



WAGE DETERMINATION AND EMPLOYMENT ADJUSTMENT IN CROATIA

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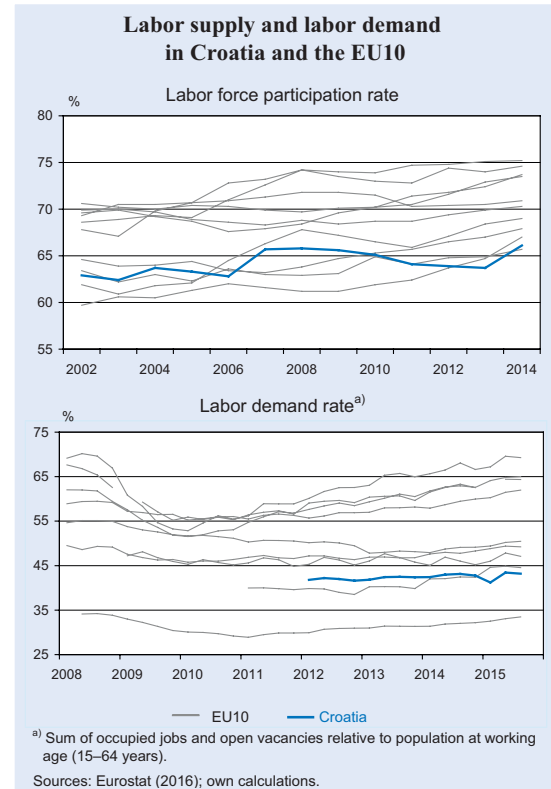
Introduction

Croatia suffers from comparably low labor force participation rates and low labor demand. According to Eurostat (2016), in 2014, only two-thirds of the population of working age (15–64 years) was officially active in the labor market, while Croatian public and private employers offered jobs for less than half of the population of working age (see Figure 1). In consequence, Croatia experienced an inordinately high unemployment rate of 17.5 percent. These poor labor market outcomes, even in comparison to its peer countries, the EU10,¹ are not solely a result of the recent economic crisis, but rather reflect structural weaknesses both on the side of labor supply as well as on the side of labor demand. This article investigates aspects that explain Croatia's low labor demand.

Two major obstacles to employment growth prevail in Croatia: labor costs that are not in line with labor productivity, and costly and cumbersome employment adjustment procedures. This was particularly evident during and after the recent crisis, when wages in Croatia adjusted more slowly to changes in the macroeconomic environment than in the EU10 (Orsini and Ostojić 2015). Croatian firms opted for reducing employment rather than wages, but were subsequently quite sluggish in hiring new workers, partially because of high hiring and firing costs (Kunovac and Pufnik 2015).

To better understand the mechanisms behind these stylized facts, I present Croatian labor market institu-

Figure 1



tions involved in wage determination (section 2) and employment adjustment (section 3), taking into account the most recent labor market reforms, which were introduced in 2013 and 2014. In each section, I discuss the implications of the relevant labor market institutions for Croatia's employment and international competitiveness. I conclude with some policy recommendations.

Wage determination

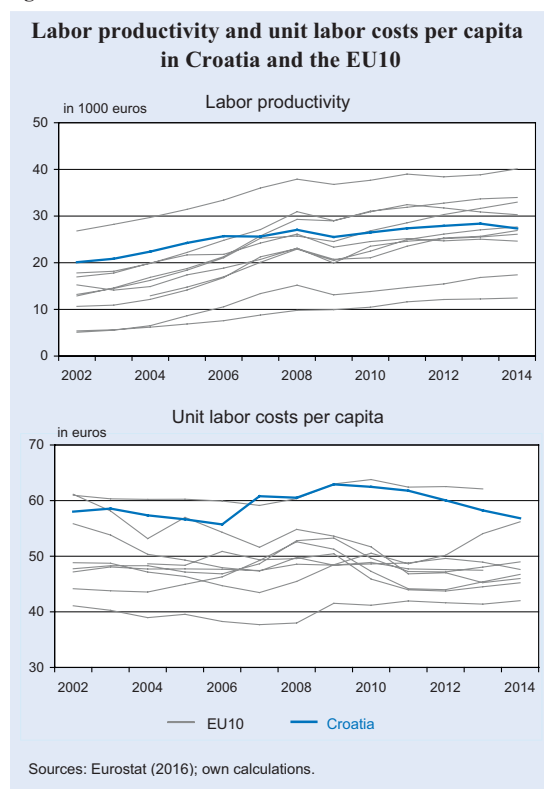
Institutions

Compared to the EU10, which have a similar productivity level, unit labor costs in Croatia are relatively high (see Figure 2). In 2014, Croatia's labor productivity was similar to Latvia's and Lithuania's, but its unit labor costs were more than 25 percent higher than in these two countries. This is partly a consequence of the Croatian wage setting system, which entails a stat-

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¹ In this text, the EU10 refer to Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

Figure 2



utory minimum wage, collective bargaining, and a substantial public sector wage premium that puts upward wage pressure on the private sector.

