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Towards a More Inclusive Labour Market in Hungary

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TOWARDS A MORE INCLUSIVE LABOUR MARKET IN HUNGARY

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ABSTRACT/RESUMÉ

Towards a more inclusive labour market in Hungary

A rapid decrease in unemployment is a short-term priority to limit social problems and reduce the risk of rising structural unemployment. To this end, strengthening labour market policies to sustain labour demand is key. The public works programme should remain temporary and become more focused on training. The authorities should also refrain from further raising the minimum wage. Fundamental structural reforms are needed in the medium term to raise one of the lowest participation rates in the OECD. This challenge is acute in the context of a rapidly ageing population. The authorities have started restructuring the tax/benefit system to make work pay and increase labour supply, yet additional efforts are needed to foster the inclusiveness of the labour market. Groups which are significantly under-represented in the labour market include the low-skilled, youth, the elderly, women of childbearing age, the disabled and the Roma. Structural measures are needed to develop part-time and other flexible forms of employment, reform family policies, ease the integration of people with disability into the labour market, better attune the education system to labour market needs, enhance the level of qualifications and skills at different ages, diminish disincentives to work at older ages and break the segregation of the Roma.

This Working Paper relates to the 2012 *OECD Economic Survey of Hungary* (www.oecd.org/eco/surveys/hungary)

JEL classification: J13, J14, J21, J26, J32, J65

Keywords: Labour market policies, unemployment, labour force participation rate, benefit system, minimum wage, Hungary

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Vers un marché du travail plus inclusif en Hongrie

L'une des priorités immédiates des pouvoirs publics consiste à faire reculer rapidement le chômage afin de limiter les problèmes sociaux et de réduire les risques d'une montée du chômage structurel. Pour y parvenir, il est indispensable de renforcer les politiques du marché du travail, capables de soutenir la demande de travail. Le programme de travaux publics doit rester temporaire et être davantage axé sur la formation. Les autorités devraient également s'abstenir de relever davantage le salaire minimum. Des réformes structurelles fondamentales sont nécessaires à moyen terme pour que le taux d'activité de la Hongrie ne figure plus parmi les plus bas de la zone OCDE. Il s'agit d'un enjeu majeur dans le contexte du vieillissement rapide de la population. Les pouvoirs publics ont commencé à restructurer le système de prélèvements et de prestations afin d'augmenter les incitations financières au travail et l'offre de main-d'œuvre. Néanmoins, ils devront consentir des efforts supplémentaires pour veiller à ce que le marché du travail soit plus inclusif. En effet, plusieurs catégories de population sont significativement sous-représentées sur le marché du travail, comme les peu qualifiés, les jeunes, les seniors, les femmes en âge de procréer, les handicapés et les Roms. Des mesures structurelles s'imposent pour développer l'emploi à temps partiel et d'autres formes flexibles d'emploi, réformer les politiques familiales, faciliter l'insertion professionnelle des handicapés, adapter le système éducatif aux besoins du marché du travail, accroître le niveau de qualifications et de compétences à tous les âges, renforcer les incitations à la poursuite de l'activité à un âge avancé et lutter contre la discrimination à l'égard des Roms.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Hongrie, 2012 (www.oecd.org/eco/etudes/hongrie).

Classification JEL: J13, J14, J21, J26, J32, J65

Mots-clés: Politiques du marché du travail, chômage, taux d'activité, système de prestations, salaire minimum, Hongrie

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TOWARDS A MORE INCLUSIVE LABOUR MARKET IN HUNGARY

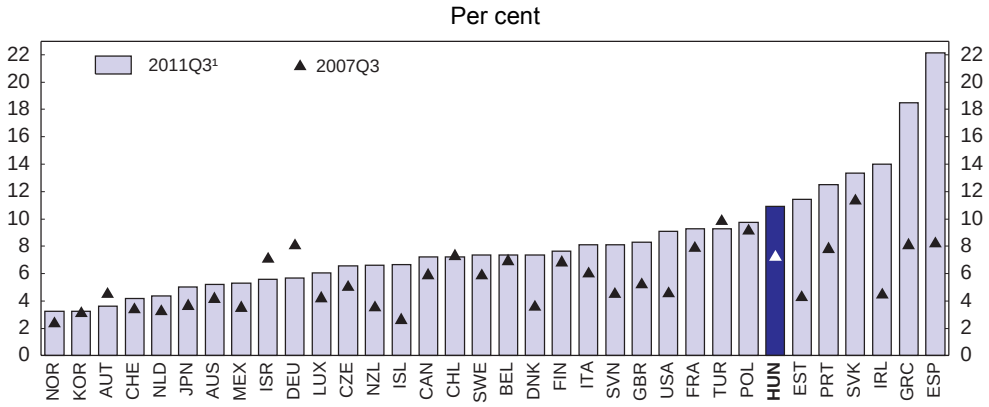
by Rafał Kierzenkowski[1]

The crisis and its aftermath have taken a heavy toll on the labour market

A limited impact of growth on job creation so far

The labour market was significantly affected by the global crisis and the recovery has so far been too weak and allowed only a small fall in joblessness, which exceeds 10%. Between the third quarter of 2007 and the same quarter of 2011, the total unemployment rate increased by 3.5 percentage points, to close to 11% (Figure 1). Low and medium-skilled youth and prime-age workers in the construction and manufacturing sectors took the brunt of the shock, while the employment of older workers actually rose (Figure 2). Total hours worked declined less than GDP and, as a result, hourly productivity fell as the output shock was partly absorbed by labour hoarding (de Serres *et al.*, 2012). In the early stage of the crisis, the decline in total hours worked resulted from a fall in employment, but also from an equivalent drop in average hours worked per worker.

Figure 1. **Unemployment rates have increased since the crisis**



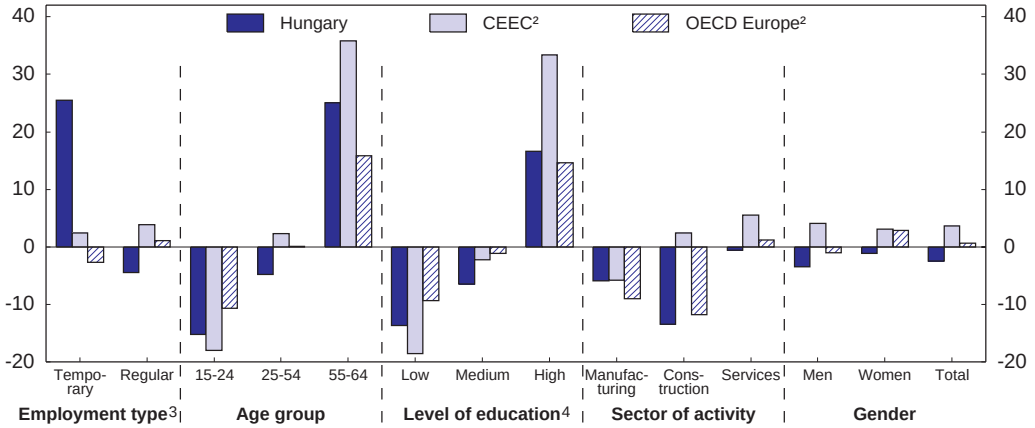
1. 2011Q2 for Ireland and 2010Q4 for Japan.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), January.

1. Head of Hungary/Slovenia Desk at the OECD (rafal.kierzenkowski@oecd.org). This working paper was originally published as Chapter 3 of the 2012 *OECD Economic Survey of Hungary*, published under the authority of the Economic and Development Review Committee (EDRC). The author is grateful to Pierre Beynet, Andrew Dean, Robert Ford, Viktoria Kis, Beatriz Pont, Anne Sonnet, Alastair Thomas and other OECD colleagues for helpful discussions, comments and suggestions, as well as Desney Erb for excellent statistical assistance.

Figure 2. **The effects of the recession across groups of workers**

Percentage change in employment by workforce group from 2007Q3 to 2011Q3[1], age 15-64



1. 2008Q3 to 2011Q3 for sector of activity due to the change to NACE Revision 2 classification in 2008.
2. Weighted averages. CEEC covers the following Central and Eastern European countries: Czech Republic, Poland and Slovak Republic. OECD Europe covers all European OECD countries (excluding Turkey by sector of activity).
3. Regular is the difference between temporary employees and total employment.
4. Based on the International Standard Classification of Education (ISCED97): "Low" covers pre-primary, primary and lower secondary levels of education (0-2); "Medium" covers upper secondary including post-secondary non-tertiary education (3-4); and "High" covers tertiary education including advanced research programmes (5-6).

Source: Eurostat (2012), "Labour Force Survey", *Eurostat database*, January.

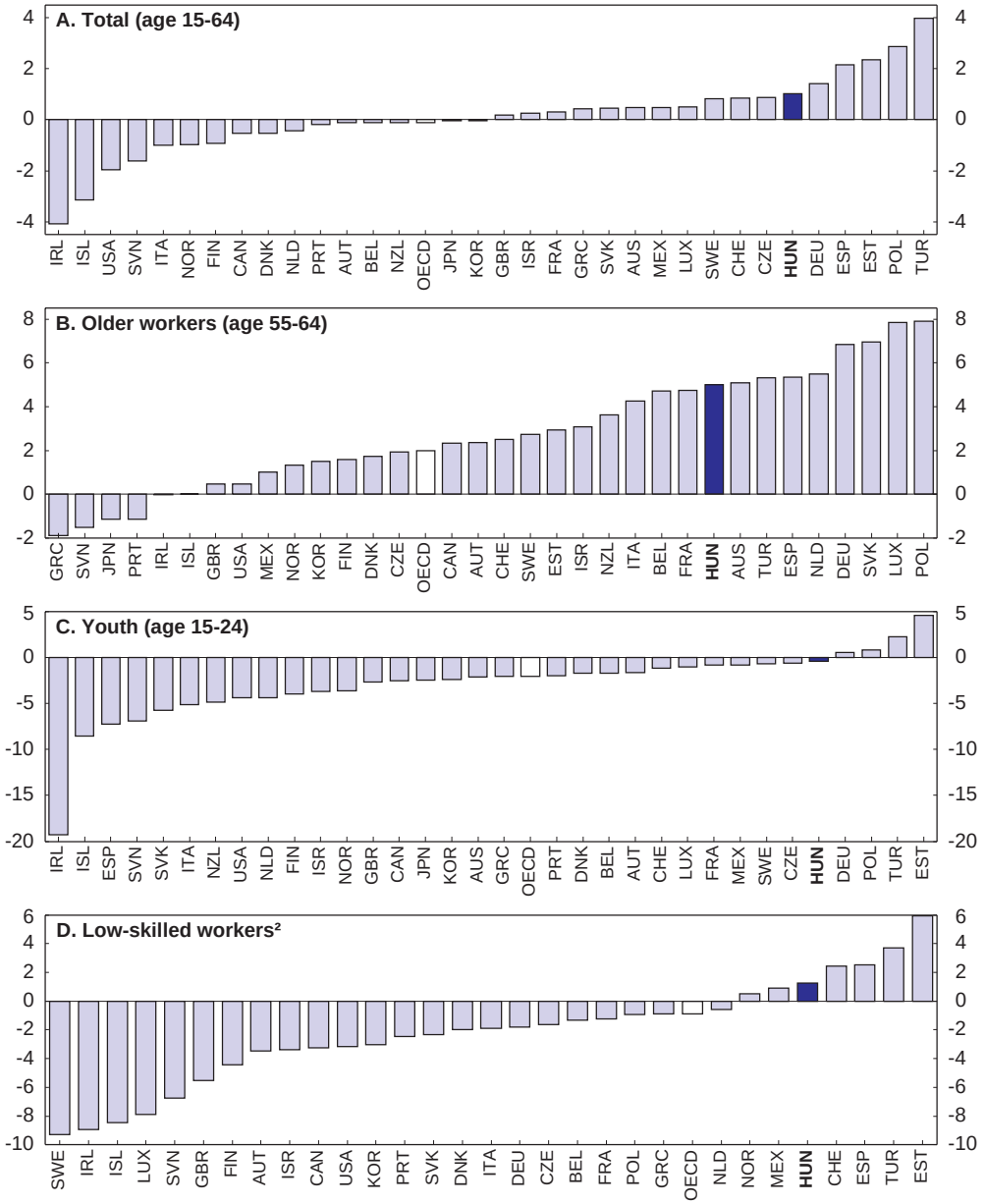
Various policy measures and wage adjustments partly offset the initial impact of the crisis on the labour market. In 2009, the adjustment in hours had been favoured by the use of short-time work arrangements (Hijzen and Venn, 2011; OECD, 2010a). The downward flexibility of real hourly wages, which from the real GDP peak to trough dropped more than labour productivity per hour (OECD, 2011a), helped to mitigate the extent of the shock on total hours. In the public sector, a freeze of the wage bill, a cancellation of a supplementary thirteenth-month salary and other cost-cutting measures (implementation of an income ceiling and a revision of one-off payments) contributed to wage moderation in the economy through direct and spillover effects. Labour demand was also supported by a permanent reduction from 32% to 27% of employers' social security contributions.[2] In 2010, a lump sum employers' health care contribution, which weighed relatively more on low-wage labour demand, was cancelled. Finally, the minimum base for social security contributions set at twice the amount of the minimum wage was abolished in 2011, which provided an additional boost to labour demand. These measures had a positive effect on employment given the high wage-elasticity of labour demand in Hungary (Cseres–Gergely, 2010). According to original official estimates, the above cuts in non-wage costs could have increased private-sector employment by 1.4-1.8% in the medium term.

