

OECD ECONOMIC SURVEY OF THE CZECH REPUBLIC 2004

Excerpt from Chapter 5, Improving the Reallocation of Labour

INACTIVITY TRAPS AND MOBILITY

Tackling inactivity traps and increasing mobility

Issues related to the Czech welfare system

Background

1. Czech welfare has three main systems of state help: social insurance, state social support and social assistance (**Box 5.2, Table 5.1** and **Annex 5.A1**). The social insurance system includes unemployment, sickness, disability and old-age benefits. The state social support system provides general financial assistance to both the employed and non-employed for housing, raising children and other forms of family support. The benefits are not dependent on labour market status, but some of them are income-tested. The social support and insurance systems are backed up by social assistance schemes that provide a safety net for individuals or households with insufficient income.¹ In general, the socially acceptable minimum income is defined by the *minimum subsistence amount* (MSA). The MSA varies according to household characteristics. Strictly speaking it is only a guide to welfare payout and there is therefore room for discretion in the amount paid.

Box 5.2. The social protection system

Social insurance covers situations of unemployment, in-work sickness, disability and old age. Contributions are defined as a percentage of gross earnings and are divided between the employee and the employer. Benefits are paid in relation to previous net income, but the formulae for computation of the benefits entail significant redistribution.

State social support addresses the financial needs connected with family life. Most of the benefits are income-tested. Support covers child benefits, parental allowances for parents taking full-time care of their children, social family allowance for low-income families with children, housing allowance for low-income families and some other benefits (**Table 5.1**).

Social assistance provides safety net income. If the income of the concerned person or family, including all other state support benefits, pensions or sickness insurance benefits, does not reach a state-defined minimum (the MSA), and eligibility conditions are met (**Table 5.1**), the gap is typically matched by social assistance. However, in reality, the after-benefit income may be both above and below the MSA. The MSA (**Table 5.2**) is constructed from two components, one setting the amount for the basic personal needs of each member of the household (personal needs) and the other setting the amount for the needs of the household as a whole (household needs).

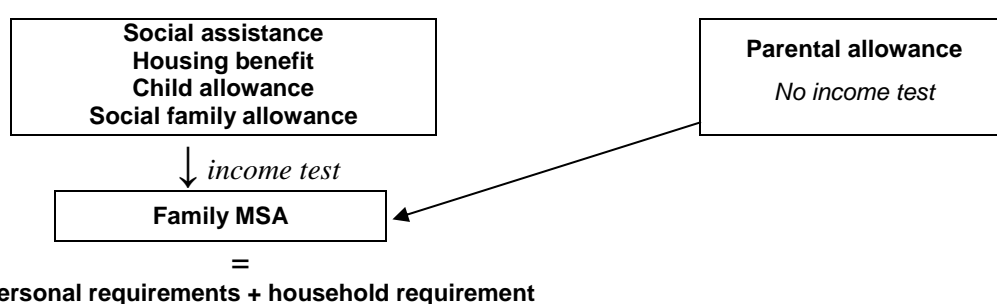
Table 5.1. Low-income assistance and family benefits

