# Child-Related Social Security Spending in Ukraine: Overview of Related Programmes and Reform Priorities

- **Social Insurance**
- **Social Assistance**
- **Social Services**
- **Health Care**

This report is a deliverable within a consultancy contract with UNICEF Ukraine. It is part of on-going technical support which FISCO id (www.fisco-id.com) is providing to UNICEF in the area of public finance during 2010, to facilitate more effective redistribution of resources to enhance children's wellbeing and protect their rights. The views expressed are those of the authors and do not necessarily reflect the policies or views of the UNICEF.

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## Acronyms and Abbreviations

| | |
|---|---|
| CIS | Commonwealth of Independent States |
| DFID | UK Department for International Development |
| EC | European Commission |
| ECA | Europe and Central Asia |
| ECSR | European Committee of Social rights |
| EU | European Union |
| GDP | Gross Domestic Product |
| GIS | General Income Support |
| IDSS | Institute of Demography and Social Science |
| ILO | International Labour Organization |
| IMF | International Monetary Fund |
| MFYS | Ministry for Youth and Sport |
| MoES | Ministry of Education and Science |
| MoH | Ministry of Health |
| MoLSP | Ministry of Labour and Social Policy |
| OECD | Organisation for Economic Co-operation and Development |
| OOP | Out-of-pocket Payments |
| PAYG | Pay As You Go |
| PFM | Public Financial Management |
| PFR | Public Finance Review |
| PIT | Personal Income Tax |
| SSC | State Statistics Committee |
| UAH | Ukrainian Hryvna |
| UN | United Nations |
| UNICEF | United Nations Children's Fund |
| UNPFA | United Nations Population Fund Activities |
| USSR | Union of Soviet Socialist Republics |
| VAT | Value Added Tax |
| WB | World Bank |
| WHO | World Health Organization |

## Scope and purpose of this paper

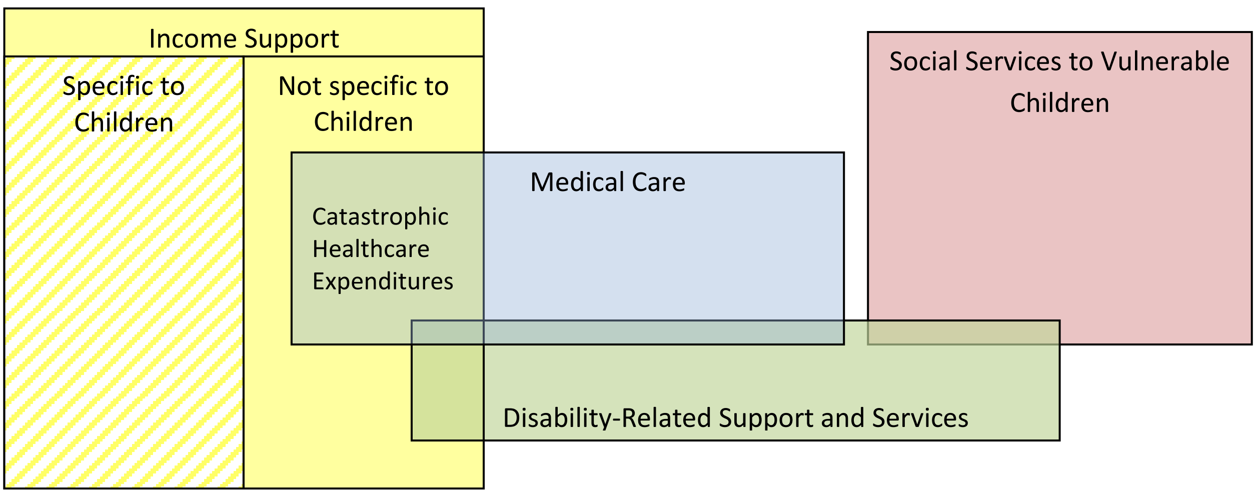
This overview is a background paper commissioned by UNICEF Ukraine to facilitate its support to more effective redistribution of resources to enhance children's wellbeing and protect their rights. The ToRs for the paper requested it to analyse financial flows related to cash benefits, privileges and services for vulnerable categories of children (particularly those deprived of parental care), including recommendations on feasible priority steps for improvements of PFM approaches in this area, as well as systems for healthcare financing in Ukraine. In other words, this request essentially implied a brief public expenditure review in the area of child related social security, defined rather broadly as a fusion of measures to address multiple risks that adversely affect the well-being of children in Ukraine.

Given the broad and multi-faceted nature of child-related social security programmes, we have crystallised a working definition of this area for the purposes of this paper, in order to meaningfully choose which social benefits, privileges and spending programmes on public services should be covered by the analysis. In particular, in this paper, we understand child-related social security as a system of measures providing direct or indirect protection to children against socially recognised conditions which expose children to risks outlined in the UN Convention on Children's Rights(Office of the United Nations High Commissioner for Human Rights 1989). In particular, the key risks covered by this definition include poverty, disability, disease, absence of parental care, violence, abuse and exploitation.

To ensure that this paper is relevant for effective policy-interventions by UNICEF, in this analysis we define child rights measures as those focusing on broader interaction between children, the state, and the society. This means that to understand social security measures affecting the child, the analysis should take on board not only direct support programmes focusing specifically on children, but also broader linkages which affect the income of households with children and related risks to the child's wellbeing and development.

**FIGURE 1** illustrates the key components of the social security system covered by this analysis. It includes income support measures (both child-specific and non-child-specific measures which still affect incomes of families which children) and a range of public services including healthcare, disability-related services and a range of social services for vulnerable children, including child care. Importantly in the Ukrainian context, we would like to focus on the impact of Health Care financing on household income in terms of catastrophic medical expenditures, including out-of-pocket payments.

FIGURE 1. KEY ELEMENTS OF CHILD-RELATED SOCIAL SECURITY SYSTEM



Organisation of social security funding varies considerably across countries and, in particular, debates are on-going on what are the best ways to organise, finance and administer social security in the developing and transition countries in order to effectively reduce poverty and minimise coverage gaps(McKinnon 2003). Two basic aspects of any such system include:

a) the way in which it is funded (in particular, by what mix of contributory and non-contributory schemes), and

b) how effectively collected funds are allocated to ensure minimum errors of exclusion and inclusion, as well as best value for the money spent in terms of outcomes for the population (including in terms of organisation of service provision).

Needless to say, approaches and nuances in both financing and provision vary for the individual systems such as social protection, healthcare or social services for vulnerable groups.

## Sources and Systems of Funding

### Contributory versus Non-Contributory Schemes

**Ukraine's overall system of funding of social security affecting children is presented in FIGURE 2**. The core pillar of the system is non-contributory funding from the government's consolidated budget. This funding is "non-contributory" in a sense that the amount of benefits from these schemes to which a recipient is eligible does not depend on the amount of contribution he or she has made to the resource pool. A smaller amount of resources is raised and allocated through contributory social insurance schemes represented by four off-budget funds. On top of this, some resources are provided by charities, private sector corporate responsibility measures and international donors.

**The balance between contributory and non-contributory funding represents a choice within a trade-off between individual and collective responsibility for the cost of social insurance, and is therefore reflective of the underlying societal philosophy.** The non-contributory funding scheme for social security provision is intrinsic to both post-soviet public financial management system and the underlying societal attitudes to social security as such. Social insurance in the soviet planned economy was regarded as primarily the state's function, rather than individual responsibility. While social insurance existed as a theoretical concept, in reality it was a regular social protection programme funded from the general budget. Social insurance was part of the state budget of the USSR, managed by the trade-unions who essentially performed a quasi-fiscal function(Ukrainian Centre for Social Reforms 2009).

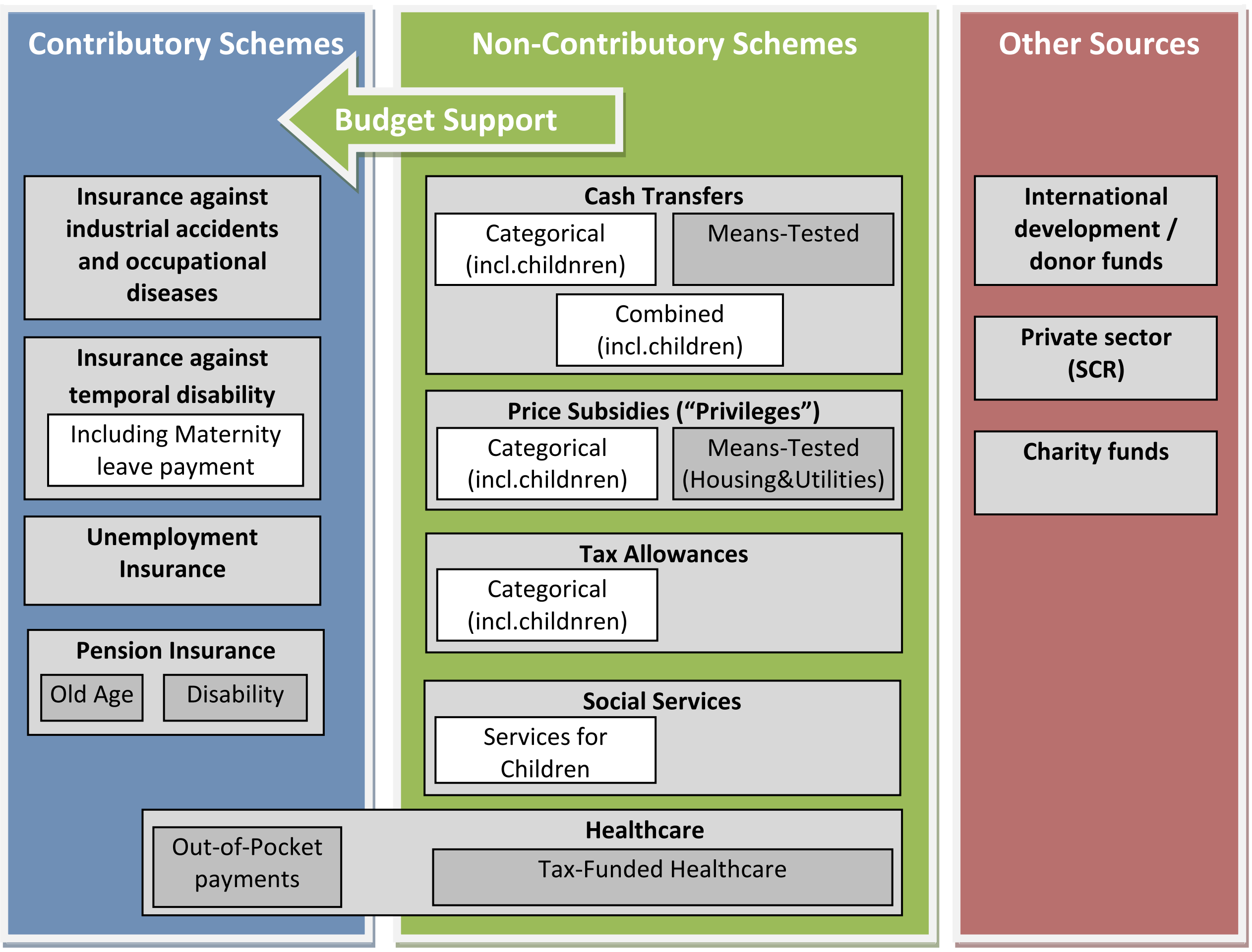
**Some features of the system of attitudes to social security heavily tilted towards collective responsibility are especially notable:**

- **The quasi-fiscal nature of the system.** It is notable that the soviet tradition of "non-contributory insurance" was quasi-fiscal in nature. Although enterprises did make payroll contributions to this fund, it was generously sponsored by the general budget revenues but allocated in an off-budget, less transparent way. "Quasi-fiscal activities" are generally defined as any activities undertaken under the direction of the government by financial or nonfinancial institutions outside general government that are fiscal in character – that is, in principle, they can be duplicated by specific fiscal measures such as taxes, subsidies or other direct expenditures(IMF; Fiscal Affairs Dept 2001). In this case, disguised funding from the general budget provided to cover any emerging deficits essentially represents a social protection programme but such which is funded by an arms-length organisation.
- **Weak role of individual responsibility reflected in both non-contributory financing and non-monetised benefits.** Another notable feature of the same philosophy was a large range of free-of-charge services, privileges and in-kind benefits (housing, baby-goods etc). As we will discuss in more detail in the sections on current reform plans to monetise some of the Ukraine's existing social

privileges, the philosophy of free and in-kind social benefits – which are not related to monetary contributions and are not monetised, making it impossible for the individual to either contribute to, or make a choice in utilisation of the benefit - is considered by many observers as a fundamental element of the soviet view on justice and fairness (defined by some as "Russian sociality"(Kara-Murza 2005)).

- **Relatively weak role of tax sources in non-contributory budget funding.** Although non-contributory funding in the soviet social security system was heavily subsidised by the general budget, it was not, in a pure sense, a "tax-funded" system. Taxation in the Soviet public finance did not play its usual role of ensuring accountability of the budget spending (rather, the central task of the fiscal policy in a planned state-owned economy was to absorb excess consumer (household) purchasing power generated by the very high rate of non-consumption expenditures normally provided by the state(Holzman 1953). At the same time, the state was heavily dependent on its oil-related revenues which made it less dependent on fiscal revenues(Zainulabideen 2009, Sunley 2002). This aspect of funding will be discussed later as a continuing problem for post-soviet countries, whose public finance system do not fully utilise the political benefits of taxation and rely increasingly on non-tax sources of funding which promote a non-contributory attitude to social security(Zainulabideen 2009, Moore 2004, Tabata 2001).

Figure 2. Social Security Funding Schemes in Ukraine




**Ukraine's contributory financing of social insurance is organised through an opaque quasi-fiscal structure of four off-budget funds.** Contributory financing of social security in Ukraine is represented by four off-budget social insurance funds, listed in **Figure 2** and described in more detail below. The funds represent four separate programmes funded by payroll taxes (compulsory social insurance contributions). All four agencies administering the funds are highly opaque structures, which makes it difficult to compare the share of contributory insurance in total volumes. It includes:

- Industrial accident insurance
- Temporary disability insurance;
- Unemployment Insurance; and
- Pension Insurance.

**The Pension Fund is strongly supported by transfers from the State Budget.** One particular barrier to transparency and accountability of the pension system, as well as overall social insurance system, is the fact that current deficits of all four funds are covered by transfers from the general budget. Therefore, the system remains quasi-fiscal and highly opaque. The situation is further obscured by the fact that the Pension Fund receives transfers not only from the State budget but also from two other funds: Unemployment and Occupational Incidence Fund, even though these transfers are relatively insignificant. Budget support transfers for the Pension Fund are described in **TABLE 1**: it shows that in 2008-2010 general government was responsible for around 30% of the Fund's budget (33.7% in the 2010 Plan).

TABLE 1. PENSION FUND SYSTEM BUDGETS OVER 2004-2010 (UAH THOUSAND)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|
| **Total Revenues** | **36,182,866** | **49,157,453** | **62,912,811** | **95,592,919** | **147,761,439** | **151,089,053** | **165,686,327** |
| Payroll tax revenues + carry overs | 30,010,919 | 42,214,813 | 52,841,396 | 70,440,357 | 106,166,993 | 114,913,338 | 127,043,212 |
| Transfers from State Budget | 5,884,305 | 6,663,992 | 9,737,683 | 24,884,478 | 41,423,745 | 35,822,793 | 38,175,149 |
| Transfers from Unemployment Fund | 97,642 | 142,000 | 215,000 | 167,500 | 75,587 | 30,708 | 46,320 |
| Transfers from Occupational Injuries Fund | 190,000 | 136,648 | 118,732 | 100,584 | 95,115 | 322,214 | 421,645 |
| **Total Expenditures** | **36,182,866** | **65,502,143** | **70,202,306** | **95,592,919** | **147,761,439** | **164,142,093** | **192,282,030** |
| **Deficit (covered from the State Budget)** | **0** | **-16,344,690** | **-7,289,495** | **0** | **0** | **-13,053,040** | **-26,595,704** |
| Total amount transfered from the State Budget | 5,884,305 | 23,008,682 | 17,027,178 | 24,884,478 | 41,423,745 | 48,875,833 | 64,770,853 |
| **State Budget support as % of PF Total Expenditures** | **16.3%** | **35.1%** | **24.3%** | **26.0%** | **28.0%** | **29.8%** | **33.7%** |

Source: Pension Fund

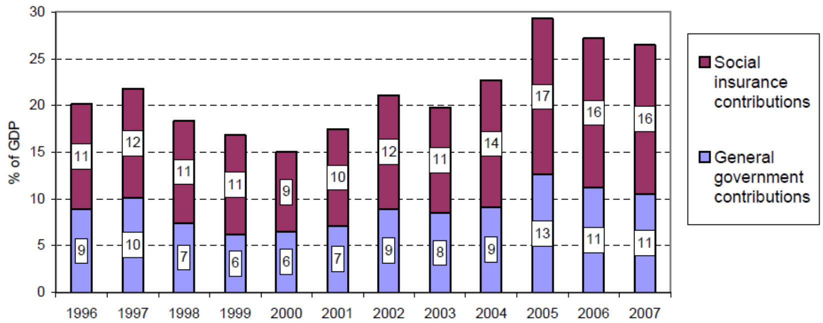
**It is difficult to assess comparative roles of contributory and non-contributory financing in the overall social protection spending over a significant amount of years.**

- At the moment, state support is most significant for the Pension Fund (33.7%) and Occupational Injuries Fund (14%), but is less palpable as a share of Temporary Disability Fund (6%). Ukraine's Unemployment Insurance Fund, based on its latest publicly available budget (for 2009) did not assume any budget support. (**TABLE 2**)
- Estimating trends in the comparative significance of contributions in the budgets of the funds versus state support (that is, non-contributory revenue source) is difficult because it requires access to Fund's budgets or execution data over respective years. On the one hand, there are some indications that the role of contributory financing has been growing. In particular, one existing source of public information which sheds some light on the size of contributory social insurance schemes is provided in the report prepared by the Ukrainian Centre for Social Reforms, a think-tank affiliated with the Institute of Demography and Social Research under the Ukraine's National Academy of Science, for the EC Directorate-General for Employment, Social Affairs and Equal Opportunities (Ukrainian Centre for Social Reforms 2009). The report presents data which shows that the role of contributory funding has gradually increased in Ukraine since independence (see **FIGURE 3**, copied from this report).
- However, it is somewhat difficult to interpret these data without clear identification of how the totals were calculated (what types of contributions they represent), and data for more recent periods are not available. In another section of the same report, the ECSR points that in 2007 expenditures of all four social insurance funds was equal to 15.7% of GDP, which indicates that data in **FIGURE 3** most likely represent expenditures of the insurance funds, rather than sources of their revenues. Since all of these funds – and especially the Pension fund (the largest) – are subsidised by the general government, it means that a significant portion of the "social insurance contributions" in this Figure are actually general budget funds.