Sustained high unemployment raises the risks of losses of human capital and discouragement effects, but so far there has been little evidence of labour force withdrawals. Between the third quarter of 2007 and the third quarter of 2011, labour force participation rates showed remarkable resilience as they improved (admittedly, from low levels) for low-skilled workers and increased significantly for older workers (Figure 3). Participation of young workers deteriorated only marginally. Possible explanations are that some of those who lost their job did not withdraw from the labour market, inactive second earners re-entered the labour market to offset the impact of job losses of primary earners on family income, while the supply of older workers was enhanced by favourable cohort effects and increases in the retirement age

2. As of mid-2009, employers' contributions were cut for wages less than double the minimum wage and further extended to all wage levels at the beginning of 2010.

of women. However, the risk of unemployment persistence has also picked up. The incidence of long-term unemployment (measuring the share of people unemployed for 12 months in total unemployment) has inched up close to 50% by the end of 2011 (OECD, 2012). Unemployment turnover has diminished and there is empirical evidence that exit rates from unemployment decline with the length of jobless spells (de Serres *et al.*, 2012). In this context, creating conditions for a rapid growth and labour market recovery is one of the main short-term policy priorities in Hungary.

Figure 3. **Change in labour force participation rates**
Percentage points, 2007Q3 to 2011Q3[1]



1. 2007Q2 to 2011Q2 for Switzerland. No data is available for Chile.
2. Workers with below upper secondary levels of education, levels 0-2 of ISCED (International standard classification of education). No data available for Australia, Japan and New Zealand.

Source: OECD (2012), *Quarterly Labour Market Indicators Database*, Directorate for Employment, Labour and Social Affairs, January (unpublished data).

Ensuring labour market recovery

Restructuring the public works programme

The authorities have put significant emphasis on direct job creation through public works programmes as a temporary substitute for insufficient labour demand. A large programme "Pathway to Work" targeted at long-term unemployed (more than 100 000 affected per year) was introduced in early 2009. The aim was to identify those long-term unemployed who had the physical capability to work and make financial support for them conditional on their participation in public works organised by local authorities. The programme was terminated in early 2011. A new public employment scheme has been launched since then (managed by the Ministry of Interior since June 2011), characterised by a higher enrolment rate and a high prevalence of part-time and short-time (2-3 months) employment (220 000 people but 100 000 full-time equivalents in 2011), a fixed budget (of 0.2% of GDP in 2011, around half of the expenditure on the previous programme), and a stronger involvement of local authorities in its funding. There are plans to expand the new programme and related expenditure will be scaled up to 0.5% of GDP in 2012. The objective is to create strong financial incentives to resume work by providing a higher income than social assistance, but a lower one than the minimum wage. Between September and December 2011, unskilled workers could earn 73% of the minimum wage for full-time work and this ratio increased to 77% in 2012.

The programme is essentially centred on low-skilled, low value-added jobs and manual tasks. Even though training to obtain a vocational qualification has been offered to some participants, an insufficient provision of such opportunities is a concern given the participation of disadvantaged groups with depreciated human capital and skills (such as long-term unemployed and former disability pensioners). Moreover, the recent shortening of the duration of unemployment benefits from nine to three months risks increasing inflows to the scheme, especially if other active measures fail to ensure labour market reintegration. Subsidised public sector employment may entrench dependence on such programmes as reduced job search and re-employment support preclude mobility into non-subsidised jobs (OECD, 2010b). Evidence derived from a large number of empirical studies (a meta-analysis) suggests that subsidised public sector employment programmes are the least effective form of active labour market policies, whereas training programmes are associated with positive medium-term impacts (Card *et al.*, 2010). Empirical evidence for Hungary shows that various public works schemes experimented in the past have failed to improve the employability of participants and to provide a foothold in the open labour market (Fleck and Messing, 2010; Budapest Institute 2011a). Therefore, the effectiveness of the public works programme should be fostered by providing significantly scaled up training and skill-upgrading services for participants so as to ease their transition to the primary labour market.

Restructuring the personal income tax system

The previous government implemented cuts in social security contributions and personal income taxes in 2009 and 2010. The current government has favoured reductions in the tax wedge by significantly alleviating the personal income tax burden. In 2011, a flat-rate personal income tax rate at 16% was adopted, cancelling the remaining two tax brackets at 17% (with no tax-free allowance and up to two times the average wage) and 32%. Yet, notwithstanding the employment tax credit, the effective tax rate was 20.3% as employer's social security contributions remained part of the tax base. At the same time, generous tax expenditures were granted to families with children, but employees' pension contributions were hiked from 9.5% to 10% and the amount of the employment tax credit (available up to around the average wage) was reduced from 1.6% of GDP in 2010 to 1.2% of GDP in 2011. Further modifications of the personal income tax system were adopted in late 2011 to move the effective tax rate closer to the statutory rate in 2012. Employers' social security contributions were excluded from the tax base for earnings below the average wage, the employment tax credit was cancelled, and employees' health care and labour market contributions were increased from 7.5% to 8.5%.

As a result of these tax changes, the tax wedge increased for low-income earners (especially those without children) and declined significantly for high-income earners (Ladanyi and Kierzenkowski, 2012). Despite the indication of significant positive effects of taxation on the taxable income of high-income earners in Hungary (Bakos *et al.*, 2008; Kiss and Mosberger, 2011), empirical evidence for OECD countries suggests that such effects are mainly due to lower tax evasion and enhanced effort or creativity, but that labour supply could remain unaffected at the hour-work margin for this type of worker (Meghir and Phillips, 2010). Yet this contrasts with the finding by Kiss and Mosberger (2011) of a Hungarian tax reform episode in 2007 that had an impact on labour supply on the intensive margin. At the same time, the increase in the tax wedge on low-income earners creates a risk that they could drop out of employment (or shift to the informal sector). In particular, the scrapping of the employment tax credit is likely to hamper work incentives of low-income workers. The in-work tax credit was well designed, provided a significant incentive to enter the workforce, was paid throughout the year (improving effectiveness compared to schemes with annual payments) and avoided discouraging second earners (being withdrawn on an individual rather than family basis). Finally, the overall net impact of this tax reform on labour supply may be lower than expected once the fiscal measures needed to offset the sizeable budget cost of the introduction of the flat tax are taken into account (Beynet and Kierzenkowski, 2012).

Even though household income increased overall, more people were left worse off than better off as a result of the tax changes (Benczúr *et al.*, 2011). To offset such unfavourable distributional developments, the government implemented wage compensations in the public sector to preserve nominal net earnings of affected employees and favoured wage increases in the private sector through different channels. *First*, the minimum wage was hiked by 6% in 2011 and 19% in 2012. *Second*, the authorities gave incentives to businesses to increase wages, supported by a law adopted in mid-2011 and effective in January 2012 stipulating an exclusion from public tenders and subsidies for enterprises failing to comply. In practice, the authorities recommended an increase in wages in the private sector of between 4 and 6% in 2011. The recommendation for 2012 was an increase of 5%, with any increase beyond that (and up to a certain threshold corresponding to the abolished employment tax credit) refunded through cuts in employers' social security contributions. The labour cost of low-income earners will nevertheless increase after the end of 2013 when the complex wage compensation system will cease as currently expected. Yet the impact could be somewhat mitigated with cuts in employers' social security contributions targeted at some low productivity occupations available from 2013 (see below). *Finally*, a temporary scheme compensates those earning above the minimum wage and not befitting from any offsetting wage increase in the private sector in 2012.

Beyond large fiscal costs, negative income distribution effects call into question the sustainability of the flat tax. Preserving elements of redistribution is therefore essential. A re-introduction of the employment tax credit would provide income to low-income earners and enhance work incentives at the same time. The fiscal cost could be lowered by phasing it out from a lower income level than was previously the case, while the problem of widespread tax evasion and under-reporting of earnings should be addressed by strengthening tax inspections and imposing higher sanctions for tax avoidance. This could be also achieved by keeping a larger tax base for those earning above the average wage by, for instance, not exempting employer social security contributions from gross earnings as currently planned in 2013. Another possibility is to adopt a tax-free income allowance.

Containing the minimum wage

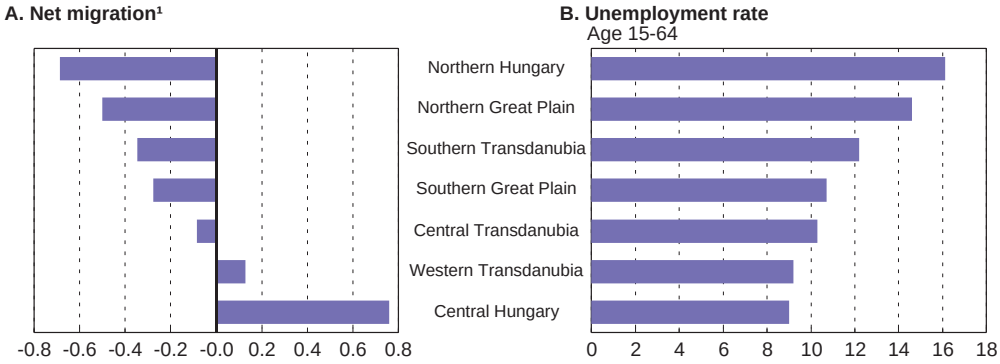
High wage and non-wage labour costs at the minimum wage level could represent important barriers to hiring young and/or unskilled people. Up to recently, this did not seem to be a major concern at the macroeconomic level in Hungary. In2010, the ratios of the minimum to the median, for both wages and labour costs, were close to the OECD average and only 2-3 percentage points higher than in regional peers (Poland and the Slovak Republic). The ratios were more than 10 percentage points higher than in the Czech Republic, which however had the lowest ratios in the OECD. To encourage skilled labour supply

and reduce tax evasion, Hungary also applies a guaranteed minimum wage for workers in jobs requiring at least secondary school or vocational training qualification (OECD, 2010c). Even though entry level wages of young graduates are above the guaranteed minimum wage, this system could reduce labour demand for skilled (older) workers with insufficient productivity. In January 2012, the standard and guaranteed minimum wages were hiked by 19% and 15% respectively, which is likely to hurt labour demand and weaken cost competitiveness in the medium term. Therefore, the ratio of the minimum wage to the median wage should be reduced by ensuring that further increases in the minimum wage do not exceed consumer price inflation over an extended period of time.

