Criticism of the Welfare State Concept and the Need for Liberal Reforms in the Ukraine

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I. Motivation

The global financial crisis of the late 2000s and the recession that followed have seriously destabilized economic situation in many countries throughout the world. Larger budget deficits due to increased social security expenses, a general slowdown in economic activity, double digit unemployment rate and other severe social and macroeconomic problems are seriously testing the soundness of the economic policies that have been adopted in the last decades.

In this paper we look at the welfare state concept which was popular in the CIS countries after the dissolution of the Soviet Union. Part two of the paper describes the concept, critically analyzes it and reviews its history and theoretical arguments. In part three, we present rigorous statistical analysis and discuss the economic situation in the Ukraine as well as the economic achievements of Georgia. Through critical analysis and based on the interesting findings of the research we have conducted, we try to demonstrate the failure of the concept and advocate the need for liberal reforms in the Ukraine. Lastly, we present our conclusions and recommendations following which is the bibliography of the materials we used in preparing this paper.

II. Description of the issue

II.1. Theory of socialists and the welfare state

The welfare state theory is based on the policy of the German government which was implemented in the 1880s and introduced old age pensions, medical care and unemployment insurance. The theory of welfare is founded on the works of German socialists and social democrats (SD), such as Wilhelm Liebknecht and Eduard Bernstein. Some of ideas were formulated by socialists, such as Oskar Lange. The main concepts of the welfare (as part of SD economic program) are as follows:

- A mixed economy consisting of both private enterprise and publicly owned or subsidized programs oriented at education, universal health care, child care and related social services for
all citizens;

- An extensive system of social security (although usually not to the extent advocated by socialists), with the stated goal of counteracting the effects of poverty and insuring the citizens against loss of income following illness, unemployment or retirement;
- Government entities that regulate private enterprises in the interests of employees and consumers by ensuring labor rights (i.e. supporting worker access to trade unions), consumer protections, and fair market competition;
- A progressive taxation system to fund government expenditures;
- Fair trade over free trade.

If we analyze the main differences between welfare state concept (as a part of SD) and classical liberalism (Locke, Smith, Ricardo, Mill), we can see several essential distinctions:

**Illustration 1. Welfare state theory diagram**

Practical implementation of the welfare concept in Western countries started during the Great Depression in the US, and is associated with John Keynes (substantiated active role of state in economy), Frances Perkins (implemented Social Security Act) and Franklin Roosevelt (introduced Undistributed Profits Tax and managed all “socialistic” methods [1]). Nowadays the US has several welfare state elements in their socio-economic system, such as Medicare and Medicaid programs financed from federal and regional budgets, ramified system of public education, overregulated and running a deficit pension system, inflated grants and subsidies for rural economy, etc. They are widely criticized by most experts who stress the need for reforms and the reduction in the volume of such programs. [2], [3], [4].

**II.2. Liberals’ criticism of the welfare state**

The criticism of welfare theory and interventionism [5] started as soon as the theory
appeared. It was first mentioned in John Stuart Mill’s “Principles of Political Economy” (Book 2 and 5). Broader criticism of socialism and welfare state and appeared in the 20-th century by liberals and Austrian School economists.

Ludwig von Mises in his “Critique of interventionism” (1929) elaborated on the unemployment benefits: “unemployment compensation cannot eradicate the evil. It merely delays the ultimately unavoidable adjustment of wages to the fallen marginal productivity. And since the compensation is usually not paid from income, but out of capital, ever more capital is consumed and future marginal productivity of labor further reduced.”[5]

Another important characteristic of modern welfare policy is minimum wage laws, which have become widespread in many countries of the world. Minimum wage laws are also widely criticized by contemporary economists who base their conclusions on the empirical studies on effectiveness of these laws.

