

Benefit systems and their interaction with active labour market policies in the new Member States

Summary report

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Preface

In 2003-2004, the European Commission launched a study on the relationship between benefit systems and active labour market policies in the 15 EU Member States. In 2007, DG Employment and Social Affairs commissioned ECORYS Nederland BV to conduct a similar study for the ten new EU Member States. The ten countries under study entered European Union in 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Romania and Bulgaria that entered the European Union in 2007 are outside the scope of this study. The main findings and policy suggestions presented in the final report of the study are summarised in this document.

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1 Introduction

The study's overall objective is to contribute to the ongoing reform process and to assess the implications of reforms on benefit systems and active labour market policies (ALMPs). The study includes the following research tasks:

1. A review of current benefit systems and their interaction with ALMPs in order to identify the strengths and weaknesses, and the potential implications of recent policy reforms.
2. Design of an appropriate methodology for the analyses.
3. Simulations of best practices in the Czech Republic, Cyprus, Slovenia and Slovakia.
4. Comparative analysis in order to characterise the development of passive and active policy schemes.
5. Principal lessons from the analysis, implications for Commission policy development on benefit systems reforms and interaction with ALMPs, and policy suggestions for individual Member States.

The study was conducted on the basis of a review of international literature and data, country studies conducted by national experts and four simulations of policy initiatives carried out by experts using national models and data.

The study examined the interaction of benefit systems and ALMPs with regard to labour market participation on the basis of economic search theory. Benefits and ALMPs were examined in each of the new Member States focusing on three labour market transitions:

- From unemployment to employment;
- From inactivity to employment for the disabled, inactive spouses and individuals with family responsibilities;
- From employment to retirement.

The primary focus was on financial incentives and disincentives for entering and remaining in employment. These were examined within an analytical framework that takes into account other considerations such as cultural differences and the labour market situation.

2 Quantitative trends in benefit systems and ALMPs

Even though employment is currently increasing in the new Member States and unemployment levels are decreasing, employment and activity rates remain low. In most new Member States, overall benefit dependency rates are declining, or at least growth rates were decreasing in 2005. However, in many new Member States, the numbers of people receiving social assistance, taking early retirement or on disability schemes is continuing to increase.

Between 2004 and 2005, participation in active labour market policies (ALMPs) declined slightly and overall expenditure on labour market policies decreased. However, there has been a positive shift in most new Member States from expenditure on passive labour market policies (such as benefits) to more active policies.

3 From unemployment to work

In Europe, there are three main types of unemployment benefits:

- Income-compensating benefits, such as temporary unemployment insurance or social assistance;
- Income-supplementing benefits, such as family benefits and housing allowances;
- In-work benefits to stimulate people to take up employment and/or to participate in active labour market policies (ALMPs).

The three types of unemployment benefits are briefly described and subsequently, the impact of ALMPs on employment is discussed. Finally, the overall impact of benefit systems and recent policy reforms are discussed.

3.1 Impact of income-compensating benefits on transition to work

Effective policies to make benefit systems more active and to increase incentives for employment imply stricter eligibility criteria, short duration of benefits and decisive points when benefits are stopped. Job search activity is also stimulated by the application of sanctions and close monitoring of job search activities and compulsory participation in ALMPs. A mix of passive measures and effective ALMPs might reduce the period on unemployment benefits and increase labour market flexibility.

Income compensation benefits are available in all new EU Member States:

- Most new Member States provide unemployment insurance benefits based on a percentage of the last earned wage or the wage on which contributions have been paid over the individual's working life. A flat rate benefit is paid only in Malta, Poland and Lithuania.
- Most new EU Member States provide unemployment insurance benefits for a period of 12 to 18 months. The level of these benefits varies from 40 to 70 percent of last earned wage. Unemployment benefits are fair and even low in some of the Baltic States and Hungary, but supplements for dependants are rather generous in most countries.
- Five new Member States provide unemployment benefits that decrease with the length of the period the benefit has been claimed.
- Flat rate fixed amounts are paid in Poland, Lithuania and Malta and are difficult to compare with benefits paid in other Member States.
- Eligibility for unemployment benefits requires a work record, which ranges from a record of five in six months in Cyprus to three in four years in Slovakia.

