

Chapter 5

Employment and Social Policies: Making Formal Employment More Attractive

Hungary has one of the lowest employment rates in the OECD. This partly reflects the amount of unregistered activities, but various work disincentives also play a role. The relevant features include the welfare benefit system, family policies, and a relatively high minimum wage. This chapter discusses options for labour market policy to increase labour utilisation in Hungary while also improving the conditions for formal employment. Progress is being made to limit access to disability benefits, via encouraging rehabilitation. Also, there have been changes to the unemployment benefit system as well as in sickness pay rules. This chapter discusses ways to support these changes by creating an effective system of public employment services (PES) and private subcontracting arrangements. On family policies, this chapter suggests measures to improve the balance between work and family life, including by raising the provision of childcare facilities and a system of childcare vouchers which would help to widen choices. Assessment also suggests a need for increasing employment opportunities for low skill workers by keeping minimum wages moderate. This chapter also discusses policies for promoting better co-ordination between the minimum wage system and taxation so as to avoid poverty traps.

Background and main policy recommendations

Hungary's relatively low standard of living is also related to a low employment rate. As highlighted in recent OECD Economic Survey of Hungary and Going for Growth analyses, Hungary has one of the lowest employment rates in the OECD (OECD, 2007a, 2008). Formal employment is particularly low for vulnerable groups – such as low skilled youth, women and older workers, often of Roma origin – while under-reporting economic activity and income is widespread. This backdrop suggests that there is scope for reaping substantial reform dividends, with appropriate policies having a strong potential to bring undeclared work into the formal economy. Moreover, the higher registered employment would simultaneously raise taxable incomes and reduce government spending. Such developments would also strengthen public finances, which is an urgent policy concern (see Chapter 2). And they would facilitate a reduction in tax rates, which – in turn – could spur potential output and growth even further.

The low employment rate is the result of a combination of factors. In addition to a large tax wedge (Chapter 2) and early retirement induced by the pensions system (Chapter 4), it reflects incentive effects in the welfare benefit system and family policies, as well as distortions induced by a relatively high minimum wage. This chapter examines recent progress and policy options in employment and social policies and makes suggestions for further reforms based on experience in other OECD countries. The main policy recommendations are:

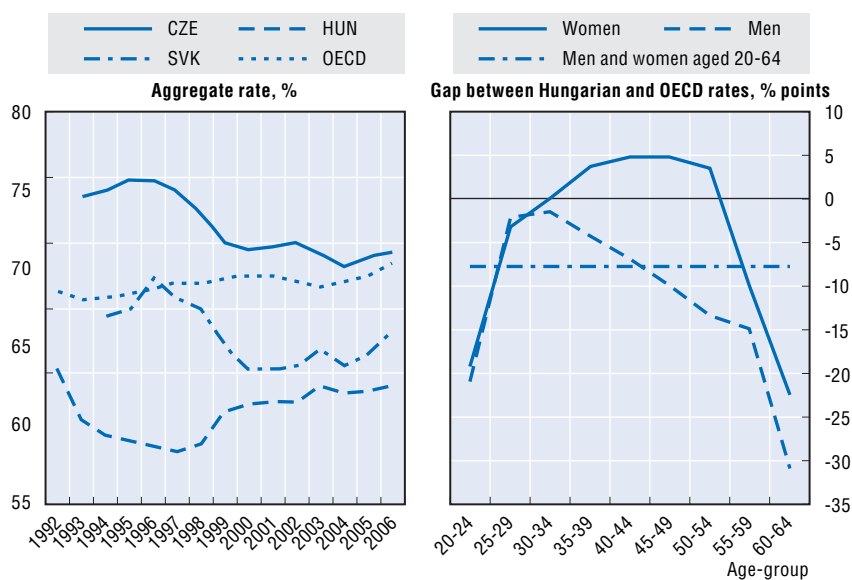
- **Several labour and social welfare reforms have been introduced in the recent past. However, the payoffs from these changes are crucially dependent on the creation of an effective system of employment services.** The institutional setup for the delivery of such services should be reassessed, possibly eliminating the overlap of responsibilities with social service providers. The case evaluation system needs to be strengthened by consistent reporting standards. Competition to allow the expansion of subcontracting arrangements with private or quasi-private service providers would be one way of widening service provision, but preventing “cream skimming” is a key issue.
- **Family policies should aim to improve the reconciliation between work and family life by raising the provision of childcare facilities, while a system of childcare vouchers can increase choice in, and efficiency of, service delivery.** Reform to the comparatively long parental leave provisions should also be considered. However, this should be done in combination with measures to enhance gender-equity and to spur the use of more flexible work practices.
- **The high minimum wage reduces employment opportunities for low skill workers. In setting the minimum wage, careful consideration needs to be given to the interactions with the tax system to avoid poverty traps.** Recently introduced “guaranteed wage minima” that are based on educational and vocational qualification required for the job need to be carefully evaluated.

