

The Masters Research Paper

**Social Transfers Policy and Its Impact
on Income Inequality in Ukraine**

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Abstractⁱ

The paper discusses the challenges of social policy in Ukraine, in particular the costs of extensive social spending for productive sectors of the economy and for sustained growth in the long run. The paper also considers the distributional impact of social transfers policy, and the effectiveness of social spending in reducing inequality. The main findings of the paper are that the social transfers are highly regressively distributed. Most social support is going to the population in the top decile income groups. Among the examined transfers, family allowance and enterprises' transfers are the most pro-rich distributed.

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1. Introduction

The end of 1980s and the beginning of 1990s was a time of significant economic restructuring that took place in the countries of Eastern and Central Europe. The process of transition is still far from complete. The breaking up of the old system and creation of the new involve many challenges of the transition: macroeconomic and financial instability, fiscal imbalances, inefficiencies of the state owned enterprises, growing social discontent.

The transition economies have achieved various degrees of success in addressing these problems. The Czech Republic is probably the only country that managed a smooth transition with least cost to society. The “Velvet” revolution in that country has brought it onto a new market oriented path. Poland followed with the shock therapy reforms. That approach, although it produced high costs at the beginning of restructuring, has sped up economic recovery, and, on the whole, explains much of the current economic success in that country. Ukraine is one of the slowest reforming countries. Its continuous delay in reforms is the main reason for its deep economic crisis and prolonged slowdown of economic activity.

This paper is concerned with one of the important reform issues in a transition economy, namely, the targeting of social spending policy in Ukraine and its effectiveness in addressing the most needy and potential costs for the productive sectors of economy. In this context, social policy is defined

as government cash and non-cash benefits, as well as transfers provided by the state-owned and newly privatized enterprises to their employees.

The issue of social policy is of growing importance in the transition economies, both in countries which are advanced reformers, as well as in those that chose gradual paths of reforms, like Ukraine. Irrespective of the path of reforms pursued, nearly all of the transition economies are facing social and economic challenges of transition: unemployment and poverty levels are high, real incomes are declining, inequality is growing, etc. To prevent the growth of social imbalances and people's discontent of the reforms, social expenditures were increased in all transition economies.

Some countries like Poland, the Czech Republic and also Hungary have managed to achieve macroeconomic and financial stability, overcome crisis and return to growth in a relatively short period. This success allowed these countries to maintain the social protection at the pre-reform levels, as well as to introduce new programs, like unemployment benefits, that did not exist previously. Although Poland, the Czech Republic and Hungary were able to escape the overwhelming poverty levels, as occurred in Ukraine or Russia in the 1990s, they are facing the problems of too generous social protecting policies,¹ and badly targeted social transfers,² which requires many resources to be sacrificed for the short run objectives and in the long run may undermine the growth potential of these countries.

As of 1998, Ukraine still had not managed to overcome the economic downturn. Real GDP is contracting. In 1997 it fell by 3.2%. The standard of living has shrunk, and a large share of the

population is living below the poverty level. According to a recent study of poverty assessment in Ukraine made by the World bank the poverty head-count index, which measures the percentage of households whose per capita consumption is below the poverty line, was 29.5% in 1995,³ and then slightly decreased to 26.6% in 1996.⁴ These problems require the creation of a social safety net which would be effective in reaching the most needy.

As is argued by Anders Aslund about the social policy in Russia, which in many respects exhibits the similar problems as Ukraine:

Contrary to popular perceptions, the problem is not that too little is spent on pensions but too much. However, social benefits are spread thinly and go to many who do not need them. They should be targeted to those who need them the most.⁵

Taking into account the high opportunity costs of high social spending and continuously declining budget revenues in Ukraine, the targeting of government social transfers and composition of government social spending become very important issues. Increasing the efficiency of government spending through reform of the pension system as well as improvement in targeting would decrease the level of social spending and the costs associated with loose social spending, and it would also assist the sustainable long term growth.

The objectives of this paper are, first, to examine the trends and composition of the government social spending in Ukraine; second, to discuss the potential costs of high social spending for economic activity; third, to evaluate effectiveness of social transfers in targeting the most needy, in reducing inequality; and, finally, to suggest further policy changes. Targeting of social transfers will be examined

using income distribution and progressivity measures. Comparisons will be drawn between social spending in Ukraine and other Central and Eastern Europe countries.

Section 2 develops the normative analysis of social policy and discusses the existing theory on income redistribution. That is done in the context of the modern Welfare Economics. Section 3 gives a literature review on social policy in the transition economies. Then an overview of social policy in Ukraine, main problems in it and its costs for economic growth in the long run, is provided in Section 4. Section 5 discusses the various inequality measures that will be used in the paper to estimate the distributional impact of social transfers on inequality. Section 6 examines the distributional impact of government and enterprise social transfers in Ukraine. Also, comparisons are drawn with other transition economies of Central and Eastern Europe. Suggestions for possible changes in social policy in Ukraine are discussed in Section 7, and Section 8 concludes.

2. Theoretical Background of the Problem.

This section reviews the reasons for government intervention and for redistributive government social policy from the perspective of mainstream welfare economics. Welfare economics is the branch of economic theory which provides the analytical framework used by economists to evaluate the normative rankings of alternative economic policies and events.⁶

Public finance economists distinguish three rationales for government to intervene.⁷ First, government policy is necessary to correct for allocative inefficiencies that arise as a result of market failure to deal with public goods, externalities both positive and negative, and monopolies. Another reason for government to intervene is to achieve an income distribution objective. An outcome achieved under free market conditions and no government regulation may be Pareto efficient,ⁱ but socially inferior. Hence, government involvement is needed to provide income reallocation to achieve a socially optimum solution. The third reason is to carry out the stabilization function. That is, the government may intervene to increase employment, to achieve inflation or growth targets, etc.

The implementation of any income distribution policy is complicated due to an equity-efficiency dilemma. Efficiency requires reliance on market forces and non-distortionary taxation, which presume higher growth, rapid economic development, and also development of a private sector. An efficient

ⁱ An allocation of resources is Pareto efficient if no person can be made better off without making another person worse off, see, for instance, Rosen (1995), p. 41.

solution may not involve equitable distribution of income and wealth in the society. It can be a socially inferior outcome compared to the desirable equity objective.

The mere existence of market failure does not justify government intervention. Although government intervention is a necessary condition for reducing inequality because markets usually fail to produce equitable distribution of wealth, it is not a sufficient condition. Government intervention may be also inefficient, and introduce its own distortions. Hence, another challenge of income distribution policy is to reduce the distortionary impact of government intervention. Government income redistribution policy should minimize distortions of incentives to work, to save, to grow in the long-run.

High social spending is costly, as far as it necessitates high taxation to cover budget expenditures. Because taxes distort economic decisions, they produce excess burden, or a loss in welfare, that is a deadweight loss for society.⁸ A graphical illustration in a partial equilibrium context of deadweight loss for society from taxation is given in figure 1. A per unit tax of t levied on the producer will shift the initial supply curve S to S' . With the tax, the production will fall from Q to Q' and the consumer will pay the price P' , and the producer will receive the price P'' . The government will collect tax revenue equal to the area $BP'P''C$. The welfare loss of consumers, in terms of consumers' surplus, from the imposed tax is ABP' . The welfare loss of producers, in terms of producers' surplus, is area $APP''C$. The sum of the before tax consumer and producer surpluses, area AEK , exceeds the sum of

the after tax consumer and producer surpluses and tax revenues collected by the government by the area ABC. This triangle is the deadweight loss for society from the taxation.

Hence, although government needs to undertake a policy aimed to correct income distribution and to avoid excessive distortions, this policy has to be directed not to everybody in the economy, but to those who are least protected, who need social support most.

