

CHAPTER 5

THE ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES

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Since independence, the Government of Kazakstan has introduced several pieces of legislation like the Law on Representative Bodies of Local Governments and the Law on the Budget System, which have given subnational governments more autonomy than they had under the former regime.

Despite these reforms, Kazakstan still lacks a clear decentralization strategy. On the one hand, *oblast* and *rayon* governments have been given legal autonomy to formulate their budgets and spend their funds any way they wish. This is a practice similar to that followed in decentralized government systems. On the other hand, revenues and the overall level of the budget are determined alone by the central government. Politically, *oblasts* and *rayons* have their autonomously elected legislative organizations. However, the executive branches of government at the *oblast* and *rayon* levels are headed by the President's Representative appointed by the central government and representing it.¹ The present confusion in institutions has led to an unwieldy mix of deconcentration and decentralization of government activities, without clear distinction between the two.

There is a need to distinguish between the deconcentration of central government functions and the decentralization of the public finances. Many central government services and functions, affecting citizens throughout the entire national territory, are carried out, not only from the capital, but also from deconcentrated offices of the central government in the regions and localities. This may be the case, for example, for national roads, tax administration, police,

¹ See World Bank (1996a) for a discussion of the administrative structure.

or mail services. The more efficient administration of many central government services often requires that these services be supervised and delivered from regional and local agencies of the central government. Deconcentration involves moving powers and responsibilities to the territorial offices of the central government.

Unlike deconcentration, decentralization of government promotes the self-government of regions and localities. Decentralization is accomplished by giving regional and local governments the responsibilities and the financial resources to formulate their own budgets and provide services which exclusively affect their residents. Two key ingredients of a decentralized system of government are that local government decision makers are elected by local residents, and officials working for subnational governments have exclusive subordination to subnational authorities. Decentralized local governments have their own legal status and charters as well as ownership of local facilities and infrastructure necessary to discharge their responsibilities. Decentralization of government finances allows a more efficient use of public resources because local officials are more knowledgeable and more responsive to the needs and preferences of local residents.

Economic instability marked with hyperinflation, and important institutional and policy changes, such as the new tax code and the new health system, have had intended and unintended impacts on decentralization policy. Uncertainty about the final direction in other areas has added to the state of flux of fiscal decentralization in Kazakhstan. A stable and meaningful decentralization of governance in Kazakhstan will require an unambiguous and well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government, and sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government. The present chapter addresses the issues surrounding expenditure responsibilities.

ROLES OF THE PUBLIC AND PRIVATE SECTORS IN THE ECONOMY

Before the question of expenditure assignment between levels of government is addressed, it is necessary to define clearly the roles of the private and public sectors in the economy. Massive privatization of state and local enterprises involved in what can be basically considered private economic activities still has not taken place in Kazakhstan. But it is imperative that it do so. The role of

the public sector should be limited only to those services and activities that private markets will not supply efficiently, either because of difficulty of charging a price, or because of joint-consumption benefits, or those services and activities with desirable redistributive value.

Achieving a clear delimitation between the public and private sectors is a longer term goal. During the transition years, inevitably some activities that belong in the private sector will still be carried out by SOEs. This may be so because of the adverse effects privatization may have in the level of employment in a particular region, or because of the difficulties in privatizing very large state enterprises. But even during this period of transition, state enterprises should act as much as possible as private enterprises albeit owned by the state. This will mean that they should compete on even terms with private enterprises in the same area of business and that they should concentrate exclusively on economic production. All public service activities should be taken over by government.

After SOEs shed responsibilities for social services perhaps via privatization, there remains the question of expenditure assignment. That is, which level of government—*rayon*, *oblast*, or central—should be responsible for the specific functions and activities that do belong and will remain in the public sector?

CURRENT ASSIGNMENT OF EXPENDITURE FUNCTIONS

The current expenditure assignment is not regulated or prescribed in any legal form but is based instead on the traditional assignment of expenditure responsibilities inherited from the Soviet Union. The main difference is, of course, that the central government is now in charge of areas previously assigned to Moscow, such as national defense and foreign policy.

The current assignment of responsibilities among the three levels of government is summarized in Table 5.1. This assignment agrees in many ways with the principles of expenditure assignment in the public finance literature. In particular, there is a broad correspondence between the geographic dimension of benefits from a particular service and the level of government responsible for its provision. By and large, the functions allocated to the central government have a national dimension. These include defense and internal security, the justice system, foreign relations, and research in health and education. Expenditures with macroeconomic and redistributive implications, such as pensions and unemployment compensation, are also the responsibility of the central government. These two activities are financed by extrabudgetary

Table 5.1. Expenditure Assignment in Kazakhstan

Expenditure	Federal	<i>Oblasts</i>	<i>Rayons</i>
Defense	Almost 100 percent	Some local facilities and benefits	Some local benefits
Justice/Internal Security	Almost 100 percent	-	-
Foreign Economics Relations	100 percent	-	-
Education ^a	<ul style="list-style-type: none"> • All university and research institute expenditures • Some technical schools • All building construction 	<ul style="list-style-type: none"> • Most vocational schools • Schools for orphans and the handicapped 	<ul style="list-style-type: none"> • All operations and maintenance of primary and secondary schools including teacher salaries • Some kindergarten
Culture and Parks ^b	<ul style="list-style-type: none"> • National museum • National theater • All capital infrastructure and building 	<ul style="list-style-type: none"> • Some museums with <i>oblast</i> significance 	<ul style="list-style-type: none"> • Some museums • Zoos • All recurrent expenditures of all sport and park facilities and all other cultural facilities
Health ^c	<ul style="list-style-type: none"> • Some tertiary hospitals, specialized hospitals, and medical research institutes • All capital expenditures 	<ul style="list-style-type: none"> • Some tertiary hospitals, psychiatric hospitals, and diagnostic centers 	<ul style="list-style-type: none"> • Operations of secondary hospitals • Primary health clinics • Medicines
Roads	<ul style="list-style-type: none"> • Construction of all roads • Maintenance of state roads 	<ul style="list-style-type: none"> • Maintenance of <i>oblast</i> roads 	<ul style="list-style-type: none"> • Maintenance of <i>rayon</i> and city roads

Table 5.1 *continued*

Public Transportation	<ul style="list-style-type: none"> • Highways, air, and rail transport • Subsidies for other facilities 	<ul style="list-style-type: none"> • Some public transportation facilities 	<ul style="list-style-type: none"> • Some transportation facilities
Fire Protection	-	<ul style="list-style-type: none"> • Most fire protection services 	<ul style="list-style-type: none"> • Voluntary, military and enterprise services possible at this level
Libraries	<ul style="list-style-type: none"> • National libraries and museums 	-	<ul style="list-style-type: none"> • Most local library services
Police Services	<ul style="list-style-type: none"> • National militia 	-	-
Water and Sewage	<ul style="list-style-type: none"> • Infrastructure investment 	<ul style="list-style-type: none"> • Operation and maintenance 	<ul style="list-style-type: none"> • Operation and maintenance
Public Utilities ^d (gas, electricity, heating)	<ul style="list-style-type: none"> • Capital structures 	<ul style="list-style-type: none"> • Shared subsidies to users 	<ul style="list-style-type: none"> • Shared subsidies to users
Housing ^e	<ul style="list-style-type: none"> • Building and development 	-	<ul style="list-style-type: none"> • Maintenance and small-scale building
Welfare Compensation ^f	<ul style="list-style-type: none"> • Pension, unemployment, and social insurance 	<ul style="list-style-type: none"> • Shared responsibilities with <i>rayons</i> 	<ul style="list-style-type: none"> • Orphanages, retirement homes, and other local assistance to the poor
Environment	<ul style="list-style-type: none"> • National environmental issues 	<ul style="list-style-type: none"> • Local environmental issues 	-

^a State enterprises operate kindergartens and some vocational-technical schools.

^b Some enterprises operate sports facilities.

^c Some enterprises have polyclinics and hospitals and operate them. Starting January 1996, there will be a Health Insurance Fund, an extrabudgetary fund operated at the central government level.

^d Until this year, prices of services were controlled by the central government.

^e Enterprises still own about 30 percent of housing stock.

^f The Pension Fund, the Unemployment Fund, and the Social Insurance Fund are extrabudgetary funds of the central government.

Source: Based on information compiled by authors.

funds. Correspondingly, most of the expenditure responsibilities of subnational governments involve services with regional or local “benefit areas” such as polyclinics,² primary education, fire protection, and sanitation. However, several important problems remain in this area, which are addressed below.

Subnational Governments’ Expenditure Shares

The share of local government in the consolidated budget for 1995 was 43.4 percent. This level reflects both the shifting of expenditure responsibilities to subnational governments and the budgetary priority given by the government to some of the services provided at the subnational level, such as education and health, in the face of shrinking real resources accruing to the public sector.

The 1995 budgetary division of responsibilities between the central and subnational governments by main type of expenditure category is presented in Table 5.2. Local governments financed most social expenditures: 74.7 percent of total education, 81.7 percent of total health, and 82 percent of total social welfare. The subnational governments still played a very significant role in the “economic sphere” with 44.8 percent of consolidated public expenditures for 1995. These expenditures included energy and coal, and the agro-industrial complex, and, much more importantly, expenditures in the “social complex.” The latter covered gas, fuel, heating, and communal services and housing. Subnational governments also had a substantial participation in the Road Fund and the much smaller Nature Protection Fund.

