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Financial and Banking Services Market

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MUNICIPAL BOND MARKET IN UKRAINE: HISTORICAL BACKGROUND AND PROSPECTS

Abstract

The paper reviews the historical background and the development of the local loans markets in Ukraine. The paper examines the municipal loans markets in other EU and Asian countries. The paper also examines the current issues of the development of the local loans market in Ukraine. The paper ends with certain suggestion for improvement in the national system for allocation of local budgets.

Key words:

Local (domestic) loans, home debt, securities, project borrowings, loans to redeem the temporary cash gaps, municipal securities market, restricting norms, rating agency, default, debt refinancing, emergency budget.

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Introduction

Strengthening of the municipal government and securization of risks of its financial self-sufficiency in the frameworks of a state democratization is becoming a major problem. A lot of scientific researches are substantiated on the issues of formation and operation of the local budgets, as well as on the improvement of the interbudgetary relations. Moreover, the issues of the local loans, that do play an important role in the mobilizational process of financial resources of the municipal government, are not studied properly and require more complete investigation. Therefore, the issues of the local borrowings and municipal credit have been widely disputed in the literature of Tsarist Russia and that of the USSR at the end of the 19^{th} century and at the beginning of the 20^{th} century. Among, the most prominent scientific researchers at that time were A. Doroshenko, I. Ozerov, V. Tverdokhlyebov, E. Chernekhovs'ky who provided a scrupulous analysis, while N. Grynchuk and V. Kravchenko investigated only some aspects of this problem. The issues on the municipal loans drew a bit greater attention from a few foreign researchers – Y. Bezsmertna, E. Dobson, R. Grunin, V. Lexin, S. Pakhomov, A. Pigut, I. Starodubrovs'ka, J. E. Stiglitz, B. Kheifetz, D. Chernik, V. Sharomova, A. Shvetsov. As the majority of these investigations seem to be not sufficient, a principal question remains unanswered: how to form an efficient system of the local loans? How to optimize its functioning?

Consequently, there are many urgent issues in the sphere of domestic borrowings that are to be settled both in theoretical, and in practical aspects. Currently, this investigation is of a prior importance as it is tightly connected to the resolving of the tasks that strengthen the financial basis of the local self-government authorities.

The objective of this research is to define the ways for improvement of the local credit system in Ukraine taking into account the national and foreign experience.

I. Theoretical Background of the Local loans

Local self-government authorities try to select the best sources for the resource-base formation in order to consolidate the financial resources for implementation of their activity. This brings about a dilemma for local self-government – whether to be restricted by the incomes, which were allocated to the budget at the non-payable base, or to attract the loan receipts. Any preference has both positive and negative aspects.

Recently, the amount of public and local borrowings has risen considerably in the majority of the developed countries. Some basic factors that has influenced it greatly are: a) from the psychological perspective, the people react on the public debt growth in more subtle way, rather than on the growing tax rates and on the cutting down of the budget expenditures; b) domination of the Keynesian approaches in the fiscal policy of the post-war countries that approved the expediency of the public loans and; c) an increasing expansion of the financial markets.

An alternative to the public welfare financing, loans are more lucrative compared with the income tax revenues. As a rule, the financial resources are the principal source of the obligatory budget payments by the local subjects of economic activity with a corresponding self-governing authority. Therefore, the financial resources tend to shift from private finances to the public ones, negatively influencing the potential of the enterprises. With the development of the financial markets many natural and legal entities from different places are becoming the local creditors. Such cases results in foreign capital inflow at local level thus increasing the regional economic potential.

An essential difference between tax and credit way of the formation of a budget resource base is in the completely different approach to the payment obligations.

According to Arthur Pigut: «One of the two well-off men, who builds a factory, and another, who is not able to invest his capital, the latter will eagerly take part in the loan allocation. But taxes do put them both into the equal conditions» [1: 200]. Therefore, we may trace a general increasing of the efficient finances consumption by two men.

Developing of loan market involves, local self-governing body specifying the formation of the creditors groups, who will be more interested in the efficient economic activities of the local authorities. Tax payers knowing of their burden of debt redemption will get more conscious in the quality of the governing policy of the elected members. These actions will in turn lead to the improvement of local budgets' management.

Currently, operating with the domestic loans the local self-government authorities stimulate the growth of the level of social service consumption at the expense of the new generations to come, which will cover the debts later. From another viewpoint, the finances index of the long-term projects is unfair regarding to the present generation, as, in such case, only future generation will receive the revenues out of these projects. Joseph E. Stiglitz substantiates the conclusion: «The expediency of such policy (borrowings) is a matter of a temporary distribution of an income, a matter of a rational distribution – whether it should be left for the present generation or for the future one» [2: 803]. Consequently, a current science on the domestic finances is considered to be reasonable in financing of the long-term projects at the expense of the costs from the loan sources that will be of a great value for the future generations, responsible for the burdensome taxes, that are integrally connected with an obligation of the service outlays allocation as well as with the reimbursement of loans.

II. Historical Background of the Local Loans Market

Adoption of the Magdeburg Law to many Ukrainian towns became an impetus for the development of the local self-government institute of our country. The Magdeburg Law was adopted by Lviv in 1356, Kamianets'-Podilskyi in 1374, Luts'k in 1432, and Kyiv in 1494–1497, in a whole, the Magdeburg Law was widely spread in more than 500 Ukrainian towns [3: 21].