TABLE 2. CONTRIBUTORY AND NON-CONTRIBUTORY FUNDING OF UKRAINE'S SOCIAL INSURANCE FUNDS

| | | Contributions | State Budget Funds | Overal Expenditures | Contributions as % of Total Expenditures | State Budget Support as % of Total Expenditures |
|---|---|---|---|---|---|---|
| 2009 budget | Unemployment Fund | 6,613,432 | 2,128 | 6,979,381 | 95% | 0% |
| 2010 budget | Temporary Disability Fund | 7,027,800 | 494,558 | 7,849,629 | 90% | 6% |
| 2010 budget | Occupational Injuries Fund | 3,890,639 | 602,769 | 4,383,775 | 89% | 14% |
| 2010 budget | Pension Fund | 127,043,212 | 64,770,853 | 192,282,030 | 66% | 34% |

FIGURE 3. ECSR: FINANCING OF SOCIAL PROTECTION BY SOURCES IN 1996-2007 (AS % OF GDP)




## Contributory Financing: Weaknesses in Payroll Taxation

**Payroll taxation (compulsory social insurance contributions) is recognised to be extremely problematic because of its narrow base, high rates, and burdensome administration.** Payroll taxes collected to the four social insurance funds represent one of the weakest aspects of Ukraine's taxation system and raised calls for urgent reform throughout the last decade. The key problem with payroll taxation is its narrow base and the high marginal tax burden which it causes. The WB estimated that under the current system, the employer contribution rate alone (not including personal income tax (PIT)) is close to 37 percent, which covers contributions to the four funds (payroll taxes are made on wage withholding). For some occupations with higher risk of industrial accidents combined tax rates may exceed 40 percent. (See **TABLE 3**)(World Bank September 2006).

TABLE 3. WB PFR 2006: TAX RATES IN SOCIAL INSURANCE PROGRAMMES (AS PERCENT OF EMPLOYEE WAGE INCOME)

| **Contributions (*)** | **Pension Insurance** | **Unemployment Insurance** | **Temporary Disability Insurance (2)** | **Industrial Accident Insurance** | **Total** |
|---|---|---|---|---|---|
| **Employer** | 31.8 | 1.3 | 2.9 | 1.5 (4) | 37.5 |
| **Employee** | 1.0 / 2.0 (1) | 0.5 | 0.5 / 1.0 (3) | --- | 2 – 3.5 |
| **Total** | 32.8 – 33.8 | 1.8 | 3.4 – 3.9 | 1.6 | 39.5 - 41 |

(*) Rates as established in the 2006 Budget of Ukraine
(1) Includes sickness, maternity and funeral insurance. The average total rate for the Pension Fund alone is 33.8% of wages.
(2) An average weighted rate. The rate the employer pays varies from 0.66% to 13.6% depending on the degree of hazardous risk level.
(3) 1.0% of gross taxable income under UAH 150; 2.0% of gross taxable income over UAH 150.
(4) 0.5% for wages below the subsistence threshold, 0.1% for wages above the subsistence threshold.
Sources: MoF, MoL, Budget 2006

**Complex administration of payroll taxation will be modified from January 2011 when contributions to the four funds will be replaced by a single social tax, but the reform will not improve the key problem of narrow base and high rates.** Until recently, the four social insurance programmes were administered, regulated and operated completely independently from each other. Respectively, each fund had a separate system of collection of respective payroll taxes, even though all these taxes are withheld on the same base with the same method (by employer on gross wage incomes). An additional complication was the multiplicity of rates within a single insurance programme that applied for different types of employees working for the same employer. All these problems, duplications and inefficiencies created extreme costs of compliance with payroll taxation. (World Bank September 2006). The new legislation approved in 2010 (Verkhovna Rada of Ukraine 2010) will replace this system with a single social tax to be administered through the Pension Fund for subsequent redistribution between the four separate social insurance programmes. This change may improve administrative complexity and costs. However, it had no affect on the level and base of payroll taxation.

**Compliance with payroll taxation is also distorted by the inefficient system of simplified taxation.** Since 2000, Ukraine operates a simplified taxation scheme for firms and individuals whose original intent was to provide favourable conditions for small businesses and start-ups. However, this policy was not well co-ordinated and resulted in a situation when many firms and individual migrated to the simplified system away from the general payroll taxation scheme in order to lower their tax burden.(World Bank September 2006).

## Pension Insurance Crisis

**Pension insurance affects children indirectly, but very significantly.** Insurance against old age and disability (pension insurance) is one of the programmes which does not relate directly to children, but it actually represents one of the critical factors affecting household income, including families with children. **TABLE 4**, borrowed from the IDSS analysis of poverty and social assistance system in Ukraine, shows that Pensions represent 9.46% of household income among families with children – much more than any other type of social benefits available to such families (Cherenko n.d.). Moreover, as we will see in this section, mounting problems with the Pension fund balance have recently created larger macro-fiscal risks such as higher probability of inflation and rising overall tax burden, which affects most significantly poorer families with children.

TABLE 4. IDSS: PROPORTION OF SOCIAL TRANSFERS WITHIN HOUSEHOLD INCOME

| | Pensions | Child benefits | Targeted low income benefit | Other benefits | Housing subsidies | Social privileges |
|---|---|---|---|---|---|---|
| Households with children | 9.46 | 2.75 | 0.26 | 0.47 | 0.07 | 0.72 |
| Households without children | 31.76 | 0 | 0.01 | 0.54 | 0.17 | 1.44 |
| All households | 21.4 | 1.28 | 0.12 | 0.51 | 0.12 | 1.1 |

Source: Institute for Demography and Social Studies, National Academy of Science of Ukraine; period not specified

**Ukraine's pension system is subject to two major risk factors: problematic system design and rapidly aging population, which jointly make it fiscally unsustainable.** Ukraine's pension system is typical to other countries in the region and is fully based on a PAYG principle. The key features of the system's design are listed below (based on (World Bank September 2006)):

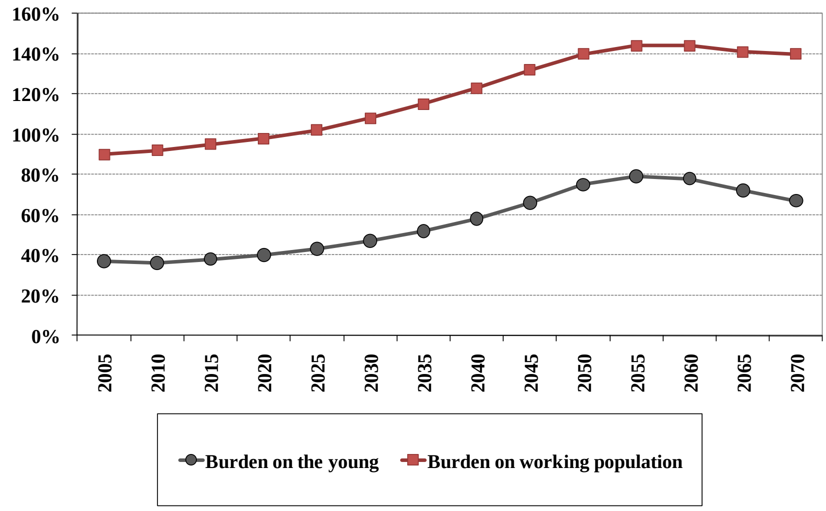
- A defined benefit scheme (a guarantee that the pension agency will pay a benefit based on a prescribed formula);

- High replacement rates (at around 40% in average) – defined as the value of a pension as a proportion of a workers wage during a base period before retirement or the entire lifetime average wage;
- Low retirement age (60 for men, 55 for women);
- Full old-age pension entitlement based on 20 years of service for women and 25 for men;
- Numerous special early retirement provisions.

**The rapidly aging population in Ukraine is a risk factor for tax system because of the shrinking contribution base and growing beneficiary population.** As in many other countries around the globe, Ukraine's population is ageing. As illustrated in **Figure 4**, the ratio of people aged 65+ to working population is forecasted to increase from 90% in 2005 to over 100% in 2025 and over 140% in 2055. In other words, by 2055, there will be only one worker in Ukraine per every 1.42 pensioners(World Bank September 2006). Moreover, unlike most other European countries, Ukraine's population is ageing at the background of decreasing longevity as a result of deteriorating quality of public healthcare services resulting from weak capacity of the healthcare system to address high prevalence rates of non-communicable diseases(FISCO id 2010). Without systemic reforms in the healthcare sector (which are also currently off track), this trend will persist in the forthcoming years. Respectively, growing number of pensioners at the background of reduced number of workers under a Pay-As-You-Go scheme will consistently increase fiscal pressure on the Pension Fund.

**As noted earlier, Pension Insurance is also subject to overall compliance problems in payroll taxation resulting from cumbersome administration and distortions created by simplified taxation schemes.** As discussed in the previous section, pension insurance contributions – the biggest of all payroll taxes – is highly vulnerable because of how complex and costly it is for employers and employees to comply with the payment procedures. Moreover, the possibility of migrating to the simplified taxation scheme without clear losses in the long-term probability of pension benefits distorts incentives to comply with pension contributions, which results in additional losses of revenues to the fund and increases its deficit.

Figure 4. Forecasted change in the ratio of population aged 65+ to young (15-64) and working population in Ukraine




Source: **(Ministry of Labour and Social Policy of Ukraine / UNFPA 2008)**

**Despite growing imbalances in the Pension Fund, the Government has continuously increased the level of benefits in the recent years, which further exacerbated the problem.** Already in 2006 observers explicitly agreed that Ukraine's current pension system was not macroeconomically sustainable. The year of 2006 marks the point when frugality of the pension system was clearly illustrated with statistical evidence in the World Bank Public Finance Review with strong recommendations to the Government on the urgently needed reforms. The WB noted continuous increases in pension benefits which, by that time, made Ukraine's PAYG system one with the highest transfer levels in the world as a share of GDP (**Figure 5**). However, in the years since that time benefits continue to increase. In particular, during 2009-2010 the Government has increased pensions further, to compensate the impact of the crisis on purchasing power of the population, raising the level of overall pension transfer by 4% of GDP to reach 18%, estimated by the IMF(IMF August 2010). The IMF also estimated that the deficit of the Pension Fund in reached 7% of GDP.

**The key challenge of the pension reform in Ukraine is the need to coordinate it with tax reforms.** In previous years, Ukraine created a legal platform and a wide consensus around the need to transfer to multi-pillar system which would include mandatory and voluntarily fully-funded state pension insurance. However, actual implementation of this reform remaines unaccomplished and challenging task, even after Ukraine has explicitly committed to change within the recently signed standby agreement with the IMF(IMF August 2010). One of the key challenges to introduction of the second pillar is the need to mobilise considerable funds to support this mechanism without raising tax rates and jeopardising macroeconomic stability (as discussed in earlier section). Therefore, the only path to continuation of this reform lies through the widening of tax base and especially through reforms in payroll taxation, including:

- Unification and rationalisation of the payroll taxation rates, and streamlining administrative responsibilities for payroll taxes, which are currently fragmented across four diverse structures, redirecting them to the Pension Fund.
- Introduction of a clear coordination mechanism between the Pension Fund and the State Tax Administration, which should act jointly to minimise possibilities for tax manipulation and minimisation;
- Strengthening the analytical capacity of the Pension Fund to address manipulations in social insurance payments;
- Reforms in the simplified taxation system, which currently allows to minimise social insurance payments.
- Increase female retirement age from 55 to 60 years by 2017, with an increase of 6 months per year.
- Lengthen the required contribution period for eligibility for a full minimum pension to 30 and 35 years for women and men, respectively
- Suspend the increase in pension benefits up to subsistence minimum if pensioner continues to work.
- Replace minimum pension with means tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level.
- Introduce a regular contribution rate for those taxed under the simplified tax system.

**The forthcoming years will have to see significant changes in Ukraine's social insurance landscape as the Government will have to address the Pension Fund's balance.** Despite the political difficulty of addressing the above described policy trade-off, the growing imbalance in the Pension Insurance system will lead to either tangible reforms in the system design coupled with taxation policy changes (which will affect household incomes and income distribution) or a major crisis in the country's public finance making the government default on its unsustainable social commitments, either through major payment arrears or through inflationary measures.

FIGURE 5. OVERALL PENSION EXPENDITURES AS PERCENT OF GDP: AN INTERNATIONAL COMPARISON

| | | | |
|---|---|---|---|
| Cyprus | 8.0 | Austria | 14.5 |
| Czech Republic | 7.8 | Belgium | 10.0 |
| Estonia | 6.9 | Denmark | 10.5 |
| Hungary | 6.0 | Finland | 11.3 |
| Latvia | 9.8 | France | 12.3 |
| Lithuania | 5.3 | Germany | 11.8 |
| Malta | 5.4 | Greece | 12.6 |
| Poland | 10.8 | Ireland | 4.6 |
| Slovak. R. | 7.9 | Italy | 13.8 |
| Slovenia | 13.2 | Netherlands | 7.9 |
| Bulgaria | 9.1 | Portugal | 9.8 |
| Romania | 6.4 | Spain | 9.4 |
| **EU new and accession** | **8.0** | **EU pre-2004** | **10.4** |
| **Ukraine 2003** | **9.2** | | |
| **Ukraine 2004** | **11.4** | | |
| **Ukraine 2005** | **15.3** | | |
| **Ukraine 2010(*)** | **18.0** | | |

(*) Source for this figure: IMF Estimate

Source for other data: EU and OECD, quoted in WB Public Finance Review (2006)

## Problems with contributory financing in terms of weak link to benefits

**The amount of benefits to which participants of the contributory system are eligible is almost at all independent on the amount contributed, which distorts incentives and discredits the idea of social insurance.** While efficiency of allocation of social insurance payments are discussed in a respective section further in text, it is important to note in terms of the programme financing that it generally suffers from a weak link between the level of contributions and the level of benefits. In particular, the funds raised by the four insurance schemes – including the Pension Fund – are utilised to finance a wide range of benefits, with a very weak (if at all existent) connection between the amount paid and an amount to be received by the contributor. At the moment, and specifically in the Pension insurance, the level of benefits is almost flat, which means that for the contributors the only link is to stay within the system and be eligible to receive a pension in the future almost regardless of the amount contributed (World Bank September 2006). This aspect of the system reflects a very shallow nature of the contributory insurance system, which does not create incentives for the participants to invest into their future benefits or, in fact, disclose their real incomes.

## Key issues in non-contributory financing

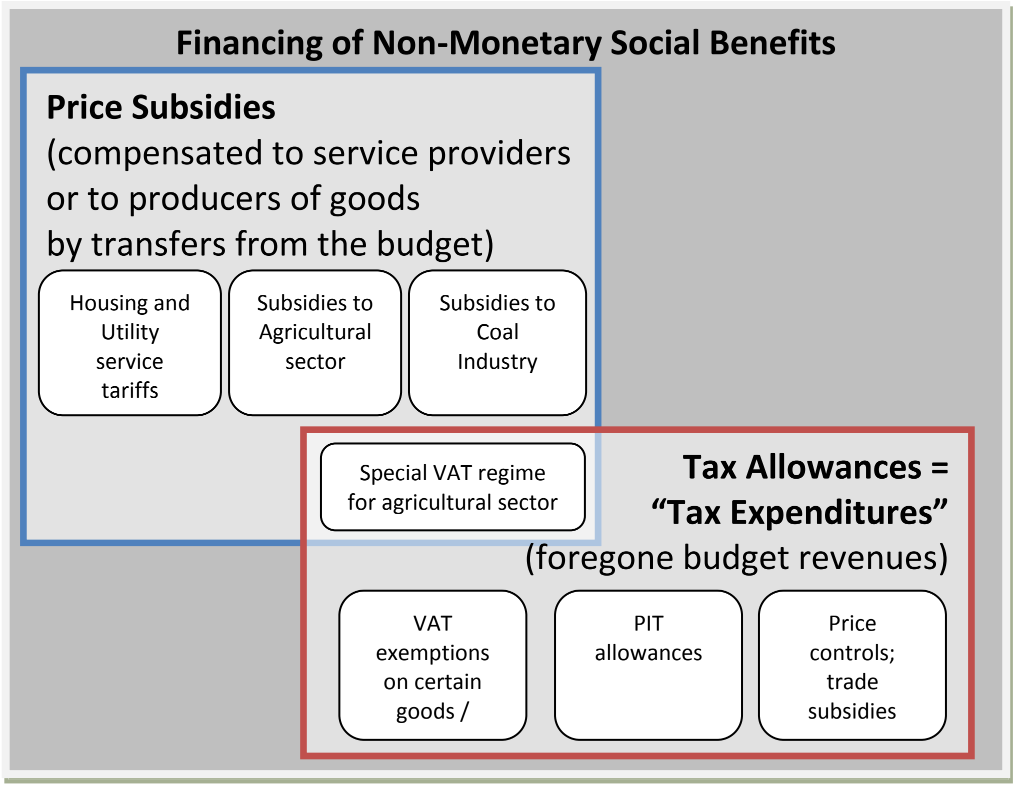
### Revenue sources utilised to fund non-contributory social security programmes

**Efficiency and fiscal sustainability of non-contributory social security programmes depends on nature and robustness of the underlying system of taxation and public financial management.** Non-contributory funding for general government programmes listed in Figure 2 (cash transfer, price subsidies, tax allowances, social services and public healthcare) is provided form Ukraine's consolidated budget. Detailed analysis of the issues in Ukraine's fiscal policy framework is outside this paper. However, this section outlines some of the key aspects of the financing side of non-contributory schemes which have important implications for the system's efficiency and long-term sustainability.

### Sources of funding for non-monetary benefits (price subsidies and tax allowances)

**Although social privileges and tax allowances are provided in non-monetary form, they represent tangible costs to the budget which need to be funded.** A significant share of social protection benefits in Ukraine are provided in non-monetary form. The non-monetary support is available in a form of price subsidies (direct, known as social privileges, and indirect, provided to certain sectors such as coal or agricultural production) and tax allowances (see **FIGURE 6**). Despite their non-monetary appearance to recipients, and although it is often quite difficult to establish their monetary value, all these benefits represent costs to the budget. In terms of financing, these costs come it two varieties: subsidies (which have to be covered by general budget revenues) and "tax expenditures" - various exemptions, privileges, holidays and other concessions which reduce government revenue collection (that is, represent foregone revenues and therefore a cost to the budget). (World Bank September 2006).

FIGURE 6. HOW ARE NON-MONETARY BENEFITS FUNDED?




**Non-monetary social benefits represent a recognised weakness of Ukraine's public finance, since their efficiency is low and their economic value is difficult to assess.** They include various types of privileges granted to a diverse range of client groups, such as discounts for housing payments, free or discounted access to certain educational programmes, proclaimed rights for extended paid vacations or free/discounted meals, or declared rights for priority service in recreational facilities. The volume of these benefits is significant, and yet there is no accepted methodology in place for assessing their financial value and economic implications (FISCO id 2008).

**Programmes represented by tax allowances are also very significant, distortive, and even more difficult to quantify.** But an even bigger distortion for the public financial management system and for the efficiency of social protection spending is represented by tax expenditures. Tax expenditures – or costs incurred by the budget as a result of certain tax privileges granted to numerous beneficiaries – are very prevalent in Ukraine's economy, despite continuous efforts to eliminate them. A lot of these tax allowances represent social privileges, in a form of reduced tax obligations for certain categories of population or in a form of reduced prices for certain goods and services. Even though many of these instruments do not specifically target children or families with children, but still have a considerable affect on their welfare.

**Tax allowances with strongest relevance to household income and, specifically, to incomes of families with children, are allowances in VAT (Value Added Tax) and PIT (Personal Income Tax), described below.** This description is based on the current tax legislation, and will have to be revised to take account of changes introduced in the new Tax Code approved in December 2010.

- **Value Added Tax exemptions** include
  - Supplies of food for children;
  - Education, after school activities, alternative care for children etc.;
  - Pharmaceutical products.

  Because of the indirect nature of these exemptions, it is very difficult to estimate either the cost of these exemptions, or their impact on the household incomes.

  - Estimates of costs are likely to be generated by the State Tax Administration, but are not publicly disclosed.
  - Estimates of impact is even more difficult, but a methodology for such exercise was proposed by FISCO in 2008 in co-operation with UNICEF Ukraine(FISCO id 2008). In particular, the nature of impact of these VAT exemptions on household incomes could be tested using data on household expenditures. This analysis could show whether current VAT exemptions are regressive (whether they influence poorer families – which are likelier to have more children - less than more affluent families). It is possible to use these data to categorise households based on their income levels, and then to calculate average relative importance of goods exempt from VAT in the consumption baskets of households in each category (e.g. child nutrition products). This will show, households of which income group are the key recipients and how important is this privilege for the poorest families.

