



United Nations Development Programme

## *Millennium Development Goals Project*



Ministry of Economy of

Ukraine Ukraine

# Ukraine. Poverty Alleviation

## Significance

During the UN Millennium Summit that convened in 2000 world leaders determined the key goals and targets of development till 2015 known today as the Millennium Development Goals (MDGs). Out of 8 Global Millennium Development Goals, **Poverty Reduction** is by far the number one goal and priority for each nation.

Widespread poverty is one of the most acute socio-economic problems for Ukraine. The extent of poverty, its depth, as well as critical income polarization between social groups remain a major cause for concern in Ukraine.

The fact that the problem of poverty persists despite strong economic recovery during the past five years (2001-2005) shows that successful economic policies that generate economic growth do not automatically translate into poverty reduction. Conversely, improvements in living standards achieved through significant increases in social transfers in 2005 do not guarantee sustainable poverty reduction without the underlying economic growth.

Presently, the evolution of social and economic policies in Ukraine is not mutually reinforcing, which emphasizes the need for more effective economic growth strategies from the very perspective of strengthened social policy in general and poverty alleviation in particular. Finally, it has become increasingly important to radically reevaluate the views on the role of government in building market economy and focus on channelling the benefits of economic growth towards poverty reduction and raising population standards of living.

## Background

In contrast to other developing economies, in Ukraine poverty is a relatively novel and unexpected phenomenon, which originated from the re-distribution of resources during the country's historic transformations on the way to a market-based economy. Based on the official data, immediately after the start of the reform process in the early 1990s monetary income of an average Ukrainian family fell by almost 60%— an extraordinary development by international standards. As a result, a massive stratum of the “new poor” was generated comprising individuals who would normally not be at risk of poverty in a stable economic environment (fully employed, professionals, highly skilled workers). The abrupt termination of social insurance, which had guaranteed a moderate level of economic and social security for decades, created among that latter group a widespread sense of “abandonment” by the state. As a survival strategy, most of “the new poor” had to turn to the shadow economy or to non-monetised self-production, thus producing widening cleavages in society, while encouraging corruption and crime.

Failure to embed a balanced socio-economic model of Ukraine's transition to market economy into the reform process in Ukraine led to the social sphere development lagging behind the economic changes. The very term “poverty” required time to be fully entrenched into the local political vocabulary, reflecting painful reevaluation of the material status of Ukrainian population, most of which used to boast predominantly medium incomes in the past. In the meantime, Ukraine was rapidly evolving to become a nation with a considerable proportion of people living in poverty, a tendency only likely to increase in the absence of specifically targeted and comprehensively developed policies to combat poverty.

Until 1999 poverty as national problem was not recognized in Ukraine. Needless to say that there was no commonly accepted definition of poverty, single methodology or strategy for poverty reduction. In 1999, after a careful selection and analysis of international experience in poverty monitoring, a relative poverty measure – 75 % of median expenditures per equivalent adult – was chosen to be an official poverty line definition in Ukraine. In Presidential Decree issued on August 15, 2001 the Ukrainian Government explicitly recognized the problem of poverty as the inability of the household to provide for its basic needs and instated relative poverty line definition as the basis of the first State Poverty Reduction Strategy. The methodology for measuring poverty comparable to the international standards was established and poverty monitoring finally began in Ukraine.

## Extent and peculiarities

Despite the certain progress in poverty reduction in Ukraine, which is evident from the increased real wages, pensions, social payments, as well as lower unemployment, recent data have confirmed Ukraine's position among the countries with a high poverty level. The official data of the Ministry of Economy of Ukraine indicates that in 2005 27.1% of Ukrainian population were below the poverty line (using the official definition of poverty line as 75% of median daily expenditures per adult).

