

EXECUTIVE SUMMARY

Kazakstan became an independent country in December 1991, upon dissolution of the former Soviet Union (FSU). At the time of independence it lacked the legislative, judicial, and administrative institutions and the legal structure of a national government. It inherited (with adaptation) some institutions and laws from the Soviet era, created other institutions, and began to enact laws more appropriate to a market economy. This book describes and evaluates several closely related aspects of fiscal transition in Kazakstan, namely: tax reform, budgeting, and reform of intergovernmental fiscal relations (expenditure assignment, tax assignment, and intergovernmental grants).

In tax reform, Kazakstan has made more progress than other members of the FSU. The new tax code, which became effective on 1 July 1995, is comprehensive, modern, and investor friendly. The need for further tax reform is thus relatively limited. By comparison, budgeting and IFR have hardly advanced beyond the Soviet system. Thus, the bulk of this report focuses on budgeting and IFR.

HISTORICAL AND ECONOMIC BACKGROUND

Geographic and Demographic Features

With an area of 2.7 million square kilometers (five times that of France), Kazakstan is the second largest republic of the FSU and the ninth largest country on earth. But its population is only about 17 million (about 30 percent of that of France), making it one of the world's least densely populated countries.

Kazakstan is landlocked. It shares land borders on the west, north, and northeast with Russia, on the southeast with PRC, and on the south with three of the other four Central Asian republics of the FSU. It is also bordered on the west by the Caspian Sea, which in turn is also bordered by Russia, Azerbaijan, Iran, and Turkmenistan. This geography has dramatic implications for the future economic development of the country.

Until relatively recently the native people of Kazakstan were primarily nomadic. Several developments changed this. In the 19th century, Russians began to cultivate the northern part of the

country and to exploit its mineral resources. During the 1920s and 1930s, industrialization began and the collectivization of agriculture occurred. Further industrialization occurred during World War II, with the relocation of industrial facilities from the western parts of the FSU to Central Asia and the forced removal of large numbers of persons deemed to be security risks to Kazakstan. Then, during the 1950s Khrushchev undertook to bring the "virgin lands" of Central Asia under cultivation to increase agricultural output and "sedentarize" the nomadic people of the area. It is estimated that 57 percent of the population of the country was urban in 1993. Whereas most Kazakhs still live in rural areas, Russians and others live primarily in urban areas.

The country's population is about 40 percent ethnic Russian and 40 percent Kazakh. The demographic balance has been shifting in favor of Kazakhs, because of the higher birth rate of Kazakhs and the emigration of Russians, other Slavs, and Germans following the dissolution of the FSU. The geographic location of the population tends to be split along ethnic lines, with Kazakhs found mostly in the south and southwest and Russians and others found mostly in the north and in Almaty, where they have formed a majority, because of their predominance in administrative positions under the FSU.

Economic Background

Mining. Mining, an extremely important industry in Kazakstan under the FSU, promises to become even more important. Kazakstan has 90 percent of the FSU's proven reserves of chromium and almost half of its lead, wolfram, copper, and zinc. Kazakstan also accounted for about a fifth of the output of coal of the FSU; some was used to provide electricity to the Ural region of Russia, and some was used in the metallurgical industry around Karaganda and in the Urals.

Although Kazakstan produced only about 5 percent of the oil of the FSU, its prospects are for much greater production. Proved and provable reserves have been variously estimated to be equal those of western Europe or just over 10 percent of those of Saudi Arabia. In 1993, Chevron formed a joint venture (Tengizchevroil) to develop the vast Tengiz oil field in Atyrau, in the western end of the country. British Gas, Agip, and Gazprom, the Russian gas giant, have exclusive rights to negotiate for the Karachaganak gas field, one of the largest in the world. Elf-Aquitane has been chosen to develop resources in Aktubinsk. Exploration in the Caspian Sea

is being conducted via a joint venture that includes a consortium of western companies (British Petroleum/Statoil, British Gas, Royal Dutch/Shell, Mobil, and Total).

Currently, oil flows from western Kazakstan to the Russian Black Sea port of Novorossysk, where it is loaded on tankers. The capacity of this pipeline is well below the projected output of Kazakstan oil. The key to the development of Kazakstan's oil reserves — and, indeed, to the economic development of the country — is a new pipeline that will take the oil to export markets. In December 1996 an agreement was signed to lay a new pipeline to Novorossysk. Reflecting its strategic importance, Russia owns (directly or indirectly) 37.75 percent of the equity in the pipeline company.

Agriculture. Agriculture in the north is dominated by rain-fed cultivation of wheat and other cereals, while in the south it is dominated by irrigated production of cotton. Kazakstan is the third largest producer of grain in the FSU, after Russia and Ukraine. Yet, its agriculture is, by all accounts, quite inefficient, in part because the virgin lands campaign placed land under cultivation that would have better been left to other uses.

Manufacturing. Under the FSU, Kazakstan was a provider of natural resources and other unprocessed (or largely unprocessed) materials (especially crude oil, base metals, chemicals, and metallurgical products) and a consumer of final products made in Russia and other parts of the FSU. In recent years it has specialized in processing of minerals, light industry, and the manufacture of heavy machinery (including agricultural machinery and washing machines), cement, knitted garments, and steel.

