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POVERTY, WELFARE
POLICY AND SOCIAL
TRANSFERS: THE CASE
OF THE REPUBLIC
OF CROATIA

In general, the art of government consists in taking as much money as possible from one class of citizens to give to the other.

VOLTAIRE (1694-1778),
French writer and philosopher

And distribution was made to each as had need.

ACTS 4:35

A decent provision for the poor is the true test of civilization.

Samuel JOHNSON (1709-1784),
English lexicographer and writer

Almighty God! Thou who holdest in thy hand the minds of men, deliver us from fatal arts and science... give us back ignorance, innocence and poverty which alone can make us happy and are precious in thy sight. (Discourse on the Arts and Science, 1750: 27)

Jean Jacques ROUSSEAU (1712-1778),
French philosopher, social and political theorist

WHETHER ECONOMISTS SHOULD CONSIDER DISTRIBUTIONAL ISSUES AT ALL?

Some argue that discussion of distributional issues is detrimental to objectivity in economics and economists should restrict themselves to analysing only the efficiency aspects of social issues. One can assert that only efficiency matters, but this in itself is a value judgment.

Second, decision-makers care about the distributional implications of policy. If economists ignore distribution,

then policymakers will ignore economists. Policymakers may thus end up focusing only on distributional issues and pay no attention at all to efficiency. The economist who systematically takes distribution into account can keep policymakers aware of both efficiency and distributional issues.

A related question is whether government ought to be involved in changing the income distribution. Some important traditions of political philosophy suggest that government should play no redistributive role. However, even the most minimal government conceivable influences the income distribution.

There are a number of distinct approaches to providing the recipe for an optimal distribution of income. **Normative theories** tend to be more egalitarian:

- **Utilitarianism** – associated with the maxim of the greatest happiness to the greatest number of people, so maximize social welfare is to equalize the marginal utility from income.
- **Uncertainty** – in an uncertain context the expected sum of utility will be maximized by an equal distribution.
- **Social welfare function** – Rawl's assertion about original position where people have no knowledge of what their place in society is to be: will they be rich or poor, and redistribution is insurance against disastrous outcome.

Positive theories are generally more pessimistic about redistributive prospects:

- **Independent utility function** – independence is tied to specific goods (health care or education), so with many “haves” emerges a free rider problem.
- **Majority voting** – a vote maximizing political party therefore has an incentive to propose redistribution from the richer segment to the poorer majority.
- **Income insurance** – redistribution is based on the idea of income uncertainty and possibilities for insurance, individuals can gain from ensuring an average income in all period provided the transaction costs of the policy do not fully swamp the potential gain.
- **Buying protection** – the rich will be happy to see the potential revolutionaries bought off.

To understand poverty, it is essential to examine the economic and social context, including institutions of the state, markets, communities, and households.

POVERTY IS MULTIDIMENSIONAL

The persistence of poverty is linked to its interlocking multidimensionality: it is dynamic, complex, institutionally embedded, and a gender- and location-specific phenomenon. The patterns and shape of poverty vary by social group, season, location, and country. Poverty differences cut across gender, ethnicity, age, location (rural versus urban), and income source.

In households, children and women often suffer more than men. In the community, minority ethnic or religious groups suffer more than majority groups, the rural poor more than the urban poor; among the rural poor, landless wagers suffer more than small landowners or tenants. These differences among the poor reflect highly complex interactions of cultures, markets, and public policies.

The state has been largely ineffective in reaching the poor. The role of NGOs in the lives of the poor is limited, and the poor depend primarily on their own informal network. Households are crumbling under the stress of poverty. The social fabric, poor people's only insurance is unravelling.

How poverty is created

Numerous characteristics of a country's economy and society, as well as some external influences, create and perpetuate poverty:

- political instability and civil strife;
- systemic discrimination on the basis of gender, race, ethnicity, religion, or caste;
- ill-defined property rights or unfair enforcement of rights to agricultural land and other natural resources;
- high concentration of ownership and asymmetrical tenancy arrangements;
- corrupt politicians and rent-seeking public bureaucracies;
- economic policies that discriminate against or exclude the poor from the development process and accentuate the effects of other poverty-creating processes;
- large and rapidly growing families with high dependency ratios;
- market imperfections owing to high concentration of productive assets and distortionary public policies;
- external shocks owing to changes in the state of nature (for example, climatic changes) and conditions in the international economy.