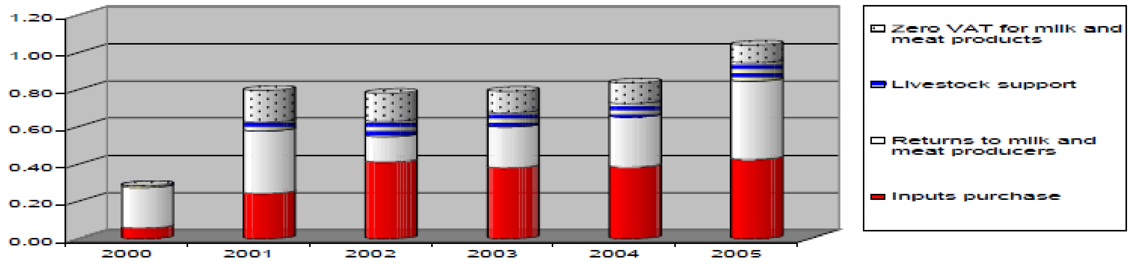
- **Personal Income Tax** allowances include:
  - Social tax privilege – various deductions for vulnerable families (single parents, families with more than 3 children, disabled children)
  - Other deductions: interest on mortgages, expenses on education and healthcare, contributions to private pension funds
  - Exemptions of charity contributions.

  As with VAT exemptions, it is possible to test hypothesis about the impact of PIT allowances on families with different income levels using the Household Expenditure Surveys.

**The biggest and most distortive and inefficient tax expenditures are concentrated in agriculture.** Tax allowances with indirect influence on household incomes and on the welfare of families with children are scattered across sectors, but most of them are concentrated in the programmes of state support to agricultural producers, which is assumed to also affect agricultural product prices and household purchasing power capacity. Tax expenditures on agriculture are very significant in Ukraine, and they have increased during 2002-2005 (from 0.5 % of GDP to 1.04% of GDP)(World Bank September 2006). These expenditures include a range of VAT concessions granted to agricultural producers. The special VAT regime for agriculture is assessed as complex, inefficient and detrimental for long-term competitiveness of Ukraine’s farmers.

**Non-monetary financing of social protection and social security programmes is the strongest representation of non-contributory element of social insurance, since it makes it even more difficult to establish the link between contributions and benefits, and to assign responsibility for the received social support.** This aspect of non-monetary programmes makes it especially difficult to confront and reform them, despite general acknowledgement of their inefficiency and distortive affect on the economy and society. In particular, one of the core reform agendas – monetisation of social priveleges (particularly, of price subsidies for transportation and utility tariffs) proved to face unexpected difficulties in Ukraine, supported by even more dramatic experience in Russia.

FIGURE 7. VAT CONCESSIONS IN AGRICULTURE (BY TYPE AND AS % OF GDP), BASED ON WB PUBLIC FINANCE REVIEW - 2006




Source: MoF; Bank staff calculations; 2005 calculations are Bank staff estimates based on preliminary data from the MoF, quoted in the WB Public Finance Review (World Bank September 2006).

**The experience of monetisation of social privileges in Russia offers an insight into intrinsic nature of non-contributory financing.** The reform in question (introduced in 2004) had stimulated massive and rather dramatic public protests which became widely registered, especially given that they have led to the second in history decrease in the popularity of V. Putin and coincided with the events around Orange revolution in Ukraine. On the one hand, these difficulties were explained with a range of weaknesses in the reform design, recognised by Russian and international observers[1]. However, some analysts point that the strongest factor which made it especially difficult for the population to accept the idea of monetisation was related to widely shared attitudes to the concept of social security and the role of non-monetary privileges. A quote which captures this attitude is provided below:

> *"These reforms hit the fundamentals of the social system which was created by our people during the Soviet period and which was most relevant to their views on the right and fair social order. No other painful reforms – be it price increases, privatisation, harder labour regulations or housing reforms – had such a strong potential to raise protests as "monetisation of privileges". […] Formally, monetisation was an innocent reform which was not supposed to create losers: privileges were simply replaced with cash. But it was exactly this "replacement" which would ruin the whole structure of Russian sociality, even if the reform were conducted perfectly, honestly, and without administrative chaos which it actually created. This structure is based exactly on the idea of 'free-of-chargness', freedom of social order from monetary relations and from the 'hard cash' of limited social guarantees."*
>
> Y.Holmogorov, quoted in (Kara-Murza 2005)

[1] These weaknesses included (Cerami 2009):

- Placing responsibility for monetisation of most privileges on regional budgets without providing adequate financial compensation. Regional authorities were given a choice, whether to monetise privileges and receive 40% compensation from the central budget, or keep the priviletes but fully compensate related costs to transport companies and other service providers;
- Failure to complement the reform with introduction of an equalisation scheme to take into account considerable differences between the regions;
- The above weaknesses were characteristic for the bulk of monetised privileges and mostly affected pensioners who were the key protesting category (monetisation of privileges funded from the central budget – those paid to disabled, war veterans etc - was not as painful);
- Weaknesses in calculations of the required financial compensation to match estimated demand (number of beneficiaries);
- Unfortunate timing the reform, which coincided with the increases of service tariffs.

## Problems with the shrinking size of the non-contributory pool and its increasingly non-tax nature

**Economic crisis created significant fiscal pressures on Ukraine's budget, which was intensified by post-crisis fiscal policies.** Shortage of funds made it even more obvious than before that Ukraine's traditional approach to increasing fiscal space for extra expenditures has been based on extremely myopic, confused and undemocratic political process. In particular, the key measures taken by two consequent governments during the crisis period (2008-2010) included progressive increase in nominal pensions, social benefits, and recurrent spending in social sectors without steps to release administrative inefficiencies and unfunded vertical mandates on local budgets. At the same time, the two governments progressively relied on funding this inefficient expansion with hidden and unsolicited quasi-fiscal borrowing such as VAT refund arrears, mandatory advanced tax payments, and wage arrears(FISCO id 11 May 2010).

**Ukraine's key taxes are falling throughout 2010.** Ukraine's consolidated budget execution in January-October 2010 showed that most of the key taxes were below period baseline projections, especially Ukraine's most fiscally important tax – VAT (which was 10.5% behind period baseline projection in October 2010, and 7.5% lower than during the same period of 2009 (in real terms)). This means that non-contributory funding available for public services is becoming scarcer.

**Consolidated budget pool is increasingly dependent on non-tax revenues – which are less "contributory" in nature.** The pool of revenues available for redistribution through various public services in healthcare and social protection became much less reliant during 2010 on taxation, and much more biased towards non-tax revenue sources. Taxation is an important element of democratic governance which helps to establish an accountability link between the government policies and the voters who pay for these policies as taxpayers(Moore 2004). However, this instrument becomes increasingly alienated in Ukraine. Growing deficits are covered not only by expanded public debt but increasingly also by monetary emissions, non-tax revenues such as rent payments for gas extraction, and ad hoc sources such as administrative fines and penalties (FISCO id 2010). At the same time all key taxes are underperforming (remain far below period baseline projections). These processes illustrate a decaying compact between the state and its taxpayers, and shrinking opportunities for the citizens to influence their budgets (given that it depends less on a revenue-raising mechanisms established in a clear and accountable way). In terms of social security system, this process represents a further decay in the link between the contributions provided by the citizens to fund the services and the value which they receive in return.

**Shrinking budgets highlight the need for Ukraine to concentrate on efficiency of social protection and social security programmes.** Ukraine is unique in terms of the very high amount of public resources it spends on key services (healthcare, education and social protection) and extremely poor results achieved with these resources. For example, Ukraine's spending on Education as % of GDP by 2006 was already higher than the average for EU-10 and for all OECD countries. Similarly, spending on Healthcare is also very high (especially i out-of-pocket payments are taken into account). However, outcomes for both of these sectors are extremely poor. Therefore, existing technical recommendations also demonstrated that improvement in public services could be achieved not by higher spending but through administration and governance reforms, as well as through introduction of long-term budgeting framework(World Bank September 2006),(World Bank February 2008). With fiscal pressures created by the crisis, efficiency consideration will only increase. There is plainly no way for Ukraine to continue providing the same level of services at the background of shrinking budgets without improving efficiency of spending.

## Financing of medical services: how, and how much, revenues for healthcare are currently raised in Ukraine?

### Government funding versus out-of-pocket financing

**The key principles behind effective financing system for healthcare include the need for pooling and prepayment, which means that health insurance (including tax-funding) is most efficient while out-of-pocket payments are the worst option.** Pooling of resources should be facilitated so that people can put their resources together to maximise the advantage of resource usage and minimise individual risks. Risk pooling in healthcare is critical both for equity and efficiency, because societies typically agree that individuals should not be fully individually responsible for their health risks, and because pooling increases productivity of healthcare and reduces related uncertainties to individuals (Smith 2004). Prepayment principle means that people make contributions to their healthcare at the time when it is affordable rather than when the risks materialise and they are sick. As illustrated in Figure 8, a system which promotes both principles is some form of insurance, while out-of-pocket payments represent the worst possible scenario of funding in terms of individual risks and efficiency of spending. The WHO Health Report 2010 selected as its central message the observation that out-of-pocket payments are by far the greatest obstacle to achieving universal healthcare (WHO 2010).

Figure 8. Pooling and Prepayment principles in Healthcare financing

| | | Prepayment | |
|---|---|---|---|
| | | **No** | **Yes** |
| **Pooling** | **No** | Out-of-pocket payment | Medical Savings Accounts |
| | **Yes** | Charity | Health Insurance (Tax- or Insurance Based) |

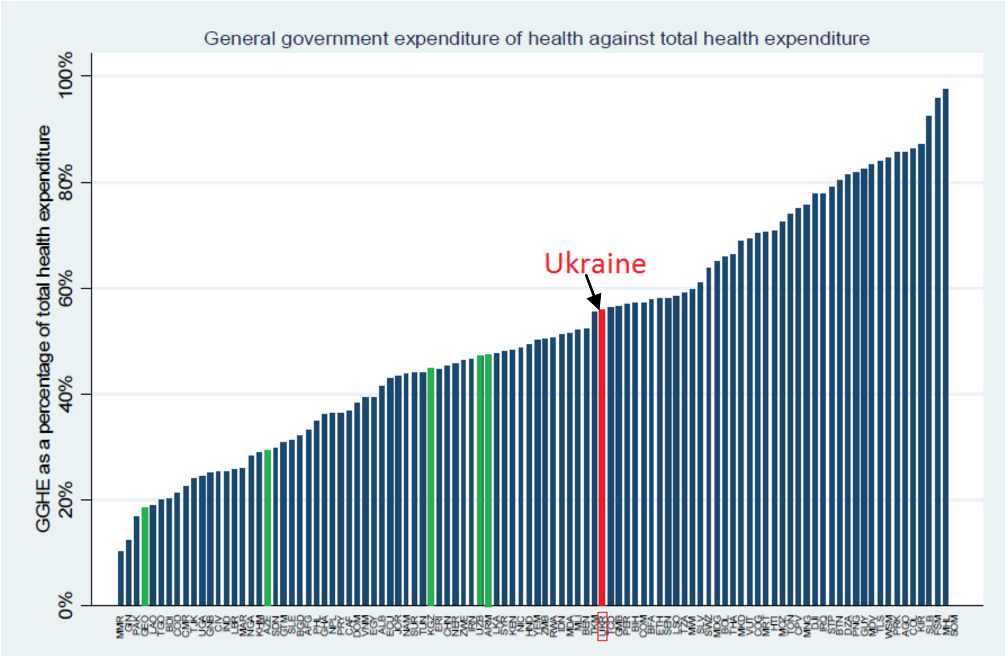
**Only about 60% of healthcare budget in Ukraine is raised via taxes, while the rest represents OOPs.** Based on current estimates, only about 60% of Ukraine’s overall healthcare spending is raised through the general government budget. With the private insurance still being a very narrow source of funding, the rest of costs represent out-of-pocket payments by the population. The World Bank estimated that, despite constitutional provisions which guarantee free healthcare to Ukraine’s citizens, out-of-pocket spending (i.e., “voluntary/formal” and informal payments) in public medical facilities were around 2.8% of GDP in 2005 (which at the time was about the same size as overall government’s spending on this sector) (World Bank February 2008). More recent figures quoted by the WHO for 2007 suggest that the share of tax-funded spending had slightly increased (to about 60%). Although this level of government spending compared to out-of-pocket financing is the highest compared to other low and low-middle income countries of the CIS-plus[2] (Georgia, Azerbaijan, Kyrgyzstan, Uzbekistan and Armenia) (see **Figure 9**), it is still a dangerously low figure.

**One of the major detrimental outcomes of OOPs is their adverse impact on income distribution and level of inequality.** According to the World Bank, OOPs in Ukraine are more regressive compared to other countries in the region and to the OECD countries, and have the potential to push a large number of people below the poverty line. This primarily results from the very significant catastrophic expenditures which they create for the families, the majority of which are in the poorest deciles (see **Figure 10**). Another detrimental outcome for the poor is a disincentive created by OOPs to use specialised facilities. The size and the likelihood of direct OOP financing rise considerably with the level of specialization of care needs, and the largest share of OOP expenditure in every oblast is comprised of prescription drugs. Respectively, the need to make informal payments deters poorer people from

[2] We use the term “CIS plus” for analytical purposes only, to describe a group of countries covering CIS and other post-Soviet countries except Baltic States.

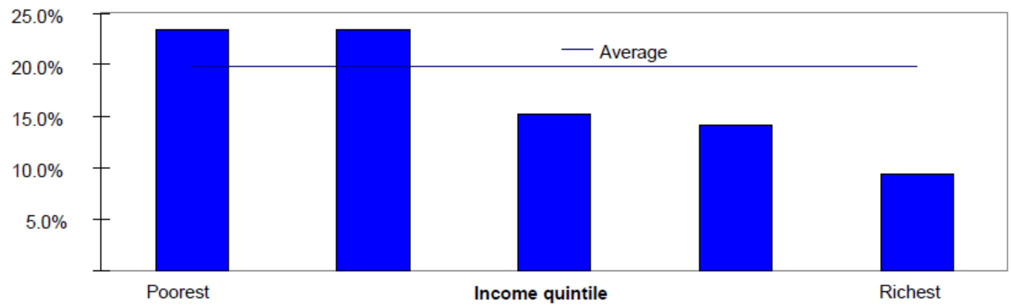
utilising more specialised care, especially preventive services(World Bank February 2008). The World Bank also indicated that organisation of public healthcare exacerbates this problem, since 70% of public healthcare expenditures are focused on hospitals, specialised and preventive facilities.

FIGURE 9. GENERAL GOVERNMENT EXPENDITURE ON HEALTH AS A SHARE OF TOTAL HEALTH EXPENDITURE IN LOW AND LOW-MIDDLE INCOME COUNTRIES IN 2007 (WHO)




Source: Based on WHO World Health Report 2010 Background Paper, (WHO 2010)

FIGURE 10. WB PFR: PERCENT OF HOUSEHOLDS IN UKRAINE WITH CATASTROPHIC OOP, BY QUINTILE




Source: Calculations based on World Health Survey results, 2003, quoted in the WB Public Finance Review 2008(World Bank February 2008)

**Out-of-pocket financing of healthcare in Ukraine is a triple challenge: it has a large fiscal size, it distorts healthcare policy priorities and it creates resistance to reforms.** Most types of existing OOP contributions to healthcare (both formal and informal) occur without sufficient transparency and therefore the size and efficiency of this spending is beyond the influence of government regulators. In reality, a large portion of these funds is utilised unproductively (without actual provision of a medical service in response for payment) or could be detrimental, adding to inequality of access and creating financial interests which resist reforms. The unproductive share of OOPs originates from abuse of managerial authority within the healthcare organisational structure.

**Institutional origins of OOPs are related to dramatic failures of the public healthcare system as well as of the failures in the informal markets for healthcare**.

- **Vertical planning of healthcare leads to a classic set of government failures and is the key reason for growing out-of-pocket spending.** Financial, regulatory and administrative framework of Ukraine's health care system retains all core features of the so called «Semashko» integrated health care model. Developed in the Soviet Union in early 1920s, this model is based on totally centralized system of publicly owned medical institutions, financed and regulated by central authorities through universal and rigid vertical command. During and after Soviet times, out-of-pocket payments represent a reaction to this approach and to the government failures that it creates.
- **Compulsory territorial assignment of patients allows informal charging for intermediation.** In the Soviet Union, compulsory assignment of patients among territorial units for health care provision was a source of substantial informal spending by patients who sought admission to facilities bypassing officially prescribed roots. This spending benefited either local specialists, who were able to refer patients to the facility of their choice (including popular semi-recreational services in sanatoriums) in return for a gift or service, or facility management, who could offer admissions without referral, through similar informal deals.
- **The influence of compulsory assignment on informal spending continues because facilities are not financed based on performance.** The current system released the legal power of medical referrals allowing patients to seek care in any medical institution. However, given that medical institutions continued to be financed based on norms-based indicators and that overall local healthcare budget depends on population, both clinics and hospitals keep a semi-formal right to charge patients not referred by local doctors on the grounds that extra people mean extra costs.
- **Legal mechanisms through which this practice continues include official user-fees and charity contributions.** Out-patient services to patients without referral are subject to a list of official user-fees, legally defined in 2005 after a constitutional dispute[3], but not supplied with clear mechanisms for pricing and for monitoring of spending efficiency, which again remains exclusive responsibility of facility management. In-patient care has to be provided free of charge to all patients with medical referrals and emergency hospitalizations. In all other cases, hospitals can reject care seekers, redirecting them to their local facilities. However, facility management can agree to hospitalize them in return for a charity contribution (unless doctors formalize it as emergency, leaving the compensation to themselves rather than management). Legislation insists that charity payments should be voluntary and should be directed on institutional priority needs. However, these funds are accounted as one bulk revenue and expenditure line in the budget of each facility and oversight of their efficiency and good-will origin is exclusive responsibility of the facility management[4] and is not subject to any cross-check. Thereby, the current system shifts the previous benefit sharing arrangement. Big portion of money patients are willing to pay for bypassing territorial assignments has relocated from informal benefits of local specialists in unattractive facilities to official accounts under control of management in more advanced institutions.
- **Control mechanisms do not develop, failing to compete with the authority concentrated at the regulatory and managerial level.** Professional associations tend to avoid the agenda of objective control over decisions in healthcare as this jeopardizes careers of their members and is rarely a major priority. Many members of such associations are highest-rank system representatives, potentially benefiting from the current inefficiencies. Objective external control is also weakened by access of the managerial and regulatory chain to exclusive opportunities for social and political networking. Ability to facilitate medical help of influential patients can immunize such managers against the majority of legal, financial and administrative accusations.

[3] *The list of paid services, which could be provided in the state and communal health care facilities, higher medical academic institutions and research facilities*, approved by Cabinet of Ministers Resolution No 1138, 17 September 1996, amended in 1999, 2002 and 2005.
[4] *Procedures for receiving charity contributions from legal entities and physical persons by public facilities and institutions in education, health care, culture, science and sports for directing on their financing needs*, approved by Cabinet of Ministers Resolution No 1222, 4 August 2000, Art. 2-3.

