



INSTITUT PRO EVROPSKOU POLITIKU  
**EUROPEUM**  
INSTITUTE FOR EUROPEAN POLICY

## **European Employment Strategy and Selected Trends in the Czech Republic**

Policy paper by Marek Havrda  
November 2002

Despite considerable effort and some partial success mainly in the second half of the 1990s, the European Union experiences a higher unemployment rate when compared to other developed countries, such as the United States or Japan. With the aim to tackle the unfavorable situation, the member states adopted the European Employment Strategy (EES) in 1997. The EES is based on four key pillars:

1. Employability
2. Entrepreneurship
3. Adaptability
4. Equal opportunities

Thus, the EES is directed to both the demand side as well as the supply side of the labor market. It is expected that the Czech Republic will join the European Union in 2004 and thus will be formally obliged to apply the EES. However, the Joint Assessment Paper (JAP) was already signed by the Czech Republic and the European Commission in 2000. The Czech Republic was the first accession country that signed the JAP. The JAP articulates the key employment policy priorities for the Czech Republic.

This paper does not intend to cover all aspects of the Czech labor market nor all the details of the EES, but focuses on selected key trends and sketches policy recommendations for the most pertinent problems. Although the JAP does correctly identify the key outstanding tasks, i. e. tax reform, welfare reform, pension system reform, regional mobility facilitation and modernization of the education system, in practice, substitute measures are often sought and carried out.

### **Economic Situation**

In 2001, despite unfavorable conditions in the world economy, the Czech Republic maintained an economic growth of 3,6%. In comparison

with the base year 2000, the inflation rate grew slightly to 4,7%. The budget deficit increased to 2,5% of GDP, with budget deficit not considering privatization revenues being 5,2 % of GDP, thus significantly exceeding the Maastricht Criteria. In spite of the Czech Crown appreciating and the slowing economies of the Czech trade partners, the external balance improved slightly. Although the unemployment rate fell in comparison with the previous year to 8.0%, it was far above the 1997 level of 4.3%. The unemployment rate has recently exceeded 9% and it is expected to surpass 10%. How were the long term negative trends tackled and the EES priorities fulfilled in this relatively successful year for the Czech economy with the exception of the enormous growth of the budget deficit? What other potential solutions might be identified?

## **1. Employability and support of an environment favorable to employability**

### **1.1.Wage increase and labor productivity**

The administrative wage increase in the public sector that took effect on January 1, 2002 was sufficiently compensated by the productivity increase in the private sector. Thus, there was no significant disparity between the overall wage growth and the growth of productivity of labor. Consequently, the competitiveness of the Czech economy was not considerably endangered. However, recent wage growth has not been supported by relevant productivity growth. This trend might be slowed down or even reversed thanks to the zero increase of administrative wage classes and lower growth of wages of public servants.

### **1.2. Minimum wage and subsistence level**

A crucial factor for establishing the minimum wage level, is the relationship of the minimum wage with the subsistence level. Although the minimum wage is indeed relevant only for a very small number of employees, it may play a rather important role especially vis-à-vis the unemployment rate of recent graduates. Despite the increase in the minimum wage by 115% between 1998 and 2000, the minimum wage is only 15% higher than the subsistence level of a single adult person. This marginal difference certainly cannot serve as a motivating factor to seek employment. From the point of view of microeconomic analysis, the value of free time (and its potential use in the informal economy) will probably outweigh the benefit of a few hundred crowns. Thus a situation of the poverty trap is created.

Nevertheless, the relationship between the minimum wage and the subsistence level is even more important for juveniles. Net minimum wage of juveniles based on 80% of minimum wage of adults is 3854 CZK per month, whereas the subsistence level of a single person in this age group is 4230 CZK per month. The subsistence level is thus almost 10% higher than the appropriate minimum wage!! In this case the minimum wage is

not a motivating factor at all.

The unemployment rate of young people (age group 15-24 years) increased from 12.4 to 16.3% between the years 1998 and 2001. Whereas during the same period the unemployment rate in the age group 15-19 years increased by more than 12%, from 25.1 to 37.3%. However, the rise in the unemployment rate of girls between 15-19 years is the most striking, which exceeded 43%!!! Although these high unemployment figures are partly due to the participation in the educational process, the discouraging relationship between the minimum wage and subsistence level certainly plays an important role here.