Absolute poverty can be alleviated if at least two conditions are met:

- economic growth must occur – or mean income must rise – on a sustained basis;
- economic growth must be neutral with respect to income distribution or reduce income inequality.

Generally, poverty cannot be reduced if economic growth does not occur. Successful poverty alleviation rests on providing **opportunities, security** and **empowerment**. Creating opportunities for the poor to lift themselves out of poverty requires action to create an economic environment more conducive to equitable growth. Supporting the long-term poor and extending the safety net to mitigate impoverishment due to transitional shocks will result in greater security. Creating institutions that enable 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 clear complements and reinforce the positive effects of each other.

HOW TO MEASURE POVERTY OR WHO IS POOR

A person considers himself to be poor because he has a Cadillac but his neighbor has a BMW.

A) Using the distribution of money income among households (Table 1)

Table 1
 The distribution of money
 income among households
 for USA

Year	Lowest fifth	Second fifth	Middle fifth	Fourth fifth	Highest fifth	Top 5 percent
1967	4.0	10.8	17.3	24.2	43.8	17.5
1972	4.1	10.5	17.1	24.5	43.9	17.0
1977	4.4	10.3	17.0	24.8	43.6	16.1
1982	4.1	10.1	16.6	24.7	44.5	16.2
1987	3.8	9.6	16.1	24.3	46.2	18.2
1992	3.8	9.4	15.8	24.2	46.9	18.6
1996	3.7	9.0	15.1	23.3	49.0	21.4

The table suggests the presence of a lot of inequality and it has increased.

B) To compute the number of people below the **poverty line**, a fixed level of real income is considered enough to provide a minimally adequate standard of living.

While there is clearly **some arbitrariness** in determining what is adequate, the notion of a poverty line still pro-

vides a useful benchmark. (To compute the poverty line, the first step is to estimate minimum cost of a diet that meets adequate nutritional standard. The second step is to find the proportion of income spent on food in families of different sizes. The poverty line is then found by multiplying the reciprocal of this proportion by the cost of the “adequate” diet.)

The poverty line for a **family of four in 1996 in USA was \$16,036**. During the same year, the median income – the level half the families were above and half below – was \$35,492. In 1996, 36.5 million people were below the poverty line, 13.7 percent of the population. Poverty rate has changed over time so the incidence of poverty in the USA is considerably lower now than it was three decades ago (Table 2).

Year	Poverty rate (%)	Year	Poverty rate (%)
1959	22.4	1979	11.7
1960	22.2	1982	15.0
1965	17.3	1985	14.0
1970	12.6	1989	12.8
1976	11.8	1996	13.7

Table 2
 Poverty rate in USA

In contemplating policies that might alleviate poverty, it is sometimes helpful to know how far the poverty population lies below the poverty line. The poverty gap measures how much income would have to be transferred to the poverty population to lift every household's income to the poverty line (assuming the transfers had no effects on the recipients' work effort). In 1996, the poverty gap stood at roughly \$80 billion.

Practice which is conventional among OECD poverty researchers is taking 50 (or 60, 70) percent of median national equivalent disposable income (or consumption) as poverty line.

The conventions and limitations of data

Data on the income distribution and the poverty rate receive an enormous amount of public discussion. It is therefore important to understand the conventions used to construct these figures and their limitations:

- Census income consists only of the family's cash receipts.
- The official figures ignore taxes.
- The official figures exclude in-kind transfers from the government.

- Income is measured annually.
- There are problems in defining the unit of observation.

Any poverty number depends critically on the choice of methodology, especially on the poverty line chosen. For that reason it is often hard to compare poverty rates across countries, these comparisons can be meaningless if the countries' poverty lines are widely different.

Former political system and poverty

In former socialist countries full employment was ensured, job security was guaranteed and unemployment usually actual illegal. There was every incentive to expand employment, and none to economize on labor use. Employers were paid relatively low net wages with particular low returns to education. In addition to their central role in providing the employment guarantee, a number of social functions devolved to enterprise, including the provision of many social services. The enterprise often provided to their employees goods in short supply, and considerable amount of compensation was in-kind (housing, food, other subsidies) rather than as a part of the explicit wage. Economic risk-taking was discouraged.

