

**Fiscal Decentralisation and Public Financial Management Reforms in Central Asia:  
Challenges and Opportunities.**

**Background Paper:**

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## Getting to Grips with the Basic Alignment of Fiscal Decentralisation and Public Financial Management

1. The government sector of virtually every country consists of more than one level of government. Typically, a country has a central government that exercises jurisdiction over the entire national territory. In addition, virtually all countries have one or more levels of sub-national government, which only exercise jurisdiction over a particular region, district or locality. Intergovernmental fiscal relations and fiscal decentralisation deal with how public expenditure is organised between these different levels of government and how it is financed. *Fiscal* decentralisation thus constitutes the public finance dimension to decentralisation *in general*, defining how and in what way expenditures and revenues are organised between and across different levels of government in the national polity. The precise nature of intergovernmental fiscal relations and fiscal decentralisation policy in any given country varies depending on how sub-national government and administration is organised. In recent years, transition countries have sought, to varying degrees, to decentralise functions and responsibilities to lower levels of government. The main reasons for such reforms are often political in nature, but governments have also adopted them as a way to improve service delivery and local government. At its core decentralisation can be defined as the “*transfer of authority, or dispersal of power, in public planning, management and decision making from the national level to the sub-national levels or, more generally, from higher to lower levels of government*”<sup>1</sup>. Decentralisation is not of a single type and can be classified along three dimensions **AND INTO THREE OPERATIONAL MODES**<sup>2</sup>:

Table 1: Dimensions and Modes of Decentralisation

Dimensions	OPERATIONAL MODES
<p><b>Administrative Decentralisation</b> - focuses on how responsibilities and authority for policies and decisions are shared between levels of government and how these are turned into allocative outcomes</p>	<p><b>Devolution</b> – the deepest form of decentralisation, in which a government devolves responsibility, authority and accountability to a lower administrative level with some degree of autonomy.</p>
<p><b>Fiscal Decentralisation</b> - focuses on the assignment of expenditures, revenues [inter-governmental transfers and/or revenue-raising authority] and borrowing among different levels of governments</p>	<p><b>Delegation</b> – Some authority and responsibilities for a service or function transferred by the government to an agent [state, for profit, non-profit], but with the agent remaining accountable to the government</p>
<p><b>Political Decentralisation</b> – focuses on how the voice of citizens is integrated into policy decisions and how civil society can hold authorities and officials to account at different levels of government</p>	<p><b>Deconcentration</b> – The shallowest form of decentralisation which involves the transfer of responsibilities to an administrative unit of central government, usually a field office or municipal unit</p>

2. Underpinning decentralisation is the principle of *subsidiarity*, which encapsulates the transfer of authority on the basis that services should be delivered by the lowest level of government capable of providing the service. **IT IS EASY FOR** advocates to get enthusiastic about the opportunities of fiscal decentralisation as a panacea for economic development and public administration reform, while underplaying the necessary wherewithal to capture the

<sup>1</sup> Rondinelli, D. [1981] [1983]

<sup>2</sup> Borgenhammer [1993] [1990]

economic benefits which are posited to include: shifting finances “closer to the people” [Musgrave 1959, Oates 1999]; a more efficiently sized public sector [Brennan and Buchanan 1980]; and improved allocative efficiency and more innovation through competition in the public sector<sup>3</sup> [Tiebout 1956, Breton 1996]. These potential effects of fiscal decentralisation are hard to measure<sup>4</sup> and relatively abstract, and the evidence of practical concerns and potential cost of decentralised finance [Breton and Scott 1978] – including macroeconomic instability, lack of fiscal discipline, inefficient spending arising from weak local administrative capacity, local elite capture and local corruption – carry significant weight in implementation. Indeed, the route towards greater levels of fiscal decentralisation has been characterised as having “dangers” [Prud’homme 1994], “**PITALLS**” [Tanzi 2001], and an absence of evidence on a “causal link between decentralisation and improved service delivery” [World Bank 2008]. While there is broad agreement that central government should have responsibility for aggregate fiscal discipline, the primary concerns voiced about the efficacy of fiscal decentralisation can, in part, be attributed to the question of whether some countries have “the economic, institutional and administrative wherewithal to capture the benefits” [Bahl 2008]; and partly to fragmented approaches that drive the reform of intergovernmental relations. Broadly speaking, the drivers for fiscal decentralisation can be delineated into **FOUR NON-MUTUALLY EXCLUSIVE APPROACHES**<sup>5</sup>:

- As **public finance management reform** with the limited goal of encouraging fiscal discipline, improving the efficiency of the budget, and improving the effectiveness of public finances – often driven by the Ministry of Finance;
- As mechanism in the wider context of **governance** reforms aimed at reducing the monopoly of central government over political, territorial and economic space by distributing power and resources between national and sub-national levels of government with a view to improving participatory governance, community empowerment, and improving accountability of public officials to citizens – often driven by the Ministry of Local Government;

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<sup>3</sup> In principle, fiscal space can be created by improving the allocative and technical efficiency of government expenditures, thereby allowing more outputs in terms of public goods and services to be produced for a given amount of budgetary resources. However it is very difficult to quantify in a rigorous manner the magnitude of expenditure inefficiency and the potential scope for creating fiscal space through efficiency improvements.

<sup>4</sup> Methodologies exist for quantifying the technical efficiency of government expenditures. Herrera and Pang [2005], for example, estimate the technical efficiency of education and health expenditures in a sample of 140 countries using the Free Disposable Hull [FDH] and the Data Envelopment Analysis [DEA] methodologies: these methodologies involve estimating an efficiency frontier, which represents the level of efficiency reached by the most efficient country in the sample, from a production function linking inputs [sectoral government expenditures] to sectoral outputs [indicators of health status and educational attainments]. However, there are serious weaknesses in the data which impede any comparison of expenditure efficiencies. In particular, the measures of outcomes in key areas such as health and education are unreliable. In addition, the production frontier methodology takes no account of factors of production other than government expenditure which could have a significant impact on output indicators. Government expenditures often comprise only a small share of total expenditure in health and education sectors; and it is difficult to distinguish the impact of government health and education spending on health and education outcomes from that of health and education expenditures from other sources. Furthermore, the efficiency frontier methodologies only apply to technical inefficiency, not to allocative inefficiency.