### **1.3. Taxation of Labor**

The tax burden imposed on labor is relatively high in the Czech Republic. The average income tax, including compulsory insurance contributions, is 21.3%. However, the employer's contribution to the social security of 35% of the employee's salary must be added to the average tax figure. Thus, the taxation of labor exceeds 50%. Except for minimal tax preferential treatment of life insurance and private voluntary pension insurance, there was no substantial positive improvement in this area.

### **1.4. Demographic development and pension system reform**

The Czech Republic, like other candidate countries and the EU member states, is far from fulfilling the European Commission's objective to reach 50% employment in the age group of 55-64 years. Moreover, the Czech Republic experienced a slightly negative trend when the employment in this age group fell from 40.0% in 1997 to 38.7% in 2001.

In 2001, the average age of retirement was 58 years. On average, men entered retirement at 60 years and women at 56 years. In comparison with the year 1996, there were virtually no changes, despite the increase in the age of legal entitlement for pension (each year by two months for men and four months for women). This curious situation was caused by early retirement leave, which was made legally possible by up to three years. This opportunity was used by over 58% of all persons that entered retirement in 2001. According to the Ministry of Labor and Social Affairs, early retirement was clearly beneficial by about 10% when considering the life income. The government was apparently fighting the unemployment through early retirement. What is most striking is the share of early retirement pensions on the total sum of pensions, which grew by factor of twenty from 1996 to 2001, from 0.61 to 11.35%.

Discrimination in favor of early retirement can positively influence the unemployment rate in the short run and it clearly contributed to the very low unemployment figures in the first half of the 1990s. However, in the medium and long run it is a non-sustainable policy that brings about a negative social pattern that is difficult to correct due to political reasons. In addition, this policy caused lower economic activity in the segment of

55-64 years, and thus higher social dependence of this group. Moreover, the policy led to increased pressure on the pension system, which in the case of the "pay-as-you-go" scheme requires higher social security payments (or budget deficit), and therefore leads to the increase of cost of labor. Consequently, the competitiveness of the whole economy is lowered, which further strengthens the pressure on unemployment. This, when combined with the current demographic development in the Czech Republic, constitutes a deadly mix.

### **1.5. Occupational mobility**

There are significant regional differences in the unemployment rates across the Czech Republic. The unemployment rate in the Moravia-Silesia region exceeds 14%, whereas it is below 4% in Prague. In addition, there are large regional disparities in economic output. In terms of GDP per capita, the Czech Republic experiences the second largest (after Poland) regional discrepancies. Thus there are clear problems with the occupational mobility. The most negative factor influencing the situation is the non-existence of the rental apartment market even after twelve years of market reforms. In international comparison, the Czech Republic does not suffer an absolute deficiency of apartments. This should be taken as a starting point of further analysis. However, in 2001, the state spent over 10 billion CZK as a subsidy to individual building savings plans. Moreover, there are no monitoring mechanisms to assure that these resources are used for housing purposes and thus they are often not used as investments into housing. At the same time, there still persists rent regulation.

Regarding future occupational mobility within the EU, we should mention the preparation of the Czech Republic to take part in the EURES (European Employment Services), which gathers and maintains information of vacancies and life and working conditions in the EU member states, as well as in Norway and Iceland. Nevertheless, its value for the Czech Republic will depend on the transition periods limiting the free movement of persons by the EU member states.

### **1.6. Human resources development**

In the comparative view, there is a very low proportion of young people in the Czech Republic who are involved in the educational process. Although in the academic year 1999/2000 100 % of all fifteen year old pupils were studying (the result of the introduction of the ninth grade), the Czech Republic falls behind the EU in the group of eighteen year olds. In the Czech Republic, only 70.1% are studying, whereas the EU average is 74.5%. In this respect, the Czech Republic is also far behind Poland and Hungary, where the participation rate for the same age group is over 77%. Nevertheless, the figure for the age group of twenty year olds is indeed catastrophic, where only 28.6% of them study, while in the EU it is 48.9%, in Hungary over 45%, and in Poland even 54.8%. Thus the

current generation will obtain on average a significantly lower education than their future competitors in the EU labor market.

In addition, as mentioned above, the juvenile (15-24 years) unemployment rate has been rising rapidly, from 7.0% in 1997 to 16.6% in 2001! During the same period the relative unemployment rate of juveniles grew from 160% of total unemployment to 200%.

Furthermore, in comparison with the EU level the Czech private sector provides a smaller share of funding for life-long education. Thus social partners are not involved sufficiently in human resources development.