Economic theory suggests several approaches for what can be considered a fair income redistribution policy. Musgrave⁹ subdivides them into:

1. endowment based criteria;
2. utilitarian criteria;
3. egalitarian criteria;
4. mixed criteria.

The theorists of the endowment based criteria consider several principles according to which the distribution of income can be justified:

- everyone can keep what he can earn in the market, (or in the more restrictive case in the competitive market);
- one may keep labor income undistributed, but the capital income should be taxed more heavily and be distributed;

- one may keep what he earns in the competitive market, given that there are equal positions at the start.

The first principle suggests that everyone must be rewarded by his abilities, and achievements, while the third one suggests that everyone should have equal opportunities, and the potential to apply his abilities and talents. These principles do not interfere with the efficiency objective and are important for promoting growth.

According to the utilitarian theorists, the income has to be redistributed up until the point when the total welfare, defined as $W = U_1 + U_2 + \dots + U_n$, where U_i is the i^{th} individual utility, is maximized.¹⁰ One individual should be given more income than the other if his marginal income utility is higher, and in this case the total utility will be maximized. If the marginal income utilities of the individuals are not equal than the sum of total utilities will not be at its maximum. Under the assumptions that firstly, individuals have identical utility functions, secondly, utility functions exhibit diminishing marginal utility, thirdly, the total amount of income is fixed, and fourthly, the social welfare function is additive, redistribution of income can produce complete equalization of incomes in the society.¹¹ In general case, utilitarian social welfare function for n individuals with individual utility U_i is $W = F(U_1, U_2, \dots, U_n)$. It is assumed that an increase in any of the U_i , without making any one else worse off, i.e. a Pareto improvement, increases social welfare.¹² The maximization of this welfare function requires the equalization of the weighted marginal utilities of income.

Egalitarianism views the problem of income distribution in the three main perspectives.¹³ Under the first, equality is seen as the main objective, meaning that a fair distribution involves equalized total welfare. Egalitarianism says that if two individuals have different total income utilities then the income should be distributed from the individual with higher total income utility to the individual with lower total income utility to achieve equal total welfare. Hence, in contrast to the utilitarian approach, welfare is maximized when total utility, not marginal utility is equalized.

The second approach sees maximizing the income of the lowest income individual as an objective of income distribution. This is known as a maximin criteria due to Rawls.¹⁴ The social welfare function for n individuals with individual income I_i is defined as $W = \text{Minimum}(I_1, I_2, \dots, I_n)$, and it depends only on the income of the person who has the lowest income.

The third perspective of the egalitarianism considers distribution not in terms of income, but in terms of consumption goods. Under this approach categorical equity is viewed as an objective.¹⁵

Mixed criteria combine the various approaches discussed above. It is the one that is most often chosen to follow in many countries. It is impossible to find in pure form any one of these philosophies but the combination of them can be found in many world economies.

These various approaches to distribution equity provide justifications for government income redistribution policy and suggest what it should be. Most forms of the social welfare functions suggested by the normative theory of economics favor some degree of redistribution from rich to poor individuals.

International experience supports the idea of at least mild redistribution in that direction, especially in democratic countries. In discussing the desirable social objectives, most analysts seem to agree that a desirable objective is to eliminate extreme inequality, and this is likely to be the case in most market based economies. Even not knowing the social welfare function (some of them were discussed above), it seems that there is a consensus that severe inequality is not socially desirable.

Taking this aversion to extreme inequality and distortions from government intervention discussed before as given, I will evaluate effectiveness of government social policy. The focus will be on the targeting efficiency of government spending, its impact on reducing of inequality, as well as on the potential costs of government spending that fall on the productive sectors of economy. Since much of the burden of obligatory social spending in Ukraine falls on the state owned enterprise, the redistribution impact of enterprise social spending, its contribution to reduction in inequality, along with costs associated with this spending, will also be examined.

3. Review of Literature.

There is much work written recently on the issue of social policy, inequality and poverty in transition economies. This topic is of growing concern in all transition economies from the economists' and public policy makers' perspective. Branco Milanovic argues that

The area of income distribution has so far failed to receive the attention paid to other issues in the economies in transition like macro stabilization, privatization or trade reform. This is because ... the system of social transfers and taxes which exerts a significant influence on income distribution is difficult to overhaul. It is not accidental that, in contrast to dramatic changes elsewhere, social security and fiscal systems have in all economies in transition remained (except for the introduction of unemployment benefits) broadly the same.¹⁶

An excellent overview of the problem is given in the articles by Michael Mandelbaum, Walter Connor, Mark Kramer and Anders Aslund.¹⁷ Therefore, a brief review of them is in order.

Walter Connor examines the inefficiencies of social policy under socialism with a pervasive role of the state and an egalitarian objective. The author argues that it was the system which "made for a world in which those whose talents were wasted or underrewarded chafed against the system, while those who connected social justice with low-level equality and uniformity lived with it, and feared change."¹⁸

Mandelbaum discusses the difficulties of switching from the "fishnet" system which existed under the communist regime. It was the system that provided a relatively high floor below which none can fall, and also very low upper boundary above which none could get. The transition from such a

system produced many costs for those who liked to be taken care by the state and felt completely secure. Transition has also its winners who gained from greater independence and freedom.

Transition from the socialist welfare regime involves trade-offs between insecurity and growth which are thoroughly examined by Kathie Krumm et al.¹⁹ The authors argue that high social spending would require high taxation levels, as well as low private and public capital investment, also lack of competitiveness in the long run. They suggest relying on less distortive social policy alternatives like flat rate pensions, and local rather than general social assistance.

Mark Kramer²⁰ discusses the difficulties of social policy in East-Central Europe transition economies, and aspects of reforms provided and that have to be provided. The author concludes that the existing system of social protection in the East-Central Europe countries is hardly appropriate due to its generosity, poor targeting and high opportunity costs for future growth.

The idea of generous government expenditures in East Central Europe is examined by Barbara Fakin et al.²¹ Those authors argue that the main problem of high social expenditures is loose eligibility criteria which allows much of funds to be given to those who do not need them much.

In the opinion of Aslund,²² who examines the issues of social policy in Russia, the transfers in Russia are at the reasonable level, but are very poorly targeted. He also argues that the high inequality is not due to the decline in the volume of social expenditures, but is a result of massive rent-seeking (impact of rent-seeking on inequality will be discussed in section 4).

Much work on the income distribution issues during the transition in countries of Central and Eastern Europe is written by Milanovic.²³ That author analyses the distributional impacts of the government cash and in-kind transfers and other income sources by income categories. He concludes that social transfers in transition economies, although they have redistribution impact, are less efficient and are much more broadly targeted in post communist countries than in western economies. According to Milanovic "...efficiency of cash transfers in reducing of income inequality [in Eastern Europe] is only about one half of what it is in capitalist countries."²⁴ Among government cash transfers, the most pro poor are family allowances, while sickness benefits are most regressive and devoted to the rich.

Cornia²⁵ examines the "social issue", and adequacy of social policy in the transition economies. In that author's view, the existing transfer policy in Eastern Europe is biased against children and the working poor, and this has to be corrected.²⁶ She recommends categorical targeting as a solution to avoid targeting inefficiencies. Under categorical targeting, the key indicators which can be attributed to the people in the bottom decile income groups are identified. They are, for instance, family size, family working profile, number of children, etc. Targeting support to the groups that possess characteristics, which are highly correlated with poverty, increases efficiency of government income redistribution in reducing inequality.

