

From Job Shortage to Skilled Worker Shortage

To address skill and labor shortages countries need to increase effective labor supply

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Until the early 2000s labor market outcomes were disappointing in virtually all New Member States (NMS — the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia, Bulgaria and Romania). Unemployment was high — often in double digits — and the employment/working age population ratio, at around 60%, was low and below the EU-15 average of about 65%. These unfavorable labor market outcomes persisted despite economic growth; in fact, many countries experienced periods of jobless growth.

Firms in these countries tried to become competitive by reducing costs and shedding redundant labor. The size of the new expanding sector (mainly small private firms and services) was too small to absorb labor released from declining industries (such as heavy industry and mining). Moreover, many workers, especially older ones, who lost their jobs in these declining industries, lacked the skills required in the new sectors and withdrew from the labor force, discouraged by the scarcity of job opportunities. This was facilitated by the availability of early retirement schemes and other welfare benefits.

The scarcity of job opportunities is no longer present in the NMS. In the mid-2000s — ignited by favorable glob-

al market conditions, the EU accession of eight transition economies and an increase in the labor driven growth — labor demand picked up and since then jobs have become more plentiful. The most spectacular turnaround occurred in the Baltic States, but also in Poland and Bulgaria. For example, in Estonia the annual rate of employment growth increased from -2.0% during 1997-2000 to 3.7% during 2005-2006.

In the early 2000s the unemployment rate in the NMS hovered around 15% (with the exception of the Czech Republic, Hungary, Romania and Slovenia). Currently, in most countries the unemployment rate is below 10%. The most dramatic drops in the unemployment rate occurred in the Baltic States, Bulgaria, Poland and Slovakia. For example, in Lithuania the unemployment rate fell by nearly 11 percentage points over six years.

Surge in Labor Demand

What has caused the recent spectacular improvement in labor market conditions in the region? Strong economic growth can only be part of the story. Among other possible explanations for the recent fall in unemployment, an increase in firms' demand for labor associated with successful firm restructuring is the most plausible one.

The average job vacancy rate in the region, which is an indicator of the strength of labor demand, increased by almost 60% within the last two years alone. For example, from 2005 to 2007 the vacancy rate more than tripled in Lithuania, doubled in Poland, and almost doubled in the Czech Republic and Latvia.

The wage growth that has accompanied employment growth is yet another sign of an increase in labor demand in the region. During the most recent period (2003-2006) wage growth was strongest in the Baltic States, where large-scale out-migration (relative to labor force) reduced labor supply adding to the wage pressure.

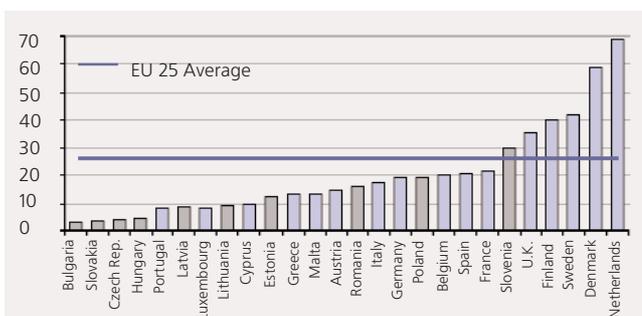
While in the earlier period firms were able to meet the demand for their products by increasing productivity, and improving competitiveness through laying-off redundant labor — a process known as "defensive restructuring" — recently firms have moved to "strategic" restructuring, which is associated with using productivity gains to increase market share, expand output, and consequently, hire more workers. Strong and robust export growth since 2004 (at an annual rate of around 20%) supports the assertion that the countries reaped the benefits of the earlier restructuring efforts, became more productive, and can now successfully compete in the global market.

Low Participation Rates among Youth and Older Workers

While the unemployment rate has declined substantially, the employment/working age population ratio remains relatively low, especially among younger and older workers. In the NMS the average youth employment rate is 27%, compared with 40% in the EU15. The difference for older workers is less pronounced: 42% against 45%; however, it varies widely: from 28% in Poland, to 59% in Estonia. Clearly some countries face a bigger challenge in increasing the employment rate among older workers than others.

The youth employment rate is low because young people in the NMS tend to stay longer in education than their EU15 counterparts, and they are less likely to combine education with work. In few countries does youth account for

Graph 1. Share of 15-24 in Part-Time Employment, 2006



Source: Eurostat, Bank staff calculations

more than 10% of part-time employment, which is still well below the EU25 average of 27% (see Graph 1). Young workers may also suffer from strict employment protection regulations, such as high rates of labor taxation or high minimum wages, which discourage employers from hiring inexperienced workers whose productivity is uncertain.