<sup>5</sup> The first three approaches tend to focus on policy interventions that largely take place at the central level, and the impact on the quality of local governance and local public service delivery is often observed in indirect forms. While the latter focuses on line ministries and sub-national localities, but is often unhinged from the wider institutional dynamics of fiscal decentralisation reforms initiated at the level of central government.

- As a mechanism for **public administration** reform with an emphasis on improving efficiency and equity in the way resources are managed across government or within a sector – often linked to PFM or governance driven reforms;
- As a mechanism for strengthening **local service delivery** – such as education, health, and social protection - often driven by sector line ministries.

### 3. A COMPREHENSIVE APPROACH TO FISCAL DECENTRALISATION

**SHOULD**, ideally, incorporate all four drivers because fiscal decentralisation reforms tend to fail when the devolution of fiscal resources is not accompanied by appropriate local governance mechanisms, or when policy reforms at the central level are not accompanied by sector specific level measures that impact on service delivery at the local level. The challenge for fiscal decentralisation is often further compounded by diverging institutional incentives within central government, and misalignment between line ministries towards fiscal and non-fiscal [i.e., governance, public administration, and sector service delivery] components of fiscal decentralisation. Without alignment between Ministries of Finance, Ministries of Local Government and line ministries – such as those with responsibilities for education, health and social protection - fiscal decentralisation is less likely to succeed. Thus, unless all four drivers are embraced – for example, through a sector-wide approach - the chances of success with fiscal decentralisation are significantly diminished. It is, therefore, useful to have the merits and risks of decentralisation firmly in sight in looking at alternative ways of achieving particular outcomes from fiscal decentralisation in social sectors [Table 2 below provides an overview of the benefits and risks associated with different modes of fiscal decentralisation], and an appreciation of the extent to which fiscal decentralisation is aligned with the basic components of the Public Financial Management [PFM] system i.e., aggregate fiscal discipline, the achievement of strategic priorities and a focus on value for money.

**Table 2: Benefits and Risks in Modes of Decentralisation**

Type of Decentralisation	Merits	Risks
<b>De-concentration</b>	Reduced need for central administrative bodies <b>AND ENABLING ENVIRONMENT CREATED FOR LOCAL INNOVATIONS</b>	Unacceptable variations in practice, and increased fragmentation
<b>Devolution</b>	More local decision-making and opportunities for more people to gain influence, and less centralised power	Lack of political control and oversight at the centre
<b>Delegation</b>	Faster implementation of decisions	Less influence of professional values, and difficulty in maintaining quality and efficiency if decentralised units are too fragmented and lack technical and fiscal capacities

4. The Public Financial Management [PFM] system is basically about the tools, routines and procedures that are used to align the policy cycle with the budget cycle and focuses not just on applying the right routines and procedures, but also on the efficiency with which government institutions – at national and sub-national levels - operate. Governments whose policies and interventions are largely funded through taxes and, who have to report to elected parliaments, face three major questions when they plan, implement and their PFM systems:

Table 3: **The Basic Questions for the PFM System:**

Basic Questions	Explanatory Tasks
How to maintain fiscal discipline	Make sure spending is affordable - that is, to keep spending within government's ability to raise revenue and to keep debt within levels that are not prohibitively expensive to service;
How to promote strategic priorities	Use the budget to achieve key goals - that is, to allocate resources in those areas which make greatest contribution to the government's objectives;
How to deliver public value	Maximise net benefits of spending for people – that is to aim for the most efficient ways of spending and selecting appropriate systems of delivery to implement strategic priorities.

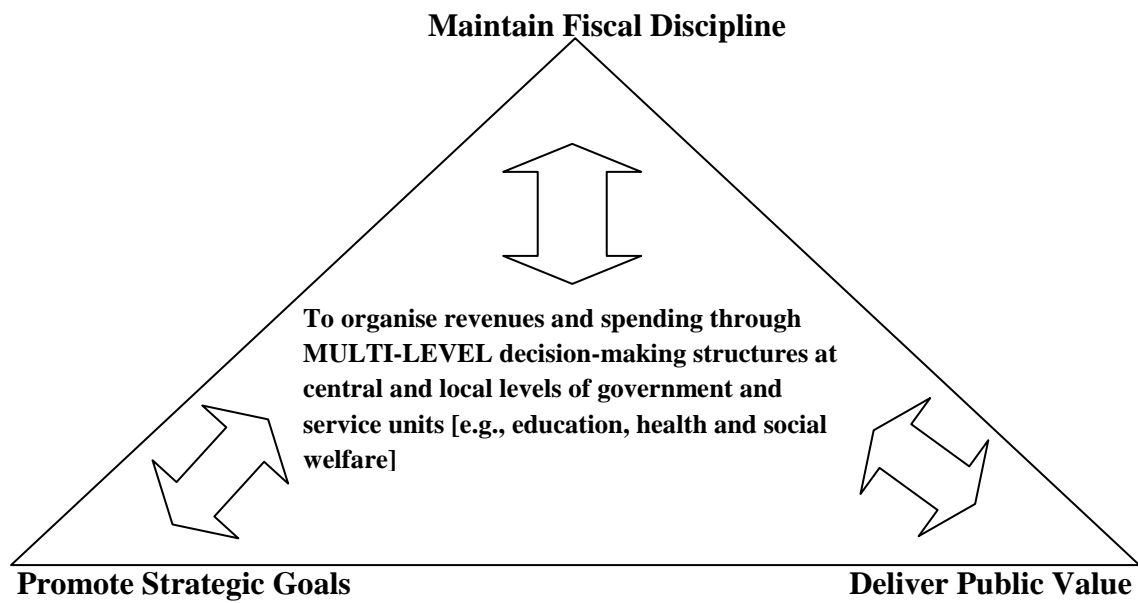
5. There are risks associated with omitting these questions when assessing options for fiscal decentralisation. The three questions posed in PFM are interdependent and, ideally, should reinforce each other, in practice this is not always the case. Governance, financial and administrative pressures can bias attention towards one or another task. This creates risks of achieving isolated short-term usually unsustainable benefits at the expense of significant long-term losses. Examples of such risks include:

