4. EMPLOYMENT INCENTIVES AND THE SOCIAL WELFARE SYSTEM

The motivation of the unemployed to seek formal employment depends crucially on whether work "pays" in comparison to the receipt of social benefits. In short, it needs to be obvious to beneficiaries that they become better off as a result of finding employment. While this is typically obvious for well-paid jobs and highly skilled job-seekers, it often is not for those at the bottom of the skills distribution and who can expect wages close to the minimum wage as a result. Indeed, as Chapter 2 showed, social welfare benefits received by Roma in marginalized localities appear close to the minimum wage, suggesting that many Roma may suffer from an inactivity trap. This chapter formally analyzes the incentives for unemployed resulting from the social benefit and tax system, comparing the benefit and tax systems in place in 2007 and, after a recent reform, in 2008. It pays particular attention to long-term unemployed and families of different sizes. It finds that, while in 2007the tax and benefit system retained substantial work disincentives in particular for unemployed expecting to earn just above the minimum wage, employment incentives in 2008 have been significantly strengthened, in particular following a tightening of benefits for long-term unemployed.

4.1 **With a view to improving labor market outcomes OECD and EU countries have increasingly introduced revisions to the tax and benefit system to "make work pay"**, either through tightening access to and level of "out of work" social welfare benefits or through increasing "in work" benefits via tax breaks and other incentives or through a combination of both. For example, Germany under its "Hartz" labor market reforms, has tightened benefit rules for long-term unemployed and reduced benefit levels. Slovakia has reduced social assistance benefit levels, as has Switzerland. Portugal and Hungary have decreased the duration of receipt of unemployment benefit[72]. Bulgaria has introduced a time-limit for the receipt of the Guaranteed Minimum Income benefits for able-bodied working age individuals. Often complementing a tightening of benefit eligibility, France, Hungary, New Zealand, Netherlands, Switzerland and the UK have strengthened in-work benefits.

4.2 **The Czech Government has recently introduced a reform to the social welfare and child protection system as well as the tax system to strengthen pro-work**

[72] OECD (2007a)

incentives. The reform, put in effect on January 1 2008, transfers some of the tax burden from capital to consumption and affects labor taxation.[73] Specifically, it

(a) introduces a cap on social security contributions,
(b) lowers the corporate income tax from 24% to 19% by 2010 (and broadens tax base),
(c) increases the lower VAT rate from 5% to 9%,
(d) puts (at least a temporary) halt to indexation of social benefits (but not pensions),
(e) introduces an unusual flat personal income tax (PIT) rate (applied to the so-called 'super gross wage', including employer contributions),
(f) expands child tax credits (bonuses deducted from tax, not from tax base),
(g) lowers the income eligibility threshold for child benefits,
(h) abolishes joint taxation of married couples and allows parents to choose different combinations of entitlement length and benefit level for parental allowances (but it keeps the quantitatively more important spouse tax deduction),
(i) introduces tax credits for retirees, and
(j) lowers welfare support for inactive long-term unemployed.

4.3 **This chapter aims to shed light on the nature of the social support system in the Czech Republic–the combination of unemployment and social benefits offered with income taxation, and whether it creates incentives to supply labor and participate in the official economy.** To this end, it presents two simple measures of the monetary incentives built into the set of main government labor-market programs that affect labor supply decisions: the Net Replacement Rate (NRR) and the Marginal Effective Tax Rate (METR). The Net Replacement Rate is the ratio of net income of the household when unemployed to the net income of the same household under the alternative situation when one of its members has a job. The Marginal Effective Tax Rate, on the other hand, asks how much of a given (small) increase of the gross wage is taken from a household by both explicit income taxation and the implicit taxes of the social benefit system[74]. The chapter extends existing calculations in two dimensions: it concentrates on family types typical of socially excluded, and compares current institutional settings to those in place in 2007. Specifically, the calculations in this chapter quantify the combined effects on pro-work incentives of reform steps (e), (f), (g), (h), and (j) above.[75] It is important to note that the measurements cannot fully reflect one key dimension of the Czech social support system, unaffected by the reforms, but important for socially excluded, namely the complicated nature of the system resulting in uncertainty about benefit level and availability. It also does not factor in any income that the unemployed benefit recipients may earn from informal employment.

