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**DEVELOPING A SAFETY NET FOR UKRAINE:
POLICY PROBLEM IN INTERNATIONAL
PERSPECTIVE**

Oleksandr Rohozynsky

Kyiv, Ukraine, 2006

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Publisher:
EDC. Private Company Economic Development Consulting
10 Starokyivska str., Kyiv, 04116, Ukraine
tel.:+380 (39) 491 2712, +1 (404) 418 6698
e-mail: research@edc.com.ua
web : <http://www.edc.com.ua/>

Abstract

This paper inspired by recent increases of social benefits in Ukraine, and is first work of EDC researchers that tries to look at these increases from broader international perspective. The paper describes current situation and development of Social Safety Net (SSN) in Ukraine, and compares it with development in countries of Eastern Europe and CIS. The research also provides simple economic framework to analyze the issue of increase in social benefits. The paper finds that neither experience of countries surrounding Ukraine nor economic theory support the statement that increase in social benefits will be financially feasible in long-term perspective.

Acronyms

SSN	Social Safety Net
CEE	Central and Eastern Europe
GDP	Gross Domestic Product
FSU	Former Soviet Union
PAYG	Pay as you go
CIS	Commonwealth of Independent States
PFU	Pension Fund of Ukraine
MinFin	Ministry of Finance of Ukraine
MinEcon	Ministry of Economy of Ukraine

Authors

Alex (Oleksandr) Rohozynsky is founder and development director of the Economic Development Consulting. Mr. Rohozynsky is also associate researcher at CASE Ukraine, and was executive and research director of the organization in 2003-2006. He holds masters degrees in Applied Mathematics, Economics, Policy Analysis, and Business Administration, and is working towards his Ph.D. in Policy Analysis at the RAND Graduate School. He is economist and researcher with over 9 years of experience working in Ukraine and the US, including: leading and managing projects for Ukrainian think-tank; working with various international organizations, including World Bank, Soros International Economic Advisory Group, HIID/CASE; and providing support and advise to decision-makers in Ministry of Economy, Ministry of Finance, Prime-Minister and Secretariat of the President of Ukraine.

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Chapter I: Introduction

This paper is an attempt to look at the recent increases of social benefits in Ukraine from broader view and in international perspective. The social policies are constantly changing around the World. Everywhere social safety net policy is a fine balance between desire to provide highest protection to the poor, maintaining the fiscal and financial feasibility of the system, and ensuring that the system does not discourage employment and economic growth. This balance is especially hard to achieve in the economies of transition that change the social safety nets simultaneously with combating consequences of economic downturn.

The paper explores if an increase in social security benefits is an effective policy to combat poverty in countries of transition and in Ukraine in particular. We provide information about the international experience in social safety net development with particular emphases on the countries surrounding the Ukraine. We also provide simple theoretical framework to analyze economic and behavioral effects of social safety net and discuss fiscal and economic implications of recent increases in social welfare spending in Ukraine.

Similar to other FSU countries, Ukraine experienced large decrease in output at the beginning of the process transforming economy from central planning to market-oriented model. After gaining independence (from the Soviet Union) in August 1991 and until 1998 the real GDP fell almost 50%. Although unemployment remained at low level, the economic downturn reduced real income of population. Hyperinflation at the beginning of the period (reaching 10,256% a year in 1993) destroyed private savings, making poor more dependent of the SSN.

Extensive social safety net inherited by Ukraine from the Soviet Union was not able to protect this large fraction of population against poverty. The system involved large, usually not means-tested in-kind transfers, provided by state enterprises. When the government took over the social safety net, the government attempted to finance it in three ways. First, the government printed money, resulting in hyperinflation at the beginning of the period. Second, it introduced payroll taxes with total tax rate of 52% of the wage fund. Third, it borrowed large amount of money on internal and external markets.

The money collected with the payroll taxes were not sufficient to finance projected expenditures, and these programs de-facto run deficits in form of arrears in payments of social security benefits. The high payroll taxes stimulated growth of unofficial economy in Ukraine and further reduced tax base.

Similar to other FSU countries, beginning 1996 Ukrainian government was implementing policies to reduce budget deficit, government expenditures, and taxes. The budget deficit was reduced below 2 percent of GDP; consolidated budget expenditures were reduced from 52% of GDP in 1994 to 27% of GDP in 1999, major taxes were significantly reduced, including reduction of payroll taxes to the level of 39%. These reforms stimulated rapid economic growth in the country during the period 1999-2004. The reforms did not change principles of SSN, but resulted in decreasing social benefits to fraction of minimal subsistence level.

Major political change in Ukraine in 2004 (the “orange revolution”, which replaced political forces that managed country during the first decade of independence with more democratic opposition) substantially changed the environment in which the SSN policy is made. The election campaigns of all political forces during 2004 presidential election and 2006 parliamentary election included promises of significant increases in the social security benefits. These promises were partially implemented in 2004 - 2006. As of this writing in late-2006, future promises and increases in SSN benefits are likely to continue in 2007 and to be a basic feature of 2010-2011 election cycles.

Intuition suggests that even currently implemented increases in social benefits may be fiscally unsustainable in a long run. The increased level of social benefits requires additional financing which would require increase in taxation or budget deficit. The concern is that increased budget pressure will slow economic growth and reduce real income of large proportion of population while failing to provide sufficient protection to the population living below poverty line. This paper is provide background to formal analysis of this problem, and is first in a number of papers EDC is planning to produce investigating the sustainability of Ukrainian SSN.

The paper is structured as follows: next chapter shows current development of the social safety nets around the world and establishes analytical model to discuss the properties of the safety net. Third chapter discusses the recent development of the social safety net in countries of transition surrounding Ukraine. This chapter also extends the analytical model to account of specifics of countries in transition. Fourth chapter discussed the development of SSN in Ukraine, and provides insight about current trends of the social sector reforms in the country. Final chapter discusses policy conclusions derived from the simple analytical framework and comparison with other countries in transition, and provides recommendations for the social safety net policy in Ukraine.

Chapter II: Social safety net as a policy problem

The social welfare programs started to appear as government policies around the world at the end of 19th – beginning of 20th century. Since that time the governments are working to improve the welfare policies to balance between three major objectives: sufficiency of the benefits provided, financial feasibility of the system, and its effect on population behavior towards work.

This chapter describes the development of the social safety nets in different parts of the world, lays down general economic model used to analysis the problems of the welfare system, and describes the problems of the welfare systems emerged around the world.

The social safety nets around the world

Poverty alleviation programs exist for centuries. For example, British programs date up to 1598, when the first “Poor Law Act” was introduced, and Denmark adopted “Poor Relief Act” in 1708. However, the history of the modern welfare programs is often counted from the end of 19th century, when the concept of “welfare state” was first used in discussion about the social insurance system. In response to the challenges of fast industrialization, Bismarck, the Counselor of Germany, introduced system of medical, disability, and old age insurance (see 9). That was the bases for the German welfare system model with the following basic features: coverage is earnings-related, the system is managed through corporate structures like mutual aid association, and the government intervention in the system is minimal (see 25).

Extending the classification discussed by Sapir (see 23), we can distinguish five types of welfare systems in the world: “Socialist”, “Nordic”, “Continental”, “Mediterranean”, “Anglo-Saxon”, and “Liberal”.

The social security system similar to German was also adopted at end of 19th century at France. The major difference of the French system from German is principle of solidarity, which broadened the French system to include the people who might be excluded in the German model. This was achieved by greater involvement of government in management of the system. However, the social welfare programs in both countries are considered belonging to the same model, called “Continental Model”. The Continental model relies on the high social insurance contributions as the main source of funding, and strict regulation of the labor market. This model is also used in other Western European countries, like Belgium and Luxemburg.

Even higher social protection is provided to the population in the countries that adopted “Nordic” or “Swedish” model of social protection. This model guaranties minimal income or service level to all citizens through the government managed healthcare and social transfer systems. It is based on the recognition of independent persons and commitments of the public sector (see 23), the one of the goals of the Nordic welfare system is equalization of incomes. As the result, the income inequality in Sweden, Norway, Denmark, or Finland that adopted this system is lower than in other developed countries. The model is based on extensive taxation of enterprises and strict regulations of employee – employer relations.

The Nordic model is the closest to the “Socialist model” which was unsuccessfully tried in the Soviet Union. This model was based on the government ownership of the means of production, and government involvement in income distribution and equalization at all levels, starting from the wage income. The government was also responsible for providing social services (healthcare, education, childcare) to everybody on the need bases. The systems did not hold due to the economic failure of the planned economy on which it was based.

On the other side of the spectrum is “Mediterranean model” that is similar to the Continental model, but puts more emphases on the old-age pensions and provides lesser unemployment protection. The

model also puts strong restrictions on the labor markets, but the unemployed depend more on the informal family safety nets to escape the poverty since unemployment insurance is small. The Mediterranean model is adopted in Greece, Spain, and Italy (see 23).

Further at this side of the spectrum is the Anglo-Saxon social protection model, which is adopted in the Great Britain. The model is characterized by low labor market regulations and employment protection. The system provides cash transfers as the last resort; however it only guarantees the minimal standards, which allows the system to be relatively inexpensive. All other social services provided on the institutional bases to the whole population as a part of the normal government services (see 23 and 25).

Finally, on the extreme side of the spectrum is the “Liberal model” used in the USA, and that was used in England before the “Anglo-Saxon” model. The model is based on the self-responsibility (see 23). It does not regulate labor markets in order to lower costs of hiring for the firms and create opportunities for employment. It provides social protection only for those unable to find a job and avoid poverty without the welfare. The working individuals have choice of private health and pension insurances to care for them.

All the models will rank differently in terms of the generosity of protection, cost to the society, and the effect on the long-term economic growths. We will discuss the problems faced by all these systems from the point of view of the modern economic model used to describe the basic properties of the social welfare programs.

Economic model for social safety net

In order to continue analysis of the social safety nets, we would like to introduce a simple economic model. Let's assume that we have an economy with N individuals, and:

- (1) Every individual in the country can consume either goods c or leisure l .
- (2) Every individual has the same concave and twice differentiable utility function $U(c,l)$ that this individual tries to maximize.
- (3) Every individual has an income i , which consists of government transfers and the labor income, and is equal to the time the person works multiplied by his/her wage: $i=b+w*(T-l)$.
- (4) Each individual maximizes his/her utility given this budget constraint. Assuming there is no savings and the whole income is consumed, the constraint is $c=i$. General solution of this problem is to choose level of work at the point where marginal rate of substitution is equal to the wage rate. Assuming for simplicity that the utility is linear in consumption, the utility-maximizing amount of work is given by: $\partial U(c,l)/\partial l = -w$.

In order to introduce social welfare system into this economy, we have to make at least two critical assumptions about individuals in the country.

- (5) The individuals in the country have different abilities. For simplicity, we can assume that λ percent of population has high abilities able to earn wage a_H and $(1-\lambda)$ has low abilities and wage a_L .
- (6) The individuals with low ability can not generate labor income sufficient to bring their consumption to some minimal social standard of consumption (minimal subsistence level) M .

Therefore, the government has to step in and supplement the income of the low-ability individuals with the level Z (which may be equal or differ from M , depending on the generosity of the system), developing a simple safety net.

Finally, we assume that the government is interested to minimize expenditures on social safety net given necessity to bring income of all individuals in the country to the level at or above Z . Total cost of the SSN is determined by government's ability to monitor individual's abilities and earnings.