- Reforms become misguided as a result of misunderstandings between agencies. Policy makers may develop strategic reform goals in specific sectors without due consultation with financial authorities regarding their budgetary implications. In such cases, laudable reform initiatives may meet unnecessary internal resistance. Moreover, practical implementation of such initiatives may be distorted and delayed by financial constraints, creating perverse outcomes and discrediting the reform process.
- Short-term fiscal concerns undermining strategic prioritisation and delivery of public value. It is reasonable for the government to strongly focus on fiscal discipline – that is, on matching expenditures to available resources. However, governments often pursue fiscal discipline through methods which overlook the tasks of making expenditures more strategic and more efficient.

6. The division of administrative and financial roles between participants of the PFM process significantly affects the ability of countries in general to manage fiscal decentralisation successfully. In particular, addressing each of the three questions listed in Table 3 above depends on the specifics of the following interactions:

- **BETWEEN THE LEGISLATURE, THE EXECUTIVE AND JUDICIARY ARMS OF POWER;**
- Between key national agencies, including line ministries and the Ministry of Finance;
- Between the national and sub-national tiers of government; and
- Between government, private sector and civil society

Figure 1: **PFM Interactions – Inter-governmental finance and decentralisation**



7. In order to accurately assess policy or reforms related to public finance along the dimensions of: (a) maintaining fiscal discipline and affordability; (b) strategic appropriateness; and (c) public value for money, it is important to consider how delivery will be affected by the division of roles between national and sub-national tiers of government. Moreover, in **MULTI-LEVEL** decision systems, fiscal relationships between the different governmental layers usually represent a particularly big complication for understanding public spending and which have to be understood and overcome to sustain the momentum of reform. Comprehensive assessment of any actions financed through public expenditures [whether current programmes or planned reforms] therefore need to establish, to what degree such actions are helping or **HINDERING** achievement of all the three tasks. For the social sectors, notably education, health, and social protection, the quality of services provided to the population is impeded not just by competing demands for aggregate resources, but by serious weakness in the way resources are allocated and in the way resources are spent.

### **Opportunities and Challenges for PFM, Governance and Fiscal Decentralisation in Central Asia: Tajikistan, Kyrgyz Republic and Kazakhstan**

8. The types of public finance management systems in Central Asian countries, despite their common origins in the Soviet system, depend very much on the organisation of their budget systems and on their systems of governance. This variety can be explained by different sizes of the countries, the level of economic development, the extent of heterogeneity in terms of population, revenue structures, and the actuality and risk of conflict. Indeed, the creation of states in Central Asia – in a sudden and unexpected manner – contributed to an emphasis on defining their legitimacy and territorial boundaries without a

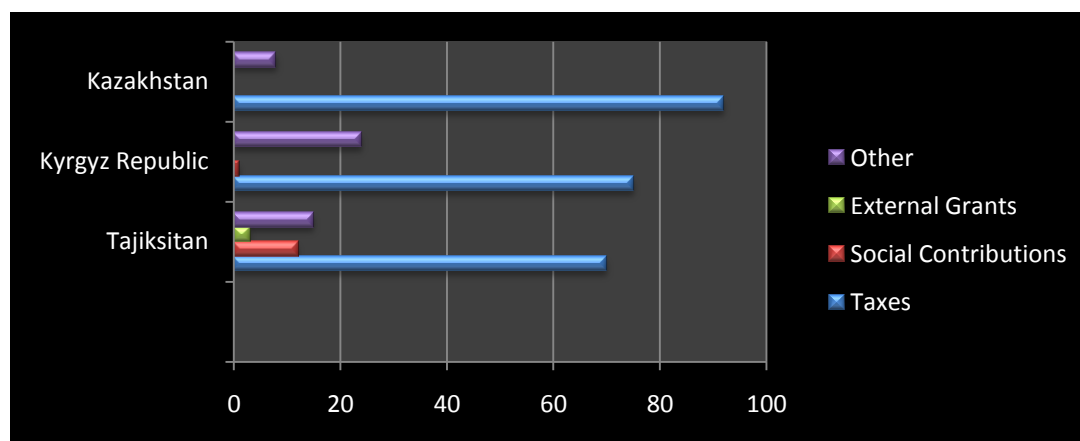
period of preparation for assuming the powers and functions of a state<sup>6</sup>. In this political environment, dominant power structures looked on decentralisation as a mechanism that could – potentially – lend support to separatist and ethnic aspirations that were either latent or vocal. Any indication of providing more powers and authority to sub-national levels, where loyalties were not to the new nation state could have appeared as a signal of weakness, rather than progress towards building fiscally decentralised systems of governance [Joshua 2008a].

9. A full discussion of fiscal decentralisation across all Central Asia states would require more space than can be captured in this background paper, and for the sake of brevity attention is devoted to opportunities and challenges in the PFM and governance systems in just three states: Tajikistan, Kyrgyz Republic and Kazakhstan. The empirical analysis<sup>7</sup> draws on PFM and governance reviews [Joshua 2008b, 2008c, and 2009] undertaken for the UNICEF regional office as part of a regional initiative to scale-up policy level engagement with PFM, Governance and Social Policy in the CEE-CIS region; and, in the context of advancing policy dialogue on Medium Term Expenditure Frameworks [MTEFs] which – in the context of sustaining aggregate fiscal discipline and establishing credible budgets - have been one of the drivers for fiscal decentralisation.