Kakwani²⁷ examines income inequality, welfare and poverty issues in Ukraine during the period of 1989-1992. In his paper, he presents the quantitative tools for the analysis of the distributional

impact of different income components on income inequality, welfare and poverty. One of the author's conclusions is that increases in income inequality and poverty during 1991-1992 in Ukraine occurred partially as a result of pro rich distribution of government social benefits. Due to insufficiency of data, the author did not examine which social transfers most contributed to the increase in inequality and poverty in Ukraine. Doing so will be insightful and will be done in the analysis that follows.

4. Social Transfers Policy in Ukraine

This section gives overview of the problems in the social policy in Ukraine. The main social support programs and the inefficiencies and the costs of these programs for economy are discussed.

Overview of the problem

The gradualist path of reforms in Ukraine, which were initially aimed at lowering the social costs of transition, turned out to be much more costly than in countries that followed the shock therapy. Due to the rapid growth, the quickly reforming countries were successful not only in recovering their economic growth, but also in retaining social protection at a high level (although it is questionable whether such high expenditure policy is necessary), and in avoiding high poverty levels.ⁱⁱ

In Ukraine, transition produced a substantial increase in insecurity, growth of income inequality, and a drop in welfare levels and, hence, increased the potential scope for government social protection activity. To deal with the challenges of transition, it is important to redirect the government social expenditures to the most unprotected, to those who are the most hurt by the transition. They are children in families with one parent, poor families, old people, unemployed, disabled, others.

There are several difficulties involved with pursuing a targeted social policy in a transition country like Ukraine and other post socialist economies. Many of these support programs, like unemployment insurance or provision for the poor, did not exist before. As it is argued by Milanovic, in

the socialist countries there was no provision for the poor because poverty was viewed to be non-existent. As a result, there was little experience in identifying the most needy and delivering support.²⁸

The social protection system that existed in the socialist countries resembled the “fishnet” system, as it is called by Mandelbaum.²⁹ The system supported everybody and provided little insecurity. It was very general and protected those who needed support as well as those who did not.

Hence, Ukraine like many other transition economies, inherited a system with no institution effective in directing support to the most needy.

The problem with current social policy in Ukraine is that it continues to be pursued basically in the same way as it was done under the Soviet regime. Very little reform of the social safety net was implemented. As of 1998, there are still no clearly defined priorities as to whom to support first. Most of the support programs remain broadly based.

Social Support Programs: scope and efficiency aspects

The largest part of social expenditures in Ukraine, as well as in Poland and Hungary, constitute expenditures of the Pension fund. Government plays the leading role in redistributing the pension outlays in most transition economies. In Ukraine expenditures on pensions were 35.34% of total social

ⁱⁱ One exception is Poland where despite the rapid growth in 1993-1994 poverty was very high. The poverty headcount index in 1993-1994, according to Milanovic (1995), was 20%, and only after 1994 did the poverty levels decline gradually.

expenditures in 1996 (see table 1). In Poland they were about 50% of total social expenditures in 1995 (see table2).

The centralized pension system, until recently, was effective in collecting resources and giving pensions to retirees. But this system, funded on a 'pay as you go' basis, is highly inefficient, due to numerous distortions that it imposes first of all on producers through payroll taxation.ⁱⁱⁱ Heavy taxation of the producer involves high costs in terms of slower growth of investment, of the private sector and the overall economy. Another inefficiency aspect is that the pension system is unfunded, so today's contributions to the Pension fund are immediately paid to current retirees. Hence, today's pensioners receive miserable benefits in comparison with those contributions they made in the past, and there is no guarantee that the future generations of the retirees will be supported adequately by their contributions.³⁰ Ukraine has nearly 14 million pensioners.³¹ This is a lot, given that the total population is 50.1 million. The number of contributors, that is the working people who support the security payments, is about 12 to 23 million.^{iv} Additionally, the number of contributors is continuously decreasing, due to the high burden of payroll taxation, as many of the contributors shift to the shadow sector, and the official tax bill decreases. Despite high government pension payments, pensions are miserable (up until 1998 they were below the poverty line), and many of the retirees whose only income is pensions live

ⁱⁱⁱThe payroll tax is 48% of the wage bill, of which 1% is paid by employees.

^{iv} The number depends on whether the jobs or full time equivalent positions are counted, as well as on statistics one uses, see Snelbecker, David. (1997). «Pension Reform in Ukraine.» Mimeo, HIID.

below the poverty level. By neglecting pension system reform, Ukraine has slipped into a critical situation with pension payments in 1996-1997, and the crisis continues in 1998.

Some progress was made with the introduction of unemployment insurance, as well as housing subsidies for the poor families. The level of unemployment payments is not large for two reasons. First, registered unemployment is very low, only 2.9%³² of the total labor force. This number does not capture the hidden unemployment of people on forced, temporary leave. The rate of unemployment under the International Labor Organization Methodology, calculated on the basis of the survey statistics of the State Committee of Statistics of Ukraine is 5.6%, including 6.3% among males and 4.9% among females.³³ Second, the average monthly level of unemployment benefits was only 40.4UAH in 1997,³⁴ which is below the monthly poverty level of 48UAH.

There are several problems with housing subsidies. First, along with prolonged economic decline, there are more and more people eligible for these subsidies. This increases government obligations substantially. Another problem is that these subsidies are not targeted well.^v Finally, there is a lot of bureaucracy involved in receiving these subsidies, which makes them extremely difficult to get.

Family allowances, including child allowances are very low in Ukraine. Targeted support to the poor families and children is about 2% of GDP, and is only about 1/5 of support that goes to pensioners.³⁵

^vThis issue will be discussed in the next section

Table 1 presents the composition of government social spending, total expenditures and revenues in Ukraine during the period of 1992-1997. Despite the decline in budget revenues, government expenditures in the social sector remained unaltered. During the period of 1992-1997, social expenditures, including subsidies to consumers, on average were at 27% of GDP. They were especially high in 1993-1994 at 29% and 28% of GDP and in 1997 at 29% of GDP.

For comparison, in Poland social expenditures in 1995 were 30.9% of GDP (see table 2), in Hungary and Czech Republic total social expenditures were correspondingly 31.8% and 20.5% of GNP (see table 3). In all these countries, social expenditures have increased during the transition. In the Czech Republic, the increase in social spending was small, at only 3% of GNP during 1989-1995. In Hungary there was a 12% of GNP increase in level of social expenditures, and in Poland the increase was the highest, about 15% of GNP.

Social spending in Ukraine exhibited up and down movements, which suggests an absence of clearly defined social policy. Changes in the level of social spending are made based mainly on political and not on economic considerations. For instance, a 5% increase in social expenditures in 1997, compared to 1996, was due to political reasons in expectation of the parliamentary elections in March 1998. That increase in social spending was aimed at lessening social discontent with the difficult economic situation and at gaining support for politicians who wanted to be reelected for the next term. At the end of 1997, Parliament adopted an amendment to the law on pensions, according to which

minimum pensions had to be increased. It remains unclear from which sources the government will finance these increased social obligations, especially when pension arrears are also growing.

Social expenditures constitute a large share of total government expenditures. During the period of 1992-1997 on average they were 56% of total government spending.

All these data suggest that social spending in Ukraine is substantial. Besides the political reason suggested above, there are several others: (1) social protection remains general; (2) there are loose eligibility criteria; (3) transfers are poorly targeted.

The level of social support in Ukraine may not seem to be so high if compared with Hungary or Poland, or even Czech republic. But such a comparison is not appropriate due to the following reasons. First of all, economic growth in Ukraine has not recovered. Real GDP is still declining. As a result, Ukraine has much less resources to devote to the social sector. The second reason, related to the first, is that GDP per capita level in Ukraine is lower than in Poland, and much lower than in the Czech republic. As a result, it is more difficult and more costly to undertake high social expenditures policy. Thirdly, it is not relevant to compare Ukraine with countries of Central Europe as far as loose social expenditures policy is concerned. These countries are following the model of the universal social welfare system with an expensive, pay-as-you-go-system (PAYG).³⁶ This welfare model has proved to be inefficient in the European Union countries, and many of them are considering reforming this system. It may not be reasonable for either Central European countries or for Ukraine to follow this experience.