If the government is able to clearly observe individuals' abilities and earnings, the total expenditures for the social safety net will be minimal at the level be $E = N * \lambda * (Z - a_L * (T - l(a_L)))$. Coate and Besley (see 2) show in their article that in such conditions the government will have to pay only $Z - a_L * (T - l(a_L))$ in social benefits to the low ability individuals and will not pay any social benefits to the individuals with high abilities.

If government is not able to observe abilities, even if it is able to perfectly observe the level of wage earnings, the theory leads to conclusion that high-ability individuals may modify their work behavior in order to receive the benefit $Z - a_L * (T - l(a_L))$. Since the high-ability people are more productive, it will take them less time to work for the wage-income generated by low-ability people, (only $a_L * (T - l(a_L)) / a_H$ hours) The high ability people will alter their income if their utility working less with total income at level Z will be higher than utility from higher consumption and higher work $U(Z, [(a_H - 1)T + l(a_L)] / a_H) \geq U(a_H * (T - l(a_H)), l(a_H))$.

Coate and Besley (see 2) show that in this situation the government has two choices that minimize the expenditures for the welfare system. First is to offer the benefits of $Z - a_L * (T - l(a_L))$ to people with wage income $a_L * (T - l(a_L))$ and smaller benefit B that will satisfy criteria $U(B, [(a_H - 1)T + l(a_L)] / a_H) = U(a_H * (T - l(a_H)), T - l(a_H))$ to the population with income above Z . The total cost of the welfare system will go up to $E = N * (\lambda * (Z - a_L * (T - l(a_L))) + (1 - \lambda) * B)$.

Second possibility is to offer social security benefit only to people who identified themselves as low ability, but require them to work R hours at government organized work in exchange for this benefit. Given this solution to the individual problem, the low-ability individuals will lower their work for wage to the level of $T - l(a_L) - R$, therefore the size of the welfare benefit will rise to $Z - a_L * (T - l(a_L) - R)$. However, the R is chosen to so that $U(a_H * (T - l(a_H))) \geq U(Z, [(a_H - 1)T + l(a_L) - R] / a_H)$. In other words, with the work requirement the high-ability individuals will not be interested to take this solution, because working R hours at the private market for higher wage will generate more utility for them than participating in the government program. This solution to the failure of the social programs due to the behavioral response is called "workfare". The workfare expenditures of $E = N * \lambda * (Z - a_L * (T - l(a_L) - R))$ will be cheaper for the government than the first solution if there is sufficient difference between the wages of high and low income groups (the difference have to be such that $a_L < (1 - \lambda) a_H$) (see 2).

Most countries finance their social security programs by payroll taxes or other taxes on wage income. The tax as the source of funding for the SSN can be introduced into the model. Under assumptions of the model, there is sense to tax income of high-ability individuals only, because the social system will have to return to the low-ability individuals all the taxes that they paid. It also does not matter if the tax is a payroll tax (tax on enterprise) or income tax (tax on a person), because in any case at competitive labor market the tax will result in decreased wage income of the workers.

If the government imposes the tax of τ on the income of high ability people, the wage that they receive will become $(1 - \tau) a_H$. Given the concave utility function, the high ability people will work less, their wage income will become $(1 - \tau) a_H * (T - l((1 - \tau) a_H))$. According to the model, in this case the total expenditures of the welfare system will increase. If government is not able to observe individual's abilities, the government will have to implement more costly system that provides benefits to everybody, but the benefit provided to the high-ability population will rise. If the government considers to implements the "workfare" system, this task may become impossible if tax is significantly high, because the "workfare" system is possible to implement only is holds

condition $a_L < (1-\lambda)(1-\tau) a_H$. The government will also have to increase the work requirement $R_\tau > R$ since the difference in the cost of leisure for high ability people lowered.

If the welfare system is fully financed by the taxes on wages, it faces additional constraint in terms of our model. The total expenditures of the system can not exceed the total amount of taxes collected $E = N(1-\lambda) \tau a_H (T-l((1-\tau) a_H))$, and the tax rate has to be limited so that the condition $U(Z,R) < U(a_H (T-l((1-\tau) a_H)), T-l((1-\tau) a_H))$ holds, otherwise the high-ability people will exit labor market. The highest benefit that can be offered to poor people in this case can not exceed $(1-\lambda) \tau a_H (T-l((1-\tau) a_H)) / \lambda$, and this benefit will not alter behavior of high-ability people only if “workfare” system is used in the country.

Problems with the social safety net system observed around the world

The analysis of the simple economic model of social safety net leads to the conclusion that any social safety net can experience a number of problems. First problem is increase in the cost of the system due to the changing behavior of the potentially eligible population. We already discussed that if government is not able to observe abilities of an individual perfectly, the individuals with the high abilities will be interested to work for an income of low-ability person, and receive social benefits. This problem comes from inability of government to observe ability level of an individual. We also discussed that the policy solution that minimizes government expenditures in this situation is to introduce “workfare” policy.

However, even if the government perfectly observes ability of the population, the cost of the SSN can grow over the time. If the next generations of people will prefer to develop no ability and to receive the benefits at the total amount of Z , and the total cost of the welfare program will increase.

The steady increase in the costs of social welfare programs is the problem that can be easily demonstrated by the recent developments in the Western Europe and the United States, and the theory presented above is one of possible explanations of this phenomenon. In his recent review of the European welfare systems and labor markets James Heckman (see 8) notices that there is large empirical evidence that generous welfare systems are responsible to the decreased employment in the countries that adopted Continental or Mediterranean welfare system models.

Another possible factor contributing to the increase of unemployment in these countries is extensive protection of employees that is provided through policies of high minimal wages and strict firing rules. Both policies force firms to reduce employment of low-ability individuals, since for some of such individuals the productivity is less than minimal wage, and for another there is always a risk that the productivity will become lower than new minimal wage. It is demonstrated by Heckman that the rise in the number of unemployed and in the cost of social protection in the continental and southern Europe is likely the results of such restrictions (see 8).

Second problem foreseen by the simple model of SSN can accrue if low-ability populations’ ability to generate income is reduced. In order to compensate for the reduction of the income, a government will have to increase social benefits. The total cost of the SSN will increase, and may become fiscally unsustainable. Researchers debate that one of the major factors attributing to the reduction of opportunities for low-ability population in developed countries is economic globalization and outsourcing. Economic changes in China, India, and the Soviet Block together with increased world trade resulted in drastic changes at the labor markets of developed countries. Outsourcing and shifting production to the developing countries impacted the job opportunities for low-ability individuals in the developed countries, and, therefore, increased the pressure on the social welfare systems. According to Heckman (see 8) and Sapir (see 23), the globalization strongly impacted the counties with Continental and Mediterranean models, because strict labor market regulations in these countries did not allow firms to adapt to the new economic conditions. Sapir

(see 23) also argues that countries with these models of welfare systems discouraged increase in ability level, and further reduce abilities of low-ability population to find a well-paying job.

The economic model suggests that one of the responses to the decreased income opportunities for the low-ability individuals will be policy aimed to increase abilities of the population. This is possible explanation for the better performance of the US and Scandinavian countries. Researchers demonstrate that the countries adopting Nordic or Anglo-Saxon model stimulated greater proportion of the labor force to receive higher education (see 23). Large proportion of the universal institutional welfare benefits in these countries provided smaller discouragement for shifting from low-ability welfare receiver to high-ability working category.

The policy stimulating fast economic restructuring and economic growth is another possibility to increase income of low-ability individual and decrease the cost of the system. Karl Aiginger in his recent article (see 27) argues that American “liberal” welfare system and labor market policies are important factors in the ability of USA to overcome challenges of the globalization and to sustain higher rate of economic growth than the Europe. The flexible labor market policies and easier company registration procedures allowed the US firms to restructure. Low, because of the comparatively low benefits, cost of the social security system, and, therefore, low taxes also considered being significant contributors to the economy growth. Together with the economic growth the welfare system in USA provided sufficient resources to combat poverty in the country.

Despite the ability to generate faster economic growth and low cost of the system, we think that the whole social safety net in the US can not be considered exemplary because of the problems with the low coverage of the healthcare and pension system. First, due to the design of the healthcare system, the cost of the medical care in the US is going up, making the healthcare unaffordable not only for the poor, but almost for any person not working for a large company. It also substantially increases costs for government Medicaid and Medicare programs (see 5). Second, the US pension system is expected to face difficulties, which will be discussed later.

At the same time, simple economic model predicts that large amount of social benefits (Z) can create another problem with the social safety net. If a country has relatively small amount of low-ability individuals and society is tolerant to taxes, the government can introduce large level of social benefits. We already showed that if the government is not able to observe the abilities of the population perfectly, both low-ability and high-ability population groups will receive benefits. While the proportion of low-ability individuals is relatively small, the relative tax (the difference between taxes paid and benefits collected) on the high-ability population will remain low, and the government can provide large level of benefit to the low-ability individuals. However, if with the time the number of low-ability individuals increase, the government will not be able to keep fiscal balance and provide high level of benefits to low-ability population. This situation is clearly observed in the Scandinavian countries today.

The present welfare system of the Scandinavian countries was developed during the high economic growth in 1970-1980, and was not designed for the large number of unemployed or other benefit receivers that emerged in 1990th, when the rate of economic growth started to decline. In order to maintain budget balance, the countries are slowly cutting some parts of the welfare system, nevertheless trying to keep the welfare model intact. The countries also develop supplementary welfare systems that provide benefits through collective agreements between employee and employers to employed, but not the whole population (see 19). The supplementary welfare system is acting as an opposite of workfare system, providing stimulus to work in order to receive larger benefits.

Cutting the level of benefits is not the only solution to this problem. In our opinion, the Scandinavian countries demonstrated that economic growth can help sustaining social security systems with the large benefits. Aiginger (see 27) shows that despite the largest expenses on the

social security system, the countries with the Nordic model of welfare system had the best economic performance among the European countries. It is largely attributed to the ability of these countries to stimulate education of the labor force. Facing the challenges of the globalizing economy, they revised social welfare policies, putting attention to the learning programs, investment in research and education quality. Although these countries had large expenditures, they also had the strictest budget disciplines and lowest government debts among the European countries, and Sapir (see 23) argues that smaller deficit helped to sustain higher rate of economic growth in Scandinavian countries.

The role of the social security system and its impact on economic growth is widely discussed in Europe. Currently the EU continues debate on the future development of the social safety net in the countries of the union and on joint social welfare policy. Since according to the EU agreement the fiscal policy and the safety net policy are decided at the national level, every country will build its own welfare system. However, since the EU has common labor market, there are strong arguments to harmonize the welfare programs in the countries of the union (see 23). Based on the example of Denmark, the Western European countries are developing new social welfare model, called “flexicurity”. The model suppose to provide generous welfare benefits, but abolish labor market regulation to simplify hiring and firing processes, and adopt active labor market policies to help unemployed qualify for a new job (see 27). Easing restrictions on the labor market will provide flexibility to employ low-ability individuals, and the active labor market policies will allow transferring some low-ability individuals into high-ability group. Finally, the main purpose of the new policies is to stimulate economic growth, and increase wage income of both high and low-ability groups of population.

Although it is outside of further discussion of this paper, we would like acknowledge another problem with the SSNs that is observed around the World. Due to the demographic changes in the structure of the population, most European countries and the US are predicting significant problems financing pension systems in the nearest future.