A permanent reduction of non-wage labour costs at or around the minimum wage could increase incentives to hire low-skilled youth and a new scheme permanently reducing employers' payroll taxes by a third (capped at 9% at the minimum wage) for workers in elementary occupations will be available in 2013. Yet, the experience of France and Belgium suggests mixed effects on employment creation (OECD, 2010d; Gautié and Margolis, 2010). Moreover, such measures could be costly to finance since, partly as a result of large tax evasion and the under-reporting of earnings, as much as 1.2 million Hungarians (representing a third of total employment) report earning the minimum wage according to annual tax record data. Another option would be to introduce a youth sub-minimum wage (in force in 10 out of the 21 OECD countries with a statutory minimum wage). But in the presence of a large pool of inactive youth there is a risk that if the sub-minimum wage is uniformly lowered across the country to below reservation wages, this would further reduce work incentives and discourage labour supply.

Hungary combines strong regional disparities in unemployment rates and low internal labour mobility rates (Figure 4). Insufficient labour mobility is partly due to an underdeveloped housing market (a limited rental market and tiny social housing sector) and large regional differences in house prices. The latter create problems of affordability and increase the costs of relocation to more promising labour markets (Gerőházi *et al.*, 2010). The recent shortening of unemployment insurance (job search allowance) from nine to three months and, except for older workers, cancellation of unemployment assistance (job search benefit) previously available up to three months, will hamper labour mobility. In this context, the authorities could consider differentiating the nominal minimum wage on a regional basis, as is the case in Canada, Japan, Mexico and the United States. Recent changes in the labour code have allowed for the introduction of such a possibility, which is a welcome step. The minimum wage could be reduced in regions where productivity and living costs are low and where there is room for cuts *vis-à-vis* reservation wages, which would stimulate labour demand without discouraging labour supply.

Figure 4. **Regional migration and unemployment**
Per cent, 2010



1. In per cent of resident population. Net migration is the difference between the number of in-migrants who register into a given administrative unit and the number of out-migrants who register into another administrative unit from a given administrative unit.

Source: HCSO (2011), "Data on Internal Migration", *Dissemination Database* and *Stadat Tables*, Hungarian Central Statistical Office, December.

Reducing employers' social security contributions

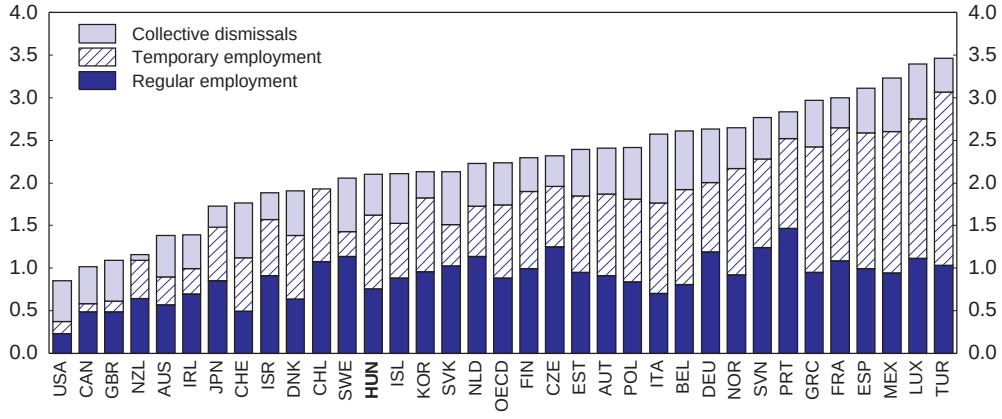
Employers' social security contributions continue to be high in Hungary, at 22% of labour costs in 2010, against an OECD average of 14% (OECD, 2010e). Temporary and targeted cuts in labour costs may also support job creations in the early stages of recovery and overall increases in labour demand (OECD, 2010a; 2011b). Hungary uses various temporary employment subsidies in the form of tax reductions in employers' social security contributions. The "Start programme" providing gross hiring subsidies for the employment of career-starters has been widely used, but an insufficient targeting suggested large deadweight costs (Cseres-Gergely, 2010). However, the level of subsidies has been lowered for high-skilled youth more recently, which is a welcome step. Besides, programmes for parents returning to work after parental leave ("Start plus") and for older, low-skilled or long-term unemployed ("Start extra") appear to be well targeted and should be continued. Both programmes were replaced with a new programme ("Start bonus") with a shorter availability but increased tax allowance in 2012. As opposed to gross hiring subsidies, marginal employment subsidies targeted at raising net employment, such as the "SME+ programme" in Hungary, minimise the risk of displacement effects. Yet maintaining low compliance costs to enhance their take-up rate is important.

Supporting labour market flexibility

Easing employment protection legislation (EPL) could represent another policy lever to stimulate labour demand. The OECD indicator of strictness of EPL does not reveal major hindrances as its overall value was below the OECD average in 2008 (Figure 5). Its three main components suggested a relatively flexible approach to collective dismissals, protection of permanent workers and regulation of temporary forms of employment. The authorities amended the labour code in late 2011 to increase further the flexibility of the labour market, notably by easing individual dismissals, except for older workers. On the other hand, the standard length of the probation period has been shortened from three to one month (against an OECD average of four months), which could increase employers' *ex ante* uncertainty about the skills and productivity of young people and therefore hamper their recruitment. However, a longer probation period (up to six months) has been allowed in the case of collective bargaining agreements, which should affect employment in the opposite direction.

Figure 5. **Employment protection legislation**

Index scale of 0-6 from least to most restrictive, 2008[1]



1. 2009 for France and Portugal.

Source: OECD (2010), "Employment Protection Legislation", *OECD Employment and Labour Market Statistics* (database).

Securing appropriate Public Employment Services' (PES) intervention

Non-employed people are a heterogeneous group, which requires a careful profiling of the PES and services targeted to specific needs to limit scarring and hysteresis effects. Job-search assistance is the most cost-effective instrument for those who are assessed as ready to work. A shift from a "work first" to "learn/train-first" approach could be considered for those who have difficulty in finding a job and a low level of education, all the more so as a weak economic recovery lowers the opportunity cost of skill upgrading. More in-depth action is needed in the case of the most disadvantaged groups, who usually cumulate various social risk factors, and may require comprehensive re-employment packages, including remedial education, income support and job-search assistance (including mobility and housing assistance). A threat of moderate benefit sanctions could strengthen the effectiveness of activation measures. The recent tightening of eligibility conditions for unemployment benefits, which have been cut to three months (against an OECD average of 15 months in 2010) and capped at the level of the minimum wage, may have negative social consequences when labour demand is weak, and result in inefficient labour allocation if people do not have enough time to search for a suitable job. This could turn cyclical unemployment into structural, which would call for an extension of the duration of unemployment benefits.

Raising participation rates

Various groups of workers are poorly attached to the labour market

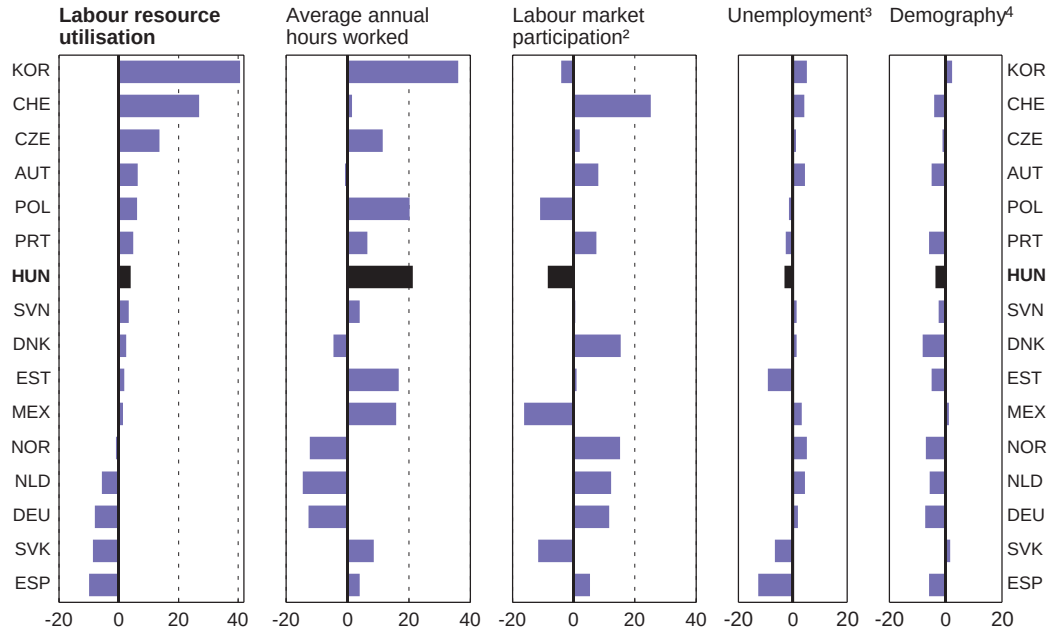
Overall labour resource utilisation in Hungary is comparable to the average of the most affluent OECD countries, but significantly higher average hours worked are compensated for by one of the lowest participation rates in the OECD (Figure 6). Therefore, it is not so much a relatively high unemployment rate or a slightly negative demographic structure that prevents higher labour force utilisation, but an insufficient activity rate. Still, since 1997, there has been a steady increase in the labour force and participation rate, driven by a rise in the statutory retirement age, improvements of the education system and changes in the composition of the working-age population towards higher educational attainment (Cseres-Gergely and Scharle, 2010).

Nevertheless, significant gaps in activity rates remain along various dimensions. When considering a breakdown by age group and gender (Figure 7), participation rates are the lowest in the OECD for youth (with a rate below 5% in the 15-19 age group against an OECD average of around 30%) and the age group between 60 and 64 (with a participation rate at 13.5% as compared with an OECD average of close to 40%). A focus on gender differences indicates that, with the exception of Turkey, the participation rate of men is the lowest in the OECD almost across the whole age range. There is also a significant gap for women of childbearing age *vis-à-vis* the OECD median.

The Hungarian labour market is characterised by low participation rates of those with less than upper secondary education, which for prime-age workers average 60% in Hungary against almost 70% for other Central and Eastern European (CEEC) countries and an OECD median of around 75% (Figure 8). The situation is significantly better for graduates with upper secondary and tertiary education. Yet Hungary almost never outperforms the CEEC average or OECD median.

