Croatia
Economic Vulnerability and Welfare Study

April 18, 2001

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region
CURRENCY AND EQUIVALENT UNITS

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US$1.0 = 8.68 Kuna
(As of April 12, 2001)

ACRONYMS AND ABBREVIATIONS

CBS  Central Bureau of Statistics
CEE  Central and Eastern Europe
CIS  Commonwealth of Independent States
Crostat  Croatian Bureau of Statistics
EBRD  European Bank of Reconstruction and Development
FDI  Foreign Direct Investment
GDP  Gross Domestic Product
HBS  Household Budget Survey
IDPs  Internally Displaced Persons
ILO  International Labor Organization
LFS  Labor Force Survey
OECD  Organization for Economic Co-operation and Development
PPP  Purchasing Power Parity
SME  Small and Medium Enterprises
UNICEF  United Nations Children’s Fund
UNU/WIDER  United Nations University/World Institute for Development Economic Research
WTO  World Trade Organization

Vice President:  Johannes Linn (ECAVP)
Country Director:  Andrew Vorkink (ECC05)
Sector Director:  Pradeep Mitra (ECSPE)
Sector Manager:  Daniela Gressani (ECSPE)
Task Team Leader:  Ruslan Yemstov (ECSPE)
Team Members:  Marcelo Bisogno, Paulette Castel, Erzo Luttmer, Jim Lynch, Sanja Madzarevic-Sujster (ECSPE), Elizabeth Gomart (Consultant)
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EXECUTIVE SUMMARY

1. With a per capita income over US$4,500 Croatia is the second richest of the former republics of Yugoslavia. Social indicators, such as infant mortality, literacy and life expectancy are at par with rich countries. The system of social transfers is one of the most extended in the region. However, these factors do not preclude the existence of absolute poverty, whose extent depends on how wealth, income and transfers are distributed.

2. This report is the first study of poverty and income distribution in Croatia. Its aim is to provide the assessment of where Croatia stands now in terms of poverty, to explain why some people are poor, and to recommend ways to help them in the most efficient way.

A. ASSESSMENT: POVERTY PROFILE

Absolute Poverty is Low ...

3. Using an internationally comparable standard across transition economies (US$4.30 a day per person at purchasing power parity) with recent representative household survey data, this study finds that the incidence of absolute poverty in Croatia is very low at 4 percent (Figure 1).

4. An international poverty standard, however, may not adequately reflect country-specific conditions. The report has estimated the level of total household expenditure at which families, after paying for essential non-food expenditures, just attain minimal nutritional needs. This level of expenditures therefore represent an absolute poverty line and amounts to HRK 41,500 per year (in 1998 prices) for a couple with two children or

---

1 Between 1991 and 1998 there was no representative household budget survey on the territory of Croatia. The analysis presented in this report is based in the first representative survey of incomes and expenditures of households in Croatia since Independence. It was conducted by the Croatian Bureau of Statistics in 1998 and covered 3,123 households randomly selected throughout the country.
HRK 15,474 for an adult. Fewer than 10 percent of the Croatian population falls below this nationally specific poverty line.²

<table>
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Source: HBS (1998). Notes: PPP - purchasing power parity. Values are expressed in May 1998 prices, correcting for regional price differences. Poverty with international line uses per capita consumption, national line is based on equivalent consumption (OECD scale: first adult has a weight of 1, subsequent adults have a weight of 0.7 and children have a weight of 0.5).

5. It would be affordable for Croatia to eliminate absolute poverty completely. The analysis of poverty in this report shows that poverty is shallow: the poverty gap is 1.8 percent of total consumption, and on average the consumption of a poor household is 20.7 percent below the poverty line. To bring all Croatia’s poor above the poverty line with perfect targeting (i.e., to give each poor person a transfer exactly equal to the poverty gap) would cost only 1 percent of GDP.

... but Those Who Have the Misfortune to be Poor are Seriously Deprived

6. The life of the poor differs in many respects from that of the non-poor. The poor tend to live in overcrowded, poorly maintained dwellings; their diet is limited (especially for the urban poor who can afford little beyond basic staples such as bread, potatoes or milk); and, they are poorly educated. Few of the poor have savings; they are often immobile, and their social networks are very limited (Figure 2).

![Figure 2: How many among the poor are deprived](image)

Source: HBS (1998), baseline definition of poverty based on national line at 8.4 percent of the population.

² Poverty rate in the Table 1 (8.4 percent) covers only part of the territory not directly affected by occupation during the 1992-95 war and does not cover IDPs and refugees. It is estimated that inclusion of these groups would raise the poverty rate from 8.4 percent to 10.0 percent. The statistical error of this estimate is ±2 percent.
The Poor Have Distinct Characteristics ....

7. Poverty is not confined to certain areas or ethnic groups: although some regions (Slavonia), especially rural areas, and certain ethnic groups (Serbs, Albanians, Roma, Bosnian Muslims) have higher poverty rates, the poor live in all regions and are predominantly Croats.

8. The poverty profile is dominated by two groups: poorly educated individuals and the elderly. Almost three-fourth of the poor live in families whose head has primary education or less. These individuals are likely to have little prospect of finding work if they are not employed, or to have low earnings if they are employed. The risk of poverty is particularly high when poor education is combined with unemployment.

9. Low or non-existent pension benefits in old age is the second cause of poverty: 40 percent of the poor live in households with a retired household head. In 1998 when the HBS survey was conducted, as many as 25 percent of retirees did not receive pension benefits at all and about half of pension beneficiaries received pensions that were below the poverty line.

... Which in Combination With Limited Opportunities Make Them Likely to Be Stuck in Long-term Poverty

10. Poverty in Croatia already has many features of a permanent state. There are two basic reasons why the poor are unlikely to escape poverty easily: (i) the limited nature of economic opportunities; and (ii) the limited capacity of the poor to benefit from such opportunities as exist.

11. Economic opportunities are limited because growth has thus far has not generated enough jobs. Despite positive economic growth in 1995-98, the net change in employment has been persistently negative: many old jobs have been destroyed and very few new ones have been created. Growth has benefited primarily those who have kept their jobs, but for those locked out of employment, the effect has been was close to nil, if not negative. An internationally comparable ILO definition of unemployment shows that Croatia in 1998 had one of the highest unemployment rates in the region (Figure 3). The employment situation by the end of the year 2000 has worsened further (ILO unemployment rate reached 15 percent of the labor force).
12. Meanwhile, over-regulation of employment is limiting opportunities for small businesses and flexible working arrangements, both of which could constitute a viable alternative to wage employment for the poor. As demonstrated by Figure 4, Croatia has a low rate of employment in SMEs, in self-employment activities outside agriculture, and in flexible part-time employment.

13. The poor are at a disadvantage in benefiting from new opportunities. Once locked out of jobs, the unemployed and economically inactive have difficulty in breaking the circle of impoverishment. Over half of the jobless are long-term unemployed, and analysis of labor market flows suggests that both the unemployed and the inactive are unlikely to find a new job.

14. Most working age individuals who are not employed have either very low educational endowments (primary or less) or narrowly focused skills (vocational school graduates). Meanwhile, the high general level of wages in the Croatian economy compared to other countries in the region puts local labor intensive industries at a competitive disadvantage vis-à-vis those of other CEE countries. Therefore the prospects for future export-based expansion of industries demanding only these narrow or low skills are poor.

15. Those who are currently locked out of remunerative employment due to low levels of education are also likely to see their limited opportunities perpetuated for their children. The education system lags behind other transition economies with respect to post-primary schooling, as UNICEF data suggest (see Figure 5). Household survey data (HBS) also show that the access of children from poor families to upper secondary and higher education is severely limited.

Figure 4: The Extent of Flexibility in Labor Market Arrangements (shares in total employment).


Figure 5: Net secondary education enrollment rates

Note: Total number enrolled as percent of relevant age group. Source: WDI indicators and UNICEF (TRANSMONEE) database.
16. **Inequality.** The gap between the rich and the poor in Croatia is wider than in middle or low-inequality countries (Figure 6).

![Figure 6: The gap between the rich and the poor](image)

Note: Left side of the bar is 10th percentile to the median equivalent income, right side – 90th percentile. Luxembourg Income Study (LIS) equivalence scale (square root of family size to correct for economies of scale). Source: LIS database, www.lissy.org, for Croatia – staff estimates based on HBS (1998).

17. An increase in inequality is a normal result of transition, as markets start to reward scarce skills and entrepreneurship. However, inequality in Croatia is far higher than generally observed in transition and market economies.

18. **Why is inequality an issue?** High inequality means a weaker impact of growth on poverty. This report estimates elasticity of poverty with respect to growth at only 2.1 in Croatia: that is for every one percent growth in consumption poverty falls by 2.1 percent. Growth that accrues mainly to those at the top of the income distribution does little to improve the living standards of the poor, and increases in inequality can easily swamp the positive impact of growth. Inequality also leads to lower participation in civil society, thus reducing the opportunities for the poor to influence policies (La Ferrara(1999)). Empirical studies show that higher inequality leads to significantly higher levels of violent crime (Fajnzylber, Lederman and Loyaza(1999)). High inequality leads to sharper crises in response to external shocks, as distributional conflicts between the rich and the poor impair the functioning of democracy (Rodrik(1999)).

19. High relative poverty. Inequality also matters because it determines how many people are poor relative to the middle or feel poor. The number of people in Croatia who consider themselves poor relative to others is high, and had fallen only marginally in 1999 compared to 1994 (CEMA 2000), indicating deep discontent among the population about growing inequality.

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3 Using data from over a hundred countries Ravallion and Chen (1997) estimate that average growth elasticity of poverty with respect to growth is 3.1.

4 To measure relative poverty the conventional practice among OECD poverty researchers is to take 50 percent of the median national equivalent disposable income (or consumption) as the poverty line. On this basis, the incidence of poverty in Croatia (7.9 of the population) is higher than in other CEE countries (where relative poverty rate is ranging from 2.6 in the Czech Republic to 7.2 in Poland) – see Making Transition Work for Everyone, Statistical Annex.
20. In summary, absolute poverty in Croatia is low, but this diagnosis is misleadingly comfortable. Inequality is high; Croatia would have had even a lower poverty rate, if inequality were comparable with other CEE countries. The type of economic growth that Croatia had, failed to generate enough economic opportunities, and the poor are at a disadvantage in benefiting from these limited opportunities.

B. Causes

21. The poverty profile reveals two main economic causes of poverty: limited employment opportunities and inadequacy of the social safety net. War accompanied by hyperinflation contributed to a sharp deterioration in living standards in 1991-95 and sharpened pre-existing inequities. But war is not the cause of poverty in Croatia today: in the period between 1995 and 1999, the economic policies pursued by the government have tended to exacerbate, rather than to dampen, the consequences of war.

Macroeconomic and Structural Policies were Key Determinants of Weak Employment Growth

22. Macroeconomic policy over the period after the successful stabilization in 1994-95 up until the end of 2000 was characterized by a mixture of loose fiscal and tight monetary policies. The two most immediate outcomes of these policies were high real interest rate, which inhibited capital investment; and the appreciation of the real exchange rate, which led to a loss of competitiveness for traditional Croatian exports. Both effects militated strongly against employment generation.

23. The model of privatization that Croatia has chosen has given strong preference to insiders – managers and employees of formerly socially owned enterprises – over outsiders (including potential foreign investors). This has inhibited FDI flows and further limited prospects for job creation in the country.

24. Insider privatization, in combination with interventionist Government and subsidization of ailing firms, has created strong coalitions that have been able to slow down the restructuring of the economy, protecting privileges and rents for entrenched firms and industries. Soft budget constraints take away the “economic space” for the new entrants to thrive. This strategy has backfired, resulting in obsolete assets and a vanishing competitive edge.

Labor Market Policies Have Worsened the Negative Impact of Macropolicies on Income Distribution

25. Against a background of falling demand for labor Croatian Government has relied excessively on early retirement to ease pressures in the labor market. This policy created a gap between the falling number of contributors to the pension system, and to the State transfer system in general, and the growing number of beneficiaries. As a result, transfer recipients had to rely on smaller benefits (Figure 7). The poverty profile which is dominated by the elderly and non-employed, can be traced to these developments.
26. The growing number of transfer recipients and the shrinking number of contributors has led to higher taxes on labor. Workers receive only about a half of what it costs a firm to employ them, a larger differential than in other European countries, and making labor more expensive as a factor of production. In addition this generally high tax burden has pushed economic activity underground, contributing to corruption and higher rents.

27. On the other hand, real after tax average wages of those who are employed have reached pre-transition levels. This recovery was also far from equitable. The public sector has been the leader in obtaining rapid wage increases. Sectors under the direct or indirect control of the State (40 percent of employees) absorbed almost all the economy-wide increases in the real wage bill between 1997 and 1999. On the other hand, some workers were subject to persistent wage arrears, and by the end of 2000 one in 10 employees has not been paid on time.

28. The inequitable growth was therefore a result of specific policies. The widening gap in average incomes between the employed and transfer recipients accounted alone for as much as 10 percent of total inequality in incomes by 1998, and, arguably, for a substantial part of the increase in inequality since 1990. The main contributor to inequality, however, is non-wage market income (income from self-employment and informal economic activities), which is distributed very unevenly. Why some of the self employed and entrepreneurs fare so much better than the others? The study argues that rents and barriers to competition explain high inequality in earnings, as well as the high returns for those who are involved in these activities. The non-agricultural self-employed constitute 7 percent of all non-agricultural employment, but collect almost 20 percent of all non-agricultural income.
29. Finally, failure to enforce anti-discrimination laws, both by private firms and by the public sector, has, according to the Social Assessment conducted for this study, created an environment where inequality and discrimination based on ethnic origin are entrenched. Non-Croat workers have been turned down by potential employers, or face barriers in obtaining necessary documentation, or suffer from the lack of protection of their rights. Access to social benefits and services for work incapable non-Croats has been reported to be constrained in various ways, including open discrimination practiced by some local officials.

Transfers Have Not Played a Countervailing Role to Arrest Rising Inequality and Poverty

30. The Croatian Government spends over 25 percent of GDP on social sectors and social protection programs, more than other countries in CEE, but achieves little real redistribution, because most social spending is costly and poorly targeted, while relatively well targeted social assistance programs are small (see Table 2). The concentration coefficient for total transfers is positive, showing that instead of reducing inequality, they actually increase it.

31. Pension expenditures, which account for the bulk of social transfers, are rising rapidly (from 12 percent of GDP in 1998 to 14 in 1999), leading to a deficit in the pension system covered from general Government revenues. Incidence analysis shows that pensions represent a transfer to the relatively well-off, and do not adequately and equally protect all elderly and disabled from falling into poverty. One quarter of this group do not receive a pension, one-half receive benefits lower than the poverty line. Therefore deficit financing of the pension is a diversion of budget resources that could otherwise be redirected towards the poor.

<table>
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<tr>
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<th>How much the government spends on social programs?</th>
<th>How much the poorest 20% of population receives?</th>
<th>How much the poorest 8.4% of population receives?</th>
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<tr>
<td>Pensions</td>
<td>12</td>
<td>1.9</td>
<td>0.7</td>
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<tr>
<td>Social Assistance</td>
<td>0.4</td>
<td>0.2</td>
<td>0.1</td>
</tr>
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<td>Child &amp; Family Allowance</td>
<td>1.4</td>
<td>0.3</td>
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</tr>
<tr>
<td><strong>All transfers</strong></td>
<td><strong>17</strong></td>
<td><strong>2.8</strong></td>
<td><strong>1.0</strong></td>
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<td>Education spending</td>
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<td>Health care (estimate)</td>
<td>7</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Total social spending</strong></td>
<td><strong>27</strong></td>
<td><strong>3.7</strong></td>
<td><strong>1.4</strong></td>
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Source: staff estimates based on HBS(1998) and Government expenditure data from Madzarevic-Sujster (2000)
C. ACTIONS

32. Successful poverty alleviation will rest on the three pillars of opportunity, security and empowerment. Providing opportunities for the poor to lift themselves out of poverty requires action to create an economic environment more conducive to equitable and sustainable growth. Supporting the long-term poor and extending the safety net to mitigate impoverishment due to shocks will result in greater security. Creating institutions that empower the poor to directly affect policies and social processes will make State interventions more effective in combating poverty. These three elements of the anti-poverty strategy are complementary, with each reinforcing the positive effects of the others, as powerfully demonstrated in the World Development Report on Poverty (2000/01).

Policies to Foster Opportunities: Macroeconomic Stability, Flexible Labor Market and Education

33. Equitable growth is of central importance for several reasons. First, it will raise incomes of the working poor, giving them an opportunity to escape poverty. Second, it will provide employment opportunities for unemployed and inactive workers – a group facing especially high poverty risks. Third, it will provide the tax base for programs to alleviate poverty among those who cannot otherwise escape it.

34. Four conditions are required to achieve equitable growth: (i) sustaining macroeconomic stability; (ii) creating an enabling environment for private businesses; (iii) increasing flexibility of the labor market; and (iv) increasing investment in human capital.

35. To maintain and consolidate macroeconomic stability would involve a continued effort towards the following objectives:

(a) Strengthen institutions for Government economic policy making, especially for implementing structural reforms;
(b) Improve fiscal management and transparency, including by establishing mechanisms to eliminate arrears; and
(c) Strengthen fiscal discipline, including by phasing out subsidies and price controls, introducing new wage policy and limiting the structural deficit of the pension system.

36. Enabling private sector-led growth is the key condition for making the growth sustainable. To achieve progress in this direction the Government will need to:

(a) Increase flexibility and efficiency of the economy, remove regulatory obstacles for establishing new business, improve and harmonize land, cadastre and real estate registration systems, and streamline administrative procedures involved in FDI;
(b) Strengthen market institutions: revise and update competition policy legal framework, ensure proper functioning of competition enforcement agency,
and harmonize competition enforcement with new licensing requirements; and

(c) Improve governance framework for businesses: amend company law to strengthen minority shareholders rights, amend take-over law to promote pro-competitive mergers, amend company law to encourage nomination of outsiders to boards of directors, streamline the court processing of commercial cases, and strengthen the implementation capacity of commercial courts.

37. Reducing taxes on labor, that the Government has already undertaken, will improve competitiveness and create an environment for job creation. But it will not in itself guarantee the employment generation in the private sector. Other reforms are needed to make labor market more flexible and translating economic growth that would resume in the right economic policy environment, into new jobs.