### The Structure and Composition of Government Budgets:

10. In all three countries taxes [see Table 4] are the main source of government revenues ranging from 70 per cent in Tajikistan; 75 per cent in Kyrgyz Republic to 90 per cent in Kazakhstan<sup>8</sup>] followed by social contributions, other revenues, and external grants – with Tajikistan being the largest recipient of the latter and Kazakhstan registering none.

Table 4: Structure of Central Government Revenues [%]



Source: IMF: GFS 2007

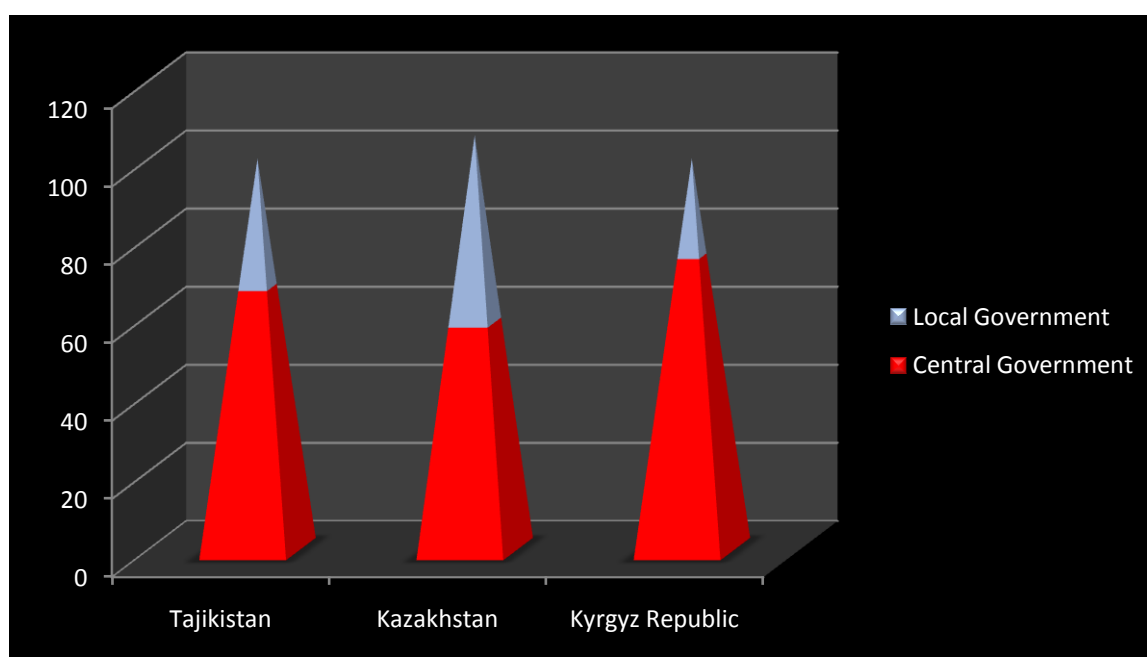
<sup>6</sup> Other conflicts that developed in transition states – such as the Caucasus and the Western Balkans, appear to have created substantial anxieties among ruling elites in Central Asian countries, and clan based and ethnic divisions also appear to have played a part in undermining the political will to support the functions of an effective decentralised state. For a discussion on the history behind the situation in Central Asian states see the Central Asia Human Development Report for 2005: *Bringing Down Barriers: Regional Cooperation for Human Development and Human Security*, published by UNDP.

<sup>7</sup> The data is based on IMF General Financial Statistics 2007

<sup>8</sup> In IMF GFS 2007 data on social contributions is not separated from taxes for Kyrgyz Republic and Kazakhstan.

11. In all three countries central government controls more than 60 per cent of the general government budget [see Table 5]. In all three countries the share of public expenditures that are made sub-nationally [i.e., the expenditure decentralisation ratio, or EDR] is less than 40 per cent. This rather large share can be accounted for by the comparatively large shares allocated to social protection, the relative size of each state's population, and the extent to which fiscal decentralization has been implemented through the process of delegation rather than devolution or de-concentration<sup>9</sup>. The EDR can be seen as a measure of the degree of **ANTI**-decentralisation, given that sub-national tiers of government do not have full control over the financial resources of their government level – see Figure 2 and Annex 1 – and as such does not provide an adequate measure of the share of public resources over which sub-national governments and their constituents are empowered to make decisions on allocations.

**Table 5: Structure of General Government Expenditures in Tajikistan, Kazakhstan and Kyrgyz Republic**



Source: IMF GFS 2007

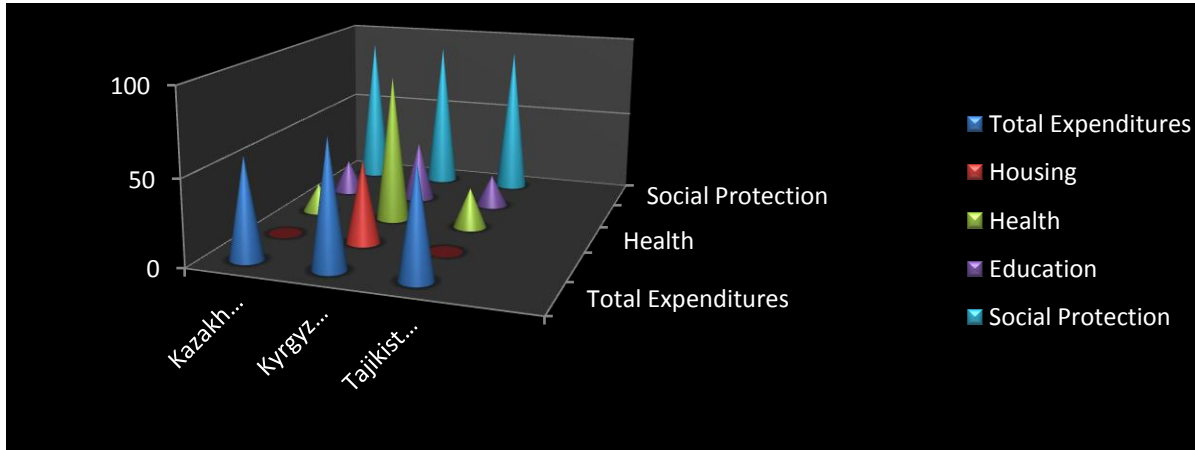
12. In terms of social sector spending [see Table 6], 90 per cent of social protection<sup>10</sup> in all three countries is provided by central government; while education varies from high of 36 per cent in Kyrgyz Republic, to around 20 per cent in Kazakhstan and Tajikistan; and in health central government contributions range from 88 per cent in Kyrgyz Republic through

