

Report No. 20489-KZ

# Kazakhstan Public Expenditure Review

(In Three Volumes) Volume II: Main Report

June 27, 2000

Poverty Reduction and Economic Management Sector Unit  
Europe and Central Asia Region



## CURRENCY AND EQUIVALENT UNITS

(As of December 31, 1999)

Currency Unit: Tenge (T)

Exchange Rate:

US\$1.00 = 0.00724

Tl = US\$138.20

Average Exchange Rate: Tenge per US\$1		
1997	1998	1999
75.44	78.30	119.52

## ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
AEP	Agency for Economic Planning
AIDS	Acquired Immune Deficiency Syndrome
ASPR	Agency for Strategic Planning and Reforms
BOP	Balance of Payment
CHIF	Compulsory Health Insurance Fund
CHP	Central Health Purchasing
CIS	Community of Independent States
CIT	Corporate Income Tax
CMIF	Compulsory Medical Insurance Fund
CPC	Caspian Petroleum Consortium
CPI	Consumer Price Index
DFID	Department for International Development (U.K.)
FSU	Former Soviet Union
GDP	Gross Domestic Product
GFS	Government Finance Statistics (IMF)

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HIV	Human Immunodeficiency Virus
IAAP	Internationally Accepted Accounting Practices
IBRD	International Bank for Reconstruction and Development
IEO	International Energy Organization (U.S. Dept of Energy)
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
MOES	Ministry of Education and Science
MOF	Ministry of Finance
MSR	Ministry of State Revenue
MTEF	Medium-Term Expenditure Framework
NBK	National Bank of Kazakhstan
NFC	Normalized Fiscal Capacity
NSA	National Statistical Agency
OECD	Organization for Economic Co-operation and Development
OSHF	Oil Stabilization and Heritage Fund
PAYGO	Pay As You Go
PEMS	Policy and Expenditure Management System
PHC	Package Health Care
PIP	Public Investment Program
PIT	Personal Income Tax
PSRMAL	Public Sector Resource Management Adjustment Loan
REF	Regional Equalization Fund
SAF	State Accumulation Pension Fund
SAI	Supreme Audit Institution
SAP	Social Assistance Program
SCI	State Committee on Investment
SEZ	Special Economic Zones
TIMSS	Third International Mathematics Science Study
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
USAID	U.S. Agency for International Development
VAT	Value Added Tax
VTE	Vocational and Technical Education
WHO	World Health Organization
WTO	World Trade Organization



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## ABSTRACT

This is Volume II of the Public Expenditure Review (PER) that has been prepared at the request of the Government of Kazakhstan. This PER builds upon the Bank's previous work on the country's transition experience to a market-oriented economy<sup>1</sup> and recent public sector reforms. This report aims at identifying key public expenditure issues and suggesting possible strategies and policy options. The PER is part of a capacity building effort to encourage the Government to independently carry out this exercise as a regular undertaking to effectively manage the country's public finances.

Kazakhstan is a reforming economy in the process of completing a first generation of structural reforms (by consolidating institutions and policies towards liberalization and financial stabilization), and is on the verge of preparing a second generation of structural reforms aimed at sustainable economic growth. The country has made significant progress on liberalizing and stabilizing the economy, and on implementing important institutional reforms to discipline public expenditures by: a) adopting international classification and standard reporting systems; b) adopting budget ceilings by function, program and program manager; c) incorporating extra-budgetary funds into the budget; d) formalizing intergovernmental relations; e) formalizing a Budget Commission to guide the budget process; d) starting an incipient Public Investment Program; and e) establishing a National Treasury.

Current outstanding public expenditure issues identified by the report as deserving particular attention from the Government include: a) persistent underlying fiscal imbalance; b) deficient domestic resource mobilization management; c) lack of reliable mechanisms for effective expenditure prioritization; d) inefficient budgetary execution, weak audit and lack of performance evaluation; e) deficient mechanisms of intergovernmental fiscal relations; f) inefficient public service delivery; and g) large disparities on per capita social expenditures (health, education, and social assistance) across regions.

The report points out strategy options and policy reform that can, through programmed deficit reduction, converge the system to fiscal sustainability by: a) rationalizing domestic resource mobilization, mainly oil/gas rents, which preserve domestic savings, capital accumulation and development of non-oil sectors; b) focusing governmental actions only on few areas (of market failure and/or for equity reasons), by prioritizing programs on the basis of output/outcomes, multiyear budgeting, and performance evaluation; c) strengthening intergovernmental relations, by extending the scope and improving central coordination of fiscal decentralization, increasing autonomy and accountability of local managers and authorities, and reforming the tax sharing and transfer mechanisms; and d) increasing efficiency of spending and improving access and quality of public service delivery, by focusing social assistance exclusively on the poor, restructuring service facilities (including selective rehabilitation of basic infrastructures and equipment, and phased implementation of public service reform), and creating conditions for private initiative participation.

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<sup>1</sup> "Kazakhstan: Transition of the State", World Bank Country Study, 1997; "Kazakhstan: Living Standards During the Transition", World Bank Report no. 17520-KZ, 1998.

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This report was written under the general guidance of Kiyoshi Kodera (Country Director), Pradeep Mitra (Sector Director), and Hafez Ghanem (Sector Manager). Valuable inputs and suggestions were received from Deborah Wetzell, Helga Muller, Amitabha Mukherjee, Anwar Shah, Friedrich Konigshofer, Maureen Lewis, Betty Hanan, John Langenbrunner, and Julia Devlin. The report was edited by Usha Rani Khanna and processed by Nancy Davies-Cole.

## **CHAPTER I**

### **TRANSITION AND CHALLENGES**

1. This introductory Chapter places the public expenditure in Kazakhstan broadly in the context of the country's transition process from macroeconomic stabilization to sustainable growth. The Chapter's objectives are to: (a) take stock of the structural and economic reform achievements so far; (b) identify the challenges that lies ahead; and (c) propose a macroeconomic framework that allows for stable government financing in Kazakhstan, while promoting diversified output growth. Public expenditure priorities, public expenditure management, fiscal decentralization, and the public expenditure issues of social sectors are analyzed in Chapters II, III, IV, and V, respectively.

#### **A. TRANSITION EXPERIENCE: STRUCTURAL REFORMS AND STABILIZATION EFFORTS**

##### **The Structural Reforms<sup>2</sup>**

2. Since independence in 1991, Kazakhstan made substantial progress towards transforming its economy into a market-oriented system. Although this progress has been intermittent, important economic and institutional reforms have been implemented and the size of the government significantly reduced, particularly from the mid-1990s. Liberalization of the economy (freeing most prices, interest rates, and exchange rates) and trade regime (elimination of quantitative restrictions and rationalization of import tariff schedule) has largely been accomplished. Reforms for opening up and deepening the financial sector are in an advanced stage of implementation, and deregulation and a new regulatory framework for the normal operation of a market economy is progressively replacing the old system of regulation.

3. Although the "blue chip" privatization program (which include Banks, Kaztelecom, power companies, extractive sectors) has been delayed, most of small and medium-sized enterprises has been privatized. In 1998, a rationalization of public administration started reducing the number of public employees, but a more comprehensive public service reform is still in its initial phase. Since the mid-1990s, fiscal structure and management have been reformed and budget formulation, execution and control systems have been strengthened. Governance (prevalence of the rule of law, transparency in decision-making, minimum bureaucracy, and combating corruption) are still areas in need of more accelerated progress.

4. The next steps in the transformation process are an accelerated completion of the structural and institutional reforms already initiated. These include public employment and wage reform, financial sector deepening, strengthening of the Treasury and other Budget institutions, reviewing and restructuring of tax and customs system, fiscal decentralization to sub-government

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<sup>2</sup> For a detailed description of the structural reforms during transition, see Annex I.1.

level, and a rationalization of the natural resource mobilization system. Improving governance by increasing transparency and accountability, and eliminating corruption are critical for successful implementation of these reforms.

### **Stabilization Efforts and Economic Performance<sup>3</sup>**

5. The stabilization efforts implemented during the transition process were quite successful, but the basis for a vigorous economic recovery has not yet been established and the underlying imbalance of fiscal accounts are still to be resolved. This sub-section synthesizes the process and the outcomes of the stabilization experience of the 1990s, and identifies the main remaining policy issues.

6. Since independence, Kazakhstan experienced a dramatic economic recession (GDP fell 50 percent in real terms between 1990 and 1995) and hyperinflation (price changes were above 2,000 percent in 1993 and above 1,000 in 1994) in the first half of the 1990s. However, with the stabilization and liberalization efforts put into place since the mid-1990s, the government succeeded in stabilizing the economy. Inflation steadily declined to single digits in 1998, and the output stabilized (Table I.1).

7. During this transition and stabilization process, Kazakhstan's economy underwent a major structural change. Agriculture and manufacturing collapsed both in absolute and relative terms, while the mining/extractive sectors (mainly oil/gas) took predominance in the industrial area, and the informal economy (mainly services) expanded. These developments in the real sector are of far-reaching importance, since they can lead to: (a) a lopsided economic structure (pockets of growth in *enclave* extractive-exporting sectors, without much domestic employment and income generation effects); (b) vulnerability of the balance of payments to fluctuations of commodities' prices (oil, for instance); (c) excessive exposure of the economy to "Dutch disease" effects (exchange rate real appreciation, which further hurts the non-oil sectors); and (d) excessive expansion of the informal economy, which can jeopardize fiscal sustainability by increasingly demanding infrastructure and public services, but not paying taxes.

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<sup>3</sup> For a detailed analysis of the recent economic developments, see Annex I.2.

<b>Table I.1. Kazakhstan: Key Social and Macroeconomic Indicators</b>							
	1993	1994	1995	1996	1997	1998	1999 Estimate
<b>Product and Employment</b>							
Real GDP growth rate (%)	-9.2	-12.6	-8.2	0.5	2.0	-2.5	1.5
Per capita GDP (in US\$) <sup>c</sup>	693	730	1036	1321	1407	1415	1025
Oil production (thousand bpd)	460	407	414	459	517	518	502
Oil production (% of GDP)							
Actual unemployment rate <sup>a</sup>	2.6	7.8	12.0	9.4	8.1	6.8	
<b>Poverty, Health and Education</b>							
Poverty--head count (%)				34.6			
Infant mortality per thousand	28	27	27	25	25	22	
Life expectancy (years)	67	65	64	64	64		
Literacy rate	98		99				
Enrollment rate--basic ed. (%)	92	91	90	90	89		
<b>Prices</b>							
End-year inflation rate (%)	2165.0	1158.3	60.3	28.7	11.2	1.9	15.0
Oil export price (US\$ per barrel)			9.6	12	14.2	10.5 <sup>b</sup>	11.6 <sup>b</sup>
<b>Exchange rates (year aver.)</b>							
Nominal (KZT/US\$)	2.20	35.54	60.95	67.30	75.40	78.30	119.00
REER Index, US\$/KZT (1995 = 100)			100.0	111.6	119.4	131.7	106.8
<b>External Accounts</b>							
Exports FOB (US\$ million)	3324	3285	5164	6292	6899	5839	5651
o/w Oil/gas		638	793	1257	1671	1650	1927
Imports FOB (US\$ million)	4528	4205	5386	6617	7176	6589	5541
Trade balance (% of GDP)	-10.5	-7.7	-1.3	-1.5	-1.2	-3.4	0.7
Current Acc. Bal. (% of GDP)	-14.4	-7.6	-3.1	-3.6	-3.6	-5.4	-1.7
External Debt (% GDP)	3.1	27.2	20.6	20.0	26.8	34.3	49.1
External Debt Serv. (% of exp.)		4.2	5.6	6.8	8.9	39.4	17.8
o/w Interest		1.4	1.3	1.2	2.0	5.3	5.3
<b>Government Budget</b>							
Revenue (% of GDP)	21.2	18.5	16.9	13.2	19.5	18.3	17.4
Expendit. (% of GDP)	25.2	26.0	20.0	18.6	28.4	26.0	20.7
<b>Overall Fiscal balances</b>							
Deficit, incl. privatiz. (%GDP)	-1.3	-7.2	-2.5	-3.1	-5.6	-3.3	-1.0
Deficit, excl. privatiz. (%GDP)	-4.0	-7.5	-3.2	-5.3	-8.9	-7.7	-3.3
Sources: IMF, KET, EIU, UNDP (HDR, 1994, 1998), World Bank (Rep. 17520-Kz, 1998), Kazakh National Statist. Agency							
<sup>a</sup> Ratio of number of officially unemployed plus that of hidden unemployed to the labor force.							
<sup>b</sup> Estimated as 75% of the Brent North Sea crude's spot market price (Source: Energy International Center (1999))							
<sup>c</sup> Using the nominal exchange rate to convert Tenge into US\$.							

8. The increasing vulnerability of the Kazakhstan economy is already evident. The drop in oil prices, associated with the Russian crisis and bad harvests at the end of 1998 and early 1999 had a major impact on the country's BOP, resulting in the 1998 recession, fiscal difficulties, and devaluation of the currency. This external crisis built upon a trend of increasing external debt of the economy, to about 50% of GDP in 1999, from 3% in 1993.

9. The escalating Public Sector Debt/GDP ratio, already at 30%, is a worrisome outcome with far-reaching consequences over the growth rate of the economy for the years to come. This has been a result of the persistent underlying public sector deficits since independence (between 4 and 9 percent of GDP).<sup>4</sup> Although privatization proceeds have increased since 1996 and been intensively used to finance the deficit, they have met half of the public sector borrowing requirements in the last few years, with the rest being financed mainly from abroad. Domestic

<sup>4</sup> Excluding privatization receipts, since they actually represent a financing item for the overall deficit.

financing has been limited, since seignorage is still low and the domestic financial market is not developed enough.

10. Despite the persistence of unsustainable fiscal deficit, government spending in Kazakhstan has been substantially cut from more than 30% of GDP by the time of independence, to about 23% in the period 1997-99, comparable to western middle-income countries. Public employment is excessive, and the wage-bill consumes almost one-fourth of total expenditures, but wages are extremely low.<sup>5</sup> Therefore, public service reform may not generate relevant savings in the short-term, after making corresponding wage adjustments for those who stay in public service. Spending on interest on debt is not alarming yet, but may become a problem soon if indebtedness continues at the current pace. Capital expenditure, although rather obscure because of guarantees and frequent assumptions of liabilities under the rubric of net lending, is too low (less than 2% of GDP, and an expenditure share of about 8%).

11. The structural and stabilization policies have apparently protected the social sectors in a relative sense. In fact, the functional distribution of public expenditures shows that Kazakhstan allocates about 60% of total expenditures to social sectors (education, health, and social security), compared to 46% and 54% in the western middle- and high-income countries, respectively. Therefore, the overall aggregate inter-sectoral allocative efficiency in Kazakhstan seems to compare favorably to western countries. However, the intra-sectoral and technical efficiency at the local and facility level, access, and equity aspects of public service delivery have deteriorated dramatically with the decline in the absolute amount of resource allocation, poor management, and lack of controls (see Chapter V).

12. In spite of the reforms of the mid-1990s (new Tax Code, implementation of VAT), the state revenue collection system has under-performed and contributed to the underlying deficit and increasing indebtedness. As in other Eastern European and FSU countries, the tax system in Kazakhstan has not been used effectively, and tax administration has been inefficient. The last three year average tax collection was 18% of GDP, which compares unfavorably even to Russia (23%) and other transition countries. Only VAT and excises have shown some improvement in collection, while the other revenue sources (including income tax, social tax, local property tax, and non-tax revenue) have either declined or stagnated. Three major factors has impinged on the tax (and customs) system performance: (a) its use for several contradictory objectives, which weakened the system's essential function of maximizing collection as efficiently and equitably as possible; (b) excessive and widespread exemptions and privileges (tax incentives, tax holidays, accounting offsets); and (c) lack of transparency, coordination, and accountability.

13. In conclusion, the stabilization effort during transition has been successful in bringing prices under control, mainly through tight monetary policy, but has fallen short of putting in place the underlying fiscal conditions for financial stability. Public sector borrowing requirements have been systematically high, stretching public debt to its limits (33% of GDP). Expenditure policies have not been effective and efficient at sectoral level, delivery of public services has been deficient, and the revenue mobilization system has under-performed and been unpredictable, undermining the maintenance of a reasonable public expenditure program.

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<sup>5</sup> There still are many hidden non-monetary *fringe benefits*.

## B. CHALLENGE AHEAD: SUSTAINABLE ECONOMIC GROWTH

14. The major policy challenges at this point are to go beyond the first step of stabilization and move towards sustainable growth. This requires a full commitment to restoring the underlying balance of government accounts, while putting in place the necessary conditions for a diversified economic recovery. A rational mobilization of domestic resources-cum-implementation of a second generation of institutional and structural reforms are necessary conditions to facilitate fiscally-sustainable economic growth.

### Indebtedness and Conditions for Fiscal Sustainability

15. From a long-term perspective, the existence of underlying fiscal imbalances are a matter of great concern for Kazakhstan's future development, because they reduce national savings, and draw resources away from investment. The current high public sector borrowing requirement has only been possible by keeping interest rates high, at the cost of crowding out private investments. Moreover, persistent public deficits lead to a build up of government debt, increase risks for lenders, and the interest rates charged on government loans abroad rises accordingly.<sup>6</sup> Over time, the debt service burden tends to increase, threatening stability and rendering the fiscal policy unsustainable. As mentioned above, the Kazakhstan Public Debt/GDP ratio (D/GDP) has increased too fast, and all the advanced indicators are already signaling that the country's fiscal sustainability has reached its limits.

16. Perhaps the simplest way to see the implications of the current and prospective fiscal situation is to compare the country's actual primary fiscal balance with the primary fiscal balance that would be required to stabilize the D/GDP ratio at its current level—about 30 percent.<sup>7</sup> Box I.1 shows that, given the current D/GDP ratio, the size of the required primary fiscal balance that stabilizes this ratio<sup>8</sup> depends essentially on how fast the real GDP grows vis-à-vis the real interest rate, and also on how much of the fiscal balance (measured in terms of GDP) the government can finance via seigniorage.<sup>9</sup>

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<sup>6</sup> The problems faced by the Treasury during the third and fourth quarters of 1999 to place its bonds in the international market are an indication of these difficulties.

<sup>7</sup> Primary fiscal balance is the overall government accounts balance excluding interest due on public debt. The additional adjustment effort necessary to restore fiscal sustainability will therefore be higher, the more the *actual* primary balance deviates from the *required* primary fiscal balance (Box I.1).

<sup>8</sup> Stabilization of the D/GDP ratio is a natural proposal since: (a) on one hand, further increases on it are limited by the obvious risks presented by a country with high volatile revenue sources and extremely low savings ratio; and (b) on the other hand, decreases in the ratio are constrained by the present difficulties in generating fiscal surpluses in a budget that is still struggling to resolve its considerable deficits.

<sup>9</sup> While in the short-term the government has extensively used privatization receipts to finance the fiscal deficit, this is actually a sporadic source of financing and cannot be counted on in the medium- and long-term. Even if this financing source would last for the next two of three years, it will eventually vanish. Then it could, at most, be considered only a temporary expedient to help during the adjustment process.

### Box I.1 Fiscal Sustainability Scenarios for Kazakhstan

Fiscal sustainability can be indicated by the size of the primary fiscal deficit ( $p$ ) required to stabilize the Public Debt/GDP ratio ( $d$ ) in the medium-long-term. The indicator results from balancing over time the public sector borrowing requirement (including the burden of the interest rate ( $r$ ) on debt) with the government *regular* financing sources--seigniorage ( $s$ ), and debt expansion, with the latter equal to the GDP growth rate,  $g$ . After some algebraic handling, the following simple equation results:\*

$$p = [(r-g)/(1+g)] \cdot d - s$$

Because in Kazakhstan seigniorage as a source of financing is still too small, basically what the equation says is that whenever interest rate exceeds the GDP growth rate, a primary surplus will be required in order to stabilize the Public Debt/GDP ratio. Government sporadic receipts from privatization, although a financing source as well, it is not a *regular* source; thus it is not a relevant factor for balancing the public sector borrowing requirement from a long-term perspective (i.e. the steady-state  $p=p^*$ ).

Table I.4. Kazakhstan: Grade of Possible Fiscal Sustainability Scenarios								
Required Primary Surplus to Stabilize Public Debt/GDP ratio at 25%								
Assumption: Seigniorage/GDP = 0.1%								
(in percentage of GDP)								
annual r->	5%	6%	7%	8%	9%	10%	12%	14%
annual g								
0%	1.2%	1.4%	1.7%	1.9%	2.2%	2.4%	2.9%	3.4%
1%	0.9%	1.1%	1.4%	1.6%	1.9%	2.1%	2.6%	3.1%
2%	0.6%	0.9%	1.1%	1.4%	1.6%	1.9%	2.4%	2.8%
3%	0.4%	0.6%	0.9%	1.1%	1.4%	1.6%	2.1%	2.6%
4%	0.1%	0.4%	0.6%	0.9%	1.1%	1.3%	1.8%	2.3%
5%	-0.1%	0.1%	0.4%	0.6%	0.9%	1.1%	1.6%	2.0%
6%	-0.3%	-0.1%	0.1%	0.4%	0.6%	0.8%	1.3%	1.8%
7%	-0.6%	-0.3%	-0.1%	0.1%	0.4%	0.6%	1.1%	1.5%

Kazakhstan: Grade of Possible Fiscal Sustainability Scenarios (Low Case)								
Required Primary Surplus to Stabilize Public Debt/GDP ratio at 20%								
Assumption: Seigniorage/GDP = 0.1%								
(in percentage of GDP)								
annual r->	5%	6%	7%	8%	9%	10%	12%	14%
annual g								
0%	0.9%	1.1%	1.3%	1.5%	1.7%	1.9%	2.3%	2.7%
1%	0.7%	0.9%	1.1%	1.3%	1.5%	1.7%	2.1%	2.5%
2%	0.5%	0.7%	0.9%	1.1%	1.3%	1.5%	1.9%	2.3%
3%	0.3%	0.5%	0.7%	0.9%	1.1%	1.3%	1.6%	2.0%
4%	0.1%	0.3%	0.5%	0.7%	0.9%	1.1%	1.4%	1.8%
5%	-0.1%	0.1%	0.3%	0.5%	0.7%	0.9%	1.2%	1.6%
6%	-0.3%	-0.1%	0.1%	0.3%	0.5%	0.7%	1.0%	1.4%
7%	-0.5%	-0.3%	-0.1%	0.1%	0.3%	0.5%	0.8%	1.2%

In addition to the results of the simulation discussed in the main text of this report, the Tables presented above show, by using the same scenarios for  $r$  and  $g$ , the sensitivity of those results to changing Public Debt/GDP ratio, " $d$ ", to be stabilized. Each table presents the required primary surplus consistent with more desirable lower " $d$ ": an optimistic  $d=25\%$ , and a super-optimistic  $d=20\%$ . Thus, assuming the ranges of 7-9% for the interest rate and 2-4% for GDP growth rate, the required adjustment effort (i.e., the divergence between the *actual* primary surplus and the *required* primary surplus) would be in the interval of 6.1-7.2%, as compared to 7% obtained in the main text to stabilize " $d$ " at 30%. The problem with the "more desirable" assumptions is that during the process of adjustment, the fiscal effort to be effectively realized,  $p$ , should be higher than the one calculated here for the steady-state  $p^*$ , in order to generate enough primary surplus to help amortize part of the principal

(\*) See Buiter, W.H. (April 1997), "Aspects of Fiscal Performance in Some Transition Economies Under Fund-Supported Programs", Working Paper 97/31, IMF; and Garcia, Valeriano (June, 1997), "The Demand for Base Money and the Sustainability of Public Debt", Policy Research Working Paper, number 1774, World Bank.

