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Analysis of the Severance Pay Scheme in the Republic of Croatia: current arrangements and changes to be considered

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0. Executive summary

The national severance pay scheme, its regulation in the law and in other sources, its practice and practical application, and all the amendments of the statutory basis are the consequence of considering individual and social implications of the termination of an employment contract or the termination of employment, in one of the ways regulated by the Labor Act.

Each change in the national severance pay scheme is necessarily connected with redefining and newly balancing worker's and employer's interests, with aspects of employment security and flexibility and it requires processing and analyzing various aspects of the national severance pay scheme. To this end, this report aims to present and analyze all the interconnected determinants of the national severance pay scheme, such as:

- (a) overview of theoretical qualifications and determinants within the national severance pay scheme;
- (b) overview of arrangements within the national severance pay scheme through legal and other regulatory arrangements;
- (c) overview of arrangements in different comparable national severance pay schemes;
- (d) special overview of the current reforms of the severance pay scheme in the context of other relevant countries;
- (e) presenting the plan for the amendments to legal and other regulatory arrangements;
- (f) assessing the practical implications of the planned amendments to legal and regulatory arrangements and their effects on the national severance pay scheme; and
- (g) final proposals and comments.

Both the legislator of the Labor Act and its amendments, and the discussions of social partners - trade unions and employers' associations - are focused on considering the options and the usefulness of establishing a severance pay fund in the Republic of Croatia, with designated workers' accounts, to which the employers would pay defined monthly contributions, as in the "Austrian model". With this, the current definitions and arrangements within the severance pay scheme would be lost, and a new scheme would be set up, which is mostly based on the characteristics of a globally innovative model for a reformed severance pay scheme as exists in the Republic of Austria.

In the light of positive expectations from this scheme, and taking into account numerous obstacles and economic difficulties in the Republic of Croatia, it is evident that an approach to such a reform of the national severance pay scheme in the Republic of Croatia would be loaded with risks if it is not based on information and analyses. The conclusions of this study point to the fact that there are several key stages to this process and several issues to be considered before making a final decision on approaching the changes to the national severance pay scheme in the Republic of Croatia.

1. Factual conclusions based on the practice, but also the opinion of various authors point to the fact that the existing scheme is characterized by numerous problems and that it ought to be improved.
2. Taking into account the above conclusion, the prerequisite for any kind of action is to start from a detailed analysis of the status quo in the national severance pay scheme.
3. After the analysis of the status quo in the national severance pay scheme, it is necessary to define problems, which the reform ought to cover and the aim that the reform wishes to achieve.
4. In the light of these aims, one of the possibilities is to reform the national severance pay scheme according to the Austrian model, but this decision would imply radical changes in the national severance pay scheme.
5. There are alternatives to the reform of the national severance pay scheme according to the Austrian model – it is, for instance, possible to change individual parameters and to improve the outcomes of the existing severance pay scheme.
6. There are no clear arguments that would definitely support the recommendation of any of the possible options – therefore, sustainability and implications of each proposed option should be tested, especially taking into account the problems, which the reform should cover and the aims to be achieved by the reform, and an evaluation of feasibility and economic reasonability of any such action should be made, particularly in the light of implementing this reform in the current situation of economic crisis.
7. For the introduction of a new national severance pay scheme, it is necessary to achieve broad consensus of social players and stakeholders, and any hasty decisions should be avoided, especially if they lead to radical changes in the status quo.

Consequently, we have undertaken the following analysis of the severance pay scheme in the Republic of Croatia, which is delivered as World Bank technical assistance to the Government of the Republic of Croatia. Its systemic approach and analytical background, and its final proposals and comments regarding various scenarios of amendments to the legal and other regulatory arrangements should contribute to developing a discussion about possible reforms of this very important segment of employment relations, labor law and life of any active employee.

1. Introduction

1.1. Severance pay - the term

Severance pay (Engl. *severance pay*, *severance allowance*; Germ. *Abfindung*, *Abfertigung*; French *indemnité de résiliation du contrat de travail*, *indemnité de résiliation de licenciement*), or the severance pay scheme, is one of the most common and most widely represented, but also one of the most controversial social schemes.¹ It represents a guarantee of pecuniary prestation to the worker after dismissal or after termination of the employment contract, and this guarantee exists in almost all legal systems worldwide.² However, the fact that severance pay is a common phenomenon across the world does not mean that the terms or its functions, legal sources, legal basis, amounts or ways it is funded are the same, on the contrary - there are systematic differences. It is therefore difficult to introduce a uniform definition of the term severance pay, because such a definition, in order to be valid, should cover all the globally different characteristics, which would lead to its simplification. One such definition is the one where the term severance pay is connected to the final payment from the employer to the worker, whose employment contract was terminated³, from which definition no significant conclusion on the term 'severance pay' can be made.

In view of this simplification, the definition of the term severance pay should - *par excellence* - be sought in the national context, in this case in the Croatian legal system. After that, the report will discuss some basic differences in the function, legal sources, legal basis, amount and way of funding severance pays.

The term 'severance pay' in the Republic of Croatia is most often defined as the pecuniary amount, which the employer pays to the worker, for whom it terminates the employment contract, besides the worker's salary.⁴ This amount belongs to the worker after the expiry of the period of notice, after the termination of the employment contract. Although it has been originally conceived as reward to the workers for their loyalty to the employer, in essence the severance pay should alleviate the negative consequences of the dismissal for the worker,⁵ and it is frequently considered a means of ensuring an income, or a replacement income, so that it contains elements of social security.⁶ In theory, severance pay is sometimes also understood as delayed payment of salary.⁷

¹ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 2.

² Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 1.

³ Please see: Entry "Severance pay". *Glossary of Labour Law And Industrial Relations (With Special Reference to the European Union)*. Geneva: International Labour Office, 2005, p. 231

⁴ Please see: Entry "Severance pay". *Pravni leksikon (Legal Lexicon)*. Zagreb: Leksikografski zavod Miroslav Krleža, 2007, p. 1013

⁵ Please see: Bejaković, Predrag. Poteškoće oko mogućeg osnivanja posebnog fonda za otpremnine (Difficulties related to possible establishment of a Severance Pay Fund) *Radno pravo – Journal*, 10, 2013, 5, p. 32

⁶ Please see: Entry "Severance pay". *Pravni leksikon (Legal Lexicon)*. Zagreb: Leksikografski zavod Miroslav Krleža, 2007, p. 1013

Besides the legal definition of severance pay as the entitlement of the worker whose employment contract was terminated after two years of uninterrupted employment, provided that the dismissal was not caused by worker's conduct, the term severance pay in Croatia is also used to designate any payment by the employer to the worker after the termination of employment, and as a consequence of such termination, based on some source of entitlements related to labor or based on a unilateral decision of the employer, for instance in case of retirement, consensual termination of the employment contract or judicial termination of the employment contract^{8,9}.

1.2 Function of Severance Pay

Differentiating the definitions of the term severance pay as - on the one hand - reward to the workers for their loyalty to the employer, and - on the other hand - as a means to alleviate the negative consequences of dismissal, which some authors refer to as “the protective clause”¹⁰, points to the dualism of social functions of severance pay. This dualism can also be seen as pluralism of functions: thus, severance pay can be identified through its "penalizing" function towards the employers - because it makes dismissals more expensive and thus prevents employers to dismiss workers without consideration and recklessly¹¹, or through the function of increasing workers' and their families' purchasing power, which contributes to workers' social security.¹² Pluralism of social functions of severance pay should be seen as a consequence of the dynamics of its development, throughout which this entitlement was given several, even different functions, depending on the time, place and purpose of its introduction and legal arrangements.

In a large number of countries severance pay and the entitlement to severance pay was first introduced in the legal systems at the end of the 19th century, as a consequence of developing industrial serial mass production, and it is also related to the development of the social state. Thinking about the first industrial restructuring imposed the need to find systematic solutions, which would alleviate the effects of mass dismissals on the social position of workers, and which would be motivating for the remaining workers. Back then - at the time before any insurance scheme, which would provide the unemployed with some minimum protected income during the period of unemployment, the severance pay became the first instrument with such a social-

⁷ See also: Potočnjak, Željko. Prestanak ugovora o radu (Termination of the Employment Contract), in: Radni odnosi u Republici Hrvatskoj (Employment in the Republic of Croatia) (ed. Potočnjak, Željko). Zagreb: Faculty of Law Zagreb; Organizer, 2007, p. 375-494

⁸ Please see: Zuber, Marija. Plaće (Salaries), in: Babić, Vera *et al.* Veliki komentar novog Zakona o radu (Comprehensive Commentary of the new Labor Act). Zagreb: Vaša knjiga, 2010, p. 132

⁹ Please see: Entry “Severance pay”. Pravni leksikon (Legal Lexicon). Zagreb: Leksikografski zavod Miroslav Krleža, 2007, p. 1014

¹⁰ Please: Crnić, Ivica. Otkaz ugovora o radu (Termination of the Employment Contract), Zagreb: Organizator, 2013, p. 213.

¹¹ Please see: Bejaković, Predrag. Poteškoće oko mogućeg osnivanja posebnog fonda za otpremnine (Difficulties related to possible establishment of a Severance Pay Fund) Radno pravo – Journal, 10, 2013, 5, p. 32

¹² Please see: Zuber, Marija. Plaće (Salaries), in: Babić, Vera *et al.* Veliki komentar novog Zakona o radu (Comprehensive Commentary of the new Labor Act). Zagreb: Vaša knjiga, 2010, p. 132

protective function¹³. In many developing countries, in which the social protection system is underdeveloped, the severance pays still predominantly reflect such a social-protective function.¹⁴

In the context of legal arrangements regulating employment and protecting workers' rights with respect to employers at the turn of the twentieth century, the severance pay was emphasized as an important element among legal conditions to terminate employment contracts, and its role was to guarantee indemnification for workers whose employments were terminated by their employers, who have thus - in a way - "violated" (the purpose) of the employment contract. At that time, the severance pay was often agreed *ad-hoc* between the employers and the trade unions, with the aim to reduce workers' resistance towards restructuring implying significant reductions in the number of jobs. At the same time, in some of the manufacturing industries, primarily those that require higher qualifications and expertise, and higher investments into workers' skills, employers themselves proposed that high severance pays be introduced, along with other workers' rights in order to bind the employer to the workers and establish mutual trust. In this way, the employers have increased the cost of dismissing workers, which provided the workers with a sense of security and reduced the probability for them to transfer to another employer for a higher salary, which would incur losses to the original employer. Thus, the severance pay became a protection instrument, a reward to the workers for their loyalty to the employer and it thus had a role in improving the efficient management of human resources.¹⁵

Finally, after the Second World War, through development of the social state¹⁶ in developed welfare states, the severance pay was not abolished, regardless of the fact that a separate system of

¹³ This is about severance pay as a pecuniary benefit for the workers during the period of unemployment and indemnification for the total years of service with a single employer.

¹⁴ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 18-19 See also: Holzmann, Robert *et al.* *Severance Pay Programs around the World: History, Rationale, Status, and Reforms*. Hirscheegg; Marseille; Pretoria; Washington: The World Bank; IZA, 2011, p. 5-6

¹⁵ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 19-20. Also see: Holzmann, Robert *et al.* *Severance Pay Programs around the World: History, Rationale, Status, and Reforms*. Hirscheegg; Marseille; Pretoria; Washington: The World Bank; IZA, 2011, p. 6-8

¹⁶ Most authors in the field of studying social policies equate the term "welfare state" with the term "social state" (Please see: Puljiz, Vlado. *Socijalna politika: definicije i područja* (Social Policy: Definitions and Areas), in: Puljiz, Vlado *et al.* *Socijalna politika* (Social Policy). Zagreb: Pravni fakultet, 2005, p. 6). Please see: Entry "Socijalna država" (Social state). *Pravni leksikon* (Legal Lexicon). Zagreb: Leksikografski zavod Miroslav Krleža, 2007, p. 1485 However, here I believe that in the legal and constitutional perspective, the term and concept of "social state" (German *Sozialstaat*; French *état social*) should be differentiated from the term and concept of "welfare state" (German *Wohlfahrtsstaat*; French *état-providence*). Namely, welfare state is a term that designates the arrangements that were introduced in almost all developed states in the course of the 20th century as a response to the functional need for a modern capitalist economy, founded on market principles, whereas the term social state implies a leading normative principle, which systematically regulates the obligations of a state in the sphere of social and economic policy. We can therefore discuss the term social state as a legal form of organizing a form of welfare state, where the constitution entrusts the state with a leading and visible role in ensuring social security and diminishing social differences. Consequently, any social state is at the same time welfare state, but not necessarily vice versa. Please see: Katrougalos, George S. *The Implementation of Social Rights in Europe*. *Columbia Journal of European Law*, 1996, 2, p. 277-278 See also: Mishra, Ramesh. *The Welfare State in Crisis: Social Thought and Social Change*. Brighton: Wheatsheaf Books, 1984, p. 101; Ploug, Niels; Kvist, Jon. *Social Security in Europe: Development or Dismantlement?* The Hague; London; Boston: Kluwer Law International, 1996, p. 51-53

social insurance started developing, which provided the unemployed - after the termination of their employment - with a protected minimum income during the period of their unemployment. On the contrary, the existing contractual or voluntary arrangements related to severance pay were expanded to all employed persons, and they were anchored in legislation. By introducing legal basis for the entitlement to the severance pay, the protective function of severance pay was emphasized - i.e. its function of providing the workers with protective reward for their loyalty to their employers.¹⁷

Through these three stages of severance pay development, several intended purposes of severance pay can be identified as follows:

- (a) a "primitive" form of social benefit, which preceded the introduction of unemployment insurance and pension insurance, which guarantees income replacement instead these forms of insurance;
- (b) an instrument to increase the efficiency of human resource management, which - together with the components of providing a benefit, guarantees that interests of employers and workers will be balanced in knowledge-intensive forms of production; and
- (c) an instrument to protect employment, as an unintended consequence of legal systems or an intended consequence of expanding the legal systems, all as a consequence of political economy, which cannot be changed.¹⁸

In view of the above, and bearing in mind the various intended purposes, severance pay can be related to several social functions, which it should serve. Initially, this had to do with:

- (a) rewarding the workers for their fidelity to their employers; and

In order to elaborate this division in greater detail, one ought to mention that the term "welfare" has been deducted from the considerations of Pareto optimality or Pareto efficiency, according to which the equilibrium and efficiency cannot be optimized by making any one individual better off without making at least one individual worse off (in other words there is nothing, which would be "more optimal" than the "optimum"), which is one of the values or maybe even the central value of the legal theory of law and economics, which is significantly represented in the United States, not as a normative, but a positive law theory, which emphasizes formal and procedural and not material contents of the rule of law, constitutional order and social action. In this context, the welfare or well-being imply the possibility to achieve optimum social solutions, but not on the normative level, which would be done by conceptualizing or constitutionalizing the obligations and the role of the state in that respect, but from the standpoint of positive law, which make it possible to achieve welfare, though they do not guarantee it. In that sense, the well-being is inherent to the tradition of a liberal state, which is focused on the individual and the market. And this is precisely what differentiates the terms and the concepts behind the welfare state and the social state: the welfare state makes it possible (though it does not guarantee) to achieve optimum social solutions, creating market and social conditions to achieve this, but itself it does not take any active role in this; on the other hand the social state itself actively uses its authorities and obligations to work towards achieving optimum social solutions.

We can find this same division in the conclusion that "between the social state and the welfare state there is a certain difference in the first important element (duty of the state to equitably divide the national income), and for that reason the former has more to do with social justice, whereas the latter is more connected with deserved justice." According to: Ravnić, Anton. *Socijalna država i država blagostanja (Social State and Welfare State)*, in: *Hrvatska kao socijalna država: Zadanosti i usmjerenja (Croatia as a Social State: Actualities and Directions)* (ed. Bahtijari, Hašim). Zagreb: Centar za industrijsku demokraciju SSSH, 1997, p. 72

¹⁷ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 20-22. Also see: Holzmann, Robert *et al.* *Severance Pay Programs around the World: History, Rationale, Status, and Reforms*. Hirscheegg; Marseille; Pretoria; Washington: The World Bank; IZA, 2011, p. 8

¹⁸ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 9

- (b) help¹⁹ to mitigate the negative consequences that the termination of the employment contract has for the worker, in the form of securing income, or a replacement income, that is to ensure workers' subsistence until they conclude a new employment contract or ensure a new source of income²⁰,

however, through later stages of development, it became possible to identify some further, comparatively more sophisticated functions of severance pay and national severance pay schemes in the labor market, such as:

- (c) indemnification for the termination of the employment contract that is for the loss of a job;
- (d) stabilization of the employment and preventing unemployment by discouraging terminations of employment contracts²¹; and
- (e) encouraging long-term employments, which keep valuable workers and reduce transaction costs resulting from turnover of labor force with a single employer.²²

1.3 Severance pay - legal sources

There are several legal sources for regulating severance pay. At the national level, the legal source for the payment of severance pay may be:

- (a) the law - the obligation to pay severance pay regulated by the law;
- (b) collective agreements - the obligation to pay severance pay regulated in collective agreements;
- (c) unilateral voluntary arrangements by the employer (work regulations or employer's decree) – the employer decides himself how he will pay severance pay even in cases when there is no legal obligation or collective agreement binding him and the decision on the payment of severance pay is based on encouraging voluntary character of employment terminations; and
- (d) a combination of the above mentioned legal sources.

The World Bank Report “Severance Pay Programs Around the World” provides an overview of 183 states, according to which in hundred and fifty-two states - which accounts for 82 percent - there is a legal obligation to pay severance pay in different situations when there is employment termination. In further 18 states - 10 percent - the same obligation exists, only based on collective agreements, whereas in thirteen states - seven percent - there is no obligation to pay severance pay.²³ In the same report, several other conclusions are stated. So, in a large number of developed states, severance pay is regulated by a combination of legal provisions, collective agreements and voluntary arrangements by the employers through their work regulations or unilateral decrees issued by the employer. Further, in most states the obligation to pay severance pay covers all

¹⁹ This is how the case law in the Republic of Croatia defines severance pay. Please see: Decision of the Supreme Court of the Republic of Croatia, no. Revr-206/06 of 6 September 2007;

²⁰ Please see: Crnić, Ivica. Otkaz ugovora o radu (Termination of the Employment Contract). Zagreb: Organizator, 2013, p. 213.

²¹ Please see: Bejaković, Predrag. Poteškoće oko mogućeg osnivanja posebnog fonda za otpremnine (Difficulties related to possible establishment of a Severance Pay Fund) Radno pravo – Journal, 10, 2013, 5, p. 32

²² Please see: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 2

²³ Please see: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 26

employers, whereas in a smaller number of states, it depends on a minimum number of workers, only affecting those employers who employ more than a certain number of workers, the threshold ranging from five to twenty.²⁴ Also, in some states the legal obligation to pay severance pay is just focused on the private sector, whereas civil servants have a different regime, which achieves a similar purpose.²⁵ It is also evident in the fact that the best developed states most often have legal arrangements, which regulate that severance pay is only binding for the private sector, whereas the Eastern European states more often have the legal obligation for the severance pay to be paid to all.

1.4 Legal basis for the payment of severance pay

The legal basis for the payment of severance pay, that is its individual concretization, will answer the question in which legal situations there is the obligation to pay severance pay. Thus, it becomes evident that in most states, the obligation to pay severance pay exists as a consequence of the termination of the employment contract by dismissal, after the worker was dismissed as technological surplus. The key trigger for the payment of severance pay is thus the termination of the employment contract for reasons, which were not conditional on worker's conduct, which corresponds to the mentioned definition of the term severance pay. This legal basis can thus be either set up in a way that it is defined in connection with the termination of the employment contract, which is a consequence of dismissing the worker as technological surplus, or other dismissals not caused by workers' conduct.

However, in some states the severance pay is paid even in the broadest scope of cases. Thus, there are states where severance pay is paid in all cases of employment contract termination. Other states are not focused on all forms of employment contract terminations, but only on those, based on dismissals by the employer. However, in both these examples, some ways of terminating employment contracts are most frequently excluded, e.g. if the termination of the employment contract or the dismissal was caused by worker's conduct, or if is the expression of the worker's will – where the workers themselves terminate their contracts.²⁶

Along with the above mentioned, another legal basis for the payment of severance pay is also the termination of the employment contract as the consequence of bankruptcy, old-age retirement or disability.