<sup>9</sup> See Table 1

<sup>10</sup> Extra budgetary funds [EBFs] – particularly for social contributions - usually have dedicated revenue sources, and are legal entities in their own right with budgets separate from the central government budget. Pension funds are the largest EBFs. The main rationale – albeit questionable - for extra-budgetary funds, given their insurance base, is to keep them separate from other redistributive social expenditures [e.g., health, education, housing etc]. **SOCIAL SECURITY SCHEMES** have significant redistributive mechanisms - such as minimum pension, and unemployment benefits - which are paid regardless of individual contributions. A second rationale is to earmark revenues for particular purposes such as health funds – such arrangements reduce the fungibility of government resources. Kazakhstan also has an oil fund which is used to smooth revenue flows for financing regular expenses such as social expenditures.

to around 20 per cent in Tajikistan and 17 per cent in Kazakhstan. Only Kyrgyz Republic plays a role in providing expenditures to cover housing and community amenities.

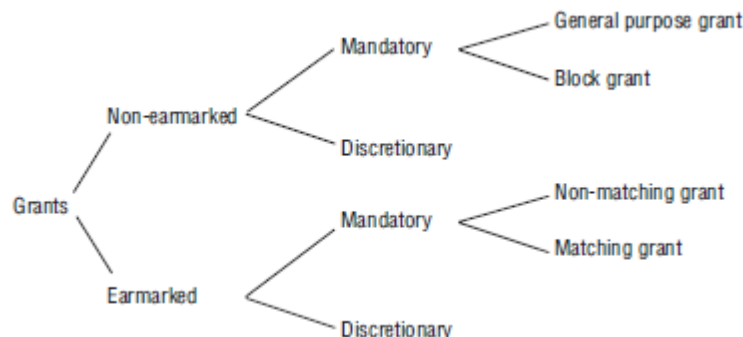
**Table 6: Shares of Central Government in General Government Expenditures: Education, Health and Social Protection and Housing**



Source: IMF GFS 2007

13. Taxes are one of the main revenues of local governments, and their share in total local government revenues vary from around 90 per cent in Tajikistan, to around 60 per cent in Kazakhstan and 40 per cent in Kyrgyz Republic. These are mostly comprised of land and property taxes [which usually accrue to the lowest level of government] and personal and corporate income taxes [which shared between sub-national and national budgets. However, amounts raised through local taxes are not sufficient to finance implementation of government functions that are delegated to local levels. To fulfil these functions local governments receive large transfers from central government<sup>11</sup> [see Figure 2]. In Kyrgyz Republic and Kazakhstan these inter-governmental transfers perform a larger role than locally collected taxes [see Table 7]. The relative size of transfers depends on the extent to which specific functions are delegated. However, in some instances functions – such as community-based social care services and early child education – can be delegated to sub-national levels without corresponding inter-governmental transfers and in effect become unfunded mandates due to the limited scope of the local revenue base.

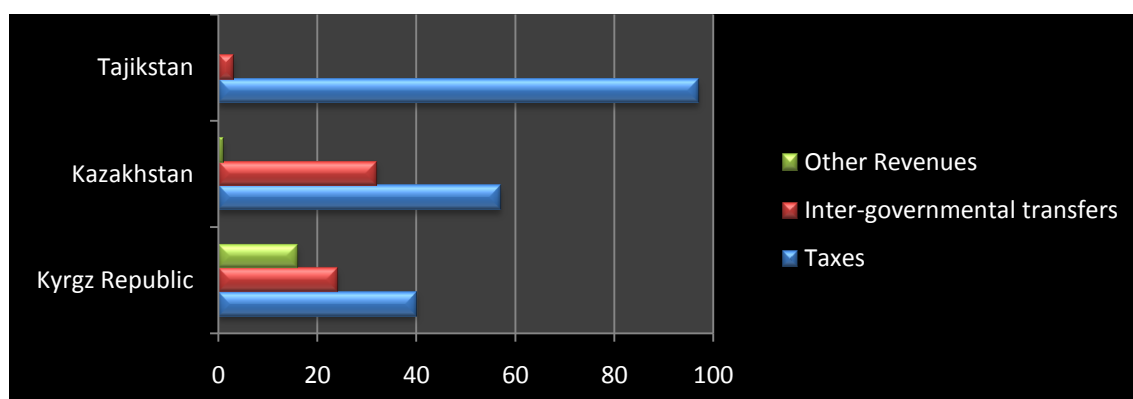
**Figure 2: Types of Intergovernmental Transfers and Grants**



Source: Bergval et.al [2006]

<sup>11</sup> See Annex 1 for a delineation of inter-governmental transfers and grants