Fourth, the explicitly provided social transfers indicated in the table 1 do not include government implicit transfers through subsidies and credits to the state owned enterprises, as well as the significant amount of non cash benefits provided by the enterprises to the employees. Such benefits include maternity leave compensation, sickness benefits, and in-kind benefits, such as health care centers, recreation facilities, kindergartens, etc.

The low rate of unemployment in Ukraine, only 2.15% (officially registered) in 1997,³⁷ supports the argument that people are reluctant to leave jobs because they do not want to lose the numerous benefits. As a result, there is a substantial part of unregistered or hidden unemployment. The incentive for the employer to hoard labor has arisen from the legal obligation of severance pay and may be also due to the belief that the current situation is temporary.³⁸

As is argued by Krumm et al,³⁹ wages received by the employees in the unproductive enterprises, whose activity either directly or indirectly is financed by the government, are the same as transfers, and these transfers are the burden for the productive sectors of economy. Those authors say that:

credit to enterprises and arrears are *de facto* transfers from a public sector banking system to households with wage earners in unviable jobs. Eventually the rest of the population pays, whether via inflation or other taxation. These continuing larger transfers to enterprises offset - most likely more than offset - the lower share of explicit transfers in the former Soviet Union as compared with most Eastern European countries.⁴⁰

In Ukraine, budget support of the economy was especially high during the 1992-1994 years. The highest expenditures on the economy and subsidization of foreign trade were in 1994 at 21.4% of

GDP.⁴¹ Since then they gradually declined to 6.5% of GDP in 1997,⁴² but still remain quite high. For comparison, in Poland, Hungary and the Czech Republic subsidies to producers, although rather high at the beginning of reforms, were cut dramatically. In 1995 among these countries, enterprise subsidies were the highest in Czech Republic at 3.8% of GNP level (see table 3).

Besides wages, subsidies to loss making enterprises can translate into the numerous benefits provided by the enterprises themselves. This is another part of transfers not included in the official data on social expenditures. Such transfers are provided by the state owned or newly privatized enterprises, either loss making enterprises (supported by the state), or productive ones which have been traditionally providing these benefits to the employees. These transfers remain rather high in Ukraine if compared with the countries of East-Central Europe. They are highly inefficient for several reasons. First, they impose a financial burden on the enterprise, lower its competitiveness, and growth potential. Second, these transfers have to be financed by someone, and the burden is most likely to fall on the productive sectors of economy. Thirdly, they are ineffective in terms of targeting. The distributive impact of these transfers is not pro poor. This will be examined in the section on the distributional impact of transfers.

A significant part of benefits provided by enterprises are compensation for utilities and transportation payments. Decreases in the amount of subsidies to the enterprises, as well as hardening of the budget constraints, led to the situation when many of enterprises could no longer subsidize numerous benefits. This created huge arrears, especially to the utilities sector (direct gas and heating).⁴³

As a result of extensive and unacceptable social payments, Ukraine has an unsustainable transfer system, the characteristics of which are high taxation, arrears, implicit transfers through enterprises, etc,⁴⁴ and numerous inefficiencies.

Pension Fund arrears in 1997 were UAH1.28 bln. They constituted 1.3% of GDP.⁴⁵ This is a large amount, given that there is a tendency for further increase in arrears. The situation is complicated due to a continuous decrease in the number of contributors, and a growing number of pensioners. Also, beginning with January 1, 1998, the minimum pension was raised to the poverty level. It is not clear how the state will finance increased pension contributions and also growing pension arrears.

The existing social policy is biased towards the older generation. A considerable amount of all social spending goes to pensioners, including those who have other sources of income and, therefore, are not in extreme need.

Welfare support to poor children is miserable, which suggests that Ukraine underinvests its human capital resources.

Thus, the transition created the dilemma, stressed by Michael Mandelbaum:

Generous social benefits seem necessary to sustain political support for the transition from plan to market...But overly generous benefits retard economic growth, the promotion of which is the purpose and the payoff of the transition to a market economy and the ultimate basis of political support for free markets.⁴⁶

On the one hand, there is much social insecurity and a lot of need: real wage and pensions are falling, consumption and income levels are low, unemployment, although currently low, is in danger of growing rapidly. On the other hand, there are costs of loose social spending:⁴⁷

- high government expenditures have to be financed through high taxes, levied on business activity, higher taxes mean more distortionary taxation, which in turn impedes economic development and growth of private sector in the long run;

- high spending through high taxation promotes tax evasion and the development of the shadow sector;

- high spending crowds out investment both private and public that is essential for long term growth,

- high spending creates disincentives in the labor market, as far as it affects the decision to work and to hire labor force,

- high spending may create arrears when planned public spending can not be attained, people may lose trust to government that does not perform its obligations before social sector, this will increase social unrest and instability in the economy;

- loose spending levies a high burden on the government budget, especially when tax revenues have decreased substantially as a result of economic decline;

- loose spending creates a threat to monetary and financial stability, especially if the budgetary deficit is high, and fiscal policy is not sustainable, and also if capital and financial markets are not well developed;

- high expenditures on social sector cause delays in reforms, which sooner or later have to be run. The longer delay persists, the higher are costs of reforms.

International experience suggests that high social spending and “big governments” are associated with high taxation, and produce economic inefficiencies: accumulation of considerable public debt, slower economic growth, growth of shadow economy, higher unemployment.⁴⁸ Tanzi et al question the benefits of high social policy and “big government.” In particular, “one has to ask whether it is worthwhile to spend an extra 20% of GDP to raise the income share of the bottom 40% of households by only 2-3%.”⁴⁹

Taking into account high costs of government spending as well as social needs during the transition two reform issues are crucial: efficient targeting of social expenditures, and reform of the pension system.

Efficient targeting would allow minimization of the costs of high spending and permit addressing the needs of the most poor. Hence it would reduce income inequality and increase welfare. Reform of the pension system is also urgent for decreasing the level of social spending and lowering the distortionary impact of payroll taxation.

The next section examines targeting of social transfers, namely the impact of the government and enterprise (mostly state owned enterprises, but also newly privatized ones) social transfers on inequality, and their effectiveness in reaching the most needy and reducing inequality.

5. Inequality Measures

This section reviews the measures of inequality and income redistribution that will be used in the following section to examine inequality, distribution of transfers and their impact on inequality in Ukraine. This overview draws extensively on Milanovic⁵⁰ and Kakwani.⁵¹ To make understanding of the formulas easier some simple examples will be given.

One of the instruments for measuring inequality is the Lorenz curve, which is illustrated in figure 2. It shows how equally income or wealth is distributed among the people. Each point on the curve shows the share of total income, or wealth, held by the share of the population associated with that point; population is ordered on the horizontal axis, starting with the poorest and rising to the richest group. The more the curve is skewed towards the 45° line, the higher is income equality, and vice versa. If income is distributed equally then the Lorenz curve coincides with the 45° line.

A closely related measure of income inequality is the Gini coefficient. The Gini equals one minus twice the area under the Lorenz curve or graphically it is the ratio of area C to C+D (see figure 2). The computational formula for Gini is:

$$G = \frac{1}{\mathbf{m}} \sum_{j=1}^k \mathbf{m}_j C_j, \quad (1)$$

where \mathbf{m} is the mean society income, and \mathbf{m}_j is the mean of the j th income component, C_j is the concentration coefficient of j income component, and k is amount of income groups. One problem

with the Gini is that it can take the same value even when Lorenz curves for different income distributions intersect.

