

## ***Chapter 11:***

### ***Systemic Soft Budget Constraints in Ukraine***

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An important question for transition economies and especially Ukraine, is what is the proper degree of decentralization within a changing financial and economic culture, macroeconomic and political system. Although the benefits associated with fiscal decentralization are well documented, they assume a number of important conditions such as the autonomy and accountability of lower levels of government. It is important in the case of Ukraine that decentralization be considered with care because of the already difficult nature of the market transition process. The continued year-to-year decline in real revenues and budget shortfalls have resulted in a high level of distrust between the different levels of government. Unfortunately, during the near decade of Ukraine's independent existence, these levels of government have shown more alacrity in undermining one another's fiscal and political authority than they have for constructively working together to bring the country out of its economic malaise.

Ukraine has not yet successfully put into place mechanisms for implementing a hard budget constraint. Indeed, the system as it currently functions creates incentives in almost every realm for soft budget constraints. In such a context, the lack of hard budget constraints cannot be attributed to a specific policy failure or the lack of a single mechanism. Rather it is a systemic failure. This chapter is organized around three channels that influence budget constraints: section I focuses on the intergovernmental system; section II assesses the

political realm; and section III considers capital markets for subnational entities. In each of these areas, few of the conditions that promote hard budget constraints are in place.

### **I. The system of intergovernmental finance and its implications for budget constraints**

Ukraine's population, land area, and degree of urbanization are similar to that of France and Italy. Its population is about 52 million people and its area covers 579 thousand square meters. Some 71 percent of the population live in urban areas (World Bank 1999). By population and land area it is larger than most other transition and European countries. At 1,200 1996 dollars per capita, its GNP per capita, however, is considerably smaller than its European neighbors.

Ukraine operates under a unitary system of government, although it has some characteristics of a federal state. In addition to the central government, there are 27 regional or oblast level governments (including the Crimean Republic and the Cities of Kiev and Sevastapol which have oblast status), 490 rayon district governments, some 447 municipalities and a large number of settlements and villages. The average size of these different administrative layers varies considerably. Oblasts have populations that range from 0.9 million (Chernivetski) to 5.1 million (Donetsk). The size of rayons typically ranges between 100,000 and 300,000, whereas the size of cities and large towns can be as high as 2.6 million (Kiev). In contrast, settlements and villages typically range in population between 500 and 2500 people.

As seen in Table 1, activity at the subnational level is an important component of the Ukrainian economy. In 1998, revenues provided to local governments were 14.4 percent of

GDP<sup>1</sup>, whereas total consolidated budgetary revenues in 1998 were 35.9 percent of GDP<sup>2</sup>. With the exception of 1995, total local revenues (including shared taxes and transfers) as a share of total consolidated government revenues have remained stable at 40 percent.

In 1998, local expenditures on a cash basis are recorded as 14.5 percent of GDP. This amounts to 38.1 percent of total consolidated government expenditures. The data on a cash basis suggests local government deficits are minimal, relative to a deficit of about 2.0 percent of GDP for the consolidated government, however this neglects expenditure commitments made but not yet paid out. Consideration of local expenditures based on commitments rather than a cash basis significantly increases the overall imbalances between revenues and expenditures at the local level. The consequent arrears are symptomatic of soft budget constraints at the very foundation of the system.

**Table 1 Consolidated Government and Local Expenditures**

(percent of GDP, Consolidated figures include the Pension Fund, but exclude state and local enterprises)

	1993	1994	1995	1996	1997	1998
Consolidated Revenues	42.8	43.4	37.9	37.1	38.3	35.9
Local Revenues 1\	17.6	17.3	18.0	14.9	15.5	14.4
Consolidated Expenditures	71.0	53.6	44.9	39.9	44.9	38.0
Local Expenditures 2\	16.0	17.0	17.9	14.9	15.4	14.5
Consolidated Cash Deficit	-28.1	-10.2	-7.0	-2.8	-6.5	-3.0
State Arrears3\	Na	Na	0.8	0.6	0.4	Na
Local Arrears13\	Na	Na	2.3	3.3	0.0	Na
Pension Arrears13\	Na	Na	0.1	1.3	0.2	Na
Total Arrears3\	Na	Na	3.2	5.2	0.5	Na
Consolidated Commitment Deficit	Na	Na	-10.1	-8.0	-7.1	Na
GDP (nominal millions of UAH)	1,483	12,038	54,516	81,519	93,365	103,869
Local Revenues/Total Consolidated Revenues	41.1	39.8	47.5	40.2	40.5	40.1
Local Expenditures/Total Consol. Expenditures	22.5	31.7	39.8	37.3	34.4	38.1
Local Expenditures &	Na	Na	44.8	45.5	34.9	Na

<sup>1</sup> Local revenues in Table 1 include those raised at the center and allocated to local governments through shared taxes. See section below on local revenues for further detail.

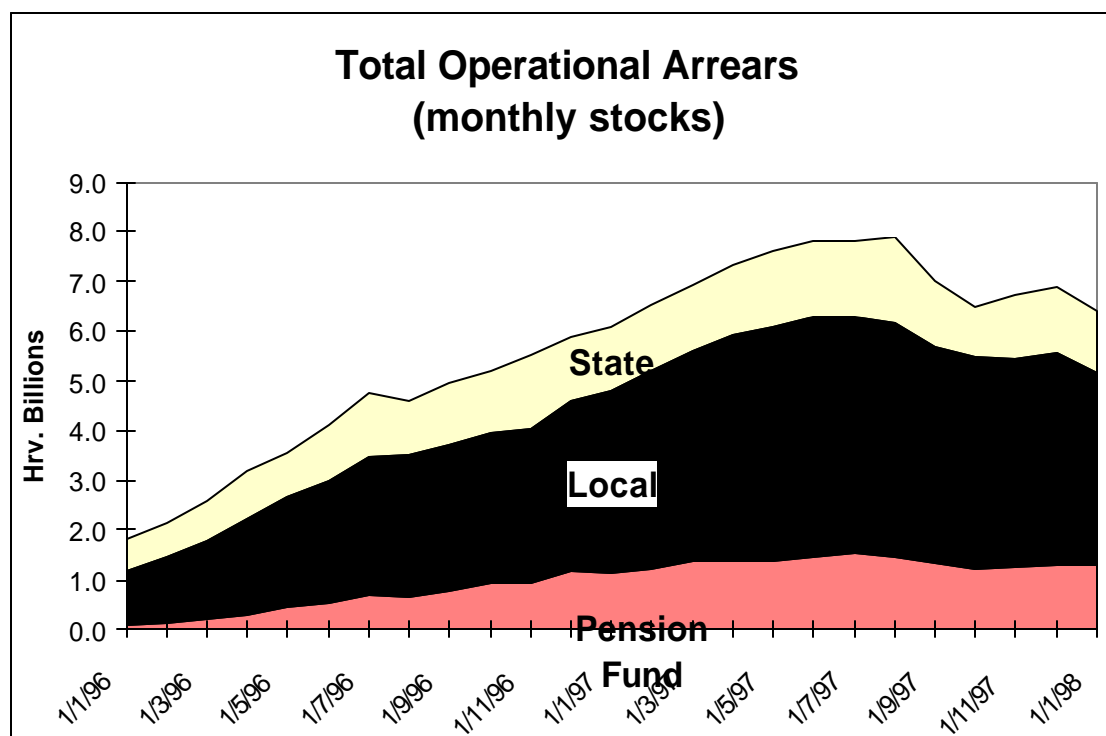
<sup>2</sup> Note that consolidated figures include the pension fund but exclude state and local enterprises.

Source: World Bank 1999, p. 9. "Na" indicates not available. 1\ Local revenues include transfers and shared taxes from the state budget. 2\ Expenditures include transfers to state budget from local budget. Local revenues and local expenditures include consolidated information from the oblast level and below— so all levels excluding the central government. Note that the data may exclude extra-budgetary, off-budget and special funds at lower levels of government (see below). 3\ Arrears include non-payment of wages, benefits and goods and services as recognized by the Ministry of Finance.

Figure 1 gives an indication of both the magnitude and distribution of arrears among levels of government and shows that most arrears are accumulated at the local level. At end 1997, total stocks of operational arrears amounted to 6.9 billion hryvna. This amounts to about 7 percent of GDP. Of these 4.3 billion, almost 60 percent are accumulated at the local level. Although the outstanding stock of arrears began to decline towards the end of 1997, there are indications that local government arrears rose again in 1998. Complete data on arrears for 1998 are not yet available, however it is estimated that at end-1998 budget arrears and pension arrears were UAH 1.97 billion and 0.96 billion, respectively. One estimate is that total arrears, which includes public enterprises (for which the government is not formally liable) at end 1998 amounted to 8.5 billion UAH or about 8 percent of GDP (World Bank, 1999, p. 13).

Arrears in social protection are largest, followed by those in education, and health. Table 2 shows arrears as a percentage of total expenditures committed at the local level in these sectors between 1995 and 1998. Although not as significant a problem as in 1996, arrears in these sectors are significant with between one-fifth and one-third of committed expenditures not being paid. No matter what the sector, expenditure commitments on wages are those with the highest share of arrears.

**Figure 1 Arrears 1996-1997 (in billion hryvna)**



Note: "state" refers to central government.  
Source: Ministry of Finance

**Table 2 Subnational Arrears as a Percentage of Total Expenditures Committed, 1995-98.**

	1995	1996	1997	1998
Education	17	31	21	24
Health	14	28	17	21
Social Protection	4	39	32	32
Culture	10	23	18	20
Communal Services	Na	Na	Na	15

Source: World Bank, 1999, p. 12.