| Scheme | Key eligibility conditions | Maximum length of benefit | Main benefit amount | Funding arrangements |
|--|--|---|---|----------------------|
| State social support | | | | |
| Child allowance | Have a child fulfilling obligatory school attendance or a dependent child under 26 years old, and a family income not exceeding 3 times the family MSA in the last year. | No | A percentage of the child's personal needs depending on last years' family income. - 32 per cent if family income below 1.1 times the family MSA - 28 per cent if between 1.1 and 1.8 times the MSA - 14 per cent if between 1.8 and 3 times the MSA | State budget |
| Parental allowance | Until the child is 4 years old (7 years in the case of child's long-term incapacity); full-time and regular care. The limit imposed on income was abolished in 2004, but the entitlement is lost if the child attends a child-care institution for more than five days in a month. | No | 1.54 times parent's personal MSA (about 50 per cent of the minimum wage) | State budget |
| Housing benefits | Accrues to the owner or tenant of a flat, who is permanent resident, if the family income does not exceed 1.6 times the family MSA. | No | A share of the defined household needs that decreases with the relevant family income including other state social support benefits. | State budget |
| Social family allowance | Taking care of at least one dependent child; family income including other state social support benefits does not exceed 1.6 times family MSA. | No | A share of the defined child's personal needs that decreases with the family income. Level of benefits depends on state of health, number of family members, children etc. | State budget |
| Unemployment insurance benefit | 12 months of work in the last 3 years; 6 months of contribution; no income from work. | 6 months; persons close to the retirement age are entitled to another 3 to 6 months of benefits | 50 per cent in the first three months of the last earned income net of tax and social security contributions up to a maximum of 2.5 times the MSA. 45 per cent after the third month, 60 per cent of previous earning during retraining (up to a maximum of 2.8 times the MSA). | State budget |
| Social assistance benefits (in accordance with Social Need Act) | Insufficient income and inability to increase it. The prime-age unemployed have to be registered with the public employment service. They are required to take up an available work opportunity, to make use of own property, and to see to school attendance of their children. | No | Level of benefit depends primarily on fulfilling the eligibility conditions and the difference between MSA and family income; further determinants are expenditures on living, health status, own property etc. | State budget |

Source: Ministry of Labour and Social Affairs.

2. The MSA (**Table 5.2**) is central to the state social support and social assistance benefit system, representing the minimum individual or family income that is considered necessary to fulfill basic needs. In addition, multiples of the MSA serve as limits for income tests throughout the welfare system. Households with net income (including other relevant state support benefits) below the MSA can receive the social assistance benefit. Eligibility for social assistance requires prime-age adults to be registered with the public employment office and to be available for work. The means test implies that, in principle, all avenues to increase household income should be exhausted before social assistance is granted. Although the benefit is not automatically awarded and eligibility requirements apply, the size of the benefit, in practice, mostly at least equalizes the family income to the level of the MSA.² The value of the MSA is set by the Ministry of Labour and Social Affairs. It is worth noting that the amounts do not vary regionally as the costs of living are not assumed to differ substantially.

Table 5.2. Definition of minimum subsistence amount (MSA) and income tests for low-income assistance
Monthly, CZK



| Amounts needed to insure sustenance | | Amounts needed to assure household | |
|-------------------------------------|-------|------------------------------------|-------|
| For dependent children | | Household with | |
| To the age of 6 years | 1 690 | 1 member | 1 780 |
| From 6 to 10 years | 1 890 | 2 members | 2 320 |
| From 10 to 15 years | 2 230 | 3 or 4 members | 2 880 |
| From 15 to 26 years | 2 450 | 5 and more | 3 230 |
| For other persons | 2 320 | | |

Source: Ministry of Labour and Social Affairs.

3. Unemployment insurance is not especially generous in international comparison (**Annex 5.A2**). While on unemployment insurance, individuals may also be eligible to benefits under the social support system and household incomes may also get topped up through the social assistance. Recent legislation (**Box 5.3**) focuses on unemployment benefits, making eligibility to benefits more stringent in general but also making targeted increases in generosity. For example, the new legislation weakens the incentives for older workers to look for work as the benefit period was extended.

Box 5.3. The new Employment Act

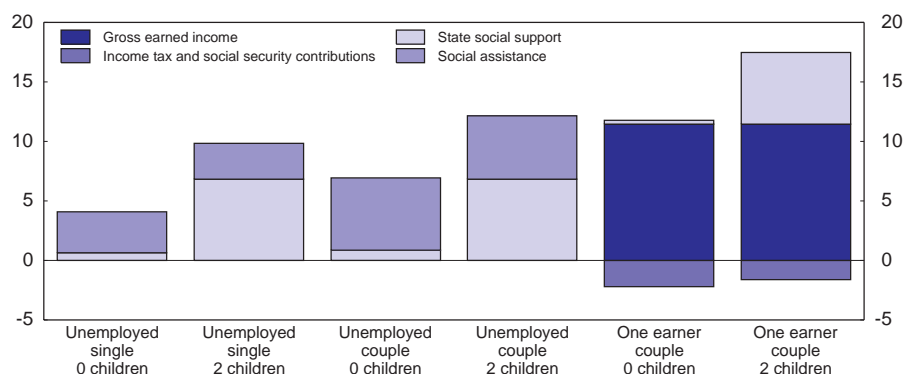
A new employment law has been in force since October 2004. It regulates the implementation of state employment policies, including rules for job placement and entitlement for unemployment benefits, employment of workers with disabilities and employment of foreigners. The new law also defines tools for active policies (**Box 5.4**) and assigns duties for labour inspection of both Czech and foreign workers.

