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## Highlights in this issue:

- Despite recent improvements, the situation on the Polish labour market is still the worst in the EU.
- The flexibility of labour market in Poland does not differ significantly from OECD or EU averages, but there are some specific rigidities.

## High unemployment in Poland – not only a labour market problem

By Michał Narożny\*

### Summary

*In 2005, 17.7% of the active labour force in Poland was unemployed. Despite a substantial fall from nearly 20% in 2002, the unemployment rate remains the highest in the EU. Similarly, the employment rate in Poland, at 52.8%, was the lowest in the EU. Recent developments on the Polish labour market justify some optimism, but a heavy structural unemployment component makes rapid improvement unlikely. The picture is complex as the Polish labour market is not significantly less flexible than EU and OECD averages. Nonetheless, there are specific impediments heavily weighing on labour market performance which are related to the high tax wedge, the undiversified level of minimum wage, insufficiently flexible forms of employment, inactivity traps built into the transfer system and low regional and trans-professional job reallocation.*

### Labour market institutions and labour market performance

Labour market performance is determined by factors that influence the costs, demand and supply of labour. The role of labour market institutions in influencing the wage formation mechanism, firms' hiring and firing decisions and workers' participation behaviour has been widely recognised (e.g. Nickell et al., 2005). Table 1 presents an overview of the determinants of labour market performance (column 1), with indicators commonly used to analyse them (column 2). Situation in Poland is described in column 3, which summarises the findings of the following three sections.

\* Directorate for the Economies of the Member States.

**Table 1: Labour market institutions and labour market performance**

		Indicator	
		Description	Situation in Poland
Labour costs	Wages	Structure of wage bargaining	Centralised in public sector, decentralised in private sector
		Relation to prices	High
		Relation to productivity	High
		Sensitivity to unemployment	High in private sector
	Reservation wage	Replacement ratio	Low
		Length of reception of unemployment benefits	Short
		Level of minimum wage	Relatively low but rising, no regional differentiation
	Strength of trade unions	Rate of unionisation	Low
Union coverage		Low	
Extra-wage labour costs	Tax wedge	Very high	
Labour demand	Part-time work	Part-time employment rate	Very low
	Non-typical forms of employment	Tele-working, temporary contracts, work on demand	Permitted but rarely used
	Employment protection	OECD's EPL index	Average
Labour supply	Overall labour force mobility	Labour turnover	Average
		- hiring rate	Average
		- termination rate	Average
		Inter-regional job turnover	Very low
		- housing market	Ill-functioning
	- transport infrastructure	Weak	
	Educational infrastructure - Adult education - Training	Lifelong learning participation rate	Very low
Inactivity traps	Net replacement rate (non employment benefits)	Very high for pre-retirement and disability schemes	

Source: Based on Layard (2005), OECD (2004, 2005)

## Labour costs

Labour costs are determined by several factors, such as the structure of wage negotiations and the sensitivity of wages to changes in unemployment, inflation and labour productivity; the strength of trade unions; the tax wedge; and unemployment benefits (both replacement ratio and length of reception of benefits) and minimum wages, which influence both the willingness of the unemployed to take up jobs and their bargaining strength in wage negotiations (i.e. their reservation wage).

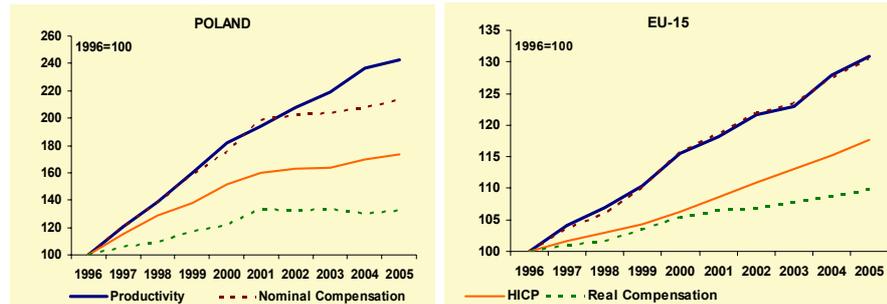
### Wage bargaining

Wage agreements in the EU are often based on collective negotiation structures. The role of trade unions in these negotiations varies among EU countries. The main differences are in the degree of centralisation, frequency of negotiations and the number of people affected by collective labour agreements. The empirical evidence (e.g. OECD, 1993) suggests that countries with both centralised and decentralised bargaining tend to perform better than countries with industry-level bargaining. In Poland there is a dual structure of wage negotiations: decentralised in the non-unionised private sector and centralised in the sector of state-owned enterprises, with an overall positive impact on the labour market.