Alternatively the Gini can be calculated as,

$$G = \sum_{j=1}^k w_j C_j, \quad (2)$$

where w_j is the share of the j income source in the total income.

The concentration coefficient⁵² shows how evenly an income component is distributed over the total income. It measures the concentration of an income source j when recipients are ranked by total income. In the case when the income source j is the total income the concentration coefficient is equal to the Gini coefficient. The formula for the concentration coefficient is:

$$C = 1 - \sum_{t=1}^k f_t (q_t + q_{t-1}) \quad (3)$$

where f_t is the proportion of recipients in income group t , q_t is cumulative proportion of income source j received by people in income groups from 0 to t , and k is total number of income groups. The concentration coefficient ranges from -1 , when all income component is received by the poorest individual, through 0 to 1, when all of an income component is received by the richest individuals. Because we want social transfers to favor the population in the bottom decile, we expect the concentration coefficient for transfers to be negative. A negative value of concentration coefficient for

transfers means that transfers are negatively correlated with total income. The concentration coefficient for transfers can also be written as:

$$C = \frac{2 \operatorname{cov}(s, r_y)}{\bar{s} \cdot N} \quad (4)$$

where s is amount of transfer income, \bar{s} is the mean amount of transfer, N is the sample size, and $\operatorname{cov}(s, r_y)$ is the covariance between transfer s and ranking of the recipient according to total income.⁵³ From equation (4), it is clear that the sign of the concentration coefficient depends on the numerator. To have transfers progressively distributed,^{vi} that is to favor the bottom deciles, the numerator has to be negative. The higher is the absolute value of covariance, the more negative the concentration coefficient, and the more progressively distributed are the transfers.

In figure 3 different distributions of income sources that have different concentration coefficient values are depicted. The X-axis measure of this figure is the same as for the Lorenz curve, namely the percentage of population ranked according to total income. On the Y-axis measure is the cumulative percent of j income source. When the income source is total income than the distribution of this income source coincides with the Lorenz curve. Curve 1 depicts a hypothetical distribution for pro-poor social transfers. It is skewed to the left from the 45° line, which indicates that transfers are progressive, and the concentration coefficient for this distribution will be negative. Curve 2 depicts hypothetical

^{vi} By progressivity of social transfers here and later I mean that social transfers are negatively correlated with income, that is social transfers go more to the population in the below average income groups than to the population in the above average income groups.

distribution for the wage income. It is skewed to the right from the 45° line, indicating a pro rich distribution of wage income. The concentration coefficient for this distribution will be positive. Line 3 coincides with the 45° line. Such distribution of income source equally favors the poor and the rich. The value of the concentration coefficient in this case will be zero.

To measure the contribution of the distribution of the j income component to the overall level of inequality, the following formula can be used:

$$D_j = \frac{C_j \cdot w_j}{G} \tag{5}$$

D_j measures what share of the inequality that is explained by the distribution of the j income source. A positive D_j measure for distribution of j social transfer income suggests that j income component contributes to inequality, and a negative value to equality.

Let's illustrate calculations of these measures with a simple hypothetical example. Assume that we have a 5 individual economy. Also, assume that the total income of individual consists of three income sources. They are wage income, social transfers, and capital gains. The distribution of income sources among five individuals is assumed to be the following:

	1-st	2-nd	3-rd	4-th	5-th	Total	Mean
Wages	100	200	300	400	700	1700	340
Capital gains	30	50	150	300	500	1030	206

Social transfers	70	60	50	30	10	220	44
Total	200	310	500	730	1210	2950	590

The concentration coefficients for wages, capital gains, social transfers calculated from formula

(3) will be:

$$C_{\text{wages}} = 1 - (1/5 * 100/1700 + 1/5 * (100/1700 + 300/1700) + 1/5 * (300/1700 + 600/1700) + 1/5 * (600/1700 + 1000/1700) + 1/5 * (1000/1700 + 1700/1700)) = 0.32$$

$$C_{\text{cap.g}} = 1 - (1/5 * 30/1030 + 1/5 * (30/1030 + 80/1030) + 1/5 * (80/1030 + 230/1030) + 1/5 * (230/1030 + 530/1030) + 1/5 * (530/1030 + 1030/1030)) = 0.46$$

$$C_{\text{soc.tr}} = 1 - (1/5 * 70/220 + 1/5 * (70/220 + 130/220) + 1/5 * (130/220 + 180/220) + 1/5 * (180/220 + 210/220) + 1/5 * (210/220 + 220/220)) = -0.27$$

The calculated concentration coefficients suggest that most of wage and capital gains income go to the individuals in the top income groups. The concentration coefficients for these two income sources are positive. The distribution of social transfers is progressive, meaning that individuals in the bottom income groups receive the highest share of this income source. The concentration coefficient for social transfers is negative.

The same conclusion can be drawn by observing the income data table given above. There is a negative correlation between the amount of transfers given to the individual and the amount of the individual's total income, and a positive correlation between the amount of wage and capital gains

income sources and the total income of the individual. From formula (4), this suggests that transfers are devoted to the bottom income groups individuals, and wages and capital gains are mostly devoted to the top income groups individuals.

The Gini calculated from formulas (1), (2), (3) under these assumptions will be:

$$\text{from (1): } G = 1/590*(340*0.32+206*0.46+44*(-0.27)) = 0.32$$

$$\text{from (2): } G = (1700/2950*0.32+1030/2950*0.46+220/2950*(-0.27)) = 0.32$$

$$\text{from (3): } G = 1 - (200/2950*1/5 + 1/5*(200/2950 + 510/2950) + 1/5*(510/2950 + 1010/2950) + 1/5*(1010/2950+1740/2950)+1/5*(1740/2950+2950/2950)) = 0.33$$

The contribution of distribution of each income source to overall inequality using formula (5) will be:

$$D_{\text{wages}} = (0.32*1700/2950)/0.32 = 0.58, \text{ or } 57\%$$

$$D_{\text{cap.g}} = (0.46*1030/2950)/0.32 = 0.50, \text{ or } 50\%$$

$$D_{\text{soc.tr}} = ((-0.27)*220/2950)/0.32 = -0.07, \text{ or } -7\%$$

The calculated contribution measures suggest that social transfers reduce overall income inequality in this small economy by nearly 7%. That is to say, the total income inequality, i.e. the value of Gini, will be 7% higher if there were no social transfers in this economy.

6. Distributional Impact of Social Transfers on Inequality.

The analysis of the distributional impact of social transfers is made on the basis of the household and the individual survey conducted by the Kyiv International Institute of Sociology in the summer of the 1996 year.

The ranking of the recipients is done by the per capita disposable household income. Household units were considered as recipients. Calculations were done based on the grouped data, divided into ten income groups. For the description of the survey and data used see **Appendix III**.

The distributional impacts of the following social transfers were investigated: pensions, unemployment allowances, stipends to post secondary students, non-cash benefits to pensioners, house subsidies, compensation to the CHAES victims, family allowances, state-owned enterprises transfers. For description of benefits that each transfer includes see **Appendix III**.

Before examining the distributional impact of each of these transfers, it is worthwhile to consider the overall distribution of income. The total inequality of the household income, i.e., the value of the Gini, calculated for the examined household sample was 0.39 in 1996. Income inequality has increased substantially compared to 0.23 at the beginning of reforms calculated by Kakwani.^{vii} Figure 4 depicts

^{vii} One has to be cautious to compare these as well as other inequality numbers. Kakwani calculates income inequality measures for gross individual income ranked by the gross per capita household income, while I calculated income inequality for disposable household income ranked by the per capita household income. There are several methodological problems in comparisons when different concept of income, type of recipient, ranking criterion is

the Lorenz curves for the distribution of total income in 1992 and 1996 years. The Lorenz curve for 1996 income distribution is skewed farther away from 45° equality line than Lorenz curve for 1992. Since the curves do not intersect, one can conclude that there was an unambiguous increase in inequality during the transition.

