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Setting Regulatory Framework for Municipal Borrowing and Debt in Ukraine

Executive Summary

Presently, high risks associated with local borrowing in Ukraine provide a ground for setting significant (though non-prohibitive) legal restrictions in order to ensure fiscal stability and protection of creditors' rights. The focus of a new Draft Law "On Municipal Borrowing and Guarantees" should be **shifted from the borrowing stage to debt redemption**. **In particular, we recommend** to:

- cancel restrictions on stock of municipal debt and set the upper limit for debt servicing (including interest and principal payments) at 15% of annual revenues of municipal budgets (without transfers and development funds);
- replace authorization procedure for municipal borrowings by registration procedure;
- insert in the law an explicit requirement of targeted use of municipal borrowing for investment financing;
- specify the types of collateral for municipal loans and allow using local budget revenues to pledge municipal debt;
- define a clear regulating mechanism of LGEs defaults with all the necessary steps (selling of assets pledged as collateral, transfer of local budget revenues, voluntary rescheduling, external financial governance).

In the medium run, development of regulations on local borrowing is closely related to the reform of intergovernmental relations (increased fiscal autonomy and responsibility of LGEs), improvements in protection of property rights and general investment climate, development of other instruments of financial markets, and market-oriented reforms in infrastructure sector. These measures will help to reduce the risks of local borrowing while ensuring fiscal discipline, and provide ground for liberalization of market for local borrowings.

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Introduction

Local borrowing is an important instrument for financing local/regional development. When managed properly, it allows decentralized decision-making in regard to local investments, raising additional resources for meeting LGEs' capital needs, and promoting prudent and market-oriented policy concerning public utility companies – the main beneficiaries of borrowed funds.

Current Ukrainian legislation[1] on local borrowing sets the restrictions on the size of borrowings and use of proceeds, define a mechanism for receiving an approval for issuing municipal debt from the Ministry of Finance and registering it in the State Commission for Securities and Stock Market, and introduce the general register of municipal borrowings. However, **legislative basis is fragmented and incomplete, it lacks integrated system of regulation of local borrowings and settlement of local liabilities.** Therefore, design of efficient regulatory framework for municipal borrowings and debts is still on the agenda.

Although experience of East European transition countries shows a potential for the development of local borrowing up to 2-3% of GDP without significant threats to financial stability[2], in Ukraine, it is used on a very limited scale[3]. Presently, the level of municipal debt in Ukraine is estimated at 0,2-0,3% of GDP and until the end of 2004 it will not exceed 0,5% of GDP. The main reasons include lack of security of creditors' rights, considerable risks for financial stability of the country, low fiscal autonomy of LGEs and lack of debt management skills on the local level.

Draft Law "On Municipal Debt and Guarantees" that is prepared in the Ministry of Finance intends to regulate the main issues related to local borrowings and debts. The main questions in this regard are the following: What are the risks associated with local borrowing compared to the other relevant instruments of financing local investments? Should local borrowing be fostered before substantial increase in autonomy and responsibility of LGEs is achieved? What should be the main focuses of new legislation on local borrowing? We discuss these questions in the first chapter of the paper. Then, we proceed with short analysis of international experiences in designing regulatory and supervisory framework of sub-national borrowing. Finally, we assess the new Draft Law on

[1] In Ukraine, legislative basis for municipal debt regulation is represented by specific provisions of the Budget Code, Presidential Decree "On Ordering of Domestic and Foreign Borrowings Undertaken by Local Self-Government Bodies" of 18.06.1998, Resolution of the Cabinet of Ministers of Ukraine «On Approval the Order for the Borrowings to the Local Budgets» of 24.02.2003, and Decision of the State Commission for Securities and Stock Market "On Approval the Order for Issuance of the Bonds of Domestic Municipal Loan" of 07.10.2003.

[2] At the end of 2001 sub-national governments debt constituted 2,25% of GDP in Czech Republic, 2,09% of GDP in Estonia, 1,29% of GDP in Slovak Republic.

[3] In 2003 p. only two cities floated municipal loans – Kyiv (150 mn USD and 120 mn UAH) and Pivdenne (1,2 mn UAH).

Local Borrowings and Guarantees and provide some recommendations concerning its improvement.