38. **Reforms of the labor market** institutions are needed to ensure it works to support the employment generation, and not against it. The thrust of reforms is to remove disincentives to job creation and encourage different part-time and casual working arrangements, while enforcing a minimum level of regulations to ensure workers' rights (e.g., to sick leave, limited work hours, and regular pay; to protection from harassment and discrimination; and to workplace safety). The specific policy actions will consist of:

(a) Amend the labor law to reduce costs to employers for hiring and dismissing of workers and encourage flexible working arrangements;

(b) Ensure the public has adequate information on main workers' rights that are enforceable through the legal system, and monitor cases of discriminatory practices; and

(c) Improve labor market information systems to monitor effects of adjustment and to facilitate the evaluation of programs.

39. To equip the poor to take advantage of growth opportunities, a reform of the **education system** is needed, that will help workers adapt to the market economy and foster an entrepreneurial culture. In the context of closer integration with Europe, and in partnership with European institutions and programs, Croatia needs to reform the curriculum by focusing on general skills and abilities valued by the market economy, and to change the governance by making the whole system more **equitable, flexible and adaptable** to a changing environment.

40. Local authorities should be given more of a role in defining the profile of public education, post-compulsory education should reflect individual need and user choice, and vocational programs should be more closely connected to economic actors (through provisions, funding and guidance). A new structure will need to be more flexible and take into account the increasing demand to change one's individual schooling and educational career, switch between tracks, leave and re-enter education, and find continuing opportunities for further training and re-training. All these principles are reflected in the Government's proposal of education system reform (discussed at social
policy workshop in January, 2001), specifically in its principle of "school of success for all" with the emphasis on those who under perform or drop out of school.

41. However, the Government is only at the beginning of a long and complex process of reform which will involve the following steps:

(a) Finalize sector strategy and policy agenda for dialogue with the stakeholders;
(b) Prepare the legal and administrative framework for increasing the role of private sector in education;
(c) Adopt a framework for the new core curriculum, which promotes skills and facilitates active learning and teaching; and
(d) New standard examinations will need to be piloted and introduced to improve transparency and quality.

Towards Greater Security: Protecting Those Who Fall Through the Cracks of the Safety Net

42. Enhancing security has two dimensions: reforming the safety net to prevent new people slipping into poverty, and extending the protection to the poor who are currently not served by the system.

43. Putting the social protection of a strong financial footing will involve introduction of the new multi-pillar pension system and reform of social assistance — including reallocation of spending towards better targeted programs and improved monitoring and governance of social policy as a whole. Steps now underway to reform the pension system will eliminate poverty among pension beneficiaries, but will leave open the issue of coverage.

44. Hence, a simulation using LFS data and the legal framework laid out in the proposed pension reform shows that by 2018 the new multi-pillar pension system would create a fiscally sustainable system which would eradicate poverty among those eligible for pensions. At the same time, however, as many as one-fifth of new retirees will not qualify for a pension under the new system.

45. Therefore it will be essential to increase coverage under the system, to expand social assistance programs, or to design new programs to address the needs of those who are currently left out. Given the strong capacity of current welfare programs in Croatia to reach the poor, the Government may want to assess the need for expanding well-targeted social benefits. Simulations using the 1998 HBS show that reallocating a mere 1 percent of GDP from untargeted subsidies to poverty oriented benefits would reduce poverty by 1.2 percentage points (from 8.4 percent to 7.2 percent).

46. The Government faces an even greater challenge in mitigating the negative impact of reform and preventing new groups from falling into poverty. Alongside budgetary reallocation, substantial changes will be required in the management, the competencies and responsibilities of line ministries and individual social protection schemes. The current fragmented system of social benefits should be made simpler and easier to monitor. The process of reforming the system should rely on improved
governance, as already started with the first steps in the development of National Program for Fighting Poverty and Social Exclusion.

47. As the Government stands at the very start of the reform process, it is important to lay out the full policy “package” to reform the social protection, which will consist in:

(a) Conducting an evaluation of existing social assistance programs (including the recently amended child allowance program) using the most recent household survey data and administrative information; also conduct a beneficiary assessment;

(b) Ensuring that the level of public expenditure per beneficiary on major anti-poverty programs remains adequate (i.e., cash assistance program); over the medium term employ the official poverty line as a base for defining the level of means-tested benefits;

(c) Rationalization of the targeting of anti-poverty programs with the objective to eliminate leakage to non-poor beneficiaries (by improving means testing);

(d) Preparation of a plan for increasing budgetary allocations to the better targeted programs through the increase in the number of beneficiaries/amount of assistance, and for decreasing spending and number of beneficiaries of programs not well targeted to the poor; and

(e) Improvement in coordination among different agencies managing multiple types of benefits and programs through the creation of inter-agency body responsible for design and monitoring the enforcement of social policy (Ministry of Labor and Social Welfare, Ministry of Reconstruction, Office of Refugees and Displaced Persons, Ministry of Health, Pension Fund, Employment Service, and regional and local governments).

48. To meet these objectives and implement these measures in the most efficient way, Croatia needs to establish a poverty monitoring system to track and report the social impact of economic reforms and evaluate the results of efforts to improve targeting and access to social assistance programs. The initial step in this area will be to establish a Government commission for drafting the legislation on the social minimum (poverty line), and to adopt official guidelines for calculation of poverty line and for poverty monitoring.

Empowering The Poor to Make Progress In Poverty Alleviation Irreversible

49. Empowerment involves giving the poor “voice” to influence the institutions and policies that affect their lives. Currently Croatia’s poor are afflicted with voicelessness and powerlessness, reflecting fragile democratic institutions, an immature civil society, and a weak enforcement of laws – especially anti-discrimination laws.
50. The new Government of Croatia is the result of the first democratic transition. Its commitment to strengthen the democratic institutions of Croatian society needs to be sustained not only because such institutions are a basic human right, but also because the quality of governance and democracy, the rule of law and the efficacy of a country’s public administration are important factors that promote the inclusion of the poor in policy making. This inclusion is possible when a democracy is firmly based on a fabric of civil society that gives citizens voice to influence policy making.

51. Fostering civil society will require bringing about a change in the nature of existing NGOs and social movements by creating an enabling institutional environment, i.e., a framework for encouraging poor people themselves to take an active role. Such an environment is best created through better governance of State-run institutions and a greater tolerance in society.

52. Finally, empowerment will include first and foremost the enforcement of anti-discrimination laws by: (i) reorganization of the civil service, improving capacity and monitoring administration at the local level; (ii) judicial reform, eliminating undue influence on the nomination of judges and improving the access of all citizens to courts; and (iii) reform of the media, including measures to turn the State media into public service broadcasters.
1. HISTORICAL AND POLITICAL CONTEXT FOR UNDERSTANDING POVERTY

A. INDEPENDENCE AND INITIAL CONDITIONS

1.1 Croatia's experience with the transition to a market economy differs in many respects from that of other CEEs. The country was initially well positioned for transition, with a high level of economic and social development, a sizable private sector and a strategic location. Its less centralized approach to socialism created some market institutions in factor markets in general and in the labor market in particular. During the past decade, however, the combination of war devastation and a number of specific policy choices has frustrated initially high expectations with respect to transition.

1.2 Despite war and devastation, Croatia has managed to preserve its high level of human development. The majority of the population has access to high quality health and education services, as reflected in key social indicators (Table 1.1).

<table>
<thead>
<tr>
<th>Country</th>
<th>GNP per capita, (US $)</th>
<th>Life Expectancy (years)</th>
<th>Infant Mortality (per 1,000 life births)</th>
<th>Net secondary enrollment (% of relevant age group)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia 1997</td>
<td>4,060</td>
<td>72</td>
<td>8</td>
<td>66</td>
</tr>
<tr>
<td>Croatia 1992</td>
<td>2,079</td>
<td>70</td>
<td>12</td>
<td>62</td>
</tr>
<tr>
<td>Hungary</td>
<td>4,510</td>
<td>71</td>
<td>10</td>
<td>87</td>
</tr>
<tr>
<td>Poland</td>
<td>3,590</td>
<td>73</td>
<td>10</td>
<td>85</td>
</tr>
<tr>
<td>Estonia</td>
<td>3,360</td>
<td>70</td>
<td>10</td>
<td>83</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2,260</td>
<td>71</td>
<td>10</td>
<td>80</td>
</tr>
<tr>
<td>Latvia</td>
<td>2,430</td>
<td>69</td>
<td>15</td>
<td>79</td>
</tr>
<tr>
<td>Romania</td>
<td>1,410</td>
<td>69</td>
<td>22</td>
<td>73</td>
</tr>
<tr>
<td>Russia</td>
<td>2,680</td>
<td>67</td>
<td>17</td>
<td>..</td>
</tr>
<tr>
<td>High income countries</td>
<td>25,890</td>
<td>77</td>
<td>6</td>
<td>91</td>
</tr>
</tbody>
</table>

World Bank World Development Indicators, 1993-99, and refer to 1997 or the most recent year available.

1.3 Immunization rates for, e.g., polio, tetanus, and TB never fell below 85 percent even in the worst years of the war; nutritional standards were satisfactory even among the most vulnerable.\(^2\) Access to public utilities was traditionally high (75 percent of the population have piped water supply, and 99.7 percent have electricity connections).\(^3\)

\(^1\) UNICEF TRANSMONEE database, 1999.

\(^2\) According to the UNICEF monitoring program in 1993, only 1.2 percent of children aged 1-6 were undernourished. This share was not statistically different among the refugees and IDPs, and dropped to 0.9 by 1997 (UNICEF, 1998).

Education is the only source of concern in this otherwise rather positive picture. Upper secondary school enrollment rates in Croatia are low for its level of development, and inequality in educational attainment is high (for a European country).

B. WAR AND ITS CONSEQUENCES

1.4 The war not only led to loss of lives; it also forced over half a million people from their homes and inflicted severe physical destruction on infrastructure and housing. The war also adversely affected the economy. War led to heavy direct economic losses (US$27.5 bln., more than a year’s GDP). Croatia lost its main traditional foreign markets; the war interrupted trade flows with the former members of SFRY, and seriously hurt the tourism industry, Croatia’s main source of overseas earnings. In addition, the war-induced increase in country risk contributed to a loss of foreign direct investment flows. Meanwhile, the political circumstances associated with conflict led to increasing post-war international isolation, denying Croatia important flows of international assistance. And finally, the occupation of over one-third of Croatian territory resulted in a four-year interruption of the main traffic links between the central part of the country and the east and south.

Box 1.1: Drnis: Echoes of the War

Drnis is a small town (with 2700 inhabitants in 1999, down from 4600 in 1991) with a mixed population (20 percent Serb before the war) located inland between Sibenik and Knin. At the outset of the war in 1991, most of the residents fled by foot. However, some stayed behind. Most of the people who stayed were elderly, handicapped elderly and their children who refused to abandon them. There were also those who did not want to abandon their property. In 1995, there were officially 200 people registered as living in Drnis during the war. However, according to interviews with those who stayed, the number is closer to 400.

Life was difficult during the war since social networks were reduced dramatically and most people lost their jobs. These material woes were overshadowed by the physical and psychological suffering inflicted upon residents by the occupying Serb paramilitary forces.

But misfortune has not ended with liberation. Apart from the emotional and physical scars that remain today to haunt them, those who remained are severely ostracized by the returnees who view them as traitors. Those who stayed view the returnees with great envy: they lived in hotels by the sea for four years, with food, board and spending money provided by the government and “most of them returned with cars from exile.” Fights break out in bars today over the conflict. Some report that City government, local police and enterprises also feed this antagonism by making it very difficult for those who stayed to regularize their papers, and many remain without documents (work papers, unemployment documentation, ID, etc). Thus, they forego health insurance, welfare and unemployment benefits.

Source: E. Gomart (2000)

1.5 Between 1990 and 1993, the combination of war and transitional recession contributed to a particularly severe economic crisis. GDP fell by almost 30 percent, the most severe decline among Central European Economies (CEEs, see Figure 1.1).

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4 10,668 people were killed, 2,915 reported missing, and 37,180 wounded.

5 A key source of foreign exchange before the war, tourism revenues dropped to 10 percent of pre-war levels by 1993.
1.6 Preserving the living standards of the population under these circumstances has taken a huge toll in terms of government finances. Defense expenditure, mounting demands for social protection from people affected by the war, and the unsatisfied demand emerging from the diminished role of enterprises in the social area, have all led to an expansion of the role of the State that has continued after the end of the war, to the point where public expenditure amounted to over 55 percent of GDP by 1999. The effects of war have fostered a culture of interventionism that has characterized most of the Government’s post-war activities and its overall relationship with the real sector.

Figure 1.1: GDP Growth in Selected CEEs

![GDP Growth in Selected CEEs](image)

Source: WDI, World Bank

1.7 In October 1993, the Government launched what turned out to be one of the most successful exchange-rate-based stabilization programs in the region. Subsequent growth performance was strong. In fact, only Poland and the Slovak Republic grew faster than Croatia between 1994 and 1998. However, recovery has been insufficiently strong and ran out of steam too soon to restore pre-transition levels of output. Export performance has been particularly disappointing, and external imbalances have grown (Table 1.2). Croatia’s GDP in 1999 was at only 78 percent of its 1989 level. Industrial production has followed an even more adverse path; by 1999 it remained about 40 percent below its 1989 level.

C. POST-WAR ECONOMIC POLICIES

1.8 Lack of political will to undertake painful structural reforms and extensive use of macroeconomic instruments as temporary remedy to a structurally ill economy were distinctive features of economic policies in 1995-98. This course has exacerbated old and created new imbalances which made the past-war economic recovery unsustainable and resulted in the loss of competitiveness. Croatia’s reform agenda remains unfinished until today, and efforts are needed to bring the country into the mainstream of the European economy.
Macroeconomic and Structural Policies

1.9 Growth in the period 1995-98 was based largely on booming domestic consumption and reconstruction (primarily of the housing stock), not on productive investment. These high levels of consumption and residential construction were financed by large private transfers from abroad. The boom was also fueled by rising public spending, mainly in the form of higher public sector wages and overly generous entitlements for privileged groups. This fiscal expansion ran contrary to a commitment to a stable exchange rate and low inflation.

1.10 The expansion of the Government sector has put Croatia in an unusual position compared to other transition economies of Eastern Europe, the majority of which have managed to decrease their share of public expenditure in GDP over the same period. To finance this increase, Croatia has expanded taxation levels. But even becoming one of the highest-taxed Central European economies did not help to balance the Government’s finances, and the budget deficit has gradually risen out of control. High levels of taxation have in turn hampered private sector growth and contributed to driving economic activity underground.

1.11 Tight monetary policy has been extensively used to counter the effects of loose fiscal policy, resulting in sharp increases in the current account deficit. The most immediate consequence of monetary “over” tightening was a high real interest rate (over 10 percent throughout the period), adversely affecting investment and slowing down restructuring of the economy. In addition, tight monetary policy generated pressures toward a real appreciation of the exchange rate. As shown in Domac (1999), this artificially increased consumption of imported goods to the detriment of employment in potential export activities.

1.12 Despite years of stable exchange rate and low inflation, dollarization remained a prevailing mode of financial transactions, reflecting lack of confidence in the sustainability of economic policies. In 1999, amidst the banking crisis that led to a depreciation of the kuna, the indexation of contracts in DM has adversely affected living standards: as shown in Miljenovic (1999) it was the major factor explaining the fall in personal consumption in 1999 as the interest payments of households for consumer loans rose dramatically.

Table 1.2: Croatia – Selected Macroeconomic Indicators, 1994-2000

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita in current USD</td>
<td>3,137</td>
<td>4,029</td>
<td>4,422</td>
<td>4,398</td>
<td>4,805</td>
<td>4,456</td>
<td>4,229</td>
</tr>
<tr>
<td>Change from previous period (in %)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Gross Domestic Product</td>
<td>5.9</td>
<td>6.8</td>
<td>6.0</td>
<td>6.5</td>
<td>2.7</td>
<td>-0.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Retail Price Index (annual avg.)</td>
<td>97.5</td>
<td>2.0</td>
<td>3.5</td>
<td>3.6</td>
<td>5.7</td>
<td>4.2</td>
<td>6.5</td>
</tr>
<tr>
<td>Exports (GNFS, current dollars)</td>
<td>14.1</td>
<td>1.3</td>
<td>10.6</td>
<td>2.2</td>
<td>4.4</td>
<td>-0.2</td>
<td>n.a.</td>
</tr>
<tr>
<td>As % of GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Expenditures*</td>
<td>44.1</td>
<td>48.9</td>
<td>51.9</td>
<td>50.9</td>
<td>53.6</td>
<td>55.9</td>
<td>50.1</td>
</tr>
<tr>
<td>Direct Foreign Investment (net)</td>
<td>0.7</td>
<td>0.5</td>
<td>2.7</td>
<td>1.8</td>
<td>3.4</td>
<td>5.1</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Source: "Croatia: Beyond Stabilization." World Bank, 1997, staff estimates based on CBS data, see www.worldbank.hr; * on accrual basis, staff estimates; n.a. – not available.
1.13 The key problem undermining public confidence was patchy progress in the structural reforms necessary to ensure long term stability and sustainable growth. More specifically, the progress with privatization and enterprise restructuring, reforming public finance and creating conditions for flexibility and competitiveness of economy has been slower than desired.

1.14 **Privatization, Governance and Role of the State.** The Socially-Owned Enterprise (SOE) model inherited from the Yugoslav socialist system largely determined the privatization process launched with the 1993 Law on Transformation of SOEs. This law gave an overwhelming preference to manager and employee buy-outs. Although many SOEs are completely privatized, their governance has changed little. Compared to Hungary and Poland for example, fewer Croatian SOEs have changed their managers after privatization. The prevailing enterprise culture remains centered around two concerns: first, to preserve existing employment (rather than improving the company’s results); and second, to maintain political connections. In the past the Government had been bailing out enterprises through a variety of methods: straight subsidies, debt write-offs, non-enforcement of fiscal obligations, etc., amounting to soft budget constraints. The Government indirectly subsidized some sectors under State control (such as shipbuilding) in a variety of ways. Shipyards had very easy access to government guarantees, and have not been paying social security contributions - or sometimes even their workers’ wages (which have been paid directly from the Ministry of Economy budget). This created an environment prone to rent-seeking, anti-competitive behavior and persistent inequities.