²⁴ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 28-29

²⁵ Here, I would like to mention examples where the right to pay severance pay is regulated for some groups of workers with a single employer, i.e. for administrative workers or what is called 'white collar workers'. Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 23

²⁶ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 23

Finally, the legal bases for the payment of severance pay can be divided as follows:

- (a) dismissals from reasons not dependent on worker's conduct;
 - (b) dismissals of technologically superfluous workers;
 - (c) termination of the contract due to bankruptcy;
 - (d) termination of the contract due to disability;
 - (e) retirement; and
 - (f) any (other) form of termination of the employment contract
- } Non-voluntary terminations
} Voluntary terminations

Between the mentioned legal bases for the payment of severance pay it is quite evident that on the one hand there are forms of severance pay, which are the consequence of employers' decisions to terminate employment contracts, where severance pay serves as a remuneration or reward to the workers for their loyalty to the employer in cases of termination, which were not caused by workers themselves, whereas on the other hand the payment of severance pay represents the final payment by the employer to the worker, for whom the employment contract ceases, in any such case of termination²⁷. Looking at these two "extremes", it is evident that the broader the range of cases anchored in the legal basis regulating the payment of severance pays, the more the severance pay loses the feature of being a reward to workers for their loyalty to the employer, which would classify it exclusively as an instrument of the labor law, with only a marginal connection to certain elements of the (social) security system²⁸ after the termination of the employment contract not caused by the worker, and they are actually more prominently characterized as a part of the system of (public) savings funds²⁹, which have a clear impact on employers' costs related to employments and dismissals. Naturally, in the latter case, the severance pay primarily serves to mitigate the adverse consequences that the termination of the employment contract has on the worker, and it is thus a means to ensure income, or a replacement income.³⁰

Here, it needs to be mentioned that the way of terminating the employment contract itself does not imply sufficient legal basis for the payment of severance pay, but it is combined with the factor of fulfilling the minimum period of employment, meaning the years of service, which are necessary for the employer to be obliged to pay severance pay to the workers. All this corresponds to the definition of the term severance pay as it was presented earlier.³¹

²⁷ Please see: Entry "Severance pay". Glossary of Labour Law and Industrial Relations (With Special Reference to the European Union). Geneva: International Labour Office, 2005, p. 231

²⁸ Please see: Ravnić, Anton. Osnove radnog prava – domaćeg, usporednog i međunarodnog (Foundations of Labor Law – Domestic, Comparative and International). Zagreb: Faculty of Law, 2004, p. 244-245

²⁹ Please see: Ravnić, Anton. Osnove radnog prava – domaćeg, usporednog i međunarodnog. (Foundations of Labor Law – Domestic, Comparative and International). Zagreb: Faculty of Law, 2004, p. 245-247

³⁰ In case that severance pay fulfills this role, the workers have the right to withdraw the funds from their individual savings accounts. Thus, the severance pay in this system becomes something completely different to the severance pay as it is currently regulated in the Labor Act.

³¹ Please see: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 23

1.5 The amount of severance pays

The amount of severance pay that belongs directly to the worker is directly connected with the legal basis for the severance pays. Namely, this amount is connected with the individual concretization of the legal basis, the duration of employment, which is now terminated, whereas the relevant variables are most often the following:

- (a) duration of employment³²; and
- (b) the amount of salary³³ of the concrete worker.

Based on these two variables, the amount of the severance pay, which is actually paid, is most often defined by a formula, which multiplies the years of service with a single employer with the amount or a part of the amount of the worker's salary.³⁴

In the vast majority of the national severance pay schemes, this formula is identically applied in all cases of severance pay payment, however national severance pay schemes in some states define different formulas for calculating the amount of severance pay, depending on the reason for the termination of the employment, so that the way of terminating employment also plays a certain role and influences the formula of calculating severance pay. On the other hand, the way of terminating the employment contract, that is different situations and legal bases for the payment of severance pay, in which the employer is obliged to pay it, may have the effect of just increasing (or decreasing) the amount of the severance pay, which is defined according to a uniform formula. Thus, for instance, in the Republic of Croatia, the amount of severance pay is increased for certain protected categories, and a multiplying factor is applied to calculate the amount of severance pay.³⁵

Along with the concrete way that the employment contract was terminated, other factors may also have an impact on the formula of calculating the severance pay:

- (a) age; and
- (b) repeated, additional, duration of employment.

³² Relevant duration of employment almost always refers to the duration of employment or years of service with a concrete employer. According to available data, the only state where a formula is used, according to which the employer would be obliged to calculate severance pay according to the full duration of all employments or the total years of service is the Republic of Serbia.

³³ Most frequently the last salaries or salaries of some reference period towards the end of employment.

³⁴ The amount of legally regulated minimum severance pay is the highest in less developed states with lower salaries, whereas in most developed states, with the highest salaries, the amount of legally prescribed minimum severance pay is the lowest. This may at the first sight seem surprising, however, one has to bear in mind several facts. In the developed states, the legal minimum is actually really treated as the minimum, whereas the collective agreements regulate much higher amounts of severance pay. However, a more important reason is that in most less developed states, the severance pay truly has a social and protective function, which compensates for the lack of legal insurance systems, in that it provides replacement for unemployment benefits. Please see: Holzmann, Robert *et al.* Severance Pay Programs around the World: History, Rationale, Status, and Reforms. Hirschegg; Marseille; Pretoria; Washington: The World Bank; IZA, 2011, p. 16

³⁵ See also: Knežević, Nikola, Božina, Anja. *Prestanak ugovora o radu (Termination of the Employment Contract)*, in: Božina, Anja *et al.* Radni odnosi - Primjena Zakona o radu: RRiF plus d.o.o., 2010, p. 503-513

These two variables can sometimes be included or used in a way that – depending on the age and the duration of employment, the variable of the amount of salary of a concrete worker is corrected, most often entitling older workers or those who have worked longer for that employer to increased amounts.³⁶

Almost as a rule, the severance pay is paid as one-off amount, in full, although there is the possibility to pay it in monthly installments. The latter would primarily be possible in those states, where severance pay displays strong features of a social system of (public) savings funds or where it has a prominent social protection function. Also, severance pay is paid after a case occurs, which is an individual concretization of the legal basis for the payment of severance pay, whereas in systems, which display more features of a social system of (public) savings funds, the funds can be withdrawn from the individual accounts at the termination of employment, or this withdrawal of funds may be postponed until the point of leaving the labor market, that is until retirement, after which it is paid in monthly installments, serving basically as another pension insurance pillar.

1.6 Financing severance pay

Payment of severance pay may be financed:

- (a) internally, or
- (b) externally.

Internal financing is possible from the operating revenues of the employer at the time of payment, and it is possible to make a provision for severance pay in the accounting. External financing means that there are individual savings accounts for any individual worker in either public or private funds to which contributions are paid, i.e. it is possible to finance them from general centralized, mostly state funds to which the severance pay contributions were paid.

In practice, in most states severance pays are financed from the employers' operating revenues.

1.7 Taxation of severance pay

An important element in considering severance pay is also the issue of severance pay taxation. Severance pay may be covered by various taxation regimes. It can be:

- (a) tax privileged in a way that it is (a1) tax exempt; or (a2) that tax deductions, reliefs or incentives apply; or
- (b) taxed as salaries or income.

³⁶ Also, the way of terminating employment contracts, differences between groups of workers with a single employer, e.g. administrative workers or what is usually called “white collar workers”, as opposed to manual or “blue collar” workers, or differentiations between open-ended and fixed-term employment contracts, as well as the differences between workers covered by collective agreements and those who are not covered by collective bargaining, all this may be the basis for differentiation. Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 24

It ought to be mentioned here that any differential tax procedure and treatment in comparison with the salaries or income is actually an incentive for tax evasion and for using some concrete special tax status.

2 Statutory regulation of the severance pay scheme in the Republic of Croatia

On 4th December 2010, after long-term preparations and exhausting attempts to harmonize the positions of social partners, the Croatian Parliament enacted the Labor Act, which was published in the Official Gazette 149/09 of 15 December 2009, and which became the new source of labor law regulations in the Republic of Croatia. With the entry into force of this Act, on 1st January 2010, the old law, which had been adopted on 17th May 1995 and published in the Official Gazette 38/95 of 8th June 1995, ceased being effective after fourteen years of application. The old Labor Act, which came into force on 1st January 1996, was one of the more “longevous” Croatian acts, which from today’s perspective, and despite several amendments, although not amendments of structural type,³⁷ can be said to have corresponded to the need of setting up modern interest-balanced labor legislation both from the point of view of its contents, and its methodology, and provided the general legal framework and regulated obligations in the individual and collective labor relations, but also specific institutional structures, which are inherent to the social-market economy of the so called Rhine model, which is something that the Republic of Croatia as a social state is aspiring to achieve. The very fact that it was balanced, and particularly in view of the fact that this law was the basic source of all labor law contracts, it has had a strong influence on the economy and social reality in the Republic of Croatia.

Later on, the Labor Act³⁸ was amended on several occasions, in a relatively short period of time. Thus in 2011, the Amending Act to the Labor Act³⁹ only managed to “correct” some of the identified deficiencies with respect to regulating individual employments to a smaller extent. After that, the Act on the Criteria to Participate in Tripartite Bodies and Representation for Collective Bargaining⁴⁰ made some changes with respect to regulating collective employment relations, and primarily collective bargaining and collective agreements, by applying direct and indirect derogations from the provisions of the Labor Act. Finally, the Amending Act to the Labor Act⁴¹ of June 2013 changed the contents of the Labor Act into what we have today.

The Labor Act of 2009 is really an iteration, only partially reshaped contents of the normative solution from the 1995 Labor Act, with all the amendments made until the date of adopting the

³⁷ The Labor Act (Official Gazette 38/95); Correction to the Labor Act (Official Gazette 65/95); Amending Act to the Labor Act (Official Gazette 17/01); Amending Act to the Labor Act (Official Gazette 82/01); Amending Act to the Labor Act (Official Gazette 114/03); Correction to the Amending Act to the Labor Act (Official Gazette 142/03); and the Decision of the Constitutional Court of the Republic of Croatia No. U-I-2766/2003, U-I-469/2004, U-I-1607/2004, U-I-4768/2004, U-I-4513/2004 of 24th May 2005 (Official Gazette 68/05).

³⁸ Labor Act (Official Gazette 149/09).

³⁹ Amending Act to the Labor Act (Official Gazette 61/11).

⁴⁰ Act on the Criteria to Participate in Tripartite Bodies and Representation for Collective Bargaining (Official Gazette 82/12 and 88/12-correction).

⁴¹ Amending Act to the Labor Act (Official Gazette 73/13).

new act, and the only additional contents stipulated in the negotiated Chapter 19 “Social Policy and Employment”, that is the EU *acquis* in the field covered by labor legislation, as a necessary prerequisite to achieve complete harmonization of the national labor legislation with the legislation of the European Union. This also concerns the severance pay scheme in the Republic of Croatia. From the legislative perspective, it is regulated by the provisions of the Labor Act. This means that the current regulations actually date back to 2003, and the amendments adopted then, whereas there are also connections to the original Labor Act of 1995.

2.1 The legislative history of the contemporary severance pay regulations in the Republic of Croatia

The Labor Act of 1995 regulated severance pay in two provisions of Article 118. The right to severance pay belonged to workers, then employees, who were parties to an employment contract concluded for an indefinite period, where the employer terminated that contract after two years of uninterrupted work, in every case of termination of an employment contract, except if it was terminated for reasons caused by the employee's own conduct. Severance pay was regulated in relation to the length of the previous uninterrupted length of the employment relationship with that employer, and it was not permitted to agree, or establish it in an amount less than one half of an average monthly salary, paid to the worker in the period of three months preceding the termination of the employment contract, for each complete year of work with that employer.

In the Act on Amendments and Supplements to the Labor Act of 2001, according to the provisions of Article 42, in addition to Article 118 paragraph 3, salaries paid on the basis of a management contract cannot be taken as the base for definition of severance pay. The sense of this provision has never been comprehensible and it leaves room for unequal interpretation of its content, so that already in the next Act on Amendments and Supplements to the Labor Act, it was repealed. Therefore, by this improvement, the Act on Amendments and Supplements to the Labor Act of 2003, the regulation of the severance pay scheme became what it is today. Along with repealing the provisions on the base for determination of severance pay from a management contract, the key amendments were that it was established in a completely straightforward and unambiguous manner that the amount of severance pay is established from the worker's gross salary⁴². At that time, the link between the right to severance pay exclusively with the termination of an employment contract for an indefinite period of time, was repealed, whereby the possibility was opened of payment of severance pay upon termination of any employment contract, even a temporary one, of course, under the condition that it had lasted uninterrupted for at least two years. By the same act, the amount of the statutory minimum severance pay was redefined in that it could not be agreed or set in an amount less than one third of the average monthly salary earned by the worker in the three months before the termination of the employment contract, for each complete year of work with that employer. The maximum was six average monthly salaries, which the worker earned in the three months before the termination of the employment contract, if by a law, a collective

⁴² This follows from the provisions of Article 83, paragraph 5, of the Labor Act added at that time: "Salary within the meaning of this Act is the gross amount of the salary." This is now Article 84, paragraph of the Labor Act. "Salaries and remuneration within the meaning of this Act are salaries and remuneration in the gross amount."

agreement, labor regulations or an employment contract it was not prescribed or prescribed or regulated differently.

As has been said, when the Labor Act was passed in 2009, and the later relevant amendments and supplements to the Labor Act, the legal regulation of the right to severance pay did not change.

2.2. Regulation of severance pay in the provisions of the Labor Act

The severance pay scheme, the right to severance pay and severance pay itself are regulated in the Labor Act in Title XIV: "Termination of Employment Contracts" in the provisions of three paragraphs of Article 119: "Severance Pay".

The first paragraph of Article 119 of the Labor Act prescribes the payment of severance pay to a worker who is given notice by his employer after two years of uninterrupted work, unless the employment contract is terminated for reasons caused by the worker's own conduct. So, the right to severance pay belongs to workers who fulfill the prerequisite of two-year uninterrupted employment, provided that their employment contract is terminated due to personal or business reasons, but workers whose employment contract is terminated due to their own wrong conduct do not have that right, and neither do workers, who by their own conduct, have committed a grave violation of their obligations from their employment, and their employment contract has been terminated as a result. Also, the workers whose employment contracts are terminated by a judicial decision do not have this entitlement.⁴³ As an *argumento a contrario* to the latter, the right to severance pay would also belong to a worker whose employment contract has been terminated by the employer due to: "some other especially important factors", when even "with respect for all the circumstances and interests of both contracting parties, the continuation of the employment is not possible". That is to say, when it is a case of circumstances outside the influence of the worker or his responsibility, the right to severance pay is not excluded.

From the statutory regulation of the entitlement to severance pay, persons from the provision of Article 2 paragraph 3 of the Labor Act are excluded. Namely, a natural person who is a

⁴³ In the case of judicial termination of an employment contract, the worker does not have the right to severance pay. In the case of judicial termination of a worker's employment contract, instead of severance pay, the worker has the right to compensation, in the amount of three to eighteen average monthly salaries, depending on the duration of the worker's employment relationship, age and number of dependants, but practically the courts could also consider, as an additional criterion, the amount of the severance pay which the worker would have been entitled to, if the employer had terminated his employment contract lawfully. Here, it is necessary to refer to the Decision of the Supreme Court of the Republic of Croatia, nr. Revr-287/13 of 17 April 2013, and the Decision of the County Court in Zagreb no. Gžr-1752/12 of 13 November 2012 and the Decision of the Municipal Labor Court in Zagreb no. Pr-1613/12 of 13 July 2013. In these decisions, the legal issue of whether a person is entitled to severance pay based on the termination of the employment contract by a court decision, is answered affirmatively. However, in order to avoid any confusion, these judicial decisions do not refer to all cases of judicial termination of employment contracts, but only to cases where workers would be entitled to severance pay based on some autonomous source of law – here the collective agreement, or in other cases prescribed by the Labor Act, so in the specific case also in case of judicial termination of the employment contract, given that the right to severance pay from the collective agreement did not exclude judicial termination. *Per analogiam* this relates also to the entitlement to severance pay in case of consensual termination of the employment contract, if the *ex lege* conditions of age and years of service etc. are fulfilled.

Management Board member, a CEO or who performs any other office in accordance with a special law, and who is individually and independently or jointly and severally authorized to conduct work of the employer, may – but need not – perform this work for the employer as an employed worker, and even if that person does perform these tasks as an employed worker, the provisions of the Labor Act on the termination of employment contract do not apply, so that this person is not entitled to severance pay.⁴⁴ Consequently, for this category of workers – “managers” – the entitlement to severance pay is a matter of their individual contracts, so that it is a part of the civil obligations law.

Alongside establishing the reasons for termination of the employment contract, a requirement for attaining the right to severance pay is also the previous uninterrupted duration of the specific employment, for more than two years. This also determines the level or the amount of severance pay, according to the length of the previous uninterrupted employment relationship. Article 119, paragraph 2 of the Labor Act establishes the lowest amount of statutory severance pay, in that it may not be agreed or set in an amount less than one third of the average monthly salary, which the worker earned in the three months before the termination of the employment contract, for each complete year of work with that employer.⁴⁵ So, the lowest amount of severance pay according to the Labor Act is calculated as one third of the worker's average monthly salary earned in the last three months before the termination, and the number of complete years of uninterrupted pension qualifying period served the worker with the specific employer.

Apart from establishing the lowest amount of severance pay, the Labor Act also establishes the highest amount of severance pay. That is to say, if severance pay is only established on the basis of the legal provisions, it may not be in an amount greater than six average monthly salaries which the worker earned in the three months before the termination of the employment contract. This provision of Article 119, paragraph 3 of the Labor Act is only relatively cogent in nature, since it prescribes that by some other law, collective agreement, labor ordinance or employment contract, severance pay may also be established differently. In the latter case, the severance pay may be agreed, or established, under more favorable terms in an amount higher than according to the law. When the right to severance pay is agreed or established for someone who is retiring, than it is not deemed to be a right from the Labor Act, but a right from a collective agreement, work regulations or an employment contract, since for that case, the Labor Act does not prescribe the right to severance pay.

The Labor Act, in the provisions of Article 80, establishes, as an exception and under certain conditions, the right to severance pay of at least double the amount of severance pay they would otherwise be entitled to for especially protected groups of workers who have suffered an occupational injury or who are suffering from an occupational disease. These are workers who, after they have completed treatment and convalescence, cannot return to work with their employer, or they cannot be offered an employment contract for some other work, so their employment

⁴⁴Please see: Crnić, Ivica. *Otkaz ugovora o radu (Termination of the Employment Contract)*. Zagreb: Organizator, 2013, p. 215-216.

⁴⁵ According to the Opinion of the Ministry of Labour and Social Welfare, Class: 110-01/97-01/61, reg. no: 524-02-97-2 of 14 March 1997, if a worker was not paid a salary for the last three months, then the level of his salary is established on the basis of the salary of a worker doing the same work.

contract will be terminated by regular or conditional notice, after proceedings have been conducted.⁴⁶

The right to severance pay may also be established by a program to take care of excess workers. These workers may be granted the right to severance pay under more favorable terms and in a higher amount than the amount established by the provisions of Article 119 of the Labor Act. A program of care for excess workers (redundancy) is adopted as a unilateral act by the employer, but workers' representatives may take part in its adoption, so this program may also take the form of a collective agreement or an agreement between the employer and the workers' council.

The employer's decision to terminate an employment contract may, but does not have to, establish the right to severance pay or establish the amount of severance pay.⁴⁷ The obligation to pay severance pay is due on the last day of the employment relationship. The fact that a worker would stop work, at the request of or by a decision of his employer, before the expiry of the statutory or agreed date of notice, does not affect the existence of the right to severance pay, and also when for attaining or establishing the amount of severance pay the duration of the period of the previous employment is important, that period also includes the period of notice, and the salaries earned during the notice period.

The entitlement to severance pay is due on the day of termination of the employment contracts or the employment, and in case when there is an entitlement to severance pay, this is most often the date of expiration of the period of notice, unless the parties have agreed some other later due date.⁴⁸ This is also the relevant date for the expiry of the statute of limitations on the employer's obligation to pay severance pay to the worker, which is three years.