1. Risks associated with local borrowings in Ukraine

Municipal borrowing is only one instrument for financing local infrastructure investment. Others include loans from international financial organizations (EBRD etc.), corporate bonds, private-public partnerships. All instruments involve risks both for creditors and central budget related to the uncertainty of expected profits from investment projects. In transition economies these risks are higher than in developed countries, as country-specific risks in the former result from poor protection of property rights, poor and unstable regulatory environment, high volatility of asset prices (capital assets are illiquid in many cases). Sector- and company specific risks related to infrastructure financing arise from:

- inefficient regulations in infrastructure (especially tariff setting oriented on subsidizing some groups of consumers) which prevents its profit oriented activities and limits inflow of private investment in infrastructure objects,

Table 1. Creditors' risks and potential pressure for the central budget associated with different financial instruments

Financial instrument	Creditors'/investors' risks	Potential pressure on the central budget
Loans from international organizations (e.g. EBRD)	*Low sector- and company-specific risks due to*: targeted use of funds for individual investment project; risk assessment by international creditors with relevant experience; international evaluation and monitoring of the projects using international accounting standards; special requirements concerning implementation of market-oriented regulations in the targeted sectors *Low country- and company specific risks due to* state guarantee on international loans	*Predictable pressure* (state guarantees) and direct responsibility of the central government for the efficient use of resources.
Public-private partnerships (PPP)	*Relatively low risks due to:* sharing operating and investment risks between private investors and local governments; better assessment of the risks by private investors (due to their involvement in the investment projects); probability of efficient use of public funds is higher (due to private management by the borrowing company);[4].	*Minimal potential pressure* due to the absence of state guarantees
Corporate bonds	*High risks* due to in-transparent financial accounting and corporate governance; deficient judicial system and huge inter-enterprise arrears; low liquidity of the bonds (underdeveloped stock market).	*No pressure on the central budget*
Local borrowing	*High risks* due to low fiscal transparency on the local level; difficulties in risk assessment of local investment projects; lack of project management skills in LGEs; poor protection of creditors' rights in case of local defaults	*Unpredictable pressure on the central budget* in case of local defaults and political pressure for bail outs; no direct central control over using of

[4] See more details in: S20

		borrowed funds

- domination of state (municipal) ownership in infrastructure resulting in difficulties in evaluation of the companies due to their in-transparent financial accounting and poor management[5].

Does local borrowing differ from the other instruments of financing local infrastructure investment projects with respect to creditors' risks and potential pressure on the central budget in transition country like Ukraine? Table 1 presents a short comparison of different financial instruments.

As can be seen, presently, municipal borrowing in Ukraine is associated with high creditors' risks related to:

- low fiscal transparency on the local level that results in difficulties in risk assessment and monitoring of local investment projects;
- high probability of inefficient using of borrowed funds due to the low skills of project management in LGEs;
- poor protection of creditors' rights in case of LGEs' defaults due to the absence of relevant regulations, low liquidity of assets pledged as a collateral, inefficiency of judicial system.

At the same time, local borrowing jeopardizes fiscal sustainability both at the central and local levels. Though Ukrainian Budget Code contains "no-bail-out" legal commitment of the central government, its credibility under present circumstances is doubtful due to the following reasons:

- general implementation gap (i.e. laws and regulations are not implemented properly) creates expectations for no-bail-out clause to be violated in case defaulted regional authorities impose political pressure on the central government or there is a danger for international image of the country;

- low fiscal autonomy of Ukrainian LGEs is reflected in a lack of reliable own revenue sources for local budgets[6] and low responsibility of LGEs for performing their tasks. Both factors constitute a danger for fiscal solvency of LGEs and increase the risk of pressure on the central budget in case of local defaults.

To summarize, local borrowing is associated with high creditors' risks, which makes the former an expensive tool for financing investments in infrastructure. On the other hand, presently, credible enforcement of the LGEs' fiscal discipline in case of local default is unlikely, which implies a high pressure on the central budget in case of excessive local borrowings.

Therefore,

- presently, it is better to use less risky instruments of financing investment in regional development (especially infrastructure objects), leaving a limited room for local borrowing;
- current regulations on local borrowing should be focused on ensuring fiscal stability and providing the framework for protection of creditors' rights. In addition to no-bail-out commitment, they should envisage restrictions on

[5] Public Private Partnership as Alternative to Privatization, *With an Application to OJSC "Ukrteleco"*, Advisory Paper S20, Institute for Economic Research&German Advisory Group, 2003.

