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THE SHAPE WE'RE IN

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ECONOMIC POTENTIAL

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The Czech economy is currently the fastest growing in Europe. The annual growth rate in the second quarter of 2015 reached 4.6 %, the best result since 2007. Czech exports have been growing continuously: they no less than tripled between the years 2003 and 2014. Should we be satisfied with these figures? Do they express the real competitive standing of the Czech economy?

The answer to both questions is 'No'. The overall performance of the economy is far from stellar. Would you believe that over the last 10 years we have not made up any ground on Germany, Finland or the Netherlands? Or that Poland and Slovakia have grown faster and Estonia overtook us outright? In many ways, the past 10 years can be considered a lost decade with almost zero productivity growth. Those are the facts.

The Czech economy grew by only 4 % per year (measured by purchasing power parity) in the 2003 – 2013 period compared to 7.0 % in Poland, or 6.6 % in Slovakia. In terms of per capita GDP, today's Czech Republic lags behind Estonia, despite a head start of 47%. So, the much repeated claim that we are the richest among post-Communist countries no longer applies. Thanks to reforms at the turn of the century, even significantly wealthier Germany has grown faster than the Czech Republic over the last 10 years.

If someone had predicted anything of the kind in 1993, would you have believed them? There are several reasons why the Czech Republic's economic growth, particularly over the last decade, has been unsatisfactory. During the last 10 years, our investment level per full-time employee has been about half that of Germany, Ireland or the Netherlands. Labor productivity in the Czech Republic has been stagnant since 2007, while in the other economies of Central and Eastern Europe it has grown by some 2 – 3 % each year.

What is to be done to put us back on a path of long-term growth? In order to maintain objectivity while looking for answers, and to draw on well-founded data, we went through a series of competitiveness reports (World Economic Forum, IMD, World Bank, OECD,...) and looked at the strategies of those countries that have been very successful in recent decades.

As for growth factors, we first selected 11 topics relevant to the Czech Republic. After analysis and quantification of their impact on the Czech Republic's GDP, we focused on the most important ones, and grouped them into three categories:

- Long-neglected “homework”, which needs to be addressed at last:
 1. Remedying the institutional environment.
 2. Improving the outcomes of education.
 3. Ensuring labor market competitiveness in relation to other Central and Eastern European countries.
- Creating a strong “vision for the future” based on:
 1. Entrepreneurship, innovation and technology.
 2. A far more “urbanized” population – with people living in or commuting to centers of business and life.
 3. Mobilization of sources of domestic and foreign investment.
- Focusing on burgeoning high-productivity sectors, i.e. the already very successful sectors of manufacturing and IT, engineering services, consulting, pharmacy and FMCG.

Let us now take a look at each of these areas. First, we will focus on each of the “homework” tasks, then on our “vision for the future”, and finally on the sectors that merit being at the center of our attention as we move toward a highly productive economy.

WELL-KNOWN HOMEWORK TASKS

Homework task no. 1:

To improve the institutional environment: *The Czech Republic lags behind in many aspects of the institutional environment. No matter whether we consider the quality and stability of the regulatory environment, level of corruption, efficiency of institutions, or administrative burden on doing business, the comparison with other countries is unflattering.*

For example, according to a Transparency International study on perceived corruption (Figure 1a), the Czech Republic ranked 53rd; out of the peer group only Slovakia fared worse. According to the Ease of Doing Business analysis, it takes 19 days to start a company in the Czech Re-

Figure 1a: Corruption perceptions index
Index value

Source: Transparency International, World Bank - Doing Business

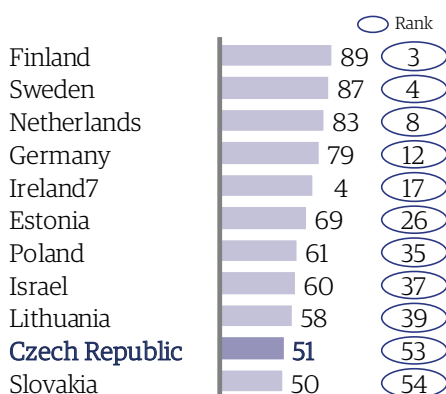


Figure 1b: Time to start a business
Days



public, almost five times longer than in Lithuania (Figure 1b). The Czech Republic also has room for improvement in the area of state regulation, where it takes 120th place, way behind successful Estonia (23rd place) and Lithuania (103rd place). Last but not least, one of the most important decision-making factors for investors in choosing a country to invest in is the reliability of the legal system in resolving disputes. Here the Czech Republic comes 90th, far behind Estonia (39th) and Lithuania (67th).¹

