

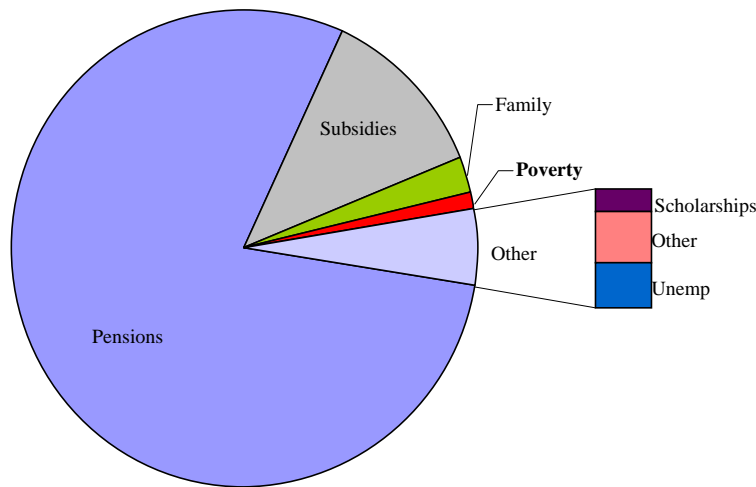
## Chapter IV: Public and Private Social Safety Nets

When facing with economic downturns, households respond by using instruments that enable to offset income losses or provide additional consumption. These mechanisms could be either provided by the government or by private networks. In Ukraine, as well as in other transition economies, there are a number of public safety net transfers that have been in the process of reforms in the last years. In addition, social insurance interventions in the form of a broad and generous pension benefit provide a significant amount of income to the elderly. Finally, households responded to the uncertainty during early transition by diversifying their labor resources through migration and hence increasingly benefiting from remittances. This Chapter assesses the role of each of these mechanisms in the process of poverty reduction during the last years.

### 4.1. Public interventions: social insurance and assistance transfers

**In 2003, the Government of Ukraine spent about 40 percent of public expenditures on social security and welfare affairs, mainly on social insurance items.** About 40 billion UAH were spent on pensions and social protection transfers to individuals, representing almost

**Figure 4.1: Ukraine: Composition of Government transfers for Households, 2003**



Source: World Bank estimates using HBS 2003

impact on poverty. Government interventions can be divided into social insurance and social assistance transfers. Social insurance transfers include pensions, unemployment insurance, health benefits and others. Social assistance interventions are composed by a large number transfers that can be organized into housing subsidies and privileges, family benefits, scholarships, and a poverty targeted transfer. Figure 4.1 provides a households' perspective of the different transfers.

15 percent of the GDP (IMF, 2005).<sup>27</sup> These expenditures are mainly dominated by pension benefits, which account for 21 billion UAH in 2003. This significant fiscal effort reaches a broad range of households. About 76 percent of the population in Ukraine lives in a household which benefits from one or more public transfer. These transfers, however, significantly differ in their benefit levels, eligibility criteria (targeting) and their

<sup>27</sup> This refers to the "Consolidated Budget of Ukraine" that includes budget and non budgetary entities (IMF, 2005) and not only the Central and Local budgets (NBU, 2005).

Overall, pension benefits are the largest transfer followed by subsidies, and family and poverty targeted transfers still playing a very small role in households' economies.

### Pension benefits and poverty

**More than half of the population benefits from pensions because of the large fraction of households with pensioners.** Pensions are targeted to a number of beneficiaries depending on age, disability or survival eligibility criteria, and more than half of the population lives in households with pension beneficiaries, most of them old-age pensioners. The fraction of population that benefits from pensions is similar across income groups and reflects the aging process in Ukraine where almost half of households have an elderly pensioner member. This is clear in rural areas where almost 60 percent of the households have an eligible elderly compared to only 43 percent in urban areas. Despite this, the population coverage of pensions is slightly higher for the non poor (53 percent) than for the poor (49 percent), partly because households with elderly individuals are usually smaller hence limiting their coverage. There is still then a fraction of households without pensioners that did not benefit from the one of the largest and fastest growing transfers in Ukraine.

