RECENT CHANGES IN THE FISCAL ENVIRONMENT OF LOCAL BUDGETS IN UKRAINE AND THEIR IMPACT ON APPRAISING CITY CREDITWORTHINESS

Prepared by

Wayne Thirsk

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EXECUTIVE SUMMARY

One of the major aims of Ukraine's new Budget Code was to establish a stable fiscal climate for the country's local budgets. An important feature of this Code was the transition towards a formula-based transfer system that in principle promised several benefits in the form of better preparation and execution of local budgets; greater budgetary transparency; equalization of expenditure potential; and much better incentives for expenditure economy and revenue mobilization.

This formula-based transfer system, in conjunction with clear-cut and sensible expenditure and revenue assignments, was designed to make local budgeting a highly predictable event. Local governments, and cities in particular, were thought to have been provided all of the fiscal tools that would allow them to reliably forecast their future revenues and expenditures. In this new and presumably stable fiscal environment, it was expected that many cities would be in a position to issue new debt to refurbish their inadequate, and in some cases crumbling, public infrastructure with a minimal risk of debt default. In short, there would be no more Odessas.

This report challenges the rosy scenario one gets from a reading of the Budget Code. Starting in 2004, a series of events have conspired to erode a number of the expected budgetary benefits in the Budget Code. The assault on the Code has come from two quarters: first, through the negative influence of other Ukrainian legislation; and secondly, from the failure to properly apply and enforce the provisions in the Code itself.

This report describes how city budgets have been subjected to a number of unexpected expenditure and revenue shocks in recent years that have raised the risk attached to municipal borrowing. The Verkhovna Rada has given with one hand and taken back with the other. In the 2005 State budget the Rada gave all of the proceeds obtained from the single or unified tax to local budgets. A few months later, in response to a pension funding crisis, the Rada amended the budget to reclaim about half of the single tax proceeds for the State budget. Since 2004 there has also been a dizzying rate of increase in the minimum wage that has reduced the expenditure flexibility of local budgets and has not been coordinated with the local budget cycle. To partially offset the impact of higher minimum wages the Rada has, in 2004 and 2005, provided additional grants to local budgets. However, these grants restore the old budget hierarchy. They are allocated to oblasts, who then have significant discretion in how to further reallocate them to cities and rayons. This practice contravenes the Code. In the 2004 State budget, inter-budgetary lending was reintroduced in the form of medium term Treasury loans, again contrary to the Code.

The flat rate personal income tax reform that was ushered into existence in 2004 has also rocked the local budget boat in several ways. It first of all exposed how vulnerable city finances are to changes in national tax legislation. The formula- based transfer should have been able to accommodate this reform but by and large, the equalization transfer failed the test. It failed largely because income tax reform wiped out the revenue forecasting capability of the Ministry of Finance. Transfers in 2004 did not adequately compensate for the revenue losses experienced by local budgets. To regain its revenue forecasting capability the Ministry has adopted a new forecasting technique that runs counter to the provisions in the Code. For 2006, the Ministry jettisoned the use of indexes of relative fiscal capacity, as required by the Code, and instead based its forecasts on an extrapolation of observed revenues in 2005. This report carefully documents how the new forecasting method is inimical to revenue-raising incentives, another outcome that the Code tried very hard to avoid. The report concludes with the message that municipal borrowing is an inherently risky affair and discusses ways in which this risk might be safely contained.

Introduction

With the adoption of a new Budget Code in 2001 it was felt in many quarters that Ukraine was firmly set on a new path of intergovernmental finance that would successfully resolve almost all of the problems of inter-budgetary relationships that had been experienced since independence. The Budget Code established clear, and sensible, expenditure assignments for all levels of governments and distinct, and rational sources of revenue for both State and local budgets. Greater fiscal decentralization was achieved by abolishing the previous budget hierarchy and replacing it with independently formulated and executed budgets at the oblast, city and rayon levels of local budgeting. All of these different types of local government became linked instead to the State budget through a system of formula based equalization transfers intended to provide sufficient revenues for local budgets to fulfill their transfer related expenditure obligations and compensate for differences in the size of local tax bases. Local budget autonomy was protected by making these equalization transfers unconditional in nature and allowing local governments considerable discretion in deciding how to use the resources at their disposal.[8] Another important linkage to the State budget was in the form of conditional transfers to local governments to pay for national programs of social protection. As a result of these new fiscal arrangements, the funding of local budgets was expected to be much more transparent and predictable than in the past.

This report examines recent changes in Ukrainian legislation and the administration of the Budget Code in light of how they have affected the ability to accurately assess the creditworthiness of Ukrainian cities. The report is organized in the following manner. Part one considers how the Budget Code should have been a positive factor in appraising creditworthiness. In the second part a series of recent events, beginning in 2004, is discussed that, in combination with each other, have all worked to undermine the potentially positive impact of the Budget Code and have seriously compromised any effort to confidently appraise city creditworthiness. Despite this pessimistic conclusion, the third, and final, part of this report argues that, while it may not be possible to determine absolute credit worthiness, it is feasible to compile a profile of city creditworthiness and rank different cities according to their relative creditworthiness.