- The maximum duration of unemployment benefit ranges from three months to two years and varies according to contribution record or age. Six of the new Member States offer unemployment benefits for six months only.
- New Member States impose labour market requirements, which are often enforced through benefit sanctions. The requirements vary, however. In Cyprus and Poland, it is sufficient to be registered as a job seeker at the public employment agency, while the unemployed in the Czech Republic, Hungary, Latvia, Slovakia and Slovenia are obliged to actively search for work. In Estonia and Lithuania, there is a requirement to accept any suitable job offer.
- A minimum unemployment assistance as a follow-up benefit is available in the Czech Republic, Estonia, Hungary, Malta and Slovenia (abolished in 2007). In the other new Member States, the follow-up benefit is a percentage of last earned income.
- The Czech Republic also has a separate activation benefit scheme.
- All new Member States provide social assistance schemes based on means-tested household income to support long-term unemployed. Activation of social assistance claimants in the labour market is growing in importance. Job search requirements are included in all schemes but sanctions are not mentioned.

3.2 Impact of income-supplementing benefits on transition to work

Income-supplementing benefits, especially housing and family benefits, are equally important as potential disincentives to seek employment.

Housing benefits can be either a separate benefit for low income groups or part of social assistance schemes and therefore restricted to recipients of social assistance. In the new member States these benefits are usually substantial and can amount to 80 or 85 percent of housing costs. They are a major source for poverty trap and unemployment trap problems.

Family benefits, which may be either part of social security or tax benefits, are the most widely used benefit in the new Member States. These benefits account for most differences in income between single-person households, two-person households, and households with children. Family benefits are means-tested flat rates in the Czech Republic, Poland and Slovenia but are not means tested in Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta and Slovakia.

While family benefits can distort the differential between income from work and income out of work, in many Member States lowering the benefit rate may increase poverty rates. In addition, literature reviews (OECD, 2004 and 2006) show that traditional one-earner and one-and-half earner families do readily accept lower paid jobs. Thus high benefits are not necessarily a disincentive to work for these household types.

3.3 Impact of in-work benefits on transition to work

Incentives to work include tax credits or tax allowances for the employed and help to reduce the poverty trap. Tax allowances are frequently used in the new EU Member States, but vary in amount and apply to the employed and inactive alike. There are employment tax credits in Malta and Hungary and a working parent tax credit in the Slovak Republic. In contrast, a tax bonus is available to the unemployed in Slovakia and is thus not an incentive to take up work. National experts report high effective tax rates, as well as government efforts to reduce tax wedges and labour costs. A major issue in most new EU Member States is the shortage of work opportunities because of the insufficient demand related to labour costs.

3.4 Active labour market policies and the unemployed

ALMPs are provided in all new Member States and public employment services deliver information, and carry out matching and placement activities. Many ALMPs were introduced during the accession period and are difficult to compare because they are defined either in very broad terms or tailored to specific groups. The main group tends to be the unemployed, and particularly the long-term unemployed.

About half of the new EU Member States have job rotation and job creation measures. In contrast to most old EU Member States, employment incentives are not targeted especially to low wage earners but to groups with specific personal characteristics. There are few start-up incentives for businesses; these are targeted to specific groups in Estonia and Cyprus and they are not available in the Czech Republic, Poland and Latvia.

ALMPs are compulsory in almost all new EU Member States, where participation is requested by the public employment service. Also, sanctions and other incentives to increase job search activities have been implemented in all countries. Some experts, however, conclude that sanctions should be stricter in order to have a greater impact on labour supply.

Various studies have shown that –compulsory- participation in an ALMP is the most effective incentive to increase job search activity. Many ALMPs are not aimed at direct labour market integration, but tend to concentrate on skills development and attitudes and habits related to working life. Also, start-up incentives are not very common. While the choice for measures that have a more indirect impact on employment may well be justified by the skills of the target group, the impact on employment is by definition lower and it also entails the possibility that motivation of –potential- participants is lower.

3.5 Overall impact

Evidence shows that people are reluctant to move into work when the financial gain is small. This is known as the unemployment trap. The final difference between income from work and from benefits, defined as net replacement rates, is available only for about half of the new EU Member States¹. These rates are, however, often high for one-earner or two-earner families with children, and with the exception of Poland, are average for single persons. While replacement rates are high for families with children in Slovenia and Slovakia, rates of about 40 percent (for example, Hungary) are at the lower end in Europe.

Net replacement rates for low-wage unemployed people (67% of the average production worker's income level) range from 50 percent for a single person in the Czech Republic to 85 percent of previous income for a two-earner married couple with two children in Slovakia.