The main changes introduced by this law are:

- Stricter registration and reporting requirements with labour offices and conditions for provision of unemployment benefits.
- The six-month standard duration of unemployment benefits has been prolonged to nine months for those older than 50 years and to twelve months for those above 55 years of age, conditional on 25 years of participation in pension insurance (30 years for the twelve-month extension).
- The amount of unemployment benefit is to remain the same for the first three months of unemployment (at 50 per cent of previous net earnings) but has been increased from 40 to 45 per cent thereafter, with the maximum amount remaining 2.5 times the personal minimum subsistence amount (**Table 5.2**).
- “Partial unemployment” has been introduced, in which the unemployed can earn up to a half of minimum wage (working maximum of a half of legislated fixed working time) and still get unemployment benefit.
- Principles and conditions of active labour market policies have been re-defined.
- With EU accession, all EU citizens and their families are granted the same legal status on the Czech labour market as Czech citizens. Employment of other foreigners is subject to a labour market test, and its control is assigned to labour offices (**Chapter 6**).

4. When unemployment extends beyond six months, provided eligibility conditions are met, household income will almost always be at least at the MSA through a combination of state social support and social assistance. About 7 per cent of households are estimated to be receiving social assistance (2001 figures).³ For unemployed families, state social support accounts for most income with social assistance playing a smaller role. For example an unemployed family with two children gets a majority of its income from state social support (**Figure 5.1**).

Figure 5.1. Sources of monthly income of families in long-term unemployment, 2004¹
Thousand CZK



1. Unemployed: no income from work, not eligible for unemployment benefits, eligible for social assistance.
One-earner couple: employed spouse earns 67 per cent of average production worker wage. It is assumed that household income below MSA is topped up to the level of MSA by a social assistance benefit.

Source: OECD computation.

Poverty traps for families

5. Successive *Surveys* have emphasized that there are poverty traps in the welfare system, particularly for families. Due to the minimum income *de facto* guaranteed by MSA, taking up work often does not substantially change household income.⁴ For instance, a worker with a non-employed spouse and two children, starting a job at two-thirds of the average-production wage will see family income increase by less than ten per cent (**Table 5.3**). Further down the earnings ladder, job offers at the minimum wage, and to a certain level above it, do not imply any increase in household income because of the income guaranteed by the MSA (**Figure 5.2**, lower left panel). In short, the tax-benefit system means there are high average effective tax rates facing families with children that often lock them into inactivity. The situation is similar, though the disincentives are somewhat weaker, for single parent families and also childless unemployed couples. Single persons and spouses of employed workers do not face such significant tax-benefit disincentives to take up jobs.

6. Although social assistance benefits are conditional on availability to work and sanctions can be imposed, checks and enforcement are not very strict. In addition, state social support is not conditional on active job search. As a result many beneficiaries do not look for work and remain for prolonged periods on benefits, often augmenting income by working in the grey economy. Indeed, Renooy *et al.* (2004) list “people without proper employment (registered unemployed, housewives) receiving social benefits, social assistance or pensions” as one of four main groups of undeclared workers.⁵

Table 5.3. **Average effective tax rates (AETR) for transitions from full-time unemployment to full-time employment¹**