The roots of Hungary's low employment problem

Although the employment rate has been recovering since the late 1990s it remains below the OECD average by a substantial margin (Figure 5.1). In contrast, survey-based unemployment rates have typically been much closer to the OECD average in recent years. Nevertheless, this more reflects abandonment of jobs search by the non-employed, rather than progress in establishing a well functioning labour market. Particularly low employment rates prevail among those in their late 50s and early 60s. However, employment rates are also relatively low among prime-age men and persons in their early 20s, as well as for women with young children.

Hungary stands out as a low employment country also in comparison with its peers – *e.g.* the Czech Republic, Poland and Slovakia. These countries have been able to sustain very robust rates of employment growth since the early 2000s (Rutkowski, 2007), while employment growth has slowed quite sharply over the same period in Hungary.

Figure 5.1. Employment rate among 20-64 year-olds, 2006¹



1. The employment rate is the number of persons employed as a percentage of the population of the same age and gender. OECD figures refer to the average across member countries. Negative gap values mean that Hungarian rates are lower than average OECD rates in 2006.

Source: OECD Labour Force Statistics Database, 2007.

The poor employment performance of Hungary reflects a combination of factors. As discussed in Chapter 1, it is in part explained by the high tax wedge on labour. This weakens labour demand and also encourages employers and employees to look for ways to avoid the wedge by under-reporting economic activity. Another part of the gap in employment rates is due to disincentives created by the welfare system. The provision of income support for the unemployed became significantly distorted during the industrial re-structuring of the 1990s. In that period, schemes intended for other contingencies – most notably the disability pension and several early retirement schemes – were allowed to absorb individuals prematurely leaving the labour force *en masse*.¹

Regarding disability, problems are particularly acute in the age groups from 45 to 60 years where over 40% of the non-employed receive disability benefits (Figure 5.2). Moreover, there are approximately 350 000 additional people on disability pension above the age of retirement, with policy relevant implications for the old-age pension system (Chapter 4). The number of early retirement pension recipients has also grown massively over the past decade or so. As a result, unemployment benefits and regular social welfare payments play a secondary role in the income maintenance of the non-employed: the number of recipients in these schemes is only about half the number of persons receiving disability benefits and early retirement pensions (Table 5.1).

Figure 5.2. Disability benefit recipients by age, 2006



Source: Hungarian Ministry of Finance.

Table 5.1. Key features of commonly used benefit schemes among working-age adults

Scheme	Key features of eligibility conditions	Maximum length of benefit	Benefit amount	Number of recipients (approximate latest available figures) ¹
Disability pension	Assessment by doctors and social assistance experts employed by the National Agency of Rehabilitation and Social Expertise. Entitlement requires a minimum two-year of contribution record and at least 50% loss of ability.	Indefinite	It depends on the age of the insured and the length of his/her insurance period. Below 25 years of insurance, it ranges between 37.5% and 63% of the average earnings. Above 25 years of insurance it is defined according to the old-age pension formula. There is a floor approximately equal to the minimum old-age pension. The disability pension has no ceiling.	452 000 below retirement age plus 350 000 above that age
Regular social benefit for the disabled	Entitlement requires 2-16 years of contribution record (depending on age) and at least 40% loss of ability.	Indefinite	HUF 26 420 below retirement age and a maximum of HUF 30 680 above retirement age.	185 000
Temporary allowance	Entitlement requires the years of contributions for the old-age pension and at least 40% loss of ability. The claimant's age has to be no less than five years the retirement age.	Maximum 5 years	75% of the old-age pension. There is a floor equal to the amount of the regular social benefit for the disabled.	21 800
Invalidity annuity	Entitlement requires at least 80% of loss of ability before the age of 25.	Indefinite	HUF 32 610	30 000
Rehabilitation benefit (as of January 2008)	Individuals with remaining working abilities are entitled to a rehabilitation benefit instead of a disability benefit.	Up to 3 years	120% of the disability benefit	-
Early retirement	Based on number contribution-years to PAYG pension and age. For women, those aged 57, 59 from 2009 and 60 from 2013 and upwards are eligible. For men, those aged 60 and upwards are eligible.	Up to 5 years before retirement; up to 3 years before retirement from 2009 for women and up to 2 years from 2013 for both genders	Full pension or permanently reduced pension, depending on the scheme	240 000