David Neumark and William L. Wascher in their latest book “Minimum Wages” (2008) argue that minimum wages do not achieve the main goals set forth by their supporters. They reduce employment opportunities for less-skilled workers and tend to reduce their earnings; they are not an effective means of reducing poverty; and they appear to have adverse long-term effects on wages and earnings, in part by reducing the acquisition of human capital. The authors argue that policymakers should instead look for other tools to raise the wages of low-skill workers and to provide poor families with an acceptable standard of living. [6]

Murray Rothbard in his fundamental work “Man, Economy, and State” (1962) concludes that “...while the announced aim of a minimum wage law is to improve the incomes of the marginal workers, the actual effect is precisely the reverse—it is to render them unemployable at legal wage rates”. [7]

Some authors argue that monopoly of state in social security service leads to low quality of service and contradicts classical liberal human rights (as theft). [8][9]

**II.3. Modern welfare models**

Some variations on the welfare state concept have been successfully implemented in several countries. Nordic states like Denmark, Iceland, Norway, Sweden and Finland have built stable economic systems, known as a Nordic model [10]. Nevertheless, the implementation of welfare elements hasn’t been global, and it significantly deviates from the theory. We believe that the success of modern welfare models can partially be attributed to the high income which welfare implementing countries get from selling energy supplies (Norway, United Arab Emirates, Brunei, Kuwait, Qatar, Bahrain, Oman, and Russia). For example, oil and gas industry make up roughly 25% of the GDP and 32% of all income in Norway. [11]
III. Analysis

III.1. State of the Ukrainian economy

According to the data we have acquired, in 2010 the Ukraine was the 40-th biggest economy in the world. The GDP of the country was made up of 9.4% - agriculture, 33.6% - industry, 57% - services which puts the Ukrainian economy (according to generally used methodology) in the post-industrial state category. Main industries are coal, electric power, ferrous and nonferrous metals, machinery, transport equipment and chemicals. [12] Nevertheless, the standard of living in the Ukraine is much lower than that of other comparable states. In 2010 Ukraine’s per capita GDP (PPP) was $6,700, which puts it in the 133-rd place in the world. [13] In the chart that follows you compare Ukraine’s GDP per capita to that of other comparable countries.

![Illustration 2. Countries by GDP per capita (PPP)](image)

As we can see Ukraine’s GDP per capita is quite low for a European country. For the sake of comparison, this indicator in Poland is $18,800, in Romania - $11,600, in Belarus - $13,600 [13]. It is worth noting at the same time that by Human Development Index the Ukraine is in the 69-th place in the world and is in the group of countries with high human development, according to the data on the year 2010 [14]. Experts explain this by good indicators in education and public health (still working soviet system which, however, demonstrates a lasting trend of gradual collapse).

The Ukrainian economy is facing significant systemic problems which are interrelated. To name but few:

- Prolonged transition from planned to market economy;
- High corruption level (Corruption Perceptions Index) [15];
- Overregulation of basically all economic fields;
- High taxation; [16]
• Very low level of economic freedom and ease of doing business; [17]
• Low competitiveness of the economy.

Another worthy-of-notice problem in the Ukrainian economy is rising national debt, that will be around 42.4% GDP in 2011 (forecasted by the IMF) and regular budget deficits which have constituted approximately 1.5% of GDP in the last 5 years. [18]

Despite this the government of the country continues to initiate and finance social benefits programs which do not have a lasting positive effect on the economy and just help politicians raise their rating in the public eye. [19][20] These actions have positive effects in the short-term but can have a lasting negative long-term effect on the economy.

III.2. Statistical analysis

To understand the impact of government expenditure on well-being of nations, we conducted considerable research and statistical analysis and came up with two hypotheses. We gathered and used data on 164 countries and looked at four main statistics: GDP [13], budget expenditure [13], Human Development Index [14] and Ease of Doing Business Index [17]. Below we summarize our findings in two hypotheses.

**Hypothesis 1.** There is no significant positive relation between the volume of government expenditure and the well-being of a nation.

To empirically test and verify this hypothesis, we used the following indicators:

• Budget expenditure to GDP ratio (as relative government expenditure);
• HDI (as integrated indicator of well-being);

We conducted correlation analysis and calculated the correlation coefficient of 0.344 between budget expenditure to GDP and Human Development Index. The value of the coefficient shows that there is no statistically significant relationship between the two.

Illustration 3. Correlation between budget expenditure/DGP and Human Development Index
Interestingly, the average indicator of relative government expenditure in very high human development countries is much higher (0.41) than in high human development (developing) countries (0.22); correlation coefficient is also higher, but not strongly enough (0.55). These figures fully support the hypothesis.

