

SEQUENCING REFORM OF SUB-NATIONAL GOVERNMENT
BORROWING IN UKRAINE BASED ON REGIONAL
EXPERIENCE

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Abstract

The research discusses the municipal borrowing reform in Ukraine. Like other Central and Eastern European transitional countries, Ukraine has launched the reform in municipal borrowing. Sequencing is an important element of such reform: however, there is no literature available on sequencing reform in transition Central and Eastern European countries. The research uses the framework consisting of three groups of variables: a legal and regulatory framework, allocation of credit by risk and debt management capacity. In order to find an appropriate sequence for Ukraine, the research employs comparative method and case-studies of Russia, the Czech Republic, Poland and Romania. The research provides a sequence starting with reforms in regulatory framework. It suggests following two steps for the stage of legal and regulatory changes: adjusting macro environment and establishing the basic regulations on municipal borrowing. The research further reveals that introducing allocation of credit by risk and debt management capacity should be paid equal attention at second stage.

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Introduction

With the recent decentralization trend, local governments in transition countries are enjoying an increase in local policy-making and financial freedom. As the capacity to plan and implement capital improvements increases, local governments need diversified sources of finance. The local infrastructure is often in an appalling condition in transition countries and the need for additional finance is urgent and universal.

Ukraine shares the problems of transition countries, and its infrastructure investment needs are huge. A recent World Bank study (PFR 2006) estimates the total investment needs in Ukraine over the next ten years at USD 100 billion. The majority of these investments are supposed to be spent at the local level. According to the National Programme of Housing-Municipal Sector Reform and Development, total investment requirements in the municipal sector equals to USD 7 billion over the 2002 – 2010 period (DANCEE¹ 2004: 1). The main components of the National Programme include upgrading of housing municipal assets (32%); development and rehabilitation of water and wastewater facilities (20%); energy saving (13%); renovation and development of municipal electric transport (9%); and development and rehabilitation of heating supply facilities (8%) (Noel 2006a: 6).

The most practical and urgent local problems which are constantly on the agenda are roads condition, school assets, water and sanitation facilities, sewage for the emerging suburbs of big cities. Citizens' constant complaints about these problems decrease their trust in the authorities and diminish taxpayers' discipline. Two examples are relevant to illustrate the problems mentioned above. First, the majority of water purification systems are old-fashioned, and were built 20-60 years ago. These systems are unable to deliver an appropriate quality service.

¹ DANCEE - Danish Fund for Cooperation for Environment in Eastern Europe

Second, overcentralization in communal heating systems and the usage of outdated equipment decrease the reliability of heating service delivery. Due to frequent break-downs and repairs, the cost for consumers increases significantly. The old pipes of the heating systems do not satisfy local standards. The ‘budget squeeze’ results in decreasing finance for repairing and renovating the heating system. There have been several emergency situations due to the breakdowns of the heating systems. For example, the 2006 heating breakdown in Alchevsk in an extreme cold with - 30° C winter became a real catastrophe. 120 000 people were left without heating because the local government had not repaired the old boiler. This forced the local authorities to resign and diminished trust in competence and professionalism of the state power to solve urgent questions. These were just two examples, but in practice, there is a great amount of problems in different spheres of municipal infrastructure.

These problems need to be solved, and changing public finance sphere offers new solutions. The recent blurring of the borders between public and private finance facilitates applying new financial instruments in the public sphere. New forms in which private funding comes to the public sphere became popular: municipal bonds, loans, joint ventures, private-public partnerships, concessions and leasing. Municipal borrowing proved to be the most appropriate mechanism in financing of local capital expenditures in developed and transition countries (Boex 2001).

Municipal borrowing is a tool that allows municipalities to improve the local infrastructure in a constant situation of ‘budget squeeze’ through engaging finances as loans or issuing debt. This tool has been successfully applied in the USA and Western Europe. Recently, it has been used for raising capital for investment in the infrastructure in transitional and developing countries.

The issue of sequencing in public finance reforms is one of the secrets of success of municipal borrowing (Bahl 2006, Guess 2005, Martell and Guess 2006). Mistakes in

sequencing can lead to sufficient resource costs and a loss of confidence in the decentralization initiative (Bahl 2006). In this research, ‘sequence’ means the order of the priorities of reforming related spheres and the priorities of actions within these spheres.

As mentioned above, healthy sub-national government (SNG) borrowing mechanisms can help renew and repair municipal infrastructure. Ukraine is currently at the stage of the overall design of an emerging system of municipal borrowing. Selection of the strict or liberal limitation of debt and type of limitation of the purpose of borrowing are related issues.

The market principles are making their way in public finance to satisfy the increasing need for finance in Ukraine. In this situation, there is a need for a framework of sequencing of the reform. However, this kind of framework is absent in Ukraine. The key laws on borrowing and the bankruptcy of SNGs are not on the political and legislative agenda yet. Therefore, there is a demand for a scientific justification of choosing an appropriate sequence of the reform of the SNG borrowing in Ukraine.

There are various approaches to sequencing proposals for the reform of municipal borrowing. Liegland (1998: 748) focuses on allocation of credit by risk based on updated information. Petersen (2004) and Swianiewicz (2004a) consider the development of the municipal borrowing market through legal and regulatory policies. The third approach to sequencing local credit market reform focuses on borrowers’ creditworthiness and financial management (Martell and Guess 2006: 94). These approaches will be applied in present research and groups of variables will be identified to measure each of them in Chapter 1.

The issue of sequencing reform has immense academic and practical significance for Ukraine. It could be used as a background for the new Law on Municipal Borrowing and Municipal Guarantees, as well as the national framework for fiscal decentralization and in the national debate on decentralization in Ukraine.

Most people would agree that the recommendations to transitional countries should not provide theoretical descriptions of an ideal municipal credit market nor recommend development through one proposed line. Instead there should be a consistent order of recommendations for legal and regulatory policies, debt management, macro parameters and borrowers creditworthiness. These recommendations should be prioritized for the region and particular country.

Therefore, the purpose of the present research is to identify an appropriate sequencing of the reform of the municipal borrowing market in Ukraine. In particular, the order of priorities and actions that should be taken in Ukraine based on the experience of similar countries in the region. The hypothesis is that for the transition states, a legal framework is crucial at the initial stage. However, once minimum necessary norms are established, the borrowers` creditworthiness and debt management capacity should be equal priorities in time and efforts.

To test the hypothesis and answer the research question, the comparative method is applied. Russia, Poland, the Czech Republic and Romania are selected for analysis with the framework of sequencing proposals. The countries were selected on the basis of their efforts to develop municipal debt market. These countries have applied similar reforms under similar regional conditions. For a deeper analysis of the Ukrainian context, I have conducted a series of structured interviews in Ukraine with the representatives of the commercial banks, the Kyiv City Council and the experts on local government reform.

The structure of the thesis is the following. Chapter 1 covers the review of the literature about the sequencing of SNG borrowing reform. It defines a theoretical framework, which is of value later in analyzing cases with comparative method in the last chapter. Chapter 2 describes the existing fiscal decentralization process in Ukraine, focusing on the problem in SNG borrowing. Data from the interviews, as well as statistics are used. Chapter

3 applies the theoretical framework and comparative method for Russia, Poland, the Czech Republic and Romania to decide what is the order of the priorities of spheres that should be applied in Ukraine. The last section lists the basic findings and recommendations which are developed to match the Ukrainian context.

CHAPTER 1. Setting the framework

This chapter provides a theoretical framework for the research. This framework is based on a literature review, description of the variables and clearly defined methodology. The first section of the chapter analyzes the contemporary literature on priorities and the sequence of the municipal borrowing reform in transition states. The literature identifies the approaches for sequencing reform and provides variables for these approaches. The comparative method will be discussed in the last section. The framework and method will be used to analyze Ukraine in Chapter 2 and the case-studies in Chapter 3.

1.1. Defining approaches

The goal of the governments of the transition states is to facilitate sub-national governments' access to private credits. This goal should be reached in a way that should be consistent with the general fiscal stability of the government and the viability of local credit markets (Petersen 2004: 3). The sequence of priorities and actions to create a successful local capital market is directly relevant this goal, however, scholars are still debating about it.

There are two categories of literature on the reform of municipal borrowing in transition states. The first category describes actions, sequencing and prioritizing. The second category of literature discusses the obstacles for the reform, without discussing the stages.

1.1.1. Literature providing proposals on sequencing. This section focuses on the category of literature in which authors define priorities in the reform. Martell and Guess (2006) have summarized this type of literature and provided a framework which is used in this research.

