

RESEARCH PAPERS

UNDECLARED WORK IN THE CZECH REPUBLIC AND ITS IMPLICATIONS FOR THE CZECH LABOR MARKET

Strielkowski, W.

This paper aims at describing the issue of undeclared work in the Czech Republic and to explain the burdens it represents for the national economy. It also describes what measures can be undertaken in order to tackle undeclared work and uses some real-life examples to illustrate their outcomes. Undeclared work and the so-called “švarc systém” (the employer-employee relations with a person exercising the employer’s normal activities not being an employee in legal terms but acting as an independent entrepreneur) are among the biggest issues on the Czech labor market nowadays. According to some estimations, the Czech state loses about five billion CZK annually in the form of uncollected taxes, unpaid revenues and health and social insurance payments. New changes to the Czech labor legislation that came into force in 2012 were envisaged to tackle undeclared work, reduce tax evasions, fight shadow practices on the labor market, and to prevent social deprivation and other threats for the society by shifting the competences to conduct random checks, and controls of firms and businesses were transferred to the State Labor Inspection Offices (SLIO). The changes in the legislation facilitated the identification of the undeclared work and penalizing of its bearers, which minimized the losses from the illegal employment.

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1. Introduction: Economic and Business Development of the Czech Republic

Czech Republic represents a post-transition economy with labor market distortions which are notorious for all transformation economies of the Central and Eastern European (CEE). The country underwent a solid transformation that caused its volume of production to drop significantly in the first phases of transition. Transformation brought about a significant change in consumer demand and the quality of production (see e.g. Rutland, 1992; Claessens and Djankov, 1999; or Machek, 2012). However, it appears that the assessment of these changes cannot be accurately conducted based on current available statistical indicators (both CZSO and Eurostat), as far as it does not affect the qualitative differences in the market and centrally planned economy. This fact has to be considered if one wants to comprehend the depth of decline in gross domestic product that has occurred in all CEE countries. The Czech Republic (together with

Poland) noted the smallest decline in GDP among all CEE countries – by 13 or, respectively, 14% (see e.g. Vintrova, 2004; or Kawecka-Wyrzykowska, 2013). The Czech economy recovered from the systematic changes very fast and began to grow starting from 1993 in terms of turnover and GDP, with the latter increasing at a faster rate than the EU average (Machková and Mohelský, 2012).

Between 2000 and 2010, the Czech economy yielded positive growth and its gross domestic product (GDP), expressed in the 2000 constant prices, grew annually by 3.24% on average. By 2001, when economic reforms brought their fruits such as successful transformation, marked inflows of foreign direct investment and preparations for the EU accession, the unemployment rate dropped down to 6.98%. The EU accession resulted in a decrease of the unemployment rate from 7.8% in 2004 to 4.4% in 2008. However, in 2008 favorable growth and development, especially at the labor market, was halted by the strong economic recession.

Table 1 Job market indicators in the Czech Republic (2000-2010)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GDP (% change)	4.2	3.1	2.1	3.8	4.7	6.8	7.0	5.7	3.1	-4.7	2.7
Employment (1000s)	4 732	4 728	4 765	4 733	4 707	4 764	4 828	4 922	5 002	4 934	4 885
Unemployment (1000s, registered)	455	418	374	399	426	410	371	276	230	352	384
Unemployment, Female (%)	10.6	9.9	9.0	9.9	9.9	9.8	8.8	6.7	5.6	7.7	8.5
Unemployment, Male (%)	7.3	6.7	5.9	6.1	7.0	6.5	5.8	4.2	3.5	5.8	6.4
Employment of foreigners (1000s)	164.9	167.6	161.7	168	173.2	218.9	250.7	309	361.7	318.4	306.3

Source: Czech Statistical Office (2012)

At the end of 2008, the Czech labor market received a devastating blow when the economic crisis settled in. In 2009, the GDP change to the previous year yielded a negative change of -4.7%. The unemployment rate during the six quarters of 2009 and 2010 yielded a net increase by 3.76 percentage points. The sharp decline in the employment rate and subsequent stagnation around 7.5% followed (Tuleja and Trvdon, 2011).

In 2010, the unemployment rate spiked to 8.5% for females and 6.45 for males in comparison with 5.6% and 3.5% in 2008, respectively. The employment of foreigners also dropped significantly (about 15% throughout the period from 2008 to 2010).