Figure 6. **The source of differences in labour utilisation in selected OECD countries**

Gap relative to the upper half of OECD countries, 2010[1]

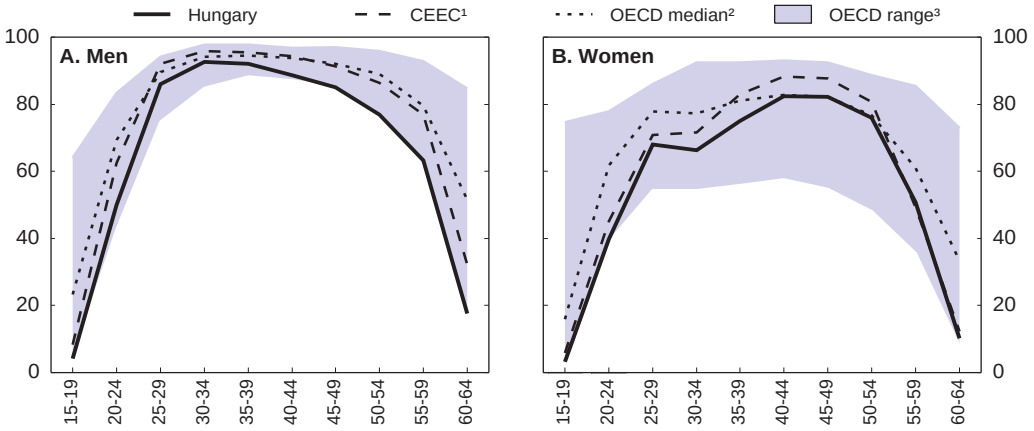


1. Percentage point differences relative to the average of the highest 16 OECD countries in terms of GDP per capita (excluding Luxembourg due to the difficulty of excluding cross-border workers from the breakdown), based on GDP in US dollars at current prices and 2010 purchasing power parities. The sum of the percentage gaps do not add up exactly to the total since the decomposition is multiplicative.
2. Share of labour force in working-age population. The labour force has been calculated as employment divided by 1 less the unemployment rate in order to obtain a labour force consistent with the national accounts employment data.
3. Calculated as 1 less the unemployment rate.
4. Share of working age in total population.

Source: OECD (2011), *OECD National Accounts Statistics* and *OECD Economic Outlook: Statistics and Projections* (databases); and *OECD Productivity Database*, December.

Figure 7. **Labour force participation rates by age group and gender**

Per cent, 2010

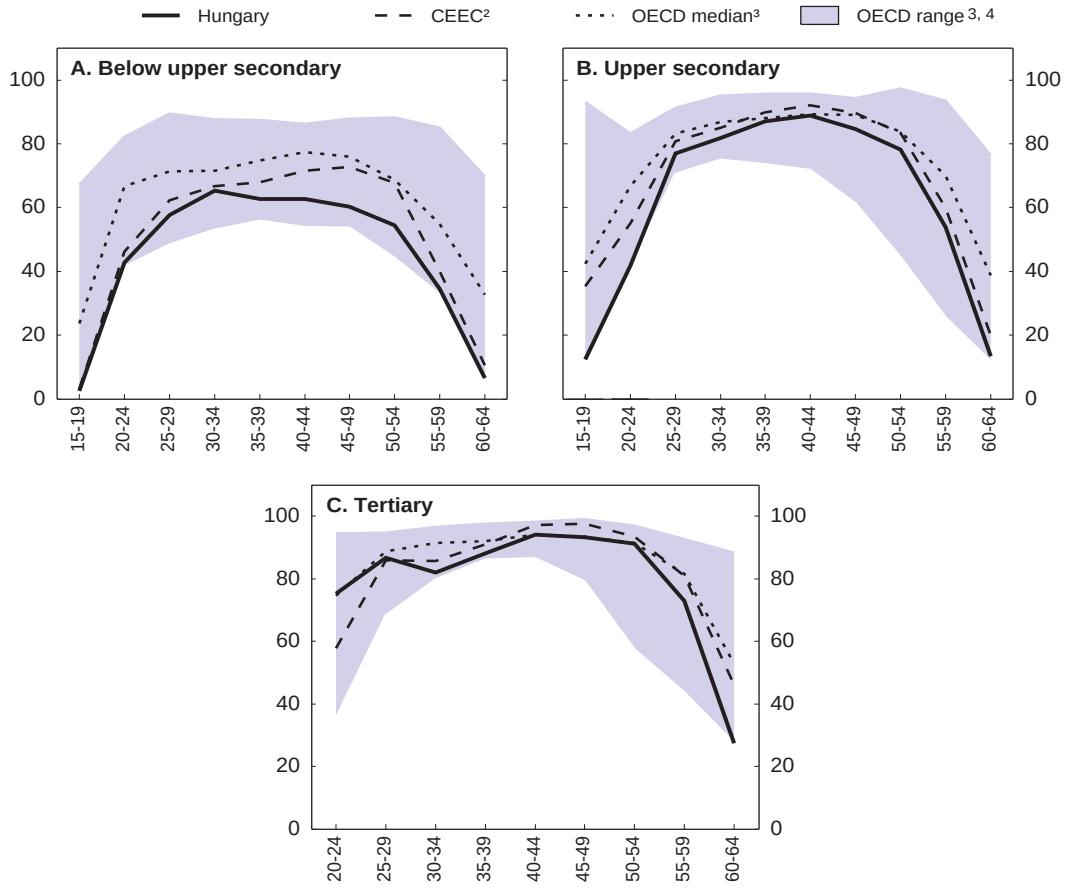


1. Unweighted average of data for the Czech Republic, Poland and Slovak Republic.
2. Excluding Turkey (outlier for the participation rate of women).
3. Range between the highest and lowest participation rate for each age group among OECD countries excluding Turkey.

Source: OECD (2011), *OECD Employment and Labour Market Statistics* (database), December.

Figure 8. **Labour force participation rates by age group and level of education**[1]

Per cent, 2009



1. Based on the International Standard Classification of Education (ISCED97): Panel A covers pre-primary, primary and lower secondary levels of education (0-2); Panel B includes post-secondary non-tertiary education (3-4); and Panel C includes advanced research programmes (5-6).
2. Unweighted average of data for the Czech Republic, Poland and Slovak Republic.
3. Excluding Chile, Korea and Japan (no data available).
4. Range between the highest and lowest participation rate for each age group.

Source: OECD (2011), *Education at a Glance 2011*.

Improving the integration of under-represented groups in the labour market

Notwithstanding weak labour demand, various structural factors explain weak activity rates, including: *i*) underdeveloped flexible forms of employment (including part time); *ii*) family policies that do not encourage the labour market participation of women, in particular those with young and/or several children; *iii*) the second highest share of disability benefit recipients in the working-age population in the OECD; *iv*) low overall educational attainment and an education system insufficiently attuned to labour market needs, contributing to youth non-employment; *v*) large disincentives to work at older ages; and *vi*) the widespread labour market exclusion of the Roma. These groups are reviewed in turn in this section.

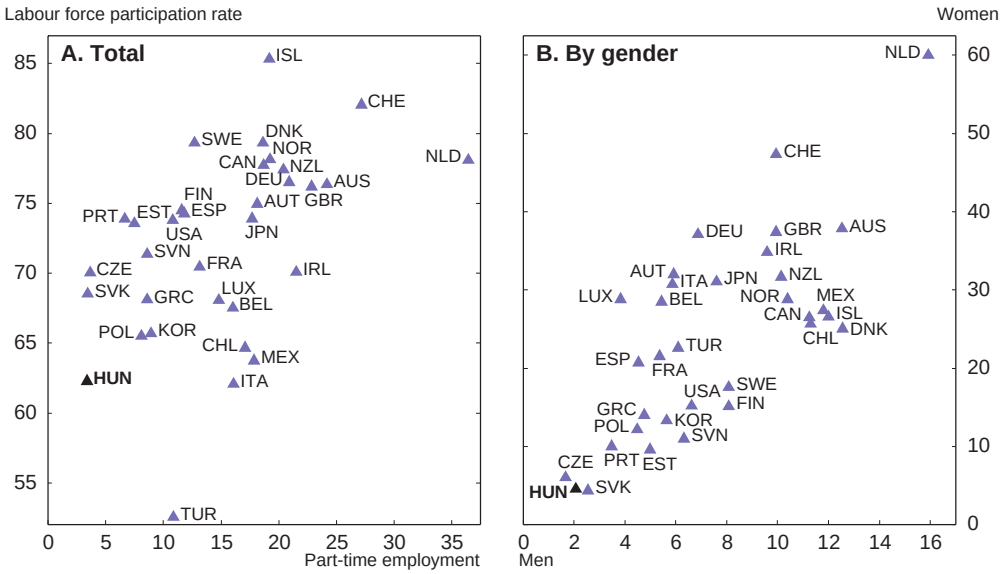
Fostering the development of part-time employment

Hungary has among the lowest share of part-time work in total employment in the OECD, while other countries with a higher ratio also tend to have higher activity rates (Figure 9). In OECD countries, this form of employment is predominantly used by women, who nevertheless prefer substituting part-time to

full-time work when aged above 40 and when caring responsibilities for children are less important as a reason for part-time work OECD (2010a). Part-time work provides more opportunities for youth to combine study and work. For instance, it ensures smooth school-to-work transition in Denmark and the Netherlands. Even though the growth of part-time work can be mainly explained by labour supply factors (OECD, 2010a), demand-side factors, such as the shift towards the service sector, play a role as well. Part-time work is low in all low-income OECD countries, which usually have a higher share of industrial production in GDP.

Figure 9. **Part-time employment**[1]

Per cent, age group 15-64, 2010



1. Part-time employment in per cent of total employment in panel A, in per cent of total employment for men and women in panel B. Part-time employment refers to persons who usually work less than 30 hours per week in their main job.

Source: OECD (2011), *Labour Force Statistics* (database), December.

Although the estimated effects of regulation can be rather modest in OECD countries (OECD, 2010a; 2011c), the flexibility of part-time regulation is low for private sector workers and can contribute to a low incidence of part-time work in Hungary. Requests to work part-time can be refused based on any grounds in Hungary (except to care for a child, which is subject to agreement), whereas employers can only refuse on serious business or operational grounds in countries where the prevalence of part-time work is high. Moreover, there is no obligation for employers to revert to full-time hours on employees' request, while such a possibility is offered in countries with developed part-time work. Even though recipients of childcare benefits are allowed to combine allowances with part-time work, labour legislation should be reviewed by removing any remaining constraints for parents (as is the case in Belgium, France or Netherlands). Yet this could come at a risk of generating adverse effects on labour demand. Compared to full-time employees, the penalty linked to part-time work in Hungary is mainly characterised by weaker opportunities for advancement for women, lower share of permanent contracts and the highest training deficit for both men and women among OECD countries (OECD, 2010a).

Despite associated benefits of developing part-time work, it should be noted that demographic groups with a high propensity for part-time work are also those that are at risk of poor labour force attachment (mothers with caring responsibilities, youth and older workers). The poverty rate among part-time workers is more than three and half times higher than that observed among full-timers in Hungary (OECD, 2010a).

This is due to a high proportion of part-time workers who are primary earners, while in-work poverty is significantly lower among part-timers who are second-earners and whose earnings do not represent the main component of household income. Moreover, incentives to take-up part-time work are hampered by a wage distribution skewed to the bottom (implying even lower wages for part-time work in the official sector) and relatively high commuting and administrative costs. Empirical evidence also suggests a positive and statistically significant correlation between the effective retirement age and the incidence of part-time work (OECD, 2006). Chronic capacity shortages in crèches (see below) often lead to the exclusion of young mothers working part-time, which represents another barrier to the development of this form of employment. Finally, developing other flexible work arrangements (teleworking, distance working, flexible working hours, etc.) may not only have a positive impact on labour force participation, but possibly also promote the development of part-time work.

