International Center for Economic Growth

European Center

ICEG EC OPINION NR. 7

Wages and competitiveness in the Central European New Member States

by Gábor Pellényi

December, 2005

Introduction

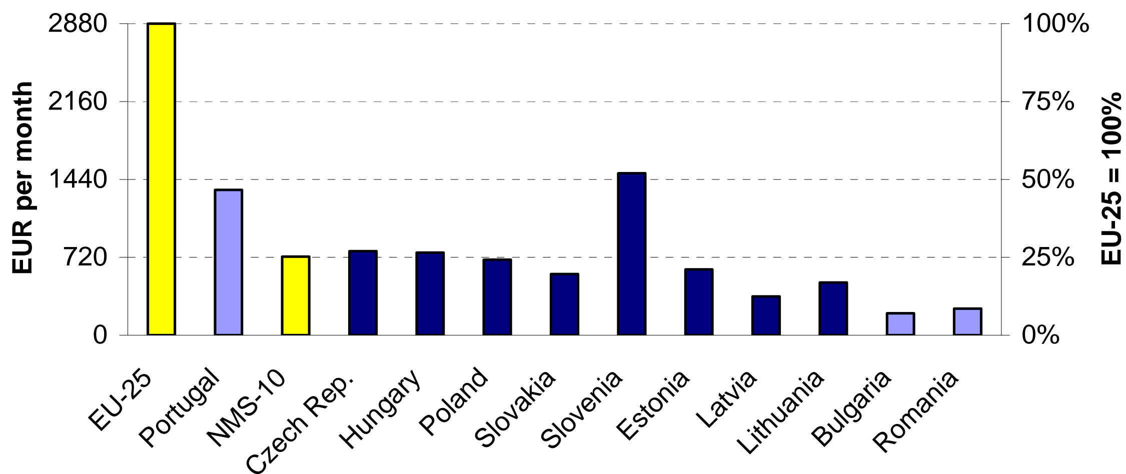
The New Member States of the European Union may be less developed than the 'old' Member States but they are gradually converging towards the Western European level of development. On this path of convergence relatively cheap labour is one of their comparative advantages that can act as a catalyst to growth. On the other hand however, these countries all suffered from post-transition depression that put its mark on the labour market: large-scale unemployment or inactivity is an important issue in most of these countries. Moreover, economic growth since transition has not been coupled by significant employment growth suggesting that labour as a comparative advantage has not yet been utilised to its potential. This paper assesses the relative labour cost advantages of the Central European New Member States within the European Union and investigates why employment and job creation could have remained laggard in recent times.

Relative labour costs

A first glimpse at labour costs (including all taxes, social security contributions and other costs) indicates that the new Central European EU members can be sorted into three groups: while Slovenian labour costs amount to about 50% of the EU-25 average and exceed the level of Portugal, the cheapest of the EU-15, in the Visegrad countries[1] total labour cost is around one quarter of the EU average (half of the Portuguese level) and the three Baltic states are at around 15-20%. Note however that outside the European Union there are even cheaper countries: labour costs in Bulgaria or Romania are less than one-third of the average of New Member states.

[1] The Czech Republic, Hungary, Poland and Slovakia.

CHART 1.: TOTAL LABOUR COST



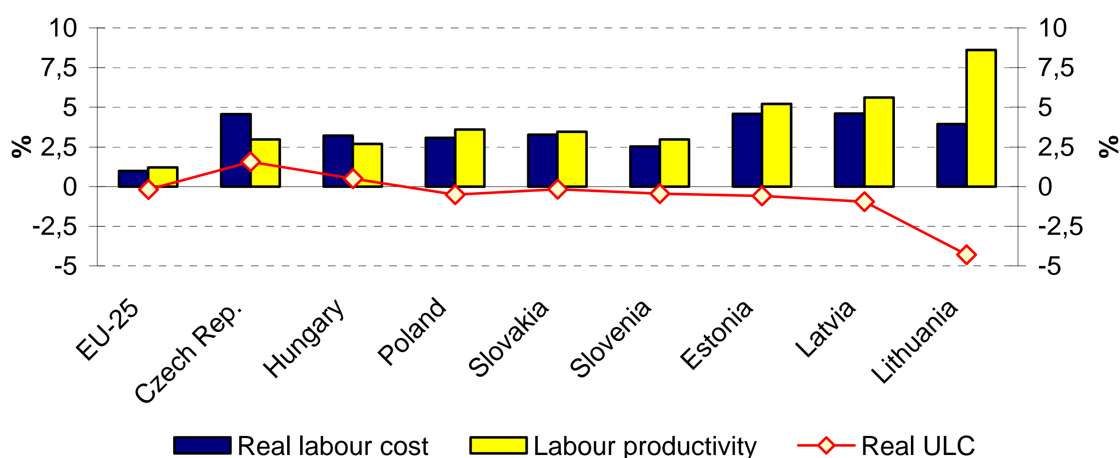
Note: business sector in 2003
Source: Eurostat