The magnitude of arrears at the local government level reflects in part an imbalance between mandated expenditures at local levels and the capacity of local government to finance such expenditures. It also reflects the squeezing of deficits through the system – from

the central government, to local governments onward to companies, wage earners and other parts of the economy. In effect, arrears are a form of forced borrowing (without interest) from other parts of the economy. An additional factor behind the build up in arrears is that barter has become an increasingly common method of transaction at local levels of Government, leaving governments with little cash for payment purposes. Indeed, with the use of mutual offsets (see section on revenues below), localities have a positive incentive to build up arrears that can later be offset against revenues owed by the center. Such transactions tend to reinforce soft budget constraints rather than discourage them.

### *Expenditure assignments*

One of the factors generating arrears and poor fiscal discipline is the unclear assignment of expenditure responsibilities. For local governments to exercise discipline over their expenditures, it is important that there be clarity with respect to the roles and responsibilities that different levels of government are expected to provide. In Ukraine, there are a range of issues that imply lack of certainty over which level of government is supposed to do what.

The current legal foundations of the intergovernmental system leave a great deal of ambiguity regarding not only what level of government is responsible for carrying out what service, but also what the functions of the executive and legislative branches at each level should be. The centerpiece of legal foundations for intergovernmental finance in Ukraine is the country's Constitution, which establishes the territorial division of Ukraine, includes provisions for local state administrations and local self-government, and for independently elected regional legislatures. The Constitution emphasizes that rayon and oblast radas may be

considered as local government bodies only when they represent and follow common interests of territorial communities in villages, towns, and cities. Otherwise they act as deconcentrated agents of the center.

Provisions for decentralized government in Ukraine are further specified in the Law on Local Self-Government and other laws including the Law on the Budget System and System of Taxation, and the Law on Local Taxes and Duties. Many of these laws must still be amended to be brought in compliance with the Constitution. Specifics of intergovernmental finance for a given fiscal year, and most notably allocation of shared taxes and equalization transfers, are provided by the annual Law on State Budget of Ukraine. Tax laws, and in particular Laws on VAT and Profit Tax, and the Real Estate Tax also include important provisions for intergovernmental public finance.

In the system established by these laws, the various relationships (between executive and legislative branches, between the center and subnational units, and between state administration and local self-government) are peculiarly interwoven. The system is one of deconcentrated state executive power with full vertical subordination, plus a three-layer system of mutually independent legislatures. The latter are relatively strong at the top level, and much less significant at lower levels. The existing legislation does not state clearly the roles and responsibilities of the executive bodies that represent the state administration and the local representatives that represent self-governing bodies. In addition, the legislation offers no procedures to resolve competence issues over shared responsibilities. This confusion has already produced a number of constitutional conflicts, for example, the controversy over roles and division of responsibilities between the head of council of city of

Kiev, who assumed executive functions according to the Law on Local Self-government, and the head of city's State Administration appointed by the president.

The ambiguity present in the legal framework manifests itself even more when it comes to determining the specifics of expenditure assignments. Current legislative arrangements are not clear on which level of government is meant to provide what service. Each level of government has some authority to act in each given sector and in recent years many functions have been "passed down" to local governments. In theory, oblasts and rayons are meant to provide services only on a delegated basis when it has been agreed by either the state or by subordinate governments that a "common interest" must be served. In practice, the data (Table 3) indicate that the bulk of expenditures occur at the oblast and rayon levels. For example, most health and social protection expenditures take place at the oblast and rayon levels. A different set of expenditure division problems arise at the sub-oblast level. Between oblasts, rayons, villages and settlements there is a lot of confusion over who should pay for communal services. These issues are further complicated by the issue of divestiture of enterprise social assets to rayon and municipal governments. Local governments have been asked to take over social services previously provided by state companies, without any increase in resources.

In addition to the existing lack of clarity, the legislation also allows the possibility for functions to be delegated downward or upward. For example, if a village finds that it cannot or does not want to take on responsibility for a specific item it can delegate the function, along with the transfer meant to finance it, to the rayon. Cities can also join together and delegate functions upward. This allows for the possibility for changing assignments over time and across the country depending on the desires of the localities. No specifics are

provided in the legislation as to procedures for delegation upward or downward.

**Table 3 Composition of Local Expenditures By Type of Expenditure and Level of Government, 1997** (percent)

	Oblast Consoli dated	Oblasts	Oblast- level Cities	Rayons	Cities under rayon authority	Settle- ments	Villages
Social-cultural total	53.1	38.1	55.1	65.0	66.8	75.6	80.1
O/w: Education	26.1	12.1	28.1	31.9	58.8	64.9	62.4
O/w: Health	24.5	23.4	25.2	30.1	6.0	7.9	11.8
O/w: Culture	2.5	2.6	1.8	3.0	2.0	2.8	5.9
Social Protection	26.0	25.6	29.5	28.0	10.2	4.2	1.3
National Economy/ Communal Services	4.9	4.7	6.5	1.8	14.8	9.3	1.0
Administration	1.9	0.2	2.5	0.4	4.4	7.2	16.0
Transfers to State	5.6	16.7	0	0	0	0	0
Budget Loans	1.0	2.3	0.1	1.0	0	0	0.1
Other	3.9	5.5	3.7	2.8	2.3	2.1	1.0
Total	100	100	100	100	100	100	100
Memo:							
Capital Investment	3.6	6.8	2.6	1.1	1.6	1.7	0.5
Share of Government Level in total subnational expenditures	-	34	37	21	2	2	4

Source: World Bank, 1999, p. 32

Finally, there is a serious mismatch between fiscal responsibilities and the authority of local governments to reduce or increase expenditure commitments. Local governments may have responsibility for delivering services, but at the same time they do not control key variables such as wages, prices, hiring decisions and the like. There are a number of laws regulating wages, social payments to the population under social assistance programs and detailing individual functions and expenditures of local governments. Other laws and by laws detail or define responsibilities of local government for setting prices and tariffs for housing and communal services, authorize local governments to establish minimum norms and volumes of budget financing for communally-owned educational institutions. At the same

time other laws may regulate salary levels to be paid, benefits and privileges to be provided and items that have a direct influence on the provision of services at the local level. In effect, localities – though nominally autonomous –are limited in their decision making authority. The only mitigating factor is that enforcement of legislation and standards is relatively weak.

All in all, some of the key conditions for hard budget constraints that relate to expenditures are not met in Ukraine. First, there is little clarity in the legislation about what level of government is meant to provide what service and, even at the same level (center, oblast, rayon, village) which part of the government (state administration vs. local representatives) is responsible for which particular activities. This makes it easy for local governments to exercise discretion in the services they chose to provide and makes imposition of fiscal discipline a much more difficult task.<sup>3</sup>

A second condition is that local governments be in a position to control their expenditure commitments and to exercise decision-making authority. Many decisions are imposed on local governments from above and a local government's ability to make independent decisions in order to meet their responsibilities effectively and efficiently is often limited.

Finally, to some degree soft budget constraints have been institutionalized by inconsistencies in the system. Many of the services local governments are required to provide are constitutionally mandated or have significant externalities and/or redistributive implications. For example, Article 53 of the Constitution mandates free secondary education and Article 49 free medical services. However, the responsibility of providing these services is left to subnational levels of Government which often have insufficient resources to finance

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<sup>3</sup> In the Spring of 1999, a Budget Code was presented to Parliament that included a much more specific set of expenditure assignments, however, the Code has not yet been passed.

all of the mandated functions. This contradiction leads to a standard argument between lower levels of government and the center: local governments provide services that they are unable to finance because they are mandated to do so by the Constitution. This leads to a large accumulation of arrears, particularly for wages and pensions. At the same time, the legacy of the communist state is such that even if they go unpaid, individuals and companies continue to work or provide services, under the assumption that eventually the center will provide sufficient resources to pay off back wages, back pensions and the like. Given the political clout of some groups (especially coal miners) this is not a mistaken assumption. As a result, soft budget constraints are a fundamental part of the current system.

#### *Revenue assignments and transfers*

The conditions necessary for hard budget constraints to be effective also concern the sources of revenue for local governments. To the extent that a local government can push financing of local services on to another level of government it will promote a softer constraint, because the given locality will have to bear less of the political burden of the taxation. Autonomy over local tax rates (“own taxes”) is also important because then local governments are more likely to be held accountable for how resources are used. An objective method for allocating transfers is also important for stability and predictability of the system. Table 1 indicates that in 1998 local revenues constituted 14.4 percent of GDP and about 40 percent of total consolidated revenues. As in many countries, however, it is necessary to examine quite closely what falls under the rubric of “local revenues”.

Table 4 shows the decomposition of revenues for sub-national or local governments between 1993 and 1998. Local governments rely on a number of sources of revenues, but

they have little control over most of these. The bulk of local revenues come from shared taxes, in which both the rate and base of the tax, as well as the rate of sharing is determined by the center. In 1993 such taxes provided some 83 percent of local revenues. In 1998 the share of such taxes was 68 percent of total local revenues. “Regulated” taxes consist of four of the key tax bases in the country, the value-added tax (VAT), the corporate income tax (CIT), the personal income tax (PIT), and the excise tax. In the early years of the transition, the central government “regulated” the amount of tax revenue transferred to each oblast, by determining the share it would get of each of the taxes<sup>4</sup>. While this was convenient for the central government, it was not very transparent – it was not always clear on what grounds some regions were given higher shares than others. By 1996, the system was altered so that sharing rates for all shared taxes other than the VAT were uniform across oblasts. Different sharing rates for the VAT were maintained as a “regulating mechanism.” In 1998 these arrangements were changed further --local level governments were assigned 100 percent of the revenue from the CIT and the PIT, whereas revenues from VAT and excise taxes went to the central government. In the 1999 budget, the Government has returned to regulating taxes with different oblasts receiving different shares of the PIT, CIT and excise tax – a move back to a much more discretionary system.