Few studies on unemployment benefits have been carried out with regard to employment impact and the incentive to employment. Some countries indicate substantial poverty and unemployment trap problems, such as Poland and Slovenia. In other countries, the unemployment benefits have little impact on employment, for instance Hungary where the unemployment benefit is of short duration, or the Czech Republic where the unemployment benefit is low.

3.6 Recent policy reforms

In the process of EU accession, many new Member States adapted social security systems to meet the requirements of EU employment guidelines. Recent reforms are, thus, in line with EU employment policies. Reforms centre on increasing access to unemployment benefits for some groups difficult to reach such as seasonal workers and on increasing rather than reducing benefit levels.

However, for most new EU Member States, wage levels have increased much faster than social assistance and unemployment benefit levels. Although there has been no active intervention or reform to reduce benefits, benefit level in relation to wages is decreasing in many new EU Member States. Key activities to increase employment have not been linked to reforming tax-benefit systems but concentrate on reducing labour costs.

¹ For a better measurement, the marginal effective tax rates (METRs), data were not available at the time of the study.

4 Transition from disability to work

This chapter presents an analysis of income-compensating benefits and income-supplementing benefits for disabled followed by a discussion of the impact of active labour market policies (ALMPs). Finally, the overall impact of benefit systems and recent policy reforms is discussed.

4.1 Impact of income-compensating benefits on transition to work

Income compensation schemes for people temporarily or permanently (partly or fully) unable to work include sickness or short-term disability programmes, lump sum payments and long-term invalidity schemes to which employers or employees, or both contribute. These schemes offer either full or partial income replacement.

Impact of sickness benefit on transition to work

Sickness benefit is provided to employees unable to work due to sickness or injury but who are expected to return to employment. Long-term sickness leave is often an initial step to invalidity in many countries, particularly where generous benefits are provided for a long period. The level of sickness benefit ranges from 50 to 60 percent of average wage in Cyprus and Slovakia and up to 90 percent of previous wage in Slovenia. Many new EU Member States have no regular procedure for review during sickness nor is the system strictly enforced. Moreover, only Poland has a requirement for participation in rehabilitation or ALMPs to obtain extension of sickness benefit. Re-integration in the labour market is not facilitated.

Key factors in assessing the impact of short-term sickness benefits are how those on sick leave are monitored and how sanctions are applied. The analysis revealed that most new EU Member States do not have clear procedures for review and return to work, nor is the system strictly enforced. Benefit levels in invalidity schemes are calculated in very different ways. However, benefits based on accrued contribution in years as well as last wage levels are generally more attractive for older workers who are either on higher wages or have more contribution years. Many new EU Member States review invalidity benefits at one to three year intervals.

Impact of invalidity programmes on transition to work

Invalidity benefits and pensions are provided to employed individuals who have suffered permanent full or partial loss of capacity as a result of illness or disability. The likelihood of transition to invalidity depends on the generosity of benefit and ease of access.

- The level of capacity loss at which people can stop working and claim some invalidity pension is lowest in Latvia at 25 percent loss of capacity. Cyprus, Estonia, Hungary and Malta only provide benefits for 100 percent loss of capacity to earn.
- Invalidity pensions are calculated in different ways and are based on a combination of previous earnings, and/or loss of capacity, and/or insurance contributions. In the Czech Republic, Latvia, Poland, Slovenia and Slovakia, the number of insurance contributions affects the total amount, and pensions are, therefore, less generous for younger people. In Cyprus and Hungary, pensions are based on loss of capacity, and income and benefits are thus attractive to all age groups. In Lithuania, the pension is flat rate also but only depends on the level of incapacity.
- There are few reviews of invalidity pensions in the new EU Member States, especially for those deemed not capable of full-time employment with limited chance of re-integration.
- In five of the new Member States, earnings cannot be accumulated while on full pension. However, in most new EU Member States, partial pensions can be accumulated to some extent with earnings. This has facilitated return to the labour market, particularly where there are no restrictions as in Latvia, Lithuania, Slovakia and Estonia.
- Apart from Estonia, all new EU Member States offer benefit programmes for individuals permanently invalid as a result of an accident at work or occupational disease. These benefits are more generous than standard invalidity pensions, with less strict reviews and no qualifying insurance period. This can act as a disincentive to re-integration in the labour market.
- Several new EU Member States have specific minimum benefits aimed at people with disabilities or long-term illness and not receiving benefits from social insurance. These people were disabled before 18 years of age, or do not fulfil insurance requirements for standard invalidity pensions. These schemes are mostly flat rate amounts, are means tested, and unlikely to be generous.