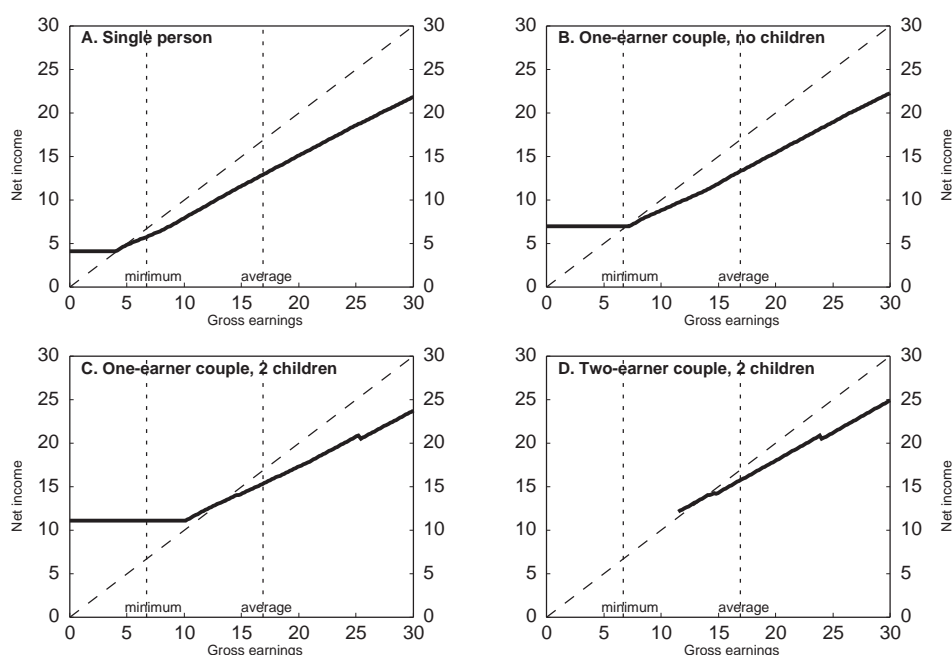
| | Household type | Earnings as a share of average production wage in per cent | | | | |
|---|--|--|-------|------|------|------|
| | | 33 | 50 | 67 | 100 | 150 |
| 1 | Single | 80.6 | 67.8 | 57.1 | 47.5 | 41.9 |
| 2 | Single parent 2 children | 100.0 | 89.6 | 76.9 | 64.7 | 54.9 |
| 3 | One earner married couple, no children 1st spouse = inactive, 2nd spouse... | 100.0 | 88.3 | 76.3 | 62.1 | 51.4 |
| 4 | One earner married couple, 2 children 1st spouse = inactive, 2nd spouse... | 100.0 | 100.0 | 91.2 | 74.2 | 62.5 |
| 5 | Married couple, no children 1st spouse = 67% APW, 2nd spouse... | 28.8 | 27.7 | 27.2 | 27.5 | 28.5 |
| 6 | Married couple, 2 children 1st spouse = 67% APW, 2nd spouse... | 32.6 | 30.6 | 29.4 | 31.1 | 30.5 |

Note: AETR = 1 - (change in net income/change in gross income). AETR_x% is that part of additional gross earnings that is “taxed away” when moving from unemployment (full-time with previous earnings of x% APW) to full-time employment (with current earnings of x% APW). AETRs are measured at the household level and take into account increasing taxes and contributions as well as reduced benefits. Weekly working hours are 0/40 for the out-of-work/in-work situations. For household types 3 and 4 the first spouse is inactive with 0 earnings. The “x%” therefore relate to the second spouse only. For household types 5 and 6 the first spouse’s earnings are held fixed at 67% of APW. The “x%” therefore relate to the second spouse only.

1. Czech Republic 2002.

Source: OECD Tax-benefit database.

Figure 5.2. **Gross earnings and net income, monthly, 2003¹**
 Thousand CZK



1. Net income is gross earnings plus social benefits less tax. One-earner couple: a couple with one spouse not in the labour market. Two-earner couple: a couple with one spouse earning 67 per cent of the average production wage (CZK 11 500). Children are aged 4 and 6 years.

Source: OECD, Tax-Benefits Database.