The poor and attitudes towards them. Social assistance for the poor played a highly subsidiary role. The employment guarantee, widespread transfers, free or almost free health and child care and education, combined with high labour force participation rates for women and subsidization of essential products, were the principal instruments for prevention of poverty. However, the role of social assistance was not comparable to that it typically has in the rich Western countries, neither in terms of its extent nor consideration for the poor. In part this was due to the fact that poverty was not widespread, and in part to the ideological taboo that preferred not to see poverty, since in an ideal socialist system poverty would be eliminated. Anti-poverty policy thus dealt only with “excess” cases of alcoholics, handicapped, etc. and was undertaken half-heartedly by local authorities or, if tolerated, by charitable organizations.

Not surprisingly, the “capitalist” poor, who, under the new system, were given the chance to educate their children, migrate to cities, or make successful careers in state or party-sponsored institutions, often proved the strongest supporters of socialist regimes. But, in regard to the “socialist poor” the authorities were generally indifferent. Not only did the existence of the poor mock the regime's claim that poverty was a capitalist phenomenon, communist ideologues genuinely regarded such people as

aberrations. They argued that if everyone was guaranteed free schooling, to be followed by a steady state job and all the benefits that go with it, if everyone could avail of generous family allowances, and, after retiring, could enjoy adequate pension, then the fault for being poor lay with these people and not the system. Poverty was not only viewed as social pathology and an implicit denial of the “perfectness” of the system but rather as an explicit **anti-social choice** by the poor (“the poor do not want to work” hence “they do not want to contribute to the building of the new society” hence “they are anti-social elements, parasites”). The communist view had logic: if perfect society is here, and its virtues are self-evident, only the ill-disposed and wicked people can refuse to participate in such an endeavour. Communist authorities therefore encouraged the stigma in which other citizens anyway tended to hold the poor. And, to make their plight worse, communist authorities discouraged non-government organizations from helping them, because they distrusted all non-governmental initiatives and viewed them as politically motivated ploys to acquire influence by helping the disenfranchised.

Why is inequality an obstacle to economic growth especially in transitional countries?

There is a negative impact from inequality to growth:

- High inequality leads to **sharper crisis** in response to external shock as distributional conflicts between the rich and the poor impairs functioning of newly establishing democracy.
- Higher inequality leads to significantly **higher violent crime** because of relatively higher pay-off from crime to those who are poor.
- Inequality also leads to **deterioration of the (small) social capital** and **lower participation** in civil society thus reducing opportunities for the poor to influence policies.

Croatia, like ex-Yugoslavia after all, was not a classic planned-economy. It can be said that until the beginning of the transition process, unemployment and low levels of qualifications and education were the most important determinants of poverty. In other words, the danger of marginalization was directly linked to exclusion from the world of work. If employment or unemployment is one of the determinants of the need for welfare benefits, another one is the amount of the wage earned. In many cases low and irregular wages are an important cause of poverty.

With a per capita income over US\$ 4,500 Croatia is the second richest of the former republics of Yugoslavia. Its output structure resembles that of a Western economy. Social indicators, such as infant mortality, literacy or life expectancy are similar to other European countries. The system of social transfers is one of the most extended in the region. However, all these factors by themselves do not preclude the existence of absolute poverty; its extent depends, in fact, on how income and transfers are distributed.

Using an **internationally comparable** standard across transition economies (4.30 US dollars a day per person at purchasing power parity) it was found that the incidence of absolute poverty in Croatia is very low. This international standard, however, may not reflect adequately specific conditions of each society. For policy makers what matters is the extent of poverty based on nationally relevant standards.

There is no **national** official poverty line in Croatia. The World Bank study has estimated the level of total expenditures (including non-food items) of households in Croatia at which families, after paying for essential non-food expenditures, just attain minimal nutritional needs. This level of expenditures represents therefore an **absolute poverty line** and amounts to 41,500 HRK per year (in 1998 prices) for a couple with two children or 15,474 HRK for an “equivalent adult” (Table 3). Only around 10 percent of the Croatian population fall below this nationally specific poverty line.

The analysis of poverty has revealed that the **poverty gap** is 1.8 percent of total consumption, and that on average the consumption of a poor household is 20.7 percent below the poverty line. To bring all poor above the poverty line with perfect targeting (*i.e.*, each poor person is given a transfer exactly equal to the poverty gap) would cost 1 percent of GDP; and to give to all poor the amount equivalent to the poverty line would require 4 percent of GDP. Therefore, it would be affordable for Croatia to completely eliminate absolute poverty.