4.2 Impact of income-supplementing benefits on transition to work

Transport benefits are probably the most widely used benefits by people with disabilities or illness. The benefits may include an allowance to buy a suitable car, as in Cyprus and Hungary, and/or financial support for public transport. However in Cyprus and the Czech Republic, these supplementary benefits are restricted to working people with disabilities and as such are not disincentives to remain inactive.

In addition to invalidity pensions, a range of other supplementary benefits are offered for people with severe disabilities, for instance wheelchair-bound people in Cyprus, and are incentives to remain inactive. Other incentives, such as subsidisation of vacations for the persons with disabilities and their dependants, may also act as a disincentive to employment.

4.3 Active labour market policies and the disabled

ALMPs are not necessarily obvious in relation to disabled workers. In many countries, rehabilitation is considered to be purely a medical problem. Moreover, employers may be reluctant to recruit disabled workers for fear of productivity loss. However, the focus is shifting due to growing labour shortages, high costs of invalidity benefits, and the growing number of inactive people.

Provision of ALMPs with special attention for disability varies across the new EU Member States:

- A number of countries, including Cyprus, Hungary, Slovakia and Latvia, offer training programmes to raise participation rates of the disabled.
- Rehabilitation is offered alongside invalidity pension programmes in Hungary, Lithuania, Poland, and in most other countries often results in increased levels of benefits. Only Poland offers early rehabilitation programmes during sickness benefits.
- In some new EU Member States, such as Cyprus, Malta and Estonia, there is strong emphasis on supported employment, which research has shown to be more effective than formal training (OECD, 2003).
- Wage subsidies including health insurance reductions are also a common approach in Estonia, Hungary, the Czech Republic, Latvia, Lithuania and Slovenia. Although a popular approach, recent studies have revealed displacement and dead weight effects.
- Sheltered workshops are not offered in many new EU Member States, demonstrating a shift to supported employment and a move away from workforce segregation. Moreover, employment is supported by legal instruments such as quotas.

ALMPs for the disabled aim at re-integration into the labour market or at least sheltered work places, and include policies, projects and incentives for employees and employers to work. In contrast to policies for other groups on the labour market the participation of the disabled in ALMPs tends to be wholly voluntary. New social inclusion policies have responded to this issue by making activation an essential part of active inclusion.

4.4 Overall impact

Evidence shows that people are unlikely to become active if the financial gains are small. However, income comparisons show that the disabled have much lower incomes than employed people. In broad terms, effective results in bringing disabled people back into the labour market through active labour market programmes have been reported in Cyprus, the Czech Republic and Latvia. Significant disincentives resulting from disability benefits have been reported in Estonia, Latvia, Lithuania, Malta, Poland and Slovakia.

Few evaluation studies have been undertaken in the new EU Member States on the impact of inactivity benefits on employment. The results available show a mixed picture. A study in the Czech Republic in 2005 found that the current social security system is a step towards employment incentives for all groups of long-term unemployed. In Latvia, the success of subsidised employment is evident, but a study in Estonia highlighted negative effects of invalidity pensions and benefits on employment levels.

4.5 Recent policy reforms

Following the process of accession to the European Union, many new EU Member States have adapted their tax benefit systems and labour market policies to EU requirements. Policy measures have been directed to decreasing the inflow into disability in Hungary and Lithuania. In line with new EU policies, most new Member States focus on providing effective active labour market programmes to promote re-integration in the labour market. Most reforms have focused on improving ALMPs as reported in the Czech Republic, Estonia, Latvia, Slovakia and Slovenia.

5 Transition from inactivity to work for non-working spouses

The transition of inactive people, mostly women, to employment depends on many interrelated factors such as income-replacing and income-supplementing benefits, as well as taxes. After a discussion of these three issues and ALMPs in the new Member States, the overall impact and recent policy reforms are summarised.