Over the past years the main characteristic of "Ukrainian poverty" has been the problem of poverty among the employed population. As was shown by the population distribution between the main social groups in 2005 household survey, in the lowest consumption population group 37.5% were working adults, while 14.0% are non-working retired citizens, 31.9% are children under 18 years old, 2.1% are students, and 14.5% -- others. Such problem is not surprising considering the fact that over half of the working population 50,8% have total income per capita below the subsistence minimum amount. **Given the full impact of the low income level problem, it is one of the main poverty causes in Ukraine for both employed and unemployed.**

At least three distinct obstacles on the way of poverty reduction exist in Ukraine: limited goods and services market (low demand), widespread monopoly and corruption. These problems are interrelated and interdependent:

The first obstacle—limited goods and services market, drives down employment and lowers labor cost. Under the condition of limited demand, the investments are made only into modernization of manufacturing process, with the goal of raising the level of business competitiveness and economic effectiveness. At the same time, the number of jobs is shrinking and the cost of labor (wages) are decreasing accordingly. Only stimulation of domestic demand and development of domestic markets are capable of providing a significant influx of funds into the country, attract investments for expansion of production, which in turn would stimulate job creation.

The second obstacle- monopoly, eliminates fair competition for skilled labour among the employers, limits workers' employment choices, and creates conditions for artificially driving down the wages. Present concentration of the economic growth benefits in the hands of a few interest groups is especially detrimental to balanced socio-economic development, as the dominating financial and industrial groups and big businesses have vested interest in preserving the existing state of affairs, in which they occupy privileged positions on domestic market.

In turn, monopoly relies heavily on corruption—a tool used by monopolists for retaining their competitive advantages and eliminating small businesses. In addition, corruption drives budget funds away from their proper use for implementation of social programs.

Artificial depression of labour cost is the legacy of the old command economic system with its low wage and high consumption levels, which were distributed through the so-called social funds via state subsidies. Transition to market economic system destroyed the subsidy system, while the effort to stay competitive on world markets created the need to retain low labour costs. Economy that is based on low labour cost lacks the capacity to provide high consumption standards and quality labour force renewal, provoking most economically innovative citizens to seek employment opportunities abroad or increasingly rely on various types of social support. However, without high wages, high social transfers can not be sustained.

Another factor in lowered real wages is the macroeconomic instability and inflation, as its most acute manifestation. For the second consecutive year Ukraine is suffering from severe inflationary pressures. The official Consumer Price Index over the past two years is close to 124%. Suppressing inflation is a very difficult task, especially since only part of its causes lay on the surface. However, it is important to continue identifying and eradicating deep causes of macroeconomic instability, as inflationary expectations give rise to inflationary mentality: in the process of price formation entrepreneurs begin to incorporate expected resource cost increase ahead of time. Unfortunately, it should be noted that over the last year the government failed to demonstrate consistency and pragmatism in its economic policy. The most serious consequence of the government's nearsighted policy were the shrinking of business activity levels and unfolding of new conflicts between the government and business owners, which combined led to practically freezing of foreign direct investments inflow and provoked the reluctance of potential investors to work in Ukraine. Under such conditions, few sources of renewed economic growth are left to back up improving forecasts.

## **Current Trends and Problems**

1. **Extreme Poverty** Government activities in 2005 aimed at poverty reduction were concentrated on ensuring that state minimum wage and level of social support for vulnerable groups of society continue to increase, approaching the subsistence minimum level. It is significant that in 2005, a decrease in the level of extreme poverty and poverty depth in Ukraine was observed by 0.2% - from 27.3% to 27.1% and from 24.0% to 23.8% respectively. Share of the population with average per capita consumption below subsistence minimum fell to 55.3% (65.6% in 2004).