However, formation and development of the mechanisms of the local loans processes by the local self-government of Ukraine took place much later – in the second half of the 18th century. During this period land reform were conducted in Zemstvo (1864), and an urban reform (1870) in the Ukrainian territory. Also it is important to note that Ukraine was being a part of the Russian Empire. While the region of Galicia was a part of the Austrian State (since 1867 – Austrian-Hungarian Empire). A public law on the local self-government was enforced in 1862, and the laws on the urban (1889) and rural (1866) self-governments were adopted by the Galician Seim [4:71].

At the end of the 19th and at the beginning of the 20th century Tsarist Russia that included the most of Ukraine territory developed different forms of the municipal credits: funded and non-funded loans, state credits, rural, commercial and public banks, since 1912 – State Treasury Urban and Land credit.

Though, many towns of the Russian Empire used different tools of domestic borrowings, a share of funded loans performed the greatest half of the urban liabilities, and in 1912 it amounted to 343.28 billion RUR or 76.89% of a total debt [5: 63]. Structure of the municipal credit of that time (Table 1) indicates that other ways of domestic borrowings couldn't compete with the funded loans, specifically in the biggest cities of the state.

Table 1.

Debts in the Tsarist Russia in 1912 according to the Municipal Credit [6]

Credit Forms	Debt Amount, mln. of rubles	Share in Total Debt Amount, %
Credit Forms	343.28	76.89
Funded loans	42.20	9.45
Public and private bank's loans	31.00	6.94
Private and institutions' loans	18.00	4.03
Debts to private owners	12.00	2.69
Treasury and state bank loans	446.48	100.0

The issue of the municipal funded loans in the pre-war Russia was rather popular and efficient way of costs attraction to the local budgets, and the annual amount of expenses grew considerably at that time.

The first security bond loan was issued in Revel town of the Eastland province (now Talinn) in 1871 for a term of 34 years. The amount of the loan equalled 50 thousand rubles [5: 63]. Since then, such form of municipal loan had spread widely in the Ukrainian cities. Thus, the funded loans issued by Kyiv in 1876 amounted to 500.000 rubles and in Odessa in 1879 for 3 mln. 750 thousand of rubles These were among the first loan bond issued by the Tsarist Russia [7: 210]. By 1 January of 1913, 65 towns of the Russian Empire had issued the loan bonds. Moreover, it is worth while to mention that 522 loan bonds of the urban and rural communities were already been circulated in Germany [7: 210]. More efficient expansion of the loan bonds in the pre-war Russia was hampered by the undeveloped home market of the municipal securities. Thus, the greatest share of loan bonds were floated in the Western European countries. Moreover, the municipal loan bonds were mostly issued in the largest Russian cities, which could afford the cost of issuing and its allocation.

By 1 January of 1913, the total amount of the municipal funded debt of the six greatest Russian debtors: Moscow, St. Petersburg, Warsaw, Baku, Riga, and three Ukrainian ones: Odessa, Kyiv and Kharkiv amounted to 82%. The total nominal value of the out-standing municipal loan bonds was 471 182756 rubles. Before the World War I, Moscow only issued 48 loan bonds for more than 150 mln. RUR [5: 63].

Traditionally, the municipal loan bonds were issued for long periods, approximately from 30 to 50 years, sometimes more. For instance, a loan bond issued in St. Petersburg for duration of 73 years and Kyiv floated loan bond for 77 years. It was the most long-term loan in the Tsarist Russia in 1909 [7: 212].

A determined character of the loan bond was its peculiar feature. Loans on allocation of the lucrative projects or waiving the expenses to cover the debt performed a basic category (over 60%). Though, about 22% of the loan bonds were aimed at realization of the socially-important unprofitable projects. Few loan bonds were issued to redeem the previous bond issues.

On condition of a sustained growth of the budget expenditures in Kyiv, the bond issues were allocated to cover the debts. Despite the accelerated economic growth that influenced an increasing volume of incomes to the local budget, that kept growing significantly, and in 1879 it made 0.8 mln. rubles, amounted to 1.3 mln. of rubles in 1895, and to 4.2 mln. of rubles in 1912 [8: 304]. According to the urban reform of 1870, local budget should distribute the cash expenses to support the local council, governing institutions, court, police, fire brigades, budget-financed enterprises, educational and charity institutions, hospitals, jails, etc. These obligatory expenses were high enough, thus the cash expenses allocated for the city welfare (road building and repairment, bridges' construction, towns' premises, paving the streets and other requirements) were definitely not enough.

The funds borrowed by Kyiv Duma were distributed for the building construction (4.2 mln. RUR), sewer system (3.1 mln. RUR), street pavement (1.4 mln. RUR), and the municipal enterprises (1.3 mln. RUR) [8: 305].

Structure of the credited budget expenses in Kyiv on 1 January of 1913 is illustrated in Table 2.

Table 2.

Borrowings to Kyiv's local budget on 1 January of 1913 [8]

Target finance expenses	Amount, mln., RUR	Share of the total loan amount, %
Public construction	4.2	36.2
Water supply and sewerage	3.1	26.7
Road construction	1.4	12.1
Municipal enterprises construction	1.3	11.2
Educational establishments construction	1.0	8.6
Medicine and sanitation	0.45	3.9
Other spheres	0.15	1.3
Total	11.6	100.0

As it is shown in Table 2, the allocation of borrowings for development of the local infrastructure and city welfare were the basic objectives. While the investments to the lucrative projects were limited, such financial distribution provided for no high revenues.

