

Report No. 88975

Kyrgyz Republic

Public Expenditure Review Policy Notes

Intergovernmental Fiscal Relations

May 2014

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region



Document of the World Bank

KYRGYZ REPUBLIC - GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 30, 2014)

Currency Unit = Kyrgyz Som (KGS)

US\$1.00 = KGS 53.9615

Weights and Measures

Metric System

ACRONYMS AND ABBREVIATIONS

ECA	Europe and Central Asia
GDP	Gross Domestic Product
OECD	Organization for Economic Cooperation and Development
KGS	Kyrgyz Som
PER	Public Expenditure Review

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Acknowledgements

This note is part of the Kyrgyz Republic Programmatic Public Expenditure Review (PER) led by Evgenij Najdov (Task Team Leader) and K. Migara O. de Silva (co-TTL). The PER work was initiated by Orhan Niksic. Faruk Khan took over as Task Team Leader from September 2012 to June 2013. K. Migara O. de Silva's co-TTL-ship was uninterrupted with primary responsibility for the sector notes on wage bill management, public investments management, and intergovernmental transfers.

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The team is grateful to the UK's Department for International Development (DFID) and the Swiss Economic Cooperation Organization (SECO) for co-financing this programmatic Public Expenditure Review.

Contents

1.	Executive Summary	1
2.	Context for Intergovernmental Fiscal Relations.....	2
3.	Delineation of Expenditure Responsibilities.....	5
4.	Revenue Assignment.....	14
5.	The System of Transfers	17
	Categorical Grants	17
	Equalization Grants	18
	Matching (Incentive) Grants	21
	Mutual Settlements.....	21
	The combined impact of all transfers.....	23
6.	Subnational Public Investments and Borrowing.....	24
7.	Conclusions	26

List of Annexes

Annex 1.	Local Functions Enumerated in the Local Self-Government Act.....	29
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List of Boxes

Box 1.	Delineation of Responsibilities Between three Subnational Tiers in Russia	10
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List of Figures

Figure 1.	Diagram of the Tiers of Public Administration	4
Figure 2.	Distribution of Aiyl Okmotus by size.....	5
Figure 3.	State Budget Expenditures – by Level of Government.....	6
Figure 4.	Recent Trends in the Decentralization of Recurrent Expenditure	7
Figure 5.	Economic Classification of Subnational Expenditures.....	8
Figure 6.	Composition of Subnational Revenue, by Source.....	14
Figure 7.	Recent Trends in Locally-Derived Revenues	15
Figure 8.	Incidence of intergovernmental grants, by Oblast, 2011.....	22
Figure 9.	Incidence of intergovernmental grants, by Oblast, 2013.....	22
Figure 10.	Decentralization of Recurrent and Capital Expenditures, 1997-2008	25

List of Tables

Table 1.	Administrative and political decentralization.....	3
Table 2.	Functional Classification of Recurrent Subnational Expenditures, 2013	7
Table 3.	Conformity of Expenditure Assignments with Normative Prescriptions	13
Table 4.	Shared and Local Taxes	16

1. Executive Summary

1. **Intergovernmental fiscal relations have advanced over the last decade in the Kyrgyz Republic.** Since the previous Public Expenditure Review in 2004 (World Bank 2004),¹ the government of the Kyrgyz Republic has developed a number of policy changes in the area of intergovernmental fiscal relations, which are generally in line with the recommendations of that report. These policy changes helped the country to introduce a more transparent and equitable system of local government financing. Thus, revenue retention rates for shared taxes are now set uniformly for each tier or type of local government. The allocation of categorical grants for education had been gradually transitioned to per student expenditure norms, before centralized per capita financed was rolled out across the entire sector in 2014. Capital (incentive) grants employ means-tested matching rates and the current allocation of equalization grants is based on objectively measured indexes of expenditure needs and revenue capacity.

2. **Still, effective decentralization continues to face challenges.** A number of issues identified in the 2004 Public Expenditure Review (PER) remain unresolved. For instance, expenditure assignment still remains ambiguous and is largely informal in nature (i.e., who does what is not clearly defined). In addition, the system is biased toward operating (protected) expenditures and municipalities face a soft budget constraint resulting from negotiations over budget plans and gap-filling transfers during budget execution (mutual settlements), and limited revenue-raising powers granted to local governments. Also, due to incomplete implementation of some of the reforms in recent years, these have not yet produced the desired outcomes. The formulae used for grant allocation are complex and in some cases reflect historical spending patterns rather than cost of service delivery.

3. **This chapter provides a set of policy recommendations for the government to consider that are designed to clarify the role of local government and provide better incentives for improved service delivery.** These are based on a review of the four pillars of intergovernmental fiscal relations in Kyrgyz Republic: i) the expenditure assignment (of who does what) ; ii) revenue assignment (with what resources) assignment; iii) the system of transfers; and iv) borrowing. Some of key recommendations are:

- Develop a comprehensive policy document laying out policy choices regarding the role of local governments and based on this document, clarify and rationalize the legal delineation of expenditure responsibilities.
- Consider broadening local revenue autonomy by allowing local governments to set different rates for some taxes, at least in cities.
- Consider the explicit use of per capita (or per client) expenditure needs in the equalization grant formula to increase the transparency of grant allocation. Expenditure needs can be calculated by applying an adjustment coefficient to capture the effect of some cost factors, such as those incurred by local governments in mountainous and remote areas.

¹ World Bank. 2004. *Main Report*. Vol. 1 of *Kyrgyz Republic - Public Expenditure Review: fiscal policies for growth and poverty reduction*. Public expenditure review (PER). Washington D.C. - The World Bank.

- Combine all non-educational services provided by local-governments (*aiyl okmotus*) together under a single composite expenditure norm in the equalization grant formula. If equalization grants were to be provided to cities, then a separate expenditure norm could be used for expenditures on housing and utilities, because they have different underlying cost drivers.
- Consider assessing the revenue capacity for local governments' own sources of revenue (land and property taxes) on the basis of objective indicators rather than projections based on past collections.
- Pool the share of revenues from national taxes going to *aiyl okmotu* in a redistribution fund and then allocate to each *aiyl okmotu* on a formula basis. Such a mechanism would reduce the volatility of their revenues by offsetting cyclical fluctuations in tax payments from various businesses located in individual *aiyl okmotus*.
- Continue shrinking the share of ad hoc transfers (mutual settlements) while increasing the reliance on predictable and transparent formula-based grants.

4. **The structure of this chapter is as follows.** By way of background, the next section (Section 2) provides a brief description of the institutional context in terms of the structure of government and the elements of political and administrative decentralization. Section 3 analyzes the delineation of expenditure responsibilities among government tiers. Section 4 analyzes revenue sources assigned to each tier of government. Section 5 focuses on the system of intergovernmental transfers. Section 6 examines subnational public investments and borrowing. In each of these sections main issues and problems are identified in the current system and the desired directions for reform are pointed out.

2. Context for Intergovernmental Fiscal Relations

5. **The current system of intergovernmental fiscal relations is a mix of the administrative structure inherited from the Soviet Union and subsequent modifications undertaken over the last two decades.** At independence, the country inherited a five-tier structure of administrative division of its territory (see Figure 1). In 1996, genuine local self-government was superimposed over the sub-raion tier of the old administrative structure comprised of rural districts (*aiyl okmotus*) and sub-raion cities. Until 2012, the intermediary tier of raions and sub-oblast cities has had a hybrid form of government with an elected local council adopting its own budget but relying on the centrally appointed officials for the execution of its decisions. With the adoption of the 2010 Constitution and the new Local Self-Government Act,² city councils have been allowed to select their executive heads.³ At the same time, after having their budgets and councils abolished, raions became a pure de-concentrated arm of the national government, similar to oblasts.⁴

² Law No. 101 of 2011 (art. 43 and 49).

³ In cities, the hybrid model of government continues through the dual sub-ordination of sectoral branch offices, whose heads are appointed by the line ministries from a short-list of candidates proposed by city authorities.

⁴ Throughout this report, subnational expenditures and revenues refer to those controlled by local governments that have legitimacy separate from the national government by virtue of being elected by the local residents, at least the representative branch. Thus, subnational expenditures do not include deconcentrated expenditures by the regional

6. **While losing their status as autonomous levels of government, raion authorities continue their liaison role in intergovernmental fiscal relations.** Essentially, raion financial officials act as gatekeepers for the Ministry of Finance in the regions. On behalf of the Ministry of Finance, they conduct budget negotiations with each individual aiyl okmotu over their planned revenues and expenditures and then negotiate with the Ministry of Finance headquarters over consolidated raion revenues and expenditures. Table 1 below provides more details on the current political and administrative arrangements in terms of the delineation of powers between the local representative branch, local executive branch and the national government.

Table 1. Administrative and political decentralization

Local Council	Local Executives	National government
<ul style="list-style-type: none"> • Adoption of the budget and final accounts • Adoption of policies on economic development and social protection • Introduction of local taxes and fees, setting tax exemptions and rates, including zonal coefficients for the land tax • Adoption of the municipal charter • Election of council chair and his/her deputies • Setting the number and structure of the executive body staff • Setting the user fees • Appointment of the executive head and initiation of dismissal (by prime-minister in the case of city mayors and by the raion heads in the case of aiyl heads) • In the case of city councils, no objection to appointment and initiation of dismissal of department heads responsible for the safety nets • Setting policies on leasing of public agricultural lands • Setting policies on the management of municipal assets • Regulation of the sales of alcohol and tobacco 	<ul style="list-style-type: none"> • Drafting and execution of municipal budgets • Drafting and execution of policies on economic development, social protection • Management of municipal assets • Adoption and implementation of the master development plan • Hiring and firing of department heads (in the case of cities, with no objection from the council) • Drafting and execution of policies on job creation in the case of aiyl okmotus 	<ul style="list-style-type: none"> • Dismissal of local executive heads for non-compliance with national normative acts or based on a non-confidence vote by a local council • Appointment of an interim local executive head until a new one is elected • Setting norms for the number and structure of the executive body staff • Setting social norms for the local government services • Setting the procedures for local elections • Monitoring compliance with laws by local governments and their officials

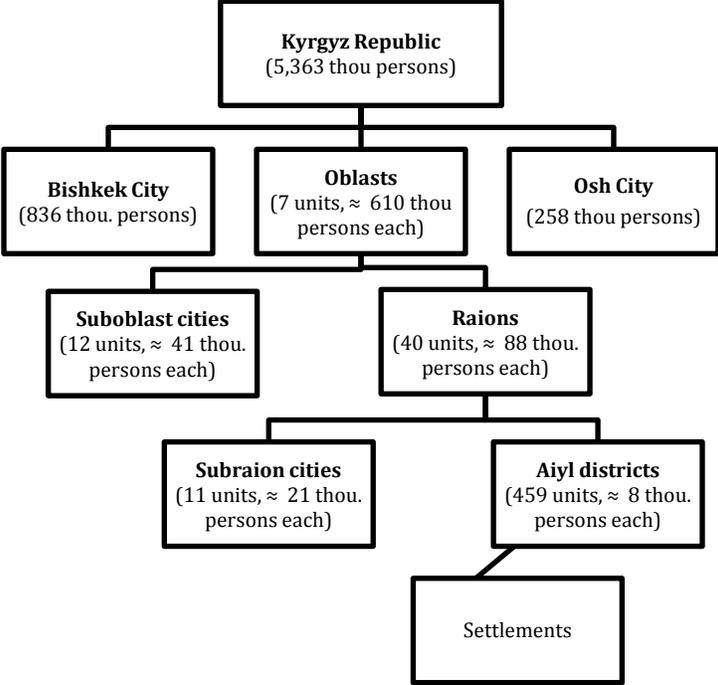
Source: Law on Local Self-Government (No. 101 of 2011).