1.15 **Failure to create competitive markets.** Emerging coalitions between SOE managers, banks (often controlled by enterprises) and local Governments have prevented the development of a fully competitive market structure. The tightly controlled distribution system is rivaled only by the lack of competition in the retail sector and the absence of any foreign distributors as illustrations of remaining barriers to competition.

1.16 **Trade policies** prior to accession to the WTO were oriented towards maintenance of the status quo. The new Custom Tariff Law adopted in 1996 was broadly consistent with WTO requirements, but protection has been set at very high levels for some sectors. The average tariff on agricultural production exceeded 35 percent (before some rates for imported food products, directly competing with domestically produced exceeded 1000 percent). The reduction of protection in 2000-01 for Croatia’s bid to join the WTO has severely hit these industries that had few prior incentives to restructure and further underscored the structural nature of economic problems.

**Key Sectoral Policies**

1.17 Sectoral policies in the 1990s have had also some very distorting outcomes. Particularly worrisome were developments on labor markets, in the social sectors (health and education) and in the social welfare policies.

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6 Though direct subsidies amounted to 2 percent of GDP, there are many off-balance forms of subsidies that lead to high costs to the economy because of misallocation.
Labor Market Policies

1.18 Croatia inherited sizeable excess employment from the socialist regime. The best strategy for dealing with labor hoarding is rapid reallocation of labor from shrinking and overstaffed enterprises to new expanding sectors. This strategy requires flexible labor markets and an emphasis on new job creation. The government has chosen a different strategy aimed to minimize the pain of restructuring by slowing down the pace of labor reallocation.

1.19 Labor regulations and labor market policies in Croatia have been greatly influenced by job protection objectives, focusing on "core" full time employees, while placing restrictions on temporary and fixed-term contracts and imposing penalties on job terminations. For the workers that they cover, these laws and regulations may have increased job stability, but at the cost of flexibility; they have also created a bias against formal contracting of "outsiders".

1.20 The current labor code (Labor Act No. 758/95) impose high direct costs on employers (see Table 1.3) compared to EU countries. Termination of employment is particularly cumbersome; the law provides for advance notice of up to six months in some cases, and requires the agreement of a workers’ council. Severance pay is set at a minimum level of one-half of average monthly salary for each year of tenure. These restrictions inevitably hinder employment creation, because employers are unwilling to hire new workers to avoid future risks and liabilities. There are also limits on part-time work, and restrictions on the duration or renewal of part-time (or contractual) employment.

Table 1.3: Employment Protection Legislation. International Comparison

<table>
<thead>
<tr>
<th></th>
<th>Lay-offs procedural inconveniences</th>
<th>Notice and severance pay for no-fault individual dismissals</th>
<th>Difficulty of dismissal</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Procedure</td>
<td>Notice period after 9m, 4y, 20y</td>
<td>Severance pay after 9m, 4y, 20y</td>
</tr>
<tr>
<td></td>
<td>Delay</td>
<td>Score</td>
<td>Days</td>
</tr>
<tr>
<td>Croatia</td>
<td>3</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>EU mean</td>
<td>1.7</td>
<td>12.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Germany</td>
<td>3</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Spain</td>
<td>2.25</td>
<td>40</td>
<td>1</td>
</tr>
<tr>
<td>Austria</td>
<td>2</td>
<td>5</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: OECD The OECD Job Study. 1994 and Labor Act for Croatia (No.758/95) Explanations:

- **Lay-off procedural inconveniences** when issuing a regular dismissal notice: 1 for a statement in writing to the employee of reasons for dismissal, 2 for notification to a third party, 3 when permission for dismissal must be obtained from a third party. (higher number indicates stricter procedure).
- **Delay in effectiveness of notice**: the delay between a decision to dismiss and the time that notice can become effective after following required procedures, days.
- **Notice period, 9m, 4y, 20y**: the period between issuance of dismissal notice and the effective cessation of employment, in months. The columns refer to workers who have been with the employer 9 months, 4 years and 20 years, respectively.
- **Severance pay, 9m, 4y, 20y**: a lump-sum payment to the dismissed employee at the time of cessation of employment. The columns refer to workers who have been with the employer 9 months, 4 years and 20 years, respectively.
- **Definition of unfair dismissal**: 0 when worker performance or redundancy are adequate grounds for dismissal, 1 when social considerations (age, health status, etc.) influence the choice of which worker to dismiss, 2 when attempt to retrain worker to adapt for a different job is compulsory prior to dismissal, 3 when worker capability can never be a basis for dismissal.
- **Compensation at 20y**: the compensation payable to worker who has been unfairly dismissed after 20 years with employer, in months of regular salary.
1.21 **Flexible working arrangements are considerably underdeveloped.** The vast majority of employees in Croatia work full-time; only about 3 percent are part-timers, substantially lower than in the EU (almost 18 percent). The difference is particularly great for female workers. In the EU, 33.1 percent of female employees work on a part-time basis; the comparable figure for Croatia is only 4.1 percent (see Bisogno 2000).

**Human Capital Development and Education Policies**

1.22 The Government of Croatia has kept education reform on its agenda since the country gained its independence in 1991. However, a coherent national strategy has not been pursued, as education remained mostly a political issue, and reforms implemented in 1991-95 did little to improve quality, efficiency and equity of access to education. To date, the Government’s foremost priority and politically most visible item on the reform agenda has been replacement of the old “Yugoslav” content of education with a “Croatized” curriculum and national traditions. This goal covers a whole range of issues in history, geography, literature, language training and beyond. However, these objectives also feed into traditional approaches to pedagogy, which relies on the learning and repetition of facts (even if these facts are considered new and modern ones). This is an approach that has been considered outdated across Europe, including a number of other countries of the CEE.

1.23 Outdated curricula are not the only weakness of the Croatian education system. The system accumulated handicaps across other dimensions: governance, finances, assessments and quality control, institutional structures, teachers policies. The key issue is an early tracking into highly specialized inflexible programs. In the present system it is very difficult for the individuals to modify their education and training profile within the school system. Most importantly, in absence of adequate forms of second choice training and bridging programs, the system does not provide an adequate strategy of schooling and intellectual development for those whose performance is considered to be at medium or low levels. This is an undesirable direction for a new market economy and an open society.

**Figure 1.2: Net secondary education enrollment rates (percent)**

![Bar chart showing net secondary education enrollment rates for Croatia, Hungary, Poland, Estonia, Lithuania, Latvia, and Romania.]

Source: WDI indicators and TRANSMONEE database.

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1.24 Structural problems in education system lead to its low efficiency and the fall in demand for its services. Figure 1.2 shows that post-primary education in Croatia lags behind other transition economies, even at a rather basic level (secondary). Thus the system is not including a substantial fraction of labor market entrants, lowering their chances for getting productive employment in the future.

1.25 The health sector in Croatia offers almost universal access to a wide range of health services and benefits. However, the present range of services is not fiscally sustainable, and does not represent a cost-effective response to the existing burden of disease in the country. The sector represents a major fiscal problem, and increases the vulnerability of overall public sector finances. At the same time, there is a sizeable group of population which is excluded from the system (see Chapter 3).

Social Insurance and Social Assistance Programs

1.26 The Croatian public sector is the largest in Central Europe and has been on a rising trend, unique in the region (Figure 1.3).

Figure 1.3: Consolidated Government Expenditures, 1993 and 1997

Source: Consolidated Central Government Expenditures (does not include municipal budgets). Madzarevic-Sujster (2000)

1.27 Social spending (social insurance, protection, social sectors, including education, employment, unemployment, social protection, pensions and health care, war-related expenditures including reconstruction) were to large extent responsible for such a rapid expansion. In 1999, net of administration costs, all layers of government spent 26.4 percent of GDP on social programs, or 48 percent of consolidated Government expenditure. In 2000 this trend continued, and the share of social programs has expanded

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8 The structural problems of health sector and outcome of health policies are discussed in detail in the upcoming World Bank Public Expenditure and Institutional Review.
further to half of State spending. The total cost of all social spending programs, including the salaries of public employees who are administrating them, was around 34.4 percent of GDP in 1999. Figure 2.9 also illustrates why Croatia has such a high level of social spending: public expenditure on health and social transfers (including pensions) clearly outpace what is observed in other countries.

1.28 Pension system. Pensions represent the largest item in social expenditures of the public sector. Croatia still operates a mandatory, pay-as-you-go (PAYG) pension system, although the reform to introduce a multi-pillar system is in full swing. Generous benefits combined with a rapid fall in number of contributors per beneficiary has meant that spending is high and unsustainable. A low retirement age, easy access to early retirement, the creation of merit pensions after the war, as well as the Constitutional ruling against the Government’s decision to adjust pensions with prices, have pushed pension expenditures from 9.2 percent of GDP in 1994 to 13.5 percent in 1999. Despite this high level of spending, many pensioners receive very low benefits. In 1998, 47 percent of pensioners received benefits of less 1000 kunas per month. Moreover, more than one fourth of individuals aged 60 years old and older did not receive any benefit.

1.29 Housing subsidies is an example of poorly targeted, expensive and inefficient system. Utilities’ policies present serious equity problems. Electricity, communication and gas companies dominate their sectors and enjoy quasi-monopolies. Tariffs were twice as high as in comparable economies prior the oil prices increases. The weak enforcement of payment discipline, which so far has been the strategy in Croatia to address social considerations, is the most inefficient way to alleviate the social burden related to increased costs of energy. Recently, as much as 25 percent of electricity consumed was not paid for, or paid for with considerable delay. On the other hand, there is no coherent assistance program for the poorest segments of the population that lack the income to pay utility bills. Municipalities run special assistance programs to help the poor with payments of debts to utilities, but multiple criteria are used in different parts of the country with no attempt to unify the approaches and develop a consistent policy.

1.30 The energy tariff system applied in Croatia is profoundly anti-poor. There are two tariffs for household electricity consumption for different hours of the day, but households are unable to control the costs of consumption because only some households have two tariff counters for electricity use and those with one counter always pay at the higher rate. As international comparisons show, the Croatian tariff system and the

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9 These data are derived from the official finance statistics (on a cash basis for Croatia). Payments made through shares or through humanitarian sources are not included in the estimation, neither are private sources. Detailed table on social expenditures can be found in the background paper for this study by Madzarevic-Sujster.

10 The electricity tariff at the end of 1999 was US$ 0.06 as opposed to a range of US$0.03-0.045 in CEE countries.

policies of ad-hoc assistance perform poorly compared to two or three block tariffs (Lovei (2000)).

1.31 **Reconstruction of demolished homes.** This is another example where the unintended social consequences of the program are far from being pro-poor. The cost of the program to the budget amounted to an average of 1 percent of GDP each year from 1995 to 1998 (see Madzarevic-Sujster (2000)). The program requires substantial matching spending by beneficiaries, which the poor often cannot afford. In the social assessment participants in the areas affected by war complained that government-financed reconstruction of their homes has been slow, insufficient and of very low quality. The program is also prone to corruption and discrimination.

**Consequences: Uncompetitiveness, Unemployment, Inequality**

1.32 The piecemeal approach to structural reforms followed in the 1990s and accompanied by lax fiscal policy backfired through loss of competitiveness, rising unemployment and growing inequality.

*Uncompetitiveness*

1.33 Overvalued exchange rate together with high taxes is putting many sectors of the Croatian economy at a competitive disadvantage, as demonstrated in lackluster export performance: for example, in 1993 Croatia’s exports were at the same level as those of the Czech Republic, Poland and Hungary; subsequently, however, these other countries’ exports have quadrupled, while Croatia’s have stagnated.

1.34 Insufficient **enterprise restructuring** is one of the root problems of the poor financial performance of the enterprise sector, and the growing problem of arrears. Poor profitability limits investment resources, while arrears erode the proper system of market-driven incentives; as a result growth in productivity is compromised.

1.35 Resolution of social and political tensions through granting wage increases in a environment of highly centralized wage bargaining led to escalating wage increases. The level of wages in Croatian industry is substantially higher than that of other CEE countries (Figure 1.4). Those high wage levels limit Croatia’s comparative advantage in labor intensive production and thus limit employment opportunities for unskilled workers.

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12 The Government finances only reconstruction of the outside structures (exterior walls and roof), and a standard number of square meters per inhabitant registered at the address. Households are left with the costs of renovating interior walls, painting, etc.

13 Losses of loss-making enterprises still exceed the profits of profitable ones.
1.36 Dealing with the falling demand for labor the Croatian Government has relied excessively on early retirements, pushing redundant workers out of economic activity altogether. While this strategy helped to minimize the social stress of reducing excess employment, it effectively slowed down the pace of labor reallocation, limited potential productivity gains and further compromised the competitiveness of economy.

1.37 The rising number of transfer recipients and the smaller number of contributors forced the Government to rise taxes, including payroll taxation, making labor more expensive as a factor of production. The current level of payroll taxes and personal income taxes creates a differential of about 80 percent between take-home pay and employers’ labor cost, a level far higher than in Croatia’s main competitors (see Figure 1.5). These high total labor costs inhibit new employment growth, and lead to a proliferation of informal payments,\textsuperscript{14} even for workers in the formal sector,\textsuperscript{15} to avoid taxes.

\textbf{Figure 1.5: Tax Burden as \% of GDP by Types of Taxes, Cumulative 1995-98}

Note: Payroll = total social security contributions and other payroll taxes, VAT = value added tax, PIT = personal income tax, CIT = corporate income tax, tariffs = taxes on foreign trade, other = excises and property taxes. Source: M. Keen et al (IMF, 2000).

\textsuperscript{14} As shown in Madzarevic and Mikulic (1997) the growth of the informal economy is largely due to economic activities seeking to avoid regulation and taxation. Informal activities were estimated to represent between 23 and 33 percent of recorded GDP in 1995.

\textsuperscript{15} In HBS (1998) 30 percent of wage employees declared additional labor earnings.
Nowhere is the failure to create an economic environment conducive to innovation and productivity growth as evident as in Croatia's underdeveloped Small and Medium Enterprises. Croatia still lacks an active and dynamic SME sector. Like other transition countries, Croatia inherited from the previous system a preponderance of large enterprise and a business culture which emphasized economies of scale, mass production, vertical integration, and self-sufficiency marked by in-house production instead of subcontracting/outsourcing. Total private SME employment has not increased at all between 1996 and 1999. Figure 1.6 shows how far Croatia lags behind other CEE countries in the extent of SME development—mainly reflecting a poor business environment; difficulties in finding financing at reasonable terms; high taxation; and the lack of a well articulated pro-SME policy in the country.

![Figure 1.6: Share of SME in Total Wage Employment in 1998](image)

Note: SME—small and medium enterprises with less than 100 employees in all sectors of economy. Source: Business Environment and Enterprise Performance Survey (EBRD-World Bank, 1999).

Privatization favoring insiders also deterred the flow of Foreign Direct Investment (FDI). During 1994-98 FDI amounted to only 2.2 percent of GDP—below the CEE average and less than half that of Hungary. In particular, "greenfield" investment was very low, reflecting a general lack of incentives and a relatively poor investment climate. Recent granting of substantial incentives to FDI has not changed the situation dramatically.

Unemployment

Unemployment responded to higher labor costs and poor incentives structure. Domac (1999) investigated the wage–unemployment dynamics in Croatia using a VAR model based on monthly data. His findings show that, while most of the upward trend in unemployment is structural in nature, wage increases and high payroll taxes also contribute to rising levels of unemployment, after controlling for the level of economic activity. Specifically, over a 36-month timeframe, variations in real wages explain 26 percent of the variation in unemployment. Decision making dominated by insiders is also not conducive to employment generation.

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16 IMF (1999)

17 As the literature on structural unemployment in Europe witnesses—see Nickel (1995).
1.41 Unemployment, when measured in a consistent and internationally comparable way is not nearly as high as registered, although it is higher than in most CEE countries and is on a rising trend. There are two different measures of unemployment in Croatia, which give quite different numbers. Taking the number of unemployed persons registered at the Croatian Employment Office (CEO) and dividing it by the total labor force, estimated by taking employment levels from administrative sources, gives the **registered unemployment rate**. By the end of 1999, and after years of growing more or less steadily, this rate reached **20.8 percent of the labor force** (in the year 2000 it increased to 21.4 percent). But taking the number of unemployed persons and the total of the active population from the Labor Force Survey gives a completely different **LFS unemployment rate**, which stood at **12.6 percent** by the first semester of 1999, and increased to 15 percent by the mid-2000.

1.42 The difference between the registry and LFS unemployment numbers is among the largest in Central Europe, second only to Slovenia (see Bisogno). The LFS reveals that only 60 percent of those registered as unemployed at the CEO are truly (ILO) unemployed. The remaining 40 percent either are working in the informal sector (15 percent) or, more often, are not looking for a job or have no intention to work (and hence count as inactive by ILO standards). There is no or little check on the willingness and availability for work among those who are registered. Therefore the registered unemployment rate reflects the incentives to register, primarily in order to receive health insurance and other social benefits. The LFS-based measure of unemployment is less subject to distortions and consequently more reliable. In addition, this indicator of unemployment, unlike the registered unemployment rate, is internationally comparable as it is not subject to the international variations in registration procedures and regulations. Croatia’s rate, though roughly half that of the registered unemployed, is nevertheless high by international standards (Figure 1.7).

**Figure 1.7 Unemployment rates in 1998 (ILO methodology)**

![Unemployment rates in 1998 (ILO methodology)](image)


1.43 There are very limited opportunities for those unable to find jobs as wage employees, because the environment for self-employment activities is poor. Non-agricultural self-employment is also low in Croatia compared to other CEE economies (see Figure 1.8, despite the considerable premium associated with self-employment, as revealed by HBS: the self-employed in Croatia earn 2.5 times more than an average employee, a figure which far exceeds the crude premium in Hungary (40 percent), Poland
(70 percent) or the Czech Republic (90 percent). This suggests the existence of high rents associated with entrepreneurial activities. Usually, such high rents reflect entry barriers and corruption.

1.44 The businesspersons interviewed in the social assessment see a sharp division between the legal environment before and since 1994, when registration laws increased the cost and complexity of registration. In addition, since 1998, many self-employed respondents have noted a culture of non-payment of contracts (by government agencies and other private entrepreneurs), and a restrictive tax and legal environment. The resulting trend of fewer people starting their own businesses is also evident from other sources.

![Figure 1.8 Non-agricultural Self Employment as % of Total Non-Agricultural Employment](image)


**Maldistribution of Gains from Growth**

1.45 The economic environment created by Croatia’s distinctive transition experience has tended to create substantial divergence in living standards between different social groups and households.