**Table 7: Structure of Local Budgets Revenues in Tajikistan, Kazakhstan and Kyrgyz Republic**



Source: IMF GFS 2007

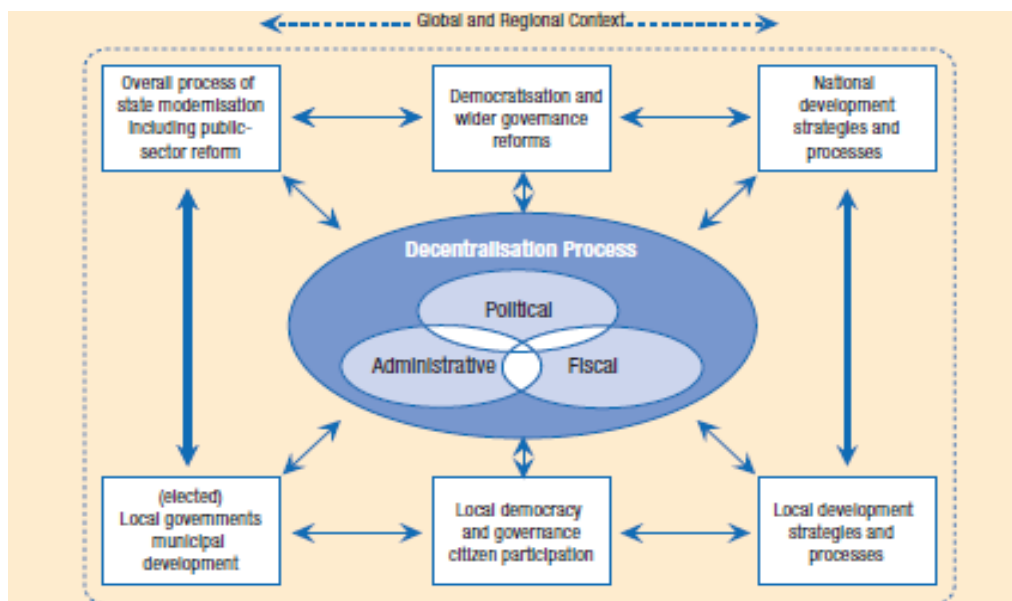
### Measuring the Impact of PFM and Fiscal Decentralisation Reforms:

14. Measuring progress in PFM and decentralisation reforms in Central Asian states – in terms of outcomes - is a complex task and partially reflects the limits of the current state of knowledge on real world reforms. This is evident from uncertainties surrounding the effectiveness of fiscal decentralisation, and the absence – in the empirical literature – of conclusive evidence as to whether fiscal decentralisation initiatives are – as a rule – associated with improvements in public service delivery or improved public service delivery outcomes, or whether the risks and failures of fiscal decentralisation – such as macroeconomic instability, local corruption or local elite capture – outweigh the potential benefits of reform. A common problem encountered with fiscal decentralisation reforms is the extent to which there is a disconnection between the devolution of fiscal resources [such as intergovernmental resources from central government] and the nature and functioning of sub-national political institutions. Indeed, many sector policy reforms, in particular, those in education, health and social protection imply changes in financing and governance mechanisms [such as the transition to per capita financing<sup>12</sup> of services that replace input-based methods].

15. **A CONSENSUS IS GRADUALLY EMERGING AROUND FISCAL decentralisation approaches which places governance centre stage, emphasises an “open systems” approach, focuses on looking beyond the traditional pillars of decentralisation, and incorporates the non-fiscal aspects of decentralisation [Rodden 2006, Weingast 2006, EC, 2007].** In essence, the “open systems” approach explicitly brings together the core components of PFM and the benefits from fiscal decentralisation – whether in terms of improved economic growth, improved public service outcomes, or improved allocative efficiency due to greater sub-national discretion over public resources – and predicates reform on the need to have appropriate intergovernmental and sub-national institutions in place. The shift in approach to fiscal decentralisation is captured in Figure 3 below

<sup>12</sup> Per capita financing is based on the principle of ‘money following the user’ and is associated with giving managers of schools, hospitals, social care services etc greater administrative autonomy, and flexibility in planning and using budgets. It is also associated with allowing local communities to be more fully involved in the affairs of the service. Per capita financing is usually combined with formula funding and focuses on managing budgetary constraints, efficiency, equity and autonomy.

**Figure 3: An “Open Systems” Approach to PFM and Fiscal Decentralisation**



Source: EC 2007

16. In operational terms, the importance attached to governance and institutions – alongside fiscal stability - is demonstrated in the emergence of the Public Expenditure and Financial Accountability [PEFA]<sup>13</sup> as tool for assessing progress of PFM reform. PEFA was launched in 2005 and has been applied so far in over 60 countries. Unlike other diagnostic tools for reviewing PFM systems - including Country Financial Accountability Assessments [CFAA], Country Procurement Assessment Reports [CPAR] and Reports on the Observance of Standards and Codes [ROSC] - PEFA focuses on improvements in performance based on a framework consisting of 28 indicators [with an additional three dedicated to donor practices], which attempt to capture the capacity of country PFM systems to deliver positive outcomes across seven key PFM areas: (i) budget credibility, (ii) transparency and comprehensiveness, (iii) policy-based budgeting, (iv) predictability and control in budget execution, (v) accounting, recording and reporting., (vi) external scrutiny and audit, and (vii) donor practices. PEFA provides:

- Information to stakeholders [both government and donor agencies] on current strengths and weaknesses of PFM systems at a broad level
- Support to stakeholder dialogue on PFM, including on PFM reform measures
- A baseline for measuring future progress on PFM improvements [but only with caution]

Table 8, below, provides an **OVERVIEW OF TRANSITION** countries that have conducted PEFA assessments.