“Fixed taxes fees and other” form a second category of revenue sources. These are taxes, fees and charges that are assigned to local governments, although the bases and rates of the taxes and fees are still determined by the central government. This category includes some taxes (trade tax and vehicle tax), some fees (forestry fee, water fee and land fees), as well as other non-tax sources of income such as funds from privatization. As a source of

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<sup>4</sup> See Martinez-Vasquez, McClure and Wallace (1995) p. 297-301 for further detail on “regulated” and other local taxes in the early years of the transition.

revenues these so-called “own” taxes and fees have increased from 7 percent of total revenue in 1993 to 15 percent in 1998. Most of these taxes and fees bring in very little revenue – the increase in recent years is largely attributable to an increase in land taxes.

**Table 4 Composition of Sub-national Revenues 1993-1997**

(percent of total subnational revenue)

	1993	1994	1995	1996	1997	1998 1\
<b><i>"Regulated" taxes:</i></b>	<b>83</b>	<b>80</b>	<b>77</b>	<b>74</b>	<b>65</b>	<b>68</b>
VAT	33	21	31	29	-	-
CIT	34	46	36	33	39	42
PIT	10	10	9	11	22	26
Excise	5	3	1	1	3	-
<b><i>"Fixed" taxes and fees and other:</i></b>	<b>7</b>	<b>6</b>	<b>10</b>	<b>14</b>	<b>14</b>	<b>15</b>
Trade tax	0	0	0	0	0	0
Forestry fees	0	0	0	0	0	0
State duty	0	0	0	1	1	1
Fees and other non-tax duties	3	2	2	3	3	3
Water fees	0	0	0	0	0	0
Vehicle tax	0	0	1	1	1	1
Excess consumption fees	1	0	0	1	0	0
Privatization	0	0	1	2	1	1
Land fees	3	2	5	5	7	8
Other funding	0	1	0	1	1	1
<b><i>Local taxes and fees</i></b>	<b>Na</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>3</b>
<b><u>Total revenues without funds from other budgets:</u></b>	<b><u>90</u></b>	<b><u>86</u></b>	<b><u>88</u></b>	<b><u>90</u></b>	<b><u>83</u></b>	<b><u>86</u></b>
<b><i>Total funds from state budget</i></b>	<b>10</b>	<b>14</b>	<b>12</b>	<b>10</b>	<b>17</b>	<b>14</b>
Subventions from state budget	0	8	4	6	14	14
Short-term loans from state budget	9	1	2	4	0	0
Mutual settlements from state budget	1	5	6		3	
<b><u>Total revenues including funds from other budgets</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>	<b><u>100</u></b>

Source: Ministry of Finance and Treasury

1\Excludes revenue from extra-budgetary funds.

What the public finance literature typically refers to as “own revenues” –e.g. revenues over which local governments have some degree of control over either the rate and the base – are seen here under the category of local taxes and fees. Some 16 local taxes and fees, over which local governments can control the rate and/or the base, have been provided to the local governments in Ukraine. These taxes include items such as the dog tax, tax on advertisement, tax on gambling and so on. These taxes are administratively costly but provide little in the way of revenue. As seen in the above table, they provide only 3 percent of local government revenues and do not even amount to 0.5 percent of GDP. The main share of local taxes comes from a small tax charged to non-state funded enterprises based on the number employed at a firm (53% of total local taxes). All budgetary and state subsidized firms are exempt from this tax. The other main local taxes are hotel fees (5%), market fees (25%), and kiosk licensing fees (8%).

Recent experience with revenue implementation has highlighted the increasing role played by both tax offsets (non-cash forms of tax payment) and tax arrears. Tax offsets as a share of the total tax take have on average increased five fold since 1995 (see Table 5). The share differs considerably among regions but the pattern of increasing use of tax offsets is consistent across all oblasts. These offsets are at least in part the result of a “cash crunch” at lower levels of government brought on by the country’s overall fiscal crisis. While such offsets are frequently a convenient means for settling obligations, they also create difficulties for budgetary management. To the extent that tax receipts are in kind, it reduces the flexibility and liquidity of the government receiving the in kind payment and complicates budgetary management fiscal crises. This increase in offsets takes place in the context of the dramatic increase in arrears at all levels of government discussed above. In 1998,

accumulated tax arrears more than quadrupled in nominal terms. Both tax offsets and tax arrears are also closely tied to the issuing of veksel, which allow local governments to issue paper in order to procure services and reduce tax arrears at the same time (see below).

**Table 5 Tax Offsets in Total Tax Intake (percent)**

	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Republic of Crimea	3.4	15.4	28.5	22.3%
Vinnytzka	0.2	13.9	37.5	32.6%
Volynska	0.9	11.8	18.3	23.9%
Dnipropetrovska	7.4	32.0	45.2	27.0%
Donetzka	4.3	28.0	30.3	27.5%
Zhytomirska	0.7	19.2	30.1	30.2%
Zakarpatska	2.0	16.3	11.6	17.7%
Zaporizka	5.5	15.6	18.8	17.4%
Ivano-Frankivska	4.8	38.9	43.4	50.5%
Kyivska	3.6	23.9	26.5	20.0%
Kirovogradska	1.9	19.9	43.0	45.7%
Luhanska	9.0	34.8	44.0	31.4%
Lvivska	3.1	21.9	25.0	20.2%
Mykolayivska	8.2	28.5	36.1	43.0%
Odeska	0.6	9.9	13.2	11.1%
Poltavska	9.3	33.0	52.0	44.1%
Rivnenska	4.5	26.4	32.9	40.8%
Sumska	7.8	32.3	43.4	28.2%
Ternopylska	2.8	22.1	40.0	44.7%
Kharkivska	17.2	48.6	48.4	42.2%
Khersonska	3.3	26.0	50.5	51.9%
Khmelnytzka	3.0	29.1	33.4	43.6%
Cherkasska	0.4	13.5	31.7	27.9%
Chernivetzka	5.7	25.3	37.3	44.1%
Chernihivska	2.3	12.5	29.6	20.7%
Kyiv	1.5	37.2	19.9	14.8%
Sevastopol	4.3	20.8	25.7	24.1%
<b>Total</b>	<b>5.2</b>	<b>28.4</b>	<b>33.1</b>	<b>27.7%</b>

Source: Ministry of Finance

In addition to the large amount of resources provided to local governments through tax sharing localities receive also receive an important share of their revenues through subventions and subsidies. In recent years, between 10 and 17 percent of local government

resources have been provided in the form of transfers. There is little clarity in how transfers are allocated. There is no formula-based system and for the most part transfers are allocated on an ad hoc basis as part of the annual process of budget negotiation. The system has been plagued by a tendency to overestimate revenue forecasts and, subsequently to sequester transfers mid-way through the year. For example, in 1998, just 77 percent of planned transfers were given to local governments. Moreover, there was extremely wide variation among oblasts in terms of their receipt of transfers in terms of a percentage of plan. Oblasts such as Zhitomir, Sebastopol, Ternopil and Khmel'nytsk all received 100 percent or more of planned transfers. By contrast, Kiev oblast, L'viv, and Odesa all received 35 percent or less. It appears that most transfers were directed at the most needy oblasts.

Neither the system of local revenues nor the system of transfers has any of the characteristics that are typically found to help strengthen hard budget constraints. The large majority of revenues come to local governments through either shared taxes or transfers. Typically the revenues provided are insufficient to cover the mandatory responsibilities and even the allocation of the budgeted amounts is highly uncertain. Localities have authority over the tax rates or base of any of their significant sources of revenue. They also have little incentive to increase their own revenues because in doing so, they typically experience a reduction in transfers. Transfers are allocated on an arbitrary basis, and although there has in recent years been discussion of introducing a system of formula-based transfers, this has not yet occurred. As a result, transfers often go to the most needy (which provides an incentive to overspend) or to the most politically powerful.

Typically borrowing from banks and the issuing of debt would not be treated as a revenue item, but rather a financing item. These items appear to play a small role in local

government budgets although their role has been increasing. According to the budgetary data, only in 1997 do they make up even 1 percent of local government sources of finance. The system for subnational borrowing and its implications for budget constraints will be discussed further below.

In sum, the system of intergovernmental finance and the hierarchical relations between levels of government that it creates tends to promote soft budget constraints. Constitutionally mandated services, unclear expenditure assignments and unpredictable transfers put localities in a position where they have every incentive to spend on the assumption that they will receive resources from somewhere. Each year the central government says it will clear arrears, and each year they continue to grow. The system of tax sharing of revenues and transfers gives them no incentive to increase local own revenues, since other transfers will then be reduced. In its transition from a command to a market economy, many of the key fiscal mechanisms for supporting hard budget constraints are still to be implemented. In part, this relates to fundamental political uncertainties over the nature of the new regime that are discussed in the next section.

## **II. Political Mechanisms and their Influence on Budget Constraints**

A fundamental premise that underlies much thinking on decentralization and its benefits is that local citizens will be in a position to hold their local governments accountable for their actions through the political process. Either through “voice” (the press, election outcomes, etc) or “exit” (leaving a community), citizens have a mechanism for expressing their views on the effectiveness of the local government in carrying out its functions. In this

section we consider the extent to which the existing political institutions in Ukraine allow citizens to hold their local governments accountable and whether there is an incentive to do so. Despite close to ten years of transition, many of the political mechanisms that help to support hard budget constraints are not yet in place in Ukraine.