5.1 Impact of income-replacement benefits on transition to work

The only benefit available to inactive people, mainly women, not in paid employment due to their care responsibilities is social assistance. All new EU Member States provide social assistance as a benefit of ‘last resort’. Whether the applicant has children or not is always taken into account in determining the level, albeit in different ways. Social assistance benefits are typically means tested, which means that if a spouse is working or in receipt of other benefits, the other spouse is unlikely to qualify for social assistance. In most new Member States, family benefits count as income in the social assistance means-test and thus reduce the level of social assistance benefits.

5.2 Impact of income-supplementing benefits on transition to work

Impact of child-care allowances

Child-care allowances are available in only a few of the ten new EU Member States. Such allowances are provided as either in-kind benefits or financial support to parents to make use of public care facilities, or as a combination of the two. The Slovak Government, for example, subsidises pre-schools and provides allowances to job applicants participating in training programmes.

Child-care facilities provided in kind as subsidies to child-care organisations are not a particular financial incentive for parents to start working. Almost all new EU Member States provide subsidised child care. In order to set incentives to promote employment, child-care facilities could better be provided as a financial supplement, a benefit, or tax credit to working parents. Financial supplements for child care have recently been introduced in Slovakia. Child-care benefits other than child-care provision are available in Estonia, Lithuania, Slovenia and Slovakia and in the exceptional case of refugees, also in Cyprus.

Impact of child-rearing allowances

Child-rearing allowances are intended for parents taking full-time care of their children. In some Member States, parents may continue to receive this allowance after they start working, while in other countries, employment means loss of eligibility. Several countries use this allowance as an instrument for parents to combine work and family life. In Estonia, Poland, and Slovenia, parents are only eligible when on parental leave from work. In these countries, child-rearing allowances are expected to have little influence on the transition of inactive women to employment.

Child-rearing benefits provide the option for parents, mostly mothers, to leave the labour market temporarily in order to care for their children. The positive incentive is that the parent retains the right to return to his/her old job. This benefit gives more flexibility. However, many experts have concluded that child-rearing benefits keep mothers especially out of the labour market for long periods.

Child-rearing benefits are available in all new EU Member States except Malta and Cyprus. The benefit varies from lump-sum payments for care in Latvia, small contributions to income, to full income-replacing benefits in Estonia. These benefits are paid until the youngest child is three years of age, but in most Member States are paid for one year per child. Malta and Cyprus rely heavily on family structures to care for children, which may have negative labour supply effects on other parts of the family that take care of the children and that are thereby not working.

An important aspect is whether these benefits provide for the cost of children or are income replacing. In the latter case, parents receiving child-rearing benefits cannot work as is the case in Slovenia, Poland and Estonia.

5.3 Impact of taxation

The transition of inactive spouses to employment can be either stimulated or impeded by taxation systems. Some Member States have low taxation rates as a result of their flat tax system or because of specific tax credits for women returning to work after a period of inactivity. Other countries impede the participation of women by offering tax allowances for dependent spouses. Breadwinners lose the opportunity to earn tax-free income in addition to their personal and child allowances when their spouse takes up work. Such tax measures raise the wage reservation for non working spouses, mainly women, willing to work.

Taxation measures may be an incentive for women to enter the labour market. Most new EU Member States apply either joint taxation reports or individual taxation but neither are incentives for spouses to work. While flat rates are more beneficial for high than for low

incomes, they do not distort incentives to work. Flat rates are applied in Estonia, Lithuania, Latvia and Slovakia.

Taxation splitting² between married partners provides a disincentive to work in some cases for the second earner when the income differential is high between the partners. The high income partner, therefore, has the opportunity to transfer some income to the other partner and so pay less income tax. In such cases, it is more beneficial to the household if the second partner works less. Income splitting is done in Poland and the Czech Republic. Specific tax allowances are more advantageous for persons in part-time or low paid work because most income is covered by the allowance and only a small proportion is subject to taxation.

However, a shortage of part-time jobs and lack of flexibility in working hours appear to be greater obstacles than the lack of financial incentives. Most studies suggest that high unemployment is a stronger factor than financial incentives in driving women out of the labour market. Also, time-use patterns changed considerably after the transition phase in Eastern and Central European States and have led to new cultural values that perceive female inactivity as a symbol of escaping the working class and a sign of personal affluence.

5.4 Active labour market policies and inactive spouses

Few ALMPs are targeted at inactive spouses with care responsibilities in the new EU Member States. Only Cyprus and Malta provide programmes for this group. In Poland, there is vocational training for unemployed persons with small children. Governments will need to give more attention to inactive spouses when designing future ALMPs.

