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**The Jobs Challenge  
in Poland: Policies to Raise  
Employment**

**Andrew Burns,  
Przemyslaw Kowalski**

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## **ABSTRACT**

### **THE JOBS CHALLENGE IN POLAND: POLICIES TO RAISE EMPLOYMENT**

by Andrew Burns and Przemyslaw Kowalski

With almost 50 per cent of the working age population not working, improving labour market performance represents an essential and daunting challenge for Poland. While some of today's joblessness is cyclical in nature, most of it appears to be structural. This paper argues that to increase employment levels policy will need to focus on reducing significantly the inactivity traps inherent in the Polish personal transfer system, while improving the efficiency and targeting of social transfers to ensure resources flow to those truly in need. Simultaneously, efforts must be extended to increase firms' propensity to hire the out-of-work, by lowering the costs of low-skill labour, reducing associated administrative and regulatory costs and in the longer term by providing graduates with more relevant skills. This paper outlines reforms in each of these areas which, if implemented, would serve to reverse the recent decline in employment and improve the fairness of income distribution, thereby reducing poverty, raising the rate of growth of incomes, and speeding economic convergence with the rest of the OECD.

Key words: Poland, labour market policies, personal transfer system, labour costs, active labour market policies, flexibility of working rules, education

*JEL Classification:* E24, H52, J20, J21, J22, J23, J24, J26, J31, J32, J65, O52, O57

### **LE DÉFI DE L'EMPLOI EN POLOGNE : POLITIQUES EN FAVEUR DE L'EMPLOI**

par Andrew Burns et Przemyslaw Kowalski

Alors que près de 50 pour cent de la population d'âge actif est sans emploi, améliorer les performances du marché du travail représente pour la Pologne un formidable défi. Une partie du non-emploi est certes conjoncturelle mais, pour l'essentiel, c'est un phénomène structurel. L'idée développée dans cette étude est que, pour élever le niveau de l'emploi, il faudra s'attacher à réduire notablement les pièges à l'inactivité liés au système des transferts sociaux en Pologne, tout en améliorant l'efficacité et le ciblage des transferts de façon que les flux de ressources aillent vers ceux qui en ont véritablement besoin. Parallèlement, il faudra redoubler d'efforts pour inciter davantage les entreprises à embaucher les personnes sans emploi, en abaissant le coût de la main-d'œuvre peu qualifiée, en réduisant les coûts administratifs et réglementaires connexes et, à plus long terme, en orientant les étudiants vers des qualifications plus pertinentes. Cette étude présente des réformes dans chacun de ces domaines qui, si elles étaient mises en œuvre, aideraient à enrayer le récent déclin de l'emploi et amélioreraient l'équité de la distribution des revenus, contribuant, par là même, à réduire la pauvreté, intensifier la progression des revenus et accélérer la convergence économique avec le reste de la zone de l'OCDE.

Mots clés : Pologne, marché du travail, transferts sociaux, coûts salariaux, politiques actives concernant le marché du travail, enseignement

Classification JEL : E24, H52, J20, J21, J22, J23, J24, J26, J31, J32, J65, O52, O57

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## THE JOBS CHALLENGE IN POLAND: POLICIES TO RAISE EMPLOYMENT

by

Andrew Burns and Przemyslaw Kowalski<sup>1</sup>

1. With only slightly more than one in two Poles of working-age employed and an unemployment rate of 19 per cent, improving the functioning of the labour market is a top economic and social priority for Poland. To increase employment levels policy will need to focus on reducing significantly the inactivity traps inherent in the Polish personal transfer system, while improving the efficiency and targeting of social transfers to ensure resources flow to those truly in need. Simultaneously, efforts must be extended to increase firms' propensity to hire the out of work, by lowering the costs of low-skill labour, reducing associated administrative and regulatory costs and in the longer term by providing graduates with more relevant skills. Finally, product-market reforms are required to raise investment rates and thereby stimulate overall demand for labour. This paper outlines reforms in each of these labour-market areas, which if implemented, would serve to reverse the recent decline in employment and improve the fairness of income distribution, thereby reducing poverty, raising the rate of growth of incomes, and speeding economic convergence with the rest of the OECD.

### **Social benefits, unemployment insurance, poverty and employment**

2. To improve the functioning of labour markets and job creation, policy needs to focus on three issues: 1) reducing the unemployment and poverty traps associated with current benefit systems; 2) targeting more effectively social transfers; 3) eliminating administrative and regulatory distortions that favour non-employment, low-productivity agricultural work and involvement in the underground economy.

### ***Personal transfer systems***

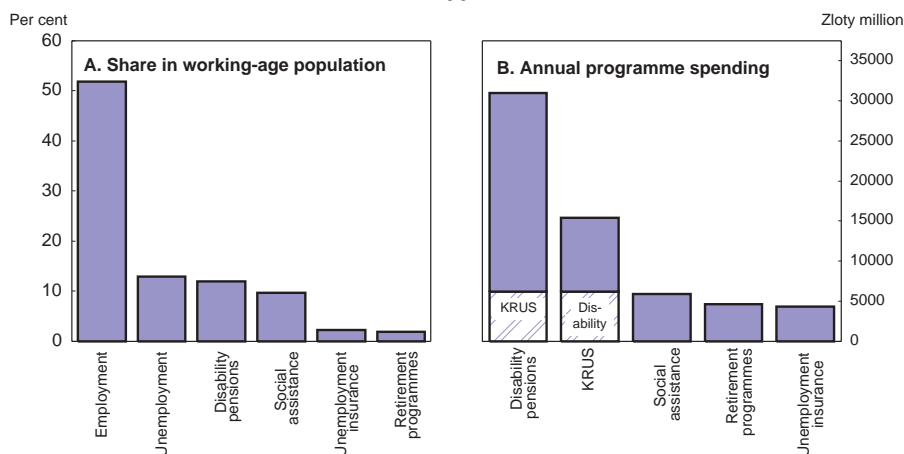
3. Abstracting from old-age pensions, about one in 5 Poles of working age receive some form of social transfer. The most important social benefit schemes in Poland are the disability pension system and the special farmers' social insurance programme (KRUS) - both in terms of expenditures and beneficiaries. Spending on disability programmes equals about 3½ per cent of GDP and although access to benefits has been restricted in recent years, beneficiaries represent 13 per cent of the working-age population or 25 per cent of employment (Figure 1). The economic consequences of the non-disability components of the KRUS system are less easy to measure. KRUS offers to individuals associated with a farming household virtually the same benefits (and more) as the general system, but at a 95 per cent rate of subsidy. As such it serves as a potent incentive for individuals to remain in low-productivity agricultural work and explains to

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1. At the time of drafting this paper both authors worked in the OECD Economics Department. An earlier version of this paper served as an input into the 2004 *OECD Economic Survey of Poland*. The authors are particularly grateful to Agnieszka Chlon-Dominczak for her valuable insights and generosity in sharing her in depth knowledge of Polish labour markets. In addition, the authors would like to thank the many other Polish officials, experts and academics, too numerous to list here by name, who shared their knowledge of Polish labour market with a similar spirit of generosity and patience. The authors are also indebted to colleagues in the OECD Economics Department, in particular Jean-Philippe Cotis, Val Koromzay, Andrew Dean, Willi Leibfritz and Stéphanie Jamet, for useful comments and drafting suggestions. Special thanks go to Roselyne Jamin for technical assistance and Nadine Dufour and Chrystyna Harpluk for assistance in preparing the document.

a significant degree why over 30 per cent of the Polish population remains in rural areas. Moreover, it helps explain why measured agriculture employment represents as much as 19 per cent of total employment, even though the sector produces less than 3 per cent of GDP. In contrast to these two programmes, social assistance and unemployment insurance programmes are small both in terms of spending levels and the number of beneficiaries. Moreover, as described below, they are not as generous, are relatively well targeted and generate smaller work disincentives. The following paragraphs provide some detail on the various systems and conclude with a discussion of the authorities' current reform plans and some recommendations as to how these could be extended.

**Figure 1. Relative importance of different personal transfers**  
2002



Source: Central Statistical Office and OECD.

#### *The disability systems and premature labour-market withdrawal programmes*

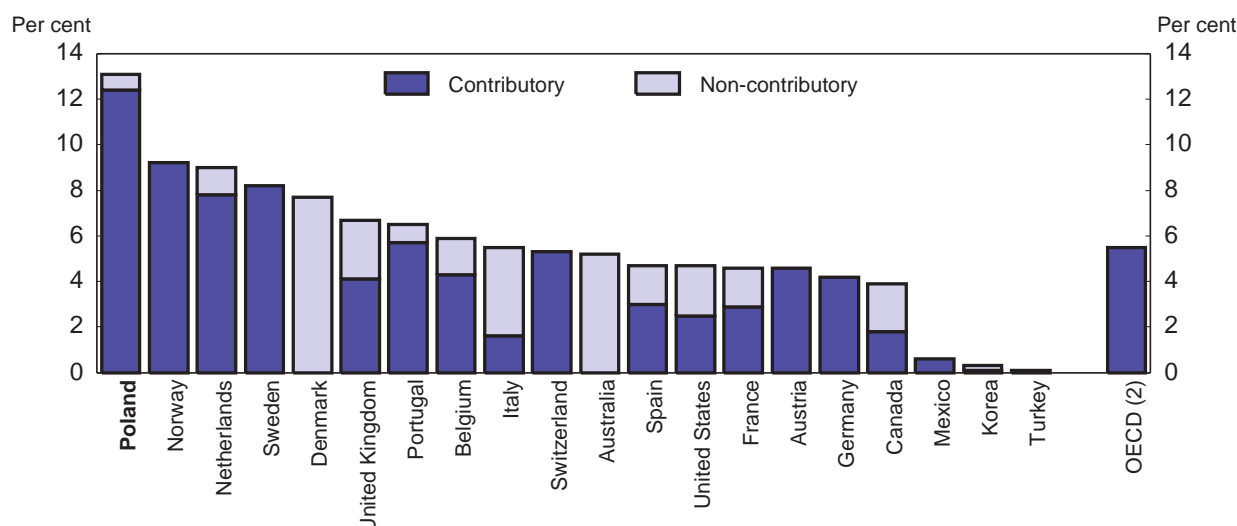
4. As of 2002, over 2.4 million people were receiving a disability pension, about half of which were in the form of permanent disability pensions (Box 1). The share of working-age persons receiving a disability pension, 13 per cent, is by far the highest in the OECD - more than double the modal level of 6 per cent (Figure 2). Assuming that the distribution of disability in Poland is roughly similar to that in other OECD countries, this suggests that as many as two-thirds of disability pensioners are using the system as an early-retirement scheme. Indeed, the share of the working-age population that is both disabled and working is roughly the same in Poland as in the rest of the OECD - but the share of non-working pensioners is more than three times as high.<sup>2</sup> Although the value of the average pension has been reduced from 51 to 47 per cent of the average wage between 1995 and 2002, net income from it can be twice as high as that associated with a minimum wage job. As such it represents an attractive source of unearned income especially as it is legally possible to work while receiving the pension.

2. Only 20 per cent of Polish disability pensioners work as compared with 45 per cent in the rest of the OECD (OECD, 2003). However, given the higher incidence of disability pensioners expressed as a per cent of the population the incidence of work and disability pension receipt is about the same in Poland and the rest of the OECD, 2.6 per cent. On the other hand, the share of the population receiving a disability pension and not working (10.4 per cent in Poland) is 3.2 times as large as the share in the OECD as a whole, 3.3 per cent.

### Box 1. The disability pension schemes

**Disability pension systems** are operated by the State social insurance institution (ZUS) and funded by the social insurance fund (FUS) and the special farmers social insurance fund (KRUS). Disability pensions can only be authorised by a doctor and, since 1997, are awarded on the basis of an individual's physical incapacity to work. Beneficiaries must have at least 5 years of insurance (contributory and non-contributory combined) unless the beneficiary is under 30 and the disability must arise while the individual is employed, unemployed or in the 18 months following employment. The benefit is equal to that of an old-age pension under the old system, except in the case of a partial disability in which case it is  $\frac{3}{4}$  of that amount. In 2002, there were 3.2 million people on disability pensions or 14 per cent of the working-age population, the highest incidence of disability pension in the OECD by a factor of two. Of these 2.4 million were receiving a pension from the general ZUS system and 0.8 million from the special system. As concerns the ZUS system, more than 50 per cent of disability pensioners are between 40 and 55 years of age. Within this age group, 18 per cent of the population is benefiting from a disability pension. Approximately half of disability pensions are permanent.