Relative wages and labour costs differ across industries as well. Wages in the private services sectors are generally 1-3% points closer to the EU-25 average than industrial wages. Wages in the financial intermediation sector are the closest to Western Europe with figures between 20% (Latvia) and 67% (Slovenia) of the EU-25 average.

Labour compensation per employee relative to value added per employee (the wage share or unit labour cost) is 5-10 percentage points lower in the New Member countries than the EU-25 average of 59.7%. This might be a misleading indicator however as Central Eastern European countries usually host assembly plants producing lower value added per employee. Detailed sectoral data of the GGDC suggest a significant productivity gap (at least fivefold difference) in most industries. Some notable exceptions are the manufacturing of insulated wire, telecommunications equipment, radio and television, scientific instruments and motor vehicles, sectors dominated by export-oriented assembly plants. In these sectors value added per employee can reach 50-80% of the EU-15 average.

It is somewhat more meaningful to look at the dynamics of the unit labour cost as this measure captures changes in (labour) cost-competitiveness. During the last five years the real unit labour cost of almost all New Member States declined while the average of the EU members remained stable. The Baltic states experienced annual productivity growth rates of above 5% while labour costs grew at 4 to 4.5% per year. In the Visegrad countries and Slovenia both productivity and labour cost growth remained closer to 2.5-3%. The Czech Republic and Hungary experienced a policy-driven surge in labour cost growth recently but on a longer time horizon their ULC is slightly decreasing as well.

CHART 2..: UNIT LABOUR COST GROWTH



Note: average annual growth between 2000-2005, all sectors.
Source: AMECO Database

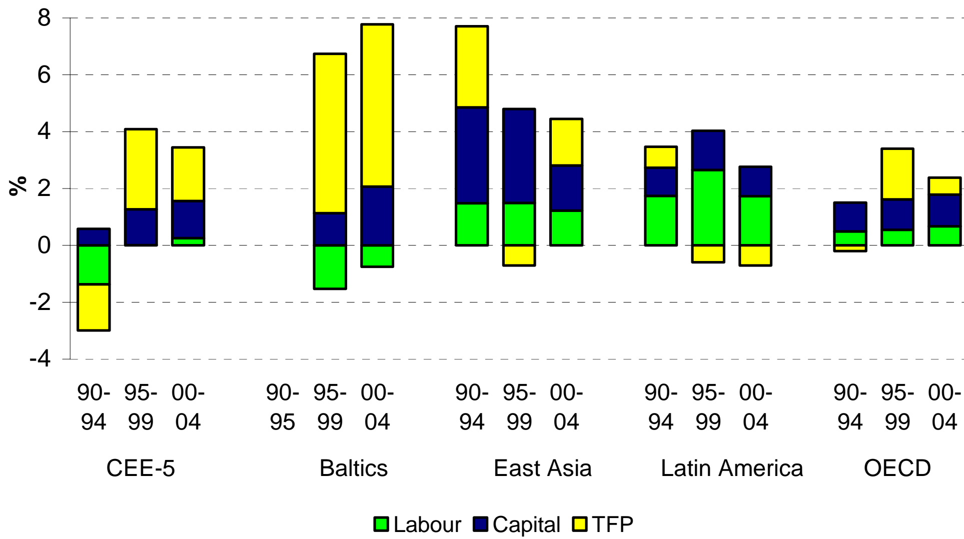
There is little sense in estimating the exact time required to achieve full wage convergence because these trends are nonlinear by nature and they are very likely to change during long time horizons. Notwithstanding these reservations a simple projection of the trends of the last decade suggests that it can take as much as 50 to 60 years for most New Member States to achieve the average wage level of the old EU members. As this simple exercise suggests, labour in the Eastern member states will be cheaper than in the West in the foreseeable future.