- **Unsatisfied demand for quality service creates an informal healthcare market.** Assuming that patients have a certain willingness to make additional out-of-pocket contribution for medical services of a certain quality (at a price which clears the overall market), the absence of the possibility to pay (acting as official price cap) and compulsory assignment to the single supplier (assigned doctor) both create a deadweight loss of consumer surplus. Patients may choose a more proactive way to utilize this surplus (searching for better quality at higher informal price) or a less proactive way, when they stick to the assigned supplier but feel happy to offer him a gift when they feel that quantity of quality service exceeds the average level expected in a monopolistic relationship with such assigned doctors. In this way the absence of formal regulated mechanisms for absorbing the surplus of patient's willingness to pay for better quality creates an informal market for such additional quality. It includes ex post tipping of doctors by grateful patients, as well as provision of more expensive services to patients who seek them deliberately in return for compensation.
- **Unregulated informal healthcare market dramatically fails, leading to distortions in pricings, policies, health outcomes and equity of access.** The secrecy of transfers makes it difficult for all sides to understand the market and does not allow informal prices to fully reflect the market value of service. Lack of transparency in pricing also considerably complicates financial planning for both patients and doctors, and distorts patients' care seeking strategies by unrealistic vision of service affordability. On top of that, informal markets do not reflect systemic health care priorities and avoid services with large externalities given that people are not willing to pay out of their pockets for services they cannot enjoy directly and exclusively. Finally, reliance on informal markets for ensuring service quality leads to extremely and increasingly unequal access to the care which has quality higher than the minimum guaranteed free of charge.
- **Complete reliance on planned economy approaches in health care distorts the culture of care-seeking behavior.** Compartmentalization of public health care and resulting separation between treatment and prevention, neglect to awareness raising, over-reliance on specialized services, and lack of engagement from patients and doctors to the system oversight shifts public attitudes towards short-termism, lack of trust in healthcare system and overall misunderstanding and pessimism regarding health care as such. Distorted attitudes can significantly reduce the efficiency of available medical services and the resulting national health outcomes.

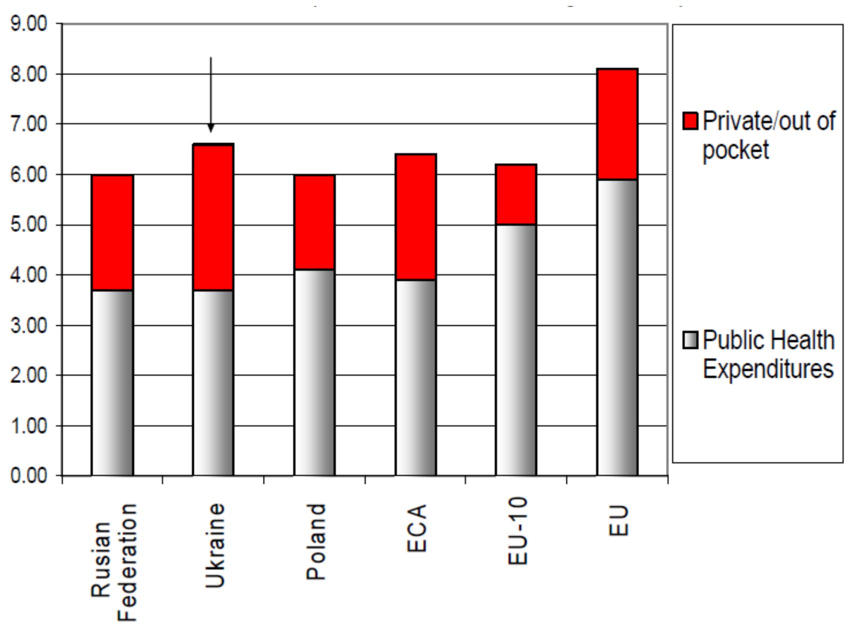
## Trends in funding raised through the general government

Formal healthcare system in Ukraine is mostly funded through the government's consolidated budget, which allocates to this sector over 4% of GDP. Although Government's spending on healthcare gradually increased in the recent years as a % of GDP, it remained at about the same level as a share of overall consolidated budget (somewhat above 11%), as illustrated in **Table 5**. If these expenditures are combined with estimated size of out-of-pocket payments (at the 2005 level), Ukraine's overall healthcare budget would reach 7% of GDP which would take Ukraine above the ECA average but still below the EU average (See **Figure 11**).

Table 5. Spending on Healthcare in Ukraine's Consolidated Budget in 2004-2010 (UAH mln)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 Plan | 2010 Jan - Oct |
|---|---|---|---|---|---|---|---|---|
| **Total Healthcare expenditures** | | | | | | | | |
| **Consolidated budget** | **12,159** | **15,476** | **19,738** | **26,718** | **33,560** | **36,565** | **44,025** | **33,981** |
| State (central) budget | 3,448 | 3,508 | 4,100 | 6,321 | 7,366 | 7,535 | 8,733 | 5,887 |
| Local (sub-national) budgets | 8,712 | 11,968 | 15,638 | 20,397 | 26,194 | 29,030 | 35,292 | 28,095 |
| **Local exp. as % of total** | **71.64%** | **77.33%** | **79.23%** | **76.34%** | **78.05%** | **79.39%** | **80.16%** | **82.68%** |
| **Consolidated Healthcare expenditures as % of:** | | | | | | | | |
| GDP | 3.52% | 3.51% | 3.63% | 3.71% | 3.54% | 4.00% | 4.07% | |
| Total consolidated expenditures | 11.99% | 10.92% | 11.26% | 11.82% | 10.85% | 11.89% | 11.07% | 11.53% |

FIGURE 11. REGIONAL COMPARISON OF HEALTHCARE EXPENDITURES, 2002-06 (WB PFR)




Source: World Bank ECA regional fiscal dataset; Eurostat; Ministry of Finance and State Treasury of Ukraine; Bank staff calculations, based on (World Bank February 2008)

**A notable observation in the WB PFR of 2008 is that compared to other countries, Ukraine's public and total health spending as a share of GDP is just above average for its income level.** These comparisons are based on the overall pattern of countries generally spending more on health as their incomes rise. If Ukraine's expenditures on healthcare are compared to other countries with similar income levels, its healthcare budget still remains above average (see **FIGURE 12**). (World Bank February 2008)

FIGURE 12. WB PFR: UKRAINE RANKS CLOSE IN AVERAGE IN HEALTH SPENDING AS A PERCENT OF GDP WHEN NORMALIZED BY LEVEL OF PER CAPITA INCOME


Note: The figure is a log scale. Data for Ukraine are for 2006; data for other countries are for 2004. Sources: World Development Indicators; WHO; SSC of Ukraine; Bank staff calculations, quoted in the World Bank Public Finance Review 2008 (World Bank February 2008)

### Tax-funding versus healthcare insurance

**There is ample objective evidence showing that poor health outcomes in Ukraine result from inefficient, rather than insufficient, spending.** Previous sections have illustrated that the amount of public funds which Ukraine spends on healthcare is rather generous. However - and as discussed in further sections - given the extremely poor and deteriorating healthcare outcomes, it is clear that the system is not delivering good value for money. Therefore, international observers agree that additional budget resources will not enable Ukraine to remedy its health care system problems until the shortcomings of the current system are resolved.

**Introduction of healthcare insurance would not improve service quality but may create macro-fiscal risks.** Proposals of a social health insurance system have been considered by various stakeholders including several consequent governments in Ukraine. However, since the system needs to spend better rather than to spend more, raising additional funds through introduction of social health insurance would not resolve current systemic inefficiencies, but would create additional tax burden on the economy which would be detrimental. Based on these considerations, the current health insurance reforms under debate, which also focus on raising additional sources of financing for the health sector, would not solve the fundamental distortions, inefficiencies, and inequities that underlie the health system but might create an additional tax burden and cause wasteful spending. Thus, priority reform efforts (in a first stage) need to be focused on addressing the inefficiencies of the current system, rather than introducing additional Healthcare insurance funding schemes.

# Efficiency of allocation

## Functional composition of social security expenditures

**Ukraine's spending on social security is not clearly linked to social policy objectives.** Assessing efficiency of allocation of social expenditures and the value for money which these programmes are bringing to the population starts with a formulation of the policy goals of such programmes. Unfortunately, policy-making process behind social security spending in Ukraine is very weak, which makes it difficult to assign expenditures to intended outcomes and to analyse the functional structure of the social security system. This task is further complicated by the significant role of non-monetary programmes and by the difficulty in obtaining detailed administrative data in the area of healthcare spending, social protection and social services to vulnerable groups from respective ministries.

**Generally, Ukraine's public financial management in recent years has been strongly biased towards social spending programmes and reflected weak linkages between social guarantees and fiscal affordability.** Overall social expenditures – on broad measures in social security covered by paper (including Healthcare, Social Protection and Pensions) as well as Education and Culture have dominated in the increases of consolidated expenditures since 2002 and especially during 2008-2009 (World Bank September 2006),(FISCO id 2010). This bias persisted through the post-crisis period despite the fact that it was strongly pro-cyclical and risky: on the one hand, the Government had reduced its investment expenditures (which could have helped to sustain and stimulate GDP growth) and on the other hand it expanded long-term social commitments in terms of pension benefits and social protection (such as minimum wages). The fact that these policy decisions were highly dissonant with the affordable fiscal framework highlighted the weakness of connection between the State's social guarantees, on the one hand, and the willingness of the society to bear respective costs, on the other (reflected in Ukraine's constitutional tradition).

**Overall amount of social security spending – not including social services – exceeds 30% of GDP, with more than half going on Pensions.** **Table 6** describes overall composition of social security spending, mostly based on approved budgets for 2010 (this list does not include social services for vulnerable population groups for the reasons described in the next paragraph). Overall amount of public funds spent on social security is equal to more than 30% of GDP this year, and around 18% is spend on old age and disability pensions (as discussed earlier, this level of spending on pensions is one of the highest in the world). The second biggest functional category is Healthcare (especially if assessed jointly with out-of-pocket payments). Social assistance cash transfers represent 2.2% of GDP, and another range of programmes – social privileges, money follows the child, and support to housing purchases each take up less than one percent. One more type of programme – tax expenditures resulting from subsidised prices as a result of VAT exemptions, especially in agriculture – are not included into this composite list, but for reference such programmes were estimated in 2005 to amount to additional 2.7% of GDP of costs to consolidated budget.

**The size of allocations on social services, and their role in overall functional composition of expenditures on social security, is difficult to assess because of fragmented institutional responsibilities and classification of related data.** Assessing financial value of ocial services to vulnerable population groups – absolute or as a % of GDP – represents an analytical task which is impossible without access to classified financial data. The bulk of spending on social services is administered from sub-national budgets who report these expenditures under functional categories of several line ministries who oversee respective programmes. Overall, these expenditures are fragmented across several ministries (such as Ministry of Labour and Social Policy (MoLSP), Ministry of Education and Science (MoES), Ministry of Health (MoH) and Ministry of Family, Youth and Sport (MFYS)) and are not reported in a coherent way. The MoLSP directly finances a minor share of the overall social services budget represented by two national level institutions and several national level NGO service providers (whose joint expenditures represent less than 1% of the MoLSP budget) (Joshua 2006).

**Social protection of military officers represents an entirely separate budget administered through respective ministries and impossible to assess with publicly available data.** One top of fragmented responsibilities for social services; non-monetary benefits; distortive tax allowances and out-of-pocket payments, there is one more source of obscurity which makes the system of tax-funded social security less efficient. Social protection of certain occupational categories of population (mostly military officers and their families) receive due benefits through an entirely separate mechanism administered through respective sector budgets. People who belong to these professional categories are eligible to the same level of social protection as regular citizens, but respective payments are included into the sector budgets, not into social protection expenditures. This makes it nearly impossible to assess the size of "agency spending" on such programmes, or to co-ordinate them under a coherent national social policy framework. The occupational categories which fall under these parallel financial arrangements include:

- National Military Forces;
- Border Service;
- State Security Service;
- External Intelligence Service;
- Civil Defence Forces;
- Other military formations;
- State Special Transport Service;
- Internal Affairs authorities;
- State service for special communications and information protection
- State Prisons Service.

TABLE 6. COMPOSITION OF SOCIAL SECURITY EXPENDITURES**, AS % OF GDP (2010 BUDGET)

| | | |
|---|---|---|
| **Total Social Security Spending (without Social Services)** | **30.09%** | |
| **Social Insurance Funds** | 19.56% | |
| Pension Insurance (Old Age and Disability) | | 17.80% |
| Unemployment | | 0.64% |
| Occupational Injuries | | 0.40% |
| Temporary sickness | | 0.72% |
| **Healthcare (funded from the budget)** | 4.07% | |
| **Healthcare (funded by OOPs*)** | 2.80% | |
| **Social Assistance (administered through local budgets)** | | |
| Cash transfers to families and children | 2.20% | |
| Subsidisation of housing and utility prices | 0.80% | |
| Money follow the child | 0.03% | |
| **Support for Purchases of Housing from State Budget** | 0.25% | |
| **Other central social protection programmes funded from the State Budget** | 0.38% | |

*Estimated based on WB Public Finance Review 2008
** This list does not include social services for vulnerable population groups: a spending category fragmented across functional ministries and difficult to estimate with publicly available statistics.
Sources: State Treasury of Ukraine; Budgets of Social Insurance Funds; WB Public Finance Review (World Bank February 2008)

## Social insurance benefits (occupational injuries; sickness; unemployment)

**Social insurance funds are responsible for a wide range of benefits aimed to support individual income in situations of materialized risks such as sickness, occupational injuries or unemployment.** Ukraine's three social insurance funds (against occupational injuries, temporary sickness and unemployment) provide a wide range of benefits which, as already noted, are not strongly linked to the amount of contributions made by the recipients. The key benefits provided by these funds are listed below. All these benefits represent income support transfers and are therefore only indirectly related to the welfare of children. However, one closely related benefit is a set of maternity-relayted payments, provided by the Temporary Disability Fund.

| Insurance Fund | Type of benefits provided |
|---|---|
| Occupational Injuries | A wide range of benefits intended to ameliorate the effects of industrial accidents and occupational diseases which lead to income loss due to health problems, including:<br>▪ compensation for health hazards;<br>▪ death grant;<br>▪ first aid in case of an industrial accident;<br>▪ organisation of treatment; rehabilitation of disabled people. |
| Temporary Disability (Sickness) | Temporary disability benefits, including:<br>▪ assistance in case of temporal loss of ability to work (including care after a sick child);<br>▪ maternity and childbearing benefits;<br>▪ funeral allowances (except unemployed persons, pensioners and persons who died due to industrial accident, recreational activities (payment for sanatorium and rehabilitation treatment). |

| | |
|---|---|
| Unemployment | A range of benefits including:<br>▪ full unemployment benefits;<br>▪ vocational training allowance;<br>▪ redundancy compensation;<br>▪ funeral allowances in case of a death of unemployed;<br>▪ benefits in kind: vocational training; services for unemployed and jobs search assistance. |

**Activities of the social insurance funds are not co-ordinated either with each other or with wider policy objectives.** As already discussed, despite the closely related mandates of the three funds and very closely related payroll sources of their funding, the three funds exist as completely independent and rather isolated structures, and their benefit programmes are not related in terms of policy goals and efficiency gains. Respectively, very little analysis exists on the impact of these benefits on the household incomes and on any of the social policy goals which these programmes might pursue (such as specific support to families with children through benefits for extra-curricular activities funded from the temporary disability fund).

## Temporary disability insurance

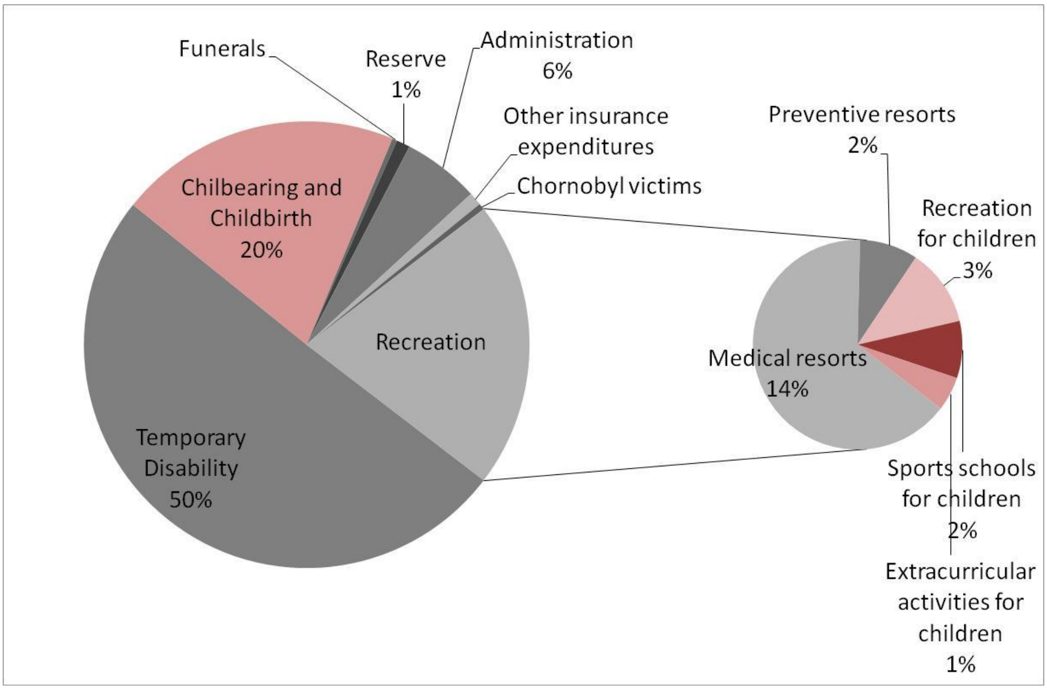
**Sickness insurance fund equals 0.72% of GDP (UAH 7.8 bln in 2010), and is the only programme with direct benefits on children.** In 2010, Temporary Disability Fund is responsible for expenditures budgeted at the level of UAH 7.8 billion or about 0.72% of the annual GDP forecast. As illustrated in **Figure 13**, half of the Fund's budget is spent on actual sickness benefits; and another 20% - on maternity and child-birth related payments. A considerable part of expenditures are spent on recreative programmes (about 20%), some of them – for children (such as medical resorts and sport schools).

**The Fund provides maternity and childbirth benefits to insured women (and insured people who adopt children) in full amount of their income during 126 days around childbirth.** Maternity and childbirth benefits («Допомога у зв'язку з вагітністю і пологами») are provided to women via their employers in a size which fully compensates their average income during 70 days before and 56 (70 for twins or medical complications) days after childbirth (Verkhovna Rada of Ukraine 2001). Women who are not insured (e.g. unemployed) receive maternity and childbirth benefits as well, but these are funded from consolidated budget, in amount linked to subsistence minimum, and paid during the same amount of days (70 before and 56 after childbirth) through local social protection offices (Verkhovna Rada of Ukraine 1992). Importantly, these benefits are also provided to people who adopt children, but only when adoption occurred during two months from the child's birth. In such cases, the benefits are paid during the reminder of the 56 days from childbirth from the point of adoption (70 days for tw*ins*).