**Figure 2 Disability benefit reciprocity rate<sup>1</sup>**  
Percentage of population 20-64, 1999



1. Data are corrected for persons receiving both contributory and non-contributory benefits, except for Canada (unknown).
2. Average of contributory and non-contributory benefits for the 20 OECD countries for which data are available.

Source: OECD database on programmes for disabled persons.

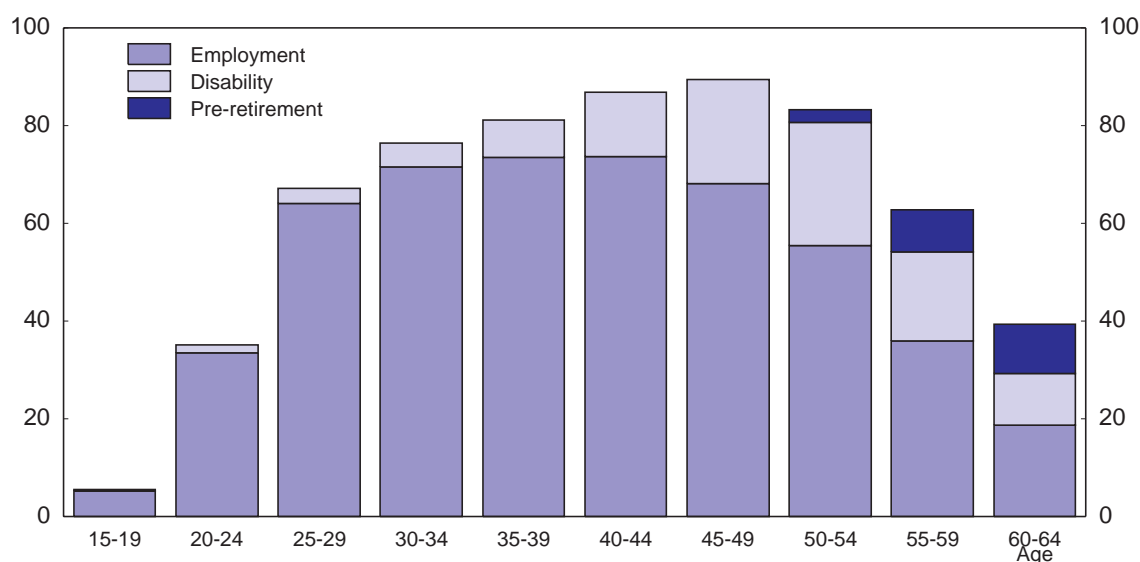
5. Recent steps to restrict access to the disability system have succeeded in reducing inflows by requiring beneficiaries to visit approved doctors and by introducing a more restrictive approach to granting permanent disabilities. This tightening of the system has contributed to a 300 thousand person decline in the stock of disability pensioners from its peak in 1997. As a result, inflow rates have fallen substantially at least for the ZUS system (Table 1). Nevertheless, the stock of disability pensioners remains very high and unless steps are taken to re-evaluate individuals already receiving disability pensions future declines in the stock of disability pensioners are unlikely to be sufficient to overcome the distortions the system currently imposes on the labour market.

**Table 1. Age specific disability benefit inflow rates**  
1999

	Inflows per 1 000, by age group				
	20-34	35-44	45-54	55-59	60-64
Australia	3.2	5.1	8.6	17.7	14.6
Austria	0.7	2.2	9.5	34.9	5.1
Denmark	1.6	3.1	7.0	11.1	11.1
Germany	0.6	2.3	6.9	18.5	16.6
Mexico	0.0	0.1	0.3	0.7	4.1
Netherlands	8.3	11.6	15.6	12.0	12.5
Norway	3.3	8.5	18.2	36.9	60.0
Poland (1999)	1.6	7.1	18.1	11.7	2.7
Poland (ZUS only, 1999)	1.6	6.8	14.5	8.5	2.2
Poland (ZUS only, 2003)	0.9	3.0	6.3	4.1	1.4
Portugal	1.2	2.0	7.7	19.8	30.5
Sweden	1.9	5.0	9.6	19.8	31.6
Switzerland	2.4	4.4	8.5	14.1	12.4
United Kingdom	9.7	12.4	17.8	22.3	11.8
United States	2.7	4.5	7.8	13.9	12.8
OECD (13)	3.0	5.1	9.8	18.5	18.6

Source: Ministry of Economy, Labour and Social Policy, OECD database on programmes for disabled persons.

**Figure 3. Population shares of the employed and disability and pre-retirement pensioners**  
Per cent



Source: Central Statistical Office, Ministry of Economy, Labour and Social Policy; and OECD.

6. In addition to the disability pension system Poland operates two separate early-retirement programmes, *early-retirement pensions* offered by the social insurance fund and *pre-retirement benefits*

offered by the unemployment insurance scheme (Box 2). For individuals between 45 and 65 years of age, enrolment in these two programmes represents more than one third of total employment (Figure 3). Currently, there are 400 000 individuals receiving these benefits, the after-tax level of which can exceed the minimum wage<sup>3</sup> - making them attractive for less skilled individuals. Moreover, inflows into the programme have been rapid, with the share of individuals receiving such benefits reaching about 10 per cent of the eligible population in three years. The authorities have moved to reduce the disincentive effects of these benefits by allowing beneficiaries to combine income from other sources (including work) with receipt of the benefit. Under the new rules combined benefits and earnings can reach twice the minimum wage before the benefit is entirely extinguished. While this reform increases employment incentives substantially, it would appear to introduce an important moral hazard that could encourage individuals to leave employment so as to qualify for the benefit and then take on work to increase overall income.

#### **Box 2. Other labour force withdrawal schemes**

**Separate early-retirement and pre-retirement programmes** are operated by ZUS and labour offices respectively. The ZUS programme is available to workers in certain "difficult" professions, among which teachers, miners, and steel and railway workers. This system is set to expire in 2006. The pre-retirement programme is available to unemployed individuals with 20 years or more work experience who are 58 (women) or 63 (years of age). Individuals who are unemployed for "economic" reasons with at least 6 months in their last job and 35 (women) or 40 (men) years job tenure qualify as of age 50 (women) or 55 (men). It is also available to unemployed former employees of state farms over 50 years of age (55 for men), having worked at least 20 years for a state farm living in a region with high unemployment. The amount of the pre-retirement pension is set at 80 per cent of the amount the individual's old-age pension but cannot be less than 120 or more than 200 per cent of the unemployment insurance benefit. In 2002, there were some 500 000 individuals receiving such benefits.

#### *Farmers pension system*

7. The special farmers social insurance system was set up towards the end of the 1970s. It was seen as a mechanism of social cohesion, providing often very poor farmers with the same level of pension and other social benefits as individuals subscribed to the general system (ZUS), but for a much lower fixed fee. While it probably made the early phases of the transition easier it has contributed significantly to slowing the pace of restructuring in rural areas. Moreover, its special provisions, by offering a substantial implicit subsidy to individuals involved in agricultural and rural employment (see Box 3), have hobbled labour market adjustment and contributed to substantial employment and poverty traps, which go part of the way to explaining the very low rates of agricultural productivity. Rather than being a temporary transition measure, the KRUS has become a permanent source of dependency and membership has actually increased 15 per cent since 1996.

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3. The legal limit is twice the minimum old age pension, which as indicated in Figure 3.13 exceeds the minimum wage.

**Box 3. The special farmers pension system (KRUS)**

**The special farmers pension system (KRUS)** offers farmers and their extended families a range of social insurance benefits (health, sickness and accident insurance, old-age and disability pensions) roughly comparable to those offered by the general regime (ZUS).

The KRUS system differs from the ZUS system in several respects:

To be eligible for benefits an individual must be:

a farmer owning at least one hectare of land, or

a member of a such a farmer's household who derives his or her income from farming, or from a non-farm activity nevertheless related to the agricultural land, or

be inactive and a dependent of a qualified farmer.

Old age and disability pension contributions are 165.8 zloty per quarter per member of the household and sickcare and workman's compensation contributions are 54 zloty – less than  $\frac{1}{3}$  of the contributions that would be paid by a minimum wage earner in the general system.

Members of the household who work off the farm must pay into the general pension system but receive health insurance as a result of their association with the KRUS system and therefore do not need to pay health insurance premia.

Eligible individuals whose farm is less than 2 hectares do not have to pay contributions to the unemployment benefit system but are eligible for benefits.

The range of benefits in the farmers' system are generally lower than in the general system but high relative to contributions. As a result, the farmers' system operates a large deficit. Since 1996, registration in the system has been increasing each year - having increased by 15 per cent since that time. In 2002, all told KRUS spending amounted to 2.1 per cent of GDP in 2002, with contributions covering only 5 per cent of this amount.

*Unemployment benefit system*

8. The unemployment benefit system is financed, along with active labour market programmes, by a payroll tax equal to 2.45 per cent of the gross wage bill of a company, which is used, in combination with transfers from the State Budget to maintain the Labour Fund.<sup>4</sup> Eligibility is limited to individuals having been under contract for 365 days (including holidays and weekends) in the previous 1½ years. Benefit levels are independent of previous income but depend on life-time work experience. Maximum duration ranges from 6 to 18 months depending on regional unemployment rates (see Box 4). Overall spending levels on unemployment insurance are low and as a result of the rising incidence of long-term unemployment only 15 per cent of the unemployed were receiving benefits during 2003. Nevertheless, because the level of benefits depend on one's employment duration, not salary, replacement rates for the low-skilled can be very high (see Figure 3.6 below).

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4. The unemployment insurance scheme's share in them is 2.45 percentage points.

#### Box 4. The unemployment insurance and social assistance systems

**The unemployment system** provides short-term revenue replacement to jobless individuals, independent of their means. Unemployed individuals having worked 365 days in the preceding 18 months are eligible for UI benefits, the amount of which are independent of previous earnings but increases as a function of life-time work experience. Net of tax, benefits equal 62, 77 and 90 per cent of the minimum wage for someone with less than 6, between 6 and 20 and more than 20 years work experience. Including additional housing benefits to which the unemployed are entitled, replacement rates increase to 82, 106 and 120 per cent for individuals with similar work histories. Maximum benefit durations depend on regional unemployment rates, ranging from 6 to 18 months (in regions where the unemployment rate is twice that of the country average). Recent school leavers who are without work are also entitled to benefits equal to those of unemployment insurance benefits, subject to the same regionally-based duration rules. The rising incidence of long-term unemployment and short employment histories among new job seekers means that in 2003 only 15 per cent of the unemployed were receiving benefits.<sup>1</sup> Spending on benefits represents more than half of all labour market programme spending, but, at 1 per cent of GDP, it is much less than spent by other OECD countries.

**The social assistance system** comprises three basic forms of assistance: income-tested temporary benefits, which are available to individuals independent of labour market status; permanent income-tested benefits available to single parents; and means-tested specific benefits to pay for special costs. The temporary and special benefits are time-limited with benefit duration typically not exceeding 5 months and averaging less than three months. Taken in combination with the housing benefit, replacement rates for a minimum wage earner are about 54 per cent – although for single parents they approach 70 per cent. In 2002, on average there were some 400 000 social assistance beneficiaries or 2.8 per cent of total employment.

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Chlon-Dominczak *et al.* (forthcoming).

#### *Other social assistance schemes*

9. The various social assistance programmes in Poland are also described in Box 3.4. As indicated earlier, total spending on these transfers is limited and, by and large, they are well targeted on the poorest households. A notable exception is the family or survivor's pension, both the absolute value of which and its share in household revenues rises with income levels.