[73] A useful memorandum item is that the Czech tax structure is highly unusual in international comparison. It relies heavily on social security contributions (which are among the highest in the world) and the corporate income tax, and less on taxation of personal income, consumption and property.
[74] For a detailed description see the Annex.
[75] These changes were introduced on top of the expanded accommodation allowance (regionally set housing support) introduced already in 2007.

4.4 **The Czech Government has introduced substantial changes to its tax-benefit system in 2007 and 2008 aimed at strengthening work incentives and making work "pay".** This section reviews the main changes introduced. From January 2008, the system is to follow the following sequence of policy rules:

- Persons receive earnings, unemployment benefits, sickness benefits and pensions.
- Gross earnings determine the income tax base from which social and health insurance contributions and other tax exemptions are deducted; next, personal income tax (PIT) is determined. In the next step, child tax deductions are deducted depending on the presence of children. If the resulting tax amount is negative, the household is eligible for a tax bonus.
- Net household income for the purpose of income testing for means-tested state social support benefits equals income net of taxes and contributions, plus stipends, housing supplement from employers, alimony, sickness benefits, unemployment benefits, pensions and income from abroad. The child tax bonus is not included.
- Based on information on the composition of the household, the household-level amounts of so-called Minimum Living Standard (MLS) and Existential Minimum (EM) are determined.
- An income test for child allowance is performed using the net household income.
- An income test for social allowance and housing benefit is performed using the net household income from the previous step, including child allowance.
- An income test for social necessity benefits (described below) is performed using the income from the previous step including social allowance, housing benefit and child bonus.

Taxes

Payroll taxes

4.5 **Payroll taxes – health and sickness, employment and pension fund contributions – are paid from the gross wage of households or from gross profit of entrepreneurs.** The contributions are divided between employees and employers, with the employee paying 12.5 percent and the employer 35 percent of the gross wage. There was a significant change in the structure of personal income tax (PIT) in 2008, as this tax is now calculated from the so call "super-gross" wage which includes not only the worker's gross tax-base (as defined in 2007), but also the payroll contributions paid by the employer.

Income Tax

4.6 **The Czech Republic introduced a flat income tax in 2008.** Until the end of 2007, the Czech Republic had a progressive taxation system. Table 20 depicts monthly gross wage income brackets as well as marginal tax rates for every bracket. In 2008 this system was replaced by a 15% flat tax. However, payroll taxes including those paid by employers are not deductible from the tax base anymore.

Table 20 **Monthly gross wage income brackets and marginal tax rates in 2007**

Net Tax Base (CZK)	Marginal Tax Rate +(%)
0-10,100	12
10,100-18,200	20
18,200-27,600	25
27,600-	32

4.7 **In 2007 married couples with at least one child (all living in the same household) could choose to fill out a joint tax return.** The tax base of the couple would then equal the sum of their personal tax bases. The base would be split evenly among both taxpayers and the (equal) tax rate determined separately. Given the progressive tax schedule, joint taxation reduced the taxation of married couples as the income of the spouse with higher earnings was taxed at a lower marginal rate. In 2008 joint taxation was abolished due to the introduction of the flat tax rate. In 2007 tax deductions from actual tax were introduced to replace deduction from tax base. With the introduction of the flat tax, the level of these tax deductions was dramatically expanded. Table 21 lists *monthly* deductions from tax duty in 2007 and 2008.

Table 21 **Monthly deductions from tax duty, 2007 and 2008**

In CZK	**2007**	**2008**
Personal Deduction	600	2,070
Deduction for Wife with low income	350	2,070
Child Bonus	500	890

4.8 **The Child Bonus works differently from other deductions.** If the tax duty after the deduction of the Child Bonus is negative, the difference is called a tax bonus and is paid to the taxpayer as a bonus, but only to families with at least one member working. This bonus is not tested as an income for state social support benefits.

Social Benefits

Unemployment Benefits

4.9 **Unemployment benefits are available for individuals actively searching for a job who were employed for at least 12 months in the previous three years.** The basis for calculating unemployment benefit includes income net of social insurance contributions and income tax, i.e. the average net monthly wage in the previous job. The amount of unemployment benefit is determined as 50% of the previous income in the first three months and 45% in the following three months of the unemployment spell, but not

more than 2.5 times the MLS of an adult one-member household (CZK 7,815 = 2.5 times CZK 3,126, see table below). There were no changes to unemployment benefits between 2007 and 2008.