### *Access to information*

Most Ukrainian citizens can understand or find out without difficulty how their local government is organized, who is technically in charge of specific decisions, how budget resources are collected and how much is allocated among different categories. Many Ukrainian cities and oblasts regularly publish their budgets and city council decisions in local newspapers for the benefit of the regional population. Despite these positive factors, in fact Ukrainian citizens have access to little or no *accurate* information, authority, or even incentives to monitor and control their local government officials. Moreover even if they had such information and influence, there are strong, systemic disincentives to act through political or any other available channels against local officials.

Although local citizens have access to some information, they have virtually no access to information on how, when and why important decisions such as expenditure allocations were made. Because of the ad hoc system of transfers, and the lack of any tender or audit requirements, most budget implementation is determined by closed-door negotiations. These negotiations occur both inside and between oblasts and municipal governments. The negotiation process for limited available funds between the oblasts and municipalities is especially adversarial, with both sides employing zero-sum game strategies. The result is that important decisions are made beyond the public eye and citizens are

excluded from local government. Moreover, in the few cases where citizens try to participate, they find themselves at a severe disadvantage since they do not have the financial nor political means to participate in the negotiation process.

The negotiations-based system leaves little data for monitoring and ex-post analysis of the budget process. In addition, the often arbitrary and unpredictable nature of the central government handling of the budget, such as sequestration of transfers, implies that local governments can effectively argue that any movement away from expenditure plans was the result of actions from above. With little monitoring and virtually no audits, both skepticism and distrust toward local government pervades the population of Ukraine. The result is little transparency in local government and insignificant participation.

Numerous interviews and media surveys indicate that even if citizens had irrefutable evidence that their local government representative had defrauded his constituents, they still would not act for fear of reprisal. The widely held belief that local government representatives may have illicit connections is deeply embedded in the Ukrainian psychology. This combines with the other elements of the system discussed above to create circumstances in which there are few mechanisms for gaining accurate information and little or no incentive to take an active role in monitoring local government.

### *Accountability*

A key issue for implementing hard budget constraints is that of accountability –to whom are the different levels of government responsible? As discussed above, the current structure of intergovernmental finance in Ukraine incorporates two competing types of accountability. The first is “vertical” accountability in which lower levels of executive

government bodies are held accountable to higher levels all the way up to the president. The second is accountability in which legislatures are held accountable to the citizens and voters who have elected them. In Ukraine the struggle between accountability to higher levels of government and accountability to citizens and voters reflects larger issues of the evolution of Ukraine's Government as a presidential versus a parliamentary government.

Under item 10, Article 106 of the Constitution, heads of the local state administrations are appointed by the Prime Minister of Ukraine and dismissed by the President of Ukraine. In practice, the oblast governor, his political apparatus and oblast administration and department heads are entirely subordinated and dependent upon the President and may be removed at any time by presidential order. The one exception to presidential authority in the oblast administration is the oblast council, which is directly elected in a first-past-the-post vote by the local population.

While the oblast council nominally possesses a significant amount of authority over oblast activities, in reality the oblast council is typically a weak partner. The oblast council is legally the controlling entity for forming the oblast budget. However, the oblast financial administration, which is controlled by the President through its double subordination to the Ministry of Finance and the oblast governor, controls implementation of the budget. In the current circumstances of persistent budget shortfalls, the oblast financial office decides not only those budget programs that are fulfilled and those that are not, but also which are fulfilled in cash and which fulfilled in either barter or through mutual debt cancellations. Because a large part of the oblast's budget is fulfilled in non-cash outlays, real authority resides with the financial administration office and thus remains accountable to the President. A similar situation holds at the rayon level.

At the municipal level, however, the Mayor is directly elected to a four-year term by majority vote of the city population, in a first-past-the-post system. At the same time elections are held for the City Council. Because the Mayor and City Council are directly elected, they are much more attentive to their constituents' demands, and the two tend to generally have a collegial relationship, as opposed to the adversarial relationship that typically develops between the oblast governor and the oblast council. At the municipal level there is intense pressure for the two sides to work together to give the impression that they are providing for the citizens' needs because dissatisfied electorates can and do take advantage of their one opportunity to directly take part in local government by voting out unpopular municipal governments.

Municipal governments are legislatively protected from central government interference. Article 20 of the Law on Local Self-Government establishes strict separation of power between the central authority and the municipal authority and states that mayors and city councils are accountable only to their constituents. Article 26 (subsections 10, 14 and 16) establishes that the removal of the Mayor or a Deputy of a local government council (rada) can only be done by the decision of a majority vote of the city council. While this legislation protects municipal governments from political reprisal arising after conflicts with the oblast during budget negotiations and implementation, there are exceptions. Two exceptions to the rule are when the Verkhovna Rada (National Parliament) convenes in a special session to vote, and votes in the affirmative, on removing a city head or when a higher court decision finds a violation of national law or the constitution, which mandates the removal of the municipal authority in violation of the law. Many consider that since the court system is heavily influenced by the Presidential Administration, the President can and does remove

Mayors overly antagonistic to his regime through biased court decisions. For example, the removal of Mayor Hurlitz in Odessa in 1998 and subsequent replacement with a strong supporter to the President is thought to have been influenced from above.

Despite the mechanisms and pressures for accountability to their local constituents, the oblast continues to have extra-ordinary influence over the activities of municipalities. In practice, municipalities are heavily influenced and held accountable to the oblast government. Because of its role in the budget process, the oblast acts as a controller and monitor of municipal spending. At the same time, because the oblast also controls the bulk of revenues flowing to the municipal authorities, it possesses an undue amount of influence over the governance of municipal entities. This enables the oblast to punish or reward cities based on its actions and loyalty to the center. While there is no formal central government veto power over local government fiscal decisions, in practice, the oblast authority has a de facto veto over municipal fiscal decisions. This veto power is so ingrained into the political system in Ukraine, that municipalities typically do not make any important fiscal decision independent of receiving the oblast's opinion first. However the central government and its agents face little incentive to look out for the interests of the local governments and in fact, have a greater incentive to push problems down to the local level.

### *Evolving democratic practices*

Democratic political practices are evolving over time in Ukraine. They are not yet at a stage where they are institutionally strong enough to contribute to a hard budget constraint. For example, with the exception of the Communist Party, there is no party label or discipline that carries any weight. Ukraine currently has over 75 political parties and few of these

parties have strong economic programs. This combined with constantly changing political alliances and ever-fragmenting coalitions makes Ukraine's political landscape one of the most chaotic in the transition countries. To some degree, this negates the importance of political parties. For example, the President is not affiliated with any party. At the local level, the Communist Party does have some influence, although other party names are generally a non-factor and many candidates are unaffiliated.

In terms of campaign finance, at the oblast level there is no formal campaign to finance because the Governor is appointed rather than elected. However, the governorship of an oblast is a powerful position and the lobbying for the post is fierce. There is no formal criteria setting out who may be nominated and in general, the process lacks transparency. One obvious criteria has emerged in recent years. This is the ability of the Governor to deliver votes to the President during the presidential elections.

Municipal heads, municipal councils, rayon and oblast councils are all voter elected positions. During elections some public financing is provided to qualified candidates, however the real value of these resources is low. The Law on Elections of Local Government Deputies and Mayors restricts the maximum amount a candidate may spend on his/her candidacy to 50 times the non-taxed minimum wage. This implies restricting expenditure to approximately \$1,125. In theory, free time is provided equally to all candidates on both radio and TV. In reality, the stronger regional interest groups can usually guarantee that their candidate receives a disproportionate share of air time. In addition, special interest groups, often set up by the candidates themselves, frequently set up special funds, usually not legally related to the elections but are used to finance elections campaigns. The result is that

candidates are largely funded with contributions from specific sources and interest groups with little transparency or accountability over how the funds are used.

### *“Exit”*

An additional way for citizens to demonstrate preferences and in some sense hold governments accountable is through “exit” or relocation to another community. However, in Ukraine, as in other countries of the Former Soviet Union, the system of the “propiska” is a legacy that largely precludes relocation as an option.

The urbanization of Ukraine took its lead from Soviet-style industrialization. Seven decades of industrialization policies emphasizing heavy industry and one company towns have left a legacy of profound misallocation of capital and human resources. However, many of the past professional and residential choices cannot be sustained under market conditions. For the system of public finance these misallocations imply a double burden: such a heavily distorted economy does not provide an adequate tax base for the public sector and at the same time requires massive subsidies to households lacking access to market sources of income. Such a mis-match is especially felt at the lowest levels of government and in the most economically weak regions of Ukraine.

However, the ability of Ukrainian citizens to “exit” or relocate to another community or town is restricted. The “propiska” or permit that authorizes residency in a community and a “workbook” are both necessary documents for receipt of most social benefits. Despite the fact that greater mobility of the population is a means of easing some of Ukraine’s most urgent fiscal problems, generally mobility remains highly restricted. With social benefits tied to the “propiska” and “work book”, relocation often implies losing access to social benefits

and presents a great disincentive. Hence “exit” as an option for indicating preferences is highly limited in Ukraine.

Political mechanisms and their implications for accountability play a critical role in helping to support hard budget constraints. While political and democratic practices have taken great strides since Ukraine’s independence, they are not yet sufficiently mature to play a strong role in supporting hard budget constraints. If anything, these mechanisms often create incentives that weaken hard budget constraints. Fundamental issues of accountability remain unresolved in Ukraine and contribute to adversarial relations between branches of government (the executive and parliament) and levels of government (oblasts, rayons and municipalities). They also contribute to unclear “rules of the game” and promote the discretionary nature of the system in the political realm as well as in the fiscal realm. In such an environment, it is exceedingly difficult for citizens to get accurate information on government decision-making and to hold governments (at all levels) accountable. At the same time citizens are limited in their ability to make use of “exit”. While citizens can and do make use of elections to express their views on current governments, in general most of the incentives within the system do not encourage accountability. This carries over into the realm of capital markets and local government borrowing, the third mechanism for supporting hard budget constraints, which is considered in the following sections.