Reforming family policies to enhance women's labour market participation

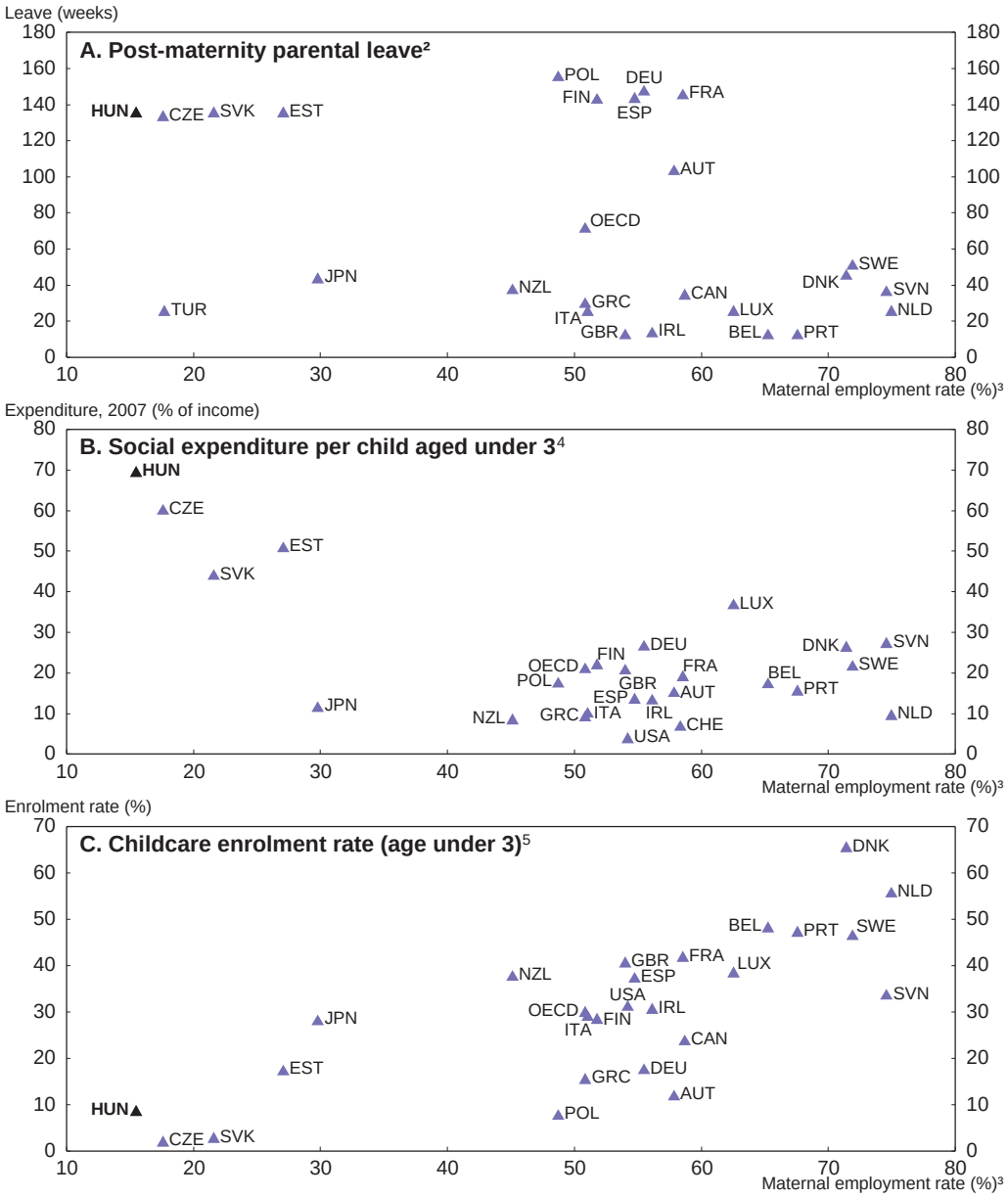
Labour participation of women is not only affected by the availability of flexible work arrangements, but is also influenced by the generosity of family policies. In Hungary, family policies are geared toward increasing the fertility rate through high public spending on family benefits and prolonged duration of post-maternity parental leave[3]. However, they have largely failed to boost fertility rates, which started to decline in the late 1970s, collapsed in the early 1990s and stabilised at a low level in the 2000s (OECD, 2007). At 1.33 children per woman in 2009, Hungary had the third lowest fertility rate in the OECD whereas the average was 1.74.

Family policies in Hungary have a significant negative impact on the labour force participation of women with young children. Out of six main leave policy models in Europe, Hungary's model can be characterised as a long-leave, home-centred model (Wall, 2007). Its main feature is maternal home care when the child is very young, with mothers only gradually taking up work again as the child gets older. The model is also characterised by the most generous cash benefits and tax breaks in the OECD per child (further extended in 2011), until the child is three years old (Figure 10, Panel B). At the same time, despite some recent progress the availability of early childhood education and care (ECEC) services is still low for children aged under three. In 2008, the enrolment rate amounted to almost 10% against an OECD average of 30% and the EU target of 33% set up by the Barcelona strategy. As a result, at only 15% the employment rate of mothers with children aged under three was the lowest in the OECD, where the average rate was around 50% in 2008.

Policies that favour the reconciliation of work and care responsibilities have a positive effect on fertility patterns, although the composition of family-friendly policies also plays an important role (OECD, 2011c). Empirical research indicates that the link between the duration of leave entitlements and fertility seems ambiguous and small. Financial transfers have a positive, but small and temporary effect on total fertility rates. They mainly accelerate the timing of births. On the other hand, empirical evidence invariably points to a positive effect of formal childcare on fertility patterns. This is a key factor explaining cross-country differences in fertility and is also likely to affect fertility rates on a structural basis. Yet it is more a package of policies (including opportunities to work part-time or flexible workplace practices, leave around childbirth and availability of ECEC services) rather than each single component which has a positive influence on fertility outcomes and intentions.

3. The maximum length of maternity and post-maternity leave was re-extended by one year to three years in mid-2010, after it had been cut back by the previous government a year earlier.

Figure 10. **Maternal employment rates relative to social expenditure, parental leave and childcare**[1]
2008



1. For further information see indicators LMF 1.2, PF 2.1 and PF 3.2 of the *OECD Family Database*; also figures 2.4 and 4.1 of *Doing Better for Families*.
2. Parental leave and subsequent prolonged periods of paid and unpaid leave women can take after maternity leave to care for young children.
3. Mothers with children aged under 3.
4. Average annual expenditure in per cent of median working-age household income. Expenditure covers cash benefits and tax breaks only and excludes childcare, education and other in kind benefits. Income is the equivalised disposable household income.
5. Enrolment in formal childcare adjusted for intensity of use.

Source: OECD (2011), *Doing Better for Families* and *OECD Family Database* (*www.oecd.org/els/social/family/database*), October.

Best-performing countries in terms of employment outcomes of women with children aged under three combine short post-maternity parental leave with low cash benefits and tax breaks per child. At the same time, they also have high participation rates in ECEC services (Figure 10). Therefore, an overhaul of family policies is needed to better combine work and family life and improve the inclusion of women in the labour market. The generosity of post-maternity parental leave should be significantly reduced. From a career development perspective, women would be best advised to return to work no later than around six months after childbirth.[4] At the same time, public expenditure needs to be re-oriented from cash benefits and tax expenditures towards the development of childcare services for children aged under three. A higher availability of ECEC services would also improve the fertility rate. A cost-effective solution could be sought to develop such facilities within railway station buildings in the suburbs of big cities (as recently experimented with in France) or post offices which are often well-located in downtowns. By remaining close to the routes between work and home, this would strengthen accessibility.

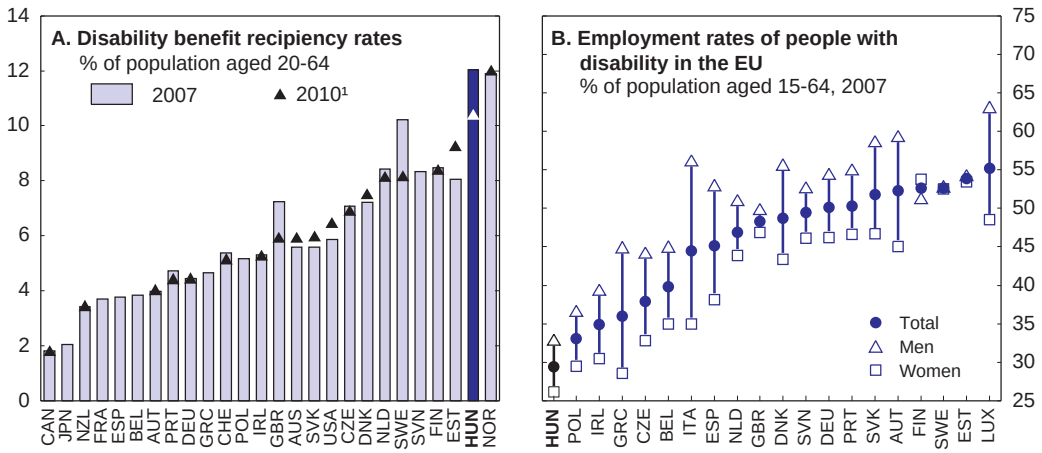
Stronger provision of childcare support for children aged under three would remove important barriers to employment for many mothers. A higher provision of ECEC services for children above that age makes it easier to combine work and families. Indeed, at 52% in 2008, maternal employment rates were significantly higher for children aged between three and five. However, the female employment rate was still ten percentage points below the OECD average. Therefore, female employment does not fully catch up with the OECD average when the provision of childcare support becomes more abundant for older children, indicating that the long duration of post-maternity parental leave is likely to make the return to work more difficult. To some extent, a long period of inactivity may have similar negative consequences as long-term unemployment for the probability to take up a job. The fact that women with three or more children may take additional leave and continue to enjoy benefits when staying out of the labour market may explain their second lowest employment rate in the OECD which, at around 25%, was 20 percentage points lower than the OECD average in 2008.

Improving labour market integration of disabled working-age population

Disability benefit systems can steer people into labour market exclusion and welfare dependency (OECD, 2010f). At slightly above 10% in 2010 (age group 20-64), the prevalence of disability benefit recipients in Hungary is one of the highest in the OECD (Figure 11). Among the factors which contributed to an upsurge in disability claimants are the rapidly deteriorating health of the population in the second half of the 1960s and the political will to ease the social cost of transition in the 1990s, inducing a *de facto* transformation of disability benefit schemes into an early-retirement route. However, net inflows into disability benefits had been contained in the first half of the 2000s and reversed more recently, notably by altering the system of assessments through streamlined medical guidelines for eligibility (OECD, 2005a; 2011d). Despite still sizeable gross inflow rates into disability benefits of close to 5% in 2008, the main policy challenge now is to reduce the overall number of disability benefit recipients of working age by re-integrating most of them into the labour market. Even though the age distribution is skewed towards older ages, around half of recipients were aged under 54 and a fourth were aged below 49 in 2008.

4. Leave shorter than six months may also induce negative effects on children's cognitive outcomes, but the evidence on this is mixed (OECD, 2011c).

Figure 11. **Disability benefit recipients and employment rates of disabled workers**



1. 2009 for the Czech Republic, Germany, Finland, Mexico, Norway, New Zealand, Switzerland and United Kingdom.

Source: OECD (2011), *OECD Employment Outlook 2011* and W. Eichhorst *et al.* (2010), "The Mobility and Integration of People with Disabilities into the Labour Market", *IZA Research Report*, No. 29, Institute for the Study of Labour, October.

Only around 25-30% of disabled people work (Figure 11) and the unemployment rate is one and a half times higher than for able workers OECD (2010f). About 150 000 people who suffer from sickness or disability would like to work but cannot find a job (Scharle, 2011). While there is a high correlation between the overall level of employment and the employment rate of the disabled, people with disability face greater barriers in the labour market due to various factors (OECD, 2010f; Eichhorst *et al.*, 2010). In particular, their job prospects are more sensitive to economic downturns. Promoting flexible forms of employment (part-time work, temporary work, self-employment, distance and teleworking) would enhance work possibilities for people with disability. Employment opportunities are also hampered by a low educational attainment. Lifelong learning programmes would help to narrow the educational gap between disabled and non-disabled. However, other more specific measures are needed as well.

