

## POVERTY AND LABOR MARKET POLICIES IN CROATIA

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### *Abstract*

*This paper compares indicators of the Croatian labor market and implemented policies with indicators and policies in other countries of Central and Eastern Europe. Although unemployment and long-term unemployment (which latter is particularly correlated with poverty in the transition countries) do not in Croatia depart from the range in which other transition countries are positioned, still they are above their average, which is connected with the somewhat less flexible nature of the Croatian labor market. New findings on the effects of labor market policies in the transition countries indicate that the process of the reform of the institutional framework through which in the last few years the restrictiveness of Croatian employment protection legislation has been reduced might work in the direction of reducing overall and long-term unemployment. The paper suggests that it is possible to improve the effectiveness of the application of active policy measures. Furthermore, a better compensation for a reduction in the restrictiveness of the regulations would probably be an increase in average unemployment benefits rather than an extension of their duration, while greater labor market flexibility, resulting from the reforms, should contribute to a greater coverage of unemployed persons. The expected reduction of overall and long-term unemployment under the influence of the new institutional framework, in spite of the possible emergence of low-paid and insecure jobs, might alleviate the problem of poverty, because unemployment and, especially, long-term unemployment are among the prime causes of poverty in the transition countries.*

*Key words: unemployment, labor market policies, Croatia*

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## **1. Introduction**

The relationship between unemployment and poverty is not a precise one. If unemployment is a result of a dynamic labor market where many new jobs are created daily, and unemployed individuals do not remain unemployed for long, even a high unemployment level does not necessarily need to have serious social consequences. However, if new jobs are few, and the unemployed represent a stagnant group of population, even low levels of unemployment can have serious and undesirable social consequences and represent a challenge for social policy.

In most Central and Eastern European transition countries, unemployment does not only represent an underutilization of productive resources and loss of GDP. The transition process brought with it the closing of numerous jobs and the opening of new ones in different sectors, but worker flows usually occurred within the group of the employed. The appearance of long-term unemployment, social exclusion, exclusion from the labor market and poverty are thus tightly linked in transition countries. Long-term unemployed individuals are faced with an increased risk of falling into poverty, while the depreciation of human capital due to unemployment and a weak linkage to the labor market strengthen the vicious circle of exclusion and poverty. Therefore, understanding the processes in the labor market in transition countries as well as the policy options available are of especial importance in the fight against poverty and social exclusion.

As the mentioned problems are not germane to the transition countries alone, labor market institutions in various other countries, reforms of those institutions and their relationship with labor market outcomes have recently come into the focus of many researchers and international organizations. Organizations such as the World Bank (Pizzati and Funck, 2002), United Nations (Jackman, 2002; Nesporova, 2002), the International Labor Organization (Cazes and Nesporova, 2004) and the European Commission frequently organize roundtables and publish numerous papers covering these topics. Since Croatia is omitted from most of those studies, this paper aims to fill the gap, to create a well-rounded picture of the main institutional features of the Croatian labor market and outcomes perpetuated by those institutions.

The following chapter reviews the main outcomes of the Croatian labor market and compares those with outcomes in other transition countries. Available evidence would tend to suggest that unemployment is somewhat higher in Croatia than the average in those countries, but it is below the top of the observed range. The same pertains to the long-term unemployment that is related to weaker labor market dynamics; this is also supported by the available evidence. Further on, the paper observes labor market policies that have been proved by many studies to play an important role with respect to overall and long-term unemployment. Finally, the paper closes with recommendations to reform some of the policies in order to reduce overall and long-term unemployment.

## **2. Labor market in Croatia**

According to the criterion of registered unemployment, which stood at about 19% at the end of 2003, Croatia had one of the more serious unemployment situations among

the Central and Eastern European transition countries, most of which are “new” EU members. However, according to the survey unemployment rate, which is a much better basis for comparison because it is calculated according to the uniform methodology proposed by the International Labor Organization, which is not affected by the peculiarities of the national systems<sup>2</sup>, Croatia did not stand out from the group. According to survey unemployment, Poland, Slovakia and Bulgaria had the highest unemployment rates, which amounted to 17-19% in 2003. The fact that Poland is the most successful transition country, according to recovery of GDP in comparison to the pre-transition period, suggests that favorable macroeconomic indicators alone are not sufficient to solve unemployment problems. The survey unemployment rate for Croatia in that year was about 14%, which is somewhat lower than in the countries mentioned and also represents a slight decline compared to previous years, but it is still about 3 percentage points above the average for the selected countries. Bulgaria and Lithuania were in the same group with Croatia, while Estonia’s and Latvia’s unemployment rates were slightly lower. Four of the selected transition countries had single digit survey unemployment rates. Romania owes its low unemployment rate to the stalling of reforms and the importance of agriculture for its economy, which is related to relatively high employment rates. The Czech Republic has since the beginning of transition had the best unemployment indicators, but the advancement of the reforms led to unemployment growth in that country. Hungary and Slovenia represented the two countries that had the least problem with unemployment in 2003, and they were even slightly better than the EU average. However, Hungary is also an example of a country where a large decline in employment during the 1990s did not even remotely affect unemployment, pointing to some deficiencies in a focus on unemployment rates<sup>3</sup>.

Along with an unemployment rate that hovered above the average of the selected transition countries, Croatia also had higher long-term unemployment. High levels of total and long-term unemployment in Croatia fit well within the general features of the unemployment in Central and Eastern European countries, where high unemployment has been tied to high long-term unemployment and exclusion from the labor market. Fairly high long-term unemployment in Croatia has been a consequence of weaker labor market dynamics, or fewer newly-employed workers, but also of fewer separations. The share of employees with tenures of less than one year in total employment (accession rate) in Croatia is amongst the lowest for the selected countries, regardless of the source used. Moreover, average tenure<sup>4</sup> in Croatia amounts to 12 years, which puts Croatia, together with Slovenia, at the top of the range observed in selected countries and confirms that the Croatian labor market is one of the least dynamic.