### **III. Sub-national Borrowing and Hard Budget Constraint Failure**

It is generally accepted that since most local governments provide services that require substantial up front investment and because these services provide a stream of future

benefits over a long period that it is appropriate to finance them through borrowing to spread the cost of the assets over time. Both the Law on Local Government and the 1991 Law on the Budget System Local Governments are given the authority to borrow directly and to issue debt.<sup>5</sup> However, the regulatory framework for such borrowing has remained limited and there are few institutional mechanisms that help to maintain a hard budget constraint. After briefly considering the regulatory framework for subnational borrowing, this section focuses on specific aspects of the Ukrainian capital markets to develop a broader picture of why a hard budget constraint fails to apply in Ukraine. It addresses local government loans from higher levels of government, then the issue of “veksels” by local governments, and finally, it discusses the Odessa municipality bond default.

#### *The regulatory framework for subnational borrowing<sup>6</sup>*

Ukraine does not have a well-established legal and regulatory framework for subnational borrowing. Subnational governments presently have access to three types of borrowing; (i) borrowing from higher levels of government, ii) borrowing from commercial banks, and iii) issuing bonds. Borrowing from higher levels of government is undertaken without any clear guidelines for determining how to allocate such loans, and frequently they are converted to subventions at year end. Borrowing from commercial banks is limited to oblasts and medium-size cities for liquidity purposes, and for short maturities, often with the lender bank being the depository of the borrower's cash accounts. Finally, SNGs have not been successful with bond issuances, either based on volume issued or the experience of issued bonds (see the discussion

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<sup>5</sup> In Ukrainian legislation, “balanced” local government budgets are required, however, borrowing is classified as a revenue item rather than a financing item in local government accounts. Thus, local governments accounts may be “balanced” at the same time as local governments borrow.

of the Odessa bond issue below). The reasons for the anemic bond issuance are varied, but include high rates of inflation, lack of creditworthiness, lack of available capital, etc. Overall, the current legal framework does not offer the predictability and reliability necessary to reinforce hard budget constraints.

The source of borrowing authorization for SNGs is contained in Article 70 of the Law on Local Self-Government in Ukraine, and in the Law on Securities and The Stock Exchange (Articles 3 and 11). The Law on Local Self-Government deals with all forms of debt, while the Law on Securities and The Stock Exchange only deals with debt issued in the form of securities, i.e. bonds.

***Article 70. Participation of Local Self-Government Bodies in Financial and Credit Relations***

1. *The council, or -- on the council's decision -- other local self-government bodies may issue , in accordance with legislation, local loans, lotteries and securities, may obtain loans from other budgets to cover temporary cash imbalance, to be settled by the end of the budget year, and may also receive credit from banking institutions.*
2. *Local self-government bodies may create, within the limits of legislation, communal banks and other financial and credit institutions, may act as guarantor of credits of enterprises, institutions and organizations which are the communal property of the corresponding territorial communities, may place their proper funds into banks of other subjects of the property right, and may receive interest, in accordance with the Law, and include this interest in the revenue part of the corresponding local budget.*

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<sup>6</sup> This section draws heavily on Michael A. DeAngelis 1998. “ Legal and Regulatory Environment for Ukrainian Subnational Borrowing.” Background Paper to World Bank Report Intergovernmental Finance in Ukraine: An Agenda for Reform.

This provision is the legislative authorization for borrowing for all forms of debt. The details of good subnational debt legislation (the types of debt, the method of securing such debt, the remedies upon default) as discussed below, are completely absent from the Law. Article 11 of the Law on Securities and The Stock Exchange governs the authority to issue bonds. The absence of sufficiently descriptive procedures for issuance of securities is a substantial defect of this law.

Neither of these Laws address the practice of the issuance of Bills of Exchange ("veksels" – see below). Although they are symptomatic of the problems of expenditure and revenue assignments discussed above, vekselns are another example of an additional source of debt authority (and a soft budget constraint) that produces confusion. The current rules for issuing vekselns approved by Joint Decree of the Cabinet of Ministers and National Bank No. 528 dated September 1992 state that only "businesses" are allowed to issue *veksels*, be acceptors, endorsers or guarantors. However, a cabinet of Ministers Decree No. 1440 dated September 15, 1998 allow oblasts to issue vekselns in connection with electricity through the end of 1998. The National Treasury guarantees such vekselns. There also appears to be a lack of consensus regarding regulatory jurisdiction over the use of vekselns.

Presently, pursuant to a Presidential Decree adopted as a result of the Odessa default in June of 1998, and Regulation 48 of the Securities and the Stock Market Commission as amended by Regulation 91, all subnational borrowing must be approved by the Minister of Finance. Yet there is no explicit statement that the central government will not bail out local government who cannot repay loans or debt issues, nor is there any clear elaboration of procedures for obtaining authorization. It is also not yet clear which department in the Ministry of finance will carry out this function.

Neither the Law on Local Self-Government nor the Law on Securities and the Stock Exchange contain any provision relating to the type of security a subnational government may pledge to the payment of its debt. There is an existing Law on Pledge that is functional and essentially adequate to provide for securitizing debt. However, the Law has developed relatively recently and there is little experience with the judicial recognition and enforcement of these security rights on a timely basis. In addition, various issues have been raised with regard to its provisions. For example, the registration of pledges in the State Registry is permissive, but clearly states that any pledgee that registers a pledge will have the claim recognized prior to nonregistered pledges. However, there is not presently any unified registration system in Ukraine, making it very difficult, if not impossible, to carry out due diligence on existing pledges. The pledge may be registered in the location of the pledgor, the pledgee or the property.

There is little experience in Ukraine in judicially enforcing financial obligations against defaulting subnational issuers of debt. Even in the Odessa situation (see below), neither the Securities and Stock Market Commission or the city courts are aware of any pending litigation, although letters of complaint have been received by both the Commission and the Ministry of Finance. There is an apparent absence of clearcut negative consequences resulting from default.

One reason for the absence of the judicial remedial enforcement may be a requirement that a plaintiff in a financial reclamation lawsuit deposit an amount equal to five percent of the value of the lawsuit in Hryvnya in order to commence legislation. This could be a substantial deterrent to creditors seeking legal recourse. For example, in the Odessa situation, litigation by nonresident debtholders would require a deposit of approximately \$1,000,000 in Hryvnya. Given the potential length of litigation and the potential for devaluation, this is a substantial cost

even to a successful plaintiff and obviously discourages enforcement of claims. Experience on foreclosing against specific property is also limited and varied. There are cumbersome and lengthy procedural requirements to liquidate collateral. An additional issue with regarding enforcement relates to the lack of clarity of title for local government property. The title to much property remains unclear and is still in the process of devolving from the state or being privatized.

With respect to monitoring and disclosure, there is no requirement that local governments receive independent audits, nor is there any effective audit for the full financial status of a subnational government. A body called the Control-Inspection Service (CRU) does monitor local governments, but its focus is on uncovering criminal wrong-doing rather than providing a source of regular financial accountability by auditing the financial performance of local governments. There is also a perception among some local officials that CRU audits may have been used for political ends in some instances. There does not appear to be any monitoring of the financial viability of sub-national governments or their compliance with debt payment requirements.

There is however a resolution by the State Committee on Securities and Exchange that sets forth the disclosure requirements in the case of issuance of local bonds. These requirements are designed to reflect material and relevant information about a local government. Much of the required information is appropriate, however, there is no requirement for continuing disclosure for the period the bonds are outstanding. Furthermore, the SCSE does not appear to have any enforcement or remedial powers to deal with noncompliance and existing prospectuses are very weak.

Finally, there is no any legislation dealing with the insolvency of local governments. A recent draft Law on Bankruptcy is only applicable to corporate entities, not local governments.

Overall, the legislation relating to subnational borrowing in Ukraine does little to help reinforce a hard budget constraint. Local governments are authorized to borrow, but there is little or nothing said about processes, collateral, disclosure and monitoring. Indeed only in the wake of the Odessa bond default in June 1998 did the Government begin to issue statements requiring the registration and approval of all subnational borrowing and statements that such borrowing would not be guaranteed by the central government. Even with the existence of such decrees and the regulations, implementation and enforcement are weak. As we shall see, in an environment when the rules of the game are weak and poorly enforced, there is ample opportunity for the softening of budget constraints.

#### *Borrowing from higher levels of government*

Due to the weakness of private capital markets in Ukraine for sub-national borrowing, loans from higher levels of government are the most widespread form of borrowing used by local governments. Unfortunately, these loans make a direct contribution to the persistence of soft budget constraints in Ukraine.

The process for intergovernmental loans in Ukraine is not one that resembles true loan finance at all. The 1991 Law on the Budget System and the 1995 draft revision of this same Law indicate that intergovernmental loans may only be given to subnational governments (oblasts, rayons, and/or municipalities) which are experiencing budget short-falls or cash shortages. In the Ukrainian context of scarce liquid funds and compressed budgets virtually every sub-national body is eligible for these loans. Near universal eligibility and

correspondingly insufficient funds results in a high level of discretion in allocating the loans. Since the loans are applied for on the basis of need rather than on the basis of quality of projects and creditworthiness, local governments have every incentive to spend. In addition, loans are made on the basis of 100 percent up-front disbursement and at zero interest. Combined with a practice of turning unpaid loans into subventions, this creates a system whereby loans from higher levels of government are more frequently taken to be part of the system of grants than as a financial obligation.