Table 5.1. **Key features of commonly used benefit schemes among working-age adults (continued)**

Scheme	Key features of eligibility conditions	Maximum length of benefit	Benefit amount	Number of recipients (approximate latest available figures) ¹
Unemployment insurance benefit	At least 365 days of insured employment over the four years prior to becoming unemployed.	9 months	60% of previous nominal earnings in the first 3 months with a floor and a ceiling respectively set at 60% and 120% of the minimum wage (<i>i.e.</i> about HUF 69 000 per month in 2008). For the next 6 months the benefits becomes uniform at 60% of the minimum wage.	80 000
Unemployment assistance	At least 180 days of unemployment insurance benefit contingent upon having spent at least 200 days in employment over the four-year period before becoming unemployed.	3 months (6 months for eligible individuals above 50 years)	40% of the minimum wage	35 000
Sickness pay (extension into unemployment)	Eligible as long as the person goes on sickness benefit at least three days before becoming unemployed.	45 days	Normally 70% of the previous average wage but notably with no ceiling.	85 000
Social assistance	General income support (financed and managed at local government level). Prime-age workers refusing an offer of public work are denied benefit.	Indefinite	Variable, top up on equivalent income (up to 90% of minimum old-age pension) and capped at the net minimum wage, <i>i.e.</i> about HUF 56 190 per month.	160 000

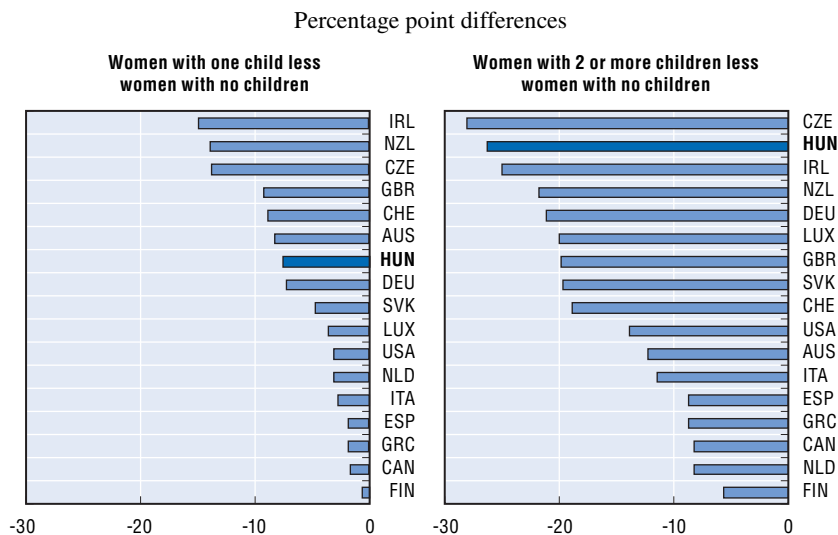
1. Early retirement recipients include those receiving the Advanced Retirement Pension, the Reduced Advanced Retirement Pension plus small numbers on an "employer sponsored" early retirement scheme and a special scheme for miners (Ministry of Finance). For sick-pay recipients the figure refers to the number of recipients of earnings-related sick pay who are unemployed.

Source: Hungarian Ministry of Finance; Hungarian Central Statistical Office, Statistical Report; OECD.