Describing social welfare programs with economic model we showed that a system financed by taxes on income will significantly suffer from change in the proportion of working people and beneficiaries. Modern government pension systems in the developed countries are based on the pay as you go principle (PAYG), meaning that current pensions are financed from the contributions of current workers collected in a form of payroll tax. The number of workers significantly exceeded number of pensioners in 1960th-1990th due to the post World War II increase in birthrate, and the PAYG systems were running surplus or were able to provide generous pensions. However, demographic forecasts suggest that in the next decade large number of these workers becomes pensioners, significantly reducing the number of workers who pay the tax, and increasing the number of pension beneficiaries. In order to avoid large deficit of the pension system, the countries have to decrease the benefits. For political reasons they choose gradually increase pension age instead of lowering the amount of pensions. Increasing pension age will result in longer contributions by a person, and shorter period when this person receives benefits, which will help keeping the PAYG systems in balance.

Conclusions

The development of safety net is endless process of balancing between desires to provide higher benefits to the needy population, financial feasibility of the system, and avoiding discouragement of work the microeconomic level and of economic growth at the macroeconomic level.

Experience of the developed countries shows that there is no ideal social safety net model. Social safety net systems with generous benefits risk becoming fiscally unsustainable in a long-run. The systems with low level of benefits avoid fiscal constraints, but are not able to provide government protection according to the modern standards for the developed countries.



There are different policy levers that allow reduce the risk of becoming fiscally unsustainable: introduction of effective stimulus to work, reduction in the level of benefits, and development of ability to generate income by low-ability group of population. However, the policies that support stable economic growth considered the most beneficial solution that increases income of all population groups and reduces the cost of the social safety net system.

Chapter III: Specifics of the Social Safety Nets in Transition

Despite apparent differences, the social safety nets in the developed countries of the world have common feature: these nets are functioning in the countries that have strong economies. The policy problem for these safety nets can be reformulated in simple words: how to change the nets so they do not become a reason for economic depression in the future. Majority of the population developed countries lives above poverty and has option to work. However, the generous welfare programs allow them to live well without working, creating the problems for the system.

The most economies in transition face the opposite problem: they are looking for the social safety net policy that will bring majority of population out of poverty induced by the economic downturn at the beginning of transitions. We show that common distinctive features of the transition economies, especially economies of former Soviet Union countries, are poor conditions of national economy, large extend of poverty, and generous welfare systems. The extensive social safety net successfully reduced poverty only in the countries that could sustain the SSN with the balanced budgets. In the countries that experienced larger economic downturn supporting social safety nets put large burden on economy. It reduces economic growth and does not allow majority of working population get out of poverty. We conclude that the policies stimulating economic growth at the expense of reduction in Social Safety Nets can be optimal policy option for such countries.

Brief history of SSNs in transition countries

By the end of 1980th countries of the “Soviet Block” (the Eastern European countries and the Soviet Union) had most advanced social safety nets (SSN thereafter). For example, the social safety net in the United States consist of about 80 mean-tested federal programs that provide some cash (TAFT program), in-kind (housing and food), healthcare assistance (Medicaid) to the low-income individuals and households (see 13), and the government pension program. The total cost of the welfare programs in the US is only about 16% of GDP (see 27). The Western Europe has more generous and expensive social safety net that includes government-funded or obligatory health insurance, higher pension and unemployment benefits, earlier retirement, government assistance for education. This system is more expensive, and European counties spend about 24% of GDP on the safety net. The SSN of the former Soviet Block countries provided free healthcare and education (including higher education) to everybody, and the cost of other services, such as childcare, vacations, etc. were greatly reduced by the price equalization mechanisms. B. Milanovic (14) in his recent book showed that social transfer constituted about 19% of personal income in typical socialist economy (see Table III-1), while accounted only 14% in typical market economy. This difference may be even larger because some benefits provided in-kind or through discounts by the state enterprises to their workers can not be captured by such simple comparison. The pensions were generous and the retirement age was around 55 year for females and 60 for male, in addition retirees received a package of discounted or free services, like housing, phone, and other. Because of the full employment, the unemployment benefits were small or non-existent in these countries. The cost of the SSN was huge, but was largely carried by the state-owned enterprises and not by the state budgets.

At the end of 1980th and beginning of 1990th the Soviet Block countries started transitioning their economies from the planned to market economy system. It was obvious that it will be impossible to make the transition without transforming the SSN because price controls and heavy SSN burden on the enterprises were not compatible with the market economy. However, even when the SSN became government responsibility, it had to be reformed because (1) it did not match new tasks and poverty profiles, and (2) the economic slowdown accompanying the transition put constraints on the government expenditures.

Economic Downturn and Changing Poverty in the Region

Despite the ethnical and cultural differences, the countries of the Soviet Block started transition from the same economic model that characterized by high levels of urbanization, large wage economy, broad social programs and large social infrastructure. The economic structure implied above-average social indicator, low level of inequality and high expectations regarding the government protection (see 7). However, we can clearly observe that there are two general passes of transition that allow us to divide transition countries into two categories with different approach to the social safety net reform.

The cultural legacy of the Eastern European countries probably predetermined their aggressive approach towards the economic reforms. This approach resulted in the shorter period and smaller depth of the recession.

The Central and Eastern European (CEE) countries combated recession by fast restructuring of the economy, which was accompanied by large layoffs of workers, while people who remained employed were able to maintain relatively decent income. Unemployment in CEE countries rose dramatically at the beginning of transition, and even now remains higher than in most of CIS countries. For example, currently, the unemployment rate in Poland is around 19%, which is comparable only to that in Georgia, the country that was a war zone for the last decade.

The labor market transformation in current CIS countries took the path different from the transformation in countries of the Eastern Europe (current new EU states). Despite massive drops in GDP, unemployment in CIS countries remained at relatively low levels. During the period 1990-1994 average decline of GDP in the CIS countries was around -11%, while decline in employment was only -1% (compare to the -3% and -4% respectively in CEE countries) (see Table III-3 and also 17). During the periods of 1994-1998 and 1998-2004 the figures were (-0.2%, -0.3%) and (+4.5%, +0.3%) respectively. Only countries that went into war, such as Armenia, Georgia, and Moldova experienced sharp decline in employment. The adjustment took the form of lower real wages, which dramatically draped for the CIS region during the transition, and still remain lower than in pre-transition period (see Table III-4).

The unemployment became one of the new sources of poverty and targets for the social support systems in the CEE countries. Creating strong and extensive unemployment programs helped these countries to fight poverty among unemployed and keep national consensus about the speed of the reforms and establishing open –market economic relations. Active labor market policies and “back to work” programs helped population to get out of poverty once they exited unemployment (see 7).

Because of the reluctance to fire extensive labor force during transitions in the CIS countries, the unemployment was not the major precondition for falling in poverty in these countries. The low-income employees were first to experience the massive delays in paying wages, pension and other benefits in these countries (see 28). By the end of 1990th, there emerged new social groups prone to poverty: families of officially employed persons on unpaid or partially paid leave, public workers, small farmers and rural business owners (see 1). The working poor accounted for about half of poor in Russia, about 87% of poor live in families where one or several members are working (see 18). In Ukraine, about 78% of poor families had at least one working member in 1999 (see 12).

The economic decline during the initial stage of transition sharply affected the more educated social groups (see 1). World Bank study of poverty in the CIS region in 2000 (see 28) showed that contrary to OECD countries, the competitive advantage of higher education in the CIS was fairly low: not all the qualified workers in the CIS can find positions adequate for their qualifications. However, the later studies start finding that poverty is negatively correlated with education. Buitano (3) showed that in Ukraine the higher level of education of the head of the household, the less likely the family will be in poverty.

For the CIS region the highest risk of becoming poor is for families with high number of dependents (children, disable and old pensioners), supported by one working member. The World Bank study (see 28) finds that children are especially risky factor for families in Central Asian CIS, and having a child dramatically reduces chances to escape poverty in European CIS.

Despite common perception, the elderly and pensioners are not in higher risk to fall in poverty than the rest of the CIS population. Only pensioners who unable to work and live in sing-person household would almost certainly fall in poverty (see 1). The explanation of this phenomenon is low pension age remaining in most CIS countries. The pensioners continue to work after retirement, and the pension is a supplementary payment sufficient to bring their income above poverty line. The World Bank found that risk of poverty for working pensioners is only about one third of the average risk in Russia (see 28).

Analyzing implications of the transition by economic model of social safety net

Changing economic environment and poverty profile impacted social safety nets is the countries in transition. Here we would like to discuss the impact of such changes with the simple model of SSN developed in previous chapter.

First, we would like to argue that political changes in the country had to decrease performance of the social safety net and increase it's cost because of change in governments capacities to observe abilities of population. This increase should especially affect the countries based on authoritarian political system. The abilities, work efforts and earnings could be fully observable under authoritarian central-planned regime, for example the one existed in Soviet Union. We showed that perfect observation of individual's abilities allow keeping the social payments at low optimal level. This can partly explain ability of the Soviet Union to support extensive social safety net. The beginning of economic transition in the countries of CEE and FSU coincided with rebuilding of democratic society. Because of the respect for personal liberties, the democratic societies generally do not have instruments to observe working abilities of individuals perfectly. Therefore, according to the model, the countries of transition had to experience increase in social safety net expenditures from $E = N * \lambda * (Z - a_L * (T - l(a_L)))$ to the level $E = N * (\lambda * (Z - a_L * (T - l(a_L))) + (1 - \lambda) * B)$, where B is the benefit received by high-ability population.

Further increase of the cost of social safety nets in the countries of transition comes from decrease in income of population and change in the poverty profile. However, before discussing these implications, we would like to extend our model to incorporate modern theories of growth into the model.

We incorporate the Lewis model of economic growth in a country as the basic model for economic growth. The Lewis model assumes that an economy consists of two sectors. First sector is "traditional" economy with low productivity and excessive supply of labor. Second sector is the "modern" economy with high productivity of labor. The model assumes that "modern" sector has higher economic productivity, and there is significant difference in wage in "traditional" and "modern" economy. The labor force has strong incentives to work in "modern" sector. The economic growth in the model is achieved by transition of excessive labor from "traditional" to "modern" economy.

There are differences in observed patterns of economic transformation and poverty profile in two groups of countries: fast-changing economies of CEE and slow-changing economies of FSU. These differences can be explained in terms of the Lewis model. The faster-changing countries had to develop larger "modern" sector of economy, while slow-transitioning countries can be characterizes as countries with small "modern" sector and slow transition from "traditional" to "modern" sector of economy.

We argue that in the fast-changing countries of CEE the economic transformation created the “modern” economy sector that absorbed significant part of high-ability population. The rest of the high-ability population constituted excessive labor force and was fired. The laid off high-ability population became new users of the social security benefits. If there was significant difference between wages in “traditional” and “modern” economies, and social benefits to unemployed were sufficient to avoid extreme poverty, the high-ability individuals will prefer receiving benefits and looking for a job in “modern” sector to the job in “traditional” sector. At the same time, if difference in wage income in “traditional” and “modern” sectors of economy is sufficient to satisfy criteria $U(Z, [(a_H - 1)T + l(a_L)] / a_H) < U(a_H * (T - l(a_H)), l(a_H))$, the difference in wages should keep employed high-ability population from altering behavior and applying for social security benefits even if government is not able to observe individual ability levels. Therefore, the fast-transitioning countries should be able to discard any categorical benefits provided to all population groups, and keep the cost of the social safety net at the level $E = N * \lambda * (Z - a_L * (T - l(a_L))) + \lambda_u * N * Z$, where λ_u is the proportion of unemployed high-ability individuals.