2. **Population Income - Trend** Driven by the substantial minimum wage increases in 2005, which by the year-end grew by 27%, as well as the completion of the first stage of planned transition to the “Single Tariff Compensation System,” for state employees, the national average wage of a full-time employee increased by 36.7% and amounted to UAH 806.28. The ratio of the average wage to the current subsistence minimum amount reached 190%, as compared to 152% in 2004, and 80% in 2000. The real wage growth rate in 2005, against prior year was 20.3%, significantly exceeding both GDP growth rate of 2.4% and inflation rate of 10.3%. Real population income in 2005 went up by 20.1%, while population savings grew by 33 billion Hrivnyas.
3. **Income Gap** The gap between the rich and poor is widening. A distinctly uneven income distribution is continuing to form in Ukraine, with majority of the population concentrated in the low-income category. The gross consumption ratio of the top 10% to the bottom 10% of population income groups over the 2004 - 2005 period was 6.9 times. The substantial increases in population income in 2005 driven by minimum wage and various social payments increases did raise the average monthly expenditures per capita, but unfortunately did not help to reduce the income gap.
4. **Population Income Structure-Trend** In an effort to accelerate poverty reduction, in 2005 the government implemented significant increases (compared to increases in wages) of social payments. As the result of social support increases, by the end of the year the ratio of the wage-income component (40.5%) and income from social payments component (42%) in the structure of total population income fell to .96. In 2004, the share of wages exceeded that of social transfers by 10%, which points to a disturbing 2005 trend of lowering economic activity of the population and increased reliance on social payments for income. At the same time, positive dynamics were observed in formation structure of household income: in 2005, monetary income as a component in total household resources increased to 86.4% (85.1% in 2004). In urban households the change was 0.9 % (to 89.6%) while in rural—2.7% (to 78.9%).
5. **Income Comparison with Other Countries** Despite the relative increases in population income indicators over the past few years, the overall income level in Ukraine is significantly lower than that of the closest European neighbors: according to the European Employers Federation, as of January 7, 2005 the minimum wage in Poland was 463 USD, in Czech Republic - 490, Turkey - 576, Slovenia – 1001, against 265 USD in Ukraine (based on the purchasing power parity of national currencies). Another sign of low income level in Ukraine is the fact that over the past

years, the wage component of GDP has remained below 45%, while in most developed countries it accounts for nearly 60% of GDP.

6. **Regional Income Disparity** In line with patterns characteristic of least developed economies, pronounced differences in wage levels persist across the regions of Ukraine. In 2005, significant gaps between wage levels in different geographical regions of Ukraine remained very pronounced. For instance, average wage level in Donetsk oblast (962 UAH) differed from that of Ternopil oblast (553 UAH) by 1.74 times. The highest paying location remained Kyiv, averaging 1313.96 Hrivnyas per month. The wage gap is the largest between the capital and provinces, especially those in the predominantly agrarian west of the country. Overall, Ukrainians living in large cities, particularly in the capital, are less likely to become poor than those living in the country.
7. **Sectoral Income Disparity** There remains a significant differentiation in population income and consumption levels between different industries. Especially dangerous is the fact that many professional groups (doctors, engineers, teachers, scientific professionals, social workers) fall into the poorest categories. Among the social sphere workers, more than a third received wages below the minimum wage, while the wages of overwhelming majority (estimated 80-90%) were below the subsistence minimum. Shift of the specialists from social, education, healthcare, scientific, and cultural fields into the low income group is fraught with serious consequences such as provoking the shrinking of society's development potential. But the most critical situation remains in agricultural sector, where according to the calculations of the Ministry of Economy, the wage level is the lowest, while the productivity is the highest among all types of economic activity. In 2005 the average wage in agricultural sector was 414.97 UAH, reaching only 51% of the national average, and close to 70.8% of agricultural households had average per capita consumption below the subsistence minimum. Increase in wage level in rural areas in many cases is hindered by employer monopoly: usually only a small number of employers (and often only one) are present in any given rural area, which deprives the workers in the area of employment choices and allows the employers to set wages at the minimum acceptable level. However, it should also be noted that in agricultural sector, as opposed to other types of economic activity, significant share of labour compensation is delivered in-kind, creating a gap between accrued wage and actual labour compensation amounts and increasing the error range in income level calculations for rural areas.
8. **Arrears of Wages** Although by the end of 2005 the total arrears of wages went down by 13.6% compared to the beginning of the year, the issue still remains very problematic in Ukraine. At 10.7%, the ratio of total arrears of wages to the total national wage fund by the end of 2005 was

still unacceptably high. 38.5% of the total sum of the arrears drops to enterprises which are in the process of their financial solvency restitution or bankruptcy, 13.4% - to enterprises which suspended their production and economic activities in 2005 and the previous years. As compared to 2005 the number of permanent employees of economically active enterprises who weren't paid on time went down by 321.2 thousand (46.4%) and comprised 370.9 thousand people (3.4% of the total number of permanent employees).