Active labour market expenditure on employment programmes and vocational rehabilitation is very low (OECD, 2010f). In 2008, a rehabilitation allowance was introduced for new claimants of disability benefits who have a good chance of returning to the labour market (based on their health). Recipients of the allowance (paid at a higher level than a standard disability benefit) have to participate in a comprehensive rehabilitation plan designed by the employment office with a view to partially or fully recover their work capacity. However, only people with a health impairment of more than 50% were allowed to participate in comprehensive rehabilitation. Moreover, the experience of OECD countries suggests mixed outcomes from vocational rehabilitation measures notably due to lock-in effects (during the rehabilitation period participants usually do not look for a job, which increases the risk of non-employment). Therefore, vocational rehabilitation measures should be coupled with work-first measures (including job coaching, workplace adaptation, and personal assistance) to limit the period of inactivity and enhance the probability of returning to work.

In 2011, the authorities cut by half the generosity of sickness allowances. Yet sickness absence rates are low and, empirically, a previous sickness benefit spell does seem to increase the probability of receiving a disability benefit in Hungary (OECD, 2010f). While the provision of medical guidelines for doctors has represented a welcome step to curb the inflows, there is still room to improve the rules and the practice of evaluation committees in the examination of disability pension claims (Scharle, 2008). In particular, there should be a more prominent focus on remaining work abilities rather than on health problems. Better exploiting partial work capacity could be achieved by shifting from a medical towards a

more social approach to disability. In the case of Austria, the latter is defined notably as an ability to acquire and perform gainful employment and achieve a reasonable and adequate income without social assistance.

To enhance labour demand for the disabled, Hungary applies a quota-levy system whereby firms with more than 25 employees (20 employees before January 2012) are required to employ at least 5% of workers with disability, or are subject to a rehabilitation tax. In 2010, the amount of the tax was more than quintupled to almost HUF 1 million per year for each employee below the quota. In 2011, the tax base was extended to temporary employment agencies. However, international evidence indicates an uncertain effectiveness of quota systems (Eichhorst *et al.*, 2010). Quota positions are often filled through internal not external recruitment and individuals can be hired into low-skilled and token jobs. Moreover, cream-skimming effects can happen as employers target those who are only moderately disabled, in particular if the quotas are not differentiated according to the levels of disability. Therefore, to enhance the labour demand for people with significant health damage and/or weak earnings potential, such differentiation could be explicitly introduced in Hungary.

Another policy instrument to promote the employment of people with partially reduced work capacity is a system of employment subsidies for sheltered firms and accredited employers.[5] This system absorbs a large share of wage subsidies, but provides employment to only a limited number of people (Scharle, 2011). However, the effective share of disabled workers in such workplaces is often very high, thus perpetuating their segregation. Moreover, incentives for firms to ensure a transition of their workers to unsubsidised jobs in the regular labour market are weak, while workers' rehabilitation activities, professional development and skills tend to be firm specific. There is a weak pathway from sheltered workshops or accredited firms to regular jobs, which induces a risk that subsidised employment becomes a trap for people with more labour potential (Scharle, 2011). Better outcomes could be achieved by promoting new forms of sheltered employment closer to the open labour market (like the social enterprises in France and Finland) or tailoring sheltered jobs to those offered by regular firms (as in the Netherlands). Other options would be to limit the share of people who can stay in sheltered employment indefinitely (as in Norway) or link the financing of such firms to the placement of a certain share of disabled workers (adjusted for work capacity) in the regular labour market. Finally, a recent adoption of tax allowances for employers, who are exempted from social security contributions up to double the minimum wage, may also promote labour demand for disabled workers provided that such incentives are well targeted according to the levels of disability.

Re-employment chances of people with disability could be fostered by relying more extensively on non-governmental organisations. Empirical evidence suggests that, in such cases, reemployment chances are significantly higher compared to disabled workers in sheltered employment, while the best service providers can place between 30% and 50% in unsubsidised positions in the open labour market (Scharle, 2011). However, the accountability of private service providers can be enhanced by creating an outcome-based funding mechanism (as in Australia, Netherlands, United Kingdom or United States), whereby providers are paid based on how many disabled persons they have successfully helped to get back to work. Moreover, cream skimming in the intake phase could be avoided by differentiating fees depending on the degree of disadvantage in the labour market (as in Australia). Funding of such re-employment services could be achieved by reallocating part of expenditure away from wage subsidies for accredited employers, in particular for those failing to place a certain share of disabled workers in the regular labour market.

5. Sheltered firms also require accreditation, but qualify for higher subsidies.

In 2011, the government announced a large-scale review of disability rights with an objective to bring back into the labour market 110 000 people, out of a planned review of 220 000 disability pensioners under the age of 57 (five years before the statutory retirement age). Retesting beneficiaries according to new assessment criteria is a welcome step. The authorities have secured part of labour demand by directly creating jobs within the framework of the new public works programme. However, as discussed above, for people who remained detached from the labour market over a protracted period of time a comprehensive activation strategy based on extended training, skills upgrading and pre-employment support is needed to reduce the risk of a subsequent shift of public works participants into unemployment or social assistance. Following a retest of the entire caseload of beneficiaries aged below 45, the experience of the Netherlands suggests that about one-third returned to the labour market within 18 months, but partly with special reintegration support offered to this group. Therefore, to maximise re-employment chances in the primary labour market a tailored engagement of public employment services leading to a systematic profiling and identification of those most in need of pre-employment intervention is necessary and should be coupled with the provision of some disability services contracted out to the private sector.

Remedying youth non-employment by reforming the education system

At close to 18%, Hungary had the lowest employment rate of youth aged 15-24 in the OECD in 2010, where the corresponding (weighted average) rate was close to 40% (OECD, 2011d). Weak employment outcomes were driven by a high unemployment rate of around 26.5% (exceeding the OECD average by nearly ten percentage points) and a very low participation rate of around 25% (against an OECD average more than 20 percentage points higher). Besides, almost 12% of those aged 20-24 and 16.5% of those between 25 and 29 were inactive and not in education in 2009 (OECD, 2011e). Therefore, Hungary faces a double challenge: to avoid a further increase in the share of young people disconnected from the labour market and to reduce the high inactivity rate of youth further down the road. Measures to keep in check and adapt the minimum wage to local labour market conditions are important (see above), but reforming the education system is critical as well.

The educational profile of the working-age population is low (a fifth of 25-64 year-olds has no diploma, that is less than an upper secondary education), which creates an additional challenge to increase the overall level of educational attainment and ensure high quality standards (including for general education). This is all the more important as higher qualifications have a positive effect on both employment prospects and wages. However, the education system has to be also more attuned to labour market needs so as to reduce the risk of qualification mismatches. In 2004, almost 30% of workers held jobs in areas unrelated to their field of study (OECD, 2011d). While this may signal some welcome mobility and career development, it may also indicate a mismatch between study choices and labour market needs.

The authorities have lowered the age of compulsory education from 18 to 16, starting from September 2012. Yet it would have been preferable not to introduce such a change and instead encourage young people to stay on at school longer.[6] Young people who leave school at the minimum leaving age without sufficient qualifications are exposed to a high risk of spending a long time out of work during their working life. Another risk is a reduced ability to participate in lifelong learning. These problems are particularly acute in Hungary where the share of under–qualified is very large, even though further skills are acquired outside the formal education sector. More than 50% of workers possess fewer qualifications than required by their job, which is by far the highest ratio in the OECD (OECD, 2011d).[7] In the majority

6. The school-leaving age was raised from 16 to 18 at the end of the 1990s in order to reduce the number of early school leavers.

7. This result for Hungary is mainly driven by a large share of workers with below-secondary qualifications in craft occupations.

of OECD countries, compulsory education ends at age 16, but in some countries it can be age 18 as in Belgium, Poland, Canada, Netherlands and United Kingdom. However, only the last three countries took positive measures to diversify educational pathways by alternating study and on-the-job training, notably through part-time vocational education (OECD, 2010d).

Continuing the reform of vocational education and training (VET) is essential to strengthen the job prospects of youth. The shift to a market economy combined with a failure to adapt to rapid changes in labour demand during economic transition have led to a gradual devaluation of VET quality, contributing to poor labour market outcomes of disadvantaged and/or lower-skilled individuals and creating a need for reforms (OECD, 2008a; 2010c). Recent steps by the authorities have included the introduction of a scholarship system in support of apprentices aiming to acquire qualifications for which there is evidence of excess labour demand. In addition, specialised workshop-based education has been brought forward, starting right after primary education (in the 9th grade), as opposed to the previous practice of grade 10 for vocational training schools, and grade 12-13 in the case of vocational secondary schools. Regional Education and Development Councils have been set up to monitor the system of secondary vocational education regionally and reduce skill mismatches. Moreover, additional responsibilities about the overall design, organisation and control have been and are planned to be further delegated to the Hungarian Chamber of Commerce and Industry, which should create conditions to improve the quality and labour-market relevance of the system. Yet any changes in the institutional structure should be subject to close monitoring and assessment as there is evidence that the creation of a network of so-called regionally integrated vocational education centres has proved to be expensive and not very efficient in some cases, even though career guidance was improved (Cseres-Gergely, 2010). The authorities have sought to address this issue and restructure this network with a recently adopted new law on VET.

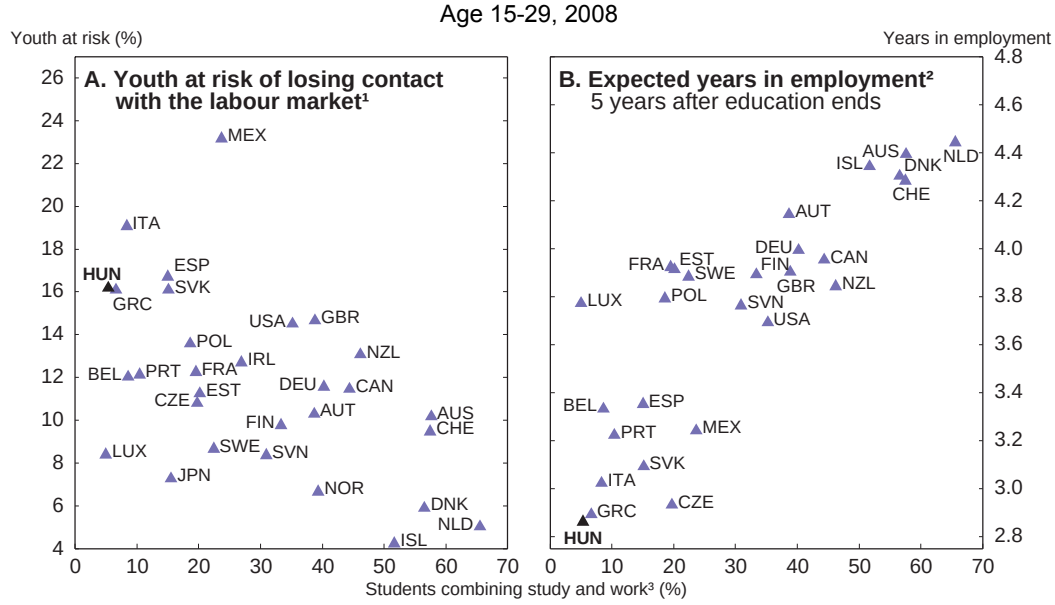
The employment rate of youth is a growing function of the level of education, and the probability of moving from inactivity to employment rises steadily with the level of educational attainment for both genders (OECD, 2008b). Hungary has the highest earnings premium for tertiary education in the OECD (OECD, 2010g). Moreover, low-skilled youth (without an upper secondary education) had on average an unemployment rate which was more than twice as a high as the unemployment rate of high-skilled youth (with a tertiary education) in 2008. These factors should represent a strong incentive for undertaking tertiary education, but graduation rates are low. While enrolment rates in long-cycle theory-based studies ("type A") exceeded 50%, slightly above to the OECD average, educational attainment was almost ten percentage points below the OECD average in 2008. Short-cycle tertiary programmes focusing on practical, technical or occupational skills ("type B") are typically less developed in OECD countries, though they are important for good employment outcomes. Yet their incidence was even lower in Hungary and graduation rates did not exceed 5%, half the OECD average, in 2008.

