

## Legal Regulations and Local Government Loan Prospects in Ukraine: an Analysis

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*The major problems of municipalities (especially small ones) are roads and bridges, the waste management infrastructure, the clean water infrastructure, sewage treatment facilities, the natural gas delivery infrastructure, electricity, public transit, etc. As a rule, municipal budgets don't provide sufficient funds for solving these problems. Thus, the major sources of funding those specific needs are loans. According to the Budgetary Code of Ukraine (Article 16, Part 2) the following entities have the right to borrow: city councils (radas) and the Verkhovna Rada (Parliament) of the Autonomous Republic of Crimea (ARC). The Verkhovna Rada of the ARC and city councils have the right to receive internal loans (except in cases mentioned in Article 73 of the Budgetary Code of Ukraine); city councils of cities that have more than 800 thousand inhabitants (according to official records of government statistics at the time a decision about the loan is made) have the right to take outside loans. The Council of Ministers (Rada Ministriv) of the ARC, local state administrations, executive bodies of particular city councils may, subject to a decision by the Verkhovna Rada of the ARC or the proper city council, take out a loan from financial institutions to fund temporary budgetary gaps for a term not longer than three months within the time frame of the same budgetary period. The Ministry of Finances defines the manner of those loans. Budgets cannot make loans to each other (Article 73 of the Budgetary Code).*

A local government's borrowings have to have a defined objective and must be repaid. Local governments may take out loans only for their development budget, except in cases described in Article 73 of the Budgetary Code. The central government is not responsible for loans to local governments. Expenditures for servicing such debt are made from the budget. If in the process of paying the debt and servicing expenditures according to the agreement between borrower and lender the borrower fails to meet the payment schedule, the particular city council shall lose the right to borrow for the next five years (Article 74, Parts 1-3, 5 of the Budgetary Code).

Expenditures for servicing a local government's debt shall not exceed 10% of that government's budget during any budgetary term (Article 74, Part 4 of the Budgetary Code). However, neither the Code nor any other law defines the limits of the allowed borrowing and the fact that expenditures of local governments may vary, depending on the population of the city or region has not been taken into consideration.

Thus, cities with a developed economy and smaller cities without such potential have the same rules for borrowing within the above-mentioned 10% limit. For example, the overall budget of Kyiv is 2 billion hryvnias, while the budgets of such cities as Dnipropetrovsk, Odesa and Donetsk are 300-500 million hryvnias annually. Therefore, for servicing its debts Kyiv may spend 200 million hryvnias, which is a little bit smaller than the entire budget of Dnipropetrovsk [1].

To regulate the manner of borrowings, as defined in the Budgetary Code of Ukraine, the Cabinet of Ministers of Ukraine issued Resolution<sup>1</sup> 207, dated February 24, 2003 [2]. The resolution makes it mandatory for city councils and the Verkhovna Rada of the ARC to reach agreement with the Ministry of Finance of Ukraine on planned borrowings and any restructuring of debt. In order to get rid of bureaucratic delays the Ministry of Finance, after receiving the necessary information and documents specified in the resolution of the Cabinet of Ministers, must within twenty days review and determine whether the expenditures for servicing the local

government's debt is going to be made in accordance with the Budgetary Code. However, since the Ministry of Finance, in accordance with the law and procedures, has the right to demand additional information, the process of making the decision may be extended for an unspecified amount of time.

Borrowing is one of the sources of forming the special funds of local budgets (e.g., Article 70, Part 1, the Statute "About the State Budget for the Year 2004"; Article 62, Part 1, the Statute "About the State Budget for the Year 2005").

### **Types of Borrowing**

Local government borrowing may be in the form of bonds, internal local loans or agreements as to loans from financial institutions. Restructuring loans based on securities shall not maximize the local government's debt. In general, the local government's debt is the sum total of debt of the local community or the ARC, comprising all issued and unpaid debts of the particular community, including debts resulting from issuing credit guarantees or obligations resulting from an agreement or by statute.