17. However, the possibility of seigniorage financing in Kazakhstan is not a very promising alternative for the time being, since the demand for money is still low. The simulation presented

in Table I.2, based on 0.1% of seigniorage ratio and a 30% D/GDP ratio to be stabilized, illustrates quite well the challenges faced by the country presently.<sup>10</sup>

**Table I.2. Kazakhstan: Grade of Possible Fiscal Sustainability Scenarios**  
Required Primary Surplus to Stabilize Public Debt/GDP ratio at 30%

GDP = 0.1%

annual r->	5%	6%	7%	8%	9%	10%	12%	14%
annual g								
0%	1.4%	1.7%	2.0%	2.3%	2.6%	2.9%	3.5%	4.1%
1%	1.1%	1.4%	1.7%	2.0%	2.3%	2.6%	3.2%	3.8%
2%	0.8%	1.1%	1.4%	1.7%	2.0%	2.3%	2.8%	3.4%
3%	0.5%	0.8%	1.1%	1.4%	1.6%	1.9%	2.5%	3.1%
4%	0.2%	0.5%	0.8%	1.1%	1.3%	1.6%	2.2%	2.8%
5%	-0.1%	0.2%	0.5%	0.8%	1.0%	1.3%	1.9%	2.5%
6%	-0.4%	-0.1%	0.2%	0.5%	0.7%	1.0%	1.6%	2.2%
7%	-0.7%	-0.4%	-0.1%	0.2%	0.5%	0.7%	1.3%	1.9%

18. Sixty-four scenarios for the *required* primary balance are presented, based on eight assumptions on possible real interest rates (r) on the debt and on eight assumptions on possible real GDP growth rates (g) for Kazakhstan economy for the near future. Because of the volatility in the international capital market, one could rather optimistically select a 7-9 percent average range for the interest rate to be faced by the country. For the average annual real growth rate range, it may probably situate between 2 and 4 percent; the higher case is more probable if the Caspian Petroleum Consortium (CPC) pipeline construction is completed as programmed (by 2000-01) and production starts soon, and the lower case if production does not start in the few years' (see discussion below). These assumptions (rather optimistic) lead to a minimum required primary surplus range of 0.8-2.0 percent, with an average of 1.4 percent.

19. The required surplus increases with interest rates and decreases with the GDP growth rate. Thus, on the one hand, the 0.8 percent of primary surplus would be required in a scenario where a "high" annual real growth rate of 4 percent would coexist with a "low" interest rate of 8 percent. On the other hand, 2.0 percent primary surplus are required if a "low" 2 percent growth would coexist with a "high" 9 percent interest rate. By comparing the 1.4 percent average of the *required* primary surplus range with the *actual underlying* primary surplus of -5.6 percent (the last three-year -6.6 percent average of the overall deficit minus about the one percent average interest on debt for the same period—see Table I.2) would suggest the necessity of an additional effort of fiscal adjustment of 7 percent of GDP (in relation to the average last three-year fiscal stance). This is not a trivial adjustment effort and should be developed in the context of a medium-term macroeconomic framework, where consistent resource mobilization could go in tandem with efficient and equitable allocation of public expenditure. Even in the interim, when the government may still use temporary privatization receipts as a device to help finance the

<sup>10</sup> In Box I.1, this simulation is expanded to show the sensitivity of results for changing Public Debt/GDP ratio to be stabilized. Although the assumed lower Public Debt/GDP ratios (25% and 20%, respectively) are *more desirable* (because, once adjusted, they would entail less debt burden for the budget) they are unlikely; because they would require, in the interim adjustment process, an even larger primary surplus to help amortize part of the principal in order to bring the Public Debt/GDP ratio down.

excess deficit (an average 3.5 percent of GDP in the last three years—Table I.1), at least about half of the additional required effort above identified for long-term fiscal sustainability still remains to be adjusted immediately. This necessary fiscal adjustment will certainly demand from the government a focus on public expenditure prioritization criteria (Chapter II and III) and on improving the regular flows of revenue from domestic resource mobilization.

### **Mobilization of Domestic Resources**

20. Attainment of sustainable high economic growth that can guarantee adequate employment for the population in the private sector and predictable fiscal revenue flows to maintain public programs, requires a vision that goes beyond short-term fiscal stabilization which just manages to finance the deficit (either through privatization proceeds or indebtedness). A long-term vision would focus on sustaining compatible revenue and expenditure flows to eliminate the financial gaps and stabilize the stock of debt. In this respect, once the government is committed to furthering structural reforms (aiming at reaching fiscal sustainability) and promoting market incentives, the prospects for long-term economic development in Kazakhstan are favorable. The country is endowed with a broad range of natural resources for diversified growth in agriculture (including grains, potatoes, sugar-beet, vegetables, animal products), mining (including oil, gas, ferrous metals, copper and coal) and manufacturing (including alloys and metal products, mineral fertilizers, a range of light industries). If well managed, these sectors, especially the rich mineral reserves, can generate resource to be mobilized, and can substantially improve export earnings, tax revenue, and savings. Moreover, the Kazakhstani labor force is educated, and able to quickly respond to market incentives by developing a sound domestic private sector.

21. Apart from the other rich mineral reserves, oil and gas are the most promising and can have a substantial economic impact in the near future. Oil and gas production and exports have increased significantly since the mid-1990s and have already become main export earners and contributors for the GDP.<sup>11</sup> Considering the pace of exploration, signed contracts and investment since then (especially the prospective completion of construction of the CPC pipeline), this sector will become a major resource source for Kazakhstan economic growth.<sup>12</sup>

22. The downside of these recent developments and perspectives is that the economy can become excessively dependent on few extractive sectors and exposed to unpredictable international price fluctuations of those commodities. Also, as past international experience has shown, indiscriminate depletion of the natural resource basis can mortgage the future of younger generations. Therefore, the rents of extractive sectors should be rationally mobilized aiming at: (a) guaranteeing a permanent income flow and future sustainable economic growth; and (b)

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<sup>11</sup> Oil and gas represented 12% of GDP and 35% of exports in 1999 (projected to 28% and 40% of GDP and exports, respectively, in 2010), as compared to 4.5% and 15%, respectively, in 1995, respectively. The current crude oil production is about 0.5 million barrels per day, and the prospective production is about 1.5 million barrels per day, once the CPC is completed.

<sup>12</sup> Estimated proven oil reserves are in the 10-18 billion barrel range (IEO, US Department of Energy, 1999). This estimate proven reserve (i.e., economically feasible to extract and transport) is substantially lower than the initial estimate of about 25 billion barrels in the ground, because of the quality and the high costs associated to reach accessible markets.

insulating the non-oil sectors (including the government budget) from extreme revenue volatility and “Dutch disease” effects of windfall gains and losses from extractive (e.g., oil/gas) sectors. For this purpose, this report suggests that an adequate proportion of extractive activity net revenues should be *set aside* and allocated to secure portfolio investments abroad—at least for the time being, while the national absorptive, technical and administrative capacities are being built.

23. (a) *mobilizing natural resources.* Natural resources like oil and gas are depletable assets. They are by nature non-renewable resources. As such, net proceeds (sales revenues minus production costs) from their exploitation do not constitute *permanent* income because, once the resource basis have been exhausted, the income stream ceases to exist. This means that dissipation of their full proceeds in current consumption would leave the country worse off when the reserves vanish. Therefore, decisions on natural resources mobilization are crucial intergenerational decisions, because they impinge on future income and consumption levels.

24. In this respect, Kazakhstan can learn from international experience and avoid the illusion of treating the full amount of net revenue (R) that flows from exploitation of non-renewable natural resources as a perpetuity. These resources do not last forever. In the case of oil for instance, the ratio of the estimated 15 billion barrel of proven reserve to the prospective 1.5 million barrel per day extraction indicates that in about 27 years’ time (i.e., not more than one generation’s span) the reserves would be exhausted. Thus, only the *permanent* income component could legitimately be considered *income* from the oil rent and be used for current needs without mortgaging the future. But the amount which exceeds the natural resource permanent income (i.e., the depletion factor, D)<sup>13</sup> should be set aside to be re-invested in foreign assets that can guarantee a secure return. For illustrative purpose, the depletion factor can be computed simply by discounting all the non-renewable natural resource expected net revenue stream (R) by the expected rate of return (r) on the portfolio investment abroad,

$$D=R[1/(1+r)^{n+1}]$$

where n is the number of years still remaining of the resource’s productive life; in this case, 27 as estimated above.<sup>14</sup> Thus, for a 5 percent discount rate (on purpose, reflecting a conservative expected average investment return rate), the corresponding depletion rate (D/R) to be set aside would be 25 percent of the current revenue stream. For a lower rate of return on the financial portfolio abroad, say 4 percent expected rate of return, the percentage to be set aside would be higher, 33 percent.<sup>15</sup>

25. The important message in the case of non-renewable resource mobilization is that it should be assured that the resource should not be absorbed in its totality by the present generation, and a substantial proportion of its current revenue stream should be re-invested; in

<sup>13</sup> Which would correspond to the *transitory* component of the income stream. This transitory component would last only during the non-renewable reserve life span.

<sup>14</sup> El Serafy, Salah “*The Proper Calculation of Income from Natural Depletable Resources*”, in Y.J. Ahmad, S. El Serafy, E. Lutz (eds.), *Environmental Accounting for Sustainable Development*, A UNDP-World Bank Symposium, June 1989.

<sup>15</sup> Naturally, when other given conditions change (e.g., expected international price) the optimal extraction/production flow changes, and so the depletion factor also changes accordingly.

this case allocated in a financial asset portfolio outside the country with a certain real return rate.<sup>16</sup> The complement of calculated depletion factor D (i.e., R-D) is the *permanent* component of the oil/gas inflow streams and, under regulated conditions, could be transferred to the government budget, and its use be submitted to the normal budgetary process.

26. Sound institutional arrangements should be put in place in order to guarantee that strict technical criteria is followed in the determination of the size of the set-aside and in its proper allocation and management in a financial asset portfolio abroad. For this purpose, the government may consider setting up an independent “*Oil Stabilization and Heritage Fund*” (OSHF), strictly regulated and submitted to permanent scrutiny by the government, the parliament, and the civil society. Implementation of well designed transparency and accountability mechanisms are crucial for a successful implementation and operation of the OSHF. For example, the OSHF could be directed by an independent Board, formed by the Minister of Finance, the Minister of Economy, the Governor of NBK, the Head of Kazakoil, the Director of the State Budget, and two representative of the civil society proposed by the government and approved by the parliament. The members of the Board could be individually made fully accountable for the Board decisions. The OSHF past performance and financial programming for the coming years should be subjected to periodic auditing both by the national “Accounting Commission” and by an international reputable auditing firm. The OSHF regulation should ensure full disclosure of the Fund’s financial transactions. A special annex on the availability and use of the Funds should follow with the annual budget submission to Parliament, and quarterly reports on their execution should be published and widely disseminated.

27. The OSHF needs to be conceived in a way to simultaneously neutralize the effects of the vagaries of the international oil markets over the balance of payments and the domestic non-oil economy, as well as to smooth the part of the *permanent income component* which flows into the government’s budget. To avoid the “Dutch disease” effects of a too fast appreciation of the exchange rate, which would disrupt non-oil domestic production, and to avoid public over-spending, any windfall gain resulting from abnormally high prices (and/or too fast extraction rate) should also be sterilized by investing it *abroad* as well with the same criterion described above. This would add to the external reserves and would allow OSHF tap later on in case oil prices fall below the long-term price trends (say, a three or five year moving average spot price, or an adequate futures price, or any other relevant forecasting criterion).<sup>17</sup> The formula

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<sup>16</sup> In certain circumstances, buyback Kazakhstan foreign debt at a discount rate may be a good option. It may even be the case, if the expectations is of higher oil prices in the future, of slowing down current production, which would mean investing in the reserves on the ground themselves for direct use and decision by the future generations.

<sup>17</sup> Among others, “*Chilean Copper Stabilization Fund*” created in 1985, with the support of the World Bank’s First Structural Adjustment Loan was a successful case. See Rodrigues, Carlos A. (mimeo, March 1991, IBRD), *Evaluation of the Chilean Copper Stabilization Fund*. World Bank’s experience in this area includes, among others, the cases of Botswana (diamond), Lesotho (water), and United Arab Emirates, Bahrain, and Oman (oil). Kuwait and Norway also run oil stabilization funds. Interesting experiences with oil funds (stabilization and/or investment) include the States of Alberta (Canada) and Alaska (USA), as well as Venezuela and Norway, among others.

presented above as an example on how depletion rate could be computed can easily take care of this aspect as well, by simply considering the expected current revenue stream (R) already net of the windfalls/loses.<sup>18</sup>

28. **(b) Strengthening the tax system.** For both the oil and the non-oil sectors to effectively contribute to economic development, the government still has to substantially strengthen the Kazakhstan tax system as an effective instrument of resource mobilization in the context of a market-oriented economy. The current tax system is not keeping pace with the liberalization reforms in the country, and cannot continue as a soft instrument aiming simultaneously at several contradictory objectives, such as keeping failing enterprises alive, sustaining employment by informally tolerating wage bill payment instead of tax obligations, promoting small businesses, stimulating specific economic activities<sup>19</sup> and regions<sup>20</sup>. The result has been, on the one hand, the existence of too many and discretionary tax exemptions, tax holidays, special tax payment concessions, accounting *offsets*, and low compliance and excessive tax arrears.<sup>21</sup> On the other hand, these practices end up putting too heavy a burden on those who really pay tax, generate a feeling of unequal tax treatment, stimulate moral hazard behavior and further tax evasion.

29. There are a basic nominal tax rate structure and a regulatory framework in place, but the system has not yet functioned satisfactorily in the market economy environment.<sup>22</sup> The result has been the one described in the previous paragraph: a complex and ineffective system, with too many and high nominal tax rates<sup>23</sup>, narrow tax basis, non-compliant contributors, and low collection rates (Annex I.2). For the tax system to perform its proper function of mobilizing resources in a market economy, this situation should change.

30. A full-fledged analysis of the tax system goes beyond the scope of this report.<sup>24</sup> Nevertheless, the government may consider reviewing and probably overhauling the current tax system, especially the tax administration, including customs. Clearly, the tax administration system in Kazakhstan needs to be streamlined and tailored to operate in a market economy, and then strengthened in order to make the critical public spending functions of the government affordable. In principle, given the parameters of the tax policy (tax rates and Tax Code rules), the relevant function that the tax system is expected to play in a market economy is essentially one: to raise state revenue as efficiently and equitably as possible. This is the only necessary

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<sup>18</sup> Just by considering the long-term (i.e., expected or normal) in lieu of the *actual* prices/quantities.

<sup>19</sup> For instance, Law 76-1 (February, 1997) amended the Tax Code by allowing up to 100% reduction of income tax for the first five years, and a further 50% reduction for the following 5 years, for taxpayers under contract with the State Committee on Investment (SCI). Corporate income tax exemptions are also generally granted for other activities, such as banks providing agricultural credit, expenses related to employment of disabled people, housing construction in Astana. Lower CIT tax rate (10% instead of 30%) is granted for those whom land is the main production factor.

<sup>20</sup> For those operating in the still remaining Special Economic Zone (SEZ) of Astana CIT rate also lower (20% instead of the regular 30%).

<sup>21</sup> See Wooster, J.H. (1998), "*Structuring the Ministry of Revenue*", paper presented at conference on State and Tax Standards, November 24.

<sup>22</sup> For a regional comparison of the nominal tax structure: Michael Engelschalk, "*Strategy Options for the World Bank Projects on Tax Policies and Tax Administration in CIS Region*", February 2000 (non-published report).

<sup>23</sup> Although at the regional standard.

<sup>24</sup> Except for the intergovernmental tax sharing issues, which is treated in Chapter IV.

and sufficient function that the tax system has to perform in Kazakhstan as well, but effectively and efficiently. Other objectives that contradict this function should be left to be performed by other policy instruments.

31. Moreover, the tax policy itself should be revisited, since the Tax Code that was adopted in 1995 has been amended so many times—as a result of pressure groups' influences—that a new one is needed. Aiming at rationalizing tax rates and expanding the tax basis, the revision of the Tax Code—which is already a government priority and is being done—should be concluded and implemented urgently. Besides the issues mentioned above, serious distortions have been accumulating in the CIT, PIT, and VAT systems, including the special treatment of small enterprises. Also, the enormous expansion of the informal sector of the economy deserves special attention, as providing the right incentives for them to become tax contributors (expansion of the tax basis), while guaranteeing the necessary legal protection for their normal operation.

32. Nevertheless, the major concern for resource mobilization is related to the special fiscal treatment that is still dispensed to the mineral exploitation sector, particularly to oil and gas. Because of special fiscal concessions for accelerated depreciation of prospecting and exploration costs made on a contractual basis, production base levies and profit taxes on oil and gas are considerably low. The fact that contracts signed with foreign corporations are not available for review, and the lack of transparency in the financial relationship between Kazakhoil (the national petroleum company), the NBK, and the National Treasury are a matter of great concern. For instance, neither the proceeds from the *signature bonds* obtained from the recent oil/gas exploration concessions can be found in the state budget, nor are the Kazakhoil shares on the oil/gas exploitation rents available for evaluation.<sup>25</sup> Moreover, the NBK does not seem to register in a transparent manner the profit remittances resulting from foreign companies operations in the mineral sectors. The fiscal treatment of these financial flows—which should be transparent in the budget—should be urgently addressed by a tax system and policy review aimed at substantially improving resource mobilization to sustain economic development in Kazakhstan.

### **A Sustainable Economic Growth Scenario**

33. In the long term, economic growth and poverty reduction in Kazakhstan<sup>26</sup> will crucially depend on an increasing rate of private investment beyond the extractive sectors, developing and diffusing new technologies, and acquiring the skills necessary in a diversified market economy. The strong natural resource endowment of Kazakhstan (non-renewable—e.g., hydrocarbon—and renewable—e.g., arable land) and its people are its main sources of economic recovery, but this resource basis needs to be rationally mobilized to promote *sustainable* growth. However, for this to start being realized during transition to a market-oriented economy, it is necessary that the government put in place consistent policies which can keep the system moving towards a financially stable, decentralized governance by:

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<sup>25</sup> As the profit shares of Kazakhoil in oil business is part of the country's oil rent referred to above, they should be treated accordingly.

<sup>26</sup> As envisaged in the President's guidelines "Kazakhstan 2030", and in the Government's "Program of Action, 2000-2002".

- (a) reinforcing its firm commitment to *macroeconomic stabilization*, and consistently showing convergence of its policies towards a sustainable fiscal stance as described above; and
- (b) accelerating completion of essential *structural reforms* initiated in the mid-1990s (liberalizing markets and streamlining government), and promptly start implementing a second generation of structural reforms, such as:
  - (i) establishing clear expenditure priorities (as discussed in Chapters II and III),
  - (ii) strengthening central fiscal controls and decentralizing fiscal decision-making by giving autonomy to perform and making decision-makers accountable (see Chapter IV and V);
  - (iii) accelerating implementation of public service reform including the subnational government levels;
  - (iv) proceeding faster with the large scale privatization process (especially the “blue-chip” program, and banks), aiming at improving competition and allocative and technical efficiencies in the economic system as a whole. (Privatization proceeds would also help as a temporary non-inflationary financing source during the fiscal adjustment process—see below);
  - (v) completing the legal/regulatory framework reforms (e.g., financial sector reform, land property rights, banking); and
  - (vi) reviewing and restructuring tax and custom policy and administration.

34. Evidence on firm commitment to macroeconomic stabilization is *sine qua non* to preserve the Kazakhstan government’s credibility, which will be a necessary condition to restore private investment and economic growth. Economic agents have to realize that the system is fiscally sustainable, in the sense that public sector financial flows are compatible with price stability, and that public sector debt dynamics will not disrupt the domestic financial market. Table I.3 shows that, under the assumptions underlying the projected macroeconomic framework—which assumes that the NBK would continue pursuing prudent monetary policy, including flexible exchange rate and free interest rate—a one digit inflation rate can be restored by the end of the year 2000 and can converge to below a 5% rate towards the end of the decade. In the interim, the overall public deficit would rapidly decline to no more than one percent of GDP, consistent with a 1.4% primary surplus to stabilize the Public Debt/GDP ratio to 30% by mid-second half of the decade. During the first three years of the decade, privatization proceeds of around 3% of GDP would help finance the government’s deficits, while the “above the line” budget is being trimmed. Meanwhile, implementation of structural reforms has to be accelerated, to make it possible for the fiscal adjustment path to quickly converge to its sustainability level by the second half of the decade.

35. Most of the impacts of the structural changes (see Chapters II to V) will be reflected in the opening of new opportunities and increased competition, which will increase economic efficiency and quality of services, both in the private and in the public sectors. This will give the government the opportunity to save allocations in current expenditures from about 24% of GDP in 2000 to less than 20% towards the end of the decade, but cutting mainly on subsidies to loss-making state enterprises, rationalizing further social expenditures (although maintaining a

minimum of one percent of GDP for social assistance programs), and general administration. Although the public service reform that the government is about to implement can substantially reduce public service employment (particularly at the subnational level), one could not expect great financial savings in the public sector wage-bill in the short-term because of the need to adjust wages upwards for those who stay, in tandem with the removal of remaining discretionary fringe-benefits.

36. The structural reforms would restore fiscal accountability and create an enabling business environment required for the resumption of private investment and the development of the private initiative. If the above-mentioned conditions start being implemented soon, both domestic and foreign investments are expected to pick up and general economic growth can be restored. If foreign companies' plans (mainly in the oil/gas and ferrous metal sectors) are realized, foreign direct investment can well reach about 1.5% of GDP starting 2000, and total gross investment can increase to 16-17%, as compared to 14% in 1999 and 11.5% in 1998 (Table I.3). Nevertheless, for these investment ratios-cum-production diversification to be sustained it is essential that the government move on a fast-track in its market liberalization policies, with special attention to the non-extractive sectors, and small and medium-sized businesses, to allow them to benefit from the elimination of excessive bureaucracy, undue political interference, and better governance in general.