## Occupational injuries insurance

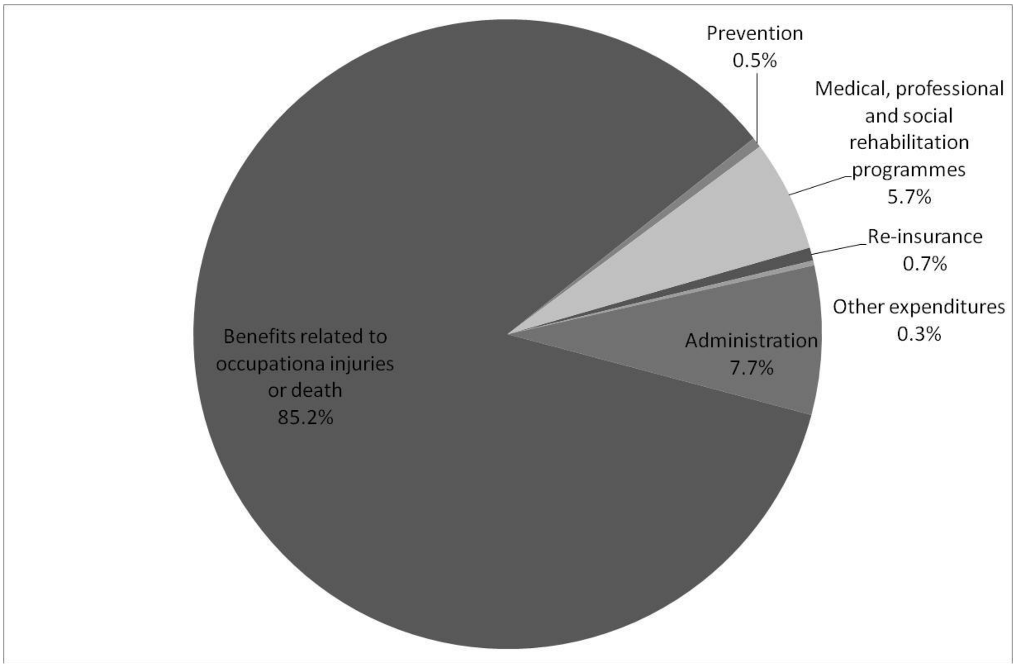
**Occupational injuries insurance fund equals 0.4% of GDP (UAH 4.4 bln in 2010), spent mostly on direct benefits related to injuries.** Expenditure composition of the fund is described in **Figure 14**, based on the Fund's approved Budget for 2010 (Board of the Fund for Social Insurance Against Industrial Accidents and Occupational Diseases 2010). The bulk of spending is on the benefits to compensate the damage from industrial injuries, with another 5.7% directed on related rehabilitation programmes.

FIGURE 13. EXPENDITURES OF THE TEMPORARY DISABILITY FUND (2010 BUDGET)




Source: Fund for Social Insurance Against Temporary Disability (Board of the Fund for Social Insurance Against Temporary Disablity 2010)

FIGURE 14. EXPENDITURES OF THE OCCUPATIONAL INJURIES FUND (2010 BUDGET)



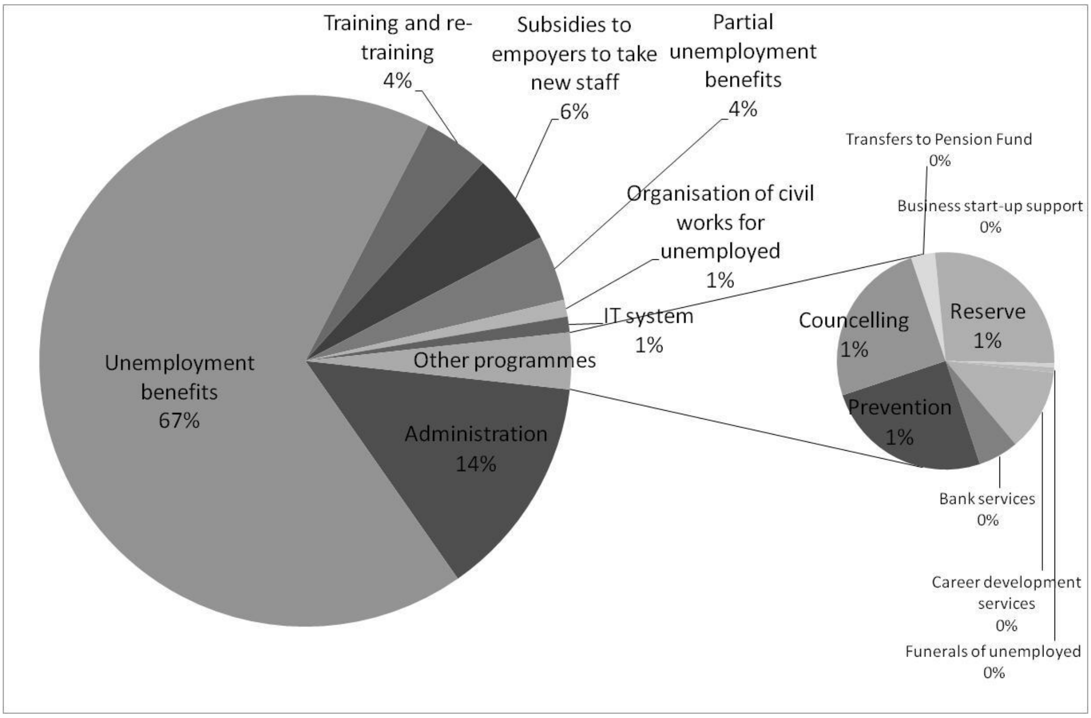

Source: Fund for Social Insurance Against Industrial Accidents and Occupational Diseases (Board of the Fund for Social Insurance Against Industrial Accidents and Occupational Diseases 2010)

## Unemployment insurance

**Unemployment insurance fund equals 0.64% of GDP (UAH 6.9 bln in 2009), spent mostly on unemployment benefits, although a significant share of expenditures is also directed on other types of support and administration.** Expenditure composition of the fund is described in **FIGURE 15**, based on the Fund's approved Budget for 2009. It shows that unemployment insurance benefits are provided through a variety of types of support, most of which are cash benefits to unemployed (67% of all expenditures), but also include training and retraining programmes, organisation of civil works, counselling and career development services, as well as subsidies to employers who decide to take up staff out of those who were previously unemployed. A lot of these alternative benefits are therefore in-kind. It is notable that the Unemployment Fund's administrative spending is the highest compared to all other social insurance funds (14% of its budget in 2009).

**Eligibility criteria and benefit scales contain loopholes for manipulation, and were tightened after the crisis.** The system of unemployment benefits is based on a rather complex regulatory system, linked to a set of eligibility criteria for registration in the Public Employment Service. The system was slightly modified after the crisis to tighten eligibility conditions even further (ILO 2010). There are also ample sources for manipulation with the size of the unemployment benefits to which a registered person is eligible: while all unemployed should receive a minimum benefit, legislation also requires special and much higher redundancy payments if the person was fired because of enterprise restructuring[5]. Obviously, this creates motivation for manipulation with the official statements on the reasons for one's unemployment. The level of the minimum unemployment benefit is below minimum wage (66.1% in 2008), even though it continuously increased in all previous years (Ukrainian Centre for Social Reforms 2009).

FIGURE 15. EXPENDITURES OF THE UNEMPLOYMENT INSURANCE FUND (2009 BUDGET)




Source: Unemployment Insurance Fund

## Budget-funded social assistance: financial flows through multi-layer system

**Social assistance financing from the general government's budget in Ukraine is organised through a deconcentrated multi-layer programme:** while all benefits are defined by the central government and funded in exact and full amount from the central budget, the actual payments are administered through local administrations. This kind of fiscal relations between tiers of governments represents "deconcentrated funding" because it assumes the weakest existing scale of financial decentralisation: local authorities play a minimum role as administrators of the programmes, but all decisions and all financial responsibility remains with the central government and its budget.

[5] In particular, social redundancy package includes benefits in the amount of 100% of dismissed worker's average wage during 60 days; in the amount of 75% — for next 90 days; and in the amount of 50% – for next 210 days. These benefits cannot be larger than the average monthly wage in the economy of the corresponding region (oblast) and not smaller that minimum statutory wage (Ukrainian Centre for Social Reforms 2009).

**Deconcentrated funding was introduced in 2001 as a significant improvement: it is reasonable for the central government to be responsible for these expenditures but engage local authorities as administrators.** This approach to the design of intergovernmental fiscal relations in the area of social assistance was introduced in Ukraine in 2001 with the approval of the country's Budget Code, and corresponds to the international good practice. Redistributory nature of social assistance means that stronger decentralisation of these expenditures may result in negative selection of voters in more generous jurisdictions, and in distortions which would be politically difficult to reverse. However, while it is reasonable for the central government to retain responsibility for social assistance, and to engage local authorities as administrators, it is also important to ensure that local governments have sufficient funding to exercise these tasks. Prior to 2001, responsibility for social assistance financing was not clearly assigned to any tier, and was therefore often shifted down to the lowest level of governments, who did not have sufficient funds, and therefore it represented an unfunded mandate, resulting in arrears and fiscal stress on other local functions. Placing full financial responsibility for these expenditures on the national government was widely supported by domestic and international observers.

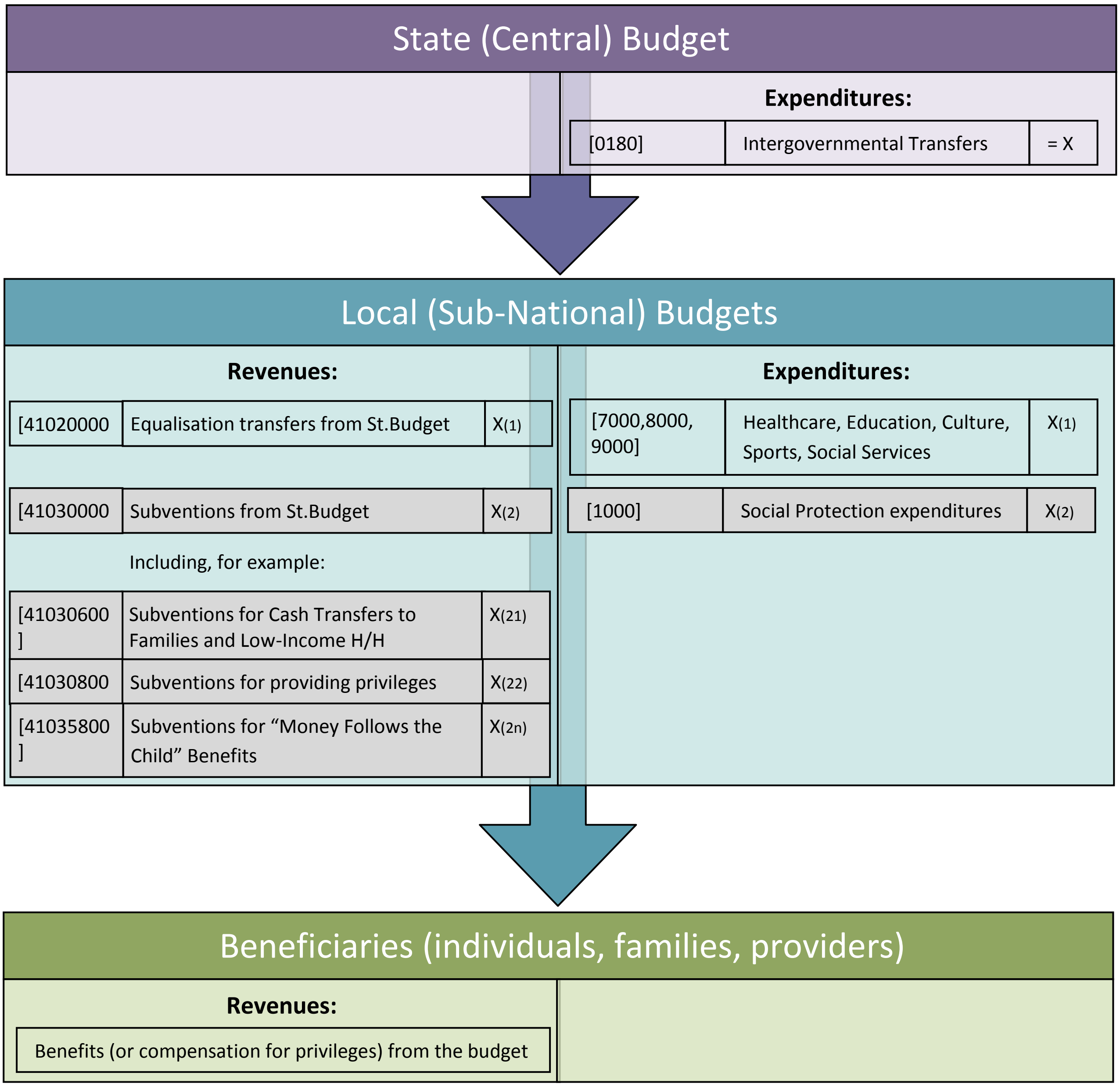
**Social assistance budget is allocated as an earmarked transfer through the local budgets.** FIGURE 16 illustrates the logic of financial flows behind multi-tier financing of social assistance. The way fiscal deconcentration works is through allocation of an earmarked transfer from the central budget to the local budgets which should be used exclusively on a certain range of payments: in this case, a legislatively specified range of benefits, whose size, beneficiaries and therefore expected overall cost can be clearly established. This earmarked transfer ("subvention") is accounted as an expenditure of the central budget, and as a revenue of each recipient local budget. After the money are transferred to beneficiaries, they are accounted as local expenditures under respective line of the functional classification (i.e. "Social protection").

**Unlike equalisation transfers, social subvention is earmarked.** It is notable, that the amounts of intergovernmental transfers are presented as a single amount at the stage of central budget reporting, but their breakdown is available in the revenue side of sub-national budget reports. Earmarked transfers used for social assistance are only one type of intergovernmental transfers: other major transfer is the equalisation grant, which is available to local governments to fund other decentralised expenditures such as healthcare, education, culture or social services to vulnerable population groups. However, formally speaking, equalisation grant is unconditional: local governments can allocate it across programmes, making sure that they manage to deliver public services in delegated sectors. In reality it is not as clear-cut; and local authorities actually remain subject to numerous spending requirements which limit this theoretical flexibility (as we will discuss in next sections). But unlike social assistance, expenditures on education, healthcare, culture, sports and social services are fully funded from the local budgets and their respective costs are not fully and automatically compensated by the central government as it happens in the case of social assistance.

**At the same time, non-monetary benefits create risks of unfunded mandates even under a deconcentrated arrangement.** Although central funding of social assistance is a deconcentrated programme whose whole philosophy is based on full and automatic compensation of local costs by the central authority, this principle is rather difficult to maintain given that a significant portion of these expenditures represent price subsidies (social privileges) to population. Unlike with cash transfers, when the local authorities pay the benefits directly to the beneficiaries, expenditures related to privileges represent financial compensation from the budget to those providers who incurred losses as a result of mandatory decreases of prices and tariffs to certain categories of consumers. In other words, these amounts are transferred to respective utility companies, transport service providers and other intermediaries. The non-monetary manner in which privileges are provided make it difficult to explicitly and objectively assess resulting obligations (although procedures exist for identification exact amounts of eligible beneficiaries and the resulting costs). This circumstance creates frequent situations when provision costs are not funded in full and are therefore shifted away from the budget on the shoulders of the providers.

**Earmarked subventions to local budgets cover the majority of social assistance programmes** (only few other social protection expenditures are funded directly from the state budget, and, in principle, local governments are allowed to introduce their own top-ups for cash benefits for low-income families). These subventions are allocated across three kinds of programmes, discussed in subsequent sections: cash transfers; compensation for social privileges, and benefits related to specific social services such as "money follows the child" (see **Table 7**).

Figure 16. Deconcentrated financing of social assistance in Ukraine's system of fiscal relations between budgetary tiers




**Spending on cash transfers in social assistance significantly increased over 2004-2010.** **Table 7** shows that overall spending on social assistance (administered from the local budgets through the earmarked subvention) currently represents around 2.9% of the country's GDP and take up about 8.1% of the overall consolidated budget expenditures. It also shows that in the recent years, there was a continuous and considerable increase in the amount of cash transfers: they grew both as a share of GDP (from 0.5% in 2004 to 2.2% in 2010 Budget, as illustrated in **Figure 17**) and as a share of consolidated spending (from 1.7% in 2005 to 6.3% in the 2010 actual spending for January-October). Child Care benefits – which actually also represent cash transfers – have also increased (although this trend is less visible given their comparatively small size). Spending on social privileges slightly decreased, but remain at the level of about 1% of GDP. The gradual expansion of social transfers illustrates the general movement of Ukraine's public finance towards social expenditures, described earlier.

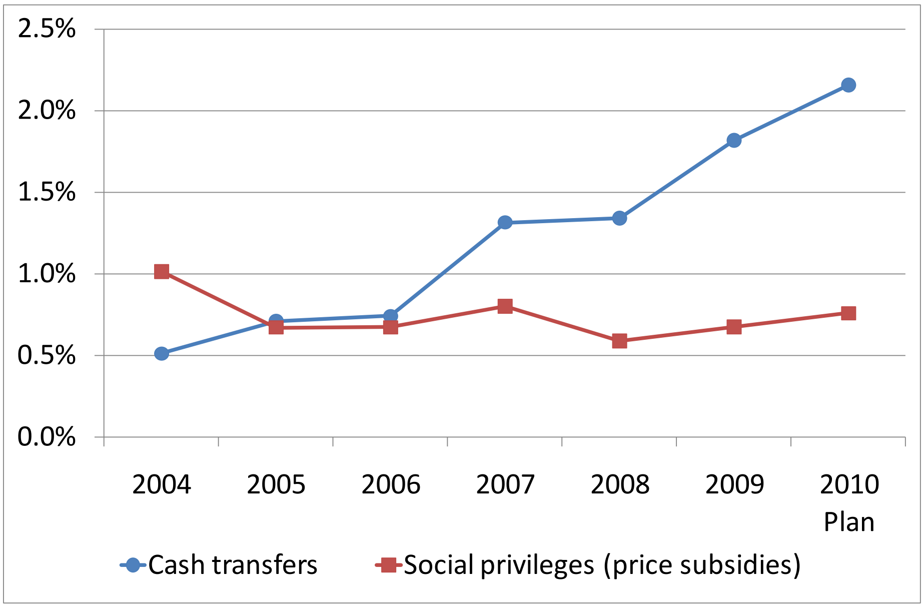
TABLE 7. SOCIAL ASSISTANCE SPENDING FROM LOCAL BUDGETS IN 2004-2010

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 Plan | 2010 (Jan - Oct) |
|---|---|---|---|---|---|---|---|---|
| **Nominal Allocations (in UAH mln)** | | | | | | | | |
| **Eamarked transfer for social assistance: TOTAL** | **5,255** | **6,145** | **7,687** | **15,309** | **18,406** | **22,949** | **31,830** | **23,901** |
| Cash transfers | 1,761 | 3,137 | 4,028 | 9,469 | 12,718 | 16,620 | 23,350 | 18,624 |
| Social privileges (price subsidies) | 3,494 | 2,955 | 3,652 | 5,771 | 5,562 | 6,172 | 8,204 | 5,081 |
| Child care benefits (incl. 'Money Follows the Child") | 0 | 0 | 6 | 68 | 126 | 156 | 275 | 195 |
| **Allocations as % of Total Consolidated Budget Expenditures** | | | | | | | | |
| **Eamarked transfer for social assistance: TOTAL** | **5.2%** | **4.3%** | **4.4%** | **6.8%** | **6.0%** | **7.5%** | **8.0%** | **8.1%** |
| Cash transfers | 1.7% | 2.2% | 2.3% | 4.2% | 4.1% | 5.4% | 5.9% | 6.3% |
| Social privileges (price subsidies) | 3.4% | 2.1% | 2.1% | 2.6% | 1.8% | 2.0% | 2.1% | 1.7% |
| Child care benefits (incl. 'Money Follows the Child") | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.1% | 0.1% | 0.1% |
| **Allocations as % of GDP** | | | | | | | | |
| **Eamarked transfer for social assistance: TOTAL** | **1.5%** | **1.4%** | **1.4%** | **2.1%** | **1.9%** | **2.5%** | **2.9%** | n/a |
| Cash transfers | 0.5% | 0.7% | 0.7% | 1.3% | 1.3% | 1.8% | 2.2% | n/a |
| Social privileges (price subsidies) | 1.0% | 0.7% | 0.7% | 0.8% | 0.6% | 0.7% | 0.8% | n/a |
| Child care benefits (incl. 'Money Follows the Child") | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | n/a |

Source: State Treasury of Ukraine

**Breaking down cash transfers statistics based on publicly available data seems impossible.** Notably, cash transfers – which are the fastest growing social assistance item in Ukraine's budget – are reported as a single line in the budget execution reports (apart form child care benefits), and therefore are difficult to analyse in more detail based on publicly available information.