Employment decisions also reflect family policies. In this regard, Hungary stands out in international comparison as a country that offers relatively generous options for taking time off to raise children on a full-time basis. As a result, the gap between the employment rates for women with children and those without is relatively wide (Figure 5.3). Hungary also has the lowest female participation rate in comparison with other central and eastern European countries (Scharle, 2007). Women's inactivity rates reach over 80% for households with at least one child aged below three years. At the same time, the proportion of children under the age of three attending childcare institutions is comparatively low (Bálint and Köllő, 2008). The current system of family support is relatively onerous for the general government

budget. Moreover, international evidence suggests that long separation from the labour market damages women’s earnings and career prospects, thus reducing the employment rate and weakening human capital development.

Figure 5.3. **Comparative gaps in employment rates between women with and without children, 2003¹**



1. The employment/population ratio for women with one child is the ratio of employed women aged 25-54 with one child to the total number of women aged 25-54 with one child. Children aged 14 years or under are counted in the data.

Source: OECD (2007), *Society at a Glance: OECD Social Indicators*, 2006 edition, OECD, Paris.

As most other OECD countries, Hungary has a statutory minimum wage. Since the early 2000s, the OECD country average of the minimum wage has increased slightly, indicating that minimum-wage workers have tended to participate proportionally in the wage gains or losses experienced by the working population at large. By contrast, in Hungary the minimum wage doubled between 2000 and 2002, narrowing the gap with the average wage. Including social security contributions, the minimum cost of labour has oscillated between 35% and 40% of the average labour cost, a comparatively high ratio among OECD countries (OECD, 2006). A relatively high minimum wage contributes to making formal employment relatively more attractive to individuals with some basic qualifications, while at the same time reducing the demand for low productivity workers. It thus ultimately exacerbates the problem of the employability of the low skilled whose productivity falls below the level of a high minimum wage. In addition, there is concern with the new system of “guaranteed wage minima” for jobs requiring a secondary school or vocational training qualification.

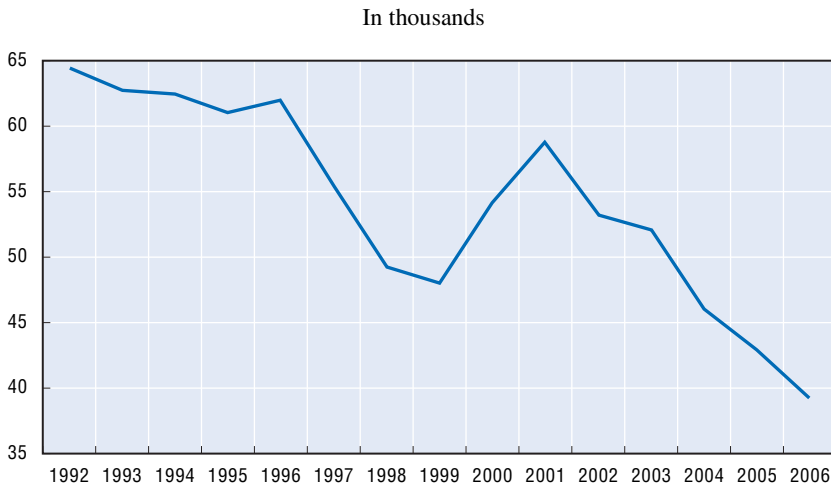
Consolidating progress in welfare policies requires efficient employment services

The government acknowledges that there are problems in the assignment of recipients to different benefit schemes. Specific labour market policy initiatives are focussed on three major areas: active labour market measures intended for the unemployed; measures specifically targeted to promoting the transition to work of inactive individuals with residual work capacities, and the reform of sickness pay rules. These changes are part of a broad strategy to raise participation rates, including measures to tighten eligibility conditions to access early retirement (Chapter 4), along with other supply side measures, such as reducing the tax wedge (Chapter 2). Although substantial immediate progress in raising employment is unlikely, the expectation is that employment ratios will start to rise when economic activity picks up again.

Measures to limit disability benefit inflows

For the past few years one policy priority of the Hungarian authorities has been to contain the inflow to the pool of disability benefit recipients. Medical assessments are now made by qualified professionals from the National Agency of Rehabilitation and Social Expertise, a body supervised by the Ministry of Social Affairs and Labour, and inflow figures since 2001 show a declining trend (Figure 5.4). Recent measures include a tightening of guidelines for eligibility: new guidelines were distributed to the experts of the Agency in 2005 that put the focus of the assessment on the remaining work capacity of the claimant.