I. The contribution of the Budget Code to the Evaluation of Creditworthiness

In principle, a number of the provisions in the Budget Code should have made the task of appraising city creditworthiness easier. For one thing, the Code encourages prudent borrowing practices by establishing a relatively low ceiling on debt servicing of ten per cent of general fund revenues and allowing borrowing only for purposes of development or capital fund financing. It also heavily penalized any act of debt default. In addition, if all the provisions of the Code were strictly enforced cities would face a firm or hard budget constraint fostering fiscal discipline and discouraging reckless budgeting.[9] Moreover, the Code provided cities with relatively stable, annual revenue flows, primarily in the form of proceeds from the buoyant personal income tax, that enhanced the predictability of future revenues and the ability to repay debt obligations. Finally, the Budget Code built into the calculation of formula based transfers fairly strong incentives for cities to grow their revenues without the fear that the State, as it did before the adoption of the Code, would try to extract any "surplus" revenues.[10] This incentive to grow revenues was anchored in the Code's requirement of the use of relatively stable indexes of relative fiscal capacity to estimate a city's

[8] Although neither the formula nor the State budget dictate how local budgets should allocate their resources, local budgets are nonetheless hemmed in by a proliferation of service provision norms laid down by State line ministries. These norms, prescribing how local services should be delivered, limit the expenditure flexibility of local budgets.

[9] Before the Budget Code, local budgets' revenues were established through a highly non-transparent and unpredictable bargaining process. Oblast officials annually negotiated their transfer levels and revenue shares with State officials and when that round of negotiations ended city and rayon officials could begin to make their revenue demands to the oblast financial office. Without any clear-cut revenue allocation rules, no participant in this murky process could ever be certain of what their revenue level would be in any year or how that amount might change from one year to the next.

[10] Cities can enlarge their revenue base by improving the quality of their public services in a way that attracts new economic activity, especially high wage activities, by leasing land to new businesses, by encouraging new business to register on their territory, and possibly by bolstering tax collection efforts.

forecasted revenues in determining the size of any transfer, either to or from the State budget, for the fiscal year ahead. According to the Code, the value of these indexes could be adjusted no more than once every three years.

Local budgets can be planned with a deficit if reasonable sources of deficit financing are available but can only be planned with a surplus if that surplus is intended for repayment of debt principal (articles 14(1) and (2) of the Code). However, in the course of budget execution, local budgets may develop an operating surplus either by generating higher than expected revenue or by trimming some planned expenditure. These operating surpluses can be carried forward from one year to the next and are having no effect on transfer calculations. Most local governments use these surpluses as a source of finance for their development or capital funds.

Article 55 of the Code allows State and local budgets to specify certain protected expenditure items whose budgeted amounts cannot be altered if any budget sequestration occurs after budgets have been approved. The list of protected items is spelled out in the annual State budget law and in recent years has been confined to wages, the social security taxes tied to wages, food expenses, medicines, debt servicing and debt repayment obligations and transfer payments. Local governments are not required to copy this list but in practice almost invariably do so.

How well, then, have these promising features of the Budget Code been realized in practice?

II. Recent Fraying of the Budget Code

Starting in 2004, a concatenation of events has conspired to erode a number of the expected budgetary benefits in the Budget Code. This erosion of the Code has occurred in two ways, first through the influence of other Ukrainian legislation and, secondly, through the failure to properly apply the provisions of the Code itself. In no particular order, each of these events is described below.

(a) The Single Tax Zigzag

The single tax is a presumptive tax levied on small businesses and entrepreneurs at a flat rate on business turnover. In the Budget Code it is a component of so-called first basket revenues that are used in the calculation of equalization transfers.[11] Until 2004 it was a shared tax with local governments receiving 43 per cent of the total proceeds and the State pension fund the remainder. In 2004, however, the Verkhovna Rada passed a 2005 State budget law that allocated all of the proceeds of this tax to local budgets and local budgets were prepared for the 2005 fiscal year on the assumption that they would continue to receive all of these revenues.

However, in a complete policy reversal, the Verkhovna Rada passed a supplementary budget law early in 2005 restoring the original revenue sharing arrangements and local budgets suddenly faced an unanticipated drop in their first basket revenues of about 5 per cent. Populist politics appear to lie behind this flip-flop in tax policy. The central government in its desire to raise living standards of ordinary Ukrainians, both before and after the Orange Revolution, has been rapidly escalating the levels of both public pensions and minimum wages. Pension benefits currently constitute 16 per cent of GDP, a relatively high figure by international standards, and the pension fund has been unable to finance the more generous level of benefits setting off a scramble to find more sources of revenue for

[11] First basket revenues consist of a portion of the personal income tax. For cities this is a 75 per cent share of the amount collected on their territories, a portion of the stamp duty, license fees, business registration fees, fees from trade patents, proceeds from administrative fines and a portion of the single tax. A heterogeneous second revenue basket, comprised mainly of proceeds from the land tax, is not relevant for transfer payment calculations.

the State budget. As a result, the reclaimed share of the single tax has been earmarked to help finance the pension fund.