7. **The current territorial organization exhibits some fragmentation at the bottom tier of local self-government, though most municipalities are of sufficient size to allow efficient delivery of most services.** According to the latest (2009) Census, 40 percent of aiyl okmotus have

branches of the national government, for example by the raion authorities after they had lost their independent legitimacy in 2012.

fewer than 5 thousand residents, and 70 percent of aiyl okmotus have fewer than 10 thousand residents (Figure 2). On the other hand, more than 98 percent of aiyl okmotus have over one thousand residents and more than 92 percent have over two thousand residents. Based on the existing empirical evidence from other countries, overall there is no pressing need for consolidation of aiyl okmotus other than those 43 with fewer than 2,000 residents (or those 70 aiyl okmotus with fewer than 500 school-age children).⁵ A number of empirical studies on other countries have looked for and found little evidence of economies of scale for most local government services, unless local governments are below a quite small size, such as 2,000 residents.⁶

Figure 1. Diagram of the Tiers of Public Administration



Source: Prepared by authors based on data from the 2009 Census of Population (National Statistical Committee of the Kyrgyz Republic).

8. However, efficient provision of selected services will require stronger cooperation between municipalities. There is consistent evidence from various countries suggesting the existence of economies of scale in the delivery of water services, with up to 150,000 or so customers required for efficient operations. This comes as no surprise given the large capital expenditure in infrastructure that is required to build water treatment facilities. Similar evidence exists in the case of garbage collection services, which require construction of disposal facilities or maintaining landfills. Some forms of public transportation services also show the presence of

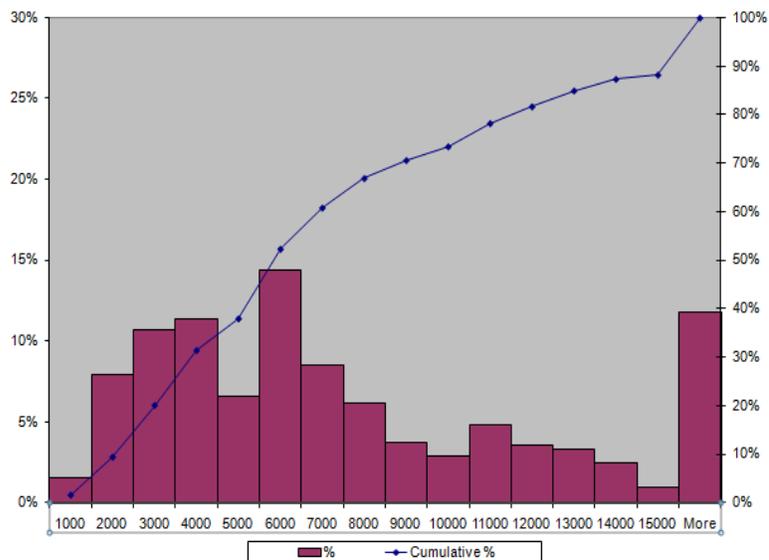
⁵ Even for these few extremely small municipalities, the potential economies of scales from consolidation might be hard to materialize in the specific context of high mountainous terrain found in some parts of the Kyrgyz Republic, ⁶Economy of scale means the average cost decreases as the volume of service provision increases; for example lower per-students costs of education in municipalities with more students. For a comprehensive review of studies of economies of scale see, for example, Jorge Martinez-Vazquez and Muhammad Handry, Understanding Sub-National Government Proliferation in Indonesia, Asian Development Bank, Manila, 2010. They find little evidence of economies of scale in police services, fire-fighting, public housing, social services, and general education beyond 500 students in a jurisdiction.

economies of scale. Therefore, the relatively small size of *aiyl okmotus* calls for special care in assigning responsibility for selected public services that exhibit significant economies of scale. With the abolishment of all intermediate tiers of local self-government, contracting with other municipalities and private vendors that operate at the regional scale is the only available option for efficient provision of those selected services where significant economies of scale are present.

9. This will require enough flexibility to be provided to *aiyl okmotus* in discharging their competences.

Local governments should be allowed to contract out the actual delivery of these services to other municipalities or to private vendors. Still, the current normative framework and the arrangements for grant allocation do not accommodate the possibility of such flexible modes of service provision as inter-municipal cooperation and outsourcing.⁷ Similarly, earmarked funding in some sectors (e.g. categorical grants in education before being discontinued in 2014) does not seem to allow flexibility in delivering public services through multi-functional facilities, where the same municipal entity could be used by several sectors. For example, half-day early child development programs could be delivered in the same facility as social welfare services.

Figure 2. Distribution of *Aiyl Okmotus* by size
(Percent of total number)



Source: Prepared by authors based on data from the National Statistical Committee of the Kyrgyz Republic

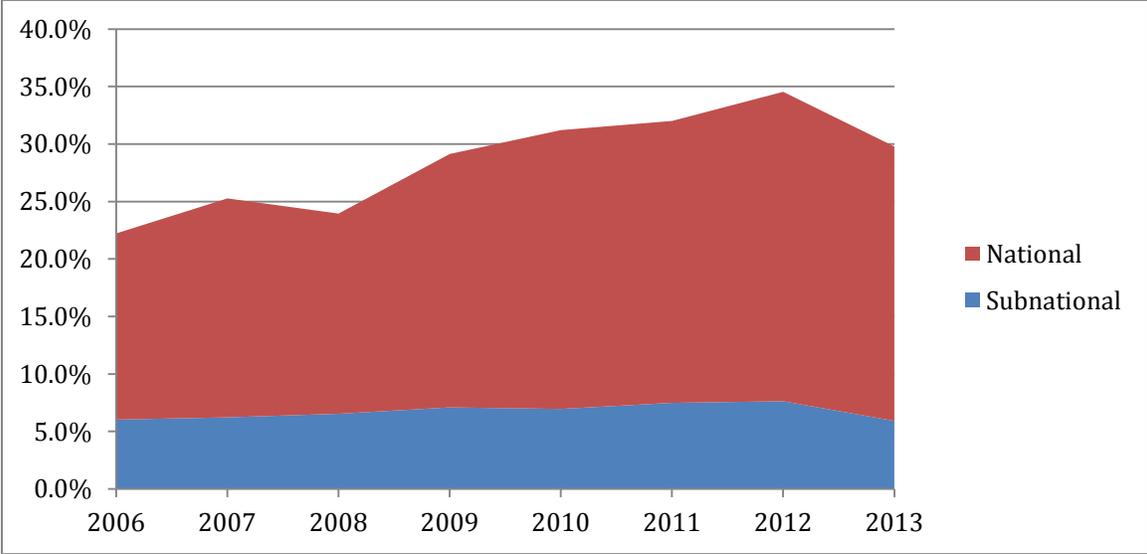
3. Delineation of Expenditure Responsibilities

10. Ad hoc responses to various shocks have resulted in a rapid rise in government expenditures during the last five years, mostly at the central level. Between 2009 and 2013, spending by the central and local tiers of government (state budget) increased by 5 percentage points of GDP as the authorities attempted to mitigate the impact of the 2009 global crisis, the 2010 revolution and repeated global price shocks by increasing wages, social transfers and public investment. State budget spending was on an upward trend until 2012; however, buoyant growth and restrained public spending reduced it to around 30 percent of GDP in 2013 (Figure 3), still

⁷ While the Law on the Financial and Economic Foundations of Local Self-Government allows for intergovernmental contracting, to our knowledge the required regulatory framework has never been developed (Art 26 of Law No. 215 of September 2003, last amended in January 2010). This could partially explain the proliferation of ad hoc intergovernmental transfers in the form of “mutual settlements” in place of contractual payments.

above the average for a low income country.⁸ While the increase in state government expenditures until 2012 was primarily due to higher central government spending, the decline (as percent of GDP) in 2013 was more equally shared between the local and central government tiers. As a share of GDP, subnational expenditures shrank from 7.6 percent in 2012 to 5.5 percent in 2013 due to lower spending on education and culture as a result of the abolishment of raions and reassignment of raion facilities to national line ministries.

Figure 3. State Budget Expenditures – by Level of Government
(Percent of GDP)



Source: Prepared by authors based on data from the Statistical Yearbook (2011).

11. Still, with subnational tiers accounting for almost a fifth of the state budget expenditures, on the face of it, the Kyrgyz Republic has a degree of decentralization around the average in the ECA region. The legal framework in the Kyrgyz Republic envisages local government involvement (either through sole responsibility or through sharing of responsibilities among tiers of government) for a long list of activities. In particular, subnational governments account for half of state budget expenditures on education and two thirds of expenditures on housing and utilities (Table 2). As a result, education spending consumes almost 60 percent of total subnational government expenditures (this ratio is probably higher outside of Bishkek), while 12 percent of local expenditures are spent on housing and communal services. An additional 12 percent of local expenditures are used to finance general public services. Local governments also account for significant part of the total republican budget spending in culture, sports, and media as well as in health.

⁸ The analysis and comparisons in this note are mostly done using the “state budget” definition of government which includes the central and local governments but excludes the social fund. The other notes prepared under the PER mostly use the general government budget definition (including the social fund). The more narrow definition of government is chosen in this note as it is more adequate for the purposes of the analysis of inter-government fiscal relations.