[6] For details see Local Government Revenues: Increasingly Dependent on Kyiv? Advisory Paper T23, Institute for Economic Research&German Advisory Group, 2004.

the amount of borrowing, targeted use of borrowed funds, clarification of the types of collateral, and regulation of default;

- in the medium run, development of regulations on local borrowing is closely related to the reform of intergovernmental relations (increased fiscal autonomy and responsibility of LGEs), improvement in protection of property rights and general investment climate, development of financial market and diversification of financial instruments, market-oriented reforms in infrastructure sector. These measures will help to reduce the risks of local borrowing, and provide ground for its liberalization.

Before turning to the analysis of newly drafted Ukrainian legislation, a brief summary of international experience in regulating local borrowing is very helpful.

2. International experience in regulating markets for sub-national debt

Regulatory framework for sub-national credit markets covers: supervision and disclosure standards, debt issuance, settlement and repayment order, bankruptcy / work out procedures for insolvent borrowers[7]. Regulations also describe types of collateral that municipalities can provide for loans.[8]

In many countries, issuing of municipal loans requires authorization or registration procedures that confirm their legitimacy and certify that loans' safeguards and remedies provided for creditors are supported by central/regional laws and regulations.[9]

As a rule, central government doesn't guarantee sub-national debt in order to avoid moral hazard problem: Municipalities that expect such support have reduced incentives to take a prudent economic course and be cautious in incurring debt, while creditors are less prudent in their risk assessment. "*No Bail-out*" provisions are reflected in the national legislation of South Africa, Mexico and some other countries.

Restrictions, that may be imposed by central governments on municipal debts and borrowings concern the following:

- size of borrowing;
- purpose of borrowing and use of proceeds;
- type of security given to lender and the remedy actions in case of default.

2.1. Restrictions of the amount of borrowing

They are, typically, represented by *debt service caps* (i.e. maximum share of interest payments on debt in total revenues of the local budget). They are established in Argentina, Brazil, Italy, Japan, Spain, Lithuania, Poland, Columbia. The size of caps is limited by debt service tolerance of the local residents: in OECD countries a threshold for debt tolerance appears to lie between 5 and 10% of revenues. Interest payments of sub-national governments do not exceed 4% of revenues in USA, 8% - in Germany, and 12% - in Canada .[10] Debt service caps, as a rule, are defined as percentage of the total revenues of local budget (including transfers).

[7] D. Weist. Borrowing and Capital Financing. – World Bank, 2002.
[8] G. Peterson. Building Local Credit System. – The World Bank, 2000.
[9] M. Noel. Building Sub-national Debt Markets in Developing and Transition Countries. – World Bank, 2000.
[10] W. Dillinger. A Briefing Note on Measuring Municipal Creditworthiness. – World Bank, 2000.

2.2. Restrictions on the purpose of borrowing and use of proceeds

"Golden Rule" provision (i.e. allowing *borrowing exclusively for capital expenditures*) is used in Brazil, South Africa, India. In Canada, USA, Austria, Germany, France, Switzerland, Netherlands, and Sweden there are restrictions on using municipal borrowings exclusively for investment purposes. For instance, in Netherlands municipalities are allowed to float loans only for purchasing of fixed assets. In Sweden, proceeds from local borrowings can be used only for capital construction[11]. Alongside with local borrowing for general investment, project financing- i.e. local borrowings that are allocated to particular projects and backed by project revenues - has become a fast growing component of international capital market[12](see Box 1). Project financing is feasible when it is administratively possible to charge customers for using of services (like in case of water, gas, and electricity supply, solid waste collection, mass transit and toll roads).

Box 1. Project Financing by Municipalities in Selected Countries.

In *Russia,* Moscow's cities council float loans only for specific revenue-generating projects related to financing construction and production facilities. Practice of assignment of local borrowings to specific investment projects is widely used in *Great Britain* and *France* .

