to move money across borders, and the richest leave the country with their capital for tax reasons.

2. Three Factors Influencing the Current State of Economic Inequality in the Czech Republic.

2.1. Social and Economic Status - Categories of Workers

Prof. Eric Maskin of Harvard University (Kremer, Michael, and Eric Maskin: *"Globalization and inequality."* 2006; also as well at the Lindau Meeting on Economic Sciences, recited from The Economist, August 23, 2014, p. 64) focused on the problem of "matching". He divided workers into four categories: A - skilled workers in rich countries; B - low-skilled workers in rich countries; C - highly-skilled workers in poorer countries; D - low-skilled workers in poorer countries.

In the first wave of globalization, workers in the C and D classes worked together, but the next wave of globalization based on trans-national strategies of value creation added chains that distorted the pairing. Highly-skilled workers in poorer countries work (due to the outsourcing of parts of up-stream industries, i.e. semi-finished products that account for almost two-thirds of global trade) more readily with low-skilled workers in rich countries, thus creating a new segment of society in poorer countries. It is noteworthy that multinationals pay above-average wages in developing countries (i.e. VW Group for Skoda workers). The result is higher demand and productivity for skilled workers in poorer countries. We can look beyond VW Group and Skoda workers to shared services in the Czech Republic, usually located in the two biggest cities: Prague and Brno. There are 15,000 employees in shared services centers in Brno working for more than 40 multinational corporations. They provide services in accounting, logistics, and research projects. An even higher number of employees is working in shared services centers or multinational companies in Prague: the city's 32,000 workers make up almost 50% of all those employed in the sector (HN July, 17-19, 2016). However, work in outsourced industrial production or services managed by large multinational companies is considered unskilled by the standards of wealthy countries. Skilled workers in poor countries therefore cannot be "matched" with skilled workers in wealthy countries. The least-skilled workers in poor countries lose not only access to skilled jobs in rich countries, but also access to skilled workers in their own economies. This tendency has been strengthened by offshoring production into developing countries with much lower labor costs than those in less developed EU member states. The comparison of average salaries in EU countries has resulted in quite interesting findings (see the ETUI report). The biggest differences at the same positions can be seen across branches of industry and qualifications required. The standard of living of a person working for McDonald´s in Mladá Boleslav (where the Skoda factory is headquartered) has a closer standard of living to the person working in the same position in Wolfsburg than that of Czech technicians working for Skoda and those working in Wolfsburg. Highly-qualified professionals are generally penalized more than less-qualified workers in less complex branches of business. It is evident that globalization does not create equal wage growth for all. Therefore, this results in rising income inequality between countries as well as within individual countries.

Can a new category of workers influence this imbalance? **Contract workers**, perhaps? Silicon Valley's favorite slogan calls this the "gig economy," which is the result of two factors: a) technological development: researchers at the UK´s Oxford Martin School estimate that almost half of all US jobs are at risk of being automated in the next two decades; and b) the changing character of work. Only a few short years ago, it was assumed that a "job" meant working for a company on a fixed schedule. Many workers in the developed world no longer fit in that category. Although they work for a single company, they are self-employed and work irregular hours. Their jobs consist of a series of short-term projects coordinated through a mobile app. These alternatives comprise the proportion of highly-skilled workers that do not have traditional jobs, who instead work as independent contractors providing temporary or on-call services. We can witness this phenomenon in the most-developed economies, such as in the US. The number of Americans working under these alternative arrangements rose to 9.4 million from 2005 to 2015. The big question for the next decade is whether this shift to contract work will also occur in developing countries or whether it represents only a one-off event. If this trend is copied, the authors see the biggest implications for Central European countries in social insurance. Employers in Central European countries traditionally take the burden of protecting workers from things that can go wrong in life. They provide health and social insurance, compensate people who are injured on the job, and pay unemployment insurance and benefits to those who are laid off. According to statistics, there are around one million freelancers in the Czech Republic and for 60%-70% of them their chief source of income their freelance activities. The government has taken a number of measures, especially using tax benefits, to motivate individuals to enter or stay in the freelance market. This would give people the opportunity to use their abilities and avoid low-paying jobs in the manufacturing units of large multinational corporations. However, it could also lead to tension on the employment market, which currently lacks thousands of workers, and undermine the performance of the Czech economy. Moreover, the overall support for freelancing does not solve the situation of low-skilled category D workers.

