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Skill shortages and labor market outcomes in Central Europe

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ABSTRACT

The new Central European members of the EU have been characterized by low employment rates, especially among unskilled workers, despite the GDP recoveries and large private sector shares in output and employment. Evidence points at skill shortages in Central Europe as a key impediment to faster labor reallocation and convergence to the EU-15 employment structures. In this paper, we develop a simple model of labor reallocation with transaction costs and show how skill shortages can inhibit firm creation and increase income inequality. We use the model to examine the impact of training subsidies and their financing on skill acquisition and start-ups of new private firms, and show that the positive effect of subsidies would be mostly offset by high wage taxes. Shifting financing from wage to consumption taxes would improve incentives for workers' training and firm start-ups, while relying more on income taxes could reduce the income gap between workers and entrepreneurs.

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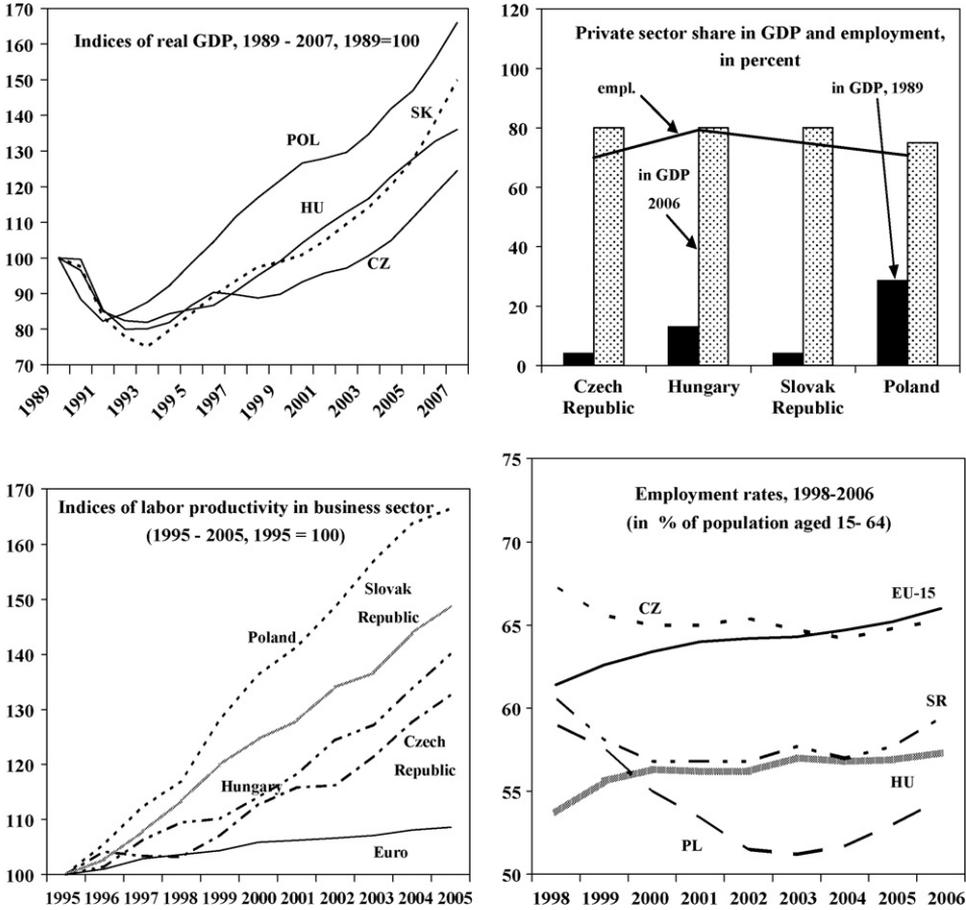
1. Introduction

The transition in Central Europe (CE)¹ has involved reallocation of workers from less productive firms in the state sector towards more productive ones, typically in the new private sector.² The initial

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¹ In what follows, we refer to the Czech Republic, Hungary, Poland and the Slovak Republic as CE.

² More recently, a similar process has been under way as a part of "catching up" and convergence of these countries to the EU-15 production and employment structures, but the reallocation has been occurring mostly within the private sector.



Source: OECD, Eurostat, EBRD, IMF.

Fig. 1. Output and labor productivity in Central Europe. Source: OECD, Eurostat, EBRD, IMF.

view was that employment would decline only in the short run, because of the rapid enterprise restructuring and job destruction, but recover over the medium term. However, with the exception of the Czech Republic, employment rates remain low almost two decades later despite the GDP recoveries, large private sector shares in GDP and employment, and EU accession (Fig. 1). Moreover, in all CE countries the low employment rates of unskilled workers are striking and raise political concerns about income distribution and social equity. As a result, researchers and policymakers have turned their attention to the structural factors that affect employment in the new EU members, including the skill composition of the labor force.³

At the outset of the transition, formal measures of educational attainment were pointing to higher human capital stocks in the CE countries than in countries with comparable income levels. However, already a few years into the transition, evidence of skill shortages has emerged, due to shifts in the

³ Three explanations for low employment rates in the CE countries have been discussed: (i) ongoing reallocation of labor due to structural shifts; (ii) finished reallocation with redundant labor; and (iii) wrong choice of institutional framework. Recent work by Faggio (2007) showed a negative correlation between job creation in the private sector and unemployment in transition economies of CE and the Commonwealth of Independent States (CIS), and suggested that the process of reallocation still influences today's labor markets in these countries. Our paper concentrates on the "ongoing reallocation" hypothesis.

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