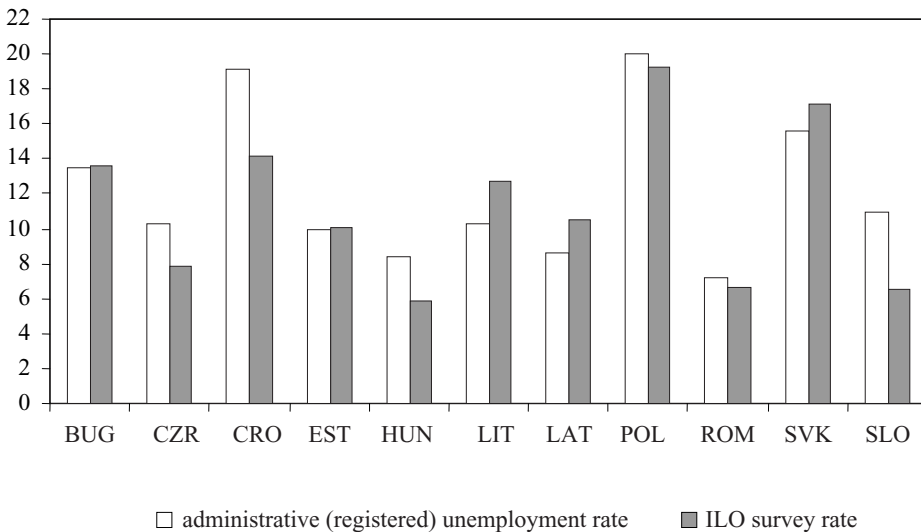
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<sup>2</sup> The peculiarities of the national systems primarily pertain to incentives to register such as privileges arising from registering and conditions these persons have to meet in order to be able to register.

<sup>3</sup> For example, the employment rate declined by almost 23 percentage points in Hungary between 1989 and 1996 (from almost 80% to about 55%, or to a level comparable to Croatia; according to Boeri, Burda and Köllö, 1998), which is the largest reduction among the transition countries of Central and Eastern Europe. However, about three-quarters of the employment decline pertained to exits from the labor force (often supported by early retirements, while discouraged worker effect was important as well) so the unemployment rate remained single-digit despite recorded employment fall.

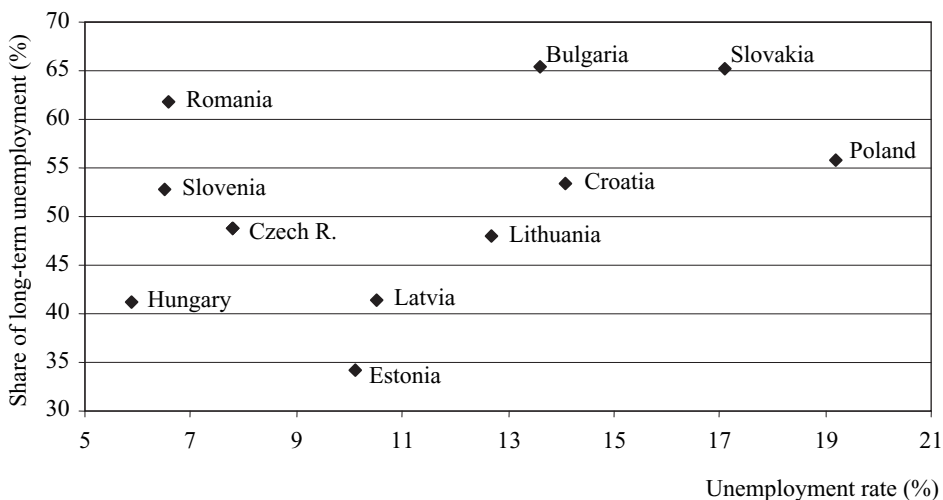
<sup>4</sup> Job tenure pertains to the length of continuous employment with a single employer.

Figure 1 Administrative (registered) and survey unemployment rates, 2003



Sources: DZS (2004); Eurostat (2004); WIIW (2004).

Figure 2 Overall and long-term unemployment, 2003



Sources: Eurostat (2004); DZS (2004).

These indicators reveal that Croatia has a fairly stagnant labor market with fewer new jobs created than is typical in other observed countries. The overall level of unem-

ployment does not have to be directly related to the dynamics of job creation and job destruction, but lower job creation directly increases the duration of unemployment or the level of long-term unemployment, so weaker job flows are the main cause of high long-term unemployment in Croatia (Rutkowski, 2003).

*Table 1 Employment structure according to tenure (% of total)*

	Less than 1	1-2	2-5	5-10	10-20	More than 20	Average tenure	Median tenure
Cazes and Nesporova (2001) - data refer to 1999								
Czech R.	14.6	18.4*	15.3**	26.2	12.3	13.2	8.2	
Estonia	18.4	6.7	31.1	23.9	10.8	9.1	6.9	
Hungary	12.6	11.3	20.0	25.3	17.9	13.0	8.8	
Lithuania	12.8	9.2	29.0	24.8	14.5	9.6	7.6	
Poland	14.5	11.7	19.0	17.7	20.3	16.7	9.6	6.2
Slovenia	12.0	5.1	18.2	16.5	23.6	24.6	12.0	
Rutkowski (2003)								
Lithuania (2001)	15.4	8.9	21.6	25.4	16.8	11.9	8.3	5.0
Bulgaria (2001)	14.0	9.5	25.2	20.8	19.8	10.8	8.1	5.5
Czech R. (1995)	19.2	36.6	12.0	14.8	17.4	9.0	2.0	
Croatia (2001)	9.7	5.1	17.2	21.3	20.7	26.0	12.2	8.0
author's calculation								
Croatia (2002)	13.4	6.3	16.7	21.1	19.2	23.3	11.8	7.9