2.2. Multinational Corporate Profits Transferred from the Czech Republic

The Czech economy is an open economy and hundreds of multinational corporations (MNCs) operate on the Czech market either directly or through local branches. According to Thomas Piketty's study published on the blog site of Le Monde (January 2018), the Czech Republic belongs to the group of countries that are owned by foreign proprietors. The economy is owned by 87,000 foreign, primarily German, Austrian, and French companies, as well as those from elsewhere. Around CZK 400 billion leave the Czech Republic (combined volume in 2017; or 8.3% of Czech GDP) in repatriated profits and nearly another CZK 700 billion disappear through transfer pricing, other payments, and fees for patents, licenses, and software packages each year. This sum represents the approximate level of government spending on social issues in 2015, or 12.6% of GDP. For objectivity, we should mention that foreign-owned companies are not the only ones to transfer profits, as another 14,000 Czech companies are located abroad to avoid paying taxes at home. These facts influence inequality in two ways: First, wealth created in the Czech Republic doesn´t stay here in the country to be used to reduce real inequality; and second, it increases inequality in the home countries of the corporate owners. These resources could be used in government solidarity policies to deal with growing inequality caused by two other factors described above.

2.3. Crony Capitalism (As Expressed by the Crony Capitalism Index)

Two years ago, *The Economist* constructed its crony capitalism index that aims to measure trends among rent-seekers. The assumption is that tycoons increase their wealth and influence as a result of favorable political policies set by government officials. As a result, they hold a larger part of national income instead of generating more wealth for the whole of society. In some extreme cases, certain favored suppliers can strongly influence the establishment and application of business-impacting laws, while citizens must pay a tax in the form of purchasing overpriced products supplied by the favored corporations. The most visible case can be seen in the photovoltaic industry where governmental subsidies policies led to certain “solar barons” acquiring CZK 20 billion to the detriment of Czech households. Ten industries that are susceptible to monopolies, require licensing, or are highly dependent on the government were selected: casinos; coal; defense; retail and investment banking; infrastructure and pipelines; ports; airports; real estate and construction; steel and other metals; and utilities and telecom services. The index is calculated using the ratio of billionaires’ wealth to GDP in their own countries. The higher the ratio, the greater the possibility of crony capitalism.

Using the methodology from *The Economist* (The Economist, May 7th-13th, 2016, p. 46) we can calculate the values for the Czech Republic. We will use two different data sets:

a) those taken from the *Forbes* rankings for 2015 where Czech GDP = CZK 4.477 billion and the wealth of the 60 richest billionaires amounted to CZK 846.9 billion (a year-on-year increase of 14% according to Forbes data). The calculation is thus: 846.9: 4,477 = **18.92%.** By comparing the result with the ranking calculated in *The Economist* (May 7th, 2016, where there was only one Central European country, Poland, with the result of 2%), we can state that the impact of crony capitalism in the Czech Republic is much higher than in its post-communist neighbor to the north.

b) We can use an alternative measurement by taking the wealth of dollar-denominated millionaires (defined as a segment of society who invested an amount of one or more million USD, not including durable goods or personal consumption). The number of people included in this segment in the Czech Republic according to Forbes totals 23,200. (Týden CZ, 2016). We can take the current exchange rate: $1 = CZK 24.2; 23,200 x 24.2 = CZK 561 billion. The calculation would thus be 561: 4,477 = **12.53%**. Then, suppose the millionaire group does not include the billionaire group of the 60 richest (Forbes, 2015). If we put both groups together and sum up their wealth:
846.9 + 561 = CZK 1,407.9 billion. Then the index is: 1,407.9: 4,477 = **31.45%**