The model for social safety net in the fast-transitioning countries is not significantly different from the original model of social safety net discussed in previous chapter. Assumed large difference between wages of high-ability population in “modern” sector and level of benefits allows to impose a tax on employed high-ability individuals in order to finance the SSN. If the tax is the only source for finance the SSN, and the SSN budget is balanced, the affordable level of benefits will remain low until number of high-level unemployed is high. This will ensure that working high-ability individuals are not altering their work behavior in order to receive benefits. Finally, the obvious policy to ensure balance of the social safety net is to stimulate employment in “modern” sector which simultaneously decreases number of high-ability individuals who are unemployed and are receiving benefits, and increases the tax base for the financing of the system. As the number of working high-ability individual increases, the tax rates can be decreased, stimulating further development of the “modern” sector.

The model for the fast-transforming countries of CEE depended on the assumption that significant number of high-ability individuals became employed at the “modern” sector of economy, received high wages, and were able to finance the social safety net with the taxes. The assumption of large “modern” sector does not seem plausible in the slow-transforming economies of FSU. As we showed, these countries experienced longer and deeper economic downturn, which should not happen if there is large “modern” economy in a country. The poverty profile in these countries indicates that unemployment in the countries is low, but employment does not guaranty most of the population staying out of poverty. We propose to extend our model with different assumptions in order to explain these observations.

Let's assume that because of transition, the population of the country can be devised into three categories: low-ability people, who receive wage of a_L ; the high-ability people whose abilities sufficient to work in “modern” sector of economy and generate income a_H ; and the high-ability people who do not have skills to find employment in the “modern” sector of economy, and are able to work at high-skills jobs of “traditional” economy, generating wage a_M .

We assume that economic downturn in the slow-transforming countries of transition forced wage of low-ability population a_L close to zero, and the wage at high-skilled jobs of “traditional” economy a_M close to minimal subsistence level M (poverty line). The wage of the high-skilled workers at “modern” economy is high, but proportion of such workers in low compare to the proportions of high-skilled workers in “traditional” economy. We also assume that this proportion in slow-transforming countries is significantly lower then proportion of high-skilled workers in “modern” economy of fast-transforming countries.

These assumptions place significant restrictions on the balance of social safety net in a slow-transforming country:

- (1) Because the difference between labor income of high-skilled labor in “traditional” sector $a_M*(T-l(a_M))$ and minimal subsistence level M is small, it is almost impossible to impose tax on these people. Maximum amount of tax that will not put this part of population in poverty $M - a_M*(T-l(a_M))$ will be significantly lower than the tax collected from employees of “modern” sector of economy. The resistance to this tax will be high, and the employees will have strong incentive to avoid taxation and work in “shadow” economy.
- (2) Because proportion of labor in “modern” sector is smaller in the slow-transforming countries than in fast-transforming countries, the same level of taxation of “modern” sector will generate smaller revenues and will provide smaller funds to finance SSN.
- (3) Because the labor income of low-ability people is close to zero, the total expenditures for ensuring income at level Z will be close to $N*\lambda_L*Z$, where λ_L is proportion of low-ability population in the country. These expenditures will be higher than expenditures in fast-transforming country with the same proportion of low-ability population.
- (4) If government finds sources of funding to provide social benefits to the low-ability population at level Z close to the poverty line M , it will not be able to implement this policy. Because high-ability people in “traditional” economy have work income close to M , they will prefer quitting job and receiving income Z . Then total cost of the social safety net will increase to $N*(\lambda_L+\lambda_M)*Z$, where λ_L is proportion of low-ability population in the country, and λ_M is proportion of high-ability people working in “traditional” economy in the country.

The model presented here suggests that reforms of the social safety nets in the slow-transforming countries of FSU will be governed by fiscal feasibility of the system, and will consist of constant cuts in the amount of benefits. The ability to finance the SSN will greatly depend on the development of “modern” sector of economy. Attempts to impose high taxes on “modern” economy or on high-ability population in “traditional” economy will lead to development of large “shadow” economy.

At the same time, any attempt to increase social benefits for low-ability people will immediately trigger change in behavior of other people in “traditional” economy, increasing number of beneficiaries that were not considered when the system was designed. In order to keep cost of SSN low, the government will need to implement sophisticated screening for the benefits or introduce “workfare” policies. However, since the number of potential beneficiaries of untargeted social transfers is high (equal to $N*\lambda_M$), there will be significant political pressure to keep the untargeted benefits.

The effect of political “lock-out” of inefficient social system with high untargeted benefits is not only phenomenon of transition economies, but can be observed in any democratic country with large proportion of urban population and developed infrastructure for government social services. Christian Ponce de Leon (see 20) derived this effect from the simple economic model of SSN that we discussed in previous chapter. Instead of single benefit to the poor low-ability people, he assumed that there are two possible policies. One is to provide benefit B_1 to the poor people whose ability do not allow them to receive enough income; this is usually the benefit provided by special poverty alleviation programs, such as workfare. Another is to provide benefit B_2 to everybody in the country; the example of such policies can be institutional policies such as universal healthcare and pension benefits. The benefits are financed by taxes, and are subject to budget constrain $(\lambda B_1 + B_2)N = E$, where E is the government revenues dedicated to these programs.

If the choice between these two policies is made by simple voting, it is easy to see that the high-ability people will always vote in favor of spending all money on the benefit B2 since we assume no personal utility from providing benefits to somebody. Ponce de Leon shows that the low-ability individuals in rural areas will prefer targeted poverty benefits B1 program. However, the low-ability people in urban areas, where the infrastructure is more developed, will prefer a mix of targeted poverty benefits B_1 and the universal benefit B_2 with emphasis on the universal benefits (see 20). The researcher also shows that in the countries where most of the population leaved above the poverty line, the voters will select policy B_2 . In the developing countries where most of the population leaves below poverty line, but proportion of urban population is large, the voters will also select mix of large universal policies B_2 and small targeted assistance programs B_1 . Because most of the transition countries of Soviet Block have large level of urbanization and developed social infrastructure, we may expect that development of targeted social assistance programs in these countries will be limited by political reasons.

Social Safety Net reform experience in the transition countries of CIS and Eastern Europe

The development of the social safety nets in the countries of transition confirms that conclusions that we derived with the theoretical model. Transformation of the social safety nets in these countries in transitions generally lagged behind the economic transformation. The countries tried to follow the experience of developed countries. The success of the SSN reforms greatly depended on the economic conditions in a country and ability to finance SSN. The speed of economic transformation was major predetermined willingness to reform the SSN.

The fast-growing countries of Eastern Europe experienced economic decline that lasted only 3-4 years, and cumulative decline was 20-25% of GDP. Most of these countries reached the pre-transition level of output by year 2000. These countries were able to afford government expenditures on the level of 40% of GDP, and spend 15-20% of GDP on social safety net programs. The largest expenditures were on free healthcare and education, followed by unemployment protection and other social benefits. The pension programs accounted for another 7-15% of the GDP in expenditures. In accordance to the conclusions of our theoretical model above, some researchers attribute success in restructuring labor markets and keeping population out of poverty to the unemployment programs with active-market policies in these countries (see 7). Because of the fast recovery that simulated economic growth and in accordance with the expectations with derived from our theoretical model, the CEE countries were able to adopt European models for social safety nets. At the same time, researcher attribute major role in combating poverty in these countries to sustained economic growth (see 7). The long-term feasibility of their SSN remains questionable in these countries because as they approach end of the fast-growth transition period, their SSN will face the same problem faced by the developed European countries. However, currently continued economic growth creates in these countries pre-conditions for successful further SSN reform in accordance to the new European SSN models that we discussed in previous chapter.

The countries of FSU took path of slow reforms. They experienced longer (more than 6 years) and deeper (60-80% of GDP cumulative decline) economic slowdown. Due to this slowdown, the average tax revenues in the CIS countries felt from 28% of GDP in 1992 to 22% of GDP in 1998, and some countries with slower transition like Georgia, Kyrgyzstan, Tajikistan experienced drop in revenues under 15% of GDP (see 28). Transition to the market economy forced government to reduce some budget functions such as direct subsidies to the national economy, but the SSN systems remained almost unchanged. It seems that FSU countries were caught in the political lock-up that did not allow cutting any social benefits that are provided to the whole population. Most of the countries (except Russia and Kazakhstan, which have significant income from oil trade)

constantly run significant budget deficits in order to finance government obligations (see Table III-5).

Large parts of social safety nets in the most of the CIS countries are education and healthcare systems, since traditionally these countries declare right to free education and healthcare in their constitutions. The countries spend large portion of the state budget on these items, however with time the financing for these parts of the social safety net become lower than required to provide the service with adequate quality. Reform of the education and healthcare systems in these countries of transition is important issue for sustaining SSNs, but it is generally out of scope of this paper, and we will not discuss it in further detail.

The largest social welfare item outside the state budget in FSU countries is pensions, accumulating and spending 7-12% of GDP. Despite being the largest expenditure item, in accordance with expectation that we derived from our theoretical model, due to the lack of funding the pension became only valuable co-payment for working pensioners, and by itself do not provide income sufficient to stay out of poverty (see 28). For example, universal pension in Georgia in 2000 was only 23% of the living wage, and in Ukraine the average pension was only 36% of living wage in 2003. Following the example of the CEE countries, the CIS countries started pension reform, introducing multi-tier (mandatory and voluntary funds) pension system. However they are just at the beginning of the process and the new systems expected to have an impact in 15-20 years.

The social welfare system in the CIS countries did not change significantly from the universal social welfare system that they inherited from USSR. The system remains very poorly oriented towards supporting the poor. The social assistance programs remain aimed at providing services or supplementary payments to certain groups of population (elderly, children, disabled) and putting the task of reducing poverty at the last place. Reacting on the dramatic change in the structure of expenditures and in order to retain the soviet-time system of special rates, the governments of the CIS countries introduced large number of subsidies or discounts, often provided in-kind. For example, until 2005 Russia kept 156 types of subsidies and social payment that were directed to 236 different population groups. Almost 70% of the Russian population was recipients of the welfare benefits (see 4). At the end of 1990th about 3% of GDP in Moldova were distributed among more than 100 different subsidies and discounts. Armenia and Ukraine had the same situation (see 7). As we derived from our theoretical model, the number of beneficiaries for these assistance programs became enormously high, while the size of the benefits gradually decreases due to the lack of financing. Despite the significant expenditures on subsidies and discounts, these programs very severely underfinanced. It was estimated by the researchers at the Center of Strategic Research (Russia) that financing need for the subsidies established by federal law in Russia exceeds 15% of GDP in 1999. In order to improve monitoring and targeting of these social benefits, Russia monetized the in-kind benefits in 2005 (Federal Law #122). However, the monetization of the benefits triggered strong negative social reaction and did not begin the reform of the social benefits in order to reduce their cost.

Apparent problem of non-payment of social benefits because of the huge difference between the required expenditures and available revenues was partially resolved by decrease of real amounts of the payment because of high inflation. Until the beginning of 21st century, the payments were not automatically indexed with inflation, but rather revised on irregular bases. As the result, by the 2003-2004 the welfare payment became symbolic in most of the countries. For example, the social benefits in Russia amounted about 6% of average wage, in Ukraine and Azerbaijan about 3-4% of average wage.

Contrary to the fast-transforming countries of CEE, the unemployment insurance in the CIS countries did not play significant role in keeping people out of poverty. At the beginning of transformation period, most CIS countries tried to implement the unemployment insurance programs similar to the programs in developed market economies. However, due to the difficulties

to fund the system, the unemployment benefits were rather low and terms of applying to the unemployment payment were harsh. As the result, despite the increase in unemployment, the percentage of people registered to receive benefits was low, and the role of the unemployment system in reducing poverty in CIS countries was extremely low (see 22).