9. In an effort to better address arrears of wages issue, in 2005 the government ratified convention #173 of the International Labour Organization, which provides for employee rights protection in case of employer's insolvency, and made a corresponding addition to the Ukrainian legislature (Statute #2597, as of 31.05.05).
10. **Unemployment - Trend** The weight of unemployment, as the driver of poverty in Ukraine, has decreased over recent years. The unemployment indicator has been exhibiting a consistent downtrend, falling from 12% of economically active population in 1999 to 8.6% in 2004 and 7% in 2005 (calculated using International Labour Organization methodology). This shows that multiple government measures taken in 2005 in an effort to create work places and stimulate entrepreneurial activity were indeed effective. At the same time, a number of problems remain in employment sphere—significant shadow employment, low skill level of work force, qualitative disparity between demanded and supply of work force, low motivation for work.
11. **Unemployment Aspects** The official unemployment figure fails to completely account for hidden unemployment, which is manifested in the forms of “involuntary” part-time employment and so-called forced “administrative vacations”. Close to 3 million people, or more than a third of rural residents of working age, are technically unemployed, as majority of the population working on their own small farms do not consider themselves employed. Large numbers of rural residents of most active working age are forced to move away from their places of residence in search of employment, including moving abroad (by some estimates 1.0-1.05 million people). Although the minimum amount of unemployment compensation was increased from 108 UAH in 2004 to 150 UAH by the end of 2005, the compensation amount (about 30 USD) remains rather symbolic. Thus, the number of officially registered unemployed citizens is likely unreliable—instead of registering with state unemployment agency many de-facto unemployed choose to leave the official labour market and move into the shadow economy, including illegal work abroad, or remain passively unemployed, afraid of losing even low paying jobs because of poor prospects.

## **Poverty: Social Groups and Social Support**

**Families with children** Although the risk of poverty depending on the number of children in the family is true for most countries in the world, even those with relatively high levels of income, this risk is particularly high in Ukraine. If, among single-child families remained in 2005 58% had average per-capita consumption below the set subsistence minimum, the figure was significantly higher for the households with 2, 3, and 4 children – 75.8%, 93.2% and 100% accordingly. At the same time, only 47.1% of childless households are below the subsistence minimum level.

The poorest among Ukraine's all population groups are families with children below the age of consent. First of all this applies to families with children aged under three and families with over three children. Only one parent in these families tends to have full employment, who is on average still unable to secure proper support for the whole family. Only those Ukrainian families in which one child is supported by two employed parents can be considered relatively protected from the most extreme forms of poverty.

In 2005 the Ukrainian government directed an additional 1,686 mln. Hrivnyas for social aid payments to families with children, which is 2.6 times more than what was spent in 2004. Compared to 2004, the number of qualified families receiving the aid payments increased by 11%. In addition, government support to the families with a newborn child increased by 11.3 times (from 764 to 8498 Hrivnyas) and support to families with children under care or guardianship grew from 90 to 263-468 Hrivnyas per month, depending on the child's age. A new type of social protection was instated for single-parent families, who do not receive support (alimony) from the second parent. These measures are expected to have stabilizing effect on the situation with poverty among families with children in Ukraine and hopefully began to reverse the negative poverty trend in this population group.

**Unemployed** Unemployment is one of the major drivers of poverty risk. In families with unemployed adults, living standards usually fall for the entire family— in 2004 in the households where everyone was employed, the poverty level was 14.7%, while in the households with one or more unemployed –30.7%. Although the minimum unemployment compensation amount was raised by 39% during 2005 to reach 150 UAH, at only 35% of the subsistence minimum level it remains unacceptably low. To ensure sustainable positive trend for reducing poverty among this social group, future government efforts should be focused on labour market development (new job creation) and improvement of labour competitiveness level by providing life-long learning and professional development opportunities for labour force.