FIGURE 17. CASH TRANSFERS AND SOCIAL BENEFITS AS % OF GDP IN 2004-2010




Source: State Treasury of Ukraine

## Budget-funded Social Assistance: cash transfers

### Categorical versus means-tested

**Cash transfers include categorical, means-tested and combined types of programmes.** **TABLE 10** shows that most cash benefits are categorical (provided to specified categories of eligible recipients), and only a few programmes – cash support to low income families, social assistance to citizens who are not eligible to receive pensions and to disabled (including support to their caregivers), as well as child-raising allowance – include a means test.

**The size and share of categorical programmes is growing, while importance of means-testing is declining.** The recent considerable increase in cash transfers is explained exclusively by the growth of categorical benefits (and a moderate growth of combined transfers), while means-tested programmes actually decreased, both in nominal terms and as a % of GDP. **TABLE 8** summarises available data on the amounts of cash transfers administered from Ukraine's budget over 2005-2008[6]. The programmes which have grown considerably during this period are categorical, while means-tested benefits decreased not only as a share of total cash transfers (**FIGURE 18**), but also in absolute terms (**FIGURE 17**).

**At the same time, targeting of both types of cash benefits is relatively strong.** Unlike non-monetary types of budget-funded assistance (price subsidies and tax allowances), cash transfers have been rather efficient in terms of targeting families in need. Coverage of households by each type of these transfers was strongly increasing with the decreasing household incomes: the lowest income deciles had received the biggest shares and the highest income deciles have received the smallest share (see **TABLE 9** and **FIGURE 20**). The most efficient programme is social assistance to low income families, which does go to the poorest, and indicates that means-testing methodologies which are currently in use allow rather strong targeting and could be extended further.

TABLE 8. SOCIAL ASSISTANCE CASH BENEFITS IN UKRAINE IN 2005-2008 (UAH THOUSAND)

| Means tested or categorical? | Type of benefit | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| Means-tested | Support Low Income Families (GIS) | 1,208,477 | 1,047,650 | 822,824 | 1,012,562 |
| Means-tested | Benefits for ineligible to pensions | | | 1,585 | 9,566 |
| Means-tested | Support to care givers | | | 15 | 42 |
| Means-tested | Support to care givers for mentally disabled | 17,134 | 10,908 | 10,001 | 8,861 |
| Combined | Child Raising Allowance | 643,267 | 734,515 | 1,607,726 | 2,177,176 |
| Categorical | Birth Grant | 517,720 | 1,355,452 | 3,786,792 | 5,671,991 |
| Categorical | Maternity Benefits for Uninsured Women | 98,369 | 115,636 | 137,352 | 187,035 |
| Categorical | Child Guardinaship Allowance | 86,887 | 185,777 | 243,705 | 295,236 |
| Categorical | Temporary aid if parents avoid alimony | | 40,543 | 90,278 | 123,993 |
| Categorical | Benefits to disabled from childhood | 213,937 | 561,604 | 1,153,287 | 1,933,733 |
| | **Total Mean-tested** | **1,225,611** | **1,058,558** | **834,425** | **1,031,031** |
| | **Total Combined** | **643,267** | **734,515** | **1,607,726** | **2,177,176** |
| | **Total Categorical** | **916,913** | **2,259,012** | **5,411,414** | **8,211,988** |

Source: Calculations based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

[6] Unfortunately, data for later periods is not available since such expenditure breakdown is not provided in regular Treasury Budget Execution reports. The data in the table, sourced from the MoLSP, were quoted in the World Bank report.

FIGURE 18. INCREASING SHARE OF CATEGORICAL CASH-TRANSFERS COMPARED TO MEANS-TESTED PROGRAMMES

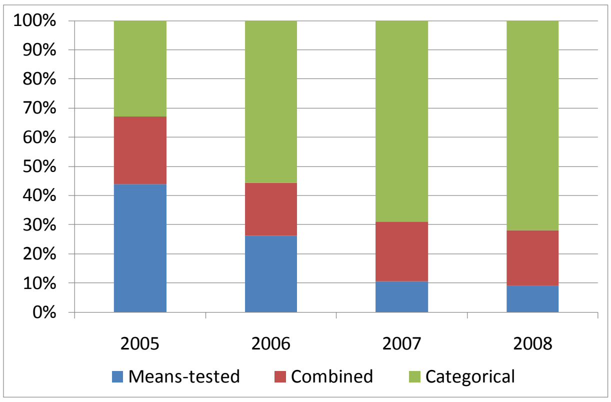
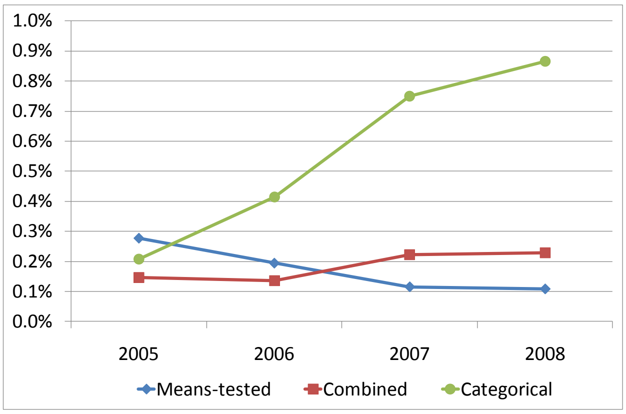



FIGURE 19. CASH TRANSFERS AS % OF GDP



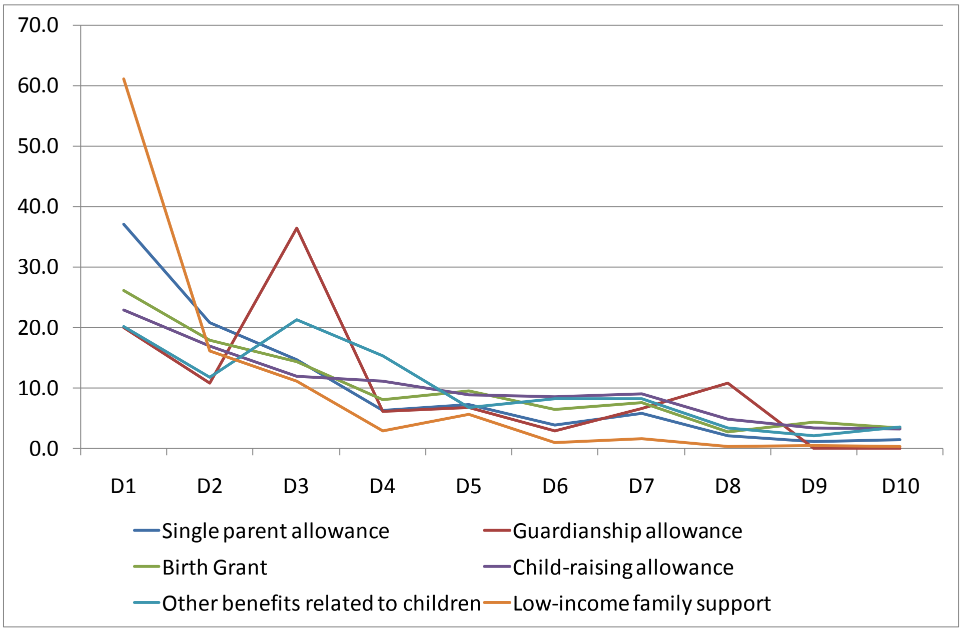

Source: Calculations based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

TABLE 9. CASH TRANSFER COVERAGE BY INCOME DECILES

| | Total | Income deciles (without respective benefit) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | D1 | D2 | D3 | D4 | D5 | D6 | D7 | D8 | D9 | D10 |
| Single parent allowance | 100.0 | 37.0 | 20.8 | 14.7 | 6.2 | 7.2 | 3.8 | 5.7 | 2.1 | 1.1 | 1.4 |
| Guardianship allowance | 100.0 | 19.9 | 10.7 | 36.4 | 6.1 | 6.8 | 2.9 | 6.5 | 10.8 | 0.0 | 0.0 |
| Birth Grant | 100.0 | 26.1 | 17.8 | 14.3 | 8.1 | 9.5 | 6.4 | 7.5 | 2.7 | 4.3 | 3.3 |
| Child-raising allowance | 100.0 | 22.8 | 16.9 | 11.9 | 11.1 | 8.8 | 8.4 | 8.9 | 4.8 | 3.3 | 3.1 |
| Other benefits related to children | 100.0 | 20.0 | 11.7 | 21.2 | 15.3 | 6.6 | 8.2 | 8.1 | 3.4 | 1.9 | 3.5 |
| Low-income family support | 100.0 | 61.0 | 16.1 | 11.1 | 2.8 | 5.6 | 0.9 | 1.5 | 0.3 | 0.4 | 0.3 |

Source: based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

FIGURE 20. CASH TRANSFER COVERAGE BY INCOME DECILES




Source: based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

## Types of benefits and regulatory details

**Social assistance transfers, summarised in TABLE 10, are defined by a complex fragmented legislation.** Direct cash support funded through this programme includes a range of benefits, described in **TABLE 10**. As the table shows, each of the benefit is regulated by a separate national law (or government's resolution), although many categories of recipients are eligible to a number of various benefits, some of which are mutually exclusive, which makes overall regulatory framework rather complex and burdensome. Notably, some of the legislation was changing during 2009-2010, with one amendment – the increase in the amount of birth grant – to become effective next year.

TABLE 10. OVERVIEW OF SOCIAL ASSISTANCE CASH BENEFITS (ADMINISTERED THROUGH EARMARKED TRANSFER)

| Type of Cash Benefit | Eligibility | Amount |
|---|---|---|
| **Categorical benefits** | | |
| **Maternity and Childbirth benefits for those who are not insured in by Temporary Disability Fund** **(«Виплата допомоги по вагітності та пологах»)** | Women (or people adopting children) who are not insured in by Temporary Disability Fund | 100% of a person's average monthly income but no less than 25% of monthly subsistence level for people of active age. (Article 9, (Verkhovna Rada of Ukraine 1992). |
| **Birth grant[7]** **(«Допомога при народженні дитини»)** | One of parents (or foster parent, guardian, grandparent or other) | – 1st child: 22 child subsistence minimums[8] (= UAH 17 578)<br>– 2nd child: 45 child subsistence minimums; (=UAH 35 975)<br>– 3rd and each subsequent child: 90 child subsistence minimums; (=UAH 71 910)<br>(Article 12 in edition to become effective on 1 January 2011, (Verkhovna Rada of Ukraine 1992) |
| **Adoption grant** **(«Допомога при усиновленні дитини»)** | A person adopting the child (or children) (in case the child is adopted by a couple, one of them based on their choice) | The same amount as Birth Grant for the first child (22 child subsistence minimums9 (= UAH 17 578)). In case of adopting more than one child: same amount for each child.<br>(Article 12-3, (Verkhovna Rada of Ukraine 1992) |
| **Child-raising allowance** **«Допомога по догляду за дитиною до досягнення нею трьохрічного віку»** | One of the parents (or foster parent, guardian, grandparent or other) who actually takes care of the child, for each child of 0-3 years | Difference between the subsistence minimum for able to<br>work persons and average monthly income of the family for the previous 6 months, but no less than UAH 130<br>(Article 15, (Verkhovna Rada of Ukraine 1992) |

[7] Indicated amounts are those which will be effective from 1 January 2011 in accordance with legislative amendments approved in 2009. The change will link birth grant amounts to subsistence minimum (earlier, it was fixed in UAH). Indicative UAH amounts for this benefit in the table are provided based on the 2010 subsistence minimum levels, but these are likely to be revised in the next year's budget.

[8] Subsistence minimum for children under 6 years old.

[9] Subsistence minimum for children under 6 years old.

| | | |
|---|---|---|
| **Single parent allowance («Допомога на дітей одиноким матерям»)** | Single mothers who are not married; single persons adopting children; divorced widows or widowers. Benefits are provided for each child. | Difference between 50% of the subsistence minimum for children of the respective age category and average monthly family's income per person for preceding 6 months, but no less than 30% of the subsistence minimum.<br>(Article 18-3, (Verkhovna Rada of Ukraine 1992) |
| **Benefit for children under Guardianship («Допомога на дітей, над якими встановлено опіку чи піклування»)** | Guardians of children | Two subsistence minimum for children of respective age. If the child is eligible to any state pensions, stipend or alimony, the benefit is reduced by their amount.<br>(Article 18, (Verkhovna Rada of Ukraine 1992) |
| **Temporary support for children, whose parents avoid paying alimony, do not have means to raise the child or whose location is unknown («Тимчасова допомога дітям, батьки яких ухиляються від сплати аліментів, не мають можливості утримувати дитину або місце проживання яких невідоме»).** | Children, whose parents avoid paying alimony, have no possibility to support a child or if their place of residence is unknown.<br><br>Applications for this benefit should be renewed every 6 months. | 30% of the subsistence minimum for children of respective age category<br>Paid via a specially appointed bank or post office.<br>(Article 8 (Cabinet of Ministers of Ukraine 2006)) |
| **Support to people disabled from childhood and to disabled children (plus allowance to their care-givers and funeral allowance in case of their death)**<br><br>**(«Допомога інвалідам з дитинства та дітям-інвалідам, надбавка на догляд за ними, виплата допомоги на поховання»)** | Children aged 0-18 years with disability; individuals over 18 years, who 0061re disabled from childhood. | Calculated based on "subsistence minimum for persons, who have lost ability to work":<br>– Disabled from childhood of the I group – 100% of subsistence minimum (plus allowance to their care-givers at 50% of subsistence minimum)<br>– Disabled from childhood of the II group – 80% of subsistence minimum; (plus allowance to their care-givers at 15% of subsistence minimum)<br>– Disabled from childhood of the III group – 60% of subsistence minimum (plus allowance to their care-givers at 15% of subsistence minimum);<br>– Children aged 0-18 years with disability – 70% of subsistence minimum (plus allowance to their care-givers at 50% of subsistence minimum for children of respective age).<br><br>Benefit sharing rules for cases when respective persons live full time in residential institutions:<br>– Adults disabled from childhood: 25% goes to the disabled person; the rest |

| | | |
|---|---|---|
| | | to institution;<br>– Disabled orphans: full amount of benefits goes to their personal bank accounts;<br>– Other disabled children: 50% goes to their personal bank accounts; the rest goes to the institutions but “should be spent exclusively on improvement of living conditions for these children”.<br><br>Funeral allowance equals to two monthly social benefits.<br><br>(Article 13-15, (Verkhovna Rada of Ukraine 2000) |
| **Combined approach** | | |
| **Support to individuals, who are not eligible for pension, and for disabled persons (plus allowance to their care-givers) («Соціальна допомога особам, які не мають права на пенсію, та інвалідам; Державна соціальна допомога на догляд за ними»).** | Citizens of Ukraine, for whom all of the following is true:<br>– They reached the age of 63 (for men) and 58 (for women) and are not eligible to receive pensions OR are disabled (any age);<br>– do not receive support from Occupational Injuries fund;<br>– have low income.<br><br>(Article 4, (Verkhovna Rada of Ukraine 2004)) | Calculated based on “subsistence minimum for persons, who have lost ability to work”:<br>– For disabled of the I group and women classified as “heroic mothers” (>3 children) – 100% of subsistence minimum;<br>– For disabled of the II group – 80% of subsistence minimum;<br>– For disabled of the II group – 60% of subsistence minimum;<br>– For persons with formally recognised careers in religious organisations – 50% of subsistence minimum;<br>– For disabled persons who are also older than the age of 63 (for men) and 58 (for women) – 30% of subsistence minimum.<br>Selected categories of persons eligible for this type of benefit (listed in the law) also qualify to entitle their care-givers to receive monetary allowance in a size of 15-50% of subsistence minimum. (Article 7-9, (Verkhovna Rada of Ukraine 2004)). |
| **Means-tested approach** | | |
| **Allowance to families with low-income**<br><br>Note: The national law allows local governments to establish additional benefits to low-income families at the cost of local budgets. | Families (including single persons) whose joint average monthly income during 6 months before application is below a “family-subsistence minimum”, defined as a combination of subsistence minimums defined for population categories which correspond to members of this family. | Difference between the “family-subsistence minimum” and the joint average income of this family, calculated based on a methodology defined by an executive authority. The calculated amount should not exceed 75% of the family-subsistence minimum.<br>(Article 5, (Verkhovna Rada of Ukraine 2000)). |

## Budget-funded Social Assistance: Expenditure Privileges

**Overall system of privileges is fragmented, complex, and opaque.** A significant share of the social assistance spending consists of costs incurred as a result of expenditure privileges – rights given by the national legislature to certain individuals to receive services and/or goods at discounted prices. These privileges are also frequently called social and occupational, based on the policy intent behind these programmes. The World Bank had broadly defined four categories of target population covered by the existing system of privileges(World Bank September 2006):

- Those who earned a distinguished status by some positive contributions to the society in the past (e.g. war veterans);
- Those whose occupations are considered to be making positive contributions to the society at present (e.g. judges);
- Those exposed to social risks such as poverty, illness or child-specific risks (such as lack of parental care);
- Those who have sustained damage or losses in the past (e.g. Chornobyl victims).

**Overall totality of privileges is regulated by a fragmented and complex legislation without a clear and coherent policy to explain societal merits of providing respective privileges and their efficiency as opposed to alternative means of support.** Moreover, non-monetary nature and institutional fragmentation of this instrument makes it extremely difficult to assess, analyse and regulate.

**Expenditure privileges equal to about 1.6% of GDP, of which 0.8% are housing and utility subsidies to low-income population.** The World Bank estimates that approximate overall size of expenditure privileges was around 1.6% of GDP in 2006. At the time, the key privilege programmes included discounted pricing for the 13 programmes services and target populations outlined in **Table 11**. As discussed in earlier sections, around 1% of GDP (0.8% in 2010) of this amount was represented by housing and utility subsidies to low income groups funded through earmarked subvention to local budgets, discussed further in this section. Exact mechanisms of funding of other privileges are not covered by this paper.

Table 11. Types of Privileges and Budget Allocation in 2006 (UAH mln)

| Privileges by type of services | Special Merit Based | Social Characteristics Based | Occupation Based | Total |
|---|---|---|---|---|
| Housing and utility services | - | 2,907.3 | 565.3 | 3,472.6 |
| Communication services, installation of telephone and security and alarm system | - | 179.2 | 1.5 | 180.7 |
| Public transport and baggage handling | 21.9 | 549.7 | 181.8 | 753.4 |
| Prescription medicines | 192.4 | 70.4 | - | 262.8 |
| Dental treatment and prosthesis | - | 174.6 | - | 174.6 |
| Sanatorium treatment | 5.7 | 1,112.3 | 128.2 | 1,246.2 |
| Cars to drivers with disabilities | - | 84.4 | - | 84.4 |
| Dwelling repairs | - | 13.1 | - | 13.1 |
| Preferential/subsidized credits and loans | 14.7 | - | 15.0 | 29.7 |
| Free/discounted purchase of food products | 1,445.4 | - | - | 1,445.4 |
| Compensations for special categories of individuals | 115.4 | - | 2.6 | 118.0 |
| Other | - | - | 52.0 | 52.0 |
| **Total** | **1,795.5** | **5,091.0** | **946.4** | **7,832.9** |

Source: Research paper on "Analysis of special privileges in Ukraine" by Nechai, A., quoted in the WB Public Finance Review (World Bank September 2006)

**Specific price-subsidies available for families with children (apart from housing and utility services) are listed below:**

- 50% discount for low income families for nutrition and accommodation in public preschool / internat facilities;
- Free nutrition for children from low income families in secondary schools;
- Free education for children from low income families in public schools of esthetic education.