While the long-term dynamics of wage (and labour cost) convergence are determined primarily by productivity growth, short-term changes can be influenced by labour market conditions and economic policy. Labour shortages in specific sectors and occupations can drive up wages even though these countries have large unutilised potential workforce in the forms of unemployed or inactive population. Economic policy may also aim to pace up wage convergence: pre-election (and post-election) public sector and minimum wage rises were the main culprits of rapid Hungarian labour cost growth between 2000 and 2003.

Employment and growth

The fact that relatively cheap labour is a comparative advantage of New Member States would suggest that the utilisation of labour input contributes significantly to economic growth. In reality however, there is hardly any contribution of labour to economic growth. Following transition labour utilisation decreased severely resulting in a negative contribution to growth. There has not been any rebound in employment: in the Baltics decreasing labour inputs actually reduced GDP growth by 0.75% per year on average between 2000 and 2004 while in the Central Eastern European states labour contribution is virtually zero.

CHART 3.: DECOMPOSITION OF GDP GROWTH



Note: average contribution to annual GDP growth
Source: IMF

What drives GDP growth then? Capital investments add 1.3% points in Central Eastern Europe and 2% points in the Baltic states. The rest comes from total factor productivity which grows by 1.9% in the CEE and at an astronomical pace of over 5% in the Baltics. What does this high TFP growth exactly mean? The exact answer is: 'We don't know'. TFP is a residual measure capturing scale effects, non-embodied technical change and all sorts of measurement errors. The closest one can get to the truth is by defining TFP growth as an imperfect measure of the contemporary spill-over effects of technological progress.[2] This definition suggests that economic growth in the New Member States has been driven by capital investments, technology import and increasing productive efficiency. Employment decreased exactly for the sake of higher efficiency especially in the initial years after transition. After the early recessions economic growth returned soon, but it did not lead to a return to former levels of employment. In other words, these countries generally experience 'jobless growth'.

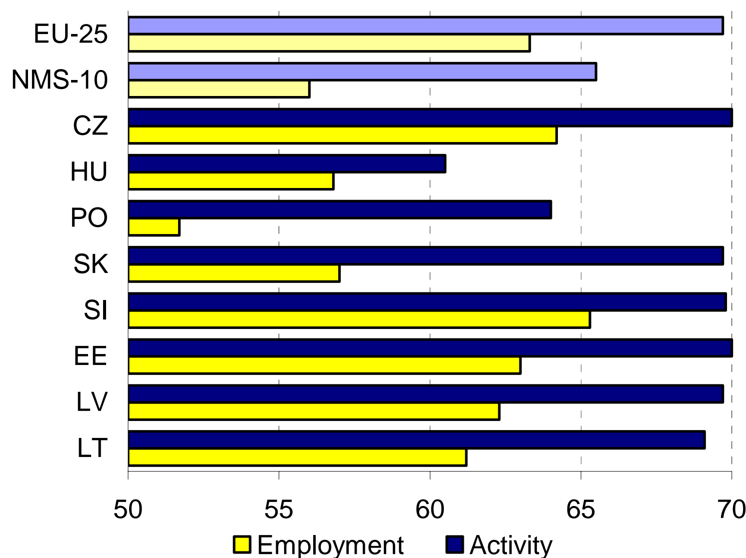
Compared with development stories in East Asia and Latin America this is a unique phenomenon: in other leading developing countries of the world labour has a significant positive contribution to growth while TFP is generally much more contained. Why is this so? A potential explanation is the different background of these countries. In East Asia and Latin America development has largely been a story of creating new industries, services and jobs. In transition economies however, development means dismantling obsolete industries and the illusion of full employment. 'Job destruction' is a lengthy process: even if economic reforms were swift, public and political resistance can 'save' employment inefficiencies especially in the public sector and state-owned enterprises. On the other hand, the largest share of GDP growth comes from relatively capital-

[2] For a discussion of the correct interpretation of TFP growth, see: Lipsey, Richard G. and Carlaw, Peter (2004): Total factor productivity and the measurement of technological change. *Canadian Journal of Economics*, Vol.37 No.4 (November), pp. 1118-1150.

intensive industries where only modest job creation can be expected. It might take time before more labour-intensive services begin to create jobs and contribute more to overall economic growth.