5.5 Overall impact

The impact of tax and benefits on the transition of women from inactivity to work depends on a multitude of interrelated factors. Child-care support most clearly helps to reduce barriers to women joining the labour market. This has been shown in studies in countries with few child-care facilities and where women's inactivity is high, and in countries where child care provision seems sufficient to guarantee a high level of female employment. The participation of women in the work force, however, not only depends on public tax and benefit measures, but also on the labour market situation and cultural norms on child rearing.

² Splitting refers to a situation where a couple can have a joint taxation report on overall family income from work which is divided over both partners.

5.6 Recent policy reforms

Recent policy reforms that influence the transition of women to work focus on the tax system. In most countries, taxation measures are directed to making low-income work pay and vary from lowering income tax rates to introducing higher tax allowances for dependant children.

6 Transition to retirement

The key decision that workers make in their transition from work to retirement is the extent to which they can leave the labour market with sufficient income. The main exit routes are:

- Pension systems and provisions related to early retirement, in combination with the legal retirement age and the taxation on pension income;
- Early retirement schemes;
- Other exit routes, notably through unemployment and disability schemes.

These exit routes are discussed in this chapter, and followed by sections on active ageing, overall impact and recent policy reforms.

6.1 Impact of pension schemes on employment

All new EU Member States provide salaried workers with a public pension. This pension may be resource tested as in Slovakia and Latvia; flat rate amounts as in Lithuania, Estonia, the Czech Republic, Hungary and Latvia; or an minimum income that is not income or asset tested, as in Malta, Cyprus, Poland and Slovenia.

Insurance-based pensions may be publicly or privately funded and function as “pay as you go” systems in most new EU Member States. Other pensions are private occupational or individual pension schemes which are usually not mandatory. In many new EU Member States, such as Malta, Hungary and Poland, occupational schemes have been introduced only recently.

The legal retirement age is lower in new Member States (approximately 61 years) than in the old EU Member States (average 65 years). The legal statutory retirement age varies from 61 to 65 years for men and 56 to 65 years for women in the new EU Member States. Only in Slovakia, Cyprus and Hungary the legal retirement age for men and women is the same. Eligibility for pensions depends mostly on age, but a minimum number of contributions or working years needs to be fulfilled. The implications of retirement rules for women who stayed home to raise their children are not always clear. In Slovenia early retirement without penalties is possible under certain conditions, among other for women who have raised children and are between 56 and 58 years (depending on the number of children), and having a full pension qualifying period. The available information does not provide a clear picture on how governments deal with the period of child bearing for women in the calculation of pension entitlements.

The pension value in most countries increases with each year of contribution or earnings. In almost all countries, accumulation of pension and earnings is possible. Most pension systems in the new EU Member States include early retirement provision within the old age system.

Taxation and payment of social security contributions is a key incentive to continue working or to retire, because it affects the gap between gross and net income. In the Czech Republic, Lithuania and Slovakia, old age pensions are not taxed and beneficiaries do not pay social security contributions. Only in Hungary are pensions fully taxed.

6.2 Impact of early retirement schemes on employment

Early retirement schemes are available in most new EU Member States and make early exit from the labour market more favourable. Such schemes often result from policy reactions to high unemployment rates during the transition period. Early retirement regulations enable people to retire two to five years earlier in nine of the new Member States. However, in Cyprus, Hungary and the Czech Republic, pensions are higher when retirement is postponed.

The median withdrawal rate is five to seven years earlier than the statutory retirement age. Studies in Hungary, Poland and Slovenia report that financial incentives for early retirement, alternative exit routes and pension schemes contain strong disincentives to employment. Benefits constitute moderate disincentives to employment only in Estonia. Women are prepared to accept benefits of up to 75 percent of former income while men are only prepared to accept a drop in income to 81 percent. When considering disincentives to continue working, not only income but also assets play an important role, as well as motivation. Active labour market programmes were reported to increase motivation.

6.3 Impact of other avenues to retirement on employment

The transition from long-term unemployment to retirement for decades has been an accepted avenue to retirement. Overall, the age at which older unemployed become eligible for special provisions is well below that for statutory or even early retirement. In many new EU Member States, unemployment insurance is commonly used to exit the labour market. There are waivers for job search and unemployment insurance in about half of the Member States for older long-term unemployed.