While on 1 January of 1913, only 65 towns issued the municipal funded loans – a principal source of the local borrowings, more than 300 Russian prewar provincial towns and boroughs, implemented other means of loans [5: 64]. Such restricted loans performed a low share of the total debt amount. While on 1 January of 1898, the amount of the State Bank loans for towns and villages (zemstvoes) still made 52 thousand RUR, but by the year 1904 such loans did no longer exist. Because of some legal and financial restrictions, the credit volume of the land and commercial banks was also insignificant at that time [9: 205–207].

An adoption of the law on formation of separate counter cash for town and zemstvo credit in the Russian Empire in 1912 brought about a new institution in the sphere of the municipal credit. Towns and zemstvoes were allocated both long-term and short-term loans. Long-term loans extended only on the capital expenditures, mainly on the purchase and diversification of the municipal property; short-term loans were allocated on some definite projects, as well as on the in-flows to local budgets. Fixed and current capital of the counter cash of town and zemstvo credit made 20 bln. RUR was formed via State Treasury expenses. The law provided the municipalities with a loan allocation without the mortgage ensuring of the joint stock banks, as well as the long and short-term loans allocation by the land banks [9: 213]. The activities of the local communal banks were diversified. The first local communal bank appeared in 1778 in Vologda [7: 211]. Some positive changes in the sphere of the municipal loans were hampered by the World War I, and later by the Revolution of 1917.

The average indebtedness on the municipal loans in the eve of the World War I did not exceed 20 RUR per capita in the pre-war Russia, that debt amount was considerably lower than that of the majority of debtors – cities in the Western Europe and the USA. For instance, the debts of Manchester was to the amount 350 RUR per capita, New York – 284 RUR, Rome – 150 RUR, Genoa – 100 RUR, Dublin – 60 RUR [5: 63]. However, the indebtedness in some cities of the Russian Empire was increasing dramatically.

On 1 January of 1913, the total debt amount in Kyiv was around 11.6 mln. RUR that exceeded 2. 5 times the total amount of the budget revenues. On average, a per capita expense in Kyiv was around 8.6 RUR in 1904; 17.8 RUR in 1910, and 20 RUR of the city debts in 1912 [8: 305]. The process of a debt growth influenced the other towns of the Empire. For instance, in 1902 a total debt amount in Kharkiv amounted to 3.7 mln. RUR, and exceeded 1.9 times the amount of the prospective revenues for 1902 [10].

The cost on the municipal loan redemption and debt service constituted significant part of the budget expenditures in the pre-war Russia. Moreover, they tended to grow both in the absolute and relative indexes. For instance, in Moscow such expenditures made 411,9 thousand RUR, or 5.3% of the total budget expenses in 1890, in 1900 – 1373.1 thousand RUR, or 10. 8%, and in 1913, the total expenditures amount made 9065.0 thousand RUR, or 19.1% [11: 55–59]. While, an average annual growth rate of the obligatory payments volume on service and debt redemption exceeded 90% for that period.

A sustained growth of the local debts had many negative consequences. Thus, Kyiv State Duma stipulated to take to some unconsidered and inefficient moves that brought the most lucrative communal enterprises to concessions. Before the World War I, the most important branches of the public utilities, such as: tram, electrification, gasification, water supply system, etc., were governed by the concessionaires, predominantly, foreign proprietors. Specifically, 90% of Kyiv electricity community shares belonged to the German capitalists, and 85% of the public tram shares – to the Belgian ones. Earning billions of revenues, they paid off miserable percents to the local budget, and when the local authorities started negotiating on the enterprises redemption, they started charging high tariffs for utilities. An obligation to pay them out led to new borrowings, and new debts. For instance, in 1908 Duma borrowed 1 mln. Hryvnas to repair the sewerage. The local self-government authority had to make a big loan of 21 mln. Hryvnas to redeem the public tram, and till 1917 a tram was not repurchased [8: 305].

At the end of the 19th century and at the beginning of the 20th century in the Western Ukraine, which was a constituent part of Austro-Hungarian Empire, and later of Poland, bank institutions promoted issue of loans to the municipalities. Specifically, the borrowed costs were distributed for the reconstruction of St. Ann's Roman Catholic Church in Lviv, for the agricultural school in Dubliany, school of drama, and for the voluntary fire protection. In the year 1880, the Galician Saving Bank allocated the State Budget of Lviv with a loan in 800 thousand (ryns'ky) golden coins for construction of schools, and barracks for the military service men [12: 22]. In the year 1930, when Galicia was under Polish control, the local authority of Lviv used 8 mln. Zlotykh as bank credits, which were directed to finance the projects on the city arrangement and welfare [12: 65].

It is quite obvious, that the practice of domestic borrowings in the pre-war period was spread and diverse. In our opinion, both positive and negative outcomes of such experience are to be considered in the modern era. In view of this, all possible measures should be implemented to strengthen the financial base of the local government authorities, for the improvement of the investment mechanisms, the municipal infrastructure, and the quality of the public service. Currently, the municipal credit remains a unique market, and its feasibilities are not completely realized in Ukraine yet.

It is worth to mention that the loans were not only allocated to the lucrative projects, but were also were allocated for the communities projects of the corresponding municipalities. Now, when the social role of the local budgets gets more significance, it would be irrational to ignore this matter, forgetting that a social effect can be sometimes as important as the direct material benefits.