Table 3
 Absolute poverty in 1998 in
 Croatia

Internationally comparable poverty line (USD 4.30/day at PPP)	7,321 HRK/year
National absolute poverty line	15,474 HRK/year
Poverty rate with international line	4.0%
Poverty rate with national line	8.4%

Those who have the misfortune to be poor are seriously deprived

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

The poor have distinct characteristics...

The poverty profile is dominated by two groups: poorly educated individuals and the elderly.

Almost seventy-five percent of the poor live in families where the head has **primary education** or less. They are likely to have bad prospects for finding employment when they are **not employed**, or have low earnings when they are employed. The risk of poverty is particularly high when poor education is combined with unemployment.

Low pension benefits or no pension at all in old age is the second cause of poverty: 40 percent of the poor live in households with a **retired** person. In 1998 as many as 25 percent of all retirees did not receive pension benefits and about half of pension beneficiaries received pensions that were below the poverty line.

In combination with limited opportunities the poor are likely to be stuck in long term poverty

Poverty in Croatia has already many features of a permanent state: the poor are unlikely to escape poverty easily. This is due to two basic reasons:

- There are limited economic opportunities because growth so far has not **generated enough jobs**. Despite positive economic growth in 1995-98, the net change in employment was persistently negative: many old jobs have been destroyed and very few new jobs have been created. **Growth has benefited primarily those who kept their jobs**. But for those locked outside employment, the effect was close to nil, if not negative. Furthermore, **over-regulation of employment**, especially constraints on layoffs, is limiting opportunities for small businesses and flexible working arrangements, both of which could constitute a viable alternative to wage employment for the poor.
- The poor are at a **disadvantage** to benefit even from this limited set of opportunities. Once locked outside

employment, unemployed and economically inactive have limited possibilities to break the circle of impoverishment. Over half of the unemployed are long-term unemployed, so analysis of labor market flows suggests that both unemployed and inactive are unlikely to find a new job. Most of the working age individuals who are not employed have either very **low educational endowments** (primary) or **narrowly formed skills** (vocational schools graduates). Those who are currently locked outside remunerative employment due to their level of education are also likely to see their limited opportunities perpetuated for their children.

- In addition, **inequality is high, and the poor are likely to be also socially excluded**. The gap between the rich and the poor in Croatia is wider than in middle or low-inequality countries. Increase in inequality was a normal result of transition, as markets started to reward scarce skills and entrepreneurship. However, inequality in Croatia rose to levels far exceeding those generally observed in transition and market economies.

Absolute poverty in Croatia is low, but this diagnosis is deceptively comfortable. Inequality is high; Croatia would have had even a lower poverty rate, if inequality were in a range of other CEE countries. The type of economic growth that Croatia had failed to generate is enough economic opportunities, and the poor are at a disadvantage to benefit from these opportunities.

CAUSES OF POVERTY IN CROATIA

The poverty profile reveals two main economic causes of poverty:

- limited employment opportunities and
- inadequacy of a social safety net.

Poverty is not limited to certain areas or groups of population: although certain ethnic groups (Serbs, Albanians, Romanians, Bosnian Muslims) have higher poverty, **the poor live in all regions and are predominantly Croats**. Moreover, the analysis of poverty risks shows that higher regional poverty risks are themselves primarily a result of lower educational attainment of population in these areas. War accompanied by high inflation contributed to a sharp deterioration in living standards in 1991–95 and sharpened pre-existing inequities. At the same time, many vulnerable families fell through the cracks of the inherited social protection system. But the war is not the **only** cause of poverty in Croatia nowadays: since 1995

the **economic policies** pursued by the government have tended to exacerbate income inequality.

Since the beginning of transition, the 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. The poverty profile, which is dominated by the elderly and non-employed, can be traced to these developments. On the other hand, real wages of those who are employed have reached pre-transition levels. This recovery was also far from equitable and is likely to turn out unsustainable. The public sector has been the leader of 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 real wage bill between 1997 and 1999.

High and growing expenditures for social insurance and protection in Croatia are the consequence of the large number of persons who depend on assistance from the state (pensioners, the unemployed and, in general, economically inactive persons) with the shrinking number of contributors. This has led to **higher taxes on labor** (workers receive only about a half of what it costs a firm to employ them, a larger wedge than in other European countries, resulting in a higher tax burden on the economy) making it more expensive as a factor of production and limiting the demand for labor. This generally high tax pressure pushed economic activity underground, contributing to corruption and higher rents.