Table I.3. Kazakhstan: Macroeconomic Framework								
(in percent of GDP)								
	1998	1999	2000	2001	2002	2003	2004-08	2009
GDP growth %	-2.5	1.7	3.0	3.5	4.5	4.5	3.2	3.5
Inflation %	7.2	8.4	12.2	8.0	5.8	4.5	4.5	4.5
<b>National Acc. Structure (% GDP)</b>								
<b>Investment (gross)</b>	<b>11.5</b>	<b>14.6</b>	<b>17.3</b>	<b>16.4</b>	<b>16.1</b>	<b>16.6</b>	<b>16.1</b>	<b>17.0</b>
o/w: Government	2.8	0.8	1.4	1.5	1.6	1.7	2.6	3.5
Private	7.7	12.4	14.7	13.8	13.6	14.1	13.0	12.9
<b>Consumption</b>	<b>93.0</b>	<b>84.8</b>	<b>83.2</b>	<b>83.7</b>	<b>82.5</b>	<b>79.6</b>	<b>80.5</b>	<b>80.9</b>
o/w: Government	20.6	20.2	19.5	18.8	18.2	18.0	17.5	16.5
Private	72.4	64.6	63.7	64.9	64.3	61.6	63.0	64.4
<b>Gross Savings</b>	<b>11.5</b>	<b>14.6</b>	<b>17.3</b>	<b>16.4</b>	<b>16.1</b>	<b>16.6</b>	<b>16.1</b>	<b>17.0</b>
o/w National	6.0	13.4	14.9	14.4	15.3	18.5	18.5	18.7
Foreign	5.5	1.3	2.4	2.0	0.8	-1.9	-2.3	-1.7
Gross Domestic Savings	7.0	15.2	16.8	16.3	17.5	20.4	19.5	19.1
<b>Govern. Acc. Structure (%GDP)</b>								
<b>Revenue</b>	<b>18.3</b>	<b>18.2</b>	<b>18.9</b>	<b>19.9</b>	<b>20.6</b>	<b>20.6</b>	<b>21.3</b>	<b>21.7</b>
o/w: Tax Revenue	16.3	16.9	17.3	18.0	18.6	18.7	19.3	19.8
Non-Tax Revenue	2.0	1.3	1.6	1.9	2.0	2.0	2.0	1.9
<b>Expenditure</b>	<b>26.0</b>	<b>23.4</b>	<b>24.5</b>	<b>23.5</b>	<b>23.0</b>	<b>22.6</b>	<b>22.7</b>	<b>22.3</b>
o/w: Current Expenditures	23.3	22.6	23.1	22.0	21.4	20.9	20.2	18.8
o/w: Interest on Debt	0.8	1.2	2.5	2.2	2.2	2.1	2.2	2.1
o/w: Hlth, Educ., S.Ass.	13.3	17.0						
Capital Expenditures	2.8	0.8	1.4	1.5	1.6	1.7	2.6	3.5
Fiscal Current Account Balance	-4.9	-4.4	-4.2	-2.1	-0.8	-0.2	1.1	2.9
<b>Primary Balance</b>	<b>-6.9</b>	<b>-3.9</b>	<b>-3.1</b>	<b>-1.4</b>	<b>-0.2</b>	<b>0.1</b>	<b>0.8</b>	<b>1.5</b>
Overall Balance (and financing)	-7.7	-5.2	-5.6	-3.6	-2.4	-1.9	-1.4	-0.6
Seigniorage	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Privatization proceeds	4.4	1.9	2.6	1.8	1.2	0.6		
Public debt (dom. & foreign)	3.2	3.2	2.9	1.7	1.1	1.2	1.3	0.5
<b>Public Debt/GDP ratio</b>	<b>22.4</b>	<b>37.5</b>	<b>36.7</b>	<b>36.0</b>	<b>34.6</b>	<b>33.6</b>	<b>32.4</b>	<b>30.2</b>
<b>External Accounts (in US\$ million)</b>								
<b>Resource Balance</b>	<b>-980.7</b>	<b>92.9</b>	<b>-63.2</b>	<b>-9.8</b>	<b>223.8</b>	<b>679.0</b>	<b>699.2</b>	<b>520.5</b>
o/w Exports (Merchandise)	5838.7	5878.4	6582.9	7108.7	7855.0	8858.8	10889.5	13141.1
o/w: oil	1654.5	2146.4	2755.7	2888.9	3316.0	4078.7	5198.6	6176.0
o/w Imports (Merchandise)	6588.6	5659.7	6447.8	6914.2	7400.8	7926.6	9919.5	12312.1
<b>Financing Needs</b>	<b>1400.9</b>	<b>1095.8</b>	<b>887.8</b>	<b>1358.6</b>	<b>1107.1</b>	<b>297.3</b>	<b>269.5</b>	<b>262.8</b>
Current Account Deficit	1200.9	198.0	346.9	305.4	128.1	-342.9	-486.4	-411.3
Reserve accumulation of NBK	-308.0	51.8	18.9	283.1	138.1	175.8	222.7	237.7
M & L term debt amortization	508.0	846.0	522.0	770.0	840.9	464.4	533.3	436.5
<b>Financing Resources</b>	<b>1400.9</b>	<b>1095.8</b>	<b>887.8</b>	<b>1358.6</b>	<b>1107.1</b>	<b>297.3</b>	<b>269.5</b>	<b>262.8</b>
Official transfers	-369.0	-325.0	-325.0	-300.0	-300.0	-300.0	-300.0	-300.0
M & L term borrowings	1772.0	1034.8	664.7	953.5	707.8	201.7	279.7	162.8
IMF (net)	115.0	-144.0	13.0	95.0	39.3	-154.4	-100.2	
Foreign direct investment	1149.0	1005.0	1010.0	1010.0	1010.0	950.0	750.0	750.0
Other short-term (*)	-1266.1	-475.0	-475.0	-400.0	-350.0	-400.0	-360.0	-350.0

(\*) includes Portfolio Investment

37. To avoid “picking the wrong winners”, price distortions, and undesirable fiscal impacts, it is important that the fiscal incentives system of the present industrial policy be reviewed and largely eliminated. In general, as long as transparency and free entry and exit exist, the market itself can best choose which specific industries have better comparative advantages. Nevertheless, the government still has a big role to play in assuring the right business environment by eliminating and simplifying licensing processes; providing and disseminating relevant information; clarifying and defining property rights; updating the civil, commercial and

tax codes; and improving the bankruptcy law. Government bureaucracy should not interfere or obstruct business decision beyond the rules of the Law, and the government should refrain from competing in any productive activity where the private sector can deliver a better job.

38. The government itself could expect gradual adjustment of its investment to about 3% of GDP during transition in order to support private investments (especially in agricultural services—research and extension—irrigation systems, road rehabilitation, information dissemination systems) and the development of social areas (mainly health facilities and school rehabilitation).<sup>27</sup> It is important, however, that the government reviews and rationalizes its allocation priorities in favor of basic countrywide infrastructure rehabilitation and their corresponding recurrent expenditure needs, in lieu of the more expensive construction expenditures (e.g., in Astana city, and new roads). The government can significantly increase the PIP allocation over time, as long as the resources from the termination of the SEZ-Astana (Chapter II and IV) and from the non-renewable sources are mobilized through the republican budget. These public investment levels are necessary to support a GDP real growth rate of 3 to 4% in the near future (Table I.3).

39. Sustainable growth of a diversified output and poverty reduction hinges on the government's ability to rationally mobilize domestic resources. For this, tax policy and tax administration restructuring are instrumental. But, as tax reform policy implementation itself and the full benefit of this restructuring are expected to take time, authorities should give the highest possible priority to this area of reform and start implementation soon. However, even taking into account these efforts, one should not expect large initial impacts in collection in the next few years. Nevertheless, if concrete actions are taken soon and policy implementation followed up doggedly, a gradual increase in tax revenue collection to at least about 1.5% of the GDP in the next three years, and smaller increases afterwards, can be projected. Thus, a convergence to about a 20% tax revenue/GDP ratio towards the end of the decade could be expected.<sup>28</sup>

40. The immediate impact of strengthening the tax system should come from the elimination of the excessive exemptions (specially by reviewing the generosity of tax incentive policy to specific industries, the *special* exemptions to many categories of consumers, and consolidation/rationalization of excessive tax rates) and increasing excise tax rates. In the medium term, collection should improve from the strengthening of tax and custom administration, expansion of the tax base (by providing the right incentives to attract informal sectors), and in the property tax (including land) at local levels (which probably requires updating property cadastres). Although non-tax revenue can be substantially improved by the introduction of innovations, like royalties on the mining concessions, and by improvements in cost recovery efforts at local levels (mainly at health and education facilities, and by making these cost recovery revenues explicit on local budgets), the projections for the next few years should be conservatively maintained at about 2% of GDP. Notwithstanding the observations

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<sup>27</sup> See discussion of local governments' investment in Chapters III and IV, and social sectors' in Chapter V.

<sup>28</sup> How significant the impact of oil rent possibilities could be, depends on a thorough examination of the nature of government contracts with the oil companies and the financial/fiscal relationships between KazakhOil, NBK, and the National Treasury.

made in this paragraph, total revenue projection to 21.7% of GDP towards the end of the decade can still be considered in the lower side of the oil/gas producing/exporting countries.<sup>29</sup>

41. Critical to the consistency of the above described level of domestic absorption is the real resource balance (i.e., exports minus imports of merchandise) of external accounts. The real resource balance should show improvements in 2000 and 2001—as a result of the trade and exchange rate liberalization initiated in 1999 and the recovery of oil prices—and should substantially improve from 2002 onward, for the additional impact of the CPC pipeline completion on oil exports, which will gradually reach full capacity in the years ahead.<sup>30</sup>

42. Because of the trade balance performance, it is expected the present external current account deficits of 1-1.5% of GDP may even slightly increase in this and next year on account of oil/gas sector equipment imports, but can turn into a surplus of about 2-2.5% by the mid-decade. The overall balance of payments financing needs reflected by this macroeconomic framework will be mainly affected by the debt amortization, which will be more severe in the next two years (around 5% of GDP), but will abate gradually towards the end of the decade (to about 2%). The NBK may also need a net accumulation of foreign reserves in 2000 to replenish the stock after the losses in the last two years inflicted by the policy of defending the value of the Tenge. From 2001, it is assumed that an additional accumulation of around 1% of GDP per year will be necessary to keep the country in a comfortable reserve position (maintenance of a stock of international reserve of corresponding to 3 months of import).

43. The financing resource envelope basically assumes: (a) a small increase (from 6.4% to 6.9% of GDP) in the inflows of foreign direct investments in the year 2000—with the intensification of the final phase of the CPC pipeline construction—and a gradual decline after that; (b) a gradual decline in borrowing disbursement in the next three years and a sharp decline after that in order to meet the requirements of government (30% of GDP) and total (50% of GDP) debt sustainability by the second half of the decade; and (c) short-term financing and official transfers are assumed to continue to be negative but gradually declining during the decade.

44. The sustainability of the above described base-line macroeconomic framework assumes: (a) continued government commitment with financial stabilization; (b) full implementation of a second generation of structural reforms recommended in this report (including natural resource mobilization policy, for output and employment diversification and income protection of future generations); (c) no major external shocks on the prices of commodities<sup>31</sup>; (d) no major economic/political disruption in neighboring countries, especially Russia; and (e) completion of the CPC pipeline construction on schedule.

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<sup>29</sup> Total revenue to GDP ratio are 35%, 26%, for Venezuela and Mexico, respectively (Source: Interamerican Development Bank (1997), *Latin America After a Decade of Reforms, Economic and Social Progress, 1997 Report*, September (Statistical Profile, pgs. 285 and 293).

<sup>30</sup> The full additional export capacity of the CPC pipeline would be 1-1,5 million barrels per day by the mid of the decade.

<sup>31</sup> The macroeconomic scenario used World Bank commodity price projections.

## **Downside Risks**

45. The above scenario has three distinct downside risks, all related to the excessive exposure of the Kazakhstani economy to its balance of payments external conditions, which might threaten economic recovery and sustainable growth: (a) a deepening in the regional economic crisis, especially in Russia, which would lead to further devaluation of the Ruble; (b) a sharp fluctuation in international prices of commodities, especially oil; and (c) an excessive delay in the CPC pipeline project completion, beyond 2002.

46. Further devaluation of the Ruble would affect Kazakhstani competitiveness and trade, increase pressures on monetary authorities, and could disrupt monetary policy, thus reducing the chances of internal stabilization and jeopardizing growth. A sharp fall in the oil price could have a similar effect, magnified by a slow down in the rate of oil extraction and export and additional delays in the CPC pipeline project construction. A sharp increase in oil prices, on the other hand, would likely affect the speed of structural reforms, since the temporary relaxation of the financial constraints caused by this “windfall gain” would make authorities’ justifications for change more difficult. An excessive delay in the completion of the CPC pipeline project would directly affect the projected resource balance, domestic absorption (private and government expenditures, including investment) would have to be reduced, and sustained growth, as envisaged, would be impossible.

47. Nevertheless, the impact of these risky events would always be more dramatic in a low case scenario resulting from procrastination of reform decision and implementation. Such a low case scenario would be characterized by: (a) fiscal slippage and financial instability; and (b) excessive exposure of the economy to external shocks and “Dutch disease”. In such a scenario, credibility would be low, non-extractive activities would hardly recover, fiscal stance and growth would be unsustainable. In such an economic environment, the potential impact of the simultaneous occurrence of the mentioned risky events would be devastating. The accelerated implementation of the economic and structural reforms suggested in the context of the previous section sustainable scenario are intended to counteract these risks.

## CHAPTER II

### EXPENDITURE PRIORITIES

1. In the face of revenue shortfalls, government spending has to be restrained if an accumulation of arrears and unsustainable debt is to be avoided. At the same time, efforts must be made to minimize disruptions to the provision of public services and to ensure that priority services are delivered as efficiently as possible. Efficient delivery requires an adequate institutional set up that can provide the right incentives for the proper use of resources and for increased standards of service within sectors.

2. Optimization of public expenditure will only be fully effective if certain basic conditions are fulfilled *ex ante* in the budgetary process. These conditions are related to the: (a) appropriate role of the government; (b) transparency of programs' benefits and costs; (c) existence of the necessary technical and administrative capacities for implementation; and (d) clearly established expenditure priorities.

3. If there is no rationale (economic or social) for government intervention, then the program/project/activity under consideration should be left to the private sector, regardless of other considerations. Regarding benefits and costs, clearly established social benefits (expected outcomes) have to outweigh the social costs, and the latter should be the minimum among the alternative strategies. Technical and administrative capacities of implementation have to be in place, otherwise government programs are not going to be successful, regardless of their potential merit. Finally, because of resource constraints, the government has to opt among alternatives and prioritize its expenditures, since it cannot finance all of the projects and programs that meet the previous conditions. Prioritizing public expenditures will involve hard choices, but shows the extent to which the authorities are committed to the country's financial stability. This Chapter focuses on the criteria and conditions for public expenditure prioritization in Kazakhstan.

#### A. CHANGING THE ROLE OF GOVERNMENT

##### The Transition Process

###### a. From Socialism to a Market Economy

4. Kazakhstan has made remarkable progress in its transition from a planned to a market economy relative to many other countries of the former Soviet Union, especially in the privatization of small enterprises and the reduction of the public sector's relative size in the economy. The share of targeted small firms that have been privatized increased from just under 42 percent in 1994 to 100 percent in 1997 (Table II.1). Over the period, the private sector's share of GDP has shown substantial improvement, moving from 20 percent to approximately 55 percent, about the average for transition economies in Europe and Central Asia (Table II.2).

	1994	1995	1996	1997	1998
Private Sector Share in GDP (%)	20	25	40	55	N/A
Initially-Targeted Small Firms Privatized (%)	41.7	60.0	79.5	100.0	100.0
Small-Scale Privatization (units)	2,748	2,477	3,393	5,590	2,535
Mass Privatization (units)	-	147	497	1,122	516
Case-by-Case Privatization (units)	-	5	28	47	13
Credit to Enterprises (% of GDP)	26.8	7.1	4.5	4.5	N/A
N/A - information not available SOURCE: European Bank for Reconstruction and Development, <i>Transition Report 1998</i> ; International Monetary Fund, <i>Republic of Kazakhstan: Selected Issues and Statistical Appendix</i> Staff Country Report No. 99/95, September, 1999.					

5. Where Kazakhstan has not fared as well is in the privatization of large enterprises. Less than half of the large enterprises are in majority private hands, and fully state-owned enterprises continue to contribute a substantial share of the country's GDP (nearly 35 percent in 1998).<sup>32</sup> While Kazakhstan continues to privatize large enterprises on a case-by-case basis, the process slowed considerably in 1998 and 1999 with deteriorating market conditions (Table II.1). As in Russia, Kazakhstan has been waiting out the decline in an effort to maximize privatization revenues. While the rationale behind this delay is understandable, the risk of losing an opportunity to move forward with the privatization program is very high. Ridding the government of typically private sector activities should be a first priority. Allowing market system institutions to develop is necessary to increase economic efficiency and to boost the private sector's reliance on market rules.

6. Not only has Kazakhstan been slow to privatize large enterprises, but the government has retained large stakes in many of the enterprises that have been privatized. There is no convincing rationale for continued government involvement in these enterprises, and efforts should be made to disentangle the public sector role completely. Doing so would increase the efficiency of these firms by compelling financial discipline; that is, removing the soft budget constraints induced by state support. The government can no longer afford to use extremely scarce resources to support failing enterprises.

<sup>32</sup> EBRD (1998) estimate.

**TABLE II.2**  
Private Sector Share of GDP for Transition Economies in Europe and Central Asia, 1997

Country	Private Sector Share in GDP	Country	Private Sector Share in GDP
Albania	75	Latvia	60
Armenia	55	Lithuania	70
Azerbaijan	40	Moldova	45
Belarus	20	Poland	65
Bulgaria	50	Romania	60
Croatia	55	Russian Federation	70
Czech Republic	75	Slovak Republic	75
Estonia	70	Slovenia	50
FYR Macedonia	50	Tajikistan	20
Georgia	55	Turkmenistan	25
Hungary	75	Ukraine	50
<b>Kazakhstan</b>	<b>55</b>	Uzbekistan	45
Krygyzstan	60	<b>AVERAGE</b>	<b>55</b>

SOURCE: European Bank for Reconstruction and Development, *Transition Report 1998*

#### b. New Challenges in the Transition

7. The government of Kazakhstan must not only accelerate the reduction of its direct involvement in the production of private goods and services, but should also consider refraining from its indirect influence on private sector decisions. The government still maintains a significant, although decreasing influence in production enterprises through its use of tax incentives, government loan guarantees, and the direct support of agriculture and small and medium sized businesses. Kazakhstan may have an interest in promoting the development of its infant market economy, but policies in this area should be balanced with the competing and more traditional government roles of maintaining adequate public spending in the social sectors and basic infrastructure. Moreover, development efforts are likely to be more cost-effective if they are refocused on creating a *generally* attractive environment for business rather than targeting or supporting *specific* sectors and enterprises.

8. As Kazakhstan continues to inventory its budget in an effort to identify activities that would be better left to the private sector, it may consider responsibly extending its privatization program to encompass private production of some public services as well. Public *provision* of public goods and services does not necessarily imply public *production* (or delivery) of these goods and services. For example, some activities in the health and education sectors (*e.g.*, some clinics, hospitals, schools, and universities) may be more efficiently produced in the private

sector, although the government may retain its role in overseeing that these services are being financed and delivered in an efficient and equitable manner. To a certain extent, this has already been happening in the health sector with the state order system and formal user charges (Chapter V, Section C), and the emergence of private schools in the country (Chapter V, Section D).

### **The Role of Government in a Market Economy**

9. *Sine qua non* to optimize public expenditures is to define the appropriate role for government in a *market* economy. Over the 1990s, Kazakhstan has made commendable progress towards a market economy, and has been experiencing the transition process of a first generation phase of reforms. The next step is to clearly redefine the government's role in a market economy.

#### **a. The Rationale for Government Intervention**

10. Apart from pursuing social equity objectives (poverty alleviation and income redistribution), the rationale for government intervention in a market economy is justified only in those cases in which there is a compelling market failure, such as that which occurs with public goods, externalities, and uncontested markets. In turn, social equity objectives should be pursued by the government in such a way that distortions to the market economy are minimized.

11. The existence of public goods is perhaps the most fundamental market failure, and provides a clear rationale for the government intervention in a free-market economy. National defense, and to a lesser extent, public order and security, could hardly be provided in the absence of government because individuals cannot be excluded from enjoying the benefits, and hence, cannot be individually charged by a private provider. Moreover, even if individuals could be charged, the fact that they would all benefit simultaneously from each unit provided means that the good would be under-provided by the private sector; i.e., its provision would be inefficient from the resource allocation point of view. Because a sense of security is fundamental to a well-functioning society, national defense and public order must continue to require provision by the public sector, even in a democratic, free-market system. Non-excludable common areas such as parks and monuments and clean air and water are among other examples of public goods for which government must take charge.

12. Although externality producing activities could be provided without government intervention, the resulting allocation of resources would be inefficient. For example, immunizations benefit not only those individuals being immunized, but also the remainder of the population that then becomes less exposed to illness. These externalities are not accounted for in the private market, and hence under-provision would arise as a case justifying government intervention. Nevertheless, the government can subsidize immunization in a way that the socially optimal level is provided. By the same token, firms producing negative externalities (such as pollution) can be taxed so that their product is not over-produced. In brief, the government can intervene to ensure that private providers internalize social costs and benefits adequately, thereby "forcing" the market to account for potentially harmful or beneficial external effects.

13. Uncontested markets, where decreasing costs tend to drive out competitive forces, also require government regulation if they are to be efficient. That is, technical efficiency requires that a single firm produce the product, while allocative efficiency requires that multiple firms produce the product. Public utilities are a case in point, and to some degree, telecommunications. Although a large part of the transition process in Kazakhstan involves getting the public sector away from controlling private enterprise through privatization, there may be cases of uncontested markets where a clear rationale for maintaining government control exists. One option in these special cases is to impose efficient prices (regulation) on these firms. While truly efficient prices would require that the firms absorb losses, prices could be set to cover costs plus a reasonable profit. Alternatively, the government could retain control, setting efficient prices and making up the losses with general revenues.<sup>33</sup>

14. Finally, poverty reduction and income redistribution goals necessitate government involvement. The key to achieving these goals in a market system is to provide for the less fortunate in a way that minimizes distortions to market prices. In most cases, this means getting away from the subsidy mechanism common to socialist systems and, instead, utilizing a direct cash transfer mechanism targeting the poorest (Chapter V, Section A). Because cash transfers do not distort relative prices, they tend to be neutral to consumer choices, and hence do not directly impede market forces.

#### b. Evolving Priorities

15. Kazakhstan has also made progress in its transition from their former heavy, ubiquitous and “all-encompassing” state to a new supportive, “mainly regulatory” state which basically aims at supplying infrastructure, regulating economic activities as appropriate, administering social justice, and protecting the poor and the environment. The government’s stated priorities, during the transition, has been the reduction of expenditures on “social areas” (meaning, the traditional privileges, generalized unemployment benefits, and the direct maintenance of tertiary and specialized schools and hospitals) and administrative areas (including military and defense) and to fundamentally increase expenditures on basic infrastructures while protecting the poor. The *Kazakhstan 2030* document reflects these priorities by establishing as long-term objectives for the country: (1) national security; (2) domestic political stability and consolidation; (3) economic growth; (4) improved health and education; (5) enhanced power resources; (6) improved infrastructure, especially transport and communications; and (7) a professional civil service.

16. These broad objectives are consistent with the role of government in a market economy, as outlined above. To what extent these stated long-term objectives are translated into actual policies and to what extent these objectives can be achieved considering the present institutional environment are two major challenges that the government has to face at the present moment. Section B of this Chapter addresses the first challenge by examining the country’s public expenditure policy priorities. Chapter III addresses the second challenge by examining the expenditure management set up and ways to effecting prioritization of public expenditures in Kazakhstan.

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<sup>33</sup> Or charging average-cost prices. There is no *a priori* reason to expect taxes on utilities or other decreasing cost enterprises (in the form of departures from marginal cost pricing) to be less efficient than other taxes.