Figure 5.4. Inflows of recipients of disability benefits



Source: Hungarian Ministry of Finance.

Recent policy changes contain an emphasis on rehabilitation. The new disability benefit system that came into effect on January 2008 aims to encourage return to the labour market of new claimants who have been assessed to have remaining work capacities. These individuals have to participate in a rehabilitation plan designed by the employment office. Any suitable job offer received by the individual through the employment authority during the course of the plan has to be accepted. For those eligible for the rehabilitation scheme, a transitory rehabilitation benefit replaces the disability pension, and the duration of the rehabilitation benefit is commensurate to the length of the rehabilitation process – albeit capped to three years. The new rehabilitation system also involves a focus on training as a way to strengthen the remaining abilities and skills of disabled individuals. In part, these programs will be financed using European Union (EU) funds under the ongoing EU 2007-13 budget.

Even though the new accent on rehabilitation marks a positive step, the 20% higher level of the rehabilitation benefit relative to the level of the disability benefit may not be an optimal use of resources. Insofar as the rehabilitation test is mandatory, there is no need to encourage people to go for rehabilitation, rather than disability. It would be more efficient to use these funds for in-work support to encourage people to take up lower paid jobs.

Changes to the unemployment benefit system

Consistent with past OECD recommendation, unemployment benefit reforms introduced in 2005 have made the system more “front loaded”. Notably, the maximum possible duration of benefits has been reduced from 15 to 12 months, and only benefits during the first three months are now related to previous earnings. Another feature of the revised scheme is its “mutual obligations” character: a new Job Search Allowance scheme requires commitment by recipients to more intense co-operation with labour offices on job search, combined with increased help in the form of job placement services. As a positive incentive mechanism, if the recipient finds work before the expiration of the benefit period, half of the remaining benefits can be paid as a lump sum. Following a slow start, results are increasingly encouraging. The incentive-to-work effects of the scheme show up in the fact that in 2006 about 35% of recipients of the Job Search Allowance have found a job before their entitlement expired. This compares with only 25% in the previous year.

Recent sickness pay rules have helped but there remains loopholes

Under current rules, sickness pay is usually 70% of earnings (with no ceilings) and can be drawn for an extended period after the termination of employment. There are around 85 000 individuals on sickness pay, compared with some 115 000 persons on unemployment benefit. This suggests that eligibility rules for sickness benefits are too generous. Recently the period of entitlement was reduced in two rounds once from six to three months and more recently further down to 45 days. Overall, this has contributed to a fall in the number of sickness days by over 10%.

Past OECD Economic Surveys underscored that the system of sickness benefits has remained subject to abuse, not least because the uncapped benefit is much more generous than the tightly capped unemployment benefit. In addition, though the standard extension has been reduced, an extra period of 45 days can be granted on a discretionary basis (using means tests and taking account of other circumstances, such as the length of the contribution period). This margin is motivated by the need to prevent unreasonable hardship but may lead to abuses. One way to eliminate this risk would be to shorten the period of unemployment payments accordingly when the individual takes advantage of the sick-pay extension.

Options for the creation of efficient activation programmes

Starting the 1980s most OECD countries have increasingly given attention to the effectiveness of the activation strategies implemented by employment services. Many reforms have aimed to orient jobless individuals from benefits linked to inactivity to services more focussed on activity. This requires the backing of an effective job placement infrastructure, even though the implementation of such an infrastructure may require some time. The OECD has developed a comprehensive toolkit of measures aimed to ensure the activation of individuals considered able to work, rather than continuing transfer payments to inactive candidates (OECD, 2005; Carillo and Grubb, 2006; OECD, 2007b). The toolkit offers several policy solutions that could help the expansion of labour market activation services.

Institutional capacity building

For Hungary, one factor weakening institutional ability to handle the expected growth in numbers of individuals under rehabilitation is that responsibilities for providing employment and related services are split and not clearly defined. Such services are provided by both a labour market institution (typically the public employment service, PES) and a poverty and community care organisation (usually a municipality). Therefore, in practice there are two institutions responsible for the same group of clients. This creates a problem of coherence between employment and social policies reflecting the fact that the recipients of social benefits often fail to fall in the sphere of action of the PES because they are not required or encouraged to visit them.