The tale of the single tax zigzag is a classic example of the well-observed tendency of higher level governments to shift down their deficit problems to lower levels governments. The Budget Code was not oblivious to the likelihood of these pressures and sought to prevent them from damaging local budgets. Article 103 of the Code states than any time the State provides benefits that result in revenue losses for local budgets, the State Budget Law will be amended to provide compensation for those losses. Such compensation simply did not happen in the case of the unified, or single, tax.

(b) Rapid Acceleration in the Growth of Minimum Wages

Since 2004 there have been several hefty increases in the legal minimum wage. From November 30, 2004 to July 1, 2005 minimum wages have grown by 68 per cent and in real terms by over fifty per cent during this period. These wage increases affect not just low paid government workers but the entire local government labor force, because many salaries paid by local governments are geared to a multiple of the minimum wage.

Higher minimum wages have created two kinds of problems for local budgets. First, local government total spending and revenues have not kept pace with the growth in minimum wages. In part this trend reflects another trend in the share of local government spending in the consolidated budget. This share peaked at 42.4 per cent in 2003 and has fallen steadily since then to 38.1 per cent in 2005.[12] As a result, wage payments of local budgets (including rayon and oblast budgets) as a fraction of general fund revenues have risen steadily, from 64 per cent in 2004 to almost eighty per cent in 2005. As a result, when other protected expenditure items such as food and medicines are taken into account, local budgets currently have much less expenditure flexibility than they had a few years ago. Also worth mentioning is the fact that cities also have limited revenue flexibility to respond to higher wages as the tax rates on their most important revenue sources are set by national legislation. As a result, higher wages normally force cuts in other types of spending such as capital spending.

In the second place, the cycle of increases in the minimum wage has not been coordinated and synchronized with the local budgeting process. Hikes in the minimum wage have typically been announced after local budgets have been prepared and approved, leaving local budgets scrambling to stretch for the revenue room with which to pay the higher wages and generally upsetting the budget priorities set out in the approved budget.

While rapid growth in minimum wages in no way violates the Budget Code it does run counter to the philosophy of the Code that stressed the need of the State budget to adequately finance the delegated expenditure responsibilities of local budgets. To be fair, however, the Verkhovna Rada has made belated efforts to ameliorate the impact of higher wages in the form of additional grants to local budgets, although these new grants have also inflamed old budgetary sores as explained next.

(b) Additional Grants to Local Budgets

In 2004 the Verkhovna Rada introduced a new type of grant to assist local governments in paying for higher wages in the amount of 633 million UAH, an amount which represents about two per cent of local government general fund expenditures in that year. A grant of a similar size was recently made in 2005.While the amounts involved are too small to have a major impact on city borrowing capacity, it is the way the grants have been administered that signals a serious departure from Budget Code principles.

While these grants no doubt helped to relieve some of the pressure exerted on local budgets by higher wages, they are entirely ad hoc and have several disquieting features. Somewhat disturbingly, the method of distributing these grants revives old budgetary practices that the Budget Code tried to firmly lay to rest. Once again, grants from the State budget are being channeled to cities and rayons in a hierarchical chain. Additional grants are made first to oblast level governments who are supposed to use discretionary means to further redistribute these funds to cities and rayons within the oblast.[13] The Budget Code attempted to squeeze discretionary elements from Ukraine's transfer system because discretionary allocation of grants had become highly politicized prior to the adoption of the

[12] The point to be grasped here is that the consolidated budget contains an overall expenditure envelope for local budgets and the size of this envelope is one determinant of the amount of planned transfers to local budgets. If the amount in this envelope falls in relative terms so does the amount of planned transfers.

[13] Apparently, the Ministry of Finance did issue recommendations to the oblasts on how to distribute these funds but oblast governors are not bound by them and can exercise a great deal of discretion in allocating these grants.

Code and supported the prevailing system of bargained and negotiated local budgets. With the restoration of lobbying pressures under the new additional grants Ukraine runs the risk of reverting to the pre Budget Code era when local budget resource allocations were highly non-transparent and in many cases bordered on the arbitrary. It is dangerous in any country to operate without clear-cut rules and procedures of the budgetary game.

(c) The 2004 Reform of the Personal Income Tax and its Aftermath

At the beginning of 2004 a flat rate personal income tax of 13 per cent was introduced and replaced the previous income tax that had five rate brackets ranging from 10 to 40 per cent. The flat rate of 13 per cent is scheduled to rise to 15 per cent in 2007. Low income tax relief was also featured in the reform as taxpayers with an annual income of less than 40 minimum monthly wages were allowed to claim a deduction from taxable income equal to the minimum monthly wage multiplied by the number of months the taxpayer worked during the year. This so-called social tax privilege was to be gradually phased in at 50 per cent in 2005, 80 per cent in 2006 and 100 per cent in 2007.

