

# VECTORS OF PUBLIC FINANCE IMPROVEMENT: GERMAN EXPERIENCE AND UKRAINIAN REALITIES (*BASED ON SEMINAR «MODERNIZATION OF THE PUBLIC FINANCE IN UKRAINE: CHALLENGES, OPPORTUNITIES AND LIMITATIONS OF FISCAL DECENTRALIZATION»<sup>1</sup>*)

**Hanna Kotina**  
PhD,  
Associate  
Professor

**Maryna Stepura**  
PhD,  
Associate  
Professor

SHEI «Kyiv  
National  
Economic  
University named  
after Vadym  
Hetman»

Rationally constructed system of public finances is an important tool for socio-economic development. Prudent and reasonable macrofinancial management puts largely on economic growth, stability and sustainability of the financial system, the impact of structural socio-economic reforms is essential for ensuring financial security and sustainable economic growth.

Recently Ukraine has made important progress in reforming and modernizing the public sector, including aspects of transparency, predictability and control over the public financial resources, launched decentralization reforms, changes in tax policy and government expenditures, reforming the public sector organizations and so on. However, the current transformation processes accompanied by increased risks of recession in the form of «prolonged» recession, the accumulation of a significant amount of public debt, that affecting the increase of financial system uncertainty and instability and medium-term recovery of the economy. Ensuring the successful functioning of the public sector in such conditions requires a synthesis

of international financial community reforms and the use of new tested methods and mechanisms of public financial management of developed economies. Relevant experience will contribute to the tools elaboration to identify potential threats and strengthening measures to avoid them, developing their own concept further modernization of public finances on the background of modern integration processes.

The Finance Department of Kyiv National Economic University named after Vadym Getman — the leading financial center of economic sciences in Ukraine — were carrying out the First International Seminar «Modernization of the Public Finance in Ukraine: Challenges, Opportunities and Limitations of Fiscal Decentralization» as the first step towards positive experience in public finance reforms and exchange results in this direction. Modern Ukrainian scientific school of public finances was created as a result of our activities in the 70's of the XXth century. Scientific achievements of the Chair of Finance are remarkable and are recognized both in Ukraine and abroad.<sup>2</sup>

**ТЕОРИЯ**

<sup>1</sup> Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - 84 p.

<sup>2</sup> Fedosov V., Oparin V. Modern Ukrainian scientific school of public finance // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 4.

The scientific event was held in April 2016 in cooperation with University of Bremen (Germany) and the German University of Administrative Sciences, Speyer (Germany) with support from the Konrad Adenauer Foundation in Ukraine aimed to discuss the results of public finance researches in Ukraine, the positive experience of fiscal federalism reforms and the effects of public-private partnership in Germany.

The scientists outlined the alternative idea of modernizing the public sector in Ukraine and Germany, given the existing opportunities, vectors of improvement and reforms consequences. Scientific discussion focused on the current problems of the public sector and its relationship with the financial system and socio-economic development. In particular, national and international researchers were interested in the following issues:

**1. *The structure of national wealth, its creation and use, as determinants of financial development.*** Professor I. Bobukh<sup>3</sup> in her research noted that national wealth (NW) is the potential of economic development of countries, determinant of economic growth. The nature of the interconnection between financial development and economic growth is complex and controversial, but the indisputable fact is that the financial aspects of the formation and use of National Wealth play an important role in creating the basis for a new quality of economic growth and financial development of countries. In addition to volume and structure of National Wealth, the determinants of financial development are its rational use and the improvement process of its formation. In Ukraine, the share of GDP and NW redistributed through the fiscal sector is quite

large, but the uses of accumulated funds do not facilitate creating the basis for economic growth and financial development. Reformatting require tax assets – financial, real estate, natural resources – and expenditure structure of these funds, which should be accompanied by the development of infrastructure, improvement of the business climate and other reforms implementing.

**2. *The development of public finances and civil society: the dialectic of relationship*** (Assoc. Prof. Gladchenko L.<sup>4</sup>). The development of democracy and civil society institutions has a strong influence on public finance and the quality of public financial management. Civil society in Ukraine started developing in the beginning of 1990s and has activated during the last couple of years. The common trend of public finance development demonstrates the drawbacks in government collaboration with civil society organizations. Government accountability in Ukraine is weak. Civil society still does not have efficient instruments of control and influence on politicians and bureaucracy. There are problems of trust and effective public dialog. Long-term ignorance of civil society interests caused weak fiscal effectiveness and had negative influence on public finance and domestic political situation.