Transportation. Rail lines, power transmission lines, and pipelines run predominantly to and from the rest of the FSU (especially Russia). Transportation within the country is difficult or nonexistent, whether by rail, pipeline, or power line.

Economic restructuring and fiscal transition. The patterns of production and trade inherited from the FSU, based on central planning and epitomized by specialization as producers and processors of raw materials, economically inefficient production, and transportation links primarily with other republics of the FSU, left Kazakstan highly dependent on Russia and the FSU, and thus vulnerable to economic disruption (of input supplies and export markets) when the FSU broke apart. Trade within the FSU has fallen precipitously and has not been replaced by non-CIS trade; nor will it be replaced soon. Lack of direct access to the sea aggravates this problem. Yet trade and production will change, if

only slowly, to reflect market forces and competitive advantage. Tax policy should facilitate the transition to a market economy.

It would be a mistake to replace central planning with its functional equivalent, tax incentives intended either to hasten or prevent economic transition. Tax policy should be neutral. It should not be an exercise in picking winners and losers; that is the task the market performs remarkably well.

There will almost certainly be pressures for unwise investment of oil revenues in downstream production (sometimes called resource-based investment) and for tax incentives intended to encourage development of nonoil sectors. International experience suggests that neither of these strategies is likely to be productive.

The north is the industrial heartland of Kazakhstan, while the south is primarily agricultural. This is reflected in differences in levels of income, which are much higher in the north. Development of the country's oil reserves will accentuate inequalities in income, both between households and across regions. Tax policy and intergovernmental fiscal relations must address issues of income distribution and regional imbalance.

History of Tax Policy

The history of tax policy in Kazakhstan reflects the country's history of socialism and central planning. Unlike taxation in market economies, taxation in the FSU did not greatly affect the allocation of resources or the distribution of income; that was determined by the quantities, prices, and wage rates set by the planners.

In the FSU most government revenue was derived from turnover taxes and the transfer of enterprise profits to the budget. Turnover taxes consisted of the (positive and negative) differences between prices at the wholesale and retail levels (net of a margin) set by the planners. Transfers of profits flowed to the budget of the government-Union, republic, or *oblast*, etc. to which the enterprise was subordinated, regardless where the enterprise earned its profits. Taxes on the incomes of individuals existed, but were dwarfed by the taxes implicit in ceilings on wages.

This is essentially the system Kazakhstan inherited from the FSU when it became a separate country at the end of 1991, although changes had begun to be made by then. Further changes were made between then and July 1995, when the new tax code became effective, but the prereform tax code was woefully inadequate for a market economy.

Enterprise Profits Tax. Beginning in July 1991 enterprises operating in Kazakhstan were subject only to the profits tax of

Kazakstan. There was a standard rate of 35 percent, instead of the standard rate of 45 percent under the FSU. Banks and insurance companies paid a rate of 55 percent, and some sectors paid lower rates, including the 10 percent levied on agriculture. A presidential decree issued in February 1994 reduced the standard tax rate to 30 percent (and the rate on banks and insurance companies to 45 percent). Dividends and interest were subject to a withholding tax of 15 percent if paid to enterprises, but not if paid to individuals; receipt of such income was exempt for both enterprises and individuals.

The definition of the base of the profits tax reflected the thinking and methodology of central planning, rather than Western accounting concepts. It clearly would not provide investors the economic incentives and the clarity and certainty they need.

There was initially a large number of exclusions, exemptions, and other preferences, including provisions for tax holidays; thus, planning had shifted from explicit direction to tax-based incentives. There was no allowance for loss carryforward, which would have been more appropriate and more effective as a stimulus to investment. Even worse, the law allowed subnational governments to provide additional tax preferences essentially with revenues that would otherwise flow at least in part to the central government. The 1994 amendments eliminated most of these preferences and introduced a three-year loss carryforward.

Individual Income Tax. The income tax on individuals, although revised in 1991, remained similar to that under the FSU. It was a "schedular" tax levied on various types of income, instead of a "global" tax levied on the sum of income from all sources. Rates were relatively low; the top marginal rate was 30 percent, except in a few cases. Much of the tax was collected at source on income from employment; in most cases it was not necessary for taxpayers to complete tax declarations. Perhaps the most glaring defects were the existence of numerous tax preferences and the exemption of interest income.

A second presidential decree issued in February 1994 substituted a global income tax for the previous schedular tax and eliminated many of the tax preferences provided in the earlier law. The top personal rate was set at 60 percent in the decree, but was reduced to 40 percent in the budget law enacted in July 1994, following outcries from many sources, including governments of the home countries of foreign investors.

Value-added Tax. Like the rest of the former Soviet Union, Kazakstan adopted a value-added tax (VAT) at the beginning of 1992. This VAT differed in important respects from those found

elsewhere. First, the standard credit method (in which tax on purchases is deducted from tax on sales) was not employed in the taxation of commerce. Instead, the subtraction method was employed, so that tax was paid on the difference between purchases and sales. This facilitated various forms of evasion.

Second, the VAT paid on purchases of capital goods was not allowed as a credit against tax on sales. Because it raises the cost of capital, this can be a serious impediment to investment.