State Social Support

4.10 **State Social Support defines three main types of means-tested benefits:** Child Allowance, Social Allowance and Housing Allowance. The level of available social support depends on the household income relative to the household level of Minimum Living Standard (MLS), which equals the sum of MLS of all family members. Table 22 presents the thresholds for the calculation of State Social Support. They remained unchanged between 2007 and 2008.

Table 22 Minimum Living Standard thresholds, 2007and 2008

	MLS level in CZK
Single Household	3,126
First Adult	2,800
Other Adult	2,600
Child below 6 years	1,600
Child between 6 and 15	1,960
Child between 15 and 26	2,225

Child Allowance

4.11 **Child Allowance has been limited to low income families in 2008, yet it is less generous for the least well off.** In 2007 a family was eligible for child allowance if it had an income including net salary, unemployment benefits, and excluding child bonus below 4 times MLS. In 2008 the ceiling was limited to 2.4 times MLS. Table 23 summarizes the levels of the benefit. Another difference vis-à-vis 2007 is that families with income below 1.6 MLS receive the same level of benefit as those with higher income, as long as it stays below 2.4 MLS. The eligibility for child allowance is conditional on the child attending compulsory schooling.

Table 23 Child Allowance benefit structure, 2007 and 2008

In CZK	2007			2008	
Income	< 1.6 MLS	< 2.4 MLS	< 4.0 MLS	<2.4 MLS	> 2.4 MLS
Child < 6	576	496	256	500	0
Child 6-15	706	608	314	610	0
Child 15 – 26	810	698	360	700	0

Social Allowance

4.12 **The level of Social Allowance has declined between 2007 and 2008.** If family with at least one child has an income including net salary, unemployment benefits, child allowance and excluding child bonus below 2.0 MLS in 2007 (1.6 MLS in 2008), it is eligible for Social Allowance. The levels of benefits are summarized in the following table.

Table 24 Social Allowance benefit structure, 2007 and 2008

In CZK	2007			2008	
Income	< 1.0 MLS	< 1.6 MLS	< 2.0 MLS	<1.0 MLS	< 1.6 MLS
Child < 6	873	437	146	800	320
Child 6 -15	1,070	535	179	980	392
Child 15 -26	1,228	614	205	1,125	450

Housing Benefits

4.13 **The level of Housing Benefits has increased in 2008 over 2007.** The benefit depends on the actual amount spent on housing compared to total income, and the so-called "Socially respectable cost of living". Total income includes net salary, unemployment benefits, child allowance, but not social allowance and child bonus. Socially respectable costs of living depend on the number of family members and the size of the municipality where the house or flat is located. Table 25 depicts socially respectable cost of living for rented apartments across municipalities of different size. The Housing Benefit is then calculated as socially respectable cost – (Income * 0.3). The previous table shows that between 2007 and 2008, socially respectable costs of living have been raised. The coefficient 0.3 can be interpreted as saying that housing expenditures as high as 30% of income are socially acceptable.

Table 25 Housing Benefit structure, 2007 and 2008

	2007			2008		
Population	> 100,000	> 50,000	> 10,000	> 100,000	> 50,000	> 10,000
1 member	2,893	2,659	2,518	3,383	3,155	2,895
2 members	4,233	3,913	3,721	4,998	4,686	4,331
3 members	5,858	5,440	5,188	6,971	6,563	6,099
4 and more	7,453	6,948	6,644	8,824	8,332	7,772

Social Necessity Benefits

4.14 **Social Necessity Benefits serve as an income source of last resort.** It is intended for families with net income (including state social support) below the household Minimum Living Standard level – even after receiving State Social Support benefits. Social Necessity Benefit includes two types of benefits. The *Housing Supplement* increases income to meet the level of actual cost of housing, where necessary. The *Livelihood Benefit* levels up income of household to MLS or Existential Minimum (EM, to be defined below) after costs of housing are paid. This means that after paying for housing, a given family ought to have income as high as MLS or EM. However, the right for social necessity benefit is not automatic. It is up to each municipality to decide whether to grant these benefits or not. The decision depends on the subjective state, activity, etc. of the family in question, e.g., their willingness to move to a cheaper flat.