Inefficiency of the legal and regulatory system is indicated by other metrics. According to a CERGE-EI analysis, the number of words in the Income Tax Act quadrupled between 1995 and 2005, and the number of sentences with the phrase “with the exception of” in the Act doubled.

What can we improve and how is it done elsewhere?

Success is an option even in the post-Communist sphere. This is clearly exemplified by the Baltic countries, where Lithuania and Estonia have taken the following steps:

- Digitizing major public services (e.g. changing permanent address, issuing documents, company formation).
- Shortening the company formation process to 4 days (Lithuania), and replacing today’s system of “authorization” with a simple “declaration” process.
- Improving financial efficiency of institutions, by means of e.g.:
 - » Publication of all public contract documentation.
 - » Separating decision-making on state-owned non-strategic enterprises from political decisions, and making it compliant with the best practices of the private sector.
- Stabilizing the judicial system with faster decision making, and ideally including a fast-track appellate procedure.

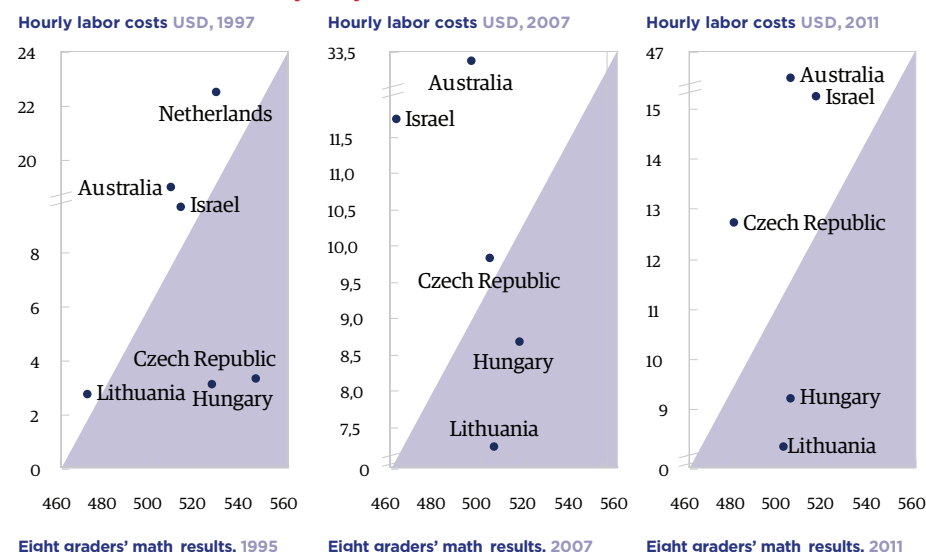
Homework task no. 2:

Improving education: Over the last 20 years the Czech Republic has achieved partial success. The proportion of students in tertiary education has risen to the standard level of other EU countries, even if quality remains open to question. The eighth grade pupils of elementary schools are also showing the best computer skills in their category. Yet the same survey demonstrates that this corresponds to the amount of time spent on computer at home.

A number of problems remain to be resolved. The quality of education has dropped, as is apparent from a comparison of mathematics results among eighth graders (Figure 2). Also notably absent are certain basic language capabilities. Although many students pass foreign language tests, the percentage of those able to communicate in a foreign language fluently is dramatically low – 27%, as compared with, e.g. 90% in the Netherlands. Shocking! Cooperation between businesses and schools is very limited. Our parents could make use of what they learned at school over their lifetime. Those days are over.

Figure 2: Eight graders' math results related to labor costs

Source: TIMSS, EIU, McKinsey analysis



What can we improve and how is it done elsewhere?