3. How Can We Reduce Inequality in the Czech Republic?

3.1. Attracting FDI in Industries with More Added Value

To create incentives to attract FDI to the Czech economy, it is necessary for the government to formulate conditions requiring that at least some parts of investment go to sectors with more added value or to the creation of centers of excellence, thus providing greater career and employment options for category C workers. In the Czech Republic, the number of university graduates (21.1% of all employed people) can be considered as formally qualified for a job in group C. (Doležalová, 2015). To attract investors to fields with more added value would require changes to the secondary and university school systems. The current 5% of GDP spent on education will have to increase by at least 3% to ensure competitiveness in terms of skills. The belief that a university degree in social sciences is the only tertiary qualification that matters can have dysfunctional results. In order to increase employability in preparation for Industry 4.0, the government needs to support non-degree tertiary qualifications that deliver substantial benefits to students and employees.

3.2. Raising the Minimum Wage (in Monthly or Per Hour Terms)

Increasing the minimum wage is one of the most direct and efficient ways to address inequality. While average workers' wages struggle to copy inflation rates, the salaries for those at the top have skyrocketed. Raising the minimum wage is not just a matter of equity or a means to fight inequality. It is also a basic method to improve the economy. Raising the minimum wage would put money into the pockets of D category workers who usually spend their income directly at businesses in their communities. Just as importantly, research shows that a higher minimum wage can positively affect economic growth by prompting more human-capital development, which can also help to lower income inequality. An example can be the introduction of minimum wages in Germany: since 2015, Germany has had a minimum wage of €8.84/hour and Germany continues to have one of the lowest unemployment rates in the EU. However, the current minimum wage level in the Czech Republic is €472/month, or €2.78 /hour, does not help reduce inequality. The minimum levels in Germany and France (€9.88), where the wage equates to about 45% of the average salary, give enough space for the government to intervene. The current Czech level should be increased to €540/month in 2019 and trade unions demand the level reach 45% of the average salary in the foreseeable future. This ambitious goal will face strong opposition from employers, so the government must be well-prepared to push the increase through.

3.3. Strengthen and Protect Workers

Moreover, collective bargaining rights should be increased to give workers the influence they need to negotiate for better wages and benefits. A good example can be seen in Scandinavian countries where collective bargaining pushes wages higher. This tool has been recognized and used by Czech trade union leaders and has significantly influenced the salary policies of some supermarket chains. (LIDL s.r.o. increased monthly salaries to CZK 29,000, (€1,160), thus slightly above the median wage of CZK 27,320 (€1,075). Competitors followed suit as did many other players in services and other industries as well.

3.4. Increased Access to High-Quality Preschools

Children of low-income workers fall behind before they even step foot into kindergarten and can be months or even years behind children of the same age from wealthy families. Researchers estimate that half of the performance gap in secondary schools can be attributed to children's experiences before age 5. Differences between children arise early, leading to large gaps in key skills, such as vocabulary. Preschool programs can help children gain four months of additional learning, and the highest-quality programs have been shown to help children gain an additional year of learning. Children who attend high-quality preschools have positive outcomes throughout their lifetime. They are more likely to graduate from secondary schools, attend colleges and universities, and consequently earn higher wages as adults. The newest government proposals (from 2017) introduce obligatory attendance of preschool for children of five and thus can be considered a step in the right direction.

3.5. Introduce and Support Apprenticeships

Apprenticeships are a form of paid training, working for a company while simultaneously attending school. This system significantly boosts workers' lifetime wages and creates pathways to well-paid careers for unemployed young workers. Many countries already consider apprenticeships to be the central tool for developing a competitive workforce. Apprenticeships benefit workers by connecting them with paid jobs, raising their lifetime wages, and by offering them a post-secondary education with little or no debt.