<sup>13</sup> PEFA is an initiative jointly funded by the World Bank, the European Commission, the UK DFID, the Swiss Government, the French Government and the IMF. Assessments are undertaken in close collaboration with governments and information about PEFA country review reports can be accessed at [www.pefa.org](http://www.pefa.org)

Table 8: PEFA Assessments

Country	PEFA Review Status	Country	PEFA Review Status
Albania	2006	FYR of Macedonia	2007
Armenia	2008	Moldova	2006, 2009
Azerbaijan	2008	Montenegro	2009
Belarus	Started	Russia	2007
Bosnia and Herzegovina	2009	Serbia	2007
Croatia	No	<b>Tajikistan</b>	<b>2007</b>
Georgia	2008	Turkmenistan	No
<b>Kazakhstan</b>	<b>No</b>	Ukraine	2007, 2009
<b>Kyrgyz Republic</b>	<b>2006, 2009</b>	Uzbekistan	No

17. PEFA assessments are a unique source of information and although the reviews consider sub-national finances, more often than not, sub-national expenditures are relegated a secondary role. To the extent that the use of intergovernmental transfer resources and local revenues are considered in the context of PFM reviews, the emphasis tends to be on the relative inefficiency of local public spending [rather than on the inefficiency and ineffectiveness of central spending]. There is clearly scope for the PEFA tools to be adapted and modified to give greater prominence to fiscal decentralisation and to assess performance related outcomes in key areas of governance and institutional matters associated with social policy.

#### **Governance and Institutions Matter:**

18. The development of more decentralised systems of governance in Central Asia has lagged behind other regions, particularly when compared with countries in Central Europe where accession to the EU has been a key driver; but also compared with countries in South Eastern Europe [e.g., Macedonia, Albania, Serbia] and the Caucasus [e.g., Georgia, Armenia and Azerbaijan]. Quantification of the governance situation in Central Asia countries is possible using the *World Bank Governance Indicators*<sup>14</sup>, which utilise a composite of indicators from surveys and other sources to provide a percentile ranking of countries linked to six governance factors:

- Voice and Accountability,
- Political Stability and Absence of Violence,
- Government Effectiveness,
- Regulatory Quality,
- Rule of Law, and
- Control of Corruption.

The governance indicator data for the three countries is presented in Table 9 below.

<sup>14</sup> The indicators and ranking of countries can be assessed at: [www.worldbank.org/wbi/governance](http://www.worldbank.org/wbi/governance)

Table 9: **World Bank Governance Indicators [Percentile Ranking 0-100]**

Indicator	Kyrgyz	Kazakhstan	Tajikistan
1. Voice and Accountability	22.7	15.0	15.9
2. Political Stability & Absence of violence	13.7	46.7	9.4
3. Government Effectiveness	20.6	29.2	12.4
4. Regulatory Quality	24.8	35.1	15.8
5. Rule of Law	13.5	26.6	16.9
6. Control of Corruption	13.8	18.2	11.8

Source: World Bank Institute Governance Indicators, 2006

20. The salient feature of these governance indicators is that two of **THE** three Central Asian states are generally in the bottom 25 percentile on practically all of indicators. Only Kazakhstan has scores that are above the 25-percentile level of indicators. Other widely used indicators also bear out the state of governance and institutions is the *Transparency International Corruption Index*<sup>15</sup>, which has the Central Asian states ranked below the first 100 countries in the degree of corruption. Kazakhstan stands at 107<sup>th</sup>, Kyrgyz Republic at 130<sup>th</sup> and Tajikistan at 144<sup>th</sup>. In addition, trends in political and economic governance can be measured using the *Bertelsmann Transformation Index*<sup>16</sup>, which records a decline in the ranking of all three countries between 2003 and 2006. This illustrated in Table 9 below:

Table 10: **Transformation Index:**

	Country Ranking	Country Ranking
	2003	2006
<b>Kazakhstan</b>	61	66
<b>Kyrgyzstan</b>	69	78
<b>Tajikistan</b>	100	102

Source: Bertelsmann Transformation Index, 2006

21. Taken together these indicators reveal some aspects of trends in the governance system in these countries, and the data needs to be assessed as part of the overall objective of implementing decentralisation policies linked to local government reforms. Participatory mechanisms, efficient sub-national administration and downward accountability provided by sound effective institutions are clearly important factors in the governance and institutional environment, but intergovernmental fiscal reform will not always require greater

<sup>15</sup> The CPI uses an eclectic mix of third-party surveys to sample public perceptions of corruption through a variety of questions, ranging from "Do you trust the government?" to "Is corruption a big problem in your country?". **THE SURVEYS, WHICH CAN BE ACCESSED AT [www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi) NEED TO BE TREATED WITH CAUTION GIVEN THE MIX OF SOURCES AND INABILITY TO OFFER DIRECT EXPLANATION OF CAUSES.**

<sup>16</sup> The Index can be accessed at [www.bertelsmann-transformation-index.de/155.0.html?&L=1](http://www.bertelsmann-transformation-index.de/155.0.html?&L=1)

decentralisation: sometimes more centralisation or qualitative improvements in intergovernmental fiscal or institutional architecture will be warranted, especially when the possibilities for achieving relatively accountable sub-national governments are weak. Engagement with the governance and institutional environment therefore needs to take account of constitutional arrangements; the budget law and the budget cycle; taxation frameworks; public administration reform; decentralisation – including the assignment of local government competencies, the assignment of revenues and expenditures, and intergovernmental transfers; auditing, monitoring and evaluation regimes, and sector specific strategies – such as education, health and social protection. Streamlined, more transplant budget and policy systems can be of some help. However, given the wide-ranging nature of fiscal decentralization reforms in the real world, the current state of knowledge on fiscal decentralization in Central Asia, and data from governance and institutional indicators, a degree of scepticism is understandable, but misplaced, with regarding the prospects for fiscal decentralisation.