1.46 Sectoral data reveal deeply unequal growth of earnings for those who do have jobs. The state sector has led the process of wage increases, generating the most significant percentage increase in the wage bill; it is also the only sector that has consistently expanded employment. The overall improvement in wages has been concentrated in three activities marked by direct or indirect state intervention (transport and communications, finance, and the public sector), which accounted for 40 percent of

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19 Croatia exhibits levels of rents in self-employment similar to those in Russia, a country notorious for a poor business environment. – Ibid.

20 Malekovic et al. (1998).
1998 formal employment and absorbed almost all the economy-wide increase in the real wage bill between 1997 and 1999.21

Figure 1.9: Wage growth rates for low and highly-paid workers: 1998/96

Source: LFS (1996 and 1998) nominal after tax wages, percentiles of wages in 1996, only full-time workers in paid employment

1.47 Labor Force Survey data on the actual growth of nominal wages of individual workers between 1996 and 1998 confirm this picture. They show that the pay of those with wages below the median level has been growing more slowly over the period than that of higher paid workers at the 60th and 75th percentile of the wage distribution (see Figure 1.9). Clearly, the benefits of growth have not been distributed equally.

1.48 Average wage in public administration exceeded the average manufacturing wage, and this gap has been increasing from 19 percent in 1997 to over 70 percent at the end of 1999. Wage increases granted to civil servants in the end of 1990s have had an effect on wage expectations of workers in private and privatized enterprises. Particularly strong increases in salaries have been recorded in the least competitive, but highly unionized industries (textiles, rubber and plastic). It soon became evident that much of these wage claims were not sustainable. Wage arrears, which are confined mostly to FSU countries and that can hardly be found anywhere else in CEE, have spread through the Croatian economy; at the beginning of 2001 one in ten employees in Croatia was not paid on time. Arrears are a very powerful driver of inequality and a source of risk and volatility for household welfare.

1.49 The gap between the rich and the poor in Croatia is wider than in other countries (Figure 1.10). Increasing inequality was a common feature of transition, as markets started to put a premium on scarce skills and entrepreneurship. However, inequality in Croatia is substantially greater than that observed in successful transition and established market economies.

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21 Data from CBS.
1.50 Inequality weakens the impact of growth on poverty. Inequality reduces the likely future effects of growth on poverty. The estimated elasticity of poverty with respect to growth in Croatia is 2.1: that is, for every one percent growth in consumption, poverty falls by 2.1 percent. This relatively low elasticity is due to high inequality: Ravallion and Chen (1997) estimates that average growth elasticity for low inequality countries is 3.1. High inequality also amplifies the negative effects of growth shocks, leading to sharper crisis in response to adverse external developments as distributional conflicts between the rich and the poor impair the functioning of democracy (Rodrik, 1999).

1.51 Inequality has an adverse societal impact. Empirical research has demonstrated that, other things being equal, higher inequality leads to significantly higher violent crime rates, because of the relatively higher pay-off from crime to those who are poor (Fajnzylber, Lederman and Loyaza (1999)). Inequality also leads to lower participation in civil society groups, thus reducing opportunities for the poor to influence policies (La Ferrara (1999)).

1.52 To understand better the reasons behind the higher levels of inequality in Croatia than in other countries, Table 1.4 presents a decomposition of inequality in disposable income. The main driver of inequality in Croatia is income from entrepreneurial activities and informal sector earnings ("other market income", including net income from self-employment, additional earnings, free-lance income, income "from direct negotiations", and profits). These sources account for more than half of all inequality and close to a third of total incomes. This is in sharp contrast with the fact mentioned earlier that the self-employed constitute only 7 percent of non-agricultural employment, and demonstrates the existence of high rents.

1.53 State transfers in aggregate do not act to reduce inequality, which means that richer people, on average, get higher absolute amounts of state transfers than poorer individuals. This is a disappointing result given the high share of transfers in GDP. In Croatia a substantial part of income is informal and therefore not directly taxed; hence,
similar tax rates on total income imply much higher taxes on formal income in Croatia than in comparator countries.

Table 1.4: Decomposition of inequality in incomes in selected CEE countries.

<table>
<thead>
<tr>
<th></th>
<th>Croatia</th>
<th>Hungary</th>
<th>Czech Republic</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share in income</td>
<td>Contrib. To inequality</td>
<td>Share in income</td>
<td>Contrib. to inequality</td>
</tr>
<tr>
<td>Wage income</td>
<td>59.6%</td>
<td>0.188</td>
<td>74.1%</td>
<td>0.277</td>
</tr>
<tr>
<td>Other market income</td>
<td>32.2%</td>
<td>0.232</td>
<td>4.7%</td>
<td>0.025</td>
</tr>
<tr>
<td>In-kind income***</td>
<td>6.5%</td>
<td>0.008</td>
<td>7.9%</td>
<td>0.015</td>
</tr>
<tr>
<td>Private transfers</td>
<td>5.7%</td>
<td>0.014</td>
<td>2.6%</td>
<td>0.006</td>
</tr>
<tr>
<td>Pensions</td>
<td>15.6%</td>
<td>0.002</td>
<td>24.2%</td>
<td>0.028</td>
</tr>
<tr>
<td>Other transfers</td>
<td>3.9%</td>
<td>0.001</td>
<td>10.0%</td>
<td>-0.019</td>
</tr>
<tr>
<td>Taxes and contributions</td>
<td>-23.5%</td>
<td>-0.092</td>
<td>-23.4%</td>
<td>-0.100</td>
</tr>
<tr>
<td>Net income</td>
<td>100.0%</td>
<td>0.352*</td>
<td>100.0%</td>
<td>0.232*</td>
</tr>
</tbody>
</table>


1.54 Thus, inequality is high, and is driven primarily by the size of the informal economy, by the lack of a competitive environment, and by a failure to redistribute. Whether existing income disparities increase or fall in the future depends crucially on the ability of the Government to implement reforms in the real sector, together with reforms in public expenditure, especially with respect to targeting of social spending.

1.55 The pattern of inequitable distribution is evident from LFS data, which show substantial sectoral, regional and gender gaps, even controlling for the human capital characteristics of workers (see Bisogno). All other characteristics being equal, a professional without post-graduate studies earns on average 69 percent more than someone with uncompleted primary education, and a worker who has attained post-graduate education level earns twice more than a worker with uncompleted primary. These high returns are combined with relatively high dispersion of education to produce highly inequitable outcomes: the standard deviation for years of schooling of the population over 25 years old is 4.2 in Croatia (with a mean of 9.5), higher than in Argentina and Uruguay and significantly higher than in European countries. This points to the existence of a stratified educational system which fails to operate as a mechanism for social mobility.

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22 See "Facing Up Inequality in Latin America". IDB, 1998, Ch. 2.
2. WHO ARE CROATIA'S POOR?

2.1 Analyzing Croatia's poverty profile is essential to understand the causes of poverty, and to formulate actions that address these causes in the most efficient way. This chapter asks how many are the poor people in Croatia, who are the poor, and identifies key economic causes of poverty.

A. THE SCALE OF POVERTY IN CROATIA

2.2 In the broadest definition, poverty is the status of a person who falls short of a level of economic welfare deemed to constitute a reasonable minimum, either in some absolute sense or by the standards of a specific society. This minimum level is usually called the "poverty line". Analysis of poverty depends on the accurate measurement of incomes or consumption levels. Information on consumption and income is obtained through sample surveys, during which households are asked to answer detailed questions on their spending habits and sources of income. Between 1991 and 1998 there was no representative household budget survey on the territory of Croatia. The analysis presented in this report is based in the first representative survey of incomes and expenditures of households in Croatia since Independence. It was conducted by the Croatian Bureau of Statistics in 1998 and covered 3,123 households randomly selected throughout the country.

International Comparisons

2.3 Any poverty number depends critically on the choice of methodology, especially on the poverty line chosen. It is therefore often hard to compare poverty rates across countries; comparisons can be meaningless if countries' poverty lines are widely different. It is therefore necessary to choose a comparable poverty line and limit comparisons to countries which have recent representative household survey data - the only basis for determining how incomes and consumption are distributed in a society.

2.4 The World Bank\textsuperscript{23} uses internationally comparable poverty figures based on a line of US$4.30 per person per day at purchasing power parity (PPP). This poverty line is applied to per capita consumption expenditures. The results of a recent update for countries in transition indicate that Croatia's poverty rate is among the lowest in the region (Figure 2.1), but this diagnosis is deceptively comfortable.

2.5 Two factors determine the poverty rate: the average level of well-being in a society and how this well-being is distributed between individuals and social groups. The countries shown in Figure 2.1 have widely different incomes expressed in PPP dollars. One way to assess more accurately where Croatia stands in terms of poverty is to

\textsuperscript{23} See WDR 1996 From Plan to Market
simulate what the poverty rate might be if the distribution of welfare were comparable to other countries. Applying this method we estimate that the poverty rate in Croatia would in fact be **lower by a third** (3 percent poor instead of 4 percent) if inequality were comparable to that in a range of other CEE countries.

**Figure 2.1: Absolute Poverty Rates, International Poverty Line**

<table>
<thead>
<tr>
<th>Country</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td></td>
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<tr>
<td>Poland</td>
<td></td>
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<tr>
<td>Romania</td>
<td></td>
</tr>
</tbody>
</table>


### Setting the National Poverty Line

2.6 As already noted, however, there are drawbacks to applying a single standard to different countries, and there are many methodological difficulties in estimating PPP. Moreover, for policy makers what matters is the extent of poverty based on a nationally relevant standard. Basic needs do vary across time and societies. Therefore and each country uses its own lines which are appropriate to its level of development, societal norms and values. Thus, poverty needs to be defined in a particular cultural context and in terms of specific local conditions.

2.7 A Social Assessment conducted specifically for this study aimed to establish what people in Croatia identify as poverty. It found little public awareness of absolute deprivation in the country. The non-poor focus group respondents assume the poor to be marginal, lazy (unwilling to work), alcoholics, etc. **The higher up on the social ladder, the less knowledge there is about the situation of the poor.** But for the poor, the stereotype does not seem to fit their own experience, since for the most part they are neither beggars nor homeless. The continued lack of information about poverty reflects the fact that poverty is mostly experienced behind closed doors, among home owners and working families who generally seek help from their immediate relatives. It also confirms the expectation that in a relatively wealthy society, extreme poverty is rare and such poverty as exists is a matter of **social exclusion** rather than physical deprivation.

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24 This result applies Hungary's distribution (TARKI household survey) of consumption to Croatia mean per capita consumption at PPP. Similar, but smaller order of effects are obtained using Polish or Romanian data.
2.8 Poverty can be considered as the inability to meet what a given culture defines as basic physical and social needs. In Croatia, basic needs include:

- food (a varied diet which includes meat, milk, fruits and vegetables);
- clothes;
- housing, utilities (electricity, water, heat, phone) and basic appliances (refrigerator, gas or wood stove, heating stove, TV);
- school supplies and textbooks;
- health costs; and
- resources that are in line with cultural and social norms such as reciprocity in social networks.

**Box 2.1: The Routine of Poverty: Unemployed in Zagreb**

BZ is 58 years old and lives with his wife, daughter and eight-year-old grandson in an apartment in Zagreb. The building is old but well kept. The 73-square meter apartment consists of two rooms: a kitchen and a bedroom. It is very cold because the family is saving on utility costs. All the furniture and appliances are twenty years old. BZ inherited the right to the apartment from his mother in 1998 and they have been paying the mortgage since then. In accepting the apartment, they lost the right to 560 kuna in welfare benefits.

BZ worked for 29 years at the "Koncar" factory until he was fired as "surplus labor" in 1991. At the time, he sold their old car for 300 DEM. His 29-year-old daughter works as an unregistered saleswoman in private shops earning 1500 kuna a month (when she works). BZ's wife is a housewife and has never worked. They are all registered at the unemployment office to receive health benefits. In three years, BZ will be eligible for a 750 kuna pension. He manages to get small jobs two to three times a month for two to three days. His wife also cleans for a neighbor who pays her 60-80 kuna a month plus a chocolate bar for her grandson and some coffee. Last autumn, BZ's wife sold on the street some of her old clothes, pants and bathrobe for 10 to 15 kuna on a few occasions. All these activities do not add up to their total expenses. Without a permanent income, they are now "riddled with debts."

They have bread every day in the household, milk, stewed cabbage, greens, leeks, potatoes or beans. They eat meat once a month, but only the cheapest chicken or 300 grams of ground meat (12 kuna per kilo), which they eat with pasta. On several occasions a month, they run out of coffee or tea. Their grandson eats the same as the adults; his only extra is a monthly chocolate bar. They get some vegetables two to three times a year from BZ's sister who has a garden. But she is on a pension and cannot afford to help them much. Several times a year, BZ gets 200 to 250 kuna from one of his friends who receives a pension. He doesn't have the courage to borrow more because he knows that he cannot repay the money. BZ and his family believe that the majority of people survive thanks to help from relatives, and that others (like themselves) are "doomed to failure."

Source: Gomar E. Social Assessment of poverty in Croatia.

2.9 There is no national official poverty line in Croatia. This study has estimated the level of total expenditure of households in Croatia at which families, after paying for essential non-food items, just attain minimal nutritional needs. This level of expenditure

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25 The Ministry of Welfare uses many thresholds to establish eligibility for welfare benefits (ranging in 1998 from 350 kn/month per beneficiary for the basic allowance to 525 kn/month per beneficiary for disabled beneficiaries). There is a poverty line used by the Confederation of Independent Trade Unions (HRK 55,763 per year for a couple with two children). This poverty line relies on a per capita equivalence scale (thus ignoring economies of scale) and a non-food component, which reflects the consumption patterns of the average Trade Union member, not that of a poor household.
therefore represents an **absolute poverty line** and amounts to HRK 41,500 per year (in 1998 prices) for a couple with two children or 15,474 for an “equivalent adult.”

**Box 2.2: War and Poverty**

About a third of the country was affected by the war, directly by occupation or indirectly (i.e., zones which were mined and suffered from bombing). This was-affected area depressed compared to the rest of Croatia. The region had historical links to the former Yugoslavia (Serbia and Bosnia) while the rest of the country faces outward to Italy, Hungary and Slovenia. It used to be more mixed ethnically and has seen its communities demolished and rebuilt around nationality.

All sources of household data in Croatia cover only the territory that was not directly affected by occupation; thus they may underestimate the true extent of poverty. We address the issue of coverage in two ways. First and most importantly, the **qualitative study** assesses poverty among those not covered by the existing household surveys (with over-sampling of sites from the previously occupied areas). Second, we use supplementary sources (the registry of refugees and returnees, UNHCR) to estimate how the exclusion of war areas and people living in collection centers may have affected the poverty estimate. According to Census information, 180,000 households lived in 1991 in the areas not covered by the HBS. During the war these areas were severely depopulated and the population has still not returned to pre-war levels. Based on discussions with various local officials, we estimate that in 1998 around 50 percent of the population had returned, leading to a population of about 90,000 households with about 270,000 individuals in the previously occupied area. We guess that the poverty rate in those areas is about three times as high as the national average (based on data provided by the office of refugees and consistent with information from UNHCR about provision of assistance to vulnerable returnees). Furthermore, we assume that about 50 percent of the roughly 25,000 IDPs living in collection centers in 1998 are poor. Based on these rather pessimistic assumptions, inclusion of the previously occupied territories and IDPs living in collection centers would raise the poverty rate by about a fifth, from 8.4 percent to 10.0 percent.

Source: Luttmer (2000)

2.10 We compare this poverty line with a comprehensive measure of household consumption. Our measure of consumption includes consumption expenditures, the rental value of the dwellings, and food items produced at home or received as gifts. We exclude all consumption expenditures on durable items, but include the rental value of consumer durables for which we have ownership information. Whenever we find that consumption per equivalent adult is below the poverty line, we count a household as poor.

**Table 2.1: Absolute Poverty in 1998**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>International Poverty Line (USD 4.30/day at PPP)</td>
<td>7,321 HRK/year</td>
</tr>
<tr>
<td>National Poverty Line</td>
<td>15,474 HRK/year</td>
</tr>
<tr>
<td>Poverty Rate with International Line</td>
<td>4.0%</td>
</tr>
<tr>
<td>Poverty Rate with National Line</td>
<td>8.4%</td>
</tr>
</tbody>
</table>

Notes: Data from 1998 Croatian Household Budget Survey. Poverty lines are expressed in May 1998 prices. The national poverty line is estimated using the Food-Energy-Intake method. Poverty is based on equivalent consumption using the OECD-1 equivalence scale in which the first adult has a weight of 1, subsequent adults have a weight of 0.7 and children have a weight of 0.5.

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26 Using the Eurostat equivalence scale, in which the first adult has a weight of 1, subsequent adults have a weight of 0.7 and children have a weight of 0.5.

27 Consumption poverty is used as this report’s baseline because consumption is generally considered a more accurate measure of well-being than income. About 75 percent of the consumption poor in HBS (1998) are also income poor.
2.11 According to this methodology the poverty headcount in Croatia is 8.4 percent. As with any statistical indicator, this is not a precise estimate: the standard error on the poverty rate (0.6),\textsuperscript{28} indicates that with 95 percent certainty the poverty rate lies between 7.2 percent and 9.6 percent. The poverty gap for the basic line is 1.8 percent. This means that if the country could mobilize resources equivalent to 1.8 percent of the poverty line for every family (both poor and non-poor) and if these resources were given to the poor, all the poor could be lifted out of poverty.\textsuperscript{29} The average deficit is 20.7 percent which means that the poor, on average, have an equivalent consumption level that is 20.7 percent below the poverty line.

**Dynamics of Poverty**

2.12 There was no representative household survey in Croatia between 1991 and 1998; comparison of 1998 data with those for 1991\textsuperscript{30} is impossible, since the surveys have completely different designs. As we have seen, economic developments in Croatia have had rather ambiguous repercussions on household welfare: the incomes of those in employment have been rising, but their number has been shrinking; the number of transfer recipients has risen, but their benefits have been stagnant; there is also an important informal part of the economy not covered by official statistics. Hence, aggregate macroeconomic indicators will not be sufficient to trace the evolution of poverty.