In accordance to the theoretical model that we discussed above, the attempt to finance expensive social security system with taxes on employees would stimulate high-ability individuals in “traditional” economy to shift to the informal economy. This might be one of the reasons why the transition to market economy in CIS countries was characterized by rapid growth of informal sector, reaching 39% of economy in Kyrgyzstan, 44- 45% in Armenia and Moldova, 50% in Ukraine, 60% in Azerbaijan and Georgia (see 6). Obviously, the employees of the shadow economy were not covered by the unemployment insurance. However, they qualified for other social benefits and subsidies, although they did not contribute to the system.

The expensiveness and bad performance of the post-soviet SSN were recognized at the early stages of transition. B. Milanovic in his book in 1997 (see 14) suggested abolishing categorical benefits in SSNs of countries in transition and introducing Minimal Income Guaranty programs, which will provide benefits only for the people whose income is below the guaranteed income, and in the amount only sufficient to reach the minimal guaranteed income. Since that time a number of means-testing programs were introduced in the CEE and CIS countries.

The mean tested programs are viewed as policy that can significantly reduce cost of the SSN by cutting benefits to the population that is not in deep poverty. International experience suggests that the programs based on Verified Means Testing (VMT), such as used in the USA, are very precise in targeting the poor, but extremely costly to implement. Less expensive are Unverified Means Testing (UMT) programs, which do not require expensive verification of submitted information. They are proven to be less effective in targeting poor than VMT, but more effective than categorical benefits. Another inexpensive approach, based on assertion of income from social characteristics, is called Proxy Means Testing (PMT). This approach was successfully used in Chile, Colombia, Costa Rica and Mexico and provides targeting comparable with VMT programs (see 24). The governments of the CIS countries with support of international organizations like the World Bank were implementing such systems at the national level. The pilot projects of the means-tested social programs proven to be successful in targeting poor, but extent of the projects was negligible. For example, Romania in 2000 provided only 1% of total social assistance through mean-tested programs (see 7).

However, the ability of these programs to substantially reduce poverty at national level is questionable. One possible explanation of the unsuccessful implementation of the means-tested programs in these countries at the large scale we derived from our model. By design the means-tested programs supposed to provide relatively large benefits to the people with low ability to generate income. However, according to our model, the number of people who will change their behavior in order to receive the large social benefits (high-ability workers in “traditional” economy in the model) should be large, and even means-tested programs will large benefits will be very expensive because of the large leakage from the system.

Another explanation is that any means-testing welfare program requires extensive monitoring and constantly updating system of social indicators. Such systems were not present in the CIS countries in the past and are under development now. The only successful targeted programs at the CIS countries were programs implementing PMT-type targeting, such as the support to families with children (see 7).

Conclusions

Similar to developed countries, the countries of transition face the same problem of balance in the development of social safety net. However, while developed countries are looking for reform of the safety nets that will prevent future downturns in the economy, countries of transition are reforming the SSNs while recovering from depression.

The development of the social safety nets similar to the SSNs in developed countries is feasible task for the fast-transitioning countries. However, for the slow-transitioning countries of FSU the economic growths may be important factor in reducing poverty than the social safety net. Therefore, reducing speed of economic growth by excessive taxation of successful sectors of economy in order to finance large social safety net might be inappropriate policy in these countries. Even more dangerous policy might be increase in social benefits because of the possible behavioral response of the large proportion of population.

Tables and figures

	Socialist countries	Market countries	Developing countries
Primary income	77	85	90
Labor income	63	64	35
Self-employment income	13	14	48
Property income	1	5	6
Occupational (private) pensions	0	2	0
Social transfers	19	14	3
Pensions	13	12	2
Child benefits	4	1	0
Other cash transfers	2	1	0
Other income	6	1	7
Gross income	100	100	100

Table III-1. Sources of income in socialist countries and market economies

Source: B. MILANOVIC, "Income, Inequality, and Poverty during the Transition from Planned to Market Economy", World Bank 1997

	1989	max 1992- 1996	max 1997- 1998	1999	2000	2001	average 2002- 2004
Armenia	14.3	54.7	53.7	53.7		47.4	42.5
Azerbaijan	33.6	72.2	71.2	54.3	52.3	49.6	
Belarus	3.3	38.6	33.0	46.7	41.9	28.9	25.1
Georgia	13.0	80.0	50.2	51.4	51.4	52.0	52.0
Kazakhstan	15.5	34.6	39.9	34.5	31.8	28.4	24.2
Kyrgyzstan	32.9	51.9	63.6	64.1	62.5	56.4	
Moldova	11.8		61.6	71.1	70.5	62.3	
Russian Federation		33.5	23.3	28.3	28.9	27.3	20.8
Tajikistan	51.2			95.7	83.0		
Ukraine	6.0	29.5	28.5	27.8	26.4	27.2	27.2

Table III-2. Poverty levels in CIS countries (% of people living below national poverty line)

Sources: Ovcharova et al.(1999), Falkingham (2003), and publications of national governments

	1990-1994		1995-1998		1999-2002	
	Employment	GDP	Employment	GDP	Employment	GDP
Armenia	-2.2	-16.2	-2.2	5.8	-0.94	7.9
Azerbaijan	-0.5	-17.0	0.5	1.0	0.12	9.7
Belarus	-2.3	-7.8	-1.5	2.7	-0.40	4.6
Georgia	-10.8	-27.5	-0.3	6.6	-0.65	3.8
Kazakhstan	-4.2	-9.6	-1.8	-2.1	2.30	8.8
Kyrgyzstan	-1.5	-14.4	0.9	3.3	2.06	3.6
Moldova	-5.1	-20.5	-0.6	-4.2	0.00	-1.1
Russia	-2.3	-10.3	-2.0	-2.9	0.69	0.8
Tajikistan	-1.1	-20.1	-0.7	-2.7	0.00	0.9
Turkmenistan	3.5	-9.2	2.5	-5.2	0.00	3.8
Ukraine	-2.4	-14.1	-0.7	-6.9	-0.18	-0.1
Uzbekistan	1.3	-4.9	1.9	1.9	0.35	1.0

Table III-3. Employment and GDP dynamics in the CIS countries, average growth rate

Source: *Economic Survey of Europe 2004; EBRD Transition reports; author's calculations*

	1989	1991	1993	1995	1997	1999	2001	2002	2003
CEE countries									
Bulgaria	100	64	78	60	39	51	51	51	
Czech Republic	100	69	79	93	103	108	115	120	
Estonia			102	120	132	150	169	183	
Hungary	100	97	98	92	93	99	111		
Latvia		68	49	55	58	63	68	72	
Lithuania	100	78	33	40	48	57	56	57	
Poland			100	104	117	127	131	134	
Romania		85	64	74	64	62	71	72	
Slovakia	100	67	71	76	87	86	82	90	
Slovenia	100	57	62	67	73	76	80	82	
CIS countries									
Armenia	100	51	6	5	7	9	11	14	15
Azerbaijan	100	80	44	14	26	37	50	60	71
Georgia	100	73	15	12	24	31	40	45	0
Kazakhstan		83	34	23	25	30	36	43	45
Kyrgyzstan	100	82	28	21	24	24	26	30	33
Moldova	100	96	41	25	28	26	32	39	47
Russia	100	76	33	36	54	34	52	57	63
Tajikistan	100	88	17	5	4	6	7	9	12
Ukraine	100	108	47	44	41	38	46	56	63
Uzbekistan	100	91	100	133	165	240			

Table III-4. Real wages in CEE and CIS countries since 1989

Source: *Economic Survey of Europe, 2004; National sources; Authors calculations*

	Consolidated general government deficit/surplus						Public debt				
	2000	2001	2002	2003	2004	2005 target	2000	2001	2002	2003	2004
Armenia	-6.4	-3.7	-0.3	-1.1	-1.3	..	..	45.3	46.6	40.9	..
Azerbaijan	-1.3	1.2	-0.4	-2	-1.2	..	..	..	..	..	..
Belarus	-0.2	-1.9	-1.8	-1	-1.5	-1.5	15	..	13.1	10.6	9.4
Georgia	-4.7	-2	-2.2	-1.3	-1.2	-0.5	60.3	57.7	55	54.3	..
Kazakhstan	-0.8	2.7	1.4	3	2.3	1.6	25.5	20.4	17.7	15.5	14.4
Kyrgyzstan	-9.9	-5.5	-6.3	-5.5	-4.7	-4.5	112.4	100.4	103	101.6	..
Republic of Moldova	-2.8	-0.5	-2	0.2	-0.7	-0.5	73.2	60.7	56.9	47.1	39.1
Russian Federation	3.1	2.7	0.6	1.1	3.2	1.5	63.3	50.8	43.2	32.1	28.1
Tajikistan	-0.6	-3.2	-2.4	-1.8	-3.5	..	..	..	..	..	..
Turkmenistan	..	-1.1	-0.7	-0.9	-	-	..	..	..	..	..
Ukraine	-1.3	-1.6	0.5	-0.7	-4.3	-1.3	..	31	29.2	25	23.1
Uzbekistan	..	-1.3	-3	-2.2	-1.1	-1	..	..	..	..	..

Table III-5. Fiscal deficits and public debt in the CIS economies, 2000-2005 (percent GDP)

Source: *THE COMMONWEALTH OF INDEPENDENT STATES, Economic Survey of Europe, No. 1, 2005 pp. 59-81*

Country	Survey date	Percent living in extreme poverty (\$2.15 a day)	Percent living in poverty (\$4.30 a day)	Total population extremely poor (thousand)	Total population poor (thousand)
Central Europe and Baltic states					
Estonia	1998	2.1	19.3	30	280
Latvia	1998	6.6	34.8	162	852
Lithuania	1999	3.1	22.5	115	833
Czech Republic	1996	–	0.8	–	82
Hungary	1997	1.3	15.4	131	1558
Poland	1998	1.2	18.4	464	7114
Slovakia	1997	2.6	8.6	140	464
Slovenia	1997-1998	–	0.7	–	14
South-east Europe					
Albania	1996	11.5	58.6	383	1952
Bulgaria	1995	3.1	18.2	256	1503
Croatia	1998	0.2	4	9	187
Romania	1998	6.8	44.5	1531	1016
Republic of Macedonia	1996	6.7	43.9	135	882
CIS					
Armenia	1999	43.5	86.2	1651	3271
Azerbaijan	1999	23.5	64.2	1860	5080
Georgia	1999	18.9	54.2	1020	2926
Kazakhstan	1996	5.7	30.9	860	4664
Kyrgyzstan	1998	49.1	84.1	2291	3925
Tajikistan	1999	68.3	95.8	4133	5798
Turkmenistan	1998	7	34.4	330	1620
Uzbekistan	2000 ..	..	..	2395	11977
Belarus	1999	1	10.4	102	1060
Republic of Moldova	1999	55.4	84.6	2022	3088
Russian Federation	1998	18.8	50.3	27548	73706
Ukraine	1999	3	29.4	1501	14714

Table III-6. Percentage of the population in poverty using international poverty standards

Source: UN ECE (2004): *Poverty in Eastern Europe and the CIS, Economic Survey of Europe, No. 1 2004, pp. 163-176*

Chapter IV: Analyzing Social Safety Net in Ukraine

Ukraine started the process of transition to market economy in 1992, which immediately triggered necessity of social safety net reforms. The country received significant international assistance in designing the new social safety net, however most of Ukrainian SSN is not reformed yet. Recent debate about increase in social benefits can significantly change the policy-making around the issue of SSN reform in the country. Understanding of the economic development and poverty profile, as well as current trends and historical development of the SSN are essential for further analysis policy analysis in this paper.

This chapter describes the socio-economic situation in Ukraine and the development in of the SSN in the country. It provides insight for the current trends in the development of the social programs in Ukraine, and describes the policy problems for the government implementing the changes. The chapter provides background information for further evaluation of the cost of the social safety net in Ukraine.