Finally, the destination principle was not applied to trade within the FSU. Whereas a standard VAT is imposed on all imports, but not on exports (and tax paid before the export stage is refunded), under the VAT adopted by the members of the CIS, this treatment is applied only to trade with non-CIS countries. Only the value added after importation from the rest of the CIS is subject to tax, and exports to other CIS countries are taxed. This system raises troublesome issues of tax administration and of tax exporting from producing CIS states to consuming states.

Excises. Excises were introduced to complement the VAT in replacing the turnover taxes. Like the VAT, they were levied on the origin principle in the case of trade with the rest of the CIS.

Number of Taxes. Kazakhstan inherited a number of minor taxes (reserved primarily for subnational governments) from the FSU and enacted a few more before the new tax code was adopted. Thus, almost 50 taxes were in existence in 1994. This imposed substantial administrative burdens on the tax authorities, as well as unacceptable compliance burdens on taxpayers.

Tax legislation and codification. The many taxes levied in Kazakhstan were not codified before 1995. Nor was there a standard method of enacting legislation involving taxation. Some laws were enacted by presidential decree and some were included in the annual budget law. Tax provisions were included in nontax legislation. Thus there was no single place a taxpayer, a potential investor, or a tax administrator could find all the country's tax laws. The Ministry of Finance and the State Tax Service were not always consulted before legislation was enacted. Reflecting their genesis, many tax laws contained glaring technical flaws.

Intergovernmental Fiscal Relations in the FSU

The system of intergovernmental fiscal relations in the FSU has often been described as the "Russian doll" model. Like a matrushka doll, the relations between the Soviet Union and its 15 constituent republics were repeated in the relationships between the republics

and the first level of local government (*oblasts*, *okrug*s, and *krais*) and between first and second level subnational governments.¹ Although the dissolution of the former Soviet Union eliminated the outside layer of this multilayered system, lower layers remained essentially intact, as described further in the remainder of this report and summarized below.

Expenditure needs were determined in the FSU by application of expenditure norms. Revenues from local taxes were deducted from expenditure needs to determine residual financial requirements of republics to be financed through their shares of regulating taxes and subventions. Kazakhstan (like the other four central Asian republics) retained 100 percent of the revenues from the turnover tax in 1990 (as in 1989), all revenues from the personal income tax in 1990 (up from 50 percent in 1989), and 20 percent of the enterprise profits tax.

Subventions from the budget of the FSU represented fully one fourth of budget revenues of Kazakhstan — an amount equal to about 10 percent of GDP. (While Russia continued to make small transfers to Kazakhstan in 1992 and 1993, by 1994 they had been eliminated.) Elimination of these subventions left a large gap in the budget of Kazakhstan and in the welfare of its citizens (although the figure of 25 percent of budget revenues represented by subventions from the FSU probably overstates this effect, for reasons explained in the report.)

TAX REFORM

The new tax code reduces the number of taxes from 46 to 11. It contains all tax laws, except customs duties, social insurance contributions, and state duties, and repeals all laws inconsistent with it. It covers taxation at all levels of government: central, *oblast*, and local.

There are six nationwide taxes: income tax on individuals and legal persons, value-added tax, excises, tax on securities, and taxes and payments by mineral resource users.² Reform—and this Executive Summary—focused on the first four of these. (Taxation

¹ The Russian term commonly translated into English as "local" encompasses all governmental units below the central government; it does not have the same meaning "local" has in English. To avoid confusion, this report uses the Russian terms for *oblasts* (the second tier of government) and *rayons* (generally the level below the *oblast* level), and generally uses "subnational" for all units below the central level.

² Strictly speaking there is only one income tax which applies to both individuals and legal persons. Nonetheless, it is convenient to think of this as two taxes.

of natural resources is the subject of a special working group.) *Oblasts* share revenues from these five "regulating taxes."

Kazakstan has chosen to rely on market forces to direct investment. The income tax, profits tax, and VAT are generally applicable, with only minor instances of preferential tax treatment of selected industries, new investment, foreign investors, etc.

Income Tax

Taxpayers. A single income tax applies to individuals and legal entities. Income of simple partnerships (including consortia) is attributed to the partners, not subject to an entity-level tax. Taxpayers with more than one contract to use mineral resources cannot consolidate operations in computing any tax. Resident individuals and resident legal entities are taxed on worldwide income. Foreign enterprises and nonresident individuals pay tax only on income from local sources.

Business Income. Deductions exist for most business expenses, with limits on interest expense (to prevent thin capitalization), reserves for bad debts (limited to actual losses), research and development (no expensing for capital assets), and charitable contributions (limited to 2 percent of taxable business income). Deductions for major expenses are crucial if foreign (especially US) investors are to take credits for Kazakstan's income tax. Unfortunately, a presidential decree made "excess wages" nondeductible at the end of 1995.