### **1.7. Active Labor Market Policies (ALMP)**

The long term unemployment grew from 1.3% to 4.1% between 1997 and 2001. This rise suggests an increase in structural unemployment. The share of long term unemployment on the total unemployment also grew, from 0.30% to 0.51% during the same period.

Although the Czech government was supposed to launch two pilot programs to address the problem in 2002, it is not possible to assess them yet. The first program, "First Opportunity", focuses on juveniles up to 25 years of age before they reach six months of being unemployed, whereas the "New Start" program is aimed at adults before they reach 12 months of being unemployed.

The expenditures on the ALPM grew more than four times from 0.9 billion to 4 billion CZK during the period between 1998 - 2001. The efficiency of the funds devoted to the ALPM bears a large question mark. Despite the favorable macro-economic conditions, the unemployment rate did not fall, nor was the structure of unemployment improved, e.g. shorten the average time of being unemployed. The key objectives of the ALPM should be to improve employability and prevent social exclusion of the unemployed person. In spite of a substantial increase of funds spent on AEP measures, the share of unemployed who participate in the ALPM programs did not change. Despite the European Commission's recommendation to focus ALPM on re-qualification and training, the Czech Republic has reduced the share of ALPM expenditures spent on re-qualifications from 16.3% in 1998 to 9.5% in 2001. Moreover, the expenditures assigned to subsidized jobs grew five times and in public works it grew more than three times. However, the number of applicants, who found jobs thanks to these activities, only doubled during the same period. Subsidized jobs and public works are much less effective in comparison with training and similar investments in human resources.

An important problem of re-qualification programs and the ALPM measures in general is the so called creaming effect. This means that only individuals who are most flexible and willing take part in the programs while those who would need the assistance the most are left out. Currently, there is no relevant criteria that could be used to evaluate the ALPM measures with regard to the creaming effect.

## **2. Entrepreneurship**

Small and medium size enterprises may play a key role in absorbing employees from the sectors undergoing restructuring. Although the share of self-employed in the Czech Republic is comparable to that of the EU, the Czech Republic does not provide a suitable environment for development of entrepreneurship. Registration of new firms, an over-regulated labor market, an insufficient system of financing of SMEs, and high taxation of labor remain the most troublesome problems.

## **3. Adaptability**

The Czech labor market is characterized by full-time jobs with contracts for an indefinite period. In 2001, only 8% of all employees were employed for a fixed-term, which was the same level for 1997. Referring to the main indicators of adaptability quoted in the EES, fixed-term contracts and part-time jobs, the Czech Republic clearly belongs to the countries with rigid labor environments. Although fixed-term contracts clearly contribute positively towards higher adaptability of employers, the Czech Republic lags far behind the EU average of 13.4% (2001) of all contracts.

Over 95% of all employees in the Czech Republic were employed full-time in 2001. Moreover, the number of part-time jobs has been slightly falling in last four years. The percentage of part-time jobs is far below the EU average of 17.8% (2001). However, the notion of part-time jobs can serve as an indicator of adaptability only in the case that working part-time is based on the voluntary agreement between the employer and employee.

## **4. Equal Opportunities**

The long term statistics show a lower employment rate of women and also the average wage of women is around 70% of that of men. Therefore, women have to face a higher unemployment rate, e.g. in 2001 it was 9.9% whereas the unemployment rate of men was only 6.9%. Moreover, they are paid less than men for comparable jobs.

## **Conclusions**

When examining the development of unemployment in the Czech Republic, a number of negative trends can be identified. It is not the development of unemployment (which is comparable to the EU level), but the structure of unemployment that is deteriorating. The most troublesome is the rising share of long-term unemployment and the share of juveniles without work. In addition, the level of unemployment will be negatively affected in the future by other more general trends, such as aging population. The government is well aware of these trends, but established measures are not able to tackle them in a effective manner.

The efficiency of the traditional AEP measures is insufficient. Despite the significant growth of funds devoted to the AEP along with favorable economic conditions (especially economic growth), the government did not manage to reverse these negative trends or at least stop them. Although the current situation is partly the result of insufficient restructuring of the Czech economy, it has deeper roots in the labor market rigidities.

In general, it is possible to recommend a personal and focused approach to individuals, with regard to the social welfare, as well to the motivation to stay employed or, in the case of being unemployed, to look for a new job. On the other hand, the entrepreneurship environment should be as stable and transparent as possible. It should also motivate creation of new jobs by lowering taxes on labor and decreasing administrative burdens. The government should focus on providing a level field for all economic subjects and stop creating further market distortions. This can bring about multiplication effects, e.g. FDI, higher competitiveness of the Czech economy, etc., and thus also create a positive impact on unemployment. All mentioned recommendations are only indicative and each topic would deserve a separate study. The author is also fully aware of political difficulties connected with the materialization of described recommendations.