III. The Development of the National System of the Local Loans

Active development of modern Ukrainian system of the local loans market started an in the mid 90's of the last century. A national market for the municipal loans began operating in 1995. State Commission on securities and stock market was also responsible for the issue of the domestic funded loans in the current year. First Ukrainian local funded loans appeared in 1995 in Dnipropetrovs'k, Kyiv, Kharkiv, and Donets'k. By 1998, more than 10 Ukrainian cities issued bonded securities to the amount of 200 mln. Hryvnas [7: 204–207]. The borrowed money was used mostly in the communal economy, housing, and local transport infrastructure. The years of 1996 and 1997 were the most progressive in the history of the local loans market. During this period, a normative and legal security of the local loan system was started. On October 1997, State Commission on securities and stock market worked out the first regulations and procedures on the bond allocation of the local loans. Next year, President of Ukraine issued adopted a decree #655/98 dated June 18, 1998 «On Ordering of Internal and External Borrowings by Local Governments». It corresponded to the governing trends in the highly developed world countries, specifically, in EU. A resolution on the access of the local authorities to the capital market to allocate the loans, ratified by the European Council in the early 1970 of the previous century became the impetus of the local loans development [13].

Decrease in the activity of the national market of domestic loans started in 1998. According to one viewpoint, the reason was the announcement of default of loan bonds exceeding 91 mln. Hryvnas in Odessa. However, we suppose that the inconsistent state policy on the domestic loans system and local finance in a whole had the deepest and most negative influence. The preference to allocate the borrowings imposed on the local authorities in the context of the law «On the Local Self-Government in Ukraine» failed to be reasonably implemented

Under such circumstances, both legal, organizational and technical security of the local borrowings market required a radical improvement.

The adoption of the Budget Code started a new stage of the municipal loans development in Ukraine. Except this normative act, the other laws of Ukraine, such as: «On the Local Self-Government in Ukraine», «On Securities and Stock Exchanges», «On State Regulation of Securities' Market in Ukraine», recomendation of the Cabinet of Ministers of Ukraine #207 dated February 24, 2003 «On Approval of Procedure of the Loan Allocation to the Local Budgets», and recomendation #414 «On the Process of Ordering of the Bond for Internal Loans», ratified by the State Committee of securities and stock market, dated October 7, 2003 created the legislative base of the national system of domestic loans. It is worth noting that adoption of some important normative documents regulating a sphere of domestic loans for the recent two years should be treated positively. However, the loan market that is open to all the changes occurring in the system of domestic borrowings regulation proves that this system still tends to be reformed. Consequently, in 2003 only two Ukrainian cities allocated the loans – Kyiv (150 mln. USD and 120 mln. Hryvnas), and Pivdenne (1.2 mln. Hryvnas) [14: 2].

The fact the availability of the two principal groups of municipal loans peculiar to the modern national system of the local loans became typical, with each performing different functions, benefiting each other. The first group comprised loans which serve to cover the temporary cash gaps, emerging in the local budgets' operations; while the second one – involves the loans for the development budgets' of the local authorities.

The commencement of the cash service at all budget levels by the Treasury authorities brought about the trend to allocate the loans to the local budgets for covering the temporary cash gaps by means of the resources of a single treasury account. The local authorities receive these loans on the free-of-charge base from the regional State Treasury institutions. The procedures of these loans are not complicated, and their requirements are accessible for all local budget levels. The loans for covering of all the temporary cash gaps ensure a timely allocation of the current expenditures, primarily, the social ones, from the local budget fund.

Traditionally, the loans that are delivered to the budget for development stipulate the extension of the local infrastructure and strengthen the material and financial base of municipalities at the expense of revenues from the lucrative projects. These loans tend to resolve the strategic tasks that lead to a highly qualitative financial security of the self-government authorities rather than on doing away with the local issues. The loans can be collected in two ways – either by means of local loan bonds issue or agreements on the receiving of loans, credits and credit lines from the financial institutions. The bonds may be issued to the payee both in documentary, or non-documentary form with an identification of nominal holders.

According to Article 16 of the Budget Code of Ukraine [15] only Verkhovna Rada of the Autonomous Republic of Crimea and the local authorities are authorised to transfer the borrowings to the budget of development. The majority of the local authorities, primarily, village and district administrations are deprived of such feasibility, which could have considerably improved their material and financial base.

Current system puts a number of other restrictions on the local loans. Thus, the external loans may be borrowed only by the local councils of the cities with the population over 800 thousand people. Current official statistic data analysis showed that only six cities – Kyiv, Kharkiv, Dnipropetrovs'k, Odessa, Donets'k and Zaporizhya are among them.

An assessment of the Ministry of Finances upon whether such loans meet the Budget Code requirements is an obligatory stipulation for the loan allocation to the budget of development of the local authority. Moreover, any local authority should be rated by the Rating Agency. It is worth noting that the World Bank, International Monetary Fund or the European Bank of Reconstruction and Development confirmed the status of the Rating Agency by the expert certificate [16].

The debt reimbursement cannot exceed 10% of the total capital expenses of a corresponding local budget during any budget period, when the debt service is planned. In few cases, corresponding council are sometime are deprived of allocating the new borrowings for the next five years [15].

The analysis of the normative and legislative base of the local loans market shows discrepancy, lack of consistency, and prevents the formation of the integral system of the local loans' regulation. A system of valid restrictions, some of them being rather poorly substantiated, considerably hampers the development of the local loans in Ukraine. Undeveloped market of the municipal securities at the national market is the other obstacle.