4.15 **Set significantly below the level of the MLS, the Existential Minimum serves as a testing income level for the purpose of determining social necessity benefits for family members unemployed for more than 12 months.** In these cases, the Existential Minimum replaces the Minimum Living Standard. The Existential Minimum (EM)

threshold is currently CZK 2,020 – 65 percent of the MLS level for a single adult and 70 percent of the MLS level for the first adult person of a jointly assessed household. The Existential Minimum was originally introduced in 2007 to "punish" inactivity; however, it was not used in practice as the Labor Offices found it difficult to determine whether long-term unemployed beneficiaries were or were not actually searching for jobs. Since 2008, the EM, instead of MLS, automatically serves as the benchmark for determining minimal income of those with more than 12 months of unemployment. The EM is not applied to dependent children, people with a disability and to workers on pension or over 55 years of age. However, the EM is applied to LTU adults in families with children. The simulations for 2008 below take EM into account when calculating long-term NRR and long-term METR.

Table 26 Summary of Changes to the Tax and Benefit system 2006-2008

	2006	2007	2008
Tax rates, percent	12; 19; 25; 32	12; 19; 25; 32	15
Minimum Living Standard	Incl. accommodation	Excl. accommodation	Excl. accommodation
Child Allowance, threshold	1.1; 1.8; and 3.0 times MLS	1.5; 2.4; and 4.0 times MLS	2.4 times MLS
Social Allowance, threshold	1.6 times MLS	2.2 times MLS	2.0 times MLS
Separate accommodation allowance	Moderate	Expanded	Expanded
Cap on social security contributions	No	No	Yes
Tax credits	Moderate	Moderate	Expanded
Existential Minimum for LTU	Not defined	Defined, not used	Used
Joint taxation	Yes	Yes	No

EMPLOYMENT INCENTIVES IN THE TAX AND BENEFIT SYSTEM

4.16 **How do the policy changes and other factors impact on the labor supply decisions of individuals?** This section presents results from simulations of NRR and METR for one-earner families with 0 to 5 children, with incomes ranging from close to the minimum wage (8,000 CZK) up to average production wage (20,000 CZK). The key assumptions for the analysis are stated in Box 7. It also reviews the effect on work incentives of widespread indebtedness of Roma long-tern unemployed.

Box 7**: Net Replacement Rates and Marginal Effective Tax Rates**

The ***Net Replacement Rate (NRR)*** is defined as the ratio of net income when unemployed to the net income when employed. The ratio takes values from 0 to 100. The higher the ratio, the lower the incentives to look for an employment opportunity. For example, at a NRR of 100, there are no monetary incentives to look for a job, since a given household receives the same level of income independent of the employment status. Since households enjoy not only consumption but also leisure and also face search costs and fixed costs of participating in the labor market (transportation to work, higher cost of food outside of the household, etc.), it is reasonable to expect that even net

replacement rates significantly below 100 may not provide sufficient incentives for job search. Furthermore, the actual level of NRR that can be expected to effectively generate labor-supply incentive depends not only on valuation of leisure and transaction costs, but also on outside options such as shadow-economy employment opportunities and others.

The ***Marginal Effective Tax Rate (METR)*** shows which part of a change in earnings is "taxed" away from the combined effects of income taxation and social benefits taken from a household that experiences an increases in its gross earned income. Because the maximum level of benefits is often received by families with no income and because benefits are sometimes reduced almost CZK for CZK with additional earnings, the welfare system is expected to discourage labor force participation and hours of work. It is therefore important to measure the strength of such disincentives. METR rates of over 100% indicate strong inactivity traps where individuals have negative incentives to increase their gross income. This chapter presents METRs for CZK 200 rises—corresponding to a gross-income increase of 2 percent at (monthly) income level of CZK 10,000.