2.13 The only continuous source of micro level data for this period is the omnibus household survey conducted by CEMA.\textsuperscript{31} They suggest that perceptions about the extent of poverty have improved somewhat since 1994 (a politically important point) but that even on a perceptual basis the degree of change has been limited, and by the end of 1999 poverty has been roughly 5 percent below its peak in 1994. In effect, poverty is perceived as stagnant.

\textsuperscript{28} Adjusted for sample clustering.

\textsuperscript{29} In practice, it would require more resources because of targeting errors, the administrative costs of running the transfer program, and the impact on incentives: individuals would change their behavior (lower their income) in order to obtain government transfers.

\textsuperscript{30} A. Posarac (1991) reports that 14 percent of the population of Croatia was poor in 1988; the poverty line used was roughly equivalent to US$2 per day at the current exchange rate (194.5 dinars per capita, per year); this was the second lowest (after Slovenia) incidence of poverty in the Former Yugoslavia. However, it was a year of growing macroeconomic imbalances, and annual data can be misleading. Note that the line applied for this report is higher in dollar equivalent, that the average income of the population is lower, the inflation is higher than in 1988 and yet the poverty is lower, suggesting that in fact the results from two surveys: and old Yugoslav household budget survey and the new survey, are not comparable.

\textsuperscript{31} The survey used a subjective poverty approach. Subjective poverty is an important complementary source of data on deprivation, that is extensively used to analyze various determinant of well-being and social mobility (Ravallion/Lokshin(1999) and Milanovic (2000)). The indicator is obtained by comparing actual income or consumption as reported by a household with the household specific minimum threshold that is considered as a poverty line; on this basis, as many as 80 percent of Croatians consider themselves poor.
B. WHO ARE THE POOR?

2.14 Description of poverty or poverty profile consists of three parts: composition of the poor, risks of poverty by groups of the population and description of the ways in which lives of the poor are different. Knowledge of the composition of the poor helps us understand which policies can reach a large fraction of the poor. By examining poverty risk for different groups of the population, one can gain insights into which factors are associated with poverty. Understanding living conditions of the poor helps to assess the prospects of people lifting themselves out of poverty over time.

Poverty Profile

2.15 While the poor are a heterogeneous group, some general observations based on HBS data can be made (see Figure 2.2).

- Almost three-fourth of the poor live in families where the head has only primary education or less. They are likely to have bad prospects for finding work when they are not employed, or to have low earnings if they do find work;
- Forty percent of the poor live in households with a retired household head, and have no regular earnings from employment;
- Only a third of the poor live in families that could be called working poor;
- The unemployed form the smallest group among poor household heads; but there are many poor households with inactive head of working age; and
- Thus, about half of the poor depend on the state of the labor market (employment opportunities and earnings), another half depend on transfers.

Figure 2.2: Poverty Profile: Education and Employment Status of Household Head

Source: HBS (1998), absolute poverty line.
2.16 The Social Assessment carried out for this study revealed that the poor in Croatia today may be broadly viewed as a combination of two groups:

(a) The poor who have always been poor but who could in the past meet their basic needs thanks to low costs of living, wages from employment, opportunities for additional earnings and/or government assistance. These include those who have never had a permanent job (i.e., only seasonal and contract work), and those who have difficult family situations (e.g., single mothers, isolated elderly people, alcoholics, the sick and handicapped) or belong to ethnic minorities. The prospects for these people to escape poverty are now severely limited; and

(b) The newly poor are the impoverished working class and pensioners who used to be able to share in the leisure and luxuries of the middle class in Yugoslav times, such as taking holidays, buying quality food, owning a car, buying appliances, etc. Small farmers, retired manual workers, and those employed in agro-processing industry constitute the majority of these new poor.

2.17 A poverty profile dominated by the unemployed and the inactive suggests that poverty is a long term condition

Poverty Risks

2.18 Using the HBS (1998) we find four groups in which the risk of poverty is substantially above the national average:

- Unemployed or inactive. Those living in households with an unemployed or inactive household heads are around 3 times more likely to be poor than the population as a whole; the probability of poverty is even greater for the unemployed with small children;
- Poorly educated. Households whose head has primary education or less are about 2 times more likely to live in poverty;
- Elderly without a pension. Elderly individuals without a pension are about 3 times more likely to be poor than an average person. Poverty rates are especially high among the older elderly (70+). Many of the poor elderly have employment histories in agriculture; and
- Living in rural Slavonia or rural Central. Those living in rural Slavonia or rural Central region face about twice the average poverty risk.

2.19 Understanding the respective causal impacts of these factors on poverty requires multivariate analysis. For example, to see why people in rural areas are poorer, the simplest approach is to look within groups of people with the same characteristic.

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32 Because some of these risk factors only affect a small share of the population, a group with a high poverty risk need not necessarily account for a large fraction of the poor. For example, only 2.9 percent of the population lives in households with an unemployed household head and only 5.4 percent live in a household with a head that is inactive in the labor force (but not retired).
(for example, education level): are those living in rural areas still poorer? The background paper by E.Luttmer (2000) looks in detail at such estimates. The next few paragraphs give summary findings.

Figure 2.3: Risk to fall in poverty, by labor market status, age, education, and location

Source Luttmer (2000) based on HBS, bands are 95 percent confidence intervals.

33 The regression predicts the consumption of the household based on its characteristics – see Luttmer (2000). It controls for own education and education of the household head, labor force participation, regions, dependency of children and elderly, and household size.
2.20 Figure 2.3 presents four charts displaying risks of poverty (indicating 95 percent confidence intervals) for the four key factors listed in para. 79 as strong and robust predictors of poverty: education; labor market status; location; and age. Each chart has four bars for any group. The lowest bar always represents the crude (observed) poverty risk for a certain group (relative to average risk of poverty). The other three bars are based on regressions which control for each factor separately, and finally for all factors simultaneously.

2.21 Education. To examine whether labor force participation, region, dependency or household size can help explain the relation between education and poverty the analysis evaluates poverty risks by education after controlling for the partial effects of each other factor. The chart shows that education is a strong independent determinant of poverty. None of the control variables has a large effect on the link between low education and poverty. However, controlling for the partial effects of region decreases the differences in relative poverty risk by education somewhat, suggesting that those living in poorer areas tend to have larger education. On the other hand, controlling for labor force participation or household size seems to exacerbate differences in relative poverty risk by education, suggesting a combination of disadvantage based on human capital and employment opportunities.

2.22 Employment status. Households headed by those who are unemployed and inactive but of working age make up a relatively small fraction of the population, but their poverty risk is very high.

2.23 Controlling for all other factors has little effect on differences in poverty risks between the employed and the jobless. This means that the effect of labor force status is mostly direct and not mediated through any of the other factors mentioned above.

2.24 Age. Children face an average poverty risk, working age individuals face a below-average poverty risk, and the elderly face a higher poverty risk. The roughly one quarter of the elderly who do not receive a pension are in the worst position. For this group, the poverty risk is equal for men and women but seems to rise slightly with age. The elderly with a pension also face an above average poverty risk, but their situation is less dramatic.

2.25 Controlling for the partial effects of education significantly reduces disparities in poverty risk by age, indicating that those with less education are most likely to be older and not covered by the pension system. This may reflect the fact that many agricultural workers (who tend to be less educated), or their family members, were not covered by the regular pension system. Controlling for the other factors has little effect on disparities in relative poverty risk by age.

2.26 Location. The analysis covers five geographic regions, each of which includes urban and rural areas. Most of the regional differences in poverty risk are not statistically significant, with the exception of two regions - Rural Central and Rural Slavonia - with a large and significant relative poverty risk. Poverty risks are significantly below average in Zagreb and in the urban part of Istria.
2.27 Once we control for the partial effects of education, the relative poverty risk in Rural Central and Rural Slavonia becomes statistically insignificant compared to the average. Hence, differences in average educational attainment are a major determinant of differences in poverty risk by region: people living in poorer rural areas have less education - in turn suggesting access to education varies by region.

2.28 A second group of variables is relevant for understanding poverty, but in practice their correlation with poverty is weak or disappears after controlling for the main correlates discussed above. For example, in terms of sector of employment farmers are more likely to face poverty than those working in any other sector. However, after controlling for education, this group’s poverty risk no longer differs statistically from the average. Similarly, once farmers are excluded, there are no differences in poverty risk between private and public employees. There are also no significant differences in poverty risk by gender, or by the gender of the household head. The poverty risk by household size is very sensitive to the choice of equivalence scale. At the baseline scale, smaller (two persons or less) and larger (five persons or more) households face a higher poverty risk. But relative poverty risks for larger household size are not substantially different from average after controlling for education.

How the Poor Live

2.29 Not surprisingly, the life of the poor differs in many respects from that of the non-poor. Being poor in Croatia means: inadequate and monotonous diets (consisting of two or three staples, such as bread, potatoes and milk), lower consumption (where anything beyond strict necessities is a luxury), no savings to rely on, indebtedness, poor housing and often cold living conditions, limited education, and severely curtailing prospects for rising out of poverty (Figure 2.4).

**Figure 2.4: Dimensions of Deprivation Among the Poor**

- Rotten walls
- Leaking roof
- No savings
- No regular employment
- Monotonous diet
- Less than 7 years of school
- More than 2 people per room

Source: HBS(1998)
2.30 To the poor, poverty is more than just a lack of material wealth. In addition, it is important to get a household-level picture of non-material deprivation by looking at the cumulation of disadvantages across key social arenas. To determine the incidence of multiple deprivation, we count the numbers of people who were simultaneously at the bottom of the income, education and employment distributions. There are relatively many - 3 percent of households with prime working age heads - that fall in the bottom quintile in all in three dimensions; in addition, female headed households have twice as great a risk of falling into the bottom quintile in key aspects of well-being, than male-headed ones.

2.31 The sources of income of the poor differ in important respects from those of the general population, as shown in Figure 2.5. First, the poor get a much smaller share of their income from self-employment, entrepreneurial activities and informal sector jobs (only 6 percent as opposed to 20 for the population).

![Figure 2.5: Sources of income: average person and a poor person.](image)

Source: Luttmer (2000) based on HBS (1998). The unit of observation is the individual. The baseline income measure, which includes imputed rent and income from own production, is used.

2.32 Second, the poor derive almost a third of their income from state transfers, compared to only 16 percent for the overall population. This is not surprising given that the elderly are over-represented among the poor. In fact, state transfers are the largest source of incomes for 60 percent of the poor (as opposed to only about a third for the general population).

2.33 Third, the poor rely proportionally more on in-kind income, i.e., the value of “own production”, such as vegetables grown in a family’s garden or small plot of land. This form of income accounts for 13 percent of the total income of the poor but only 5 percent of the income of the general population. In fact this “own production” is the
sole source of income for as many as 20 percent of poor households in rural areas. Work in agriculture and subsistence farming is an important component of the labor force: it is also a survival strategy of the poor. The agricultural sector, excluding subsistence farming, creates 8.5 percent of total value added in the economy, employing around 17 percent of the labor force. Subsistence farming accounts for a further 13 percent of the labor force, producing only 1 percent of GDP. These figures show how dramatically different is the productivity of subsistence farming, hence how poor are chances of its integration in the modern economy.

C. Economic Causes of Poverty

2.34 After evaluating a number of correlates of poverty, the above analysis reveals three that are robust and independent: limited employment opportunities and poor human capital endowment, together with the failure of safety net arrangements to protect especially vulnerable groups.

2.35 We have already noted that employment opportunities are limited in Croatia as a result of certain policies chosen (Chapter 1), a factor which reflects a failure to translate economic growth into employment generation. This problem is compounded by the second factor noted above, the inability of the poor to benefit from even limited opportunities, reflecting their inadequate human capital, primarily low education. Finally, we are going to show that the welfare system in Croatia is expensive, but many of the vulnerable fall between its cracks.

Limited Economic Opportunities

2.36 Economic opportunities are limited because growth has thus far has not generated enough jobs. Despite positive economic growth in 1995-98, the net change in employment has been persistently negative: many old jobs have been destroyed and very few new ones have been created. Meanwhile, over-regulation of employment is limiting opportunities for small businesses and flexible working arrangements, both of which could constitute a viable alternative to wage employment for the poor. Growth has benefited primarily those who have kept their jobs, but for those locked out of employment, the effect has been was close to nil, if not negative. An internationally comparable ILO definition of unemployment shows that Croatia in 1998 had one of the highest unemployment rates in the region (see Chapter 1).

2.37 The poor are at a disadvantage in benefiting from new opportunities. Once locked out of jobs, the unemployed and economically inactive have difficulty in breaking the circle of impoverishment. Half of the LFS unemployed are long term (over one year), and 33 percent have been jobless for over two years. Unemployment rates differ persistently by region, suggesting the presence of structural problems and a high degree of geographical immobility of the labor force. At the end of 1999, regional unemployment, as measured by the LFS, ranged from 5.2 percent to 21 percent.

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34 1998 estimate based on HBS
2.38 **Unemployment and non-employment are stagnant pools.** To capture the magnitude of flows within the labor market, Table 2.2 gives data on job turnover, that is, the movement from and to employment (E), unemployment (U) and inactivity (N) in Croatia, and in the Czech Republic and Poland.

### Table 2.2: Job turnover in selected transition economies

<table>
<thead>
<tr>
<th></th>
<th>E-E</th>
<th>E-U</th>
<th>E-N</th>
<th>U-E</th>
<th>U-N</th>
<th>U-U</th>
<th>N-E</th>
<th>N-U</th>
<th>N-N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia 1998</td>
<td>0.914</td>
<td>0.033</td>
<td>0.053</td>
<td>0.335</td>
<td>0.037</td>
<td>0.628</td>
<td>0.035</td>
<td>0.021</td>
<td>0.942</td>
</tr>
<tr>
<td>Croatia 1996</td>
<td>0.904</td>
<td>0.038</td>
<td>0.058</td>
<td>0.162</td>
<td>0.025</td>
<td>0.812</td>
<td>0.037</td>
<td>0.020</td>
<td>0.928</td>
</tr>
<tr>
<td>Czech Republic 1997</td>
<td>0.953</td>
<td>0.019</td>
<td>0.024</td>
<td>0.429</td>
<td>0.124</td>
<td>0.435</td>
<td>0.041</td>
<td>0.016</td>
<td>0.938</td>
</tr>
<tr>
<td>Poland 1995</td>
<td>0.910</td>
<td>0.035</td>
<td>0.055</td>
<td>0.380</td>
<td>0.156</td>
<td>0.564</td>
<td>0.060</td>
<td>0.032</td>
<td>0.908</td>
</tr>
</tbody>
</table>


2.39 Table 2.2 shows that movements out of employment and the proportion of employees that remain in employment are similar in Croatia and other CEE economies. But it also shows that the pools of those who are unemployed and out of the labor force are much more "stable", or stagnant in Croatia than elsewhere. Once workers have moved out of employment, they seem to have had little chances to come back to work. As many as 81.2 percent of the unemployed in 1996 stayed unemployed throughout the year. On the other hand, Croatia had a smaller share of unemployed or inactive workers who entered employment: in 1996 - only 16 percent and 3.7 percent respectively. In 1997-98, job prospects for the unemployed improved somewhat (one third of them moved to jobs), but this was still a lower proportion than for the other countries in the table. And LFS results for 1999 show that this improving trend of movement from unemployment to work was subsequently reversed (Bisogno, 2000).

**Poor Endowments**

2.40 Those out of work have human capital characteristics that are less valued under the new market conditions. Persons with lower education have both the highest incidence and the longest duration of unemployment. One may think that this problem will be particularly acute for older workers who generally have lower education and did not benefited from late socialist universal access to education. In fact, opposite is true. The unemployment rate is highest and rising among the young. Between November 1996 and the first half of 1999, the youth unemployment rate rose from 26.9 percent to 33.7 percent.

2.41 High unemployment rate among the young suggest that there is not only a problem with quantity of education. There are serious deficiencies in its quality. Most working age individuals who are not employed have either very low educational endowments (primary or less) or narrowly focused skills (vocational school graduates).

2.42 Those who are currently locked out of remunerative employment due to low levels of education are also likely to see their limited opportunities perpetuated for their children. The children of the poor are very likely to drop out of the schooling system early, and differences in access to higher education are now very stark. None of the poor children in the HBS 1998 survey has attended college or university, and only 10 percent attended advanced vocational schools. The poor have access to university only through
relatively few highly competitive scholarships (compared to other CEE countries, Croatia has the lowest share of education spending on stipends). The lack of access to levels of education that are highly valued on the market tends to perpetuate existing inequalities in earning prospects between the poor and non-poor, and to create the potential for the inter-generational persistence of poverty.

Inadequate Safety Nets

2.43 Those who rely on transfers constitute half of the poor. What features of Croatia’s social assistance system make them vulnerable to poverty?

2.44 The poverty profile identifies the elderly excluded from the pension system or receiving low pensions as particularly vulnerable to poverty, and constituting the largest group among the poor. Pension expenditures account for the bulk of social transfers. However, pensions do not adequately and equally protect all elderly and disabled from falling into poverty. One quarter of this group do not receive a pension, one-half receive benefits lower than the poverty line. Specifically those relying on “social” pensions are vulnerable, as their benefits are not linked in any way to the minimum subsistence levels. Other group which has low levels of benefits are farmers, whose families’ benefit is predetermined by their history of contributions to the Farmers’ Pension Fund. Again there is no safeguard on the minimum level of benefits protecting this group from poverty.

2.45 Where pensions are de-facto de-linked from the poverty alleviation objective, social assistance programs targeted have a particularly important role to play. In Croatia one benefit is aimed directly to alleviate poverty - social assistance benefit (or “maintenance” allowance) that is paid out to approximately 80,000 beneficiaries and represents 0.6 percent of total net money incomes of population as a whole. A household would, in principle, qualify for social assistance if its monetary monthly equivalent disposable pre-assistance income was less than HRK 350 (about US$55 at the time of the survey), - an amount way below any reasonable estimate of the poverty line. A mere 5.2 percent of households report receiving social assistance. Despite these low overall amounts, the importance of social assistance for the recipient households is substantial, covering on average over a quarter of the expenditures of poor households.

2.46 Performance of the system. Using the approach from Braithwaite et al. (1999), Figure 2.6 below compares social assistance systems in seven transition countries.