Table 2. Functional Classification of Recurrent Subnational Expenditures, 2013

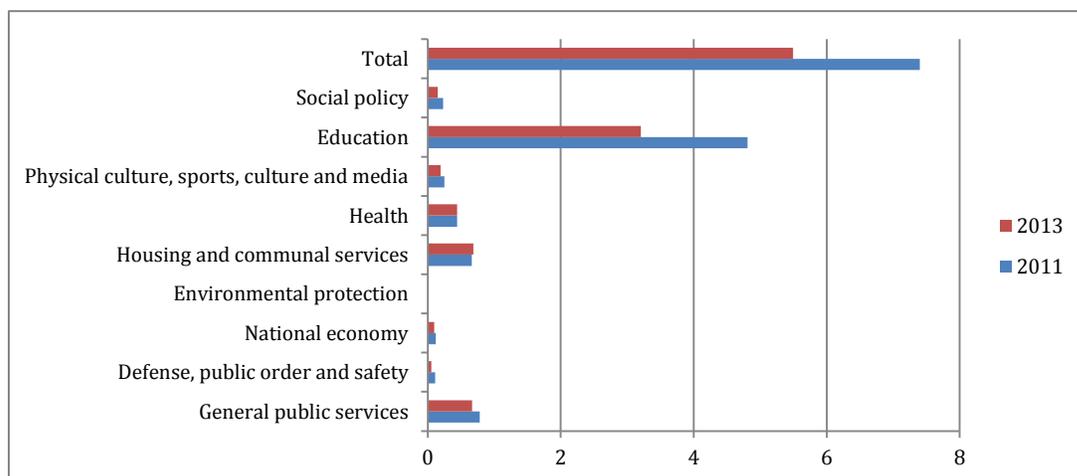
(Percent)

Functional Category	Percent of GDP	Percent of state budget expenditures	Percent of subnational government expenditures
General public services	0.7	22.0	12.0
Defense, public order and safety	0.0	0.0	0.0
National economy	0.1	9.0	2.0
Environmental protection	0.0	0.0	0.0
Housing and communal services	0.7	68.0	12.0
Health	0.4	13.0	8.0
Physical culture, sports, culture and media	0.2	25.0	3.0
Education	3.2	52.0	58.0
Social policy	0.2	3.0	3.0
Total	5.5	22.0	100.0

Source: Prepared by the authors based on Ministry of Finance data.

Figure 4. Recent Trends in the Decentralization of Recurrent Expenditure

(Percent of GDP)



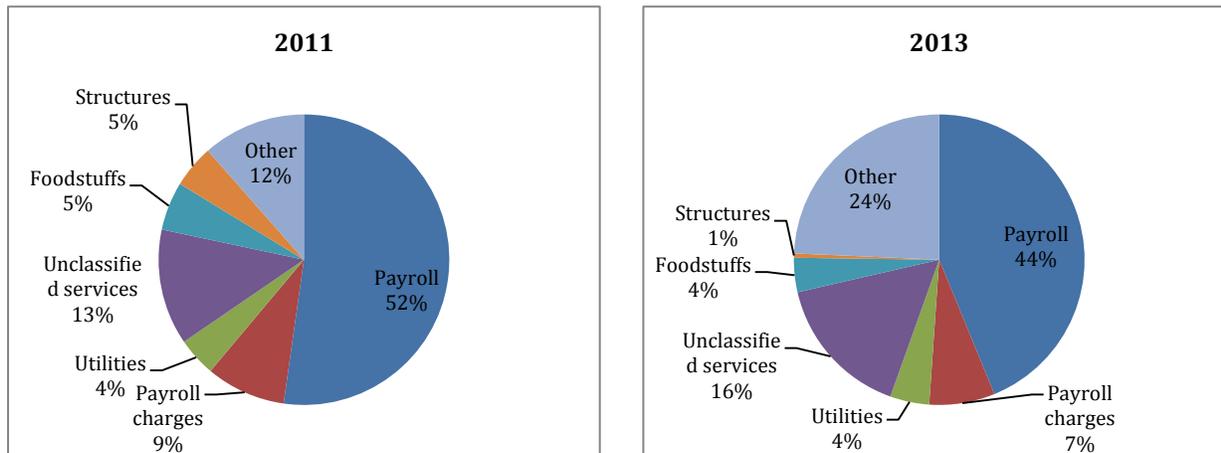
Source: Prepared by the authors based on Ministry of Finance data.

12. **The functional classification of spending is also reflected in the economic structure of expenditures.** With education and public administration accounting for three quarters of subnational expenditures, it is not surprising that over half of subnational budgets are spent on personnel (down from 60 percent in 2011), including salaries and payroll charges (Figure 5). The economic breakdown of expenditure also reveals a relatively large share (16 percent) of purchases of services that could not be classified into any of the dozen of categories of services in the budget classification. Previous reports traced this down to the budgets of *aiyl okmotus*, where as much as 30 percent of expenditures were found reported as purchasing of unclassified services.⁹

⁹ Deryugin, Alexander. *Issues in the current system of allocating grants to local budgets in the Kyrgyz Republic: Recommendations for Improvement* (in Russian).

Figure 5. Economic Classification of Subnational Expenditures

(Percent)



Source: Prepared by the authors based on Ministry of Finance data.

13. **The existing legal framework does not provide a clear delineation of responsibilities between the tiers of government.** A clear assignment of expenditure responsibilities is the first and most important step for successful fiscal decentralization. Without certainty and transparency in “who is responsible for what” there is no accountability in the system and further, the usefulness of discussing revenue assignments or transfers is limited since it is impossible to identify the needs of local governments. Even though the new Constitution of 2010 calls for delineation of functions between state and local government bodies (Art. 3.4), the 2011 Law on Local Self-Government (Art. 18) repeats almost verbatim the list of local functions from the previous law (see the Annex for a complete list of local functions).¹⁰ Also, the current Budget Law (No. 78, art. 37) states that local governments are responsible for funding frontline service delivery units that are *owned by or put under authority* of local governments. Thus, the delineation of responsibility is centered around facilities rather than functions provided with these facilities. As a result, the division of responsibilities for many of the core functions between the levels of government is determined according to the framework of what is the current distribution of “social assets” (or infrastructure) between the levels of government.¹¹

14. **Similarly, the responsibilities on activities for which local and central governments are jointly responsible remain unclear.** The current organic budget law also envisions a separate category of expenditure responsibilities shared between the central and local levels, but once again lacks clarity on the division of responsibilities when different levels of government are jointly responsible for the delivery of a public service. Rather than clearly assigning responsibilities for regulation, financing, and the actual implementation (delivery or production) of the public service to different tiers of government, the legislation employs vague terms, with no legal definition provided, such as “ensuring the operation,” “creating the conditions,” “assistance in

¹⁰ The only substantial change is reclassification of three functions from being exclusively local to those that can be delegated to local authorities and the introduction of a “general competence” clause allowing local governments to perform functions beyond those specifically enumerated in the law as long as they are not explicitly disallowed in the legislation.

¹¹ Still, in a number of functional categories the organic budget law establishes exclusive responsibilities of the central government. In particular, the national government has an exclusive responsibility in the area of defense, foreign affairs, fundamental science, law enforcement, statistics, strategic reserves, mining, manufacturing, construction, energy and fuels, telecommunications, and other economic affairs.

organizing,” and so on. Thus, the 2011 Law on Local Self-Government (Art. 10) assigns to the national level the responsibility for “ensuring pre-school, general and vocational education according to the state educational standards” without unequivocally implying national responsibility for either financing or provision of these services.

15. **Sectoral laws do not bring much more clarity to the expenditure assignment either.**¹² Thus, the Law on Education (No. 92, Art. 36) gives local governments (cities and *aiyl okmotus*) the authority to expand the network of schools, maintain and fund existing schools, provide free textbooks to students from indigent families. However, it is silent on the retrenchment of staff and closing of schools. As a matter of fact, the authority to downsize the network of schools is not explicitly assigned to any level of government in this law. While the downsizing authority falls within the broad powers given by the Law (Art. 37) to the school management, it is unlikely that this authority will be used by any school to initiate self-liquidation or merging with another school in case of underutilization. Overall, the education law is sound when it comes to defining the role of the central government, which is properly defined as setting standards and performing accreditation of the frontline delivery units (though it is unclear if this takes place fully in practice). It is when it comes to giving local governments a meaningful role in managing education, where the law is lacking substance. Overall, the law excessively focuses on the authority of individual schools and provides too little attention to the role of local and central governments or any other authority that could effectively manage the network of schools *as a system*.¹³ Besides realizing the economies of scale in managing the network of schools, for example by sharing specialized staff among schools, local governments could also realize economies of scope in using the same facility for several functions, for example for education and culture.

16. **The authorities should adopt a strategic government policy document that would clearly state strategic choices as to what level of government is responsible for which attribute (e.g. regulation, financing, provision) of which public service.** Without such a coherent blueprint, there is nothing to guide drafting of various laws and by-laws that would have to be enacted and/or amended in order to put in place a normative framework clearly assigning expenditure responsibilities to different types of local government. Such a document should form a policy consensus regarding the roles of different levels of government in providing public services, and it has to be introduced with some sort of government act to direct subsequent implementation.

17. **Based on the consensus for the strategic role of the local government, a review of expenditure assignments will be needed to ensure adequate resources are provided to perform the functions.** The review of expenditure assignments needs to be a comprehensive exercise involving many central government agencies as well as representatives of sub-national governments. Ideally, the leadership for the process of the reform should be assigned to an “Intergovernmental Reform Commission” with wide representation of the most important stakeholders at the central and sub-national levels (e.g., the Kozak Commission discussed in the

¹² Here we focus on education because, until 2014, it was the largest functional category of subnational expenditures and because healthcare is completely centralized except for the special case of the City of Bishkek.

¹³ While a comprehensive assessment of international practices in the decentralized provision of education would fall well beyond the scope of this note, there appear to be mixed experiences of transferring some authority to different groups of stakeholders (subnational governments, school management, and local communities). In fact not all responsibilities are always transferred to a single level of government or institution. Thus, a balanced approach seems to be warranted and the optimal balance is likely to vary from country to country depending on the local context.

case of Russia in Box 1).¹⁴ The Commission, with support of a technical secretariat or working group needs to establish the general strategy and scope of the reform as well as an implementation plan with an explicit time schedule. The reassignment of expenditure responsibilities is by necessity cross-cutting all central government ministries and agencies, and therefore it is desirable to charge with this task an institution that can rise above turf battles and interests and that has command and authority over specific ministries and agencies. Many countries have gone through such process of reviewing expenditure assignments, including Romania, Russia and Ukraine. The Russian exercise provided information that more than one quarter of expenditure assignments to sub-national governments were in the form of unfunded mandates and this led to the explicit prohibition of unfunded mandates in the new Budget Code and making federal provisions for funding through transfers and reassignment of revenues for the remaining mandates.