Efforts are needed to continue to expand higher levels of education, but policy action is needed on two fronts to bring them closer to labour market needs. *First*, by enhancing the provision of high-quality post-secondary vocational training and tertiary-type B programmes to help students gaining valuable higher level vocational, technical and professional skills. *Second*, while high failure rates in type A cycles could be due to capacity constraints and biased financial incentives (OECD, 2010c), the structure and quality of educational output are also partly at variance with actual labour market needs, notably due to an insufficient supply of graduates from science, technology and engineering areas (Government of the Republic of Hungary, 2011). A better match between supply and demand could be achieved by developing career guidance (managed from outside schools) as well as by collecting and publishing information on the labour market outcomes of students. Recent changes aimed at tracking the career development of higher education students are a step in the right direction, but should be backed by a strong and transparent dissemination of information.

Blending learning and working would facilitate the transition from school to work by improving labour-market entry of students and their subsequent career prospects (Figure 12, Panel A). In 2008, the median age of 21 of leaving education was equal to the OECD average, but the percentage of students aged 15-29 who combined study and work (including apprenticeships and other work-study programmes) was below 10%, against an OECD average of close to 35% (OECD, 2010d). In the latter report, four groups of OECD countries are identified depending on the relationship between the median age of leaving education and the combination of school and work: "study late while working" in most of the Nordic Countries (except Sweden) and the Netherlands; "study while working" in the Anglo-Saxon countries and Sweden; "study first, then work" in many European countries and Korea; and "apprenticeship systems" in German-speaking countries. Hungary belongs to the third group, where the transition from school to work is abrupt and contrasts with the other groups where more than one-third of students work. A poor labour market integration of new entrants is confirmed by the second lowest level in the OECD for expected number of years spent in employment during the five years after the completion of education (Figure 12, Panel B). Post-school labour market outcomes of youth could be enhanced via apprenticeships, compulsory internships and a combination of study and work during the school year to the extent that work is not harmful to studies (*i.e.* no more than 15-20 hours of work a week).

Figure 12. **Combining study and work is an effective pathway to enter the labour market**

Age 15-29, 2008



1. Youth who are not in education and are either unemployed or not in the labour force, in per cent of the population of the age group.
2. For details of the calculation see Box 3.2 of *Off to a Good Start? Jobs for Youth*. Data for 2006 for Australia.
3. Youth who are in education and are either employed or following in-work study programmes (including those on apprenticeships), in per cent of the age group in education.

Source: OECD (2010), *Education at a Glance 2010* and *Off to a Good Start? Jobs for Youth*.

To help young people with college and university degrees start their careers, Hungary developed a programme of "Paid Internship Employment", combining tax incentives for employers and adult mentoring. It has been mainly used in the public sector (Kun, 2010). To boost the amount of workplace training offered by companies, Hungary applies a "train-or-pay" levy, but financial incentives for small and medium enterprises to hire apprentices are low, the administrative burden is large and few foreign companies participate (OECD, 2008a). International experience suggests a mixed effectiveness of such schemes. When designing apprenticeship schemes, a right balance has to be found between different incentives so as to maximise employers' and employees' participation, while ensuring a good quality of workplace training (OECD, 2010h). This implies a relatively low apprenticeship wage (below the

minimum wage) rising with the development of skills and productivity, but coupled with a training commitment of the employer (in return for a lower labour cost). However, any development of specialised skills matching specific tasks should not be too firm specific and occur at the expense of a comprehensive provision of sound general literacy and numeracy skills, which are essential to underpin lifelong learning (see below). Otherwise, this could undermine the ability of vocational students to adapt to technological changes and future shifts in labour demand. Deficiencies in broader generic, transferable skills (such as problem-solving and communication) hamper the employment prospects of workers educated in vocational training schools in Hungary (Kézdi *et al.*, 2009). Therefore, adequate support is needed for students facing difficulties in acquiring basic skills.

Promoting the participation of the elderly

At nearly 35%, Hungary had the third lowest employment rate of workers aged 55 to 64 in the OECD in 2010, even though it improved by more than ten percentage points over the last decade. If participation rates by age and gender remain unchanged at their current levels, the ratio of inactive population aged 50 and over to the labour force would almost double and exceed one in 2050 (OECD, 2006). What is more, the total inactive population as a share of the labour force would reach a ratio close to two by 2050. Remaining in work longer would have a double dividend as it would: *i*) boost labour force growth and thus help offset the effect of demographic ageing on potential output; and *ii*) improve public finances as a result of lower expenditure on pensions and higher tax revenues.

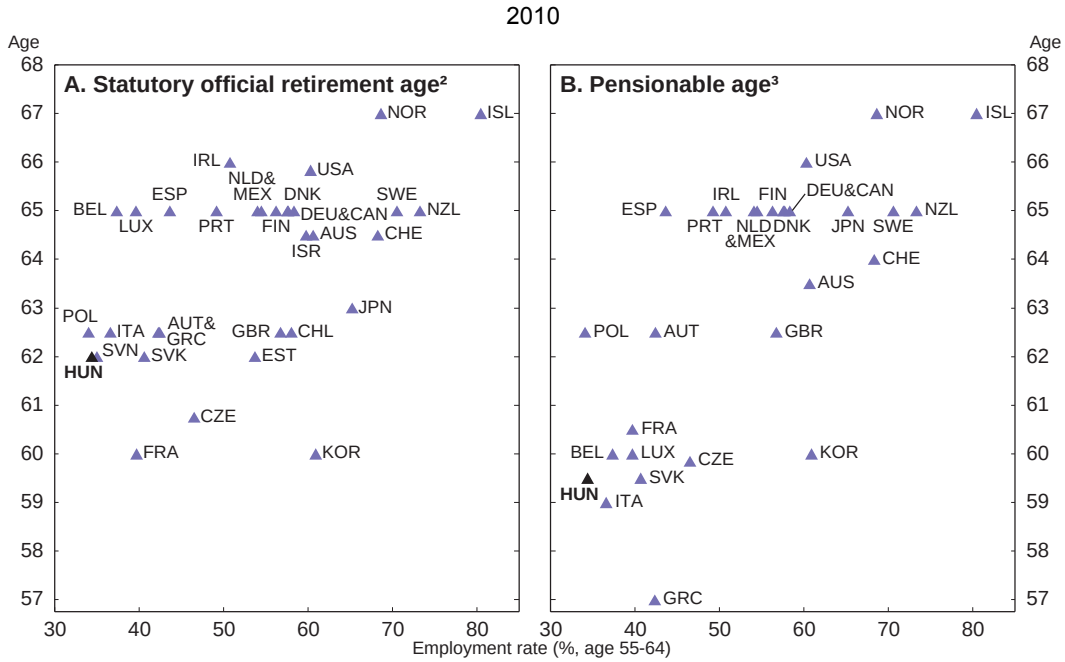
Notwithstanding recent improvements, the disability and old-age pension system provided in the past strong financial incentives for an early exit route from activity, especially for those with weak labour market and insecure wage prospects (Cseres-Gergely, 2007). Moreover, Hungary has a high share of low-qualified workforce in the working-age population and empirical evidence suggests that blue-collar and low-skilled workers are likely to retire earlier than white-collar and more high-skilled workers (OECD, 2006). Even though the participation of future cohorts of older people should gradually increase in line with rising educational attainment, structural measures are needed to increase the employability of current older workers, notably by further reforming the pension system and addressing specific employer and employee barriers on the labour market.

Reforming the pension system

In the second half of the 2000s the authorities made various parametric changes to the first (defined-benefit) pillar of the pension system (OECD, 2010c), which improved work incentives of older workers. Increases in statutory and pensionable[8] retirement ages should enhance the employment rate of older workers (Figure 13). In 2002, the legal retirement age was 62 for men and 58 for women. The statutory retirement age for men and women was equalised in 2009 and, starting from 2014, both will be gradually increased to 65 by 2022. Reforms have also tightened the qualifying conditions for early retirement. In 2002, the pensionable age was 60 for men and 55 for women. It reached 59 for women in 2009 and the common pensionable age should converge to the statutory retirement age by 2022. Continuing the reform of the first pillar of the pension system by increasing the statutory retirement age in line with gains in life expectancy, reducing replacement rates and effectively closing pathways into early retirement for women and special pension regimes would also favour longer activity (Beynet and Kierzenkowski, 2012).

8. The pensionable age is the age at which people can first draw full benefits without an actuarial reduction for early retirement.

Figure 13. **Employment rates of older workers and retirement age**[1]



1. Retirement ages are unweighted averages of data for men and women.
2. Age at which a pension can be received irrespective of whether a worker has a long insurance record of years of contributions.
3. Age at which people can first draw full benefits (that is, without actuarial reduction for early retirement).

Source: OECD (2011), *Pensions at a Glance 2011*; *Labour Force Statistics* (database) and "Ageing and Employment Policies – Statistics on Average Effective Age of Retirement", September.

Addressing barriers on the side of employers

Some employers may discriminate against older workers due to negative perceptions about their ability to adapt to technological and organisational change. In 2003, Hungary introduced legislation banning age discrimination. Slightly above 3% of workers reported discriminatory practices in 2005, a ratio similar to the average observed in most other EU countries. A detailed empirical examination reveals the lack of a negative correlation between different subjective measures of age discrimination and the employment rate of older people (OECD, 2011f). Moreover, there is mixed evidence about the effectiveness of public information campaigns in tackling ageism in the workplace. If anything, information campaigns should put emphasis on the benefits of age diversity in the workplace to avoid stigmatising older workers.

At around 1.4 for men in Hungary, the ratio of earnings of 55-59 year-old to 25-29 year-old full-time workers could contribute to weak employability of older workers. Labour market prospects could be hampered if the cost of employing older workers rises more steeply with seniority or age than productivity does. Empirical cross-country analysis reveals a strongly negative and statistically significant relationship between "seniority wages" and hiring rates of older workers, but no obvious linkages with their employment rate (OECD, 2011f; d'Addio *et al.*, 2010). However, seniority-wage systems are increasingly unsustainable in the wake of an ageing workforce, making it less possible to offset above-productivity wages of older workers with below-productivity wages of younger workers. Therefore, it is essential that the authorities along with social partners take steps to ensure that wage–setting practices are adapted to the ageing of the workforce. Any seniority clauses in pay arrangements could be replaced by performance clauses as, for instance, has been done in the public sector in Sweden. Korean authorities have encouraged

the implementation of a "peak–wage" system with downward wage flexibility after a given age in return for greater job security. Lifelong learning would support the productivity of older workers and prevent the risk of a growing misalignment with their wages (see below). Indeed, empirical evidence suggests a strong positive correlation between training incidence and the retention of older workers relative to younger workers (OECD, 2006).

Addressing barriers on the side of older workers

The demands for different skills are subject to constant change under the influence of globalisation, technological progress, work organisation and consumption patterns. Moreover, the closer a catching-up country moves to the technological frontier, the greater the need for sustained adult learning and training to remain competitive. In this context, current and future older workers are exposed to a risk of depreciation of their qualifications and skill obsolescence in the absence of continued investment in adult education and training. Lifelong learning is a key instrument to help to preserve and augment human capital and thus to make older workers more employable. Its incidence declines with age, as a result of a reduced focus of public employment services on the employment of older workers and, more importantly, due to shorter expected pay-back periods on investment in training when the distance to retirement is small (OECD, 2011f). Extending the effective retirement age should raise the potential net returns to training, while the rise in educational attainment of successive cohorts (participation in training is more prevalent for high-skilled than for low-skilled workers) should lead to higher participation.