2.47 How does Croatia's social assistance system perform compared to other countries? The first observation stemming from Figure 2.6 is Croatia’s relatively modest level of spending, which is in sharp contrast with its overall exceptionally high level of spending on social transfers. In order to compare how well the transfer mechanism works in different countries, we need to assume that the objective of the social assistance system in each country is the same. As in Braithwaite et al. (1999), we assume that the poor in each country are the bottom ten percent of the population and that the objective of social assistance is to help them. The success of the social assistance system is then measured by how much of the (pre-assistance) poverty gap of the bottom decile is eliminated (a measure of effectiveness), and how much of disbursed social assistance is received by them (a measure of efficiency). As Figure 2.6 suggests, Croatia's results are
remarkable. Social assistance covers about 10 percent of the poverty gap of the bottom decile, the highest proportion for all countries shown except Hungary. Relative effectiveness is defined as the percentage of the poverty gap eliminated (i.e., effectiveness) divided by the resources used in the system (i.e., the ratio of spending on social assistance to total expenditures). This indicator combines the achievement (how much of the poverty gap was reduced?) with its costs (how much was spent to achieve this?). On this count Croatia performs better than any country listed in Figure 2.6.

![Figure 2.6 Performance of Social Assistance.](image)

Note: Efficiency defined as the percentage of social assistance received by the lowest decile, effectiveness is the assistance to the bottom decile as a percentage of the poverty gap. Relative effectiveness is the ratio between effectiveness, and the size of social assistance (the latter expressed as percent of total expenditures). Source: Croatia – own estimates based on HBS(1998). Other countries and definitions - Braithwaite et. al (1999).

2.48 This analysis suggest that Croatia has a strong capacity in its administrative system for well-targeted social assistance. This capacity is underutilized, however, because the amounts spent on social assistance are low compared to other social programs.

2.49 About half of the potential beneficiaries of transfers are not receiving social assistance. Therefore the "error of exclusion" is about 50 percent. Can we explain who among the poor are excluded from social assistance and why? We find in Croatia that owning a house or car or being employed or having one's own business do matter. Very significantly, household with poor housing conditions are more likely to receive assistance. Gender of household head also matters. In other words, the system seems to rely quite heavily on a set of observable characteristics that are closely correlated with poverty. It also seems to use the judgement of social workers. This mechanism works quite well in identifying certain (but not all) groups of the poor.

### D. POVERTY REDUCTION: PROSPECTS AND PROBLEMS

2.50 Central to any poverty reduction strategy is robust and balanced economic growth. Growth is critical for poverty alleviation for three reasons. First, it will raise the wages of the working poor, giving them an opportunity to escape poverty. Second, it will provide employment opportunities for unemployed and inactive workers – a group with especially high poverty risks. Third, it will provide the tax base for programs to alleviate
poverty among those who cannot otherwise escape poverty. Table 2.3 explores what would happen to the poverty rate in one year, in 5 years and in 10 years under various growth scenarios. The critical assumption underlying these projections is that growth is evenly distributed, i.e., that both rich and poor experience the same real increase in consumption.

<table>
<thead>
<tr>
<th>Annual growth</th>
<th>1 year</th>
<th>5 years</th>
<th>10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>-2%</td>
<td>9.1%</td>
<td>11.8%</td>
<td>15.5%</td>
</tr>
<tr>
<td>0%</td>
<td>8.4%</td>
<td>8.4%</td>
<td>8.4%</td>
</tr>
<tr>
<td>+2%</td>
<td>7.7%</td>
<td>5.8%</td>
<td>4.4%</td>
</tr>
<tr>
<td>+4%</td>
<td>7.0%</td>
<td>4.4%</td>
<td>2.0%</td>
</tr>
<tr>
<td>+6%</td>
<td>6.6%</td>
<td>2.9%</td>
<td>0.8%</td>
</tr>
<tr>
<td>+8%</td>
<td>6.0%</td>
<td>2.0%</td>
<td>0.4%</td>
</tr>
<tr>
<td>+10%</td>
<td>5.9%</td>
<td>1.5%</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

Note: These projections assume that the equivalent consumption distribution remains constant, i.e., that everybody experiences the same rate of consumption growth.

Source: simulations using HBS (1998) and assuming similar increase in consumption for all households and constant poverty line (in real terms)

2.51 As the table shows, sustained positive growth can substantially reduce poverty rates over the longer term. But these poverty reduction projections will only materialize if the government ensures that those at the bottom of the income distribution share equally in growth. Over the short term, growth has a more limited impact on poverty, and other policies are called for.

2.52 Slow restructuring of the real sector is hindering employment growth. The fear of job losses associated with drastic enterprise restructuring (including major downsizing) has stifled the progress in the enterprise sector, depriving Croatia’s economy of all the long-term benefits of restructuring. One consequence of inadequate restructuring of Croatia’s enterprise sector is decapitalization and a decline into obsolescence. Many Croatian enterprises have not been investing enough in modernizing their plants, primarily because of inadequate cash generation from operations and lack of new equity investments by outsiders. As a result, a major part of the enterprise sector has slowly but steadily fallen into technical obsolescence as compared to competitors in other countries. In capital intensive industries and in highly competitive sectors, this slide into obsolescence has reached the point of no return for a number of enterprises which have no prospects of survival. Keeping them alive through direct and indirect State subsidies will lead to a waste of resources and should be ended. But for restructuring to be socio-economically acceptable, a comprehensive social package with measures to deal with large scale lay-offs (including retraining, redundancy payments and assistance to start new business) must be put in place.

2.53 How much labor does Croatia still need to reallocate? A comparison of sectoral employment rates with selected OECD countries (i.e., the average employment structure in France, Greece, Italy and Spain) shows that Croatia is as close to its “target” structure of employment as Hungary, or the Czech republic. But so far, adjustment has been operating through labor shedding in stagnating sectors (manufacturing, transport, power

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generation), and not through job creation in expanding sectors (services, finance). Thus the decisive move towards the sectoral employment structure adequate for a market economy is still to be made. Given the existing pattern of slow labor market adjustment, the evolutionary process of moving towards a market-oriented pattern of employment may take years to realize; meanwhile, inefficiencies are likely to persist.

Box 2.3: Facilitating restructuring: benefits and costs

If Croatia is to converge to a sectoral structure of employment close to that of the EU (the Southern group of countries, as defined by Jackman and Pauna (1997)), further labor reallocation must take place. In particular the share of tertiary employment is expected to grow, given the existing differences with EU countries and the importance of the tourism sector in Croatia, and its potential for further development. There is also some scope for moderate re-industrialization if competitiveness is restored. Agriculture is expected to lose at least half of its workforce and substantially to raise its productivity.

The costs stemming from the Government's economic reform program, and particularly the layoffs of personnel, are expected to be concentrated in the near term, while the benefits are more long-term. The upcoming layoffs are likely to raise unemployment levels before private sector recovery could pick up a substantial part of the labor shed by the state sector. Worse, the workers laid off from this process have proven to be particularly difficult to re-employ (as they are usually older workers with specific qualifications not typically demanded by the private sector). In particular, workers laid off from the state sector are subject to longer unemployment spells than, for example, first time job seekers or workers laid off from the private sector; making the restructuring of the state sector more costly in terms of its effect on overall unemployment.

Thus costing out the budgetary implications is important. But this is not the only problem in designing an adequate response to restructuring. To be effective, measures for protecting laid-off workers must be carefully designed and targeted, and there should be continuing social monitoring of displaced workers to ensure that services reach the most needy and that the most vulnerable are identified early and provided with special assistance.

Based on the sectoral analysis of "Croatia: A Policy Agenda for Reform and Growth", we begin with a forecast of how many workers are likely to be laid off. The total number of those affected by layoffs is estimated at 50,000. Note that moving Croatia towards an OECD structure of employment would mean creation of at least 80,000 jobs in the new expanding sectors (primarily in finance and services). Thus the prospects of those laid off would not necessarily be unduly bleak if bold structural reforms are carried out.

Second, we estimate the future prospects of laid off workers. The assumption here is that the profile of these workers will not be dramatically different from that of those who were affected by lay-offs in 1996-1998. Based on this assumption, we rely on the panel component of the LFS that traces the same workers over three consecutive years. We find that immediately after lay-offs only very few workers find employment, and about a third becomes inactive. After about a year, one third of the laid-off workers move to employment; by the second year, the share of successful job searches increases to one half of all workers that have been laid off. About one third moves into retirement or receives social benefits and the rest becomes inactive and supported by their households.

Severance pay of all laid off workers would amount to 1.3 percent of GDP, unemployment and other costs of benefits (including early retirements) amount to another 0.2 percent. Given that maintaining current employment levels has both direct budgetary costs and important costs in terms of efficiency losses, the order of magnitude of the costs of restructuring is not prohibitively high. It also shows that there a room for increasing the compensation packages to mitigate possible resistance to reform. But such a reallocation would require a reform of the safety net.

Source: Staff estimates based on LFS and World Bank (1999) Croatia: A Policy Agenda...
2.54 Helping growth to trickle down to the poor is important because there are risks of increasing inequality. Growth which accrues mainly to the top of the distribution may do little to improve the living standards of the poor, and increases in inequality may easily swamp the positive impact of growth. A simulation using HBS data shows that a very plausible increase in consumption inequality to levels already observed in Croatia for income inequality (a rise in the Gini index by 15 percent), will lead to an increase in the baseline poverty rate to 14.1 percent. It would then take four years of robust annual 4 percent growth of consumption to undo this and simply return to the initial level of poverty. Figure 2.7 illustrates the effect of this worsening of the distribution over the long term.

Figure 2.7: Poverty Projections with 4% Annual Growth in Consumption

![Graph showing poverty projections with 4% annual growth in consumption.](image)

Source: Simulations based on HBS (1998), assuming poverty line constant in real terms.

2.55 In the short and medium term the key instrument which could be applied to contain increases in inequality is redistribution. As we have seen, Croatia does a lot of redistribution through its budget. As a result of poor targeting, the poverty impact of spending is less than in other countries. A comparison of the results of Government redistribution (through transfers and taxes) in three Central European countries (Hungary, Croatia and Poland) shows that the Government intervention has a relatively limited poverty reduction effect in Croatia (Figure 2.8). This result is particularly disappointing in view of the higher total amount spent from the Croatian budget.

Figure 2.8: Poverty reduction by Government interventions

![Graph showing poverty reduction by Government interventions.](image)

Note: relative income poverty (50 percent of median income per equivalent adult) method: Goodin et al. (1999).

Source: Croatia, Hungary, Poland – own estimates based on household data.

2.56 Relatively poor performance in achieving poverty alleviation can be traced to the problems with specific types of expenditures and the overall structure of expenditures. Combining household survey data (HBS 1998) with detailed budgetary statistics we are
able to estimate the incidence of public spending on social protection, health and education (roughly half of total State spending). We find that the poor, while constituting 8 percent of the population, receive only 2.5 percent of public health spending. The incidence of public spending on education is slightly better: the poor get 6 percent. Thus, the overall impact of social services financed by the government is definitely regressive. Privately households spend 2.3 percent of GDP on health care and 0.7 percent on education. The poor spend only 2 percent of these total amounts; therefore government spending is crucial to provide access to these services for the poorest. The poor are not excluded from the system, but those who are relatively well-off benefit most.

2.57 Table 2.4 shows that while Croatia is spending heavily on social programs as a whole, primarily health and pensions (especially early retirement), these programs are not well targeted to the poor. On the other hand, its “social assistance” transfers, which are better targeted, have a much lower share in overall spending.

<table>
<thead>
<tr>
<th>Table 2.4: Percent of GDP in 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td>---------------------------------</td>
</tr>
<tr>
<td>Pensions</td>
</tr>
<tr>
<td>Social Assistance</td>
</tr>
<tr>
<td>Child &amp; Family Allowance</td>
</tr>
<tr>
<td>Unemployment benefit</td>
</tr>
<tr>
<td>All transfers</td>
</tr>
<tr>
<td>Education spending</td>
</tr>
<tr>
<td>Health care (estimate)</td>
</tr>
<tr>
<td>Total social spending</td>
</tr>
</tbody>
</table>


2.58 Pensions are the largest component of total social transfers. Hence, the distribution among income groups of social transfers depends strongly on the distribution of pensions.

2.59 Since January 1, 1999, Croatia is implementing an ambitious pension reform which will gradually split the previous pay-as-you-go system into a multi-pillar system. Eligibility criteria have been modified, and new pension formulas and new indexing rules have been set. How will pensioners fare under the new system?

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36 Budget unit costs are based on budget data combined with indicators of use. Household data provide a basis for estimating the use of these services by the poor. While exact data are available on school attendance, inexact proxies are needed for health care access. Consolidated spending on health care by Government amounted to 7 percent of GDP, on education - to 3 percent of GDP.

37 One may argue that the pension system is not primarily designed to protect the poor. This argument weakens if it is remembered that large transfers from general tax revenue (as much as 4 percent of GDP in 1999) are necessary to protect the solvency of the system.
2.60 We simulate the impact of pension reform using 1998 LFS data. Our analysis is based on each individual worker's profile as reported in the LFS. We predict the impact of the pension reform on workers who will retire in the next 20 years (see background paper by P. Castel for details). Most current workers will be affected by the reform, as over 85 percent of them are insured.

2.61 The simulations show that the pension reform will eliminate poverty almost completely among those covered by the system. Only 2 percent and 1 percent of the workers who will retire over 1999-2008 and 2009-2018, respectively, will be poor. An additional 4 percent of workers find that their wages and therefore contributions were too low to be eligible under the new rules for a pension. These are mainly women who have very short or disrupted working careers or low earning capacity.

2.62 The benefits of existing beneficiaries, if indexed according to the new rules, will increase in 10 years to bring 40 percent of those now receiving benefit but are below the poverty line, out of poverty. When we combine the simulations for expected coverage and level of benefit, we find that about 30 percent of those who will reach retirement age in the next 10 years are likely not to receive benefits (or to receive benefit below the poverty line); this share will drop to 20 percent if we take a longer forecasting horizon (20 years). Therefore the impact of reform is definitely positive (see Figure 2.9).

Figure 2.9: Pension reform and poverty among retirees (all retirees=100 percent)

![Figure 2.9: Pension reform and poverty among retirees](image)

Note: The total number of retirees is the sum of the elderly (over 60 years) and disabled individuals. The poverty line is constant in real terms, and is set at 1000 HRK per month per capita in 1998. Source: Castel (2000).

2.63 The success of pension reform will entirely depend on the performance of economy and sustainability of real wage increases in the future. Small number of pensioners under the poverty line under the new system reflects two factors: (i) economy wide wage growth; and (ii) protection of a minimum benefit.

2.64 The new indexing rules imply that, once granted, pension benefits are adjusted annually by a combination of half the rate of increase in the retail price index and half the rate of increase in nominal wages. This will affect not only new pensioners, but also those who retired under the previous system. As we assume following Government's own projection, that real wages will grow on average by 4 percent per annum, all pensioner “will grow out of poverty” by 2018. It should be noted, however, that if real wages grow by 2 percent per year instead of the 4 percent in the forecast, the benefits of
about 249,000 pensioners in 2008 and 100,000 (age 60 and above) in 2018 will be too small to lift them above the poverty line.

2.65 The payment of a **minimum benefit per year of service** will help most of the new pensioners to live above the poverty line. This minimum is particularly generous for workers who remain in the public system, whose benefits cannot be lower than 0.825 percent per year of service of the average gross wage in 1998. Again, the poverty impact of pensions will depend crucially on the performance of average wage. The payment of the minimum benefit per year of service is a powerful instrument for poverty alleviation among pensioners. Estimations without taking account of this component of the new system show that 20 percent of new pensioners would receive benefits below the poverty line (instead of a projected 5 percent with the minimum benefit payment) in 2008. The estimated costs of providing the minimum benefit are 0.2-0.5 percent of GDP in 2008 and 0.4-1.1 percent in 2018.38

2.66 Since at least 20 percent of retirees will not be covered in the new system, there remains an important policy issue: should the Government be aiming at increasing the coverage of the pension system or to expand social assistance programs to cover the elderly poor.

2.67 Because targeted programs currently command now an inadequate share of overall Government social spending, the welfare system has a limited capacity to deliver protection to the most vulnerable. At the same time, substantial resources are misallocated to non-poor beneficiaries in politically driven social programs. Thus, the system needs substantial reallocation of resources to address more adequately the needs of the poor.

2.68 Table 2.5 uses HBS data to model the effects of reallocation of funding between main government social spending items. It shows that there are big differences between programs in terms of their impact on poverty. For example, if we assume the current efficiency of targeting, increasing government spending on social assistance by one percent of GDP will reduce poverty by 1.2 percent age points (from 8.4 to 7.2 percent of the population). If the total envelope of social spending has to stay fix, these resources can be reallocated from, for example wage bill. Such a reallocation will have a net negative impact on poverty, reducing it by 1 percentage point (1.2 percentage points minus 0.2 percentage points).

2.69 This simple exercise underscores two conclusions of the safety net analysis. First, there is still a lot of room for improvement in the current programs. The analysis of poverty depth in paragraph 2.11 suggested that with perfect targeting one percent of GDP will be sufficient to eliminate poverty completely. On the other hand, it shows that simple reallocation of resources within the existing institutional framework will have only limited impact on poverty. Much deeper reforms are needed to ensure that safety nets are performing their tasks.