*Note: \* refers to 1-3 years; \*\* refers to 3-5 years.*

*Sources: Rutkowski (2003), Cazes and Nesporova (2001) and author's calculation.*

Recent studies (Cazes and Nesporova, 2003) report that labor market policies played an important role with respect to total and long-term unemployment in transition countries, so the following chapter reviews Croatian labor market policies and compares them with the labor market policies of other transition countries as well as advanced market economies, wherever deemed appropriate.

### **3. Institutional framework, the role of economic policy and labor market**

State intervention on the labor markets may, in principle, have several justifications. It may derive from the desire to make the labor market function more efficiently, to promote alternative social goals at the expense of efficiency or simply from spillover effects of measures not primarily aimed at the labor market. It is undeniable that there is a valid rationale for state intervention if there are market imperfections. In transition countries, where problems of information asymmetries and incomplete information on worker qualifications, poorly organized labor markets with significant potential for externalities in the job search process and barriers to labor mobility in the form of real-estate market imperfections and weak protection of property rights are present, there is a significant scope for state intervention to improve the functioning of the labor market. These inter-

ventions take place primarily in the form of job-search assistance, worker training programs, and other measures falling within the scope of active labor market policies.

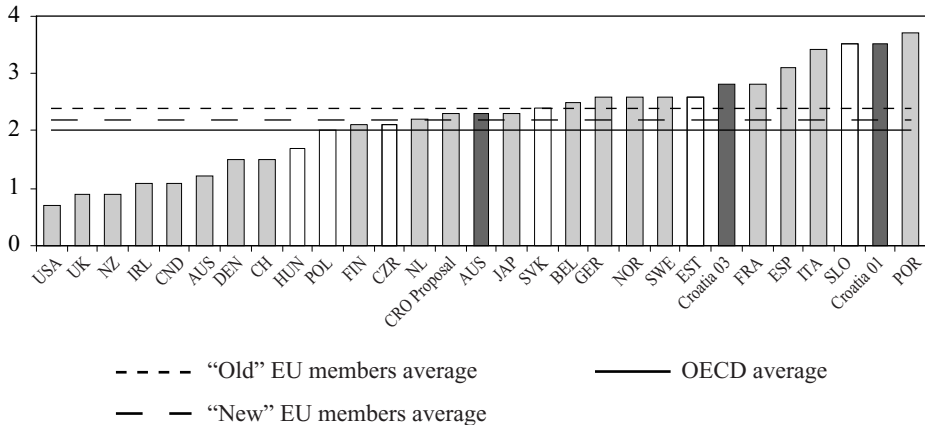
However, state intervention was not always motivated by the promotion of efficiency. Central and Eastern European countries, and Croatia too, belong to a group of European countries that use economic policy measures in order to avoid excessive income inequalities and uncertainty arising from the market, and state intervention assures solidarity between the more and less fortunate. In order to achieve these goals, countries adopt regulations such as constraints on worker dismissals or minimum wages, or measures providing different social rights to certain groups such as unemployment benefits or early retirement. These rights are mainly financed through labor taxes and contributions, which are fairly high in transition countries, increasing the costs of labor and introducing additional distortions into the labor market. Regulations and labor taxes, along with the goals for which they are employed, also increase labor market rigidities, hindering the reallocation of resources in transition economies and reducing incentives to work. Therefore, the costs of government labor market policies are often studied. Finally, the broad role of the state is wider still: its decisions on employment and wages as well as the mode of collective bargaining used affect all other labor market participants. Government also uses measures, more or less successfully, to increase the efficiency of the public administration, provide quality public goods and promote fiscal sustainability, which in the end affects the economic growth rate and employment.

Cazes and Nesporova (2003) provide an up to date review of institutional frameworks and labor market policies in Central and Eastern European countries. According to their study, those countries employed institutional frameworks similar to those of their western neighbors while grouping around the "middle-ground" or allowing for less dispersion in individual measures than obtains among Western European countries. Further on, Cazes and Nesporova (2003) empirically evaluate impacts of labor market policies on labor market outcomes while particularly focusing on overall and long-term unemployment. Employment protection legislation is a first such policy, although the importance of such regulation is not clear cut. While some results of empirical investigation point to association between employment protection legislation and unemployment, it is not the case according to other results. Further on, passive labor market policies also proved to be significant, especially the duration of the benefits, which seems to particularly increase long-term unemployment, while the level of benefits does not appear to be as important. Active labor market policies in transition countries show the potential to lessen overall and long-term unemployment in particular. Labor taxes and contributions do not constitute an independent economic policy measure, but they are rather defined by public spending and other measures, while the government can influence their level and decide on the balance between direct and indirect taxes, so a comparative overview of labor taxation will be presented as well. Finally, higher coverage of employees with collective bargaining drives up unemployment in transition countries, but this will not be discussed, as government does not directly influence the bargaining structure. Moreover, as there are no indicators for the coverage and structure of collective bargaining in Croatia, it is not possible to scrutinize their effects analytically.