Employment trends show great variation across countries. The activity of working age population is comparable with the European Union average – two notable exceptions are Hungary and Poland. Employment rates are higher than the EU-25 average in the Czech Republic and Slovenia, slightly lower in the Baltic countries, and much lower in Hungary, Slovakia and especially Poland.

CHART 4.: ACTIVITY AND EMPLOYMENT RATES AMONG THE 15-64 YEARS OLD



Source: Eurostat

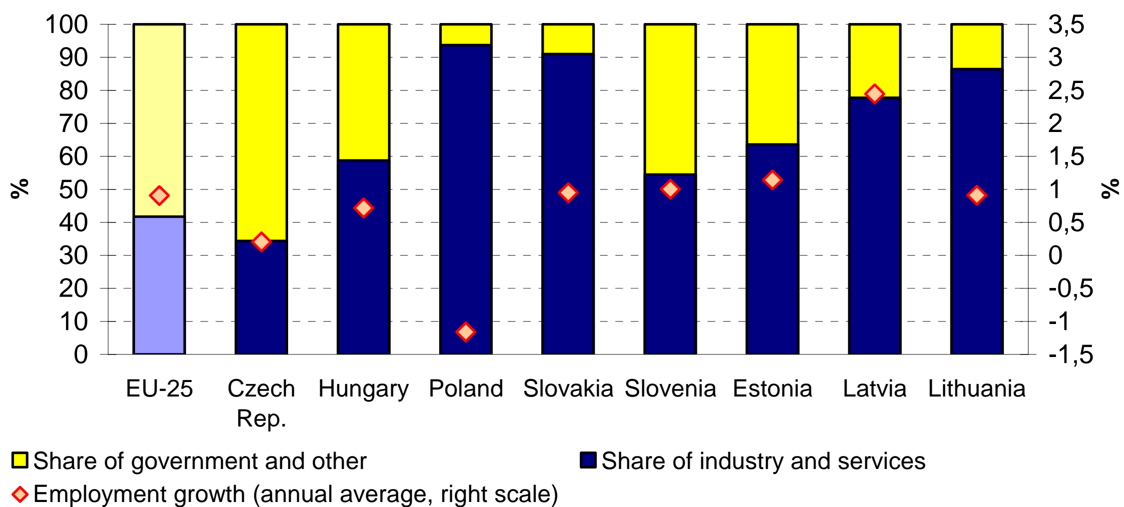
The most important issues in employment include low activity rates of the young and elderly population, and high unemployment. Activity and employment among the 15-24 years old is 10-20% points lower than the European Union average for all countries except Slovenia; youth unemployment is a significant issue in Poland and Slovakia. Employment among the 55-64 years old is around 10% points lower for Hungary, Poland, Slovakia and Slovenia – this can be attributed to the fact that early retirement was a widely used strategy to contain unemployment during transition and that the obsolescence of old skills forced a large number of elderly employees into retirement. Finally, the overall unemployment rate is around 10% in the Baltic countries, and is near 18% in Poland and Slovakia with long-term unemployment especially high in the latter two.

Activity and employment gaps are the largest in the population with low education levels. In other words, well-educated citizens generally have jobs, while unemployment and inactivity is concentrated in the population with poor education. The slump of labour-intensive industries (e.g. clothing, tobacco, etc.) hit the group of unskilled and semi-skilled workers the hardest, while job creation usually presents opportunities for skilled workers and people with higher education. Furthermore, low-skilled workers are the most difficult to retrain as they often lack basic education

necessary to absorb new skills and knowledge. What remains for this population is basically the informal economy: subsistence agriculture, day-labour and the construction sector.

Employment growth since 2000 has been fairly comparable with the average of the European Union; most countries experienced an average annual growth rate of one percent. Poland is the only country with declining employment, especially in the business sector; the Czech Republic witnessed stagnation while Latvia is the sole outstanding performer. The fact that only 40% of new jobs were created in industry and business services in the EU-25 might be a consequence of the competitiveness problems of Western Europe. The situation is generally more favourable in the New Member states. In the Baltics the business sector accounts for 64-86% of new jobs, in Slovakia around 90%. The government and public services (education, social and health care, etc.) have larger shares in Hungary, Slovenia, and most notably, the Czech Republic. This result is in line with the general trend of 'leaner' public sectors in the new Baltic states and more extensive ones in the Visegrad countries.