In *USA,* municipalities issue both general bonds and revenue bonds that are assigned to specific project financing and secured by user fees. US revenue bonds are used for financing projects in transportation (highways, mass transit, toll roads, ports, airports) and utilities (water/ waste water systems, supply of electricity and natural gas). In case project revenues are not sufficient to service the debt (like in case of projects for financing municipal facilities) sales tax or a fuel tax (or combination of both) is used for collateral. In USA, revenue bonds constitute a dominant part of local borrowings.

2.3. Collateral for municipal loans and default regulations

Legal framework for municipal borrowing has to define the types of collateral provided by sub-national borrowers. As a rule, potential investors look for a wide range of collateral that in addition to project revenues includes some local revenues and/or assets[13].

A well-designed local government bankruptcy framework is important for clarifying rights and obligations of creditors and borrowers in case of default (see Box 2).[14] Legal framework should provide creditors with sufficient protection, promote full responsibility of borrowers for efficient use of resources, and ensure provision of public services.

Other words, the regulation on LGE bankruptcy should aim at preventing and preempting municipal defaults; defining clear procedures for settlement of creditors' claims; setting up reorganization and workout procedures for LGEs in case of default; minimizing the risks for national government to deal with local debts; maintaining public services financed by local budget; relating expansion of local borrowing to a respective increase in local revenues.

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[11] С. Пахомов. Из Западноевропейской практики управления муниципальным долгом // Российский экономический журнал. – 2000. - №7. – С.93-96.

[12] G. Peterson. Building Local Credit System. – The World Bank, 2000.

[13] In 1995, Naga City in Philippines was going to finance bus terminal as a "self-liquidating, income-producing" project. The city pledged all revenues from the project for debt service. In addition, all city revenues from other sources was pledged (see: Leigland.L. Accelerating Municipal Bond Market Development in Emerging Economies: An Assessment of Strategies and Progress. – http://www.rti.org.)

[14] M. Noel. Building Sub-national Debt Markets in Developing and Transition Countries. – World Bank, 2000.

Box 2. Bankruptcy Procedures for Municipal Borrowers in USA and Hungary

In *USA,* municipal bankruptcy is handled by Chapter 9 of the US Bankruptcy Code. Restructuring of municipal debt is typically accomplished by extension of debt maturities, reduction of near-term payment of principal and interest, refinancing the debt via new loan backed by new taxes, and budgetary austerity. There is no provision for liquidation of municipal assets and passing the proceeds to creditors. Only a debtor can file for bankruptcy. States' governments intervene aggressively in the fiscal affairs of defaulting municipalities that lose much of their fiscal sovereignty.

Hungary started to regulate defaults of the local governments in 1995. If the city is not able to meet its financial obligations, the Major has to appeal to bankruptcy court within 8 days after the deadline has been missed. The court may reject a bankruptcy petition in case it determines that obligation can be met within existing assets and cash flows. Otherwise, the court declares the commencement of bankruptcy process and appoints a trustee. The municipality has 8 days to form a crisis committee and 30 days to prepare an emergency budget that finances only mandatory tasks. The trustee examines the legality of the decisions that have caused financial crisis and makes recommendations to the court for criminal/civil prosecutions. In case the municipality fails to pass an emergency budget, the trustee recommends the court to start asset liquidation (in the order that is favorable for the creditors). In the most difficult cases, the court can request the Parliament to dissolve local government and call for new elections.

To summarize, international experience shows that in order to safeguard financial stability of the country central government regulates the main issues of municipal borrowing by *imposing restrictions* on the amount of borrowing, purpose of borrowing and use of proceeds, and *defining* the types of collateral and the remedy actions in case of default.

Now we turn to Ukrainian legislation and look whether it provides an efficient framework for regulating municipal borrowing.

3. Evaluation of the Draft Law and recommendations

Current Ukrainian draft law "On Municipal Borrowings and Guarantees" tries to ensure fiscal discipline by **strengthening the restrictions on debt issuing and preserving the mechanism of authorization of local borrowing by the Ministry of Finance**. At the same time, **it does not clarify the process of debt redemption** offering no transparent mechanism for settlement of outstanding creditors' claims in case of default. Consequently, adoption of the current draft law will, on the one hand, hamper demand for borrowing by LGEs, and, on the other hand, further restrict lending activities of potential creditors whose rights are not sufficiently protected. This cannot be considered as a proper solution even in the short run.