Various approaches to the sequencing proposals are found in the literature. Depending on the factors which are prioritized, there are three main approaches. According to the prioritized factor, these approaches include a legal and regulatory framework, allocation of

credit based on risk and debt management capacity. Following sections discuss these approaches in detail.

Approach 1. Legal and regulatory framework. The proponents of the first approach prioritize the legal and regulatory policies for the development of local credit markets. Petersen (2004) and Swianiewicz (2004a) discuss in detail the necessary elements of a legal framework. Swianiewicz (2004a: 391) suggests four necessary elements. These elements include the purpose of borrowing, the level of debt, the limit of debt, special conditions and a supervision of local borrowing. In practice, countries choose different styles of regulation of local borrowing. The USA, for example, has very few regulations on local capital and credit markets but has the most developed market in the world. However, when the Czech Republic and Russia had unregulated local borrowing, it brought on over-indebtedness and defaults. Poland has very restrictive regulations and one would expect the Polish municipalities to be reluctant borrowers. Though, despite the very strict rules, the local debt is increasing rapidly. To sum up, regulations are important for the transitions and they should cover basic dimensions. In practice, a perfect legal framework is not enough for a successful local credit market. Therefore, legal and regulatory policies form the first group of variables of the research.

Approach 2. Allocation of credit on the basis of risk. The second approach (Liegland 1997: 748) suggests that the financial instruments and institutions should be developed in line with the revenue capacity of the projects. The approach stresses the importance of the allocation of credits on the basis of risk. The indicators of the risk assessment capacity are the yields, priced for risk, market placement, with private underwriters and lenders, risk assessment by professional institutions and clear principles of distribution of central transfers and subsidized market loans (Martell and Guess 2006: 94).

To discuss the application of this approach, the financial operations of SNGs are strongly affected by the financial market (Liegland and Thomas 1999: 29). In growing market systems, the liberalization of capital markets and greater devolution tend to go hand in hand. This approach, (1999: 20), recommends to build a broader marketplace where bonds of longer maturities can be sold. Following the example of South Africa, Liegland suggests facilitating the availability of information for investors to make informed decisions about the local government debt. Another application of the second approach is to strengthen fiscal capacity of the municipalities and the ability to present reliable information to the investors. Reliable, accessible and updated data is a guarantee for sound allocation of credit. Therefore, the allocation of credit by risk is the second variable of the research.

Approach 3. Debt management capacity. The third approach prioritizes the ability of the municipality to manage debt (Martell and Guess 2006, Noel 2000a). The main problems hindering the development of the local credit market are weak accounting practices, rare use of multi-year budgeting processes, and absence of the accounting systems of municipal assets (Noel 2000a: 39). The indicators of high performance in debt management are the accounting systems that support local liability management. More advanced countries would use asset management systems and regular reports to compare planned and actual expenditures (Martell and Guess 2006: 95).

To act in the frames of debt management capacity approach, accounting, auditing, and disclosure of the municipal financial conditions should be fixed (Petersen 1999: 53). Thus, a comprehensive, unified and clear set of accounting practice should be established. The audit of municipal accounts should be performed by independent auditors. However, in the majority of transition countries the audit is made by internal auditors, and the results are seldom made public. The ability to manage debt, borrow and budget is the third group of variables of the research.

Martell and Guess (2006), using a framework combining three approaches, advocate the primacy of institutions over the capacity for building a local debt market. They divided these sets of indicators into institutional and capacity variables. They have concluded that the priority should be the strengthening of a legal and financial institutions prior to local capacity building for debt management and capital budgeting. Martell and Guess (2006: 96) put emphasis on developing legal and regulatory framework and institutional incentives or eliminating major disincentives. However, using the same framework, the conclusions might be different for post-socialist transition countries, being analyzed in this research. The purpose of the using this framework is to find unique, specific sequence for countries of this region, which has not been done yet.

Till now, the research focused on the first category of relevant literature. This category described actions, sequencing and prioritizing. The other category of literature discusses the obstacles for the reform, without discussing the stages. The following section provides a brief review of such literature.

1.1.2. Other relevant literature. Among the factors strengthening the reform, Swianiewicz (2004b: 401) advocates for macroeconomic stabilization and the strengthening of the national banking sector. The other factors are increasing financial management skills among local government staff, advice and pressure from the international financial institutions and donor organizations and exhaustion of possibilities to finance investments through revenues from sales of assets and property.

Similar to Swianiewicz's, the approach of Singh and Plekhanov (2005) focuses on the institutional characteristics, particularly the degree of vertical fiscal imbalances, the existence of any bailout precedents, and the quality of fiscal reporting (2005: 23). By vertical fiscal imbalance, the authors mean the gap between the local tax revenue and local expenditure responsibilities. This gap is filled with central transfers, which measure the degree of the

imbalance. The bigger the degree of the imbalance, the bigger the problems of moral hazard and adverse incentives. To sum up, Singh and Plekhanov recommend to decrease fiscal imbalance, improve fiscal reporting and avoid bail-outs. Their arguments on vertical fiscal imbalance are relevant to this research.

The approach proposed by Noel (2000) is similar to three groups of variables identified for the present research, but Noel proposes simultaneous reform of all five constraints. The approach distinguishes five types of constraints, which need to be addressed differently at each stage of development of the financial system from closed, through intermediate to open. The constraints are moral hazard, lack of market transparency, the weakness of market governance, and distortions in the framework for competition among market participants, and a lack of capacity for financial management by sub-national entities. Noel's descriptions of the constraints broaden and provide details to the approach provided by Martell and Guess (2006).

Having analyzed the literature, a gap is identified regarding the sequencing and prioritizing of measures. The literature does not cover the question of priorities of the factors like legal and regulatory framework, allocation of credit by risk and capacity to manage debt in post socialist transition countries.

This section has analyzed two categories of the literature on the reform of municipal borrowing. There are three relevant approaches within the first category. These approaches will be used in the next section for defining the variables for each approach.

1.2. Defining three groups of variables

This section discusses the variables of the three sequencing approaches and starts with variables for estimating results of the reforms.

Estimation of the results of the reform is a crucial part of the framework. In this regard, municipal credit market development variables are introduced to measure the success

of different strategies used by four countries. For this purpose, three indicators are used defined by Martell and Guess (2006) to estimate the current condition of the local capital market. These indicators include debt market structure and size as well as maturities and diversity of the instruments.

The maturity of a debt instrument means a period between the borrowing and repayment of the principal (Petersen 2004: 77). Ideally, the maturity should be the same as the period of use of the asset which is financed by the debt. Analyzing the diversity of the debt instruments from different types of credit institutions, the variety of options is available to the municipalities. These include the loans from central government agency, special development funds, government banks, private banks, domestic securities market and international securities market (2004: 37).

1.2.1. Variables for Approach 1. The first group of variables is the level of the legal and regulatory framework. Assessing the legal framework, it is important to focus on the regulations of purpose of borrowing, limit of debt, supervision by central government and regulation of potential insolvency situation. Martell and Guess (2006: 94) propose a list of necessarily regulated provisions. These include ‘devolution of sufficient own-source revenues’ (2006: 94), devolution of decision-making on local budgeting, regulations on borrowing and the limits and the purpose of borrowing (2006: 94). In addition, the regulations should include (2006: 94) clear debt limits, procedures of default and separation of capital and operating budgets (2006: 94). These variables of Martell and Guess (2006) are used to assess the level of legal framework in Russia, the Czech Republic, Poland and Romania.

1.2.2. Variables for Approach 2. The second group of variables is the allocation of credit on the basis of risk and the development of financial market instruments. For the financial instruments variable several issues are discussed: rules which regulate the

availability of information, creditors' rights and default procedures (Martell and Guess 2006: 107). Furthermore, risk assessment institutions should be evaluated to make sure the decisions are made on the basis of risk and not political negotiations. The central government guarantees are in fact indicators of the maturity of the local credit market and its instruments. Immature market would allow interest-free or subsidized Treasury loans for intermediate period and other kinds of distortions. For the second group of variables, access to information, creditors' rights and default procedures are analyzed using the approach of Martell and Guess (2006).

1.2.3. Variables for Approach 3. The capacity to budget, borrow and manage debt needs a great deal of attention in the region. There are three main problems in local budgeting hindering the development of local credit markets in transitional states (Noel 2000: 18). First, almost all countries have weak accounting practices, often without the separation of operating and capital expenditures. Second, municipalities seldom apply multi-year budgeting processes (2000: 18). Last, the vast majority of local governments do not have an accurate accounting of the assets they own, even fewer municipalities have a valuation of these assets. These issues need to be specifically addressed for each country.

The indicators of developed debt management are the 'accounting systems that support local liability management, asset management systems' (Martell and Guess 2006: 95) and regular reports on expenditures (2006: 95). The municipal capacity is estimated by the ratio of total current budgetary surplus to total current expenditures.