The 2015 statutory minimum wage in Croatia has been set at 3,029.55 kunas, which equals about 38 percent of average monthly gross earnings.² According to the 2010 Structure of Earnings Survey (more recent data is not yet available), 9.2 percent of all employees earned less than 105 percent of the statutory minimum wage (European Commission 2015). This is one of the highest shares among all EU countries and implies that many employers struggle to pay their employees such high wages. Since 2013, the minimum wage is discretionarily determined by the government after consultation with the social partners, though the minimum wage may not be reduced.

For 50 to 60 percent of all Croatian employees, wages above the minimum wage are directly determined by collective agreements. The share is higher in the public sector (70 percent) than in the private sector (45–55 percent) (see Kunovac and Pufnik 2015). Collective agreements are most often concluded at the firm level; there are only a few sectoral and national collective agreements. Sectoral agreements

² In the first ten months of 2015, average monthly gross earnings in Croatia amounted to 8,031 kunas (CBS 2015a).

may be extended by ordinance to non-signatory parties in the same sector. Collective bargaining in Croatia shows a medium degree of centralization, with a low degree of coordination within and across sectors (Eurofund 2016). Additionally, industrial relations are characterized by mutual distrust (see Seperic 2015).

Collective agreements are particularly relevant in the public sector, where they stipulate wages increases by 0.5 percent for each year of tenure (Orsini and Ostojić 2015). The public sector wage premium, conditional on worker characteristics, amounts to 5 percent; in state-owned enterprises, the conditional wage premium totals 7 percent (Nestić *et al.* 2015). Due to their large share in total employment (2014: 27 percent and 37 percent, respectively; see CBS 2015b), public sector and state-owned firms put upward wage pressure on private firms, in particular in the tradable sector (see e.g. Orsini and Ostojić 2015).

Discussion

Croatia's wage policy is insider-biased, deteriorates the country's external competitiveness and deters internal labor demand. The statutory minimum wage sets an income floor for all employees, but prevents job-seekers whose productivity lies below the minimum wage from making any earnings. Thus, the minimum wage hinders employment of the most vulnerable workers: the young, the low-skilled, and the long-term unemployed. Reduced minimum wage rates for these workers would help to integrate them into employment.

The minimum wage also deters labor demand in sectors or regions whose average productivity is fairly low. It should therefore be reduced at least in sectors (and regions) with below-average productivity. Sectoral minimum wages, stemming from collective agreements, exist, for instance, in Germany and Denmark. In the latter, the system of implicit minimum wages is perceived to be more efficient than a statutory national minimum wage, and to ultimately enhance productivity (McLaughlin 2009). Actually, sector-specific minimum wages exist also in Croatia in sectors where the government has extended collective agreements to non-signatory parties. This tool can be used more frequently, so that a uniform statutory minimum wage becomes obsolete. This would, however, require more coordination of the industrial relations than is currently observed. Also, priority rules have to

be applied if there are several collective agreements by competing unions within the same sector. In Germany, for instance, only collective agreements covering at least 50 percent of all employees in an industry can be extended to non-signatory parties in that industry (Frings 2013). In sectors not sufficiently addressed by the social partners, no minimum wages are to be set. In these sectors, implicit minimum wages will result from the unemployment benefit and from the wage schedules of other sectors with minimum wages. In fact, minimum wages would become immediately obsolete if workers possessed skills in occupations that meet the demands of Croatian firms, and if workers were completely mobile across sectors and occupations. Workers' mobility would ensure an efficient allocation of labor across sectors, making wage schedules align across sectors and with workers' productivity. This would help to fight undeclared work if wages in the informal sector happened to be lower than those stipulated by the statutory minimum wage and the collective bargaining system. It would also help to restore Croatia's international competitiveness.

Currently, however, Croatia's international competitiveness is under risk by wage spillovers from the large public sector on the exposed tradable sector. This is in contrast to most EU10 countries, which experience wage spillovers in the other direction, from the private to the public sector (D'Adamo 2014); this is also the case of successful exporting countries like Germany and Austria (European Commission 2014). Croatia's case results from the unfavorable combination of high unionization and low coordination. The Nordic economies, for instance, combine a highly unionized public sector with a highly centralized bargaining system (see Lindquist and Vilhemsson 2006). Like Croatia, they exhibit spillovers from the public sector onto the tradable sector, but, in contrast to Croatia, wage setting in the public sector takes these spillovers into account. A more coordinated bargaining system would therefore lift the upward wage pressure from the tradable sector, and would therefore help to stabilize Croatia's international competitiveness.

Employment adjustment

Institutions

Until recently, Croatia's hiring and firing regulations were very strict (rank 124 out of 144 countries according to the Global Competitiveness Report; see

Schwab 2012). After deregulating the organization of work both along the extensive and the intensive margins in 2013 and 2014, Croatia's employment protection index is now in the range of most other OECD countries (European Commission 2015).