Alternatively, we recommend shifting the focus of the draft law from the borrowing stage to the mechanisms of debt redemption. This will help to reduce creditors' risks and increase responsibility of LGEs concerning their debt obligations, thus promoting development of local debt market instead of its implicit prohibiting.

Restrictions on municipal debt issuing should be combined with clear mechanisms for settlement of creditors' claims, as well as ensuring full responsibility of LGEs for meeting their financial obligations**.**

3.1. Restrictions on the amount of borrowing

A) In the draft:

Budget Code of Ukraine (Art. 74) requires that servicing of local debt does not exceed 10% of total local budget expenditures (its general fund). New Draft Law "On Municipal Borrowings and Guarantees" strengthens current restrictions in the following way: Firstly, it limits stock of *total municipal debt* by 15% of annual local budget revenues (without transfers from the central budget and development budget)[15]. Secondly, for a given year, *flow of local borrowing* may not exceed 5% of local budget revenue (without transfers from the central budget and development budget).

New limits are more restrictive (They are 2-3 times more restrictive compared to those in the other countries. In addition, when these indicators are brought to comparable basis -netting off principal in the nominator and adding up transfers and investments to the denominator- disparity reaches 5-15 times[16]). However, presently, restrictions on the amount of borrowing seem to be justified by low financial independence and responsibility of LGEs. However, since debt stock ratio performs the same function as debt service ratio and both ratios represent the measures of creditworthiness, and their complex application is hardly to be expedient. Besides, international experience offers only regulation of interest payments.

B) Our recommendation:

We propose to abolish the **restriction on stock of debt and relate the restrictions on flow of debt the size of municipal borrowings to the total debt payment (both principal and interest payment):**

In general, ensuring fiscal sustainability implies that debt burden grows not faster than the resources, which are necessary for debt servicing. The basic assumption is that debt re-financing is ensured, and terms of re-financing do not change dramatically. In the industrialized countries, central and sub-national government can refinance their debts permanently paying moderate interest rates on their debts. However, this assumption may not hold for transition country such as Ukraine, where in case of unexpected deterioration of market situation LGEs will face difficulties in floating new loans at a reasonable price. Therefore, in order to ensure debt redemption the restriction on debt servicing should concern both interest and principal payments. It is sufficient to set this limit at the level of 15% of annual revenues of local budget (without transfers and development budget).

3.2. Registration vs authorization of municipal borrowing

A) In the draft:

Draft Law preserves **authorization procedure, i.e.** local borrowings are to be authorized by the Ministry of Finance (Art. 8). This clause provides room for subjective decisions and corruption in the authorization agency, and

[15] For comparison: At the beginning of 2004, debt of the central government constituted 147% of central budget revenues without transfers to lower budgets.

[16] Let us assume that municipal loans are floated at the average yield of 20%, then 15% limit for local debt implies 3% limit for interest payment. Moreover, if the amount of interest payments is divided by total revenues (including interbudgetary transfers and investments), than 3% limit turns to be 1-2,5% limit.

discourages issuing of municipal debt by keeping respective time costs rather high.

Given existing quantitative limitations on the size of debt and "no-bail-out" commitment of the central government (no state guarantees on municipal loans) authorization procedure for municipal borrowing seems unjustified.

B) Our recommendation:

We propose to **cancel authorization procedure for municipal borrowings** completely **and replace it with registration procedure**. Registration would make issuing of local borrowing simpler and more transparent without threatening fiscal stability.

Registration of municipal loans should confirm their compliance with legislative requirements concerning the size and types of borrowings, targeted use of the borrowed funds, types of collateral and default regulation procedures. Other words, registration of municipal borrowing by the central government is to be limited to the confirmation of its legal nature. In case all legal requirements are fulfilled, registration of municipal borrowing should be done automatically without additional authorization by any state authority.