The exit route through disability benefits is less common. Only in Poland, Lithuania, Slovakia and Slovenia are disability benefits income-related and thus comparably attractive exit routes for older workers but largely depend on medical assessment.

Alternative exit routes lower the effective retirement age considerably, for instance to 55 years in the Czech Republic. The effective mean withdrawal age from the labour market

in all New Member States is lower for women than for men. The difference amounts to one to almost six years.

6.4 Active ageing

Active ageing is a comprehensive set of measures to promote employment of older workers, including flexible working hours and gradual retirement schemes. Yet in spite of demographic necessities, extension of the working life is not a major priority for public actors in the new EU Member States. Six countries, however, have at least one project for older workers, and many projects are in pilot or implementation phases.

Except for Poland, Slovakia and Lithuania, all countries provide at least one active labour market scheme that supports employment of older workers. There are schemes for gradual retirement in Hungary, Malta, Poland and Slovenia.

6.5 Overall impact

A number of studies have evaluated the impact of the pension system and early retirement regulations on employment. For instance, a study in Estonia concluded that, although many people receive early retirement pensions, the effect on employment is modest because of the low level of pensions. In Poland, however, the current benefit system encourages older people to become inactive through early retirement, pre-retirement and invalidity pensions.

6.6 Recent policy reforms

Discouraging early exit became an important issue in increasing participation, improving the financial viability of pension schemes, and in facing the demographic issues of an ageing population. The last issue is less relevant for some new EU Member States, such as the Baltic States and the Czech Republic, which have relatively young populations.

Most policy reforms aim to modernise pensions and to provide adequate pension replacement rates. Nonetheless, policy reform in the new EU Member States is still directed more to providing adequate pensions and reducing unemployment by allowing early retirement.

Thus, pension reforms have not particularly contributed to increasing employment incentives, and have been directed to modernising and providing adequate pension replacement rates. This continues to be the main issue in many new EU Member States. Modernising pensions implies the introduction of contribution-defined systems that have had a positive effect on employment, at least for men, in Hungary, Slovenia and Poland. Latvia introduced an early retirement scheme only recently.

7 Outcomes of the policy simulations

To investigate the impact of potential reforms on employment, four relatively recent policy initiatives from different Member States were analysed. Impacts of these policy initiatives were simulated by comparing the predicted employment rates with and without the reform.

In Slovakia, the ‘material needs benefit’ was reformed in 2004. The reform included stricter conditions for full benefits and retention of up to 25 percent income from work while on benefit. The result was a sharp decrease in claimants, from 9.3 percent of working age population in 2003 to 6.3 percent in 2004. The unemployment rate has also dropped steadily but income inequality has increased.

The Czech Republic and Cyprus have introduced changes to their income tax systems. The Czech reform of joint taxation in 2005 aimed to stimulate the non-working spouse of the main earner with a high income in a family with dependant children. The effect was positive but statistically insignificant, with apparently limited consequences for the state budget and income inequality. The Cypriot reform offered a high tax-free income, abolished specific tax deductions (main one being a tax allowance for children and other dependants), and lowered income tax rates. The combined reforms had an overall impact of 0.8 percent on the employment rate, with a 1.8 percent contribution to the employment rate of persons aged 55 to 64 years.

In 1999, the pension system in Slovenia was reformed substantially. As a result, the employment rate of older workers increased from the previous very low levels. The outcomes for Slovenia are very much in line with findings for the EU-15 in the previous report; the employment rate of older workers was effectively increased by increasing the minimum early retirement age.

8 Main policy suggestions

The policy suggestions formulated in this study are based on the empirical and theoretical findings in this study and the opinion of the experts that were consulted within the project. The reform of the Lisbon Strategy in 2005 has placed the emphasis on growth and jobs. In order to elaborate on the implications of the results of this study for the European Employment Strategy, policy suggestions are presented with regard to the new EU Member States. First we summarise the main suggestions for Member States, structured according to the three transition points described above. Then, the main suggestions relevant to the elaboration and implementation of Guidelines 17-19 are presented.

Transition from work to retirement

The policy suggestions for this transition mostly concern the transition from work to retirement. All new EU Member States, except Cyprus and Malta, need to close early retirement pathways and/or increase the statutory retirement age. In countries such as Estonia and Lithuania early retirement pathways are often used by vulnerable groups. In Estonia, it would be beneficial to monitor the old age pension closely to maintain employment incentives without increasing poverty rates. In Malta, more attention to life-long learning and training could help increase participation of older workers, particularly so in the light of the expected increase in retirement age.