Composition of Subnational Government Expenditures

Within the consolidated subnational budget (see Table 5.3) social expenditures (health, education, and social welfare) took the largest amount with 64.11 percent of all subnational expenditures. However, the category “financing of national economy” represented a share of expenditures as large as either health or education. These three items combined made up 83 percent of consolidated subnational government expenditures.

The assignment of expenditure responsibilities at the subnational level of government is relatively well defined in practice, if not in law. In this division, local governments tend to be responsible for the provision of public goods and the benefits

² A polyclinic provides a variety of ambulatory services including primary, out-patient specialist, and diagnostic services.

Table 5.2. Distribution of Budgetary Expenditures, 1995

	Total	Subnational	Central	Subnational	Central
	Tenge 000			Percent of Total Expenditures	
Total Expenditures	226,275,218	98,287,897	150,435,221	43.44	66.48
Financing of National Economy	59,166,175	26,514,148	32,652,027	44.81	55.19
Sociocultural Expenditures	84,368,820	63,007,630	21,361,190	74.68	25.32
Education	34,610,057	25,761,111	8,848,946	74.43	25.57
Public Health	33,144,324	27,074,517	6,069,807	81.69	18.31
Social Security	10,571,134	8,669,489	1,901,645	82.01	17.99
Defense, Police, Courts, and Administration	47,059,397	6,253,910	40,805,487	13.29	86.71
Funds	5,162,325	1,841,980	3,320,345	35.68	64.32
Foreign Economic Activity	9,905,296	0	9,905,296	0.00	100.00

Note: These data (and the percentage distributions) appear in the source document; there is no explanation for the discrepancy.

Source: 1995 Budget of Kazakhstan.

Table 5.3. Composition of Central and Subnational Budgets

	Subnational Budget Distribution		Central Budget Distribution	
	Tenge 000	Percent of Total Expenditures	Tenge 000	Percent of Total Expenditures
Total Expenditures	98,287,897	100.00	150,435,221	100.00
Financing of National Economy	26,514,148	26.98	32,652,027	21.71
Sociocultural Expenditures	63,007,630	64.11	21,361,190	14.20
Education	25,761,111	26.21	8,848,946	5.88
Public Health	27,074,517	27.55	6,069,807	4.03
Social Security	8,669,489	8.82	1,901,645	1.26
Defense, Police, Courts, and Administration	6,253,910	6.36	40,805,487	27.12
Funds	1,841,980	1.87	3,320,345	2.21
Foreign Economic Activity	0	0.00	9,905,296	6.58
Subventions to Local Budgets	0	0.00	22,447,900	14.92
Foreign Economic Activity	668,367	0.68	19,827,361	13.18

Source: 1995 Budget of Kazakstan.

accrue to residents of the local jurisdiction. Local schools and health clinics are under the control of the *rayons*, while specialized hospitals and institutes of higher learning are operated at the *oblast* level.

Tables 5.4 to 5.7 help to explain the composition of expenditures and the division of expenditure responsibilities within Almaty and Taldykorgan *Oblasts*.³ The information contained in Tables 5.4 and 5.5 demonstrates the composition of expenditures in each *oblast*. It is interesting to note that there is some consistency in the composition of budget expenditures for the local government in both *oblasts*. Social services in the form of education and health expenditures account for almost 75 percent of the *rayon* and city budgets in both *oblasts*. For these two *oblasts*, social services (education, health, and social protection) account for between 55 and 59 percent of *oblast* government expenditures, which is slightly less than that for the average *oblast* in Kazakhstan. Administrative expenditures are significant for all levels of government: *oblasts*, *rayons*, and cities.

The data in Tables 5.6 and 5.7 give an overview of the division of responsibilities between the *oblast* and its subordinate governments. Not only do *rayons* and cities spend most of their budgets on education and health, they make most of the total expenditures on these items in the *oblast*. *Rayons* and cities account for over 75 percent of the education expenditures within these *oblasts*, and over 66 percent of the health expenditures. The social protection expenditures are largely carried out by the *oblast* government, as one might expect given the redistributive nature of these expenditures.

Table 5.4. Composition of Budgetary Expenditures - Taldykorgan Oblast
(percent)

Expenditure	Share of Budget <i>Oblast</i>	Share of <i>Rayon</i> and City Budget
Housing and Communal Services	0.00	9.18
Education	20.17	49.87
Health	16.83	24.73
Social Protection	21.95	1.62
Other Social and Cultural Expenditures	1.02	3.32
Administration	15.30	8.01

Source: Taldykorgan 1994 Executed Budget.

³ Similar data for Karaganda were not available.

**Table 5.5. Composition of Budgetary Expenditures -
Almaty Oblast**
(percent)

Expenditure	Share of Budget <i>Oblast</i>	Share of <i>Rayon</i> and City Budget
Housing and Communal Services	2.74	11.29
Education	19.11	46.59
Health	16.53	24.93
Social Protection	19.64	0.77
Administration	9.00	6.07

Source: Almaty 1994 Executed Budget.

These case studies show that the lower levels of government are entrusted with a significant amount of expenditures, particularly in the realm of social services. Given the increasingly difficult nature of meeting expenditure needs and the importance of the expenditures carried out by these levels of government, it is important that the Government of Kazakhstan considers ways to integrate these local governments into the intergovernmental reform

**Table 5.6. Composition of Budgetary Expenditures -
Taldykorgan Oblast**
(percent)

Expenditure	Share of Budget <i>Oblast</i>	Share of <i>Rayon</i> and City Budget	Total
Housing and Communal Services	0.00	100.00	100
Education	23.06	76.97	100
Health	33.52	66.48	100
Social Protection	90.92	9.08	100
Other Social and Cultural Expenditures	34.85	65.15	100
Administration	58.35	41.65	100

Source: Taldykorgan 1994 Executed Budget.

process. In particular, a hard look at the principles of expenditure assignment is necessary at all levels of government as discussed below.

**Table 5.7. Composition of Budgetary Expenditures -
Almaty Oblast**
(percent)

Expenditure	Share of Budget <i>Oblast</i>	Share of <i>Rayon</i> and City Budget	Total
Housing and Communal Services	14.75	85.25	100
Education	22.67	77.33	100
Health	32.14	67.86	100
Social Protection	94.81	5.19	100
Administration	51.47	48.53	100

Source: Almaty 1994 Executed Budget.

GENERAL PRINCIPLES OF EXPENDITURE ASSIGNMENTS

One way to examine the adequacy of expenditure assignments in Kazakhstan is to see how well the present assignment of responsibilities fits the fundamental rules for the ideal assignment of responsibilities in a decentralized system of government. There is no absolute best way for deciding which level of government should be responsible for particular public services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the government in its decentralization strategy. The fact, that it is up to the government to set these objectives, should not be interpreted to mean a murky assignment is acceptable. Clearly, without a specific assignment of expenditure responsibilities, it will not be possible to assess the adequacy of the revenue and tax assignment to different levels of government, or the need and effectiveness of a system of intergovernmental transfers. Commonly accepted objectives for fiscal decentralization include those of an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and preservation of macroeconomic stability and promotion of economic growth.

Critical Role of the Efficiency Criterion

The efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as much

as possible. This is best achieved by the subsidiarity principle. Responsibility for the provision of services should be at the lowest level of government that can discharge the services effectively. This is generally determined by the size of “benefit area” and economies (and diseconomies) of scale and scope associated with various services (Oates 1972, 1990). The benefit area for sanitation services is clearly the local community, but for air traffic control the benefit area is the national territory. Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient underprovision of services; for example, a tertiary hospital providing regional services is solely financed by a single municipality. Efficiency in the provision of public services is enhanced when consumption benefits are linked to costs of provision via fees, service charges, or local taxes (Bird 1976; Bahl and Linn 1992).

Achieving the goal of efficiency requires a minimum degree of subnational government autonomy. That is, local officials must be able to satisfy citizen preferences by adjusting the level and composition of local public expenditures. It is also required that local officials are elected and finally accountable to voters.⁴

Objectives of Redistribution and Stability Best Pursued by the Central Government

It is generally thought (Musgrave 1959, 1983) that expenditures undertaken by government for equity or income-equalization reasons, such as social welfare and low-income housing, should be the domain of the central government. Local or regional governments will not be able to sustain independent programs of this nature because they will attract the needy from other areas while they will have to tax their (potentially mobile) residents more heavily. While funding for these expenditures should be a central government responsibility, implementation can very well be left to local governments, which may have informational and other comparative advantages. Expenditures undertaken for the stabilization of the economy, such as massive investment or unemployment compensation, are best ascribed to the central government. The central government is the only one that should engage in deficit finance. Furthermore, most of the benefits of subnational efforts at stabilization would “leak” out of the local economy.

⁴ The roles played by discretion and accountability are discussed further in Chapter 6.