Regarding the future of Czech education, fundamental expert discussions are underway. Some measures can, however, be introduced without changing the overall concept. These include:

- Resetting expectations about knowledge of foreign languages. We might, for example, raise the number of compulsory hours of foreign language study at entry-level schools from the current roughly three per week to five or more per week, as has been done in Poland, and later on, ideally teach some subjects directly in a foreign language. We could also allow foreign language learning to go on beyond the classroom by increasing the proportion of un-dubbed programs by bringing the television broadcasting regulation closer to the Scandinavian model. The new definition of literacy should be “to be able to read, write and talk fluently in a foreign language”.
- Cooperation between educational institutions and industry should increase substantially, to allow for flexible response to changing economic needs, and to strengthen adult education.

Additional improvement levers to follow up with include:

- Regular and frequent exchange of best practice (e.g. sample hours, weekly teaching plans, appointing individual coaches for each school and coaching teachers, such as in the Boston school system in the USA).

- Improving quality through effectual and quality-focused school principals.
- Making structural changes, whose importance is exemplified by Poland. The country has greatly reformed the system of elementary and secondary schools. This change has led to an objectively significant improvement. Specifically, Poland shortened elementary schooling from 9 to 5 years and established a mandatory follow-up 4-5-year grammar school program. Only after completing this can the student decide whether to go on to an apprenticeship or to academic education.

Homework task no. 3:

Ensure the competitiveness of the labor market in comparison with the other countries of Central and Eastern Europe: *The Czech labor market looks very positive at first glance. Unemployment has stayed at between 6 and 8% over the last 15 years, putting the country among the leaders in the EU.*

But a closer look shows a somewhat different story. The labor market does not include at all some 9% of the working-age population – in other words, nearly every tenth person is not working, by their own choice.

In addition, over the last 20 years the self-employed portion of the workforce has grown from 13 to 18% and the CR is today in this regard 1st among comparable countries. While this might be seen as clear evidence of the growth of entrepreneurship, there is much to show that this is either due to the so-called Švarcsystém or occasional part-time working. These people probably do not use their full potential nor developed their skills in a broader social context.

The picture is not too positive either when looking at immigration trends: 29% of immigrants have low education. This proportion is 11 percentage points higher than for the native CR population, which is the biggest discrepancy among the reference group of countries. Only 19% of immigrants have reached tertiary education – the lowest percentage among comparable European countries.

The CR also has a lower participation of women in the labor market than in most of the developed countries in Europe. Only some 56 % of Czech women are economically active – far less than in the Netherlands (69 %) or Norway (73 %). In view of the fact that the German economy has over the last 10 years (2003 – 2013) grown faster than the Czech one, the reform of the labor market in Germany at the beginning of the 21st century may serve as inspiration.

What can we improve and how is it done elsewhere?

Germany has simplified new job creation by:

- Introducing the possibility to renew open-ended work contracts with fixed-term ones.
- Creating systems of educational vouchers, which allow people to pay for training courses of their choice
- Introducing short-term and part-time employment schemes (i.e. “mini-jobs”) with higher ceilings for tax and social contributions for employees to provide encouragement for recruitment and to reduce job protectionism.

Make unemployment and economic inactivity still less attractive by:

- Introducing tiered unemployment benefits, according to employability and previous contributions to the social security system.
- Making it obligatory to accept a “reasonable” job offer or provide a valid reason to reject it (and therefore shifting the burden of proof from social workers to the unemployed).

NOW IS THE TIME TO START BUILDING OUR "VISION FOR THE FUTURE"

Vision for the future no. 1:

An economy founded on entrepreneurship, innovation and technology: *The last decade saw an unprecedented number of changes due to the growing speed with which new technologies emerged.*

The chart in Figure 3 shows how quickly lifestyles and the business environment can change. For example, the Uber concept moves taxi driving job from one group of people to another at night. If electric cars become widespread, this will mean major changes for makers of catalytic converters and gearboxes.

The good news is that Czechs are open to new technologies. They were the quickest of European nations to adopt mobile phones and contactless payment cards. Even more encouraging is the 1st place of Czech eighth graders in the International Computer and Information Literacy Study (ICILS 2013). There is room for improvement, nevertheless, and we should make use of it. In the Bloomberg innovation index, the country came 31st out of 50 countries studied, falling behind its neighbors, Germany (3rd), Austria (17th), and Poland (25th). In the Global Entrepreneurship Index, Czechs show several undesirable characteristics, in particular low tolerance to business risk, a negative view of entrepreneurs (as value creators), and a skeptical view of business opportunities.