## **Recommendations**

### **1.1. Wage increase and labor productivity**

It is necessary to keep monitoring the relationship between wage growth and labor productivity growth in order to prevent wage growth exceeding labor productivity growth. This should be done in cooperation with all social partners.

### **1.2. Minimum wage and subsistence level**

The minimum wage can not be constructed with regard to the average wage, but needs to reflect its impact on the most likely affected groups. The difference between the minimum wage and the subsistence level must be a real motivating factor, so an unemployed person would be looking even for jobs paying minimum wage. With regard to the rising juvenile unemployment rate, it is necessary to reform the education system so that young people would stay longer in the educational process. A further potential recommendation might be to differentiate the subsistence level across the regions, because the living costs in different regions vary substantially.

### **1.3. Taxation of Labor**

The key recommendation would be to reform the tax system from direct to indirect taxes and thus to lower the tax burden imposed on labor. Not only would this reform have a positive impact on employment, but it would also decrease the costs of production, and thus improve the competitiveness of the Czech economy, as well as labor flexibility.

Furthermore, it would lower the incentive for illegal employment. Last but not least, pension reform is needed.

#### **1.4. Demographic development and pension system reform**

The legislative changes that came into effect on the 1<sup>st</sup> of July, 2002, follow the right direction, but they are insufficient. A new system, that will motivate people to stay economically active despite their age, must be created. Early retirement should be phased out or at least efficiently penalized. The pension reform must assure that the pension is based on the life income. Thus the pension received during the retirement will more closely reflect the payments made into the social security system during the economically active period. Introduction of partial capital financing of both state and private pensions is absolutely vital. With regard to the demographic development in the Czech Republic, it is also necessary to enable immigration of qualified workers to the Czech Republic.

#### **1.5. Occupational mobility**

No further state subsidies towards acquiring own housing are needed in order to improve labor mobility. It is rent regulation that is causing the illiquid rental apartment market, which is the main factor hindering occupational mobility. The current mechanism of administrative increases of regulated rents led to the situation that the regulated rents virtually reached the levels of market rents in certain regions. Unfortunately, this happened mostly in the regions with the highest unemployment rates, and not the case of regions where more apartments would be needed in order to enable relocation. Rent deregulation must be accompanied by direct individual social subsidies and recent signals from the Ministry of Regional Development suggest that it may eventually take place. However, the question of the speed of deregulation remains unanswered. In addition, the current systems of subsidies towards individual building saving plans and other mechanisms supporting individual investment into housing including mortgage subsidies, should be redefined in such a way that they would be used solely to solve the housing situation of individuals in need. Potential employers' tax write-offs of support to relocate of new employees might be considered.

#### **1.6. Human resources development**

The education system and its post-secondary sphere in particular must be substantially reformed in order to reverse the negative trend of low participation in the educational process. The post-secondary education must be both attractive and accessible. Furthermore, the education system must be flexible enough in order to react to the needs of the changing economy. To introduce mechanisms that would improve the cooperation between schools and private companies may be the first step in aligning the educational plans with the needs of the employers. Further consideration may be given to the tax write-offs for employers contributing to human resource development.



### **1.7. Active Labor Market Policies (ALMP)**

The AEP should be oriented towards re-qualification and further training. The AEP should be able to respond in a flexible manner to the changing demand on the labor market. The efficiency of AEP needs to be monitored with regards to spent sources, its effects on various groups of unemployed and also macroeconomic indicators.

### **2. Entrepreneurship**

An entrepreneur friendly tax system must be introduced. Also, the administrative burden of establishing and resolving SMEs and hiring new employees must be significantly lowered.

### **3. Adaptability**

Legislative changes should enable to create more flexible legal relations between employees and employers which would at the same time provide sufficient protection for the employees. Here the Dutch experience of flexible employment based on the needs of a particular firm should be taken into account.

### **4. Equal opportunities**

It is necessary to provide the conditions for lowering the female unemployment rate, including more flexible labor relations. The problem of different wages between men and women should be tackled by strictly imposing the rule of the same wage for the same work. The practical experience of the EU member states with Mainstreaming may serve as an inspiration.