22. Integrating the basic questions that **ARE** of concern to the PFM system alongside governance and sector policy into fiscal decentralisation – through an “open systems” approach – creates opportunities for renewed focus – by domestic governments and external partners - on the following:

- The need for sound economics and sound public administration that enable budgetary resources to flow in a manner that links resource allocations as closely as possible with policy objectives and the desired policy outcomes;
- The need for greater alignment between fiscal decentralisation and the simultaneous decentralisation of [some] political power, political accountability and administrative control at the sub-national level. **PROGRESS ON ALIGNMENT IS DEPENDENT ON THE EXTENT TO WHICH CENTRAL-LOCAL POWER RELATIONS ARE PREDOMINANTLY BASED ON CONSENSUS OR CONFLICT;**
- The need to recognise that rather than focusing on fiscal decentralisation as an end-point in itself, reforms should be seen as a gradual and iterative process that involves explicit recognition that fiscal decentralisation is both a technical and political process;
- The need to integrate fiscal decentralisation and local governance into PEFA assessments – particularly with regard to social sector policies – with a view to improving sub-national budget transparency and introducing results based budgeting that empowers local communities;
- Developing realistic expectations about the benefits and risks of fiscal decentralisation in transition country contexts, and recognise the distinctive attributes of the dimensions and modes of decentralisation that are suited to particular sectors and circumstances.

## **Concluding Observations:**

23. Fiscal decentralisation is clearly relevant to policy environments of Central Asian states, but external partners should resist the temptation of pursuing fiscal decentralisation as an article of faith, and need to substantiate – and where appropriate, qualify – the potential benefits of decentralisation. In a similar vein, external partners that aim to promote fiscal decentralisation – whether as an ingredient of public finance management, governance, public administration, or improving service delivery – should give greater weight to considering the gradual and iterative nature of decentralisation and the possible sequence of reforms. As such, steps need to be taken on three fronts to move the agenda of fiscal decentralisation and intergovernmental finance in Central Asian states:

### **[SPACING OF POINTS LISTED BELOW]**

- (i) Widen and deepen the understanding of fiscal decentralisation through evidenced-based analysis of each country and within regions of each country;
- (ii) Take note of the systemic nature of fiscal decentralisation and not underestimate the merits of a “joined-up government reform” approach; and
- (iii) Shift away from discrete technical assistance projects and widen the scope to take account of institutional insights, the agility of policy, and right technical expertise to analyse and implement the right combination and sequence of interventions.

## Annex 1:

### Intergovernmental Transfers and Grants

1. The assignment of revenue sources rarely provides local governments with sufficient revenues to fund their expenditure functions, intergovernmental transfers are often necessary to assure revenue adequacy. Transfers are grants from one level of government to another [usually from higher to lower governments] for the purpose of funding public services. The term “transfer” is often used interchangeably with the term “grant.” In some transition countries, transfers may also be known under different names, such as “subventions” or “local government subsidies.” Transfers can be used for a wide variety of purposes. They can be used to:

- Ensure “vertical” fiscal balance [providing additional resources to the local level, so that there is a balance between the fiscal needs and resources available to different levels of government];
- Ensure “horizontal” fiscal balance [ensuring fiscal balance in resource allocations between government units at the same level of government];
- Ensure the funding of specific national priorities; or
- Ensure that the effects of inter-regional spill-over’s, or externalities, are counteracted.

2. Intergovernmental transfers aim to provide sub-national governments with a source of revenue in addition to the sub-national tax base. A central government may choose to provide transfers, rather than extend the sub-national tax base or tax-sharing arrangements, either because of the distortionary effects of sub-national taxes or the high administrative costs of sub-national tax collection, or because it wishes to control sub-national spending. Furthermore, transfers are perceived as necessary if the central government imposes new programmes or extends the legal minimum standards of sub-national service delivery [the alternative being that sub-national jurisdictions would have to cut back on existing services or increase tax rates, which is commonly seen as unfair or counterproductive].

3. In transition countries there are many types of intergovernmental transfers in use [see Figure 2 in main text]. Transfers can be either earmarked or non-earmarked. An *earmarked grant* is a transfer that is given under the condition that it can only be used for a specific purpose [e.g., payment of teachers’ salaries or some types of social benefits]. *Non-earmarked grants* can be spent as if they were the receiving sub-national government’s own [non-earmarked] tax revenues. Both earmarked and non-earmarked transfers can be either mandatory or discretionary. *Mandatory grants* [entitlements] are legal, rules-based obligations for the government that issues the grant. This requires that both the size of the transfer and the conditions under which it is given be laid down in a law or executive decree and that these conditions are both necessary and sufficient. Most transfers that are given to sub-national governments on a regular basis are mandatory. The size of *discretionary grants*, and the conditions under which they are given, are not determined by rules but decided on an

ad hoc, discretionary basis. Discretionary transfers are often temporary in nature and include, for example, grants for specific projects or programmes, or emergency support to an area affected by disaster.

4. Earmarked mandatory transfers can be matching or non-matching. *Matching grants* complement sub-national contributions. Matching transfers are dependent on normative or actual spending for services for which the transfers are earmarked or on local revenue collection related to these services. All mandatory earmarked transfers that are not given to complement sub-national contributions are *non-matching*. Mandatory earmarked transfers may also be dependent on contingencies other than sub-national contributions, for instance on local circumstances or performance indicators: in these instances, the transfers are considered as non-matching. A decisive question is whether the decrease in sub-national spending would automatically lead to a decrease in the transfer.

5. Non-earmarked mandatory transfers can be general purpose or block grants. Both types are similar in that they increase the sub-national governments' revenue without changing relative prices in the provision of services. The difference is that a block transfer is given by the grantor for a specific purpose [or purposes]. However, because the transfer is not earmarked, the grantee's actual use of the transfer is not controlled. Instead, the output can be regulated through, for example, a set of minimum standards that the sub-national government has to meet. In this case, resources are transferred to the sub-national governments to cover all or part of the cost for certain sub-national services. The criteria used to calculate the level and distribution of the transfer are usually connected to the normative cost of providing the goods or services for the sector as a whole, using variables that a specific sub-national government cannot directly control. The rationale for this type of transfer is to improve efficiency in the use of resources at sub-national level, whereas the activity is financed, in part or fully, by the central government. If a sub-national unit is able to perform the activity at lower than normative costs, the transfer will not be reduced for that unit as a consequence, thereby giving the sub-national government an incentive to fully explore the advantages of decentralised service provision. This kind of transfer can be a means towards moving away from earmarked grants.

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