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38 The range depends on the forecast assumptions – see Castel (2000) for details.
### Table 2.5: Change in Poverty Rate

<table>
<thead>
<tr>
<th>Type of spending</th>
<th>With increase of spending by 0.2% of GDP</th>
<th>With decrease of spending by 0.2% of GDP</th>
<th>With increase of spending by 1% of GDP</th>
<th>With decrease of spending by 1% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old age pensions</td>
<td>-0.2%</td>
<td>+0.3%</td>
<td>-0.7%</td>
<td>+0.8%</td>
</tr>
<tr>
<td>Survivors pensions</td>
<td>-0.2%</td>
<td>+0.2%</td>
<td>-0.5%</td>
<td>+0.5%</td>
</tr>
<tr>
<td>Disability pension</td>
<td>-0.1%</td>
<td>+0.1%</td>
<td>-0.4%</td>
<td>+0.4%</td>
</tr>
<tr>
<td>Sick leave</td>
<td>-0.1%</td>
<td>+0.1%</td>
<td>-0.1%</td>
<td>+0.1%</td>
</tr>
<tr>
<td>Disability Allowance</td>
<td>-0.1%</td>
<td>+0.2%</td>
<td>-0.2%</td>
<td>+0.3%</td>
</tr>
<tr>
<td>Maternity leave</td>
<td>-0.1%</td>
<td>+0.1%</td>
<td>-0.3%</td>
<td>+0.3%</td>
</tr>
<tr>
<td>Child allowance</td>
<td>-0.4%</td>
<td>+0.1%</td>
<td>-1.1%</td>
<td>+1.0%</td>
</tr>
<tr>
<td>Social assistance</td>
<td>-0.5%</td>
<td>+0.6%</td>
<td>-1.2%</td>
<td>+2.2%</td>
</tr>
<tr>
<td>Unemployment benefit</td>
<td>-0.3%</td>
<td>+0.3%</td>
<td>-0.6%</td>
<td>+0.6%</td>
</tr>
<tr>
<td>Government net wages</td>
<td>-0.1%</td>
<td>+0.0%</td>
<td>-0.3%</td>
<td>+0.2%</td>
</tr>
<tr>
<td>State-owned enterprise net wages</td>
<td>-0.0%</td>
<td>+0.0%</td>
<td>-0.4%</td>
<td>+0.4%</td>
</tr>
</tbody>
</table>

Source: Simulations using HBS (1998), assuming zero saving from a transfer, no change in the number of beneficiaries of any transfer and across-the-board proportional increase/decrease of the amount; basic poverty line and initial incidence of poverty at 8.4 percent.
3. SOCIAL ASSESSMENT: WHAT DO THE POOR SAY?

3.1 While rigorous analysis of household data helps to delineate factors associated with poverty, Social Assessments, based on in-depth interviews with the poor and focus group discussions, offer insights in what the poor themselves perceive as reasons for poverty, giving them "voice". We find very close consistency between household survey results and subjective views about poverty, especially those of the poor themselves. This consistency between quantitative and qualitative findings reinforces our conclusions.

3.2 Household surveys give us only a snapshot (or a series of snapshots) of poverty. They do not indicate whether poverty is a long-term or only a transient state. However, the Social Assessment conducted for this study, together with other sources of information, suggest that poverty in Croatia already has many features of a permanent state, and those who are poor are unlikely to escape poverty easily.

A. CAUSAL FACTORS: HOW THE POOR SEE IT

3.3 For the poor, the causes of poverty are often out of their control. They primarily mention non-employment and low education (or a mismatch between their skills and those required for getting work) as causes of their poverty. They also express pessimism about their ability to change their own situation, saying that they are unable to afford retraining, and that they are often told to their faces that they are unemployable because they are too old, are in poor health, or have young children.

3.4 Other broadly reported causes of poverty are systemic: the war, corrupt privatization practices, and the negative impact of government policies, such as high taxes and failure to restructure agricultural production. People especially blame the war for the decline in living standards and dislocation in the formerly occupied zone. Another reported culprit is "wild privatization", which has led to the misallocation of resources into the hands of a small number of incompetent managers who are blamed for unnecessary bankruptcies and mass unemployment.

3.5 Ethnic minorities are also likely to highlight issues which affect their own groups. Bosnian Muslims in Ludbreg noted problems in adapting to the new environment. Serbs in Drnis, Petrinja and Beli Monaster reported rising nationalism, social isolation and discrimination as causes of poverty.

39 The Social Assessment consisted of one hundred and forty in-depth interviews (one hundred with poor respondents and forty with non-poor respondents); thirty focus groups (ten with poor; ten with non-poor and ten with special groups) in ten sites, including three villages; it was conducted in late 1999-early 2000. For more details refer to background paper “Social Assessment of Poverty in Croatia” by Elizabeth Gomart, available upon request.
3.6 The Social Assessment shows that Croatia's poor and non-poor alike see the lack
of rule of law – especially in the context of labor legislation – as a cause of poverty. The
concept of the rule of law requires that formal rules are made known, enforced in a
predictable way through transparent mechanisms, and applied to all citizens equally in a
non-discriminatory fashion. The Social Assessment reveals problems in all three areas:
information, enforcement and equal access.

3.7 Access to legal information through formal institutions is seen as inadequate. As
a result, people need to use informal access – "connections" – to learn about laws and
have a voice. The poor have weak connections, and often are not well enough educated
to compensate for this fact. In a society like Croatia's which is transitioning from
socialism, economic and political power remain closely intertwined. This has meant that
the benefits of the transition have accrued to the better-off with "connections".

3.8 With respect to lack of the rule of law in the workplace, the poor speak of feeling
exploited by employers and being without recourse. In particular unofficial workers in
the private sector report going unpaid, very long work days (12-14 hours), and being fired
without pay; they also say that they often find out only after being fired that their
employers have not contributed in full to the health and pension funds. Late payment of
wages affects many workers who come to work without knowing whether or how much
they will be paid. The culture of late or non-payment spreads far beyond wage arrears
and creates a hostile environment for small businesses. Entrepreneurs (and farmers)
mention their struggle to survive because they cannot collect receivables in a timely
basis; this in turn weakens their ability to take on recurrent costs and hire formal
employees. Similarly, private farmers report that buyers (many of whom are under State
control) have not paid for produce delivered months earlier and yet they are required to
pay taxes (with penalties if they pay late). The complexity of tax laws also creates a
sense of vulnerability and distrust among the self-employed and farmers, who say that
they pay fines for unintentional mistakes. The lack of rule of law is also perceived as the
underlying cause for corrupt privatization practices. Finally, lack of rule of law is also
said adversely to affect access to some social benefits, and households with connections
in the formerly occupied zone are perceived as getting more help with housing
reconstruction than the standards prescribed by the law.

3.9 These perceptions of failures to enforce laws are to a large extent related to
systemic problems in the legal system. By 1998 the courts in Croatia struggled with a
one million case backlog; 70 percent of disputes took more than a year to resolve, and
problems are compounded by the unpredictability and low quality of courts decisions; for
example, 75 percent of first instance court decisions were reversed on appeal or returned
for new proceedings.

40 One estimate of 125,000 workers was quoted in the daily newspaper "Jutarnji List," February 14, 2000.
41 "Croatia: Legal and Judicial Reforms in Croatia: A Policy Agenda for Reform and Growth", World
Bank (2000).
42 A recent report of the Croatian Bar Association has stated with respect to the governance of the courts:
"Some habits existing in the previous system, in first place the one that other powers, especially the
executive one, frequently and eagerly interferes with the tasks and duties of the judiciary, have not
3.10 Discrimination in the application of laws is a frequent complaint with respect to labor legislation - notably in the form of gender discrimination, especially against young women (where employers reject them for work if they care for children), and age discrimination (where many respondents feel that young job applicants without experience are often hired over more seasoned workers like themselves, and that they are often rejected for jobs requiring retraining).

3.11 Ethnic discrimination is also widely felt with regard to employment, particularly in areas in or around the formerly occupied zone -- i.e., Eastern Slavonia, Dalmatia and central Croatia. Non-Croats often report that once they reveal their ethnicity (e.g., give their last name, or let the employer know where they lived during the war) they are turned away. The Serb focus group in Osijek for example remarked that the basic qualification for employment in a private or government firm is to be “a politically acceptable Croat.” Interviews revealed a number of accounts that suggest a pattern of discrimination (see Box 3.1 below).

**Box 3.1: Cases of Ethnic Discrimination**

Even if they were living outside the formerly occupied zone, Serbs reported instances of employment discrimination. Respondents in a focus group in Petrinja reported that all Serbs in their firms were fired in 1995 after "Operation Storm": some were told directly that they were no longer wanted because of their ethnicity, others were fired under the pretext of a labor surplus. In a village near Petrinja, a Serb woman who used to teach the Croatian language in the local school before the war applied for her previous position upon her return from Yugoslavia. She was turned down for lack of qualifications. Instead, a young inexperienced teacher from Sibenik was hired. Discrimination also affects hiring for temporary, informal jobs. In Dmris, a healthy 48 year old Serb said that since 1995 he has been hired once, in August 1995, to repair equipment, by a local Croat entrepreneur who did not care about his ethnicity. But five days after he started work, someone called his boss and told him that he should not have hired a "traitor." His boss came to him and told him that he must go because he had just lost a contract over him. This man believes that neither he nor his wife will ever get a job again because of their ethnicity.

Albanians in Zapresic and Pula also mentioned discrimination, explaining that they were turned away by potential employers when they revealed their ethnicity. Bosnian Muslim refugees who are left in a legal limbo without Croatian citizenship said that the main consequence of their lack of legal documentation is continued unemployment and ability to work only "on the black."

Ethnic tensions are replicated at all levels of society. Focus group participants shared their poor experience with government institutions. There were complaints about endless resolution of property cases. Entrepreneurs who have returned found their premises privatized or leased to others, and have seen little progress in restitution. None of the focus group participants in Petrinja had health insurance coverage though they were all registered at the employment bureau. The employment office told them to make contributions, although registered Croats did not have to do so, and although no other bureau at any other site required contributions from Serbs.

Source: E. Gomart (2000)

disappeared. Influences, and attempts to influence the courts and judges are numerous, and frequently very strong” (“The Situation in the Croatian Justice System”, April 1998).

43 It should be noted that these personal reports are consistent with evidence from other sources. For example, in Osijek, the OSCE reports that 118 Serbs are suing employers for discriminatory firing, contrary to the agreements which led to re-integration of the occupied zone, under which Serbs were not to lose their jobs.

44 The cases reported here are among the most extreme examples of discrimination that were found by the Social Assessment. It is important to note that in most sites discrimination was not reported to be as pervasive as that reported in Petrinja and surrounding villages, which are located in areas severely affected by war.

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3.12 Ethnicity is thus a factor in determining well-being and vulnerability. In Social Assessment interviews Serb returnees report that their ethnicity has had a detrimental effect on their employment status and social networks – two of the most important ingredients for surviving the crisis. Foreigners (foreign spouses in particular) and Bosnian Muslims say that they are not able to obtain citizenship; they are therefore limited to informal jobs without work permits or social assistance, face higher education costs, and must make full payment for health services. The availability of important determinants of living standards (such as housing or access to education) is also much lower for the Roma minority than for those in the mainstream Croatian society (see Box 3.2).

Box 3.2: Roma Village: Kursanec, Medimurje District

Kursanec is a small village near Cakovec in Medimurje County. It has about 1100 Roma residents (including 560 children). According to an NGO working with the Roma, eighty percent of the families are socially deprived. Many receive small welfare payments. Most families do not have formal employment although many work informally on a daily basis in construction and collection of metals (aluminum, copper, iron) for resale. Begging is also widespread.

Roma families live in tiny homes - huts built of stone, wood or mud. Households, which include on average four or five children and grandparents, share a single room that serves as bedroom, kitchen and living room. There is no running water or electricity. The floors are often earthen and the only door must remain open to allow light and air. The huts are therefore dark, wet and cold. A small number of families have started to build permanent houses, but because they lack building permits, they run the risk of potential demolition by local authorities. The new houses are an improvement on the huts even though they still do not have basic sanitation facilities. There is neither sewerage nor piped water in the village. The whole village uses one pump.

There are 187 school aged children in the village. Officially, all children are enrolled in the nearby school which has the largest number of Roma children in the district. The school is three kilometers from the village, therefore children have to walk six kilometers a day to go back and forth from school. The school organizes special classes for Roma children, but because of poor conditions at home (lack of electricity, sanitary conditions, and lack of support from parents), these children often arrive at school unprepared for the learning environment (unclean, barefoot, hungry and without suitable clothing). Teachers do not allow them to take textbooks home, making it harder for them to complete their homework. The school has tried to solve the problem with extra teaching hours and staff, but the biggest problem with respect to the Roma children is school attendance; an estimated seventy percent of them do not attend school regularly and most of them drop out at age ten.

An estimated twenty percent of this Roma village’s population have no health insurance. Only a few children have regular check-ups and vaccinations. In addition, a number of children are born at home and not in the hospital. As a result of poor food and sanitation, these children are susceptible to contagious and dangerous diseases.

Source: E. Gomart (2000)

3.13 Non-governmental organizations lack power to protect the poor from discrimination. Croatia has seen a rapid growth of NGOs in response to the war. Many groups initially emerged in response to funding provided for humanitarian assistance, then for assistance to war victims and refugees, and now for human rights and civil society activities. As in other former socialist states, there is a lack of community-based
organizations, most of which are based in the main cities. Thus, the development of NGOs as a component of the social fabric of civil society remains at an early stage.

3.14 Corruption is a key aspect of governance that directly affects the life of the poor. It takes a toll on the poor through many channels: lower growth, regressive taxes, lower effectiveness of social spending. Corruption makes it harder for the poor to escape poverty through small-scale entrepreneurial activities. It generates policy biases that tend to worsen income distribution. "Petty" administrative corruption on a daily basis also burdens the poor disproportionately, and opportunities for corruption are enhanced when the administrative procedures for delivering a service are complex, nontransparent and subject to change. The Social Assessment has identified a number of public programs whose mechanisms are prone to corruption in these ways, and hence biased against the poor.

3.15 For example, disability pensions and allowances are particularly difficult to obtain since they require collecting a mass of documentation which must be presented to a health commission for approval. This process was reported as corruptible, with people who did not qualify medically reportedly able to obtain coverage through acquaintances on the health committee. Under these circumstances, unskilled disabled workers face a high poverty risk: they no longer have the capacity to do the hard physical jobs that are mostly open to them (in construction, loading and unloading, or agricultural work); they often have no documentation from their casual jobs, and thus fail to qualify for disability allowances; and they are generally unable to circumvent the procedural requirement, because they lack necessary "connections" with administrators.

3.16 More generally, social services exclude many poor households on the basis of criteria that do not reflect vulnerability characteristics - such as real estate ownership and formal employment - and include many non-poor households that fit outdated criteria. The social services also seem to focus a broad range of assistance on a small number of repeat recipients.

3.17 Ad hoc assistance programs run by the municipalities and one-time assistance schemes managed by the Ministry of Labor and Social Protection are often perceived as inherently unfair, offering help to households that already receive welfare allowances, but not to those who fall between the cracks of the existing social protection system. Government benefits in general - and health insurance benefits in particular - are poorly understood by some potential beneficiaries who seem to lack basic information about their rights, thus exacerbating a process of social exclusion. Meanwhile, the Government provides numerous benefits to the non-poor; the most obvious case is that of child allowances, which have been exclusively reserved for the employed. Other benefits have also accrued to war veterans, who are not poor as a group but compete with poor households for scarce resources such as free textbooks and subsidized lunches.

3.18 Informal payments are not widespread, and social service providers (doctors, teachers) were not perceived by Social Assessment respondents as discriminating against the poor. None of the poor respondents had found it necessary to bribe health providers for services, nor had they felt discriminated against because of their inability to offer luxurious gifts. On the other hand, the non-poor said that they felt compelled "to thank"
health providers, offering them gifts every time they went for a check-up with a specialist or after a successful life-threatening operation. These gifts are common practice and considered simply politeness, even though they are known to be illegal. Patients ask other patients who have received a similar treatment by the same doctor what would be an appropriate amount to give in order to thank him for his efforts. Gifts and payments are also important to get speedier treatment or treatment not covered by the public system. However, no gifts or extra payments are required for common services, even births.

3.19 While petty corruption in Croatia was reported to be largely contained, the population in general and especially the poor perceived themselves as having been hurt by corrupt privatization practices, which they saw was one of the key causes of destitution for many.45

B. CONSEQUENCES: COPING (OR NOT) WITH POVERTY AND THE THREAT OF MARGINALIZATION

3.20 Poverty is not the outcome of economic processes alone, and differences in living standards between individuals, communities and countries cannot be fully explained by differences in economic endowments. Social capital and social networks play a crucial role as determinants of well-being.46 At the micro level, social capital includes local associations and networks and the underlying norms of trust and reciprocity within the community. At the macro level, it is often defined to incorporate institutions, such as the rule of law and civil and political liberties, which affect national economic performance and poverty reduction.

3.21 At the micro level one can distinguish three levels of social capital: bonds (horizontal with friends and relatives), bridges (horizontal inter-community ties), and links (vertical to power).

3.22 In Croatia the poor rely for day to day assistance on immediate horizontal "bonds". These bonds are helpful to obtain assistance within geographic limits. However, since these bonds are mainly with other poor people, the extent of the material assistance that they can provide is limited and offers little opportunity for advancement. Moreover, while bonds are good for "defense", "bridges" are better for "playing offense", i.e. getting ahead. Since the poor lack inter-community connections, i.e., "bridges", because of their lack of mobility, their low level or non-existent employment status, and their limited networks (based on inability to reciprocate), they cannot use this element of social capital to get ahead.

3.23 Matters are made worse in the Croatian context by the fact that "bonds" are often limited to a small nuclear family (compared to the large extended families in the Caucasus, for example). Meanwhile, "bridges" are maintained through work, for example, membership in associations, and socializing in bars. But because the poor are

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45 This is also revealed by other sociological research (S.Stulhofer).

often without work or even the cash to buy coffee in cafes, their chances of benefiting from bridges - for example by learning about job and other opportunities - are limited. Social capital has also been reduced by the fighting between the Serb and Croat communities, which has broken down a number of former bridges between ethnic groups and made these communities more hermetic. This aspect of weakened social capital also helps to explain why mixed-marriages are vulnerable, because their membership in any one community is not clear.

3.24 Certain coping strategies used by the poor have a tendency to marginalize them. During Yugoslav times, the short supply of housing especially in large cities was already a problem. Today, however, the problem seems to have worsened. The lack of employment, high interest rates and stringent mortgage requirements are keeping even the non-poor from purchasing their own homes and apartments. In order to be able to afford these costs, households are sometimes compelled to accept sub-standard living conditions or to regroup into three-generation households.

3.25 As already noted, the cost of utilities - electricity, water, heat, gas - is high and usually not affordable for the poor. Among the poor, electricity consumption is rarely less than 100 Kuna (a level applicable only among pensioners in small villages and towns) and generally hovers around 150 Kuna per month for a family. Water bills for the poor generally average around 150-200 Kuna, rising with the number of small children in the family. Cooking gas averages 50 Kuna, depending on whether the family has an electric water heater for heating bath water and washing clothes or is using the stove to heat water. Reported phone costs are generally a little under 100 Kuna (service costs 30 Kuna per month). Thus, utilities generally total approximately 500 Kuna per month. For the cash constrained poor these are large sums of money (more than the welfare benefits for an individual, 350 Kuna). As a result, many of the poor report that food is a secondary issue after utilities; when they receive salaries, pensions or benefits, they pay for utilities first and then use the rest for food. Despite this, the vast majority of poor respondents claim that they have difficulty paying utilities and are compelled to incur debts.