In relation to the earlier regulation of the right to severance pay, some questions and lack of clarity have arisen in practice.

For instance the question arises of the right to severance pay with the use of the institution of notice and an offer of an amended employment contract, or when workers who refuse to accept the employer's offer for an amended employment contract, "accept" the termination of their employment contract. This is a case of an attempt to amend the employment contract at the proposal of the employer as a contracting party, and if this amendment is unacceptable for the worker as the other party, then the possibility arises for the employer to terminate the employment contract. Here the worker is protected in almost the identical way as in the case when notice is given without offering to conclude an amended employment contract. Therefore, and due to the express legal provisions about who has the right to severance pay, a worker, whose employment contract is terminated because he refused an offer of an amended employment contract, also has the right to severance pay. In the same way, if the worker accepts the offer of the amended employment contract, he will not have the right to severance pay, because then the employment contract is not terminated.

⁴⁶ See also: Crnić, Ivica. *Otkaz ugovora o radu (Termination of the Employment Contract)*. Zagreb: Organizator, 2013, p. 214-215.

⁴⁷ Please see: Decision by the Supreme Court of the Republic of Croatia, no. Rev-1368/01 of 23 October 2001.

⁴⁸ Please see: Legal understanding adopted at the fifth session of the Civil Division of the Supreme Court of the Republic of Croatia (V/07) no. Su-IV 46/07 of 28 May 2007.

Further, even in the case when the employer's business is undergoing reorganization, where the existing employment contract is terminated by agreement between the worker and the employer, and at the same time the worker concludes an employment contract with another employer, the question arises of the existence of the right to severance pay. However, due to the fact that the employment contract is not actually terminated, the worker does not have the right to severance pay. Thereby, in our opinion, the general question of the right to severance pay is answered - the right follows termination of an employment contract for reasons not caused by the worker's own conduct, but it is also necessary for the employment relationship of the worker with a specific employer effectively to end. In this sense, a worker will not have the right to severance pay if the company or part of the company is transferred to a new employer, business operation or part of another business operation, since in that case the existing employment relationship is also transferred to the new employer, with unaltered content, and the employment relationship continues, that is, it does not end.

It also needs to be mentioned that outside of the scope of the severance pay regulated by the Labor Act, there is another severance pay *sui generis* in the Republic of Croatia.⁴⁹ It is something that is identified as "purchase of supplementary pension benefits", in the form of severance pay, which is paid in installments for life, through which the employer "indemnifies" workers who opted for early retirement and compensates them for the amount, which is equal to difference of their pension benefit based on early retirement and what would have been their full retirement benefit. This role of this instrument is thus to ensure social security, because the pensioner, previously the worker, receives the severance pay in installments together with the pension, each month for life, and it is precisely calculated, equaling the amount of his early retirement "penalization". This is a form of reward to the worker, and it is an important message to new, young generations of how the oldest workers should be treated and how to protect their dignity, and from the social and financial standpoint it is more favorable than payment of one-off severance pay.⁵⁰ The nature and the characteristics of this type of severance pay are such that it won't be elaborated further in this text, but it can certainly represent one form of thinking about various functions of the severance pay scheme in the Republic of Croatia.

2.3 Regulation of severance pay in collective agreements and work regulations

We do not have any knowledge of any analysis of the regulation of the right to severance pay in collective agreements, or alternatively in work regulations in the Republic of Croatia. In that sense it is only possible to mention in passing here the possibility of a definition in more detail of the right to severance pay, which we expect will be used in collective agreements.

⁴⁹ Please see: Opinion of the Ministry of Economy, Labor and Entrepreneurship, Class: 140-01/10-01/156 filing number: 526-08-01/1-10-2, of 16. December 2009.

⁵⁰ Also see: Bulaš, Ivo. Dokup mirovine – vrsta otpremine (Purchase of Supplementary Pension Benefits – a Type of Severance Pay). *Radno pravo – journal*, 8, 2013., 4., p. 44-52.

Article 119, paragraph 3 of the Labor Act allows severance pay to be regulated differently by another act, collective agreement, work regulation or employment contract, in an amount higher than that in the Labor Act. Here lies the authority for bilateral agreements based on free will of both parties, on severance pay through collective agreements, or for voluntary unilateral regulation by the employer, but only in a way that is more favorable for the worker, that is in a higher amount than the regulations in the Labor Act.⁵¹ At the mention of free will, it also has to be mentioned that in case an agreement about the termination of the employment contract is reached between the worker and the employer, or *per analogiam* even in cases of employment terminations where there is no obligation to pay severance pay, the employer may independently introduce a right to severance pay, and it can even exceed the mandatory amount.⁵²

So for example, in the Basic Collective Agreement for Civil Servants and Employees in Public Services⁵³ the right to severance pay is regulated in the provisions of Article 47, paragraphs 2 to 5. Every "employee" in public services, "civil servant" and "employee" who is given notice by the employer, and the reason for notice is not the conduct of the employee, has the right to severance pay pursuant to the Labor Act. Article 47, paragraph 3 of the Basic Collective Agreement for Civil Servants and Employees in Public Services prescribes exceptions to the general regulation of the right to severance pay in the public services, in that an "employee" with thirty years or more of pension qualifying period with the same employer, is paid a privileged severance pay in the amount of at least sixty per cent of the average gross monthly salary paid to the employee in the three months before the termination of the employment contract, for each complete year of work. Here, the pension qualifying period with the same employer, pursuant to the provisions of Article 49 of the Basic Collective Agreement for Civil Servants and Employees in Public Services, is counted as uninterrupted work in public services, regardless of a change in employer.⁵⁴

Therefore, in public services the pension qualifying period with an employer is taken to be uninterrupted work in public services, regardless of a change of employer, which makes it possible to accumulate pension qualifying period realized with different employers or institutions in the same or different public services. Regarding the level of severance pay, for a person who has thirty or more years of pension qualifying period in the public services with the same employer, payment is prescribed of a privileged severance pay, in the amount of no less than sixty per cent of the average gross salary, paid to the employee in the three months before the termination of the employment contract, for each complete year of pension qualifying period.⁵⁵ Thereby in these two elements the right to severance pay in the public services has been "enhanced".⁵⁶

⁵¹ Also see: Decision of the Supreme Court of the Republic of Croatia, nr. Gzz-110/03 of 17 September 2003.

⁵² Please see: Decision of the Supreme Court of the Republic of Croatia, nr. Revr-536/07 of 23 December 2008; Decision of the Supreme Court of the Republic of Croatia, nr. Gzz-110/03 of 17 September 2003.

⁵³ The Basic Collective Agreement for Civil Servants and Employees in Public Services (Official Gazette 141/12)

⁵⁴ The exception to this is in the calculation of severance pay of "employees" who, during their work in public services and upon the termination of their employment relationship, have already realized the right to severance pay, since in that case the uninterrupted pension qualifying period will not include the period for which severance pay has already been realized. The vagueness of the general meaning of this provision, and the possibility of working for several employers part time at the same time, indicate the questionable implementation of this limitation in the application of the calculation of the total pension qualifying period in public services as the pension qualifying period with a single employer.

⁵⁵ Pursuant to Article 47, paragraph 5 of the Basic Collective Agreement for Civil Servants and Employees in Public Services severance pay is due and paid no later than 30 days from the end of the employment relationship. The same

Alongside this severance pay, which in a regulatory sense is equivalent to severance pay from the Labor Act, Article 61 of the Basic Collective Agreement for Civil Servants and Employees in Public Services also regulates severance pay upon retirement, whereby an "employee" in public services, who is retiring, is entitled to the right to severance pay of three bases for calculation.

From a review of other collective agreements in the Republic of Croatia, primarily those in state and public services, and those with employers in "majority ownership of the Republic of Croatia", it may be established that the question of the right to severance pay is regulated in them in many different ways, or in relation to many different factors.

In some collective agreements the amount or level of severance pay is determined in that the number of years of pension qualifying period with an employer determines an amount of severance pay higher than in the Labor Act - one third of the average monthly salary which the worker earned in the three months before the termination of the employment contract - whether as a percentage or a proportion of the average salary, or as an absolute number, in cash.

Also, the highest amount of severance pay is established differently in some collective agreements, as a higher amount, whether by setting a higher number of monthly salaries for that amount, in comparison to the six average monthly salaries from the Labor Act, or by setting the highest amount of severance pay as an absolute amount.

It may also be established that for some categories of workers, older workers or workers with more pension qualifying period with an employer, incentives are sometimes prescribed in the formula for calculation of severance pay, so that the severance pay is increased by those sums. Also, in some collective agreements, the elements of the formula for calculation of severance pay differ between workers who do different jobs.

Already in the presentation of the possibility of different ways of regulating the right to severance pay in collective agreements, or alternatively in work regulations, it was noticed in a review of collective agreements and work regulations in the Republic of Croatia, which, since there has been no more detailed or systematic analysis of the regulation of the right to severance pay, is practically the only way to encompass this subject matter, that in this country various corrective elements have been introduced in many different ways, which have acted to increase the amount of severance pay, for all or some workers.

It is also necessary to mention that since it is possible to regulate the right to severance pay differently in both collective agreements and work regulations, under more favorable terms or in

Article 47, paragraph 4 of the Basic Collective Agreement for Civil Servants and Employees in Public Services states that if the "employee" has not been paid a salary in the last three months before the termination of the employment contract, but rather remuneration pursuant to separate regulations, or part was paid as a salary and part as remuneration, pursuant to separate regulations, then for calculation of the severance pay to which he is entitled, the salary will be taken which would have been paid if that person had worked full time.

⁵⁶ Pursuant to the provisions of Article 48 of the Basic Collective Agreement for Civil Servants and Employees in Public Services, the provisions of Article 47 on severance pay do not relate to the heads of institutions in the system of public services.

higher amounts than in the Labor Act, there are still certain differences between the possibilities of these two choices, although everything that has been said here regarding collective agreements is also applicable to the regulation of the right to severance pay in work regulations, still the key fact is that the extent of the regulation by work regulations is must smaller, due to the fact that these are unilateral (self) regulations by the employer, who in their work regulations most often merely repeat the regulations from the Labor Act, with only minimal alterations. An exception may be mentioned here in relation to reconstruction by employers, whereby employers sometimes, unilaterally and voluntarily, raise the amount of severance pay, according to the years of pension qualifying period with that employer, to motivate workers to "accept" termination of their employment contract⁵⁷, or to accept an offer to conclude an agreement on termination of the employment contract.

2.4. The status of severance pay in the provisions of tax regulations

The Labor Act contains cogent provisions on severance pay, which guarantee the lowest level of rights regarding severance pay. Tax regulations deal with the status of severance pay regarding the part that is taxable and the part which is non-taxable.

The non-taxable amount of severance pay which an employee may pay his workers, and the requirements for payment of a certain amount of non-taxable income, are prescribed by the provisions of Article 13, paragraphs 1 and 2 of the Ordinance on Income Tax⁵⁸, and in the light of the provisions of Article 14, paragraph 1, point 1, subsection 1.2 of the Act on Income Tax⁵⁹. If the requirements are not met for payment of the non-taxable part of severance pay, the entire amount paid, for tax purposes, is deemed to be salary and is subject to tax, surtax and insurance contributions. Also, in the amount above the non-taxable amount, the difference above the non-taxable amount is equivalent to payment of a salary for tax purposes.

Therefore, pursuant to the provisions of Article 13, paragraph 2, point 21 of the Ordinance on Income Tax, severance pay for termination of an employment contract for business or personal reasons, as established by the Labor Act, is not subject to tax up to HRK 6,400.00 for each complete year of work with the employer. In the same way, severance pay is also not subject to tax paid that follows the termination of an employment contract due to an occupational injury or disease, up to the amount of HRK 8,000.00 for each complete year of work with the employer. The tax regulations also deem work with the same employer to be a period of work with a previous employer, if, pursuant to the provisions of the Labor Act, the workers' employment contracts were transferred to the new employer for work in a company or part of a company, which by change of

⁵⁷The termination of an employment contract is a case of a unilateral form of termination of an employment contract, and in that sense, the worker's acceptance is not legally either necessary or relevant, but in fact it may be relevant in that it means that the worker himself does not dispute the termination of employment contract, whether with the employer or in court.

⁵⁸ Ordinance on Income Tax (Official Gazette 95/05, 96/06, 68/07, 146/08, 2/09, 9/09 - correction, 146/09, 123/10, 137/11, 61/12 and 79/13).

⁵⁹ Act on Income Tax (Official Gazette 177/04, 73/08, 80/10, 114/11, 22/12 and 144/12).

status or legal transfer was transferred to a new employer. These provisions are also applied *mutatis mutandis* to institutions and other legal persons.

There are several open questions in this form of regulation. First of all, the terminology of the provisions of the Ordinance on Income Tax is not quite clear. That is to say, it states: "severance pay due to termination for business or personal reasons according to the Labor Act", whereby it is not completely clear whether this means that severance pay following termination of an employment contract for business or personal reasons, is non-taxable pursuant to the Labor Act, which is well known, or it means that severance pay is non-taxable if it is given according to the parameters and calculation formulas from the Labor Act, or that any severance pay is non-taxable that is given whether it is according to the parameters and calculations formulas in the Labor Act, or according to some other parameters from another law, collective agreement, work regulation or employment contract, which pursuant to the provisions of Article 119, paragraph 3 of the Labor Act, regulate severance pay differently, under more favorable terms or in a higher amount than under the Labor Act. The fact that the tax regulations do not limit the highest amount of the non-taxable part of severance pay does not help here.⁶⁰

Also in relation to establishing the amount of severance pay, it is not completely clear if severance pay established in an amount higher than the non-taxable amount belongs to the worker as a net sum or if it is a gross sum, from which contributions from the salary and income tax need to be deducted. Since the latter is a significant expense, the parties to this agreement (the employers, the unions and the workers) and decision making (the employers) should prevent disputes over this through ensuring clarity in the content of regulations stating the amount of severance pay and the extent of the obligation to bear all further burdens.

The provisions of Article 13, paragraph 2, point 20 of the Ordinance on Income Tax also treat as non-taxable severance pay given on retirement up to the amount of HRK 8,000.00.

Given that the statutory regulations on severance pay indirectly exclude natural persons who are Management Board members, CEOs or who perform any other office in accordance with a special law, and who are individually and independently or jointly and severally authorized to conduct work of the employer⁶¹, who – even if they perform this work as employed workers, are excluded from the provisions of the Labor Act regulating employment termination and even if such persons perform these tasks as employed workers, the provisions of the Labor Act on the termination of

⁶⁰ It has to be pointed out here that the justice and social justification are questionable of the interpretation of these provisions, where any severance pay would be non-taxable, which is given either according to the parameters and calculation formula from the Labor Act, or according to some other parameters from another law, collective agreement, work regulation or employment contract, which pursuant to the provisions of Article 119, paragraph 3 of the Labor Act, regulate severance pay differently, under more favorable terms or in a higher amount than under the Labor Act. That is to say, it is doubtful whether the employer should be permitted to pay out severance pay on the basis of an agreement or a unilateral decision, that is non-taxable and not burdened by insurance contributions, and in that way more acceptable and more favorable to him, and for it to be an incentive to evade paying tax and to use some other specific special tax status as opposed to a salary. Thereby it also stands in contrast to the Constitutional principle of participating in the defrayment of public expenses, in accordance with one's economic possibilities.

⁶¹ Based on the provisions of Article 2 paragraph 3 of the Labor Act these persons may – but need not – perform these tasks for the employer as employed workers, but even if they perform they work as employed workers, the provisions on the termination of employment and provisions on severance pay from the Labor Act do not apply to them.

employment contract do not apply to them, including the provisions on severance pay, so that these persons, even if they have some civil-law agreement on severance pay, will be excluded from the privilege of non-taxable amounts of severance pay from the Ordinance on Income Tax, which means that the full amount of their severance pay will be taxable.

3. The economic characteristics of the severance pay scheme in the Republic of Croatia

Regarding the severance pay scheme in the Republic of Croatia, we can differentiate three segments of the labor market. The first segment relates to workers in the public sector, who are mostly covered by collective agreements which offer more than generous severance pay. Within that system, a large amount of manipulation has been noticed⁶².

The second segment relates to workers of employers that are bankrupt, who receive part of their payment of severance pay, in the amount of half the sum established by the Labor Act, through the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer.⁶³ However, they most often never receive the remaining amount of severance pay which they are entitled to because the bankrupt employer rarely leaves sufficient funds in the bankruptcy estate to settle those claims.

The third segment relates to workers in the private sector who are not entitled to severance pay, whether because the employers do not respect their obligations established by law, or because the employers try to manipulate the way they terminate their workers' employment contracts. In view of the fact that the right to severance pay is only realized in the case of the termination of an employment contract by the employer, the employer either makes them conclude a temporary employment contract, or he terminates employment contracts before the right to severance pay is attained after two years of an uninterrupted employment relationship with the employer, or, in the case of a long-term contract, the employment contract is not terminated, thereby reducing labor mobility. Therefore, from this it is clear that a problem that occurs in practice in the Republic of Croatia is that workers in the private sector most often do not realize the right to severance pay, the severance pay to which they are entitled is not paid or that payment is made difficult or reduced.

It must be pointed out here that there is no centralized data base recording claims on the basis of the right to severance pay, or which records severance pay paid out in the public and private sectors. The Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer is an exception to this, in view of the fact that it is possible to monitor the results of its work analytically. Therefore it is only possible to reach any conclusions on the basis of data from

⁶² These manipulations range from introducing instruments, which greatly differ from the purpose of the law and the regulations on severance pay to plain illegal conduct, either in the form of distorting facts, on the basis of which the severance pay is calculated or in the form of introducing fake reasons or fake dismissals with the aim of paying severance pay, which would otherwise not be due, or to increase its amount or to abuse the non-taxable amount of severance pay.

⁶³ According to Article 3 of the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer (Official Gazette 86/08 and 80/13).

several sources and by establishing presumptions based on an estimate of employment and labor mobility. In any case, it may be said that the burden of implementing the current system is to a large extent borne by the State Budget of the Republic of Croatia, and workers, who are denied their statutory rights.

In view of this, it may be said that the existing mechanism of payment of severance pay is inappropriate, that is, that there are practical hindrances to realization of the statutory aims and parameters of the severance pay scheme, which indicate the importance of removing or improving these weaknesses, whether through the partial or complete reform of the system. Here, the aims of the reform would be:

- (a) a reduction in the burden of payment of severance pay on the employers
- (b) ensuring payment of severance pay to workers to provide income during a period of unemployment
- (c) increased labor force mobility; and
- (d) a reduction in the burden on the State Budget of the Republic of Croatia.

3.1 The characteristics of the Croatian severance pay scheme

The system of regulation of the Croatian national severance pay scheme is described here. Severance pay, as regulated by the Labor Act, if the worker has been in an uninterrupted employment relationship with the same employer for longer than two years, is calculated as the amount of one third of the salary for each complete year of employment with that employer, and no more than six salaries, but may also be regulated more favorably by a collective agreement, work regulation or an individual employment contract. Mainly these more favorable amounts relate to workers in the public sector.

Regarding the criterion of the reason for the termination of the employment contract, in practice the following types of severance pay are paid out:

- (a) severance pay for termination of an employment contract for business or personal reasons
- (b) severance pay for the uncontested termination of an employment relationship
- (c) incentive severance pay, which is paid on the basis of the termination of an employment contract for business reasons, or the uncontested termination of an employment contract, and
- (d) severance pay upon retirement.

It is important to differentiate three sectors in the analysis of the scheme. The first relates to the public sector, which is well protected by collective agreements and where severance pay is generous. Then there is the system of insurance of protection of claims by workers in the case of bankruptcy, conducted by the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer. The third part is the most comprehensive, relating to workers in the private sector, whose rights to severance pay are regulated by the general provisions of the Labor Act, or individual collective agreements for each branch. This part of the system is least transparent and reform is possible, precisely aimed at resolving the problems involved in insurance of protection of payment of severance pay to workers in this sector. Unfortunately, although the statutory requirements exist for creation of a centralized data base, to provide an insight into the status of claims on the basis of the right to payment of severance pay and severance pay paid out,

this base does not exist. Data exist on the amount of severance pay paid out in the public sector and these same data within the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer.