The relevant variables for the three groups of variables have been identified in this section. All of them, together with a framework are used to analyze the cases of Russia, the Czech Republic, Romania and Poland in Chapter 3.

1.3. Methodology and selection of cases

The four transitional countries, Russia, the Czech Republic, Romania and Poland have many commonalities. They made considerable efforts to decentralize, increased their own-source revenues and local fiscal autonomy in the 1990s. They also had enough international assistance, advice as well as pressure from EBRD, USAID and World Bank (Swianiewicz 2004b: 401).

The selected Central and Eastern European countries are in post-socialist transition. They have common fiscal problems such as a centralized administrative structure, soft budget constraints, low own-source revenues and a vague determination of the responsibilities of local government. Though the selected countries have different administrative forms of states, they are good cases for the present research. In addition, the countries represent both failures and successes, which is valuable for making recommendations to other countries of the region.

Table 1. Comparison of the fall in economic performance in Russia, the Czech Republic, Poland, Romania and Ukraine.

Country/indicator	Number of years in a row when the amount of production was falling	Total decrease in production, %	Relation of GDP in 2000 to GDP in 1990, %
Russia	7	40	64
Czech Republic	3	12	99
Poland	2	6	112
Romania	3	21	144
Ukraine	10	59	43

Source: Malyi 2005

The Table 1 shows that the experience of the selected countries is relevant for the purpose of the research. Ukraine has the biggest number of years when the amount of production had been falling. In addition, it had the biggest total decrease in production and the lowest growth of GDP in the period 1990 – 2000.

However, there are two major limitations in this regard. First, it is difficult to compare the paths in the reforms in local government and finance, as there are subtle factors of mentality, tradition and history, which influence the success of the reforms in local

government. Second, the four countries did not follow completely different paths but had various levels of success in every area: legal, financial market and debt management capacity. This complicates drawing conclusions as assumed by comparative method. To overcome this problem, we will pay more attention to the qualitative factors that can affect the results. In each section of Chapter 3, we will briefly analyze the possibility of applying the experience of each of the four countries for Ukraine.

CHAPTER 2. Ukraine: the current situation in municipal borrowing

This chapter covers the existing situation in municipal borrowing in Ukraine. It is commonly accepted that municipal borrowing is directly linked to the success of the decentralization reform. For this reason, the first section discusses the decentralization path of Ukraine. The second section discusses the experience and history of SNG borrowing prior to 2001, when the new Budget Code became effective. The last section characterizes the local credit market with variables defined for the framework of the present research in Chapter 1.

2.1. Track of fiscal decentralization

Despite the worldwide trend to decentralize (Bahl 2006), Ukraine is a highly centralized country (Bezsmertnyi 2006, Kyrylenko 2006). To give an overview of current position of Ukraine on the decentralization path, the section discusses issues that are problematic for Ukraine. These are the structure of the system of local government, the elections of *oblast*² and *rayon*³ Heads, and the fiscal autonomy of the municipalities.

To start with the structure, Ukraine has a three-tiered system of the elective representative bodies (*oblast*, *rayon* and town/village or city district). However, the *rayon* and *oblast* levels, which represent the collective interests of smaller units, do not have their own executive bodies and they implement decisions through the state administrations. This fact, together with the poorly defined responsibilities of the tiers of local government, causes the interference of the central bodies into local issues (Kyrylenko 2006) and worsens the position of local government.

² *Oblast* is a type of the administrative units in Ukraine. *Oblast* is a tier of local government representing the collective interests of the villages, cities and towns.

³ *Rayon* is a smaller tier of local government, representing the interests of villages, cities and towns.

To continue, it is assumed that democratic representation is a starting point of the reforms in local government. Though the mayors are elected directly, the President appoints the Head of the *oblast* state administration and approves the Head of the *rayon* state administration. In practice, the presidential authority to appoint causes frequent intervention of the Heads of oblasts in budgeting, decision-making and hiring policies.

Last, the local fiscal autonomy in Ukraine is very limited yet (Ganuschak 2006, Kyrylenko 2006). The reason is that local taxes and duties on average brought 1.0-4.0% (ACU 2004: 44) of the budgets of cities-centres of oblasts in 2004 (3-5 dollars per capita) and even less in cities, villages and towns. The main problems of the public finance sphere in Ukraine are the small own revenues of the local government and an insufficient financing of delegated responsibilities. In addition, there is a problem of unpredictability of seizures from local budgets by central government (Kyrylenko 2006: 115). The weak sides of the system of local taxation are caused by several factors. First, the weak fiscal role of local duties and taxes. Second, the narrow list of local duties and taxes. Third, the fact that local governments have no real power to establish taxes on their territory. Fourth, the absence of a link of tax mobilization and services delivered to local population. Last factor is the absence of property tax (Kyrylenko 2006: 354). Moreover, local governments in practice cannot change fees for communal services for legal and political reasons. Though the demand and urgency for local capital investments is significant, the capital expenditures made up only 6.6 % of the GDP in 2004 in Ukraine (2006: 127).

Ukraine has a huge need for investment in local infrastructure (Shvets 2004, Kyrylenko 2006). It has been estimated (PFR 2006) that the total requirements over the next 10 years are equal to USD 100 billion. The total investment needs in local government sector are about USD 7 billion for the period of 2002-2010 (DANCEE 2004: 1). The issues which are at the agenda are improving housing municipal assets (32% of funds) the development and

renovation of water and wastewater systems (20%) and development and rehabilitation of heating supply facilities (8%) (ECSPF⁴ 2006: 6). The most practical problems, which could be solved by borrowing are financing of building of housing, building mini heat power plants using cheap energy resources, utilization of the industrial wastes and renovation of public transportation facilities (Shvets 2004: 158)

There are many arguments for municipal borrowing in Ukraine (Swianiewicz 2004a: 5). First, it provides inter-generational equity, as the benefits of capital projects are available not only to current tax-payers, but also to future generations (2004: 5). As the tax burden is comparatively high in Ukraine and tax evasion is considerable, it is logical not to finance capital projects by increasing taxes or fees. Second, borrowing provides an optimal allocation of resources, as the link between those who pay for the project and those who benefit is strengthened (2004: 5). Third, the municipalities benefit from accelerated local development, which brings a spillover effect for related spheres (2004: 6). Investors usually are more interested in places with better infrastructure. A tourism business could be a good example, as poor roads, transport and police services distract tourists from visiting Ukraine. Fourth, borrowing brings the reduction of operational costs (2004: 6). Municipalities could contract loans or issue bonds to replace outmoded transport vehicles, heating systems in public organizations etc. In addition, borrowing reduces costs by decreasing the time of project, which will reduce total constant costs and make the projects cheaper. Also, a developed municipal credit market would stabilize fluctuating budget resources. These resources vary due to unexpected changes of taxing legislation, distortions and relieves. These fluctuations make financing of capital projects risky for the municipalities (2004: 6). Last, mature municipal borrowing would provide access to European and other development funds (2006: 7).

⁴ ECSPF - Sector Unit for Private and Financial Sector Development, Europe and Central Asia Region.

To sum up, the existing situation in public finance does not allow improving the local infrastructure with own-source revenues. The mechanism of municipal borrowing would solve the existing problems best, and therefore, it should be strengthened with appropriate policies.

2.2. Experience in local credit markets till 2001

This section discusses the experience of SNG borrowing in Ukraine till to 2001, when the new Budget Code became effective. The period before 2001 is relevant as some events took place which were crucial for the development of the local credit market and the attitude of investors, banks and the municipalities. These events are the Odessa default in 1998 and the Crimean fraud in 1996.

To begin, the municipalities were allowed to issue debt in 1993, and the law neither obliged them to receive authorization from the central bodies nor provided any other restrictions or regulations. Due to this, the borrowed funds were used (Varfolomeyev 2003: 22) for zero-tax schemes (Dnipropetrovsk), building housing (Lviv) and even financial fraud with violation of the legislation (Crimea). Till 1998, 15 issues of the municipal bonds were made on a total sum of almost UAH⁵ 300 million. The biggest issues were made by Crimea⁶ and Odessa, which became famous for default and fraud later.

To characterize the initial stage of the local credit market, the aggregate amount of the borrowed funds was 8.281 million in the currency which had been in use before 1996, and USD 125 million after 1996. Before 1998, thirteen cities borrowed or issued debt, which had been used for building housing, communal service systems and gasification of the cities, renovation of transport facilities and children's nutrition plants. There were examples of misuse of the instruments of borrowing, for instance in Odessa and Crimea. As these two

⁵ UAH – Ukrainian Hryvna, national currency since 1996.