#### *The transfer system considered as a whole*

10. Overall, the benefit system tends to be relatively poorly targeted. The extensiveness and relative generosity of the disability pension system and the limited resources provided to the social assistance schemes means that state-financed income redistribution is mainly being accomplished through the extended family, with old-age and disability pensioners of the general (ZUS) and special farmers (KRUS) social insurance schemes supplementing household earnings with their pensions.<sup>5</sup> Only 12 per cent of the public transfers received by the poorest 10 per cent of households come in the form of social assistance.<sup>6</sup> Moreover, the principal source of income for 80 per cent of the non-employed derives from other sources (Figure 4). Excluding old-age pensions the transfer system is redistributive in the sense that transfers

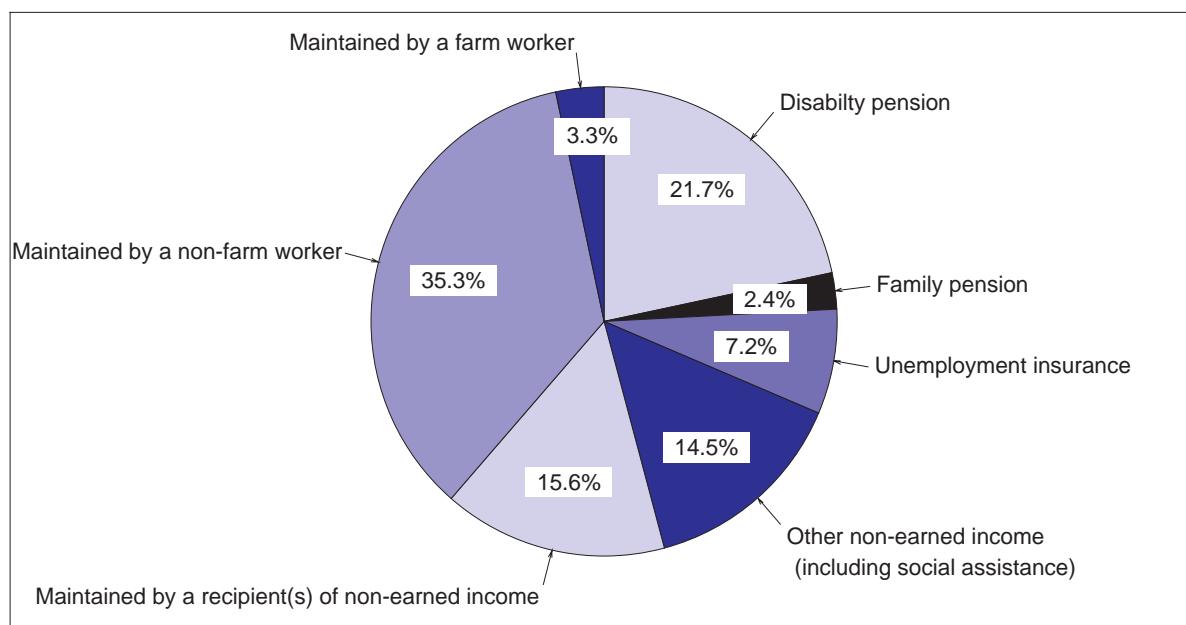
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5. Indeed, 80 per cent of cash transfers are in the form of old-age, disability and family pensions as compared with only 2 per cent in the form of social assistance benefits.

6. Permanent and temporary social assistance payments as a share of total transfers, including old-age pension.

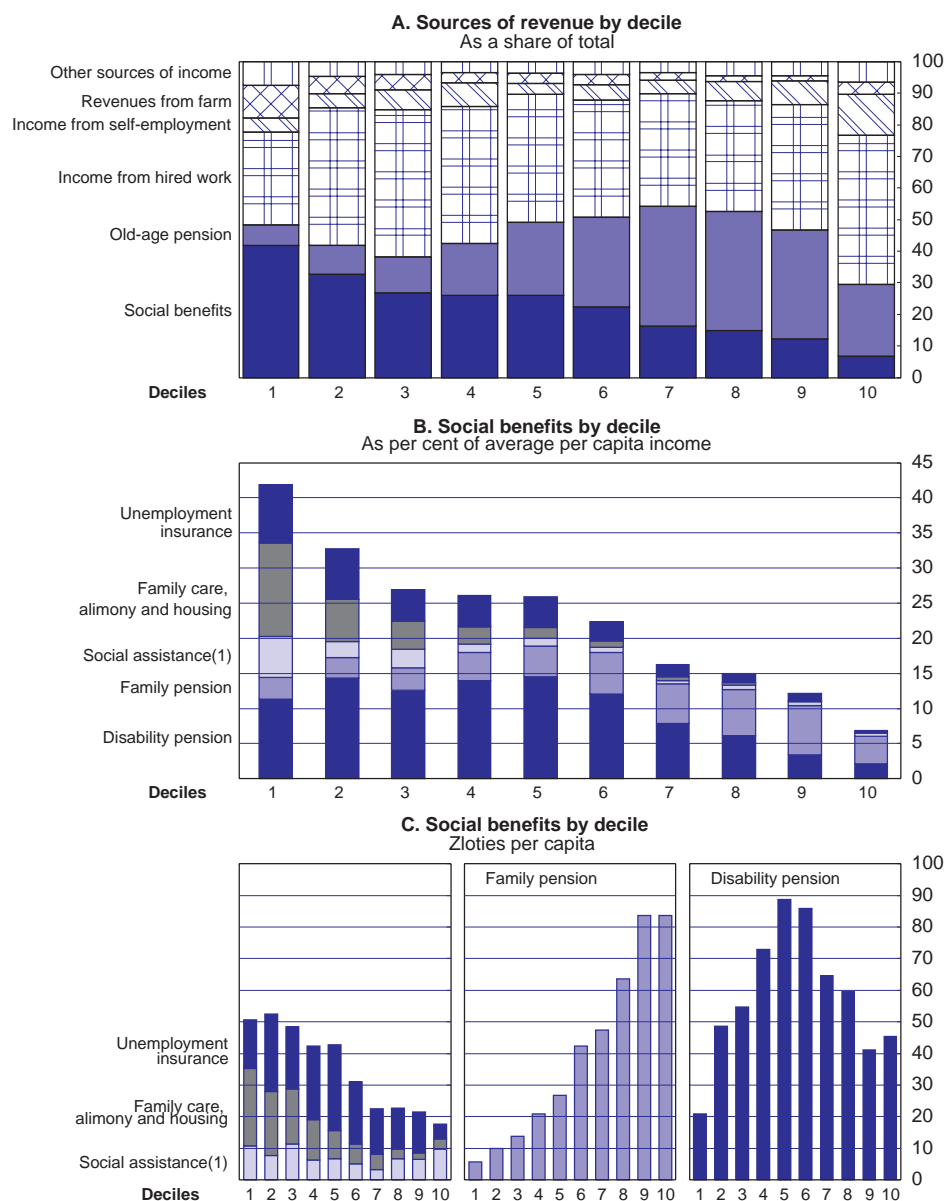
represent a larger share of household income for lower deciles than for high deciles (Panel B, Figure 5). However, in terms of per capita transfers, the reverse is true with wealthier households receiving substantially more than poorer ones. Here, the major culprits are so-called “family pensions” or survivor’s pensions and the disability pension system (Panel C, Figure 5). The main social assistance programmes,<sup>7</sup> while consuming much less in terms of resources, are better targeted on the poorest households.

**Figure 4. Income sources of the non-employed**  
2000



Source: OECD, calculated on the basis of data in Table 2.7 of Pietka (2002).

7. Permanent and temporary social assistance allowances, family care, alimony and housing allowances and to a lower extent unemployment insurance.

**Figure 5. Social transfers and the distribution of income**

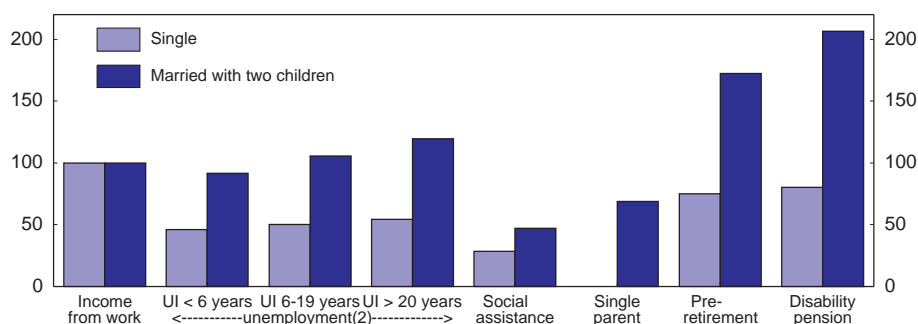
1. Permanent and temporary allowances plus other transfers.

Source: Central Statistical Office, 2002 Household Budget Survey, and OECD calculations.

11. Not only do most benefits accrue to the richest households, they are concentrated in precisely those transfers that generate the most important labour market distortions. Like the pre-retirement scheme, permanent disability pension benefit durations are unlimited and can be extended without limit in the case of temporary pensions, while net replacements are close to 200 per cent as compared with a minimum wage job (Figure 3.6) - greatly reducing financial incentives to take up work. Replacement rates in the unemployment insurance and social assistance programme are significantly lower (and in the case of social assistance means-tested), while benefit durations are time-limited, reducing their impact on work incentives. Nevertheless, with after tax replacement rates close to 100 per cent, unless these systems are also reformed, their benefits will appear much more attractive following a tightening of the disability

system and they may take that scheme's place as the most important source of dependency traps., The labour-market impacts of the disability and KRUS systems extend beyond their direct beneficiaries because of benefit sharing. The problem is especially serious within the KRUS system, where the opportunity cost for an individual leaving the farm and taking employment in an urban environment should also include the costs to members of his or her household that are non-working or working in the underground economy but who are dependent on his or her KRUS membership for access to health-care and unemployment benefits.

**Figure 6. Net replacement rates<sup>1</sup>**  
Per cent of minimum wage, 2003



1. Replacement rates are calculated including other social benefits, such as a 160 zloty housing benefit and family benefits for households with children.
2. Pre-tax unemployment insurance benefits vary with the life-time work record of the beneficiary, rising from 49 per cent of the minimum wage for someone with less than 6 years of experience to 73 per cent for someone with 20 or more years of experience.

Source: Statistical Office and OECD.

### *Improving the effectiveness of personal transfer spending*

12. Reforming Poland's personal transfer system will not be easy politically. The existing transfer system has created a serious dependency trap for a large and politically important share of the population. However, improving labour market performance is more than an option for Poland - it is a clear social and economic necessity. The rapid fall in employment levels during the recent growth slowdown has brought into sharp relief the weaknesses of existing institutions. Indeed, Golinowska *et al.* (2003) provide estimates that in some regions social and family assistance levels are such that a large proportion of those, out of work would not accept a job offer unless the wage were significantly higher than the average wage - let alone the minimum wage. These kinds of results, and the evidence from the past decade and a half, suggest that unless steps are taken to provide the 50 per cent of the working-aged population that are currently not participating in the formal economy with both opportunities (see Chapter 4 for policies in this regard) and financial incentives to take up work, Poland may continue to plod along in a low-growth, low-employment equilibrium.

13. The authorities recognise the need for fundamental reform and have recently proposed a wide range of changes designed to reduce the distortions caused by the transfer system (see Box 5). In this context, the proposed Public Expenditure Reform, which encompasses many of these changes, constitutes a critical first step in the reform process. Overall, the proposed reforms are ambitious as befits the seriousness of the problem in Poland. The following paragraphs attempt to present them and propose some additional complementary measures that, if implemented, would further improve outcomes.