Although there is no centralized data base, it should be pointed out that, in the existing regulatory and institutional framework, all the requirements exist for registering claims and payments on the basis of the right to severance pay. That is to say, pursuant to the Labor Act, in the provisions of Article 85, an employer who does not pay a salary, remuneration or severance pay on the day they are due, or does not pay them in full, is obliged to send the worker a calculation of the sum he is obliged to pay by the end of the month in which the salary, remuneration or severance pay is due (the calculation is an enforcement document). Therefore, on the basis of the documentation sent by workers who have not been paid severance pay, the tax administration would be able to keep complete records of the status of claims of workers on the basis of payment of severance pay. Currently only severance pay that has been paid through an OTP form is recorded, which the employer sends to the tax administration when paying the severance pay.⁶⁴

3.1.1. Payment of severance pay in the public sector

Regarding the public sector, a detailed review of the question of payment of severance pay and the important elements of the position of income on the basis of the right to severance pay within the tax system has been provided by Marija Zuber⁶⁵. As has been said, the rights of workers within the public sector are protected by collective agreements and they are in a significantly better position than the private sector.

Tables 1 and 2 show the values of severance pay paid for budget beneficiaries in central government since 2009. It may be seen that the amount of severance pay paid fell significantly from 2009, and stabilized at the level of about 60.0 million HRK a year. The highest amounts of severance pay paid relate to the Ministry of Defense, the Ministry of Education, Science and Sport, and the Ministry of the Interior.

⁶⁴ Pursuant to the provisions of the Ordinance on the Content of Calculation of Salaries, Remuneration or Severance Pay (Official Gazette 81/10).

⁶⁵ Please see: Zuber, Marija. Otpremnine – pravoradnika i poreznoodređenje. (*Severance pay- workers' rights and tax definition*) Zagreb: Računovodstvo i financije, 2012, pp. 100-106.

Table 1: Severance pay paid on the level of central government from 2012 to June 2013 (in million HRK)

	2012	2013
TOTAL	63,17	29,64
CROATIAN PARLIAMENT	0,07	0,00
OFFICE OF THE PRESIDENT OF THE REPUBLIC OF CROATIA	0,04	0,00
GOVERNMENT OF THE REPUBLIC OF CROATIA	0,11	0,02
MINISTRY OF FINANCE	1,29	0,65
MINISTRY OF DEFENSE	20,23	5,67
STATE OFFICE FOR CROATS LIVING OUTSIDE OF THE REPUBLIC OF CROATIA	0,01	0,04
MINISTRY OF INTERIOR	3,61	7,28
MINISTRY OF WAR VETERANS	0,09	0,02
MINISTRY OF FOREIGN AND EUROPEAN AFFAIRS	0,15	0,16
MINISTRY OF ECONOMY	0,14	0,03
MINISTRY OF ENTREPRENEURSHIP AND CRAFTS	0,19	0,04
MINISTRY OF CULTURE	0,31	0,28
MINISTRY OF AGRICULTURE	0,25	0,23
MINISTRY OF REGIONAL DEVELOPMENT AND EU FUNDS	0,14	0,03
MINISTRY OF MARITIME AFFAIRS, TRANSPORT AND INFRASTRUCTURE	0,24	0,18
MINISTRY OF CONSTRUCTION AND SPATIAL PLANNING	0,39	0,22
MINISTRY OF ENVIRONMENTAL AND NATURE PROTECTION	0,12	0,09
MINISTRY OF SCIENCE, EDUCATION AND SPORTS	26,14	6,87
MINISTRY OF LABOR AND PENSION SYSTEM	1,59	0,57
MINISTRY OF TOURISM	0,00	0,01
MINISTRY OF PUBLIC ADMINISTRATION	0,71	0,56
MINISTRY OF HEALTH	0,91	0,58
MINISTRY OF SOCIAL POLICY AND YOUTH	1,51	0,71
CROATIAN ACADEMY OF ARTS AND SCIENCE	0,11	0,04
MINISTRY OF JUSTICE	4,28	5,26
OFFICE OF THE OMBUDSMAN	0,00	0,01
GENDER EQUALITY OMBUDSMAN	0,02	0,00
CENTRAL BUREAU OF STATISTICS	0,28	0,04
STATE AUDIT OFFICE	0,08	0,00
STATE INSPECTORATE	0,17	0,03

Source: Ministry of Finance

Table 2: Severance pay paid on the level of central government from 2009 to 2011 (in million HRK)

	2009	2010	2011
TOTAL	245,01	128,27	67,84
CROATIAN PARLIAMENT	0,02	0,11	0,11
OFFICE OF THE PRESIDENT OF THE REPUBLIC OF CROATIA	0,05	0,00	0,05
CONSTITUTIONAL COURT OF THE REPUBLIC OF CROATIA	0,00	0,00	0,01
CROATIAN COMPETITION AGENCY	0,00	0,02	0,00
GOVERNMENT OF THE REPUBLIC OF CROATIA	0,13	0,21	0,09
CENTRAL STATE OFFICE FOR E-CROATIA	0,00	0,01	0,00
STATE PROPERTY MANAGEMENT ADMINISTRATION	0,00	0,02	0,00
MINISTRY OF FINANCE	1,10	1,52	1,17
MINISTRY OF DEFENSE	179,49	43,68	21,38
MINISTRY OF INTERIOR	10,69	9,59	6,88
MINISTRY OF FAMILY, WAR VETERANS AND INTERGENERATIONAL SOLIDARITY	0,12	0,05	0,00
MINISTRY OF FOREIGN AFFAIRS AND EUROPEAN INTEGRATION	0,23	0,11	0,18
MINISTRY OF ECONOMY, LABOR AND ENTREPRENEURSHIP	1,17	1,32	1,07
MINISTRY OF CULTURE	0,20	0,30	0,33
MINISTRY OF AGRICULTURE, FISHERIES AND RURAL DEVELOPMENT	0,08	0,54	0,22
MINISTRY OF REGIONAL DEVELOPMENT, FORESTRY AND WATER MANAGEMENT	0,06	0,03	0,08
MINISTRY OF MARITIME AFFAIRS, TRANSPORT AND INFRASTRUCTURE	0,14	0,10	0,18
MINISTRY OF ENVIRONMENTAL PROTECTION, SPATIAL PLANNING AND CONSTRUCTION	0,47	0,57	0,34
MINISTRY OF SCIENCE, EDUCATION AND SPORTS	40,72	59,74	25,15
MINISTRY OF TOURISM	0,02	0,00	0,00
MINISTRY OF PUBLIC ADMINISTRATION	0,63	0,82	0,55
MINISTRY OF HEALTH AND SOCIAL WELFARE	2,17	3,56	2,21
CROATIAN ACADEMY OF ARTS AND SCIENCE	0,06	0,06	0,05
MINISTRY OF JUSTICE	6,90	5,35	7,18
OFFICE OF THE OMBUDSMAN	0,00	0,00	0,02
GENDER EQUALITY OMBUDSMAN	0,00	0,01	0,00
CENTRAL BUREAU OF STATISTICS	0,11	0,25	0,18
STATE AUDIT OFFICE	0,00	0,00	0,05
STATE INSPECTORATE	0,43	0,28	0,31
COMMISSION FOR RELATIONS WITH RELIGIOUS COMMUNITIES	0,00	0,00	0,02

PERSONAL DATA PROTECTION AGENCY	0,00	0,01	0,00
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Source: Ministry of Finance

Given that one third of all persons employed in the Croatian public sector are working in bodies of local and regional government and in public companies, it can be assumed that the amount of severance pay benefits is proportionate to the below mentioned number (Table 3).

Table 3: Total number of persons employed in the Croatian public sector

			2005	2006	2007	2008	Index 2008/2006	
PUBLIC SECTOR	General state	Central state	Budgetary users (public and state officials, civil servants and employees)	234,309	235,976	246,833	248,949	105.5
			Extrabudgetary funds and users *	10,731	10,930	3,961	1,510	13.8
		Local and regional level	nn	62,362	64,621	66,806	107.1	
		Public companies	nn	68,438	68,845	70,957	103.7	
		Total	nn	377,706	384,310	388,222	102.8	
PUBLIC SECTOR	in % of the total number of persons employed in the Croatian public sector							
			Budgetary users (civil servants and employees)	-	62.5	64.2	64.1	63.6
			Extrabudgetary funds and users	-	2.9	1.0	0.4	1.4
			Local and regional level	-	16.5	16.8	17.2	16.8
			Public companies **	-	18.1	17.9	18.3	18.1
			Total		100.0	100.0	100.0	100.0

Source: Institute of Public Finance

However, the Republic of Croatia has a relatively significant number of persons employed in non-financial public companies, which are expected to be restructured in foreseeable future, which means a potentially higher number of severance pay claims. Also, workers employed at state companies are protected by collective agreements, so that the payments are significantly higher (Table 4). In addition, some claims can be expected within the process of planned privatization of financial public companies⁶⁶. However, it is very likely that the financial burden of these claims will be compensated for within the privatization process, and that it won't be financed from the state budget.

Finally, it needs to be mentioned that most manipulations with severance pay were identified with employers in the public sector, regardless if they were public and state agencies or companies "in majority state ownership", introducing elements, which ranged from significant divergence from

⁶⁶ Such as the Hrvatska poštanska banka d.d. (Croatian Post Bank) and Croatia osiguranje d.d. (state-owned insurance company).

the purpose of the law and the regulations on severance pay⁶⁷ to plain illegal conduct⁶⁸, with the aim of either paying severance pay, which was not due, increasing its amount or abusing the non-taxable amount of severance pay by paying high amounts, which were largely non-taxable. The burden of such conduct was mostly born by the employer and the state budget of the Republic of Croatia, which thus lost some of its tax revenue, and the severance pays were often even financed from the state budget. Collective agreements, which open room for moral hazards (agreement between the employer and the worker at the cost of the state) and generous tax treatment have encouraged numerous workers to use this possibility at the expense of the state budget. This situation was also enhanced by the lack of transparency and records of payment and lack of control.

Table 4: Number of persons employed in non-financial public companies

	2006.	2007.	2008.	Indeks 2008/2006
Adriatic Croatia International Club d.d. (ACI d.d.)	388	373	374	96,4
Autocesta Rijeka - Zagreb d.d. (ARZ d.d.)	550	632	762	138,5
Croatia Airlines d.d. (CA d.d.)	948	953	1.000	105,5
Hrvatska elektroprivreda Grupa (HEP)	14.158	13.855	13.835	97,7
Hrvatska Lutrija d.o.o. (HL)	1.332	1.381	1.393	104,6
Hrvatska pošta d.d. (HP)	11.406	11.410	11.250	98,6
Hrvatska radiotelevizija (HRT)	3.484	3.532	3.549	101,9
Hrvatske autoceste d.o.o. (HAC)*	-	-	2.584	-
Hrvatske šume d.o.o. (HŠ),	8.331	9.069	8.957	107,5
Hrvatske željeznice konsolidirano (5 društava, HŽ)	14.204	13.774	13.476	94,9
Jadranski naftovod d.d. (JANAF d.d.)	354	359	372	105,1
Jadrolinija	2.318	2.315	2.345	101,2
Narodne novine d.d. (NN)	600	561	546	91,0
Odašiljači i veze d.d. (OIV)	412	389	337	81,8
Plinacro	-	248	262	-
Plovput d.o.o.	290	281	280	96,6
Vjesnik d.d.	580	546	520	89,7
Ukupno	59.355	59.678	61.842	104,2

Source: Institute of Public Finance

⁶⁷ For instance, calculating pension qualifying periods with different employers in one or several public agencies or a uniform pension qualifying period, which is taken into account in calculating severance pay, then significant increase (as much as double) of individual elements in the formula for calculating severance pay, or regulations, according to which the severance pay belongs to the worker in any case of employment contract termination – even when the contract is terminated by the employee himself, as was the case in the collective agreement of the Croatian Privatization Fund.

⁶⁸ For instance, distorting facts, on the basis of which severance pay is calculated, faking reasons for dismissal and dismissal procedures, introducing the element of “voluntary” terminations and workers’ “acceptance” of the employer’s decision on notice, which was most often caused by personal or business reasons.

3.1.2. Payment of severance pay in the case of the bankruptcy of the employer

With respect to workers, whose employment contracts were terminated after the employer's bankruptcy, it was already mentioned that their claims are guaranteed by the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer.

The Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer was established by the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer. It was founded by the Republic of Croatia, and the founding rights and obligations pertain to the Government of the Republic of Croatia. Within the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer, the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer:

- issues first instance rulings on material rights of workers in the case of bankruptcy of the employer and makes payments based on these rulings to the designated earmarked account of the bankruptcy debtor, exclusively for the payment of workers' claims;
- makes sure that the proceedings to ensure workers' rights are conducted in accordance with the law;
- provides expert assistance to workers in exercising their rights as defined by the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer;
- directs and manages the funds provided for this purpose based on the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer;
- exercises procedural rights of the bankruptcy creditor in the bankruptcy proceedings for the claims that it settled;
- exchanges relevant information with competent bodies or guarantee agencies of other countries in case that business activities were conducted in two or more states of the European Economic Area;
- exercises the right to recovery for the payments made to the workers in case of bankruptcy of a foreign employer; and
- performs other tasks as established by the Act, the Statute and the acts of the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer.

Along with the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer, the administrative work related to receiving requests to insure claims is also performed by the Croatian Employment Service.

In case of the employer's bankruptcy, the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer makes sure that the workers exercise their right to:

- unpaid salary for the last three months before initiating bankruptcy, or before the termination of their employment, if the employment was terminated within three months before initiating

bankruptcy – the maximum amount being the amount of minimum salary in the Republic of Croatia for each month, in which the worker did not receive salary⁶⁹;

- unpaid amount of the compensation for sick leave, which the employer was responsible for paying in the last three months prior to initiating bankruptcy or before terminating employment, if the employment was terminated within three months before initiating bankruptcy – the maximum amount being the amount of minimum salary in the Republic of Croatia for each month, in which the worker did not receive salary;
- the compensation for the unused annual leave that the worker was entitled to in the calendar year, in which the employment was terminated, that is in which bankruptcy was initiated – the maximum amount being half the amount of minimum salary in the Republic of Croatia;
- severance pay under the conditions established by the law – half of the legally prescribed maximum amount of severance pay. The highest amount of severance pay is established by the Labor Act, and it amounts to six average monthly salaries, which the worker received within three months before the termination of the employment contract; and
- payment of the compensation of damages for injury at work or an occupational disease, based on a final court decision – the maximum amount being one third of the damages awarded by a final court decision.

Table 5 shows an overview of payments to workers employed by companies in bankruptcy proceedings within the above mentioned categories in the remit of the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer. It ought to be mentioned that up until the 1st January 2010, the insurance of worker's claims in the case of the bankruptcy of the employer was in the remit of the Development and Employment Fund. Based on the insight into the data, two important conclusions can be drawn:

- insurance of workers' claims during the entire time that this system has been in place are mostly financed from the state budget of the Republic of Croatia, which means that employers' unsettled liabilities are mostly financed from the general taxes; and
- the economic and financial crisis has increasingly contributed to the increase of bankruptcy-related claims – since 2009, there has been a significant increase in the number of claims and the amount of payments based on the exercise of workers' rights.

⁶⁹ Minimum salary for the period from 1 June 2012 until 31 May 2013 in the Republic of Croatia amounted to HRK 2,814.00 according to the publications of the Central Bureau of Statistics (Official Gazette 60/12).

Table 5: Overview of payments based on workers' claims and recovery of funds to the state budget of the Republic of Croatia within the operations of the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer

	Number of payments based on claims	Total payments (million HRK)	Total recovery (million HRK)	Share of recovered funds (percentage)
2003	142	0.41	0.00	0.00
2004	4,982	32.70	4.38	13.41
2005	1,886	28.96	6.99	24.13
2006	1,710	20.81	5.81	27.91
2007	1038	11.36	3.00	26.39
2008	2,585	11.84	2.80	23.67
2009	2,734	42.93	11.90	27.72
2010	6,789	84.16	10.37	12.32
2011	4,229	64.32	7.48	11.64
2012	4,031	65.80	15.05	22.87
TOTAL:	30,126	363.29	67.78	19.01

Source: Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer

The above data point to pro-cyclic nature of the existing severance pay scheme, which is not being sufficiently highlighted. Namely, at the time of economic and financial crisis, when employers have financial problems because of reduced demand and reduced operational revenues, one of the ways out of this situation is to reduce the number of employees. However, if it is necessary to lay off a significant number of workers, employers might find themselves in a situation that they are forced to declare bankruptcy because of significant severance pay claims by the workers or they might have serious liquidity problems.

Besides the fact that workers' claims from employers impose a significant burden to the state budget of the Republic of Croatia, it needs to be said that this system for insurance of workers' claims does not provide for maximum protection. Namely, the Act on Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer stipulates that the Agency for Insurance of Workers' Claims in the Case of the Bankruptcy of the Employer provides compensation just for one part of workers' rights, and the rest is paid in regular proceedings in line with the Bankruptcy Act⁷⁰, from the bankruptcy estate. Naturally, settlement of workers' claims thus depends on the state of the individual employer and on the bankruptcy proceedings, and it is thus possible that workers lose an important share of the claims that they are entitled to. It can therefore be said that the major share of the financial burden of this system is shared by the state budget of the Republic of Croatia and the workers. Also, mentioned procedures take time and they do not make sure that the workers will be compensated for their share in the lost profit at the moment when they lose their jobs. Therefore, the function of the severance pay as an instrument of sustaining workers' standard of living during the period of unemployment, as it is envisaged in theory, is thus not fulfilled.

⁷⁰ The Bankruptcy Act (Official Gazette 44/96, 29/99, 129/00, 123/03, 82/06, 116/10, 25/12 and 133/12).

3.1.3. Payment of severance pay in the private sector

As for the third group of workers employed in the private sector, who are regularly employed, there seems to be most uncertainties. Namely, although there is a legal obligation to record severance pays, there are no public data, on the basis of which the amount of severance-pay-based claims could be determined. It is assessed that – at the annual level – the number of workers who are entitled to severance pay ranges between twenty-five and sixty-seven thousand workers.⁷¹ The number of workers who are entitled to severance pay is significantly higher at the time of economic and financial crisis, which poses an additional burden to the private sector. Also, the majority of workers in the private sector are not “covered” by collective agreements, so that they are entitled to severance pay only by the standards of the Labor Act. It is assessed that this amounts between HRK 1,150.20 and HRK 3,082.20 billion annually.⁷²

A question imposed by this situation is to what extent such high financial burden for the employers influences their decisions with respect to the employment policy. On the one hand, the employers lack the incentive to dismiss existing workers during crisis and thus they tend to reduce their salaries, whereas on the other hand, they also lack the incentive to employ new workers, even if the business conditions improve. In any case, it is difficult to assess the proportions of social and economic effects of the existing system within the private sector. Data also show that the number of labor disputes within the system amounts to approximately 100,000.⁷³ This points to the fact that a large number of workers in the private sector are unable to timely collect their claims as prescribed by the law.

When it comes to the severance pay scheme, tax treatment of severance pay plays an important role. Namely, the Ordinance on Income Tax stipulates that the tax-free amount of severance pay for terminations of employment contracts caused by business or personal reasons amounts to HRK 6,400.00, and for terminations of employment contracts for persons with occupational disability after returning from treatment for a work-related injury or an occupational disease, to whom the employer did not offer adequate work, it amounts to HRK 8,000.00 for each completed year of work for the employer, who terminates the employer contract, and the tax regulations do not define any ceiling for the tax-free severance pay, so that a worker with thirty years of service with the same employer can be entitled to tax-free severance pay amounting to HRK 192,000.00 in the former case, and to as much as HRK 240,000.00 in the latter case.⁷⁴

The issue here is to what extent this system is just, because in a way the payment of one form of income is exempt from the progressive income tax rate, which is based on the ability-to-pay

⁷¹ Please see: Krištof, Marko. Potiču li neoporezive otpremnine prerano umirovljenje? (Does Severance Pay Encourage Early Retirement?), Banka, 2011 (available at: www.banka.hr/UserDocsImages/.../AMS_Kristof_2011-03_17.ppt).