Some expectations for the improvement of a current situation are based on the activity of the Municipal Development Fund that was financed by the International Bank for Reconstruction and Development, and was formed in Ukraine in 2004 [17]. One of the leading tasks of the Fund Program is to maintain the self-government bodies as well as their local enterprises in operation, determination of the priorities, and selection of the investment projects. However, under current conditions, fund's activity shouldn't be treated as a panacea for all the unsettled issues in the sphere of the local loans. Therefore, implemention of some substantional improvements in this sphere should be associated with the complex of interdependent measures that would improve legislative, organizational and technical security of the local loans' system.

IV. Foreign Experience Analysis of the Local Loans

Recent foreign experience demonstrates the process of diversification of the local loans as an efficient means of financing the municipal expenses. Thus, the practice of the local loans in some of the European countries goes back to the end of the 19th century, and until now, this loans have been playing an active role in the activity of the local authorities. As shown on Figure 1, the amount of the local loans on 2003 compared with GDP reached its highest point in Germany (24.9%), in Belgium (10.9%), and in Italy (9.5%) with the average exceeding 5% of GDP for the European Union countries [18]. The amount of the local loans in Ukraine is considerably lower than in the majority of the European countries. During 2004, it fluctuated within 0.2–0.3% of GDP, and by some estimate, would not exceed 0.5% of GDP by the end of the year [14: 2].

Security loans, bank and financial institutions credits, as well as the interbudgetary loans are considered to be the most expanded forms of the local loans abroad. Depending on the specifics, security loans are divided into three principal groups:

a) general obligation bonds – unprofitable bonds, secured by the budget revenues and the property of the local authorities;

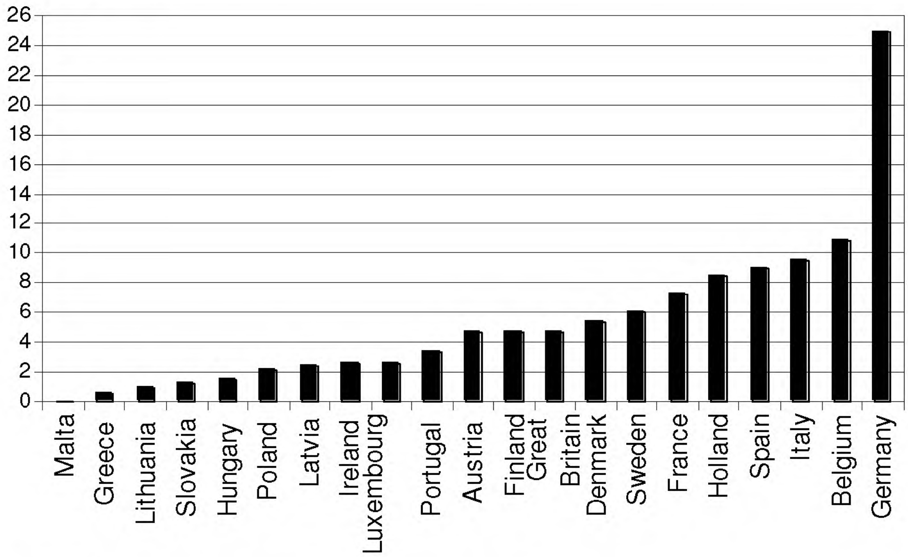
b) profitable bonds, issued for local infrastructure development, are usually redeemed by the revenues from the newly-built local infrastructure; and

c) bonds of a mixed type, providing no revenues, but are paid off by the costs from the built objects [7: 215].

Traditionally, only the most powerful foreign municipalities entered the financial markets autonomously. Therefore, the local self-government authorities of the European countries allocate the most of borrowings through the special credits from financial institutions. According to the assets amount, such institutions have become among the leading ones recently, and in the scales of the financial world market are rated to be the most confident. International (Belgian-french) banking group «Dexia Group» is the largest European institution that lends credit to the municipalities and the regional governments. In 2000 it controlled 10% of the municipal financial service market in Europe and owned the consolidated assets in the amount of 200 bln. USD [19: 93].

Figure 1.

Domestic Loans in the European Union Countries on 1 January, 2004
(in % of GDP)



Source: Committee of the European Union Statistics /http://www.europa.eu.int/comm/eurostat/newcronos.

In most of the European countries, a state is a guarantee of the obligations of the local authorities. It gives opportunity for favorable loan allocation. Rating of securities by the local borrowings in these countries equals to the rating of the state debt securities. Providing guaranties to the local loans, a state take some measures to minimize the risks. Central governments are regularly reported on the situation in the local finance sphere, also influencing in administrative matter of the municipalities.

The experience of the local loans in the developed countries substantiates the importance of the system of loan restrictions, which prevents local finance disbalance, as well as observing quality, performed by the local authorities. Loan restrictions are imposed either by a central government or by the regional and municipal governments autonomously. Both, direct restrictions, specifying the debt amount or service debt expenditures, and indirect restrictions, specifying the loan implementation or target distribution, as well as the budget deficit amount that may be allocated.

In the majority of the federal states, central government imposes no restrictions on loan amount for the regional and local authorities. In some cases, regional governments impose the restrictions on domestic debt amount autonomously, sometimes these restrictions include regional constitutions (for instance, in Switzerland the current budgets of some cantons should be balanced). In the federal states (Austria and Belgium), central and regional governments sign up the agreements on the deficit amount and lowering of the financial debt burden to ensure the Maastricht criteria within the state, that impose the restrictions on the average state debt amount [20: 81].