## B. PRIORITIZING PUBLIC EXPENDITURE

17. While the structure of public expenditures is basically consistent with the proper role of government in a market economy, there is still room for continued reduction of the public sector's intervention in private sector activities in Kazakhstan. Nevertheless, at this stage of the adjustment process, choices for a limited number of projects and programs are becoming increasingly difficult. Without well-defined and socially/politically-accepted criteria, expenditure options often are equally defensible and important. In this regard, the distribution of expenditures should be a function of the specific needs and desires voiced by the people who benefit from public services. Nevertheless, there are some basic general technical criteria that can help in optimizing expenditure composition, such as the contribution of specific programs to growth and/or social equity. Also, when a change in expenditure composition brings about a reduction in cost rather than a change in output composition, inter-sectoral priorities may be an issue of efficiency rather than value judgements.<sup>34</sup>

### Policy Priorities and the Composition of Spending

#### a. The Economic Composition of Expenditures

18. Table II.3 shows expenditure execution by economic composition for the consolidated state budget from 1997 through the first six months of 1999, as well as comparable international figures for middle and high income countries. The most obvious feature of this table is that expenditures by economic classification have been relatively stable in Kazakhstan over the last two and a half years.<sup>35</sup> The largest share of spending was in the form of transfers, mostly to households and non-profit institutions, while wages and salaries received the second greatest share, about one-quarter of total spending. The only individual item showing a systematic trend is debt servicing, which became increasingly important after 1997.

19. ***Wages, Salaries and Employers' Contributions.*** A comparison of expenditures by economic classification to other middle income countries suggests that Kazakhstan's public sector may still be spending too much on wages and salaries. Combined wages, salaries and employer contributions accounted for 26.7 percent of total public spending in the first six months of 1999, which is higher than the comparators. It seems that after making much progress in reducing the wage bill's share of public sector spending through the early and mid-1990s, the government has stopped short of an appropriate target. Kazakhstan has made a commendable effort to restructure its civil service (especially when compared with other transition economies in the region), but more needs to be done to reduce the wage bill's share of total spending if public expenditure is to be efficient and effective. As progress has been observed at the national level, much of the improvements in budget allocation now will crucially depend on the

<sup>34</sup> See Ke-young Chu *et al.*, *Unproductive Public Expenditures: A Pragmatic Approach to Policy Analysis*, Pamphlet Series No. 48, International Monetary Fund, Washington, DC, 1995.

<sup>35</sup> In Table II.3 expenditures from extra-budgetary funds for 1997 and 1998 were allocated entirely to *subsidies and transfers* in this table because a breakdown by economic composition was not available. However, most likely a portion of these expenditures are for the purchase of goods and services, and possibly for wages and salaries.

implementation of public employment and wage reforms (including healthcare and education sectors) including the subnational levels of government.

	1997		1998		1999 Jan-Jun	1996	
	Share of GDP (%)	Share of Total (%)	Share of GDP (%)	Share of Total (%)	Share of Total (%)	Share of Total (%) (Middle Income Countries)	Share of Total (%) (High Income Country)
<b>Current Expenditure</b>	<b>24.5</b>	<b>87.2</b>	<b>22.2</b>	<b>86.5</b>	<b>92.6</b>	<b>81.1</b>	<b>92.6</b>
Goods and Services**	11.2	40.0	9.9	38.6	49.9	35.1	46.0
Wages and Salaries	6.0	21.2	5.3	20.6	22.4		
Employers Contribut.	1.3	4.8	1.2	4.7	4.3	12.2	22.7
Other Goods & Serv.	3.9	14.0	3.4	13.3	23.2	17.0	21.8
Interest Payments	0.6	2.0	0.8	3.1	6.4	4.3	11.2
Subsidies and Trasfrs***	12.7	45.2	11.5	44.8	36.3	41.7	35.4
o/w subsidies	1.3	4.7	0.8	3.1	0.9		
o/w extra-budget funds	7.6	27.2	4.3	16.8	-		
<b>Capital Expenditure</b>	<b>1.8</b>	<b>6.4</b>	<b>2.1</b>	<b>8.1</b>	<b>2.9</b>	<b>18.1</b>	<b>7.4</b>
<b>Total Expenditure</b>	<b>26.3</b>	<b>93.6</b>	<b>24.3</b>	<b>94.6</b>	<b>95.5</b>	<b>99.2</b>	<b>100.0</b>
<b>Lending - Repayment</b>	<b>1.8</b>	<b>6.4</b>	<b>1.4</b>	<b>5.4</b>	<b>4.5</b>	<b>0.8</b>	<b>0.0</b>
<b>TOTAL</b>	<b>28.1</b>	<b>100.0</b>	<b>25.7</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<p>* 1997 and 1998 include extrabudgetary fund  ** AWages and Salaries® and AOther Goods and Services® do not add up to total Goods and Service in the international comparisons because some countries do not separate wages and salaries from other goods and services  *** Includes unclassified expenditures from extra-budgetary funds (1997 = 27.2%; 1998 = 16.8%)  SOURCES: Kazakhstan data, Ministry of Finance; International data, Ke-young Chu <i>et al.</i>, <i>Unproductive Public Expenditures: A Pragmatic Approach to Policy Analysis</i>, Pamphlet Series No. 48, International Monetary Fund, Washington, DC, 1995; staff estimates</p>							

20. Apparently, the greatest problem with the wage bill's share in total spending is related to intra-sectoral priorities. The general practice has been that wages and salaries are paid first, utilities second, and the purchase of goods and services or facility maintenance is left as a residual item (the latter includes direct social assistance programs). In recent years, when financial resources have been especially tight and cash controls superseded budget commitments, nearly the entire effected expenditures for some institutions has been devoted to employee compensation and utilities. For instance, in the last two years, wages and salaries have accounted for over 70 percent of local health care spending, compared to around 40 percent earlier in the decade.

21. There is a real need to reprioritize intra-sectoral expenditures so that the greatest benefits are achieved for each tenge expended. This is not done by paying salaries and utilities first and leaving the rest as residual items. Rather, if and when expenditures must be cut, the staff and facilities should go with them because they are no longer necessary.<sup>36</sup> This will ensure that scarce resources are not wasted on redundant staff and facilities, but instead are used in a mix that offers the greatest return for a given pool of resources. Moreover, research indicates that expenditure reductions are more sustainable when employment is reduced than when compensation is cut.<sup>37</sup>

22. **Interest on the Debt.** Debt servicing has absorbed an increasing share of total government resources over the last few years. In 1997 debt servicing accounted for two percent of total public sector spending in Kazakhstan, but in the first six months of 1999 debt servicing's share had increased to 6.4 percent. As a share of GDP, debt servicing has increased from 0.6 percent in 1997 to a projected 1.1 percent in 1999 and to 2.2 percent in 2000.

23. Much of the recent increase in debt service can be attributed to currency devaluation, but deficits of around four percent of GDP (gross of capital revenues) per year have added significantly to the total debt and debt servicing figures. This implies that Kazakhstan has been substituting current spending for future spending. Fewer and fewer resources will be available to finance the future needs of the government if debt servicing continues to absorb increasing shares of the total resources captured by the public sector. Thus, decision makers should understand that the maintenance of a sustainable fiscal envelope is crucially important not only for macroeconomic stability and government creditworthiness reasons, but also for keeping adequate flexibility for future spending. An important component of expenditure prioritization is the trade-off between present and future spending, and hence, each tenge of deficit financing today should be viewed in light of the spending in critical public services that will be foregone in coming years.

24. **Other Current Expenditures.** A comparison of 1997 and 1998 figures suggests that spending on "other goods and services" and "subsidies and transfers" is relatively stable, as is the economic composition of expenditures generally in Kazakhstan.<sup>38</sup> Moreover, data from the first six months of 1999 (which formerly incorporates off-budget expenditures) suggests that Kazakhstan's spending in these two categories together is more or less inline with international practice for middle income countries (about 60 percent of total spending), although Kazakhstan spends relatively more on purchases of goods and services and relatively less on subsidies and transfers.

25. An important trend evident in the economic composition of expenditures is a reduced emphasis on subsidies in favor of more direct transfers. In 1997, subsidies accounted for 4.7

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<sup>36</sup> On this issue see also Chapter III), Chapter V (Section C., on the impact of decree no. 1314/98), and Chapter V (Section D)

<sup>37</sup> See Vito Tanzi, "Fiscal Issues in Adjustment Programs," *Ricerche Economiche*, 44(2-3), 1990, pp. 173-194.

<sup>38</sup> Spending on "other goods and services" and "subsidies and transfers" is difficult to compare over time in Kazakhstan due to the lack of information on the economic composition of extra-budgetary expenditures of the past years, which for the most part would have been distributed across these two categories. For similar reasons, international comparisons are also tenuous.

percent of total public spending, but the share has been rapidly reduced to 3.1 percent in 1998 and to 0.9 percent in the first six months of 1999. An example of the policy behind this move is provided by the social protection system. Formerly, much of the social assistance in Kazakhstan was provided in the form of a myriad of price discounts and other subsidies. In April 1999, most subsidies were replaced with a single cash allowance. This is a welcome development for several reasons. First, the administrative costs are smaller for cash allowances than for subsidies. Second, transfers do not distort relative prices as subsidies do, and hence a cash transfer provides a greater addition to societal welfare than does a subsidy of equal magnitude. That is, for every tenge spent, the benefits are at least as great for a transfer as for a subsidy.<sup>39</sup>

26. However, in other functional areas subsidies continue to play a role. For example, the 1999 and 2000 Republican budgets allocate T200 million for farm subsidies. Because such subsidies have great potential for inducing (or maintaining) inefficiencies, the government may want to consider, as part of its continued effort to disengage from private sector activities, reviewing the rationale of protecting the agriculture sector through this means.

27. Another issue of concern is the practice of prioritizing wages and salaries in the face of deteriorating fiscal conditions. This has forced institutions to find alternative, nontraditional means for financing the purchase of goods and services. Many schools, for example, have been relying on parental groups to provide the necessary textbooks and materials. Also, for some medical institutions, financial relief has come only from the small number of patients that are able to pay for medicine, material and medical services (part of those resources have been used to compensate doctors and part to provide medicines for more indigent patients). Some hospitals and schools have been resourceful in finding ways to minimize disruptions in service delivery in times of fiscal constraint. This suggests that great benefits could be achieved by offering those institutions with more autonomy on the use of their funds, as a way to enhance delivery of education and health in Kazakhstan. Certainly, all funds should be on budget.

28. **Capital Investment and Maintenance.** Also as a consequence of the disproportionately large share of public spending that goes to pay wages and salaries, Kazakhstan has clearly been under-investing in its infrastructure compared to other middle income countries. In 1997 and 1998, capital expenditure accounted in average for 7 percent of Kazakhstan's total public sector spending, compared to about 18 percent of the middle income countries. While the comparable figure for high income countries is also about 7 percent, these countries enjoy a substantial amount of investment by the private sector that is not the case in the less developed countries and especially in Kazakhstan. Moreover, the public capital investment situation does not seem to be improving in Kazakhstan, rather, capital expenditure was down considerably to less than three percent of total spending in the first six months of 1999. This would amount to about 0.8 percent of GDP on an annualized basis, which is a considerably low level of investment. If Kazakhstan is to continue in its development and prosper in the future, it has to invest in basic infrastructure and better prioritize capital expenditures.

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<sup>39</sup> If *all* of the cash transfer is used to purchase goods that would have been subsidized in lieu of the transfer, then the benefits would be equal. Otherwise, a cash transfer of equal magnitude would provide *greater* benefits than a subsidy.

29. The problem of low infrastructure investment in Kazakhstan is exacerbated by the inadequate maintenance of existing facilities. As schools and hospitals have been closed as part of the reform policies, the remaining facilities have been neglected to such a degree that they are barely usable in some cases. While in many developing countries a major source of the problem is an emphasis on politically popular new investments rather than the maintenance of the existing infrastructure, in Kazakhstan overall public capital investment is dismal and the problem seems to be more a combination of constrained financial resources and a lack of well-designed priorities. Capital maintenance often is less politically appealing than other forms of current expenditure, and, lacking firmly established spending priorities at the outset of the budget cycle, tends to get a low priority during times of fiscal constraint. For example, as mentioned above, salaries and utilities generally get immediate priority, which leaves very little in the way of financing for infrastructure maintenance. The lack of expenditure for infrastructure maintenance may have disastrous consequences for the years ahead.

30. Eventually, inadequate maintenance will render infrastructure such as school buildings and hospitals useless, which will end up necessitating investment in new facilities. Maintenance of existing facilities would instead be less costly and would yield a substantially greater return. Greater priority for infrastructure maintenance is presently very critical in Kazakhstan. Seemingly, the government is aware of the problem, and the 2000 Republican budget significantly improves allocation for maintenance in the transportation sector—road maintenance is programmed to increase by T3.6 billion to T5.3 billion, an increase of about 200 percent in real terms. However, more needs to be done in other sectors, especially in the more labor-intensive sectors like education and health, which are especially affected by the established salary priority policy in times of fiscal restraint.

31. The government should urgently improve its capital investment and maintenance policy. First, a greater proportion of the budget should be allocated to investment and maintenance, by shifting the priorities away from wages and salaries and from net lending. Second, each sector needs to clearly identify infrastructure needs and prioritize these needs within the confines of available resources. Third, adequate recurrent expenditure for operations and maintenance should be explicitly appropriated from the outset when capital projects are approved—which will require much expanded use of multi-year budgeting.<sup>40</sup> Finally, those responsible for planning, budget development, and oversight should ensure that the limited resources available for capital expenditure are utilized in truly public sector projects rather than for projects that should be privately financed.

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<sup>40</sup> See Chapter III.

<b>TABLE II.4</b>				
Consolidated Expenditures by Functional Group and Net Lending As a Share of GDP (%)				
	1997 Executed	1998 Executed	1999 Projected	2000 Projected
<b>RECEIPTS</b>	<b>20.8</b>	<b>17.6</b>	<b>20.3</b>	<b>19.7</b>
<b>EXPENDITURES</b>	<b>26.3</b>	<b>24.3</b>	<b>26.1</b>	<b>24.4</b>
<b>Government Admin. &amp; Nat. Security</b>	<b>4.6</b>	<b>4.7</b>	<b>4.4</b>	<b>4.2</b>
Government Administration	1.8	1.8	1.6	1.6
Defense	1.1	1.1	1.0	0.9
Public Order	1.7	1.8	1.8	1.7
<b>Social Sector</b>	<b>16.2</b>	<b>13.1</b>	<b>16.7</b>	<b>13.9</b>
Health	2.8	2.1	2.9	2.2
Education	4.4	3.9	4.1	3.4
Social Security and Welfare	8.0	6.2	8.8	7.5
Housing and Community Amenities	0.3	0.2	0.2	0.3
Culture, Sports, and Recreation	0.7	0.7	0.7	0.5
<b>Economic Services</b>	<b>1.6</b>	<b>1.0</b>	<b>1.6</b>	<b>2.4</b>
Fuel and Energy Complex	0.1	0.0	-	-
Agriculture, Water, Forestry, Fishing, And Environmental Protection	0.6	0.3	0.5	0.5
Industry, Construction, and Mining	0.3	0.1	0.2	0.2
Transport and Communications	0.6	0.6	0.9	1.7
<b>Debt Servicing</b>	<b>0.6</b>	<b>0.8</b>	<b>1.1</b>	<b>2.2</b>
<b>Other</b>	<b>3.3</b>	<b>4.7</b>	<b>2.3</b>	<b>1.7</b>
<b>LENDING - REPAYMENT</b>	<b>1.8</b>	<b>1.4</b>	<b>1.2</b>	<b>1.2</b>
<b>TOTAL EXPENDIT. &amp; NET LENDING</b>	<b>28.1</b>	<b>25.7</b>	<b>27.3</b>	<b>25.6</b>
<b>SURPLUS (DEFICIT)</b>	<b>(7.3)</b>	<b>(8.1)</b>	<b>(7.0)</b>	<b>(5.9)</b>
SOURCE: Ministry of Finance				
NOTES: Revenues exclude capital transactions, which are treated as a financing item				
1997 and 1998 include extra-budgetary funds				
GDP (bil Tng): 1997 = 1,672; 1998 = 1,748; 1999 = 1,824; 2000 = 2,128				
Components may not sum to totals due to rounding				

## b. The Functional Composition of Expenditure

32. The functional composition of expenditures for 1997-1998 (execution) and for 1999-2000 (budget) reveal two main features of consolidated (state) public spending in Kazakhstan (Table II.4).<sup>41</sup> First, total spending has fluctuated with revenue collections, i.e., apparently efforts have been focused on financing the expenditures rather than deficit reduction. This focus seems to have changed to some degree in 2000, as planned spending is reduced by 1.7 percent of GDP from projected 1999 levels, while revenue collections are expected to drop by only 0.6 percent of

<sup>41</sup> The government significantly changed the way expenditures are reported in 1997, which makes for tenuous comparisons with earlier periods at best. For this reason, the analysis is focused on the period 1997 and onwards. More detailed tables are presented in the statistical appendix.

GDP. Second, as discussed below, when expenditures are reduced, it is spending in the social sectors that bears most of the burden.

33. Kazakhstan's inter-sectoral spending priorities, at least across the broader functional categories of expenditures, are reasonable and do not differ too much from those of other middle income countries (Table II.5). Kazakhstan spends relatively less on security (military and police expenditures) and relatively more on the growth-enhancing education and health sectors. Spending on social security and housing and other government services is more or less in line with international practices.

34. **Government Administration and National Security.** Spending in the areas of government administration and national security is somewhat lower in Kazakhstan than in other middle income countries and has been very stable as a share of GDP in the last few years. Spending on government administration and public order hovered at just under two percent of GDP in 1997-98, while expenditures on national defense were just over one percent of GDP (Table II.4). For 1999 and 2000, plans are to decrease spending on national defense and government administration by about 0.2 percent of GDP, while public order expenditures will stay fairly constant.

	Kazakhstan		Middle Income Countries		High Income Countries	
	1997-1998 (weighted average)		1983-1990 (two-year weighted averages)			
	% GDP	% Total	% GDP	% Total	% GDP	% Total
<b>Expenditure</b>	<b>25.3</b>	<b>100.0</b>	<b>23.9</b>	<b>100.0</b>	<b>39.1</b>	<b>100.0</b>
Defense	1.1	4.3	1.5	6.5	4.7	12.0
Education	4.1	16.4	2.4	10.1	4.9	12.5
Health	2.4	9.5	1.7	7.0	5.1	13.1
Social Security and Housing	7.4	29.2	7.0	29.3	11.3	28.8
Other	10.3	40.6	11.3	47.1	13.1	33.6
Number of Countries	N/A		7		8	
NOTES:	Expenditure does not include lending minus repayment					
SOURCES:	Middle Income countries include Argentina, Chile, Hungary, Panama, Romania, Swaziland, and Zimbabwe; High income countries includes Australia, Canada, Denmark, Germany, Israel, Luxembourg, United Kingdom, and the United States International Data, Ke-young Chu <i>et al.</i> , <i>Unproductive Public Expenditures: A Pragmatic Approach to Policy Analysis</i> , Pamphlet Series No. 48, International Monetary Fund, Washington, DC, 1995. Kazakhstan Data, Ministry of Finance; staff estimates.					

35. Although spending in administration and security are not out of line with international standards, their share in GDP has been basically protected. This is in line with the *Kazakhstan 2030* document, which establishes as an objective the maintenance of these state functions a first priority. The implication, however, is that the stability of these expenditures as a share of GDP

necessarily means that during retrenchment periods, social sector spending will bear the lion's share of the required fiscal adjustments in Kazakhstan.

36. **Social Sector Spending.** In fact, recently social sector spending as a share of GDP in Kazakhstan has fluctuated considerably without showing a definite trend. On one hand, during periods of more severe financial constraints (1998 and 2000) the social sectors have born most of the burden (Table II.4). Total expenditures fell by 2.0 percent of GDP from 1997 to 1998, and social spending fell 3.1 percent. Likewise, the 1.7 percent (of GDP) reduction in total expenditure for 2000 budget is encompassing a programmed 2.8 percent (of GDP) decrease in social spending. On the other hand, increases in social sector spending has tended to comprise the bulk of expenditure increases, as was the case in 1999. "Health" and "social security and welfare" components have shown more year to year fluctuations than the "education" component of social spending (Table II.6). Education expenditures have shown some stability as a proportion of GDP, but appear to be declining as a share of total spending from 1997 to 2000 (from 15.6 percent to 13.4 per cent).

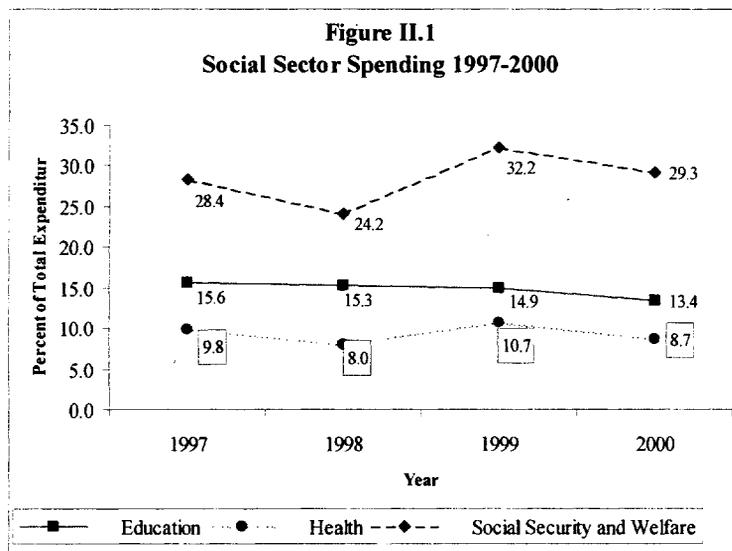
	1997 Executed	1998 Executed (% change)	1999 Projected (% change)	2000 Projected (% change)	Local Share (%) 1999
<b>TOTAL SOCIAL SPENDING</b>	<b>16.2</b> -	<b>13.1</b> <b>(-19.1)</b>	<b>16.7</b> <b>(27.5)</b>	<b>13.9</b> <b>(-16.8)</b>	<b>44.8</b>
o/w Education	4.4 -	3.9 <b>(11-4)</b>	4.1 <b>(5.1)</b>	3.4 <b>(-17.1)</b>	78.9
o/w Health	2.8 -	2.1 <b>(-25.0)</b>	2.9 <b>(38.1)</b>	2.2 <b>(-24.1)</b>	83.5
o/w Social Security and Welfare	8.0 -	6.2 <b>(-22.5)</b>	8.8 <b>(41.9)</b>	7.5 <b>(-14.8)</b>	13.8
SOURCE: Ministry of Finance, staff calculations					
NOTES: 1997 and 1998 include extra-budgetary funds					
GDP (bil Tng): 1997 = 1,672; 1998 = 1,748; 1999 = 1,824; 2000 = 2,128					
Components may not sum to totals due to rounding					

37. The large variance in social expenditures suggests that these sectors are left largely as a residual item for the budget, meaning that social spending is not given a high priority at the margin. Although education has been protected by compulsory minimum level of spending enforced on the local administrations, and has been treated as a non-sequestrable item by the annual budget laws, its share in total spending of the government has shown a declining trend (Figure II.1). This may suggest that the policy has gradually been to reduce the role of the government in the sector. The 1999 government resolutions no. 698 and 1018, implementing on an experimental basis the incentive scheme of providing grants and credit for higher education in replacement for the direct maintenance of the institutions, are policies in the direction of promoting private provision of education and increasing efficiency in the sector.

38. There does not appear to be a significant difference in the priority placed on social sector expenditures across levels of government, as social security and welfare, which is financed

primarily by the central government, follows a spending pattern similar to that of education and health, which are financed primarily at the local level.