No Single Best Assignment

The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules do not always yield an unequivocal answer. Some public services, for example, primary education and primary health services, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution, they may also be considered a responsibility of the central government. It is in this sense that it is not meaningful to talk about the best assignment of expenditure responsibilities. What is considered the best assignment will depend on the features of a particular economy and how the government weights the objectives of efficiency, equity, and stabilization. In addition, those weights are likely to change over time with changes in costs and technological constraints, as well as changes in preferences. Emphasis on stabilization, which may drive intergovernmental finances toward centralization, is more likely to be present during the transition than in later years. Changes in regional variations in income and wealth will determine the emphasis granted to centralized redistribution policies. At present, there are significant regional variations in wealth and income. The efficiency goal is more relevant the more diverse or heterogeneous the population is and the larger the country. By these criteria, efficiency should be an important objective in the assignment of expenditure responsibilities in Kazakhstan.

Even though there are technical criteria that can be used to choose among alternate assignments, ultimately, the assignment of expenditure responsibilities will involve a number of political decisions. However, the difficulties in arriving at a concrete assignment do not justify ambiguity in the distribution of responsibilities. There is a need at any moment to have a concrete assignment of expenditure responsibilities among the various assignments that could be considered optimal. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to the inefficient provision of public services.

Importance of a Clear and Stable Assignment

The lack of clear assignment of expenditure responsibilities was less burdensome in practical terms before independence from the Soviet Union because all government budgets were much more integrated with the union budget and additional resources could

be counted on when there was an unexpected shortfall. On the other hand, any unspent funds were funneled back to the union MOF. Since 1991, subnational governments have had autonomous budgets and can, in theory, run surpluses not subject to extraction by the central government. The failure to establish by law a clear assignment of expenditure responsibilities for each government level could become a source of conflict between the central, *oblast*, and *rayon* governments. The possibility of conflict will increase in the future. As in other countries in transition, in the early years of independence a certain degree of murkiness in the assignment of responsibilities has been politically attractive to both the central and subnational governments. It provides the central government additional degrees of freedom for balancing its budget (Martinez-Vazquez 1994a, 1994b; Alm and Buckley 1994). Subnational governments may have been happy to receive additional responsibilities because it increased their importance, at the same time, they believed sufficient funding would accompany the additional responsibilities.

The lack of specific assignments will condition the adequacy of any tax revenue assignment and any accompanying fiscal equalization mechanism. Clearly, both systems will become obsolete as soon as expenditure assignments are significantly changed.

The experience of other economies in transition shows that without a specific expenditure assignment, Kazakstan runs the risk of having revenue availability dictate the responsibilities of each government level. This will lead to institutional instability and to the inefficient provision of public services. These twin threats are among the most important arguments against murkiness in the distribution of responsibilities.

There is an obvious need for a policy decision on concrete assignment of expenditure responsibilities between the central government and the *oblasts* and between the *oblasts* and their *rayons* and cities. The explicit and systematized assignment of functions and expenditures to the different levels of governments should become a priority in Kazakstan's strategy for decentralization. The specific assignment would protect local government budgets by making the ad hoc transfer of responsibilities from the central government harder and help to guarantee the continued provision of services. Such services could otherwise be inefficiently supplied or simply neglected at all levels because of inconvenience and budgetary pressures. Although less likely under the current fiscal austerity conditions, the lack of a specific assignment could lead to duplication of services and waste. This specific assignment, of

course, should not detract from the flexibility needed to adapt government budgets to major changes in policy.

Once concrete expenditure responsibilities are assigned, the actual level of provision must be decided by the representative bodies of each level of government. Most of the financing for these expenditures will come from general budget funds, which in the case of subnational governments will include general transfers. The financing of some specific services may also be covered by fees or user charges and by specific grants from upper levels of government.

PROBLEMS WITH CURRENT EXPENDITURE ASSIGNMENTS AND THE NEED FOR REFORM

Lack of Formal Assignment

At present there is no formal assignment of responsibilities. While a great deal of attention has been given to issues of revenue sharing and government transfers, much less attention has been given to the logical first step in a system of intergovernmental finances: an efficient and stable assignment of expenditure responsibilities to particular levels of government. A formal assignment of responsibilities will also contribute to the stability of the system of intergovernmental finances. The recent experiences of the Russian Federation and Ukraine show how the lack of formal assignments may be a destabilizing factor in intergovernmental relations. In both the Russian Federation and Ukraine, expenditure assignments had been continuously reworked by the central authorities simply for fiscal convenience as a tool of fiscal deficit containment. Although the Kazakhstan government has not succumbed to this temptation so far, the lack of formal assignment will still make it possible. Formal expenditure assignment also introduces an important element of certainty for budget planning at all levels of government.

The argument could be made that in Kazakhstan, the objective of macroeconomic stability is more important than efficiency gains. If so, perhaps the government should keep expenditure assignments murky so as to be flexible enough to control fiscal policy options more completely than in a decentralized system. However, this argument is not convincing. There is little or no evidence that decentralized systems of intergovernmental finances are inherently less stable. Actually in the international experience, a higher correlation can be found between decentralization and

macroeconomic stability. In the few examples of decentralized systems that have experienced macroeconomic instability, such as in Brazil and Argentina, the identifiable cause has been a poorly designed system, in particular the absence of a hard budget constraint for subnational governments, exhibited, for example, in the ability to borrow from state banks.

Inefficient Assignments

There are several areas in which the current assignment of expenditure responsibilities is inefficient. First and foremost the assignment of all capital expenditure responsibilities to the central level is wrong, regardless of the level of government responsible for the provision of the services associated with the capital infrastructure. Given its importance, this issue is discussed separately below.

Other areas of inefficient assignment include the following:

- Assignment of responsibilities for social welfare to local governments presents a problem if this is understood to imply ultimate responsibility for funding, but not if these services are provided by the subnational governments but financed by the central government. Local governments do have an advantage for the efficient delivery of these services, given their proximity to local residents. But local government financing of these responsibilities runs against the ultimate objective of helping the most needy because the need for social welfare and assistance is so much higher in poorer jurisdictions, those least able to provide the necessary funds. A different issue is the distributional content of local expenditures. Many of the services in which local governments specialize may actually have a pro-poor benefit incidence.
- The current responsibilities of subnational governments for national defense and national guard, although small, should be completely reassigned to the central level.

Ambiguity in Certain Assignments

Remarkably little open conflict or disputes exist at present between the central and subnational governments on assignment of expenditure responsibilities. From the operational side, only three types of services are currently the object of negotiations among

the central and subnational governments: the maintenance of specialized education establishments, certain defense expenditures, and transfers to low-income families. However, the lack of a formal assignment of expenditure responsibilities means that practically all expenditure functions are subject to change, and more importantly that there can be a failure to provide some services and duplication of provision for other services.

Sharing of Responsibilities

The actual assignment of functional responsibilities is often quite different from what it appears to be in Table 5.1. For example, in the area of education, even though local governments were responsible for almost 75 percent of all expenditures for 1995, most of the key decisions in education policies are made at the central level. In particular, the Ministry of Education is responsible for construction of school buildings, curriculum design, teacher training, and the design and production of textbooks. However, the recruitment of teaching staff is done by the *rayon* education officer and school principals. The head of the *rayon* administration is the appointing authority for principals, school inspectors, and teaching specialists. However, even here, local autonomy is limited. It needs to be remembered that all local administration officials have dual subordination, in this case to the Ministry of Education and to the subnational government, and that even the head of the *rayon* administration is ultimately a central government appointee. Issues similar to those in the education sector arise in other sectors such as health and social welfare.

The sharing or fragmentation of responsibilities within a particular public service may cause confusion and eventually lead to the inefficient provision of public services. However, the sharing of responsibilities does not necessarily lead to inefficiencies. Sharing of responsibilities in education and other areas is not uncommon in decentralized systems, but this situation requires a complete definition of the roles to be played by the different levels of government in the provision of the service (Musgrave and Musgrave 1989). It can be argued that a more efficient delivery of a particular service takes place when all inputs of production are simultaneously decided by a single authority. Otherwise, a relative disproportion of funds may be spent on salaries and not on other operation expenditures; similarly, maintenance may be reduced to a minimum.

CAPITAL INVESTMENT RESPONSIBILITIES AND BORROWING

Need to Redress the Assignment of Capital Investment Responsibilities

Capital investment is the exclusive responsibility of the central government.⁵ This follows the tradition of the FSU when all capital investments were centralized under Gosplan.⁶ Since independence in other former Soviet republics, an increasing level of capital expenditure in the public sector has been taking place through subnational budgets. This is the case in the Russian Federation, Ukraine, and the Baltic states.

Subnational governments in the medium run need to take full charge of the planning, financing, and execution of all capital projects in the sectors or services that are their responsibility. That is, the assignment of capital expenditure responsibilities among the different levels of government should be the same as for recurrent expenditures. The reasons for the decentralization of capital investment decisions are the same as those behind the decentralization of recurrent expenditures: the increase in efficiency associated with being closer to the needs and preferences of taxpayers and government becoming more accountable and responsive to them. Of course, these arguments will not be valid unless local government officials are elected and accountable to local residents. The accountability of local officials is especially important to avoid the risk of local spending on frivolous or unneeded projects.⁷

It is unrealistic to proceed on the assumption that the central government has the necessary information to make the right decisions in multiple aspects of the life of hundreds of subnational governments. Furthermore, dichotomizing the decisions for capital

⁵ In the past several years, public investment has decreased to alarmingly low levels, less than 2 percent of GDP since 1993. The negative impact of these low levels of investment has been compounded by the government policy of concentrating most investment funds in developing oil fields. Most worrisome is the slowdown of investments in social capital. General reports indicate that the level of construction for schools, hospitals, and other forms of social infrastructure is less than one half of what it was in the late 1980s.