For all household types, the analysis contrasts the so-called short-term and long-term NRR and METR. Short-term rates assume that one family member is unemployed for a short time period such that s/he is receiving unemployment benefits, and that the other family member is long-term unemployed, thus not receiving unemployment benefits. Unemployment benefits are calculated assuming that they are based on a wage that corresponds to the wage opportunity considered in the NRR calculations. For example, when the potential wage is CZK 10,000, it is assumed that the previous wage (before unemployment) was also CZK 10,000. Moreover, the MLS rather than the EM is used as the testing level for Social Necessity Benefits when calculating short-term rates. On the other hand, long-term NRR and METR rates, which are relevant for long-term unemployed, correspond to the situation when the family does not receive unemployment benefits any more. In 2008 it is also assumed that the EM instead of the MLS serves as the testing level for Social Necessity Benefits of long-term unemployed. Finally, a number of assumptions are made on the family status. It is assumed that children are between 6 and 15 years old (so we abstract from parental allowances). It is also assumed that they live in a municipality with up to 100,000 inhabitants and that their actual cost of housing is the same as the socially respectable cost of housing. This means that they do not pay more than the level defined by law. It is also assumed that households satisfy all conditions to receive social necessity benefits.

The impact of recent policy changes

4.17 **Previously very high Net Replacement Rates have declined significantly as a result of the 2008 reforms, suggesting that labor supply disincentives have been reduced**. Figure 27 shows short term and long-term NRRs for different family size configurations for 2007 and 2008[76]. Short-term replacement rates depict the situation for families whose breadwinner has been unemployed for less than 12 months, i.e. receive

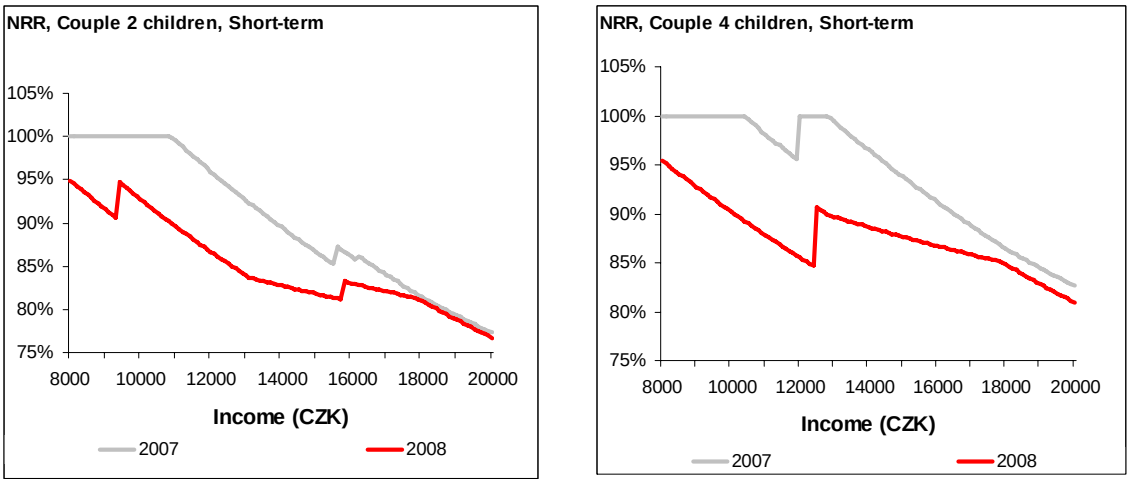
[76] See Annex for the full range of simulations.

unemployment benefits and are subject to the MLS. The long-term replacement rates present the picture for those who have been unemployed for more than 12 months and are not eligible for unemployment benefits and are subject to the lower EM instead of the MLS. There are two main observations from the simulations:

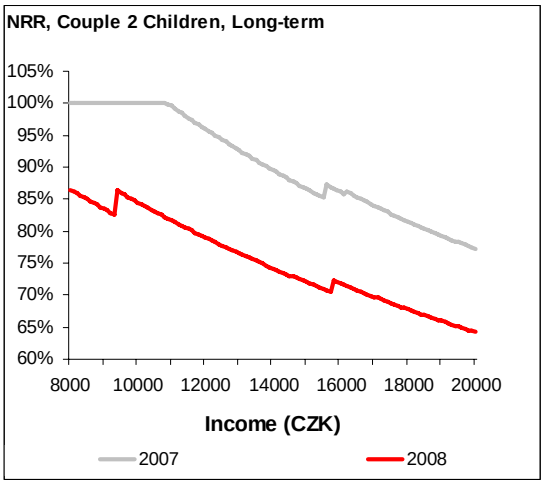
- ***The high NRRs of close to 100 percent in 2007 suggest that the system so far has had powerful labor supply disincentives***, in particular for those whose prospective labor earnings are low and for those who are able to earn income from informal jobs on top of social benefits. For example, the simulations suggest that in 2007 a couple with 4 children was as well off on benefits (NRR of 100 percent) as they would have been with a salary of CZK 13,000 which is 65 percent of the average production wage in the Czech Republic in 2007.