National governments impose both, direct and indirect restrictions on domestic borrowings in the Unitarian states. In case of violation of the imposed restrictions by the local authorities, a central government is authoritative to interfere with the financial business of municipalities. For instance, a total direct debt amount in Poland shouldn't exceed 60% of the budget revenues (no guaranties are considered). Restrictions on the annual amount of borrowings to the local authorities are imposed in Great Britain, Denmark, Lithuania, and other countries [20: 82].

Restrictions are imposed on debt service from the local budget revenues, in most of the countries. Such restrictions are there in Argentine, Brazil, Spain, Italy, Columbia, Lithuania, Poland, Romania, Hungary, and Japan. In certain countries these restrictions refer not to the total amount of revenues, but mostly to the half of them, i.e. domestic budget revenues (Hungary) or the revenues regardless the direct interbudgetary transferts (Lithuania). The limit of expenditures on the local debt service in OECD countries equals to 5–10% of the annual budget revenues. The interest payments of the regional and local authorities perform 4% in the USA, 8% in Germany, and 12% in Canada [14: 6].

The municipalities of Germany and Austria direct their budgets to the state governments to be ratified. In case of loan conditions are violated, the budgets may be declined. The local authorities in Norway and Italy should retain a sufficient current budget surplus for a debt service and for paying off its greatest half.

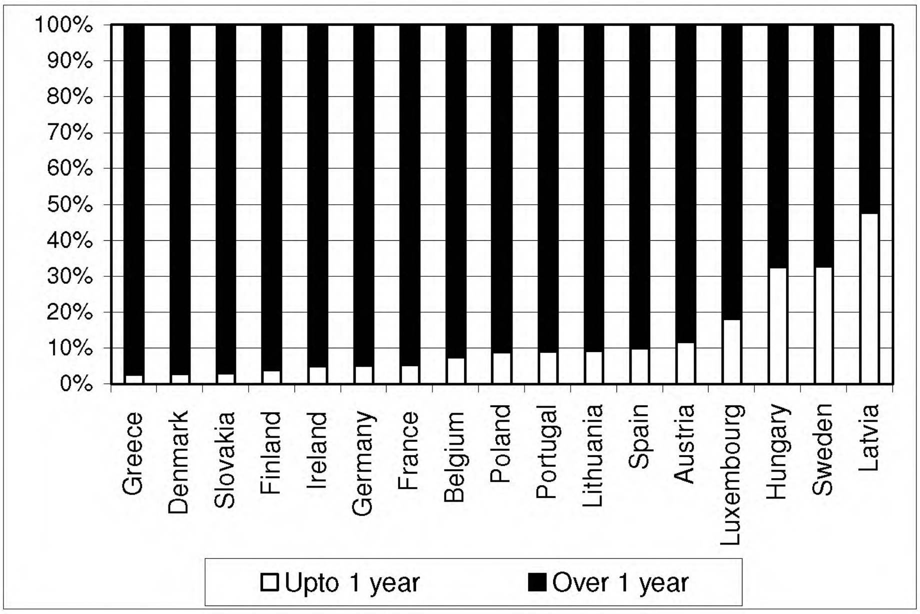
In France, there is a restriction imposed on the local budgets' deficit amount that makes 5% of the current revenues. Moreover, the legislation considers that the local self-government authorities should adhere to two stipulations: first, debt extinction is to be performed with domestic revenues (without refinancing); second, borrowed money may be allocated only on the investment projects [20: 84].

In Japan, the local authorities appeal to a central government for the permission to allocate the emission of debt securities. They have to meet the following requirements, specifically those concerning the absence of deficit of the current budget, restrictions imposed on the amount of indebtedness, the percentage of taxes' level shouldn't be lower than that of admitted by the government, as well as to provide with the reasonable indexes of the taxes' payments. In this case, an amendment of accounts by the transfers for the local budgets takes place. It guaranties the fulfillment of the obligations by the local authorities. Owing to this control system, there was no case of the municipal bond default since 1947 [20: 84].

While allocating of the local borrowings in the most of the foreign countries, there is a trend to keep to «the golden rule», thay suggests using of the borrowed money only on the capital expenditures. Such restrictions are legally imposed in Brazil, South Africa, and India. The principles of this rule function in Canada, USA, and many other European states, mainly in Austria, Germany, Holland, France, Switzerland, Sweden, where it is allowed to spend the borrowed money on the investment objectives, as well as on a debt refinancing in these countries. In several cases, it is allowed to use the loans on the current requirements, including covering of the temporary cash gaps of the state budgets provided all the loans are redeemed within a budget year [14,: 7]. Figure 2 shows a share of loans with one-year-maturity, doesn't exceed 5-10% of a total amount of the home debt in the most of the European Union states. Only in some countries, specifically in Lithuania, Sweden, and Hungary, a share of the short-term loans is much greater than that in the other states, and equals to 47.6%, 32.7% and 32.5% of the total indebtedness respectively [18].

Figure 2.

Domestic Debt Structure in the European Union Countries on 1 January, 2004



Source: Committee of the European Union Statistics /http://www.europa.eu.int/comm/eurostat/newcronos

In Scandinavian countries there were formed the central financial institutions that are governed by the co-owners i.e. local and regional authorities. These institutions provide all of the municipalities with the access to the loans. A logically worked out system of attracted means implementation guaranties a credit redemption, as well as a strict normative and legal regulation of the domestic loans make the cases, when the borrowed costs are not returned, impossible.

In Norway, a state strictly controls the loans to the municipalities. Government makes up a so-called «black list» of all the local authorities with the activity that contradicts the valid legislation. This list is extended in the Internet. The authorities being noticed in such a list, are restricted in their autonomy. To allocate the loans, they should get an obligatory permission from the central authority [20: 82].