CHART 5.: DECOMPOSITION OF EMPLOYMENT GROWTH BY SECTORS



Note: employment growth between 2000 and 2004/2005 in all sectors excluding agriculture
Source: Eurostat

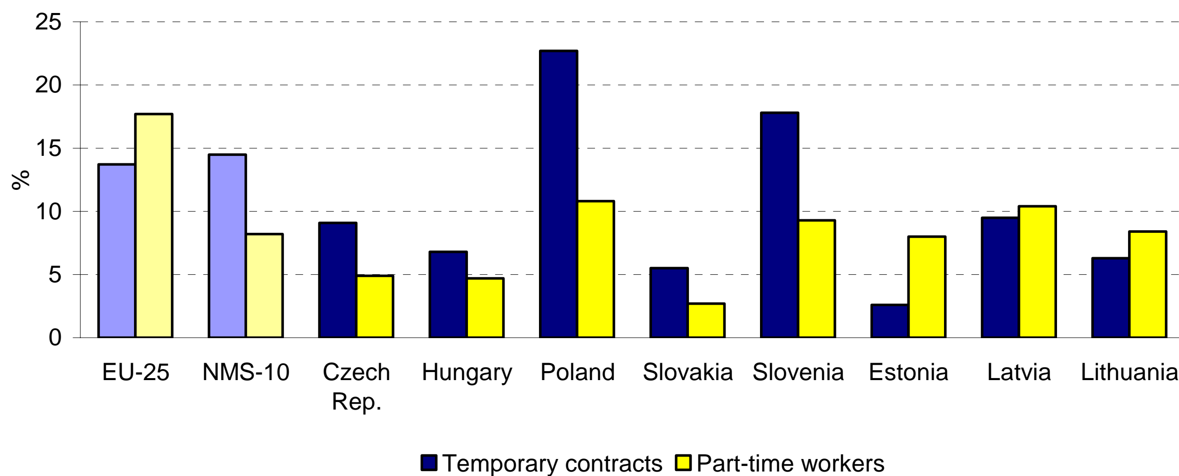
Employment problems stem from various sources, three of which merit special attention. These are: skill mismatches and problems of the education sytem, rigid labour markets and high tax wedge on labour.

The mismatch of supplied and demanded skills is in part a heritage of obsolete education systems: skilled workers and white-collar employees are increasingly in demand but these education systems failed to respond except for an overall expansion of upper education. On the other hand, computer, language and entrepreneurial skills are taught inadequately. Low cost of labour is not enough: its quality needs to be improved. These New Member States cannot compete with Eastern Europe let alone with China in terms of pure labour cost. Nor is it their objective: they all aim to attract

industries and services producing high per capita value added. The attraction of such investments requires efforts to improve the education systems as New Member States generally lag behind Western Europe in skills like foreign languages or computer literacy. Experience also shows that uneducated workers are most subject to unemployment and inactivity as they are unable to cope with changes in labour demand.

Labour market inflexibilities include various issues such as the low mobility of labour (both across jobs and geographically), inflexible wages reinforced by a compressed wage structure in the public sector (mimicked by companies), overly stringent employee protection legislation and inadequate regulation of non-typical employment. For illustration purposes it is instructive to take a brief look at this last issue.