**Figure 4.2: Incidence of Pension Expenditures**



**The differences in coverage and on pension benefits across income groups result in a regressive incidence.** Pension benefits are similar across beneficiary households, with the poor earning 8 percent lower pensions compared to the better off. These smaller pensions, combined with slightly lower coverage of pensions among the poor result in an unequal distribution of benefits (Figure 4.2). The poorest 20 percent of the population receives only 12 percent of pension benefits, while the richest 20 percent get 27 percent. Compared to 1999 the distribution has changed very little, but the second poorest quintile

has increased its share in the benefits from 14 to 18 percent while the higher income quintile (fifth) reduced its share from 31 to 27 percent.

**Pension benefits are the largest transfer and have rapidly increased in the last years.** Pension incomes are the largest transfers in Ukraine. On average, the pension benefit reported by beneficiary households during 2003 is three times the poverty targeted one, four times the family benefits or 6 times the level of housing subsidies. The level of pensions increased significantly since 2001 due to an active policy of increasing pensions much above the inflation rate: average nominal pensions by 2004 were three times the levels of 1999. This represented almost doubling the real value of pensions between 2000 and 2004.<sup>28</sup> At the household level, these increases

<sup>28</sup> This includes average pensions for all categories (old-age, disability and widows). For old-age pensions alone, with the most pensioners, the increase was 112 percent, compared to 47 percent of disability pensions.

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represented an annual 17 percent increase in average pension incomes between 2000 and 2003, very close to the increase in labor earnings of 19 percent. The increase in real pension incomes was relatively faster for households in rural areas and small towns (about 20 percent per year) compared to those in large cities (12 percent).

**Pension incomes represent about 25 percent of household incomes among the poor, compared to only 17 percent among those in the top quintile.** The relatively smaller pensions among the poor still represent a substantial component of their incomes and consumption. For households in poverty, pensions in 2003 represented more than 25 percent of the per capita household incomes compared to only 16 percent for households in the top quintile. More importantly, these incomes have increased in importance for the poor from 19 percent in 1999.

**Pensions, however, are not designed to reduced poverty, and result in very inefficient allocations.** The cost of reducing one percentage point of poverty by increasing pensions without changes in eligibility or benefits would be very expensive given the little capture of benefits among households in the poorest quintile. Although the rapid increase of pensions has played a role in reducing poverty, its potential impact in the future is limited by the fraction of population living without pensioners and their relatively lower benefit levels. Still, the pension system is one of the networks with broader coverage in Ukraine and this network can be exploited in the design and delivery of other poverty related interventions.

#### **Subsidies for housing and communal services**

**Ukraine has several types of transfers that provide subsidies for housing and utility expenses.** First, there are *housing allowances* that are designed to support families to cover their housing and utility costs. An income-based targeting mechanism was introduced in housing allowances early in 1995 but the implementation of this targeting has not been fully studied. Second, there are some *privileges* that provide in-kind benefits for certain occupational groups or categories of individuals, such as war veterans. These *privileges* are aimed to cover expenses on rent, housing maintenance, transportation, phone lines or even automobiles (World Bank, 2003). These two transfers are different in that one is income targeted while privileges are not. This report uses evidence from household surveys that do not distinguish between different *sources* of funding for housing and utility subsidies and, hence, treats all housing and utility subsidies as a single transfer in the analysis.

**The reduction in the coverage of the subsidies between 1999 and 2002 is associated with increasing costs of such transfers, episodic cuts in budgets, and changes in eligibility.** Several policy changes have affected the coverage of housing subsidies. First, in 2000 subsidies for fuel and natural gas purchases were cashed out so local governments (*oblasts*) pay to households directly. Budget allocations for subsidies are transferred to *oblast* authorities after the fiscal decentralization process started in 2001. Then, while the budget for subsidies had modest increases in real terms the cost of energy has been increasing and hence reducing the number of beneficiaries.<sup>29</sup> Second, housing subsidies started to use an income testing methodology in the