7. Czech policymakers recognise that the system of minimum-income guarantee creates key problems for incentives to search and accept work. Indeed, there are plans for reforms. The main measures foresee a new act on “material need” and an amendment to the act on the minimum subsistence amount. While details are yet to be finalised, the measures look set to make a number of positive steps. One proposal is to strengthen job-search and income disclosure requirements for eligibility to the social assistance. Also it seems likely that a greater variation in benefits will be introduced. In addition it is intended to no longer have a 100 per cent withdrawal of social assistance for earned income,⁶ thus reducing the high effective tax rates on shifting from unemployment into work. The plans to strengthen financial incentives for job-search and for stricter control are welcome and the authorities should not hesitate in implementing reforms. As a general strategy, the reform should also allow a widening of the gap between the family MSA and the average wage. In addition a general strengthening in the application of rules and conditions across all benefits is needed.

8. There are also plans, as part of the so-called second-round fiscal reforms (**Chapter 2**), to improve incentives through changes in family taxation. Three proposals are of note:

- An option of joint income taxation of spouses, conditional on the presence of children. This will increase incentives for the first job-taker in families that do not have any earned income, by reducing average and marginal effective tax rates. Two earner couples who find it more advantageous to remain under separate taxation will be able to do so. However, in designing the tax schedule for joint income taxation, the authorities should ensure that it does not create disincentives for second earners to take up work, in particular through interaction with the transfer system.

- A switch in child benefit from a tax allowance to a flat tax credit. The tax credit would compensate low-income households who cannot make full use of tax allowances. This move should help low-income households and should slightly increase participation incentives *via* decrease in the average effective tax when taking up work.
- A tax bonus for low-wage workers. The tax bonus, being available only for those in work, will reduce the tax burden at the lower end of the wage distribution.

Older workers' disincentives to continue working have been reduced

9. Older cohorts represent the biggest reserve of potential labour supply and tapping into this could increase the labour force participation rate by perhaps five percentage points (**Chapter 1**). Labour force participation rates are close to 90 per cent for 50-year-old men and women, but decline steeply towards retirement age. The good news is that employment rates of older-age workers have been increasing in recent years, reflecting earlier reforms. As of 2004, the routes to early retirement have been narrowed further, with the abolition of one scheme and a schedule implemented for phasing out another scheme by 2006. However the recent prolongation of unemployment benefit for those over 50 (**Box 5.3**) has somewhat diluted the thrust of policy, though the unemployment insurance duration period remains relatively short in comparison with other OECD countries. Also, the retirement age is set to increase to 63 by 2013, but this will still be rather low in international comparison and low from the point of view of the sustainability of the pension system (**Chapter 7**).⁷

10. The analysis in **Chapter 7** recommends measures to remove remaining incentives to retire early. This includes further tightening access to the early retirement scheme and adjustment to the rate at which pensions are increased through working beyond the standard retirement age. Until recently, pensioners were not allowed to take up work during their first two years of pension. In a welcome move, the changes in the Pension Insurance Law have allowed pensioners to receive work income without losing pension income (except in the case of early retirement). This broadens the options for working beyond the standard retirement age and for this reason should help improve labour force participation.

11. Disability schemes are possible pathways for early labour-market withdrawal, if access is insufficiently controlled. Indeed, inactivity in the pre-retirement age because of illness or disability is very high in the Czech Republic compared to other OECD countries (OECD, 2004a), which points to a possible abuse of the schemes.⁸ The incentives for abuse are particularly strong for low-income workers, as the benefits imply rather high replacement rates. While beneficiaries of partial disability benefits have their work income limited, those granted full disability are allowed to work without any limit on earned income (**Table 5.4**). Therefore, attention should be paid to definition and thorough implementation of the access rules to disability pensions to limit their use as a route out of the labour market.⁹

Table 5.4. **Disability pension schemes**
Financed from social security contributions

| Scheme | Key eligibility conditions | Main benefit amount |
|---------------------------|---|--|
| Full disability | Permanent reduction in the ability to work by at least 66 per cent and a minimum contribution period (depending on age, maximum 5 years) | Monthly: CZK 1310 plus a percentage of previous monthly earnings (decreasing with their level) for each year of contribution (years remaining until retirement age are counted as years of contribution) |
| Partial disability | Permanent reduction in the ability to work by at least 33 per cent and, except in case of a work accident, a minimum contribution period (depending on age, maximum 5 years); earned income should not exceed 80 per cent of adjusted average previous earnings | Same calculation as full-disability pension with half of the variable amount if the beneficiary's income is less than 66 per cent of adjusted average previous earnings; a half of this sum if the beneficiary's income is between 66 and 80 per cent of adjusted average previous earnings. |

Source: Ministry of Labour and Social Affairs.