Recently civil society organizations have started actively participate in the legislation process. Civil society development in Ukraine is expressed through the vast volunteer movement. In addition, collaboration between local authorities and local communities is able to ensure local governments accountability, proper choice of fiscal priorities, and contribute to the success of local governments' policy.

<sup>3</sup> Bobukh I. National wealth as a basis for financial development in Ukraine // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 42-46.

<sup>4</sup> Gladchenko L. Public finance on the way to a civil society: experience of Ukraine // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 52-55.

**3. The problem of budget expenditure optimization in Ukraine.** According to Prof. Paientko T.<sup>5</sup>, budget management is one of the main concerns of public finance for any country. The institutional asymmetry of expenditures is determined in Ukraine by three main reasons. The first is «the hand control» of budget fund redistribution which affects the overall dynamics of the expenditures. The second is the growth in the amount of financing social programs (to 2013) against the background of low GDP growth and a recession in the sector of non-financial corporations, meaning a lack of a basis of its own financial security in these processes. The third is growth of expenditures on public administration coupled with a low institutional capacity of public administration, so that the budget allocated is not used efficiently, resulting in minimal usefulness for the society.

There are three possible solutions to these problems. 1. Cut expenditures on public administration the level of developed countries. 2. Maintain a high level of public spending, including for public administration, and focus on enhancing the institutional capacity of public administration. 3. Gradually reduce budget expenditures for general government functions, improve institutional capacity of the public administration, control the growth of other budget expenditures to keep pace with GDP growth.

**4. The public-private partnership in different economies: the features, risks and prospects.** Prof. A. Knorr in his work «The potential for corruption in public private partnership: theoretical

aspects and some policy implications»<sup>6</sup> represented the German experience of public-private partnership (PPP), which in many cases supplement or replace the «traditional» governmental responsibility to provide and/or produce public services and infrastructure. These cooperation models are characterized by potentials for a – quantitative and qualitative – improvement due to increased efficiency, but also by shortcomings as their specific vulnerability for corruption.

The research conceptualizes from a theoretical viewpoint the vulnerability of PPP models for corruption against the backdrop of contract theory, principal-agent theory and transaction cost economics.

Several factors can be identified that help to control corruption – based on Becker and Stigler<sup>7</sup> (1974), the proper combination of monitoring and punishments. Overall, the specific vulnerability for corruption can be seen as inherent to the PPP system, and is therefore not easy to erase. The proposed measures to reduce the risk of corruption in the context of PPP implementation therefore can never eliminate corruption totally, but can increase the costs of corruption and/or lower its benefits; they might therefore reduce it in the long run, starting by changing the parameters of decision-making of individuals.

**5. Socio-economic effects of the tax system reform in Ukraine** (Prof. Tymchenko O., Assoc. Prof. Pyslytsya A. and Sybirianska Y.). According to Prof. Tymchenko O.<sup>8</sup> the tax reform of 2014-2015 didn't create the necessary conditions for the economic growth; the financial problems for government re-

<sup>5</sup> Paientko T. Budget expenditure optimization as affected by the institutional capacity of the state and the maturity of society // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 67-70.

<sup>6</sup> Knorr A., Schomaker R. The potential for corruption in public private partnerships – theoretical aspects and some policy implications // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 11-22.

<sup>7</sup> Becker, Gary S., and George J. Stigler. «Law Enforcement, Malfeasance, and Compensation of Enforcers.» Journal of Legal Studies 3 (1974), 1–18.

<sup>8</sup> Tymchenko O. Alternative ideas of Ukraine tax system reforming // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 80-82.

mained the same. That is why new ideas of tax reforming should be suggested. Professor summarize the main ideas of all their suggestions are: taxes do not reduce consumption and not disturb business activity in Ukraine; the tax burden is equally distributed between the taxpayers.