Box 1. Delineation of Responsibilities Between three Subnational Tiers in Russia

One of the most important developments in Russia's fiscal federalism was the appointment by President Putin of a high level commission (the Kozak Commission) to review and propose reforms in subnational government. The commission received substantial input from fiscal experts and think tanks in Russia and engaged in considerable discussion before reaching its final conclusions. Among other things the findings included the need for a clear separation of competences among the different levels of government. Based on the findings of the commission, in early 2003 the Presidential Administration introduced two laws on the reform of regional and local government respectively, which with strong backing from the President were approved in September 2003. Implementation of the reforms also required amendment of 152 existing laws and repealing another 42 laws. The two main elements of the reforms—initially planned to be completed by 2006 but eventually pushed back to 2009 in order to allow orderly transfer of assets— included : 1) Uniform two-tier structure of local government with distinction between urban and rural types; 2) Separate packages of functions assigned to each type of jurisdictions at each tier of subnational government.

At the bottom tier, the two types of municipalities are called rural and urban settlements, while at the top tier, the names are municipal and urban districts respectively. On the expenditure side, the Kozak reforms represented a significant improvement over the ambiguous delineation of responsibilities outlined in the Constitution and later in the *Budget Code*. First, they made clear the principle that for “delegated” responsibilities the upper-level government delegating those responsibilities has the power to regulate but also the obligation to ensure there is sufficient funding. Second, they make clear that for all other local responsibilities (own or non-mandated), upper-level governments cannot introduce expenditure norms. Third, the adopted legislation enumerated exclusive responsibilities of each tier and type of subnational government. A number of responsibilities not suitable for local governments were elevated to the regional level (health insurance for the unemployed, support to some disadvantaged categories of population, most outlays on general education). At the same time, street patrolling was separated from federal detective and police services and assigned exclusively to the local level.

Source: Martinez-Vazquez, Jorge, Timofeev, Andrey, Boex, Jameson L. F., 2006. *Reforming Regional-Local Finance in Russia*. WBI Learning Resources Series. The World Bank, Washington, D.C.

18. Consultations with and direct involvement of line ministries and other government agencies (both central and local) in the process of expenditure assignment reform is critical.

Besides relying on the intimate knowledge of line ministries as to how public service delivery works, expenditure assignment reform often involves significant transfers of personnel and assets between levels of government. Often the line ministries need refocusing their mission from the direct delivery of services to regulation and enabling activities in support of the decentralized governments. None of these activities will go smoothly and efficiently without buy-in of those

¹⁴ Dmitrii Kozak was deputy head of the President's Administration at that time and later the Minister of Regional Development and Deputy Prime-Minister.

agencies. Involving the sub-national governments in the reform process via their associations and representatives will also be important as these units should also endorse the reforms and have very useful perspectives on what may or may not work in the expenditure reassignment blueprints.

19. **In term of practical steps, a review of expenditure assignments often starts with a complete inventory of current normative acts, identifying the areas where there is lack of clarity.** The point of this first step is to know as well as possible what current expenditure assignments are and to identify all ambiguities. The inventory of the status quo in the formal and *de facto* delineation of expenditure responsibilities provides a necessary point of departure for expenditure assignment reform. From this perspective, reform efforts can be aimed at filling the gaps and eliminating ambiguity in the formal assignment and breaking down concurrent responsibilities into sub-activities that can be exclusively assigned to a certain level of government. Even if expenditure assignments should preferably be legislated in a single legal act, current assignments are likely to be scattered across dozens of pieces of legislation and government acts regulating different government services. Therefore, inventory of the existing legal assignments represent an important component of the expenditure assignment reform because it requires taking stock of all existing legal and regulatory acts that would need to be amended.

20. **Next, it is critical to clearly assign the new responsibilities, preferably driven by efficiency principles rather than historical practice.** Efficiency considerations imply that in case a function does not involve special circumstances, such as inter-jurisdictional spillover of benefits or economies of scale, the responsibility should be assigned to the lowest level of government that encompasses the entire benefit area of this function (applying the “subsidiarity principle”).¹⁵ Where concurrent assignments are necessary or desirable due to the aforementioned special circumstances, it is necessary to identify separate attributes (e.g., regulation, financing, administration, and delivery) or sub-functions (e.g., primary versus secondary education) associated with the particular competence and clearly assign each of them to appropriate government levels. When any of these attributes (for example regulation of education) or sub-functions is still shared by two or more levels of government, it will be necessary to further subdivide that attribute in sub-attributes (e.g. pedagogy versus material support) until these sub-attributes can be exclusively assigned to one level of government. This normative approach will require a good deal of judgment and many consultations; therefore, the reform commission will need to mobilize the expertise of all government agencies and also be guided by government objectives in other areas (for example on redistribution, social policies etc.).

21. **The expenditure assignments would need to keep pace with preferences and changing needs.** In a sense, there is no single best assignment of expenditure responsibilities and rules do not always yield an unequivocal answer. Table 3 presents a representative assignment of expenditure responsibility for a number of government functions, showing which level of government (national, regional or local) could properly be involved in the regulation, financing, provision or production of these government functions. Some public services, e.g., 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

¹⁵ The subsidiarity principle is widely accepted by fiscal decentralization experts and has also been adopted as a practical guide. For example, the *European Charter of Local Self-Government* formally adopts the “subsidiarity” principle as the most prominent guide for expenditure assignments. What this principle says is that the responsibility for the provision of services should be at the lowest level of government compatible with the size of the “benefit area” associated with those services. The benefit area for solid waste collection is clearly the local community, but for air traffic control the benefit area is the entire national territory.

responsibility of the central government. Also, many (if not most) government services ultimately will involve more than one level of government making intergovernmental cooperation and dialog critical to assure successful delivery of public services. Finally, what is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences.

22. **However, it is important that at any given moment in time, assignment of responsibilities should remain *concrete, clear and stable*.** Failure to have a concrete assignment may lead to instability in intergovernmental relations and loss of efficiency.

23. **On the face of it, the range of functions assigned and/or delegated to the local level in the Kyrgyz Republic is generally in line with the normative prescriptions.** The only possible exception may be primary healthcare where some countries have allowed for some local involvement in deciding the appropriate mix of curative services and ensuring adequate maintenance of facilities and satisfaction with the personnel. Still, the lack of clarity in delineation of local authority vis-à-vis the central government, in particular in education needs to be addressed through a comprehensive review of expenditure assignments.

Table 3. Conformity of Expenditure Assignments with Normative Prescriptions

Function	Normative Assignment of Expenditure Responsibility				Assignments in the Kyrgyz Republic	
	Regulat.	Financing	Provision/Admin.	Product.	Local responsibilities	Responsibilities to be delegated to the local level
International affairs	N	N	N	N	None	None
Defense	N	N	N	N	None	Military registration
Public order and safety	N,R,L	N,R,L	N,R,L	N,R,L	Facilitation	Residence registration
Primary and secondary education	N,R,L	N,R,L	R,L	R,L,P	Unclear	Provision of buildings and/or services
Higher education	N,R	N,R	N,R	N,R,P	None	None
Health care	N,R,L	N,R,L	R,L	R,L,P	None	De facto in Bishkek
Social security and welfare	N,R	N,R	R,L	R,L	None	Identification of indigent households and means-testing; Employment programs
Community services (water, sewer, refuse, fire protection)	N,L	L	L	L,P	Residential water supply, all sewer, solid waste, landscaping	Heating
Highways, roads and streets	N,R,L	N,R,L	N,R,L	N,R,L,P	Maintenance of local roads, street lighting	
Parks, recreation and culture	N,R,L	N,R,L	N,R,L	N,R,L,P	Ensuring operation of parks and recreation; provision of municipal libraries	
National transportation/communication networks	N	N,R	N,R,L	N,R,L,P	None	None
Regional/local public transportation	R,L	R,L	R,L	R,L,P	Regulation, ensuring operation	

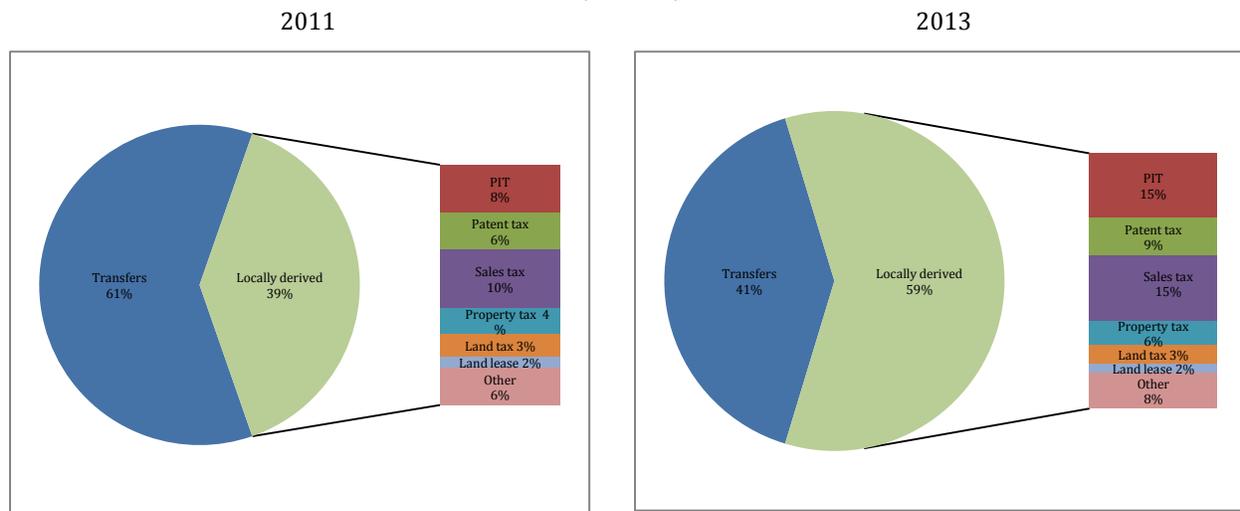
Source: Law on Local Self-Government (No. 99, art 18-20); Shah, Anwar (1999) Expenditure Assignment. Decentralization Briefing Notes, World Bank; further modified in Martinez-Vazquez, Jorge "Intergovernmental Relations in Belarus." June, 2007; document prepared for the World Bank.

Note: N denotes National Government; R denoted intermediary (Regional) Government; L denotes Local Government, and P denotes the private, non-government sector / civil society.

4. Revenue Assignment

24. **The current national legislation does not allow any level of government to introduce taxes beyond those enumerated in the Tax Code.**¹⁶ The Law includes a list of permitted taxes, broken into two categories: “statewide” taxes and “local” taxes. Classification of a tax into the “statewide” category does not determine the level of government that receives the proceeds from this tax. In fact, as can be seen from Figure 6, the most important sources of subnational revenue (PIT, Sales Tax and the patent-based taxes) are statewide taxes shared with subnational governments on the derivation basis. These sharing rates vary by tax and also by type of local government. Since 2007, the rates of the derivation-based sharing of tax revenues have been set in the annual budget law uniformly across all local governments of the same type, for example same rates for all *aiyl okmotus* (see Table 4).