This episode of tax reform highlights the lack of city control over the major component of its revenue base and the vulnerability of city finances to changes in national tax legislation. The reform also heightened uncertainty over how particular local budgets would be affected by the reform.

It was widely recognized that the benefits of this income tax reform would be reaped primarily by high income earners, who would see their effective income tax rate fall, and by low wage earners, many of whom would be removed from the income tax roll due to the application of the social tax privilege. It was also recognized that the reform would seriously challenge the ability of the Ministry of Finance to accurately forecast local government revenues in 2004 and calculate the formula based transfers of each local government. Historically calculated indexes of relative fiscal capacity would no longer be valid because of the expected uneven geographic incidence of the reform. High wage cities and low wage rayons were the most likely candidates to experience significant revenue declines. If it were adroitly administered, the formula in principle should have been capable of compensating every local government for any revenue loss associated with the reform.

Disputes even broke out within the Ministry of Finance over the estimated global impact of the reform on personal income tax revenues. The Ministry stood accused of deliberately underestimating the loss of personal income tax revenue that would accompany the reform. In particular, it was accused of willful overestimation of the economy’s wage fund and excessive optimism in forecasting the positive revenue effects anticipated from the movement of workers out of the shadow economy. As a result of these controversies, the Ministry’s chief revenue forecaster resigned in protest. That resignation was followed soon after by the departure of the head of the Ministry’s department of territorial budgets.

In the end local budgets did not fare especially well in 2004. The formula could have ridden to the rescue of local budgets only if updated and accurate indexes of relative fiscal capacity could have been constructed in advance of the personal income tax reform. But the Ministry of Finance was not up to the task and as a result many local budgets suffered. Table 1 below traces the evolution of positive and negative transfers over the period 2002-05 when the formula based transfers have been in effect.

Table 1

The Course of Equalization Transfers, 2002-05

(millions of UAH)

	2002	2003	2004	2005
Negative Transfers (Contributions to the State)	3,091	2,369	1,593	1,322
Positive Transfers (Equalization transfers from the State)	4,253	5,905	7,365	11,053
Positive Transfers Over GDP (%)	1.9	2.2	2.1	2.7

Local budget revenues, in the absence of transfers, increased a mere 4.4 per cent in 2004 compared to nominal GDP growth of nearly 27 per cent. With transfers included, local revenues grew by 15.3 per cent in 2004, less than the previous year's growth rate of 21 per cent.

If transfers had been equal to the task of compensating for a lower volume of personal income tax revenues, one would have expected the amount of transfers to increase as a percentage of GDP. Instead, as shown in the last row of Table 1, that percentage dipped slightly in 2004. A more direct comparison leads to the same conclusion. Forecasted revenues taken into account in 2004 for the purpose of calculating transfers were only 2.1 per cent lower, or by 326 million UAH, than in 2003. By contrast personal income tax revenues fell by 942 million UAH in 2004.

The finding that the transfer formula did not operate to offset local budget revenue losses in 2004 requires one important qualification. In the State budget planned for 2004 the share of local government spending in consolidated government spending declined by two percentage points and this decline by itself, as explained in an earlier footnote, would have naturally resulted in a smaller volume of transfers compared to earlier years. Note also that transfers as a percentage of GDP increased by more than a third in 2005 so there may have been a lagged response to the revenue losses associated with the personal income tax reform

(d) Changes to the Formula in the Formation of the 2005 State Budget

Shortly after the end of the first quarter of 2004 the Ministry of Finance had acquired sufficient data on personal income tax collections in different local government areas to begin a much needed recalculation of the indexes of relative fiscal capacity for each oblast, city and rayon. The methodology underlying these recalculations appeared in the Cabinet of Ministers Resolution number 1203 of September 14, 2004.

Assuming no computational errors crept into the recalculation process, the methodology utilized by the Ministry seems entirely appropriate.[14] That said, once the indexes were calibrated their new values should have been fixed for the next three year period according to the fourth closing provision of the Budget Code. But this did not happen as will be seen in a later section of this report.

At the same time, however, the Ministry seems to have committed a serious methodological mistake in also introducing a revenue stimulation factor into the revenue side of the formula. This new factor is peculiar in its design and does not seem to have been well thought out. Without delving into the rather messy mathematical details, this revenue stimulation factor works in the following fashion. If the estimated revenue capacity of a local government in 2005, based on the recalculated indexes, exceeds its estimated revenue capacity in 2004 by an amount greater than the national average ratio of these two capacities, a fiscal reward is given.[15] The estimated revenue capacity of the local government is written down in 2005 by a factor equal to the inverse of the ratio between the local government's capacity ratio and the national average capacity ratio. This is an odd procedure because, if anything, it rewards past rather than future success in growing revenue. A more sensible approach would have been to award, outside of the formula calculation, an additional grant if the growth of executed revenues exceeded the national average growth rate.