Depreciation is simple: maximum percentages of the value of pooled asset accounts (except for buildings, calculated for each structure). Repairs are deductible, up to 10 percent of book value. First-in, first-out (FIFO), last-in, first-out (LIFO), and average cost are acceptable for inventory accounting. Inflation adjustment is allowed for inventories and, as prescribed by the Cabinet of Ministers, for book values. Accounting for tax purposes must conform with financial accounting for inventories, but not for depreciation. Depreciation rates may be too low. Business losses can be carried forward five years. Five-year loss carryforwards may be inadequate for tax-free recovery of investments. Since losses are not indexed for inflation, they rapidly lose value. Allowance for effects of inflation in the calculation of income deserves further attention. (Foreign investors believe that they should be able to keep books in a "hard" currency.)

The new tax code is complicated, especially for small business. Moreover, virtually none of the personnel of the Central Tax Service has experience in implementing such a tax system. There is pressing

need for training for the tax administration.

Individual Tax Exemptions. A deduction of one minimum wage is allowed for taxpayers and each dependent family member. Interest on state securities, state pensions, scholarships, alimony, and various benefits (e.g., for pregnancy, disability, and loss of breadwinner), and gifts and inheritances are exempt. Income of veterans of WWII and certain disabled persons is largely exempt.

There is no allowance for benefits paid to expatriates to compensate for expenses incurred while working temporarily in Kazakstan (e.g., for educational benefits, home leave, and cost-of-living allowances). Besides being questionable on equity grounds, this may undermine the country's economic development, which is dependent on the expertise of expatriates.

Tax rates. Taxable income of individuals is taxed at marginal rates of 5 to 40 percent. Profits of legal entities are generally taxed at 30 percent, except in the case of income of agricultural enterprises, which is taxed at a rate of 10 percent. Dividends and interest pay withholding tax of 15 percent. This is a final tax for individuals. Local enterprises receive credit for taxes withheld on dividends and interest. There is a branch-profit tax of 15 percent.

Filing Requirements. Tax returns are required of legal persons and individuals with: (i) income not subject to withholding; (ii) construction or purchases in the year exceeding 1,000 minimum wages; (iii) foreign bank accounts; and (iv) foreign source income. With few nonbusiness deductions and withholding on employment income, most individuals will not file returns. This is appropriate; taxpayers lack expertise to file tax returns, and the tax administration lacks personnel to cope with universal filing.

Withholding and Advance Payments. There is withholding on employment income, pensions, dividends, interest, and payments to foreign persons. Claims for deductions for dependents are made to the taxpayer's employer. Legal persons and individuals engaged in business must pay tax monthly. Calculating income each month may prove to be so onerous that alternatives should be examined.

Imputation Methods. The tax administration can use the following methods to impute income: for taxpayers operating mainly with cash or few employees, a simplified system tax accounting; for accounting violations or destruction or loss of accounting records, direct and indirect methods such as assets, turnover, or production costs; for individuals declaring income inconsistent with expenses incurred for personal use, use of personal expenses.

Value-added Tax

VAT is essentially the consumption-based, credit-method, destination principle type used in most advanced Western countries. (Credit for tax on inputs, including most capital investment, is offset against tax on sales. Imports, except from the FSU, are taxed, and exports, except to the FSU, and international transport are zero-rated. No tax is paid on exports, but credit is allowed for tax on inputs.) Taxpayers are legal persons and individuals engaged in business registered for VAT. Businesses with turnover above a minimum must register. Those with smaller turnover can register voluntarily. The VAT base is comprehensive; it includes services, as well as goods, but there are (more or less standard) exemptions e.g., for lease and sale of land and buildings; financial services; activities of nonprofit organizations; funeral services; services provided by the state; and privatization and sale of enterprises. There is only one rate, 20 percent; it applies to sales net of VAT, but inclusive of excises, customs duties, and fees. The primary VAT problems relate to FSU trade. Kazakhstan cannot solve these unilaterally.

Excises

Kazakhstan levies excises on production and importation, except from the FSU, of alcoholic beverages, tobacco products, motor fuels, and passenger automobiles, and on gambling, but also on sturgeon and salmon and their roe, furs and hides, apparel made of fur or trimmed with fur, crystal, and firearms. Exports, except to the FSU, are exempt. The Cabinet of Ministers sets excise rates. Excises on alcoholic beverages and tobacco products are stated in ECUs (European currency units) per unit. These imports are taxed more heavily than domestic production. Excises on other goods and on gambling are ad valorem levies. The excise base excludes the excise itself, VAT, and customs duties and fees.

Stating excises in ECUs avoids the choice between per unit taxes fixed in the local currency (easier to implement, but vulnerable to inflation) and ad valorem rates (difficult to monitor and arguably less justified). It would be better to levy uniform excises, providing differentiation through customs duties. As with the VAT, the structure of excises on trade with the FSU is problematic.

Securities Transaction Tax

New issues of nongovernmental securities are taxed at 0.5 percent of the nominal value. Secondary transactions in securities are taxed at 0.3 percent (0.1 percent for government securities).

Mineral Resources Tax

The tax code foresees the use of bonuses, royalties, and an excess profits tax. Payment procedures, the level of payments, and other terms are to be specified in contracts. Since 1994, foreign advisors have been working with the Government of Kazakhstan to produce provisions for the taxation of natural resources that would reconcile the conflicting objectives of attracting foreign investments and providing revenues for the government. It is expected that the draft law on taxation of natural resources will be submitted to the Parliament in June 1996.