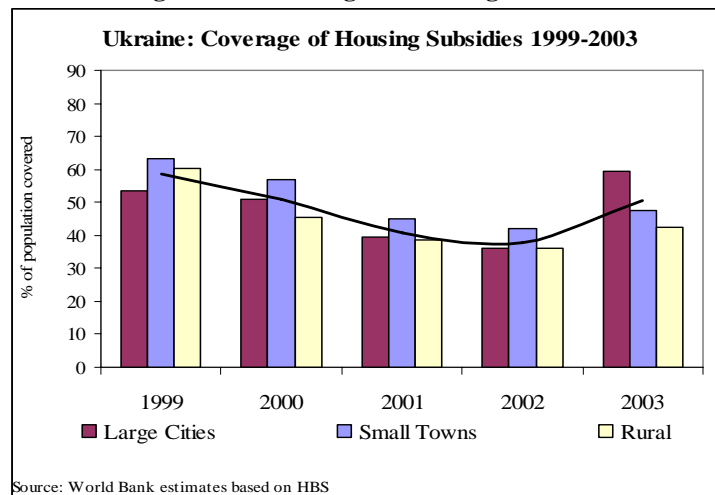
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<sup>29</sup> In fact, these subsidies have led to unfunded mandates for municipal heating and electricity companies that have relied on overcharging business customers (World Bank, 2003). Currently, tariff rates for business customers reflect the cost of production, but households still face lower than the cost rates (IMF, 2005b). Evidence from Kyiv oblast between February and June 2000, when housing maintenance tariffs were increased, shows that while the total subsidies rose by more than 9 percent, the number of recipients decreased (Levytsky and Khvaleba).

late 2001 to reduce the number of beneficiary households that were not facing financial constraints to cover their utility bills. Households that spend on energy more than 20 percent of their total income (including estimated income from self employment and even social transfers) are eligible for a subsidy. Third, privileges have been at the center of the reform of social assistance and suffered major budget cuts in 2000 and 2001. Between February and April 2000 the number of households with privileges was reduced by about 40 thousand or 21 percent in Kyiv alone, and the corresponding beneficiary population by more than 50 percent (Levystky and Khaleba). Thus, the combined effect of these changes explains the decline in coverage despite the increasing nominal expenditures (UCSR, 2004). Privileges then reappeared in the 2002 budget and the overall budget increased by 2003 (World Bank, 2003; IMF, 2005a), as reflected in the coverage increase by 2003.

**The increase in coverage in 2003 was also associated to small improvements for the poor but subsidies and privileges still benefit more the better-off quintiles in large cities.** The rebound in coverage in 2003 despite increasing cost of energy is explained by better overall funding with lower benefits per household. Between 2002 and 2003, the state budget for communal services and energy sources increase by close to 35 percent mainly driven by the increases in heating and electricity services.<sup>30</sup> The increased coverage under the existing eligibility changes improved the coverage of the poor from 27.7 to 41.1 percent compared to 41 to 52.8 percent for the non poor. Still, the gap in coverage between the poor and the non poor (about 11 percentage points) is partly due to the concentration of beneficiaries in large cities where coverage is the highest (60 percent) compared to rural areas (42 percent). About 29 percent of the population mainly relies on solid fuels (coal and wood) and they mostly live in rural areas with the highest poverty incidence (Finkel, 2005). The lack of formal billing for energy expenditures (such as wood) and the difficulties in estimating their corresponding subsidy also affects the coverage and benefit to poor households.<sup>31</sup> This way, the poorest quintile captures less than 8 percent of all subsidies while the top two quintiles capture more than 61 percent of benefits.

**Figure 4.3: Coverage of Housing Subsidies**



<sup>30</sup> The consolidated budget for Housing and Communal Services increased by 30 percent between 2002 and 2003 (Treasury Department of Ukraine, 2005).

<sup>31</sup> The subsidy is equal to the excess billing, which is the difference between actual billing and the cost of a standard consumption estimate of fuel and gas for a specific household. The standard consumption of fuel and gas is defined by the oblast state administration.

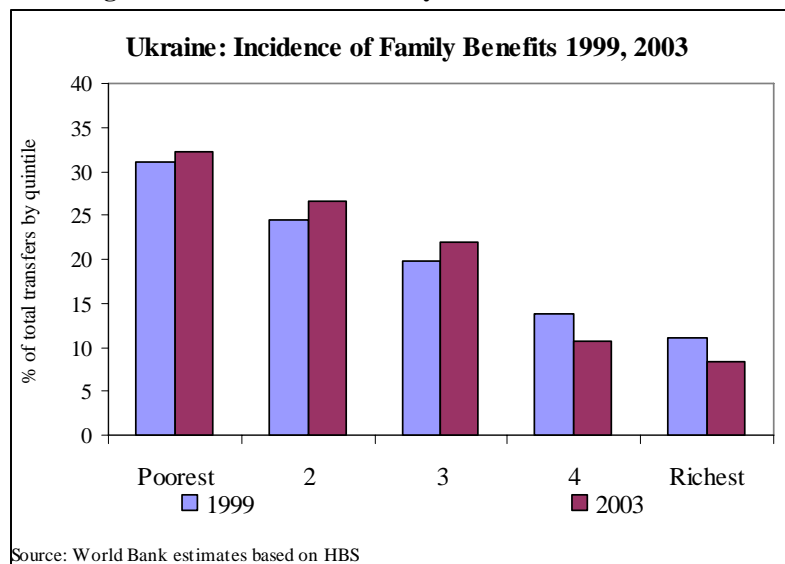
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## Social Assistance transfers