Transition from unemployment to work

The policy suggestions made in this study about the transition from unemployment to work focus on benefit levels. Benefit levels need to be monitored or reformed in Estonia, Hungary, Latvia, Lithuania and Poland in order to make work pay and simultaneously to keep people out of poverty. Benefit levels also need to be monitored closely in Latvia to prevent poverty, and increased slightly to allow for more flexibility in the labour market. In Lithuania, benefit levels could be reduced in order to make work pay, and ALMPs and benefits used as a screening device for unmotivated unemployed. In Poland, reforms are needed to make work pay.

Countries such as Slovakia, the Czech Republic, Slovenia and Cyprus need to increase and/or revise their ALMPs to become more directed to (re)-integration into the labour market. The Czech Republic would, for instance, benefit from a stronger focus on the integration of vulnerable groups. In Poland, the link between active and passive measures needs to be strengthened, for instance by introducing clearer job search requirements that can be monitored and sanctions imposed where necessary. Slovenia could direct ALMPs more to re-integration into the labour market and stimulate opportunities for life-long learning. Cyprus could increase efforts to develop demand-oriented ALMPs that focus on rapid integration into the labour market and increase the inter-linkages of tax benefit systems and ALMPs.

The Czech Republic is encouraged to continue reforming taxation by abolishing joint taxation of two-income partners/households, and Malta to continue using tax credits and increasing opportunities for women to work. Cyprus is advised to monitor adequacy of tax-benefit systems rather than disincentives and to increase the inter-linkages between tax benefit systems and ALMPs.

Transition from inactivity to work

The policy suggestions regarding the transition from inactivity to work mainly concern child care and other schemes that make it easier to combine work and family life. This issue is relevant to all new EU Member States. Cyprus and Malta need to develop effective policies to move from traditional family-based patterns to modern participation-oriented societies. More child-care facilities for working parents need to be provided in Malta, Poland and Slovenia, while Latvia needs to design child support and child rearing benefits as employment-support measures. Countries, such as Poland, Estonia and Lithuania, need to reform family benefits to provide work incentives for parents and especially women and to make it easier to combine work and family life. More extensive use could be made of child-care tax in countries such as Hungary and Estonia. In Estonia for example where there is good child-care provision, other means of financing these provisions could be considered in order to increase employment incentives. Parental benefits need to be reformed to increase employment incentives and the use of parent child care tax credits considered.

The European Employment Strategy

On the basis of the findings of this study the following suggestions are formulated for the European Employment Strategy. Between brackets the most relevant employment guideline is indicated:

- In order to manage the transition from work to retirement, the EC should continue monitoring pension policies and be aware of the trade-off between quick policy reforms in line with EC objectives that increase incentives to work and the risk of poverty. (GL18)
- In order to facilitate the transition from inactivity to work for parents, especially mothers, many new Member States should improve their formal child-care facilities. (GL18)
- In order to stimulate the transition from unemployment and disability to work for young people, Member States with flat rate unemployment and disability benefits and social assistance schemes should monitor carefully the effect on this group. Effective strategies need to be developed to tackle the hazard of benefit dependency and lock-in effects of ALMPs not directed to quick re-integration into the labour market. (GL18)
- To delay the transition from work to retirement, the new Member States should investigate the options for effective use of active ageing policies, and improve options for gradual retirement and for part-time work. (GL18)
- New Member States with high migration rates should investigate the implications of migration and develop appropriate policies to protect the migrating population. Those policies should balance the short-term gains from migration such as reducing unemployment, against future skills and labour shortages. The latter may result in

wage increases that in turn influence the sustainability of related social protection systems. (GL19)

- To increase transition from unemployment and inactivity to work, the focus must be on effective use of child-care benefits and child-care provision. This can be achieved with in-work benefits and child-care tax credits instead of generous child supplements and parental leave schemes. Incentives could be increased by financing child-care provisions not at facility level but with child tax credits for working parents. (GL19)
- With regard to the transition from work to retirement, new EU Member States should consider closing early retirement options. (GL18)
- New EU Member States should take specific action to increase the statutory retirement age and effective retirement age, and to prevent the development of claims for early retirement options. To keep people in employment, consideration should be given to increasing opportunities for active ageing and additional part-time work. (GL18)