Land Tax

Land is taxed annually at rates that depend on quality, location and use: agriculture; occupied land in inhabited localities; land used for industry, transportation, communication; land of the forestry fund; and land of the water fund. This requires an accurate and current cadastre and places great demands on the Central Tax Inspectorate. One wonders whether it can be implemented. Independent local legislation and administration of the land and the property taxes might be preferable.

Property Tax

Business assets (except vehicles subject to registration tax) pay annual tax of 0.5 percent; buildings owned by individuals pay a rate of 0.1 percent. Revenues go to the *oblast* where property is located. The tax is deductible in calculating taxable income.

Vehicle Registration Tax

Motor vehicles pay annual registration fees that depend on vehicle type and engine size. The tax is deductible in determining taxable income. Revenues go to the *oblast* where vehicles are

registered. This tax adds to progressivity and provides revenue for subnational governments. Taxes on vehicles used for legitimate business purposes are not a suitable source of revenue. But, given the latitude for abuse, it makes sense to tax all automobiles. Care is needed to see that tax rates are appropriate.

Administrative Matters

The tax code covers administrative matters, as well as tax structure. Administrative procedures generally apply to all taxes. These include a statute of limitations, appeals procedures, and conflicts of interest.

Registration. Taxpayers (and others making payments taxed at source) are to have unique registration numbers, used for all taxes.

Collection techniques. The tax code gives the Central Tax Inspectorate strong collection powers. The Tax Service can require banks to assign it priority in collection orders, demand payment from the accounts of the taxpayer's debtors, and prohibit bank transactions by the taxpayer. It can place a lien on the taxpayer's property and sell it at public auction and can suspend export operations.

Confidentiality. The Central Tax Inspectorate and its employees are to keep taxpayer information confidential, but under treaties such information can be shared with tax authorities of other countries.

THE SYSTEM OF INTERGOVERNMENTAL FISCAL RELATIONS

The system of IFR inherited from the FSU, despite significant modifications, is not appropriate for a market economy in which decentralization of government is an important objective. While expenditure assignment is generally sensible, it is not specified by law. The budgetary system deprives *oblast* (and *rayon*) governments of control over the level and composition of public expenditures affecting their constituents. It is inadequate for planning, monitoring expenditures, and evaluating performance.

The system of tax sharing lacks transparency, simplicity and logic; both the assignment of taxes among *oblasts* and sharing rates set for regulating taxes are essentially irrelevant. Budgetary officials (of the central government and of *oblast* governments) are under constant pressure to increase budgetary allocations to lower-level governments. The system handles vertical fiscal imbalance and

horizontal fiscal disparities through constant tinkering with sharing rates for regulating taxes and subventions – a practice more appropriate for a planned economy than a market economy.

The System

Expenditure assignment ideally reflects several considerations. Macroeconomic stabilization and redistribution of income are commonly assigned to the central government. While there is no single best assignment of other tasks, economic efficiency is an important consideration. It is determined in large part by the geographic scope of benefits, economies of scale, and administrative capacities of various levels of government.

Current assignment of responsibilities reflects practice under the FSU. While assignments are generally reasonable, some specific assignments are inappropriate; for example, the funding of social welfare should be a responsibility of the central government. Particularly inappropriate is the assignment of all capital expenditures to the central government, even in areas where subnational governments are responsible for operating expenses (including maintenance of facilities).

As state enterprises divest themselves of responsibilities for social services, the assignment of these services to various levels of government will be extremely important, especially since budgetary stringencies at the subnational level may make it difficult to maintain minimum level of service. This raises the issue of the degree to which provision of services can be made more effective through privatization.

Budget practice departs radically from that in most advanced market economies. It reflects a confusing amalgam of deconcentration (subnational administration of national policies) and devolution (assignment of decision-making to subnational governments).

The governmental system of Kazakstan is explicitly unitary. Yet, in principle, subnational governments have substantial budgetary autonomy. The 1991 Law on the Budgetary System states that subnational budgets are independent of the budget of the central government, it gives subnational governments control over use of their funds and forbids interference in the budget process by higher levels of government, and it prohibits recapture of surplus funds of subnational governments. Local elected assemblies have legal authority to decide on subnational budgets.

The President appoints the heads of *oblast* administrations. This dual subordination creates strong vertical links in the decision-

making process. Dual subordination of subnational officials (especially chief administrative officers of *oblasts* and *oblast* financial officers) and the process by which budgets are formulated limit subnational control over their budgets.

In the budget process information is passed up (from *rayons* to *oblasts* to the central government) and budget allocations are passed down (from the central government to *oblasts* to *rayons*). *Oblast* (*rayon*) budgets can be finalized only after budget allocations from the central (*oblast*) government are decided.

In theory, *oblast* budgets are calculated by applying normative expenditure coefficients (e.g., costs per hospital bed) to physical "needs" (e.g., number of hospital beds in an *oblast*) in the various sectors (health, education, social protection, etc.), as in the prior Soviet system. (Similar procedures are used at the *oblast* level to determine the *rayon* budgets.) In fact, in recent years, budgets have been calculated by scaling up approved budget allocations from the prior year, primarily for inflation.