**The system of social assistance has been in the process of transformation in the last years.** Among other social assistance transfers there are family benefits and poverty targeted transfers. As part of the reform process in social assistance, the Government has adopted several measures including the consolidation of different family related benefits, the introduction of a targeting mechanism (or a proxy-means income filter), and new procedures to reduce the process burden on beneficiaries.

**Family benefits have an income filter that has improved their targeting in recent years.** The consolidation of different benefits and the introduction of an income filter resulted in average benefits of more than UAH 50 in 2003. This transfer covered about 12 percent of the population, including more than 21 percent of the poor. About 32 percent of the benefits went to the poor in 2003 not very different from 1999. The introduction of the income filter, however, has improved the incidence of benefits for the rest of the groups: the share of transfers captured by the 40 percent richest population was reduced by 5 percentage points between 1999 and 2003, benefits that were redirected to households in the second and third quintiles.

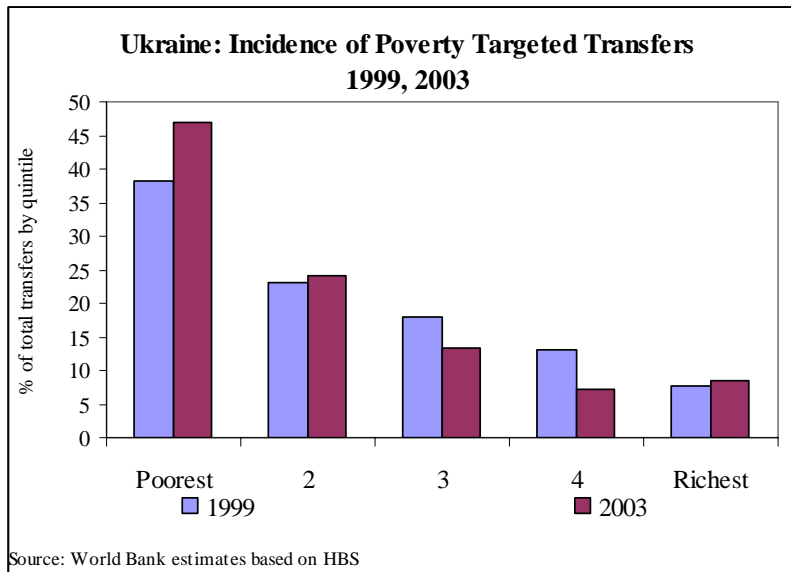
**Figure 4.4: Incidence of Family Benefits in 1999 and 2003**



**The poverty targeted transfer showed major gains in terms of targeting, but requires major coverage expansion.** Compared to the family benefit that covers about 12 percent of the population, the poverty targeted transfer covers a much smaller fraction: only 4 percent. Even within the poor, the poverty transfer reaches less than 10 percent of the poor population. The smaller coverage, however, also facilitates the identification of the poor and the transfer of benefits to them. About half of the resources channeled through the poverty benefit reach the poorest 20 percent of the population and this represents a major improvement over the situation in 1999 when only 38 percent was received by this group (Figure 4.5). Unsurprisingly, this benefit is the best targeted one but the level of benefits is also small: the average benefit during 2003 was around UAH 70 per month compared to more than UAH 200 in pensions. Still, leakages are observed in the transfer since more than 15 percent of the program resources end up in the 40 percent with higher income. The challenge of expanding the coverage among the poor while reducing the inclusion of the non-poor is the biggest challenge that this program faces since expansion of programs usually involve losses on targeting efficiency. A targeting instrument that

is responsive to the rapid changes in the economy and differentiated geographic poverty patterns could be effective in achieving this goal.