Figure 6. Composition of Subnational Revenue, by Source
(Percent)



Source: Prepared by the authors based on Ministry of Finance data.

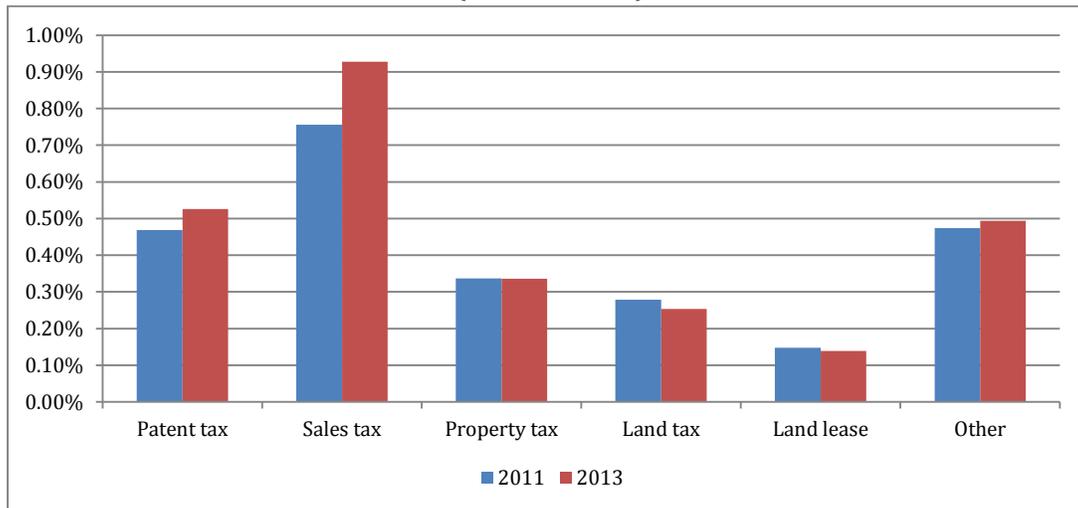
25. **The revenue raising ability of local governments has not improved in recent years and they continue to depend on explicit or implicit transfers from the central government.** The structure of local government revenues changed between 2011 and 2013 with substitution of explicit transfers with larger retention of revenues from statewide taxes. At the same time, genuine local taxes (property and land taxes) remained a relatively small share of total local government revenues (Figure 6). Figure 7 confirms this with only revenues that are outside control of local governments (e.g. Sales Tax, Patent Tax) increasing between 2011 and 2013, in effect replacing an official transfer with an implicit one. At the same time, revenues that can be affected by local authorities (e.g., land tax and land lease) have declined.

26. **Giving local governments authority to change the rates of a closed list of taxes can promote revenue autonomy at the local level.** At the moment, local governments have very limited revenue autonomy in the Kyrgyz Republic. The only revenue sources that can be affected at

¹⁶ The current draft of Kyrgyz Republic’s new Budget Code is silent on the assignment of revenue sources to different tiers and types of local governments. However, its wording does imply that all taxes in the country have to be authorized in the national legislation.

the margin by local authorities are the land tax and non-tax revenues, in particular the land lease and solid waste fees. However, these two sources of revenue (land tax and non-tax charges) cover only 10 percent of local expenditures. Local revenue autonomy could be broadened by allowing local governments to vary rates for the property tax and some other taxes, thus, increasing the share of revenues under the control of local governments.

Figure 7. Recent Trends in Locally-Derived Revenues
(Percent of GDP)



Source: Prepared by the authors based on Ministry of Finance data.

27. **An increased level of revenue autonomy leads to greater accountability and it creates the basis for local creditworthiness.** First, endowing local governments with a degree of revenue-raising authority allows them to increase or decrease those expenditures over which they are allocated responsibilities in response to the needs of their constituency.¹⁷ Second, local taxpayers will have a strong interest in assuring that local officials use local budget resources wisely. Without any local revenue autonomy, local government officials are able to ignore local residents and may be beholden to the interests of the central government or to their own interests. Dependence of local governments on the revenue decisions of the central government (including decisions concerning sharing revenue from statewide taxes and most other forms of transfers) undermines the accountability of local officials to their constituency by offering an easy “scapegoat” for poor local performance (“we do not get enough resources from the central government”). Greater autonomy would also need to be complemented by strong capacity building efforts in the area of public financial management which currently remain suboptimal in many areas, including budget planning and execution.

¹⁷ Thus revenue autonomy does not require that local governments control (i.e. determine bases and rates) for *all* their revenue sources. It would suffice if they could increase or decrease rates for a few taxes accounting for a meaningful share of their revenues while the rest coming from predictable and stable sharing of national tax revenues. However, there would be little revenue autonomy if any additional revenue from higher local taxes were almost entirely offset with reduction in grants.

Table 4. Shared and Local Taxes

Tax name	Designation	Who can introduce	Who defines the base	Who sets the rate	Who receives the revenues
Land Tax	Local	National legislation	National legislation (acreage); local councils can provide hardship relief for a period of up to 3 years	National legislation sets the base rate for each locality while local councils set adjustment of up to 3times for quality and idleness of agricultural land and between x0.3-1.2 times for the zoning of urban lands	Local governments
Property tax	Local	National legislation	National legislation (taxable value through area-based assessment for structures, engine size for vehicles)	National legislation (3.5 mils for owner-occupied residential structures; 8 mils for commercial and rental property)	Local governments
Personal Income Tax	Statewide	National legislation	National legislation (adjusted income; for wages backstopped by imputed payroll based on average wages)	National legislation (10%)	50% of revenue to the local government where collection takes place (until 2013: 50% to Bishkek and Osh cities; 40% to other types of cities and 10% to aiyl okmotus)
Sales Tax	Statewide	National legislation	National legislation (gross receipts, in some industries after deducting costs of certain inputs)	National legislation (1.5%-3.5%)	50% of revenue allocated to the local government at the point-of-sale sharing (until 2013: 50% to subrepublic and suboblast cities; 25% to other types of local government).
Patent-based tax	Statewide	National legislation	National legislation (duration of business activity in days)	Tax inspectorates based on studies of average profitability conducted with representation from the local government and business community	Local governments
Royalties for common natural resources	Statewide	National legislation	National legislation (output/sales of extracted resources)	National legislation (1%-12%)	50% of revenue to the local government where collection takes place (until 2013: 100%)

Source: Tax Code.

5. The System of Transfers

28. **The legal basis for the system of intergovernmental transfers is provided by the organic budget law (No. 78, art. 35).** It envisions four types of transfers in the Kyrgyz Republic: i) categorical grants, ii) equalization grants; iii) matching (incentive) grants, and iv) mutual settlements.

CATEGORICAL GRANTS

29. **The objective of categorical grants is to fund education expenditures of the local government which are guaranteed by the state.** In practice, until the centralization of education in 2014 on a per capita basis, the disbursement of categorical grants had been based on payroll accrued in frontline service delivery units in all localities other than those selected for piloting of a per-student formula. That is, each disbursement of categorical grants was determined and triggered by an actual wage bill to be paid in a given month. In the five pilot regions with per capita financing, the formula for the allocation of categorical grants was prescribed in the methodology decreed with Government Resolution number 91 of 2008, and later updated with Government Resolution number 563 of 2011.¹⁸ While the essence of the pilot methodology did not change in 2011, in 2012-2013 the revised methodology used a new mathematical formula expressed in terms of local co-funding:

$$CG_i = (1 - d_i^C) \times EN_i^C + (1 - d_i^{NC}) \times EN_i^{NC}, \quad (1)$$

Where,

- CG_i is the amount of categorical grant for locality i;
- d_i^C - rate of local co-funding of core (“protected”) expenses on education;¹⁹
- d_i^{NC} - rate of local co-funding of noncore (“unprotected”) expenses on education;
- EN_i^C – expenditure needs on core expenses of education facilities in locality i.
- EN_i^{NC} – expenditure needs on noncore expenses of education facilities in locality i.

30. **The grant is in the form of a top-up to the local co-funding.** The rate of local co-funding was set to be proportional to the per-student level of local revenue capacity, with capacity assessed based on actual revenue collections in the past, rather than actual estimates of capacity. In addition, the 2012-13 co-funding rates were also made proportional to the share of local budget that was historically spent on education in a specific municipality. Thus, during this period the grant formula might have allocated a smaller amount of categorical grants to a municipality with larger needs in education. This is because in a municipality with more students and higher costs, a larger fraction of the same revenue base might have been historically allocated to education than in another locality with the same revenue base but smaller expenditure needs.

31. **During the roll-out of the per capita financing, expenditures needs for all expenses other than utilities, were calculated based on a per student norm adjusted for local cost differences.** The utility expenses in general education and all expenses in other educational

¹⁸ The same formula, with slight modifications was used when the system was rolled nationwide in 2014.

¹⁹ The “protected” items include salaries, payroll charges, foodstuffs and medicine.

facilities (e.g. boarding schools and kindergartens) were calculated based on historical costs. These non-standardized expenses accounted for one third of assessed expenditure needs in the five pilot regions (Chui oblast, Batken oblast, Issyk-Kul oblast, Bishkek City and Osh City).

32. Using historical expenditures as a basis for allocating categorical grants discourages cost-saving efforts and entrenches historical inequities in access to these social services. Thus, the percentage of children under 6 years old enrolled in child day care varies widely even among cities, from 4.4 percent in Shopokov City to 47 percent in Kant City. The only possible justification for funding historic costs could be the realization that the level of service provision cannot be increased overnight and some transition period might be required.

33. Funding for all educational services should be provided on a per-client basis, where the clientele can be defined as local population of the relevant age. Given the vast disparities in actual enrolments, in particular in early child development services, a new allocation formula can be gradually phased in under a multi-year planning framework in order to allow local governments to develop work plans and infrastructure necessary to absorb these funds.

34. For the per student formula, the latest methodology did not provide justification for the calculation of adjustments coefficients applied to the per student norms. It appears particularly problematic to use adjustment coefficients compensating for higher costs in schools with lower enrollments as it appears to be grandfathering inefficiencies that the per capita financing system is designed to tackle. This was likely to have discouraged local governments from optimizing the school network by merging underutilized schools and busing students where feasible.

35. Statistical estimation should be carried out for the impacts of various local characteristics on the per student costs of providing educational services. Land area, topography, population density and distribution of population among settlements could be better indicators of objectively higher costs per student costs in rural areas than the actual enrolment size.