3.3. Restrictions on the purpose of borrowing and use of proceeds

A) In the draft:

Contrary to Budget Code, present Draft Law does not contain an explicit requirement to issue local debt exclusively for financing investment. **However,** the idea of **targeted use of municipal borrowings for financing investment** should be preserved in the new Law. **It corresponds to the "golden rule" principle of public finance, which implies that current consumption should be finance by taxes, while net investments might be financed via issuing debt.**

B) Our recommendation:

We recommend **to insert in the Draft Law an explicit requirement of issuing local debt exclusively for financing investment.** This requirement will reduce the possibility of eating-up the borrowed funds by financing current consumption. Together with the rather strict limits on the amount of debt, it might create additional incentives for LGEs to create sufficient financial basis for debt re-payment by directing municipal borrowing into financing revenue-generating investment projects

3.4. Collateral for municipal loans

A) In the draft:

Legal provisions are limited to the definition of what cannot be used as a collateral for municipal debt. Art. 11 of the Draft Law prohibits using local budget revenues to pledge municipal borrowings. This provision seems unjustified, since the law does not require using borrowings exclusively for revenue-generating project financing, and in any case all debts will be serviced out of budget revenues. Moreover, at least implicitly, such a clause brings forward physical assets as a main type of collateral. This might discourage the

creditors, since current procedures of claims to property are long-lasting and inefficient.

B) Our recommendation:

We propose to allow **using local budget revenues** as a pledge for municipal debt and to set up a **ranking order for broad range of pledges**. Such provisions would ensure some guarantees for the creditors and lower risk premiums for municipal loans**.**

In the first place, in order to secure financing of the investment projects related to public utilities, **project revenues** should be offered as a collateral. Project revenues are to be paid into a special budget fund to be used exclusively for debt redemption.

At the same time, measures proposed in 3.3 do not guarantee the targeted using of borrowed funds exclusively for financing revenue-generating projects (they only increase the probability of such a target using). Besides, there is always a risk of overestimating project revenues on debt-issuing stage. Therefore, in addition to project revenues there should be other types of collateral.

In the second place, **marketable physical assets** should be offered to creditors for ensuring project security. Facilities financed by borrowings, vacant land, office buildings, sport facilities, parking lots may serve as a collateral for municipal loans in addition to project proceeds. Primary service facilities should not be pledged in order to ensure provision of essential public services in case of default.

In the third place, **revenues** of the general fund of local budget should be pledged as a collateral for municipal loans. However, LGEs should be empowered to make additional payments from the general fund of budget only in case project revenues and receipts from sales of physical assets are not sufficient.

These measures will reduce the risk of lending and encourage creditors to provide funds on more attractive terms.

3.5. Regulation of default

A) In the draft:

According to Art. 14 of the Draft Law, in case of default creditors are allowed to meet their claims with the collateral offered in the lending agreement. Details and procedures are not clearly defined. Explicit legal and financial guarantees for the creditors are missing. LGEs' responsibility for defaults is not clearly specified either.

B) Our recommendation:

The law should specify a clear **default regulating mechanism**. Creditors' rights and procedures for settlement of outstanding claims should be well defined.

Provisions that regulate municipal insolvency should address the **stages** for settlement of outstanding claims. First of all, debt obligations should be met with the existing **assets pledged as collateral**. Then, outstanding claims should be settled using **cash flows to local budgets**, as stipulated in loan

agreement. If creditors agree, LGEs may resort to **debt restructuring** and rescheduling of liabilities.

If creditors' claims still remain unsettled, creditors should be allowed to appeal to the Ministry of Finance for appointing an external governor and implementing the **regime of external financial governance** for troubled LGE. The purpose of the external financial governance regime is to discharge remaining debt while maintaining provision of essential public services. The core of external financial governance is **emergency budget**, which finances only mandatory tasks prescribed by Ukrainian laws. The law should specify the powers of an external governor to especially approve emergency budgets, and to liquidate some assets owned by municipality.

Finally, the draft law should contain **specific provisions concerning control of law execution**. Efficient control of LGEs' debt transactions should be carried out within the framework of the general system of control of public finance.[17] In the Draft Law, we recommend to specify the controlling agency (Accounting Chamber of Ukraine) and describe in details the LGEs' responsibility for violation of legal provisions.

4. Conclusions

Presently, high risks associated with local borrowing in Ukraine provide a ground for setting significant (though non-prohibitive) legal restrictions ensuring fiscal stability and protection of creditors' rights. The focus of a new law "On Municipal Borrowing and Debt" should be **shifted from the borrowing stage to debt redemption**. **In particular, we recommend** to:

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I.A., T.V. Lector: R.F.

[17] See in details: Akimova I. (ed.), *Fiscal Transparency and Openness in Ukraine: Analysis and Recommendations*, IER, Kiev, December 2003.