**Retirees** Over recent years, poverty among retired elderly population emerged as a result of several factors: low wages, high unemployment and

shadow economy levels, high demographic pressure, which all led to the low coefficient of wage replacement by pension. In 2005 much was done by the government to raise the standard of living of retired population—the minimum pension level was raised to match the subsistence minimum level for disabled adults (332 UAH). For comparison purpose, in 2004 the minimum pension amount was only 92.47 UAH or 34.5% of the subsistence minimum. Further reform of the state pension system is needed to improve financial stability and resource management of the pension fund, thus allowing to continue raising pension payments, as well as enhance the faith of the population in the state pension system.

**Working Population** Poverty among people, which are disabled or possess a skill-set for which there is no demand on the labor market, is both intuitive and understood. Such population groups are usually unable to independently provide for an adequate standard of living for themselves, and must rely on the state for necessary support. However, in Ukraine, people that are often susceptible to poverty risk are not only educated and skilled, but are also employed on full-time basis. The 2005 increases of the minimum wage to 73.3% of the subsistence minimum level (57.8% in 2004) should result in a positive change in poverty among this population group. However, the fact that by September of 2005 14.5% of fully employed workers received wages not exceeding the minimum wage and 58 % of the population had gross income below the subsistence minimum level, underlines the need for further increases in minimum wage in order for it to reach the subsistence minimum level.

**Social Support.** During 2005 the government significantly raised social aid for many vulnerable groups: newborn children and children under the age of three, children in low-income families, unemployed, retired, disabled, victims of work-place accidents, etc. It should be noted that out of all types of social transfers (privileges, subsidies, and social aid) only the system of social aid is actually aimed at poor population groups and helps to reduce income inequality. At the same time, the existing system of privileges not only does not reduce population income inequality, but on the contrary further increases the gap. Many arguments exist against the existing complicated, financially unjustified and unfair system of privileges, where majority of privileges are used by well provided for, more educated and better informed about their rights population groups. The share of population utilizing privileges among non-poor is 30%, while among the poor-- only 23%.

The procedures for granting privileges are regulated by more than 40 regulatory-legislative acts, which provide for over 20 different types of privileges that can be granted based on 30 different criteria of eligibility. The total number of privileges granted in Ukraine today exceeds the total population of the country. Overall, only 43% of population is using their rights to at least one privilege, which means that most privileges that are provided

exist only on paper. For example, the privilege to free use of inter-city public transport is granted to 13% of population, while in reality, only 2.5% of population take advantage of this right. In addition, such overly complicated system of social support leaves a lot of room for misuse of state funds and privileges by non-qualified individuals. Thus, in order to raise the effectiveness of state social payments, the social support system needs to be restructured and oriented towards specifically targeted social aid.

## **Prospects**

Poverty reduction policy in Ukraine needs to be conducted in the direction of creating economic and legal conditions for reducing poverty—above all, among the working population. Poverty reduction policy must secure a shift away from economy based on reliance on cheap labor by creating economic and regulatory conditions for growth in economic activity and income levels of the population. This will enable the population to take control over their own welfare. Middle class forms not as a result of forced redistribution of resources, but as a result of growing numbers of those, who provide for themselves. There should be a move from fighting poverty caused by income inequality to solving poverty issues caused by lack of opportunities. Geographical location, low social status or lack of funds should not stand in the way of receiving basic medical care, adequate education, competitive professional training, and a job with decent working conditions and compensation level.

Important directions of poverty reduction policy should be decreasing income differentiation between population groups through implementing flexible (progressive) taxation system, better rationalizing and directing social transfers, integrating shadow economic activity and income—all of which should have positive impact on middle class formation, which in turn will insure stability in population's economic status.

### **A few specific measures should be taken:**

- Ensure further increase of minimum state insurance to reach Subsistence Minimum level;
- Refine legislature on the norms and criteria for determining minimum wage level and secure legislature needed for implementing an hourly minimum wage as the state social standard;
- Increase the wages of public-sector employees and eliminate cross-sectoral wage disproportions between employees of different grade-

levels and industries by implementing the second step of the Single Tariff Net;

- Reduce the pressure on wage fund by redistributing collections and payments among employers and employees and expanding the tax base;
- Ensure adequate protection of employee rights to receive timely and full wage payments, as well as full repayment of any accumulated wage debts