Current Social Security System in Ukraine

Economic Development and Poverty Profile

Ukraine followed the pattern common for the CIS countries. After its independence, the Ukraine suffered economic downturn that continued for 6 years. In 1998 the real GDP fell to the 41% of the GDP in 1990 (see Table IV-1). The GDP start growing in 1999, and by 2004 pick up a pace of 12% a year. The GDP growth was slowed down to the 2.6% in 2005 due to the political instability and new social and fiscal policy that we will discuss later in this chapter.

Ukraine experienced massive decline in the population since the time of transitions. Due to the increased death rates, decreased birth rate, and large migration out of the country, the population shrunk from 52 mln. in 1991 to 46.9 mln. in 2005 (see Table IV-2). The demographics although changed significantly because of aging. Although the proportion of people of working age (considered to be from 15 to 70 years old) did not change, the proportion of younger people decreased. The population became more economically active during the recession because most of pensioners able to work had to look for some job to supplement their pension income. At the same time, proportion of pensioners in the total population grew from 25% in 1991 to 30% of total population in 2005.

Although the proportion of employed decreased from 47% in 1995 to 42% in 2005, similar to other CIS countries, the economic depression did not result in the large unemployment in Ukraine. The largest unemployment since independence was around 12% in 1999-2000, and the unemployment rate was decreasing after that partially due to the decrease in the proportion of economically active population from 52% in 1998 to 47% in 2005 (see Table IV-2).

Rapid economic decline resulted in increased poverty. It is established that during the Soviet Union only about 6% of population of Ukraine lived below national poverty line of 75 rubles, and this was primarily rural population in depressed western regions. The poverty reached its' maximum during at the recession period 1992-1996, when about 30% of population lived below national poverty line (see Table III-2). The poverty reduced with the first signs of economic growth, but remained stable at 27% of population below national poverty line from 1999 till 2004. The comparison using international standards reveals that the poverty was in fact declining: the World Bank study in 1999 found that 29.4% of population lived for less than \$4.30 a day (see 29), and the latest 2005 study shows that the poverty was only 22.2% in 2003 (see 30).

The World Bank Poverty Assessment in Ukraine in 2005(see 30) finds that Ukrainian poverty profile similar to most CIS countries. First, there is increasing poverty gap between rural and urban

population. According to the official statistics, only 11% of population in large cities lived below poverty line, while this proportion reached 28% in rural areas. It largely effects the regional distribution of poverty: the rural regions of Western Ukraine and Black Sea coast line have above average poverty indicators, while more industrialized North-East of Ukraine and capital city of Kiev have the poverty indicators below average. Special cases are coal-mining Donetsk and Lugansk regions of Ukraine. These are densely populated areas where lives about 30% of Ukrainian population. This industrialized region has poverty level around country average, but there are pockets of deep poverty in towns around the mines that were closed during the transition.

Second, the poverty is larger in the households with large number of dependents. Only 20% of population lives in households of four people or more. But there are more than 40% of people living in large households among poor. About 42% of poor are children and youth 24 years old or younger, while youth is only 30% of total population. The large families with larger number of children constitute the poorest group of rural population.

Surprisingly, the elderly population constitutes only 11% of all poor. As we mentioned earlier, the pensioners able to work supplement their pension income with some part-time jobs, and the pensions and subsidies received by pensioners are sufficient to keep most families with elderly members out of poverty.

Although there is a large number of families that have unemployed or underemployed members, especially women, the risk of poverty is twice higher for the families with unemployed household heads compare to the families with employed heads. Although unemployment is not high in Ukraine, the underemployment considered to be significant. The World Bank researchers found that the underemployment increased from 8,4% of population in 1999 to 9.2% in 2002. In the self-reporting survey the underemployed are usually easily identified as people who reported to be unemployed and reported some wage income below minimum wage at the same time.

In order to survive the poverty, the poor population needed some social support from the government. The social welfare system built over the years since independence currently provides about 21% on income for poor families. Another 23% come from self-grown agricultural products, and only 40% of the income in poor families comes from wage income (see 30).

The Safety Net Programs

As we mentioned earlier, prior to 1992, when the Soviet Union ceased to exist, the republic of Ukraine had social safety net common to all soviet republics. At that time the primary goal of the system were to maintain a certain level of family per-capita income by supplementing wages. Because of the near 100% employment and the supplementary character of the safety net, in most cases its administration was carried out by state enterprises. The safety net relied heavily on in-kind transfers, such as free housing, childcare, reduced food and goods prices, and it was almost universal. Due to the uniformity of income the entire population was eligible for services provided by the system.

The transition forced government to take responsibility over the safety net expenditures that were previously a part of enterprise finances. At the initial years of transformation the Soviet system were converted into generous social protection system that consisted of social privileges, Chernobyl benefits, housing and utility allowances, and family benefits. More than 20 social privileges to different population groups existed until the beginning of this century; they were introduced by different laws and presidential decrees, and simulated privileges that existed during the Soviet Union. The Law on “State Assistance to Families with Children”, adopted in 1993, introduced about 11 types of different family allowances; most of these allowances are distributed on the categorical bases, and only limited number of the allowances is provided on the income-based mean test bases. The Chernobyl benefits were introduced in 1991 by the Law “On the Status and Social Protection of

Citizens Who Suffered from the Chernobyl Catastrophe”, and are provided on the categorical bases to the people resided close to the site of the disaster. Most benefits were provided in-kind. The government is supposed to provide reimbursement for the free services to the producers of such services, for example, telecommunication or transportation companies. Despite the constant attempts to fulfill its obligations, the government constantly failed to finance all obligations, increasing debts to service providers and to beneficiaries.

In 1995 in order to shield families from the impact of the rapidly increasing energy and housing prices the government introduced “Housing and Municipal Services Allowance Program”. The program increased government responsibilities and pressure on the budget. The allowances were financed from the local budgets, and the regions with the weak revenue base rapidly accumulated arrears.

Major shortcoming of all the above mentioned programs was that they were established to preserve the status-quo of the soviet era privileges rather than to fight poverty. It is officially accepted that current safety net system in Ukraine contributed to the expansion of the poverty instead of its reduction. The Decree of the President of Ukraine “On the Strategy to Eradicate the Poverty” (Decree #637/2001, August 15, 2001) mentioned that the share of social privileges in the total amount of households’ incomes of the poorest and the richest 10% of households equaled 5.5% and 8.1%, respectively in 2000..

Since the above-mentioned programs were unable to eradicate poverty because they targeted wide population, in 2000 Verkhovna Rada adopted the Law on “Targeted Social Assistance to Low Income Families”. This law provided families living below subsistence level with the compensating benefits up to 75% of the minimal subsistence level. The beneficiaries were restricted by asset test to people who do not possess second apartment, new car and did not make any substantial purchases over the last 12 months. This was the first law that directly aimed at reducing poverty, and attempted to target the benefits to the people in need.

Over the year a number of changes were introduced to the legislation governing the social benefits in Ukraine. These changes intended to reduce the number of benefits, lower the cost of the programs, and change eligibility criteria. For example, the year 2000 State Budget Law suspended a lot of social privileges, and reduced government liabilities to finance the privileges from UAH 30 bln. to UAH 17 bln. However, reduction in the cost of the programs and targeting remain inefficient, and further reform is needed.

Unfortunately, the development of the social safety net in Ukraine was not driven by the goal of reducing the poverty, but by the financial constraints on the size of the system. During the USSR the government owned enterprises, and did not need extensive tax system to collect budget revenues. The only taxes known to the population at that time was personal income tax, which was tax on wages with progressive scale from 0 to 40%. Transitioning to market economy after independence, the government of Ukraine had established the tax system. The core of the system was based on 28% value added tax, 30% enterprise profit tax, and the above-mentioned progressive personal income tax. In order to finance new social welfare programs, the government introduced 38% payroll tax to Pension and Social Insurance Fund, 12% payroll tax to Chernobyl fund, and 2% to the unemployment fund. Although small portion of these taxes was considered to be taxes on employee instead of employer, since the employer was responsible to collect and report these taxes, effectively the employer taxes on the wage fund (payroll taxes) accounted to 52%

Despite the large taxes, the government did not manage to collect revenues sufficient to finance its obligations, and run large budget deficits until 1998 (see Table IV-1). At the same time, the large taxes contributed to reduction of the tax base and increasing shadow economy. Because of the large inflation, the nominal wages of workers constantly appeared at the highest scale of the progressive personal income tax scale, and were taxed with 40% rate. In addition, the employers had to pay

52% payroll taxes, which made cost of labor 2.5 times higher compare to paying cash to a worker out of the books. Taking into account that the capital gain or interest on shares were taxed at about 15%, one of the cheaper schemes was to employ all workers at minimum wage, pay income tax at 0% plus some minimum payroll taxes, and pay the workers cash from the pocket of the owner, who it tern received the cash as an interest or though some other scheme. It was estimated that the shadow economy 1996 was the same size as the official economy (see 11) and the shadow (out of the books) employment was about 40% of total employment the same year (see 21).

The pension program is the largest social security program in Ukraine. It was the most severely hit by the decreasing tax base. Prior to the reform in 2003, the pension system of Ukraine was “pay-as-you-go” (PAYG) system that provided pensions to current retirees by the money collected from current workers. The pension program provided old-age pensions (about 80% of expenditures), disability pensions, survival, social, and service pensions. The general old-age pensions were provided to woman over 55 years old and man 60 years old, and the special pensions were provided to workers of certain professions (miners, for example) at earlier age depending on the number of years they worked. The standard replacement rate (the pension as the percentage of wage) guaranteed by the system was 55% of average wage before retirement, within the minimal and maximum limits.

Given macroeconomic and population trends, such generous pension program could not be sustainable in a long run. In 1993 the pension fund run deficit of 1% of GDP or about 10% of the pension fund expenditures, and had to be taken under the supervision of the Ministry of Finance that financed the deficit out of the state budget. The researchers expressed concerns especially because the system dependence ratio (the ratio of beneficiaries to contributors) where gradually increasing. We can see from the Table IV-2 that the while there were approximately 2 workers per every pensioner in 1991, there were only 1.6 workers per pensioner in 1996, and the ratio were declining. In fact, the researchers showed that the ratio of contributors to beneficiaries dropped further, reaching 1.15 contributors per pensioner (see 21). C.Kane from the World Bank in his research in 1995 (see 10) showed that if the current pension system will not be reformed, the constant annual deficit of the system will rise to 3% of GDP (or 30% of expenditures). The recommendations of the researcher where to increase pension age above 65 for both males and females, and decrease the replacements ratio.

Another World Bank study by M. Riboud and H. Chu in 1997 (see 21) revealed that the concerns were correct. The dependence of the pension system ratio increased, and in order to maintain some balance of the pension fund, the replacement rate was decreased to about 1/3 of average wage over the years since independence. It was achieved by indexations that lagged the inflation rate (decreasing the real pensions) and by narrowing the gap between minimum and maximum old-age wage. The authors showed that pension system in these conditions can be sustainable only if there is moderate growth achieved for the next decade. Any attempt to increase the replacements ratio (increase pensions) will result in the pension fund deficit from 3% of GDP in 2000 to 7% of GDP in 2010. They also mentioned that the pension reform relaying on the increase in pension age to 65 years and reduction of payroll taxes to 23% may create a pension system that is sustainable in the long run. Finally, they suggested that the introduction of fully-funded multi-tier (mandatory and voluntary) pension system can reduce the economic cost of the pension system in the long-run.