The policy rationale for fixing the value of the index of relative fiscal capacity for a certain period was that it rewarded good revenue raising efforts. If a city, for example, were able to increase its revenues faster than the forecasted growth rate of revenues for all local budgets, it could retain all of the amounts it collected without any repercussions on the amount of equalization transfer it would either receive or make.

[14] Based on observed income tax collections in 2004, the Ministry of Finance calculated new indices of relative fiscal capacity for that year. The Ministry further adjusted each of the three base years income tax calculations using the ratio of income tax collected in 2004 to the amount collected earlier. The previous capacity indexes were then calibrated by multiplying them by a factor equal to one plus the observed change in the value of the index.

[15] It is perhaps worth noting that this procedure gives the Ministry of Finance an opportunity to play favorites among cities simply by overestimating a city's 2005 revenue capacity.

To make matters even worse, to avoid having the State budget bear the cost of the revenue stimulation adjustment, a further adjustment to estimated revenue capacities is made. It implies that all local governments not benefiting from the stimulation provision will have their estimated revenue capacity artificially inflated in order to cover the revenue cost of any stimulation. The scheme is in effect a cross-subsidization mechanism for transferring budgetary resources from low to high revenue growth local governments and its disequalizing effects have no proper place in an equalization formula. It also adds to the increasingly opaque quality of the formula. Whether this practice was continued in the preparation of the 2006 State budget is unknown at the moment.

In the same September 2004 Cabinet of Ministers' Resolution, new procedures are spelled out for the determination of the value of "alpha" in the formula. The value of this formula parameter dictates the degree of equalization produced by the formula. A value of one, for example, means that transfers will be provided to finance all of a local government's estimated expenditure needs. Deviations from one have different implications for donor and recipient governments. In the case of a donor, a value for alpha of .9 would mean that it could retain ten per cent of the estimated revenues that exceeded estimated expenditure needs. Recipients in this case, however, would receive a transfer sufficient to cover only ninety per cent of their estimated expenditure needs.

For local governments that receive equalization transfers, the resolution sets the value of alpha at one. For donor governments, on the other hand, the value of alpha is fixed at a value of less than one according to a sliding scale that depends on the donor's year-over-year growth in contributions to the State budget. For growth rates than vary between zero and one hundred per cent, the value of alpha is .9. In the unlikely case that the growth rate surpassed ten thousand per cent, the value of alpha would dip to .6.

This asymmetric treatment of the alpha parameter has no basis in the Budget Code. The smaller value of alpha for donors appears to reflect the lobbying power of richer cities in Ukraine.

(e) The Reemergence of Inter-Budgetary Loans in the 2004 State Budget

The Budget Code explicitly banned inter-budgetary lending. Several factors lay behind this prohibition. Most important among these were that prior to the Code this type of lending was observed to take place on highly non-transparent terms, was often politically motivated and more often than not these loans were never repaid, becoming in effect disguised grants. To promote a new budget environment with hard budget constraints and to help create a harder credit culture, the Code banished these types of loans from the credit scene. The Code did permit, however, short term (up to three months) Treasury loans to finance liquidity gaps related to seasonal fluctuations in revenue collections.

It did not take politicians long to overturn this ban. In the 2004 State budget inter-budgetary loans were once again permitted and a new lending facility was opened up to local governments in the form of medium term Treasury loans. Unlike the short term liquidity loans provided for in the Budget Code, these new interest free Treasury loans could be repaid anytime within the budget year. Loans were tied to the financing of protected items of local government spending. Eligibility for receiving these loans required demonstrating that prospects for fully financing protected expenditure items were poor.

Table 2 below presents some recent data on the size and increase in the volume of medium term Treasury lending.

Table 2

Medium Term Treasury Lending

(millions of UAH)

	First six months of 2005	First six months of 2004
Medium Term Loans	3,956	1,325
Protected Expenditures	12,432	8,946
Over-due Loans	n/a	336.4

A few features of Table 2 stand out. First, medium term Treasury loans have grown rapidly since their inception in 2004 and in 2005 represent almost one third of the value of protected expenditure items. Medium term lending now rivals in size the amount of short term lending by the Treasury, which for the first half of 2005 were about four billion UAH. Secondly, a significant fraction of the loans incurred in the first half of 2004, about 25 per cent, are overdue. Moreover, there is a widely held expectation that most of these overdue loans will be written off by the Ministry of Finance in which case the loans are commingled with subsidy elements. This write off could occur because the Ministry feels some responsibility for the generally poor quality of its revenue forecasts in 2004 that adversely affected many local budgets, in particular some large city donors.

In the case of the relatively rich city of Zaporizhya for example, the Ministry overestimated its revenue capacity in

2004 and the city took out 22.4 million UAH in medium term Treasury loans to execute its budget. However, according to the Cabinet of Ministers Resolution, number t367 of March 24, 2004, this loan is to repaid through a central government subvention that will be received in subsequent budgetary periods. To some extent the advent of Treasury medium term loans has acted as a safeguard to protect local budgets from the adverse effects of the Ministry of Finance's revenue forecasting errors.