For comparison, the Gini coefficient in 1996 was about 0.32 in Hungary, about 0.20 in the Czech republic and Slovakia, 0.36 in Bulgaria, 0.46 in Russia, 0.34 in Poland.⁵⁴ In developed economies in 1990 the Gini was 0.25 in Finland, 0.31 in Canada, 0.27 in Belgium, 0.32 in Great Britain, 0.37 in USA.⁵⁵

The increase in inequality was considerable in all transition countries, with the exception of the Czech republic and Slovakia, which remain relatively egalitarian. Ukraine is among those countries which experienced the highest increase in income inequality.

There are several channels for the inequality to increase in the transition economy:

- privatization and the growth of private sector promote higher income differentials;
- price liberalization and high inflation lead to fall in the real income levels and assist growing inequality;
- changes in the composition of government spending.

used. See Milanovic (1992b) for examination of these methodological problems. Another problem is that the calculations of Gini are based on different samples, and hence may involve different estimation results.

- Aslund argues that for Russia an important reason for income inequality is rent-seeking behavior; this is also true for Ukraine.

Hyperinflation in 1992-1993, also substantial government regulation of the economic activity during 1992-1994, created a favorable climate for the high degree of rent-seeking that took place during that time. As is argued by Aslund, there are three types of rents that were used to make big money in Russia: subsidized credits, implicit export subsidies, and import subsidies.⁵⁶ In Ukraine these possibilities were huge during 1992-1994, when export-import operations were heavily regulated, and large amount of cheap credits at a negative real interest rate were given to state owned enterprises, and some private firms headed by former public officials who had connections with, and influence on, the decision making by the government institutions.

Higher prices also made part of the population worse off. These income effects were especially damaging for those parts of population who can not compensate losses in real income by charging higher prices or wages for their production. They are mainly pensioners and state employees.⁵⁷

The growth of the private sector, both in the official and unofficial sectors, is also important in explaining the growth of income differentials. The concentration coefficients for per capita distribution of wages and unregistered income in Ukraine were correspondingly 0.49 and 0.62 in 1996, contributing 74% of total income inequality (see table 4). For comparison, the concentration coefficient for salary income in 1992 was 0.31.⁵⁸ This suggests that wages became more differentiated during the transition.

Simon Commander argues that much of the increase in the inequality in transition economies is due to the increase in income holding in the upper 10%, primarily at the expense of the decrease in income holdings in the bottom deciles.⁵⁹ Such redistribution of income is likely to be true for Ukraine.

Given the substantial increase in inequality during the transition, government redistribution policy aimed at reduction of income inequality is crucial. There are basically two mechanisms that the government can utilize to affect income redistribution outcomes. They are taxation and transfers. Changes in the government social transfer policy and also in the composition of government social spending need to become an effective means to reduce income inequality in all transition countries.

According to the study of the distributional impact of social transfers in the Eastern Europe at the beginning of reforms made by Milanovic "...efficiency of cash transfers in reducing of income inequality [in Eastern Europe] is only about one half of what it is in capitalist countries."⁶⁰ However, in the process of reforms, as is argued by Commander, some countries of Central Europe have managed to increase the efficiency of targeting, and the offsetting effect of public policy on inequality was large in some transition economies. For example, in Hungary, due to social transfers, the Gini coefficient for total income in 1996 was reduced from around 0.50 to 0.30. That is to say, without social transfers total income inequality will be about 66% higher. Social transfers were the most important contributor to that reduction in inequality.⁶¹ This is significant success for Hungary, as compared with the distributional impact of transfers at the beginning of reforms in 1989. The concentration coefficient for total transfers

in 1989 computed by Milanovic was 0.01, i.e. social transfers were slightly pro-rich, and they explained 1.26% of total inequality in that year.⁶² Hence, social transfers in Hungary, from being mildly pro rich at the beginning of reforms, became better targeted, more devoted to the bottom decile income groups, and more effective in reducing overall inequality in the country.

Commander argues that the situation is different in countries outside of Central Europe. Government transfer policy in this region has mainly stimulated the growth of inequality. Thus, in Bulgaria and Russia the concentration coefficient for transfers during the transition has increased, with pensions contributing to inequality the most.⁶³

Hence, the evidence suggests that some countries have increased efficiency of the redistribution policy, and this had a desirable effect of smoothening the costs of transition and reducing inequality, while in others social transfer policy became even more untargeted.

In the analyses of income redistribution policy in Ukraine, I will compare distributional impact of social transfers in Ukraine in 1996 with distributional impact of transfers in Ukraine and other transition economies at the beginning of reforms. Unfortunately, I do not have more recent data on the distribution of social transfers in Central and Eastern Europe to make comparison with social policy in Ukraine. The inequality data for Ukraine at the beginning of transition are taken from Kakwani⁶⁴ and for other transition economies from Milanovic.^{viii65}

^{viii}Some caution has to be made while comparing data from Kakwani, Milanovic and my calculations. Milanovic calculates inequality measures for gross household income ranked by gross per capita household income, while as

According to the survey data, social transfers in Ukraine provided by the government and enterprises constitute a significant share of the total household income (see table 5). About 33% of household income in 1996 came from transfers. Pensions generate the highest share of transfer income, about 57% of transfers or 19% of total household income come from this income source. Along with pensions, an important source of income are also enterprise transfers as well as non-cash benefits to pensioners, that are about 7% and 4% of total household income, respectively.

The household data suggest that the transfer system is biased towards the support of pensioners and the old population on the whole. Pecuniary aid for poor families and children is only 3% of total transfers compared to 70% that go to pensioners. This is a highly disproportional division of social support. By neglecting children who live in poor families the country underinvests in the human capital which is an important source for economic growth in the long run.

Another conclusion suggested by the data is that the enterprise support continues to be important part of the overall social protection system. One-fifth part of support comes from the enterprises, and enterprises bear a large burden of social protection. This makes producers sacrifice many resources which, otherwise, would have been directed to investment and improvement of technology which are crucial for economic restructuring.

my and Kakwani's methodology is somewhat different, see footnote vii. The difference between the Milanovic and my methodology is likely to be small because the personal income tax revenues, which constitute the difference between gross income (chosen as ranking criteria by Milanovic) and disposable income (chosen as ranking criteria by me) in transition economies are not large, see for more detail Milanovic (1992b), pp. 1-9.

Calculated concentration coefficients indicate that the existing transfer system is highly regressive.^{ix} That is to say, the social protection system is oriented to supporting the rich and not the poor. The concentration coefficient for total transfers including enterprise transfers is 0.22, and 0.10 excluding enterprise transfers (see tables 4 & 5). Both figures indicate a pro-rich distribution of transfers. Most social assistance goes to the population in the above average income groups. The concentration coefficient for government cash benefits in the 1991 was -0.005 .⁶⁶ That suggests that during the transition, government transfers became more devoted to the above average level income groups.

Hence, social transfers went from being slightly progressive before the transition to being unambiguously regressive during the reforms.

Table 6 gives concentration coefficients of social transfers in some European countries and western hemispheric countries. Data suggest that targeting lower income groups in the developed countries is considerably higher than in the post socialist countries at the beginning of reforms, and higher than in Ukraine after nearly 7 years of transition. Ukraine did not improve its transfer policy during the transition and the distributional consequences have been largely to promote inequality. The regressive nature of distribution of social transfers contributes nearly 19% to total inequality in 1996 (see table 5).

^{ix} By regressivity of transfers I mean that the share of transfers increases as the level of disposable income increases, and that is the share of transfers going to the top decile income groups is greater than to the bottom decile.