Nominal wages, determined in a backward-looking manner, moved in step with prices between 1996 and 2001 (see Chart 1), allowing purchasing power to be preserved, but real wages fell short of productivity gains. In 2001 a restrictive and credible monetary policy succeeded in bringing inflation down substantially with wage moderation as a consequence. Real wages strengthened after 2001, as the negotiating position of employees is heavily influenced by the level of unemployment.

*Wages are fairly responsive to changes in unemployment and inflation*

**Chart 1: Productivity, inflation and compensation in Poland and EU-15**



**Unemployment regulations**

*Unemployment allowances are less generous than in the EU*

The analysis of the replacement ratio, defined as the relation between the unemployment allowance and the previous wage, shows that Poland has one of the lowest (47%) ratios in the EU (OECD, 2004b). The replacement ratio is therefore currently not a significant obstacle to taking up a job in Poland. Moreover, Poland has a rather restrictive unemployment allowance eligibility policy, as do the other EU-10 countries, and is less generous than the EU average. Relatively small number of unemployed (ca. 14%) is entitled to receive unemployment benefits. Finally, the duration of receiving the unemployment benefits is relatively short. The only EU country in which these benefits are paid for a shorter time and diminish faster than in Poland, is the Czech Republic. Unemployment benefits therefore do not play a strong demotivating role in Poland for these reasons.

*The minimum wage is planned to reach 50% of the average salary*

A high minimum wage may discourage employers from hiring low-skilled workers, who are then forced to look for a job in the underground economy. But a low level of minimum wages, together with high unemployment allowances, may push workers into the grey market. The ratio of the minimum to the average wage in Poland was 36% in 2005, similar to that in other European countries (Ministry of Economy and Labour, 2005). In July 2005 the Parliament passed a law increasing the annual growth rate of the minimum wage, making it dependent not only on projected inflation, but also on the real GDP growth. The law will apply until the minimum wage reaches 50% of the average wage, putting Poland on a par with countries with the highest minimum wages in the EU. The minimum wage is set uniformly at the national level and it does not account for regional disparities in prices, wages and economic development. This is particularly severe for low-skilled workers in less-developed regions, as the minimum wage is above the market clearing level and employers tend to hire better-skilled workers in these circumstances. The unemployment structure confirms this, as workers with basic vocational education or less, account for almost three-quarters of all the unemployed, with the two-thirds of them who live in rural areas particularly susceptible to increased unemployment after the liquidation of state-owned farms. The 2005 Labour Code revision decreased the minimum wage to 80% of the national level for new entrants to the labour market. Employers can thus hire graduates and school leavers for a period of one year and pay 80% of the minimum wage. This measure proved successful in the initial test phase in 2003-2005, and could be extended to cover re-entrants to the labour market, for example the long-term unemployed.

*Absence of regional differentiation in the minimum wage may prove problematic for low-skilled workers in less-developed regions*

**Strength of trade unions**

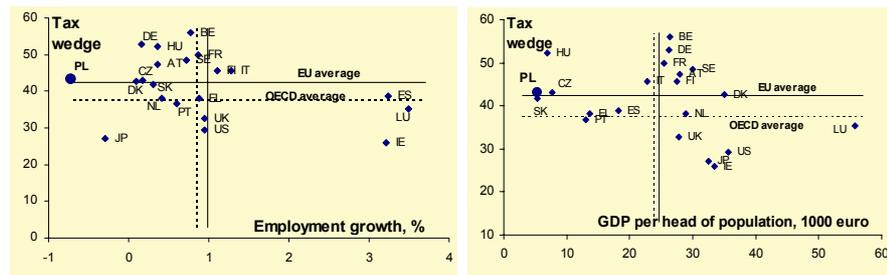
*Poland is no longer a unionised country*