39. In the Soviet era, Kazakhstan seemed to have had a social expenditure pattern more in line with high income countries (although efficiency and quality of services could be questioned). After its independence and the financial crises, it became evident that these patterns could not be sustained under the country's economic and financial conditions. On average, high income countries and middle income countries spend on education and health together about 10 percent and 4 percent of their GDP, respectively (Table II.5). As a result of post-independence adjustments, Kazakhstan spent 6.5 percent in 1997-98, projects 7 percent for 1999, and budgeted 5.6 percent for 2000. While requiring major improvements in the intra-sectoral priorities and technical efficiency fronts, the current levels are apparently still in line with international practices.



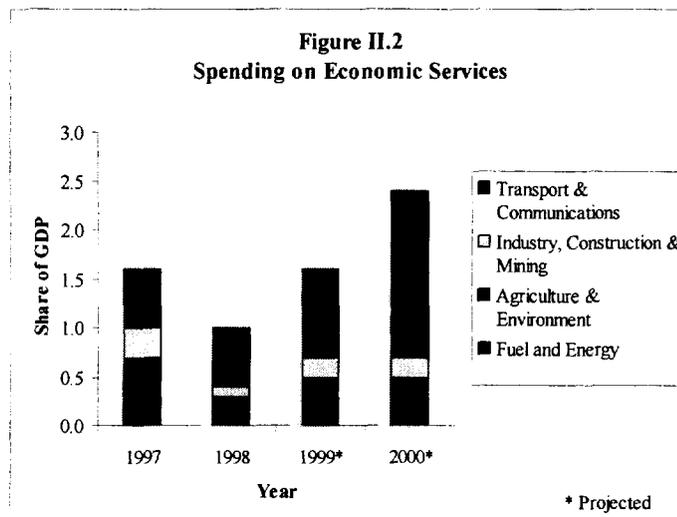
40. Because health and education expenditures make up the majority of the local budgets (approximately 60 percent in 1999 budget), adjustments in health and education spending policies have also entailed reduction in the size of the local budgets. To a certain extent this is also a result of the redefinition of the Social Assistance program and the shifting of responsibility for the Special State Allowance component to the Republican budget (Chapter V, Section B). As a consequence, as shown in Table II.7, local government budgets will bear most of the adjustment burden of expenditure reductions in 2000. Total spending from local budgets will fall by approximately 0.94 percent of GDP from 1999 levels, while republican spending is due to decrease by 0.42 percent of GDP.<sup>42</sup>

<sup>42</sup> While the new tax sharing arrangement has improved revenue flows to local governments since 1999, the new transfer mechanism has taken back a substantial part of these local gains by increasing withdrawals and reducing subventions as a share of GDP (Chapter IV).

	1999	2000	Change
<b>Receipts</b>			
<b>Republican Budget</b>	<b>15.73</b>	<b>15.99</b>	<b>0.26</b>
o/w withdrawals	2.08	2.40	0.32
<b>Local Budgets</b>	<b>12.09</b>	<b>11.03</b>	<b>(1.06)</b>
o/w subventions	1.40	1.31	(0.09)
<b>State Budget</b>	<b>23.76</b>	<b>22.65</b>	<b>(1.11)</b>
<b>Expenditures</b>			
<b>Republican Budget</b>	<b>19.41</b>	<b>18.99</b>	<b>(0.42)</b>
o/w subvention	1.40	1.31	(0.09)
o/w debt servicing	1.07	2.17	1.10
<b>Local Budgets</b>	<b>12.04</b>	<b>11.10</b>	<b>(0.94)</b>
o/w withdrawals	2.08	2.40	0.32
o/w education	3.30	2.72	(0.58)
o/w health	2.44	1.85	(0.59)
<b>State Budget*</b>	<b>27.38</b>	<b>25.65</b>	<b>(1.73)</b>
*Republican and local figures are gross of intergovernmental transfers and hence do not sum to State totals SOURCE: Ministry of Finance; staff calculations			

41. **Economic Services.** Expenditures in the economic sector account for a relatively small portion of total public sector spending in Kazakhstan. In 1997, economic services accounted for 5.7 percent of total spending (1.6 percent of GDP), while in 1998 economic services contributed only 3.9 percent of the budget (1.0 percent of GDP). As demonstrated in Figure II.2, the share of public resources allocated to economic services is expected to increase rather substantially by 2000 to 9.4 percent of total spending, or 2.4 percent of GDP. This increase will come almost entirely from additional expenditures in the transport and communications sector.

42. The budget data reflect a reduction in subsidization of industry and utilities, which is a commendable direction the government is taking (Figure II.2). Nevertheless, the country continues supporting the agricultural sector in a non-transparent way, although not to the degree that it used to be earlier in the decade. The 1999 and 2000 budgets allow T200 million for direct subsidization of farmers, and the 2000 budget allocates T740 million to a new program for state grain reserves. To justify their priority, objectives, costs and benefits of these programs should be explicitly confronted with the alternative uses for the resources allocated. Sometimes there are legitimate reasons for public sector intervention in agriculture (*e.g.*, storage of grain for food security, rural extension services, collective water supply), but, in general, government intervention in the market mechanisms (*e.g.*, price support programs—with or without stock accumulation, marketing boards, credit subsidies) tend to introduce allocation inefficiencies in the economy with high social costs.



43. The most salient feature of the data reported in Figure II.2 is the increasing trend, with a substantial increase in 2000 budget allocation, in expenditures on transport and communications. Spending in the sector is planned to increase 136.5 percent over 1999 levels, from T8.3 billion to T19.6 billion. Road expansion (construction and reconstruction) will account for the bulk of new spending, much of which will be externally financed. The projects for the construction of Kzylasker-Kirovsky road and reconstruction of Almaty-Karaganda-Astana-Borovoye road (three-quarters externally financed) alone will add T8.8 billion to the transport and communications budget, which together are larger than the entire transport and communications budget for 1999 (Table II.8). Budget provision for road maintenance will also increase considerably, from T1.6 billion in 1999 to T5.3 billion in 2000. The emphasis on reconstruction and maintenance of basic infrastructure has been justified for the lack of proper maintenance of the stock of capital during the 1990s. While the increase in spending on road maintenance is a welcome development, the magnitude of the increase is rather extraordinary given the needs in other sectors. These enhancements in infrastructure priorities must be measured against the cost of cutting the allocations for the social sectors and the cost of increasing external debt.

44. **Construction of Astana.** The current massive allocation of public resources for the construction of the new capital may raise fundamental questions pertaining to the country's expenditure prioritization. This factor alone is serious enough to jeopardize the rationalization effort made by the government in other areas of fiscal policy. The current construction process fails to fulfill some basic principles of adequate prioritization procedures: (a) allocation based on transparent and simultaneous evaluation of resource uses; (b) the role of government in a market economy; (c) financial sustainability; and (d) contribution for growth and social equity.

Item	1999	2000	Change (% Change)
Road System Maintenance at the Republican Level	1,600,000	5,263,895	3,663,895 (229.0)
Construction of Kzylasker-Kironsky Road in South Kazakhstan*	288,809	1,433,809	1,145,000 (396.5)
Reconstruction of Almaty-Karaganda-Astana-Borovoye Road*	1,487,234	7,319,340	5,832,106 (392.1)
<b>TOTAL TRANSPORT AND COMMUNICATIONS</b>	<b>8,275,330</b>	<b>19,574,257</b>	<b>11,298,927</b> <b>(136.5)</b>
* Partially externally financed SOURCE: Republican Budget 2000, Ministry of Finance			

45. While heavily financed by public funds, Astana's construction has been conducted outside the state budget; as such, it is beyond public purview. The Astana Special Economic Zone (SEZ) exceptionally benefits from 50 percent of Republican tax collections in the Zone, and allocates a substantial part of these public resources through the ASTANA FINANCE<sup>43</sup> company for the development of the capital city.<sup>44</sup> Apart from the potential inefficiencies of the SEZ *per se*, the fact that the use of a substantial volume of public resource are not submitted to public scrutiny in the same budget simultaneously (and in confrontation) with the other alternative projects, clearly prevents the establishment of adequate priorities and distorts resource allocation. Specifically, the budget does show neither (directly or indirectly) the public revenue forgone through the Astana SEZ nor the projects (individually or collectively) that these resources are financing.

46. In many ways, the conducting of Astana construction has represented a serious departure from the government's efforts to restrict public sector involvement in private sector activities in other areas. Beyond guarantees provided by the government to the private sector (not always for performing loans), the public sector has also been involved with the construction of a cinematic complex and a trade center, among several other activities outside the scope of government role in a market economy.

47. It is doubtful that the intensive and costly construction process of official buildings, commercial and social infrastructure as well as quick transplantation staff and materials to Astana, is financially sustainable in face of the serious constraints of resources experienced during the transition to an open market economy. So far, the financial stresses have been manifested through a fast increase in foreign debt and painful sacrifices of some key social sectors (health, education and social assistance to the poor) and lack of investment in and

<sup>43</sup> The former "Astana Fund", is now an Open Joint-Stock Company, a special financing instrument designed to provide credit and guarantees (including for foreign loans) to constructors and businesses.

<sup>44</sup> Although Astana has the highest per capita revenue collection (largely due to the SEZ), it is not subject to budget withdrawals like the other regions of the country. In 1999, of Astana's T13 billion budget, approximately T8.3 has been allocated to "Astana Finance" for the development of the new capital city.

maintenance of basic infrastructure in other regions of the country. It is doubtful such a process can be sustained in the near future.

48. Finally, even in the absence of the present severe financial constraints, the historical evidence elsewhere has suggested that moving the country's capital would hardly contribute to the objectives of economic growth and social equity.<sup>45</sup> Therefore, these projects could rarely be eligible as high priority public expenditures.

49. **Enhancing Inter-Sectoral Prioritization.** Can the government do better? The examination of the 1999 and 2000 budgets suggest that government still has considerable space to maneuver prioritization to increase the efficiency of public expenditures in Kazakhstan. Many areas of possible improvement are evident. For instance, the special state benefits are projected to increase by T1.8 billion from 1999 to 2000 (after annualizing the 1999 figure), an increase of 15.4 percent. Because these benefits are not poverty targeted, they are of doubtful priority. In total, special state benefits will cost the republican budget a projected T13.8 billion in 2000. Other functional groups such as defense, public order, and general government administration are programmed to have little change from 1999 to 2000. The latter is an area of significant potential retrenchment, since their contribution to economic development and social equity are not as evident as that of social sector spending and public infrastructure. As observed above, the speed of construction of the new capital absorbs an unaffordable amount of resources, some of which are of doubtful priority. Also, consideration could be given to eliminating off-budget items such as tax expenditures and loan guarantees, neither of which are being adequately prioritized, or even monitored.<sup>46</sup>

#### **Intra-Sectoral Spending Priorities**<sup>47</sup>

50. The maintenance of a sustainable fiscal environment in Kazakhstan requires retrenchment in the public sector, and even cutting popular programs. Thus, conditional to equity objectives, efficiency has to be maximized, and for this the key is to maximize the overall benefit of a given pool of resources over the long-term. This requires not only a careful distribution of resources *across* sectors, but also, and perhaps more importantly, reallocation of resources *within* sectors. Moreover, the latter must ensure an appropriate input mix of capital and recurrent expenditure and technical efficiency in the use of budgeted resources in each sector. Therefore, aiming at maximum efficiency in service delivery at the program and sub-program level is crucial for effective expenditure management.

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<sup>45</sup> See "Capital Punishments," *The Economist*, 12 December, 1997.

<sup>46</sup> For off-budget activities, see Chapter III.

<sup>47</sup> For lack of sufficiently detailed data on defense and internal security, this report limits the scope of its discussion of intra-sectoral priorities to the social and economic sectors.

a. Intra-Sectoral Priorities in the Social Sectors<sup>48</sup>

51. ***Prevention programs in health are cost-effective.*** In a sense, it is understandable that resources are only available to deal with emergency situations in Kazakhstan's health sector. This is a typical and recurrent issue in intra-sectoral public expenditure priority and management, but this approach focuses on "putting out fires" rather than preventing fires from occurring or from spreading out of control. The way to prevent uncontrollable health care costs in the future is to focus resources on prevention today. A case in point is the world-wide AIDS epidemic, which has only recently begun to surface in Kazakhstan (Box II.1). The 2000 Republican budget programs an overall decrease of T37.8 million (minus 3.2 percent) in public health over 1999 levels. At the same time, spending on specialized hospitals for the treatment and control of AIDS and tuberculosis will increase significantly (15 percent for AIDS and 63 percent for tuberculosis). From a medium-term perspective, Kazakhstan should instead be emphasizing health sector expenditures on preventing preventable disease.

**Box II.1: Economic Benefits of Prevention Versus Treatment of Disease, The Case of AIDS**

The AIDS epidemic spreads quickly once it has taken hold. There were approximately 100 documented cases of HIV infection in Ukraine 1995-96, and by 1999 there were approximately 50,000 documented cases of HIV infection and an estimated 50,000 additional undocumented cases. Today in Kazakhstan there are 900 documented cases of HIV infection and an estimated 9000 cases in total. AIDS prevention costs between US\$0 and US\$120 per person, while effective treatment of AIDS patients costs between US\$8,000 and US\$25,000 per year. Thus, there is a case for prioritize preventive measures targeted at high risk groups (Kazakhstan's estimated 250,000 IV drug users).

SOURCE: UNAIDS

52. ***Primary and secondary education maximize social returns.*** The key criterion in allocating education expenditures across programs is the maximization of the social return on public spending. There has been a great amount of research on the rates of return to education, and international research has shown that the return on spending for primary and secondary education tends to far outweigh the return from equal amounts of spending at other levels of education. This suggests that expenditures on basic education programs should receive high priority, and Kazakhstan seems to have recognized the relative importance of primary and secondary education, as its share of total education expenditure increased from 45 percent in 1994 to 62 percent in 1998 (Table II.9).

53. Maximizing social returns to education spending means that each Tenge should be allocated to the level of education where the benefits are greatest at the margin. Because the incremental benefits in each level of education tend to diminish with each Tenge spent, public

<sup>48</sup> More detailed discussion on intra-sectoral expenditure priority issues within the social sectors of health, education, and social assistance is in Chapter V.

expenditure priority in education should not necessarily concentrate *only* on primary and secondary education. For instance, after a certain amount has been spent on primary and secondary education, an *additional* Tenge may yield more benefits in university education than in primary and secondary education. If this is the case, the *marginal* Tenge should then be allocated to university education, even though the benefits per Tenge in primary and secondary education are greater *on average*. In this regard, Kazakhstan does not seem far away from what could be an appropriate balance of public resource allocation among levels of education. In the recent past, a considerable effort was made to shift public resources towards primary and secondary education mostly at the expense of preschools, vocational schools and “other institutions,” generally special schools such as those for sports and music.

**TABLE II.9**  
Distribution of Public Expenditure on Education by Level of Education

	1994	1995	1996	1997	1998
Preschool	11.7	9.8	10.5	6.8	5.7
Primary and Secondary Schools	44.7	47.5	52.1	62.5	62.3
Boarding schools	3.0	2.7	2.4	2.4	2.6
Vocational	16.6	13.3	13.2	10.1	9.3
Higher education	11.2	12.5	13.0	12.1	14.4
Other institutions	11.6	12.5	7.5	4.3	4.1
Textbooks	1.0	1.6	1.3	1.8	1.6
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

SOURCE: Kazakhstan education authorities, IMF

54. For the future, the benefits of public spending in education can be further enhanced by establishing priorities within programs. Also, as in general the benefits of further specialized education can be more easily internalized by individuals, the right market incentives should be emphasized and tertiary education should gradually be left for the private sector to both finance and deliver. In the meantime, as the private economy in general is becoming an increasingly important source of employment relative to the public sector, public spending at the tertiary level could be shifted away from the traditional training of public officials toward programs that are more valuable to modern developing activities, such as engineering, computer science, and business administration.<sup>49</sup>

55. ***Social assistance should be targeted to the poor.*** For equity reasons, scarce public resources allocated to social assistance should focus only on the poor. The government has been restructuring its “social security and welfare” policy, and in 1998 and 1999 streamlined benefits and restructured their administration. An excessive number of benefit categories was significantly reduced (from 47 to 14), a myriad of types of discounts eliminated, and financing

<sup>49</sup> Ke-yong Chu and Richard Hemming, *Public Expenditure Handbook: A Guide to Public Policy Issues in Developing Countries*, Washington, DC: International Monetary Fund, 1991.

and delivery schemes changed to increase efficiency.<sup>50</sup> While this restructuring is a welcome development, there remains considerable room for improvement.

56. One of the main remaining issues concerning “social security and welfare” expenditure in Kazakhstan is targeting the benefits. Specifically, many of the Special State Allowance programs are still targeted to beneficiaries who fall into narrowly defined categories that do not directly correspond to economic means: veterans of wars and their family members, families with many children, holders of special honors for extraordinary work or service, etc. While the majority of beneficiaries may be invalids to some extent, and some are really poor, many are not. Certainly, there is still considerable scope for better targeting based on economic need, and for a tighter screening process for claiming disability. Instead of the current categorical benefits loosely defined, state financial assistance should emphasize general social assistance programs that are directly targeted to the poor.

#### b. Intra-Sectoral Priorities in the Economic Sectors

57. ***Agriculture infrastructure, research and development, and rural extension service.*** Agricultural programs can only be considered a priority public expenditure to the extent they satisfy the criteria of: (a) being a *public good* in nature (e.g., research and development, rural extension service); or (b) generating significant *externalities* (e.g., large scale pest control, water pipelines feeding collective irrigation systems). While most of Kazakhstan’s agriculture public programs/projects fall into the categories of research and development, infrastructure, and food security, the 2000 budget allocation of T740 million for grain storage and T200 million for farm subsidies (both without clear purpose) may deserve to be reviewed in order to make their objectives transparent and a proper case if they are to remain as priority expenditures.

58. ***Institutions for Boosting Market Incentives and Increasing Competition.*** Still being in transition, Kazakhstan’s economic system has to count on the government’s assurance that fair competition and market incentives are well in place. In this area, the government’s absolute priority should focus on creating the adequate institutional framework and law enforcement mechanisms that are necessary for the system to function efficiently, as well as providing limited technical assistance for the development of new ventures in an economy new to capitalism. Thus, public support should prioritize *general* small and medium-sized enterprise programs that are limited to providing basic technical assistance, and creating and ensuring a legal framework for enabling a business environment.

59. Also, in this area the government can make major improvements. For instance, programs to support *specific* industries may imply scarce public resources being inefficiently used. Specifically, this may be the case of the present externally-financed programs to support export-oriented small and medium-sized businesses and light industries (some are part of the PIP). These programs are shifting public resources (present or future) that could alleviate social sectors, and probably are distorting market incentives, and inducing inefficiencies in the rest of the economy. Another example of inadequate, non-transparent public expenditure priority to

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<sup>50</sup> A discussion of the main issues and reform in social assistance related to public expenditure is in Chapter V, Section B.

economic sectors, which runs out of the budget, is the *tax expenditures* implicitly reflected by the fiscal incentive program to specific industrial investments. This is a large component not submitted to public scrutiny in a transparent manner in the budget.

60. There still are large segments of the local government administrations (as well as sectors of the central government) lobbying for small and medium-sized business support. In face of these pressures, the government should make sure that basic fundamental principles of intra-sector resource allocation and public expenditure prioritization are followed, and current industrial policy does not regress back to direct support of enterprises.

## CHAPTER III

### EXPENDITURE MANAGEMENT

1. Optimization of public expenditure goes beyond merely establishing priorities for the use of public resources. Equally important is developing and maintaining an institutional framework that is conducive to *effecting* policy priorities. This requires creating an environment that both ensures prioritization of *all* government activities and provides incentives to compel adherence to these priorities during budget execution. This Chapter starts by reviewing Kazakhstan's institutional set up for public expenditure management and proceeds with the examination of the effectiveness of the country's public expenditure priorities.

#### A. INSTITUTIONAL ASPECTS OF EXPENDITURE MANAGEMENT

2. The desired level and efficiency of public expenditures can be significantly affected by the procedures and institutions of the budget process itself. The Government of Kazakhstan has made significant progress in streamlining and modernizing its budget process. In particular, the recently adopted Budget System Law represents a significant step for increasing the efficiency of budgetary outcomes in Kazakhstan. However, progress has been uneven. The structure, formulation, and approval of the budget are areas where more progress has been made over the last two to three years.

3. Despite the reform started over four years ago to introduce a modern Treasury function and strengthen the control of budget execution, the increasing accumulation of budget arrears in the last years demonstrates the urgency of accelerating the pace of these reforms. The solution for the problem of budget arrears lies with the introduction of a full Treasury function that can control expenditures at the commitment level. The monitoring and evaluation stage remains the weakest link in the Kazakhstan budget process. Although recent reform plans to strengthen internal audit, an ex-post and independent audit institution remains an elusive goal. Further, at the present time, there is no budget evaluation being carried out at any level of government.

#### Budget Structure

4. As a fiscal policy instrument, the government budget needs to convey clear information on sectoral policy objectives and provide policy-makers with complete information. The budget structure inherited from the FSU did not fulfill these goals, and the government has been modernizing the budget structure since 1996.<sup>51</sup> As a unitary country, Kazakhstan has one *State Budget*, submitted to the parliament for approval. The State Budget is a consolidation of the central or *republican government budget* and the *local government budgets*; the latter consisting of oblasts' budgets, which include rayons' and city administrations'.

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<sup>51</sup> See Kazakhstan: Transition of the State, The World Bank 1997.

a. Recent reforms

5. Most of the recent reforms on the budget system have affected both the republican and local budgets. The most significant improvements over the past three years include:

6. **Adoption of IMF-GFS classification and standard reporting systems** uniformly at all levels of government, facilitating the economic analysis of resource uses and, eventually, the linking of programs' outputs and outcomes with the spending units responsible for services.

7. **Adoption of budget ceilings by function, program and program manager**, which will facilitate expenditure containment in the formulation phase, encourage discipline during budget execution, and more efficient use of budget resources. The 1999 Budget System Law states that both the republican and local budgets must specify expenditure ceilings by functional group, by program, and by local budget program administrator. This represent a major step for proper expenditure programming in budget formulation and execution, and moving away from the outdated purely budget input norms approach from the past. For the first time in 1999, the republican budget was submitted to the parliament on a programmatic basis.

8. **Incorporation of the extra-budgetary funds into the budget**, which substantially improved completeness and comprehensiveness of public finance.<sup>52</sup> Also, now the budget accounts for the profits/losses of the state enterprises, and projects that are externally-financed and included in the Public Investment Program (PIP).

9. **Formalization of intergovernmental relations through budget flows**, like the size of subventions and withdrawals (which results from the review and approval of local revenue and expenditure forecasts, and the limit on borrowing), as well as minimum expenditure requirements on local programs of national importance (currently, health and education). Since the 1999 annual budget, the explicit formalization of these flows increased transparency of the budget system considerably.

10. **Formal establishment of a Budget Commission to guide the budget process**, which, in coordination with the sectors and regions, is in charge of identifying policy priorities and assigning expenditure ceilings by programs and establishing the expenditure envelope for the public sector.

11. There still are areas of the budget system that clearly need improvement. The analyses of these areas of improvement are the subject of Section B of this Chapter and Chapter IV.