⁷² Please see: Bejaković, Predrag. Poteškoće oko mogućeg osnivanja posebnog fonda za otpremnine (Difficulties related to possible establishment of a Severance Pay Fund) Radno pravo – Journal, 10, 2013, 5, p. 33

⁷³ Please see: Zuber, Marija. Kakva je veza između uplaćenog doprinosa i mirovine? (What Is the Relationship between Paid Contributions and the Retirement Benefit?), Banka, 2011 (available at: www.banka.hr).

⁷⁴ Please see: Zuber, Marija. Plaće (Salaries), in: Babić, Vera *et al.* Veliki komentar novog Zakona o radu (Comprehensive Commentary of the new Labor Act). Zagreb: Vaša knjiga, 2010, p. 135

taxation. Additionally, it has to be mentioned that workers who are entitled to smaller amounts of severance pay due to low income are as a rule less mobile and have smaller chances of re-employment than workers with higher income, especially of older age. This system opens the possibility of moral hazard because it may be suspected that employers and employees will be prone to make mutual agreements in order to avoid the payment of taxes and contributions. This possibility is even more pronounced as there are no records on the payment of severance pays and re-employment of workers who received such severance pay based on the fact that they were dismissed by their employer: the same workers may be employed at a different job with the same or a related employer.

4 Regulation of severance pay schemes in other states

In most countries in the world there are severance pay schemes.⁷⁵ They mostly provide for lump-sum payments to workers after the termination of their employment contracts. In almost every EU member state there is some form of a comprehensive approach to severance pay: a national severance pay scheme. They differ greatly in scope and generosity from state to state. Besides, it can be noted that – along with the legally imposed and regulated severance pay scheme – there are also severance pay schemes that are based on voluntary principle, most often with concrete individual employers.

4.1 Regulation of the severance pay schemes in the EU member states

4.1.1. Regulation of severance pay in the EU member states

It is rather difficult to precisely systematize, classify and compare national severance pay schemes, given that various states inherited different traditions and attitudes towards payments to workers after the termination of their employment contracts. As we have already mentioned, if we compare national systems, they seem to serve different purposes: for instance, as compensation to workers in case of the termination of the employment contract, depending on special reasons, ways of termination or depending on the number of workers, or they provide compensation regardless of the way that the employment contract was terminated, and even in cases when it is the worker who terminated employment. Therefore, any systematization and classification may be based on the legal source of the entitlement to severance pay. In that sense, Table 6 contains an overview of the legal basis, i.e. of legal sources of the entitlement to severance pay in the EU member states.

In the EU, most members states, or rather 21 of them, base their national severance pay schemes on statutory regulations. In six EU member states, the entitlement to severance pay is regulated by collective agreements, and there are not any EU member states, which have no comprehensive severance pay scheme across the entire economy.

⁷⁵ Please see: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 17-67

However, it needs to be mentioned that any attempt at systematization and classification is rather arbitrary. For instance, German labor legislation in principle does not guarantee the right to severance pay or to any workers' claims on this basis. However, the law that regulates safeguards related to the termination of employment contracts, *Kündigungsschutzgesetz*, introduced and regulated the right to a lump sum in case that the employment contract is terminated for economic reasons.

Table 6: Legal basis for the right to severance pay in the EU member states

Entitlement to severance pay regulated by the law	Entitlement to severance pay regulated by collective agreements
Republic Austria	Belgium
Bulgaria	Cyprus
Republic of Croatia	Finland
Check Republic	Netherlands
Denmark	Poland
Estonia	Romania
France	Sweden
Germany	
Greece	
Hungary	
Ireland	
Italy	
Latvia	
Lithuania	
Luxembourg	
Portugal	
Republic Slovakia	
Slovenia	
Spain	
United Kingdom	

Source: World Bank, ILO

An important characteristic of any national severance pay scheme is a formula or a defined type and level of the benefit, or prestation, which represents the severance pay. There is a traditional connection or interdependence between severance pay and the years of service that a worker accumulated with a single employer, duration of employment, and dependence on the reason for the termination of the employment contract.

Most countries, which regulate the right to severance pay in their legislation make the right to severance pay and the payment of severance pay conditional on a minimum number of years of service, that is they regulate what is the minimum years of service with a single employer in order to qualify for severance pay. In most cases, this motivates the employers or provides an incentive to them to distort factual and legal situations regarding employment and terminations of employment contracts with the aim of avoiding the financial burden caused by the payment of severance pay. Besides this conditionality, the level of generosity of severance pay is proportionate with the years of service with a single employer.

Financing severance pays represents an additional aspect, which characterizes the national severance pay scheme. So, in general, the national severance pay schemes are financed by the employer, and this can pose a liquidity challenge in case that a larger number of workers has to be taken care of after the termination of their employment contracts, that is in cases where there is a collective surplus of workers, and this particularly applies to small and micro employers. In some countries, this leads to excluding workers employed with such employers from the otherwise mandatory national severance pay schemes, which means that in such situations there is no obligation to pay severance pay. However, in some countries, including the Republic of Austria, national severance pay schemes are funded through earmarked contributions. Here, the level of generosity of the severance pay would depend on accumulated contributions and the accrued interest rate, and funding is conducted through financial institutions, which are in charge of managing individual accounts, with the deposits being invested in capital markets.

Table 7 provides a good overview of the characteristics of the national severance pay schemes in the European Union. In two countries, in the Republic of Austria and Italy, these schemes are reformed in the direction of financing through earmarked contributions. In most EU member states, the minimum number of years of service at a single employer represents the basis for qualifying for severance pay. In six EU member states, small employers are excluded from mandatory arrangements of the national severance pay schemes.

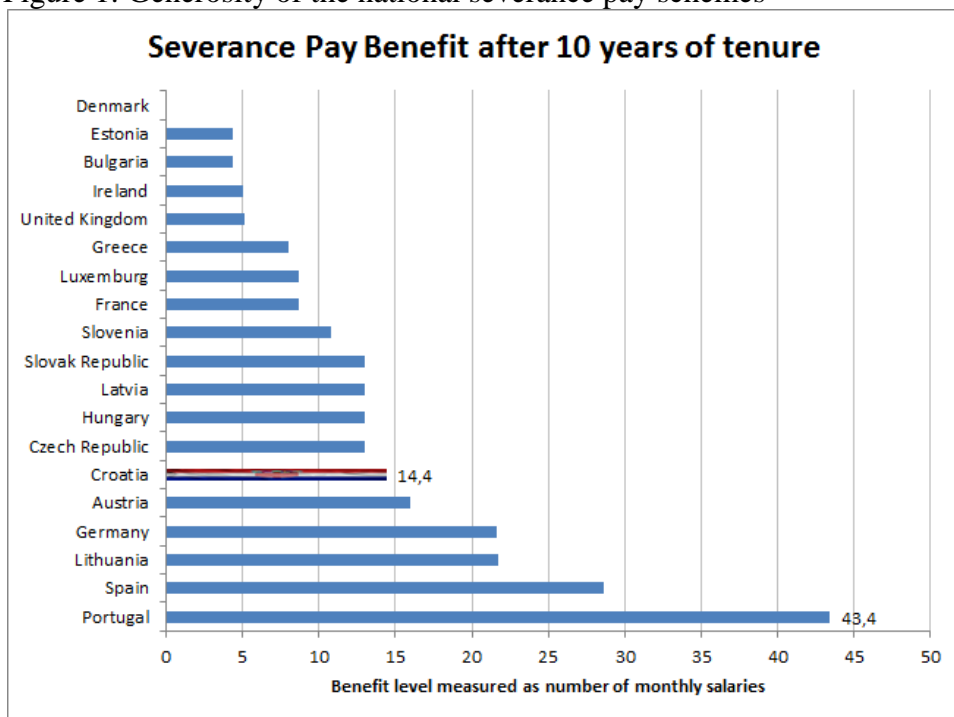
Table 7: Characteristics of the national severance pay schemes in the European Union

State	Earmarked contribution	Minimum years of service with a single employer	Small and micro employers excluded
Republic Austria	yes	no	no
Bulgaria	no	no	yes
Republic of Croatia	no	yes	no
Czech Republic	no	no	yes
Denmark	no	yes	yes
Estonia	no	no	no
France	no	yes	no
Germany	no	yes	yes
Greece	no	yes	no
Hungary	no	yes	yes
Ireland	no	yes	no
Italy	yes	no	no
Latvia	no	no	no
Lithuania	no	no	no
Luxembourg	no	yes	no
Portugal	no	yes	no
Republic Slovakia	no	no	no
Slovenia	no	yes	yes
Spain	no	no	no
United Kingdom	no	yes	no

Source: ILO, World Bank

In order to achieve effectiveness and efficiency of the national severance pay scheme, the generosity of severance pay is of key importance. Figure 1 shows severance pay generosity or the level, expressed as a number of monthly salaries paid after ten years of working with the same employer. What was taken into account here is the total amounts of severance pay paid, based on all sources of entitlement, including the amounts that the employer paid voluntarily in order to “stimulate” employment termination. Here, for example, it is revealed that the Republic of Croatia is at the sixth place among this group of countries, so among those EU member states, which are at the top in terms of severance pay generosity. Although the Republic of Austria and Germany have higher severance pays after ten years of service with a single employer in comparison to the Republic of Croatia, it is important to notice that the Republic of Austria has a scheme with an earmarked contribution, and in Germany there is a significant share of workers, who are exempt from the scheme (small employers, termination of the employment contract without an economic reason).

Figure 1: Generosity of the national severance pay schemes



Source: ILO, World Bank, own calculations

4.1.2. Economic effects of severance pay in the EU member states

There are several comprehensive studies of the national severance pay schemes.⁷⁶ A combination of a comprehensive empirical analysis and research of the literature on severance pay makes it

⁷⁶ Please see: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012; Holzmann, Robert *et al.* Severance Pay Programs

possible to draw certain general conclusions. First, it can be established that there is a stable and significant negative relationship between economic effects measured in terms of GDP per inhabitant and the generosity of the severance pay – “richer” countries display a tendency towards relatively lower amounts of severance pay in comparison to the “poorer” ones. In addition, it is possible to establish that the probability of mandatory outcomes of the national severance pay schemes is significantly lower in the countries with highly developed economies. This result is in line with the historic development of the national severance pay schemes, as a precursor of broader social policy interventions. Second, there is a consistent negative relationship between the generosity of the severance pay scheme and the unemployment benefit. This result shows that in the historic perspective, unemployment insurance absorbed the role of the national severance pay schemes in protecting the worker from the consequences of losing work. This invites us to critically re-examine the existing national severance pay schemes with respect to their adequacy. Third, the results show a consistently positive and mostly significant effect of the generosity of pension benefits on the level of the national severance pay schemes. It seems that – in this area – there is a complementary function of the national severance pay schemes and public pension schemes.

In relation to the effects of severance pays to the economic well-being, scientific research focuses on their interaction with the labor market. There is a large number of studies, which assess the effects of the employment protection legislation (EPL) on the outcomes on the labor market and on economic efficiency.⁷⁷ Although the findings are not always compatible, a clear picture emerges, showing the negative effects of the EPL on various economic variables. It has been proven that the EPL has the tendency to reduce the number of those who become unemployed or who exit unemployment, which prolongs the duration of their unemployment. This, on the other hand, may discourage fast adaptation of the labor market to changed economic conditions, and result in lower productivity growth.⁷⁸ Recent studies also confirm the assumption that the EPL reduces the division between workers and creation of new jobs, having negative consequences on the level of revenue and economic growth.⁷⁹

There is an increasing amount of evidence about the negative effects of the EPL on the results achieved by the labor market, and this has to be clearly differentiated from the effects of the national severance pay systems. The existing studies cast doubts on some significant quantitative effects of the national severance pay schemes on labor market outcomes. Thus, it is considered that the effect on workers’ separation or the average level of employment is small. He provides an argument that severance pay schemes have to be assessed in the context of the broader concept of labor legislation on the labor market and in interaction with this concept.⁸⁰ National severance pay schemes usually only provide a marginal contribution to the existing incentives, and they therefore

around the World: History, Rationale, Status, and Reforms. Hirschegg; Marseille; Pretoria; Washington: The World Bank; IZA, 2011

⁷⁷ Please see: Organisation for Economic Co-operation and Development. Employment Outlook. Paris: Organisation for Economic Co-operation and Development, 2004

⁷⁸ Please see: Davis, Steven J.; Haltiwanger, John. Sectoral Job Creation and Destruction Responses to Oil Price Changes (NBER Working Papers 7095).Cambridge: National Bureau of Economic Research Inc., 1999

⁷⁹ Please see: Boeri, Tito; Garibaldi, Pietro. Beyond Euro sclerosis. Economic Policy, 24, 2009, 7, p. 409-461

⁸⁰ Please see: Parsons, Donald O. Mandated Severance Pay and Firing Cost Distortions: A Critical Review of the Evidence, in: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012., p. 121-157

only have a minor effect on the outcomes. The empirical analysis of the Austrian severance pay scheme is in line with this general conclusion.⁸¹

4.2 Regulation of severance pay in the neighboring and other relevant states

In Germany, the national severance pay scheme is for the most part not anchored in the law. However, its existence results from the regulations on the termination of the employment contract, which are such that they encourage employers to terminate employment contracts based on mutual agreement in order to avoid court disputes. Consequently, a part of the agreement to terminate the employment contract is the entitlement to severance pay. In defining the amount of severance pay, the most relevant aspects are the duration of employment with a specific employer and the risk of losing the court dispute. As a rule, a worker whose employment contract is terminated based on business circumstances is entitled to a severance pay amounting to one half of salary for each year of service with that employer. Each severance pay in Germany is taxable and social security contributions have to be paid.

The Hungarian national system of severance pay is anchored in the law. The amount of severance pay is related to the duration of the employment with the employer. So, a worker who has worked for more than three years with a single employer is entitled to severance pay amounting to one salary. For working for more than five years for the same employer, the legal minimum increases to two salaries, and for more than ten years it is minimum three salaries, four salaries for more than fifteen years, and five salaries for more than twenty years, whereas for more than twenty-five years it is a minimum of six salaries. So it is evident that there is a correlation between the years of service and the severance pay, the relevant intervals being five years, which lead to proportionate increases by one salary amount. The only exception is the first interval, which begins with more than three years of service. Correction of severance pay is also evident in two more instances: workers who reach the retirement age (62) are not entitled to severance pay, but workers whose employment ceases at the age between 57 and 62 are entitled to three additional salaries in addition to the legally prescribed minimum. The amount of salary means net monthly salary, which belongs to the worker.

In Slovenia, the entitlement to severance pay is anchored in the labor legislation and it is connected to dismissals based on business reasons. The severance pay for workers who have worked with the employer between one and five years amounts to one fifth of the salary per year of service with the employer. For workers who have worked between five and fifteen years for the same employer, the severance pay is calculated as one fourth of the salary for each year of service. For workers who have worked for more than fifteen years, the minimum severance pay is the most generous, it is calculated as one third of the salary for each year of service with the employer. The mentioned amounts point to the fact that the amounts of severance pay are conditional on the years of service with the employer, but in a way that longer work is rewarded double – the base increases with the

⁸¹ Please see: Hofer, Helmut; Schuh, Ulrik; Walch, Dominik. Effects of the Austrian Severance Pay Reform, in: *Reforming Severance Pay* (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012, p. 177-209

duration of employment and it is multiplied with a higher number of years. The maximum severance pay is ten salaries, except in cases when it is regulated differently by collective agreements. The base is the average monthly salary in the past three months.

In Serbia, the obligation to pay severance pay results from the Labor Act, both in cases of dismissals based on business reasons and for retirements. In the latter case, three monthly salaries are paid, whereas with the termination of the employment contract, it is one third of the monthly salary for each of the first ten years of the total years of service, and one fourth of the monthly salary for each following year. Here, we can see that the growth is not proportionate, but that it drops after the tenth year. Severance pays are paid as a one-off benefit, before the employment contract is terminated. The greatest problem in Serbia is the legal provision, which stipulates that the employer is obliged to pay severance pay for each year of the total years of service of that person, and not just for the years of service with that specific employer.

5 Reform of the national severance pay scheme in the Republic of Austria

In 2003, the Austrian government implemented a widely acknowledged reform of the Austrian national severance pay scheme as it was regulated by the law. The former scheme was organized at the level of the employers and it was based on the years of service that the worker accumulated with a specific individual employer. The current national scheme is based on the mandatory savings account for all workers and on that account, the deposits are managed by investing them in capital markets.

Reform of the national severance pay scheme in the Republic Austria was implemented based on the following assumptions:

- development of the national severance pay scheme, which guarantees access to severance pay to all workers in the Republic of Austria, regardless of the length of service with a specific employer;
- avoiding negative effects of the legislation of the national severance pay scheme on market mobility and economic efficiency;
- introducing mandatory individual savings accounts, which guarantee that workers' claims are settled in due time; and
- using the savings as a potential core for developing the insufficiently developed capital-funded pillar of the Austrian pension scheme.

5.1 State before the reform of the national severance pay scheme in Austria, in 2003

Until 2002, Austrian labor legislation determined how severance pay is to be paid to workers in the private sector in case of termination of the employment contract by the employer or by mutual consent of both parties, provided that the worker worked with the employer for at least three years. Starting with two monthly salaries after three years of working for a specific employer, the

payments increased depending on the duration of the employment up to the maximum amount of one annual salary after twenty-five years of service with the same employer.

The old scheme defined the right to severance pay at the following levels of gross monthly salaries, depending on the worker's years of service with the employer:

- after two years of service: two salaries;
- after five years of service: three salaries;
- after ten years of service: four salaries;
- after fifteen years of service: six salaries;
- after twenty years of service: nine salaries; and
- after twenty-five years of service: twelve salaries.

In terms of bookkeeping, the severance pay was recorded as regular salary increase. The employers were obliged to keep at least half of the amount of due severance pay on their bank accounts.

Reforming the severance pay scheme in the Republic of Austria was debated for a long time.⁸² The earlier scheme was questioned for three main reasons.

The first important problem, which resulted from the former statutory severance pay scheme was differentiation of the entitlement to severance pay among workers. The Austrian trade union federation requested that the entitlement to severance pay is expanded in a way that not only terminations of employment contract by the employer are covered, but also terminations by the employee and situations that involve seasonal work or seasonal employment. This is what was requested in negotiations. According to some assessments, only one third of all workers really exercised their right to severance pay.⁸³

Secondly, the scheme was exposed to criticism due to its effects in terms of preventing mobility on the labor market and limitations with respect to the entitlement to severance pay. The former statutory scheme reduced the incentives for workers to change the employer, as they would lose the right to severance pay in cases they themselves would initiate the termination of their employment agreement.

Thirdly, the former scheme also had some disadvantages for the employers, particularly the SMEs.⁸⁴ They could have liquidity problems if they were obliged to make severance pay payments to a larger number of workers at some point.

⁸² Please see: *Abfertigungen im Spannungsfeld der Wirtschaftspolitik - Eine interdisziplinäre Analyse* (ed. Genser, Bernd). Vienna: Manz, 1987; European Industrial Relations Observatory. *Reform of Severance Pay under Discussion*. Dublin: European Industrial Relations Observatory, 2001 (available at: www.eiro.eurofound.ie/2001/06/inbrief/at0106220n.html); Klec, Gerald. *Flexicurity and the Reform of the Austrian Severance-pay System*. Brussels: ETUI-REHS, 2007.

⁸³ Please see: Kristen, Sabine; Pinggera, Winfried; Schön, Rosemarie. *Abfertigung Neu: Überblick über die Neuregelungen durch das Betriebliche Mitarbeitervorsorgegesetz*. *Recht der Wirtschaft* 2002, 7.

⁸⁴ Please see: Kristen, Sabine; Pinggera, Winfried; Schön, Rosemarie. *Abfertigung Neu: Überblick über die Neuregelungen durch das Betriebliche Mitarbeitervorsorgegesetz*. *Recht der Wirtschaft* 2002, 7.

In 2002, the Government highlighted another issue. In their coalition program, they emphasized the intention to develop the pension scheme, which consists of three pillars: the existing pay-as-you-go pillar, the second pillar with mandatory capital-funding, and the third pillar with voluntary funding. The government aimed at transforming the system of mandatory severance pay into a program of new professional pensions, which would also work as the second pillar of the pension scheme.