3.26 Clothing offers a very good illustration of how the failure to maintain social status has direct implications for living standards and exacerbates poverty. In Croatia, children's clothing is exchanged between households with children of compatible ages. But the non-poor were found to be more likely to be included in these exchange networks since they have clothes they can exchange and of a quality that can withstand more wear. Also households tend to exchange (rather than donate) clothes with other households of similar social standing, thus ensuring a certain quality of clothes for both parties. The poor are therefore unable to participate in a reciprocal relationship of exchange.

3.27 Health. Access to health care is nearly universal. Under Croatian law, legally employed persons are entitled to health insurance through their employer's contributions to the health fund and minimal co-payments. Children and spouses are covered through the legally employed adult. Unemployed persons registered at an employment office are

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47 A large percentage of the population is exempt from these co-payments, including children, retired pensioners, families of war veterans, etc.
also covered by health insurance. Retirees who have in their lifetime contributed to the health fund are also entitled to insurance. Self-employed entrepreneurs and farmers are covered through contributions. Finally, residents without health coverage can claim one-time emergency care through the county’s social care bureau which covers only emergency treatments. As a result only a small minority of the population is not covered by health insurance and faces high payments for health care.

3.28 Nevertheless the illness of a household member can be catastrophic for its living standards. This is partly due to the fact that sick workers are not protected from firing or discrimination in employment, and partly due to low invalidity pensions. Since middle-aged workers are already passed over for employment, those who are sick stand no chance. Very poor households are often headed by adults with illnesses and work injuries which limit their ability to find employment and/or earn money as day workers in the informal market where most opportunities entail heavy physical labor (loading and unloading, construction, agricultural work).

3.29 Education is the strongest correlate of poverty. Those with limited education have been most severely affected by Croatia’s economic crisis and have had the most serious problems in adapting to the new economic environment. While attendance does not seem to be at stake for current school age children, even relatively low education costs are a burden for poor households. The main problematic expense mentioned by poor parents is that of textbooks (around 500 Kuna per year). The problem is even more acute for children in high school. High schools started charging a registration fee of 100 Kuna in 1999. Many parents mentioned not being able to purchase all supplies (especially essential technical textbooks) costing up to 800 Kuna per year. These costs escalate for higher grades.

3.30 The social consequence of poverty is social isolation, which in turn severely limits a poor household’s prospects for escaping poverty in the future. Respondents to the Social Assessment describe retreating in the fold of the nuclear family on which they are dependent, and their resulting isolation from the community. As in all societies, poverty also takes a toll on the physical and psychological health of the population. Respondents mention depression, anxiety, hopelessness, along with youth suicides and substance abuse.

3.31 Economic policies alone may not be sufficient to prevent long term poverty from becoming entrenched. Poverty in Croatia affects the excluded: those who have received less education, have fewer assets, are relatively less skilled; those who have opted to live on the margin by working for themselves or seasonally, have been dealt a raw hand in terms of family situation, and are now without strong bonds to receive assistance from their relatives and friends. Discrimination for certain groups (Roma, Serbs, Bosnian Muslims, etc) results in the unconnected being under-protected in the face of the powerful. In addition, corruption - especially in the privatization process and in access to certain welfare benefits - affects the poor disproportionately. Failure to provide adequate legal mechanisms for contract enforcement, high taxes and a complicated regulatory

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48 Indeed, the average disability pension is 1300 Kuna, almost exactly the absolute poverty line for a single person.
framework all make it harder for the poor to escape poverty through small-scale entrepreneurial activities. Finally, civil society institutions are still at an infant stage, and thus have a limited capacity to support and empower the poor and the excluded.

3.3.2 The findings of the Social Assessment reinforce the economic analysis in chapter 2, especially with respect to the importance of improving the targeting of transfers to those most in need, and also with respect to redirecting other public expenditures to ensure that the poor can obtain better education and employment opportunities. In addition, the findings of the Social Assessment point to three main policy directions for addressing the social exclusion of the poor in Croatia and complement economic measures. Legal reform should aim at consolidating the rule of law with a special emphasis on equitable mechanisms for access to an independent judiciary. The NGO movement needs to be included in the mainstream of policymaking. Because the coping strategies of the poor often lead to even greater isolation from the mainstream, a trend towards marginalization and impoverishment of these groups should be closely monitored by policy makers to prevent the emergence of an underclass.
4. ACTION PROGRAM FOR POVERTY REDUCTION

4.1 Successful poverty alleviation will rest on three pillars: Opportunity, Security, and Empowerment. Each component of this strategy is part of a coherent whole. For maximum impact, all three should be combined together.

A. OPPORTUNITIES: “ACHIEVING GROWTH WITH EQUITY”

4.2 As stressed in chapter 2 of this report, there is a risk of Croatia that the economic growth is not equitable. The key components of equitable growth include:

(a) Maintaining macroeconomic stability;
(b) Ensuring that growth “pays off” in terms of increased employment; and
(c) Equipping the poor to take advantage of growth opportunities

Macropolicies and Governance Reform

4.3 Maintaining macroeconomic stability. Excessive expansion and lack of accountability of the public sector over 1994-99 was a key factor compromising macroeconomic stability. The Croatian Government in concluding the agreement with the IMF in December 2000 and in requesting the Structural Adjustment Loan from the World Bank to support reforms, already made first steps in the right direction of fiscal tightening; these efforts must be sustained. This would involve a continued effort towards the following objectives:

(a) Strengthen institutions for Government economic policy making;
(b) Improve fiscal management and transparency;
(c) Strengthen fiscal discipline; and
(d) Enforce wage discipline in the public sector and in the economy as a whole.

4.4 To achieve these objective a coherent set of policy measures have to be implemented in a consistent and coordinated way:

(a) Establishment of an inter-agency Economic Policy Making Council responsible for articulation and implementation for structural reforms;
(b) Starting of the Treasury system;
(c) Eliminate practice of tax offsets, make all subsidies explicit in the budget and eliminate indirect subsidies (such as waivers of payroll contributions);
(d) Define program and criteria for phasing out of subsidies and price controls;
(e) Establish mechanisms to eliminate arrears;
(f) Implementation of new wage policy with public sector downsizing, wage freeze in the public sector and social pact setting wage moderation for the economy as a whole; and
(g) Formulate measures to rationalize health and pension expenditures aimed at containing their structural deficit.

4.5 Enabling private sector-led growth is the key condition for making the growth sustainable. In particular, actions should be aimed at supporting the growth of micro- and small enterprises through facilitating financing, decreasing the costs of registering and accounting, and simplifying the legal and tax environment. Croatia needs to rapidly develop a much more dynamic SME sector to create a modern and flexible basis for growth. SMEs will be able to generate significant employment, become key exporters, absorb new technology, generate local wealth, and support the activities of larger enterprises. To achieve progress in this direction the Government will need to:

(a) Increase flexibility and efficiency of the economy, remove regulatory obstacles for establishing new business, improve and harmonize land, cadastre and real estate registration systems, and streamline administrative procedures involved in FDI;

(b) Strengthen market institutions: revise and update competition policy legal framework, ensure proper functioning of competition enforcement agency, and harmonize competition enforcement with new licensing requirements; and

(c) Improve governance framework for businesses: amend company law to strengthen minority shareholders rights, amend take-over law to promote pro-competitive mergers, amend company law to encourage nomination of outsiders to boards of directors, streamline the court processing of commercial cases, and strengthen the implementation capacity of commercial courts.

Labor Market Reforms

4.6 Reducing taxes on labor, that the Government has already undertaken, will improve competitiveness and create an environment for job creation, removing the bias against labor. A survey of enterprises indicates the substantial potential long-term impact of such tax cuts on employment generation. This impact, however, may not necessarily surface immediately after the taxes are reduced, and depends on labor market environment. Therefore it will not in itself guarantee the employment generation in the private sector. Other reforms are needed to make labor market more flexible and translating economic growth that would resume in the right economic policy environment, into new jobs.

49 At reported by EBRD (1999) 95 percent of all new business in CEE are start-ups; on average over the past three years they have expanded employment by 37 percent - EBRD Transition report 1999, p. 150.

50 Entrepreneurs in one survey of SME estimated that a 50 percent reduction of payroll taxes would lead to a 30 percent expansion in employment (Malekovic et al.).
4.7 In any economy, but particularly in transition economies, labor policies and their associated incentives are key to facilitating labor market adjustment. Reforms of the labor market institutions are needed to ensure it works to support the employment generation, and not against it. The thrust of reforms is to remove disincentives to job creation and encourage different part-time and casual working arrangements, while enforcing a minimum level of regulations to ensure workers' rights (e.g., to sick leave, limited work hours, and regular pay; to protection from harassment and discrimination; and to workplace safety). Part time employment could also help to alleviate unemployment among young labor force participants at the point when greater flexibility is introduced for the demand for labor in certain sectors such as the retail trade. The specific policy actions will consist of:

(a) Amend the labor law to reduce costs to employers for hiring and dismissing of workers and encourage flexible working arrangements;
(b) Ensure the public has adequate information on main workers rights that are enforceable through the legal system, and monitor cases of discriminatory practices; and
(c) Improve labor market information systems to monitor effects of adjustment and to facilitate the evaluation of programs.

Equipping the poor to take advantage of growth opportunities

4.8 The Government has an important role to play in creating opportunities for its citizens to participate in equitable growth, a crucial condition for poverty reduction. To equip the poor to take advantage of growth opportunities, a reform of the education system is needed, that will help workers adapt to the market economy and foster an entrepreneurial culture. In the context of closer integration with Europe, and in partnership with European institutions and programs, Croatia needs to reform the curriculum by focusing on general skills and abilities valued by the market economy, and to change the governance by making the whole system more equitable, flexible and adaptable to a changing environment.

4.9 Croatia now needs different, more reliably measured, competence-based skills to meet the needs of the marketplace. New educational policies should be implemented not only in a core curriculum framework but also in teacher training, examinations, assessments, textbooks and other instructional materials. The present 3.4 percent share of education in the budget is low - not only compared to European averages but also compared to Croatia's need to work to develop a market economy and an open society. But it is not the current low level of financing which imperils prospects for raising both productivity and long-term growth rates. This system, as we have seen, fails to prepare a substantial fraction of new workers to meet market demand.

4.10 A new structure will need to be more flexible and take into account the increasing demand to change one's individual schooling and educational career, switch between tracks, leave and re-enter education, and find continuing opportunities for further training and re-training. All these principles are reflected in the Government's proposal of education system reform (discussed at social policy workshop in January, 2001), specifically in its principle of "school of success for all" with the emphasis on those who
under perform or drop out of school. Local authorities should be given more of a role in defining the profile of public education, post-compulsory education should reflect individual need and user choice, and vocational programs should be more closely connected to economic actors (through provisions, funding and guidance).

4.11 However, the Government is only at the beginning of a long and complex process of reform which will involve the following steps:

(a) Finalize sector strategy and policy agenda for dialogue with the stakeholders;
(b) Prepare the legal and administrative framework for increasing the role of private sector in education;
(c) Adopt a framework for the new core curriculum, which promotes skills and facilitates active learning and teaching; and
(d) New standard examinations will need to be piloted and introduced to improve transparency and quality.

B. SECURITY: “INCLUDING THE EXCLUDED”

4.12 Along with securing equitable economic growth, the second key element for alleviating poverty in Croatia is reforming the social safety net system. Social protection in Croatia faces a double challenge: first, to restructure the existing system to reach the most vulnerable long-term poor; and, second, to provide short-term support to those adversely affected by the economic reform program.

Rationalizing Social Protection

4.13 Given challenges of restructuring the Government will need to increase coverage under the social protection system, to expand social assistance programs, or to design new programs to address the needs of those who are currently left out. Given the strong capacity of current welfare programs in Croatia to reach the poor, the Government may want to assess the need for expanding well-targeted social benefits. The current fragmented system of social benefits should be made simpler and easier to monitor.

4.14 Alongside budgetary reallocation, substantial changes will be required in the management, the competencies and responsibilities of line ministries and individual social protection schemes. Currently, many different agencies manage different components of the social protection system, including the Ministry of Labor and Social Welfare, the Ministry of Reconstruction, the Office of Refugees and Displaced Persons, the Ministry of Health, the Pension Fund, the Employment Service, and regional and local governments. But no single institution is entrusted with substantive oversight of the social protection system as a whole. And with the movement towards greater decentralization, the lack of coordination may result in growing disparities and inequities in access to social safety nets.

4.15 The process of reforming the system should rely on improved governance, and has already started with the first steps in the development of National Program for Fighting Poverty and Social Exclusion.
4.16 As the Government stands here at the very start of the reform process, it is important to lay out the full policy “package” to reform the social protection, which will consist in:

(a) Conducting an evaluation of existing social assistance programs (including the recently amended child allowance program) using the most recent household survey data and administrative information; also conduct a beneficiary assessment;

(b) Ensuring that the level of public expenditure per beneficiary on major anti-poverty programs remains adequate (i.e., cash assistance program); over the medium term employ the official poverty line as a base for defining the level of means-tested benefits;.

(c) Rationalization of the targeting of anti-poverty programs with the objective to eliminate leakage to non-poor beneficiaries (by improving means testing);

(d) Preparation of a plan for increasing budgetary allocations to the better targeted programs through the increase in the number of beneficiaries/amount of assistance, and for decreasing spending and number of beneficiaries of programs not well targeted to the poor; and

(e) Improvement in coordination among different agencies managing multiple types of benefits and programs through the creation of an inter-agency body responsible for design and monitoring the enforcement of social policy (Ministry of Labor and Social Welfare, Ministry of Reconstruction, Office of Refugees and Displaced Persons, Ministry of Health, Pension Fund, Employment Service, and regional and local governments).

4.17 To meet these objectives and implement these measures in the most efficient way, Croatia needs to establish a poverty monitoring system to track and report the social impact of economic reforms and evaluate the results of efforts to improve targeting and access to social assistance programs. The initial step in this area will be to establish a Government commission for drafting the legislation on the social minimum (poverty line) and adopt official guidelines for calculation of poverty line and for poverty monitoring. The existing capacity of the CBS will need to be expanded, and information on poverty needs to be in the public domain.

**Pension System Reform**

4.18 Putting the social protection of a strong financial footing will involve introduction of the new multi-pillar pension system. Pension system insolvency is one of the key risks for making adequate resources available for direct targeted programs. The new pension system will gradually eliminate the need for deficit financing and thus free up resources for poverty alleviation of other vulnerable groups. It is, therefore, important to sustain efforts in implementing the reform.
4.19 The reform combined with better prospects for the economy as a whole will have a direct impact on poverty. Steps now underway to reform the pension system will eliminate poverty among pension beneficiaries. This effect could be primarily traced to setting the minimum pension at a relatively high level, thus introducing redistribution among the pension beneficiaries. Protecting the adequate minimum and monitoring its real value will be an important part of the system of social indicators that would trace performance of the social sectors in poverty reduction.

C. EMPOWERMENT

4.20 Empowerment involves giving the poor “voice” to influence the institutions and policies that affect their lives. Currently Croatia’s poor are afflicted with voicelessness and powerlessness, reflecting fragile democratic institutions, an immature civil society, and a weak enforcement of laws – especially anti-discrimination laws.

The "Democratic Transition": Strengthening "Voice"

4.21 Strengthening democratic institutions. The new Government of Croatia is the result of the country’s first democratic transition. It will be important to maintain and strengthen commitment to democratic institutions - not only because this represents commitment to a basic human right, but also because it enhances the quality of governance and democracy, the rule of law, and the efficiency of a country’s public administration, all of which in turn facilitate the inclusion of the poor in the policy making process. Such a process of inclusion becomes possible when democracy is broadly based on a fabric of civil society that give voice to citizens - including the poor - and enables them to influence the political process.

4.22 Fostering civil society will require action to bring about a change in the nature of the existing NGOs and social movements by creating an enabling institutional environment that encourages poor people themselves to take an active role. Such an environment is best created through: Finally, empowerment will include first and foremost the enforcement of anti-discrimination laws by:

(a) Tolerance. Active participation on the part of the poor is more likely where the political environment is not hostile and punitive. In this context ethnic reconciliation and efforts to bring about social peace are crucial;

(b) Credibility is the extent to which, public officials can be relied upon to behave like good partners in their relations with the poor. This includes specific actions to improve the transparency of decision making to the public;

(c) Predictability is the extent to which Government programs are stable in content, form and procedural requirements, since they then provide scope for organizing around them. By contrast, predictability is undermined by widespread arrears in wages, benefits and contractual obligations of State agencies, decreasing trust in public institutions and turning the public sector into a source of risks and volatility for the poor in particular. Hence prompt
and predictable payment of all benefits and State debts is a key area for fostering an inclusive, cohesive civil society in Croatia; and

(d) Rights can be defined in terms of the extent to which (a) benefits received under Government programs are recognized as moral or, better, legal entitlements, and (b) there are recognized (preferably legal) mechanisms that beneficiaries can access to ensure that these entitlements are actually released. On this front a public information campaign, specifically in the former occupied territories, where awareness about entitlements is lowest, is a first important step. The efforts by international organizations (UNHCR, OCSE) need to be sustained by the media and Government agencies.

Improving Governance and Participation

4.23 Rule of law. Poverty is clearly linked to a process of social exclusion from resources, but also most importantly exclusion from information about legal rights and opportunities, citizenship, etc. Empowerment aiming at upholding the rule of law will include first and foremost the enforcement of anti-discrimination laws by: (i) reorganization of the civil service, improving capacity and monitoring administration at the local level; (ii) judicial reform, eliminating undue influence on the nomination of judges and improving the access of all citizens to courts; and (iii) reform of the media, including measures to turn the State media into public service broadcasters.

4.24 In addition to enforcement of equal rights, the rule of law is also an important element of an economic strategy designed to eradicate poverty. A central part of any poverty reduction strategy must be to ensure that state institutions work well, and that they work in the interests of the poor. Government failure is often interwoven with corruption, which reduces drastically the efficiency and effectiveness of service delivery while also cultivating distrust and disdain among those who encounter it. These trends have dramatic implications for those who rely on formal service mechanisms, whose opportunity to move out of poverty is linked to services provided by the Government. The new Government has begun an offensive against corruption, an effort that needs to be continued and sustained within a broad strategy of empowerment of the Croatian people.
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