OECD experience based on countries that have encountered similar co-ordination problems suggests that one remedy would be to shift “new” clients eligible for rehabilitation outside the structures traditionally responsible for social services and move them under the umbrella of the PES. Since rehabilitation benefits are financed at national level, to facilitate integrated management the services for this client group should be delivered by a national institution. An important advantage of this integrated management approach is that it helps to eliminate the overlap of responsibilities, while also reducing cost by exploiting economies of scale. In addition, servicing rehabilitation beneficiaries in the same environment as unemployed persons can help sustain their motivation and work expectations.

Efforts to integrate social and employment services are already underway in Hungary, based on the experience of seven local pilot projects. Participants in the projects are social institutions, local PES offices, and the municipalities. The aim of these projects is to facilitate the establishment of integrated service provision, with the PES playing a co-ordinating role. The evidence gathered from the pilot projects is to be presented in a manual of principles that is currently (spring 2008) under finalisation and will be used as a guide to nationwide integration. Besides the aim to raise the level of integration between different social service providers, there is an effort to strengthen the linkages between the PES and business, which is seen as an indispensable source of information concerning both labour needs and training requirements.

Arguably the expected transfers of new client groups to the regular PES is likely to put the PES under considerable strain. One practical risk is that the new rehabilitation clients will be hard to place, implying both long duration of rehabilitation, as well as a significant diversion of resources away from the existing PES client groups. OECD experience suggests that one way to smooth the transition would be to exempt hard-to-place individuals from work-availability requirements until the PES has gained the capacity to manage its increased caseload. Seen from this perspective, the approach chosen by the Hungarian authorities – namely, to focus policies on the inflow of new claimants to the disability benefit system, rather than to extend activity requirements to all individuals currently on disability benefits – seems prudent, as it helps to reduce the risk of overloading the PES.

Several OECD countries require disability benefit recipients with remaining work capacity to be available for work, for example on a part-time basis. Such activation tools have proven to be effective in reducing benefit caseloads and enhancing welfare-to-work transitions in countries such as Australia and Canada. A similar approach could also be used in Hungary, as the PES experience in employing new groups under rehabilitation improves. A more radical alternative would be to establish strict re-testing requirements of people's disabilities. In the Netherlands the authorities have run two comprehensive re-examinations of disability beneficiaries, once in the 1990s and another more recently. However, this practice may be politically more difficult to replicate elsewhere if the aim is to take beneficiaries off the benefit rolls.

Performance measurement and management

One important issue in the management of the PES is impact evaluation and how it can be used to improve PES management. In this regard, OECD work suggests that the governance structure of employment services is a crucial determinant of success (OECD, 2005). Even though actual implementation occurs at the local level, employment services are generally financed at the national level. When the central government finances employment services the employment services at the local level do not have a strong incentive to enforce eligibility criteria. This suggests that there may be a case for establishing some hierarchical control, even though finding the right balance between central control and local autonomy may not be an easy task. The national authority also needs to ensure consistent reporting standards as well as rapid diffusion of best practices. This can go a long way with helping to

improve practices at the local level, provided that proper local adaptation and experimentation are not discouraged.

One important difficulty regarding reporting standards is that data entries for performance management are sometimes used to “game the system”, *e.g.* classification of more jobseekers as “not job ready”, recording of multiple placements for the same individual, increasing the number of interviews at the expense of their duration. To limit this risk, some OECD countries have established the practice of making the PES an active participant in performance management. Experience suggests that relatively simple evaluations by the PES have often produced relevant results for operational purposes. For example, the pilot implementation of Restart in the United Kingdom and WRK4U in New Zealand, gave near-immediate estimates of their impact and the decision to expand these programmes could be made after just a few months of pilot operation. When employment services are outsourced within a competitive framework (see below), outcomes vary substantially, suggesting that it is possible to identify the effectiveness of different providers fairly accurately without recourse to complex statistical analysis.

The focus of impact evaluation is also important. While reducing unemployment (or reducing the number of benefit caseloads) has to be a prominent target, international experience suggests that an exclusive focus on this dimension may be inappropriate. Often, employment services play a role in exposing undeclared work and shifting it into the formal economy. This explains why a growing number of OECD countries have established the practice of matching the government’s benefit payment database to the database of social security contributions and tax records. Technical barriers to data matching are generally relatively low, even though data matching can raise issues of confidentiality and privacy.