Transition from school to work should be closely monitored

12. Youth unemployment rates are high (**Chapter 1**). Though high unemployment rates among the young are typical, reflecting the difficulties of getting a first foot on the jobs ladder, in the Czech case the welfare system has provided additional incentives to register as unemployed. Until recently, school-leavers were exempt from the 12-month work condition for eligibility for unemployment benefits and could automatically get 6-month unemployment benefit immediately after finishing school. Thus, school-leavers were often not motivated to get a job on leaving school. The new Employment Act applies the standard work-history condition for young people to get unemployment benefit, though it will allow temporary jobs and in-job training as part of schooling to count in the assessment of work history. Developments in youth unemployment should be closely monitored to examine the impact of the change in eligibility for benefit, with a view to establishing whether this measure is sufficient.

In-work sickness benefits

13. Despite improving health of the population (as documented in the previous *Survey*), the productive time lost on sick leave was continually increasing until end 2003 when it accounted for almost 7 per cent of working time, owing mainly to the increasing duration of average sick leave. The Czech sickness insurance system is similar to those in other OECD countries: eligibility requires a medical certificate and the benefit amount varies according to the length of sick leave and previous income (**Annex 5.A3**). However, the system has problems. First, when a person takes sick leave, the state bears all the payments to the employee, thus giving little incentive for employers to monitor sick leave. Indeed it is thought that employers sometimes encourage sick leave as means of labour hoarding. Second, the employers have few tools to sanction abuse and the control from authorities seems insufficient. The motivation for shirking is highest for low income workers (the benefit being capped at 60 per cent of the average wage) or workers likely to be laid off (employment protection legislation precludes dismissal of workers on sick leave).

14. In 2004, steps have been taken to try to tackle part of the problems in sickness benefit. As part of fiscal consolidation measures, the government cut the amount of the benefits in the first two weeks of sickness. This measure brought about an overall fall in the sickness rate below 6 per cent by September 2004. This drop has contained a significant decrease in the number of sick leaves but also a further strong increase in their average length. This suggests that these steps have been insufficient. Indeed, the government plans to amend the Sickness Insurance Act and to increase the obligation on doctors to make responsible decisions, and to cut employers' social security contributions by 1-2 percentage points in exchange for the employer being responsible for the first two weeks of sickness benefits.

Labour mobility is low

15. As **Chapter 1** describes, unemployment is strongly regionalised, in part reflecting weak labour mobility. One important factor hindering mobility is persistent friction in housing, particularly in the rental market. Indeed, a study by the Ministry of Finance estimates that friction in the housing market is responsible for at least 2 percentage points of the unemployment rate and represents a loss of about 2.4 per cent of GDP.¹⁰

16. The key problem in the rental market is that many rents remain *de facto* regulated and well below market rates. The *de facto* regulation applies to housing that was previously state- or municipality-owned and has since been sold off to private landlords, as well housing still owned by the municipalities.¹¹ Rents in these segments of the market were controlled by the government until March 2003, when rent regulation was ruled out by the Constitutional Court. Nevertheless, the rents have effectively stayed frozen because the existing regulation has not been replaced. These frozen rents are estimated to apply to about 95 per cent of rental apartments,¹² which accounts for more than one quarter of households. The incentives for tenants benefiting from these rents to stay put are large: rents on the open market are reckoned to be, on average, 3½ times the frozen rents and regulated rent is secure as long as the tenant maintains the lease.¹³ For example, frozen-rent apartments will often be kept unoccupied with families aiming to keep them for when children want to leave home.¹⁴ Steps need to be taken to gradually free-up the frozen rents and establish a unified rental market, as this will help mobility in the Czech labour market.