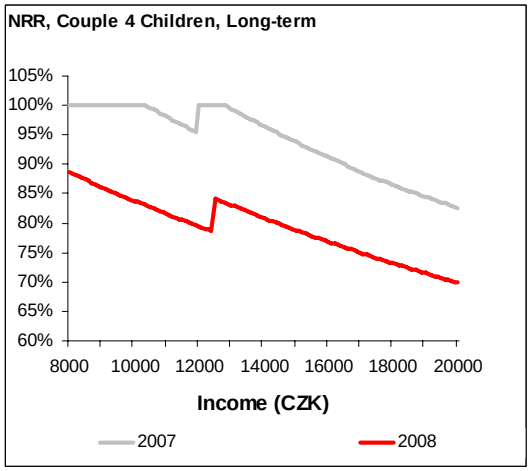
- ***The 2008 reforms have decreased NRRs, in particular for the long-term unemployed.*** The decline is more pronounced for lower income levels and is typically in the order of 20 percentage points for long-run net replacement rates. The fall in NRRs is greater for the long-run rates, reflecting the powerful effect of the application of the lower EM for long-term unemployed. Also, as shown in Figure 27, the drop in NRR is typically more pronounced for low income families with higher number of children. As opposed to that, the decline remains limited for single adult households, where NRR levels were low already prior to the reform. The sudden increases in short-term NRRs for families with 3 and more children, which are moving to higher wage levels as the number of children increases, are caused by the availability of social and child allowances (which grow as a function of family size)[77].

Figure 27**: NRRs have fallen substantially as a result of the reform, reducing work disincentives**



[77] Once family earned income exceeds the eligibility threshold, the denominator of NRR, the total family income (earned income plus allowances) decreases because allowances are no longer available. Hence the increase in the NRR.

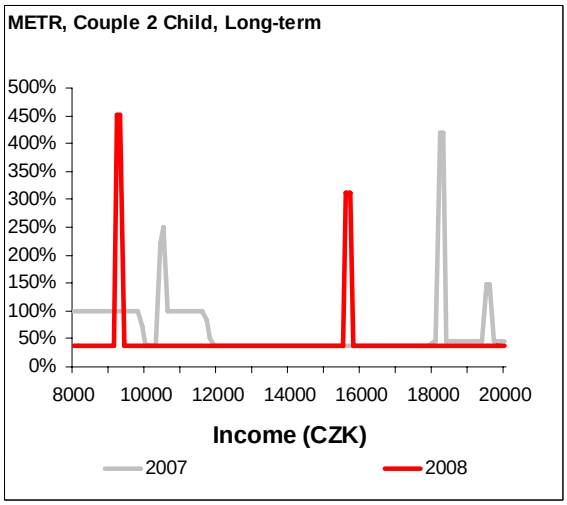


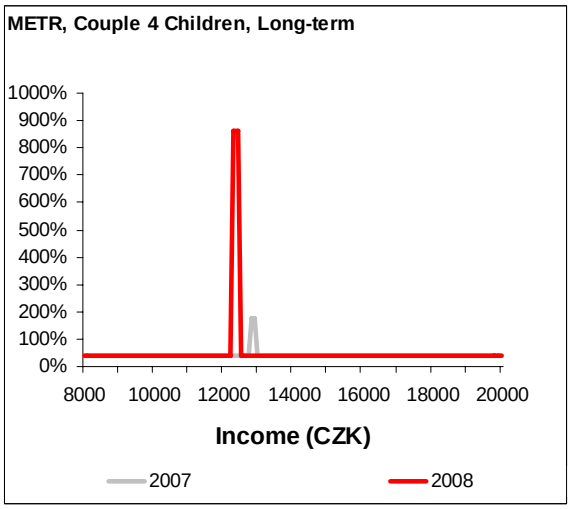


Source: Jurajda and Zubricky (2008)