Subcontracting arrangements

The management of private employment services also merits public policy attention, especially when it is partly financed by the public sector (Struyven, 2004). For Hungary, the relevance of this issue is further accentuated by the fact that the PES may need to more easily subcontract non-profit and other providers of services that the PES itself is unable to provide. In this regard, OECD experience suggests that the prevention of “cream skimming” – which happens when providers take in only the most employable potential clients – is a key issue when there are competing providers. To this end some countries have introduced deterministic referral procedures, for example through random assignment of clients to providers or requiring that jobseekers in one local area can only register with one local employment office. At the same time, service providers should be required to ensure that employment outcomes are measured for all persons referred. On the other hand, they need to be granted the possibility to report evidence of lack of availability for work or refusal to participate in a labour market programme.

Policies to help reconciliation between work and family time

The last OECD Economic Survey of Hungary (OECD, 2007a) included a thematic chapter on family policies and child care. The survey contained recommendations how to improve policies in this area, taking into account the need to reconcile family life with working needs. In Hungary mothers' decisions whether to join the labour market – or when to return to it – appear to reflect two factors:

- The first is the possibility to take long leave from work, reflecting generous leave entitlements – up to three years for each child. Partly due to these generous entitlements, at about 3.5% of gross domestic product (GDP) total spending on family support is relatively high in Hungary, on par with relatively high per capita income countries like Denmark and Sweden, and much higher than in neighbouring countries. The extended leave and cash support is sometimes justified on the grounds that it encourages women to have children, thus helping to revamp Hungary's low fertility rate.² However, it is doubtful whether this approach is effective: OECD evidence suggests that the influence of cash benefits and leave allowances on fertility is relatively small and contingent on getting other areas of policy right, such as childcare services (d'Addio and Mira d'Ercole, 2005).
- The second factor affecting mothers' choices is that public childcare services are very scarce in Hungary. This low incidence is plausibly due to weak demand, because remaining at home to care for the children is relatively attractive given current support levels. However, there are also factors pointing to inadequate supply, for example the low number of childcare places, particularly in rural areas.³

OECD evidence suggests that good policies can help families to better reconcile work attitudes with family life. One viable option would be to consider reducing the duration of leave and benefit provisions, while at the same time ensuring redirection of the funds saved into the expansion of childcare services (OECD, 2007a). The government has plans to expand capacity by 15 000 places in the next few years, partly using EU funds. Savings generated by the reform of family benefits could be channelled into the extension and co-financing of EU-funded projects.

In addition, international experience suggests that putting in place the right set of incentives can be useful in encouraging parents to work (OECD, 2007c). Successful leave schemes usually give parents choice in their return-to-work decisions and introduce a fair amount of flexibility, *e.g.* they allow a parent to return to work after a shorter period, possibly on a part-time basis. Assessing the “optimal” length of a leave period is not easy, however. From a narrowly defined labour market perspective, OECD review suggests that it should be around four to six months (measured in full-time equivalents), and employers report that leave for about four to five months after childbirth causes less disruption than longer leave periods (OECD, 2007c). However, the same review also concludes that the

child development dimension is very important as well. On that basis, it appears that lack of full-time personal care for the first 6-12 months may have negative repercussions on the development of the child, while the cognitive development of children benefits from good-quality formal care (and interaction with peers) from age 2-3 onwards. This seems to suggest that a leave system of at maximum two years would be more appropriate, when taking child development considerations into account.

However, countries that have successfully made recourse to gender-friendly policies have introduced actual leave arrangements that are even shorter than two years, without having precluded the development of the child. If fathers can take more leave, mothers' opportunities to organise their work and family lives according to preferences will expand. Many countries that have such gender-friendly mechanisms have managed to introduce paid leave arrangements of one year (others provide for longer unpaid leave), with specific leave entitlements for the exclusive use by fathers. Iceland is one example, with fathers now being allowed to take up to one-third of all parental leave days.

These considerations underscore the importance of complementing changes in leave conditions with measures to adapt workplace practices. There are indications suggesting that the latter measures are particularly effective where – such as in Hungary, for example – childcare services are relatively undeveloped. Access to (and use of) flexible work practices, reduced-hour schedules, along with other workplace support can help to balance work and childcare commitments. For Hungary, this suggests the need for further work in identifying and removing barriers to the creation of jobs with flexible work hours and other workplace conditions that suit working parents. Clearly, the willing participation of the employers will be important to achieve this objective.