A lack of ambition to be a world player is also probably a contributing factor to the fact that the Czech economy is a supplier economy. Yet the highest added value comes to those owning the brand, the technology and the business risk.

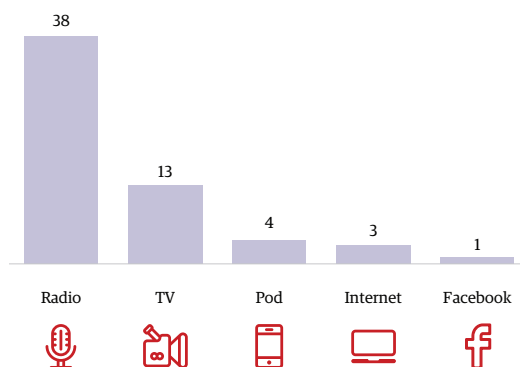
What can we improve and how is it done elsewhere?

At this time, when a whole generation separates us from the change of regime, we need to raise our aspirations and start comparing ourselves to countries like Finland, Denmark, South Korea, or the Netherlands, not just to our direct neighbors. Possible steps include:

- Ensuring the greatest possible entry of innovations and technologies into everyday life, as in the case of Estonia, where most public services have been digitized.
- Improving cooperation between the private sector and universities – including new mechanisms for allocating research funding and evaluating the results of scientific work.
- Promoting entrepreneurship as a positive, value creating part of the economy, both through financial incentives (low taxes, etc.), as well as through PR campaigns, recognition by state representatives, and media coverage of role models.
- Supporting the creation of innovative and technological clusters and incubators in order to foster the exchange of ideas and create a place where ideas and financing meet.
- Steering the young towards transferable skills and professions that build on technologies, rather than those that are replaceable with technologies.

Figure 3: Years to reach 50 million users

Source: McKinsey Global Institute analysis



Vision for the future no. 2:

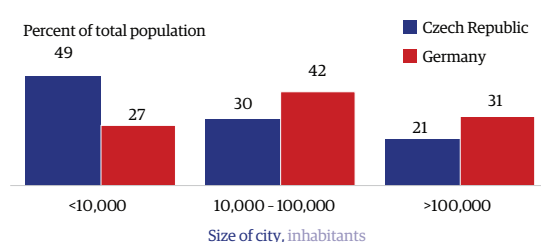
A more urbanized population – people living or willing to commute to the centers of business and life: *People living in larger urban areas generate more GDP than people in smaller (rural) areas. According to the American Bureau for Economic Analysis, areas with 200,000 and more inhabitants generate at least 37% higher GDP per capita than areas with 50,000 and fewer inhabitants. These differences are due to differences in the employment, educational and recreational opportunities.*

According to Eurostat, the Czech Republic is the second least urbanized country of the reference group² with only Slovakia being less urbanized. The GfK study (Figure 4) shows that 49 % of Czechs live in cities with fewer than 10,000 inhabitants, compared to only 27 % in Germany.

A closer look at the Czech Republic shows significant differences in GDP between regions and employment levels. In Prague, 52 % of all citizens are employed (recalculated by hours worked), compared to only 36 % in the Ústí nad Labem region. Moreover, the average wage in Prague is about 62 % higher than in the Karlovy Vary region. Such differences either indicate significant economic potential in the low-productivity areas, or the need to motivate Czechs to travel more to work.

Figure 4: Urban population in cities by size

Source: GfK



What can we improve and how is it done elsewhere?

The theme of urbanization is not just an economic issue. The solution should be a combination of people's willingness to travel to work and a greater population concentration in and around major urban centers. This may include e.g.:

- Incentivizing workers to move to higher-productivity areas (i.e. to growing regional cities) by facilitating easier-to-obtain accommodation for young people and supporting the creation of entry-level jobs in cities.
- Strengthening of cooperation and mutual support between local educational institutions and regional centers to ensure a quick response to regions' changing economic needs and to facilitate employment.
- Improving utilization of our high-density transport infrastructure for commuting to work.