**Box 5. Labour market reforms currently under consideration by the Polish authorities**

The authorities are currently considering a number of reforms which, if implemented, could have a substantial impact on labour markets. The most important of these call for:

**Disability pensions**

- A rationalisation of the number and categories of disability and associated pensions
- A dramatic reduction in the stock of disability pensioners and a return to a system whose benefits are dependent on his or her past earnings and more clearly related to the extent that a physical disability limits a workers earning potential
- The automatic transfer from disability to the less generous old-age pension scheme of individuals having reached retirement age (currently, almost 1/3 of disability pensioners)
- A one-time re-evaluation of all disability pensioners below the age of 55 for men and 50 for women who have been receiving a pension for less than 10 years or who have ever worked.
- Introduction of a requirement that temporary-disability pension beneficiaries be re-examined at least once every 5 years, and a strengthening of monitoring systems.
- A proposal to realign benefits with individual's earning potential

**The Farmers' pension system (KRUS)**

- Redefinition of eligibility criteria
- Reduction of the differences in the premiums and benefits as between the KRUS and ZUS systems, implying a reduction in benefit levels and an increase in contribution rates to the KRUS system
- Introduction of contribution subsidies for those with lower earnings
- Elimination of misuse within the system
- Elimination of associated early-retirement programmes
- Creation of a rehabilitation allowance to help farmers return to work after prolonged periods of sickness

**Unemployment benefit system**

- Replacing the dependence of unemployment benefit duration on regional unemployment rates with a length of work criteria
- Reducing the unemployment insurance benefit and introducing a temporary job-finding benefit equal to half the unemployment insurance benefit to be paid to beneficiaries who find work, with the length of this benefit to be linked to the duration of the contract.

**Social assistance system**

- A reallocation of some of savings from reforms to the disability system to bolster targeted social assistance spending

- A revision and harmonisation of criteria for family benefits and a streamlining of their financing
- A reduction in sick leave compensation to 70 per cent of wages.

Old-age pension system:

- Gradual equalisation of the retirement age of women with that of men (65)
- The replacement of automatic indexation of old-age pension benefits social benefits with a system of periodic increases approved by parliament triggered by a 5 per cent cumulative increase in the consumer price index
- Leveling of retirement age across occupational groups with earlier retirement ultimately restricted to cases where continued work would endanger an employee's health. In such cases an additional optional insurance fee would be assessed on firms to encourage them to diminish unhealthy positions
- Gradual elimination of the existing pre-retirement benefit system by 2006
- Introduction of special activation programmes aimed re-integration of older workers into the labour market
- Introduction of a partial retirement pension with part-time work from age of 62.
- Restriction of access to survivor's pensions in most cases to individuals who have already reached retirement age

14. The proposals for reform of the disability system outlined in Box 5, are far reaching and go in the right direction. Nevertheless, much more is required. Indeed, the potential benefits from bringing the disability pension scheme under control are large. Reducing the stock of beneficiaries by restricting benefits to those truly physically unable to work could save as much as 2 per cent of GDP in government spending.<sup>8</sup> Furthermore, a reassessment of benefit levels taking into consideration individuals' earnings potential before and after the disability could generate additional savings. However, achieving a substantial reduction in disability pensioners will not be easy, either technically or politically. Given the number of people involved and the extended period of time they have been out of work, it will be important to ensure that any reform includes measures to ease the transition of these people back into the labour force. Here, four principles, elements of which are included in current proposals, might be worth including in the reform:

1. Increase dramatically the strictness of eligibility requirements for the disability system and re-evaluate existing beneficiaries with an eye to rapidly bringing the stock of disabled pensioners down to OECD average or best practice levels.
2. Simultaneously introduce a time-limited and means-tested post-disability-pension social-assistance benefit coupled with a strict job-search obligation to ensure that those removed from the disability rolls are provided with income support during their transition back to activity.
3. Ensure that benefit levels in this programme are adequate to provide for individuals needs but that they do not constitute a serious barrier to employment at the minimum wage.

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8. Disability pension expenditures in 2002 represented 4 per cent of GDP. Assuming that the incidence of true physical disability in Poland is the same as in other OECD countries, then the number of pensioners and the level of spending could likely be reduced by more than 50 per cent.

4. Make greater use of in-work benefits and earned-income tax credits to increase financial incentives to take on work and increase active labour market measures to support insertion.

15. The reform of KRUS currently being discussed by the authorities seeks to redesign the system's benefits and contributions. Existing arrangements impede labour market mobility between the agricultural and non-agricultural sectors and prompt mis-use of the system by inducing individuals to participate in underground activities or remain in low-productivity agricultural or rural activities. As part of their reform efforts, the authorities are considering replacing the flat-rate contributions in the current system with a combination of a flat rate and a contribution that increases with income. Depending on implementation, this could serve to equalise the overall contribution rates of the KRUS and ZUS systems, thereby eliminating the substantial implicit subsidy that the current system affords rural-based and agricultural work. Not only would such a reform bring in much needed revenues it would be much more equitable both as concerns the treatment of farmers and non-farmers (currently the implicit per capita subsidy of the KRUS system is 7 times that of the general system). Indeed, a reform that equalised contributions with those of the ZUS system would imply no or very little net increase in contributions for poor farmers.

16. Reform efforts should not stop here however. Once equality in terms of benefits and contributions is established between the ZUS and KRUS systems, the need for special eligibility rules for the KRUS system based on land ownership and the nature of one's activity will be gone and should be dropped.<sup>9</sup> By encouraging individuals to retain uneconomically small farms, these rules have prevented the consolidation of the agricultural sector. As a result, the majority of farms do not earn enough of a surplus to finance the kind of investments and expansions that would allow agricultural productivity to increase. Not only does this condemn farmers to continued poverty, it is holding back rural development and diversification. It is only as agricultural productivity and incomes increase that a sustainable demand for rural services will arise that could support non-agricultural rural activities and employment that would yield acceptable standards of living. Proposals to grandfather existing farmers rights to the system, independent of whether they continue to hold land is a step in this direction, which should both promote mobility and permit a more socially acceptable transition towards a more equal system.

17. Finally, more needs to be done to equalise treatment under the two systems and thereby eliminate the incentives for members of farmers' extended families to remain on the farm, even though earnings opportunities are limited. In order to eliminate the incentive deriving from the extension of health insurance coverage to all members of farming household, health coverage should be made universal (see OECD [1999, 2002a] for more detailed discussions of the health system) and financed from general revenues.<sup>10</sup> Such a move would require raising the take from either the VAT or personal income taxes. It could be coupled with the elimination of ownership requirements and the equalisation of the contribution rates between the ZUS and KRUS system for individuals whose principal earnings come from non-farm work so as to promote labour mobility. As indicated below, if combined with a reduction in the associated social security contributions, such a reform would lower labour costs and boost employment prospects, particularly for the low-skilled.

18. The public expenditure reform programme includes several proposals to change the unemployment insurance system. Among these, the proposal to eliminate the dependence of benefits on regional unemployment rates would, if implemented, help to reduce the system's tendency to perpetuate

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9. Indeed, the current definition of what constitutes an eligible activity are relatively vague and contribute importantly to the sense that the system is being abused by those for whom it was not intended.

10. OECD (2002) provides additional arguments in favour of such a step. The VAT has the advantage of being relatively easy to collect and covering a wide tax base. The personal income tax system on the other hand, if amended to increase its progressivity, would offer the possibility of reducing the overall tax wedge on low-skilled workers.

non-employment in disadvantaged areas. Incentives to accept work would be further enhanced if benefit levels were made to reflect individuals' previous earnings. Such a step would reduce work disincentives for low-wage workers with long careers for whom a high fixed unemployment insurance benefit, combined with housing benefits, results in an after-tax benefit 20 per cent higher than the minimum wage (see Figure 8). Similarly, proposals to make benefit duration depend on work history could help increase incentives to take up work, but only if duration is made dependent on recent job history as opposed to an individual's lifetime work history. Combined with high replacement rates, increasing the duration of benefits for individuals with long work histories could create a serious poverty trap by encouraging the development of a dependency cycle, where workers with a significant work history effectively share jobs, working for 12 months followed by 18 months of inactivity during which they actually earn more than when working.<sup>11</sup> Finally, the idea to transform some of unemployment benefits into a temporary employment subsidy is an appealing reform that would help shift the balance of incentives towards activity, although the relative advantages of using funds in this way as compared with more targeted active measures should be evaluated.

19. The family pension or survivors benefit is something of a special case as its benefits combine a social insurance and a social assistance component. The benefit is extended to the families of disability pensioners who die. If one were to assume that the household were the production unit insured, then a survivor's benefit makes sense. However, the benefit, which ranges from 85-95 per cent of a full pension is out of line with generally accepted equivalency scales, which would provide for benefits ranging from 59-81 per cent of the original – depending on household size.<sup>12</sup> Here, plans to restrict access to these benefits to survivors of retirement age should help reduce labour market distortions and could generate substantial savings. In addition to adjusting the parameters of this benefit system, the authorities may wish to re-assess the overall usefulness of the funeral benefit (equal to 8 months unemployment insurance), the alimony fund and other benefits given Poland's overall capacity to pay and the seriousness of the social need being addressed. For the moment, limits on the duration of social assistance benefits and their low levels imply that they make little direct contribution to unemployment and poverty traps. However, their failure to address poverty effectively, both among the employed and the unemployed, has most certainly contributed to society's current reliance on other transfers.

### *Systemic reform*

20. Implementation of the above reforms would serve to improve work incentives and the number of individuals willing to accept work at wages commensurate with their productivity levels, helping to reinvigorate market adjustment mechanisms. However, if limited to these changes, they would also imply a substantial reduction in income support to poor Polish households. In order to ensure that appropriate levels of assistance are provided to the least fortunate without unnecessarily disrupting the functioning of labour markets, resources need to be transferred from pre-retirement and disability pensions to bolster targeted income support for those of working age. Given the state of public finances, this need not and should not imply additional spending.

21. Making social assistance an effective and employment-friendly mechanism for dealing with poverty will be an essential condition for any reform of the other transfer systems. What form assistance should take will depend importantly on the resources that are liberated to finance it. Nevertheless,

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11. Such forms of implicit job sharing have been observed in a number of communities, notably in Canada.

12. Based on the so-called OECD equivalency scale, which assumes a second adult adds 70 per cent to a household's expenditure, which a child 50 per cent as compared with a single adult. According to this scale, therefore, a two-person household receiving a 170 benefit could fall to 100 if one person were to die and a 3 persons (2 adults, one child) would fall from 220 zloty to 170 zloty while still preserving the same effective levels of income.

experience in other OECD countries suggests that support for the physically able who are not at work should be kept to a minimum, while resources are concentrated on programmes that support employment prospects and the incomes of the working poor. To maximize the probability that current beneficiaries reintegrate successfully into the labour market, care must be taken to avoid generating new benefit traps. As discussed below, programmes need to be put into place, which provide transitional income support on the basis of mutual obligations (especially for younger clients). Here, it will be important to make benefit receipt conditional on job-search and active participation in labour market policies (job-matching, training, work-experience placements). In exchange, the authorities should provide adequate job-search support. While some form of extended benefit might be imagined for former disability pensioners who have been out of the labour market for an extended period of time, such special aid should be time-limited and also subject to conditionality. In this context, a reduced minimum wage combined with an earned-income tax credit (see next section) could be an effective means of helping low-skill workers price themselves into the labour market and ensuring that low-skill households maximise their potential in the labour market. This would provide them with opportunities for personal advancement, while at the same time ensuring that their incomes meet social expectations.

22. In conjunction with the establishment of a better targeted social assistance scheme and earned-income tax credit, the pre-pension benefit scheme should be abolished, perhaps by initially scaling back benefits to levels less likely to interfere with work incentives for those already receiving benefits and by ceasing to accept new beneficiaries (as is being done for early-retirement pensions). Moreover, if so-called bridge pensions are to be introduced for certain professional groups who in the earlier system could retire early, then contributions should be increased for these individuals so as to retain the system's actuarial neutrality.

23. Experience with social assistance systems in other countries indicates that coherence in policy implementation among employment and benefit agencies is crucial. For the new system to work effectively, it is essential that employment authorities have (financial) incentives to carry out their employment re-integration task for social assistance clients. Here the separation of the PES system and financial responsibility for the unemployment insurance system could pose a problem. One solution might be for the Labour Fund to extend its current practice of sub-contracting job placement activities, perhaps allowing private providers to compete directly for a share in *poviat's* allotments. To further combat poverty traps, special efforts need to be extended to help individuals from disfavoured environments better themselves. Here resources might be redirected towards helping finance transportation and accommodation costs of secondary students from rural areas.