Labour market flexibility can be substantially influenced by the strength of trade unions, commonly measured by two factors: trade union density and collective bargaining coverage. The trade union density, measured as the ratio of trade union members to the total number of employees, is currently about 15% in Poland – less than half of the EU average (36%) – whereas at the beginning of the economic transformation it amounted to some 40%. This is the biggest drop in any EU-25 country. Collective bargaining coverage is measured by the number and significance of collective work agreements and the number of people covered by these agreements. The level of union coverage in all the EU-10 except Slovakia is much lower than in the EU-15.

**Extra-wage labour costs**

Taxes and social security contributions are important elements of labour costs. A good indicator for monitoring these costs is the tax wedge, defined as the income tax plus employer and employee contributions as a percentage of total labour costs.

**Chart 2: Relation of the tax wedge with employment and productivity in some OECD countries**



Source: AMECO, OECD (2005b), unweighted average

The high tax wedge is a detriment to employment growth

According to OECD (2005) data, the tax wedge in Poland (43.1%) is higher than the OECD (36.5%), EU (41.4%) and EU-8 (EU-10 without Cyprus and Malta) average (42.7%). There is no direct relation between the tax wedge and GDP per capita in OECD countries, as high GDP per capita is observed in countries with both high and low tax wedge levels. However, in the EU-8 there is a strong negative correlation between the tax wedge and employment growth, as in these countries there is a large share of low-skilled unemployed, who are particularly affected by the tax wedge. Each percentage point increase in the tax wedge in the EU-8 is estimated to decrease employment growth by 0.5 to 0.8 percentage points (World Bank, 2005).

## The labour demand perspective

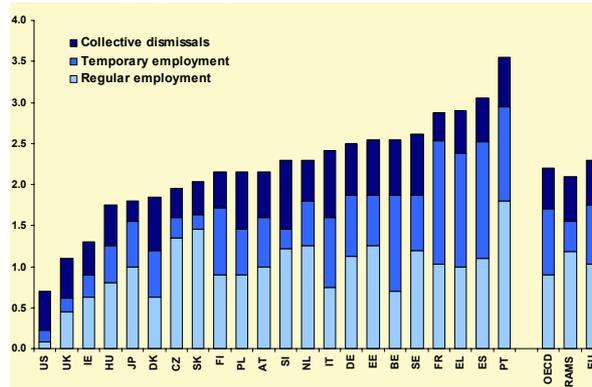
### Employment protection

Regulations are designed to improve the functioning of the labour market and to establish working conditions acceptable to both employers and employees<sup>1</sup>. In reality they sometimes end up forming barriers. These regulations concern rules that govern hiring and firing decisions, such as duration of work contracts and conditions of dismissal and severance. They tend to reduce lay-offs during economic downturns and thus increase job stability. This can promote workers' effort and willingness to be trained, which can increase economic efficiency. On the other hand, high employment protection restricts employers' abilities to adjust labour costs to unfavourable economic conditions. It prevents employers from reacting fast to economic conditions and creates certain disincentives to hire new workers in permanent posts. The high cost of laying off employees may in the future exert upward pressure on long-term unemployment. With strict employment protection employers are inclined to make more use of temporary contracts without any intention of transforming them into permanent ones.

The level of employment protection is similar to the OECD and EU average

Employment protection in Poland is comparable to that in other OECD and EU countries, according to studies done by the OECD (Nicoletti *et al.*, 2000, OECD 2004a, OECD 2006) and the World Bank (2001). With the employment protection legislation (EPL) index<sup>2</sup> at the level of 2.1, Poland is just below the OECD countries average (2.2), exactly at the level of the EU-10 average, and slightly below the EU-25 countries average (2.3) (see Chart 3). There are differences in the various components of the index, however. Poland has less protection of regular employment than the EU-10 and EU-25. Temporary employment protection is also below the OECD and EU average, but comparable to the EU-10. By contrast, Poland's legislation on collective dismissals is stricter than the EU-10, EU-25 and OECD average. These tight collective dismissal rules may hamper the privatisation/consolidation of public enterprises.