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<sup>52</sup> Including the "Pension Fund", the "Compulsory Health Insurance Fund", the "State Social Assistance Fund", the "Unemployment Fund", and the "Road Fund".

## b. The Public Investment Program

12. Since 1998, the Agency for Economic Planning (AEP)<sup>53</sup> has prepared a three-year rolling cycle Public Investment Program (PIP)<sup>54</sup>. The AEP has responsibility for establishing goals and objectives of the PIP as the state investment policy tool, developing the methodology for the PIP, and coordinating the interaction of central and local executive bodies on PIP implementation.

13. The PIP process is divided into the following phases: (a) determining the size and sources of funds for public investment; (b) selecting projects recommended to be included into the PIP; (c) developing the PIP document; (d) monitoring program execution; and (e) reporting on the PIP implementation review. Project selection and examination is envisaged to consist of two stages. In the first stage, the central and local executive bodies carry out a preliminary selection of projects, after which the local executive bodies submit the selected projects to line ministries for approval.<sup>55</sup> The projects so selected are submitted to the AEP for a decision on the inclusion of the project in the PIP database. The final inclusion of a project in the PIP is based on the recommendations of the PIP Commission.<sup>56</sup> After the final list of projects is compiled, the PIP document is elaborated and submitted for government approval.<sup>57</sup>

14. The AEP, jointly with the Ministry of Finance, monitors project implementation. Organizations involved in the implementation of projects submit quarterly reports, and the AEP is expected to carry out (based on implementation reports) an assessment and review of the program execution efficiency and to prepare recommendations for implementation in the following year.

15. Preparation of a PIP is central for rationalizing and increasing the long-term efficiency of public expenditures. However, as it is presently designed, the PIP tends to fall short of achieving these long-term goals, because of prevailing ambiguities related to the setting of capital expenditure priorities. It lacks a clear definition of the individual roles played by the several institutions including Parliament, Office of the President, the ASPR, Ministry of Finance, the Budget Commission, the PIP Commission, AEP (now Ministry of Economy).

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<sup>53</sup> Now incorporated into the newly-created Ministry of Economy. The Presidential strategic perspective "Kazakhstan 2030" is the Long/Medium-Term guidelines on the country's social-economic development broadly informing budget policy priorities. The Agency for Strategic Planning and Reforms (ASPR), now the "Agency for Strategic Planning", is the official body at the President's Office in charge of formulating policy guidelines for the medium term.

<sup>54</sup> Decrees no. 1389 and no. 772, of December 31, 1998 and June 15, 1999.

<sup>55</sup> Technical capacity both in the line ministries and local governments to conduct investment project appraisals needs strengthening.

<sup>56</sup> The intent has been to identify sectoral priorities on the basis of the "Kazakhstan 2030" long-term development vision.

<sup>57</sup> The PIP has grouped projects according to sources of financing: (a) projects financed from the republican budget on a non-recoverable basis; (b) projects financed from external government loans; (c) projects financed from external loans provided sovereign guarantee; and (d) projects financed under financial assistance grants.

16. The weak integration of the PIP process with the budget process also carries some risks for the effectiveness of the fiscal policy.<sup>58</sup> First, the PIP does not incorporate estimates of recurrent expenditures associated to investment projects. A medium-term expenditure framework could be instrumental for taking into account the future recurrent expenditures entailed by PIP projects (see Section B below). Second, the lack of integration of the PIP with the budget process can lead to a potential bias in resource allocation, in the sense that capital expenditures may always be considered more productive than recurrent expenditures. The real opportunity cost of budget resources dedicated to capital projects can be better established when these uses of resources compete openly and squarely with the rest of the budget objectives in the context of well-defined sectoral policies.

17. Presently, the determination and selection of investment priorities is heavily constrained by lack of financing. Basically, priority has been given first to ongoing projects close to completion, and second to donor-funded projects. However, the risks that this practice involve are too high, because it can easily lead to persistently wrong choices of projects for the PIP. Not all unfinished projects are worth finishing or finishing ahead of newer projects with higher rates of return. The same applies to donor financed projects requiring or not counterpart funds. Full integration of the PIP into the budget process and a medium-term framework with well-defined sectoral policies would allow for cash flow programming associated with each project and the inclusion in the budget of accurate schedules of counterpart and recurrent funds, substantially facilitating prioritization of capital expenditures (see Section B).

## **Budget Formulation and Approval**

### **a. The Republican Budget**

18. Formally, the republican budget is enacted by the annual Budget Law as approved by both chambers of Parliament and signed by the President. The 1999 Budget System Law does not establish a date for when the budgetary cycle actually begins, but it does require that the draft Budget Law has to be submitted by the government to the parliament no later than September 15 of the year prior to its execution.

19. In reality, the budget cycle starts with the appointment by the President of a Budget Commission, whose responsibility is to draft the public expenditure envelope and the main budget parameters for approval by the Government. These parameters include estimates and limits on: (i) revenues for the republican and oblast budgets; (ii) expenditures for the republican budget by functions and programs; (iii) republican loans to oblast governments; (iv) the republican budget deficit; and (v) local government borrowings.<sup>59</sup>

20. The Budget Commission was formed for the first time in April 1999 for the formulation of the 2000 budget, and was formed by 13 members (officials in the cabinet and government agencies), with the Ministry of Finance acting as a secretariat.<sup>60</sup> The Commission is authorized

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<sup>58</sup> Folding the Economic Planning Agency into Ministry of Economy will hardly help to improve this integration.

<sup>59</sup> Law no. 464-1/99 prohibits the republican government to provide credit guarantees to subnational governments.

<sup>60</sup> Decree on the Republican Commission for the Budget 2000 (#11-6), April 20, 1999.

to request any needed information from ministries and other government agencies in order to carry out its functions.

21. To effectively contribute to fiscal policy discipline, the Budget Commission should have a more stable status in the government and be entrusted with powers that go beyond setting out the current year budget priorities and the overall expenditure envelope for the public sector. First, instead of being disbanded after the budget preparation task is completed (as it is the case presently), the Commission should have permanent status, with the objectives expanded to include: (a) oversight over expected policy outcomes; (b) reconsideration of future priorities; and (c) carry on decision-making beyond the current budget.

22. Second, the membership of the Budget Commission should be a permanent, automatic, representation of ministries and agencies by officials occupying respective positions, rather than being dependent on ad hoc appointments based on individual/personal capacities as is the case presently. Third, in order to promote direct interaction among government sectors and have a more balanced representation, there may be a need to broaden the membership of the Commission to include the sectoral expertise of the most important line ministries.<sup>61</sup>

23. Once the main budget parameters drafted by the Budget Commission are approved by the Government, the department heads submit their budget programs respecting their expenditure ceilings. The responsibility for drafting the Republican budget is with the Ministry of Finance which follows the main budget parameters drafted by the Budget Commission and approved by the Government. The republican budget must contain, besides expenditure and revenues, the deficit and its financing, expenditure ceilings across functions, programs and by program administrator, overall limit for the government debt and limits on government guarantees, the list of programs not subject to sequestering, aggregate limit for local borrowing, and minimum expenditure requirements for local governments on programs of national importance.

24. The draft budget is discussed and amended first in the lower chamber or Mahilis, and then in the upper chamber of Senate. While the government discuss and provide information at the level of sub-programs, the budget is approved at the level of programs. The Government also has to present the Social and Economic Development plan, reports of the Minister of Finance, the Chairman of the National Bank as well as other officials as requested by Parliament. If the budget is not approved by a joint session of both chambers in at least two readings by December 15, the President can issue a financial plan for the first quarter of the execution year by decree. This plan is in force until the budget gets approved by parliament.

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<sup>61</sup> The Commission, however, should not become the equivalent of the Cabinet of Ministers. There may be a tradeoff between wider representation, and effectiveness and cohesiveness of the Commission. The risk is that the overall fiscal objectives—setting priorities and enforcing fiscal discipline—be diluted by more partisan interests and difficult political compromise.

## b. Local Budgets

25. Local budgets are enacted by Maslikhats Decisions.<sup>62</sup> The budget calendar requires that oblast executives develop their draft budgets by September 1 using the revenue forecasts and other fiscal parameters approved by the republican government, including the minimum expenditure requirement for the programs of national importance and the local borrowing limits. The draft local budget must be submitted to the Ministry of Finance. Not later than two weeks after the Republican budget comes into force, oblast akims must revise the draft budget prepared earlier and submit the final draft version to the oblast Maslikhat for consideration and approval. The Budget System Law requires that maslikhats approve the draft budget within two weeks of its submission by the oblast akim.

26. The Budget System Law mandates that local government budgets must contain expected level of revenues, official transfers, overall expenditure level and expenditure ceilings by functional group, by program, and by local budget program administrator, a list of local budget programs not subject to sequestering during budget execution, level of reserves, repayment of loans, lending, budget deficit or surplus, and limit on local borrowing.<sup>63</sup>

27. Budget approval at the local level is a “nested” process. Akims of rayons and cities must submit the draft budget to their local maslikhats within two weeks after the approval of the oblast budget. The rayon and city maslikhats must adopt their own budgets within two weeks of the budget submission by the akims. This nested approach starts with the approval of the republican budget and, because of the possibility of delayed approval, the Budget System Law allows local governments to start implementing, during the first quarter of the fiscal year, one-fourth of the proposed draft budget. A preferable way to handle this could be advancing the calendar for the approval of the republican budget to no later than November 15 or even somewhat earlier, so that local akims and maslikhats can have more time to deliberate their budgets.

## **Budget Execution**

### a. Expenditure Control

28. The Budget System Law (art. 24) gives authority to the Treasury Committee within the Ministry of Finance to execute the budget. The Ministry of Finance is empowered to establish accounting procedures and reporting requirements for budget execution.

29. At the central level, budget organizations spend their allocated funds on the basis of permits or warrants issued by the Treasury. In theory, the spending units are free to prioritize their expenditures subject to the limits in the warrants and the list of budget items not subject to sequestering as specified in the annual Budget Law.<sup>64</sup> In practice, the budget institutions are

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<sup>62</sup> On the structure of local governments, see Annex IV.1

<sup>63</sup> Note that local governments are forbidden to offer guarantees or assume liabilities of third parties.

<sup>64</sup> In 1998, the Treasury moved to the more desirable practice of releasing cash allocations at monthly intervals and later to quarterly intervals. Following the sharp decrease in revenue collections in the aftermath of the Russian crisis, the Treasury switched to the practice of releasing warrants on a daily basis. This practice introduces

considerably limited in their resource allocation. On the one hand, in order to avoid budget arrears, spending units are instructed to give priority financing to certain items such as salaries, contributions to social funds, and the purchase of some services such as heat and electricity. Moreover, flexibility in budget execution by spending units is also curtailed within the spending limits, because of their obligation to obey extensive lists of rules on input usage and norms. Thus, budget institutions cannot select how to deliver services (for example, contracting with the private sector) or the efficient mix of inputs of production (type of employees, use of capital equipment, supplies and so on). On the other hand, despite the introduction of program budgeting, program managers has not been held accountable for expenditure outcomes, given their limited discretion in decision making. Instead, emphasis continues to be placed on the “appropriate use” of resources and control over inputs.

30. At the local level, while the Budget System Law entrusts payments for local budget expenditures to the local offices of the Treasury, the budget execution warrants for local budget institutions are only issued by local finance departments instead of by the territorial offices of the Treasury.

31. Undoubtedly, budget arrears remain the most significant challenge in budget execution in Kazakhstan. While the use of warrants has helped to control expenditures and obligations, this system clearly has not been effective in eliminating the accumulation of arrears. Several causes can explain the persistence of the problem with budget arrears. First, the Budget System Law does not prescribe penalties or disciplinary procedures for budget officials that break the law or violate budgetary procedures. In the absence of corrective measures, budget officers have continued to have an incentive to try to maximize their effective allocations by committing obligations beyond the amounts provided in their budget appropriations.<sup>65</sup> Second, the current systems of warrants and contract registration do not prevent budget organizations from entering new obligations. What the authorities should realize is that cash rationing or control of expenditures at the *payment stage* cannot stop accumulation of budget arrears. What is needed is the control of expenditures at the *commitment stage*, and nothing will adequately address this problem short of the full implementation of an *automated Treasury*.

32. There is an on-going modernization of the Treasury with the objectives of introducing a fully-automated treasury system to provide comprehensive and timely information on budget execution, to effectively control expenditures and provide for efficient cash and debt management. The reform has been ongoing since 1995, but the full automation of the new treasury procedures did not start until 1999, and it is still incomplete. Some of the objectives that have been achieved through the implementation of the interim treasury system, include: (a) centralization of all republican budget payments and receipts in a single treasury account; (b) release of resources by economic category via a system of warrants and sub-warrants both at the central and local government levels; (c) monitoring of expenditures by economic category by Treasury units at the regional and district level; (d) budget execution reports by organization, function, program, and economic category; and (e) beginning a program to register all contracts

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uncertainty and tends to destabilize execution planning for the spending units.

<sup>65</sup> There is draft legislation that would hold public sector managers directly responsible for any expenditure commitment in excess of their budget appropriations.

above a certain threshold with the Treasury. Despite this progress, the problem of accumulation of arrears persists. There is, therefore, an urgent need to finalize the modernization of the Treasury functions.

33. Two main issues stand in the way of full effectiveness of the Treasury in the near future. First, the full centralization of payments in Astana may be too expensive to accomplish, risk-prone to telecommunication and system failures.<sup>66</sup> Second, the payroll system is not computerized, despite the fact that wages and salaries represent around 70 percent of government current expenditure.

b. Sequestering and Amendment

34. Under the sequestering mechanism, the Budget System Law gives authority to the executive bodies to re-prioritize expenditures in the case of a shortfall in revenue collections that does exceed 10 percent of the budget. Respecting the list of protected items (those not subject to sequestering) as stated in the annual Budget Law, the sequestering mechanism gives executive bodies implicit authority to reorganize expenditure priorities. However, if the revenue shortfall exceeds 10 percent of the budget, the Budget System Law requires the initiation of a formal budget amendment by the legislative body. This formal budget amendment process introduced in the Budget System Law represents a significant improvement over the previous practice of generalized and extensive budget sequestering. The budget amendment process allows for a more transparent re-prioritization of expenditures and it also restores the power of legislative bodies to state what those priorities are.

35. According to current provisions in the Budget System Law, “emergency state budget” can be advised by the Government and approved by the President. In this case, the only role for Parliament is to be informed. A questionable aspect on this provision is the lack of definition on the conditions that determine the adoption of an “emergency state budget.”

c. Reporting

36. Reporting is an area of solid improvement in the budgetary process in Kazakhstan. The central government has the obligation to submit to Parliament a report of the budget execution including explanatory notes, and a breakdown by oblast and by key programs. The budget execution report must be submitted to Parliament and to the Accounting Committee not later than July 1 subsequent to the budget execution year. In addition to the annual report, the Ministry of Finance must file monthly and quarterly reports on the execution of the republican budget at the subprogram level. At the local level, executive bodies need to submit monthly reports on budget execution to their maslikhats and to the higher level government (oblast to the Ministry of Finance, and rayon and cities to the oblasts). In addition, the Budget System Law requires the central government and oblast governments to submit quarterly reports on budget execution to the mass media.

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<sup>66</sup> Because the reforms of a single Treasury account with a single ledger and the centralization of revenues have already been achieved, the full centralization of payments in Astana—although an important objective for the medium term—may not be an urgent step for the time being.

## **Budget Monitoring and Evaluation**

37. The final phase of the budget process comprises monitoring compliance through internal and external audits, and monitoring performance through budget evaluation. In Kazakhstan, while proper institutions and process for internal audit have been created, progress on an independent external audit function has been slower. The work on budget evaluation has not begun.

### **a. Internal Audit**

38. Internal audit is the responsibility of the Treasury Committee in the Ministry of Finance. Besides its own staff, the Treasury Committee also has a number of internal auditors (“chief treasurers”) who are assigned to different departments at the Ministry of Finance and line ministries. A number of line ministries have their own internal auditors. There are also Treasury internal auditors at the local level. An important problem in the recent past has been that even though there are around 1,200 staff carrying out internal auditing activities, there has been no unifying force that integrates them, providing functional leadership. Internal audit procedures have not been fully independent because auditors have performed other activities which in turn need to be audited. The internal audit function has also lacked manuals for standard procedures and audit policies. In addition, most audit activities have focused mostly on compliance with laws and regulations and little on how to identify improvements in financial and accounting practices.

39. The government has recently initiated several steps toward organizational and procedural improvements in internal audit. A new internal audit unit was established in the Treasury Committee in November 1998 with a mandate to streamline auditing functions. Under the auspices of the World Bank’s Public Sector Resource Management Adjustment Loan, a Law on Internal Audit and manuals for audit standards and policies have been drafted. The new draft policies separate internal audit units from other operating and support units, such as accounting. This should help preserve the independence of internal auditors. The draft Law on Internal Audit establishes that auditors examine, evaluate and report on the adequacy of expenditure controls, identify any weaknesses, and develop recommendations for improvement in procedures. The draft Law actually proposes three different types of internal audits: compliance, financial, and value-for-money audits. The latter audits will look at the cost efficiency, productive efficiency, and the effectiveness of spending programs in achieving the intended results.

## b. External Audit

40. Kazakhstan still has to establish a supreme audit institution to provide external audit and verification of budget execution. The Budget System Law entrusts the Accounting Committee with “control over the implementation of the budget”, but neither the Budget System Law nor the Accounting Committee regulations address external audit explicitly. This legal vacuum reflects the lack of tradition with external audit in the budget system of the FSU. Moreover, the Accounting Committee is “directly under the command of, and accountable to” the President. The President determines the staffing and funding of the Committee and appoints its chairman for a period of 5 years.<sup>67</sup> The Accounting Committee reports quarterly to the President and issues resolutions which are sent to the President, the Parliament and the Prime Minister. These resolutions have only the character of recommendations and information but can be forwarded to law protection agencies if there is a presumption of criminal behavior. At the local level, external audit of the budgets is executed by “auditing commissions” of the maslikhats and also by the Ministry of Finance, both of which report to the respective local executives and maslikhats.

41. There are several major problems with the current arrangements for external audit. First, the Accounting Committee is currently not independent from the executive. Second, the Accounting Committee is inadequately staffed. It has 8 members and 20 staff. Third, the Committee’s staff is inadequately trained, lacks proper audit procedures and actually performs little auditing as it has many other duties. The “auditing commissions” at the local level also appear to lack adequate staff and training.

42. So far, the focus of institutional reforms of the budget process in Kazakhstan has been primarily on strengthening accountability within the government through internal audit. The lack of an independent external audit function has been addressed on several occasions, but progress toward creating this necessary function has been slow.<sup>68</sup> Nonetheless, a draft Law on External Audit has been prepared and it is expected to be submitted to Parliament in the near future. A draft of external audit standards has also been prepared. The intention of the draft Law on External Audit is to make the Accounting Committee the Supreme Audit Institution for Kazakhstan.<sup>69</sup> The draft Law introduces a degree of independence in the selection and operation of the Accounting Committee, but it would be desirable to introduce a model in which external auditing could be totally independent of the executive and respond exclusively to Parliament.

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<sup>67</sup> The chairman can be removed at the President’s discretion and can not be a member of Parliament or Government.

<sup>68</sup> See the Inception Report of the PSRMAL (World Bank, 1997), and Kazakhstan: Transition of the State, The World Bank, 1997.

<sup>69</sup> The Auditing Committee actually has, with support of the Government, applied to the International Organization of Supreme Audit Institutions (INTOSAI) to be designated the Supreme Audit Institution (SAI) for Kazakhstan. The application has been accepted.

### c. Budget Evaluation

43. A budget evaluation function does not exist in the Kazakhstan budget process. Budget evaluation and the integration of its findings into the budget formulation of the next budget period are key ingredients for improving the overall efficiency of public expenditures and increasing the accountability of program managers. Budget evaluation is also a key ingredient for moving away from the old budget approach, which did emphasize allocation of funds by budget organization and measurement of inputs, to the new approach which puts the emphasis on the allocation of funds by programs and the measurement of outcomes and performance of budget institutions.

44. For budget evaluation to be effective, the budget process will need to incorporate objective measures for the performance of projects and programs and create a culture of deriving and applying lessons from experience. Budget evaluation needs to be carried out at two levels. First, all budget organizations need to carry a self-evaluation of their programs (ex ante, ongoing, and ex post) and monitor their specific indicators of performance. Second, selective independent budget evaluation needs to be carried out upon project/program completion by an assigned agency. Such an agency may be the Accounting Committee but it does not need to be restricted to a single agency.

45. At the local levels of government, budget evaluation and monitoring of performance functions do not exist either. With increased decentralization it is now more important than ever to ensure the efficient use of funds and the achievement of desired standards of public services (education, health, or social assistance). In fact, while the role of central ministries in keeping local departments accountable has considerably diminished, there has been no adoption of alternative mechanisms for performance assessment of local budgets. Line ministries need to reinvent themselves as agencies that evaluate the performance of local governments but focusing on outputs and outcomes rather than on just controlling inputs as was done in the past. Local governments themselves need to carry out a self-evaluation of their programs and monitor indicators of performance for different programs. These can be done by the local "auditing commissions" or by special committees (with supporting staff) of the local maslikhats.

## **B. EFFECTING PRIORITIZATION OF PUBLIC EXPENDITURES**

46. Fully effective public expenditure priorities in Kazakhstan requires: (a) consolidating government operations into a single, unified budget; (b) developing realistic budget indicators; (c) hardening budget constraints; (d) planning for the medium term; (e) planning for contingency; and (f) adequately controlling and evaluating budget execution.

## Consolidating Government Operations in One Budget

47. The consolidation of extra-budgetary funds with the republican budget beginning with the 1999 budget year was a substantial step in the right direction of presenting a transparent, fully-integrated, unified state budget document. Nevertheless, there are still important off-budget items that should be carefully evaluated on a regular basis and in some cases integrated within the budget document itself. Specifically, tax expenditures, soft loans and subsidies in lending, and government loan guarantees represent hidden burdens on Kazakhstan public finance, whether direct or contingent, explicit or implicit. As such, they should fall under the same scrutiny as other budgetary outlays, and they should be examined and confronted with other expenditure allocations for an appropriate overall public expenditure prioritization.

### a. Tax Expenditures

48. Incentives designed to provide for favorable tax treatment to particular activities or economic agents (i.e., tax expenditures), as tax exemptions, credits, or special allowances designed to stimulate business investment are conceptually the same as direct, explicit subsidies to business firms.<sup>70</sup> Likewise, special tax treatment of narrowly-defined groups of individuals (such as the disabled, students, and many child parents) also represent tax expenditures to the extent they could be provided for with direct, explicit budgetary subsidies or grants. The real economic effects of tax expenditure systems are similar to those of direct expenditure program systems, except for the fact that the former hide the true size of the public sector.

49. Kazakhstan, like many other countries, employs a great deal of special tax provisions for reasons of economic development or social equity.<sup>71</sup> While both the tax expenditures and direct outlays operate to achieve government objectives, there are, however, serious issues related to budgetary control that arise in the case of tax expenditures. First, tax expenditures are less visible than direct expenditures, and in Kazakhstan they do not undergo a regular, periodic review, such as that which would occur during the annual budget process with direct outlays. Second, a large number of tax expenditures are established in the permanent legislation (such as the Tax Code), which means they follow revenue trends. Thus, tax expenditures tend to be open-ended, with their costs varying with changes in exogenous conditions (such as growth of GDP), independently of expenditure policy priorities.<sup>72</sup>

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<sup>70</sup> Tax expenditures represent forgone revenue measured by the size of the deviation of the effective tax structure from the normal nominal tax structure.