4.18 **The METR calculations suggest that few inactivity traps remain.** Figure 28 presents METRs for couples with 2 and 4 children[78]. The analysis suggests that some of the inactivity trap income regions have moved to lower income levels. Some of the "spikes" in METR are extreme thanks to the unification of thresholds for social and child allowance. Similarly, the increase in METR for single adult childless households at low wage levels is due to the unified levels of social allowance. However, the overall number of inactivity trap regions has declined for some household types, which is due to greater simplicity in the tax code. To illustrate the magnitude of some of the spikes in METR presented in Figure 28, which correspond to 200 CZK wage increases, the family head would have to obtain a wage gain of about 800 CZK *per child* in order for the spike to be eliminated, i.e., in order to stay at the same total net income level after the wage increase.

Figure 28**: METRs reveal continued inactivity traps at certain wage levels**





Source: Jurajda and Zubricky (2008)

[78] The full range of scenarios is presented in the Annex to this report.

4.19 **The previously high replacement rates were a particularly binding barrier in high unemployment and rural regions where wage levels are lower than in the booming urban settings.** The national averages presented have very different implications in different parts of the Czech Republic. Based on the calculations one can also focus on these comparisons taken at the actual regional average construction wage in 4 different regions: low unemployment rural, high unemployment urban and low unemployment urban. For example, using (i) Znojmo for high unemployment rural (12 percent unemployment rate, 42 percent of population in towns), (ii) Mlada Boleslav for low unemployment urban (2 percent unemployment, 70 percent of population in towns), (iii) Rychnov for low unemployment rural (3 percent unemployment, 58 percent of population in towns) and (iv) Usti nad Labem for high unemployment urban (11 percent unemployment, 85 percent of population in towns), one obtains the following mean (median) monthly salaries in construction from 2006: 16,460 CZK (13,540) in Znojmo, 24,352 CZK (21,366) in Mlada Boleslav, 22,026 CZK (18,225) in Rychnov and 21,039CZK (15,280) in Usti. The specific NRR and METR rates can now be read from the enclosed graphs. However, these wage levels are unrealistically high for socially excluded. Focusing on the same wage statistic for construction workers in these regions with only elementary education level, we obtain the following median wages: 9,510 CZK in Znojmo, 20,829 CZK in Mlada Boleslav, 13,287 CZK in Rychnov and 13,841 CZK in Usti. The comparatively low wages levels available in high unemployment regions as well as in rural settings suggest that the labor supply disincentives were particularly strong there.

The impact of personal indebtedness

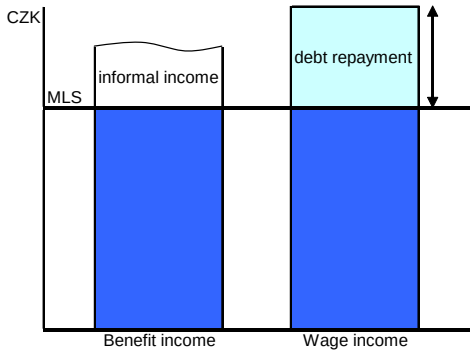
4.20 **Personal indebtedness appears widespread among Roma welfare beneficiaries in the Czech Republic, as are incidents of usury.** As presented in Chapter 2, many surveyed Roma reported that they are indebted, a finding confirmed by the experts interviewed for the purposes of this study. According to interviewed experts, most frequently they face debt towards commercial credit companies on loans with disproportionate interest growth. They are also in debt to municipal authorities, generally for rent and services connected with housing. The experts also indicated widespread debt to loan sharks. Widespread indebtedness among Roma welfare beneficiaries is not surprising, as debt is a typical feature of long-term welfare benefit recipients in many countries, with beneficiaries turning to various forms of credit to make ends meet. While informal debt within the Roma communities is common in many countries, many Czech Roma welfare beneficiaries have formal debt – to utilities companies, financial institutions and others. In particular, there has been anecdotal evidence of usury and active marketing by financial credit institutions for high interest short term loans in Roma communities.