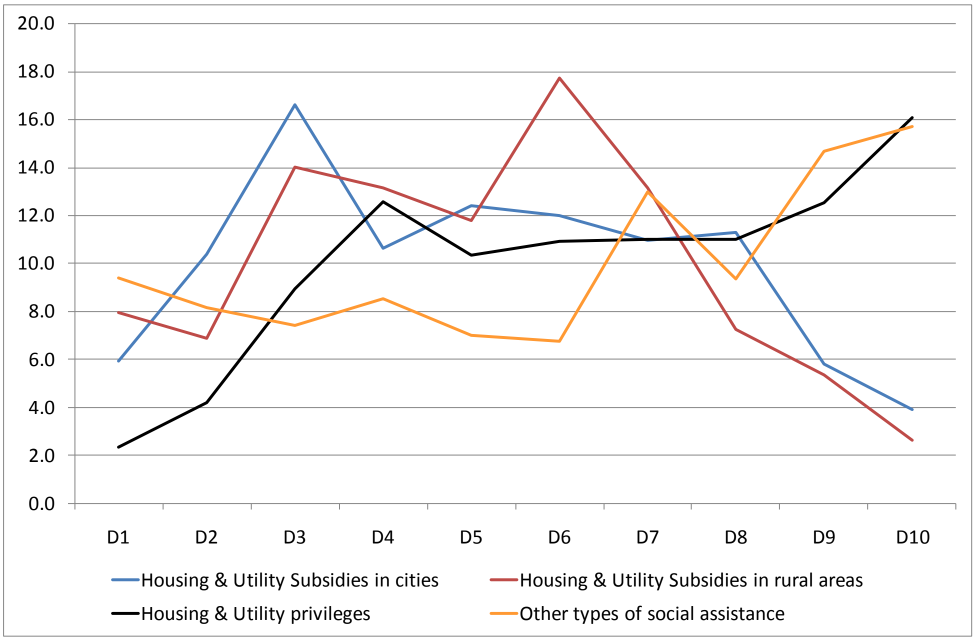
**Housing and utility subsidies are extremely inefficient and often benefit the rich more than the poor.** The size of housing and utility subsidies provided via earmarked subvention through the local budgets has remained relatively stable but rather significant over the last year (as was illustrated in **Table 6** on page 10 and **Figure 18** on page 34). However, these programmes are widely recognised as extremely inefficient because of their poor targeting and distortive because of their non-monetary nature. In particular, out of all spending on housing and utilities privileges, the biggest share (16.1%) is provided to population in the richest income decile (**Table 12**). Overall distribution of these programmes across income deciles is illustrated in **Figure 21**, which shows a complete absence of pro-poor focus and the fact that many programmes actually benefit the rich more than the poor.

Table 12. Social Privileges and Price Subsidies Coverage by Income Deciles

| | Total | Income deciles (without respective benefit) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | D1 | D2 | D3 | D4 | D5 | D6 | D7 | D8 | D9 | D10 |
| Housing & Utility Subsidies in cities | 100.0 | 5.9 | 10.4 | 16.6 | 10.6 | 12.4 | 12.0 | 11.0 | 11.3 | 5.8 | 3.9 |
| Housing & Utility Subsidies in rural areas | 100.0 | 8.0 | 6.9 | 14.0 | 13.2 | 11.8 | 17.7 | 13.2 | 7.3 | 5.3 | 2.6 |
| Housing & Utility privileges | 100.0 | 2.3 | 4.2 | 9.0 | 12.6 | 10.4 | 10.9 | 11.0 | 11.0 | 12.5 | 16.1 |
| Other types of social assistance | 100.0 | 9.4 | 8.1 | 7.4 | 8.5 | 7.0 | 6.8 | 13.0 | 9.4 | 14.7 | 15.7 |

Source: based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

Figure 21. Social privileges and price subsidies coverage by income deciles




Source: based on MoLSP data quoted in the WB report on ways to improve social assistance targeting in Ukraine (World Bank 2008/2009)

## Social services for vulnerable children

**Ukraine's overall system of social services suffers from a number of weaknesses, which make it extremely cost-inefficient.** One of such inefficient aspects is domination of residential services by large, state providers. Ukrainian government and non-state actors have jointly recognised this problem in 2003, with the approval of a framework law "On Social Services", which sets strategic benchmarks for reform. Actual implementation of these strategic reforms since 2003 has been problematic because of the scale of policy coordination which is needed to achieve tangible change (including alignment of administrative and financial responsibilities between levels of government, alignment of policy responsibilities fragmented between line ministries, performance-based and long-term budgeting, competitive commissioning of services implying risks to current monopolistic providers, etc.). Despite the expectation of significant efficiency gains after the reform, its implementation requires additional fiscal space – especially in terms of potential recovery of the hidden demand for social services with expansion of their menu through voluntary and community care. Therefore, no immediate saving is expected for local governments from introduction of such alternative services.

### Poor alignment of responsibilities between line ministries

**Responsibilities for policy development and implementation in social service provision are fragmented across several central ministries.** At the moment, responsibilities for social services to vulnerable population groups are divided between several agencies, which makes it difficult to produce co-ordinated policies, but also to simply consolidate financial statistics to assess the size of public spending on this sector. The list of five ministries all of which share some administrative role in provision of services for children is provided in **Table 13**.

Table 13. Fragmentation of responsibilities for social services for children

| Ministry | Type of social service for children | Formal Ukrainian name of service |
|---|---|---|
| Ministry of Education and Science | Boarding schools for orphans and children without parental care | Школи-інтернати для дітей-сиріт та позбавлених батьківського піклування |
| | Special boarding schools | Спеціальні школи-інтернати |
| | Orphanages | Дитячі будинки |
| Ministry of Labour and Social Policy | Boarding houses for disabled children | Будинки-інтернати для дітей-інвалідів |
| | Centres for early social rehabilitation | Центри ранньої соціальної реабілітації |
| Ministry of Family, Youth and Sports | Family-type orphanages | Дитячі будинки сімейного типу |
| | Foster families | Прийомні сім'ї |
| | Shelters for Minors | Притулки для неповнолітніх |
| Ministry of Healthcare | Baby homes | Будинки дитини |
| Ministry of Internal Affairs | Juvenile prisons | Колонії для неповнолітніх |
| | Criminal Police in Children's Affairs | Кримінальна міліція у справах дітей |
| | Juvenile reception centres | Приймальники-розподільники для дітей |
| | Temporary placement facilities for foreigners and persons without citizenship illegally residing in Ukraine | Пункти тимчасового перебування іноземців та осіб без громадянства, які незаконно перебувають в Україні |

## Poor alignment of responsibilities between levels of government

**Most of the spending on social services in Ukraine is delegated to sub-national budgets.** This means that all respective services are financed by a local administration, but the central government compensates some of these costs with a financial transfer. Unlike social assistance (whose expenditures are "deconcentrated"), "delegated" funding assumes that local governments have some flexibility in utilising central funds provided for delegate programmes, in order to make sure that services are provided in ways which are most suitable for local conditions and are therefore most cost-efficient. In principle, the way it is achieved is through dividing a pool of funds across sub-national units based on objective criteria of their relative expenditure need (such as share of population residing on their territory), and providing local governments with sufficient administrative and regulatory autonomy to organise service provision in ways which utilises available funding in an optimal way.

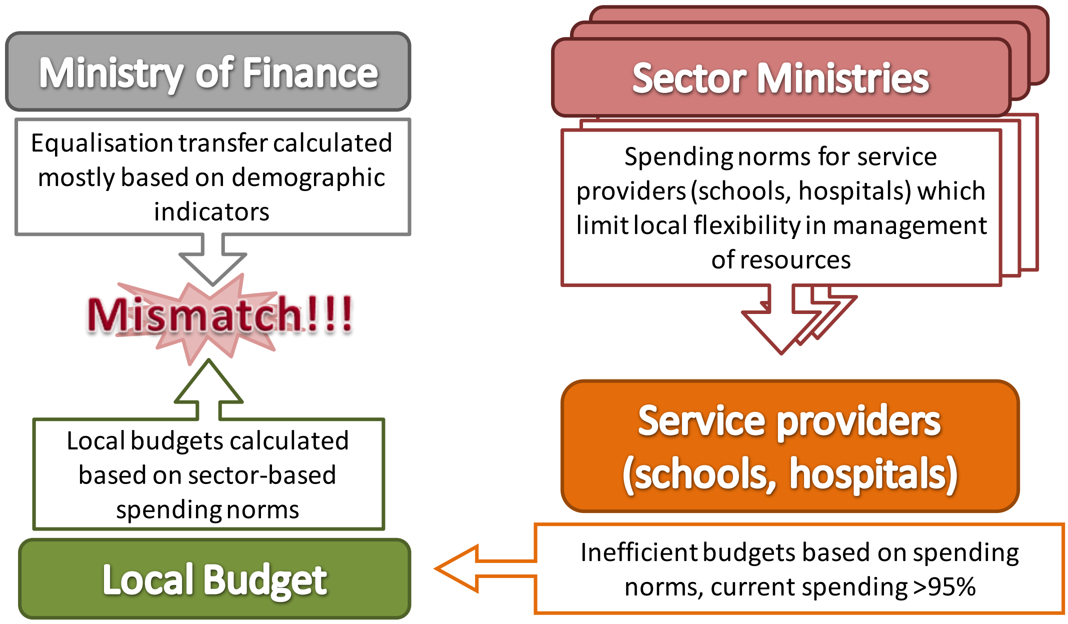
**The key spending units who administer the bulk of social service expenditures are local administrations (not line ministries).** According to Ukraine's Budget Code, this "delegated" arrangement is used for most expenditures in Education, Healthcare, Culture, Sports and Social Services to vulnerable groups: in 2008, combined spending on these functions was around 85% of local budget expenditures (World Bank February 2008). In Healthcare only, local expenditures in the 2010 budget represent 80% of total consolidated healthcare spending. One implication from this arrangement is that key spending units responsible for these programmes are respective sub-national administrations (rather than line ministries), and ministry-level spending statistics available at the central level is not suitable to assess local expenditures by type of institutions. While central ministries (who are themselves key spending units) do provide some services directly (via some central programmes), these expenditures are insignificant. For example, the MoLSP spends most of its budget on social assistance programmes (around 93% in 2005), another 6% on Research and Regulatory Activities, and only slightly less than 1% - on direct funding for two instutions and several national level service-providing NGOs (Joshua 2006).

**Delegated expenditures are covered by unconditional transfer of funds from the central budget.** According to a "delegated" principle, the central government estimates the amount of funds it is prepared to allocate to these combined delegated programmes, which is allocated to sub-national governments through a combination of shared revenues and an equalisation grant scheme. Equalisation transfers are unconditional: theoretically, they can be utilised for any of the delegated sub-programme (although there are numerous practical barriers to this rule).

**The system of intergovernmental funding of social services is inefficient in a number of ways, outlined below:**

- **Mismatch between financial and administrative responsibilities for social services delegated to local authorities, and resulting unfunded mandates on local budgets.** Local governments have very low discretion in allocating funds and administering respective programmes. Administrative decision-making (including facility-level budgeting) is subject to a rigid vertical structure of input norms, dictated by central line ministries (see **FIGURE 22**). One consequence is imposition on local governments of vertically protected recurrent spending, including half of the total public wages.

FIGURE 22. THE MISMATCH BETWEEN FINANCIAL AND ADMINISTRATIVE RESPONSIBILITIES AT THE LOCAL LEVEL

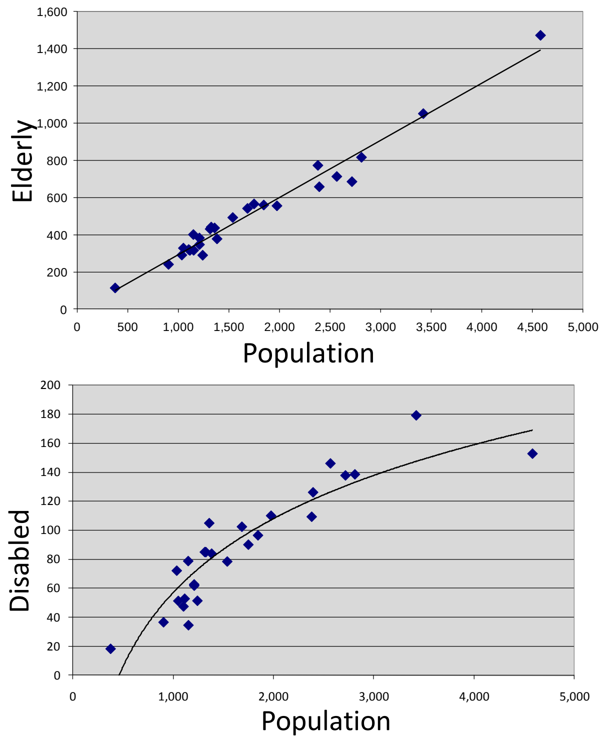



- **Financial incentives to residential provision of social services.** Some decisions on local approaches to service provision are also stimulated by incentives built in the transfer formula: although most variables in the formula are linked to demographic variables, some other variables still allocate funding based on existing infrastructure of service providers. In particular, the formula allocates funds for social care based on the number of clients registered with particular residential institutions, reinforcing their domination, because stimulates local governments to continue funding traditional residential providers, since re-allocating resources to alternative services would decrease respective equalisation transfer to such local budget.

- **Input-based equalisation formula for social services stimulates not only domination of residential institutions as service providers, but also creates considerable disproportions in service funding across oblasts.** Allocating funds based not on objective demographic indicators but based on already existing infrastructure (represented by the number of registered clients) means that oblasts receive funding which is proportional to their existing network of institutions, rather than objective demand.

  This problem is illustrated in **FIGURE 23** for social services for elderly and disabled: but entirely the same situation is observed in social for children since they are funded based on the same principle. The left side of the Figure shows that, on the one hand, proportion of elderly and disabled population is approximately the same in all oblasts. Each point on these two graphs on the left side represents the share of respective categories in overall population in each oblast. However, as illustrated by the table in right side of the Figure, oblasts with almost identical population sizes can receive very different amount of funding for social services for elderly and disabled (territorial centers and internats).

FIGURE 23. DISPROPORTIONS IN SOCIAL SERVICE FINANCING ACROSS OBLASTS




| Oblasts, paired based on similar population size | Population (2007) | Estimated expenditures for 2007, defined based on the number of registered clients: Territorial Centres | Inernats |
|---|---|---|---|
| Dnipropetrovska | 3,447 | 35,972 | 51,741 |
| Kharkivska | 2,829 | 48,716 | 48,053 |
| Lvivska | 2,577 | 46,634 | 26,811 |
| Luganska | 2,409 | 27,335 | 49,918 |
| AR Crimea | 1,984 | 36,930 | 26,831 |
| Zaporizka | 1,861 | 21,420 | 33,769 |
| Iv.-Frankivska | 1,389 | 18,104 | 15,546 |
| Khmelnytska | 1,373 | 34,055 | 25,178 |
| Cherkaska | 1,342 | 29,948 | 32,158 |
| Zhytomyrska | 1,330 | 15,086 | 39,873 |
| Sumska | 1,226 | 18,816 | 26,139 |
| Chernigivska | 1,168 | 34,334 | 28,371 |
| Khersonska | 1,127 | 15,512 | 23,087 |
| Volunska | 1,040 | 31,854 | 11,077 |

## Problems with policy-based budgeting and competitive commissioning of services

**Input (provider)-oriented allocation of funds for social services.** At the moment, most expenditures on social service provision are administered via sub-national administrations based on the existing network of service-providers. This arrangement is fundamentally different from an alternative financing principle, when the state acts as a service purchaser representing best interest of the vulnerable client, assessing the client's needs, and commissioning required services on competitive basis. Such "purchaser-provider" financing model is strongly recommended to increase allocative and financial efficiency of service provision.

## "Money follows the child" in Ukraine: new brand, old ways

**In 2006, Ukraine introduced a new benefit scheme for family-type orphanages and fostering, which was named as "Money Follows the Child" financing programme.** The programme was designed as a set of cash transfers to respective service providers (family-type orphanages and foster families), calculated on per child basis. In 2007, this programme was extended on an experimental pilot-basis (in Kyivska oblast) to include children without parental care place in the regular orphanages in this oblast. Overall size of the programme continuously increased over 2004-2010, both in absolute terms and as a percent of total social assistance related cash transfers (see TABLE 14).

TABLE 14. EARMARKED TRANSFER FROM THE STATE BUDGET TO LOCAL BUDGETS ON ON CASH BENEFITS BASED ON "MONEY FOLLOWS THE CHILD" PROGRAMME IN 2004-2010 (UAH MLN)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 Plan | 2010 (Jan - Oct) |
|---|---|---|---|---|---|---|---|---|
| Cash transfers based on "Money Follow the Child" scheme (national programme) | n/a | n/a | 6,122 | 56,961 | 109,112 | 156,048 | 275,086 | 195,105 |
| Cash transfers based on "Money Follow the Child" scheme (Kyivska oblast pilot) | | | n/a | 10,681 | 17,276 | n/a | n/a | n/a |
| **Cash transfers based on "Money Follow the Child" scheme total (as % of total cash transfers)** | **n/a** | **n/a** | **0.1%** | **0.4%** | **0.7%** | **0.7%** | **0.9%** | **0.8%** |

Source: State Treasury of Ukraine

**Ukraine's "Money follows the child" programme represents a regular categorical social assistance benefit and is not based on "money follows the client" funding principle.** In terms of its impact on social service funding system, it is structured as a classical "Money follows the provider" principle, since the money is allocated based on the type of provider (in this case, foster families and family-type orphanages), rather than through a competitive process of selection of an optimal type of care and most cost-efficient provider for a child (details about the difference between the two principles are provided in Annex 1 on page 49.)

## Problems with consolidation of fiscal data

**One complication resulting from the fragmented responsibility for social services is the difficulty to assess overall expenditures on this sector**. Since spending on the various institutions providing social services to children are reported under separate functional lines (Healthcare, Education etc) and since publicly available budget execution data by functions is not disaggregated by types of institutions / services, collecting data on these costs requires a specific effort and access to respective data sources.

**Although some pilot-level data exists for social services, extrapolating it to receive nation-wide estimates is not possible.** In 2004-2008, an attempt to collect expenditure data to assess the overall volume of spending on social services for vulnerable children was undertaken by the DFID at the level of two oblast-level pilots (in Kharkivska and Khmelnytska oblast). A sample of resulting information is provided in for 2002-2005 in **TABLE 15**, **TABLE 16**, and **TABLE 17** for Khmelnytska oblast. It shows that in this oblast, overall expenditures for social services varied very considerably during 2002-2005 as a % of consolidated oblast expenditures (the latest fiture, for 2005, was 12.8% of consolidated oblast spending). However, extrapolating this share to assess overall spending on social services at the national level is not possible given the highly disproportionate allocation of respective infrastructure. The pilot data also help to see that at least in the example of Khmelnytska oblast, residential institutions were highly dominant (taking up about 80% of all spending), although the share of expenditures on community-based services did gradually increase.