The budget process is not purely mechanical. Both the central government and *oblasts* prepare estimates of expenditure needs and revenues. These commonly differ in expected ways, with *oblasts* presenting higher estimates of expenditure needs and lower estimates of revenues. Budget allocations ultimately reflect the outcome of negotiations, as well as application of budget norms.

As responsibility for social services shifts from enterprises to the budget, adjustments are made in *oblast* budgets, creating pressure on *oblast* budgets and service levels. (Enterprises often provide higher levels of service than subnational governments.)

Oblast budgets do not include capital expenditures, which are provided from the budget of the central government. (In recent years these have been small, due to budgetary constraints.)

Once the budget is approved, *oblast* governments have great discretion to shift funds between expenditure categories (e.g., between health, education, social protection, and between wages, communal services, capital repairs, etc.). They cannot, however, deviate from centrally determined schedules for wages and salaries.

An attempt at fiscal discipline is made by prohibiting deficit spending by *oblasts*. Since *oblast* accounting is on a cash basis, this means that no more can be disbursed than has been received. It does not imply that *oblasts* cannot incur commitments that exceed either actual or budgeted receipts. In fact, *oblasts* have made such excessive commitments and some have piled up substantial arrears, especially for unpaid wages and accounts payable to suppliers, for example, suppliers of energy and communal services. Some

oblasts attempt to have the central government cover arrears, either by appealing for supplementary budget allocations or by carrying arrears forward to future years; the latter ploy does not generally seem to be successful. A system of external audit exists, but it may provide little oversight over local budget execution.

Oblast governments have funds that fall outside the budget procedures described. Extrabudgetary funds exist for a variety of reasons, including circumvention of the normal budget process.

Tax assignment and subventions also reflect prior Soviet practice. *Oblast* governments have access to "local taxes" and charges specified in the tax code; these are mostly unimportant sources of revenue, especially since the new tax code converts the individual income tax from a local tax to a national tax. (The 1995 Budget Law, as amended, continued 100 percent allocation of individual income tax revenues to *oblasts*. But the 1996 budget used the individual income tax as a regulating tax.) Revenues from purely local taxes are subtracted from target expenditures to determine the gap that must be filled by revenues from national "regulating taxes" and central government subventions.

There are four main regulating taxes, which are shared in various proportions with the different *oblasts* on a derivation basis: the individual income tax, the enterprise profits tax, the VAT, and excises. Except in two *oblasts* (Almaty City and Pavlodar), all revenues from excises go to the *oblast* where they are collected. All but Almaty City and Mangystau (which retain 20 percent) retain 40 percent of enterprise income tax. Eleven of the 20 *oblasts* ("subvention *oblasts*") also retain 100 percent of revenues from the VAT and three individual income tax receive subventions from the central government. (Almaty City is included in these counts of *oblasts*, but Leninsk City is omitted.) The remaining nine ("self-financing") *oblasts* retain smaller portions of these taxes.

This system can be presented in the following schematic terms:

Physical quantities x expenditure norms = *oblast* (local) budget

(Actually calculated by scaling up prior approved budget)

Less: estimated revenues from *oblast* (local) taxes

Equals: amount to be financed from regulating taxes and subventions

Less: estimated revenues from *oblast* (local) share of regulating taxes

Equals: subventions required for budgetary balance

All taxes are administered by the Central Tax Inspectorate, an agency of the central government. Thus, administrative effort is

beyond the control of *oblast* governments in principle if not in fact. In principle, subventions are fixed in nominal terms. In fact, the budgetary condition of the central government has recently precluded delivery of subventions promised in the budget.

Problems: Meeting Basic Objectives of Intergovernmental Fiscal Relations

The system just described is not conducive to rational decentralization of governmental decision-making. A rational system must simultaneously deal satisfactorily with at least the following objectives:

- transparency and simplicity;
- logic in assignment of expenditure functions and tax revenues;
- objectivity in the determination of budget allocations and intergovernmental transfers;
- decentralized control over the level and allocation of public spending;
- incentives for subnational governments to make economical decisions;
- a hard budget constraint facing subnational governments;
- control over public funds;
- information needed for informed decisions;
- satisfactory resolution of the problem of vertical fiscal imbalance (ordinarily manifested in inadequate revenues at the subnational levels of government) and horizontal fiscal disparities (differences in the capacity of subnational governments at a given level to provide public services).

The present system does not deal adequately with any of these.

Transparency, Logic, Objectivity, and Simplicity

The present system is not transparent, logical, nor simple. This is perhaps most apparent on the revenue side of the budget. *Oblast* budgets are financed from three sources: local taxes, local shares of national "regulating" taxes, and subventions; in total, the amounts expected from these sources must equal expenditure targets. Despite appearances, the division of tax bases among the *oblasts* and the sharing rates applied to regulating taxes (tax assignment) is largely irrelevant *ex ante*; if tax assignment were different, there would be compensating differences in the sharing rates for regulating taxes and subventions. (*Ex post*, tax assignment may matter; see next page.)

The system accommodates tax assignments that, in other systems, would be intolerable. The following are the most egregious examples of inappropriate tax assignments:

- enterprise profits tax: to the *oblast* (and *rayon*) where the enterprise is registered;
- VAT on domestic production: to the place where the enterprise is registered (converted to formula-based apportionment in January 1996);
- VAT on international trade (with countries outside the CIS): to the point of import or export; and
- excises: to the point where goods subject to excise are produced or imported.