Borrowing is a very important additional source of funding city development. Unfortunately, investment activity in Ukraine has not kept up with modern life or the real needs of local governments. The Ukrainian market of local government borrowing has several problems, one of which is the inadequate development of local government securities. For example, in the issuance of local government securities, instead of taking into consideration investor expectations and defining buyers, the main concern is the amount the government needs to borrow. Also, local governments have limited access to capital markets; the limits include terms, amounts and the manner of their issuance. Legal mechanisms for ensuring local government access to loans have to be improved. As a result, there are ongoing debates about passing a law to regulate local government borrowing and the need to protect investors. Additionally, there is a need to develop a methodology of credit, to identify conditions of obtaining credit for local infrastructure projects and to train human resources. Other problems that prevent local governments from borrowing include an unprofessional level of writing applications, insufficient transparency for potential investors and an inadequate understanding of the budgetary process. Another concern is that Ukrainian banks

are not eager to issue loans to local governments because of the high risk connected with the repayment of the loans.

### **Guaranteeing Repayment**

It is very problematic to guarantee loan repayment. Local governments borrow money only when there is a specific objective; loans have to be repaid in a timely fashion.

A mandatory requirement for a local government to borrow money from a financial institution is to secure the debt. However, it is very difficult for the local government to put something up for security. First of all, it is quite problematic to use municipal property for securing the debt. Financial institutions are not willing to take such property for securing the debt, since it is almost impossible to resell it (the sale might infringe on the interests of the local community) and there are objects that cannot be expropriated. Secondly, funds that are received from intrabudgetary transfers also cannot be used for securing the debt (because subventions have a specific goal and dotations are given only in cases where expenditures exceed income). However, they cannot be used for servicing municipal debt, in other words, for repaying the debt. The local government budget specifies the exact sum of money that may be used for servicing debt. This sum cannot exceed 10% of all spending of the particular local government budget during the budgetary term at the time the borrowing is planned (Article 74, Part 4, of the Budgetary Code).

A municipal government can only use the future income to its budget (not including intrabudgetary transfers) to secure its debt. However, this type of guarantee is usually insufficient for creditors, as it is not clear whether the government will receive its planned income.

The procedure of receiving and extending loans to local governments is regulated by the "Rules for Receiving Short-Term Loans for Funding Temporary Budgetary Gaps That May Occur During the Implementation of the Local Government Budget," as confirmed by an order of the Ministry of Finance of Ukraine, dated August 9, 2002, <sup>1</sup> 627; and the "Rules of Receiving and Repaying Interest-Free, Intermediate-Term Loans to Local Governments," as confirmed by a Resolution of the Cabinet of Ministers of Ukraine, dated March 24, 2004, №. 367 [3]).

## **Bonds as one Type of Money Borrowing**

Another type of money borrowing are bonds issued by a local government. Issuing local government bonds is a complicated administrative, legal and economic process and, according to Iryna Zaverukha, requires: indicating the purpose of the emission; an economic and financial analysis; identifying the sources and ability to repay the loan; recognizing the effect of the bonds on a local government's budget; analyzing the financial market and demand for the bonds; indicating the terms of issuing the bonds, the emission's volume and maturity dates; identifying the bond sale agents and making the necessary agreements; indicating the legal issues involved with issuing the securities; creating the mechanisms of selling the bonds and making payments [4].

A regulation on the manner of issuing local government bonds was approved by a decision of the State Securities and Stock Market Commission, dated October 7, 2003, <sup>1</sup> 414. This regulation establishes registration, issuance and announcing procedures for local government bonds (internal borrowing). Also, the document regulates the manner of reporting the results of the bonds issue, the paying off and the cancellation of the registration of the bond issue [5].

Issuing and distributing local government bonds helps to resolve several problems, in particular: 1) political (local governments can be less dependent on dotations and subventions from the central government budget); 2) budgetary (covering the budget deficit; easing the problem of irregular funding of local government budgets; partially resolves the problem of mutual computations); 3) investment (financing investment projects and the social infrastructure; activation of the local stock market); 4) social (financing social projects; creating jobs; creating new methods of protecting people's savings from devaluation) [6].

In 2003 Ukrainian local governments issued securities and bonds (internal borrowing) for the total sum of 150 million hryvnias; however, only two thirds of that sum was raised, because the distribution period was too short. The same year the Zaporizhzhia and Donetsk city councils decided to raise funds by issuing internal securities. Accordingly, they issued local government internal securities with a nominal value of 25 million and 20 million hryvnias, respectively, in 2004. There are other examples of local governments issuing internal securities; however, the

first issuance of local government internal securities in Odesa, unfortunately, was a fiasco.