<sup>71</sup> In Kazakhstan, many tax expenditures serve both economic development and social equity goals, such as special allowances for employers of the disabled.

<sup>72</sup> Allen Schick, "Controlling Non-conventional Expenditure: Tax Expenditures and Loans," *Public Budgeting and Finance*, 6(1), 1996, pp. 3-19.

**Box III.1: Calculating the Cost of Tax Expenditures**

Three main approaches to calculating the cost of tax expenditures: (1) the revenue forgone method; (2) the revenue gain method; and (3) the outlay equivalent method. The *revenue forgone* is an *ex post* measure that compares revenues that were collected with the particular tax provision to revenues that would have been collected if the provision did not exist. Virtually all countries that produce tax expenditure reports utilize this method, primarily because it is the most simple measure to calculate. The objective of *revenue gain* method is to calculate the expected increase in revenues, were the concession to be abolished. The revenue gain method is more complicated in the sense that behavioral responses must be incorporated *ex ante*. Finally, the *outlay equivalent* method, which currently is used only in the United States, measures the cost that would be incurred if the same benefit were provided as a direct expenditure outlay. As with the revenue forgone method, the outlay equivalent method proceeds under the assumption that behavior is not changed.

50. Tax expenditures absorb the same budget resources as direct expenditures, only they do so on the revenue side of the budget. Thus, in setting priorities for the use of public resources, tax expenditures should come under the same scrutiny as any other uses (like the more direct expenditure items). That is, the cost of tax expenditures should be carefully tabulated and should be evaluated on a regular basis. As currently the budget cost of tax expenditures in Kazakhstan has not been tracked, a proper accounting is the necessary first step (methodology for cost estimate, see Box III.1).<sup>73</sup> The next step would be to calculate the costs of tax expenditures, the results of which should be contained in a tax expenditure report that would serve as the basis for periodic evaluation. A good option for ensuring proper rationalization of tax expenditures would be to annex the tax expenditure report to the budget document itself. By evaluating the tax expenditure report during the course of budget preparation, it would ensure that tax expenditures are reviewed in light of the overall spending priorities of the government and that the implicit trade-offs between direct and indirect outlays are properly recognized (See Box III.2).

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<sup>73</sup> For a review of tax expenditure calculations and reporting across countries see Organisation for Economic Cooperation and Development, *Tax Expenditures: Recent Experiences*, 1996.

**Box III.2: Reporting and Managing Tax Expenditure: The Case of Canada**

Canada provides perhaps the best example of the benefits that arise from integrating tax expenditure reports with the budget. Under its Policy and Expenditure Management System (PEMS), spending ceilings are assigned to various policy envelopes. If tax expenditures increase, the cost is allocated to the relevant policy envelope, which reduces the financial resources available for direct expenditures. In an effort to prevent uncontrolled increases in direct spending, reductions in tax expenditures are credited to the relevant policy envelopes only in cases where they are “functionally equivalent” to direct outlays; otherwise, they are apportioned to general revenues. The design of the PEMS thus compels policy makers and budget planners to thoroughly consider the trade-offs between tax expenditures and more direct outlays and ensures adequate prioritization of all aspects of government fiscal activity.

SOURCE: Allen Schick, “Controlling Non-conventional Expenditures: Tax Expenditures and Loans”, *Public Budgeting and Finance*, 6(1), 1986, pp. 3-19.

**b. Contingent Liabilities**

51. Most conventional fiscal analyses focus on the known obligations of the government, such as direct expenditure outlays governed by the budget and liabilities related to sovereign debt. Another crucial component of the government’s fiscal position, however, is its obligations on contingent liabilities, or obligations triggered by a “discrete but uncertain event.”<sup>74</sup> Kazakhstan is beset with a substantial amount of these contingent liabilities in the form of state loan guarantees.

52. The temptation is to view loan guarantees as costless because no money is expended up-front. In reality, however, the government does bear a very real expense. Because there is always some probability that each loan guaranteed will default, the expected cost is always positive. Rather than viewing loan guarantees as costless, the government would be better protected by treating the expected cost of each loan guarantee as a direct outlay up-front and budgeting for that contingent expenditure accordingly by provisioning a “risk fund”. If repayment is unlikely, the government would be advised to consider financing the item with a direct expenditure, such as a grant. By budgeting for contingent liabilities, the government is not only protected from default risk, but decision makers are forced to consider the rationale of each loan guaranteed within the context of established spending priorities.

53. The Government has made some efforts recently to allocate resources to cover at least part of the guarantees that it expects to be called during the budget year. Approximately T13 billion was budgeted in 1999 and approximately T17 billion in 2000. While this effort is commendable, in reality it simply reflects the amount the government is *prepared* to pay on guarantees rather than the liability *expected* to arise from defaults. What is needed in

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<sup>74</sup> See “Contingent Liabilities – A Threat to Fiscal Stability,” *PREM Notes*, No. 9, November, 1998 (Washington, DC: World Bank).

Kazakhstan is a true “risk fund,” which would entail adequate provisions for called loan guarantees based on statistical probability of expected liability.<sup>75</sup>

54. Establishing and maintaining an adequate risk fund will not be an easy task. First, adequate provisions for the risk fund will require much larger resources for defaults than currently are being budgeted. Given the limited public resources that are available, this will require reduced funding of other areas in the budget. Secondly, an adequate risk fund will require good measures of risk. The valuation techniques, in turn, demand substantial (and costly) data and a well-trained staff. Nevertheless, Kazakhstan’s efforts to prioritize public expenditures will be continually thwarted if it does not make adequate provisions for contingent liabilities, and thus the costs involved in maintaining a risk fund are likely to be small in relation to the costs that loom ahead if adequate provisions are not made.

55. Protection from default risks is not the only issue with loan guarantees, but also the priorities implicit in the projects for which the guarantees are tendered. When guaranteed loans are defaulted, lenders can demand that the government make good on its commitment, and often do, which means the government’s priorities are set for them. Because it is known *a priori* that some of the loans will be defaulted, by issuing a guarantee, the government is making a commitment to pay for part of the project being financed by the guaranteed loan. It may not be appropriate for the government to offer a grant to the construction of a hotel in Astana (a T14.2 million deal—October 1997) or the construction of a plant for the production of spirits in Uralk (a T79 million—November 1996), but because the government of Kazakhstan guaranteed significant loans for those purposes, and there is a probability of the loans being defaulted, the government actually had prioritized and financed part of those activities.<sup>76</sup> In this sense, the expenditures financed with loan guarantees should fall under the same scrutiny given to direct expenditures or loans; otherwise—as loan guarantees have been effectively called by the creditors and the government as guarantor has honored them—it is the recipients that *ex post* end up setting the public expenditure priorities rather than the government.

56. Given the great potential for default risk and the sizeable expenditure obligations that can result, and the fact that loan guarantees often entail public expenditure priorities that are established by the recipient rather than the government, there is a great need for a more effective *ex ante* control of loan guarantees in Kazakhstan. Loan guarantees should be carefully scrutinized before they are tendered by establishing explicit limits for loan guarantees and clear criteria for issuing guarantees that really reflect public priorities determined by the government. Kazakhstan has made some progress in this direction recently by establishing a ceiling for guarantees, suspending guarantees to subnational governments, and proposing restrictions for the use of guarantees to infrastructure projects. These limitations, however, need to be legislated

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<sup>75</sup> It should be noted that even if a risk fund is adequately funded on the basis of expected liabilities, in some cases (especially if there is *not* a large number of contingent liabilities), the realized liabilities will exceed expected liabilities. Thus, consideration may be given to *over-funding* the risk fund, depending on the risk tolerances of the government. See Lewis, Christopher M. and Ashoka Mody, “Contingent Liabilities for Infrastructure Projects: Implementing a Risk Management Framework for Government,” *Viewpoint*, No. 148, August, 1998 (Washington, DC: World Bank).

<sup>76</sup> Current “Astana Finance” Joint Stock Company offered guarantees can be interpreted in a similar way, since they end up indirectly been a sovereign guarantee anyway.

and the definition of an infrastructure project needs to be clearly delineated.<sup>77</sup> Appending an account of government loan guarantees to the budget would provide a basis from which better decisions can be made about the overall level of outstanding and new guarantees (including time and cost structure of the corresponding liabilities and defaulting probability) and the distribution of these guarantees across programs.

c. Net Lending

57. Budget provision for net lending declined from approximately 1.8 percent of GDP in 1997 to 1.4 percent in 1998, and is planned for further reduction to around 1.2 percent of GDP for 1999 and 2000. Most of the lending for the current year is allocated to liabilities on state guarantees and infrastructure projects (each about 47 percent). Some of the remainder will support agricultural enterprises and small and medium-sized businesses, but as a general rule, the government appears to be shying away from lending support to the private sector, a commendable stance. What is questionable is the use of lending to finance those obligations on defaulted loans without any assurance or collateral that these new (government) loans will be repaid by the debtor later on.<sup>78</sup> Actually, the government is issuing a grant to finance the project for which a guarantee had previously been issued, and these “soft loan” operations are neither transparent to the public nor subject to the same scrutiny as an equivalent direct expenditure. This facilitates a break-up of budget discipline that can thwart efforts to prioritize public sector spending.

58. Government lending clearly is not a completely off-budget activity in Kazakhstan, as the government has made commendable efforts to report lending activities in the budget document itself. What is not clear from the budget is the extent to which lending entails subsidies and soft loans and the costs involved in administering loans. When the government issues loans at interest rates lower than it pays on its own debt, then it bears a real cost in subsidizing the loans, a cost that should be clearly articulated in the budget. The preferred approach would be to include these interest subsidies, as well as administrative costs, as separate line items in the budget, which would provide policy makers and budget analysts with a complete and transparent picture of the costs involved in their lending activities. Similarly, if the government intends to finance projects with a grant (by issuing a soft loan), then the financing should be listed in the budget as a grant, not as a loan.

### **Planning the Budget on the Basis of Realistic Indicators**

59. The planning and development phase of the budget cycle provides both the time and the opportunity for careful consideration of public expenditure priorities. Sometimes, however, as has been happening lately in Kazakhstan, adjustments are made during the execution phase of the budget cycle because actual revenue collection falls short of budget estimates. In this case, most of the potential benefits of expenditure prioritization tend to be obliterated. For this reason, it is important to minimize the necessity of making adjustments during budget execution

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<sup>77</sup> In May, 1999 the government issued loan guarantees in favor of Air Kazakhstan for the purchase of Boeing aircraft in the amount of T 36 million.

<sup>78</sup> That is, lending money to the recipient of the guarantee to pay off the defaulted loan, making the government the creditor in lieu of the initial grantor of the loan.

by basing the budget preparation on more reliable economic indicators, more accurate revenue estimates, and more conservative or realistic expenditure allocation.

60. Although budget forecasts in Kazakhstan have improved significantly over time, recent experience shows that they still are out of line with budget execution data. Revenue collections (excluding capital transactions) were off T23.2 billion (about 11 percent) from their projected levels at the end of July, 1999. For the year they will be off the target even considering a strong turnaround in revenue performance in the second quarter. This figure actually understates the discrepancy between forecasted and realized collections, however, because receipts from the use of natural resources and corporate tax collections (including tax arrears) were well above projections (Table AIII.1). The existence of under-projections in some revenue bases, coupled with substantial over-projections in other bases, indicates an urgent need to improve the forecasting system.<sup>79</sup> Often this entails changing parameters of the forecasting model, re-estimating, rethinking the model altogether, and strengthening capacities. An important initial step in this direction would be to improve the quality of data on which the estimates are based.

61. Equally important to the refinement of forecasting techniques and the quality of the data and forecasters is the assurance that budget forecast estimates are unencumbered by political or administrative influences. The net impact of political pressures on budget forecasts in Kazakhstan to make forecasts overly optimistic is not evident; it is clear though that these forecasts are not yet as objective as they should be. Usually, oblasts' projections of revenues tend to be much lower and of expenditure needs much higher than those of the Ministry of Finance; the reason being that oblasts' subventions and withdrawals are determined in part on the basis of revenue forecasts and estimates of expenditure needs.

62. One way to reduce political influences is to have more than one official agency independently producing alternative forecasts. Another, more potent option would be to have outside experts produce forecasts to serve as the basis for budget planning. Regardless of the choice that is made, the authorities have to be candid about what they can do with the limited resources available. The government budget will be on the safe side if the authorities always plan around the more conservative forecasts, without discarding a contingent plan for the use of funds should a more optimistic scenario come through. Both forecasts should be realistic, represent objective best estimates, and openly present the assumptions on which they are based.

### **Restoring Hard Budget Constraints**

63. One salient feature of government finance in Kazakhstan in recent years is the continued, and at times accelerated, accumulation of budgetary arrears. On July 1, 1999, total arrears accumulated T 75 billion, mounting to above 15 percent of the size of 1999 state (consolidated) budget. The remaining arrears inherited from the former extra-budgetary funds represented 15 percent of this total, and oblasts were still responsible for about 45 percent of it. The increase of

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<sup>79</sup> This apart from the problems related to tax administration and the health of the economy. Collections of 1999 revenue through July 31 (excluding capital transactions) were up 26.6 percent relatively to the same period the year before, suggesting that the under-performance of revenue forecasts cannot be attributed only to the increasing problems in tax administration and economic fluctuations. While these issues have certainly made forecasting more difficult, it is clear that budget forecasts need to take better account of trends in subsequent budget cycles.

these arrears were over 70 percent from January, 1998 to June 30, 1999, and only in the first half of 1999 they increased 33 percent; being “pensions and social benefits” a major component (Table AIII.2).

64. The main causes of arrears accumulation in Kazakhstan have been: (a) poor revenue forecast used in the formulation phase of the budget; (b) lack of proper expenditure prioritization; (c) poor financial programming by the national Treasury (at the “payment” stage rather than at the “commitment” stage of the expenditure process); and (d) lack of accountability of program managers (owing to absence of legally prescribed penalties and disciplinary procedures).<sup>80</sup> The remaining question is what to do about the current stock of arrears. The most equitable option is to work out a plan to pay for these liabilities, because this would improve creditworthiness of the government in the eyes of suppliers and the trust of constituents. Nevertheless, this plan should try to avoid softening the budget constraints and the associated adverse incentives, which may result from the option to pay. For this, the government should make sure that two important components are necessarily included as part of the arrears’ payment plan: (a) sound mechanisms and policies to eliminate the possibility of new arrears (see Section A); and (b) discrimination among creditors to avoid overcompensation, especially suppliers who may have imputed price adjustments.

65. Kazakhstani authorities have programmed in the 1999 budget to pay T10 billion in arrears at the republican level and T5 billion at the local levels. Nevertheless, to improve creditworthiness the commitment to pay these obligations must be accompanied by a commitment to stop accumulating new arrears. On this, Kazakhstani authorities have also taken some actions that may help stop accumulation of arrears. Recent changes have been proposed to the Administrative Code that would hold public managers more accountable for irresponsible spending authorization that deviates from the financial programming of the national Treasury. But these measures have to be implemented immediately to check the accelerated trends of arrears accumulation. These measures have the potential to substantially reduce the accumulation of future arrears if they are properly regulated and consistently enforced.

66. Nevertheless, payment of arrears has been de-emphasized in the 2000 budget, as only T6 billion has been allocated for that purpose. While cash payment of arrears is the best solution, there are alternatives that would allow the government to solve its commitment on arrears while still living within the current financial constraints.<sup>81</sup> Options go from directly securitizing the arrears to retire the entire stock of arrears by borrowing and earmarking the borrowed funds to pay off arrears.<sup>82</sup> There are advantages and disadvantages in each of these options. While some of these options may or may not be feasible, the bottom line with respect to outstanding arrears is

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<sup>80</sup> See Section A in this Chapter.

<sup>81</sup> The repudiation of arrears would be equivalent to a lump sum tax on those who are owed, which is not only inequitable from a horizontal perspective, but given the amount of pension and wage arrears, may also violate vertical equity goals.

<sup>82</sup> For options for retiring arrears, including securitization, see Alberto M. Ramos, “Government Expenditure Arrears: Securitization and Other Solutions,” *IMF Working Paper WP/98/80*, Washington, DC, International Monetary Fund, Western Hemisphere Department, May, 1998.

that the government would establish greater credibility if it were to schedule some form of payment so as to reduce uncertainty about honoring its commitments. This could be especially effective if the government were to securitize the arrears, *i.e.*, provide those who are owed payment with marketable claims with set maturity dates (possibly phased out). As well as the securitization option, retiring arrears by borrowing would also increase the total public debt for the interest on the new debt, which would be shifting from the holders of the arrears to the government. The down side of these options, however, is the potential moral hazard incentive that they can entail if the central government keeps bailing out creditors of parastatals or subnational government.

67. On the other hand, the government should avoid a continuation of tax offsets against arrears. This expedient tends to lead to very perverse outcomes. First, some claimants may not have taxes to offset, which means arrears would be paid on an arbitrary basis. Second, offsets in general (not only against arrears but expenditures as well) facilitate the breaking of budgetary discipline, put budget priorities in jeopardy, provide opportunities for hidden subsidization, and reduces the transparency of the budget. The current plans to stop with the use of offsets beyond 2001 are welcome, but should be carefully spelled out and disseminated, and the government should show a firm commitment to the policy.

### **Budgeting for the Medium Term**

68. If Kazakhstan is to be more focused on priorities in public expenditure, it has to develop a multi-year planning and budgeting process. The use of a multi-year budget would allow a better balance for the prioritization of expenditures, would provide an early warning signal for budgetary imbalances, and would help increase the allocative efficiency of expenditures. Capital investment projects may well be found to be unsustainable when recurrent costs to cover the necessary operation and maintenance in future years are considered. It is also possible that budget entitlements and obligations may be found to grow out of control in a few years should they continue to follow current trends. The government has already made significant progress in this direction by developing major macroeconomic and aggregate budget indicators for 2000-2002.<sup>83</sup> This incipient framework could now be expanded into a complete Medium-Term Expenditure Framework (MTEF) in the near future, a framework which would establish spending priorities over a 3-5 year time horizon. The former Economic Planning Agency had understood the importance of this budgeting in perspective and had started exercises to incorporate recurrent expenditures for some of the projects in the Public Investment Program (PIP).

69. Establishing a multi-year budgeting framework provides for a much greater connection between policy objectives and budget planning. First, as highlighted above, sufficient recurrent expenditures for operations and maintenance needs to be appropriated with capital investment if infrastructure development is to proceed in a cost-effective manner. The MTEF, by incorporating spending plans over a multiyear time horizon, provides a mechanism for these

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<sup>83</sup> This procedure follows suit the amendments to the Budget System Law that requires the development of three-year indicative projections for the state budget, including forecasts for GDP, the GDP deflator, CPI, average exchange rate, exports and imports, as well as projections for key fiscal variables, such as tax and non-tax receipts, aggregate budget expenditures, transfers, lending, debt service, and the budget deficit.

appropriations. Second, as also noted previously in the report, expenditures on social sectors such as health and education are much more effective if they follow a stable and predictable path. For example, education is a cumulative process, and the benefits of health efforts tend to deteriorate rapidly in the absence of continued support. The MTEF would help ensure that these dynamics are adequately considered in the annual budget in a continuous fashion. Third, the presence of a MTEF allows for more strategic, longer-term planning, which would encourage the government bodies to look ahead and establish in perspective a reasonable and thoughtful structure of spending priorities. Finally, a MTEF is expected to provide the Government with early signals that can anticipate budgetary imbalances, and if developed and implemented appropriately, the MTEF allows for a well-connected cycle of planning, budgeting, and control (Box III.3).

#### Box III.3 Budgeting in a Medium-Term Expenditure Framework

The development of a Medium-Term Expenditure Framework in Kazakhstan requires integrating planning and evaluation in the budgetary process by the following steps:

- (1) Forecast realistic scenarios for the medium-term macroeconomic framework, and project consistent and sustainable envelope of public sector resources within that framework;
- (2) Delineate outcomes-based and clearly-defined expenditure priorities with which policy objectives can be achieved;
- (3) Incorporate these priorities in a medium-term spending plan, including the necessary operations and maintenance costs to sustain the capital investment program;
- (4) Plan the annual budget within the framework of the medium-term plan;
- (5) Ensuring that mid-year revisions of budget are consistent with established priorities;
- (6) Account for expenditure by closely monitoring government activities;
- (7) Evaluate the outcome of programs, and the success or failure in reaching the objectives;
- (8) Reconsider expenditure priorities in light of evaluations before restarting the process.

*SOURCES: World Bank, Public Expenditure Management Handbook, 1998; Allen Schick, Ed., Perspectives on Budgeting, American Society for Public Administration, 1987; World Bank, Ethiopia Public Expenditure Review, November, 1997.*

70. The multi-year budgeting, however, should be seen only as a planning tool. Multi-year budgets should *not* be seen as commitments of future funds, and certainly should not be viewed as spending floors. The future fiscal environment is uncertain, and the macroeconomic envelope is likely to dictate the extent to which planned spending can be realized. This is the real danger with multi-year budgets, as they tended to hinder efforts to constrain public expenditures in many industrialized countries during the budget crises of the 1970s.<sup>84</sup> This is a danger that can be avoided, however, if the role of the multiyear budget as a planning tool rather than a list of expenditure commitments is clearly expressed up-front.

71. To start moving toward a full Medium-Term Expenditure Framework (MTEF) it is necessary to have, at least: (a) an explicit official statement of specific and clear medium-term fiscal objectives; and (b) a minimum coverage of major functional and economic aggregates of the budget. The broad allocations by sectors should preferably be accompanied by a summary statement of main sector programs and pursued outcomes. Beyond this minimum level of coverage, it would be appropriate to be selective in the detailed treatment of sectors, concentrating first on sectors where major policy changes are being considered with significant

<sup>84</sup> See Allen Schick, Macro-Budgetary Adaptations to Fiscal Stress in Industrialized Democracies, *Public Administration Review*, 46(2), 1986, pp. 124-134.

resource implications. To develop a full MTEF, however, is a complex task and usually takes time and should be done in stages.

### Planning for Contingencies

72. The necessity of several budget revisions recently in Kazakhstan, along with its volatile fiscal environment, suggest that the government should better prepare itself for fiscal contingencies in the years ahead. Even if the current fiscal crisis were to turn around, Kazakhstan's reliance on proceeds from the commodity sectors (mainly oil and other minerals), and the lack of predictability that they involve, exposes the country to future fiscal crises, with the necessity of frequent and substantial mid-year budget revisions during the execution phase.

73. One option for making fiscal adjustments is to impose across-the-board, ad hoc cuts in expenditure. This sort of adjustment often is attractive to policy makers because it is straightforward and, *prima facie*, provides an aura of fairness. In reality, however, across-the-board cuts are symptomatic of a lack of priorities and do not work to minimize the damage to social welfare that may arise from government fiscal restraint. First, some programs and projects have less slack than others, which means the cost in terms of diminished service delivery is likely to be much greater for these programs than for programs with more flexible budgets.<sup>85</sup> Second, unprioritized cuts do not take the dynamics of individual programs into consideration. As already mentioned, education and health programs must be financed in a stable fashion over time if they are to provide the expected benefits. Finally, the imposition of across-the-board cuts or ad hoc reductions does not allow for adequate planning because of the large degree of uncertainty involved.