These should be replaced temporarily with the following tax sharing rules:

- enterprise profits tax: on the basis of economic activity (introduced in January 1996);
- VAT: entirely to the central government, with no attempt at derivation-based sharing of revenues;
- excises: to the *oblast* where taxed goods excise are consumed, perhaps on the basis of a formula.

Given the administrative capacity of the country and the risk of duplication and complexity that would result from independent legislation and administration of taxes (fortunately not widely advocated), only sharing of, or surcharges on, taxes administered by the central government are viable options. As administrative realities allow, sharing of tax revenues from the individual income tax, the enterprise income tax, and excises should be replaced by tax surcharges, assigned as indicated above and administered by the Central Tax Inspectorate.

The expenditure side of the budget is also not transparent, logical, objective, nor simple. Budget allocations to subnational governments are determined through the interplay of prior application of expenditure norms, inflation adjustments, and negotiations. While there is the appearance of substantial decentralization of decision-making, the system of dual subordination makes this questionable. Once budget allocations have been determined, subnational governments are free to spend the allocations as they wish, subject to an important restriction on wage rates. Thus, the composition of anticipated (of actual) expenditures need bear little resemblance to the composition of expenditures in the budget submitted to the higher level of government and approved by it. Finally, the existence of extrabudgetary funds further obscures fiscal decision-making.

Level of Public Spending

The system employed to determine budget allocations (scaling up approved budget figures from the prior year) places undue emphasis on the base-year budget and makes too little allowance for relevant changes that have occurred during the interim (e.g., because of demographic factors and economic conditions).

Oblast control over the level of public spending is quite limited. Budget totals for current expenditures (leaving aside extrabudgetary funds) are mandated from above and can be exceeded (except by running arrears) only if unexpected funds become available. *Oblast* governments have almost no latitude in determining tax policy (essentially being limited to determining whether or not to levy certain local taxes); they have no latitude in determining the tax rates applied to the tax bases attributed to their territory. In theory, it is impossible for them to exert greater administrative effort, since the Central Tax Inspectorate is responsible for collecting local taxes. Within limits they are able to increase user charges to recoup costs of services; even here, they operate under restrictions imposed from above. (For example, free health care is guaranteed in the constitution and a presidential mandate caps cost reimbursement for meals served in kindergartens at 30 percent of costs.) *Oblasts* are not allowed to engage in capital spending, except where surplus funds are available (for example, in extrabudgetary funds). In short, local governments have little incentive or opportunity to exert greater tax effort.

Local autonomy could be strengthened in a system resembling the present one by eliminating subnational taxes from the calculation of the budgetary gap to be filled by regulating taxes and subventions and giving subnational governments control over the rates of local taxes. This would make local taxes an incremental source of revenue for subnational governments. In fact, this would not provide much fiscal discretion, given the minor nature of these taxes. A major overhaul of the system is required to give subnational governments meaningful fiscal autonomy.

Allocation of Public Spending

The latitude allowed *oblast* governments in redirecting expenditures is both too great and not great enough. *Oblasts* should be given only limited discretion in discharging programs that can properly be seen as reflecting policy of the central government (for example, payments to veterans and families with

many children), provided the funds needed to discharge expenditure mandates are provided by the central government. (There should be no unfunded mandates.) By comparison, *oblasts* should be given greater latitude in determining the wages and salaries they pay their employees. There is no reason these should be centrally mandated.

Separation of capital expenditures from current expenditures deprives *oblasts* of fiscal autonomy and distorts the budget process. Capital expenditures by the central government may not coincide with the preferences of *oblast* residents. Once capital investment occurs, the resulting social assets feed into the calculation of budgetary allocations. *Oblast*s may neglect repairs and maintenance, either because capital expenditures do not reflect local preferences or because subnational governments believe that the central government will replace facilities that deteriorate because of inadequate maintenance and repair. Only if *oblasts* are responsible for capital expenditures can these problems be avoided.

If *oblasts* are given responsibility for capital expenditures they must have access to debt finance. This raises a host of potential problems. Most obviously, subnational governments might borrow so much as to jeopardize the macroeconomic stability of the country. Thus, the central government should have advance knowledge of all debts issued by subnational governments and its approval should be required. There should be limits on the borrowing capacity of subnational governments, perhaps expressed as the percentage of revenues or expenditures devoted to debt service.

It is particularly important that the central government provide no guarantees, explicitly or implicitly, that it will pay principal and interest on subnational debt; indeed, it must state explicitly and credibly that it will not guarantee such debt and impose sanctions against individuals who represent that it will. Consideration should be given to creation of a financial intermediary that would borrow and on-lend to subnational governments.

Vertical Fiscal Imbalance

Vertical fiscal imbalance between the central government and the *oblasts* is virtually inevitable for the foreseeable future. The poorest *oblasts* are likely to remain dependent on subventions.