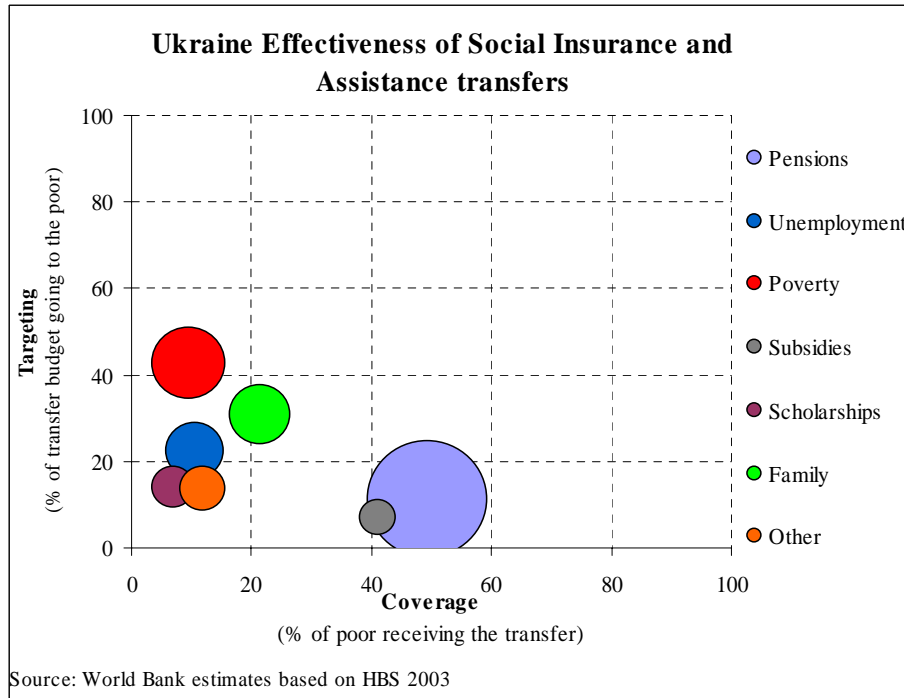
**Figure 4.5: Incidence of Poverty targeted transfers in 1999 and 2003**



**Summary: there are major gaps in terms of coverage and targeting of the poor.** Figure 4.6 shows the coverage and targeting of the poor to provide an overview of the public transfers. The horizontal axis measures coverage, the fraction of the poor that are covered by the specific programs. For instance, half of the poor receive (directly or indirectly) pension benefits. Notice that this coverage captures both direct and indirect recipients since the pension transfer will (indirectly) benefit other household members as well. The vertical axis describes the targeting of the benefit, the fraction of total resources that are going to the hands of the poor (the poorest 19 percent of the population in 2003). The size of each symbol represents the average benefit among the poor. While pensions have the highest coverage among the poor, still half of the poor population is not reached by this or other interventions. This underscores the role of the uncovered by government transfers and the need to identify other mechanisms to reach those populations.<sup>32</sup> Family and poverty benefits, on the other hand, show better allocation of resources for the poor but lack of coverage of the targeted population (the poor).

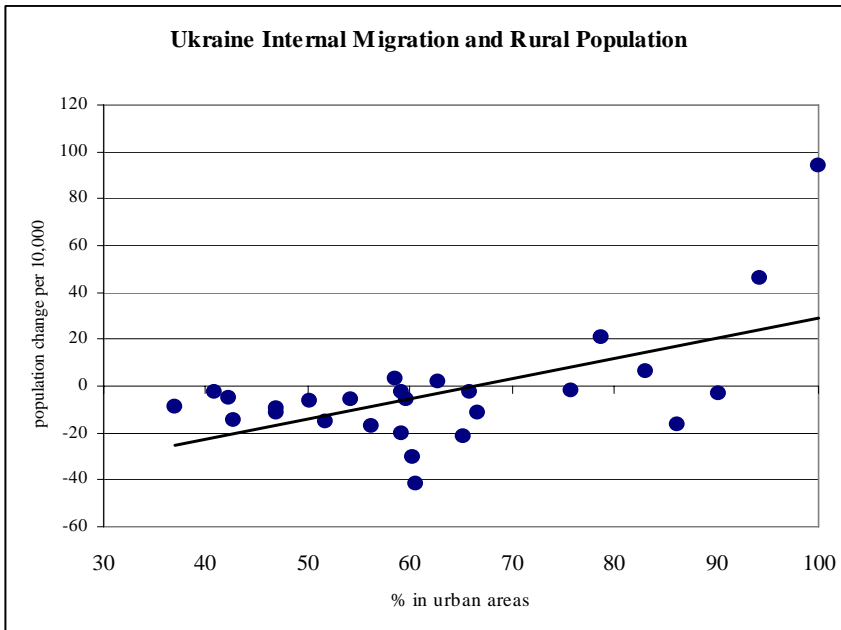
<sup>32</sup> In any case, the pension system needs to be take into account in poverty targeting policies, not because of a particular high risk of poverty among pensioners (that is not the case), but as a delivery mechanism towards the population depending on those pensioners and under certain means test criteria.