⁶ Gosplan stands for the State Planning Commission under the FSU.

⁷ The risk of unneeded capital investment projects, so called “white elephants,” is also possible, and arguably even more likely, at the central government level. The mistakes at the central level also tend to affect the welfare of the entire country rather than just one jurisdiction.

construction and maintenance also has perverse effects. When subnational governments are not at all responsible for construction or replacement of capital facilities, a moral hazard arises. It may be in the interest of subnational governments to economize on maintenance in hopes that the central government will replace existing facilities sooner. Efficient levels of maintenance require local ownership of the capital infrastructure.

At the same time these capital investment responsibilities are sorted out, subnational governments, and also the central government, should move to a multi-year capital-planning horizon—three to five years. This will help bring into focus the budgetary implications, current and capital, for subsequent years of capital projects started in the present year and increase the efficiency in the use of scarce investment funds. This issue is of special importance in Kazakhstan and other former Soviet republics given the high number of unfinished capital projects left over from the previous regime. Budgeting issues are discussed in the next chapter.

The lack of funds for capital investment, due to budgetary pressures, has left many service areas at the subnational level at an impasse. In addition, over the past four to five years there has been a drastic compression of funds allocated to maintenance and capital rehabilitation in infrastructure. If this pattern continues, damage to the existing stock of public infrastructure in Kazakhstan may be severe or even irreparable in some cases. It is a well-known conclusion that replacement costs will be a high multiple of the funds now being saved in maintenance and basic rehabilitation. In addition, if Kazakhstan is to find a steady path to growth and recovery, additional investments in local infrastructure and services will be much needed.

The shortage of capital funds for investment projects puts a premium on available resources. The decentralization of capital investment responsibilities should not be interpreted as forcing the central government to give up channeling national resources to those areas that are perceived as critical. What it means is that if the critical areas are those for which subnational governments are responsible, then the central government should see that enough resources are invested in these areas by leveraging local funds, for example, with specific matching grants. The central government should still have the ability to decide what the national priorities are for investment. The shift of some capital expenditure responsibilities should be accompanied by a large effort in technical assistance to subnational governments.

How to Address the Lack of Financing for Local Capital Infrastructure

After reaching the conclusion that a considerable share of capital investment responsibilities should be reassigned to the subnational level and that investments should be increased from their present levels, it is necessary to address the difficult question of financing.

Most subnational governments in Kazakhstan will be unable to finance their capital investment responsibilities out of current savings. Indeed, this is true of local governments in virtually all other countries. Public utilities, when (and if) they are decentralized, will also lack the necessary funds for rehabilitation, maintenance, and expansion of the capital stock.

The only practical solution to these problems is for both local governments and local public utilities to borrow the necessary funds for rehabilitation and new investment. Borrowing for long-lived infrastructure is both efficient and equitable. Most countries only allow borrowing for capital investment purposes, although international practices vary widely.⁸ Borrowing is efficient because it allows local governments to make large lump sum payments to acquire the necessary infrastructure and capital equipment for the provision of public services. Thus, borrowing solves the problem of liquidity. Borrowing is also efficient and equitable because it allows local governments to match the timing of consumption of services with payment for those services. It will not be fair to have one generation of taxpayers pay for the capital equipment and posterior generations consume the services free.

Direct access to capital markets by local governments issuing bonds as the main means of financing long-term capital investments is unlikely to be an important option in Kazakhstan any time soon. This is especially true for smaller local governments. An alternative that has been used effectively in western European countries in the past is the creation of a financial intermediary or a financial intermediation program that allows all local governments, especially those with no direct access to capital markets, to borrow

⁸ In several member countries of the Organisation for Economic Co-operation and Development with fully developed capital markets, subnational governments have the ability to borrow quite freely for capital investment purposes. Most often, even when there is direct access to capital markets, subnational governments are subject to limitation; for example, debt servicing must not exceed some percent of budget revenues. In the minority of cases, borrowing by local governments is further restricted by the type of loan (maturity, yield, collateral) and for certain types of capital projects. In most countries in transition that have approved local budget laws, borrowing by local governments for capital investment purposes is allowed, but limits on the amount of borrowing, as well as requirements to register with MOF, are imposed.

based on selective criteria.

An important advantage of this approach is that these financial intermediaries can reduce the cost of borrowing for smaller governments by spreading the risks among many of them. It is also easier for a larger borrower to acquire a good reputation as a debtor and, therefore, be able to borrow funds in the capital market at lower costs. These lower costs can be passed on to local governments. Other advantages of this approach include the ability to combine technical development assistance with lending and to facilitate central government intervention through the supply of funds.

However, the creation of a financial intermediation program also carries risks, such as political biases and abuses, that need to be assessed carefully. The experience with this type of financial intermediary in Latin American and other developing countries has often been disappointing because central government's use of soft loans has interjected grant objectives into the lending activities of the financial intermediary. There are lessons to be learned from the experience of other countries, both for errors to be avoided and successful features to be imitated (see Box 5.1).

In 1994, Poland introduced a Municipal Credit Program to provide local governments and public utilities with access to credit for capital investment purposes. The Municipal Credit Program facilitated access to alternative financing sources including international lending institutions and foreign financial markets. At the same time, the Polish government introduced a Municipal Development Agency to provide technical assistance and advisory services to smaller government units (Barbone and Hicks 1995). In Hungary, the National Savings Bank provides most lending to local governments for capital investment purposes. However, the government has been considering the establishment of a special Municipal Bank to further facilitate municipalities' access to credit (Bird et al. 1995).

There is no intrinsic superiority to any particular approach to financing local government long-term capital investment needs. Direct borrowing from private commercial banks and other financial institutions, international lending programs, bond issues, and the creation of local government development funds are all desirable alternatives that need to be pursued.

For bond issue options, MOF should act as a registration agency to ensure that the issues conform with standard specifications to provide safety to investors, and that local governments comply with borrowing limitations imposed by the central government. To facilitate bond issues by local governments, it may be desirable to support the establishment of an insurance scheme for such bond issues. However, in no case should the central government act as guarantor of the bond issues.

Box 5.1. Municipal Development Funds and Intermediaries

A municipal development fund (MDF) is defined as a pool of money operated at a level above the individual local government primarily for investment in infrastructure. MDFs are managed by different institutions such as banks or government agencies. These are the municipal development intermediaries (MDIs).

With very few exceptions, for decades western European countries as well as Japan, have had a well-established MDI channeling investment credit to local governments. In many European countries, these institutions were established also to provide a reliable outlet for private savings. Over the past several decades, MDFs have spread rapidly through countries in Asia, Latin America, and Africa. In many of these countries, the financing of capital infrastructure has been combined with objectives for longer term institutional development.

Objectives. The main objective of development funds is to mobilize resources from private lenders, central government, donor agencies, and local governments themselves, and make them available for investment in urban infrastructure. A second objective is to strengthen the operational capacity and efficiency of local governments by assisting them in the design, appraisal, and execution of investment programs; rationalization of programs moving away from ad hoc investment practices; and injecting rational criteria in the geographic and sectoral distribution of funds. Development funds are best suited to address the needs of smaller cities which tend to lack skilled administrators and access to capital markets. Development funds also have the attraction of offering a mechanism for “wholesaling” extensive programs for capital investment in infrastructure as opposed to having to micromanage a myriad of small-scale projects.

Management. The most common approach in Western Europe has been to introduce an autonomous institution with a legal and financial identity separate from the central government. However, there is great variance in the real degree of autonomy and the precise nature of the institution. Examples include the following:

- municipal development banks which are primarily concerned with financing municipal investment. These include Belgium and Danish Municipal Credit Associations, Bank for the Netherlands Municipalities, and the Municipal Bank of Norway. In all these cases

municipal government representatives control the management board;

- municipal or local government windows within institutions established to manage state-controlled pensions and insurance funds. This is the case in France, Italy, and Spain where management is appointed by the central government but municipal governments are represented in the decisions. The British Public Works Loan Board is 100 percent controlled by the central government, but half of the board draws membership from local governments;
- municipal “windows” of banks with a wider scope, including mortgages and public works. This is the case of the National Bank of Public Works in Mexico; and
- direct administration by the central government, the mode adopted by many developing countries. The central agency is the Ministry of Local Development or the Interior, or, in some cases, the Ministry of Finance. Problems with some of these new funds include lack of capacity for sustained assistance, undercapitalization, moral hazard, and poor loan repayment discipline.

Funding. In Western Europe and Japan, most of the activities of MDFs are funded by direct access to financial markets. However, the initial subscription of shared capital by either central or local governments, though not representing any significant resources for lending, has been important in establishing credibility and control. Additional resources are tapped by competing for private savings. Other financial institutions, such as banks, insurance companies, and pension funds, have been major sources of funds either through the purchase of bond issues or through directly negotiated deposits. In contrast, developing country MDIs have been largely financed with public funds. Even though most of these institutions have the power to issue bonds, most of them do not do so.

Loans and Conditions. MDFs lend money to local governments for long-term investments at preferential rates which cover interest and administration costs. In some cases, there are elements of grant or subsidized interest. These take different forms, such as matching grants attached to loans that vary with the repayment capacity of the local government, or with the type of project. Most often eligibility is unrestricted, in which case the allocation of funds depends on the bids of individual authorities. In some cases, local governments, especially large units, are given a maximum quota.