For example, Finland has helped to develop regions by:

- Incentivizing cities to identify what they are best known for and good at, and thus to attract more inhabitants.
- Inviting all regional cities to create a clear plan for sustainable growth through the assimilation of smaller municipalities around them (following the example of the Finnish town of Kuopio at the beginning of the 21st century).

² The reference group comprises Slovakia, the Netherlands, Estonia, Finland, Sweden, Germany, Poland and Ireland. An urbanized area is defined as an area with a minimum population density of 1,500 per square kilometer, and at least 50,000 inhabitants

Vision for the future no. 3:

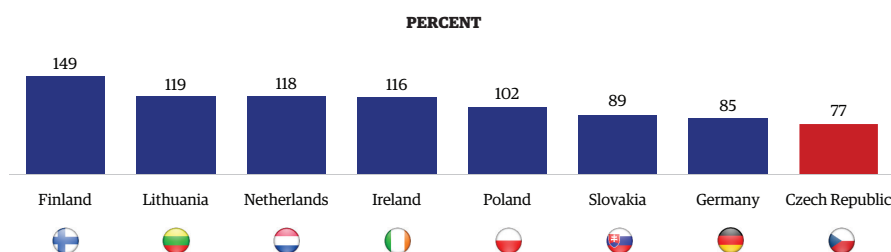
Mobilization of capital: Labor is but one component of economic productivity; an analysis of Czech GDP shows that labor contributes around 40 %, while invested capital accounts for a whole 50 % (the rest being net taxes). In the last decade the Czech Republic has invested considerably less per full-time equivalent than Germany, the Netherlands and Finland. If the Czech Republic were to close the gap to these countries, it would have to invest an additional EUR 376 billion (CZK 10 trillion), or double its annual GDP.

The required capital could come from foreign or domestic investors. Foreign direct investment (FDI) has decreased significantly since the beginning of the century. While it hovered around 7 % of GDP back then, it has barely exceeded 3 % since 2007. The situation is improving slightly: the CzechInvest agency announced an additional CZK 78 thousand million, which would raise FDI above 4 % of GDP in 2015.

Domestically, the situation looks completely different. As shown in Figure 5a,

Figure 5a: Bank loan-to-deposit ratio

Source: ECB

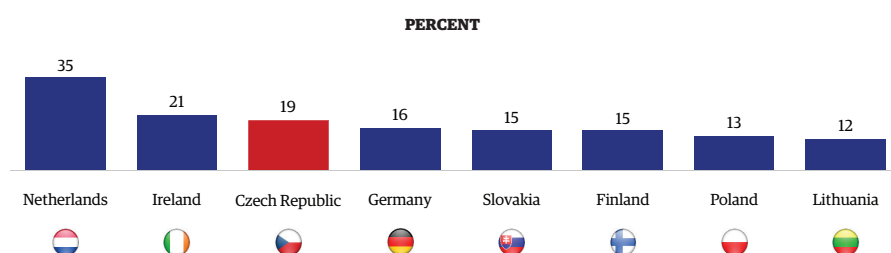


the Czech Republic has the lowest ratio of bank loans to deposits. On the one hand, these numbers illustrate the conservative approach of the Czech banking sector. On the other hand, they suggest low willingness of Czech companies to invest – the share of their loans to GDP is 20 %, which is the second lowest number in the reference group. All of this is further amplified by the country having one of the smallest capital markets in proportion to GDP.

Czech companies also hold a very high level of own funds, as shown by company deposits as a share of GDP in Figure 5b (19 % in the Czech Republic, the third highest in the reference group).

Figure 5b: Corporate loan-to-GDP ratio

Source: World Bank, IMF



What can we improve and how is it done elsewhere?

The first set of measures relates to FDI. This could include:

- Further strengthening of CzechInvest as the agency responsible for attracting investment to the Czech Republic.
- Greater involvement of other state institutions (including municipalities) in this task.

In terms of mobilizing domestic resources, the Czech Republic is in a relatively distinctive position. Partly, this task comes back to entrepreneurship and the promotion of innovation. In any case, success will require a combination of regulatory and legal changes that need to result from debate involving Czech banks, their foreign owners, the Czech National Bank, and the Government. The recipe is not straightforward, but the objective is. The Czech banking sector must significantly strengthen its role as a facilitator.