⁶ The Autonomous Republic of Crimea is a part of Ukraine.

cases are important for further development of the municipal borrowing, the following paragraphs dwell on them in more detail.

Odessa issued bonds for USD 33 million in 1998, which had been an outstanding amount compared to other issues. After the default, the municipality was reluctant to pay the debt quickly and minor court procedures last until now. This case caused cautiousness of the investors, local authorities and central government, which blocked the borrowing till the Budget Code and proper regulations of 2003 (Kravchenko 2005: 167).

The Crimean Ministry of Finance issued bonds for USD 24 million. The right to manage the debt was delegated to Bank Sloviansky (2005: 167). In this way, a criminal channel for transfer of the foreign currency had been created. The budget of Crimea had not received any money, but it was transferred instead to the investors as an income. An amount four times as much as the initial sum was illegally transferred to the bank (2005: 168).

The negative experience of borrowing of Odessa and Crimea affected both the investors and the government, which became unwilling to liberalize the market further. Caused by early defaults, since 1998, the borrowing should have been authorized with the Ministry of Finance. These strict regulations and cautiousness after defaults caused absence of any borrowing till the end of 2003.

There was one positive respect of the early defaults as the government decided not to bail out the municipalities in default (Noel 2006: 21). This can be treated as an absence of explicit or implicit guarantees of the central government for local debt.

To strengthen and facilitate the development of the local credit market, international assistance was highly important. The advice for designing the new Budget Code was particularly valuable, as it became the base for the new system of regulation of the municipal credit market. This new system is discussed in the next section.

2.3. The current situation in the local credit market

Since 2003, there have been twenty four issues and borrowing operations made by the Ukrainian cities. The total amount makes up USD 188 million for the period of 2003 – 2007 (Ministry of Finance 2007). To characterize the local credit market, next paragraph analyzes the maturity, diversity of instruments and interest rates.

The maturity is not limited in the law. The maturity on the municipal bonds make six years, while the maturity for loans has been recently extended to twenty years. Considering the diversity of the instruments, from twenty four loans and issues of bonds for the period 2003 – 2007, there were fifteen internal market bond emissions, three external bond emissions and six credits, one of which was from external market. Also, USD 600 million was borrowed at the market of Eurobonds by the Kyiv City Council. The high interest rates (12% – 16%) and risks are caused by the negative experience of the default in Odessa in 1998. So, the local credit market is dynamic but small and immature in terms of size.

2.3.1. Legal and regulatory framework. There is no unified law regulating municipal borrowing. However, the Budget Code adopted in 2001 (the Code) provides main rules. According to the Code, the main conditions for SNG borrowing are the following.

- The Parliament of the Autonomous Republic of Crimea and city councils can make internal borrowings. The oblasts, towns, villages and their groups are not allowed to borrow.
- Only the councils of the cities with population more than 800.000 have the right to make external borrowing. These cities are Kyiv, Kharkiv, Dnipropetrovs'k, Odessa, Donetsk and Zaporizha.
- The borrowing is made for a determined purpose and must be returned.
- The borrowed money belongs to the budget of development of the SNG.
- The state does not offer explicit or implicit guarantee for municipal borrowing.

- The debt service is made from the general fund of the municipal budget.
- The debt service expenditure should not make up more than 10% of expenditure from the general fund for a certain period.
- If the borrower delays the payment according to the schedule, the municipality is forbidden to borrow for a period of 5 years.

Another important issue is authorising the borrowing. The law demands to receive approval from the Ministry of Finance that the project does not violate the norms of the current budgetary legislation. Also, the decision of the council to issue debt and its choice of the form of issuance is demanded. These procedures are restrictive and burdensome, take a lot of time and efforts from the municipalities (Grydzhuk 2005).

The purpose of borrowing is not clearly defined in the legislation. The long-term borrowing can be made for a specific purpose only and should make a part of the budget of the development. The expenditures of the budget of the development according to the Code can be capital expenditures, contributions of the start-up funds of the enterprises and debt service (except short term debt) (USAID 2006).

The debt limits are not defined explicitly. The Code set that the debt service should not make more that 10% of the expenditures of the general fund of the budget in a certain fiscal year. The debt service includes only the sum of the interest rate without the main sum of the debt.

To sum up, several issues are not regulated. These issues include borrowing in foreign currency, borrowing for the purpose to refinance the debt and the procedure of the approval in the Ministry of Finance. There is no single law on SNG borrowing, no clear definition of public debt and the purpose of the SNG borrowing. The redundancy in the authorization and control requirements of SNG borrowings by are also big obstacles for SNG borrowing. There

are no insolvency proceedings and a clear procedure for the seizing of the financial control of a defaulting SNG.

2.3.2. Allocation of credit on the basis of risk

To analyze the second group of variables, it is important to discuss the central government guarantees, the availability of the rating agencies, access to information, creditors' rights and default procedures.

To start with the guarantees, the Code states that central government is not responsible for the debt of the municipalities. The guarantees can be given only on the terms of repayment, charging, collateral pledge and counter guarantees received from other actors. So, the mechanism is imperfect, and there have been no cases of defaults under new legislation introduced by the Code in 2001 for one to make predictions.

The following paragraph discusses the default procedures in detail. In case the borrower does not repay, the debt can be repaid at the cost of the assets of the borrower according to the Code. In such case government will use the mechanism used when municipalities do not transfer collected tax and non-tax revenues on time. However, current experience with the enforcement of remedies in the event of SNG default is very limited (Noel 2006a: 21). Its predictability cannot therefore be determined.

Another issue which should be paid particular attention is the availability and demand for ratings. The rating from the established rating company is a necessity for the approval of borrowing by the Ministry of Finance. Though, there is a monopolist in the sphere, the company Credit-Rating. The alternatives are Standard & Poor's, Moody's Investors Service, Fitch Ratings. This makes the rating services expensive for the municipalities.

Though the ratings are demanded, the law does not require receiving an independent audit (Noel 2006b: 57). The audits of local budgets are not enough regular and deep. The internal auditing are performed by the Agencies of the Control and Auditing Administrations

of Ukraine. The law does not require external auditing which would improve the current situation (Noel 2006a: 18).

2.3.3. Debt management capacity. There is a single State Treasury, which performs the functions of the accountant, cashier, controller and manager. The local budgets are executed by the Treasury and all accounts of municipalities are kept in the Treasury. The law states that the expenses to repay debt contracted by SNGs must be financed despite the amounts of funds made available by the municipality in the city budget (Noel 2006a: 54). This means that the Treasury is obliged to repay a creditor who presents a claim to a court demanding his payment of a due debt (2006a: 54). The Treasury in this situation refused to execute such court decisions, creating the space for moral hazard problems (2006a: 55).

Transparency of local finance characterizes the debt management and is one of the key principles of the budgetary system. There is no continuous monitoring of the financial viability of local government and due fulfilment of the debt management obligations. Local budgets should be more transparent and predictable. The own-source revenues, which are the revenues which are not counted in determining intergovernmental transfers⁷, should be increased.

Summarizing the main conclusions of this chapter, first, the local credit market is dynamic but small and immature in terms of size. Second, the existing situation in public finance does not allow improving the local infrastructure with own-source revenues. Third, legal and regulatory framework needs to be developed. The issues demanding change include borrowing in foreign currency, borrowing for the purpose to refinance the debt, the procedure of the approval by the Ministry of Finance. The guarantees and default procedures

⁷ According to the Code the revenues which are not counted in determining intergovernmental transfers include: tax from transport vehicles owners, revenues for investing temporarily free cash, fees to establish trade and service facilities, dividends for companies if local council owns a share, fees for polluting environment, money received for privatization of communal property and selling non-agricultural land owned by local government, fixed agricultural tax, revenues from renting communal property, revenues from local lotteries, grants and presents, own revenues of state local bodies, tax on revenue of communal enterprises, fees for driving within the territory of frontier regions, charged from transport when driving abroad.

mechanisms are not developed enough, and there have been no cases of defaults under new legislation to make a proper evaluation.

CHAPTER 3. Case-studies of Russia, the Czech Republic, Poland and Romania

This chapter provides an analysis of the reforms of municipal borrowing and their sequences in Russia, the Czech Republic, Poland and Romania. To evaluate success of the reforms in these countries, the comparative method and theoretical framework developed in Chapter 1 is used. To compare sequences, the clear criteria for evaluation of the level of market development are applied. For this purpose, the debt market structure and size, the maturities, diversity and depth of the market are analyzed. It is assumed that the success of the reform for a transitional country would differ from the success of a country with a developed and mature local credit market. Additionally, we need to consider the distribution of debt between municipalities of different sizes, their ability to access credits and the experience of resolving default situations in transition countries. The following section analyzes current conditions of the markets of the selected countries.