Prior to 2008, the majority of the unemployed individuals registered with the Labor Offices did not fall under the definition of International Labor Organization (ILO). As a result, many Labor Offices could not satisfy the economy's demand for labor force. However, in 2009 and 2010, the structure of the registered job-seekers changed dramatically. As the demand for Czech exports decreased, many firms opted for cutting the production costs by firing their employees. Table 1 depicts the job

market indicators for the Czech Republic between 2000 and 2010.

The impact of the economic crisis on the Czech labor market can also be demonstrated by the number of available jobs (see Table 2). Starting from April 2008, when labor supply exceeded labor demand, with its peak at more than 152 000 vacant jobs at the time, the crises reduced the number of vacant jobs to 30 900 at the end of 2009.

2. Undeclared Work in the Czech Republic

In order to understand why it pays off to do undeclared work in the Czech Republic, one has to dig into its recent history and consider many economic, social and cultural factors.

The overall atmosphere on the labor market in the Czech Republic is tense and the majority of business owners consider undeclared work as something normal, i.e. a necessity for their survival. Doing business in the Czech Republic is complicated and problematic, with many administrative burdens still in place. According to the latest ranking of the international organization Doingbusiness.org, the Czech Republic occupies 64th

Table 2 Number of vacant jobs in the Czech Republic (2008-2010, in 1000s)

Month Year	1	2	3	4	5	6	7	8	9	10	11	12
2008	145.9	150.3	151.3	152.3	151.3	151.9	150.2	150.9	139.6	130.1	111.3	91.2
2009	68.5	64.9	55.4	50.5	48.3	43.4	41.8	41.3	38.8	35.8	32.9	30.9
2010	31.6	32.1	33.1	32.9	33.1	32.9	33.5	36.6	35.1	33.7	32.3	30.8

Source: Ministry of Labor and Social Affairs (2012)

Table 3 Comparison of declared and undeclared work “svarc system” (in 2012)

	Declared work	Undeclared work
Monthly gross salary	24.000 CZK	30.000 CZK
Monthly net remuneration	18.600 CZK	26.467 CZK
Monthly costs for the employer	32.161 CZK	30.000 CZK
Spending package, 60%	n/a	tax base 72.000 CZK*
Income tax	2.760 CZK	0 CZK
Health & social insurance paid by the employer	8.160 CZK	0 CZK
Health & social insurance paid by the employee	2.640 CZK	3.533 CZK
State revenues	13.560 CZK	3.533 CZK

Note: Minimal tax base from which the tax is paid was 75.420 CZK in 2012.

Source: Own calculations

place, and is preceded by such countries as Georgia (16th place), or Peru and Columbia (41st and 42nd places respectively). Even such countries as the Slovak Republic (48th place) or Botswana (54th place) ranked higher.

On top of all that, in 2011, a prestigious British journal “The Economist” published an article in which it scrutinized the Czech political and economic system and called it “rotting partitocracy”. According to the journals, political parties in the country hijacked the democratic process and their leaders became arrogant and corrupt (The Economist, 2011). This situation might be described as the “state capture”—an excessive exploitation of public resources by the ruling elite, when the state and business start to live in a symbiosis (Grzymala-Busse, 2004).

When it comes to the undeclared work in the Czech Republic, it usually takes the form of employer-employee relations when a person exercising the employer’s normal activities is not an employee in legal terms but acts as an independent entrepreneur acting on a basis of “živnostenské oprávnění” (business concession). This type of undeclared worked was named the “švarc systém” (svarc system) after a small entrepreneur from Beroun called Miroslav Švarc who successfully used it in his own business in the early 1990s but was then convicted and served an 18-month prison term (see e.g. Duvell, 2011; or Myant, 2013).

Undeclared work seems to be more beneficial for both parties (employer and employee) and the state is ripped of its gains. An example of gains and losses showing the actual values of net and gross salaries, health and social insurance, tax and state revenues brought about by the “svarc system” is presented in Table 3.

Moreover, there is more to the “svarc system” than its monetary benefits. For instance, employees working under the provisions of the “svarc system” do not have

paid holidays nor are they entitled to have free meals or food coupons at work. Additionally, freelance employees bear the full costs of causing damages or frauds at the workplace. In spite of all these disadvantages, the survey conducted by the Ambruz and Dark/Deloitte legal consultancies in 2012 revealed that 63% of the firms are in favor of the “svarc system” and would be in favor of legalizing undeclared work (Ambruz & Dark, 2012).