Security and Debt Service. Assessing debt service capacity of local governments is one of the most difficult aspects of managing an MDF. In most cases the policy is to rely on the statutory

limitations established in the law, stating a maximum ratio of debt or debt service for local government revenues. However, in the case of self-liquidating investment, as for public utilities, the limitation depends on the internal financing viability of the enterprise and not the local government per se. There are exceptions to this rule. For example, the French Caisse de Depots bases its lending to local governments on financial forecasts, not on debt service ratios.

Sources: Davey (1988); World Bank (1995b).

Public utilities or local governments responsible for public utilities should be allowed to issue “revenue bonds” if a market for this type of bonds can be developed. Revenue bonds are nonguaranteed or limited liability debt to be paid from revenue proceeds associated with the public project the bond issue is supposed to finance.⁹ The funds needed to repay the bond are mobilized from setting public utility tariffs at full cost-recovery levels. To guarantee payment, these funds can be put in special escrow accounts as they accrue. Bond issues by public utilities can also play a significant role in the development of the domestic capital market and provide at the same time relative safe investments for private or even public pension funds (Gray and Stern 1995).

Current and Draft Legislation on Government Borrowing

At present, the central government through MOF has the right to borrow in domestic and international markets. Subnational governments do not appear, so far, to have the right to borrow. The only exceptions are loans from MOF for short-term purposes (Law on Budgetary System, clause 16).

However, there are some new developments in subnational borrowing that were not finalized at the time of the Mission; thus, some of the pieces may still be missing. First, there are plans to let some subnational governments borrow, offering real estate and other local assets as collateral. Second, there is a draft decree regulating potential borrowing activities by subnational governments in the future. The idea of letting subnational

⁹ Revenue bonds are different from ordinary local bond issues because the latter are considered “full faith and credit” debt, meaning that they carry an unlimited claim on the taxes and other revenues of the local government issuing the bonds.

governments borrow with public property as collateral is, in general, a problematic one full of caveats and should be discouraged. Developing a framework that will regulate borrowing by local governments, as done in the draft decree, is a preferable approach. The draft decree would allow subnational governments to issue bonds and it contains many positive features. It is made clear that the debt of subnational governments will not be considered central government debt and that the central government bears no collateral responsibility or offers guarantees for repayment of subnational governments' debt. The draft decree also allows local governments to offer as guarantee for repayment, revenue from the project financed with the loan, a practice common in Western countries through the issuance of revenue bonds.

There are several issues that should be considered further and probably introduced in the draft decree on borrowing by subnational governments. First, the draft decree should consider imposing a limit to the total indebtedness of individual subnational governments. This is more flexibly done by imposing a ceiling on the expenditure on debt servicing (payment of interest and repayment of principal) as percent of the annual subnational total expenditures. Ideally, debt limits should be based on some measure of fiscal capacity rather than in amounts actually spent. However, taxing capacity is difficult to measure, and it may not even be meaningful, if local governments have little or no tax autonomy. The international practice shows a range for debt service limits between 15 and 30 percent of total expenditures. The introduction of debt limits will require the government to give a careful definition of what constitutes expenditure. Provisions also will have to be made to do an annual audit of the financial accounts of local governments.¹⁰

Second, the draft law should consider including stricter requirements for registration and prior approval of bond issues by MOF. Third, the draft decree should also address the issue of how to enforce borrowing limits when subnational governments can borrow from other sources, specifically from banks. One alternative is to require the registration with MOF of all types of borrowing including loans from banks. A second alternative is to rely on subnational government reporting and ex post audit mechanisms. Also quite appropriately, the draft law imposes a limitation on short-term borrowing for liquidity purposes to less than one year and long-term borrowing only for capital investment purposes. The

¹⁰ The audit of local budgets is discussed in Chapter 6.

restriction of long-term borrowing to a maturity of five years may be justified in this period of transition and uncertainty, but it should be lifted in the future. Ideally, the maturity of the loan should match the life of the project.¹¹

DIVESTITURE OF SOCIAL RESPONSIBILITIES BY ENTERPRISES

State enterprises in the FSU traditionally played a major role in the provision of social services. In smaller towns, state enterprises were also the main providers of local infrastructure including such things as road construction and water and sewage systems. It was state policy to have cash wages that were similar across professions and geographic areas. More significant differences in compensation took place through access to services, including housing, kindergartens, and health polyclinics, which most often were provided by enterprises. However, these social services often reached outside the enterprise itself. For example, enterprise clinics have provided health care for the entire population of a particular area, including those that were not employed or in any other way related to the enterprise.

This situation is especially serious in Kazakhstan because of the relatively higher incidence of one-company towns. There are approximately 60 towns in Kazakhstan where at least 80 percent of the population is employed by one enterprise. The actual dimension of the problem is not known with certainty, but by some estimates, 40 percent of social service expenditures in 1992 were financed by state enterprises.

With the process of economic readjustment and privatization, state enterprise responsibilities in the social sectors have started and will continue to be transferred to the government sector. The discontinuation by public enterprise of the provision of public services on behalf of the subnational and central governments is overall a positive and much needed step. It will increase the transparency and efficiency of government budgets. State (public) enterprises, if they remain as such, should contribute to the provision of public services in the same way private enterprises do, exclusively through the payment of taxes and user charges.

¹¹ Of course, this does not mean that subnational governments should not refinance long maturity loans when financial markets make it profitable. The limit of loans to a maturity of five years may not be binding for the time being, anyway. Financial markets are unlikely to accept, at any reasonable cost, long-term maturities until economic stability is restored.

However, the process of divestiture has gone slowly until now. Priority throughout the country has been given to the divestiture of responsibilities carried by defense-related enterprises. In some cases, there is resistance to the divestiture, mostly coming from the enterprise workers. The main reason is that the services provided by state enterprises have been typically superior to those provided from the budget. This resistance to divestiture is more likely in the area of health services, and less for kindergarten and cultural activities. Another factor that is slowing down the divestiture process is that many state enterprises have been renting some of these facilities and are getting much needed revenues. There is also a small fiscal advantage to the continuation of these services. State enterprises providing social services can deduct these costs from the enterprise profit tax, but with a cap of 2 percent of profits (after July 1995; 1 percent prior to that).

The speed of divestiture of social responsibilities appears to have varied by type of service. In the case of kindergartens the process has been quicker. At the time of the breakup of the Soviet Union, over half of the children of early age attended kindergartens in Kazakstan, and the majority of the related services were provided by state enterprises. Kindergartens financed from the budget accounted for just over a quarter of total services. Since 1991, there has been a significant decrease in the provision of kindergarten services by enterprises. But, by the end of 1994, the provision of kindergarten services by enterprises was still more prevalent than the provision from the budget (Klugman et al. 1995).

The divestiture process raises several important concerns. How much additional burden will be imposed on local governments by this transfer of responsibilities? Will critical social services be discontinued because of the inability of local governments to absorb additional expenditure responsibilities? Will the privatization process be impeded because of the difficulties of divesting enterprises' social responsibilities?

The significance of these concerns depends on the magnitude and also on the nature of the social services divested or still currently provided by state enterprises. There is no current aggregate information on the dimension of the problem. Casual surveys in field visits showed that it can be quite significant. Housing and communal services are by far the largest expenses in the social services, followed by kindergartens and clinics. These items seem to account for the bulk of social expenditures transferred or to be transferred from state enterprises to local governments. Previous estimates for the Russian Federation have shown that in the aggregate, these expenditures represented 2 percent of GDP by the end of 1993, down from possibly 4 percent

of GDP at the end of the 1980s. Also, of much interest to the case of Kazakhstan, the estimates for the Russian Federation showed significant disparities in the importance of this problem among local governments (Martinez-Vazquez 1994a). Those jurisdictions that in the past had benefited from massive social sector investments by state enterprises are, at present, often cursed by those same investments, and they are by far the most vulnerable local governments.

As divestiture has proceeded in Kazakhstan, the central government has made some effort to compensate subnational governments for the additional responsibilities they have been forced to absorb. However, this compensation has generally not been enough to keep all the facilities transferred open, much less to maintain the level and quality of services previously provided by the enterprises. In Kazakhstan, the difficulties faced by local governments and their ability to absorb additional responsibilities is also likely to vary widely.

There is an ongoing project in two *oblasts* sponsored by the World Bank to facilitate the transfer of social responsibilities of state enterprises to subnational governments. The goal is to replicate the lessons learned in this process to the other *oblasts*.¹² The project will also be training local officials to face decreases in services and to promote a more efficient use of resources and the use of cost-recovery measures¹³ (see Box 5.2).

Box 5.2. World Bank Social Protection Project - Social Services Component

State enterprise divestiture of social assets has put local governments under significant fiscal and management pressure. Both local and central government budgets have been increasingly unable to meet the additional costs implied by divestiture. The main objective of the World Bank-financed program is to implement a pilot project in a limited number of *oblasts* and cities to learn ways for an orderly transfer of social assets from enterprises to local governments or for their privatization. The selected cities in the South Kazakhstan Oblast are Shymkent City, Kentau, and Lenger,

¹² The project will have a duration of five years during which local governments will be increasingly responsible for taking over the newly absorbed responsibilities. This duration may be too long if relevant lessons are to be replicated in other *oblasts*. The experience of the Russian Federation and the Baltic states has been that once the divestiture process is started, it goes quite fast for most enterprises in the country.