### 3.1. Employment protection legislation

Reform of the employment protection legislation, which took place between 2001 and mid-2003, resulted in significant reductions of restrictions imposed by such legislation. The reform enjoyed strong support from various international institutions so it was embodied as a structural benchmark in both the agreement with the World Bank on Structural Adjustment Loan and the Stand-by arrangement with the International Monetary Fund. However, both the awareness of the necessity of the reform and the final results of the negotiations were outcomes of the dialogue within the domestic tripartite institutions. The case for the changes of the Labor code was reinforced by the impression that it was considerably more restrictive than similar legislation in developed countries as well as in the neighboring transition countries, thus making the creation of new jobs more expensive to the entrepreneurs, driving them into the sphere of the informal economy and discouraging foreign investors. This process was also in accordance with existing tendencies in many other European economies<sup>5</sup> (Garibaldi and Mauro, 2002) so a delay in the implementation of reforms positioned Croatia as a laggard among them (Matković and Biondić, 2003).

Figure 3 International comparison of employment protection legislation index<sup>6</sup>



Source: Matković and Biondić (2003).

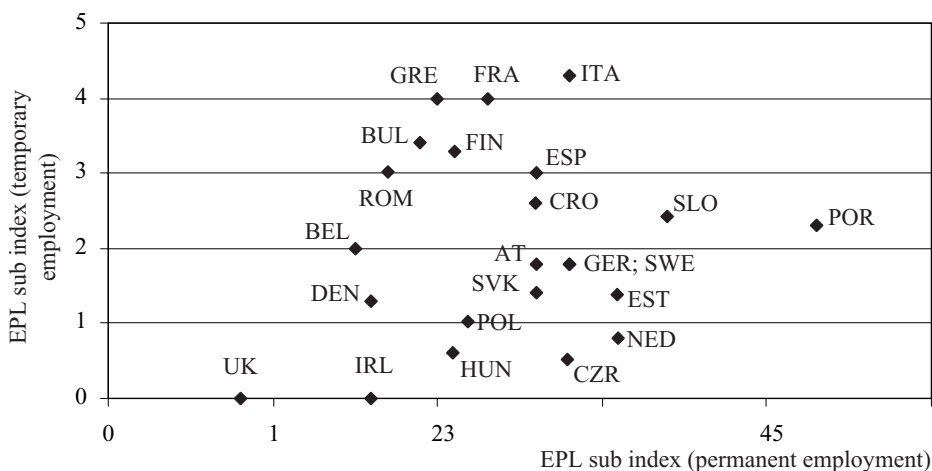
The reform process positioned Croatia close to the average restrictiveness of labor market regulation in the “old” EU member states, according to the level of the EPL

<sup>5</sup> Along with composite indices signalling less stringent labor market regulation, decentralisation of collective bargaining is also often mentioned as a confirmation that more flexibility is being introduced into the labor markets (Borghijs, Ederveen and de Mooij, 2003).

<sup>6</sup> Matković and Biondić (2003) elaborate the definition, construction and deficiencies of EPL index measuring the restrictiveness of employment protection legislation (0= the least restrictive, 6= the most restrictive) in great detail.

index, making it similar to the strategies employed by most of the Central and Eastern European countries (Riboud, Sánchez-Páramo and Silva-Jauregui, 2002). However, their strategy with respect to relaxation of legislation governing the labor market was somewhat specific. While the level of employment protection legislation subcomponent describing regulation of permanent contracts was in selected Central and Eastern European countries mostly above the average in “old” EU member states (2.5 on average in selected Central and Eastern European countries against 2.4 in “old” EU member states), regulation of temporary employment was considerably less restrictive (1.8 on average in selected Central and Eastern European countries against 2.2 in “old” EU members). This observation was particularly relevant in the cases of Czech Republic, Hungary, Poland and Slovakia, as well as Estonia, which also introduced a similar configuration of labor market regulation.

Figure 4 EPL configuration – sub-indices for temporary and permanent employment



Source: Matković and Biondić (2003)

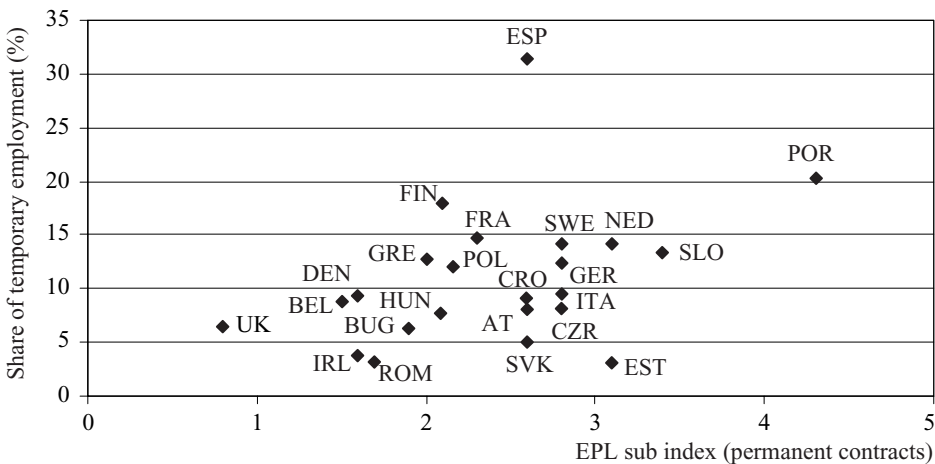
During the past two decades most European countries have consistently used the deregulation of temporary employment in order to increase labor market flexibility at the margin. Central and Eastern European countries were especially successful in employing such a strategy, resulting in even more flexible regulation of temporary employment. In accordance with this strategy, the growth of temporary employment was not only a generator of overall employment growth<sup>7</sup>, but it also absorbed some of the employment previously engaged on permanent contracts (Garibaldi and Mauro, 2002). Employers in countries with stringent regulation of permanent contracts were particularly keen to use

<sup>7</sup> The exemptions to this general tendency were countries like Ireland with flexible regulations governing permanent contracts.



temporary contracts, so it is not surprising to find larger shares of temporary employment in those countries. However, the results of deregulation of temporary contracts in Central and Eastern European countries are not yet wholly visible since the shares of temporary employment in those countries are mostly below the shares in those “old” EU members with similar labor market regulation configurations. Moreover, there does not appear to be any relationship between the regulation of permanent contracts and the extent of temporary employment in Central and Eastern European countries. Therefore, it seems that temporary employment did not develop in transition countries nearly as much as it did in the “old” EU members, despite a somewhat more restrictive regulation of permanent contracts and a more flexible regulation of temporary employment in transition countries. This might also imply that labor markets of transition countries are actually somewhat less flexible, contrary to what the aggregate level of employment protection index suggests.