3.1. The characteristics of the municipal credit market development

There are certain characteristics which measure the success of the countries on a path to working market. These characteristics include the market structure and size, maturities and diversity of the instruments. This section assesses the characteristics of the municipal credit market for Russia, the Czech Republic, Poland and Romania.

3.1.1. Russia. The Russian experience is heavily influenced by the 1998 default, when nearly all municipal bond issuers went bankrupt. The SNGs had to repay the debt and the way the debt is repaid in cases of default at the early stage of market development is crucial for the development of the market (Singh and Plehanov 2005, Petersen 2004). In Russia, the local governments were not eager to repay or restructure the debt for a long time, which led to a loss of trust from the side of investors and a decline of municipal borrowing till 2001. The

characteristics of market size, maturity and diversity are discussed in the following paragraphs.

To start with size, in 2006, the municipal debt made 58.3 billion rubles (Ministry of Finance 2006), which was 1.41% of the GDP in 2006. The main source of budget financing in Russia were budgetary loans, bank loans and sale of the property.

The maturity of debt in Russia decreased after the 1998 default, when it was just a few months long but in following years it increased and became three to five years. Considering the diversity of the debt instruments, the Russian legislation allows to use a variety of instruments. These instruments include loan agreements and contracts, issuance of municipal securities, budgetary loans and credits from other-level budgets and agreements on the provision of municipal guarantees.

There are four main issues in the Russian experience which are relevant for this research. First, it shows the dangers of unconstrained external borrowing in an unstable macroeconomic environment (Nikolov 2004). Second, it gives a lesson of dangers of the frequent financing of operating deficits by borrowing. Third, it shows the consequences of the risky debt profile after the 1998 crisis. Last, it provides results of variable interest rate and increased spending on subsidies.

3.1.2. Czech Republic. The indebtedness of the Czech Republic increased rapidly starting from 1996. The amount of debt almost doubled by 2001 and reached CZK⁸ 48.3 billion (Jezek 2004: 133). As in Slovakia, Poland and Russia, the debt was accumulated basically in the biggest cities. In 2001, half of all accumulated debt belonged to the four biggest cities, which are Prague, Brno, Ostrava and Pilsen.

The Czech Republic has the biggest share of borrowed funds to GDP, with a ratio of 3.56%. The local debt market is dominated by the loans, which made up 47% of borrowed

⁸ CZK – Czech crowns, in 2003 1 USD was equal 31,50 CZK.

funds in 2001. The bonds were used for 28% of total funds borrowed by the Czech municipalities. Compared to those in other countries, the smaller Czech municipalities are much more indebted. The current situation of the municipal debt is dangerous for macroeconomic stability as unconstrained borrowing was not matched by revenues to cover the debt, especially in smaller units.

Since 1994, the government has been pursuing a deliberate policy of increasing subsidized state loans to finance municipal investments. Since then, the share of commercial credit in total municipal borrowings has started to decline. Non commercial credits allocated by various state ministries and specialized state funds has increased. The State Environmental Fund was found to have a very high share of nonperforming loans (up to 73 percent). These loans were softening the budget constraints for local governments and constituting a source of moral hazard in the system (Jezek 2004).

3.1.3. Poland is an example of the high speed of the reforms of local finance and borrowing. The Polish municipal borrowing market developed extremely dynamically. The level of debt was 5.5% of local revenues in 1995, in 1998 it was 9.5% and in 2001 it exceeded 14%. In 2000, the majority of urban local governments and 90% of big cities (Kopanska 2004: 402) had some debt. The local government debt had increased from PZL⁹ 6, 161.3 million in 1999 to PZL 23, 237.1 million in 2006. The total amount of borrowed funds as a percent of GDP was 2.37% in 2001. The maturities seldom exceed five to seven years in Poland (Kopanska 2004: 34).

Starting from 1993, the *gminas*¹⁰ were allowed to borrow by applying for credits, loans or issuing bonds. There were two types of credit available to the *gminas* (Horvath, 2000). Commercial credit from the banking system, which made up 30% of borrowing, and non-commercial credit from funds and NCOs, which made up 70% of the borrowed amount.

⁹ PLN – Polish zloty, national currency.

The commercial credit steadily increased during 1995 – 1997, from PZL 43.262 million to PZL 442.687 million.

In addition, Poland had a peculiar sequence of the reform. Political and economic decentralization came simultaneously with the independence. There was a strong national and political support for an independent local government. The reforms were marked by sufficient own-source revenues. There was a clear separation of responsibilities between the tiers of the local government. The government explicitly stated that there will be no bail-out. Clear separation between the central and local budgets had been regulated. The Law on Public Finance introduced insolvency procedures for SNGs, including very strong negative consequences for defaulters (Kopanska 2004).

To give the full picture of the local credit market in Poland, we need to assess the diversity of instruments of borrowing. The market is currently dominated by bank loans, bringing 75% of municipal debt, while bonds account for 20% of local debt. To sum up, Poland is a successful transition to market principles in the local credit market, which is one of the most ‘robust, dynamic and sound’ (Kopanska 2004: 67).

3.1.4. Romania. Since 2001, the loans from government and commercial banks have increased drastically in Romania. However, there was instability of legislation. After tripling from 2001 to 2002, the central government loans decreased to half as much and boomed the next year (Romanian Statistical Yearbook 2004: 5). The loans from the banks increased tremendously, growing ten times from 2001 to 2003 (2004: 5). The municipal bond market had nine issues by the end of 2004 with the average sum of USD 1.42 million. The maturities usually are two to three years, with some exceptions being four to six years. The fees range from three to nine million dollars according to the Ministry of Public Finance. The diversity

¹⁰ *Gmina* is an administrative unit in Poland which often includes a major town and several neighbouring villages.

of instruments is represented by bonds, loans from commercial banks and other commercial institutions, supplier credits, financial leasing and local guarantee.

In general, the indebtedness of the Romanian municipalities is rather low and the access of small units is very limited because of the insufficiency of own revenues.

Table 2. The debt of local government in Russia, the Czech Republic, Poland and Romania. Source: Standard & Poors 2006.

Country/ debt of local government	2002, mln euro	2003, mln euro	2004, mln euro	2005, mln euro	2006, mln euro
Russia	4919	5715	6722	9194	10897
Czech Republic	1793	2208	2560	3294	3938
Poland	3815	3657	4691	6165	6710
Romania	8	14	66	595	674

Table 2 shows that Russia has the biggest local debt in aggregate terms in 2006 compared to the other countries. The Romanian local debt grew 84 times from 2002 to 2006, which is the most rapid growth. Still, the Romanian debt market is the smallest in aggregate terms, and it is the youngest compared to others.

To sum up, the experience of the countries shows the need for high quality regulations and the dangers of unconstrained chaotic operations in the experience of Russia and the Czech Republic. The characteristics of the debt market development highly depend on the overall effort for decentralization and devolution. Russia has the biggest debt among the four countries in terms of aggregate amount. However, the Russian share of local credit in the GDP is low (1.41%). Local debt makes a great share of the GDP of the Czech Republic (3.56%) and Poland (2.51%). These data will be important to assess the paths of the countries in the last section of this chapter.

3.2. Legal and regulatory policies

This section assesses the level of legal and regulatory policies through the analysis of the legislation on public finance, municipal borrowing, local revenues and local government. It also estimates the level of devolution of budgeting, fiscal and borrowing responsibilities.

3.2.1. Russia. According to the Russian law, local budgets make a considerable share of state consolidated budget as the majority of public services became financed by local budgets. However, this does not mean that municipalities enjoy fiscal autonomy, as it is practically impossible to perform local decision-making on budget composition due to a great amount of delegated responsibilities (Nikiforov 2004: 329).

Russia has a strict limitation of municipal debt in legislation (Eigel 2005). The Budget Code defines municipal debt as a sum of the obligations of a municipality, which must be fully secured by the all municipal property and treasury. The municipality's budget deficit must not exceed 15% of its revenues, excluding financial aid from the state budget (Nikiforov 2004: 355). The maximum amount of debt servicing expenditures of a subject of the Federation or municipal body must not exceed 15% of total expenditures of its budget.

According to the law, the limitation of the purpose of borrowed funds is liberal, while in practice it is inefficient and chaotic. This is an indicator of low implementation performance and transition period to the rule of law. Domestic borrowing can be used for capital investments or debt refinancing. Theoretically, municipalities can have a deficit from spending on capital investments and can borrow to cover this deficit from the state budget or as a commercial credit.