17. Government support for home ownership may also be restricting mobility. The government provides tax allowances on interest payments of mortgages and subsidising interest rates on deposits and credits of housing saving schemes.¹⁵ Although this helps to relieve some of the tension in the rental market and thus ease mobility for some households, home ownership in itself tends to discourage mobility because of high transaction costs connected with the sale of property financed by mortgages.

18. These problems have been recognised by the authorities but so far nothing has been implemented. In early 2004, members of Parliament failed to push through a proposal that would introduce 10 per-cent annual increases in regulated rents over the next three years. One reason for the unwillingness to reform is because rent deregulation would increase living costs for low-income households. However, many high-income households are also tenants of regulated-rent apartments and so the situation is an inefficient way of ensuring minimum standards of welfare anyway (Lux and Sunega, 2003). In the process of rent liberalisation the government needs to ensure welfare concerns are addressed through adjustment of the benefit system. Public support to housing should be rebalanced from encouraging ownership towards supporting rental of low-income households.

ENDNOTES

1. Social assistance benefits include the social assistance benefits provided due to low income, as stipulated by the Social Need Act, and other benefits, *e.g.* allowance when taking care of close relatives, benefits provided to senior or severely handicapped citizens, and benefits for citizens in extremely difficult circumstances.
2. In theory, the after-benefit income can be both below and above the MSA. However, according to the Ministry of Labour and Social Affairs, citizens whose after-benefit income is still below MSA include mainly those who do not take up the benefit at all (mostly homeless people) and a very small percentage of households who claim the social assistance benefit. It is more often that after-benefit income of households receiving social assistance benefits is higher than MSA.
3. The definition of MSA is narrower than comparative international definitions of poverty. In 2001, 7.1 per cent of Czech households had income below 60 per cent of the median net income generally used as the poverty measure in international studies (Sirovátka *et al.*, 2003a).
4. For the following analysis, it is assumed that households whose income from work and including benefits from the state social support scheme does not reach MSA receive a social assistance benefit that brings their income to the level of MSA.
5. According to Hanousek and Palda (2003) the share of people engaged in undeclared work has probably been growing. The study reports that workers who admitted engagement in the grey economy declared that they spent on average about 3 hours per week in undeclared activities, but this is likely to be an understatement.
6. The system will work through means-testing that allows exemption of part of earned income.
7. The retirement age for women is currently lower than for men and depends on the number of children they have had. In 2013, the retirement age of 63 will apply to men and women without children, women with children will still be able to retire earlier.
8. Probable exploitation of the system is indicated by the fact that almost 11 per cent of labour force was receiving full- or partial-disability benefits in 2003. This is above the average reciprocity rate in 16 OECD countries found in OECD (2003b).
9. While the system of medical screening for disability seems to be rather tight, the definitions of some types of disability may be out of date as they were written 10 years ago.
10. Additional cost for the public budgets stem from higher expenditures on subsidies for housing acquisition and foregone rent on municipal flats.
11. Exempted from rent regulation are apartments that have been freed by the occupant (except for the cases of exchange, inheritance and similar), newly-built privately-financed apartments, and apartments occupied by foreign corporations or foreigners without a permanent residence permit.

12. Lux and Sunega (2003); the estimate is for year 1999, but experts do not estimate a significant decrease since.
13. According to the Ministry of Finance, the average regulated rent (defined as the maximum price) was EUR 0.5 per square metre while the average market rent reached EUR 1.8 per square metre. The ratio between average market rent and regulated rent is close to 5 in Prague.
14. 450 000 apartments were unused according to the 2001 Census. However, such apartments are often sub-rented on the black market for market rent. The size of the black rental market is estimated to be close to the size of the official free market (Lux and Sunega, 2003).
15. Construction activity was also recently encouraged by the postponing the shift of residential construction from the lower VAT bracket (5 per cent) to the upper one (19 per cent) until 2008.

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