¹³ Present charges at kindergartens only recover part of the cost of food (at most 30 percent) and nothing else; many households with low income, pay nothing.

and those in the Pavlodar Oblast are Pavlodar City and Aksu. The plans are to apply the lessons learned and results from the pilot project to implement a nationwide policy. With technical assistance from the project, the government will be completing an inventory of enterprise social assets in all *oblasts* and design a comprehensive national strategy to address this problem.

The project has two main subcomponents: the first for “social service support” and the second for institutional development. The social service support subcomponent will do the following.¹¹ Of course, this does not mean that subnational governments should not refinance long maturity loans when financial markets make it profitable. The limit of loans to a maturity of five years may not be binding for the time being, anyway. Financial markets are unlikely to accept, at any reasonable cost, long-term maturities until economic stability is restored.:

- Finance upgrading and rehabilitation of critical infrastructure, equipment, and supplies in the areas of health and education.
- Support incremental, recurrent costs for divested facilities on a declining basis as local counterpart contributions increase through cost recovery and cost efficiencies.
- Rationalize local service budget management.
- Improve targeting of social assistance.
- Help with the selection of facilities to be closed or merged under the rationalization.

The institutional support subcomponent will be provided by financial, health care, kindergarten management, and other specialists in relevant areas. The main activities supported by this subcomponent will be the following:

- Develop computerized financial management systems at the *oblast* level.
- Assist the *oblast* and city administrations to prepare annual work programs to implement the rationalization plans.
- Provide technical assistance to the central government to complete a comprehensive national strategy for divestiture throughout the country.
- Support the upgrading of the analytical capacity of local and *oblast* governments to implement the project and sustain the administration of an enlarged social services sector.
- Provide training in the management of change and for local trainers, and selected study tours and internships.

The main objective is to put together a national strategy. The State Payments Committee is taking an inventory of social infrastructure facilities run by enterprises throughout the entire country. The inventory covers kindergartens, schools, cultural establishments, and medical facilities including polyclinics, clinics, hostels, and hospitals. Preliminary estimates from the inventory show that enterprise expenditures on education represented approximately 0.6 percent of GDP in 1994, and those on health were approximately 0.2 percent of GDP. The survey does not include housing now owned by state enterprises, estimated at 20 percent of the entire housing stock in the country. The survey does not provide information on capital replacement costs for the facilities. In the longer run, a significant part of the increased liability on local governments will come from the need to replace capital infrastructure facilities that in the past were also provided by state enterprises. The divestiture, and, in many cases, the discontinuation of social services provided by state enterprises, and the eventual privatization of housing services will add to the decrease in the real wages of workers. The government will need to take into account the relation between divestment of social services, housing policy, and wage policies.

SOCIAL SECURITY SYSTEM

At present, the social security system of Kazakhstan comprises a pension fund, a state employment promotion fund, a social insurance fund, and a health (medical insurance) fund. These are all extrabudgetary funds supervised by the Ministry for Social Security.

Social security expenditures are financed by a payroll tax on employers equal to 30 percent of wages. This tax is levied on all enterprises, regardless of the form of ownership. (In addition, there is a 2 percent payroll tax earmarked for finance of the state employment promotion fund.) Of the 30 percent payroll tax, 85 percent (25.5 percent of wages) is earmarked for the pension fund. Of the remaining 15 percent of revenues from the 30 percent payroll tax, 10 percent (3.0 percent of wages) go to the medical insurance fund and the remaining 5 percent (1.5 percent of wages) to the social insurance fund. The medical insurance fund was introduced in 1996. Before that, the entire 15 percent not allocated to the

pension fund went to the social insurance fund.¹⁴ The social insurance fund covers allowances for temporary health-related loss of work, work-related disability, maternity, and funerals.

Pensions

For several years after independence and before the pension fund was created as an extrabudgetary fund, pensions were paid from general funds of the government budget, under the model inherited from the Soviet Union. Although pensions are not being paid in many cases, the establishment of a separate extrabudgetary fund for pensions had the goal of making it more likely that pensions would be paid. If pensions were still being paid from the general fund, they would be forced to compete, perhaps unsuccessfully, with other expenditures. As it is, the existence of a separate extrabudgetary fund isolates pensions somewhat from these pressures. It is also justified by sound budget principles, to the extent that there is a link between contributions employers make for their workers by enterprises and the benefits employees receive. Even so, the depressed state of the economy, and of state enterprises in particular, make it difficult to meet pension obligations. Faced with the choice between paying wages and making pension contributions, employers generally opt for the former.

There are several types of pensions, those that are age-related (for example, for retirement), those for invalids, those for children without support, and pensions for those who have never worked and may be unemployable, including prisoners and those who have been disabled since childhood. Currently, some 2.5 million people receive pensions paid under the auspices of the Ministry of Social Security. In addition, a small number of persons related to the Ministries of Defense and Internal Affairs receive pensions; these are financed by the general revenues of the budget, rather than the pension fund. Benefits for state pensions are formally based on the length of work and salary, and not on the level of contributions made on behalf of the employee. Benefits are uniform throughout the country, except for areas of ecological damage, where benefits are more generous.

¹⁴ During the Soviet period, the social insurance fund was administered by trade unions, mainly as a means of providing nonwage benefits to workers. With the collapse of the Soviet Union, and subsequent reform, the social insurance fund was removed from the purview of the trade unions and is now controlled by the Ministry for Social Security.

As part of the general reform of pension law, it is anticipated that there will be a gradual increase in the age of general eligibility for retirement pensions (currently, since 1929, retirement is at age 60 for men and 55 for women) and the elimination of some benefits. Under present law, between one fourth and one third of persons of pension age have the right to retire early. For example, miners, teachers, and doctors are allowed to retire 5 to 15 years early; there are also preferences for rural professions and for entire *oblasts* and *rayons*, especially those adversely affected by ecological conditions, such as the area surrounding the Aral Sea and areas affected by nuclear testing.

Contributions to the pension fund (85 percent of the 30 percent payroll tax) are accumulated at the *oblast* level. Up to 30 percent of such contributions are transferred to the pension fund of the central government, while the rest remains with the *oblast*. Administration of pensions occurs at the *rayon* level; *oblast* and central governments provide only coordinating functions and, when necessary, financial resources. Financial requirements of an *oblast* depend on the number of pensions to be paid and their level. Total funding available for pensions available in each *oblast* depends on the state of its enterprises. In some cases, contributions are not adequate to finance all pensions. If *oblast* pension funds are inadequate to pay pensions in the *rayons* under their jurisdiction, *oblasts* can resort to the pension funds of the central government. Central government pension funds, therefore, act as a compensation mechanism across *oblasts*.

Pensions are financed on a “pay-as-you-go” basis. Thus, budgeted revenues and expenditures are equal for 1996. It is planned to submit a draft law on state pensions. It appears that this would convert the system from pay-as-you-go to insurance principles. This system would be based on contributions, and not simply years of employment and salary. Military pensions would, however, not be based on contributions. It is anticipated that transition to this system would require ten years. The World Bank is currently providing technical assistance in the reform of state pensions. One of the important needed improvements required by the shift to benefits related to contributions is in data management.

There is also a draft law on additional pensions. These pensions, to be provided by nonstate pension funds, would be related to defined contributions. Under Soviet law, there was no concept of nonstate pensions. Thus, legislation providing and regulating private pensions and regulatory institutions charged with oversight of such funds must be created.

Medical Insurance

At the beginning of 1996, the Government of Kazakhstan established a system of compulsory medical insurance (CMI), to be financed with 10 percent of the revenues from the 30 percent payroll tax levied to finance social security. The avowed purpose of this scheme is to improve health care, while reducing its costs, by encouraging competition among providers of health care. The CMI scheme provides basic coverage for all residents, concentrating on high-priority concerns such as immunization, health care, and dentistry for children; it envisages that CMI would be supplemented by fee-for-service care.

As in similar programs, difficult issues must be addressed, including (i) encouraging competition among providers (for example, if potential patients remain tied to polyclinics operated by enterprises where they work); (ii) rationing essentially free provision of services to prevent overconsumption; (iii) ensuring adequate care by providers is paid on a capitation basis; and (iv) preventing unnecessary care if providers are paid on the basis of care provided.

VERTICAL AND HORIZONTAL FISCAL IMBALANCES

Budgetary pressures are likely to continue in Kazakhstan. It is, therefore, critical to reexamine the current balance of expenditure needs and available resources at different levels of government to reorient expenditures toward priority goals and to increase the efficiency of public expenditures. The available evidence is that there are significant vertical imbalances in Kazakhstan, however vertical imbalances are measured. There are less pronounced, but still significant, horizontal imbalances, also.

