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ACTIVATING THE UNEMPLOYED: LESSONS FOR CROATIA

MARTIN WERDING*

Labour-market performance in Croatia is extremely sluggish today, triggered not only by the Great Recession, but also for reasons which appear to be fundamental, or ‘structural’, in their nature. Therefore, activating those who are currently in long-term unemployment or entirely outside the labour force is a task deserving special attention. Relying on the international experience, two types of measures appear to be particularly important for this purpose: changes in the design of existing benefit schemes and stricter use of active labour-market policies, including the introduction of work requirements for benefit recipients and the organization of public works programmes, either temporarily or on a more permanent basis.

Economic inactivity

Compared to most other countries in the EU28, labour-force participation and employment are rather low in Croatia, while unemployment is high. Two further aspects stand out as indicators for the low level of (formal) activity in Croatia. Among the unemployed, the share of those in long-term unemployment is extremely high, and the shadow economy appears to be quite sizable.

Figure 1 shows recent trends in unemployment rates across the EU. The curve representing Croatia (blue solid line) is compared to rates for EU15 countries (thick grey lines) and for other

EU transition countries (thin grey lines). In addition, the figure displays Croatian results for two sub-groups, viz. those in ‘long-term unemployment’ (exceeding one year at an individual level; blue dashed line) and in ‘very long-term unemployment’ (exceeding two years; blue dotted line). It can be seen that a huge fraction of Croatian unemployment has effectively turned into long-term unemployment in recent years. Long-term unemployment in Croatia in fact exceeds total unemployment in many other EU countries, including a number of transition economies.

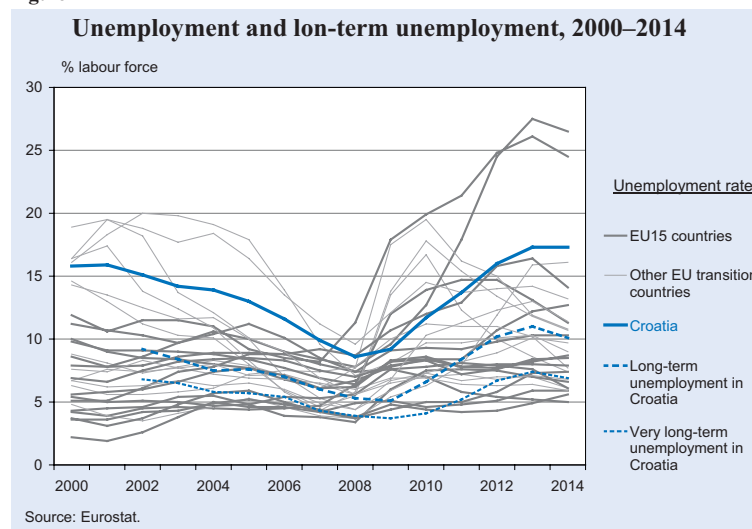
By its nature, accounting for the shadow economy is difficult. Using the ‘MIMIC’¹ approach, its size can be estimated econometrically in a way which should at least be consistent across countries and over time. Figure 2 shows that, according to a recent update of such estimates (Schneider 2015), Croatia (blue line) hosts one of the largest informal sectors across the EU. Even among the new member states, Croatia almost takes the lead in this respect, being close to Romania and second only to Bulgaria. Work in the shadow economy can assume various forms.² In any case, competition of regular employment with the

¹ ‘Multiple indicators multiple causes’ (Schneider and Engste 2000).

² Not only unregistered work, but also unregistered overtime or unregistered ‘over-pay’, implying that individuals are officially paid the minimum wage, while they actually receive substantially higher pay, free of taxes and social insurance contributions.

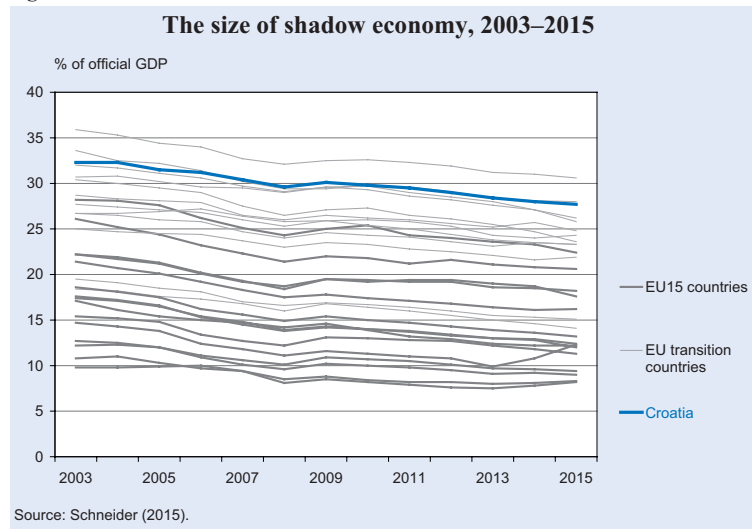


Figure 1



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Figure 2



shadow economy is highly distorted and really difficult to win.