### **Improving job prospects of the out-of-work**

24. To improve employment prospects for youth and individuals with limited skills, policy needs to focus on three issues. In the near term, further efforts are needed focusing on reducing the labour cost of young and other low-skilled workers so that they can price themselves into the job market. The combination of high taxes, a relatively high minimum wage and strict employment protection rules prevents such individuals from overcoming the inherent risk that hiring inexperienced and untried workers represents to firms. Over the medium-term, policy needs to focus on improving the quality and relevance of the skills transmitted to new graduates. For those that have already finished formal education, resources need to be reallocated towards the implementation and evaluation of training and learning schemes that yield concrete results in terms of improved employability, wages and poverty reduction.

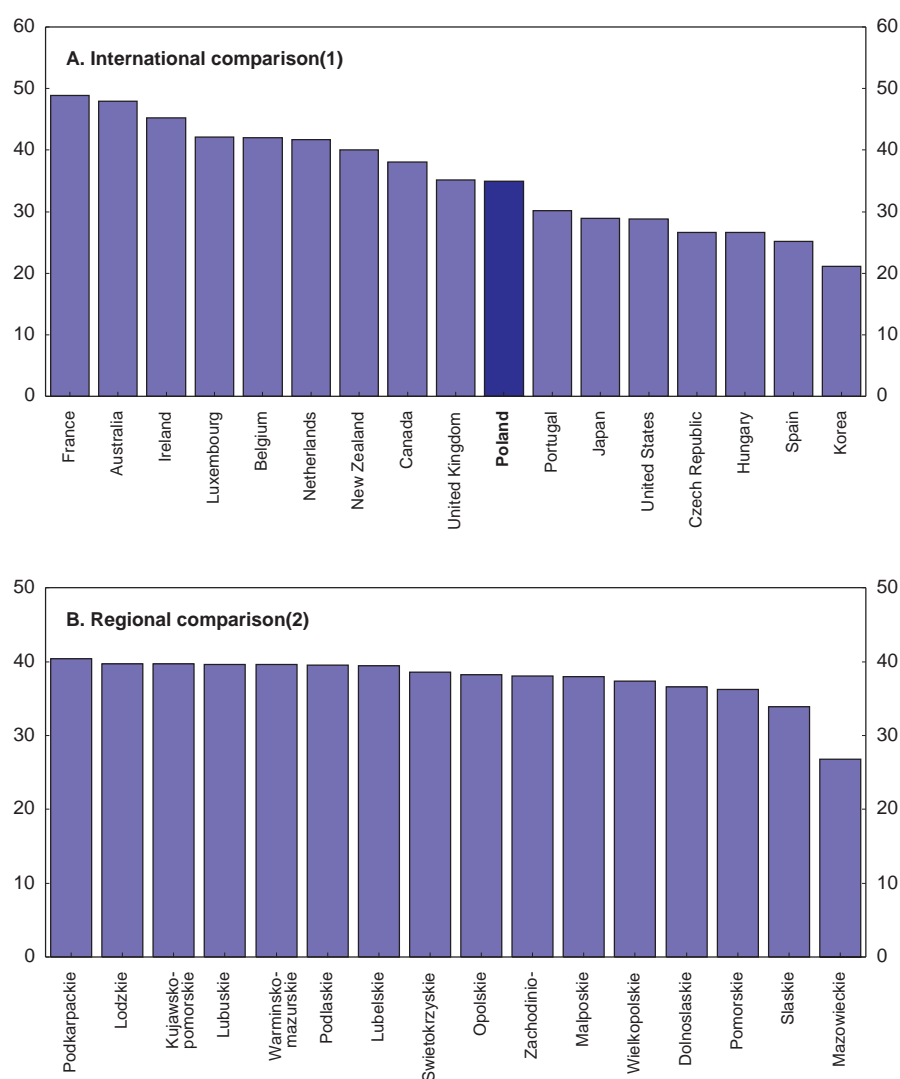
***Lower labour costs***

25. In order to address the high incidence of non-employment among all youth, even those with high educational attainments, policy needs to make young job-seekers more attractive as employees. Taking further steps to reduce the streaming and specific skills-orientation of the school curriculum would help improve the weak school-to-work transition (see below). However, efforts also need to be extended to reduce the labour cost of unskilled and inexperienced workers.

26. At 37 per cent of the average wage, the minimum wage is less high (in relative terms) than in some OECD countries (Figure 7), but on average 6½ per cent of employed workers are earning the minimum wage. However, in many regions, the minimum wage is much higher relative to average wages, making it particularly hard for job entrants, the low-skilled and the long-term unemployed to price themselves into the labour market. Indeed, in some regions, the incidence of minimum-wage work rises to between 20 and 25 per cent among employed youth and 40 per cent for those with low-levels of educational attainment (Figure 8). The coexistence of very high youth unemployment, the very high incidence of minimum-wage work among those that do have jobs and a highly skewed wage distribution suggests very strongly that the minimum wage is forming a binding constraint, preventing a significant proportion of young and low-skilled job seekers from finding work commensurate with their productivity levels. Among certain social groups the minimum wage is virtually equal to average wages (Czapinski and Panek, 2003) suggesting that a reduction could have significant impacts on employment.

27. While OECD research suggests that a minimum wage can be helpful in preventing firms from taking advantage of the weak bargaining position of some segments of the labour force, it is essential that the minimum be set at a level where labour market distortions are minimised. This is not currently the case in Poland. Parliament's recent decision to allow enterprises to pay new entrants 80 per cent of the minimum wage in the first year of a new job and 90 per cent during the second year lowers labour costs for new hires. While the outcomes of this policy have yet to be assessed, it should help make the minimum wage less binding and improve the employment prospects of new entrants with low qualifications, especially in those regions where the minimum wage is high compared with average wages. Indeed, eligibility to the programme should be extended to the long-term unemployed and individuals removed from the disability pension rolls. An even steeper discounting of this minimum for first-time workers, coupled with a monitored obligation to provide on-the-job training, could be envisaged. Over the longer term, the minimum wage should be allowed to decline relative to average wages so as to reduce the distortions it causes. Where there are concerns about the living standard that can be supported by the minimum wage, earnings could be coupled with means-tested in-work benefits to ensure that such jobs remain attractive and households incomes are maintained at socially and fiscally acceptable levels.

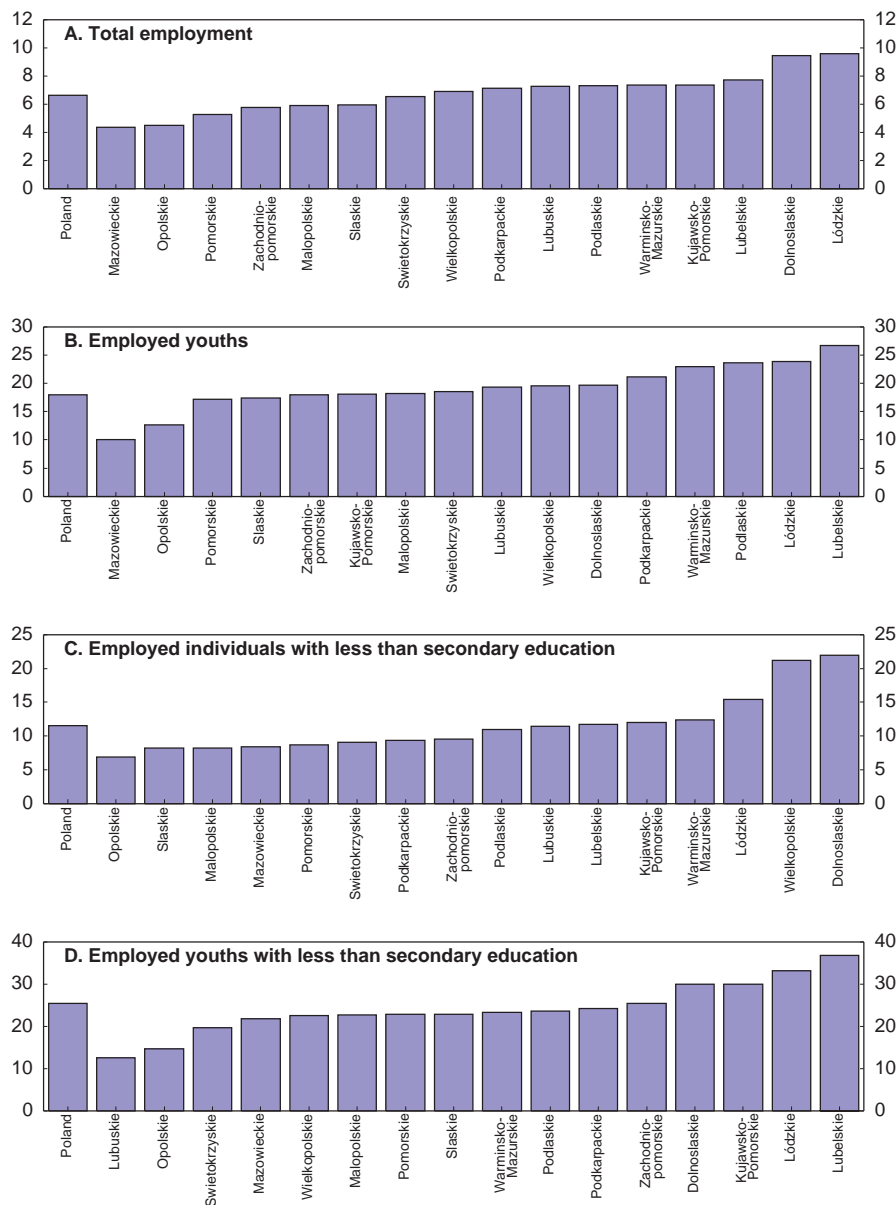
**Figure 7. Minimum wages and the distribution of wages**  
Per cent of full-time average wages



1. Data are for 2000 and concern full-time workers.

2. The ratio of average wages of all workers to those of full-time workers were assumed to be the same in all regions.

Source: Ministry of Finance.

**Figure 8. Regional incidence of the minimum wage<sup>1</sup>**

1. Per cent of employed within population group earning less than 110 per cent of the minimum wage.

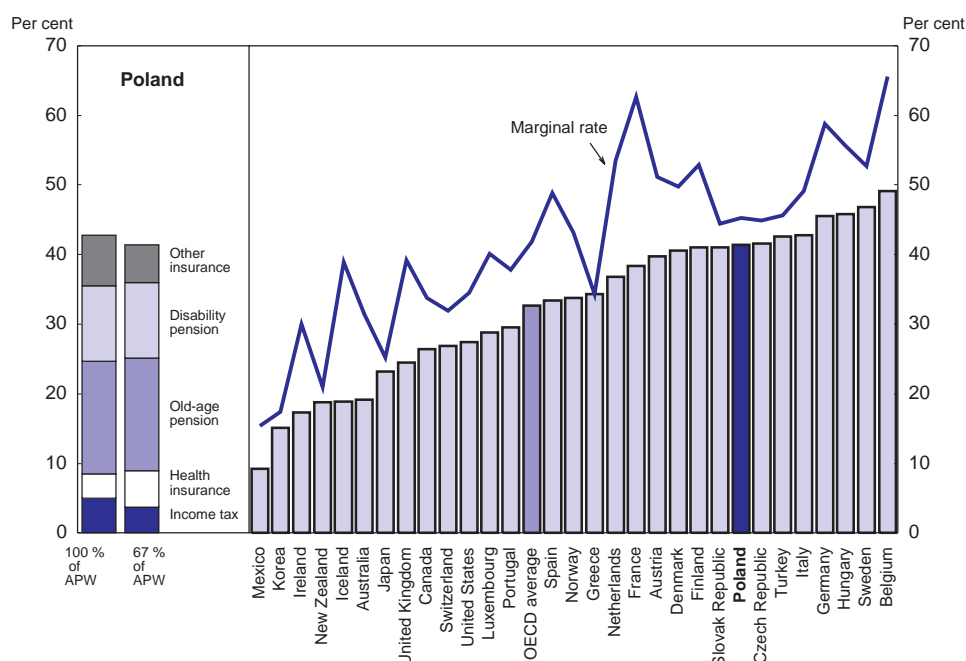
Source: OECD calculations based on Central Statistical Office data.