Economic policies and welfare in Croatia

An analysis of welfare in Croatia is difficult because of the lack of any reliable statistical indicators, and the inconsistency of the figures that are available. The Croatian Government spends over 25 percent of GDP on various social programs, but **achieves little real redistribution**, because most social spending is costly and poorly targeted, while relatively well targeted social assistance programs are small and fragmented, so instead of reducing inequality, general welfare system acts to enhance it.

Since the bulk of transfers are pensions, weaknesses of the welfare system in Croatia in helping the poor can be traced to problems of the pension system. One can argue that this is not a failure of the pension system *per se* (the social insurance system has other objectives), but expendi-

tures of pension funds are rising rapidly (from 12 percent of GDP in 1998 to 14 in 1999) and there is a deficit in the pension system covered from general revenues of the Government, drawing on budget resources that could otherwise be redirected towards the poor. The incidence analysis shows that pensions do represent a transfer to the relatively well off, and fail to protect adequately the elderly and disabled from falling into poverty.

Steps that are underway to reform the pension system will decrease poverty among pension beneficiaries introducing a separate redistributive component within the social insurance system, but will leave open the issue of coverage.

Immediate and short term action

Welfare programmes brought in by the new Welfare Law have in theory many desirable features. Nevertheless, the indicators available make it impossible to tell how effective they are in practice. Only on the basis of some special research programme will it be possible to determine how much welfare is really successfully directed to those who are truly poor and to what measure it helps them to avoid actual indigence. Thus, for the moment in Croatia there are no data enabling the vertical and horizontal efficacy of the system, and one has to refrain from making any final appraisal.

The key question of economic policy is how to bring employment in the unofficial economy into the legal framework and thus expand the base of taxpayers. This presumes re-examination of the factors that lay behind the move to work in the unofficial economy. The small number of new jobs in the official economy and moving to work in the grey zone can largely be attributed to the **high level of labour costs** (especially the high rates of contribution for retirement and healthcare insurance, together almost 40 percent of gross pay). The situation could be improved if the **total rate of contributions were cut down to about 20–25%**, which would correspond to the situation in OECD countries, although this would mean certain reductions of welfare rights for a given period of time. Increasing hiring in the official economy, which would mean greater employment and make it easier to bear the burdens of financing public needs, would palliate the negative consequences of this reduction.

Long-term action in policies to foster opportunities: opportunities, security and empowerment

Equitable growth is of utmost 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 the unemployed and inactive workers - a group with especially high poverty risk.
- Third, it will provide the tax base for programs to alleviate poverty among those who cannot escape poverty otherwise.

Three conditions are required to achieve equitable growth:

- sustaining macroeconomic stability,
- creating an enabling environment for private businesses,
- increasing investment in human capital.

This would involve **redefining the frontier between the state and the market** on efficiency grounds: the state should withdraw from activities that are inherently a market domain. A thorough public expenditure review is the first step in this direction. A reform of the **education system** needs to be put in place to help workers adapt to the market economy and to foster an entrepreneurial culture.

Empowerment is the ability of the poor to influence the institutions and policies that affect their lives.

There are many aspects of voicelessness and powerlessness that could be grouped in three blocks:

- a lack of formal democracy,
- an immature civil society,
- a weak enforcement of laws - in Croatia, especially anti-discrimination laws - leading to infringement of human rights.

Fostering civil society will require bringing about a change in the nature of the 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:

- **Tolerance:** Collective action 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 preconditions for thriving grass root social organization.
- **Credibility:** The extent to which, in their relations with the poor, public officials can be relied upon to behave

like good partners. This includes specific actions to improve the transparency of decision making.

- Predictability: The extent to which Government programs are stable in content, form and procedural requirements, since they then provide scope for organizing around them.
- Rights: The extent to which (a) the benefits received under programs are recognized as moral or, better, legal entitlements, and (b) there are recognized (preferably legal) mechanisms that the beneficiaries can access to ensure that these entitlements are actually released.

Finally, empowerment aiming at upholding the rule of law will include first and foremost the enforcement of anti-discrimination laws by:

- reorganizing the civil service, improving the capacity and monitoring the administration at the local level;
- judicial reform, eliminating undue influences on the nomination of judges and improving the access of all citizens to courts;
- reform of the media, including measures to turn the State media into public service broadcasters.

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