A long history of ups and downs in structural unemployment in various countries has sparked a huge literature on how to activate those in unemployment or even non-employment (see e.g. Werding 2006). Two aspects of policies designed for this purpose have turned out to be of highest significance, in order to go to the root of such problems. On the one hand, major changes in existing programmes with ‘passive’ benefits are needed to establish financial incentives for the unemployed to re-enter regular jobs. On the other hand, active labour-market policies and an activating orientation of the benefit administration matter as well, in fact even more than the design of benefits (Andersen and Svarer 2007; Werding and Konrad 2012). To re-qualify individuals from long-term unemployment for active labour-market participation and to target those in irregular work, strong measures of this type need to be considered, such as public work programmes combined with explicit work requirements.

Design of benefit schemes

In Croatia, benefit schemes that are relevant for solving the problem of persistent long-term unemployment are unemployment insurance and, mainly, general social assistance. Further benefits, which are ‘passive’ by definition and may also contribute to the low level of economic activity, are derived from the pension system where, in recent years, there has been a massive inflow into disability and early retirement benefits (Werding and Primorac 2016). Following a

short period of time during which a review of their status might still be an option, these individuals may be definitely lost for any re-activation. For the other programmes, changes that ‘make work pay’ should be conceivable.

In terms of benefit entitlements, Croatian unemployment insurance is not particularly generous, certainly not if unemployment exceeds three months (see MISSOC 2015 for details). However, the duration of benefit entitlements is governed by a differentiated scheme depending on the

duration of earlier employment spells, by which a substantial share of the unemployed has entitlements exceeding one year (after more than fifteen years of employment). Currently, aggregate expenditure on this scheme amounts to about 2.5 percent of total public expenditure, or 0.6 percent of GDP (Croatian Employment Service 2013).

Once entitlements *vis-à-vis* unemployment insurance have expired, individuals can be entitled to receive means-tested social assistance during a further, and ultimately unlimited, period of time (again, see MISSOC 2015). Typically, social assistance benefits are combined with housing allowances, and beneficiaries have access to health insurance benefits. The scheme has a far broader coverage (including handicapped persons, single parents and persons who are not of working age), but it effectively supports quite a number of individuals who are, or could be, job-seekers given their age and health status. In recent years, when unemployment increased and in many cases turned into long-term unemployment, aggregate expenditure on this scheme increased to about 10.3 percent of total public expenditure, or 4.3 percent of GDP (Ministry of Finance 2015).

Core elements in ‘welfare-to-work’ policies that have been discussed and applied elsewhere are ‘in-work benefits’ topping up wages of individuals with low earnings, i.e. subject to the condition that they are no longer inactive (for a review of existing instruments see Sinn *et al.* 2006). The international model for benefits of this type is the US Earned Income Tax Credit (EITC). Another interesting example is given by the UK Work Tax Credit (WTC; formerly: Working

Families' Tax Credit, WFTC). Modifications to the German benefit system for the long-term unemployed enacted more recently also reflect a step in this direction.

The basic idea of all of these schemes is to create a notable difference in the financial situation of those who return to, or take up, a regular form of employment compared to those who remain inactive for an extended period of unemployment. Whatever the precise mechanism, welfare benefits are effectively no longer withdrawn on a one-for-one basis if individuals become active. Instead, withdrawal rates are reduced so that, over a certain range of low earnings, individuals receive some amount of public benefits on top of their wages, which can also be seen as a targeted wage subsidy for those whose total income could otherwise call for means-tested benefits. However, altering financial work incentives alone may not be sufficient to help individuals re-enter regular employment if they have been inactive over longer periods of time.

Active labour-market policies and public works programmes

In-work benefits already contain an element of 'active' labour-market policies which directly aim at a re-integration of job-seekers into formal employment (through training programmes, job placements, wage subsidies, etc.). While some of these instruments can be really costly, a strict case management (with active counselling, formal agreements stating job-search requirements, and the possibility of imposing benefit sanctions on those who do not co-operate) can contribute to keeping these costs under control. Furthermore, combining measures of all these kinds has proved suitable for addressing various obstacles for the long-term unemployed to seek and find regular jobs. Some countries have even gone so far as to establish not only active job-search requirements for benefit recipients but work requirements, together with public works programmes.