CHART 6.: NON-TYPICAL FORMS OF EMPLOYMENT



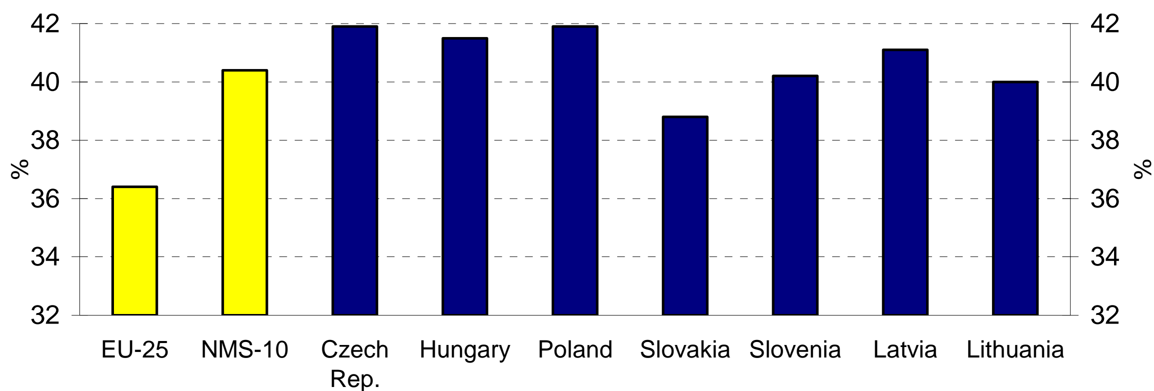
Note: percentage of employees in 2004
Source: Eurostat

Non-typical employment forms such as temporary contracts and part-time jobs could be beneficial for many worker groups including young-age and elderly workers; a more forbidding regulation of these employment forms could also help ‘whitening out’ informal labour. Unfortunately most New Member States lag behind the EU average in terms of non-typical employment; countries with large shares of non-typical workers (Poland, Slovenia, Latvia and Lithuania) are all economies with large agricultural employment. In other countries the share temporary contracts is about 5% points less while the share of part-time jobs is 10-15% points lower.

The third serious impediment to job creation is the over-taxation of labour. The total tax burden on labour is on average 4 percentage points higher in New Member States than the EU-25 average. Recent econometric studies suggest that a 10% point increase of the overall tax wedge can imply a

1-3% decrease in employment.[3] Based on these results about one percentage point of employment rate differences could be attributed to the differences in the tax wedge. As the size of the informal economy in these countries is relatively large (it can reach 20% of their GDP according to UNCTAD estimates) a lower tax rate can significantly increase the tax base. Based on the ample evidence it is suggested that New Member States should revise their tax systems in order to reduce the burden on employment. This does not directly matter much for international competitiveness and the ability to absorb foreign investments as the total labour cost is still lower than in Western Europe even with higher tax wedges. On the other hand, it is vital for domestic firms and especially small and medium size enterprises accounting for the bulk of employment – and the development of a network of potential suppliers and partners indeed influences investment opportunities indirectly.

CHART 7.: TAX WEDGE ON LABOUR



Note: tax wedge equals the sum of income taxes, social security contributions and other taxes relative to gross wages plus social security contributions paid by the employer; figures apply for a single representative worker without children working in manufacturing, paid 67% of the average wage in 2004. Data on Estonia unavailable.
Source: Eurostat

Competitiveness challenges

Although New Member States are competitive in terms of labour costs vis-à-vis EU-15, there are significant challenges ahead. The first such challenge is stiff competition from outside the EU: Southern European countries (not to mention China and other Asian economies) possess a much cheaper labour force: in some industries this alone can be a decisive factor. Fortunately for the New Member States, they are protected by some ‘cushions’. First and foremost, they are already within the European Union, they are part of the Single Market. Goods and services exported form these countries to other EU members face no trade barriers. Second, Asia is geographically distant, therefore transport costs can be significant. Third, these countries are at a more advanced stage of

[3] See for example: Planas, Christophe, Roeger, Werner and Rossi, Alessandro (2003): How much has labour taxation contributed to European structural unemployment? European Commission, Economic Papers No. 183. For a summary of results see Nickell, Stephen (2003): Employment and taxes. CESifo Working Paper No. 1109.

development: they have favourable business environment, relatively advanced financial systems, infrastructure and services sectors (compared with the Balkans for example).

Poor employment performance is an indicator of competitiveness challenges as well: low job creation due to labour market inflexibilities and other disincentives (high taxes) are probably the most important sources of concern. Job creation is an especially important issue from a social point of view, as unemployment and low labour market activity place an excessive burden on the social security, and thus on the employed endangering social cohesion in the long run. The threat of dual economies is also looming: if the education system fails to provide the future labour force with adequate skills and abilities and if job creation of domestic small and medium sized enterprises (the prospective suppliers of export-oriented transnational companies) remains laggard.

In sum, the main challenge in the coming years for the governments of New Member States will be the revitalisation of employment growth essentially by supply-side measures: investment in human capital (education) and the dismantling of disincentives to job creation.