Article 60 of the 2005 State budget was even more explicit about writing off a portion of the outstanding medium term loans of the Treasury. This article stated that if any of these loans were unpaid, the Cabinet of Ministers would write off up to 250,000 UAH on each unpaid 2004 loan. Further, if the outstanding loan balance was not paid by the end of 2005, the deadline for repayment would be extended to the end of the first quarter of 2006. Besides being the government paymaster and the executing agency of State and local budgets, the role of the Treasury has been expanded to include that of a small credit institution.

(f) Abandonment of the Indexes of Relative Fiscal Capacity in the Formation of the 2006 State Budget

To the surprise of many, and the alarm of some others, the Ministry of Finance radically altered the manner in which it forecast local government revenue in preparing the first draft of the 2006 budget. Directly contravening article 98 of the Budget Code, requiring the use of indexes of relative fiscal capacity to estimate local government revenue capacity, the Ministry instead extrapolated revenue trends observed for the first half of 2005 and added a real growth and inflation adjustment to the result.

This revised technique for forecasting local government revenue could improve the accuracy with which forecasts are made, but regardless of whether it does or not, the consequences for revenue enhancing incentives are dire. The Budget Code went to considerable lengths to ensure that the estimated revenue capacity of local governments was not heavily influenced by the most recent revenue performance of local budgets. As a result, local governments that cultivated their revenue base and grew revenues at a faster than average rate were entitled to keep any revenues that exceeded their estimated revenue capacity. Now, however, the opposite is true. Local governments that have better than average revenue growth will find either that their equalization grant from the State budget is diminished or that their contribution to the State budget will be greater.

This disincentive to growing revenues, rooted in the change in the Ministry of Finance's forecasting technique, can be illustrated by the experience of the city of Ivano-Frankivsk, which has been a small transfer recipient since 2004 when the personal income tax reform occurred. For the year 2005 the city received an equalization grant of about ten million UAH. But for the year 2006 the city's equalization grant was scheduled to decline to seven million UAH according to the first draft of the 2006 State budget, in all a 30 per cent drop. At the same time, equalization grants in the aggregate were planned to increase by 24 per cent. So why was Ivano-Frankivsk's equalization grant slated to decline?

The answer to the preceding question can be found in the Ministry of Finance's new way of calculating equalization transfers for 2006. Transfer levels (TR) are still defined as the difference between expenditures taken into account for calculating transfers (E) and the amount of revenues taken into account in calculating transfers (R). The percentage change in the level of transfers can be expressed by the following equation:

$$\Delta TR/TR = E/TR(\Delta E/E) – R/TR(\Delta R/R)$$

In the case of Ivano-Frankivsk, the Ministry of Finance estimated that the city's first basket revenues, those taken into account in the formula, would increase by 26 per cent in 2006. By comparison, the nationwide increase in first basket revenues was forecast to rise by 21.9 per cent. The Ministry also estimated that expenditures taken into account by the formula would increase by 20 per cent. In 2005 the transfer of ten million UAH represented the difference between 97.4 million in estimated expenditure needs and 87.4 million UAH in estimated revenue means. Applying these numbers to the equation above yields the following result:

$$\Delta TR/TR = 9.7(20\%) – 8.7(26\%) = .3 \text{ or } 30 \text{ per cent.}$$

If the Budget Code approach to estimating revenue capacity had been used instead in calculating the percentage change in transfers, the 26 per cent estimated gain in the city's revenues would have been replaced by the national average estimated growth in revenues of 21.9 per cent. As a result, Ivano-Frankivsk's transfer would have increased by 4 per cent, instead of falling by 30 per cent. In other words, in the case of Ivano-Frankivsk the new method of estimating revenue capacity generates an effective revenue claw-back for the State of about one-third.

What this example illustrates is that if a city has faster than average revenue growth it is destined under the new formula approach to estimating revenue capacity to experience either a drop in transfers or a rise in contributions. In other words, rapid revenue growth will, to some extent, crowd out transfers or inflate contributions and efforts to grow revenues rapidly will be discouraged. It's safe to predict that if a city such as Invano-Frankivsk continues to enjoy above average revenue growth it will soon be converted from a transfer recipient into a donor city. Elements of State revenue claw-back of local government revenue "surpluses", that the Budget Code tried extremely hard to avoid, have been reintroduced to the system of local budgeting in Ukraine. The only silver lining is that the size of the claw-back is likely to be less than one hundred per cent in most cases.

(g) An Overview: Cities Now Face Greater Uncertainty

In looking at the entire canvas of budgetary changes that have occurred since 2004 it may be concluded that there is more uncertainty now than a few years ago about the future strength of local budgets in general and city budgets in particular. Recent shifts in the budgetary landscape that have been discussed are indicative of a diminished capacity to predict what the future holds. As noted, these shifts have happened since the beginning of 2004. If so much can change in the relatively short span of a year and a half, and if not much of that change can be labeled as positive, how is it possible to confidently peer even 3-5 years into the future and make a firm judgement about a particular city's credit worthiness?