Among social transfers, enterprise transfers are most regressive. The concentration coefficient of their distribution is 0.55. They alone explain 10.2% of inequality in 1996. Thus, enterprise transfers are not only inefficient because they impose burden on the enterprise productive development, but they are also inequitable due to their high degree of regressivity.

The distribution of different types of transfer income by decile income groups is given in figures 5-8. Those figures depict what share of transfer income goes to particular income groups. If the distribution of transfer income coincides with the 10% line then the distribution is perfectly equal, and each decile group receives the equal share of transfers. In this case the distribution of transfers do not depend on the income, and the value of the concentration coefficient will be zero.

The distribution of enterprise transfers is demonstrated in figure 5. It is almost flat across first 8 decile groups, and grows sharply for the last two deciles. The last two deciles take the most part of this transfer income source. That is, nearly 65% of enterprise transfers are devoted to the top two income groups. This suggests that this transfer is highly regressive. High regressivity of the enterprise transfers can be explained by the rent-seeking behavior of the managers of the state owned enterprises. Substantial part of benefits provided by SOE are not equally accessible. Managers of SOE often distribute these benefits among themselves and collect rents from distribution of scarce and valuable transfer income.

Pensions are also poorly targeted. The concentration coefficient is 0.11 for pensions and 0.16 for non cash benefits to pensioners. They contribute, correspondingly, 5% and 2% to total inequality. The reason for pensions to be pro rich is that many of the pensioners continue to work after retirement and receive both wage and pension income. By paying equal amounts of pension outlays both to those who work and those who do not, government provides inequitable distribution of resources, and is likely to be ineffective in performing its income redistribution functions. Having limited and even declining amounts of resources in the pension fund, government has run into a pension arrears problem. Limiting the amount of pensions paid to employed pensioners can help to solve the problem of pension arrears.

Figure 6 shows the distribution of pension outlays and non-cash benefits to the pensioners. The slope of the distribution line is positive for both transfers, supporting the arguments above that pensions are regressively distributed. From the figure it is evident that most pension income goes to the population in the above average income groups, that is above 10% line, also indicating an unequal distribution of these two transfer income sources.

Concentration coefficients for pensions calculated by Milanovic for some countries of Central and Eastern Europe in 1988-1989 suggest that pensions are also one of the most regressively distributed transfers. Concentration coefficients for pensions are: in Yugoslavia 0.3, in the Czech Republic 0.08, in Hungary 0.1, and in Bulgaria 0.11 (see table 7). On the contrary, in Poland and Russia the distribution of pensions was progressive. Their concentration coefficients were

correspondingly -0.03 , and -0.2 .⁶⁷ Milanovic explains the good targeting of pensions in Russia by the low share of pensions in total income at that time, which contributed to good “targeting by default”.⁶⁸ Hence, the distribution efficiency of pensions in Ukraine is more regressive than it was in most transition countries before the reforms.

The distribution of stipends for post secondary students also has regressive features. Their concentration coefficient is 0.17 . An explanation for this is similar to that given for pensions. Many of the students combine their studies with the part time work. This helps them to support a high level of living expenses during studying. The stipend payments were significantly reduced in 1997, so their volume in total transfer payments has been reduced also and their redistributive impact is currently very small.

The concentration coefficient for scholarships in other postsocialist countries at the beginning of transition are also positive, supporting the view of regressivity of this kind of transfer. In Yugoslavia, the concentration coefficient for scholarships was 0.50 , in Hungary 0.09 , in Bulgaria 0.05 and in Russia 0.2 (see table 7).

The family allowances, as well as compensation to the CHAES victims, although being small in volume, at 3% and 0.3% of total transfers, are very regressively distributed. The concentration coefficients for these income sources are 0.39 and 0.47 , both contributing 1.13% to total inequality (see table 5).

The distribution of family allowances in Ukraine is shown in figure 5. Like the distribution of enterprise transfers, the distribution of family allowances is almost flat across first 8 decile groups, and grows sharply for the last two deciles. The last two deciles receive 51% of this type of transfer income, which suggests that distribution of family allowance is regressive. There can be several explanations for the bad targeting of this transfer income. First, there is much of bureaucracy involved in receiving family allowances. So, not all of those who are eligible for these transfers can get them. Another reason is that these transfers include benefits which are not easily accessible for the poorest due to rent-seeking behavior. In particular, medical benefits to poor or disabled children may be distributed not to them, but to children of rich families. In general, corruption and rent-seeking behavior is one of the reasons of poor targeting in Ukraine. As a result of corruption many individuals who are eligible for certain benefit may not get access to it, and this benefit may be finally distributed to those who do not need it the most.

The concentration coefficient for family allowances are highly negative in all transition economies with the exception of Russia, indication of pro-poor distribution of this income source. Thus, in Yugoslavia it is -0.2 , in Poland -0.12 , in Czech Republic -0.28 , in Hungary -0.22 , in Bulgaria -0.17 , and in Russia 0.02 (see table 7).

The regressive nature of the family allowances payments in Ukraine supports the view that Ukraine has very poorly organized support for the poor families and children. There is hardly any targeting or eligibility criteria involved in selecting the most needy.

The most targeted among the examined transfers in Ukraine is unemployment insurance. It is the most progressively distributed. Its concentration coefficient is -0.64 . However, the share of unemployment insurance in total income is very low: only 0.03%, which is due to the low level of registered unemployment in the country. The low rate of registered unemployment is responsible for good targeting of this transfer income. Because many people are reluctant to register as unemployed, those who really do have few other sources of income, and hence, the distribution of unemployment payments seems to be very targeted.

The distribution of unemployment allowance payments is shown in figure 7. This figure supports the view, that among the considered transfers, the distribution of unemployment allowances is the most progressive. The total amount of this transfer income is received by the first four income groups. It is interesting to note that according to the data most of unemployed are in the second decile group, and none in the first decile income group. This suggests that the poorest deciles of the population consists of those who are not in the labor force, and not unemployed. This decile is first of all pensioners, but includes others such as the disabled.

Housing subsidies are distributed mildly pro poor. Their concentration coefficient is -0.05 , reducing inequality by -0.16% . Being small as a share of total income, the distribution of subsidies together with unemployment payments contributes very little to reduction in inequality, only -0.21% .

Figure 8 depicts distribution of the housing subsidies by income groups. The data suggest that this distribution is regressive for the first two and the last two decile groups, that is the amount of transfers is growing with income across these deciles; but the distribution is progressive across third till eighth deciles. The distribution line of this transfer is moving around 10% line, indicating close to equality distribution of this income source.

To sum up, income inequality has considerably increased during the transition. Ukraine, being relatively egalitarian at the beginning of transition, has experienced a substantial increase in inequality. The transition to the market and the growth of private sector are the most important contributors to higher inequality. In fact, no one knows what is the optimal level of Gini is for Ukraine. A target level of Gini can be suggested by what it is in the developed economies. The Gini for these countries is on average close to 0.3. However, there seems to be widespread acceptance that the social transfers should be progressively distributed. The findings for Ukraine are that the social transfers are very regressively distributed. Most transfer income is directed to the population in the above average income groups. This indicates a poorly targeted social support system. The existing redistribution system of social transfers is not only ineffective in reducing inequality, but also contributes to total inequality by about 19%. Among the examined transfers, unemployment allowances are the most progressive, and hence most targeted. In contrast, enterprise transfers are mostly devoted to the top income decile groups.

The analysis suggests that the social transfer system with no reform has become even more regressive during the transition. This can be explained by the substantial increase in the inequality during the transition. Given that the social redistribution policy did not change, having higher inequality would automatically reduce targeting efficiency of the government social policy. The social policy under the previous socialist system with low income inequality, would seem to be more targeted than the same social policy with high income inequality.