In Denmark, the domestic loans can be allocated by the local self-government bodies only on some approved capital projects (primarily, on the development of the electric stations, gas and water supply, buying of the lands, city reconstruction, environment improvement, and the building of retired houses) [19: 95].

In some countries, a so-called project financing is widely spread. It considers a transparent connection between the loan and the implementation of the received costs in a definite investment project. This market element grows very denamically recently. The legislation of Great Britain and France envisages a fixation of the definite loans to the corresponded objects. In Japan, due to the allocation of costs on the investment objectives, some loans extend on financing of the definite projects. Project financing is considered to be substantiated only when there is a feasibility of an administrative introduction of the payments for the constructed objects exploitation.

Practice of project financing is popular in the USA. Here, the municipalities together with bonds' emission for the general investment projects emit profitable bonds on the definite projects. Project financing implemented in transport sphere (construction of roads, ports, and airports), as well as in the housing and communal economy (water supply and drainage system, natural gas supply and electrification). Municipalities are free to implement the sales and fuel taxes on securing purpose, in case when the project revenues are insufficient for debt service and redemption. In the USA, the profitable bonds are the basic types of the local loans [14: 7].

Foreign governments carry out measures to diminish the creditors' risks, stabilize the operation of the local authorities and low the prices of loans. Deposit is a significant precondition to realize the determined objectives. Normative documents define the types of the mortgages, that may be used by local authorities being granted the loans – incomes from the revenue-producing projects, total local budget incomes, definite assets' types of the municipalities, and local governments. If several different types of mortgages are implemented simultaneously, then the investors deliver the loans more eagerly.

Foreign practice highlights the necessity of a strict determination of the default procedure of the domestic budget. As, on the one hand, it helps to put in order the costs redemption due to the municipal debt, and, on the other, it guarantees the citizens with the allocation of obligatory social expenditure from the local budget. System of default regulation should strictly determine both creditors and debtors' actions. Traditionally, it envisages the implementation of a set of measures to carry out transparent administrative and legal procedures towards debtors and creditors; a defining of the reorganizational sequence and regulation of the debt requirements; a minimizing of the risks for the central self-government, and providing with the due financing standards of a social welfare.

In the USA, debt reorganization in case of default is grounded on the extension of maturity, diminishing of the debt-payments amounts for the nearest periods, debt refinancing by means of delivering of the new loans, improvement of a fiscal solvency of the municipalities and on cutting down the budget expenditures. Legislation envisages no possible assets sales by a debtor. A debtor may only be the bankruptcy initiator. In case of municipal default, the states governments actively interfere with their fiscal policy, coordinating the most challenging issues. In case of default in Hungary, a city mayor should appeal to a court with a special issue on de jure recognition the bankruptcy of a municipality. To declare the beginning of the bankruptcy procedure, the local authority forms a crisis committee and ratifies the emergency budget for 30 days, which would finance only the most obligatory issues [14:8].

V. Prospects of the Domestic Loans Development in Ukraine

There are a number of factors that hampers successful operation of the national system of municipal loans:

- a low financial autonomy of the local authorities (share of transfers in the incomes of the local budgets of Ukraine is around 42% in the first half of 2004 [21]);
- undeveloped market of the local loans, as well as the financial market in a whole;
- discrepant norms and legal regulations of the system of domestic loans;
- nontransparent reporting of the local budget operation hampers the creditors from receiving of an adequate information on the state of finances of the local self-government authorities;
- a cash basis method of a financial accounting being valid in Ukraine does not provide diversified and objective information on the financial state of the debtors;

- procedures of the budget formation and implementation are not linked to the assessment of expenses' efficiency indices;
- the local body requires a bigger number of skilled experts.

New actions in the above mentioned area can substantially improve the situation in the sphere of domestic loans.

An essential improvement in the financial self-sufficiency of the local budgets can be obligatory factor for the development of domestic loans in Ukraine. This improvement is possible due to the significant share growth of the local revenues within the structure of domestic budget incomes, increasing of an enumeration list of the local authorities with a stronger autonomy for implementation of the fiscal tools in the relevant administrative and territorial units.

Accelerated development of the financial market is one of the most important factors for a successful operation of the national system of domestic loans. On the one hand, there is a certain demand of the financial resources that could be successfully implemented in the local budgets, and, on the other, due to the great risks as well as to unstable positive practice of the local loans covering, the amount of the resources directed at the securities of the local authorities is insignificant. In this case, it would be rationally to implement some stimuli that would cut down the cost of expenditures connected with the capital expansion of the financial markets.

A highly-developed market infrastructure is of a paramount importance for the normal operation of the local loans market. Consulting firms and rating agencies are obligatory co-partners in the loans' allocation.

Moreover, it is worth noting that the obligatory requirements on the appropriation of the credit ratings to the debtors, in some cases, prevent from successful operation of the local loans' market.

In our opinion, it would be reasonable to provide such obligatory credit appropriations only in case of funded loans' issue with an amount exceeding a certain volume, for instance, over 1 mln. Hryvnas.

In the point of this, we consider that a cancellation of the agreement procedure on delivering of the local loans by the Ministry of Finance will positively influence the development of a system of the local borrowings. Moreover, in order to provide an efficient monitoring in this sphere, it is sufficient to perform a proper registration of these operations.