Figure 5 EPL sub-index for permanent contracts and temporary employment (as a share of total, 2003)



Sources: Matković and Biondić (2003); Eurostat (2004); DZS (2004).

Croatia stands out from other Central and Eastern European countries with a fairly high share of temporary employment, only slightly lower than the share of temporary employment in Slovenia and Poland. Such a position is probably to some extent a heritage of restrictive regulation governing permanent contracts during the 1990s, which was significantly reduced by the recent reform. Hence, after reform of the legislation governing permanent contracts Croatian employers face restrictions similar to the average of other transition countries, while the use of temporary contracts has evolved. This could indicate that after the reform the actual flexibility of the labor market, which is

significantly influenced by legislation, became somewhat more favorable, especially in comparison with other Central and Eastern European countries<sup>8</sup>.

### 3.2. *Passive labor market policies*

Passive labor market policies include many different measures aimed at increasing the incomes of unemployed persons. These policies usually include different measures, and the Croatian Employment Service too administers a range of different measures. Unemployment benefits are regularly prominent amongst them, if measured by the costs, numbers of persons covered by them and prevalence among countries. Therefore, comparison of the level of wages replaced by the unemployment benefits and the duration of the entitlements are usually considered the main determinants of the unemployment benefit system. The average level of unemployment benefits in Croatia, compared to the average wage, did not significantly differ from the average level in other advanced transition countries. Three of the six selected Central and Eastern European countries had lower average benefits, while three had somewhat higher benefit levels. Maximum benefit duration, that was limited to fifteen months in Croatia, was also close to the average benefit duration in selected countries<sup>9</sup>.

As can be seen from the previous table, the unemployment benefit system in Croatia, with respect to the average benefit level<sup>10</sup> (it was about a quarter of the average wage, or roughly the same as the average of selected Central and Eastern European countries) and benefit duration (it was one year, also close to the average of selected countries) does not differ from unemployment insurance systems that are in place in most of the selected Central and Eastern European countries. Somewhat lower expenditure levels in Croatia than in the selected countries resulted from lower coverage of unemployed persons with benefits than it is the case in any of the selected countries.

Indicators of unemployment benefit systems vary a great deal among transition countries, but it is apparent that countries with higher average benefits tend to limit benefit duration and vice versa. However, Croatia is somewhat specific, due to fairly low spending on passive labor market policies, measured as a share of GDP, compared to other transition countries. The spending on passive labor market policies in proportion to the registered unemployment amounted to only about a third of the transition countries' average. Even after the correction by the "real", or survey unemployment rate, spending on unemployment benefits in Croatia was lower than the average of transition countries, similar to the expenditures in the Czech Republic and Slovakia, while a lower level of expenditure is found only in Estonia, which is known for its flexible labor market. A fairly low level of spending was a consequence of high long-term unemployment

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<sup>8</sup> Such a general conclusion does not have to reflect actual position of all different groups of workers so detailed analysis would indicate that older workers (the most protected) are not very flexible, while younger worker happen to be very flexible.

<sup>9</sup> Unemployed persons with more than 30 (men) or 25 years (females) of working experience are exempted from such regulation and their unemployment benefits do not expire except in cases of reemployment or retirement. This experience limit will be gradually extended until 2007 in line with extension of pension age.

<sup>10</sup> There should be some variation in the level of unemployment benefits, based on previous earnings, but in practice it operates as a flat-rate system.

and unemployment rates for young people, who as a rule have less work experience, and therefore exhaust their unemployment insurance benefits more quickly.

*Table 2 Comparative overview of unemployment benefit systems*

	Average unemployment benefit (% of average wage)	Benefit duration (months)	Coverage (%)
Czech R.	20	6	49
Estonia	7	3-6	55
Hungary	23	12	74
Poland	40	12-24	23
Slovakia	33	6-12	28
Slovenia	44	3-24	33
Average	28		44
Croatia	26	3-15	19

*Sources: Riboud, Sánchez-Páramo and Silva-Jauregui (2002) and authors' calculation based on CES data.*

*Table 3 Spending on passive labor market policies in Central and Eastern European countries*

	(in % of GDP)	Spending in proportion to registered unemployment rate (in % of GDP)	Spending in proportion to survey unemployment rate (in % of GDP)
Czech R.	0.31	0.04	0.04
Estonia	0.08	0.01	0.00
Hungary	0.56	0.06	0.08
Poland	1.71	0.12	0.10
Slovakia	0.52	0.05	0.05
Slovenia	0.89	0.11	0.16
Average	0.68	0.06	0.07
Croatia	0.44	0.02	0.04