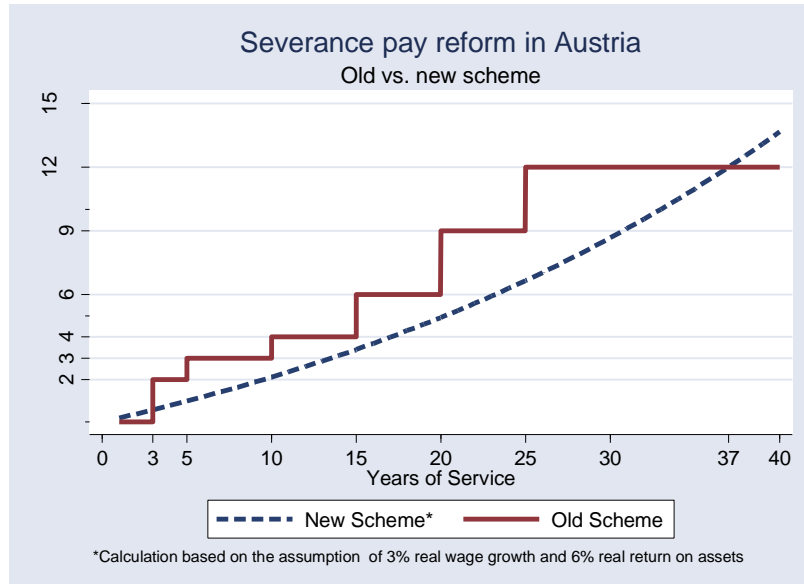
5.2 New Austrian national severance pay scheme after the reform of the national severance pay scheme in the Republic of Austria in 2003

After extensive negotiations with the social partners an agreement on the new severance pay scheme was reached in summer 2002. The reform extends the entitlement to severance pay considerably. Entitlement now starts from the first day of employment and does not depend on the way of termination of the contract. Employers have to pay a contribution of 1.5377 percent of the payroll into a fund, specified by an agreement of employer and work council, from the first day on. Existing severance pay entitlements under the old scheme remain unchanged.

In the case of dismissal by the employer after three years of job tenure the employee can choose between receiving her severance payment from the central funds at once, or saving her entitlement toward a future pension. The amount will not be paid out if the employee gives notice herself or job tenure is shorter than three years. The acquired claim, however, remains.

Figure 2 shows the evolution of severance pay claims in terms of the individual's last monthly wage in the old vs. the new scheme. While in the old scheme severance pay increased in stages and the maximum level of severance payment was reached after 25 years of employment with the same employer, in the new scheme the severance pay will rise continuously and reach the maximum value of the old scheme after 37 years (under the assumption of a rather high rate of return of 6 percent per annum). Under the new scheme, severance pay contributions are paid to a fund. In the existing scheme, the severance pay contributions are paid to a fund, and the money is invested on private capital markets.

Figure 2: Comparing the result of the previous and the existing severance pay scheme in the Republic of Austria



The dotted line – new scheme, full line – the old scheme, the y axes shows severance pay in relation to the salary in the past month

Source: Koman, Reinhard; Schuh, Ulrich; Weber, Andrea. The Austrian Severance Pay Reform: Toward a Funded Pension Pillar, *Empirica*. 2005, 32, p. 255-274

The contributions are invested into private funds. As soon as the duration of the employment contract exceeds one month, the employer is obliged to pay a contribution to the body that manages this fund, and there are ten such funds at the moment. These funds are strictly regulated, and their investments are limited to:

- bank deposits (maximum twenty-five percent per institution);
- credits and loans;
- bonds;
- shares (maximum forty percent of the total capital);
- certificates on the share in the funds; and
- maximum fifty percent in foreign currency.

At the end of October 2012, the ten funds managed the capital amounting to 5 billion EUR, that is 1.6 percent of the GDP.

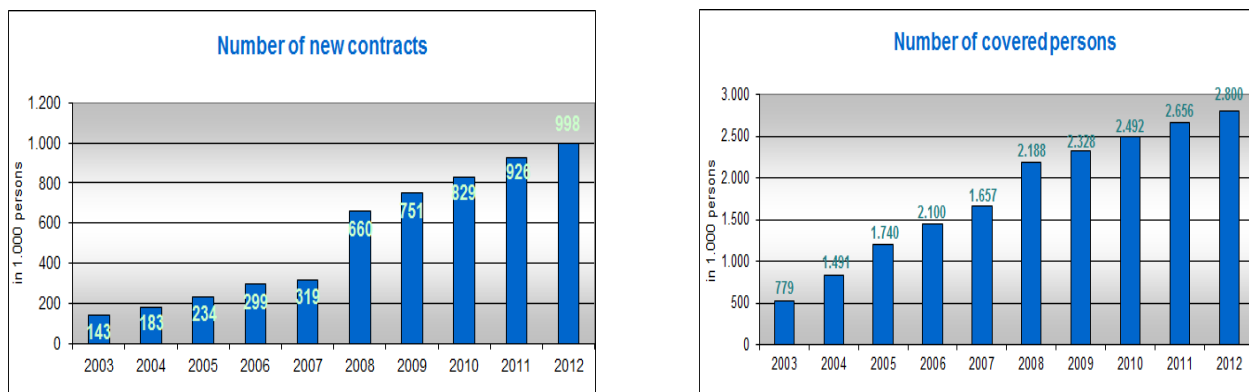
5.3 Lessons from the new Austrian severance pay scheme after the reform of the national severance pay scheme in the Republic of Austria in 2003

5.3.1. Coverage

After the reform, the Austrian model has quite a broad and comprehensive base. Namely, each worker has the option to exercise his/her right to severance pay, whereas in the former system approximately one third of all workers exercised their right to severance pay during their career on the labor market. This is related to the fact that the Austrian labor market is marked by a high level of labor force mobility. In 2012, more than one million and seven hundred thousand new employment contracts were concluded. This is one half of the total number of workers who were earning income from dependent employment in 2012, so approximately three and a half million. Approximately the same number of contracts were terminated in 2012. Average duration of employment, which was terminated amounted to 598 days. This implies that an “average” employment spell would have been far too short to qualify for severance pay in the old Austrian scheme. The average duration of employment spells is also very unevenly distributed among economic sectors. In the energy sector and in banking & insurance employment spells lasted for on average 1.600 days. On the other end of the spectrum average employment in agriculture amounted to 128 days, 235 days in tourism or 450 days in construction. The high turnover at the labour market and the heterogeneity of the length of job spells in economic sectors corresponds to the structure of the Austrian labour market. Important sectors of the Austrian economy, namely tourism and construction inhibit a very high degree of seasonal fluctuations which lead to high rates of job creation and destruction.

The implementation of the new severance pay scheme has resulted in a continuous and impressive increase of coverage. The number new entrants to the severance pay scheme increased from 143.000 persons in 2003 to 1 Mio. persons in the year 2012. In the meantime 2,8 Mio. persons are covered by the Austrian severance pay scheme. This corresponds to 80% of total dependent employment in Austria.

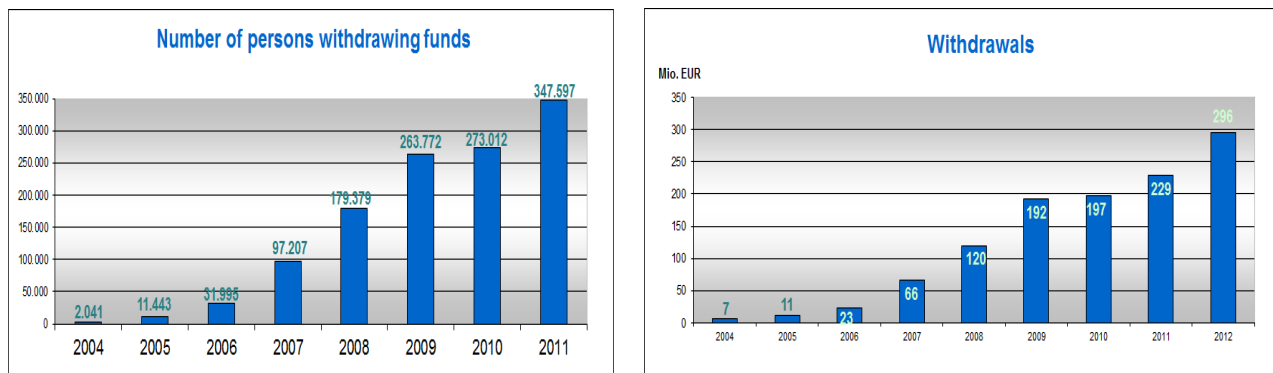
Figure 3: Coverage of Severance Pay in the Republic of Austria



Source: Plattform der Betriebliche Vorsorgekassen

In line with the increase of coverage of the new scheme it can be observed that the number of beneficiaries is expanding at high speed. In 2004 only 2.000 persons withdrew their claims from the system. With increasing coverage and more persons reaching the employment duration that allows for taking out funds from the system the number of persons that withdrew funds has increased substantially. In 2009 more than 250.000 persons withdrew funds for 2012 it is estimated that significantly more than 400.000 persons took out their claims from the system. The amount of capital that was withdrawn increased from 7 Mio. Euro in 2004 to nearly 300 Mio. Euro (around 0,1 % of GDP) in the year 2012.

Figures 4 and 5: Withdrawal of funds from the national severance pay schemes in the Republic of Austria



Source: Plattform der betrieblichenVorsorgekassen

5.3.2. Labor mobility

The former Austrian severance pay scheme has been under suspicion of distorting the labour market behaviour of economic agents.⁸⁵ The discrete increase in entitlements led to incentives on the part of employers to dismiss employees just before additional claims could arise. From the perspective of employees the severance pay scheme has reduced the attractiveness of changing jobs with increasing duration of the employment spell.

Theoretical considerations give reason to assume that the reform of the Austrian severance pay law should have increased labour mobility significantly. As a consequence beneficial effects on labour productivity should arise as the quality of matches between workers and firms would increase. In addition to that economic growth may be supported as workers move faster to innovative sectors of the economy. There are estimates that the reform “will raise the annual TFP growth in EPL-binding industries by about 0.25 percentage points, which translates into an average estimated growth rate of at least 0.1 percentage points for the whole economy.”⁸⁶ Precondition for these effects to materialize is, however, the assumed impact of the reform on labour mobility in Austria.

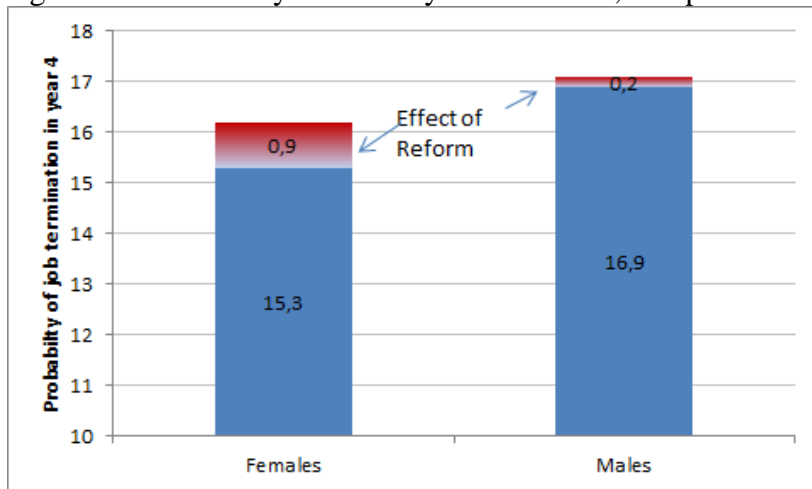
⁸⁵ See also: Organisation for Economic Co-operation and Development. Employment Outlook. Paris: Organisation for Economic Co-operation and Development, 2004

⁸⁶ According to: Bassanini, Anarea; Nunziata, Luca; Venn, Danniele. Job Protection Legislation and Productivity Growth in OECD Countries. Economic Policy, 2009., 58, p. 351-402

An empirical study investigated the impact of the introduction of the severance pay reform on labour mobility in the Republic of Austria.⁸⁷ It identified the impact of the reform by applying a difference in difference estimator on the probability of job termination for two separate groups of job spells immediately before and after the introduction of the severance pay reform. The analysis tests the hypothesis whether job mobility was enhanced by the reform. It can be inferred from Figure 2 the old severance pay scheme introduced a significant incentive for employees to avoid quits after three years of job tenure. Consequently it was expected to observe a significant increase in relative job mobility after three years of tenure for the group of job spells after the introduction of the reform.

The analysis found indeed a significant positive impact of the reform on job mobility. Job mobility was 0,9 percentage points (or 5,8%) higher for females and 0,2 percentage points (or 1,1%) higher for males. Robustness checks of the results – i.e. by restricting the analysis to direct job to job moves - revealed however, that the impact of the reform on job mobility may be substantially lower than initially expected.

Figure 6: Job mobility after four years of tenure, comparison of before and after reform



The y axes shows the probability of terminating employment in the fourth year of tenure, the left side shows women, the right side men, and red is the impact of the reform.

Source: Hofer, Helmut; Schuh, Ulrik; Walch, Dominik. 2012 Effects of the Austrian Severance Pay Reform, in: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012; own calculations

Other factors like economic conditions seem to play a much bigger role in affecting job changes in Austria. The results indicate that the adverse financial incentives of the old severance pay scheme have been – at least for job spells lasting no longer than five years – too small to have more prominent effects on labour mobility in Austria. This result is in accordance with the literature that

⁸⁷ Please see: Hofer, Helmut; Schuh, Ulrik; Walch, Dominik. 2012 Effects of the Austrian Severance Pay Reform, in: Reforming Severance Pay (ed. Holzmann, Robert; Vodopivec, Milan). Washington: The International Bank for Reconstruction and Development; The World Bank, 2012.

points to the importance of the interaction of severance pay with general provisions for employment protection legislation.

5.3.3. Capital accumulation and rate of return

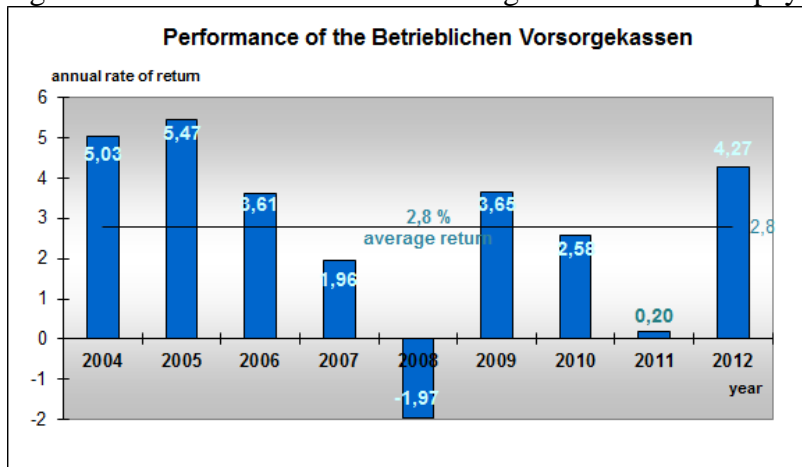
One original objective of the Austrian reform has been to contribute to the expansion of the underdeveloped second pillar of the Austrian pension system. In 2005 only 11% of all Austrian employees had claims to a funded pension scheme on the enterprise level compared to an average value of 27 % in all EU-member states. The total savings in the funded pillar amounted to 4.7% of GDP in 2005 compared to the average value of 87.6% for all OECD member states.⁸⁸ The structure of savings for old age benefits in Austria may be explained by the rather generous public pay-as-you-go pension system. However, recent pension reforms imply a significant gradual reduction in replacement rates⁸⁹ in the pay-as-you-go system by 25% in the coming decades. In this respect the savings from the severance pay system could serve as an option to fill the gap left from the pension reforms. By replacing the former defined-benefit, final salary severance payments scheme by a contribution-defined, fully funded system, the reform may be considered as a first step in this direction. The essential condition for establishing an instrument to increase savings for pension benefits is, however, not fulfilled: after 36 months of contribution to the system employees may withdraw their claims from the system. The legislator additionally provided tax incentives to motivate employees to leave their savings within the severance pay funds. Benefits from the new severance pay scheme are tax-exempt if they are transformed into a pension annuity otherwise a reduced income tax rate of 6% of benefits applies.

Consequently the decision of employees whether to withdraw their claims from the system depends on the return of the severance pay funds. The returns of the new scheme have been, however, not very promising in recent years. At the outset of the reform it was assumed that in the long term the rate of return should be at 6 percent per annum. As can be seen from Figure 7 the rate of return in the new system turned out to be well below this very optimistic target level. Returns of the Betrieblichen Vorsorgekassen (BVK) continuously declined from 5½% in 2005 to only 2% in the year 2008. On average the rate of return amounted to 2.8% for the period 2004 to 2012.

⁸⁸ Please see: Felderer, Bernhard *et al.* Perspektiven der betrieblichen Altersvorsorge in Österreich – Studie im Auftrag der Wirtschaftskammer Wien. Wien: Institute for Advanced Studies, 2008.

⁸⁹ Replacement rate is the share of average salary in the average pension.

Figure 7: annual rate of return on savings in the severance pay scheme



Source: Oesterreichische Kontrollbank

The rate of return has to be qualified as very poor. This hypothesis is confirmed by comparing the performance with the corresponding development of the private funded pillar in the Republic of Austria. The private pensions funds in Austria achieved a rate of return of 4.2% in the period 2004-2012, thus 1.5 percentage points higher compared to the BVK. It thus comes as no surprise that withdrawals from the system have been the rule rather than the exception. In 2006 it became possible for the first time for those entering the system during 2003 to withdraw their claims. As a consequence withdrawals have increased sharply. The data for 2011 reveal that 95 percent of all participants that had the option to take out their claims from the system did so. Given the foreseeable decline in replacement rates in the public pay-as-you-go pension system it may be desirable to achieve higher rates of savings for old age income via this channel in the future.

From the perspective of the BVK there are two reasons – that are not independent from each other – that seem to explain the poor performance of the severance pay funds. First the BVK are obliged to guarantee the value of the capital corresponding to the contributions. This implies a costly insurance of the funds that reduces the potential rate of return. Second the participants in the system may withdraw their claims as soon as they have contributed at least for three years to the system. Therefore the BVK have to provide for sufficient liquidity to pay out potential claims. This implies that the BVK are forced to have large shares of their portfolio to be invested in short term assets, which also reduces the potential rate of return. As these two obligations reduce the potential rate of return – which can be seen from the current performance – the incentives of employees to actually withdraw their claims from the system increases which again has negative impact on the performance of the funds.

Consequently the BVK argue for modifications of the legal provisions in order to improve their performance. They propose to allow employees to opt out of the capital guarantee and to raise the minimum contribution period into the system to five years. Another possibility would be to stick to the original intention and to restrict withdrawals until the time of retirement.

5.3.4. Conclusions on the new Austrian national severance pay scheme after the reform of the national severance pay scheme in Austria in 2003

Ten years after the implementation of the new Austrian severance pay legislation the following conclusions may be drawn:

- The new scheme extended coverage to all employees and seems to have broad acceptance among the economically active population
- The reform reduced potential liquidity problems especially for small firms
- Coverage increased fast and continuous, currently 80 % of all employees are already in the new scheme
- A modest increase in labour mobility has been identified, the impact seems to be, however, less important than initially expected
- The new severance pay scheme is in principle a mandatory savings account for employees. Data reveal that in fact nearly everybody who may withdraw funds from the system does so.
- Withdrawals from the system are induced by the very poor performance of the Betrieblichen Vorsorgekassen (BVK). The legal provisions that force BVK to guarantee for the value of capital and that allow persons to withdraw funds after 3 years of employment has a substantial negative impact on returns. In this respect future modifications of the legislation seem reasonable.

5.4 Acceptance of the new Austrian national severance pay scheme in other members states of the European Union after the reform of the scheme in the Republic of Austria in 2003

The new Austrian national severance pay scheme after the reform, which took place in 2003, is still rather unique and other member states of the European Union are rather at the stage of still studying it than adopting it. The acceptance of the new scheme has advanced furthest in Italy.