Vertical Imbalances

Conventionally, the question of vertical balance is interpreted as whether the revenue sources assigned to each level of government are adequate to finance expenditure responsibilities. This correspondence may be interpreted as whether some minimum acceptable level of needs at each level of government is not sacrificed by more generous budgets at other levels of government. However, the concept of need is ambiguous and eventually defined by the central government in Kazakhstan. From a more objective

perspective, vertical imbalances have been measured in two different ways. The first is to look at the surplus or deficit position of each consolidated level of government, before borrowing, but after all revenue sharing and transfers have been implemented.¹⁵

Over the past three years in Kazakhstan, the central government has run deficits as high as 12 percent of GDP in 1990, and as low as 1.4 percent of GDP in 1993. For 1995, the central government revised deficit (as of 7 July 1995) was T39,379 million or 17.33 percent of total expenditures, or approximately 3 percent of GDP. Officially, the consolidated subnational government budget has run a zero deficit because by law, subnational governments need to have balanced budgets and cannot borrow. In reality, subnational governments have been running considerable deficits financed by arrears in many forms, including unpaid employee salaries and debts to suppliers of goods and services, especially for gas, oil, and electricity. The actual level of these deficits is not known since MOF does not require their reporting or take them into account in the next year's budgetary cycle. However, field visits to *oblasts* and *rayons* reveal that the deficits carried by some subnational governments in 1994 were as high as 30 and 40 percent of the total local budgets.¹⁶ According to this measure, there is a significant degree of vertical fiscal imbalance in Kazakhstan (World Bank, various reports).

A second way to measure fiscal imbalance is to examine what share of local government expenditures is financed with sources of revenues under the control of local governments. For example, fees, charges, and local taxes are funds under the control of local governments while central government transfers are not. The coefficient for vertical imbalance is the share of the subnational government expenditures financed from sources of revenues not controlled by the subnational government. There is disagreement on how exactly to define those revenue sources that are controlled by a higher level of government, and

¹⁵ This measure tends to be biased toward central or federal government mismatch because in many countries, either by law or by practice, subnational governments operate more conservatively than the national government. The central government is allowed to borrow more freely to cover current operations. In contrast, local governments in most countries are only allowed to borrow for capital investment purposes or not at all.

¹⁶ For previous years there are reports that some local governments actually had small surpluses. However, these figures need to be interpreted carefully. Because of the inability of local governments to borrow, these surpluses may have been more of a reflection of the budgetary uncertainty of these transition years than a sign of fiscal health. Local governments that could afford it, kept a cushion of resources to cover unpostponable expenses in a fiscal environment where revenue sharing and transfers from the central government were late or arbitrarily reduced, and where budgets had not been approved for many months into the fiscal year.

therefore different versions of the coefficient are computed. But by any of these measures, there is considerable vertical imbalance in Kazakhstan because there is practically no revenue autonomy at the subnational level. See also Chapter 7.

Also, from an impressionistic viewpoint, there is an indication of fiscal imbalance in the number of services that are reported in the field to be inadequately provided. Most complaints at the local level have focused on the inadequacy of budgeting provisions for education and communal services, and much less so for health facilities and social assistance to the poor.

Horizontal Fiscal Disparities

There are significant differences in fiscal capacity and population needs across *oblasts*, cities, and *rayons*. Table 7.2 presents an economic profile of *oblasts*. It is quite clear that, as in most other countries, there are significant economic disparities among regions in Kazakhstan. In terms of gross regional product per capita, the range goes from two times the national average in Mangystau Oblast to a little over half the average in Kzyl-Orda Oblast. Disparities in tax collections per capita are more pronounced. For further evidence on horizontal disparities see Chapter 7. However, as Table 9.2 shows, the current system of intergovernmental finances is equalizing. The dispersion among *oblasts* for revenue collections per capita, as measured by the coefficient of variation, is as high as 0.422, but the coefficient of variation for expenditures per capita is a low 0.15.

Nevertheless, the differences in expenditure per capita are still quite large. Reducing these horizontal disparities is not only important from an equity perspective. The disparity in the level of public services across jurisdictions could also encourage inefficiencies by inducing migration that otherwise would not occur.

ARE SUBNATIONAL EXPENDITURE NEEDS COVERED?

An important issue in any decentralized system of intergovernmental finances is whether the needs of subnational governments are being met. This question is especially relevant for Kazakhstan given the severe compression of expenditure in real terms over the past few years at both the central and local government levels. Have local authorities had enough resources to deliver adequately the service and expenditure responsibilities

assigned to them?

This is a basic but extremely difficult question. The measurement of expenditure needs is a complex and inherently subjective task. The standard approach in practice is to approximate needs by calculating the costs of providing a standard level of service in a local jurisdiction. Different methodologies can be used to calculate these costs. Expenditure needs vary across jurisdictions for many reasons including the size of the population, the presence of population groups requiring special services, maintenance and replacement of infrastructure, and congestion of population.

The most sophisticated approach to the estimation of needs is regression analysis. This statistical technique uses actual expenditure data to impute explicit weights for needs based on demographics and other characteristics of the local governments. However, these statistical methods provide only a relative measure of need in the group of local governments included in the regression, and offer both advantages and disadvantages. Costing needs with a statistical approach allows us to take into account differences in prices, in level of efficiency in provision of services, and possibly in government regulations. However, the statistical methods also incorporate in a nonidentifiable way, differences in preferences and in the quality of public services. The latter may have little to do with needs. In any event the relevance of this approach for Kazakhstan is very limited at the present time given first, the predominant role played by imposed expenditure norms and the lack of budgetary discretion at the subnational level, and second, the lack of adequate statistical information such as variations in income per capita across jurisdictions.¹⁷

A different approach to the calculation of needs tries to estimate the cost of providing a defined standard of services. This is known as the “unit cost” approach. Such an approach is used in Japan and it has been used in some countries in the past, but typically it has been abandoned because of its complexity, its inability to capture the differences in “need” among local governments, and the difficulty of adjusting for inflation. The complex system of budgetary norms used in the former Soviet budgeting system could

¹⁷ Nevertheless, it is clear that the relative position of local jurisdictions, and therefore their needs, are affected by the stronger presence of certain populations with special needs; differences in the prices of inputs, such as labor and land; and contextual factors for the delivery of services, such as population density and congestion. Proxies for these factors may be used in the design of transfers for equalization purposes. See Chapter 9.

also be interpreted as an example of this approach.

Similarly, there is not much help in trying to cost directly those services for which the local governments are responsible. The main problem is that ambiguous and subjective criteria are applied when the services to be provided are defined as either “minimum level” or “adequate level” by the local authorities. These concepts will be defined differently by reasonable people. Taxpayer or resident surveys are not helpful either in defining needs. Research indicates that taxpayer dissatisfaction tends to increase with the level of service.

What may seem to be an acceptable anchor is the level of resources that at least guarantees a bare minimum standard of provision. For example, if local resources are not sufficient to provide enough books to students or basic medicines, minimum standards will be considered not satisfied. Such findings would call for a reassignment of public sector resources. There is casual field evidence in Kazakstan that this may now be the case. However, fully supporting this conclusion would require an intensive level of field work, which was not possible during the Mission.

In a truly decentralized system of intergovernmental finances the issue of minimum needs is addressed by letting voters decide whether they want to raise taxes to pay for more government services. Of course, this assumes that there exists sufficient local tax capacity to finance minimum needs.

WILL SUBNATIONAL GOVERNMENTS PROVIDE MINIMUM DESIRED SERVICE LEVELS?

One fundamental feature of the current subnational budgetary system (defined in the Law on the Budgetary System of 1991 discussed in Chapter 6) is that the bulk of subnational budgetary revenues (tax sharing and subventions) is of a block grant nature. Subnational governments are quite free to allocate those resources any way they see fit.¹⁸ This approach offers the advantages of allowing local governments a more efficient provision of services because they can adapt expenditure patterns to local needs and preferences and a more cost effective delivery of services because

¹⁸ This is true despite the fact that budget formation is still partially based on budgetary norms (defined as minimum basic need for the service), or on the adjustment for inflation of past approved (not executed) budgets. Current budgets, therefore, reflect budgetary norms used in the past.

they can optimize the use of inputs of production.

However, these freedoms also raise the concern of whether desired minimum levels of key services, now the responsibility of local governments, will be provided. Does the system guarantee that subnational governments will provide minimum desired standards once it is established that the funds are available? This is a different but complementary issue to the previous question of whether subnational governments actually have enough resources to provide minimum services. At present, the system does not have a way to ensure the provision of a minimum standard. Should the government rely on the effectiveness of democratic processes alone to guarantee the minimum funding of certain services at the local level, such as education and social welfare? Or should the central government legislate minimum expenditure standards in key areas? A third approach would be for the government to rely on categorical grants or matching grants to induce those minimum levels of provision. Another way yet to guarantee minimum levels of provision may be direct reimbursement for services provided by local governments of central government programs, such as social welfare programs.

NEED FOR PRIVATIZATION AND GREATER EFFICIENCY IN PUBLIC EXPENDITURES AT THE SUBNATIONAL LEVEL

Complementary to the question of whether subnational government needs are being met is to ask whether local government expenditures are sufficiently prioritized. Is there a way to attend to these priorities by freeing up resources via privatization and efficiency gains in subnational government expenditures? Even in sectors that are high priorities such as health and education, there are potentially significant cost reductions to be realized. The most important expenditure categories in local budgets are reviewed in the following paragraphs with the objective of pointing out where efficiency improvements are possible and where change in the scope of activities may be desirable:

- *National Economy, Agro-industrial Complexes, and Others.* These are areas where local public expenditures could be reduced significantly through privatization. At least in the short run, additional resources will come from privatization. The subnational authorities need to ask which activities remaining in the public sector could be provided more efficiently by contracting production with the private sector

on a competitive basis (construction, cleaning, and maintenance, for example). Real efficiency gains actually allow the delivery of more and better services with a smaller budget.