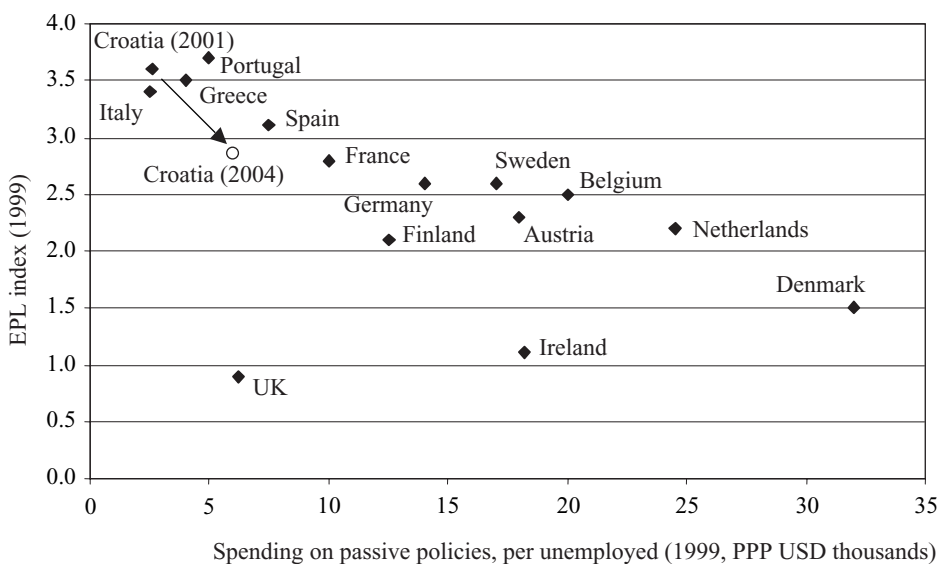
*Note: figures for Croatia pertain to the 1997-2000 average, while figures for other countries pertain to the different years for which they are available.*

*Sources: Riboud, Sánchez-Páramo and Silva-Jauregui (2002) and authors' calculation based on CES data.*

Reform of the job-search assistance, which was launched in early 2002, was the first step in the comprehensive institutional reform of the labor market. The reform was motivated by the awareness that the CES register was principally useful for the administration of social rights, while it was not performing its primary function, which is assisting in job search. The reform introduced steps to separate social rights from the rights resulting from the unemployment status. Thus, social rights were no longer supposed to

depend on the status of unemployment, but rather on the individual's real material position. In order to achieve this, it is important to enhance the network of government institutions and link existing databases on incomes and different forms of government transfers. In addition, criteria for registering with the CES were made stricter with respect to acceptance of job offers and availability for work. Demonstration of greater job-search effort was also required from the registered unemployed. Reform has opened the doors to private initiatives in the sphere of employment intermediation, which soon resulted in opening of private agencies for job search assistance, but they should also be allowed to participate in other areas of active labor market policies.

Figure 6 *Employment protection legislation and spending on passive policies*



Sources: Matković and Biondić (2003); OECD (1999); Young (2003) and authors' calculation based on CES data.

As a next step in the reform, unemployment benefits were made more generous at the beginning of 2004 by a rise in their level and an extension of their maximum duration<sup>11</sup> as a compensation for the reduction of the strictness of the employment protection legislation. Employment protection legislation and unemployment benefits are substitutes as insurance against loss of income, so workers should be indifferent if former is replaced by the later. Such a model is advocated by the EU and ILO (Young, 2003). The ILO especially highlights the example of Denmark, a country that manages to use pas-

<sup>11</sup> The highest amount of unemployment benefit was raised from 900 to 1000 kunas, which to some extent represents indexation of unemployment benefits with the costs of living, additional one-off benefits were introduced for workers with more than 20 years of tenure, while the longest duration of unemployment benefit was extended from 12 to 15 months.

sive and especially active labor market policies along with flexible employment protection legislation in order to reduce the risk of income loss for workers. This recommendation seemed suitable in the Croatian case, which until recently combined fairly low spending on active and passive labor market policies with stringent employment protection legislation regulation.

However, increase of the coverage of unemployed persons has to be carefully introduced as some studies indicate that the duration of unemployment benefits increases the average duration of unemployment, while this is not true of the average benefit level (Cazes and Nesporova, 2003). Therefore, it seems that the replacement of employment protection legislation with passive policy measures has not been done in an optimal fashion. Spending on passive policies should have been increased by a rise in the average benefit level, if such a solution could be reached in negotiations, while a higher coverage of unemployed persons will result from a more dynamic labor market, which is related to the reform of the legislation. Finally, greater reliance on unemployment benefits as insurance against loss of income should be matched by measures to activate the unemployed that are in part implemented through the reform of the employment service.

### 3.3. Active labor market policies

Active labor market policies, unlike the passive policy measures which are used to insure the unemployed financially, are most often used to reduce the imperfections existing in the labor market and promote more efficient outcomes as well as to modify those market outcomes towards socially acceptable ones. In other words, those measures are usually used to increase employment and wages of particular categories in the labor market that are thought to be particularly exposed to the risk of unemployment and poverty. The level of spending on active labor market policies in Croatia during the late 1990s did not significantly differ from the average spending levels in selected Central and Eastern European countries. However, average spending in all those countries was far below the average spending in "old" EU members and OECD member states, probably reflecting financial constraints, but also limited experience with the design and implementation of those policies.