The low employment rate among older workers in the region is strongly affected by the design of social security systems. Many people of working age (55-64) are not employed because of the low statutory retirement age, and ample opportunities for early retirement. As a result, the average retirement age is significantly lower than the statutory retirement age (see Graph 2). In some countries the gap between the statutory and actual retirement age is striking, with Poland being the most dramatic example. In addition, many older workers take advantage of the often lax rules governing eligibility for disability pensions and use them as a substitute for retirement pensions or unemployment benefits. For example, disability pension recipients account for some 30% of all the economically inactive population aged 55-64 in Poland. In Estonia and Lithuania the share is even higher.

Pervasive Problem of Long-Term Unemployment

The incidence of long-term unemployment — which is the most socially costly form of unemployment — is still high at 53% in the NMS and Croatia compared with 42% in the EU15. Under conditions of strong labor demand, the long-term unemployed are largely work-

ers who lack skills (or incentives) necessary to take available jobs. The problem is pervasive in virtually all countries in the region, but is particularly pronounced in Slovakia, Croatia, Romania, Poland and Bulgaria. Slovakia is an extreme case: three out of four unemployed persons are jobless for more than one year.

Less educated and older workers are disproportionately represented among the long-term unemployed. For example, in Poland workers with less than secondary education account for as much as 60% of the long-term unemployed, but only 40% of the employed. Apparently, long-term unemployment is strongly associated with poor or obsolete skills. This implies that unemployment in the NMS has a strong structural component that will persist even with further increases in labor demand.

Skill Shortages: An Emerging Challenge

Skill shortages have become one of the top business concerns, and are increasingly seen as a constraint to future firm growth. On average in the NMS every third company found that lack of skilled workers is an important obstacle to business growth, especially in expanding companies. In Latvia, Lithuania, the Czech Republic, Poland, Romania and Hungary the skills of available workers were seen as an important obstacle to firm activity by 35 to 45% of all firms.

The substantial skills mismatch may mean that skills acquired under central planning became obsolete, but also may suggest that education systems are not effective in producing workers with the kinds of skills needed in modern economies.

In addition to skill shortages, labor shortages have also been rising recently, in particular in the booming construction industry, but also in manufacturing. It is skilled workers for whom demand has increased the most but who are in shortest supply. Out-migration to EU15

countries has contributed to labor shortages and to wage pressures.

Policy Options

To address the emerging labor market challenges the countries need to increase the effective labor supply, that is the supply of workers that have incentives to actively seek employment, and skills that enable them to take newly created jobs. To do so they need to move in three directions:

- Improve labor supply incentives through reforming the social security systems and enhancing the opportunities for flexible work arrangements. The two target groups are youth and older workers. Labor force participation by young workers may be raised through enhancing labor market flexibility, introducing the youth sub-minimum wage (around 80% of the adult minimum wage) in countries where the statutory minimum wage is relatively high; and targeted reductions in social security contributions. Measures to raise the labor force participation of older workers include first and foremost limiting early retirement.

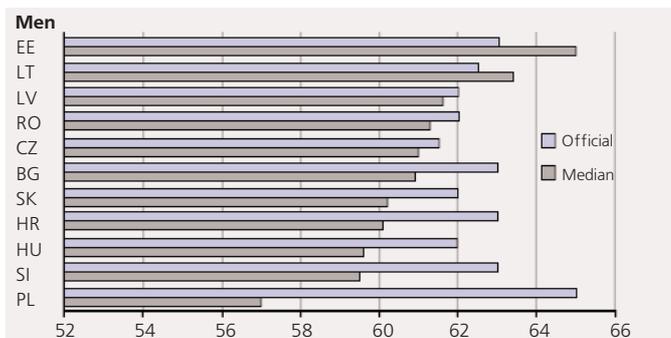
- Improve worker skills through reforming the educational systems so as to make them more responsive to labor market demands. Reforms aimed at improving worker skills include providing solid foundation for continuous learning to as many students as possible; expanding life-long learning opportunities to adapt to rapid technological change, and linking training to trends in the industrial and occupational profile of labor demand.

- Import labor with skills that are in short supply by opening labor markets to foreign workers. This is a fast way of dealing with labor and skills shortages.

Policies to address the factors causing labor shortages need to be tailored to country-specific conditions. While in some countries reforms should focus more on improving worker skills, in others they should focus more on removing labor supply disincentives created by the social security systems or on enhancing labor market flexibility.

The report was prepared by a team of World Bank economists in the region led by Jan Rutkowski. Full text of the World Bank EU8+2 Regular Economic Report published in September 2007 is available at: www.worldbank.org/eu8-report. BT

Graph 2. Official and Actual (Median) Retirement Age in EU8+2, 2005



Source: Romans (2007), MISSOC Database, National Strategy Report on Adequate and Sustainable Pensions (2006), Bank staff calculations