This climate of accentuated uncertainty casts some doubt on the ability to make accurate and reliable forecasts of a city's future revenue stream. One such attempt to cope with this hostile forecasting environment is described in detail in an annex to this report.

Sustained rates of positive economic growth of four per cent or better in real terms will no doubt contribute to the strength of local budgets and help to mitigate recent instability in tax laws, in government transfer policies and in the administration of the equalization formula. Still, there are some worrying warning signs that local budgets in general are struggling so far in 2005. First quarter monitoring of local budgets indicates that short term Treasury loans to cover temporary cash gaps have risen by 96 per cent compared to the same period a year earlier. Total local budgetary arrears have also surged by 17 per cent to a level of 97 million UAH. In addition capital spending from local budgets has shrunk by 34 per cent, a sure sign of tight local budgets, and energy spending has been only executed at an eleven per cent rate raising the looming specter of growing energy arrears.[16]

[16] Budget monitoring report for the first quarter of 2005, issued by the USAID Municipal Budget Reform Project, 2005

(h) Prudent Regulatory Control over Local Borrowing

In response to the Odessa bond default, the Ministry of Finance developed a regulatory framework for local government borrowing in the form of the Cabinet of Ministers' Resolution 207, February 24, 2003. According to this resolution municipal borrowers require approval of any borrowing from the Ministry and have to satisfy a fairly stringent set of budgetary tests before approval is given. Potential borrowers, for example, are asked to submit their budget plans for repaying debt for review by the Ministry along with information on the value of assets they own. In addition, prospective borrowers must undergo a credit rating assessment by a designated credit rating agency.

Recent events indicate that the Ministry of Finance is preparing to loosen its grip on local borrowing eligibility. The Ministry appears poised to life the credit rating requirement, probably in 2005. Moreover, an October 2005 draft Law on Local Borrowing would eliminate the Ministry's review and approval of local borrowing in most cases. In view of the erosion of local budget stability that has been described in this report, the question that quickly comes to mind is whether this is the right time for the Ministry to take its hands off the wheel.

III. A Creditworthiness Checklist

The recent history of budget-related events in Ukraine suggests that one will never know what lies around the next policy corner, but whatever lies in wait, it could have nasty implications for local budgets. The high level of uncertainty created by this situation operates to increase credit risk and complicates the task of identifying which cities in Ukraine are good credit risks. Nonetheless, despite the many concerns raised so far in this report, it should still be possible to rank the relative creditworthiness of different cities and say, with some confidence, that one city is more creditworthy than another. Discovering which cities are better credit risks, rather than fruitlessly searching for cities which present no risk, may be the most promising way to move ahead in Ukraine.

To pinpoint better credit risks, I would suggest approaching the matter from the angle of a conventional credit analysis and examine a prospective borrower's income, income prospects, collateral, and previous debt history along with other bits of revealing data discussed below. Starting from the sample of medium sized cities of oblast significance, one could look at a list of traditional debt capacity indicators that would include the following items:

- General fund revenues per capita compared to the average for all cities; one hypothesis, which can be only verified from an inspection of the data, is that donor cities will have consistently higher values for this variable as a result of their favorable “alpha” treatment. Because of alpha, higher contributions per capita should translate into higher general fund revenues per capita.

- Recent growth rates in per capita general fund revenues compared to the all city average; given the Ministry of Finance’s new methodology in estimating a city’s revenue capacity this variable should not be given too much weight. Nonetheless, the claw-back features of the current formula are unlikely to remove all of the revenue advantages of rapid revenue growth.
- The value of a city’s disposable assets in the form of land and buildings and the rate at which these assets have been depleted in the past.
- Previous debt history related to the servicing and frequency of bank and Treasury loans; the level of current debts including budgetary arrears. A distinction should be drawn between short term and long term arrears. Short term arrears that are quickly paid down represent a much less serious budgetary problem.
- The relative size of the wage bill compared to the average and the proportion of protected expenditure items in the general fund revenues. One minus the ratio of protected expenditure items to general fund revenue provides a useful measure of the amount of discretionary revenue available to a city and indicates its capacity to carry debt. If this proportion were less than fifteen per cent for any city it would suggest almost no budgetary room to issue debt.
- Consistency in generating executed revenues in excess of planned revenues.
- Diversity of the local tax base and the absence of any declining companies or industries.
- Regularity in making general fund transfers to the development or capital expenditure fund; similarly, a consistent ability to produce sizable operating surpluses in the range of five to fifteen per cent of recurring revenues.
- Although something of a judgement call, signs of good management practices and an experienced and knowledgeable financial department and department head. Reasonable indicators of sound management would include the adoption of program budgeting techniques, computerized accounting systems, consistent and transparent data collection and reporting and the publication of well articulated budget reports.
- The proportion of the desired or intended investment projects which will generate either verifiable new revenue for the city or cost savings in operations.
- Existence of a recent audit report issued by KRY, the external auditing arm of the Ministry of Finance, that suggests satisfactory budget performance.
- The extent to which a city may be legally obligated to provide subsidies to local utility companies because the city allows less than full cost utility tariffs to be charged.