The Italian severance pay scheme is quite specific, although it might be said that in Italy there is no severance pay model in the conventional sense. There are namely two schemes. The first scheme serves to provide compensation to persons, whose employment contracts were terminated with no fault of their own, which differentiates between employers with fifteen or fewer employed workers and those with sixteen and more workers. In those cases, if the court establishes that the termination of the employment contract was unfounded, the worker receives compensation (smaller employers), i.e. they can choose between the compensation or returning to work (larger employers). The second scheme is where the entitlement is exercised after the work is terminated. Here, the employer pays a contribution amounting to 1/13,5 of the worker's gross annual salary for each year of service to the worker's personal account. The funds on the account are indexed annually by a fixed factor of 1.5 percent increased by 75% value of the consumer price index as an inflation ratio versus a year earlier. If the worker accumulates at least eight years of tenure with the

employer, and if the employer agrees, these funds may be used to cover the health care cost for the worker, purchase of a house or a flat or as remuneration for a certain period of unpaid leave. Actually, this is worker's credit to the employer until the termination of employment, but the accumulated funds may be used even earlier for specific purposes.

Changes of the public policies in the past decade were focused on strengthening the pension component, which reduced the level of severance pays. Therefore, in 2004, the state provided the workers with the possibility to choose whether they want to enroll the complementary pension insurance scheme (something similar to the Croatian third pillar), in exchange for giving up the personal accounts. Both newly employed and older workers were encouraged to do so. Once a person opted for the new scheme, the decision was irreversible, while the workers who remained in the old scheme could transfer to the new scheme at any moment. In order to encourage the transfer to the new scheme and to encourage development of complementary pension insurance, numerous new solutions have been offered since 2004: it was made possible to consider participation in complementary insurance as justified avoidance of the severance pay scheme, favorable tax treatment was offered for the benefits, regardless if they were paid as a lump sum or in annuities, there were changes in the way of paying contributions, benefits, advance payments, exemptions from payments and determining the transferability. Until 2007, the Italian government decided that the employers with fifteen or more workers would have to transfer to the state all future severance pay contributions, with the state making direct payments regardless of the scheme that the workers have chosen. So far, fiscal and other incentives have produced only limited effects. Until the end of 2008, only 26 percent of workers who are entitled to do so have opted for the complementary pension insurance scheme. Possible explanations for the low rate of interest for this transfer range from pre-mature effects of the financial crisis to systemic problems, including quite a low level of credibility of complementary insurance and workers' preferences with respect to liquidity. Numerous experts are concerned about the liquidity of this system and about broader economic effects on small and medium-sized entrepreneurs who have lost access to cheap forms of internal funding.

6 Comparison of relevant economic categories between the Republic of Croatia and the Republic of Austria and reflections on the Croatian labor market

Considering that the Austrian model is proposed as a possible solution for the deficiencies of the existing national severance pay scheme in the Republic of Croatia, it would be useful to compare the most important categories, which are relevant for the direction and the scope of effects if this model is applied.

The application of the identical model in states, which are characterized by significantly different parameters, may produce significantly different effects. Table 6 shows the relevant categories, which lead to the main conclusions about the state of the labor market in the Republic of Austria and the Republic of Croatia. It can be noted that the labor markets of compared countries are significantly different. The Republic of Austria is characterized by a much higher level of development and labor market mobility at the level of full employment. On the other hand, Republic of Croatia shows unfavorable long-term unemployment indicators. It can therefore be

concluded that the labor market dynamics, which depends on the economic structure of any individual country, is in this case significantly different, and clearly unfavorable for Croatia.

Table 6: Comparison between relevant indicators in the Republic of Croatia and the Republic of Austria

	Real GDP growth rate		Employment rate		Unemployment rate		Long-term unemployment		Employment duration	
	RoC	RoA	RoC	RoA	RoC	RoA	RoC	RoA	RoC	RoA
2003	5.4	0.9	53.4	68.9	14.3	4.8	59.6	29.1	30.5	34.1
2004	4.1	2.6	54.7	67.8	14.1	5.3	54.1	24.7	30.6	34.2
2005	4.3	2.4	55	68.6	13	5.2	57.9	25.4	31.4	33.6
2006	4.9	3.7	55.6	70.2	11.5	4.8	62.1	27.3	31.4	34.6
2007	5.1	3.7	57.1	71.4	9.8	4.5	60.9	25.3	31.2	35.3
2008	2.1	1.4	57.8	72.1	8.6	3.9	62.2	23.4	31.4	36
2009	-6.9	-3.8	56.6	71.6	9.3	4.9	52	24.2	31.5	36.2
2010	-2.3	2.1	54	71.7	12.1	4.5	58.8	26.7	31.5	36.4
2011	0	2.7	52.4	72.1	13.8	4.2	63.5	26.6	31.3	36.3
2012	-2	0.8	50.7	72.5	16.3	4.4	63.7	24.2	31.1	36.6
AVERAGE	1.47	1.65	54.73	70.69	12.28	4.65	59.48	25.69	31.19	35.33

Source: Eurostat

Given that the Republic of Austria had a higher average rate of economic growth, applied to a higher base, it is clear that the tax pressure in the Republic of Austria poses a significantly smaller burden. Therefore, when analyzing the severance pay scheme in the context of the Austrian model, it is necessary to consider the burden of the labor costs as one of the important foundations for competitiveness. Table 7 compares social security contribution rates of the OECD countries and the Republic of Croatia.

Table 7: Social security contribution rates of the OECD countries and the Republic of Croatia, expressed as a percentage of gross salary

State	Social security contributions		
	By worker	By the employer	Total
Australia	0.0	5.6	5.6
Republic Austria	14.0	22.6	36.6
Belgium	10.8	23.2	34.0
Canada	6.6	10.6	17.2
Chile	7.0	0.0	7.0
Czech Republic	8.2	25.4	33.4
Denmark	2.7	0.0	2.7
Estonia	2.1	25.6	27.7
Finland	6.2	18.6	24.8
France	9.5	30.6	40.1
Germany	17.3	16.4	33.7
Greece	12.8	22.2	35.0
Hungary	14.4	22.2	36.6
Iceland	0.4	7.2	7.6
Ireland	2.9	9.7	12.6
Israel	7.3	4.4	11.7
Italy	7.2	24.3	31.5
Japan	12.0	12.6	24.6
Korea	7.4	9.2	16.6
Luxembourg	11.0	11.0	22.0
Mexico	1.2	10.5	11.7
Netherlands	13.9	9.7	23.6
New Zealand	0.0	0.0	0.0
Norway	6.9	11.6	18.5
Poland	15.3	14.4	29.7
Portugal	8.9	19.2	28.1
Slovakia	10.5	21.8	32.3
Slovenia	19.0	13.9	32.9
Spain	4.9	23.0	27.9
Sweden	5.3	23.9	29.2
Switzerland	5.9	5.9	11.8
Turkey	12.9	14.2	27.1
United Kingdom	8.5	9.8	18.3
USA	5.1	8.9	14.0
Ø OECD	8.2	14.36	22.56
Ø EU 15	9.06	17.61	26.67
Ø EU 21	9.78	18.45	28.23
Republic of Croatia	20.0	15.2	35.2

Source: Organisation for Economic Co-operation and Development Taxing Wages 2011-2012
Paris: Organisation for Economic Co-operation and Development, 2012, p. 16

It can be noted that the workers in the Republic of Croatia are burdened by almost the highest social security contribution rate in comparison to the developed countries. In terms of the total burden, France and the Republic of Austria are heading the list. The Republic of Croatia has made some progress on this issue through the past twenty years, slowly reducing the contribution rates for both workers and employers. Thus, the health insurance contribution was reduced on 1st May 2012 from fifteen to thirteen percent. In any case, any further increase of the burden of contributions in the Republic of Croatia would have very unfavorable effects in the context of the desire to increase competitiveness. In that sense, it is proposed to abolish a part of the contribution for insurance against injuries at work, the employment contribution and the special contribution for the employment of disabled persons. However, eliminating the mentioned contributions would only imply transferring these costs from the gross salary to the “invisible” costs, which would have to be borne by the employers, workers and the state budget of the Republic of Croatia. It would therefore be interesting to establish the social cost of such replacements in contributions.

One of the important goals of the reform would be to increase labor force mobility, however the analysis of the effects of this reform in the Republic of Austria did not show significant effects to this end. Table 8 shows that the lack of labor force mobility in the Republic of Croatia is still caused by specific features of the economic structure and its lacking power to create jobs – looking at the duration of the period of seeking work among the unemployed, long-term unemployed persons remain the prevalent group.

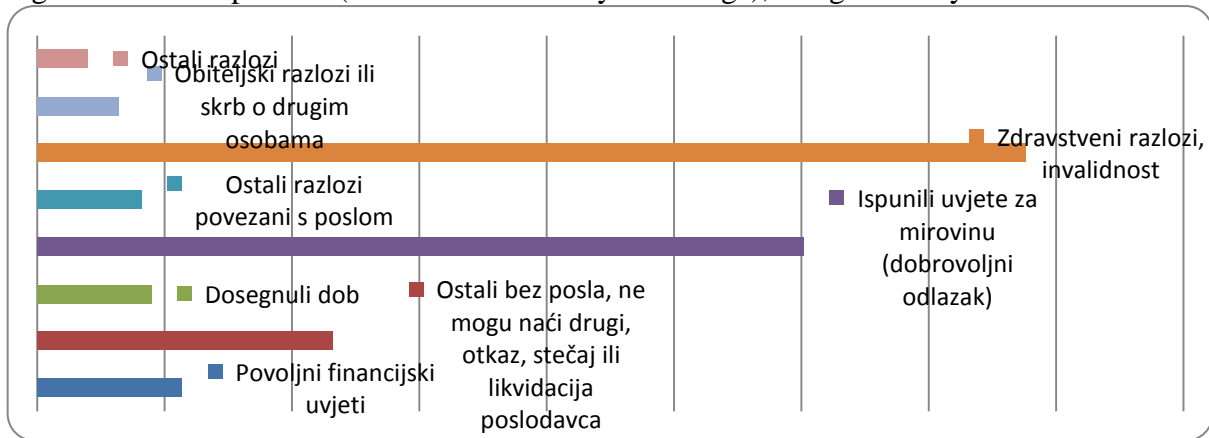
Table 8: Unemployed persons categorized by the duration of seeking employment

in months	Total (in thousands)				Total (in percentages)			
	2009	2010	2011	2012	2009	2010	2011	2012
Total	160	206	232	272	100	100	100	100
<1	4	6	5		2.5	3.0	2.1	
1-5	35	42	43	51	22.2	20.3	18.5	18.9
6-11	26	38	34	36	16.6	18.3	14.6	13.3
12-23	26	44	55	59	16.1	21.3	23.6	21.8
24>	66	75	95	119	41.2	36.5	40.9	43.7

Source: CBS Labor Force Survey

In the light of the above, the question that surfaces is to what extent the severance pay scheme influences labor force mobility in the Republic of Croatia. Based on Figures 8 and 9, it can be concluded that severance pay does not represent an important factor in deciding whether to retire or change a job. We can therefore conclude that it is not very likely that any changes in the severance pay scheme would produce significant effects on the labor market in the Republic of Croatia.

Figure 8: Retired persons (between 50 and 69 years of age), categorized by reasons for retirement

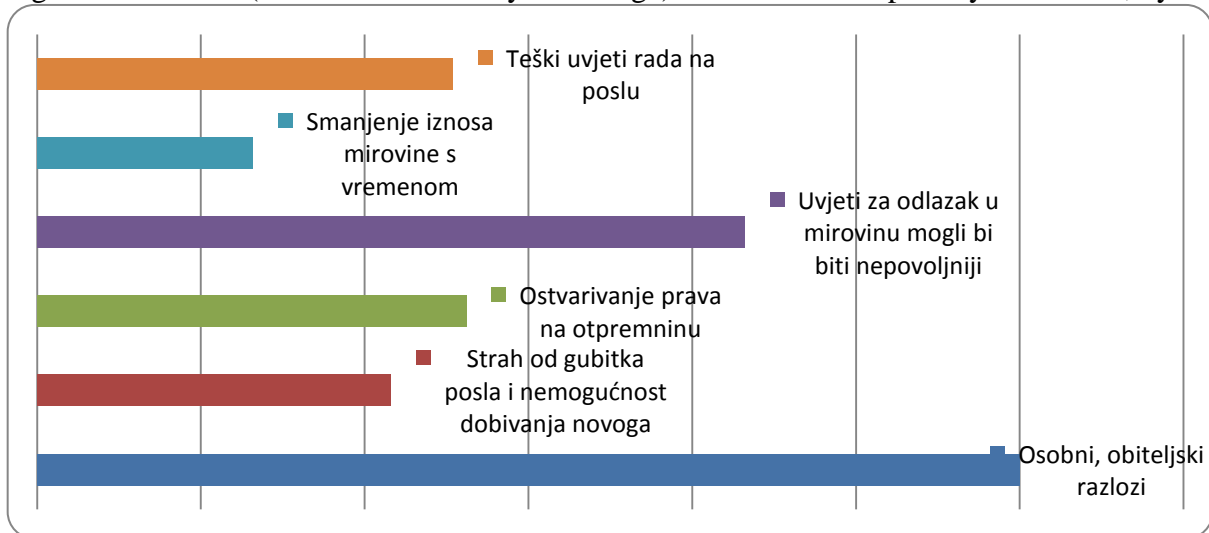


Source: CBS Labor Force Survey

(reasons, in the order of appearance in the above Figure)

- Other reasons
- Family reasons or care for other persons
- Health reasons, disability
- Other job-related reasons
- Conditions for retirement fulfilled (voluntary retirement)
- Reached the retirement age
- Lost their jobs, cannot find another job, bankruptcy or liquidation of the employer
- Favorable financial conditions

Figure 9: Workers (between 50 and 69 years of age) who would accept early retirement, by reasons



Source: CBS Labor Force Survey

(reasons, in the order of appearance in the above Figure)

- Difficult conditions of work
- Reduced amount of the pension because of early retirement
- Conditions for retirement might be more unfavorable
- Exercising the right to severance pay
- Fear of losing job and not being able to find a new job
- Personal, family reasons

It ought to be mentioned that the Republic of Croatia has by far lower labor force productivity than the Republic of Austria. This means that average Croatian employer has lower added value per worker. Therefore, any increase in costs would now pose a relatively higher burden to employers than it is the case in the Republic of Austria. Naturally, this rule also applies across industries, in the sense that industries that create higher added value will be less burdened, unlike those with lower productivity, which would carry a higher burden. Such burden is also higher in absolute terms, because the lack of productivity increases the need for a higher number of workers. On the other hand, their dismissal would result in a higher burden of severance pay payments.

7 Simulation of the model

The current severance pay regulations and the way that the amount of severance pay is determined are based on the years of service with the same employer, the average monthly gross salary in the last three months and the tax treatment of this kind of income. The model that is proposed to replace this scheme would determine the amount of severance pay based on the total years of service, that is of continued employment, gross salary contributions, tax treatment of severance pay, but also the rate of return achieved by managing the accumulated funds. Given such a diverse base of regulating the entitlement to severance pay and determining the amount, it is important to make projections concerning the amounts of claims based on the entitlement to severance pay.

The following simulations were developed based on the assumed average amount of the gross salary and years of service, 18% surtax, gross salary contribution of 1.5% and the return rate of five percent. Table 9 shows the amounts of severance pay, which would be paid under the current scheme. As it was mentioned, the current national severance pay scheme in the Republic of Croatia is opposite to the principle of vertical equity, which is otherwise applied in Croatia in standard income taxation. Namely, while the income tax is significantly progressive, the severance pay scheme shows minimum progression.⁹⁰

⁹⁰ Please see: Urban, Ivica. Što porez na dohodak u Hrvatskoj čini progresivnim? (Why can income tax in Croatia be considered progressive?) Newsletter of the Institute of Public Finance, 2006, 23. (available at: www.ijf.hr/newsletter/23.pdf); Urban, Ivica. Raspodjela poreznog opterećenja u Hrvatskoj (Distribution of the Tax Burden in Croatia). Newsletter of the Institute of Public Finance, 2011, 58. (available at: www.ijf.hr/newsletter/58.pdf).

Table 9: Amounts of severance pay claims based on average gross monthly salary and years of service (the current national severance pay scheme)

Monthly gross salary amount (HRK)	Years of service						
	1	2	5	10	15	20	30
3,000.00	-	2,000.0	5,000.0	10,000.0	15,000.0	20,000.0	30,000.0
5,000.00	-	3,333.3	8,333.3	16,666.7	25,000.0	30,000.0	30,000.0
10,000.00	-	6,666.7	16,666.7	33,333.3	50,000.0	60,000.0	60,000.0
15,000.00	-	10,000.0	25,000.0	50,000.0	75,000.0	90,000.0	90,000.0
20000.00	-	13333.3	33333.3	66666.7	100000.0	120000.0	120000.0
30000.00	-	20000.0	50000.0	100000.0	150000.0	180000.0	180000.0

Source: Calculations by the author

Table 10 shows the amounts of severance pay claims within the new scheme. It can be noted that the amounts paid by the employer are significantly smaller in comparison to the existing scheme. The new scheme also allows for continuity with respect to this entitlement, regardless of the years of service with any individual employer, but also irrespective of any limitations in the total duration of worker's employment. In this way, seasonal and other workers, whose employment contracts are shorter than two years are still entitled to severance pay.

It ought to be said that within the new scheme, in the given example, the amount of severance pay exceeds the amount of non-taxable income only for workers with the average monthly salary of HRK 20,000.00 and the total of thirty years of employment, and for workers with the average monthly salary amounting to HRK 30,000.00 after the tenth year of employment. It is important to mention that the given example only provides a frame for considerations and analyses. Namely, in practice, severance pay under the current scheme would be much smaller, since the workers in the private sector are much less bound to the same employer in the longer term. In other words, the amount of paid severance pay would be much smaller, and most workers would be entitled to severance pay based on shorter periods of service with the same employer.

Table 10: The amounts of severance pay claims based on the average monthly gross salary and years of service (the new model)

Monthly amount of gross salary (HRK)	Years of service						
	1	2	5	10	15	20	30
3,000.00	540.0	1,162.4	3,133.0	7,131.7	12,235.0	18,748.4	37,670.8
5,000.00	900.0	1,890.0	5,167.0	11,816.3	20,302.6	31,133.6	62,599.5
10,000.00	1,800.0	3,780.0	10,334.0	23,632.6	40,605.3	62,267.2	125,199.0
15,000.00	2,700.0	5,670.0	15,501.1	35,448.9	60,907.9	93,400.8	187,798.5
20,000.00	3,600.0	7,560.0	20,668.1	47,265.2	81,210.6	124,534.5	216,667.3
30,000.00	5,400.0	11340.0	31,002.1	66,913.6	106,904.6	152,837.8	269,551.3

Source: Calculations by the author

Table 11 shows differences in the amounts of severance pay claims produced by the existing and the new model. It can be noted that the new model increases payments to workers only in case the severance pay is paid based on thirty years of service (in practice, due to shorter periods of employment at the same employer, the payments in the new system would still be significantly more favorable than the example shows – especially in case of frequent change of employer). It can also be concluded that this system of capitalizing the contributions is more favorable for workers with a higher monthly income, because the return rate is applied to a higher base.