*Table 4 Spending on active labor market policies*

	Total spending				Spending on active labor market			
	1985	1989	1993	1998	1985	1989	1993	1998
Czech R.			0.30	0.36			0.16	0.13
Hungary			2.76	1.01			0.65	0.39
Poland			2.45	1.00			0.58	0.44
Average – transition countries			1.84	0.79			0.47	0.32
Croatia								0.24*
EU	2.91	2.53	3.63	2.80	0.86	0.86	1.13	1.07
OECD	2.32	2.09	3.03	2.29	0.72	0.72	0.94	0.87

\* *Figure for Croatia pertains to the 1997-2000 average due to large variation between individual years.*

*Sources: Dar and Tzannatos (1999) and authors' calculation based on CES data.*

Although macroeconomic evidence indicates that active labor market policies are efficient on the whole (Cazes and Nesporova, 2003), it does not necessarily mean that every such program was successful. Countries that implement such programs usually carefully evaluate their actual impacts or first implement those programs on an experimental basis. There is hardly any information on the impacts of active labor market policies in Croatia so it is hard to say how successful these policies are<sup>12</sup>. However, some recommendations on the possible ways to increase the effectiveness of active labor market policies can be made on the basis of experience existing in other countries. Wage subsidies, accounting for the majority of the spending on active labor market in Croatia, were general, meaning that that these measures were not targeted to particular groups, rather most of the persons registered as unemployed were eligible for some form of wage subsidy. It might be assumed that such general wage subsidies were aimed at increasing total employment and reducing unemployment, although their goal was not formally specified in their disposition. However, some of the studies report stronger impact of active labor market policies on long-term unemployment than on total unemployment (Cazes and Nesporova, 2003) so their efficiency in achieving the presumed goals is questionable. Moreover, rigorous empirical evaluations indicate that net job creation, after deadweight, substitution and displacement effects are excluded<sup>13</sup>, in none of the countries that implemented such measures exceeded a third of subsidized persons and often remains far below that (Dar and Tzannatos, 1999). Therefore, the efficiency of the active labor market policies implemented is questionable.

The main priority in the area of active labor market policies should be to develop an 'evaluation culture' and routinely test for their effects. This would help avoid the stop-go approach to active labor market policies, spending major funds and then closing the programs, which characterized implementation of active labor market policies until now. Programs should be initiated with modest funds and decide on their expansion or closing and redirecting funds into other, more efficient programs only after evaluation. Measures should also be better focused on the long-term unemployed and those at risk of falling into long-term unemployment, rather than to all registered unemployed, which proved to be inefficient in many countries.

#### 3.4. *Labor tax wedge*

Labor taxes and social contributions (direct taxation) are one of the most abundant sources of tax revenues in most countries (and in Croatia direct taxes comprise about half of total tax revenues). Some studies attribute significant part of unemployment growth to the increased taxation of labor (Nickell, Nunziata and Ochel, 2005) and call attention to the goal of many European countries to reduce labor taxes and contributions in order to encourage work and employment. Despite recent efforts to reduce direct tax-

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<sup>12</sup> One of the public works programs is an exception. However, evaluation showed that it improved neither employability nor wages of the participants after it expired. The program employed only limited resources.

<sup>13</sup> Deadweight effect of wage subsidies pertains to persons that would get employed in the absence of wage subsidies. Substitution effect refers to employing a subsidized person instead of a non-subsidized one. However, substitution can be socially justified if it helps hard-to-employ individuals. Finally, the displacement effect refers to job losses in enterprises that do not employ subsidized workers due to competitive pressures from subsidized enterprises/individuals.

ation, the average tax wedge on labor is still high in most European countries - it averaged about 40% in EU member states in 2003 (which is 1 percentage point less than in the previous year), while in four advanced transition countries that are also OECD members it averaged 44%. With such a perspective in mind, average tax wedge that amounted to 39% of total labor costs in Croatia does not seem particularly high. The tax wedge in Croatia was about 1 percentage point below the EU average and as much as 5 percentage points below the average of selected advanced transition countries<sup>14</sup>.

The burden of labor taxes and contributions in transition countries was especially heavy if their income levels are taken into the account (compared to poorer “old” EU members, such as Greece and Portugal). Such a heavy burden is a consequence of the widespread use of early retirement schemes and the rise in social expenditures that accompanied growing and high unemployment, which helped create a social consensus on the necessity of reforms. On the other hand, the taxation level discouraged job creation and resulted in a partial shift of employment from the formal to the informal sphere. The comparatively low taxation burden on labor in Croatia did not occur as an accident, but as a result of persistent policies intended to reduce the tax wedge. The total tax wedge on labor in 1995 amounted to 48% of total labor costs, which was exceptionally high, even by the standards of “old” EU member states and transition countries. Until 2001 the tax wedge was reduced to 41% and its decreasing tendency was continued afterwards (Rutkowski, 2003).

Bearing all this in mind, it seems worth asking whether it is necessary to pursue even further reductions of labor taxation, as recently discussed in public, and if so how to do it. There are several reasons why the labor tax wedge should be further decreased, irrespective of recent efforts in many European countries to do so. First of all, the labor tax wedge in Croatia is still higher than it is OECD member states (including EU member states with fairly high levels of taxes and contributions) as well as in poorer “old” EU members (Greece and Portugal) that are more comparable to Croatia. Furthermore, total labor costs in Croatia are higher than labor costs in transition countries with similar productivity levels, such as Poland and Hungary, so unit labor costs in Croatia are the highest among the Central and Eastern European transition countries. Reduction of labor taxes could probably temper the growth of labor costs to a greater degree than reduction of other taxes and therefore improve the cost competitiveness of domestic enterprises. Finally, the Croatian unemployment rate, as previously discussed, is, despite a recent decline, still high, and easing the pressure on labor costs by reductions in labor taxes could help employment recovery.

While the reduction of labor taxes and contributions can be a mid-term goal, in the short run reducing the taxation of individuals with poor qualifications who earn low incomes<sup>15</sup> should be a priority because it can improve the position of those workers and

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<sup>14</sup> International comparisons of average tax wedge should be interpreted with caution. Individual tax systems are usually quite complicated with many different rates, deductions and exceptions, so tax wedges calculated on the basis of an average production worker can be misguided. This may particularly be the case if tax systems differ with respect to their progressiveness, if there are differences in income distributions or if there are differences in public goods and services workers receive from the state.