- *Water Supply and Sewage.* Urban water supply and sewage companies are responsible for service in the capital city of each *oblast*. In most other countries these companies are under the subordination of subnational governments. At present, water charges to households are minimal. There is considerable cross-subsidization from enterprises which do pay cost-recovery fees and are subject to metering. The need for infrastructure is tremendous. Typically cities with fewer than 100,000 inhabitants have no sewage system, and for those that do, the treatment is quite primitive or nonexistent. Water systems need upgrading and rehabilitation; the need is dire. The most important problems are low capacity, the consequent overload of existing facilities, the lack of investment in rehabilitation and expansion of facilities, and the lack of full cost-recovery measures. Setting tariffs at full cost recovery (including depreciation costs) should allow utility companies to issue revenue bonds or borrow with collateralized revenues to invest in rehabilitation and capacity expansion. The development intermediary proposed in this report could play a critical role in mobilizing investment funds for this purpose. *Oblast* or local *maslikhats* should be given the authority to set tariffs for these services at full cost-recovery levels. Significant efficiencies will come from metering and also from the control of leakages.
- *Housing.* The appropriate main thrust of government housing policy is to deepen privatization, including that of housing now owned by state enterprises, and to introduce full cost-recovery pricing over a period of several years. Overall, however, little progress has been made in the privatization of publicly owned housing, the critical step for reducing local government expenditures in this area. Housing maintenance continues to be quite poor and rental charges still cover no more than 30 percent of maintenance and operation costs. The government is planning the introduction of a subsidy program for housing targeted to the poorest groups. This program would be administered like the current family allowance program, but the subsidized funds would go directly to the local budgets

and communal enterprises and not to households. These are positive measures, but in all likelihood housing will continue to be a drain on subnational budgets unless complete privatization is achieved. A sectoral review is a priority in this area. Government should consider policies that will facilitate privatization. One such policy would be to develop a national financing institution that facilitates mortgage borrowing for those households that can afford privatized housing. This would allow the public sector to concentrate exclusively on public housing programs for the very poor.

- *Education* (World Bank 1996b). The current fiscal crisis has led to real decreases in recurrent expenditures on education despite the fact the government has followed a deliberate policy of maintaining or increasing the share of education expenditures in the budget. Public expenditures in education dropped from 7 percent of GDP in 1991 to less than 3 percent of GDP in 1994. In absolute real terms, expenditures in education decreased by two thirds between 1990 and 1994. New construction has practically come to a halt. Also, maintenance expenditures for existing structures have been largely inadequate. However, improvements in efficiency in this sector should help increase the effectiveness of the limited funds. Among other measures, there is a need to increase the low student/teacher ratios in many areas of Kazakhstan, and to increase the energy efficiency of school buildings. The consolidation of schools would enable smaller systems to realize economies of scale and lower costs of provision. But even here the gains may be limited because low student/teacher ratios are often associated with rural areas where it will be more difficult to consolidate facilities. Already in urban areas more than half of the schools are operating with double shifts. The complexity of the issues surrounding the educational system warrant a comprehensive review of the entire sector. Would a more balanced expenditure or more efficient delivery of services occur if all input decisions were made at the same level?
- *Health Care*. The health system is also in need of rationalization including means to control expenditures and to increase efficiency in the delivery of services and the introduction of cost-recovery measures. However, the sector has endured very large expenditure cuts with total spending decreasing from around 4 percent of GDP in 1991 to around 2 percent of GDP in 1994. In

absolute real terms, health expenditures decreased by 60 percent between 1990 and 1994. The health sector is characterized by the Soviet tradition of emphasis on inpatient care rather than preventive and primary care, and the overall lack of efficiency in the use of available resources. There are too many doctors and paramedical personnel per 1000 inhabitants; at the same time they are poorly paid. There are too many hospital beds, considering the size of the population, and most hospitals are poorly equipped.¹⁹ But with current budgeting procedures still anchored on norms based on capacity, there is a lack of incentive for downsizing by closing facilities or reducing the number of beds. Health indicators, such as mortality and infant mortality rates have deteriorated significantly since 1991. This sector also warrants a comprehensive sectoral review to arrive at a coordinated policy.

RECOMMENDATIONS

Formal Assignment of Expenditure Responsibilities

Some expenditures should be reassigned. Expenditure responsibilities should be specified in the law. Some countries do so in the constitution, but many others do so in particular laws, such as the Law on the Budgetary System or the Law on Subnational Budget and Self-government.

Reassignment of Selected Expenditure Responsibilities

Responsibility for some expenditures should be reassigned.

- The central government should assume full financial responsibility for social welfare expenditures now assigned to local governments. Delivery of these services can still be performed via local governments on a reimbursement basis, a grant program, or another of several means.
- The central government should assume 100 percent responsibility for expenditures in national defense, including the national guard.

¹⁹ These problems reflect the inefficiencies of the previous funding system which was based on capacity, thus giving incentives for large and overstaffed facilities.

Reassignment of Capital Investment Responsibilities

Responsibilities for capital infrastructure should be placed at the level of government responsible for the delivery of the specific services, including the operation and maintenance of those facilities. This will encourage a more efficient use of resources. Only those capital infrastructure facilities actually desired by subnational governments will be built and subnational governments will have an interest in maintaining and repairing the capital infrastructure.

Provision for Capital Investment at the Subnational Level

All types of local borrowing should be closely regulated by the central authorities. Besides enforcing the debt limits established by the law, there should be a certification process of the conditions for any bond issues. The central government as a general policy should not act as guarantor of *oblast* and local government debt issues. Special circumstances, such as the borrowing in foreign currency from international lending institutions, may require central government guarantees and should be handled directly by the Cabinet of Ministers. In these cases, the central government should institute mechanisms to ensure repayment by the local government.²⁰ Borrowing by local governments to invest in commercial operations should be especially discouraged or prohibited. These activities should be privatized.

Public utilities should be commercialized if not privatized. Local governments should be allowed to issue nonguaranteed or limited liability debt for investment in public utilities which operate as separate or commercialized activities. These bonds, often called “revenue bonds,” would be repaid from revenue proceeds associated with public utility tariffs set at full cost-recovery levels.

There is considerable merit to the establishment of a subnational development fund to promote lending to subnational governments for long-term capital investment. This may be the only effective way to allow small local governments to fulfill their capital investment responsibilities. Other sources of financing include local bond issues. Both should be encouraged. However, direct access to capital markets by subnational governments is premature and will take time to develop.

Drawing from international experience, the desirable structure

²⁰ For example, this may be accomplished by giving the central government the right to garnish funds from revenue sharing through STC.

for the subnational development fund is that of an autonomous institution that takes direct and final responsibility for borrowing and investment projects. The bulk of funds for this institution should come from direct bond issues in the capital market. The central and local governments could contribute initial capital shares. The institution should be managed by independent professionals who answer to a managing board composed of central and local government representatives. Borrowing from the subnational development fund by local governments will be substantially similar to issuing “full faith and credit” bonds.

Continuation of Current Efforts to Establish a Coordinated National Policy to Facilitate the Divestiture of Social Responsibilities by State Enterprises

Lessons learned from the World Bank-sponsored project for two *oblasts* (see Box 5.2) should be applied immediately in a national program. The national strategy should contain a combination of policies including complete privatization in some cases, and absorption into subnational budgets, in others. Absorption into the public sector should be accompanied by rationalization, greater efficiency, and cost-recovery measures. The central government should provide adequate budgetary adjustments at the subnational level for any new expenditure responsibilities assigned at this level.

Minimum Standards

The central government should introduce policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced in several ways, such as enticing local governments with a matching grant program. But national standards may also be enforced by denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met. Programs in which national standards may be required include not only social welfare but also education, health, sanitation, and the environment. But restrictions should be imposed sparingly to protect local autonomy which, in general, is desirable.

Sectoral Reviews in Key Areas

Clearly the priority for public expenditures should remain in investment in human resources through good levels of education and health, and strengthening the safety net so that, in effect, there is less friction to the readjustment in the economy. However, significant changes also need to be made in these sectors to increase the efficiency of operations. Several measures in key sectors will also help increase the efficiency of public expenditures. However, all these measures should be considered within the context of well-defined sectoral policy objectives now lacking in Kazakhstan. For this reason, the government should proceed with comprehensive reviews of the education, health, and social welfare sectors.

Political and Administrative Organization Reforms

If there is to be true decentralization of the subnational finances, the heads of the executive branches of government at the subnational level will have to respond directly and exclusively either to the *oblast* and local electorates or to the subnational legislatures, rather than being appointed by the central government. The dual subordination of regional and local officials should be eliminated. Finance, health, and education officers and those in other areas working at the *oblast* and local government levels should be responsible only to *oblast* and local elected officials. Kazakhstan needs to distinguish clearly among (geographic) deconcentration of central government activities and decentralization of government powers. In the former case, the central government delegates implementation of programs to regional offices and local governments, but without devolving ultimate decision powers, financial responsibility, and budgetary controls of these programs. In the case of decentralization, local governments are devolved ultimate decision powers and full budget responsibility for the programs. In the latter case, central government financing may be present and it may be conditional upon certain standards of performance by the local governments.