EQUALIZATION GRANTS

36. The declared objective of equalization grants is to maintain social and economic stability by securing “minimum social standards” to be set by the national government for public services. The organic budget law requires the allocation of equalization grants to be governed by a formula decreed by the Cabinet and based on the gap between the expenditure needs of local governments and their revenue capacities. The first formula for the allocation of equalization grants was prescribed in the methodology decreed with Government Resolution number 101 of 2007. It was slightly revised in 2011. In the methodological approach used since 2007, the total equalization fund is allocated via two windows. In the first window, 80 percent of grant resources are allocated proportionally to the fiscal gap that is measured using a rather cumbersome mathematical formula:

$$FG^1_i = [(RC+Fund)/P - (RC/ P) \cdot r_i/e_{i,j}] \cdot e_i \cdot P_i, \quad (2)$$

Where,

- FG^1_i – the size of the fiscal gap in locality i;
- Fund – the total amount of the equalization grant pool allocated through the two equalization windows;

- RC – aggregate revenue, excluding grants, projected for all localities in the given group (i.e., all aiyl okmotus) for the coming fiscal year;
- P_i and P – the number of resident population in locality i and in all localities of the given group;
- ri_i – revenue capacity index for locality i ;
- ei_i – the index of budget expenditures of locality i .

37. After substituting into the transfer formula the expression for the index of revenue capacity (ri_i), it becomes clear that this methodology proportionally closes the shortfall in per capita level of potential revenues from the benchmark level adjusted for relative expenditure needs:

$$fg^1_i = b^1 \cdot ei_i - rc_i \quad (3)$$

Where,

- variables labeled with small letters represent per capita values of the respective variables labeled with the corresponding capital letters;
- $b^1 = (RC+Fund)/P$, is the benchmark level defined as the per capita level of the sum of fiscal capacity of all localities of the given group and the equalization fund available in the coming fiscal year.

38. **Thus, essentially the first window of the current equalization grant formula equalizes disparities in revenue capacity of aiyl okmotus.** This formula resembles the one introduced by the federal government in Russia to address fiscal disparities among Russian regions, which had 80 percent of their revenue locally derived.

39. **The formula used to allocate equalization grants, is not transparent and intuitive.** The formula is expressed in the form of a ratio of the revenue index over the expenditure index, compared to an equivalent classical formula allocating grants proportionally to the gap between the revenue capacity and the expenditure needs. The nominal amount of the fiscal gap can be equivalently expressed in a more transparent form as the difference between expenditure needs and revenue capacity:

$$FG^1_i = EN_i - RC_i \quad (4)$$

Where,

- $EN_i = ei_i \cdot [(RC+Fund)/P] \cdot P_i$.

40. **Merging categories of expenditure needs in the grant formula will simplify the system.** In addition to using a ratio of two relative indices mentioned above, the equalization grant formula is further complicated by the multiplicity of separate sectoral subindices, which are in turn calculated as relative ratios of essentially the same cost factors. The equalization formula would be simplified if the relative expenditure index were calculated for a composite of related local expenditures. In particular, it could be more practical to merge the category of “general public services” with the “Recreation, culture, and religion” category and the residual category of other public services. The latter two categories account for less than eight percent of expenditures in any type of local government units. Unless these three categories of expenditures have drastically different elasticities of per capita costs with respect to population size and the shares of population

residing in high mountainous and/or remote areas, there is no reason to have separate per client norms for local functions that serve the same clientele (total local population).

41. **The methodology could be improved by statistically estimating the impact of various local characteristics on per capita costs.** Currently the methodology does not provide justification for the way adjustment coefficients are calculated for the index of budget expenditures. For example, for urbanization the adjustment coefficient varies from 1.00 in completely rural localities to 2.00 in completely urban localities. For high mountainous and remote areas the adjustment coefficient is set proportionally to the additional remuneration and other allowances mandated by the national governments in those areas. For the demographic composition, the adjustment coefficient is equal to 0.0 in municipalities with no school-age children, equal to 1.0 in municipalities with the average share of school-age children, equal to 2.0 in municipalities with double the average share of school-age children, and so on. For the population scale, the adjustment coefficient implies that thirty percent of public expenditures is fixed for each municipality regardless of its population size while the other seventy percent is proportional to population.²⁰ This may be underestimating the fixed costs of providing some services at the local level.²¹ One way to preserve objectivity of the allocation mechanism is through statistical estimation of impacts of various local characteristics (e.g., land area to control for economies of scale) on the per client costs of providing public services.

42. **Expenditure needs for education are estimated both in the categorical grant formula and in the equalization grant formula using two different methodologies.** To avoid inconsistency and duplication, the measure of expenditure in the equalization grant formula should exclude all expenditures funded with grants other than the equalization grants.

43. **Allocation of equalization grants is further complicated by the existence of the second part (“compensation”).** In the second window of equalization grants, 20 percent of the grant fund is used to top up the first round of grants in a way that would bring every municipality up to a uniform fraction of its negotiated (incremental) expenditures or 120 percent of its revenue capacity, whichever is smaller. In mathematical terms, the amount of the second part of equalization grants is determined as following:

$$G^2_i = FG^2_i = |K_{max} \cdot B^2_i - RC_i - G^1_i|, \tag{5}$$

Where,

- G^1_i – the amount of grant resources allocated to locality i in the first round of equalization;
- K_{max} – the maximum coverage of the planned (negotiated) expenditures that is feasible to achieve with the given equalization fund;
- RC_i – revenue capacity assessed for locality i ;
- $B^2_i = \min\langle PE_i, 1.2 \cdot RC_i \rangle$ is the second equalization benchmark defined in terms of budget expenditures PE_i projected for (essentially negotiated with) locality i ;

²⁰ The population scale indicator captures how much the population size of this municipality is smaller than population of an average municipality.

²¹ The author’s calculations based on 2010 data suggest a scale elasticity of about 0.48 for functions other than education and housing and utility. Thus, the weight of 0.30 in the formula may not fully compensate for higher costs due to a lack of economies of scale in smaller municipalities.

44. **Thus the second window of equalization grants establishes a minimum coverage of local expenditure programs negotiated with the Ministry of Finance rather than based on the objective indicators of expenditure needs employed for the first window of grant allocation.** This essentially requires assessing local expenditure needs twice: once based on the objective system of representative expenditures and the second time based on negotiations with each individual local government unit over planned expenditures. In most post-Soviet countries an equalization formula replaced negotiations over local government expenditures thus simplifying intergovernmental fiscal relations. In the Kyrgyz Republic, initially the second part of equalization grants was introduced as a transitory measure aimed at compensating for the sharp differences between the historic levels of expenditures and the objective estimates of local expenditure needs. Now that seven years have passed since the equalization formula was first introduced in 2007, the need for the second window of equalization as a transitory measure can be revisited.

MATCHING (INCENTIVE) GRANTS

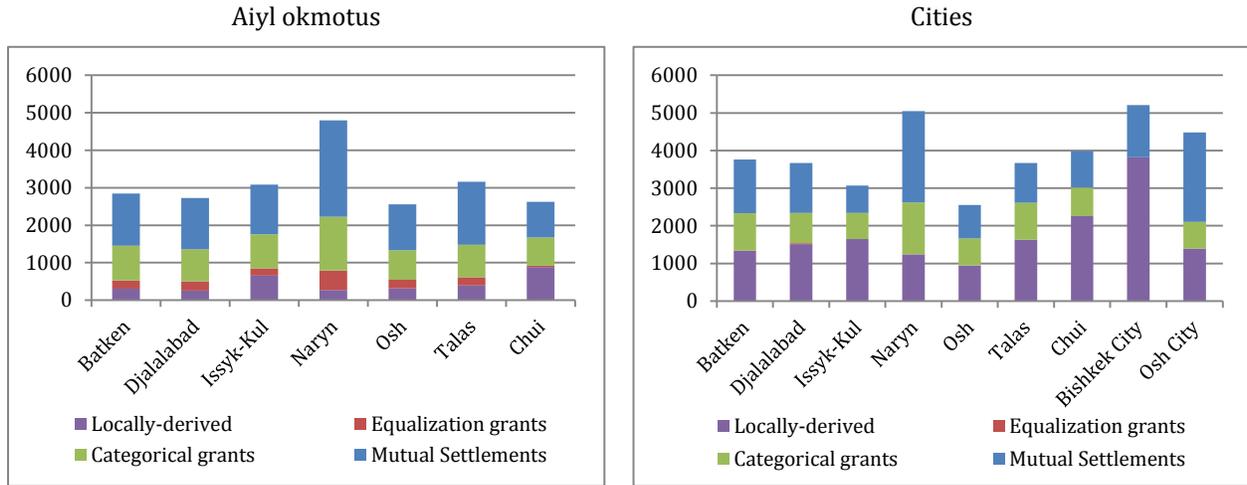
45. **The declared objective of matching (incentive) grants is to incentivize efficient use of public resources, particularly in programs of national priority, and mobilization of local government revenue from own sources.** The allocation of matching (incentive) grants is project-based. Currently the allocation of equalization grants is governed by the methodology decreed with Government Resolution number 198 of 2010. According to this methodology, the local matching rate for incentive grants is determined based on the index of fiscal capacity, defined in the equalization grant methodology as a ratio of the revenue capacity index over the expenditure need index. For the values of this index of more than three times the national average, the local matching share is set at 60 percent of project costs. For the values of this index between 1-3 times of the national average, the local matching share is set between 20-60 percent. For municipalities, with below-average values of the fiscal capacity index, the local governments are required to cover between 10-20 percent of the project costs.

46. **No capital (matching) grants to subnational governments were reported in the central government budget in 2011.** It is possible that for some projects identified by subnational governments and their front-line delivery units the disbursements were made directly from the national budget to contractors. According to the data from the Ministry of Finance, 352 projects were approved for financing with matching (incentive) grants in 2011. The national match totaled KGS 300 million while local governments contributed KGS 122 million. The local matching rate varied between 7-81 percent. For the reference, subnational outlays on fixed assets totaled KGS 1,203 million in 2011.

MUTUAL SETTLEMENTS

47. **The objective of transfers based on mutual settlement is to compensate local governments for revenue losses or additional expenditures inflicted on local budgets as a result of changes to the national legislation made in the course of a fiscal year.** Furthermore, the national government is allowed to adjust the amount of mutual settlements based on the actual collections of state-wide taxes and other macroeconomic developments. This latter justification is often used for gap-filling transfers both to compensate for short-falls in revenues relative to initial projections and to clear arrears, in particular on utility bills.