For the structure of the tax system, Assoc. Prof. Sybirianska Y.<sup>9</sup> indicates, The number of taxes has been constantly reduced from 41 before the Tax Code adoption (before 2010) to 11 since 2015. But it should be mentioned that the number of taxes has really been cut down only with the Tax Code adoption. As the result of the tax reform of 2015 the number of taxes actually was not reduced because most of taxes were combined but still continue to function as separate taxes. As the modern tax system of Ukraine and the tax systems of the EU post socialist countries are based on indirect taxes, namely VAT, this tax should remain dominant in Ukraine's tax system. The tendency when the personal income tax exceeds the tax on profit has to be preserved. But the PIT structure should be changed. The PIT rates on passive incomes should be higher than these on labour income Total tax burden on individuals' income has to be decreased. It will encourage the increase of the consumers demand and, as a result, the VAT returns will rise. The authors are unanimous that the part of green taxes and especially property tax should be raised. The share of property tax in the tax burden structure of Ukraine is too small, comparing with that of EU-11 countries (0.03% of GDP and 0.5% of GDP accordingly).

To continue their analysis, attention should be paid to the tax burden

distribution between different groups of taxpayers. It is important to focus ourselves on the large taxpayers. Large taxpayers play a powerful fiscal role in any country, including Ukraine. In Ukraine now there is, on the one hand - centralisation of the revenues, on the other - decentralisation of the fiscal service functions. Therefore, to promote real and not just declarative fiscal decentralization we should: a) increase the share of taxes that remain at the local level; b) expand the powers of the branches of large taxpayers regarding the possibility of independent decision-making<sup>10</sup>. These proposals are meant for a short period of time and are aimed at improving the conditions for economic growth.

**6. The problems of local governments financial capacity and a system of financial equalization in terms of fiscal decentralization** (Prof. Heinemann A., Buriachenko A., Assoc. Prof. Kotina H., Stepura M., Zhyber T., Ass. Prof. Volkovskyi E., assistant Aleksieieva N. and Tabakova T.)

Prof., Dr. A. Heinemann revealed German experience of local government and financial equalization, construction features, problems and future directions for reform of fiscal federalism models in his research «Cooperative Federalism and Fiscal Federalism Reforms in Germany: Lessons for Decentralized Systems».<sup>11</sup> The Professor concludes that the «Cooperative Federalism» can be justified because of many interdependences between the jurisdictions on several levels of government within the multilevel system. The German fiscal federalism scheme is dominated by the need of negotiations between the Federation and the *Länder*. In recent decades the German type

<sup>9</sup> Sybirianska Y. Tax system of Ukraine: previous reforms effects // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p.72-76.

<sup>10</sup> Pyslytsya A. Role of the large taxpayers in fiscal decentralization // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 70-72.

<sup>11</sup> Heinemann A. Cooperative Federalism and Fiscal Federalism Reforms in Germany: Lessons for Decentralized Systems // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 22-42.

of fiscal federalism has proved effective in practice. Nevertheless, jurisdictions need autonomous scopes of action to be less susceptible to developments in other jurisdictions and to tailor the public provision of public goods with respect to regional preferences. Therefore, an expansion of scopes of action for the German *Laender* is missing in the reform proposal (Abolition of the horizontal fiscal equalization among the *Laender*; Fiscal equalization of fiscal capacity differences among the *Laender* within the context apportionment of VAT revenue between the Federation and the *Laender*; Modification of General supplementary federal grant Modification of Supplementary federal grants for special needs, etc.).

Young scientists of Finance Department Tabakova T. Aleksieieva N.<sup>12</sup> presented the historical retrospective model of fiscal decentralization in another European country — France. The researchers pointed out that part of its official development assistance policy, France has been supporting decentralization and territorial governance processes for over thirty years. Although those processes have proved difficult to implement, they are still an issue of primary importance. However, the implementation of decentralization is not the merit of the modern generation. The important steps towards regional autonomy have been made in XVIII-XIX centuries. The existing accumulation of administrative units, distribution and dispersal of powers is often called «territorial milfoil». This organization is incomprehensible for citizens and nullifies the effectiveness of all public

activity areas. The territorial reform, which is now carried in France, aims to transform several hundreds of administrative units of the Republic for the purpose of reduction of public spending and better consideration of the needs of citizens.