The “svarc system” typically occurs in those sectors of the economy where working as a private entrepreneur is more beneficial due to the financial incentives (e.g. construction, repairing and other vocational trades). This is caused by the fact that since 2005, all self-employed individuals (sole traders, entrepreneurs without concessions, private farmers or people profiting from rental income) could decide for either having the standard accounting and providing tax records, or opting out for so-called “výdajové paušály” (spending packages). The current rate of spending packages is the following: 80% for vocational trades, agriculture, forestry and water management; 60% for other trades, 40% for freelancers and beneficiaries of income from copyrights, business pursuant to special regulations; 30% for rental income beneficiaries. In addition, undeclared work is notorious in the sectors where any form of control might be ineffective (e.g. accommodation and gastronomy or information and communication).

3. Employment of Foreigners in the Czech Republic

Since the Velvet Revolution in 1989, the Czech Republic has quickly become an immigration country attracting immigrants especially for economic and family reasons. As of the 30th of June 2011, 417 424 immigrants officially resided in the country. About 309 137 (74%) of them were economically active (either employed or

acting as private entrepreneurs). About 40 114 immigrants coming from third countries (outside of the EU) held a work permit or a green card (vis-a-vis 93 621 holders of a trade license) (Horáková, 2011).

Decreasing unemployment rates prior to 2008 caused an increasing shortage of domestic labor in the Czech labor market, especially in the areas such as agriculture and garment industry (see Burda and Profit, 1996; or Drbohlav et al., 2008). This shortage and the increasing demand for labor made the Czech Republic very attractive for the foreign citizens. From 2004 to 2008, the number of foreigners as employees in all categories (as defined by the Employment Act) increased almost 2.6 times (MLSA, 2012). The increase in the number of foreign citizens called for regular controls by the State Labor Inspection Office but the number of offences declined over the past decade.

The positive growth of the Czech economy in 2008 was halted by the economic recession. Many employees were made redundant and the number of employed foreigners decreased proportionally. During 2009 and 2010, the total number of foreigners employed in the Czech Republic reduced from 284 551 in 2008 to 215 367 in 2010 (Ministry of Interior of the Czech Republic, 2011). Growing unemployment at the end of 2008, and especially in 2009 also led to growing unemployment among foreigners. The pool of foreigners who lost their jobs and could not get new ones (which implied leaving the Czech Republic in two-months' time) increased (Kowalska and Strielkowski, 2013). The majority of these foreigners were from non-EU countries. These people became a potential threat for the Czech Republic because they lost their earning potential and had basically no legal possibility of obtaining a livelihood and had to return to their country of origin.

The Czech government looked for a solution and on the 9th of February 2009, Resolution No. 171 dealing with the dismissal of foreign workers due to the economic crisis and introducing the "voluntary returns project" was introduced. The project was intended to help foreigners from third countries who were legally residing in the Czech Republic and who wished to return to their home countries to sponsor their returns. The project provided emergency accommodation, one-way tickets, organized departure and offered a financial contribution of €500 for adults and €250 for children younger than 15 years of age. The first phase of the project lasted from the 16th February to 24th of July 2009 and involved a total of 1 871 foreigners. The total project costs amounted to CZK 60.7 million. The majority of foreigners taking advantage of the opportunity to return to their homeland at the expense

of the Czech Republic, originated from Mongolia (1220), Uzbekistan (287) and Vietnam (239). Given the growing unemployment of foreigners and their declared interest in the project, on the 4th of May 2009 the Government of the Czech Republic approved Resolution No 588 launching the second phase of "voluntary returns". The second phase took place from the 27th of July to 15th December 2009 with and total costs amounted at 24.4 million CZK. In the second phase, the contribution aimed at sponsoring returns was reduced to EUR 300 per adult and EUR 150 for children, housing was provided for only one night before departure, and other conditions remained unchanged. However, the second phase did not prove to be so successful and only 218 foreigners took part.

4. Policy Measures to Tackle Irregular Employment

Undeclared work deprives the Czech budget of taxes, mandatory contributions and payment of various types of social benefits which are estimated to be about CZK 5 billion annually. The "gray economy" associated with undeclared work also deepens social exclusion of long-term unemployed. Furthermore, employing illegal foreigners brings certain security risks, increases the danger of criminal phenomena and adversely affects the fair market environment.