7. Implications and Suggestions for Reform of Social Policy.

The reform of social policy is a very complex issue. It is impossible to cover all aspects of reforms needed in this section. I will just outline the areas where in my view reforms are most urgent, and give some policy recommendations.

The analysis suggest that pension outlays constitute the highest share of social spending. But the government is inefficient and ineffective in redistribution of the pensions in the sense that the current system requires high taxation levels and is not progressively redistributive. First, high payroll taxation, which supports the current pension system, is likely to be very distortive for the economy. Productive sectors are at disadvantage from high taxation, as far as this lowers firm's competitiveness, reduces potential scope of investments, and discourages growth. High taxation also contributes to the shift of production to informal activity, which in turn reduces the amount of resources for government income redistribution activity. Second, the existing pension system produces inequities in the economy. Government not only fails to reduce inequality, but its pension outlays contribute to increase inequality.

Inefficiencies and inequities of the traditional PAYG system are revealed not only in Ukraine but also in other countries where it operates.⁶⁹ Empirical evidence suggests that pensions are one of the most regressive transfers in the transition economies.

Given these inefficiencies of the pension system, the government has to decrease the scope of redistribution of pension outlays. Hence, reform of the pension system to decrease the burden of

pension payments made by the government is crucial. Government should share the responsibilities of pension payments with individuals, through introduction of individual accounts, and with private pension funds.

Government should continue to support only the least protected pensioners who are either unable to support themselves or whose pension income is below the minimum acceptable level. There are several mechanisms that can be utilized to redistribute income from rich to poor under a pension system based on individual accounts and private pension funds. The government can guarantee a minimal pension level by providing transfers that bring low pension earners up to a minimum floor. The other possibility is to make gradually progressive contributions to the pension accounts of low income people to raise their total contribution level up to a minimum floor.⁷⁰

The introduction of individual accounts and a privately managed pension system would not only be efficient in setting a closer link between benefits and contributions, it would also reduce distortions created through taxation, reduce evasion to the shadow economy, promote working longer, and increase national saving which will benefit productivity and growth.⁷¹

The suggested steps for pension policy reform are long term oriented, and would not produce immediate efficiency effects, and will not produce a cut in Pension Fund expenditures in the short and medium terms. In order to reduce pension outlays by the government earlier, several other reform policy tools can be employed. First, the pension age could be increased from the current 55 for women and 60

for men, to 60 and 65 respectively, or to 65 for both sexes. Second, pension outlays paid to working pensioners could be reduced. This would decrease the social outlays, increase the number of contributors, promote growth and make the existing PAYG system sustainable for the medium term.⁷²

The saved pension payments can be used to direct support to pensioners who live below the poverty level, and who have little or no alternative sources of income or be devoted to greater support for children in poverty.

Pension reform is the most essential and the most difficult politically to be implemented. But it would allow for restructuring of the existing social protection system.

Pension reform is also crucial to reorient the current pro old generation bias of the social protection system. Family allowances, and especially child allowances are extremely low in the transition economies, and are very low in Ukraine. By neglecting support to unprotected representatives of young generation, the country deliberately lowers the potential productivity of the human capital in future, which is an important factor of economic growth. Cornia suggests that it is necessary to increase them by between 1 and 2 percentage points, “and a minimum threshold (equal to 10-15% of minimum wage in the case of child allowances) should be established to prevent them from becoming purely symbolic.”⁷³

Another crucial step for reform is to improve the targeting of social spending as to make government redistribution policy more effective. Currently in Ukraine there is hardly any targeting of

family allowances and pension outlays. This is indicated by high positive values of concentration coefficients. The income based targeting of housing subsidies, although slightly pro poor, is not appropriate for Ukraine. This is because income targeting underestimates income received from the large shadow economy sector. Hence, much of the house subsidy support goes to the income groups that have a high income from informal activity.

One possible solution is to introduce categorical targeting. Categorical targeting may involve combining key indicators which are correlated with poverty, for instance, family size, age and activity of children, work profile of families, number of children in the family, single mother or single father family, other. Categorical targeting on the basis of selected indicators related to low income earnings will minimize the administrative costs associated with targeting, which are high in the transition economies.⁷⁴

To improve targeting efficiency, self targeting mechanisms for provision of benefits can be employed. Chu and Gupta suggest public works programs as one of the self targeted social assistance measure.⁷⁵ It would require the unemployed to exchange their work time for receipt of food or wages. Other examples of self targeting mechanisms are subsidizing of lower quality meals to the poor, low paid work, food stamps, etc.

Finally, obligatory state-owned enterprise provided social support must be eliminated. This would increase efficiency of most state owned enterprises. Instead of enterprise support, alternative sources of financing should be provided. This would lower the costs associated with any decrease in the

enterprise social spending in the medium term. Commander et al. show that social support, in the transition time from enterprise to market based benefits provision, can be financed from the savings realized from removal of current subsidies to enterprises and directing them to benefits.⁷⁶

The current crisis of welfare state in Ukraine is mostly due to the following three reasons:

1. social spending is high, and promotes high budget deficit;
2. social spending is regressively distributed, contributing to inequality;
3. budget revenues collected are insufficient to cover the growing obligation of the government to the social sector, and there is no capacity to increase the tax revenues to support high spending.

In view of these problems, the reform of social spending policy is crucial. Social spending must be cut to levels the country can afford. Also, to decrease the level of social outlays, efficient targeting of social assistance has to be a high priority in any reform.

8. Conclusions.

The paper discusses the challenges of social transfers policy in Ukraine, in particular the costs of extensive social spending for productive sectors of economy and for sustained growth in the long run. The paper also considers the distributional impact of social transfers, and effectiveness of social spending in reducing inequality.

Ukraine, like most transition economies, sacrifices much of its resources to provide social support, in order to decrease the social costs of transition.

However, the situation with social protection policy is critical. Very few reforms of social policy have been implemented. Most support programs remain broadly based. As a result of extensive and unacceptable social payments, Ukraine's transfer system is in crisis. Its characteristics are high taxation, arrears, ineffective pro-rich distribution of social transfers, and implicit transfers through enterprises.

The centralized pension system is inefficient due to numerous distortions that it imposes on producers through high payroll taxation. The system is also inefficient as it levies the burden of social protection on the producers, which undermines competitiveness of the producers, and investment and growth potential. The existing system of social protection is biased towards the older generation. Welfare support to children is miserable, which suggests that Ukraine underinvests into the human capital resources.

The main findings of the paper are that the existing social transfers system is very poorly targeted. The distributional impact of most transfers is regressive, suggesting that the substantial part of transfer income is going to the population in the above average income groups. Thus, the existing redistribution system of social transfers not only imposes a high burden on productive sectors of economic activity, but it also ineffective in reducing inequality, and even contributes about 19% to total inequality.

Among the examined transfers unemployment allowances are most progressive, and most targeted. Enterprise transfers and family allowances are the most regressive and devoted to the top income decile groups. A large part of the social support resources is inefficiently used: support goes not to the most needy and unprotected, but to those who do not need the support much. This suggests important policy implications for the government. First of all, provision of pension reform is crucial. It is necessary to decrease amount of social contributions made by the state, and to reduce the distortionary implications of extensive social protection system. Second, the social support burden of the state-owned enterprises must be substantially reduced. This would increase their competitiveness and thus growth potential. Taking into account the high opportunity costs of social spending and continuously declining budget revenues in Ukraine, the targeting of social transfers must be improved. Increasing the efficiency and effectiveness of government redistributive policy through reform of the pension system as well as

improvement in targeting would decrease the level of social spending and the costs associated with loose social spending, and would assist sustainable long term growth.

9. Endnotes

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