This scheme does not just provide advantages for trainees. Employers who sponsor apprenticeships gain skilled workers, reduce the employee turnover, and enhance productivity. Apprenticeships can help businesses address labor shortages at a time when many employers are reporting that they cannot find enough skilled workers. In the United States, 98% of businesses that sponsor apprenticeships say they would recommend them.

3.6. Offer Universal Paid Family Leave

Income inequality directly contributes to different abilities of parents to take care of their children and to provide them with the kind of living environment that would be most beneficial to their healthy growth as well as success in school and the workplace. Not only can wealthier parents afford high-quality child care, but they also have disproportionate access to flexible schedules, and paid leaves and sick days. Children benefit from more time with their parents, which results in them acquiring richer vocabularies and paying more attention to schooling and doing their homework. Attendance at parent-teacher conferences is improved and better healthcare is available as well.

3.7. Taxation

One of the most disputed tools for fighting inequality is the tax system. The tax and benefit system is a typical form of government intervention. The government could choose to impose a heavier tax burden on the rich and transfer the revenue to the poor. Income inequality can be exacerbated when the wealthy have greater opportunities for and benefits from tax evasion. Tax money can be used in the welfare sphere; i.e. for healthcare, education, transportation subsidies, and development of poor communities. In taxation, there are horizontal and vertical systems that promote equity in different ways and most governments try to adopt elements of both methods. Horizontal equity suggests that everyone should be taxed at the same rate, while vertical equity means people should pay according to their abilities and earnings. (DUŠEK, L., KALÍŠKOVÁ, K., & MÜNICH, D. 2015). Taxation is a hot topic for all democratic governments in the EU. Democratic capitalism is ruled by two conflicting principles of resource allocation: one according to merit and the free play of market forces; and the other following social needs. Governments feel pressure to honor both principles simultaneously although principally the two almost never agree. Conversely, they can afford to neglect one in favor of the other only for a short time until they are punished by the consequences, political in one case and economic in the other (Streeck, 2011).The badly-needed extra revenue to cover rising expenditures for healthcare, pensions, and long-term care an increases in taxes. A new government has been established and our study should contribute to implementing at least a sector tax and a change in the progressivity scale. However, the positions of participating parties will make it very difficult to push the implementation of a progressive increase for the rich from the current 19% through parliament.

3.8. Crony Capitalism

Data calculated for the Czech Republic does not support the general opinion that the country is an egalitarian society. With values of **18.92%** or alternatively **12.53%** on the Crony Capitalism Index, the Czech Republic should rather be ranked among countries such as Germany or the U.S. that will have to implement measures against cartels and rent seekers. The Crony Capitalism Index level could be connected with a high level of corruption that leads to an increase in hostility within the society and a growing support for populist politics. The side effect of this situation has been expressed in a disillusion of politics and politicians and an unfavorable perception of the EU.

4. Conclusion

The authors arrived at the conclusion that workers in Central European post-communist countries **will never reach the income level of their counterparts**

in groups A and B in the developed economies of the EU, partly due to the outflow of profits from the country. Inequality in the Czech Republic – contrary to the generally accepted opinion about egalitarian society – has been growing. The analysis of workers´ share of national income in the Czech Republic in the light of three specific factors **has shown an increase in inequality**, regardless of the steady growth of the average salary and of GDP. This conclusion is supported by the calculated crony capitalism index figures. As long as the inflow of FDI into the Czech economy chiefly goes into industries with low added value and not to centers of excellence, the chances of eliminating inequality among **group C workers are unrealistic**. Moreover, this study doesn´t deal with problems connected with inequality or poverty among almost one-fifth of the population: pensioners. The implementation of greater principles of solidarity for this group could create serious obstacles for the successful accomplishment of other recommended social policies. The conclusions of this study should serve the Czech government to (not only) help create a more cooperative society to deal with the greatest challenges of globalization.

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