National statistics on the absolute level of disbursed loans from higher levels to lower levels of government are not centrally recorded and hence not available. However, interestingly, national statistics on the outstanding balances of intergovernmental loans are recorded. In general, most of the oblasts apply for and receive inter-governmental loans during the fiscal year from Ministry of Finance, especially in the first half of the fiscal year before oblasts budgets have been agreed.<sup>7</sup> Since the Ministry of Finance has a direct relationship with the oblast financial offices it has greater control on their repayment rates. This generally results in a lower percent of unpaid balances for oblasts.

Table 6 presents the aggregate percentage of the budget that unpaid balances on loans constituted for each level of government. Unpaid balances vary both across regions and by levels of government. On average, unpaid balances are larger at the lowest levels of local government.

In addition to undermining implementation of a hard budget constraint in the present, the moral hazard in the current system contributes to the persistence of soft budget constraints over time. Loan funds acquired from higher levels of government on the grounds of need encourage local governments focus on lobbying and

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<sup>7</sup> This actually results in an even larger level of the sub-national loans being written off through loan reclassification. It is common for subsidized oblasts to negotiate a reclassification for loans from Ministry of

“demonstrating need” as opposed to focusing on local government creditworthiness and ability to repay, not to mention the quality of the project being supported. In turn, the focus on lobbying for loans at zero interest from higher levels of government has also served to weaken capital markets generally and eclipse any development of medium or long-term markets for municipal finance.

**Table 6 Aggregate percent of the budget that unpaid balances on intergovernmental loans constituted for each level of government, 1997**

Oblasts	Oblast	Cities Under Oblasts	Rayons	Cities not Under Oblasts	Settlements	Villages
Crimea	0%	6%	0%	9%	8%	16%
Vinnitszka	0%	0%	0%	1%	3%	4%
Volyn	0%	3%	0%	3%	4%	5%
Dnipropetrovsk	0%	4%	3%	3%	1%	3%
Donetsk	1%	6%	6%	8%	12%	22%
Zhitomir	0%	0%	0%	2%	5%	2%
Zakarpattia	0%	0%	0%	0%	0%	0%
Zaporizka	1%	2%	0%	1%	2%	5%
Ivano-Frankivsk	0%	0%	0%	0%	0%	0%
Kyiv oblast	0%	0%	0%	1%	24%	29%
Kirovograd	0%	2%	1%	0%	0%	0%
Luhansk	0%	2%	2%	13%	5%	6%
Lviv	0%	0%	0%	2%	2%	4%
Mykolayiv	0%	2%	1%	0%	0%	8%
Odessa	0%	0%	0%	19%	20%	33%
Poltova	0%	1%	4%	5%	12%	16%
Rivnyi	0%	2%	0%	7%	4%	3%
Sumy	0%	0%	0%	1%	13%	12%
Ternopil	0%	23%	8%	18%	11%	24%
Kharkiv	0%	0%	0%	10%	11%	8%
Kherson	0%	0%	0%	9%	14%	20%
Khmelnisk	0%	0%	0%	0%	1%	4%
Cherkassy	0%	0%	0%	0%	0%	0%
Chernivig	0%	17%	7%	8%	14%	16%
Chernivsi	0%	0%	1%	8%	22%	20%
Kyiv	0%	0%	0%	0%	0%	0%
Sevastopol	1%	0%	0%	23%	0%	15%
<b>Total</b>	<b>0%</b>	<b>3%</b>	<b>1%</b>	<b>6%</b>	<b>8%</b>	<b>11%</b>

Source: Ministry of Finance, Treasury department, Ukraine and Barents Group see World Bank 1999,p.69.

Intergovernmental loans are just one of the systemic factors contributing to hard budget constraints failure in Ukraine. The next section considers the issuance of local government

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Finance to subsidies. It would be far more effective to promote good governance by disbursing these funds as

veksels or bills of exchange as an instrument that offers another means of getting around a hard budget constraint.

*“Veksels”*

A Ukrainian veksel or “bill of exchange” is legally a form of short-term borrowing widely utilized by both the public and private sectors in Ukraine. Technically veksels are promissory notes, issued in accordance with procedures laid down for bills of exchange and promissory notes in the 1930 Geneva Conventions and the Joint Decree of the Cabinet of Ministers and National Bank No. 528 dated September 1992. In practice, veksel transactions are more a combination of mutual cancellation of debts among enterprises and offsetting arrangements that help localities finance expenditures and enterprises to reduce tax arrears.

In 1998, local governments, primarily oblasts and municipalities, became particularly dependent upon issuing veksels to finance planned budget expenditures and collect tax arrears. Table 7 sets out the 1998 Ukraine State Tax Administration (STA) itemized tax receipt data and reveals the extent to which local governments depend on veksels. In 1998, over 31% of all local government tax collections on enterprise profits, the primary source of local government tax revenues in that year, were collected in the form of veksels. Additionally, total income and profit tax receipts and total State tax collections show significant dependence on veksels as well, with 21% and 16% collected in veksels respectively.

Table 7 also indicates that local government veksels are primarily received and redeemed by State, communal, and collective enterprises (i.e. unambiguously non-private organizations), who also generate the largest amount of profit tax liabilities (nearly twice that

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grants in the first place. This would increase transparency.

of private and other similar organizations). The hard budget constraint failure in this process is systemic. On average only one-third of State, communal, and collective enterprises' profit tax is paid in cash, with the remainder paid in veksels or mutual tax settlements. Since payment in veksels is a non-cash payment, and as shall be seen below an overvalued payment, state and other budget-funded government agencies therefore pay their tax liabilities with lower real value obligations while retiring debt at the nominal veksel price. This amounts to an indirect and hidden subsidy by the state and local governments to state and other government-funded agencies and a failure to impose fiscal discipline on enterprises that would most likely in the absence of such transactions have to be declared insolvent.

**Table 7: Selected Itemized Tax Receipts of the State Budget of Ukraine for 1998**

Type of tax collection (in thousands of Hr.)	Total	Mutual Debt Settlements	Veksels	Receipts through bank transfers (cash)	% of total collected from mutual tax sett.	% of total collected in veksels	% of total collected in bank transfers
1	2	3	4	5	6	7	8
Profit tax on State enterprises and State organizations	2,365,000	734,409	871,623	758,712	31%	37%	32%
Profit tax on communal enterprises and communal organizations	167,669	41,468	42,417	83,783	25%	25%	50%
Profit tax on enterprises with foreign investments (private)	206,012	3,344	7,143	195,524	2%	3%	95%
Profit tax on foreign legal entities	16,793	0	323	16,469	0%	2%	98%
Profit tax on banking organizations	263,612	7,284	10,423	245,904	3%	4%	93%
Profit tax on collective owned enterprises	1,616,530	295,590	816,477	504,462	18%	51%	31%
Profit tax on Joint-ventures	2,437	2,437	2,822	38,201	6%	6%	88%
Profit tax on private enterprises	144,260	6,259	8,741	129,259	4%	6%	90%
Profit taxes on other organizations	823,365	161,790	88,424	661,782	9%	11%	80%
<b>Total profit taxes on enterprises</b>	<b>5,928,185</b>	<b>1,177,657</b>	<b>1,858,881</b>	<b>2,891,646</b>	<b>20%</b>	<b>31%</b>	<b>49%</b>
<b>Total Income and Profit tax</b>	<b>9,504,560</b>	<b>1,359,240</b>	<b>1,978,779</b>	<b>6,166,440</b>	<b>21%</b>	<b>14%</b>	<b>35%</b>
<b>Total Tax Collections</b>	<b>19,035,160</b>	<b>3,262,584</b>	<b>2,965,659</b>	<b>12,806,916</b>	<b>17%</b>	<b>16%</b>	<b>67%</b>

Source: State Tax Administration of Ukraine, compiled and collected by Lucan Way, see World Bank. 1999, p. 81

### **Box 1: A Local Government Veksel Transaction**

In early January 1999 a vodokanal (water utility) in a regional Ukraine Oblast found that it needed a significant amount of benzene as part of the normal process of conducting repairs on water systems damaged during winter. The vodokanal system was sufficiently depreciated that without repairs, the local government would lose access to running water. The vodokanal informed the Oblast administration and oblast financial offices of the situation and urgently requested transfer of the funds planned in the oblast 1999 budget for the vodokanal's repair and maintenance. The oblast did not have free funds available and informed the vodokanal it would have to finance the benzene with Oblast-issued veksel instead. The vodokanal bore the responsibility to find the seller and arrange the transaction.

In order to conduct the transaction the vodokanal hired a local financial firm, which had expertise in this type of veksel transaction. A trader at the financial firm agreed to conduct the transaction and immediately began calling different enterprises to find an enterprise that was interested in the transactions. The trader had to find an enterprise possessing several important characteristics. First, the enterprise had to possess on hand a sufficiently low grade of benzene that it was realistically willing to trade it in a veksel transaction. Second, it had to have either a "partner" enterprise with which it could conduct the transaction or it had to have significant debt to a third party firm with accumulated tax arrears that was willing to participate in the transaction to cancel its debts for tax relief. This is generally recognized as a difficult task. In this case, the trader found an enterprise, call it firm A, with benzene it was willing to trade in a veksel transaction that had an appropriate partner enterprise, call it partner firm B. The trader then had to find or set up an intermediary or "envelope" enterprise, which it did with the assistance of a local commercial bank specializing in this activity. In this case the envelope enterprise was an enterprise set up for the specific purpose of buying the benzene from firm A at a small nominal profit, and then selling it on paper to the partner enterprise at a large profit margin.