The developed regulations of local budgeting procedures would mean commitment to the reform. Budgetary expenditures in Russia are clearly subdivided into current and capital expenditures. It is allowed to establish a separate development budget, which includes part or all capital investment expenditures. Municipal finances are accounted on the cash basis, and the obligations of the municipalities are reported only when they are fulfilled. Such liabilities,

(Nikiforov 2004: 334) are excluded from the debt calculations and debt servicing expenditures. Such practices give an unrealistic picture of the situation in local finance and show a lack of will and attention for a sound legal framework in the Russian Federation.

The current regulations have a number of drawbacks and weak points. The inefficient definition of the purpose of borrowed funds allows local administrations to use borrowed money for wage payments and non-capital expenditures (Nikiforov 2004: 336). The real devolution of own-source revenues is yet to come. To sum up, the unregulated foreign borrowing and careless lending based on implicit guarantees from the central government, are the reasons to consider the Russian legal framework to be at the medium stage of development.

3.2.2. Czech Republic. The Czech Republic is a truly unique case, as until 2002, there were no regulations for borrowing. The municipalities could borrow any amount without restrictions, at any rate and for any purpose, in both domestic and foreign currencies. They could also provide guarantees to a third party. Currently, the majority of the municipalities are in debt. The first issue of municipal bonds was carried out in 1992, and nine issues were released in 1994 (Jezek 2004: 132).

The peculiarity of the Czech local government system is fragmentation that means the small constituencies of the municipalities. Fragmentation became an obstacle for sufficient own revenues and condemned local bodies to become grant-dependent because small municipalities cannot gain from economies of scale and prove creditworthiness. There was no clear policy for fiscal equalization transfers for a long time. These were the unfavorable factors for the local finance system and municipal borrowing in the Czech Republic (Havrdá 2003: 1).

Moral hazard at the local level is still left unresolved. The current monitoring and supervisory mechanisms of local financing are insufficient to prevent the destabilizing

behavior of the local government. The worst is the practice of providing zero-interest loans to municipalities by the central government, which are turned into grants or subsidies in a situation of financial trouble of a municipality. Also, there is no clear regulation on which municipality can be bailed-out in which situation (Havrda 2003). This distorts incentives for market participants and prevents further market development.

In general, the Czech borrowing framework does not satisfy high standards, as crucial issues are still left unregulated namely the purpose of borrowing, limit of overall debt and debt service, sanctions for not observing the limits (Swianiewicz 2004b: 392).

3.2.3. Poland. The Polish example is the complete opposite of the Czech one. Right in 1990, the *gminas`* budget was separated from the state budget and the responsibilities and functions between the *gminas* and authorities of the central administration were clearly divided. The Western-style public finance began to emerge at the beginning of the 1990-s (Regulski 2003).

During 1997 – 2000, the key laws regulating public finance were adopted. The *gminas* were granted the right to contract loans and issue bonds. Existing restrictions related to maximum rates of rent or the size of debt that was allowed to create (Regulski 2003). The legislation made the *gminas* safe borrowers in eyes of the banks and they were interested in cooperating closely with the local government. The factors mentioned above facilitated the rise of local finance market and banks specializing in services for the *gminas*, other financial and consulting institutions. For local fiscal transparency and audit, the Regional Audit Chambers were established.

All in all, the Polish regulations are clear, sound and appropriate with straightforward definitions of the limits of debt, instruments and purpose of borrowing.

3.2.4. Romania. The best practices were followed in the laws concerning the definition of borrowing, debt limits, and institutions in Romania. Though even ideal laws might not bring

success due to low implementation. According to the Law on Public Finance, local public administrations authorities are responsible for contracting domestic or external loans and the due payment of debt (Nikolov 2006: 19). In order to contract a loan, local public authorities need the approval of the Commission for Authorization of Local Loans (Commission). The borrowing is possible in form of a loan or bonds from the commercial bank. The purpose can be either to finance local investment or to refinance debt. For current cash gaps, interest-free loans from the Treasury are available.

The following paragraph analyzes the limitations of debt. The quantitative limitation of the amount of borrowed money should not exceed 30% of the total current revenues of the budget of any local government body. Generally, municipalities are forbidden to create debt in foreign currency. The Law on Public Finance allows denomination in foreign currency if it is approved by the Commission.

Another issue about the regulation, is the regulation of insolvency. The “financial crisis” is clearly distinguished from “insolvency” and insolvency procedures are regulated in the Law on Public Finance (Nikolov 2006: 29). A chapter in the Law on Public Finance regulates insolvency and a special Law on implementing these procedures is being drafted.

Despite excellent legislation, the Romanian local fiscal relations are characterised by instability and low level of implementation. World Bank report (PER 2006: 74) mentions in this regard fragmented tax administration and collection, an intricate equalization grant mechanism, non-transparent conditional transfers, unclear access to local borrowing.

3.2.5. Conclusions and implications for Ukraine. To sum up, all four countries have some regulations for municipal borrowing. Mostly poor or unregulated are the default procedures, sources of collateral, guarantees and the reporting procedures.

Table 3. Summary of borrowing regulations. Source: Swianiewicz 2004b (p. 392). Adapted for Ukraine.

	Russia	The Czech Republic	Poland	Romania	Ukraine
For capital or operating purposes?	Long term for investments only, but no separation of capital budget	Both	Both	Long-term for investments only, but no separation of capital budget	Both
Limit of overall debt	Annual budget revenues	No limit	60% of total revenues	20% of current revenues, short-term 5%	60% of GDP
Limit of debt service	15% of total expenditures	20% of net revenues	15% of total revenues	No limit	10% of expenditures from general budget for current period
Sanctions for not respecting	No sanctions defined	Not applicable (no limits defined)	Effectively no, but ex-ante control of Regional Audit Office	No sanctions defined	The municipality is not allowed to borrow for 5 next years
Comments	Maturity not exceeding ten years. Limitation of the budget deficit.	Limits were introduced for short period only – in part of 2002 debt servicing no larger than 15% of budget revenues.	Debt of municipal companies not included in the limits (unless formal LG guarantees exist)	All types of borrowing – only since 1999	External borrowing is allowed to cities with population larger then 800.000

It appears from the Table 3, that Ukraine has the strictest limit of debt, making up 10% of expenditures of local budgets. The tie of debt limit to expenditures but not to revenues is also an impediment for the market. Ukraine has no effective sanctions for the municipalities not respecting the debt limits. The prohibition to borrow for five years does not reach its goal and is inadequate measure for dealing with violations. The experience of Poland in sanctions for not respecting the rules should be considered for Ukraine.

3.3. Allocation of credit on the basis of risk

Second groups of variables of the financial market development includes information disclosure for the investors and the public, level of protection of the creditors` rights and default procedures. The allocation of the credit by risk will be assessed through the presence of domestic and foreign credit-rating agencies.

3.3.1. Russia is a weak performer in the disclosure and reporting of information about local finance. The Standard & Poors Rating Agency (Eigel 2005) reports low transparency and a poor disclosure of information rules. The Budget Code obligates all local government borrowers to have debt books (Nikiforov 2004: 338) containing appropriate information. However, the level of availability of information is limited. Access is provided to regional executive bodies, creditors, municipalities and law-enforcement agencies. The information about municipal securities should be made available to all interested parties according to the Russian law (Nikoforov 2004: 361). The executive bodies of the municipalities must publish quarterly the reports on the execution of their budgets and the fulfillment of their debt obligations.

It is the most difficult to obtain information about the creditworthiness of the borrower. The rating agencies (Proklov 2005) recommend disclosing the information about the structure of the obligations and the debt policy of a municipality on a more regular basis. The information about the gross regional product, the main tax-payers, the income to the regional budget from different spheres and predicted economic indicators for the term 3-5 years are almost impossible to find.

Concerning the presence of the professional intermediaries, the municipal securities were intended for a limited number of investors at the initial stage. There is a competition among the companies of underwriters now. The sector of securities is growing fast now, while the time for the rating companies has not come yet. There is neither incentive, nor obligation by law for regional authorities and municipalities to have ratings. However, such ratings can be only useful in coming to the Eurobond market (Nikoforov 2004: 374).

Domestic ratings have not become popular, as the bank lending mostly is contracted based on informal relations with the local authorities. Municipalities might also be interested not to receive ratings because the violations of spending and reporting procedures, which are

very frequent, must be reported in the ratings. There are also problems of the limited experience and reputation of domestic rating agencies in Russia.

3.3.2. Czech Republic. The Czech Republic has similar problems to Russia with regard to the availability of information to the investors, the public and intermediaries. The current monitoring and supervisory mechanisms of local financing are insufficient to prevent destabilizing behavior of local government. For example, zero-interest loans are provided to municipalities by the central government and later turned into grants or subsidies in a situation of financial trouble of the municipalities. In addition, there are no clear regulations on which municipality can be bailed out in which situation (Havrda 2003). This distorts incentives for market participants and prevents further market development.