Employees can be dismissed for misconduct, on personal grounds or on business grounds (see Kunovac 2014, for a detailed exposition). The employer has to notify in advance the worker and the workers' council about the dismissal. In firms with more than 20 employees, a worker can be fired for reasons other than misconduct only if, after exhausting all retraining possibilities, it is not possible to assign him or her to another task. In case of redundancy dismissals, priority rules apply as to which worker is to be dismissed. After a redundancy dismissal, the employer may not hire another worker for the same job within six months. Further regulations apply in case of collective dismissals. If a dismissal is ruled unlawful, but the employment contract is judicially terminated, the employer has to pay damage compensation of at most eight contractual salaries.

Even in the case of legal dismissals, employers must make mandatory severance payments for any termination for personal or business reasons of an employment contract that has lasted for at least two years (see Gotovac *et al.* 2013). The severance payment amounts to at least one-third of the average monthly salary for each complete year of work with that employer, and up to six average monthly salaries of that employee. Even higher severance payments may be stipulated in collective agreements. Particularly generous severance payments are agreed upon in the public sector, while employers in the private sector seek to circumvent severance payments, for instance by terminating the contract before fulfilling the two-year waiting period or resorting to fixed-term employment.

Fixed-term employment was deregulated in 2013. Entering into a fixed-term contract for the first time is no longer subject to time limits or objective reasons. Subsequent fixed-term contracts, however, can be concluded only for objective reasons and only for a total employment duration not exceeding three years (see Kunovac 2014).

Discussion

Economic theory and empirical evidence draw a clear picture of the effects of employment protection legis-

lation (EPL; see World Bank 2011, for a detailed discussion): it reduces job destruction, thereby increasing the incentive to invest in firm-specific human capital, and hence positively affecting labor productivity. However, employers wary of the monetary (e. g. severance payments) and non-monetary (e. g. notice periods, trials) costs of EPL are more reluctant to hire new workers when EPL is stricter. This hinders job creation and job re-allocation, and thereby slows down labor productivity growth.

Moreover, Croatia's recent labor market reforms have nurtured labor market segmentation between highly protected permanent staff, mostly hired before 2013, and weakly protected fixed-term employees, often hired after 2013. In 2014, 85 percent of all new employment contracts were entered into for only a limited period (European Commission 2015). Such labor market segmentation may have unintended socio-economic side-effects, such as lower training incidence (García-Serrano and Malo 2013) and lower wages for those under temporary employment (Boeri 2011), and delayed family formation (Auer and Danzer 2016). As for the minimum wage, the system of strict EPL for permanent workers and flexible use of fixed-term contracts often benefits prime-aged workers and harms the more disadvantaged ones (young, low-skilled, long-term unemployed).

To overcome the problem of labor market segmentation, the levels of EPL of open-ended and of fixed-term contracts have to be harmonized. As a first step, the current system of mandatory severance payments for open-ended contracts needs to be abandoned. It is both inefficient and superfluous. Inefficient, because the current minimum wage legislation causes wages to be downward rigid, severance payments thus inducing an unambiguously negative effect on overall employment (see Boeri *et al.* 2013; Garibaldi and Violante 2005). Superfluous, because the key rationale behind severance payments does not apply in Croatia: they are to provide income protection for dismissed workers and employment protection for employees, reassuring them that investments in firm-specific human capital are worthwhile (Holzmann *et al.* 2012), but income protection in Croatia is provided by the social welfare system, and employment protection by labor law. If workers questioning their dismissal can appeal to labor courts, and if these courts rule neutrally and in a timely manner, there is no need for further employment protection through mandatory severance payments. This does not rule out damage compensa-

tion in case of unjust dismissals. If mandatory severance payments are eliminated, firms can anticipate lower non-wage labor costs, which would likely increase job creation. Moreover, there would be fewer incentives to prefer fixed-term employment contracts over open-ended contracts, reducing labor market segmentation.

Conclusion

Croatia's below-average labor demand is mainly due to two structural factors: the wage level and employment adjustment costs. Labor costs are relatively high compared to productivity, which hampers international competitiveness. In order to stimulate employment, wages and productivity need to become better aligned with each other. If productivity cannot be raised towards wages, wages have to be reduced toward productivity, at least for workers with limited productivity. To achieve this, the uniform statutory minimum wage should be substituted by sectoral minimum wages (if any), and wage rates below the minimum wage level should apply for vulnerable workers. The nominal downward rigidity of the minimum wage needs to be abolished. Wage-setting above the minimum wage should be better coordinated within and across sectors. Trade unions and employers, particularly in the public sector, have to consider the impact of their wage bargaining on Croatia's international competitiveness as well as on the employment prospects of those currently not in work.

Additionally, the complexity and duration of procedures related to employment adjustment need to be reduced. Most importantly, the regime of mandatory severance payments for justified dismissals needs to be abandoned, as this would significantly reduce the anticipated costs when hiring a worker. Furthermore, the hiring ban for firms after dismissing workers for business reasons should be eliminated. This will speed up employment adjustment and subsequent productivity growth.

These reforms should be jointly pursued by the Croatian government and the social partners to improve their acceptance among the population. Implementation should consider the results of the upcoming monitoring analyses of the 2013 and 2014 reforms and of the minimum wage effects. Furthermore, complementary structural labor market reforms should continue, for instance the envisaged reform of the tax-

and-transfer system or the restructuring of the Croatian employment service.

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