Firm A accordingly sold its benzene to the envelope firm at 75 kopecks per liter, for 5 kopecks over its acquiring cost of 70 kopecks. The envelope firm in turn sold the benzene to partner firm B for Hr. 1.45 per liter, i.e. at a substantial paper profit. Partner firm B, then sold the benzene to the vodokanal for Hr. 1.50 per liter and received the Oblast veksel order as payment. To finish the deal the accountants for both partner firm B and the vodokanal went to the Oblast financial offices and registered the transaction with partner firm B's tax arrears subsequently written off equal to the value of the transaction.

The end result for the vodokanal was that it received approximately half the benzene it could have purchased had it had cash. Subsequently it can do far fewer needed repairs, many citizens will remain without water, and it will soon have to return to the oblast with an even larger request for funds for repairs. The end result for the Oblast was that its planned budget expenditures were recorded at the full value of the veksel order, as if it was a cash transaction, and it collected a matching amount of tax revenue in the form of the redeemed veksel. Both the financial firm and the agent commercial bank received a substantial fee for services performed, the envelope firm, after its namesake, was immediately closed, making collection of tax on its paper profits impossible.

Local government veksel have some fundamental characteristics that influence how they are used. Veksel are non-transferable (e.g. they can not be discounted nor traded), they are issued at full nominal value, and are only redeemable against tax arrears to local government budgets. Enterprises thus redeem the majority of local government

veksels against profit taxes.<sup>8</sup> More importantly, the combination of the above factors necessitates a complex method, in fact illegal, for conducting most local government veksel transactions . Box 1 provides an actual example of how a veksel transaction is typically conducted.

This example demonstrates the hard budget constraint failure that resulted from the local government veksel transaction. The Oblast recognized the expenditure at full par value of the veksel, whereas the true value of the service provided was half that amount. This implies that oblast expenditures are overvalued and that a hidden liability is passed on in the form of decreased services to local government citizens.

Because a veksel can only be issued at full nominal price a method for discounting the veksels must be found, otherwise they would not be accepted. Furthermore, since veksels are officially non-discountable and non-transferable but taxable, a direct transaction with veksels is highly undesirable. This is because a straight nominal value to tax relief swap veksels transaction would not only imply equal cash value for the veksel, but also produce a profit tax liability on the redeeming enterprise. In order to incorporate the true value of the veksel into the transaction, the redeeming enterprise would have to charge a higher price on the service. The enterprise would then be liable to pay that profit tax liability in cash, but meanwhile it would not have made any cash in the transaction itself, thus doubly impacting its cash flow. Therefore an illegal, open and close, envelope enterprise is required, and as this analysis suggests, is tacitly tolerated by the local governments. This results in a culture of tolerance towards illegal activity that benefits the local government.

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<sup>8</sup> The remaining local tax collections that constitute the major sources of local government tax revenues naturally lend themselves to payments in barter.

Veksels reflect an example of innovation on the part of local governments in response to capital market illiquidity, unpredictable transfers, ever-increasing arrears and non-transparency. They are used by local governments because the issuance of these notes allows some delivery of services and collection of tax arrears, when there could quite easily be none. Local governments have become increasingly dependent on veksels, as budgets have become increasingly tight in Ukraine. However, they also serve to create yet another viscous circle in Ukraine where the budget funded enterprise needs more and more funds to cover expenses, which have been only partially covered through veksel financing and results in larger and larger estimates on funds demanded from the budget. The secondary result is an incentive to maintain arrears, caused by the very same instrument meant to lower them.

#### *The Odessa Municipal Bond Default*

The 1998 Odessa default, in which Odessa defaulted on Hr 91.5 million has been one of the most important events symbolizing systemic problems in the development of local government capital markets in Ukraine. To its credit, the central government has to date not directly bailed out the Odessa municipality and the losses have been borne by the investors in the bond issue. At the same time, the Odessa story highlights how the system of intergovernmental finance, politics, and weak regulation of capital markets contribute to soft budget constraints.

At the time of their issue, the Odessa bonds appeared attractive to speculators for a number of reasons. Leading up to the bond issue the city made public its plans to fund capital investments which would have rapid turnover and carry high short term yields.

Namely, funding of construction of parking places, toll highways, a municipal taxi fleet and other activities with high turnover and a short payback period. The issue was short term --1 year -- with a 50 percent annual return, significantly higher than the 30 percent effective yearly return available on sovereign debt. The bonds were also available in a wide range of nominal values and freely transferable. As a result the Hr 61 million issue was fully subscribed with heavy participation by foreign investors.

All proceeds from the bond issue were initially transferred to an independent account of the city budget held at the city's authorized bank (Porta-Franco Bank). Porta-Franco Bank was also given responsibility for all financial transactions for channeling bond repayments. The implementing agency for investing the proceeds of the bond issue was the Odessa Municipal Mortgage Fund for Economic Development (OMMFED)<sup>9</sup>. OMMFED was empowered to spend the bond proceeds according to city-directed projects and also in short term securities in order to generate a stream of payments to repay the loan.

On May 1, 1998, the first day of the pay back period, Hr. 2 million of the total Hr. 91 million to be retired came due but no funds were transferred from the city to retire the bonds<sup>10</sup>. Thus, Odessa technically defaulted on the first day of the repayment period. On May 11, OMMFED transferred a total of Hr. 250,000 to the city budget, which was in turn transferred to Bank Porta-Franco and used to pay off Odessa private citizens' debt only<sup>11</sup>. After May 11, no more funds were transferred from OMMFED or the city budget

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<sup>9</sup> Appointed implementing agency by the mayor of Odessa, at the time, Edward Hurlitz on July 24, 1997.

<sup>10</sup> Of the first Hr. 2 million matured roughly 1.3 million was due to the Ukrainian Savings Bank "Sberbank" and .7 million was due to individual entities and private citizens.

<sup>11</sup> The next due bond payment, to Ukribank for Hr. 150,000, was not due until May 20, 1998. All bond payments made were made on May 11, 1998 by the following process: OMMFED transferred money to

to retiring the remaining Hr 90, 750 thousands debt. To date this amount remains fully in default.

Odessa, like all Ukrainian cities, is heavily influenced by the overall system of intergovernmental finance discussed above. Transfers from the State level accounted for 51 percent of Odessa municipality revenue in 1996 (down from 90 percent in 1993).<sup>12</sup> Shared taxes fluctuated dramatically and lengthy delays in the transmission of transfers were (and still are) common. Tax offsets, barter and other forms of non-cash payment to the city budget (veksels chief among them) constitute a large share of municipal revenues. Own revenues remained relatively small.

At the same time compulsory and mandated expenditure accounted for roughly 35 percent of Odessa's total expenditures in 1996 and 1997. At the same time, protected expenditures increased to approximately 44 percent of all expenditure in 1997. Although mandatory and protected expenditures do overlap, the resulting restrictions combined with non-cash payments severely limit cash flow and rule out anything more than a minor level of debt for local governments in Ukraine. At the time of the debt issuance Odessa's current deficit on a cash basis was 5 percent of the budget. However, outstanding payables for the municipality net of receivables amounted to 22 percent of the budget of the time.

Prior to and during the bond sale period, Odessa did an impressive job marketing itself to foreign investors as an economic success story with substantial potential in industry, tourism and trade. Odessa also had an influential, charismatic mayor, international recognition as a port city, and by Ukrainian standards a well-diversified tax

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the city budget, the municipality then transferred the money to Bank Porta-Franco and Porta Franco redeemed the bonds. On May 11, Hr. 250,000 was transferred to Bank Porta Franco and apparently used to pay off face value of private citizens debt who held a total value of Hr. 363,165 of matured bond debt.

base. In fact, a February 1998 rating of Odessa by the international rating agency Fitch IBCA rated Odessa senior debt at B+. Somewhat surprisingly this rating was higher than the published rating on sovereign debt at the time – Moody’s B2.

Despite the issue’s full subscription it is not easy, with the benefit of hindsight, to understand how a reasonable investor could have rated the Odessa bonds credit worthy and invested in them<sup>13</sup>. Debt service on the 1 year bond issue clearly represented over 50% of the 1997 Planned revenue of the Odessa city budget<sup>14</sup>. 91% of the Odessa issue was sold from June 12<sup>th</sup> to June 15<sup>th</sup> and therefore 91% would need to be retired in the same time period 1998. This was an extreme case of a “balloon” maturity, a sudden increase in debt servicing, which obligated Odessa to retire debt representing almost one half of its entire 1998 projected budget in less than one week<sup>15</sup>. Additionally, the issue was scheduled for repayment during the corresponding 1998 May-June period, which meant municipal planning for repayment would be difficult<sup>16</sup>. The budget process in Ukraine for municipalities is often not completed by May. Therefore, the repayment

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<sup>12</sup> All Odessa municipal finance data was acquired from the Odessa municipality financial offices.

<sup>13</sup> According to Odessa municipality financial department document’s approximately 78% of the Odessa bonds were purchased by non-residents.

<sup>14</sup> This was the first ever debt issue by Odessa. Therefore investors had no past debt servicing history to judge. However, investors could have easily projected an expected debt service to total revenue ratio for Odessa fiscal 1998. It would not have been difficult to consider Odessa’s revenue growth from 1996 to 1997 (10%) use this as base for 1998 revenue. Conservative estimates, i.e. excluding revenue generated from investment of the short term bond issue, place projected debt service ratios at .44 for equal revenue growth from 1997 to 1998, .40 for doubled revenue growth and .37 for tripled revenue growth. Even a best case scenario of tripled revenue growth, highly unlikely, implies an extremely heavy debt service ratio.