We believe that higher correlation between budget expenditure/GDP and Human Development Index in developed countries can be explained by the fact that in developed countries the systems of public administration are much more effective and efficient than those in the developing counties.

**Hypothesis 2.** There is a significant positive relation between level a country’s well-being and its level of economic liberties.

To verify the hypothesis, we used the following indicators of 156 countries:

- Ease of Doing Business Index (as an integrated indicator of the level of economic liberties);
- Human Development Index (as an integrated indicator of a nation’s well-being);

The correlation analysis we have conducted has shown that there is a strong positive statistical relation between these two indicators with a correlation coefficient of 0.754 which strongly supports our second hypothesis.

![Illustration 4. Correlation field (Ease of Doing Business Rank and Human Development Index)](image)

Based on these findings, we have concluded that:

1. Increasing relative government expenditure in the Ukraine is very unlikely to improve the economic situation in the country and well-being of its citizens;
2. To improve social and economic situation in the country, liberal reforms should be implemented.
The diagram below shows the Ukraine’s place with respect to these two statistics and compares it to other countries:

![Diagram showing correlation between the ease of doing business rank and the Human Development Index](image)

**Illustration 5. Correlation between the ease of doing business rank and the Human Development Index**

This data shows that Ukraine is located in the region of *rich in oil and gas countries*.

Despite the prospects of economic policy changes connected with the presidential elections of 2010, no serious reforms have been implemented so far. The taxation reform that was launched in 2010 has failed to change economic climate. Moreover, it has had adverse effect on some sectors of the economy.

**III.3. Liberal reforms in Georgia and the feasibility of using this experience**

To illustrate positive effects of liberal reforms in the economy, we would like to present an example of Georgia - a sovereign state in the Caucasus region which was part of the former Soviet Union. After the Rose revolution of 2003, the government changed its economic development strategy has radically reformed many aspects of Georgian economic environment. Among the changes were:

- The adoption of the Law on Issuance of Licenses and Permits introduced in 2005, cut the number of activities subject to licensing from 909 to 159);
- Enactment of New Tax Code (introduced lower, flat tax rates, 2005);
- Introduction of New Labor Code (2006);
- Successful war against corruption.

These changes helped Georgia to become the 12-th country in the world in terms of the ease of doing business and improved the situation with corruption (from 1.8 in 2003 to 3.8 in 2010, 68-th place; Ukraine’s rating is 2.3, 134-th place) [15]. Total liberalization of foreign trade resulted in Georgia’s total international trade turnover growth that was USD 6.7 Billion in 2010 (an increase
of 199% since 2005). Consistent macroeconomic policies are producing strong economic growth, with GDP increases of close to 10% before the crisis, reaching max of 12% in 2007. Despite the slowdown caused by the global financial crisis, Georgia’s real GDP growth rate was 6.4% in 2010. Government, in cooperation with private enterprises, continues to develop infrastructure – roads, railways, sea ports, and airports, while simplifying customs and other administrative procedures including licensing reforms. [www.investinggeorgia.org]

These reforms led to the unprecedented success of Georgian economy which is unique for CIS countries. We believe that this experience can successfully used as a foundation for Ukrainian policy changes as such reforms helped Georgia overcome the same economic problems that are so pressing for the Ukrainian economy and were illustrated in part III.1 of this paper.

IV. Summary and Conclusions

In conclusion, based on our research findings, analysis of the issue and the arguments we presented in this paper, we strongly believe that the Ukrainian model of welfare state which was implemented in the country after the dissolution of the Soviet Union hasn’t been successful and has decreased its economic competitiveness. What is more, the lack of liberal reforms and their slow implementation has made The Ukraine one of the most corrupted and difficult-to-do-business countries in the world. In our statistical analysis, we formulated two hypotheses and showed that increasing government expenditure doesn’t necessarily result in the better standard of living in the country. To improve the situation and make the country more competitive, we believe the government should improve the business environment by reforming many aspects of Ukrainian economic life. We recommend that the government use foreign experience in doing so.

V. Sources