The Ukrainian market of local government borrowing has more than a few problems. Local government internal securities are not well constructed. There are several explanations for this: instead of focusing on investor objectives, they focus on the local government's borrowing needs; an analysis of potential buyer profiles and his/her goals are not made. Also, local governments have limited access to capital markets; there are limitations on maturity terms, amounts and procedures of issuance and design.

In order to resolve these problems the Cabinet of Ministers on July 17, 2003 issued Resolution <sup>1</sup>1101, "On the Creation of a Cities Development Fund in Ukraine." The Cities Development Fund (further, "The Fund") was created according to an agreement between the Cabinet of Ministers and the World Bank, in order to: 1) form a system that will finance city development; 2) support socially important local government projects; 3) prepare and implement "The Fund of Municipal Development in Ukraine" project. To create the Fund in Ukraine the World Bank gave a loan of approximately \$70 million. The objective of the project was to decrease the volume of work for the World Bank in giving the loans. The elaboration of a municipal project has to be done by the borrower (the local government); in case of a positive outcome the World Bank will finance the project.

## **The Fund of Municipal Development in Ukraine**

One of the most important Fund projects supported by the World Bank is "The Fund of Municipal Development in Ukraine" (further, "The Project"). The Project will give local governments the opportunity to implement socially important projects which need financing. At present, access to financial resources is limited. Those types of investments have to promote local infrastructure development, improvement of the quality and variety of services and, finally, the total local economic improvement. Also, the financing system that is foreseen by the project will give local governments an opportunity in a quick and effective manner to decide which investment project has priority and what should be the sources and conditions of its financing. Other objectives of the project are to prove to financial institutions that giving loans to local governments is profitable, to help develop the

market of local government borrowing and to increase the well-being of the population.

According to regional coordinator Saule Illinyh, the World Bank project won't resolve all of the local governments' problems; however, it will give a good start to the improvement of the Budgetary Code and administrative and territorial structural reform in Ukraine. The program has two goals: to increase the financial possibilities of local communities and promote a partnership between commercial banks and local governments. The Cabinet of Ministers of Ukraine has to work out the mechanism of extending credit. It is up to the Ukrainian government as to whether the World Bank will grant credits to local governments in Ukraine. Certainly, there are sectors that have a priority claim on financing, first of all housing and energy conservation. Also, in order to be workable, it is important to lower the interest rate threshold for small cities. For example, the World Bank will finance projects costing 2.5 million hryvnias, but with an interest rate close to that of commercial banks (the World Bank offers interest rates from 14% to 18%). Considering that, it is easier to pay commercial banks the additional 2-3% (for a total of 20-22%), than to finance the project through the Fund. The practice in western countries is different; a high-risk project will receive a maximum of 10% interest rate. Thus it creates and stimulates demand for credit [7].

In order to finalize the financing of the Project's preparation, a letter-agreement was signed on May 27, 2004 by Ukraine and the World Bank, which stipulated that an advance in the amount of \$1,485,000 be paid. The letter-agreement took effect that same day.

On August 25, 2004 the Cabinet of Minister of Ukraine issued Resolution № 1077, "On Buying Goods and Services Within the Scope of the Advance on the Loan to Prepare the Fund of Municipal Development in Ukraine Project" (Program of Municipal Credit Markets, developed by the Ministry of Finance of Ukraine). Finally, in fall 2004 the Fund was registered. In 2005 the Fund began the registration of potential borrowers and the investment projects for which they wished to receive credit within the framework of the project undertaken together by the World Bank and the Ministry of Finance of Ukraine. The main goal of the project is to assist in the development of a credit market, in order to finance local governments' investment needs. To facilitate this goal the World Bank gave a \$150 million loan to the Ukrainian gov-

ernment. It was decided to use the loan to improve the system of intrabudgetary relations and procedures to regulate the market of local government borrowing in Ukraine.

Despite the enormous amount of work that had been done, in June 2005 it was proposed that the Fund be reorganized. The Ministry of Finance in its decision annulled the Fund; the World Bank initiated to combine all the local government support projects into one big project. This leads to another problem — it is not profitable for international organizations to invest in Ukraine. It becomes clear that a project is created and begins to function and then is annulled, with no way to get back money spent. The question is why would someone even begin to invest?