As there is no bankruptcy framework, and the Bankruptcy and Composition Act deals only with the private firms, there is no procedure to deal with over-indebted municipalities. The current condition is that 65% of all municipalities are indebted (2003: 5). Local indebtedness increased by a factor of 15 during the period 1993 – 2001 (2003: 5). The current situation shows that ten small municipalities are under the procedure of insolvency, and there were several cases of forced auction (Havrda 2003).

To conclude, an access to reliable updated information about local governments is difficult for several reasons. First, the municipalities apply different interpretations of the chart of accounting (Carmo 2001: 215). Second, often they do not keep clear and uniform registers of their assets and liabilities. Last, they fail to publish on regular basis information on debt and capacity to pay. All these characterises the Czech local finance as non-transparent, with ineffective accounting rules and a low protection of the rights of the investors.

3.3.3. Poland. In general, the requirements considering registration and access to information on municipal bonds respond to high standards in Poland (Kopanska 2004: 35).

The Law on Public Finance (1998) obliges municipalities to present their budget information with the general classification system for the public sector. Special Regional Accounting Offices (RAOs) observe that the local government budgeting and financial management is in compliance with the law. Such RAOs are the mechanisms for reviewing the local government budget and borrowing resolutions.

Credit ratings, as monitors of financial health, provide incentives for the local government as well as a good regulatory framework. Both the Ministry of Finance and the Polish Statistical Agency require the local financial reporting and regularly collect data from *gminas*. The data collected by the Ministry of Finance primarily is used for calculating local government debt. However, the local rating agencies have not become popular so far. This is partly because investors consider creditworthiness of all local governments as similar. Also, the prohibition to create debt in hard currency leaves the demand for foreign ratings low. To sum up, Poland is among the high performers in reporting, disclosure of information and a protection of creditors' rights.

3.3.4. Romania. The situation with monitoring and database of local debt in Romania is not satisfactory yet. There are three main reasons for that. First, the Ministry of Finance does not have a national database, and there is no centralized collection of such data (Chinea 2004: 294). Second, neither municipality nor lenders are obliged by law to report to the Ministry of Finance in case of default. Last, there is no public access to information about the financial situation of local governments collected by the Ministry of Finance.

Another issue, until 2007, relevant laws regulated only the situation of default in the payment of short-term debt. The amendments to the Law on Public Finance define the procedure of the insolvency. Creditworthiness is an important dimension of the regulated insolvency procedures. The law does not obligate municipalities to receive ratings. There are

no domestic rating agencies (China 2004: 299) and very few municipalities have international ratings.

The local authorities are obliged to publish on special websites and to distribute the draft of the budget, the approved budget, the budget execution and development. This information must be distributed at least once a quarter, though the practical situation is still unsatisfactory (Nikolov 2004: 25).

To sum up, external audit and oversight on local budget implementation are in poor condition. The significant improvements on disclosure of information have been done recently. Though there are many problems with reporting and access to information on borrowers' creditworthiness in Romania.

3.5.5. Conclusions and implications for Ukraine. After examining the experience of the four countries, it seems that all of them except Poland have difficulties with proper disclosure of information. Rating agencies, which are crucial for the allocation of credit on the basis of risk, have not taken the proper role in all four countries. The Polish experience of Regional Accounting Offices is relevant for the Ukrainian problems.

3.4. Ability to manage debt

In this section the debt management capacity of Russia, the Czech Republic, Poland and Romania are evaluated.

3.4.1. Russia. A uniform debt management strategy is absent, as most cities do not develop long-term financial plans in Russia. This causes the prevalence of the short-term borrowing accounts. The undeveloped criteria of assessment of the use of budget and borrowed funds hinder the development of the market (Nikiforov 2004: 337). Due to weak implementation, the 'golden rule' of local borrowing is often not observed. These factors, matched with low professionalism, cause the problems with adequate planning and linking investment, fiscal and management policies, which are almost universal in Russia. Only

several cities with good reputation as debt managers, like St. Petersburg, Moscow, Novograd and Samara, have appropriate debt management (Alam 2004: 633).

The ratio of current surplus to current deficit for regional budget was 0.98% and -2.63% for municipal budgets in 2001. More than 71% of the total surplus are provided by four subjects of the Federation: Moscow (44%), St. Peterburg (11%), Tatarstan and Saha (Yakutiya) (Nikiforov 2004). The norms of the Budget Code are often violated and the sanctions are not applied in such cases. The restriction on the aggregate amount of debt is also violated. Municipalities fail to maintain debt books properly and to make them open to the public (Nikiforov 2004: 380).

To sum up, Russia has medium debt management capacity in terms of surplus/deficit ratio, but a very poor capacity in terms of rules and practices of managing debt and budgeting.

3.4.2. Czech Republic is similar to Russia in its inefficient practices, as there is a lack of uniformity of accounting practices and transparency. Carmo (2004: 510) explains the situation by various interpretations of the municipalities of the accounting procedures and terminology.

The absence of universal standards and transparency in fiscal operations could be a threat to the stability of the macroeconomic situation. In such a case, state statistics can become unreliable, and non-transparent contingent liabilities could appear as direct municipal liabilities only when the obligations are called (2004: 510). As contingent liabilities are not appropriately reported, there is no protection system to signal the level of risk to which municipalities are exposed.

In the 1990-s, a sustained local budget deficit prevailed with the biggest deficit of - 9.6% in 1996. The ratio of current surplus to current deficit was 2.33% in 2005 according to the Ministry of Finance of the Czech Republic.

3.4.3. Poland. Borrowing regulations are quite strict, and there is ex-ante control of RAOs over not observing the limits. The mechanisms rather support fiscal prudence than flexibility

(Valadez 2004: 546). The regulations are designed with a priority of stability at the national level, which has caused conservative and cautious debt management at local level (2004: 548).

Poland has done a lot to improve local debt management and it is currently working on improving the existing system. Poland has also put the coherent asset-liability management system and risk management systems on its agenda.

3.4.4. Romania. There exists an ex-ante control mechanism of borrowing by the Borrowing Commission, and the municipalities are obliged to report debt information to the Ministry of Public Finance. However, a proper consolidated sub-national debt management system is not fixed yet. Appropriate rules and institutional development are on the reform agenda (World Bank 2006: 85).

To analyze the debt management in Romania, the debt ratio should be assessed. As the surplus of local budgets increased from ROL¹¹ 540 billion to ROL 4151 billion during the period 2002 – 2004, the ratio of current surplus to current deficit made up 2.6% in 2004 (Romanian Statistical Yearbook 2004). Based on the analysis above, Romania has a medium debt management capacity.

3.4.5. Conclusions and implications for Ukraine. Table 4 gives a summary of the chapter. The table shows that the countries have low or medium debt management capacity, which means that this sphere is a challenge for the region. Though accounting practices are developing fast, there are still problems with proper accounting and asset liability management in the Czech Republic and Russia. According to ratio of current surplus over current deficit, the Czech Republic and Romania have a medium ratio and Russia and Poland have low ones.

¹¹ ROL – Romanian Leu, national currency.

To sum up this chapter, the case-studies showed the importance of timely regulations for the transition countries. Absence of good regulations at the initial stage may cause excessive irresponsible borrowing, like in Russia and the Czech Republic. It can also bring distrust of the investors and reluctance and cautiousness of the local authorities. Once a minimum set of regulations is in place, namely debt limits and default procedures, legal framework in its own cannot facilitate further development of the market. This is the time, when allocation of credit by risk and debt management capacity become crucial. Poland, which has comparatively better local credit market performance, followed the sequence when after establishing regulatory framework the efforts were devoted to the allocation of credit by risk and debt management capacity. The weak performers, Russia and the Czech Republic, did not complete the legal and regulatory framework stage. To sum up, at the initial stage, the legal framework is crucial, but once it is established, the allocation of credit by risk and debt management capacity should be paid equal efforts and attention.

Table 4. Comparing market characteristics of Russia, the Czech Republic, Poland and Romania and selections of sequencing

Table is adapted from Martell and Guess 2006 (p.112)

Credit Market Development Measures					Explanatory Variables		
Country	Size: Total Amounts Borrowed as % of GDP	Maturity Structures	Diversity: Instruments From Multiple types of Credit Institutions	Access to credits for small municipalities	Legal and Regulatory Borrowing Framework	Allocation of Credit by Risk	Capacity – Proxy of Current Surplus/Deficit
Russia	1.41	Longer	Medium	Low	Yes	Low	Low (- 2.63%)
Czech Republic	3.56	Longer	High	Medium	Yes	Low	Medium (+2.33%)
Poland	2.51	Longer	High	Medium	Yes	High	Low (- 6.88%)
Romania	0.70	Longer	Medium	Medium	Yes	Medium	Medium (+2.60%)

Sources: Values for Russia are based on data in Federal Service of State Statistics 2007, the Czech Republic – data from the Czech Statistical office 2007, Poland – Statistical Yearbook of Poland 2006, Romania – Romania Statistical Yearbook 2005. Data are based on the following years: Russia (2005), Czech Republic (2005), Poland (2005) and Romania (2004).