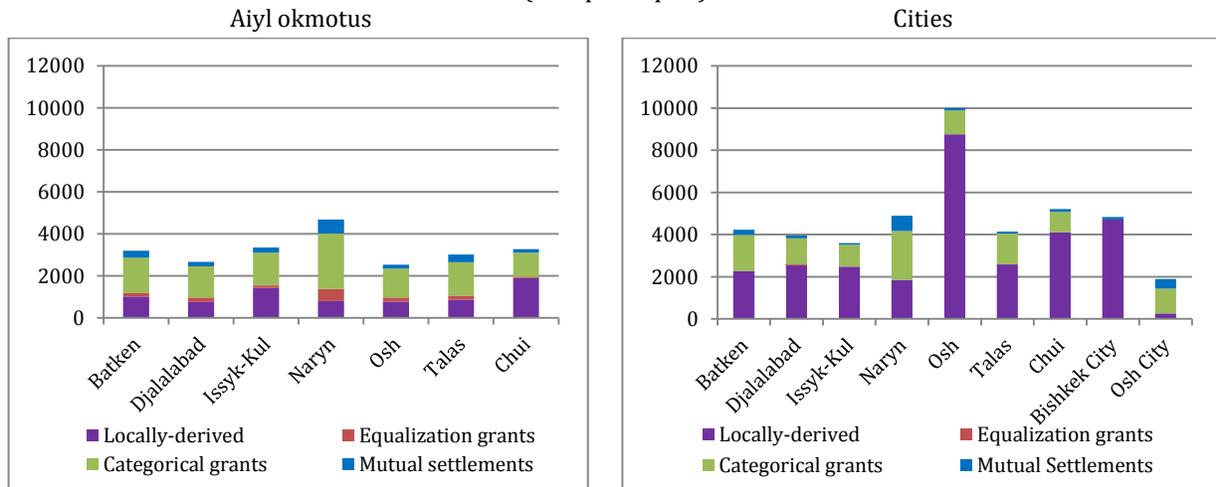
Figure 8. Incidence of intergovernmental grants, by Oblast, 2011
(KGS per capita)



Source: Prepared by the authors based on Ministry of Finance data.

48. **During 2010 and 2011, mutual settlements accounted for most of central government transfers to local governments.** Across subnational governments, these unplanned transfers accounted for over 60 percent of all transfers. Even the City of Bishkek received unplanned transfers (“mutual settlements”), mostly as a compensation for mandated increases of public pay; these transfers accounted for 20 percent of Bishkek’s total revenues in 2011. In 2010, in the absence of major unplanned expenditures imposed by the national government, unplanned transfers constituted 30 percent of all transfers. This should be contrasted with the much smaller role played by formula-based equalization grants, accounting for only 8 percent of all transfers in 2011 and 14 percent in 2010.

Figure 9. Incidence of intergovernmental grants, by Oblast, 2013
(KGS per capita)



Source: Prepared by the authors based on Ministry of Finance data.

49. **The share of unplanned transfers (mutual settlements) decreased to 14 percent of total transfers to municipalities in 2013.** The share of unplanned transfers in total local

government revenues declined mostly due to the increased retention of shared revenues from statewide taxes by municipalities. At the same time, the role of equalization grants also declined also due to dilution by the increased sharing of revenues from the statewide taxes.

50. **In addition to diluting the impact of equalization grants, ad hoc mutual settlements also reduce predictability of local government revenues.** Stable and predictable intergovernmental financing is necessary for overall budget certainty that would allow local governments to engage in multi-year planning, among other things required for managing their investment programs.

THE COMBINED IMPACT OF ALL TRANSFERS

51. **Given this limited size of equalization grants, they cannot make a big impact on disparities in fiscal outcomes among localities.** There are two important implications. First, all the efforts of redesigning and administering the formula-based equalization grants will be futile if these resources continue being diluted by other much larger, ad hoc transfers. Second, there is little justification for the excessive complexity of the current grant formula, attempting to take into account historic peculiarities, as at the end equalization grants hardly matter for the ultimate fiscal outcomes at the local level.

52. **The other transfers (mutual settlements and categorical grants), are nevertheless negatively correlated with locally derived revenues and do narrow the gap between aiyl okmotus as a group and cities as a group.** Thus, while in 2011 locally-derived revenues in aiyl okmotus were 70 percent lower in per capita terms than in the cities, after the allocation of all grants the total per capita revenues of aiyl okmotu were only 35 percent lower than in the cities. However, the case of Naryn oblast, standing out in Figure 8, clearly illustrates the arbitrary nature of these transfers. The difference in resources of aiyl okmotus and cities further narrowed in 2013 to 20 percent, mostly likely due to the means-tested matching requirement introduced for categorical grants in 2012. In addition to the aforementioned irregularity with the fiscal outcomes in the Naryn oblast, larger retention of lopsided revenues from statewide taxes in 2013 put cities of the Osh oblast far ahead of cities elsewhere in the country (Figure 9).

53. **These disparities in per capita levels of local government resources inevitably translate into disparate levels of funding on various public programs and as result disparate levels of service outcomes.**²² The 2014 Education PER finds that in 2011 students of the Naryn oblast were benefiting from 64 percent higher per capita spending on general education than in the least funded region, Jalal-Abad. The report also finds disparate levels of education quality, which however show only weak correlation with the levels of spending. Thus, while having the highest per

²² While the lack of disaggregated data do not allow us to evaluate disparities in per capita expenditures on specific functions, previous studies documented substantial disparities (Timofeev, 2011, Initial Assessment prepared for the Trust Fund “Capacity Building in Public Finance Management” project). In 2010, even among the more homogeneous group of cities, per capita total expenditures on average deviated by 33 percent from the urban mean, while per capita total expenditures of aiyl districts on average deviated by 46 percent from the rural average. At the same time, the gap between the highest and lowest per capita expenditures was eightfold for cities and 17-fold for aiyl districts. Being the largest functional category of subnational expenditures, education exhibited the extent of variation among aiyl okmotus and among cities similar to that of total expenditures in these two groups of municipalities. It is also worth noticing that education showed the least disparity *between* these groups of municipalities so that the urban average differed from the rural average by less than ten percent.

capita spending, the Naryn oblast shows student performance close to the national average. Nevertheless, oblasts with the lowest levels of spending, such as Osh and Jalal-Abad also appear to be particularly lagging behind the rest of the country.

54. **There is lack of clarity among some stakeholders about the objectives of equalization grants, in particular the choice between the goals of equal service provisions (or access to a guaranteed minimum level of services) and balanced economic development.** This confusion can be a significant impediment for the reform of intergovernmental grants as different policy goals require different and separate tools, in particular separate intergovernmental grants to address them. Thus, there appears to be a conflict in the desire to make the grant formula, on the one hand, simple and transparent and, on the other hand, to include outcome indicators, such as job creation, which are not directly related to the responsibilities assigned to local governments.

55. **Equalization transfers are generally not effective tools to reduce differences in levels of economic activities or household income across local jurisdictions.** To achieve the latter, it is usually necessary to develop policies of balanced economic development and poverty alleviation, which lie in a somewhat separate policy domain from the equalization transfer program.

56. **Indirectly, equalization grants can contribute to balanced economic development mainly by preventing migration induced by disparities in the access to and quality of public services.** Over the longer period, certain types of public services typically entrusted to local governments, such as education, may also have a significant impact on poverty reduction and income inequality. Thus, equal access to public services which enhance the stock of human capital, such as education and health, can help narrow the disparities in economic development. Equalization grants should mostly aim to achieve equitable service provision.

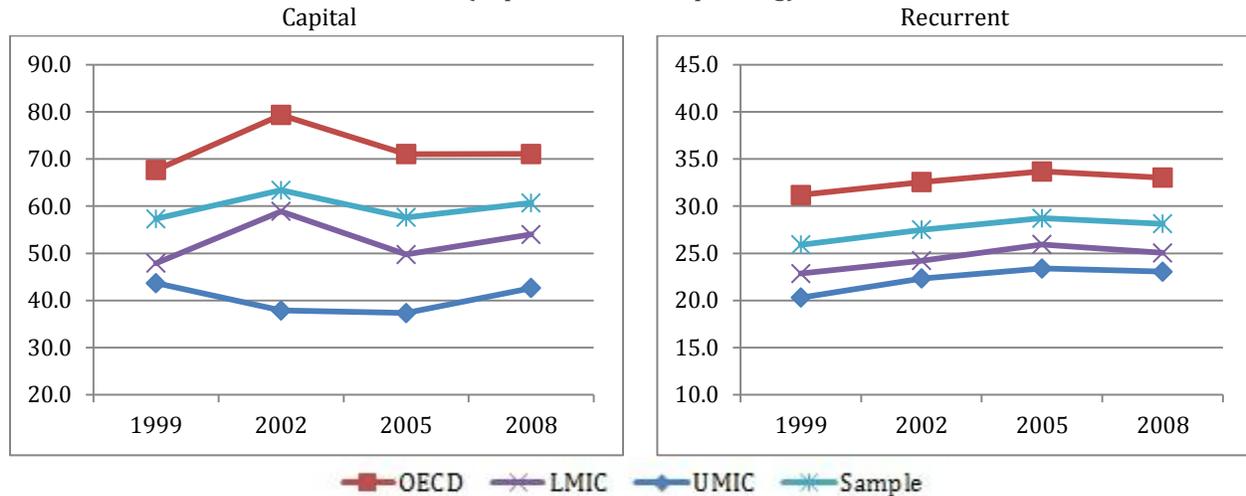
6. Subnational Public Investments and Borrowing

57. **Local governments have a limited role in public investment.** In 2013, subnational capital investment was quite low at 0.4 percent of GDP (little changed from 2011), out of total public sector investment of about 5-7 percent of GDP during 2011-13. With subnational governments accounting for 5-10 percent of public investment compared to the 22 percent subnational share in recurrent public expenditures in 2013, Kyrgyz Republic stands out from the rest of the world. Typically subnational governments tend to account for a larger share of capital expenditures than that of recurrent expenditures because municipal services tend to be more capital intensive than national functions, dominated by social services and income redistribution programs.²³ This is true for developing and developed countries, while on average, the subnational share of capital expenditures is 60 percent compared to the 30 percent represented by subnational governments in recurrent expenditures (Figure 10).

²³ Martinez-Vazquez, Jorge, and Andrey Timofeev. 2012. "Propensity to Invest and the Additionality of Capital Transfers: A Country Panel Perspective" International Studies Program Working Paper 12-16. International Studies Program, Andrew Young School of Policy Studies, Georgia State University.

Figure 10. Decentralization of Recurrent and Capital Expenditures, 1997-2008

(In percent of total spending)



Source: Martinez-Vazquez and Timofeev, 2012.

Notes: The sample includes 39 countries, out of which 6 lower middle income (LMIC), 10 upper middle income (UMIC), 2 non-OECD high income, and 21 OECD countries

58. **Local government investment spending is concentrated in housing and utilities.** Capital expenditures account for around 7 percent of subnational expenditures and, in all sectors other than housing and utilities represent less than 10 percent of subnational expenditures. However, three quarters of local government investment is concentrated in housing and utilities with local governments accounting for over three quarters of total public investment in this sector.