<sup>15</sup> There are different ways to implement it in practice, such as negative taxes, which is, however, hard to recommend in Croatia because it would strengthen incentives to underreport incomes.

*Table 5 Average tax wedge (as % of average total labor cost for single production workers without children, 2003)*

	Income tax	Social security contributions (employee)	Social security contributions (employer)	Total social security contributions	Total tax wedge
Austria	8	14	23	37	45
Belgium	20	11	23	34	54
Denmark	32	11	1	12	44
Finland	20	5	19	24	44
France	9	10	29	39	48
Greece	0	12	22	34	34
Ireland	10	5	10	15	25
Italy	14	7	25	32	46
Luxembourg	8	12	12	24	32
Netherlands	7	22	14	36	43
Germany	17	17	17	34	51
Portugal	5	9	19	28	33
Spain	9	5	23	28	37
Sweden	18	5	25	30	48
United Kingdom	14	8	9	17	31
“old” EU average	13	10	17	27	40
Czech R.	9	9	26	35	44
Hungary	10	9	27	36	46
Poland	5	21	17	38	43
Slovak R.	5	9	28	37	42
Average transition					
Central Europe	7	12	25	37	44
Croatia	7	17	15	32	39
Australia	23	0	6	6	29
Iceland	24	0	5	5	29
Japan	5	10	12	22	27
Canada	16	6	10	16	32
Korea	2	4	8	12	14
Mexico	2	1	13	14	16
New Zealand	21	0	0	0	21
Norway	19	7	11	18	37
USA	15	7	7	14	29
Switzerland	9	10	10	20	29
Turkey	12	12	18	30	42
OECD average	12	8	15	23	35

*Sources: OECD (2004) authors' calculation.*

encourage their employment. Reduction of labor taxation has been implemented in many different ways during the previous decade - by increasing existing tax deductions and introducing new exemptions, reductions of tax rates and contribution rates. There is



wide range of instruments now as well, but each of those instruments bears specific implications for different groups of workers. Since workers in Croatia on average pay about five times as much in contributions as in taxes, which is specific for all transition countries due to unfavorable demographics and widespread use of early retirement, even a modest reduction of contributions could influence income more than a significant reduction of income tax. Such an effect is especially visible in the case of low-income workers. For example, taxes account for 10 kunas or about 0.5% of total labor costs of a worker earning the minimum wage (since January 1<sup>st</sup> 2005 amounting to 2080 kunas), while the total tax wedge, comprising mostly social security contributions, amounts to about 700 kunas or 32% of total labor costs. Therefore, the manipulation of taxes (as applied in 2005) produces almost no effect on incomes and the labor costs of low-income workers. An alternative route, if one assumes that no negative taxes will be introduced, would be to reduce social security contributions. However, one has to approach such an issue with a caution. Pension reform was an important step toward establishing a link between pension contributions and pensions, and reduction of pension contributions could weaken that link. A reduction in health contributions would not have such an effect as health contributions are not linked to actual health benefits and therefore resemble taxes. Moreover, health insurance, while a universal benefit, is largely financed through contributions paid by the employees.

#### **4. Conclusion**

Although total and long-term unemployment in Croatia are somewhat higher than the average for other transition countries, these labor market indicators do not diverge from the range in which they move in those countries. However, this does not mean that unemployment is not a serious social problem and that reducing unemployment should not be one of the priorities for the economic policy. Moreover, organizations administering labor market programs have considerable experience and are probably capable of administering more ambitious programs, while we can probably expect further improvements with the opening of labor market policies for private initiative. Still, an impression cannot be avoided that some of the implemented solutions were not always optimal and did not contribute towards reducing unemployment, underemployment, social exclusions and poverty as much as they might have done.

The most important reforms implemented during the past few years managed to reduce the restrictiveness of the employment protection legislation and increase reliance on passive labor market policies, which is one of the ILO and EU recommendations. The duration of benefits was extended, which seemed justified due to the low coverage of unemployed persons. However, a reduction in the legal restrictiveness will contribute to greater labor market flexibility and higher coverage. Increased reliance on passive measures was accompanied by policies to activate unemployed persons, which was especially important due to the large disparity between registered and survey unemployment, which also made job-assistance difficult. The third important element in this "triangle of policies" is active policy measures. Spending on active policies in Croatia did not fall behind such spending in other transition countries, although it is not possible to discuss their efficiency due to lack of evaluations. Therefore, the most important recommenda-

tion pertains to developing the culture of evaluation, while the programs are in the initial phase, prior to the investment of significant funds. Moreover, judging from the experience of other transition countries, it can be assumed that better focus of these measures on particularly disadvantaged groups would probably improve their efficiency.

Increasing labor market flexibility can sometimes have adverse consequences on poverty due to the emergence of low paid and insecure jobs. However, since unemployment and especially long-term unemployment are among the prime causes of poverty in Croatia, a more flexible labor market would probably contribute to the reduction of poverty by increasing job creation, especially for low-skilled workers. Even if a more flexible labor market helped to create a new group of employees likely to remain under the poverty threshold, greater flexibility is not necessarily a bad solution, since poorly paid jobs are often stepping stones out of poverty and towards better paid jobs. Static income distribution can overestimate inequality that exists over the life cycle if there is such a dynamics on the labor market (Elmeskov, 1998). As labor market reform coincided with the rapid expansion of the economic activity, synergic effects of economic growth and reform will probably fuel employment growth and the reduction of unemployment and long-term unemployment.

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