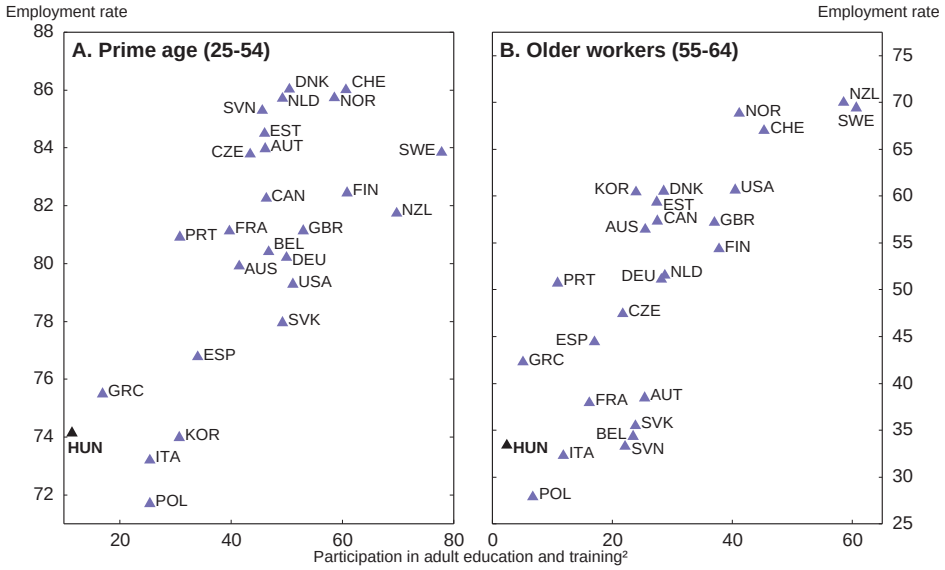
The participation of the 25-64 year-old population in adult education and training in Hungary is the lowest in the OECD. In the late 2000s it barely reached around 10% for all levels of educational attainment, against an OECD average close to 40% and a 35% average in Poland and the Czech and Slovak Republics. A low incidence of lifelong learning could contribute to a relatively lower employment rate of prime-age workers and to the significant gap in older workers' employment (Figure 14). As a result, policies encouraging regular upgrading of skills over the life course appear particularly important for underpinning higher participation rates among current and future older workers. Yet there are limitations in the effectiveness of such policies for older workers who have had very little training in their work careers. Moreover, the variation by the level of education in terms of participation is sometimes greater than by age, requiring a special focus on low-skilled workers who receive very little adult education and training over their working life. Targeting such workers at mid-career would entrench a learning habit and favour a regular updating of their skills as they age.

Various measures could support the development of adult learning and training by fostering take-up incentives, remedying the under-provision of services and spurring their quality. Reducing the implicit tax on continued work at older ages would not only increase the participation rate of older workers, but should also promote their training participation (Bassanini *et al.*, 2005). In terms of specifics, creating individual learning accounts would give individuals more responsibility and control over their own learning over the life course, while ensuring that various types of learning are adequately tailored to needs (OECD, 2005b). In terms of financing, as adult learning generates private returns it should be co-financed, but low-skilled and low-educated individuals could benefit from a higher state involvement through various types of subsidies (vouchers and allowances). The example of the Czech Republic shows that supply diversity of private providers can be supported by competitive rules for awarding retraining contracts (Bodewig and Hirshleifer, 2011)[9].

9. Moreover, the labour market orientation of public VET schools has been enhanced by turning some of them into "lifelong learning centres" and allowing them to compete with private providers in the adult education and training market.

Figure 14. **Lifelong learning and employment rates**

Per cent, 2007[1]



1. 2008 for Belgium, Canada, Czech Republic and Netherlands; 2006 for Denmark, Finland, France, Hungary, Italy, New Zealand, Poland and United Kingdom; 2005 for Sweden and United States.
2. Participation in formal and/or non-formal education in per cent of population in same age group.

Source: OECD (2011), *Labour Force Statistics* (database), December and OECD (2010), *Education at a Glance 2010*.

Adapting working conditions closer to the needs of an ageing workforce, supporting the health situation of older workers along with health system reforms (Eris, 2012), and encouraging flexible working-time arrangements to allow for a gradual transition to full retirement (through more flexibility in combining pensions and work) should also underpin longer working lives. Another issue is to increase participation of older workers in active labour market programmes while strengthening job-search requirements, which are usually low for this group of workers in OECD countries. Despite the cancellation of job-search benefit (see above), it is welcome that the authorities have decided to maintain it for those five years away from the legal retirement age. Indeed, once unemployed, the probability of finding a job is significantly lower for the older unemployed than for prime-age and youth workers (OECD, 2006). In this context, it is important to resist pressure on other publicly-supported pathways to early retirement through unemployment, disability and long-term sickness benefits. However, given the major downsizing of social benefits that has recently been implemented, this risk seems low in Hungary.

Tackling the problem of labour market exclusion of the Roma

In Hungary, the Roma represent around 7% of the total population. They suffer from widespread poverty, low employment, poor health, discrimination, and social exclusion, not only in Hungary but also in other European countries (European Commission, 2011; World Bank, 2008). The Roma in Hungary enjoyed high labour market participation during the period of the planned economy. Yet the first years of economic transition were marked by a dramatic decline in demand for unskilled labour and the destruction of jobs no longer productive in a market economy, but predominantly filled by the Roma. This led to their widespread non-employment, including significant outflows to disability pensions as an early retirement pathway (see above). By 1994, the gap in employment rates between the Roma and the non-Roma reached almost 40% for both men and women. It remained essentially unaffected by macroeconomic conditions and has widened slightly for both genders since then (Kertesi, 2010).

Various elements drive this employment gap (Kertesi and Kézdi, 2011a). Significantly lower educational attainment of the Roma contributes to at least a third of the gap and its role is increasing over time. Therefore, reducing the education gap is critical to improve the labour market prospects of the Roma. The number of children is an additional explanatory factor for women, partly as a result of relatively generous child-related direct transfers. However, even if many Roma people live in rural and remote areas with few connections to economically important towns and cities, geographic location explains little of the gap when controlling for education. The unexplained part of the employment gap may notably reflect widespread ethnic discrimination as well as unobserved differences in educational quality or content (which are known to be lower for the Roma) and labour supply preferences (for instance, due to differences in reservation wages). Educational differences are also accounting for at least half of the gap in hourly wages.

The Roma face high job insecurity and labour market marginalisation as reflected by a significantly higher unemployment rate, longer jobless spells and less stable jobs as a result of a relatively higher concentration in seasonal employment (in the agriculture and construction sectors) and their wider participation in short-term public employment schemes (Kertesi and Kézdi, 2011a). The latter play a heavy role in Roma employment, but seem to corner Roma workers into a low-level segment of the labour market and entrench their social marginalisation and dependence on such programmes (Kertesi, 2010; Fleck and Messing, 2010).

The Roma are significantly less educated than the population as a whole: 30% of Roma men and close to 45% of Roma women have less than a primary education level, compared with national averages of around 5% and 10%, respectively (Kertesi and Kézdi, 2011a). The education system fails to compensate for disadvantaged family background and does not promote social mobility of the Roma. Roma children have a lower participation in pre-school education, experience a delayed entry to primary school and, despite legal changes, are still more likely to be labelled as mildly mentally disabled and either put into special schools or receive inappropriate education within mainstream schools (OECD, 2010i). These inequities are reinforced by early tracking and a free school choice adopted in 1993. The latter led to a strong sorting by income and ethnicity that coincided with the trend of a growing share of Roma students in primary schools. Empirical research indicates that the segregation of Roma and disadvantaged students between schools is significantly stronger than between classrooms (Kertesi and Kézdi, 2010). The former is also stronger the larger the town and is the most pronounced in areas with the largest presence of Roma and disadvantaged families. This is also supported with data from international assessments (PISA): Hungary is one of the OECD countries where most of the variance in reading performance is observed between schools rather than within them, even after accounting for socioeconomic background (OECD, 2010j). As a result, there was a significant test score gap in reading and mathematics between Roma and non-Roma 8th graders in 2006 (Kertesi and Kézdi, 2011b). The gap was mainly explained by parental education and measures of family income and poverty, with health, parenting and the quality of schools operating as key transmission channels. Finally, drop-out rates from secondary education are higher for Roma and only 2-3% of Roma men and women have a secondary or higher education level.

Even though there has been some increase in levels of education among the youngest cohorts of Roma over the recent years, the ethnic gap has in fact increased (Budapest Institute, 2011b). Structural measures are needed to promote access and retention of Roma children in quality education (OECD, 2010c; 2010i). Parents should be encouraged to send their children to pre-school before the compulsory age, which leads to better educational and social outcomes and raises the probability that young children will remain longer in education after the compulsory age limit. Access to pre-school education is key to prevent the initial learning gaps that increase educational segregation between Roma and non-Roma. Establishing home-school liaison coordinators to facilitate contacts between teachers, families and communities would also foster parental engagement in educational outcomes (OECD, 2010k). Additional welcome measures would include: *i*) strengthening teacher education for diversity; *ii*) encouraging the mixing and integration of

Roma and non-Roma pupils across and within schools; *iii*) postponing early tracking in academic or vocational schools until after 9th grade; *iv*) providing learning support for Roma children lagging behind that should not be addressed by putting them in special schools (which actually widens the gap), but providing them with adequate and timely support in mainstream education; and *v*) merging vocational training schools with vocational secondary schools. The former type of school contributes to the low social mobility of Roma (almost two-thirds of Roma children in post-primary education attend this type of school) and are characterised by five to six times higher dropout rates, and two and a half to three times higher grade retention rates than vocational secondary schools or academic secondary schools (Kézdi *et al.*, 2009). Moreover, closing the skills gap among Roma adults will require the development of an employment activation policy based on systematic skills upgrading and enhanced second-chance education to foster basic skills. However, careful targeting is needed as the more complex and long-term the employment programmes are (including training and the provision of other services), the lower the rate of Roma among participants (Fleck and Messing, 2010).

Box 1. **Recommendations to foster labour market inclusiveness in Hungary**

Ensuring labour market recovery

- Restructure the public works programme by significantly scaling up training and skill-upgrading services.
- Reduce the level of nationwide minimum wage relative to the median wage over time and consider differentiating it across regions depending on local labour-market conditions.
- Re-introduce the employment tax credit, while the fiscal cost could be lowered by phasing it out from a lower income level than was previously the case.

Fostering the development of part-time employment

- Ease regulation by allowing employers fewer grounds for refusal of part-time work and granting a right to automatically revert to full-time employment.

Reforming family policies to enhance women's labour market participation

- Overhaul family policies by significantly reducing the length of post-maternity parental leave and re-orienting public spending from cash benefits and tax expenditures towards the development of high-quality early childhood education and services for children aged under three.

Improving labour market integration of disabled working-age population

- Implement the plan to redirect disability pensioners aged below 57 back to the labour market, but design a comprehensive activation strategy based on extended training, skills upgrading and pre-employment support for people losing eligibility rights.
- Consider contracting out to the private sector the provision of reemployment services, supported by an outcome-based funding mechanism.

Remedying youth non-employment by reforming the education system

- Continue to raise educational attainment and diversify educational pathways by alternating study and on-the-job training through apprenticeship programmes and compulsory internships.

Promoting the participation of the elderly

- To sustain labour productivity, promote the development of lifelong learning starting at mid-career and ensure its persistence by creating individual learning accounts and enhancing take-up incentives of low-skilled and low-educated workers through public subsidies (vouchers and individual allowances).

Tackling the problem of the labour market exclusion of the Roma

- Raise Roma's youth educational outcomes by increasing their participation in high-quality pre-school education, postponing early tracking, and providing learning support for children lagging behind.
- Encourage the mixing of Roma and non-Roma pupils across and within schools.
- Merge vocational training schools with vocational secondary schools.

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