### ***Reduce the tax wedge***

28. Such efforts to moderate the labour costs of lower-skilled workers, and thereby enhance their employment prospects, should be accompanied by efforts to reduce the disemployment effects of the tax system. The 43 per cent wedge that taxes and social security contributions drive between individuals' take-home pay and firms' labour costs (the 8<sup>th</sup> highest wedge in the OECD) is an important deterrent to employment and job creation (Figure 9) - particularly when combined with a binding minimum wage. Fully 21 percentage points of this wedge is accounted for by employees' social security contributions,

17 percentage points by employers' social security contributions and only 5 percentage points come from personal income tax.

**Figure 9. The tax wedge on labour in the OECD<sup>1</sup>**  
Single person receiving 67 per cent of an average production worker's income



1. Data refer to 2001. The average wedge is the sum of employees' and employers' social security contributions and personal income tax as a percentage of gross labour costs, i.e. gross wages plus employers' social security contributions. The marginal tax wedge is the percentage of gross labour costs represented by increased employees' and employers' social security and income tax contributions, following a rise in net wages. Source: OECD, Taxing wages 2001-2002.

29. Several European OECD countries have sought to mitigate the impacts of high minimum wages and high social security charges by reducing the latter for individuals earning wages in the neighbourhood of the minimum. While such a policy can be effective, it can also be very expensive, costing the public purse as much as 2 per cent of GDP - an expenditure that Poland can ill afford at this juncture. A less expensive alternative might be to cut earmarked social security contributions and finance various extrabudgetary activities from general revenues.

30. Funding shortfalls could be made up by simultaneously reforming the personal income tax system using its potential for progressiveness to reduce the tax wedge for low income earners. A reform that reduced substantially deductions and exemptions so as to widen this tax base could allow marginal tax rates to fall even as average rates increased. Moreover, if tax brackets were revised, the system could be designed to ensure greater effective progressiveness and in particular low average tax rates, and a lower overall tax wedge, for low income workers.<sup>13</sup>

13. Currently, parameters in the system are such that virtually everyone pays the same low average rate of personal income tax, about 5 per cent. Marginal rates are in contrast high, equal to a virtually identical at 45 per cent for individuals earnings earning 2/3, 100 per cent and 167 per cent of the average wage.

31. As indicated above, one option in this regard would involve eliminating healthcare social security contributions, which are currently collected at a constant *ad valorem* rate from wages and raising personal income taxes in a revenue neutral manner. Such a step would reduce labour costs by 2.5 per cent and, if adjustments to personal income tax parameters were made, it could also reduce the tax wedge on low-paid labour by as much as 10 per cent.<sup>14</sup> As proposed in OECD (2002a, 2004), this should be combined with a reform granting universal access to healthcare. Such a step would have the further benefit of reducing one of the important financial incentives to be associated with the KRUS system both for those not working and those active in the underground economy. It will do so by eliminating the 7.8 per cent of wages that ZUS adherents must pay in order to be entitled to health coverage but which members of KRUS households receive automatically. As a result, an individual would no longer need to remain attached to a farm household in order to benefit from health insurance.

### *Increase the effectiveness of active labour market policy*

32. If active labour market policy is to play an important role in reactivating the 50 per cent of the working-age population that are not working, spending levels will need to be increased. Indeed, despite having the highest unemployment rate and the lowest employment rate in the OECD, Poland spends less than one fourth of 1 per cent of GDP on active labour market policy - one of the lowest ratios among member countries (OECD, 2003b). While the 2003 Budget authorised the Labour Fund to run a larger than normal deficit, with the hope that the share of active measures' in total spending would increase to some 8.2 per cent, much more needs to be done to support individuals in their efforts to re-establish a connection with the labour market. Indeed, even if this goal were met, spending levels would be well below past levels and those observed in other OECD countries. Moreover, while such a stop gap measure might reverse the decline in spending on active measures, it does not address the systemic problem that results from the financing of both active and passive labour market policy through the extra-budgetary Labour Fund. Because the principal revenue source of the fund is an earmarked payroll tax, its revenues tend to fluctuate pro-cyclically. In contrast, its mandatory expenditures (essentially unemployment insurance benefits) move counter cyclically and as a result funding for active labour market policy falls precisely at the point in time when it is most needed, squeezed by both lower revenues and high passive costs (Table 2). Indeed, between 1998 and 2002 the share of active programmes in total labour market programme spending declined from 19.2 to 5.4 per cent. During the same period, spending on passive measures almost doubled, with almost all of the increase coming in the form of increased spending on pre-retirement pensions.

**Table 2. The structure of Labour Fund expenditures**

	1999	2000	2001	2002	2003 <sup>1</sup>
	Per cent of total				
Passive labour market policies	69.2	82.8	84.8	89	85.6
o/w pre-retirement benefits	6.4	13.2	20.3	33.0	46.1
Active labour market policies	19.2	11.1	7.0	5.4	8.2
Youth labour market policies	5.5	3.6	4.6	3.4	3.5
Other	6	2.6	3.5	2.2	2.6

1. Forecast by the Ministry of Economy, Labour and Social Policy  
Source: Ministry of Economy, Labour and Social Policy.

14. Assuming that a minimum wage earner pays no personal income tax. Employers pay a 2.5 per cent Labour Fund contribution and employees a 7.75 per cent Health Fund contribution.

33. As proposed in the previous *Economic Survey*, in order to enable a refocusing of spending on active programmes, the programmes financed by the Labour Fund should be re-integrated into the State Budget. Such a move, would both eliminate the pro-cyclical variation in revenues available for active programmes and also create a further opportunity for reducing the tax wedge on labour, by transferring financial responsibility to general revenues and making use of more broadly-based taxes.

*Give co-financing a larger role in active programmes*

34. The importance of ensuring that labour market spending actually improves participants' employment and labour market prospects will only increase as more resources are brought to bear. Poland operates a wide range of active labour market programmes (see Box 6), which tend to be oriented towards wage subsidies. Although little recent research has been done to examine the net impact of these programmes, OECD studies suggest that targeted subsidies, like the school leaver programme, can have a positive impact on participants' employment prospects, but that more general programmes, like the public works programmes, tend either to lower the employment chances of participants or to generate substantial deadweight losses by subsidising jobs that would have been filled anyway. Indeed, one of the few studies to examine Polish active labour market programmes, controlling for various form of selection bias found that participation in Polish public works programmes actually hurt individual's job prospects (O'Leary, 1998).

**Box 6. Active labour market policies in Poland**

Programmes include, individual counselling, group counselling, career information, job seeking workshops, job exchanges and fairs, and job clubs, training, training loans, loans to set up a business, loans to created new jobs, grants to individuals continuing education, intervention works, public works, special programs, work of public benefit, refunds of commuting costs.

Recent initiatives include the "First Job" programme introduced in 2002 by labour offices. It is aimed at improving the school-to-work transition by providing targeted advice and concrete financial incentives for both job seekers and employers. These include low interest loans equal to as much as 20 times the average monthly wage to enterprises creating new work places and maintaining them for at least 24 months.

As compared with other countries, active labour market measures in Poland, have concentrated on various wage subsidy programmes. These include:

- Public works programmes (75 per cent wage subsidy) available to sub-national governments
- So-called intervention programmes discount the wage cost of hiring unemployed workers by as much as their unemployment insurance benefit and can offer a further signing bonus if their employer signs them on after the expiration of the 12 month programme
- Special school leaver programmes that pay firms hiring eligible individuals the labour and social security costs of a worker up to those associated with the minimum wage
- Apprenticeship programmes that provide recent graduates with a scholarship equal to the amount of the unemployment benefit if they are accepted in an employment-office certified programme. Social security contributions are also covered by the office, while a designated mentor receives an honorarium equal to 10 per cent of the scholarship value
- Subsidised loans for individuals hiring the long-term unemployed and for unemployed individuals that start their own business.

While their share in total active labour market spending addressed at the able bodied has declined from more than 50 per cent in 1999 to about 40 per cent in 2001, spending on labour subsidies continues to consume a disproportionate share of active labour market spending.

35. The combination of limited funding and programmes that offset a substantial share of labour costs (between 100 and 40 per cent) means that relatively few spots can be offered and that they tend to be of short duration. Increased reliance on co-financing by both employers and employees might overcome these weaknesses by encouraging a longer-term commitment on their part and at the same time reducing the budgetary cost of each programme post and opening up the possibility of extending their duration or increasing their number. Instead of subsidising the cost of hiring apprentices or individuals receiving on-the-job training for a short period of time, the authorities might authorise firms to hire such workers at a discount from the minimum wage in exchange for on-the-job training. Programmes of this nature elsewhere in the OECD allow firms to pay workers as little as half the minimum wage in exchange for providing apprentices with a well defined training programme. In addition to minimising budgetary cost, such programmes tend to be more successful than subsidies because the apprentice, who foregoes a higher salary, and the employer, who must make a real commitment in terms of training, have significant stakes in the programmes' success. A 2003 initiative that allows youth to work for free, but which provides them with health and accident insurance as well as remuneration of the travel and other work related expenses, incorporates substantial co-financing on the part of participants, but much less so for employers. Rather than having the state pay (implicitly or explicitly) the insurance and travel costs of "volunteers", an alternative that would better leverage firms' interests would see them pay these costs. Such a change would have the advantage of opening the programme to more of the unemployed by eliminating the implicit constraint on its overall size imposed by the public-sector's financial contribution.

*Increase the central government's ability to monitor and coordinate labour market policy*

36. Coordination and management of active programmes is complicated by the fact that since 2000, the public employment service function has been decentralised and is now assured at the poviats and voivodship level. A National Labour Office retains authority for planning, evaluating and monitoring of programmes but programme delivery is provided locally. Moreover, because half of active labour market policy funds are provided directly to local governments, the ability of the central authorities to direct policy is restricted. For the 50 per cent of spending that the national office controls, it signs contracts with local offices on programme delivery and performance indicators. The other half is transferred directly to local governments on the basis of a formula that takes into account local conditions and the number of unemployed, long-term unemployed and school leavers. While this has the advantage of bringing service providers closer to clients and at least offering the possibility that programmes will better reflect both the needs of employers and those out of work, it has also resulted in a lack of coordination and introduced special challenges in establishing nation-wide jobs programmes.

37. To overcome these difficulties and to ensure that local governments do not conduct policy so as to maximise funding levels instead of employment, efforts will be required to rationalise the incentives associated with the decentralised management of the public employment service. Current programmes provide more resources to local governments with higher unemployment rates and better raw labour market effectiveness data. Unfortunately, making funding levels dependent on unemployment levels creates a perverse incentive that could be a factor in the persistence of high unemployment levels in rural areas. By the same token, concentrating on raw employment effectiveness data (*i.e.* unadjusted for *ex ante* probabilities of re-employment) likely reduces programme efficiency and increases deadweight losses. This is because local governments are confronted with a substantial financial incentive to place individuals most likely to find employment (with or without the programme) into programmes rather than those who are most likely to benefit from them in terms of an improvement in their employment chances. Moreover, because performance indicators are based on raw data there may be a tendency for offices that are efficient, given very difficult conditions, to be under-funded as compared with those where employment possibilities and, therefore, placement performance are better. Studies from other OECD countries suggest that the

deadweight loss from this kind of behaviour can exceed 90 per cent. Few such studies have been conducted concerning Poland. The most recent (O'Leary, 1998) may be out of date. Nevertheless, it indicated that intervention programmes, loans for retraining and loans for the self-employed are the most effective policies, while the employment services and public works programmes operated at that time had a zero or negative impact on participants' employment chances.

### *Increase the flexibility of working-rules*

38. In order to reduce the risk and costs associated with hiring workers, some of the most restrictive elements of Poland's Labour Code need to be further relaxed. A recent survey of Polish small and medium enterprises (PKPP, 2004) indicates that rules concerning maximum working hours, sick-leave rules, restrictions pertaining to work during holiday periods and rules governing layoffs are among those with the most serious impact on employment. In terms of rigidities associated with layoffs, Polish legislation is among the most restrictive in the OECD. In particular, administrative procedures associated with layoffs, for "economic reasons" should be made less burdensome. These rules require firms to provide unions with advance notice informing them of the scope and reasons for intended layoffs; detailed plans regarding the future level and structure of employment as well as reports on the economic and financial situation of the firm. They also require enterprises to enter into consultations with trade unions, discuss with them union-proposed alternatives and negotiate with them the sequencing and criteria for selecting the workers to be laid off. Research suggests that while such rules can encourage labour hoarding during slowdowns by slowing and imposing a large fixed cost on layoffs, they will not prevent them. Rather, by imposing a high fixed-cost on layoffs they tend to make firms favour large-scale firings over a more gradual labour market adjustment process.<sup>15</sup> Indeed, the substantial labour shedding that has been observed in Poland over the past several years would seem to bear witness to the ineffectiveness of such rules in preventing layoffs. In the context of the ongoing recovery, a substantial relaxation of such rules is unlikely to provoke more layoffs. Rather it may help promote hiring by reducing the implicit liability represented by the possibility of having to lay off a newly hired worker in the future.