<sup>15</sup> As discussed above. municipal budgets are negotiated between city financial office and the Oblast government financial offices after the Oblast concludes budget negotiations with the Ministry of Finance. Often budgets Plans for cities are not settled until mid-year. Cities begin spending before they know their exact budget and then adjust expenditures accordingly when the budget is settled. This would have made it very difficult for Odessa to organize in the budget a reserve fund to retire the debt over its pay back period, which in any case they did not do.

period would likely begin before Odessa's budget for 1998 would be agreed with the Oblast.

In the event, world and domestic financial markets tightened significantly by end October of the same year. Despite the world financial markets deterioration the Odessa city council issued a public announcement on November 6, 1997 authorizing and putting forward a second series of debt issues totaling Hr. 500 million in both national and foreign currencies<sup>17</sup>. City property and taxes, in contrast to the first bond issue, were identified as collateral for the second proposed bond issue. The second series of bond issues were abandoned after the markets showed a clear lack of demand and a formal prospectus and contract with a fiscal agency to implement the bond issue were never signed. Activity on the secondary markets for the first series Odessa bonds sharply declined at this time as well.

The financial management of the bond proceeds by OMMFED appears questionable and has been the subject of an internal criminal examination by State authorities. For much of the first month of its activity OMMFED concentrated on short term, contract selling of the bond proceeds into the Ukrainian interbank market. The above mentioned quick investment projects did not receive funding from OMMFED in some cases until even August. OMMFED's holding of funds initially in short term securities until they were finally invested in capital investments was highly loss-making.

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<sup>16</sup> Hr. 83 million of the debt servicing came due in the last week of the repayment period from June 12 to June 15. Realistically, the only way Odessa could have successfully prepared to service this "Balloon" debt would have been to prepare a sinking fund to retire the maturing bonds which it did not do.

<sup>17</sup> Note: since this figure represents nearly 3 times the entire Odessa budget it is interesting to consider the financial reasoning of those issuing the decision and if they employed similar reasoning in their first, now defaulting, bond issue.

Average effective annual return on short-term securities investments equaled only half the cost of the funds, approximately 25% <sup>18</sup>.

Additionally, the Odessa city financial office's supervision of OMMFED's management and investments was apparently weak. Odessa municipal documents up to February 11, 1998 analyzing the investment projects from the bond issue show the following use of funds (Table 8):

**Table 8: Expected Use of Odessa Bond Proceeds**

For housing construction	Hr. 18,078,000
For parking lot construction	Hr. 11,298,224
For construction of a whole sale market	Hr. 5,600,000
For construction of city "Univermag" department store	Hr. 5,600,000
<b>Total</b>	<b>Hr. 40,576,224.</b>

Source: Odessa Municipality.

The remaining Hr. 20,423,776 of the proceeds of the bond issue are not referred to in the city's analysis. The above allocation of funds was largely ineffective. Not only were none of the projects completed in time but none of the above projects has received sufficient funding to be completed at all. The most extreme example of this is the city's highly touted municipal parking garage project which, according to the city budget office, needs a further Hr. 15 million to be completed. Given the current situation raising the needed funds for completing the parking lot's construction will be virtually impossible. Currently the unfinished garage sits, already beginning to dilapidate, unfinished and empty next to the city's largest and most famous bazaar, generating zero income.

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<sup>18</sup> This was the approximate average of 83 short term deposit transactions conducted by OMMFED with different investments in short term securities and deposits at Ukrainian banks.

Little progress has been made in resolving the default. As discussed above, the State does not implicitly or explicitly guarantee local debt issues. As of end July 1998 the State has made clear that it has no intention of stepping in to bail out Odessa. It has been clear to Odessa for some time now that it will have repay its debt on its own.

However, although the default was the result of financial mismanagement, the municipality maintains that the default was due to a *force majeure* situation arising from the removal of Odessa' mayor by the Government of Ukraine shortly before the bonds' maturity. This remains the municipality's reasoning for not paying the bond debt. They maintain that it is either the debt of a previously discredited administration and hence not their fault or that alternatively, by forcing the removal of the administration, the central government became responsible for paying the debt. In either case there is a lack of recognition of the financial responsibility for the bond issue. The default remains legally unacknowledged by the Odessa municipality, even to foreign bondholders.

Security for the bonds was local property, however, and the Odessa City Property Fund-- the agency responsible for selling municipal property in Odessa-- is on record as stating that given current political difficulties in Odessa, the transfer or sale of any city real estate is not foreseen in the near future. To sell sufficient municipal property to cover the loan, the city would have to sell off an unprecedented large value of municipal property. Furthermore, market recognition of Odessa's desperate situation means municipal assets could only be sold at a firesale prices. The Odessa City Property fund, like all state property funds in Ukraine, is highly resistant to selling property at discounted prices. From the above it is clear that it is highly unlikely that sale of

municipal assets will soon contribute to paying off a significant portion of the Odessa bonds.

Given the lack of legislation on work out and weak enforcement, foreign investors have had no success in pursuing work out procedures that would cover at least part of their losses. As mentioned above, some domestic repayments were made but the mechanisms were not formal.

To the extent that investors have had to take the loss and were not bailed out by the central government, the case of Odessa shows at least one positive sign with respect to hard budget constraints. Nevertheless, it is not certain what the central government's reaction would have been had it not been experiencing its own fiscal crisis. Effectively, it did not have the resources to bail out Odessa even if it had wanted to. Nevertheless, the ability of Odessa to avoid accountability, the weakness of the legal framework that does exist and the lack of progress in resolving the issue do not bode well for Ukraine's capital market development.

#### **IV. Conclusion**

The Ukraine case is illustrative of the fact that difficulties in maintaining hard budget constraints apply to highly centralized countries as well as to more federal decentralized countries. Indeed, in Ukraine the lack of hard budget constraints cannot be attributed to a single policy or channel, but rather is the result of systemic factors in many realms. There is no doubt that the transition from a central, command economy to a market driven economy is highly complex and challenging. Yet current circumstances in Ukraine suggest that elements critical to a successful market economy, including some degree of

fiscal stability and budget constraints, continue to be lost in the fray as the country's political and economic systems develop. This chapter has examined three key mechanisms that influence the governments' ability to impose a hard budget constraint and finds that each mechanism tends to support soft rather than hard budget constraints.

The system of intergovernmental finance continues to be unclear and predictable and lacks most of the features that might help to maintain hard budget constraints. The assignment of expenditures functions is so general that in some areas it causes confusion over which level of government is to perform what function. In addition many important social and redistributive functions that are better performed at the national level have been allocated to local governments. When there are disagreements among levels there is no mechanism for resolution of differences. Local governments have little in the way of own revenues and only a marginal part of their revenue comes from residence-based taxation. The bulk of their resources come in the form of shared taxes and transfers. Shared taxes are split based on percentages set out yearly in the budget law and these percentages vary dramatically from year to year, causing both instability and unpredictability. Transfers are for the most part determined in a discretionary way based on both need and negotiation skills. Mismatches between expenditure and revenue assignments have created large vertical imbalances that manifest themselves in arrears. The system as it is currently structured gives localities every incentive to spend and increase arrears and little incentive to raise local revenues. All of these characteristics lend themselves to soft budget constraints.

In the political realm, while citizens have access to some information, decision making at all levels of government is most frequently inaccessible and citizens have few mechanisms for holding their governments accountable on a day-to-day basis. The structure

of government is such that even determining who is accountable for what can be difficult. Regional governors and rayon heads as well as bodies that are part of the state administration report upwards to the president. The legislatures at each level of government are in theory accountable to their electorate. In practice, however, these legislatures are frequently subordinated and subject to control from above. There are few authorities that actually practice independent oversight. In terms of party politics there is little in the way of party discipline and in general, the political scene remains chaotic. Of the over 75 parties that currently exist in Ukraine, few have proposals that place a high priority on economic efficiency. Given limited internal mobility, few citizens are in a position to vote with their feet.

Finally, capital markets generally, and subnational borrowing in particular, have few of the features that have played a role in strengthening hard budget constraints in other countries. The legislative and supervisory framework is weak, with implementation even weaker. There is no explicit legislation that states that the central government will not bail out local government debts. In addition, monitoring and oversight is limited and there is no legislation that addresses insolvency or debt work-outs for local governments. All these factors combined have led to the creation of instruments, such as veksel, that even further encourage soft budget constraints and create disincentives for addressing problems with arrears and non-cash payment.

The case of the Odessa municipality default illustrates how many of these factors came into play in one of Ukraine's largest issuances of municipal bonds. While the central government did not bail out Odessa, the default demonstrates the links between the intergovernmental finance, political and capital market spheres and suggests that there are

many fronts that will need to be addressed in order to support an effective subnational capital market.

All of these characteristics combined create an environment for the worst manifestations of opportunism. Extensive mandates and weak revenue autonomy lead to heavily constrained and inflexible local expenditures. Until very recently local governments had de facto borrowing autonomy. The center tries to use hierarchical authority to control the spending of sub-national governments yet it does not have the ability to micro-manage their expenditure or their borrowing. This leads to a degree of central government dominance in the system that is inconsistent with the requirements for capital market, land market or electoral discipline. This dominance is also ineffective and creates a situation in which the central government allows localities to creatively solve their financial problems. At best creditors and citizens receive their due payments in either discounted form, such as veksel, or through payment in kind, in lieu of salary arrears. Such allowance for creativity in solving budget constraints in whatever form possible, no matter how complex, nor how negative, wreaks havoc with discipline through the entire system. Only in establishing more effective central government management and rules that can be implemented and enforced, will the situation likely improve.