**Figure 4.6: Effectiveness of Social transfers**



**2.5. Private safety nets: the increasing role of migration and remittances**

**Figure 4.7: Migration in Ukraine**



**Internal migration is from rural and poor regions to urban and large cities.** The evidence suggests that rural areas, or impoverished urban regions, are sending migrants to urban and large cities. The oblasts of Kharkiv and Dnipropetrovsk, and Kyiv and Sevastopol cities evidence the largest reception of internal migrants capturing more than 80 percent of the internal migrants. These regions are either large cities or

have a large urban population (more than 75 percent living in urban areas). Donetsk and Luhansk that have close to 90 percent of urban population are exceptions since they exhibit large outmigration due to the worsening living conditions due to the closure of mines. In fact, Luhansk is one of the oblasts with the largest reductions in population during 2004, only after Kirovohrad. Oblasts with 40 percent or more living in rural areas are the sending areas: Kirovohrad, Kherson,

and oblasts in western Ukraine (Chernihiv, Ternopil, Vinnytsya, Rivne, Khmelnytskyi and Zhytomyr) represent two thirds of the internal migrants. The internal and external migration patterns suggest a strong correlation between poverty and households' allocation of labor resources. Migration is a household risk management behavior since it provides alternative sources of income.

**Figure 4.8: Transfers from Abroad**



**Remittances are becoming an increasingly important factor in the Ukraine economy.** Remittances are difficult to estimate since two thirds of incomes are not processed through the formal banking system (Malynovska, 2004). Official statistics, however, provide the amount registered as transfers from abroad as part of the Balance of Payments. Average quarterly transfers have increased from less than US\$ 200

million to almost US\$ 600 million by 2003, representing an increase from 3 to almost 5 percent of GDP (NBU, 2005). Remittances are also captured in the HBS, in the form of financial transfers from relatives and friends (family transfers, hereafter). About 60 percent of the population lives in households that received family transfers. This measure, however, includes both transfers from abroad as well as from within Ukraine. Coincidentally, the importance of these transfers has increased from 3 to more than 6 percent of household per capita income during the same period. In fact, these family transfers are increasing very rapidly in real terms, as fast as wages and salaries -- one of the main drivers of the reduction of poverty.

**Despite a poverty related migration, family transfers benefit more the better-off households and those in urban areas.** There is an increasing difference between income quintiles: remittances among the top income groups are about twice that of the poorest in 1999, but by 2003 the difference was three times. The rapid increase of remittances among the better off groups does not necessarily reflect the incidence of migration, since we observed more migration in rural and poorer areas. In fact, while in 1999 households in the poorest quintile were less likely to receive family transfers (43 percent) compared to other groups, by 2003 all income groups were equally likely to receive transfers (about 60 percent). The difference is then associated with differences in labor markets opportunities that determine the level of earnings and remittances. In fact a specific survey on migration indicate that while those in rural areas are more likely to migrate, a large part of migrants is involved in seasonal migration on construction, and some in agriculture and other services (Libanova and Poznyak, 2002).

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**Still, remittances play a role in reducing poverty in Ukraine but they may have reached a limit.** In relative terms, family transfers are very important for the poor: on average, transfers represent more than 6 percent of their consumption levels, compared to 5.4 for the middle income groups. Compared to government interventions, the level of the average family transfer is between the poverty and the family benefit (about UAH 60) but the total sum of family transfers among the poor represent as much as the total incomes from the family benefit, the poverty targeted transfer and the housing and utility subsidies combined. The role of remittances requires that the design of public transfers programs (such as the poverty targeted one) takes into account those transfers to minimize the displacement effects of public on private transfers. Otherwise, additional public transfers may simply reduce the level of family transfers and weaken the desired policy effects (i.e. higher incomes and consumption). More detailed analyses of the interaction between public and private transfers in Ukraine are needed to provide policy guidance.