WHERE WILL GROWTH COME FROM: THE MOST PRODUCTIVE AND EXPORTING SECTORS

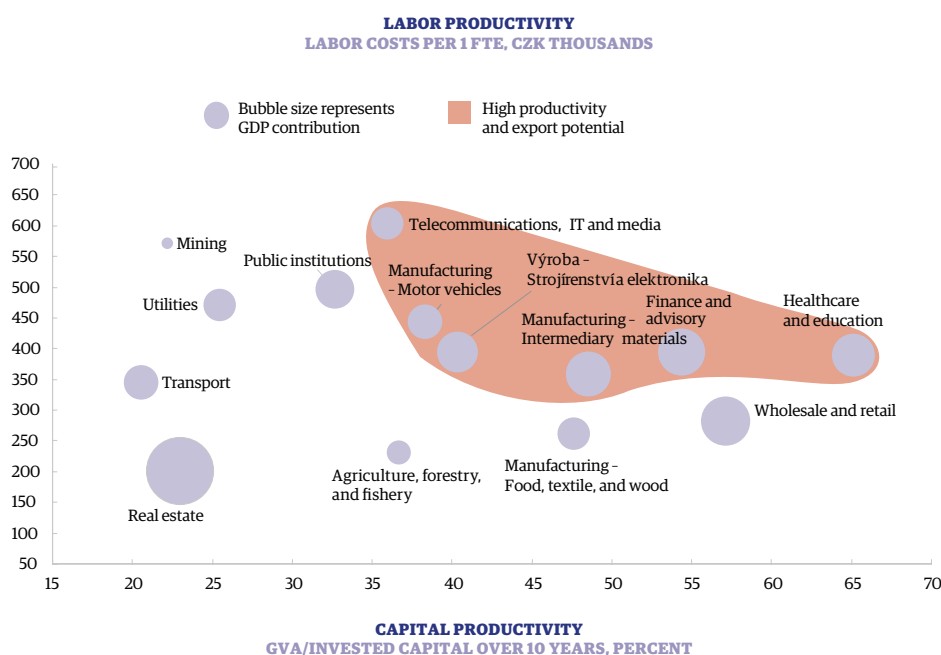
So far we have discussed the general principles that the Czech Republic should abide by in the short and long term. However, it is also key to be clear about which sectors create value for the country.

The Czech economy is export-oriented, with over two-thirds of export value generated by industry in general and two sectors in particular, namely mechanical engineering and electronics (28%), and motor vehicles (22%).

In terms of comparative labor and capital efficiency, good conditions for further growth are found in six sectors: health & education, financial and other consulting, telecommunications, IT and media, and three manufacturing sectors (engineering and electronics, motor vehicles, and production materials) – see Figure 6. Upon closer examination, the chemical, automotive, pharmaceutical and FMCG industries as well as IT and consulting stand out.

Figure 6: Productivity by sector

Source: ČSU, team analysis



The Czech Republic should thus focus on three areas of the economy:

- The three main manufacturing sectors, which make up the majority of Czech exports (engineering and electronics, motor vehicles, and production of materials).
- “Niche” sectors, which are today perhaps less significant in size but which have high productivity and equity (e.g. the pharmaceutical and FMCG industries).
- Sectors of the knowledge economy (IT, programming, engineering services, consultancy), which are export oriented and capital productive.

CONCLUSION AND NEXT STEPS

We see that in order to ensure good competitiveness we have to work on how our government and state apparatus function, as well as on education, entrepreneurship, where we work and how we treat capital. Perhaps the most important aspect is how we think about ourselves, our capabilities and the ambitions we set ourselves.

In its first year, we focused the Conference on topics which, based on our analysis, are of high priority, and ones we can start working on right away. For this reason we have not included some of the already widely debated and far-reaching themes, such as introducing the Euro, or the pension and health system reform.

It is hoped that this Conference will spawn a series of successful and regular meetings in the future. And perhaps our future seasons will, apart from opening up other topics, report on the progress we have made in our competitiveness.

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