Assoc. Prof. Kotina H. and Stepura M. revealed the content of the process of fiscal decentralization in Ukraine and specifics of the Ukrainian practice of financial equalization. Authors note that declared way of fiscal and political decentralization is absolutely justified in modern realities, but mostly government steps are not realizing its aim — increasing the fiscal autonomy of local governments and their ability to provide adequate social and economic development of regions. As can be clearly seen in 2015 observed deterioration in fiscal decentralization as revenue and expenditures. In this context, Assoc. Prof. Zhyber T. highlighted the problem of fiscal centralization, estimating Ukrainian practice of coal mines public funding and the possibility of avoiding ineffective region depending of central government expenditures. Author is sure, the satisfaction in special needs of the regions is one of the main conditions for successful fiscal decentralization.<sup>14</sup>

Ukrainian scientists (Prof. Buriachenko A.<sup>15</sup>, and Ass. Prof. Volkovskiy E.) argue that the increasing process of decentralization in public management particularly important becomes the question of evaluation of local government capacity to mobilize the budgetary resources, which helps to ensure the functioning and development of the

<sup>12</sup> Tabakova T., Aleksieieva N. Historical background of decentralization reform in France // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 22-42.

<sup>13</sup> Kotina H., Stepura M. Fiscal adjustment and financial equalization system in terms of fiscal decentralization in Ukraine // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 58-67.

<sup>14</sup> Zhyber T. Public expenditures at coal mines in Ukraine // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 55-58.

<sup>15</sup> Buriachenko A. The financial potential of local self-governments in Ukraine // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 46-49.

respective administrative-territorial unit<sup>16</sup>. The financial capacity of local government is determined the actual disparity of territories development, social-economic disproportions, significant regional differentiation, and ineffective financial potential management system.

Assoc. Prof. Kotina H. and Stepura M. prove that recent years, fiscal adjustment in Ukraine does not meet the needs of local government financial resources, given out their obligations; not based on the local financial needs; increases the dependence of local governments on intergovernmental transfers from the Central Budget. Low transparency of financial equalization mechanism has been the main obstacle for its effectiveness. Moreover, in recent years there has been the dominant system of budgets revenue equalization capacity. Equalization grant was predominant fiscal adjustment tool in the structure of intergovernmental transfers. Over the past two years there was introduced a new mechanism of fiscal adjustment in financial equalization — the horizontal equalization of tax revenue capacity (Two taxes - VAT and corporate income tax) of local budget as incentives exchange to build the revenue base balance system (principle 0,9-1,1). In addition, there was developed a number of measures to help unite local communities, the restructuring of their local revenues in terms of local taxes and fees and expansion of general fund local budgets revenues etc. Despite the progress done in improving of local budget capacity building in Ukraine, main challenges still remain: the legal framework does not ensure the sustainability of capacity development policies, the social standards of the services are still not developed in education and health treatment, ability to monitor the development of the local government finances is still weak, there are still many gaps in human resource capacity (especially in small size local government units like towns, villages, etc.).

According to researchers, economic development dynamics in big agglomerations will fasten migration processes from small villages and towns with limited growth potential. This implies the necessity of infrastructure investments in two directions: infrastructure buildup caused by urban population growth and actual infrastructural gaps liquidation. To balance this asymmetry the infrastructure building program and equal standards for urban and rural locations are to be set up. Consequently, further strengthening the financial foundations of local development requires an integrated approach and structural modifications to the delivery transfers mechanism, as well as strengthening the responsibility of all participants in the budget process.

Vice Chairman of the Organizing Committee, Head of the Finance Department V. Fedosov in his final speech stressed that attracting young scientists to consider a number of important issues about the realities, risks and prospects of public finance in Ukraine, Organizing Committee of Seminar intended to provide an opportunity to exchange experiences with German colleagues, get a lot of useful and valuable information, to agree to continue the series of similar international scientific events as an important condition for the development of national financial science and the step to integrate the national research community with the world.

PHOTO

<sup>16</sup> Volkovskiy E. The budgetary potential of self-governance in the capital of Ukraine – Kyiv city // Modernization of the Public Sector in the Ukraine: Opportunities, Challenges and Limitations of Fiscal Decentralization: Collection of Scientific Papers. Seminar, Kyiv, April 11-14, 2016 – K.: Agrar Media, 2016. - p. 49-52.