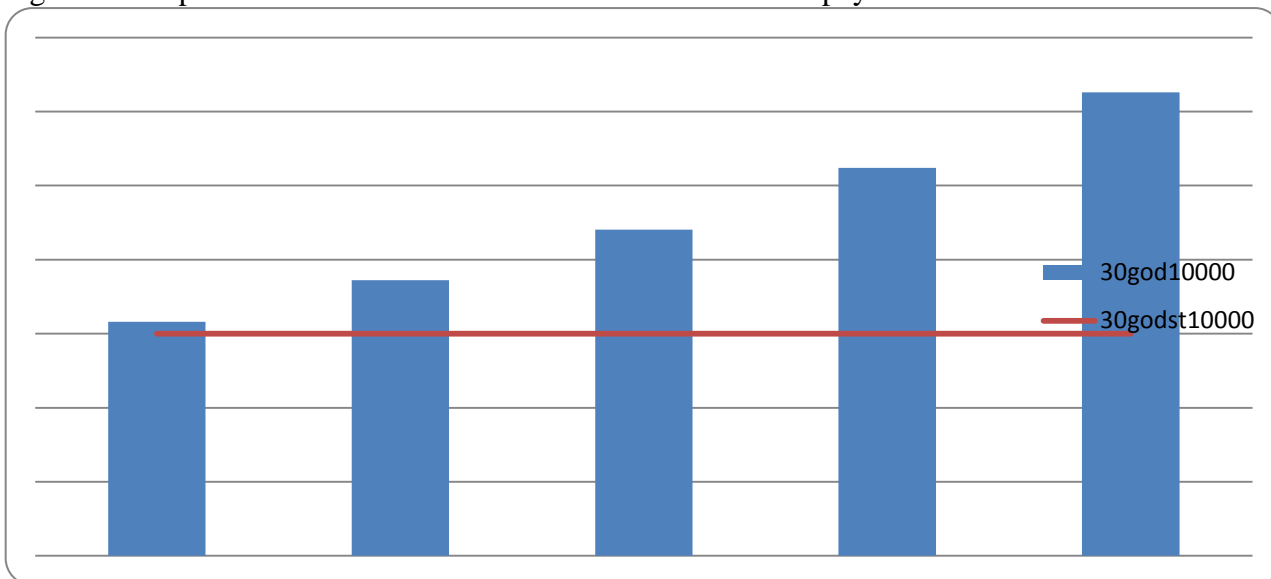
Table 11: Difference in the amounts of severance pay claims based on average monthly gross salary and years of service between the current national severance pay scheme and the new model

Monthly amount of gross salary (HRK)	Years of service						
	1	2	5	10	15	20	30
3,000.00	540.0	-837.7	-1867.0	-2,868.3	-2,765.0	-1,251.6	7,670.8
5,000.00	900.0	-1,443.3	-3,166.3	-4,850.4	-4,697.4	1,133.6	32,599.5
10,000.00	1,800.0	-2,886.7	-6,332.6	-9,700.7	-9,394.7	2,267.2	65,199.0
15,000.00	2,700.0	-4,330.0	-9,498.9	-14,551.1	-14,092.1	3,400.8	97,798.5
20,000.00	3,600.0	-5,773.3	-12,665.2	-19,401.5	-18,789.4	45,34.5	96,667.3
30,000.00	5,400.0	-8,660.0	-18,997.9	-33,086.4	-43,095.4	-27,162.2	89,551.3

Source: Calculations by the author

Finally, it is necessary to point to the relevance of adequate return rates on severance pay contributions. Figure 10 compares the amount of severance pay claims under the existing scheme (flat line – HRK 100.000,00), based on thirty years of service and an average monthly gross salary of HRK 10.000,00. On the same basis, the Figure shows the development of revenue from paid contributions based on different rates of return – ranging from 1-5%. In this example, the 4% return rate is the minimum rate, which sustains the amount of paid severance pay at the same level. In practice, the contribution rate has to be even higher because of the negative influence on the return rate caused by the need to reserve a significant share of the capital for current payments and a share of the amount that belongs to the fund that manages the revenue from severance pay contributions.

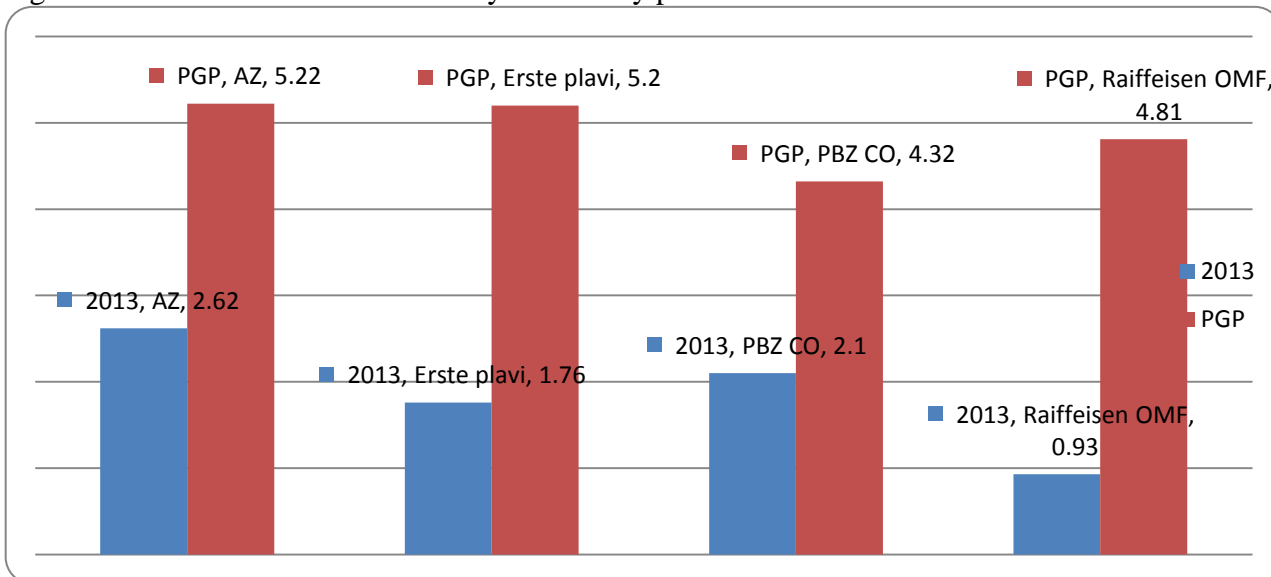
Figure 10: Impact of the return rate on the amount of severance pay in the new scheme



Source: Calculations by the author

Figure 11 shows the average annual return of mandatory pension insurance funds (for the past five years), and during 2013. It can be noted that the nominal rates of return are relatively low. It is therefore not realistic to expect significant rates of return on capital from future contributions.

Figure 11: Rates of return achieved by mandatory pension insurance funds



Source: www.in-fin.info

8 General open issues with respect to the reform and regulation of the severance pay scheme in the Republic of Croatia and approaches to their resolution

Analysis of the provisions of the Labor Act, the practice resulting from the severance pay scheme in the Republic of Croatia and placing this scheme in the global context of how national severance pay schemes are regulated, it is possible to identify some key open issues that determine the significance and the character of that national scheme.

The main issue that surfaces with respect to the reform and the regulation of the severance pay scheme in the Republic of Croatia is identifying the need to approach a systematic reform, which would thoroughly change the existing scheme in a way that it is based on the elements of the reformed Austrian severance pay system, which would be one of the options for a “systematic” reform of the scheme. Alternatively, there is a possibility to consider amending and supplementing the existing legal scheme with respect to some of its elements of legal and practical arrangements, which would mean changing some elements or parameters of the existing scheme, but not touching the whole arrangement. The third approach would be to keep the existing state as it is. Although possible, the latter solution is not realistic and it will not be considered here.

The first, systematic approach to reform and regulation of the severance pay scheme in the Republic of Croatia, would lead to comprehensive changes in the current situation, with a completely new system, which requires consideration and analyses of various solutions with respect to all elements of the system, as it was done in this analysis.

The second approach that would only deal with certain parameters of the scheme would make it possible to influence different elements of the system, to reposition them and thus to rearrange the existing scheme. Possible points that could be influenced are the following:

- eligibility conditions for the entitlement to severance pay (duration of the employment, the manner of terminating the employment contract etc.);
- amounts of severance pay per year of service with a particular employer;
- maximum amount of severance pay per worker;
- possibility of different, more favorable regulation of the entitlement to severance pay in other sources of labor law (collective agreements, work regulations, employment contracts etc.);
and
- the tax status of the right to severance pay, particularly when it comes to more favorable regulation of the entitlement to severance pay in other sources of labor law.

When it comes to opting between the first and the second approach and to designing the elements of the scheme within the selected option, a valid informed conclusion and choice between possible options can only be made if one has access to comprehensive economic and other indicators of the existing system, and to a thorough analysis of the outcomes based on these indicators. It is none the less important to clarify the intended outcomes and to consider whether there are more simple ways to achieve them, without introducing systemic changes. One thing that always has to be taken into account is that – due to various functions of severance pay – the decisions on the approach to the national severance pay scheme and its outcomes are directly related to the decisions regarding

the labor market policy, tax policy, economic and social policy in general, so that in making this decision, all considerations have to be analyzed in view of these policies as well.

It is none the less important to understand that in deliberating all the open issues, one has to take into account that these issues are of particular significance for the trade unions and employers, and without a high level of their support for the selected approach and for concrete elements of the selected approach, it is difficult to expect that the legislative changes will be accepted. Besides, given that the existing national severance pay scheme is not just a reflection of statutory regulations but also of more favorable schemes presented primarily in collective agreements and work regulations, and given that there is already a practice in applying these schemes, all significant changes imply a change of approach in the practice of collective bargaining and the unilateral self-regulation by the employers in work regulations. Consequently, all of the above points to the necessity to have a very thorough analytical approach to any changes in the existing scheme, and to reach a high level of consensus in the process.

9 Conclusion on strengths and weaknesses of introducing a new national severance pay scheme model

Legally and practically, virtually all countries value the protection of workers in case of their employment contract termination. To that end, the countries establish a scheme of rights and duties of workers and employers. One of the systems which is being built legislatively or in practice to take on that role is a national severance pay scheme, which rests upon the right to severance pay as a consequence of an employment contract termination. There are different mechanisms by which the scheme operates, ranging from compulsory contributions for the purpose of severance pay to obliging the employers to make a one-off severance pay in case of an employment contract termination. The very foundations of the scheme can vary as well, and can range from statutory or legislative arrangement of the scheme or a liberalised scheme, whose features are actually determined by collective agreements. One thing unique to the system is the fact that any national severance pay scheme has important roles to play and outcomes to reach, both from the perspective of individuals – the workers and the employers, and the society or economy alike. On the grounds of such importance and value, such a scheme is virtually omnipresent, even when its roles and outcomes are being accomplished in different ways. This is confirmed by sizable differences between, for instance, the European Union member-states: the differences in terms of persons and scope of persons exercising the right to severance pay, the conditions for exercising the right to severance pay, the severance pay amount and its tax status.

An unusual matter is that the entitlement to severance pay, the severance pay itself and the national severance pay schemes have been quite neglected as a subject of scientific or specialist discussions and research. However, this topic is being opened as well in a contemporary environment, which attributes a great deal of attention to labour market efficiency, the fact that there is a connection between the right to severance pay and the labour market rigidities or flexibilities, its impact to employment and employability that may be also expressed in terms of an EPL index. This is where specificities of individual national schemes, certain elements of the schemes, the correlation between economic and demographic indicators, labour market properties, the conditions of employment and the activities of active population, institutional and regulatory properties of the

social security and the tax systems, the degree of legislative and tax evasion combined, become a framework for reflection.

The need for rationalisation and flexibility in the labour market, including by way of providing for it through labour law, opens up space in the Republic of Croatia for reflection on the right to severance pay and the national system as a vehicle for exercising such a right. Therefore, one of such reflections has been presented via this analysis. To the greatest extent, it is founded upon the comparison between the Croatian and Austrian severance pay scheme properties, and some other solutions to a lesser extent. From this angle, the possibility of the implementation of a new severance pay model that would primarily rest upon the properties of the reformed Austrian national severance pay scheme is being analysed. Some room was devoted to an analytical overview of the existing arrangements and a possibility for changed outcomes within such an arrangement.

As the foundation of methodical reflection, the analysis itself has some limitations. These are first of all reflected in a lack of data. However, even on the basis of quite a limited insight into data and analysis of relevant labour market indicators in the Republic of Croatia, it is possible to establish and arrive at conclusions on positive and negative aspects of the existing systems. Table 12 below presents a summary of strength and weaknesses of the existing severance pay scheme model.

One may immediately say that a new national severance pay scheme model that would be built around elements that were purposed in the Republic of Austria for reforming the scheme was not chosen by chance. The similarity between the existing state-of-play in the Republic of Croatia against what existed in the Republic of Austria before the reform, coupled with closely matching conclusions on the weaknesses of the arrangements in both cases, justifies the reference to the Austrian reform model as a new model to be applied in the Republic of Croatia. It is, therefore, easy to explain a matter that could otherwise be interpreted as an interesting coincidence: The reform oriented following the properties of the Austrian severance pay scheme relatively simply overrides weaknesses and problems characterising the existing scheme in the Republic of Croatia. This may also be seen from Table 12 below. Thus, one of the most important results of the reform in the Republic of Austria deals with securing the disbursement of severance pay to the greatest portion of private sector workers. Such an effect would be even more important in the Republic of Croatia. However, since there are no relevant data at hand that would enable an assessment of a broader spectrum of the reform impact, the first step towards improving the system should surely involve making a complete database available that would be the foundation for conducting a relevant analysis of this projection.

Table 12: Summary of strengths and weaknesses of the current national severance pay scheme and the new model

	Current national severance pay scheme	New model
Positive aspects	<ul style="list-style-type: none"> • high level of severance pay • suitable for successful companies with greater productivity of workers • ensures disbursement of a portion of severance pay to workers of an employer under bankruptcy 	<ul style="list-style-type: none"> • ensures the right to severance pay for all workers • a reduced burden of terminating an employment contract for severance paying employers • assumes the creation of a central database • impetus to capital market • relaxes the state budget of the Republic of Croatia
Negative aspects	<ul style="list-style-type: none"> • it is founded on an inadequate institutional and regulatory framework (which is rigid, and does not guarantee the payment of severance pay to all workers and in the defined amounts, and it allows for manipulations) • labour market disruption • inadequate tax treatment • does not secure right to workers' severance pay, especially in the private sector • procyclical impact on employers, weakening them during economic and financial crisis, making it impossible to terminate employment contracts in case of financial difficulties • especially jeopardises labour intensive sectors • burden transferred from a portion of employers to the state budget of the Republic of Croatia and workers 	<ul style="list-style-type: none"> • tax wedge (likely adverse impact on competitiveness) • no impact on labour force mobility • reduces the amount of disbursed severance pay to workers • dependence on macroeconomic indicators and management of a competent fund • takes up a sizable working capital from employers
Risks	<ul style="list-style-type: none"> • economic and financial trends 	<ul style="list-style-type: none"> • yield rate • tax treatment

Based on the previously conducted analysis of the scheme in the Republic of Croatia and the options for improving the scheme following the Austrian model, coupled with the strengths and weaknesses of the current national severance pay scheme and the new model presented in the table above, one may arrive at a number of conclusions, as follows.

CONCLUSION 1: The existing scheme is characterised by numerous problems and requires improvement.

The relatively easy-to-detect problems stem from the fact that there is a sizable level of unexercised or partially exercised rights to workers' severance pay predominantly in the private sector, which in a way derogates the protective role of and the sense of the entitlement to severance pay; further, the existing scheme virtually enables abuses in the public sector, thereby transferring the burden of severance pay to the state budget of the Republic of Croatia; moreover, the existing scheme is burdensome for workers, the state budget of the Republic of Croatia and some employers who comply with the relevant arrangements; and it is questionable whether or not the tax treatment of severance pay is adequate. All these problems necessitate action-taking.

CONCLUSION 2: A detailed analysis of the existing severance pay scheme is a precondition for taking any action.

Without an analytical background, it is impossible to identify the actual state-of-play, problems and critical points, as well as their actual relevance by which they prevent target outcomes from being achieved. Against such a backdrop, a detailed analysis of the current state-of-play at the level of individual employers, by sectors and economy-wide stands as a *conditio sine qua non*. All the more so, strengths and weaknesses are dependent not only of theoretical properties of the models being compared or the legislative arrangements, rather they also depend on their application in practice. And such a disparity between the regulatory and the practical is problematic in its own right for the rule of law in the Republic of Croatia.

A significant practical problem surfaces along with the need for making an analysis of the existing scheme. To a large extent, the analysis is currently hindered due to the non-existence of a centralised and a comprehensive database on claims and disbursements by way of the right to severance pay. Therefore, the creation of such a database would be the first step towards the improvement and enabling an analysis of the existing scheme.

CONCLUSION 3: Reform goals should be defined

The direction of any reform depends on what is it intended to achieve. After the development of an analytical background, therefore, the next assumption for taking statutory action deals with the definition of goals to be achieved via the reform. Without that, any action would boil down to mere "takeover" of models and "copy and paste" of legal solutions, without any serious assessment of how, in which period and what results it could yield. In terms of severance pay, and given that this analysis at its very beginning stated that severance pay may have different functions and that the dynamics and trends of such functions could be monitored over time, the definition of the reform goals becomes all the more so important.

CONCLUSION 4: A reform following the Austrian severance pay scheme model implies more sizable changes.

To conduct a reform following the Austrian scheme model, it is important not only to define adequate reform goals, but it is also necessary to establish the way in which the Austrian model

could be applied within the framework of the Croatian institutional and regulatory arrangements, i.e. it requires an adaptation of the model to the framework of such arrangements.

Moreover, since a reform following the Austrian model attributes a broader meaning to severance pay and it no longer is just a consequence of an employment contract termination, one must take account of the position and the role of the new right to severance pay in a broader context of the social protection system in the Republic of Croatia.

CONCLUSION 5: The application of the Austrian model is not necessarily the outcome of the reform – it is possible to take different actions into the national severance pay scheme.

In addition to conducting a reform following the Austrian model, it would also be possible to apply different scenarios or different reform goals, comprehensive to a greater or lesser degree, as would be to focus actions beyond the labour law framework. For instance, this may entail revisiting all the parameters of the existing national severance pay scheme – eligibility requirements, amounts, etc. – and even regardless of the reforms within the framework of the Labour Law, we maintain it would be needed to explore modes for changing the severance pay tax treatment towards aligning it with the properties of the tax system (progressivity) and providing stimulus to savings. Even the latter action alone could be a significant intervention into the national severance pay scheme.

CONCLUSION 6: Sustainability and implication of each proposed action should be tested.

Once the parameters for taking action are defined, it is necessary to further explore the extent to which such a course of action would burden individual employers, how would this burden be allocated sector-wise and what would be the impact on the economy overall, and what would be the level of workers' rights given that this stands as an important element in the evaluation of sustainability of any proposal.

CONCLUSION 7: Consensus between social actors and stakeholders should be achieved to the greatest extent for the purpose of introducing a new national severance pay system.

Given the content of the actions, the introduction of a new national severance pay scheme should be previously empowered by reaching a consensus between all actors and stakeholders – the Government of the Republic of Croatia, unions and employers' as parties to tripartite social relations – in order to satisfy the interest of economic sustainability and labour force protection. If a full consensus cannot be reached, it would be worthwhile to reach an agreement between all the parties on the proposed solution to the greatest extent.

Based on these conclusions, actions towards arranging the right to severance pay should undoubtedly be taken. However, an answer to whether or not such a course of action should critically be oriented following the properties and outcomes of the Austrian severance pay scheme should be given in a professional and a detached manner, taking account of all the arguments presented.

As arguments in favour of this solution, one may indicate the need for equalising the requirements, rights and duties of all workers, as a response to polarisations existing in the Croatian society and the Croatian labour market. One such polarisation exists between employees with open-ended full-

time employment contracts and the others: the unemployed, the workers with fixed-term employment contracts, those hired part-time, seasonally, etc. Another polarisation is between employers: the successful ones who pay generous severance pays and the less successful ones facing bankruptcy and liquidation, where workers not only fail to receive any severance pay but also frequently do not receive the unpaid salaries. This could improve the social image, which in turn may improve the elements of security and equity in the labour market, especially in the light of the announced introduction of flexibility.

One must simultaneously bear in mind certain weaknesses to such a path. This would result in an additional rise in labour cost, and the difference between the employer's cost and a worker's net wage (tax wage). The fact that the employment contract termination cost would no longer rest with the employers could lead to a situation where such a severance pay scheme loses its preventative role in employment contract termination. There is also an issue of a transitional period during which the severance pay fund should be supported by contribution, while guaranteeing for the disbursement of the reached severance pay levels, as the scheme would otherwise hardly be acceptable to the unions.

The utilisation of the severance pay fund also appears as an important question. How much and how would employers contribute to the severance pay fund under illiquidity is a question that may be solved. However, the outcome of the fund's operation during an economic crisis, the investment and yields, this is an issue without a fully clear and certain answer or evaluation.

All of the above points to the need for a balanced and well thought approach. As per the proposed flow of conclusions, such an approach should be used as a vehicle for analysing the existing state-of-play and relevant elements, examining all available experiences and models and avoiding any rushed decisions on drastic changes to the existing status.

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