Conclusions

The purpose of the present research has been to identify an appropriate sequencing of the reform of the municipal borrowing in Ukraine based on regional experience. The research question was which of the three approaches should be prioritized.

The research was based on the hypothesis that a legal framework is crucial at the initial stage, but once minimum necessary norms are established, the allocation of credit by risk should be made a priority in time and efforts. The hypothesis has been confirmed in course of the research. Though, it needs specification as there is an important sequence of steps for legal and regulatory framework stage.

The result of the analysis of the cases of Russia, the Czech Republic, Romania and Poland showed that a legal and regulatory framework should be a priority for the reform. Additionally, the research showed that the stage of legal and regulatory reform should be divided into two steps. The first step should adjust the macro environment. This macro environment includes a sufficient level of development of local government and public finance. This level needs a presence of the sufficient truly own-source revenues, possibility for municipalities to pledge property or income, fair assignment of responsibilities for different tiers of local government. The necessary level of development also includes sustainable national credit and capital markets. Based on successes and failures of the four countries, the first step should include political decentralization, assignment of responsibilities along with creating local fiscal autonomy, solving the issues of the status of municipal property and allowing pledging assets and local revenues. These conditions should create the supply and demand sides for the borrowing operations.

The second step of a legal and regulatory reform stage should establish the basic regulations on municipal borrowing. These regulations include debt limits, purpose of use of

the funds, default procedures, and main insolvency procedures. Basic regulations also include the issue of guarantees of central government or another local government, public or private companies. Absence of basic regulations at the initial stage may cause excessive irresponsible borrowing, like in Russia and the Czech Republic. Absence of regulations can also bring distrust of the investors and reluctance and cautiousness of the local authorities. A legal framework, on its own, cannot facilitate further development of the market. Once a minimum set of regulations is established, it requires allocation of credit by risk and debt management capacity as well. The most important measures for allocation by risk and debt management are: facilitating increasing of number and proficiency of local rating agencies and improving disclosure of information and budgeting procedures. For success at this stage, coordination and engagement among central government, international assistance, municipalities and rating institutions is highly important.

The countries, which followed the described sequence, performed better. Following the sequence, these countries, first, created the favorable environment for local government. Second, they introduced borrowing regulations. After establishing regulatory framework, these countries devoted efforts to allocation of credit by risk, debt management capacity, improving transparency of the market and explicitly establishing hard budget constraint. The weak performers like Russia and the Czech Republic did not complete the legal and regulatory framework stage. The Czech Republic failed to eliminate interest-free long term loans from the Treasury which were turned into subsidies. Similarly, the Czech Republic failed to establish control and audit mechanisms. The four countries have some regulations for municipal borrowing with Poland having the most developed legislation. However, all of them have poor or unregulated default procedures, sources of collateral, guarantees and mechanisms of reporting.

To sum up, the legal framework is crucial at the initial stage, but once it has been established, allocation of credit based on risk and debt management capacity should be paid equal efforts and attention. These measures would improve ability to generate operational surplus at local level.

The research identifies that disclosure of information and debt management capacity are the biggest challenges for the region. These challenges should specifically be addressed through appropriate policies in Ukraine.

The research showed some other problems, which need to be addressed. Though accounting practices are developing fast, there are still problems with proper accounting and asset liability management in the Czech Republic and Russia. Another issue is a culture of non-payment of the local governments which are used to soft budget constraint after the socialist system. The research showed that Russia and the Czech Republic, failing to establish responsibility measures for local authorities, had irresponsible and imprudent borrowing. Such borrowing should be avoided in Ukraine because it poses threats to macroeconomic stability and brings over indebtedness of local government.

Recommendations

On the basis of the findings of the research, the reform in Ukraine should start with adjusting macro-environment. The second step should be the establishment of basic regulations and in case of Ukraine, elimination of disincentives for local borrowing. The second stage is to improve the access to information, creditors' rights along with debt management capacity. At the last step, further improvements in the quality of the regulations are required. The detailed recommendations for each stage are listed below.

1.1. Adjusting macro environment. The country should start with the political decentralization as the first measure. It is necessary to solve the issues of status of municipal property and allow pledging municipal assets. In addition, the assignment of responsibilities should be simultaneous with creating local fiscal autonomy.

1.1.1. In Ukraine political decentralization have not been implemented yet. Therefore, it is necessary to start with issues of direct elections of the Head of the *oblast* and *rayon* state administrations.

1.1.2. Each tier of local government should have clearly assigned responsibilities. Financing sources should match appropriately the delegated responsibilities. To prevent interference of the central and oblast authorities in local decision-making, it is necessary to clearly assign the functions to tiers of local government.

1.1.3. It is appropriate to put fiscal decentralization on social, political and media agenda. To increase own-source revenues of the local government, amendments should be introduced in the Budget Code. These amendments should grant the municipalities the right to impose taxes, change tax rate and base. The amendments should broaden the number of local taxes, ban exemptions given by the central state on paying local taxes. Local fiscal autonomy is

impossible without introducing a property tax and appropriate amendments in the Law on Local Taxes and Duties (1993).

1.1.4. Among first-aid actions to local government, fixing local budgeting system is especially important. The transition to the program-based budgeting should be performed and multi-year budgeting should be introduced.

1.2. The basic regulations on municipal borrowing: eliminating basic disincentives. To introduce sound regulations based on the principles and spirit of the European Charter of Local Self-Government it is necessary to amend current tax and budget legislation, as well as laws on financial market and local government. The authorities should stress the importance and urgency of Draft Law on Municipal Borrowing and Municipal Guarantees, which should be adopted and become effective in the nearest future. Following issues are important in this regard.

1.2.1. It should be clearly stated that there will be no bail-out by the central government. There should be no implicit or explicit guarantees. It is necessary to assert that the government does not provide guarantees SNG borrowing, and therefore that private investors lend to SNGs at their own risk. Introducing regulations of the procedures on the way municipalities can pledge assets, revenues, or fee income is urgent at this stage.

1.2.2. The amendments to the Budget Code are necessary for improving the definition and limitation of the local government debt. It would be more effective to tie the limit of debt to local revenues and not to expenditures. The definition of debt should include guarantees and other promises made by SNG to budget users or budget subjects and third parties.

1.2.3. The purpose of SNG borrowing should comply with the ‘golden rule’, allowing financing capital but not current expenditures. It should be allowed to refinance the debt with new debt.

1.2.4. The authorization and control procedure should be simple and efficient. At present, it takes a month to receive an approval from the SCSSM¹².

1.2.5. Government should introduce SNG insolvency proceedings, establishing a clear procedure for financial management of defaulting SNG. The government should appoint responsible authority to work out the debt and SNG finance management until it emerges from bankruptcy.

2. Facilitating the **allocation of credit on the basis of risk and debt management capacity** should be paid equal attention at the second stage.

2.1. Policy recommendations to improve allocation of credit by risk.

2.1.1. Urgent measures are required to improve access to information about local budgets. The responsibility of the Ministry of Finance should be determined for disclosure of full information about local budget implementation. Central government should take responsibility of control over the norms of fiscal transparency. The new technologies and Internet will improve access to updated information on implementation of local budgets.

2.1.2. After the defaults in Odessa and Crimea and long and chaotic repayment procedures the investors demand extra guarantees for protection of their rights. The laws should directly focus on the issues of pledging municipal assets, revenues, incomes.

2.1.3. The law should require local government to have external audit. It is indispensable to have regular and complete internal audit.

2.2. Policy recommendations to improve debt management capacity.

2.2.1. There is a need to improve the capital planning. Capital plans should reflect the plans of development of the cities. It is necessary to assess the condition of municipal assets regularly. Similarly, there should be new regulations regarding professional evaluation of implementation of capital investment programs.

¹² SCSSM – State Commission for Securities and Stock Market

2.2.2. It is highly important to develop national norms for management of the local debt. Disclosure of information should be performed on a regular basis in a standardised form available to everyone.

In view of the above, it is important to mention that the reform of the municipal borrowing should facilitate fiscal decentralization, devolution of power and local democracy. These principles are crucial for further economic and democratic development of Ukraine.

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