As we mentioned earlier, the pension system in Ukraine paid an important role in keeping elderly population out of poverty. It is the system that provides sizable benefits to over 30% of Ukrainian voters, and therefore the government took advise of the international community and together with the PADCO/USAID advisory project developed new multi-tier pension system. The system was introduced by law in 2003, and start operating since January 2004. The new system introduced three tiers. First tier is PAYG system with benefits based on careful accounting of personal contributions to the system instead of average wage and years worked. The pensions of the beneficiaries of

previous pension system were recalculated to the new system, and most benefits were slightly increased. Second tier is the fully-funded pension investment fund run by the government. The third tier is the system of licensed private pension funds.

The sustainability of the new pension system was based on the assumptions of: maintaining relatively low replacement ratio of the PAYG system; expanding tax base due to the decreasing payroll tax rates; starting the second tier as soon as the capital markets legislation allows creating the state investment fund, and introduction of the third tier by 2010.

Together with the introduction of the new pension system, the Ukrainian government took steps to ensure expansion of the tax base. In 2003 it cut the personal income tax to the 13% flat rate (which supposes to be replaced by 15% flat rate in 2006); decreased the payroll taxes from 52 to 37% plus 2% paid by employees; and introduced a cap on the monthly payroll tax for a single employee.

The second largest program that affects large proportion of population in Ukraine is subsidies and social privileges. By the end of 1990s almost 42% of Ukrainian households were entitled to some social privileges because of the entitlement of one household member. They included up to 50% discounts on housing and communal service, free phone lines, etc. About 25% of households also received targeted subsidies for utilities and housing prices (see 29). In 1996-1998 the expenditures of the subsidies, housing allowance and social privileges programs increased from 0.7% to about 1.7% of GDP. However, these expenditures were hard to finance, and in 1999 the program was financed in the amount of 1.4% of GDP. The cost of subsidies was increasing due to the increase in energy prices and utility costs, but the budget did not have funding to finance the increased costs. The privilege and subsidy programs suffered periodic cuts of expenditures, and it was obvious that the generous program can not be sustained in the long run. The in 2000/2001 government decided to strengthen eligibility criteria for the program and to move programs to the local budgets. As the result the amount of beneficiaries was reduced from 40% to about 21% of population (see 30). Accelerating growth allowed increasing the budget for the program in 2003, however programs remained underfinanced in poorer regions, which unable to collect enough resources and have larger number of beneficiaries at the same time.

Other social welfare programs, such as support for families with children and maternity benefits although suffered from economic downturn, and expenditures on these programs decreased over the period 1996-1999 from 4.6% of GDP to 0.9% of GDP. Some programs were canceled, and for another benefits decreased significantly. For example, benefits of the assistance to families with children programs were from 10 to 19 UAH a month per child (see 29), when average wage in the country was 126 UAH. The programs started to increase benefits when the economy started to grow in 2000-2004, however these increases were primarily based on the same program design. The policy makers did not take advantage of favorable financial situation and did not perform the social welfare sector yet.

The main critique to the social safety net in Ukraine is that it is not designed to alleviate poverty. Most programs by design provide larger benefits to the families or individuals with higher income. And because of the sluggish management, the programs were ineffective controlling the eligibility for the benefits. For example, according to the World Bank and Presidential Administration, 88% of people who received housing subsidy in 2001 should not have been entitled to it. The same year 71% of families that had right to receive the housing subsidies, eventually, were not entitled to receive it, and about 90% of families that had to be entitled to receive a support to low-income families were not among its recipients. Leakage led to the problems financing the system, and as the result, to the problem of inadequacy: the payments received by the beneficiaries are not sufficient to bring their income over the subsistence level (see 29).

At the same time, joint World Bank and Ministry of Labor and Social Protection (MLSP) research (see 29) showed that in 1999 state budget already had enough resources to bring all the poor

households above the poverty line. For example, in first three quarters of 1999 the amount of money needed to eradicate poverty was 4.2 billions, while government spent over 4.5 billions UAH over the same period on the poverty alleviation programs and did not achieve the goal.

The problem of the inefficient use of the available resources, and, in particular, insufficient targeting of the benefits and leakage from the system, remains today despite the steps taken by the government in 2002 -2004. The government consolidated benefits at the “Support to families with children program” and introduced an income filter for the recipients. As the result, the share of the program benefits received by the reaches 40% of families reduced by 5% of the benefits between 1999 and 2003 (see 30). Joint research of the World Bank and the MLSP in 2005 found that the most successful in targeting was the “Targeted Social Assistance to Low Income Families” program (see Figure IV-1). It provided one of the largest benefits, averaging 70 UAH per month in 2003, and more than 50% of these benefits reached the poorest 20% of population (see 30). However, this is smallest social security program. The extension of this means-tested program depends on the availability of monitoring and accounting system, but the government of Ukraine together with the World Bank actively developing a computer network at the social welfare offices that suppose to remove this obstacle to the program development in the nearest future. As the result, there will be opportunity to make the social welfare system in Ukraine more efficient and fiscally sustainable by moving funds from non-targeted programs to this means-tested program.

Current trend towards increase in benefits of the system

International experts agree that the pace of institutional and structural reforms of the Social Safety Nets in CIS countries slowed down at the beginning of the XXI century and did not use opportunity of increased economic performance during this period. The analysts agree that sluggish progress of reforms can be result of the electoral cycles in the countries such as Kazakhstan, Russia and Ukraine (see 26).

The period 2004 – 2005 was politically charged election period that had tremendous effect on the development of Ukrainian social safety net. Ukraine had presidential election November 2004, which resulted with “Orange Revolution” and ended January 2005. As the result of revolution, power to form the government was shifted from the President to Parliament. A year after first post-revolution government was formed, Ukraine had Parliamentarian election (March 2006). Both elections were dominated by two political forces that had almost identical number of supporters. In order to win extra votes, both political forces began promising increases in social benefits to pensioners and poor.

The increases in social benefits were implemented de-facto at the second half of 2004, and then adopted de-jure in 2005. Minimum benefits of most welfare programs increased 3 to 12 times, and average benefits increased 25-70% (see Table IV-3). Further increases are planned for 2006 (see 16). As the result, the social welfare expenditures (including pensions) increased from 11.9% of GDP in 2003 to 17.4% in 2005. The government also increased minimum wage 40% (about 30% increase in real terms) in 2005, which resulted in the increase of wages paid to the employees in public sector and increased budget expenditures on healthcare, education, and government employees.

The political situation also did not allow government to increase tax rate and even demands decrease in some taxes. For example, current personal income tax law provided 13% flat tax rate for the period of two years that had to be replaced by permanent 15% flat tax rate in 2006. However, due to the political reasons the increase was postponed. Another example is simplified taxation of small businesses. Previous president in 2001 passed a decree established “simplified taxation for small businesses”. Businesses with turnover under \$100,000 a year and up to 10 employees may pay a flat tax (only 200 UAH, or \$40 a month in 2004-2005) instead all taxes on their businesses,

including the payroll taxes. The decree had to lost power when the new president was elected in 2004, however the life of this decree was extended because of the adverse reaction of the small business owners. As the result, most employees of the small businesses still do not make sizable contributions to the pension or other social insurance funds. They are protected by some social insurances, but their contributions to the pension fund will not allow providing them anything but minimal pension when they retire.

There is no final report yet, but the deficit of the pension fund was about 5-6% of the GDP in 2005, and was financed from the state budget. However, overall performance of the state budget was not a disaster in 2005. Government managed to attract about \$2bln. from privatization of KrivoroZstal, a largest still-producing factory in Ukraine. It also managed to increased revenues from VAT and enterprise profit tax by eliminating tax exemptions, such as free economic zones, and prosecuting businesses that avoid paying taxes. As the result, the budget deficit in 2005 was kept under 2% of GDP, and the state debt was decreased.

Good performance of the 2005 budget led policymakers to believe that increasing social welfare benefits may be sustained. Extending the offers to the voters, politicians in the parliament election campaign not only promised increase in social benefits, but also promised to decrease payroll taxes from 39% up to the level of 25%. They expressed believes that in the short-run the increased social welfare benefits can be financed from other revenues of the state budget, at the same time reduced payroll taxes will stimulate expansion of the tax base for the social insurance funds in the long-run.

However, international experts do not share believe of the Ukrainian politicians that the increased expenditures can be sustained. The recent issue of the Economic Survey of Europe (see 26) noted that “The political cycle in Ukraine led to a significant relaxation of fiscal policy as the presidential elections drew closer. Although this is a widespread phenomenon, some of the populist pre-election moves (such as the large increases in pensions in September and the planned rise in public sector wages) will have lasting negative fiscal implications as they are equivalent to a general increase in government spending. As a result, the underlying structural fiscal balance is likely to have deteriorated significantly in 2004. As shown by the experience of some east European countries (for example, Hungary) this type of fiscal loosening (involving notable wage increases) can have a lasting and damaging effect on macroeconomic stability. Furthermore, the negative fiscal implications of such moves are very difficult to reverse or offset, especially during a downturn in the growth cycle.”

It seems that policymakers in Ukraine underestimate at least two phenomena that may have effect on the long-term sustainability of the SSN. First, the increased collection of revenues to finance the expanded social budget will have strong negative effect on the tax base even if it is done without increase in tax rates or through taxes other than the payroll tax. Second, the steep increase in the social welfare benefits can trigger behavioral response of the potential recipients and result in the non-linear increase in the expenditures for the welfare programs.

Conclusion

Ukraine fits the profile of the slow-transitioning economy that we discussed in previous chapter. The social safety net in the country is constrained in the same way system of other slow transitioning economies. The main drivers for the reform of the SSN in the country were financial constraints resulting from the large decline in the income of population and increase in the number of welfare recipients. The transformation of the SSN resulted in the system that provides small benefits to a large number of people. However, the reforms directed at reduction of the number of beneficiaries are limited by the political resistance to such reform from a large number of voters.

The Ukrainian welfare system has large potential to reduce costs of the welfare by improving targeting and strengthening the eligibility criteria. The means-testing should have effect while

benefits remain small. However, based on our theoretical model of SSN for countries in transition, we expect that increase in the amount of benefits will influence behavior of significant number of potential benefit recipients. They will change their economic characteristics and work behavior in order to qualify for stricter eligibility criteria. Simultaneous increase in amount of benefits and strengthening criteria will require expensive screening procedures or limitations of personal freedom that is possible only at authoritarian regime. Therefore, there is little chance that the social safety net with increased benefits can be established within current budget.

Alternative fiscally feasible policy is suggested by the theoretical model. It is the policy stimulating economic growth in the country by cutting amount of taxes collected by the government, with simultaneous decrease in cost of the social safety net. The policy is based on the expectation that resulting strong economic growth will provide employment opportunities in high-paying sectors of economy and, will be more effective to reduce number of people living in poverty than the extensive social safety net. In further research we will compare long-run abilities of economic growth and the SSN to combat the poverty in Ukraine.