**Chart 3: Employment protection strictness**



Source: OECD (2005)

**Part-time and non-typical forms of employment**

*Part-time employment not too popular in new Member States*

All EU-10 countries have a very low rate of part-time employment as a percentage of total employment, and Poland has the highest rate (ca. 10%). By contrast, only two EU-15 countries, Greece and Portugal, have a lower rate. The EU average amounts to ca. 17%, with the Netherlands at the top (46%). Part-time and non-typical forms of employment started to be popular in EU countries some 15 to 20 years ago but in EU-10 countries they only appeared in the late 1990s, not only because of setbacks in legislation but also because of anxiety about introducing them among both employers and employees.



**The labour supply perspective**

Labour force mobility – the extent to which both those in employment move from one job to another and those without a job seek one – is key to labour supply. Such movements encompass changes in workplace, occupation and residence, and shifts between employment, unemployment and inactivity. Movements between different sectors or industries (inter-industry mobility) can be analysed using the hiring rate, the termination rate and the turnover rate (the sum of the first two). Movement between regions is determined by the maturity of the housing market and the quality and accessibility of transport and educational infrastructure, and by the quality of restructuring policies in labour-sensitive sectors (i.e. heavy industry, mining and agriculture in the case of Poland). The system of non-employment benefits for a large fraction of the workforce, especially for those working in agriculture, reduces the incentives to supply labour and to geographical mobility.

*Regional and professional mobility is very weak*

On average, overall labour turnover in Poland in 1994-2004 reached 43.3%, ranging from 36.5% in 2002 to 48.8% in 1999 and was composed equally of the hiring rate and the termination rate (at about 21½%). Inter-industry labour mobility (people moving from one sector to another while changing jobs) declined substantially between 1994 and 2002, reflecting the slowdown in restructuring in Poland (Kwiatkowski et al., 2004)<sup>3</sup>. The highest hiring rates were observed in the service economy or in industries with rapid productivity growth. On the other hand, some of these industries also have the highest termination rates, which suggests large job reallocation within the same industry or service and indicates that economic restructuring and job creation can be complementary. Furthermore, capital-intensive growth may not be a detriment to employment, as can be seen for example from the fact that, in 2004, industries with the highest labour turnover rates recorded net employment growth.

Regional mobility is weak in Poland. In 1998-2003, the average net inter-regional migration rate (the sum of regional in- and outflows divided by two, to the total population aged 15-64) was 0.08% for Poland and 0.16% for the OECD average (OECD, 2005). Labour mobility across regions is hindered by a poorly functioning housing market (rental in particular) and transport infrastructure. Professional mobility is also low in Poland, and this problem is worsened by the poor functioning of the education system, especially vocational training. According to Eurostat data, the participation rate of the population aged 24-65 in any form of training or further education amounted to a mere 5.0% in 2005, one of the lowest rates in the EU.

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## Conclusions

Labour-market flexibility in Poland does not differ significantly from OECD or EU averages, but there are some specific rigidities, for example a high tax wedge, limited labour mobility and generous non-employment benefits. Tackling the Polish labour market problems thus requires a comprehensive approach, with an emphasis going beyond labour market institutions to more broadly enhance the job-creating capacity of the economy. This approach should include improving the business environment to make it conducive to stronger private investment, including larger FDI inflows, reducing administrative barriers for new firms, further restructuring labour-sensitive sectors (such as agriculture, mining and heavy industry) and consolidating public finances.

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<sup>1</sup> For further discussion on labour market institutions and labour market performance see European Commission (2004)

<sup>2</sup> OECD EPL index has a range between 0 – no protection and 6 – very strict protection. The components are weighted as follows: regular and temporary employment strictness ca. 42% each, collective dismissals – 16%.

<sup>3</sup> Inter-industry mobility, expressed as the share of workers changing sectors in the total number of workers changing jobs, declined from 9.5% in 1994 to 1.5% in 2002.

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