39. In general, other elements of Polish employment protection legislation are less rigid. Notice requirements for dismissals with cause and required severance payments are about average as compared with other OECD countries.<sup>16</sup> A recent reform allowing firms to hire individuals on a fixed-term contract to replace someone on an excused absence was an important positive step. The previous regulation denied the unemployed the opportunity of such jobs, while forcing firms to keep such posts unfilled. Indeed, the application of these rules to cases of maternity leave may have contributed to a reluctance of firms to hire women of child-bearing age. Nevertheless, some additional areas also require attention. As indicated in earlier *OECD Surveys*, rules prohibiting the termination of a working relationship during periods of excused absence need to be revised and a much more severe screening of individuals seeking sick leave implemented. Sick-leave, which can last up to nine months, is subject to frequent abuse. Anecdotal evidence suggests that individuals frequently "become sick" during the compulsory consultation period that precedes economic lay offs and thereby safeguard themselves from layoff. Such practices explain in part the very high incidence of sick-leave in Poland (on average each Polish employee is sick 17 days a year) and have a very high budgetary (extended sick leave is at the charge of the state) and economic cost, both in terms of foregone employment and output but also in terms of higher taxes and slower growth.

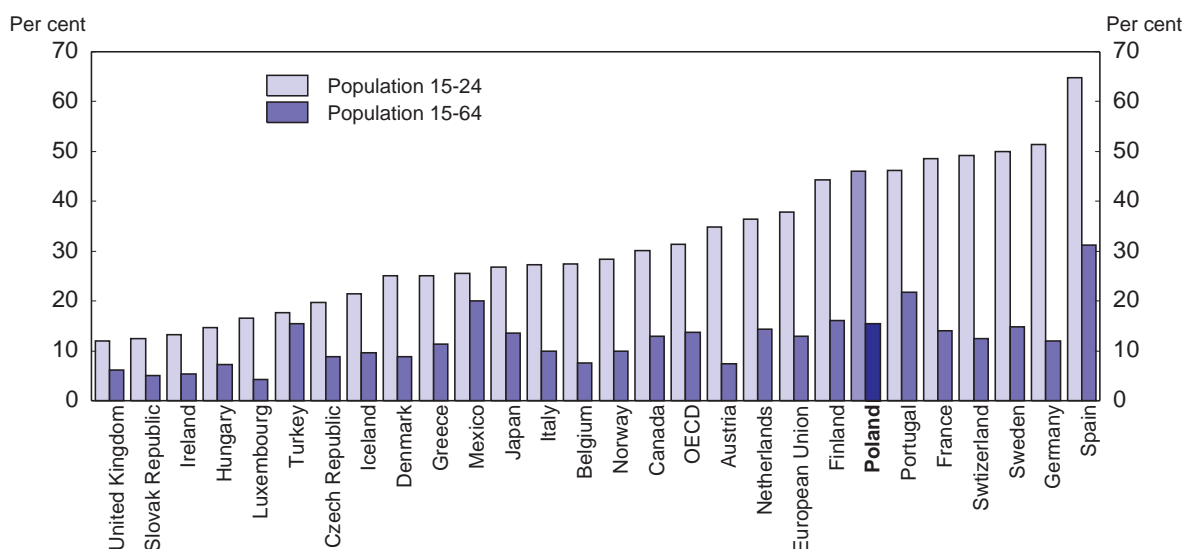
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15. Regulated delays, consultations, administrative procedures and job-search assistance requirements tend to create fixed costs for firms and generate threshold effects. If the cost of conducting a layoff equals the benefit of reducing employment by 100 workers, the firm will wait until it needs to reduce staff by this amount and then will proceed with a large-scale layoff. Indeed, perhaps the layoff will exceed 100 employees so as to ensure that it need not incur the fixed cost again soon.

16. Notice periods range from two weeks to three months depending on the type of contract and the length of employment.

40. As compared with other OECD countries the incidence of fixed term contracts is relatively low with only 6 per cent of employees signed to such a contract in 2000 (Figure 10). Since then, this ratio has been rising and, including temporary work contracts, approximately 17 per cent of the employed have temporary contracts, a ratio that rises to 28 per cent for individuals without a secondary diploma. Unfortunately, rules concerning fixed-term contracts are about to change. A recent reform of the Labour Code included a provision automatically transforming into a permanent contract a fixed-term contract (whose duration is limited by law to two years) if the employee had two such contracts with the same employer with less than a month's break between them. Prior to 1 May 2004 this provision was suspended but now it has come into force and can be expected to slow the expansion of fixed-term contracts. Indeed, such restrictions on fixed-term contracts risk reducing employment levels. Experience in many OECD countries, which like Poland have relatively stringent rules concerning layoffs shows that more flexible job forms, such as fixed term contracts, can play an important role in increasing youth and low-skilled employment by providing firms (and inexperienced workers) with an opportunity to gain on-the-job work experience without firms incurring the substantial costs implicit in a permanent contract. Indeed, during the period the law was suspended the share of fixed term and temporary work contracts increased by more than 70 per cent. Thus, the authorities should give serious consideration to cancelling the regulation.

**Figure 10. Part-time and fixed-term contracts**  
2002



Source: OECD.

41. Recent efforts to reduce rigid controls over working time and the remuneration of overtime have been positive developments that should bear fruit in terms of higher levels of employment. In particular, the recent increase from two to four hours overtime before higher overtime premia must be paid has helped firms better react to fluctuations in demand, while controlling costs - a reform that should improve their competitive position and ability to take on more staff. Similarly, a number of changes have increased the flexibility with which firms can account for total time worked. These include increasing the period during which working-time can be averaged when calculating compliance with limitations on the total number of

hours (including overtime) that can be worked,<sup>17</sup> a widening of the range of activities where task-based working time could be used and a relaxation of rules concerning what constitutes working time.<sup>18</sup> In addition, the authorities have proposed a draft amendment to the Labour Code to relax some rules concerning working time. In particular, the reform proposes introducing the possibility of allowing full-time workers to follow a non-standard work schedule if they request one in writing and their employer agrees. The reform would also allow part-time employees to work fewer days but longer hours in a week as long as no more than 12 hours were worked in a given day.

42. Notwithstanding these improvements more needs to be done. In particular, despite the above mentioned relaxation, overtime rules in Poland remain particularly binding and out of line with international practices. The overtime premium is 50 per cent for the first four hours (previously two) and 100 per cent for any subsequent hour at night, Sundays and other days of rest. Although significant cross-country differences exist in such rules, reducing the overtime premium to between 25 and 50 per cent and introducing more flexible rules on overtime would bring Polish law closer to international practices. Permitting firms to annualise working hours would enhance substantially their ability to react flexibly to fluctuations in demand without resorting to layoffs. While the benefits for firms of such a move, in terms of increased flexibility and lower costs are evident, workers too would benefit. Reduced costs would improve firms' competitiveness, leaving room for additional hiring and business expansion - especially among firms whose order books are typically subject to frequent peaks and troughs.

43. Finally a number of steps have been taken to reduce the employment-related administrative burden of firms. In particular,

- The employment threshold after which firms must meet heavier reporting requirements was increased from 5 to 20 workers.
- Requirements to establish and negotiate with unions employees' leave schedules were relaxed, but remain.
- The obligation to engage in a two-stage consultation with trade unions before terminating a permanent contract was reduced to a one stage consultation.
- Firms were given more leeway to transfer unused leave to a new contract.
- The paper work associated with renewing a contract was reduced.
- The possibility to hire individuals on a fixed-term contract to replace someone on leave was introduced.

All of these reforms should, by reducing the administrative costs associated with formal employment, serve both to boost employment and reduce the size of the underground economy.

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17. From 3 to 4 months in January 2003 for all firms, to 6 months in construction, agriculture, property, public utilities and personal-security services and to 12 months if justified by specific organizational or technical conditions influencing the course of work.

18. Firms can now deduct up to 60 minutes a day from paid working time for time spent by employees eating or attending to personal affairs. Previously, such break time was obligatorily included in remunerated work time.

***Improve the level and relevance of formal education***

44. The authorities' Strategy for Youth seeks to provide a blueprint for government action to strengthen the labour-market relevance of the educational system. It explicitly recognises that existing inequalities in access to quality education are partly responsible for uneven educational outcomes. While inequalities exist along many dimensions, rural-urban differences are some of the most striking and likely play an important role in limiting the speed of labour market and economic restructuring. The rural-urban divide in educational achievement has existed for some time. Not only is the incidence of low educational attainment in the rural population 40 per cent higher than the urban (Table 3), the severity of deficiencies is large, with as many as 25 per cent of adults without a secondary diploma functionally illiterate. Moreover, huge disparity persists: urban students are almost twice as likely as rural ones to be following an educational stream that could lead to university-entry; and the share of rural students with low grades in standardised tests is twice that of urban students. While the differential levels of pupil achievement reflect a wide range of socio-economic factors, uneven and inefficient financing of compulsory education likely plays an important role.

**Table 3. Rural vs. Urban educational performance**

A. Educational attainment rates					
	Higher	Secondary and post-secondary	Basic vocational	Primary	Incomplete primary
Rural areas	4.3	22.4	29.2	38.3	5.0
Urban areas	13.7	38.6	21.1	22.2	1.5

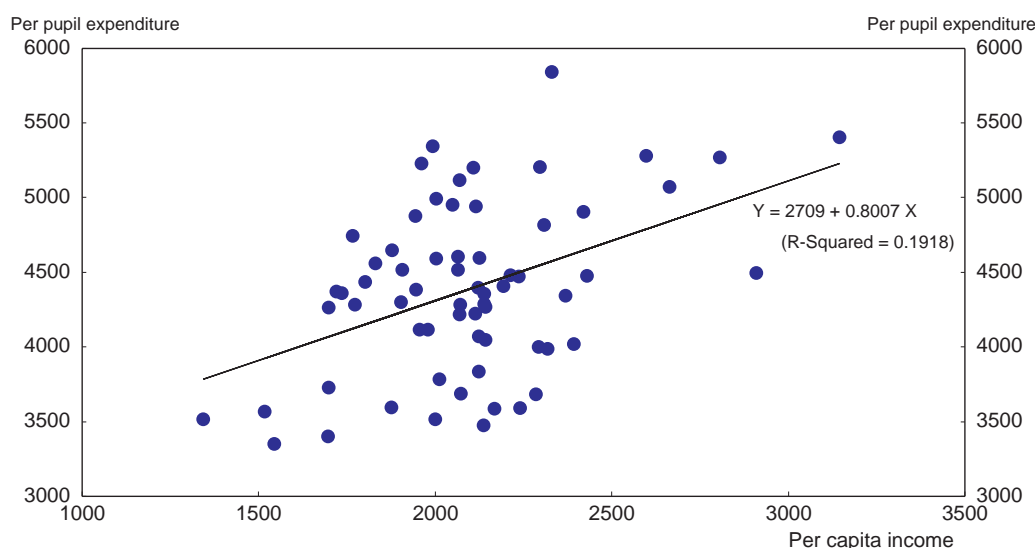
B. Distribution of students with high and low scores in standardised tests					
	Standardised test scores				
	Primary		Gymnasium		
	Low	High	Low	High	
	Per cent		Per cent		
Rural areas	25.4	18.7	26.1	20.2	
Urban areas	18.9	24.9	12.7	33.5	

Source: Panel A: National Census, Central Statistical Office (GUS), 2002. Panel B: Central Examination Board, Ministry of National Education and Sport.