In order to tackle undeclared work in the Czech Republic, the Czech government adopted two new legislative measures that came into force on the 1st January 2012. These measures, namely Act No 435/2004 Coll., on Employment and Act No 262/2006 Coll. Introduced by the Law No 365/2011 Coll., brought some significant changes to the existing practices that are listed below. Changes brought by the Act No 435/2004 Coll., on Employment, introduced by the Law No 367/2011 Coll. were the following:

- Changes in the definition of undeclared work in order to ensure more efficient control of this phenomenon (seven main distinguishing features: acting on an employer's behalf, regular remunerations in equal amounts, exclusive work for one employer, working with employer's tools and facilities, strict working hours, damage liability, narrow specialization);
- Increased penalties for undeclared work (fines starting from CZK 100 000 for employees, or from CZK 250 000 for employers);
- Centralization of the competencies to one main authority in order to increase the efficiency of tackling undeclared work;
- Exclusion of employers punished for illegal employment of foreigners, from public funding;

- The obligation to keep documents proving the legality of employment in the workplace as required by labor legislation (contracts or their copies should be present at the workplace and presented on the spot, although this aspect remains dubious and according to many lawyers is against the current labor laws).

Changes brought by the Act No 262/2006 Coll. Introduced by the Law No 365/2011 Coll. were the following:

- Changes in the definition of “dependent work” in order to eliminate covert labor relationships (of officially self-employed persons) and push through the formal labor relationships.

Implementation of comprehensive inspections of employment and optimizing the performance of SLIO and its partners were made possible thanks to passing the control powers of control of illegal employment and other selected activities of the Employment Act to the State Labor Inspection Office. Since May 2011, about 14 304 controls were carried out, 10 304 inspections completed transfer protocol, 4 464 inspections were on-going. During those inspections the following violations were found: 884 people employed illegally in the Czech Republic, 108 illegally employed foreigners from EU countries, 293 illegally employed foreigners from third countries, a total of at least 1 285 individuals engaged in undeclared work.

Hefty penalties for undeclared work were imposed by the state authorities: 123 fines for administrative offenses and penalties for four offenses in connection with illegal work, totaling CZK 34 959 900 (CZK 34 836 400 administrative offenses, CZK 123 500 offenses), 321 additional fines for administrative offenses and 49 penalties for offenses still pending. During inspections, state authorities found that a growing number of employers were aware of the project and that harmful illegal employment is damaging for the state budget but also for the competitive business environment they have to operate in.

The new organizational structure and system support for full implementation of activities aimed at tackling undeclared work in terms of labor inspection system proved to be successful. The organizational structure was completed and regional units for combating illegal employment were created. Recruitment of inspectors by the LO under the State Labor Inspection Office was

successful and the total envisaged number of inspectors was reached, although some fluctuations were observed. The project envisaged the use of mobile offices equipped with hi-tech devices for obtaining the data from the public registers; however, the public tenders were revoked twice due to the fact that only one bidder was registered. This fact leads to the lack of mobility of inspectors, which appears to be crucial in controlling illegal employment. SLIO attempted to use its official vehicles for conducting controls and explored the possibility of using private vehicles for this purpose.

In preparation for the analysis of the current methodology, a questionnaire survey was carried out by LO in order to help analyze the methodology for selected suppliers. Due to the specific activities of control and monitoring methodology negotiations on the possible implementation of the methodology, analysis and creation of its own employees instead of the implementer’s implementation through public procurement are now in progress.

The training, retraining, and secondary education of inspectors and SLIO employees was carried out by means of public tender which resulted in the selection of the contractor POE Educo Ltd. In April 2012, the contractor prepared an e-learning course and educational materials that were incorporated into e-learning applications that were used in the preparation of new full-time inspectors and verifying their acquired knowledge in e-learning course. Education for a new method of checking will be done only after the analysis and creation of a new methodology.

Pilot verification, system operation and control activities through the support of Czech Point contact points proved to be fully functional. After the initial testing of the software platform DONEZ in October 2011, the activity was launched. In the first few months, there was an exponential increase in applicants included in DONEZ. Available statistics demonstrated a gradual increase in the classification of job-seekers into the system, as well as their behavior and results of checks conducted at CzechPOINT centers (see Table 4).

In order to improve management partner competences and optimize the organizational structure, more responsibilities were delegated to the partner. Changes made thanks to this optimization will come into force during

Table 4 Number of visits at CzechPOINT centers

Month	Oct 2011	Nov 2011	Dec 2011	Jan 2012	Feb 2012	Mar 2012	Apr 2012
No of visits	13 514	72 528	173 388	210 994	190 182	162 587	146 186

Source: SLIO (2012)

the next monitoring period. The results from the implementation of the activity allowed the saving of at least CZK 10 million on the expenditure side of the state budget for job seekers employment, but the associated income effect is also associated with prevention of illegal employment (income tax, statutory insurance contributions). The total costs associated with the above number of visits made was about CZK 47 538 000.