4.21 **Formal indebtedness has a powerful impact on labor supply decisions.** Debt collectors can only enforce debt collection provided an indebted individual earns formal income in excess of the minimum subsistence level. So long as an indebted individual remains on social welfare benefits which guarantee income to the level of the MLS, debt collectors cannot enforce the debt. In effect, even when a formal sector job pays more

than the combination of social welfare benefits and the minimum subsistence level, an individual faces little incentive to take that job, because of the threat of debt collection. Because of the debt and the threat of debt collection, an individual is as well off working in the formal sector as he/she is on benefits. Under such circumstances, the individual may even be worse off in a formal job if he/she manages to earn informal income on top of the welfare benefits. Only if the wage income on top of the MLS is larger than the expected debt repayments the individual will be attracted by a job. With most individuals facing high degrees of uncertainty about possible debt repayments or fearing that they will be infinitely large at the beginning, this calculation is often impossible to make and the safest bet is to remain on benefits. Figure 29 shows a graphic presentation of the labor supply disincentive effect of debt and debt collection. Of course, this disincentive does not apply in the case of informal debt, such as debt within the community, since debt collectors are aware of any informal income the debtor is earning.

4.22 **Because of debt uncertainty, the application of a lower Existential Minimum (EM) threshold for social benefits for inactive long-term unemployed may not have the desired effect on labor supply decisions.** As noted above formal work would only be attractive if the expected wage income is going to be larger than the expected debt repayment. The EM does not remove the uncertainty about the level of possible debt repayments. Rather, individuals may choose to make up for the loss of income due to the lower EM by enhancing labor supply in the informal sector.

Figure 29: **Personal indebtedness acts as a key labor supply disincentive**



Note: This is a graphic representation not based on actual data

4.23 **With affected individuals unable to break out of the debt spiral without help, debt support needs to become a core element of employment activation policy.** Debt support has been an important element of social policy in many countries in the European Union, owing to the fact that many welfare beneficiaries resort to credit. However, the labor supply disincentive effect of indebtedness has been underestimated, and it is important to recognize that employment activation policies as well as revisions to the benefit eligibility and benefit levels are likely to fail to promote greater employment among disadvantaged long-term unemployed, unless the debt issue is addressed.

4.24 **Work disincentive effects in the Czech social support and unemployment insurance system have been gradually lowered over the last few years.** The minimum living standard has been lagging behind wage growth since 2001, the child tax bonus has replaced tax base deductions and there was a reduction in personal income tax rates for the two lowest income brackets during 2005-2006. Finally, in 2008 a number of tax and benefit changes were introduced with the stated aim of increasing labor supply incentives. Average effective tax rates declined in 2008 for both low and high income groups (thanks to tax credits and housing allowances for the former and thanks to cap on social security and flat PIT for the latter group). This section documents significant declines in most NRR rates, especially for families with several children and for long-term unemployed. The 2008 changes therefore make work for low wage more attractive compared to inactivity.

4.25 **With the measures to reduce work disincentive effects from the tax and benefit system under way, it is important to monitor their effects** prior to introducing further change. Policy directions include the following:

- *Assess the extent to which the new rules, in particular the Existential Minimum eligibility threshold for long-term unemployed are enforced across the Czech Republic.* A tightening of benefit eligibility is always difficult to implement, and there may be difficulties in enforcement.

- *Evaluate the poverty and employment effect of the introduction of the lower Existential Minimum threshold*. This would include both the effect on the share of the poor as well as the depth of poverty for those affected. It could also look at flows of registered unemployed, i.e. whether there has been an increased flow of long-term unemployed on EM into employment.

- *Make debt workout and financial literacy programs a core element of employment activation for long-term unemployed benefit recipients.* International experience suggests that this may be best done through non-governmental and non-profit agencies, for example through making debt work-out part of the menu of outsourced activation services. Debt advisory services are standard elements of social policy in many advanced OECD and EU economies, and one which is crucial to develop for the Czech Republic, if a primary barrier to employment for Roma is to be overcome. Moreover, the provision of financial literacy programs in marginalized localities may help prevent further indebtedness of households and individuals[79].

[79] See World Bank (2007b) and World Bank (2008) for specific recommendations on financial literacy programs and consumer protection and financial services.