Cities that received high marks on all of these benchmarks would constitute the group of preferred credit risks. A more refined ranking within this group could be achieved by assigning weights to each benchmark. More thought would have to be given as to what would be a sensible weighting scheme.

Cities that passed these evaluation hurdles might be deemed to have survived the first line of debt scrutiny. From that point, a more detailed financial and fiscal second line of scrutiny could be carried out as has already been done in preparing credit assessment dossiers for the cities of Cherkasy, Berdyansk, Korosten and Ivano-Frankivsk.

Some additional steps might be considered that would work towards the early identification of threats to city budgets and the minimization of city credit risk. Much of the recent pressure on city and other local budgets, both on the expenditure side and the revenue side, emanates from the annual State budget law. This law should be subjected to careful scrutiny after second reading to ascertain what changes in the law will have an impact on local budgets and how those changes might affect the ability of cities in particular to service both their current and prospective debts. But other laws besides the annual State budget law also influence the viability of local budgets, for example, the law on minimum wages, and these laws should also be systematically monitored.

Other events that impinge on the performance of local budgets, such as the recent change in the Ministry of Finance’s revenue forecasting procedures, are more subtle in nature and more difficult to detect. To keep abreast of such changes requires regular consultations with local budget experts who have access to information concerning altered institutional practices.

It should also be possible to take advantage of some provisions in the Budget Code to mitigate credit risk and enhance credit worthiness. For example, cities could be required, if they are to receive project assistance in issuing bonds, to make debt servicing and debt repayments a protected item of expenditure. Moreover, article 74(1) of the Code requires obligatory repayment of debt obligations and this article could be the foundation for creating revenue intercept mechanisms to protect against the risk of default.

ANNEX: A SIMPLE FORECASTING MODEL OF CITY REVENUES

The use of sophisticated revenue forecasting models for Ukrainian cities is precluded by recent structural changes in local budgets associated with the introduction of the Budget Code and the reform of the personal income tax, the main revenue engine of city budgets. Consequently, any forecasting exercise has to rely on limited data and a set of plausible assumptions about the future path of the Ukrainian economy.

The revenue forecasting model that has been developed for Ukrainian cities is constructed on a four layered set of assumptions that are discussed in turn below.

(1) It is assumed that cities will maintain a stable revenue structure in the future. More precisely, this assumption implies that the proportion of different types of revenue in a city's revenue base will not change over the time period for which the forecast is made.
This assumption is borne out by the revenue data that has been inspected for the cities of Ivano-Frankivsk and Cherkasy. The non-PIT (personal income tax) share of total revenue has remained constant both before and after PIT reform in these two cities.

An important implication of this assumption is that the forecasted growth of PIT will mirror the growth of total revenue (TR) or, in mathematical language,

$$\Delta PIT/PIT = \Delta TR/TR$$

(2) It is further assumed that the predicted growth of PIT over the forecasting period will reflect the predictions made about the growth of the personal income tax base. If that base is expressed as the product of real wages (W) and employment (N), the predicted growth of real PIT is captured by the following equation:

$$\Delta PIT/PIT = \Delta W/W + \Delta N/N + \Delta W/W \Delta N/N$$

This second assumption will need some small modification for the year 2007 when the flat rate personal income tax rate will be bumped up to 15 per cent from its current level of 13 per cent.

(3) The third assumption is that the current explosive growth in real wages is not sustainable over the medium term of the next five years. If the current growth rate in real wages were to continue over this period the share of wages in national income would reach unreasonably high levels. A more reasonable assumption is that the growth in real wages will track the growth of real output in the medium term and that the share of wages national income will stabilize

Thus the assumption made in the forecasting model is that real wages will grow in the future at the expected rate of growth of real GDP. Equivalently, the assumption is that nominal wage growth in the future will be equal to the nominal growth rate of GDP.

(4) A final assumption is that future employment growth of any city can be measured by the expected real rate of growth of GDP. Of the cluster of assumptions made in the forecasting model this last one is undoubtedly the weakest. A more refined approach would disaggregate the economic base of a city and forecast the future growth of each economic sector in the city. That was not done here because of data limitations and time constraints.

The model has been applied to the city of Ivano-Frankivsk using the data contained in the IMF's medium term macro-economic framework for Ukraine. The first two rows of Table 1 below show the IMF's macro forecasts for real GDP growth and inflation for the period 2006-10. Using that information and utilizing the methodology outlined in this annex generates the forecast of total revenue growth for the city of Ivano-Frankivsk shown in the final row of this table.

Table 1

Forecasting Results for Ivano-Frankivsk

	2006	2007	2008	2009	2010
1.real GDP growth(%)	5.5	5	5	5	5
2. Inflation rate(%)	14.2	14.4	10.7	4	4
3. Total Revenue Growth Forecast For Ivano-Frankivsk(%)	27.3	22	18	14.7	14.7