Adoption of the law «On the Local Loans and Guarantees in Ukraine» is an essential stipulation for the positive changes in the sphere of a municipal credit. However, currently, the majority of the unsettled issues are not solved, even being the part of this law, presented to Verkhovna Rada of Ukraine for consideration [22]. Specifically, the issue on the local debt allocation remains unsettled, the legal relations are not regulated either in case of incapability of the local authorities to pay debt interest. In our opinion, the indicators of the restricted amount for the local loans are to be substantiated.

Currently implemented draft of law restricts the amount of domestic borrowings to 15% of the local budget incomes excluding the interbudgetary transfers and budget development revenues. In our opinion, this norm limits the amount of domestic loans rather strictly, does not stimulate any long-term loans, which should be of prime significance. It is reasonable to impose the restrictions on the annual redemption of a total debt amount of 5-10% revenues of the total local budget fund excluding the inter budgetary transfers. Alternatively, restriction can be imposed on the annual debt service amount together with main amount redemption at 15–20% of the revenues from the total local budgets fund excluding the interbudgetary transfers.

Moreover, under a draft of law «On Domestic Loans and Local Guarantees in Ukraine» the list of the sources to ensure the allocation of liabilities by a municipal debt should be more defined. In our opinion, the domestic budgets' revenues should be admitted among such sources, or, at least, the budget development incomes.

More objective and logical restrictions on the local loans amount can be introduced in the accounting of budget by shifting from a cash method to the fund flow method one (extra charge method). The last method provides complete information on the amount of both financial and nonfinancial resources, as well as a total amount of liabilities into the local budget and out of it. These indexes play a decisive role in the local loans' risks evaluation.

Cash method of registration being valid in Ukraine for providing of the budget allocation accounting, prevents from full and objective information on the financial situation of the local authorities. Actually, the received data reflect only the monetary budget flows. Herewith, there are no data on the total assets amount of the local authority, a share of its liabilities that are of a principal importance in the sphere of loans. Allocation of the extra charge method is more attractive as it envisages an accounting of both financial and non financial assets. Complete and objective information will provide an objective assessment of the financial status of a debtor, as well as an evaluation of a real credit value.

An introduction of a program-and-purpose-oriented planning method will have a significant influence on the development of a national system of the local loans. The given method is regarded as advantageous due to the efficiency of the expenditures with a nominal loans value. Thus, it proves their allocation.

Considering a tight connection between the local loans and the costs, a mid-term budget planning makes sense. If there are no mid-term budgets planning (for 3–5 years) then it would be difficult to manage the investment projects, requiring the durable financing, as well as to allocate the local debt service (to meet the terms of maturity.

Taking into consideration a historical background of the municipal loans, an advanced foreign experience, we may consider that a broader implementation of the project loans as one of the most perspective trend in the development of the local loans sphere. When the attracted money are not sent for the general requirements of the local authority, but for the realization of some project, then the members of a territorial community realize the loan expediency, and the creditors are supported with the improved redemption opportunities.

Comparing with a private sphere, in case of debtor's insolvency, he may experience default; a local body will keep on operating, as well as fulfilling all the obligations. Therefore, it is important to specify default conditions legislatively. A legislator is to resolve a dilemma – on the one hand, the creditors should be supported by some guaranties and, on the other, the members of the territorial community should be guaranteed by a certain set of the social securities. Presumably, it would be reasonable to stipulate a decreasing autonomy of the local authority in case of default, as well as some lowering of a social securities level. In this situation, it is important to envisage the terms of debt installment, a feasibility of debt refinancing by means of the new loans, and maintenance from the central government. Moreover, it would be expedient to substantiate the fundamentals for the formation of the emergency budget in case of incapability to deliver the accounts by the local loans. Its prior obligation is to secure the allocation of stipulations taken by the municipality under obligatory financing of a limited set of obligatory social services.

Credit can be one of the perspective ways to improve the tools of the local loans, when the holding company (consortium), formed by the assistance of the local authority and commercial structure is a debtor. According to the foreign experience, such holding company has some advantages – the assessment of expediency of the investments and possible risks are allocated at the qualitatively-improved level; implementation of financial resources is secured more efficiently. Thus, project management at the exploitation phase, is at the qualitatively-improved level, promoting of the costs receiving on debt redemption.

Conclusions

Local loans are important financial instrument that regulates the volume of the social services and tax rates, letting the municipality investment expenditures benefits the new generations to come, providing an improved quality of such services.

The improvement of the loan market in Ukraine is an integral factor for strengthening the material and financial basis of the local authority. It stimulates the improvement of the local self-government financial sufficiency, leading to an innovative, and a highly efficient ways of development.

Unfortunately, the local loans' market of Ukraine is still not developed. Normative and legal, organizational and technical areas require certain improvement. In our opinion, to improve the national system of the local loans the below mentioned activity of should be undertaken:

- to strengthen the financial self-sufficiency of the local government bodies;
- to develop the infrastructure of the local loans market;
- to provide the local authorities of all levels, including village and settlement councils with a feasibility to allocate the loans to the budget for development, on condition of a simultaneous improvement of a current system of restrictions and an introduction of the real practice of investment project expertise;
- to optimize an existing system of restrictions of the local budget fund excluding the interbudgetary transfers;
- to substitute the procedure on the agreement of the local loans adopted by the Ministry of Finances to a registration procedure;
- to abolish the required obligation regarding the appropriation of credit ratings by all the debtors;
- to stimulate the implementation of the project loans as well as the other types of local loans;
- reform current budget accounting system by substituting of the cash method of registration to the extra charge method.

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