59. **While government recurrent spending should be met by revenues from taxes and other recurrent revenues, borrowing could be an appropriate way of financing capital projects.** Furthermore, unlike capital grants and intergovernmental loans, market-based borrowing improves the selection of projects. This principle applies to revenue generating capital projects, such as toll roads or public service utilities financed with fees and charges, and cost-saving projects, such as energy-efficient retrofitting of public facilities. The market efficiency in selection of such projects is due to lenders having (or being able to extract from local governments) better information than the central government and because local governments and lenders are motivated to be prudent as they bear the repayment costs or the default costs. Therefore, it is desirable to rely on the market approach as much as possible, rather than by-passing markets with capital grants. In many developed economies, a primary avenue for local capital development – both for urban as well as rural local governments - is local government borrowing.

60. **Adequate control mechanisms should be in place to minimize risks and contingent budget liabilities.** Despite the economic rationale for local government borrowing to finance capital expenditure, the experience of both developed and developing countries is that unsustainable borrowing by sub-national governments can create an implicit liability for the central government. Therefore, it is appropriate to have both limits on the amount of sub-national borrowing that can occur and for strong monitoring mechanisms to be in place to avoid fiscal crises at the sub-national level. The budget code currently being considered by the Parliament of the Kyrgyz Republic maintains the limits on outstanding borrowing at 20 percent of annual revenue as well as reporting mechanisms and a requirement to obtain the consent of the central government before borrowing can occur.

61. **At this stage only a few major cities in the Kyrgyz Republic borrow from private lenders for capital development.** The Law on the Financial and Economic Foundations of Local Self-Government allows for three forms of subnational debt (Art. 8-11): short-term (up to one year), medium-term (1-5 years), and long-term (over five years).²⁴ Borrowing is not allowed when the cost of servicing outstanding debt exceeds 20 percent of the annual local revenues net of borrowing. Municipalities can take short-term borrowing to cover temporary cash shortfalls with the obligation to repay them by the end of the fiscal year. Medium- and long-term borrowing is allowed only to finance capital investment or refinance existing medium- and long-term debt.

62. **The team working on this note was not been able to obtain data on the current stock of outstanding subnational debt to private creditors.** In 2013, local governments repaid KGS 110 million (0.03 percent of GDP) worth of securities (down from 225 million, or 0.08 percent of GDP in 2011) and issued KGS 110 million of new ones (down from 150 million in 2011).²⁵ In addition, during 2013, local governments paid KGS 12.8 million in interest on loans from foreign governments (down from 15 million in 2011) and KGS 17.5 million in interest on domestic securities (up from 17 million in 2011). Both the amount of principal or interest paid are relatively low compared to total local government budgets.

63. **Some municipalities are running arrears, even after receiving central government transfers to clear arrears.** According to the Ministry of Finance data, in 2012 municipalities had unpaid utility bills totaling KGS 129 million which corresponds to 14 percent of their annual utility expenses or 0.6 percent of their total annual expenditures. This level of arrears is observed after the national government has already transferred KGS 433 million in unplanned grants to clear utility arrears in the course of 2012. The level of utility arrears varied from zero in the cities of Bishkek and Osh to 2.5 percent of total expenditures in Chui oblast.

64. **Loans from other levels of government are not an important source of financing for local governments.** According to the Ministry of Finance, in 2012 there were no outstanding intergovernmental loans from the national government to municipalities. In 2013 local governments received KGS 100 million in intergovernmental loans from the central governments (during 2011 only KGS 2.8 million of intergovernmental loans were provided, all repaid within the same fiscal year). Before being written off in December 2011,²⁶ the City of Bishkek owed KGS 298 million (or 7 percent of its pre-transfer revenues) to the national government on the account of intergovernmental loans provided to cover public pay increases mandated by the national government in 2009-2010.

7. Conclusions

65. **Since the 2004 Public Expenditure Review Kyrgyz Republic has made some progress in reforming and updating its system of intergovernmental fiscal relations.** There are however a number of areas that could benefit from further reform and allow the country to realize the gains in public sector efficiency that can be derived from a well-structured system of intergovernmental fiscal relations. In this chapter a number of specific reform options are offered:

²⁴ Law on the Financial and Economic Foundations of Local Self-Government No. 215 of September 2003, last amended in January 2010 (Art 8-11).

²⁵ In 2011 total subnational expenditures were KGS 20.2 billion.

²⁶ National Parliament resolution No. 1460-V of December 29, 2011.

- Develop a comprehensive policy document laying out policy choices regarding the role of local governments and based on this document, clarify and rationalize the legal delineation of expenditure responsibilities.
- Consider broadening local revenue autonomy by allowing local governments to set different rates for some taxes, at least in cities.
- Consider the explicit use of per capita (or per client) expenditure needs in the equalization grant formula to increase the transparency of grant allocation. Expenditure needs can be calculated by applying an adjustment coefficient to capture the effect of some cost factors, such as those incurred by local governments in mountainous and remote areas.
- Combine all non-educational services provided by local-governments (aiyl okmotus) together under a single composite expenditure norm in the equalization grant formula. If equalization grants were to be provided to cities, then a separate expenditure norm could be used for expenditures on housing and utilities, because they have different underlying cost drivers.
- Consider assessing the revenue capacity for local governments' own sources of revenue (land and property taxes) on the basis of objective indicators rather than projections based on past collections.
- Pool the share of revenues from national taxes going to aiyl okmotu in a redistribution fund and then allocate to each aiyl okmotu on a formula basis. Such a mechanism would reduce the volatility of their revenues by offsetting cyclical fluctuations in tax payments from various businesses located in individual aiyl okmotus.
- Continue shrinking the share of ad hoc transfers (mutual settlements) while increasing the reliance on predictable and transparent formula-based grants.

66. **The success of decentralization in the country depends on the stakeholders agreeing on and clearly articulating the ultimate goals of the decentralization reforms.** This is important for a number of reasons. First, only clear goals can secure political support, which in turn can help work out the technicalities of implementation through the regular consultation process. Second, without a clear goal for an intergovernmental grants program, it is hard to choose the right design of the grant scheme that would achieve that goal. Different goals require very different grant designs. Finally, preceding future policy reforms with proper studies and consultations would make the overall system more predictable and thus allowing local governments to engage in medium-term planning of their activities.

67. **Trying to incorporate multiple objectives into the design of a single transfer instrument would take away from its simplicity and transparency.** Therefore, the equalization transfer mechanism should be seen exclusively as an instrument for fiscal equalization, instead of as an instrument to solve all sorts of intergovernmental fiscal issues. Issues related to national policy objectives and delegation of specific central government functions to specific subnational government units should be managed through other (sectoral or targeted) transfer instruments. Where those conditional grants target local performance, they should use objective data measuring performance in the areas where local governments have authority.

68. **It is also important to address the existing misconceptions regarding the role of revenue sharing.** In particular, this concerns recent attempts to reduce grant dependence of local governments by increasing the retention rates for the revenue from national taxes shared with local governments at the point of collection. Conceptually, this does not make local governments any

more self-reliant because tax revenue sharing is just another form of intergovernmental fiscal transfers. At the same time, derivation-based revenue sharing is less equitable and less predictable than formula-based sharing of revenue from national taxes. Furthermore, derivation-based revenue sharing makes fiscal equalization more difficult as there are no statistical indicators available that could objectively capture differences in taxable bases at the sub-region level. It would be more productive to reframe the self-sufficiency discussions in terms of a hard-budget constraint. This will require: i) reconsidering the way some transfers are allocated (mutual settlements, the second window of equalization grant); ii) replacing actual expenditures in formulas with statistically estimated expenditure needs and iii) estimating actual own-revenue capacity rather than using actual past collections. Formula-based revenue sharing, combined with adjustments for objective differences in expenditure needs, would provide each local government unit with a predictable budget envelope, allowing local governments to keep any gains they achieve in rationalizing their expenditures. In addition, it would improve overall budget certainty that would allow local governments to engage in multi-year planning, among other things required for managing their investment programs.

Annex 1. Local Functions Enumerated in the Local Self-Government Act

Other than general self-management powers, the organic law on local self-government (No. 99, art 18) enumerates the following specific functions of local governments:

- 1) Local economic development;
- 2) Management of municipal assets;
- 3) Residential water supply;
- 4) Sewerage and waste water treatment;
- 5) Maintenance of municipal roads;
- 6) Street lighting;
- 7) Ensuring the operation of funeral services and maintenance of cemeteries;
- 8) Landscaping and planting of greenery in public places;
- 9) Ensuring the operation of parks, sports and recreation facilities
- 10) Organization of collection and utilization of solid waste;
- 11) Ensuring the operation of public transport and the regulation of public transport within the boundaries of local settlements;
- 12) Protection of cultural and historic monuments of local significance;
- 13) Organization and providing for libraries of local importance;
- 14) Land use regulation;
- 15) Advertising on the territory of the settlement in accordance with the laws of the Kyrgyz Republic;
- 16) Facilitating the protection of public order;
- 17) Creating the conditions for the development of folk art;
- 18) Creating the conditions for recreation;
- 19) Organization of activities for working with children and youth
- 20) Providing conditions for the development of physical culture and sports;
- 21) Assist in the disaster prevention and relief;

In addition, the organic law on local self-government (No. 99, art 20) enumerates state competences that can be delegated to the bodies of local self-government by means of a national law:

- 1) Development and implementation of programs of employment and migration;
- 2) Residence registration, enforcement of the passport regime, voter registration;
- 3) civil registration in accordance with the laws of the Kyrgyz Republic;
- 4) provision of buildings and other facilities for the purpose of general and vocational education and healthcare, as well as for the provision of services of general and vocational education;
- 5) Provision of pre-school education;
- 6) Performance of notarial acts in accordance with the laws of the Kyrgyz Republic;

- 7) Issuance of proofs of identification, marriage status, property ownership, and other legal documents;
- 8) Registration for military service and facilitating the organization of conscription;
- 9) allocation and use of the land plots from the Land Redistribution Fund;
- 10) Synthesis of materials on the prospective development, preparation of economic forecasts for agricultural production;
- 11) Timely implementation of animal health and anti-epizootic measures, selection and breeding work in animal husbandry;
- 12) Provision of adequate measures to assist in combatting damage to crops by cattle, protection of cultivated crops, shelterbelts and forests;
- 13) Collection of taxes, charges, duties and insurance premiums from agricultural producers;
- 14) Development and implementation of measures to protect the environment;
- 15) Consumer protection.
- 16) Organization of heating in the jurisdiction;
- 17) Identification of indigent households for targeted social assistance;
- 18) Initial means-testing of households for monthly allowances for rural families with children set by the government of the Kyrgyz Republic.