Horizontal Fiscal Disparities

It appears that substantial horizontal fiscal disparities between the *oblasts* are also inevitable, because of differences

in the economic conditions of the various regions. (Whereas GDP per capita in Mangystau is twice the national average, it is barely half the average in Almaty Oblast and Kzyl-Ordin.) Disparities will probably increase with the development of natural resources. The potential for sizeable horizontal disparities also reflects the faulty interpretation given the objective of assigning revenues from certain taxes on a derivation basis, discussed above.

Information and Control

The present budgetary system is inadequate to meet normal requirements, including planning, execution, control, and evaluation. Information is not recorded in a fashion that makes this possible, and reports needed for control are not prepared on a timely basis. Because control is only exercised over disbursements, subnational governments can accumulate arrears to employees and suppliers. This threatens to undermine fiscal discipline. Sequestering of funds is at best a stop-gap solution, since it distorts budgetary execution. Containment of deficits deserves greater attention. Control based on commitments would prevent arrears and, combined with multiyear planning for investments, help rationalize investment planning and avoid uncompleted projects. Installation of a treasury function will help meet these objectives, but to be fully effective the treasury function must be extended to subnational governments.

Governmental accounting, inherited from the FSU, does not provide adequate information. Based on large "complexes," data are not sufficiently disaggregated or based on economic or functional classifications and thus not adequate for economic analysis, budgetary planning, or evaluation of performance. Both contemporaneous and ex-post control over budget execution suffer from lack of data. Accounting standards should be reformed, by implementing the budget classifications in the IMF Manual of Government Financial Statistics. The budget should distinguish current and capital expenditures, indicating (for future years, as well as the current year) sources of finance of the latter. Both internal and external audits should be initiated or improved, to protect the integrity of the system.

Summary of Recommendations on IFR

The report contains many recommendations for rationalizing IFR. The following are the most important:

Expenditure Assignment

1. Establish a formal assignment of expenditure responsibilities.

2. Reassign selected expenditure responsibilities (e.g., financing of social welfare).

3. Reassign responsibility for capital investment (to the level responsible for current expenditures).

4. Facilitate financing of capital investment by subnational levels of government.

5. Continue efforts to rationalize divestiture by enterprises of responsibility for social expenditures.

6. Implement policies that will guarantee minimal levels of crucial public services.

7. Initiate sectoral reviews in key areas, including health, education, and social welfare.

8. Consider reform of political institutions governing relations between the central governments and the *oblasts* (and between *oblasts* and lower level governments).

Budgetary Process: Formulation

1. Restructure budgetary relationships to eliminate negotiation and bring transparency to the process.

2. Develop wider and more flexible norms to replace physical expenditure norms and modify budgetary practices to deal with inflation.

3. Include all extrabudgetary activities in the budget, except for pensions and social insurance. (Done, but with addition of the road fund).

4. Include costs of fiscal privileges provided through the tax system in the budget.

5. Reconsider and reform the relationships between line ministries and subnational governments in budget preparation.

6. Place higher priority on containment of budget deficits.

7. Improve forecasts of both expenditures and revenues.

8. Adopt IMF budget classifications, to improve planning and control of the budget and accountability (begun in 1996).

9. Adopt a budget format that distinguishes capital investment and current expenditures.

10. Adopt a multiyear framework for planning capital investment.

Budgetary Process: Execution

1. Establish a treasury function that encompasses subnational governments.
2. Employ IMF budget classification for budget execution.
3. Include personnel decisions in the budget process.
4. Institute commitment accounting for investment expenditures.
5. Implement better controls of budget deficits at all levels of government.
6. Reform the accounting system to record all transactions and produce timely reports.
7. Improve the reporting system to provide reports needed for both formulation of policy and management and control.
8. Reform procurement practices.

Budgetary Process: Control, Audit, and Evaluation

1. Strengthen ex-ante controls.
2. Establish rules and regulations for administrative sanctions.
3. Establish rules and regulations for management of public funds.
4. Establish explicit rules and procedures for internal audit and control.
5. Increase the effectiveness of State Committee on Financial Control in internal audit.
6. Develop the capacity for external audit at all levels of government.
7. Establish capacity for budget evaluation at all levels of government.

Revenue Assignment

1. Increase subnational control over marginal sources of finance.
2. Restore the prior status of the individual income tax as a "local" tax (Stage 1).
3. Rationalize tax sharing rules that assign revenues to the "wrong" *oblasts* (Stage 1).
 - Eliminate derivation-based subnational sharing of VAT revenues.

- Shift sharing of revenues from enterprise income tax from place of registration to place of economic activity (done in January 1996).
 - Replace sharing of revenues with excises from the place of production or importation to sharing based on a formula reflecting the place of consumption.
4. Shift from tax sharing to a system of tax surcharges on the individual income tax, the enterprise income tax, and excises. (Stage 2)

Intergovernmental Grants

1. Implement a system of grants that allows *oblasts* to finance "typical" expenditures with typical tax rates for local taxes and surcharges.

2. As the country gains experience with grants intended to equalize the ability to provide typical levels of services with typical tax rates, explore ways to implement other objectives of grant policy.

3. When necessary, provide additional funds so subnational governments can implement policies mandated by the central government.

Timing

To allow time to "digest" previous changes, it is proposed that the changes in revenue assignment and grant policy be implemented in stages, over a period of three years.