Imposing work obligations on benefit recipients who are long-term unemployed and creating corresponding work opportunities has effectively two sides. Following long periods of inactivity, individuals have often lost motivation, earlier qualifications, and a number of basic work-related habits. Therefore, programmes of this type improve on the employability of many beneficiaries. Besides, explicit work require-

ments by which individuals have to participate in public works programmes at least for a certain amount of time per day or per week may serve a purpose in monitoring how individuals spend their time, in order to deter them from combining benefit receipt with work in the shadow economy.

The introduction of formal work obligations in exchange for receiving welfare benefits has been considered in a number of countries, but politics has often been reluctant to go in this direction. Yet, there are examples of countries which are, or have been, in a similar situation as Croatia that have utilized this instrument rather successfully. In Latvia, a public works programme applied in the period from 2009 to 2011 served as a temporary emergency measure, when unemployment peaked in the course of the Great Recession (Hazans 2012). Hungary also used such programmes to fight high and persistent unemployment in the aftermath of the crisis. However, they were built on experience with repeated use of similar programmes that effectively goes back to the early transition period starting from 1991 (Koltai 2012).

The Latvian programme was inaugurated with considerable financial support by the European Social Fund (ESF). It was positively evaluated with respect to individual-level effects and the utilization of public funds by the World Bank (Azam *et al.* 2012). Against public concerns and criticisms, it is interesting to note that many participants perceived the programme as a safety net or as a basis for doing work that is beneficial for the community. In both countries, there has been a reduction of aggregate-level unemployment. This is probably part of a general recovery, not fully a causal effect. But both countries have much lower shares of long-term unemployment than Croatia, and these shares have declined over the past few years.

Conclusion: lessons for Croatia

Under current conditions of high-level, long-lasting unemployment, activating those who are in long-term unemployment or outside the official labour force is clearly a major sub-task within an overall agenda for increasing employment and stimulating growth in Croatia. A strong recommendation for increasing economic activity is to seriously consider the introduction of work requirements for those receiving public benefits over extended spells of unemployment. To make this strategy effective, the organization of public

works schemes is also required.³ For those who do not comply with these rules, a (gradual scheme of) benefit sanctions should be introduced by which benefits can be temporarily reduced or even withdrawn.

In addition, further changes in existing benefit programmes appear to be needed. For example, with respect to existing benefit schemes, reducing the maximum duration of unemployment insurance benefits might be helpful in fighting long-term unemployment, combined with a stricter case management for those in extended spells of unemployment. In social assistance, elements of ‘in-work benefits’ should be introduced, e.g. through the reduction of benefit withdrawal rates *vis-à-vis* own earned income from 100 percent to 80 percent, like in Germany, or to between 70 and 50 percent, following the examples of the US EITC or the UK WTC. To limit fiscal costs, reduced withdrawal rates can be concentrated on certain ranges of earned income, mainly incentivising recipients to take up jobs with longer of working hours.⁴

Experience gathered in other transition countries suggests that public works schemes should aim at comprehensive coverage of geographic regions and individuals in the target group. They should be operated in a decentralised manner, e.g. at a municipal level, but in close co-operation with regional branches of public employment services, with an interactive exchange of experience between all participating bodies, and with strong political support from the central government against all kinds of resistance and public concerns. Participants should only work for municipalities themselves or in co-operation with non-profit organizations and other government institutions to avoid (criticisms of potential) displacement effects for regular jobs that might arise at a sectoral level.⁵ Last but not least, these programmes could be introduced as a temporary (‘emergency’) measure, until labour-market performance has significantly improved. They could form a new standard instrument of active labour-market policies later on, but this decision does not have to be taken upfront.

³ Croatia has some experience in this area, based on the National Employment Action plans (NEAP) from 2006 onwards, albeit with programmes that were very limited in scope (Matković 2012).

⁴ For recommendations regarding the pension scheme where inflows into disability and early retirement should be reduced, see Werdning and Primorac (2016).

⁵ These effects cannot arise at an aggregate level because saving public expenditure on issues that are taken care of by the work programmes necessarily frees up resources which can be used elsewhere. Even sectoral effects can be kept under control if public works concentrate on non-profit activities for which municipalities simply haven’t got the funds under current economic conditions.

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