45. In order to ensure that unequal access to quality education ceases to perpetuate income and labour market inequalities, the authorities need to revise the basis upon which primary and secondary schools are financed. Following the decentralisation of funding of primary education between 1996 and

1999,<sup>19</sup> the share in total educational spending controlled by local governments' increased substantially but so did the share for which they were responsible from their own revenues.<sup>20</sup> While this decentralisation may have resulted in a better targeting of expenditure and more efficiency, it also resulted in a dramatic inequality in the level of per capita government spending on primary and secondary education, with the richest *poviats* spending almost 60 per cent more on a per student basis than the poorer ones (Figure 11) and attracting the best teachers by paying them a premium over national pay scales.

**Figure 11. Regional per pupil primary-school spending by income level**



Source: Ministry of Education.

46. In order to promote the quality of education at the local level the authorities should revise the formula<sup>21</sup> that determines the level of local government subsidy by taking into better account each unit's capacity to pay. The current algorithm does so only partially by varying funding on the basis of a formula designed to reflect costs. However, as on average local level governments pay 30 per cent of educational costs from their own revenue, the current equalisation system fails to ensure that students have equivalent

19. The central government's overall contribution to sub-tertiary education fell to 75 per cent and takes the form of subsidies and earmarked grants. The increased reliance on sub-national governments' own revenues has led to an increase in the disparity of per student expenditures across *poviats*.
20. Currently, some 45 per cent of current expenditure on education is financed from the State Budget, mainly in the form of the educational component of the general subsidy for local government units, which is used to finance the expenditures on the activities of public and non-public schools, including schools for children, youth, and adults. Additionally, the subsidy may be used for financing of tasks related to the further education and professional improvement of teachers, tasks related to individual education, and expenditure related to the rationalization of the school network.
21. The educational component of the general subsidy is distributed according to a formula that is updated on an annual basis. In the design of the algorithm, the amount of the subsidy allocated is dependent on the scale and structure of the tasks assigned to a local government. The scale of such tasks is measured by the number of students and other participants of educational activities. Funding is determined as a function of the number of students in schools operating in rural areas or small towns (up to 5 000 inhabitants), transportation needs and the number of disabled children.

public resources available to support their schooling. Financing problems are not confined to equalisation. Formulae governing the allocation of resources across levels of education need to be made more flexible so that school financing keeps up with demographic changes. Existing rigidities, which are partly the result of using historic funding levels to determine current ones, mean that per-pupil pre-school funding levels are twice the OECD average, while per student secondary education spending is lower than per capita expenditures at the primary level. The World Bank indicates that in Poland maintenance and school supply expenditure are underfunded, frequently being squeezed out by wages.

47. In addition, more resources need to be devoted to ensuring that accommodation and transportation costs do not prevent rural students from pursuing educational streams that give them access to university. Currently only one in ten university students come from rural areas. Here there might be an opportunity for expanding the special scholarship programme operated by the state Agricultural Property Agency<sup>22</sup> for the children of former employees of state-owned farms. This programme helps bridge the gap in access to education between rural children and urban youth, by offsetting the transport and accommodation costs of children studying for the maturity exam certificate.<sup>23</sup> The current programme provides funding that averaged about one third of the minimum wage or half of the per capita income of rural households. A more broadly based programme, perhaps involving a smaller per student subsidy and a reimbursable student loan, might prove an effective way of co-financing an expanded programme.

48. Finally, the authorities need to look more closely at possibilities for co-financing in education. Some observers argue that in the Polish context, offering private primary and secondary-level schools the same level of subsidy as state schools represents an unwarranted subsidisation of wealthy families' decision to provide their children with a better education and as such contributes to inequality (World Bank 2003). More generally, given the strong positive private returns to tertiary education, the authorities may wish to re-examine rules concerning its financing, by allowing tuition fees to play a larger role. Currently, 46 per cent of all university-level students (those following full-time studies at state-owned universities), pay no tuition fees reflecting a constitutional provision guaranteeing access to free university-level education. In contrast, the remainder of university students, including full-time students at private tertiary institutions (28 per cent of the total) and part-time and night students at both state-owned and private schools pay fees. Allowing state-owned universities to charge fees for full-time courses would not only increase these schools resources, thereby allowing them. Although such a move may require constitutional amendment, it is warranted all the more because state-financed schools tend to be the most prestigious schools, where the private returns to education are highest and which tend to be attended by better-off students.

49. Improving the quality of rural education will require that recent efforts to reduce streaming and the specific-skill orientation of vocational programmes be expanded. While excessive streaming into non-academic specialisations is a problem throughout the Polish educational system, it is more severe in the rural sector. Here, the quality and relevance of secondary education and the employment prospects of secondary students would be enhanced by a further reduction in the variety of upper-secondary schools leading to a university-admission maturity certificate. The authorities should consider eliminating the distinction between more exclusively academically oriented schools (lycea) and the 14 different strains of more professionally-oriented schools. The co-existence of purely academic and more applied schools, which nevertheless offer virtually the same curriculum, works to the detriment of the latter, whose degrees and accomplishments continue to be viewed as inferior. A better alternative would be to unify the secondary schools offering university-admission level programmes, allowing students that wish to specialise to do so via the elective courses they choose. Moreover, the authorities should consider abandoning the basic vocational stream. There is an enormous gap between the quality of education it

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22. Formerly Agricultural Property Agency of the State Treasury.

23. Maturity exam certificate is a condition of progression to tertiary education.

offers and that offered by the general secondary education schools (OECD, 2003c). Indeed, while only 13 per cent of secondary students follow the basic stream, their graduates accounted for 41 per cent of their cohort's unemployment. Although the better labour market performance of students following the general secondary education reflects selection bias, it also reflects the more general and problem-solving oriented education that these students receive, which is better suited to today's modern and rapidly changing labour market.

#### **Box 7. The strategy for youth**

The authorities adopted in July 2003, a ten year *Strategy for the Youth*, which addresses the important link between the unequal educational opportunities and unequal labour market performance. It sets out a ten year programme during which, in addition to other objectives, reforms are supposed to equalize educational opportunities and improve the labour market relevance of the education system. The strategy seeks to improve results for four specific target groups.

- Youth in rural areas
- Disabled youth
- Youth in areas with high unemployment
- Youth from disadvantaged backgrounds

The specific actions identified in the *Strategy* seek mainly to minimise the differences in the quality of education between rural and urban areas as well as between general and vocational secondary schools. A particular area where differences are pronounced is English as a foreign language education, where enrollments ranges from 90.6 of pupils in general secondary to 12 per cent of basic vocational education.

## **Conclusion**

50. The challenge represented by reducing joblessness in Poland is enormous, as are the potential benefits in terms of higher incomes, reduced poverty, faster growth and more rapid convergence. As daunting as the task may be, it is not impossible - a number of OECD countries have succeeded in putting into place sometimes very difficult structural reforms that have enabled overall employment rates to increase by 10 or more percentage points.<sup>24</sup> While the nature of the pre-reform problems in these countries was different in each case, the striking improvement in recorded labour market outcomes reflected the results of deep-seated and fundamental labour-market reform. Moreover, while strong growth helped in many cases, this was generally a consequence of the improved labour market performance following structural changes. Box 8 summarises the recommendations of this chapter as concerns labour market policy.

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24. Over the past 30 years, the following OECD countries have succeeded in raising overall employment rates by 10 or more percentage points: Australia, Spain, Luxembourg, the Netherlands, Norway, the United States.

### **Box 8. Summary of labour market recommendations**

#### **Rationalise personal transfers to reduce poverty and unemployment traps**

##### ***Disability system***

- In order to increase incentives to work, continued access to disability benefits should be restricted to people who are truly unable to work and early-retirement schemes should be abolished.
- In conjunction with a re-evaluation of the extent of disability of existing beneficiaries, a time-limited post-disability-pension benefit should be introduced to provide income support during individual's transition back into the labour force. Benefits should be lower than in the disability pension and conditional on job-search so as to ensure financial incentives to job search.
- In exchange, job-search services and targeted active labour market programmes should be reinforced.

##### ***Farmers social insurance system***

- Contributions and benefits to the general (ZUS) and special farmers' (KRUS) social insurance schemes should be harmonised so as to eliminate incentives to remain in low productivity agricultural jobs.
- Land-ownership requirements for the KRUS system should be abandoned so as to facilitate rural-urban migration and eliminate incentives to retain uneconomically small farms.

##### ***Labour market withdrawal programmes***

- Plans to eliminate the early-retirement pension scheme should be carried through with access to the pre-pension unemployment benefits more closely monitored.

##### ***Unemployment insurance***

- The dependence of unemployment benefits on regional unemployment rates should be eliminated to reduce the risk of region-specific unemployment and dependency traps.
- Work disincentives from unemployment insurance benefit should be reduced by making these reflect individuals' previous earnings and the possibility to transform benefits into an in-work benefit should be introduced.

##### ***Social assistance***

- As resources into the disability scheme are reduced, those of the social assistance system will need to be reinforced to ensure that adequate means-tested income support is provided to those who have difficulty finding work.
- For those who are able-bodied, benefit receipt should be made conditional on active job-search.

#### **Increasing labour demand – especially for the young, long-term unemployed and unskilled**

- So as to help low-skilled workers to price themselves into the labour market, the labour cost of a worker paid at the minimum wage should be reduced by allowing the minimum wage to decline relative to average wages and by reducing the tax wedge for low income workers. For this purpose, healthcare social security contributions should be collected from a reformed personal income tax system instead of a constant ad valorem rate from wages.

- In order to increase the incentive to work and to avoid poverty of low paid workers, greater use should be made of in-work benefits.
- To make better use of limited resources and to ensure a stronger commitment between employer and employee, special employment promotion programmes (such as apprentices and on-the-job programmes, and subsidised labour schemes) should make greater use of co-financing mechanisms.
- Active labour market policy and public employment services should be made more effective by increasing funding, rationalising the mechanisms for determining central government payments, more comprehensive evaluations and by improving coordination between independent local offices.
- The pro-cyclical financing of active labour market programmes should be eliminated by reintegrating these programmes into the State Budget.

**Increase the flexibility of working-rules to promote hiring under uncertainty**

- Administrative procedures associated with layoff for “economic reasons” should be made less burdensome.
- The authorities should cancel the provision that came into force on 1 May 2004, which automatically transforms a fixed-term contract into a permanent one if the employee had two such contracts with the same employer.
- The overtime premium should be reduced and annualised working hours introduced so as to increase firms' capacity to react to fluctuations in demand.

**Improve the level and relevance of formal education**

- Regional inequalities in access to quality education should be reduced by taking into account local governments' ability to finance primary schools.
- Allocation of resources across levels of education should be made more flexible so as to adapt to demographic changes.
- More resources should be devoted to facilitating the access of rural students to university.
- Existing efforts to reduce the extent of streaming should be reinforced.
- Both for equity reasons and in order to enhance revenues and help state-financed universities grow and develop, tuition fees (and student loans) should be introduced for full-time day courses.

51. Achieving similar such employment improvements in Poland will require actions on three broad fronts.

- Ongoing efforts to reduce inactivity traps will need to be pursued forcibly and extended. Work incentives for too large a share of the potential work force are seriously reduced by various social transfers, notably disability pensions. In general, access to social benefits needs to be restricted to those in genuine need and benefit levels revised to better reflect labour market considerations. Here, a combination of greater use of in-work benefits and much more stringent enforcement of job-search requirements and means-testing would help.
- The labour costs of hiring low-skilled and younger workers need to be brought into line with their underlying productivity. Reducing the minimum wage and payroll taxes would make hiring such

workers more economical for many firms. Similarly their willingness to hire at given activity levels would be further increased by reducing burdensome administrative and regulatory requirements, notably as concerns layoffs and overtime.

- Over the long-term, continuing efforts to increase the relevance and quality of the education of school leavers would both serve to improve their employment prospects but also their incomes. Here, educational outcomes in rural areas are of particular concern.

52. Reform in all of these areas should help restore labour market adjustment mechanisms and help move Poland away from its current low-employment, low-productivity equilibrium. In addition, if product-market reforms like those outlined in Chapter 4 are pursued simultaneously, they will serve to shorten the overall transition period by boosting activity rates and the overall demand for labour.

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