Tables and figures

Year	Real GDP (1990=100)	Real GDP growth	Consolidated budget as % of GDP*			Pension fund expenditures
			Revenues	Expenditures	Deficit	
1991	91.3	-8.7%				9.5%
1992	82.3	-9.9%	24.4%	38.1%	-13.7%	7.9%
1993	70.6	-14.2%	33.5%	38.6%	-5.1%	8.3%
1994	54.4	-22.9%	43.5%	52.4%	-8.9%	7.4%
1995	47.8	-12.2%	38.0%	44.6%	-6.6%	7.9%
1996	43.0	-10.0%	37.0%	41.9%	-4.9%	9.3%
1997	41.7	-3.0%	30.1%	36.7%	-6.6%	10.2%
1998	40.9	-1.9%	28.2%	30.4%	-2.2%	9.3%
1999	40.8	-0.2%	25.2%	26.7%	-1.5%	9.5%
2000	43.2	5.9%	28.9%	28.3%	0.6%	8.4%
2001	47.2	9.2%	26.9%	27.2%	-0.3%	8.8%
2002	49.7	5.2%	27.4%	26.7%	0.7%	10.1%
2003	54.4	9.6%	28.2%	28.4%	-0.2%	9.1%
2004	61.0	12.1%	26.5%	29.7%	-3.2%	11.4%
2005	62.6	2.6%	31.6%	33.4%	-1.8%	14.6%

Table IV-1. Economic indicators for Ukraine

* Note that the Ukrainian official figures are different from reported in World Bank databases due to the difference in methodologies
Source: Committee for Statistics of Ukraine, www.ukrstat.gov.ua, *Bulletins of the Pension Fund*, www.pension.kiev.ua

	Population, thousands	Working age (15 to 70 year old) (% of total population)	Economically active (% of total population)	Employed (% of total population)	Unemployed ILO definition (% of economically active)	Unemployed registered with unemployment offices (% of economically active population)	Pensioners (% of total population)	Support ratio (Working/ pensioners)
1991	52,056.60	-	-	48.0%	-	0.0%	25.2%	1.91
1992	52,244.10	-	-	45.9%	-	0.3%	26.0%	1.76
1993	52,114.40	-	-	45.9%	-	0.4%	27.2%	1.69
1994	51,728.40	-	-	44.5%	-	0.4%	28.0%	1.59
1995	51,297.10	73.4%	49.8%	47.0%	5.6%	0.5%	28.3%	1.66
1996	50,818.40	74.1%	51.4%	47.5%	7.6%	1.3%	28.5%	1.66
1997	50,370.80	73.1%	51.8%	47.2%	8.9%	2.4%	28.8%	1.64
1998	49,918.10	73.4%	52.0%	46.1%	11.3%	3.9%	29.0%	1.59
1999	49,429.80	73.4%	45.6%	40.4%	11.6%	5.2%	29.3%	1.38
2000	48,923.20	73.9%	46.7%	41.2%	11.6%	5.1%	29.6%	1.39
2001	48,457.10	74.3%	46.3%	41.2%	10.9%	4.5%	29.7%	1.39
2002	48,003.50	74.8%	46.3%	41.9%	9.6%	4.7%	30.0%	1.40
2003	47,622.50	75.3%	46.6%	42.3%	9.1%	4.5%	30.2%	1.40
2004	47,280.80	75.8%	47.0%	42.9%	8.6%	4.4%	30.2%	1.42
2005	46,929.50	76.4%	47.5%	44.1%	7.2%	4.0%	30.0%	1.47

Table IV-2. Population and social welfare dynamics in Ukraine

Source: Committee for Statistics of Ukraine, www.ukrstat.gov.ua, International Labour Organization www.ilo.org

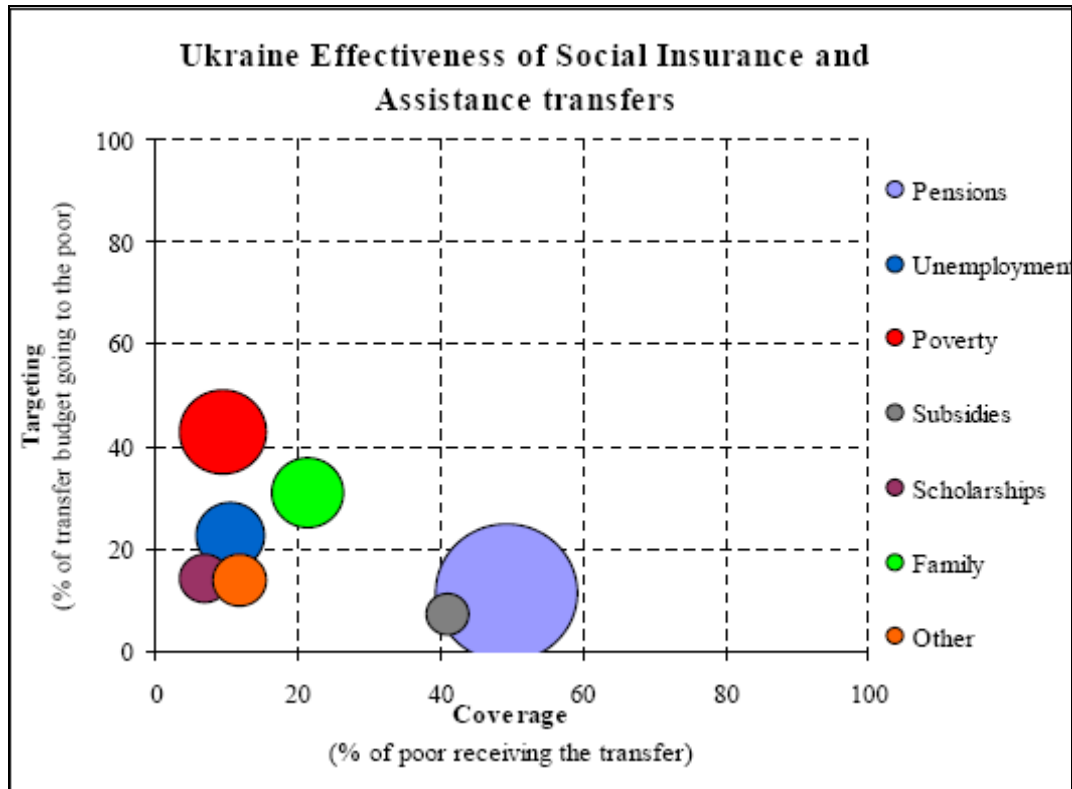


Figure IV-1. Effectiveness of Social Insurance and Assistance programs in Ukraine

Source: "UKRAINE POVERTY ASSESSMENT: Poverty and Inequality in a Growing Economy", The World Bank report # 34631-UA

Program name	Eligibility	Number of recipients in 2005	Expenditures in 2005	Changes in 2005	Changes in 2006
Pension	Old-age: women over 55 and men over 60, special pensions for lower ages disable, survivors	13.4 mln.	61,107 mln. UAH	Minimum pension increased 3.6 times Average pension increased 73%	Minimum pension increased 8% Average pension increased 29%
Unemployment	Unemployed	2.9 mln.	2,525.7 mln. UAH	Min benefits increased 25%	Minimal benefit increased 28%
Temporary disability insurance	Temporary disabled, carrying about seek child, on maternity leave to care about child up to 3 years old, giving birth, funeral costs for workers, healthcare-related vacations	around 6 mln. people a year	5.1mln UAH	Funeral cost reimbursement increased to 1000 UAH One-time birth support increased 10 times	Funeral expenses increased 20% Minimal support for carrying for seek child increased 10%
Support to families with children	Single parents if per-capita monthly family income is lower than 50% of minimum subsistence level during the last 6 months	around 1.5 mln. families	14.1 bln. UAH	Benefits increased about 3 times	Benefit increased around 28%
Support to low-income families	Families living under the minimal subsistence level who do not possess second apartment, car, and did not make large purchases over the last 12 months	2.8 mln. families	11 bln. UAH	Benefit increased around 28%	Benefit increased around 30%

Table IV-3. Summary of current social welfare programs in Ukraine

Chapter V: Conclusion

The goal of the paper was to provide information for analysis of the long-term sustainability of current social policy of Ukrainian government. Main concerns with this policy were that further increases in social benefits will lead to disproportional increases in social expenditures, which in turn will create additional pressure on Ukrainian economy, destroying it.

Both experience of countries in transition surrounding Ukraine and theoretical economic models suggest that further increases of social benefits may harm Ukrainian economy. The economic models developed in this paper suggest that increase in social transfers in slow-growing transition economies like Ukraine might trigger behavioral response of potential beneficiaries. As the result, after social benefits reach certain level, large proportion of population will decide to become officially unemployed and apply for the benefits. It will lead to the shrinkage of official economy, shrinkage of tax base for any tax on enterprise or individual incomes, and simultaneously to the sharp increase in social expenditures. Similar increase in expenditures Ukraine experienced in 1992-1994, and it was one of the major reasons for economic downturn during that time.

In our opinion, the international comparison suggest that large equalizing social transfers are possible only in the countries that are either: reach and well endowed by natural resources or other long-term sources of income; have relatively small population of potential beneficiaries; or population of which (and every individual) is ready to sacrifice personal well-being to the idea of social equality. Only in later countries is possible economic policy that provides long-term economic growth. This policy is similar to the industrialization policies of Soviet Union in 1930th and 1950th. The policy requires funds for social transfers to be collected from personal incomes, and to have no effect investment funds of enterprises. Since this is virtually impossible in market economy, the policy also implies strong government control of economy.

We know that current Ukraine is neither of the countries described above. We also observe that current preferences of Ukrainian population are against the Soviet type government control over economy and in not ready to sacrifices of personal well-being for economic equality and growth in the country. Therefore, further attempts to increase equalizing social transfers will lead to the decrease in economic growth or even the collapse of government budget.

Based on these theoretical suggestions and international experience, we conclude that:

First, policies of increasing social benefits of the current social safety net system are the least optimal policy within the scope of polices available to Ukrainian policymakers. Policies that keep social benefits on the current level in real terms, and, therefore, put lower financial pressure on economy, are better from both short and long-run perspectives.

Second, the available SSN financial resources more effective in reducing poverty if current social safety net programs are substituted by budget-neutral income guarantee program. This program could guarantee lower income than current minimal subsistence level. However, it will be more successful in reducing extreme poverty. In addition, introduction of such program requires establishing strong means-testing infrastructure that will create base for more effective social programs in the future.

Finally, economic growth in the transition countries has stronger long-term poverty-reduction effect than the social safety net. Therefore, successful social reform in Ukraine have relay more on economic growth and active policies that stimulate these growth (such as education, assistance in job search, legal support of employees, help in relocation, etc.) than on simple increases in the amounts of benefits. The social policy that minimizes social transfers in order to use available funds to decrease taxes or increase active market policies would reduce poverty by increasing wage income and will stimulate economic growth at the same time.

The conditions of this policy has to be providing minimal (need to physical survival of a person) amount of transfers to the poorest, and strict targeting of these funds to the poorest population. Minimization of the social transfer should help increasing targeting of the benefits since it creates smaller incentives change in the employment behavior of potential recipients.

Suggestions for further research

This working paper raises more questions than provides answer. The policy recommendations provided above are based on theoretical grounds, and have to be quantified and tested in order to provide further policy suggestions for the Ukrainian government. The author suggests further development of the topic in the following directions:

First is developing modern social policy evaluation tools for Ukrainian policymakers. Current advances in information technology and economic theory allow further extension and revision of these tools. Such tools may consist of macro and micro-economic simulation models that will estimate the effects of different social policies and amounts of benefits on economic development and number of people living in poverty in Ukraine. The Ukraine has sufficient data to create static microsimulation models similar to TRIM model in the USA. Using international estimates, it is also possible to create simpler macro-level models what will provide insight into balance between social expenditures, economic growth, and total household income.

Second, the policy recommendations of this paper support the view of other researchers that active market polices could play important role in reducing poverty in Ukraine. Ministry of Labor and Social Policy of Ukraine effectively developed and provided active market policies in the country for several years. It is important to study the effectiveness of such policies in Ukraine, since international research does not provide conclusive evidence of the effectiveness of the policies. Effect of the policies in Ukraine may be different that in other countries of the region.

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