Furthermore, the government could consider regulatory changes to subject the childcare system to competition. At present, competition and diversity in childcare services is limited because a considerable amount of subsidies are channelled directly either to institutional providers or families in the form of cash benefits. A system in which vouchers are given to parents to spend on child care could be one way of widening parental choices. Parents would, for example, more flexibly decide between private and public providers, including the option of daily care services at licensed private locations, including entitled families (rather than the crèche, which may not be an optimal solution in small villages).

A high minimum wage hinders the employment of low skilled workers

Evaluation of the overall impact of the minimum wage on employment is not a simple task, but OECD evidence suggests that high minimum wages tend to reduce the supply of entry level jobs and the employment rate of the young (Bassanini and Duval, 2006). In Hungary, while total employment did not decrease in the aftermath of the minimum wage increases introduced in the early 2000s, the small enterprise sector was strongly hit, with particularly adverse effects on the demand for unskilled workers (Benedek *et al.*, 2006). Indeed, since then the level of the minimum wage appears to have remained high relative to the productivity levels of low skilled workers, reducing the willingness of firms to hire such

workers. Moreover, it appears that a substantial proportion of Hungarian workers in minimum-wage jobs are not poor: in fact, they are from households where other family members also have earnings. Recent OECD research concludes that the best way to limit these downsides is to avoid setting the minimum wage at too high a level and supplementing it with in-work benefits where necessary to avoid poverty. In countries where minimum wages have been kept moderate, the employment rate of vulnerable groups, particularly the young, tends to be higher than in countries with high minimum wages.

Also the interactions between the minimum wages and the tax system merit policy attention. There is strong evidence that high minimum wages magnify the negative impact of the tax wedge on employment (OECD, 2006). This is an important policy issue for Hungary, given its relatively high level of the tax wedge on labour. A number of European countries, including Hungary, have attempted to tackle the problem by introducing tax exemptions for low wage workers.⁴ However, this approach has downsides – the most important being that tax reductions for low-paid jobs make the marginal tax schedule very erratic, thus implying very high effective marginal tax rates at certain threshold wages. As a result, it can be expensive for individuals at the bottom end of the wage ladder to be award wage increases. This underscores the need for a more cautious approach to tax exonerations and Chapter 1 presents some tax options intended to tackle the problem, while at the same time supporting employment expansion.

More recently, as part of the 2005 tripartite wage negotiations, the government introduced a tiered system of “guaranteed minima” for jobs requiring a secondary school or vocational training qualification. Wage minima for jobs requiring tertiary level education were also recommended. The government argues that the tiered guaranteed minima help cut back on the grey economy and raise the supply of skilled labour. Particularly, the authorities hope that the minima will entail substantial reduction in undeclared earnings and in-kind payments among employees without a significant negative impact on the demand for labour. However, little is known about the incidence or value of the cash payments or in-kind benefits among low-wage workers, so the net benefit of the system is hard to evaluate. Moreover, there are risks that the new minima are pricing some genuine low wage jobs out of the market, driving others completely underground. Such downside risks of the system are potentially softened by a rule that sectoral agreements can override the guaranteed minima though, as yet, this provision has been used only in one sectoral agreement for agriculture. In sum, the impact of the new system needs to be carefully evaluated and other more effective ways of reducing grey-sector activity should be sought (Chapter 2).

Notes

1. Before problems with the disability pension system intensified during the 1990s, Hungary had already experienced several episodes of granting disability pensions (Scharle, 2008). The first one occurred in the mid-1960s, parallel to a decline in the general health of the population.
2. As in other eastern European countries, the fertility rate has fallen in Hungary since the early 1990s, partly reflecting the decision of women to start families later.
3. There are only about 50 childcare facilities for the large number of Hungary's small municipalities. Crèche coverage for the overall cohort in the 0-3 year age is 8%, with the overall nationwide capacity being 25 000 places. There are reports of long waiting lists for institutional childcare places.
4. In practice, the Hungarian system of special allowances implies that those earning the minimum wage pay a zero personal income tax.

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