Overall, it has to be noted that the implementation of the policy measure designed to tackle undeclared work in the Czech Republic faced various difficulties and constraints.

For instance, the project implementation revealed many bottlenecks: only 35 thousand out of the declared 200 thousand controls per year were conducted and none of the envisaged 180 mobile offices was purchased due to the complex regulations of public tenders in the country. In addition, there was a high fluctuation among the new inspectors and only few of the uncovered employers and employees were effectively penalized.

In addition, the authorities responsible for the implementation of the project withheld project dissemination and information about the project which deprived the project from one of its most important features – creation of awareness of penalization of undeclared work and the necessity to opt to declared work schemes.

Additionally, it appears that both entrepreneurs and employees were not in favor of measures undertaken by the project and most of them still preferred to engage in illegal employment schemes (such as the well-known “svarc system”). This is stressed by the fact that in many areas of the economy (such as information and communication or accommodation and services) it proved to be quite complicated to carry out controls and to catch employers and employees red-handed right on the spot. Most of the work in these areas is organized on sporadic and irregular work hours’ basis, often on a basis of “home office” mode which makes it very difficult for the authorities in charge to track and monitor.

5. Conclusions and Managerial Implications

Overall, it has to be noted that the state policies to tackle undeclared work in the Czech Republic yielded several successful outcomes. The efforts to combat illegal employment brought unprecedented cooperation between various state authorities, social security system and Czech Post. Novel approaches and technologies were utilized and plans for a more effective system of controls were prepared.

Two major success factors of the fight against irregular employment can be identified here: enhancing

cooperation between various institutions responsible for the labor market regulation and employing new technologies (CzechPOINT) for the effective control (tracking) of the unemployed. These success factors might be transferred to other EU countries that share similar cultural, economic and socio-geographic patterns with the Czech Republic (namely, Austria, Hungary, Germany, Poland, and Slovakia).

Tackling undeclared work envisages enhancing closer cooperation between authorities (such as SLIOs, Labor Offices and Czech Social Security Administration (CSSA), as well as the Ministry of the Interior of the Czech Republic and Czech Post) and helping in integrating their databases, utilizing “Český podací ověřovací informační národní terminal” (CzechPOINT) for monitoring the unemployed individuals, and disseminating the information on the rights and obligations of employers and employees. The cooperation between all these institutions represents an unprecedented step towards linking of governmental registries and facilitating effective controls on the Czech labor market. Before 2012, all controls were run separately and sporadically by various state inspections and organizations. The unification means great progress towards a more effective system of covering, monitoring and uncovering of illegal and criminal activities on the Czech labor market.

Activities implemented through a network of CzechPOINT centers are crucial for ensuring that the maximum extent possible to reduce illegal employment of Czech citizens and foreigners will be reached and that the process started by the introduction of client access in services employment will be completed.

Using public contact points within the network of CzechPOINT for contacts with specific groups and applicants for employment (e.g. unemployed, school leavers, etc.) strengthens the control mechanism that prevents job-seekers from engaging in activities they are not authorized to perform and which are usually carried out under the so-called “grey economy”.

The system of random checks run at CzechPOINT centers prevents the officially registered unemployed from working illegally on the side because they are regularly selected for visiting CzechPOINT offices during working hours and the time to visit is made known to the candidates up to three days ahead. Due to the fact that times and places of CzechPOINT places vary, employers face increasing time and financial costs of transportation of their undeclared employees to the centers (usually Czech Post offices) where the controls are carried out. If one assumes that about 7% of the economically active population is engaged in illegal work, and the introduction of

the efficient control might bring annual economic benefits measured in the hundreds of billions of crowns.

This innovative way of working with the unemployed individuals might reinforce active labor market policy and help reduce the administrative burdens associated with managing the records of job applicants. As a result, Labor Offices will get more space for direct assistance and guidance in the placement of active job seekers to the labor market. An increase in reported vacancies in relation to the lower profitability of illegal employment might become a favorable side effect of the state anti-irregular employment policies for the Czech labor market.

This paper laid the pathway to follow and it seems useful to concentrate future research in this field on benchmarking the situation with undeclared employment in the Czech Republic with the other EU countries, especially former centrally planned economies.

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Author**Wadim Strielkowski**

Charles University in Prague

Faculty of Social Sciences

Department of Marketing Communication and PR

Opletalova 26, 11000 Prague, Czech Republic

strielkowski@fsv.cuni.cz