TABLE 15. TOTAL CONSOLIDATED EXPENDITURES ON RESIDENTIAL SOCIAL SERVICES IN KHMELNYTSKA OBLAST IN 2002-2005

| Types of Institution, Year, Expenditure, and (Unit Costs) | | | | | Expenditure Composition for Residential Services | | |
|---|---|---|---|---|---|---|---|
| **Residential Institutions** | **2002**<br>UAH | **2003**<br>UAH | **2004**<br>UAH | **2005**[43]<br>UAH | Actual expenditure in 2004 as % of annual total | Changes in the structure of actual expenditure 2004 vs 2003 as % of annual totals | Change in the structure of expenditure in 2004 (actual) with 2005 (planned) as % of annual totals |

[43] Figures on expenditures for 2005 are based on **planned** expenditures.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Orphaned children/Children without Parental care | 1,508,800 (6,035) | 2,035,000 (8,374) | 3,684,300 (12,119) | 5,635,400 | 7.8% | 0.7 | 0.1 |
| Children's Homes | 761,400 (7,147) | 1,077,500 (8,844) | 1,631,700 (10,527) | 2,478,200 | 3.5% | 0.2 | 0.1 |
| Children with Physical and Mental Disabilities | 8,581,900 (4,659) | 11,719,800 (6,338) | 12,539,700 (6,982) | 17,456,000 | 26.8% | - 0.6 | 0.0 |
| Baby Home | 1,324,500 (n/a) | 1,638,800 (n/a) | 1,758,200 (n/a) | 2,472,000 | 3.8% | - 0.1 | 0.0 |
| Disabled Minors | 661,000 (n/a) | 867,200 (n/a) | 949,200 (n/a) | 1,042,000 | 2.0% | - 0.0 | 0.0 |
| Shelters for Minors | 217,800 (7,778) | 279,800 (9,326) | 404,800 (13,958) | 584,600 | 0.9% | 0.0 | 0.0 |
| Elderly and Disabled | 10,307,600 (n/a) | 12,396,000 (n/a) | 14,381,000 (n/a) | 19,192,400 | 30.7% | 0.0 | 0.36 |
| Mental Health | 8,516,600 (6,018) | 9,771,100 (6,743) | 11,386,600 (8,047) | 17,840,000 | 26.4% | - 0.1 | 1.0 |
| **Total Expenditures** | **31,879,600** | **39,785,200** | **46,735,500** | **50,990,200** | **100.00%** | | |

TABLE 16. TOTAL CONSOLIDATED EXPENDITURES ON COMMUNITY-BASED SERVICES IN KHMELNYTSKA OBLAST (2002-2005)

| **Types of Organisation, Year, Expenditure, and (Unit Costs))** | | | | | **Expenditure Composition for Community-Based Service Agencies** | | |
|---|---|---|---|---|---|---|---|
| **Community-Based Service Agencies** | **2002** UAH | **2003** UAH | **2004** UAH | **2005**[46] UAH | Structure in % of actual expenditure on Community-Based Service Agencies in 2004 | Changes in the structure of actual expenditure 2004 vs 2003 expressed in % of annual totals | Change in the structure of expenditure in 2004 (actual) with 2005 (planned) expressed in % of annual totals |
| Centres of Social Services for Youth and Families | 384,600 (n/a) | 668,200 (n/a) | 833,900 (n/a) | 1,463,000 (n/a) | 9.0 | 2.1 | 1.67 |
| Territorial Centres and Divisions of Domiciliary Assistance | 3,881,800 (240) | 5,508,300 (173) | 7,594,000 (187) | 11,242,000 | 82.3 | - 6.6 | -0.3 |
| Early Rehabilitation Centres for Disabled Children[47] | 56,300 (605) | 604,700 (1579) | 792,200 (1204) | 1,003,000 | 8.6 | -1.1 | -1.29 |
| **Total** | **4,322,700** | **6,196,500** | **9,220,100** | **13,708,000** | **100.00%** | | |

[46] Figures on expenditures for 2005 are based on planned expenditures.

[47] This includes the early rehabilitation centre for children at the Central Rayon Hospital in Nova—Ushytsya rayon, two rehabilitation groups at the kindergartens in Vinkivtsi and Polonne rayons, and one rehabilitation group at the territorial centre for isolated and older people in Horodok rayon

TABLE 17. EXPENDITURES FOR RESIDENTIAL & COMMUNITY BASED SERVICES IN KHMELNYTSKA OBLAST IN 2002-2005

| **Year** / **Service Type** | **2002** UAH (% of total) | **2003** UAH (% of total | **2004** UAH (% of total) | **2005** UAH (% of total) | Changes in the structure of actual expenditure 2004 vs 2003 as % of total annual expenditure | Change in the structure of expenditure in 2004 (actual) with 2005 (planned) as % of total annual expenditure |
|---|---|---|---|---|---|---|
| All Residential Services | 31,879,600 (88.0) | 39,785,200 (86.5) | 46,735,500 (83.5) | 50,990,200 (78.8) | -3.0 | -4.7 |
| All Community Based Service Agencies | 4,322,700 (12.0) | 6,196,500 (13.5) | 9,220,100 (16.5) | 13,708,000 (21.2) | 3.0 | 4.7 |
| **TOTAL** | **36,202,300** | **45,981,700** | **55,955,600** | **64,698,200** | Change in actual expenditures 2004 vs 2003 (%) | Change in expenditures 2004 (actual) vs 2005 (planned) (%) |
| | | | | | 17.82 | 15.62 |
| Total Oblast Budget (General and Special) and (%) of total expenditure on social services | 132,695,600 (9.5) | 152,073,800 (30.2) | 412,370,300 (13.5) | 504,857,900 (12.8) | | |

## Healthcare spending

**Allocating healthcare resources is normally based on a set of complex social trade-offs.** Countries differ greatly in terms of their objectives and expectations with regard to health and healthcare. Since 2000, global debate on this matter had shifted away from a relatively simple focus on efficiency to a more complex debate which involves difficult trade-offs faced by each society in terms of the three generic elements of health systems (WHO 2000):

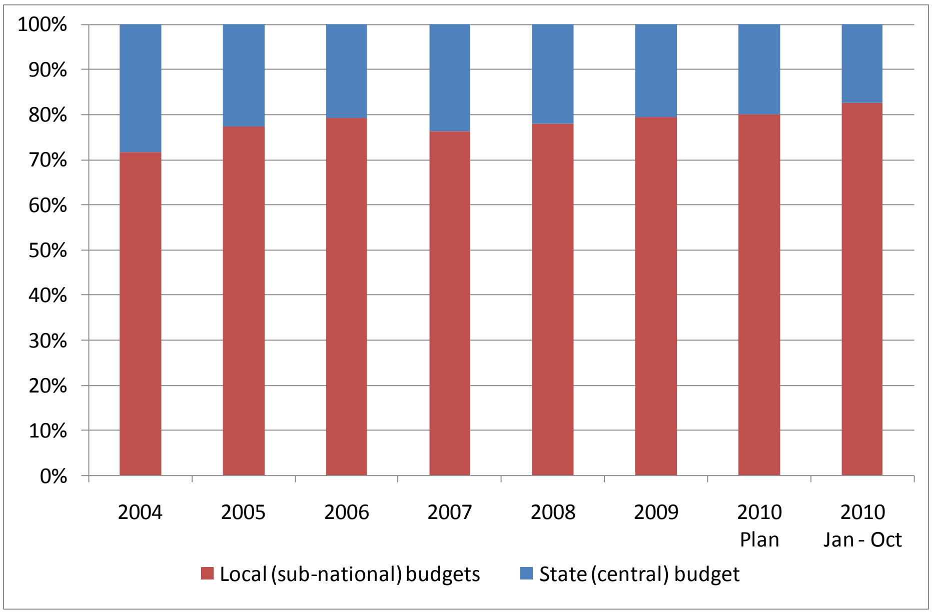
- Improving health and reducing health inequalities;
- Enhancing responsiveness “to the legitimate expectations of the population”; and
- Assuring fairness of financial distributions.

**These considerations influence the ways in which countries chose to allocate healthcare funds, through respective design of healthcare system administration, financing and oversight.** This section describes the choices made in terms of these trade-offs in the Ukrainian society, the key weaknesses of current arrangements and barriers to improvement and stronger health and equity outcomes for the population. In particular, it looks at the dominance of input-based budgeting (both in terms of intergovernmental and facility-level), with resulting barriers to clearer allocation of responsibilities for health outcomes across stakeholders, to stronger public health and prevention, and to effective treatment of non-communicable diseases, leading to rapidly deteriorating health outcomes. A major implication from this analysis – which concurs with the recommendations of the World Bank – is that in the area of healthcare Ukraine needs to start spending better before it starts spending more (including through any additional funding scheme such as mandatory social insurance).

### Input-based budgeting

**Healthcare is one of the key "delegated" functions, implying that the bulk of spending on this sector is allocated by the sub-national budgets.** As was shown in the **TABLE 5** on 22 and illustrated in **FIGURE 24** below, local governments remain key players in the public healthcare system, spending over 80% of its public budget.

FIGURE 24. CONSISTENTLY IMPORTANT ROLE OF SUB-NATIONAL BUDGETS IN HEALTHCARE SPENDING (2004-2010)




Source: State Treasury of Ukraine

**At the same time, just as it was discussed in the previous section on social services, at each stage of the resource allocation, the system is strongly conducive to budgeting which is based on a specified set of input norms, rather than expected outcomes of service provision.** This problem arises first at the stage of providing financial resources from the central budgets to local budgets to compensate for their healthcare spending, and then at the level of individual facilities.

**As in other delegated expenditures, there is a sharp mismatch between administrative and financial responsibilities allocated to local budgets in the area of healthcare.** On the one hand, Healthcare is one of the sectors which went through a progressive intergovernmental financing reform in 2001, which started to allocate equalization transfers to fund delegated expenditures based on demographic variables rather than based on existing infrastructure (such as number of hospital beds). This reform implied that allocation of finances across local budgets based on objective indicators of relative demand for services (such as share of population living in respective city, rayon or oblast) would lead to more cost-beneficial choices in organisation and provision of healthcare at sub-national level. However, despite these reforms, local administrations remained subject to very strict and detailed input-based norms established by the Ministry of Health, which indicate very exact numbers of staff, beds and other inpts which should be available in each facilitiy. Moreover, the reform left untouched the Constitutional prohibition to close Healthcare facilities (Article 49), which made it nearly impossible for local administrators to exercise the assumed flexibility in implementing delegated programmes. Other remaining regulations kept it very difficult for local authorities to fire medical personnel, which was possible only based on very complex rules established by the central ministry. This mismatch is illustrated by the **FIGURE 22** on page 42.

**Unfunded expenditure mandates on local budgets continue to increase.** Moreover, while expenditures on healthcare were delegated to sub-national levels, the central governments continued to impose new spending mandates such as national rules “protecting” numerous expenditure categories (including public wages and utility payments) and raising their standards. In practice, this implied that local authorities were forced to continuously expand current spending of their healthcare facilities and were essentially not able to introduce efficiency savings and invest into capital improvements and new technologies.

## Weaknesses in Healthcare delivery system

**Healthcare provision in Ukraine is dominated by the Government and managed through a centralised system under the Ministry of Health (MoH).** State providers are dominant players in the healthcare delivery system. They are managed through an extremely hierarchical structure, accountable to the line ministry as well as to sub-national administrations of respective levels (given their role in the system’s financing). Regulatory functions are tightly concentrated at the central level (with the MoH also being responsible for licensing of healthcare professionals and pharmaceutical manufacturers and distributors).(World Bank February 2008)

**Input-based budgeting leads to excessive and inefficient use of inputs.** Inefficient input-based norms result in excessive utilization of inputs, which, based on WB data (World Bank February 2008), are larger in Ukraine than in EU-10 and other EU countries. This relates to such inputs as number of hospitals (5.6 per per 100 000 in 2005 compared to 2.6 in EU-10) or hospital beds (868 beds per 100 000 people in Ukraine in 2005 compared to 644 in EU-10). Respectively, the system is heavily biased towards excessive, costly and counterprioductive specialisation and hospitalization. The average length of stay in hospitals in Ukraine 2005, based on the same source, was 15 days, compared to 9 days in EU average. Doctors are also inclined to specialise, and as a result primary care physicians comprise about a quarter of all doctors, while general practicioners represent less than 2% of all physicians.

# Annex 1. Input-based versus output-based financing in social services for children

## What is input-based financing, how it relates to "money follows the provider" principle, and why it is bad for children?

**Input-based allocation of funds in social services for children is rather typical for the region and is known as a principle of "money follows service provider"[10].** The essence of this terminological label is that the state agency, which acts simultaneously as a purchaser of services for the child and as a representative of the system of service provision, allocates available funds among already existing providers. In that sense, money is "following" these providers: allocation is based on already existing providers or already existing types of services. In other words, it is also "input-based", since the government allocates funds between already known set of possible "inputs". This approach to funding public services is simple and convenient, and was used in Western countries for a long time.[11]

**However, despite its simplicity and convenience, this approach also has a number of considerable downsides for the children:**

- When money follows providers, it does not leave an incentive for those who provide services to accurately evaluate current needs for services, and to search for the most effective and efficient way of providing them and of satisfying these needs. For any provider – not only residential – this approach does not create incentives to care for children better and more efficiently.
- When budgeting is based on inputs in relations between a funding agency and a service providing facility (for example, a residential care institution), it usually allocates resources based on expenditure norms for one client. This approach stimulates organisations to extend their client base or stops them from helping children to leave residential care for more flexible types of care.

**It is important to note that input-based budgeting maintains its benefits and downsides at any stage of resource allocation.** In other words, input-based budgeting happens just as well when central government allocates funds for child care across local budgeting based on existing infrastructure for service provision as when a state agency pays an orphanage in proportion to the number of "beds", "buildings" or "staff of defined categories".

## What is the essence of the alternative funding mechanism, where "money follows the client"?

**An opposite approach to the currently prevalent input-based budgeting through arrangement where "money follows providers" is a funding mechanism where "money follows the client", or, in a narrower case, the child.** Again, the fundamental difference between the two systems is in the sequence of decision making and in the roles played in the relations between the participants of the market for social service provision; that is, in the scenarios against which these relations unfold (described by the label of "routes" which money "follow").

**The essence of funding principle where money follows the client is in dividing the two key roles – the role of a purchaser and the role of the provider, leaving the role of "purchaser" to a government (funding) authority, and fully transferring the role of service provision to other organisations, which**

[10] Alternatively, this model is sometimes called "money follows the supplier" (see (Fox 2003)).

[11] See (Dzhygyr, "Money follows the child": more than family-type care 2006), (Dzhygyr, Applying unit cost indicators in social policy design and implementation: analysis of current situation and proposed points for action 2007)

**should compete with each other to receive a contract for service provision.** Such scheme creates a clear link of market relations between purchaser and provider. Moreover, the state authority, as a "purchaser", acts fully in the interest of the client (the child), and not in the interest of any provider. This state "purchaser" evaluates the needs of the child, investigates the best service options (e.g. care options) and purchases them on the market. This is why this mechanism is known as "money following the client", or, because of the clear distinction between the two roles, as a more commonly known "purchaser-provider" or "social commissioning" model.

**In other words, a purchaser-provider institutional arrangement is one of the dimensions of the transition to results-based financing; it is the institutional essence of how, practically, it could be possible to allocate resources based on expected outputs (not inputs).** A purchaser-provider setting helps to allocate resources to providers (or, indeed, to entire government tiers) not based on automatic financing of their declared needs (within limited budget envelopes), but based on agreed performance and results indicators. Such agreements (or contracts) can go into details about concrete line items of future expenses only in case, and only in size, in which this helps to achieve and control the result. Rigid line-item budgeting gives space to flexibility of using funds towards best results – at any level.

**This division gives space to resolving the problem of excessive residential care provision, which is to a large extent motivated by financial incentives to such providers to keep children in residential care.** When state representative acts as a care purchaser on behalf of the children, it opens possibilities for providing funds to residential institutions in sizes defined by entirely new principles. In the interest of the client, the state purchaser can set financing volumes for each provider not so much based on the arguments of what funds are needed to maintain this institution (including calculations based on the number of children served). Rather, such ceilings could be determined by the expected results for these children and the effectiveness of care of each provider. [12]

## What is the essence of reforms to introduce a new funding mechanism so that resources could follow the needs of the child, not residential providers?

**The essence of reforms which aim to achieve sustainable – not short-term and cosmetic – change in the provision of child care is to create an institutional setting which gives the state authority a role of service purchaser and which clearly distinguishes this role from the role of service provision.** In other words, introducing a funding mechanism where "money follows the child" implies primarily a structural change in the role of existing agents – rather than one-off reallocation of funds. Such structural changes should include, among other things, creating legal and operational basis for the existing authorities to take new roles, including clear statement of powers and responsibilities, clear instructions and help to engage in the new type of relations.

**Simply paying for some new family-based services does not bring sustainable change, or reform, for children, and could be very much input-based and systemically inefficient.** The fact that the input-based "money follows providers" model is usually oriented towards state-owned residential institutions does not at all exclude the fact, that the same model is often used to fund (rather automatically and inefficiently) some alternative care services, including private providers such as foster families or family-type orphanages. This means that creation or support of family-type care providers – or any other alternative non-residential providers – as such – does not yet imply a change from input-based towards result-based budgeting, and introducing a model where "money" genuinely follows the child, and not care providers.

**On the other hand, purchaser-provider, or output-based budgeting, when the state pays for results, not infrastructure, helps to make all kinds of services more efficient, including residential**. Very often, especially at the initial stages of such reforms, state-owned residential providers continue, for some

[12] See (Dzhygyr, "Money follows the child": more than family-type care 2006), (Dzhygyr, Applying unit cost indicators in social policy design and implementation: analysis of current situation and proposed points for action 2007).

time, to dominate on the “market” of care services for children. However, in the “purchaser-provider” setting, they do not receive their financing directly and automatically. Instead, they are forced to compete for funds, and, respectively, to “sell” their services to the state “purchaser”, who in turn can chose the best and most efficient service for the client within the available funds.

## What are practical stages for introducing a new approach?

**Introducing service commissioning requires the government to solve four major tasks:**

- To design and introduce appropriate arrangements (legal, institutional, informational) for the state authorities to act as service purchasers (including clearly defined responsibility and incentives to defend interests of the children, not care providers). These arrangements – and the role of a “service purchaser” should include sufficient flexibility to choose between different options of care, and capacity to assess and compare their costs and benefits.
- To design and introduce funding tools and budget procedures for service commissioning at all levels;
- To design and introduce other necessary tools for the authority and providers to engage in “purchaser-provider” relations (contracts, pricing, tender procedures etc);
- To reform existing providers and to create conditions for new providers (including non-state) of non-residential care to enter the market.

## Alternative forms of care as communicating vessels (and why flexibility of choice is the key tool in results-based budgeting for children).

**The key aspect of acting as service purchaser is to be able to analyse relative benefits and costs of every type of care for the children (with varying needs!), and use this information as key guidance in decisions on how much to spend on every type of care.** Respectively, to engage in such role, the purchasing agency should not only be able to conduct such analysis, but also to be flexible in using alternative forms of care as communicating vessels: being capable to influence the sizes of all types of care, reducing or extending their shares through respective commissioning decisions, as needed.

**In the practice of more advanced European systems of care provision, this flexibility is known as a “balance of service provision” model and has remained a leading concept in social care reforms in recent decades.** The idea of this concept is to help the agency responsible for service provision to qualitatively define a balanced and most efficient composition of various services which should be available to clients, depending on what are the needs of these clients (what sub-groups with what vulnerabilities are present among those who need care).

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