### **The International Experience of Local Government (municipal) Borrowing**

In many European countries the market for local government borrowing is one of the most important sources for financing long-term and expensive investment projects. International experience in this field proves it to be very effective. As a rule, the borrowing is made through the issuance of local government (municipal) securities. The majority of local governments in European countries have their own budgets and the right to define their borrowing policies. However, not all local governments have the right to issue their own securities. For example, in Sweden only the six largest cities have the right to issue their own securities; smaller cities and their councils have indirect access to the market of local government borrowing through the municipal financial corporation Kommuninvest and Sverige AB. In Denmark local governments issue their securities indirectly through the KommuneKredit Association, which is a specialized bond institution that gives loans to local governments and to companies that have guarantees from local governments. The local governments (municipalities) are members of the association and independently and/or jointly are responsible for their borrowings. In Germany and France the local governments (municipalities) may borrow only for investment projects [8].

In the U.S. the market of local government borrowing is focused on the main buyers – investment and insurance companies and individual citizens. In the U.S., local government borrowing are considered securities and are issued by states, counties, school districts and other

districts. It is very important to remember that the income from these types of securities is exempt from federal income tax. This type of income is also exempt from state and local taxes if the investor resides in the municipality where the issuing institution is located. However, there are securities that cannot be exempt – for example, those that were issued after the tax reform in 1986 and which don't have a particular objective and industry securities (income is taxed using the alternative minimal rate). The most popular types of securities in the U.S. are general obligation and revenue bonds. General obligation securities are voter-approved bonds that are backed by the full faith, credit and unlimited taxing power of the issuer. Revenue bonds are bonds secured by revenues derived from a particular service provided by the issuer or the project itself will generate income to secure the bonds [9]. There are also short-term bonds that exist in the form of credit bonds.

The market of local government (municipal) borrowing in Poland, which consists of long- and short-term securities, accounts for a big percentage of the financial market. This source of income originated in the 19<sup>th</sup> Century, when big cities started to issue their own securities to finance infrastructure development. Today the goal of local government borrowing is to fund investment in the following fields: 1) road construction, modernization and repair; 2) mass transportation and communication infrastructure; 3) housing; 4) communal management and protection of the environment, including the sewage infrastructure (these fields are mainly financed jointly with the European Union); 5) education; 6) health; 7) culture, art, sports and tourism; 8) security and fire prevention [10].

It is interesting that the Russian Federation's legislation does not include any provisions that would allow local governments to borrow externally; only federal and regional governments have the right to borrow externally. However, Article 6 of the Budgetary Code of the Russian Federation does provide the right to borrow funds from one budget to another (on a rotating, free-of-charge or paid basis for a term not more than six months); however those "budgetary transactions" differ from local government (municipal) borrowings. Local government borrowing involves a debt instrument in which the issuing authority promises to pay bondholders a specified amount of interest for a specified length of time and repay the principal invested on a given maturity date.

## Conclusion

Taking everything into consideration, we can insist that there is a need and expediency in developing a market of local government securities in Ukraine. As to the market of loans from financial institutions (mainly banks), this type of local government borrowing is not well developed in Ukraine either, due to high interest rates, as well as problems with securing and returning loans. Thus, in order to resolve these issues several laws that regulate local borrowing and local guarantees will have to be adopted.

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#### Vietinių skolinimūsi rinkos teisinės problemos ir vystymosi perspektyvos Ukrainoje

Santrauka

Straipsnyje analizuojamas Ukrainos vietinių skolinimūsi rinkos teisinis reguliavimas ir dabartinė vystymosi būklė. Nagrinėjamos įvairios skolinimūsi formos: vidaus vietinių paskolų obligacijos ar (ir) sutarčių dėl skolinimūsi, kreditų, kredito linijų finansinėse įstaigose gavimo sudarymas.

Remiantis kitose šalyse atlikta lyginamąja ir teisine skolinimūsi analize, daroma išvada, kad daugelyje išsivysčiusių šalių, taip pat ir Europoje, vienas iš ilgalaikių ir brangių investicinių projektų finansavimo šaltinių – kreditai miestams. Šiuo klausimu įdomiai pateikiama tam tikra Švedijos, Lenkijos, Prancūzijos, Danijos, JAV ir kitų šalių praktika.

Straipsnyje pagrindžiama įstatymų dėl vietinių skolinimūsi ir vietinių garantijų priėmimo Ukrainoje būtinybė.

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