74. Currently, the annual budget laws make some provisions for nonsequesterable expenditures. To a certain extent this establishes a limited means of prioritizing expenditures and provides some framework for making cuts. However, there is a need for detailed and systematic contingency planning, where spending cuts are determined *ex ante*. The first step would be for each department to establish a transparent and comprehensive set of spending priorities based on long-term policy goals. A set of these programs (and individual projects and spending activities as well) would then be targeted for elimination or postponement should resources fall short of projections. In addition to allowing for a more rational approach to spending cuts, this planning process would provide for an increased focus on prioritization during the budget development phase and would add a layer of transparency to the budget revision process itself. Moreover, the process of reducing public expenditure would be much less arduous and more politically palatable, since the natural candidates would be projects/activities that were pushed to the bottom of the priority list by the spending agencies themselves during the budget preparation phase.

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<sup>85</sup> See Managing Fiscal Stress, in A. Premchand, *Public Expenditure Management*, International Monetary Fund, 1993, pp. 53-80.

## Performing Budget Control and Evaluation

75. Prioritizing expenditures during the budget process does little good if there is inadequate control over spending on the execution end. Thus, proper audit and evaluation systems are a crucial component in creating an environment for the proper rationalization of public expenditure.

76. The budget audit and evaluation procedure in Kazakhstan is in large part limited to collecting regular accounting reports on budget execution and ensuring compliance with spending limitations (Section A). As such, the current controls are fundamentally an input-based system. Output is not properly evaluated, and outcomes are not considered at all. As part of a long-term approach to the prioritization of public expenditure, there should be increased emphasis on formal evaluations of public programs, similar to cost-benefit analyses, which would occur on a periodic basis. This would allow for an assessment of the effectiveness of programs in achieving the goals established for them and would provide an opportunity to examine if public services can be provided at lower cost via alternative delivery mechanisms. The results of these evaluations would provide an important input to the budgetary process in the sense that poorly performing programs could be retooled or eliminated. Formal outcomes-based program evaluations also provide incentives for program managers to focus on the objectives of spending programs and to economize on the use of resources.

77. Ideally, the approach to program evaluations would consist of a series of measurements that directly relate inputs to outputs, such as the cost per life saved or cost per job created. This of course necessitates objective program data, and hence, quantification of information. The major difficulty in such a process is the development of measures that accurately reflect per unit program costs and the quantification of generally qualitative data. Because useful measures of the cost-effectiveness of specific programs requires a degree of precision that often is not possible given the nature of some programs (*e.g.*, programs for which outputs are not directly measurable), outcomes-based evaluation may need instead to proceed on the basis of monitoring of a series of performance indicators. The effectiveness of these types of evaluations depends crucially on the comprehensiveness of the design of the indicators (Box III.4) and the quality of data that is available. Data availability may well be the binding constraint in Kazakhstan given

**Box III.4: Performance Indicators for Program Evaluation**

Effective performance indicators make the link between policy objectives, allocated resources, and program outputs. Indicators must reflect all relevant aspects of the programs for which they are used, including:

- the number of cases handled
- productivity, or outputs per person
- average cost per unit
- the time necessary to complete a caseload
- the demand for and availability of services, including equity aspects
- outcomes, or the results expected and their impact on the overall objectives of the program

Performance evaluation requires that a reasonable set of standards are available with which to judge the indicators. These standards may include norms, or the specification of policy targets; time series of historical data with which trends in indicators can be evaluated; control groups, or a comparison of treated and untreated cohorts; and performance indicators from other government agencies or outside groups that utilize alternative approaches.

*SOURCE: A. Premchand, "Performance Measurement and Evaluation," in Public Expenditure Management, International Monetary Fund, Washington, DC, 1993.*

the general dearth of data on program outputs and outcomes. Increased data collection efforts is thus likely to be money well spent in the sense that these efforts would pay for themselves in the enhanced evaluation that such data would make possible and the increased efficiency that it implies. Nevertheless, to the extent that the requisite data are available, program evaluation should proceed on a directly measurable basis. For example, as data on the incidence of disease and access to potable water are readily available in Kazakhstan, the current tuberculosis prevention and water quality programs could well be evaluated on a more formal and periodic basis.

## CHAPTER IV

### INTERGOVERNMENTAL FISCAL RELATIONS

1. Kazakhstan is a unitary state with three tiers of administration. At the center is the Republican government. The territorial administration is composed of two tiers. At the regional level, there are 14 oblasts and two cities with regional status, Almaty and Astana. At the third tier, the local level, there are 163 rural rayons and 79 towns of equal status as the rayons (Table B.7).<sup>86</sup>

2. Since independence until 1998, intergovernmental fiscal relations in Kazakhstan had not significantly evolved from the system inherited from the previous regime. Equalization transfers for poorer oblasts (“subventions”), to fill the gap between estimated local expenditure needs and resources, were often determined on an ad hoc basis and subject to case-by-case negotiations. Expenditure assignments were not formalized and often subject to change. Revenue sharing arrangements for some major taxes used to vary among oblasts and from year to year. Since subnational governments could always expect a bail-out from the center, the system of intergovernmental relations was mostly characterized by a soft-budget constraint, and included many perverse incentives for revenue mobilization and expenditure efficiency, budget uncertainties, and an overall lack of fiscal discipline.

3. Although there is still a long way to go for Kazakhstan to fully profit from the potential benefits of fiscal decentralization, the reforms introduced in 1999 already represent a remarkable transformation in the system of intergovernmental fiscal relations. These transformations were institutionalized mainly through the reforms on the Budget System (Law #357-I/99), on the Local State Government (Law #2324/93), on the Sovereign and Government Guaranteed Borrowing and Debt (Law # 464-1/99), as well as through the reforms on the sectors: on education and health (Law 3894/99), and on the pension system and social welfare (in 1996 and reviewed by Law 1482-1/99)—the latter accompanied by a decision to consolidate and integrate extra-budgetary social protection funds (and the road fund) into the ordinary budget.

4. Although Kazakhstan has made some progress on the *fiscal* decentralization front so far, it has to be acknowledged that this is an eminently *political process* and has to go hand in hand with *administrative capacity building*. Therefore, to be successful, its implementation require certain level of consensus and consultation, and the policy reform package has to be congruent with certain required sequencing. Simply pushing down fiscal responsibilities to subnational governments may have counterproductive results. The following Sections of this Chapter critically examine the intergovernmental fiscal relations process in Kazakhstan at the light of international best practices. Section A discuss the basic formulation principles for a successful

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<sup>86</sup> Before the 1997 administrative reform, there were 19 oblasts and two cities of regional status, Almaty and Leninsk. The number of rayons and towns were 220 and 83, respectively.

implementation of fiscal decentralization in the medium-term.<sup>87</sup> Section B, C and D examine the expenditure assignment, revenue sharing, and the transfer mechanisms between government levels, respectively, and offer options for reform. Sections D and E address the issues of borrowing access the subnational governments and of strengthening local budgeting, respectively.

## A. DESIGNING FISCAL DECENTRALIZATION

5. The redefinition and formalization of the intergovernmental fiscal relations so far represented an achievement, with the introduction of: (a) homogeneous tax sharing rates between the republican and local budgets, which tends to reduce uncertainties for the local budgets and improve predictability; (b) explicit assignment of expenditure responsibilities,<sup>88</sup> which may contribute to increase efficiency of public expenditure and to greater accountability of local public officials and managers; (c) new proposed methodology for the system of equalization transfers,<sup>89</sup> which tends to improve fairness in the distribution of resource among regions and to increase transparency; and (d) prohibition of republican government guarantees to subnational government debt and greater discipline on borrowing, which now are globally limited and controlled by the republican government.

6. The recent changes are actually establishing some of the basic foundations for a successful fiscal decentralization. If properly designed and implemented, further moves of fiscal decentralization can be used as a powerful instrument to minimizing the cost of the tight financial constraints faced by the country in the present and expected in the near future, and can substantially contribute to foster social and economic stability. On the one hand, allocative efficiency tends to improve when decisions on local expenditure priorities are taken closer to the communities and individuals preferences, who directly benefit from/paying for the public services. Also, technical efficiency tends to increase when the right incentive mechanisms for public service productivity improvement are directly provided to the institutions delivering those services. On the other hand, the potential negative inter-jurisdictional competition and macroeconomic problems that the process may entail can also be neutralized by a properly designed fiscal/financial decentralization.

7. The designed fiscal decentralization reform package has to consider simultaneously the relevant financial inter-jurisdictional relationship as part of a consistent, sustainable system. In this vein, further fiscal decentralization reforms in Kazakhstan have still to address basic issues related to: (1) the scope of fiscal decentralization; (2) the efficiency of local public expenditures and service delivery; (3) performance autonomy and accountability for results; and (4) the policy coordination.

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<sup>87</sup> Sequencing issues are addressed in the Executive Summary, and in the "Matrix of Main Issues and Options/Recommendations"

<sup>88</sup> Although not necessarily improving upon *de facto* previous assignments.

<sup>89</sup> While partially used by the government (1999 and 2000 budgets), this methodology was not formalized yet. This methodology has been rejected in its first submission to Parliament in 1999. The government is re-submitting it with modifications.

### **Scope of Fiscal Decentralization**

8. Most of the fiscal decentralization efforts to date have practically stopped at the oblast level. Third-tier governments, rayons and cities, are not yet adequately addressed even in the 1999 Budget System Law. Although oblast governments are encouraged to reform their fiscal relations with rayons, there are no established rules and the local governments are subject to the old negotiated budget system with their respective oblasts creating confusion and discontent among local officials, negative incentives toward revenue mobilization and expenditure efficiency, and the perpetuation of soft budget constraints. Provided that implementation capacity is developed at the local level, Kazakhstan still has considerable room to further increase efficiency by formally extending its decentralization reforms to the third-tier of government.

9. The current system grants oblasts a federal regime status with almost complete freedom to structure and manage their relationships with rayon, town and city governments. Increasing the efficiency of decentralized expenditures will require a formal, explicit assignment of responsibilities between the second and third tiers of government. Because not all rayon and city governments may have the administrative capacity to carry standard expenditure responsibilities, asymmetric assignments between oblast and lower level governments may be allowed.

### **Congruent Reforms**

10. Fiscal decentralization reforms can only generate the expected results if a congruous system of instruments is put in place. This system should comprise: (a) an adequate revenue sharing/assignment compatible with the expenditure responsibilities attributed to local governments; (b) an appropriate intergovernmental transfer mechanism to address vertical imbalances and horizontal fiscal disparities; (c) a controlled borrowing capacity and availability of funds to finance local infrastructures; and (d) the existence of local administrative capacity, fiscal autonomy, and accountability for policy results.

11. Beyond the improvement on allocative efficiency by promoting better public expenditure prioritization at local levels, technical efficiency can be substantially increased by focusing on the quality and costs of public service delivery. On this front, significant gains are attained when decentralization reaches further down to the implementation units, such as schools and hospitals. The recent reforms of the health and education sectors have in some ways increased the autonomy and accountability of officials in charge of the day-to-day operations of hospitals and schools. However, the reforms have stopped short of providing these officials with enough discretion to make decisions on the input mix to deliver services, and of providing sufficient oversight for performance and accountability of officials in charge of implementation units (Chapter V, Sections C and D). An important way to push transition further is to expand the new practice of funding individual institutions with lump-sum amounts based on *per capita* norms and remove unnecessary micro-management of funds from the top.

### **Clear Mandate, Autonomy to Perform, and Accountability for Results**

12. Regulation, financing, and delivery of the public service are functions that can be entirely or partially assigned to a single level of government or, as in the case of concurrent responsibilities, to different levels of government. Kazakhstan still needs to formally and explicitly establish the assignment of these functions to a particular level of government, attributing to it the adequate autonomy to perform their functions and corresponding accountability.

13. Policy implementation can be substantially improved with an adequate degree of local autonomy, but this necessitates local officials be accountable for policy results. The effectiveness of a decentralized system of government ultimately lies with the accountability of local decision-makers to their constituents. In general, democratic representation forces public officials to get to know and satisfy the needs and preferences of their constituencies or risk being voted out of office. Presently, in Kazakhstan there are no direct links between local decision-makers and the local population or taxpayers. Although the legislative branches of oblast and rayon governments, the maslikhats, are elected, the heads of the executive, the akims, are still appointed either by the President of the Republic, in the case of the oblasts, or by the akims at higher level governments (Annex IV.1). The implementation of recent proposals to provide for popularly-elected akims in Kazakhstan would be an important step in providing for the local accountability of local officials.

### **Central Policy Coordination**

14. For the decentralization process to be sustainable in Kazakhstan, central coordination and leadership should be strengthened, and the issues of expenditure assignment, intergovernmental financing, and local autonomy and accountability, along with sector-specific decentralization issues, should be directly and transparently addressed. Many conflicting issues unresolved by the formally-established rules (often related to macroeconomic policies, concurrent responsibilities and inter-jurisdictional relationships) can only be satisfactorily resolved through intense communication and cooperation among officials at the central and local levels.

15. Strengthening interaction and coordination between the oblast authorities and line ministries has a great potential for: (a) preventing the detachment of central authorities from the priorities and problems of local population, and the possibility of counterproductive regulations; (b) improving effectiveness of performance evaluation of local projects and programs; and (c) intensifying feedback between central and local authorities and resolving conflicts between the different levels of government. To this effect it would require a central government-coordinated effort to promote a permanent dialogue and cooperation among the Ministry of Finance and finance officials at the oblast level, and line ministries and oblast officials in charge of sectoral policies, as well as to disseminate best practices among local governments.

## B. ASSIGNING EXPENDITURE RESPONSIBILITIES

### Current Assignments of Expenditure Responsibilities

16. Since independence until 1998, the assignment of expenditure responsibilities by and large followed a principle of *subsidiarity*, assigning to the central level public services with a national dimension, such as defense or national highways to the central level, and to the subnational level, public services with regional or local impacts, such as tertiary hospitals and street cleaning, respectively. But, because of the lack of formal assignments the system was confusing and unpredictable for the local administrations; assignment of responsibilities was ambiguous and often responsibilities were shifted down and up according to necessity or convenience of the central authorities. At the same time the central authorities were supposed to take exclusive responsibility for all capital investments, but the financing of important aspects of social welfare were supposed to be carried out locally.

17. One of the achievements of the 1999 Budget System reform has been to reduce those uncertainties by explicitly assigning responsibilities for the central and local governments (Table AIV.7). Many of the previous *de facto* responsibilities for central and local governments have been maintained in areas such as defense, education, roads and transportation, culture and parks, police protection and security. The new Law clearly attributes to the central government expenditures related to functions of defense, justice, national militia and internal security, foreign relations, high education and scientific research, national roads and transportation, among others (like the pension programs, state special benefits, special health and education programs). Expenditure assignments among the republican and local government budgets are broadly consistent with established principles. Local budgets are explicitly assigned responsibilities related to:

- pre-school, basic, primary, secondary and vocational education;
- activities related to military service registration and enrollment;
- rescue activities at the local level;
- law enforcement activities at the local level;
- free medical services provided to the population;
- special medical programs at the local level;
- targeted social assistance in accordance with Maslikhats' decisions;
- employment programs;
- housing programs;
- cultural and public performance programs at the local level;
- industry and construction at the local level;
- research and development at the local level;
- municipal urban improvements, including construction of roads and streets;
- maintenance and repair of the road systems of local significance;
- special economic zone development programs.

18. Budgets at both levels are also responsible for their respective transfers obligations, debt services and, in the case of the local special economic zone, development programs. Under the new expenditure assignments, local governments have been reassigned responsibility for targeted social assistance, including housing allowances for low income families, benefits for families with children, and childbirth and funeral benefits. Local governments have autonomy to determine the size of these social assistance benefits, and are responsible for their financing.<sup>90</sup> Some of the reassignment of these responsibilities have been motivated by the inability of the previous extra-budgetary funds and the Compulsory Health Insurance Fund to meet all their obligations. On the other hand, the central government became responsible for the outstanding balance (as of December 1998) of the pay-as-you-go Pension System (which was replaced by the new fully-funded, capitalization pension system), and for the State Social Benefits and the State Special Benefits, some of which previously were the responsibility of local governments (Chapter V, Sections A, B and C).<sup>91</sup>

19. Local governments now became responsible for providing material assistance and training for the unemployed as well.<sup>92</sup> This follows the elimination of the unemployment fund at the central level, and the shifting of this responsibility to subnational governments.

### **Expenditure Patterns**

20. In 1998, the republican budget execution represented 61 percent of total expenditures (excluding net lending), and local budgets 38 percent. Including the extra-budgetary funds, these shares were 48 percent and 38 percent, respectively; and the extra-budgetary funds, 14 percent. After the integration of the extra-budgetary funds into the republican and local budgets, their relative shares in the revised budget for 1999 became 60 percent and 40 percent, respectively. For the first 6 months of 1999 budget execution, the share of the republican government was down to 56 percent while that of local budgets was up to 44 percent (Tables AIV.8, AIV.9 and AIV.10).

#### **a. Functional Structure of Local Expenditures**

21. The relative composition of expenditures reflects the now formal expenditure assignments and a dominance of local budgets in the social sectors (education, health and social security and welfare) which, over the past few years, have financed about four-fifths of these expenditures, absorbing around three-fourths of the local budgets (Chapter V, Section A). The republican budget, on the other hand, has financed around 88 percent of general public services, defense, law and order, economic services, agriculture, research and development, and transport and communications, which has represented about 84 percent of total republican allocations.

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<sup>90</sup> Next sub-Section discuss the (in)adequacy of these assignment of responsibilities.

<sup>91</sup> State special benefits include among others, benefits paid to participants in the "Great Patriotic War," invalids and their families, and the disabled (Categories I, II, and III), mothers of multi-children families, rewards for hard work, and so on. These "categorical" benefits are not necessarily targeted to the poor. These are all national programs and in the past represented unfunded mandates on subnational governments.

<sup>92</sup> Material assistance to the unemployed can be provided to those officially registered as unemployed and the duration of the benefits cannot exceed 6 months in a 12-month period. There are no other restrictions for social assistance at the local level (Chapter V, Section B).

22. **Education expenditures** have been mainly financed by local budgets (close to 80 percent of total education in 1998). While the local governments financed practically the totality of expenditures on pre-primary, primary and secondary education, the republican budget financed almost the totality of tertiary education. The financing composition of education services was maintained in the 1999 budget, although during the first 6 months of 1999, local financing represent 87 percent of executed expenditures in education (Table AIV.8 and AIV.9).

23. **Health expenditures** are also mainly financed by the local budgets, and the financing responsibility of the latter increased between 1998 and 1999 (from 70 percent to 83 percent) as a consequence of the elimination of the extra-budgetary Compulsory Medical Insurance Fund (CMIF) and its integration into the budgets. Actually, considering the extra-budgetary CMIF into the financing structure of the health sector, the share of local budgets jumped from 54 percent to 84 percent. This shows a considerable increase in the responsibility of local governments for the financing of health services.

24. On equity grounds, the increased responsibility of local governments for health care financing may pose a problem. On the one hand, free basic health care may be considered a national program that guarantees equal access regardless of the location of Kazakhstan citizens. On the other hand, as oblasts differ in their abilities to raise resources and they are likely to differ in their needs for health expenditures—e.g., the share of the population over retirement age, likely to need more medical care, in North Kazakhstan is twice the size of that in Kostanai (Table B.13)—it is not surprising the significant disparities in health expenditures per capita across oblasts (Section B). The latter may mean that, although needs can differ, citizens may not be having equal access to health care throughout the national territory (Chapter V, Section C).

25. **Social security and welfare expenditures** financing in the aggregate experienced an opposite shift in responsibility, from local towards republican budget; but this was mainly due to the size of “pension” and “categorical state special benefit” subcomponents. With the 1998-99 reform of the social protection system (including pension, categorical benefits, unemployment benefits, and social assistance), and integration of the corresponding extra-budgetary funds into the budgets, the direct responsibility of the republican government jumped from about 10 percent (16 percent without considering the extra-budgetary funds) to about 87 percent of the aggregate “social security and welfare” expenditure in the consolidated budgets (while the local governments’ fell from about 48 percent—84 without extra-budgetary funds—to less than 13 percent). The execution during the first 6 month of 1999 well reflect this new budget structure in the aggregate.

26. Nevertheless, with the reform of the social protection system, the subcomponents “unemployment benefit” and “social assistance” programs were entirely pushed downwards to the subnational governments. There is, however, a strong case for unemployment compensation and for many of the social assistance programs to be mainly funded from the center. The main argument is that the ability of local governments to finance these programs is likely to be inversely correlated with the incidence of the unemployed and the share of the population in real need of other social assistance. In fact, in East Kazakhstan oblast the official unemployment rate in 1997 was almost four times higher than in Almaty city, while gross value added per capita in

the former was only 40 percent of that in the latter (Table B.12). In this case, even if the system of financing local governments was able to bring them to parity in terms of resources, their expenditure needs would still differ considerably; therefore, their ability to cover needs would still be unequal. Unfortunately, in reality, the current financing system of local governments in Kazakhstan does not bring them to parity in resources either.

27. Local governments have a comparative advantage over central government agencies in administering social assistance programs, thus responsibility for the implementation of these programs should be at the local level. Nevertheless, because the financing capacity of local governments is inversely related to their needs and an effective social safety net program is of national interest, the central government should ensure that funds are available for this end. Therefore, improvement of the social assistance system in Kazakhstan may imply a re-assignment of responsibilities among levels of government. Responsibility for delivery and implementation should be kept at the local level. But, a system of conditional grants earmarked for social assistance may coexist with a general transfer equalization mechanism, which includes a poverty factor as well (to capture the social assistance needed by the poor beyond the barely minimum provided by the conditional grants). Moreover, the specific minimum level of social assistance expenditure should also be enforced on each oblast. (Section D).

28. Thus, in terms of social expenditures, the budgetary reforms over the past two years has substantially changed the relative financing responsibilities of the republican and local governments to public expenditures on "health" and "social security and welfare". This, however, did not profoundly affect the overall composition of the budgets, except for the role reversal observed in "health" and "social security and welfare" services in the aggregate for each government level's budget. In the local budgets, education still is the most important item, representing over one-third of total expenditures, while the relative importance of "health" and "social security and welfare" changed considerably. Between 1998 and 1999, health expenditures as a percent of total expenditures in the local budgets has increased from 12 percent to 20 percent, becoming the second most important expenditure component, while "social security and welfare" fell from 29 percent to 9 percent, becoming the third (Table AIV.11).

29. In general, there is a clear tradeoff between the objective of securing national priorities versus giving local governments discretion and autonomy to make their own expenditure decisions. Although justified on social equity grounds, imposition of minimum expenditure requirements detracts from the objective of promoting local autonomy and potential efficiency gains; therefore, these minimum requirements should be used sparingly in a system of decentralized government. To avoid the risk of local underspending, the government of Kazakhstan imposed minimum expenditure requirements on local governments in education (primary and secondary) and in health services for the rural areas. Although justifiable, and recommendable, the expansion of imposition of a minimum expenditure requirement on social safety net has to be done with restraint, since the already existing minima for education and health absorbed over half of the local government revenue in 1999. (Section D).

30. **Economic sectors expenditures** over the past two years absorbed almost 10 percent of the consolidated local budgets (Table AIV.11). This represents the costs of local governments direct and indirect participation in economic and commercial activities of different kinds. Many oblasts' and rayons' akims are still inclined to continue or expand local government involvement

in commercial, agricultural, and industrial activities, with the legitimate goal of directly promoting the generation of economic activity, employment, and economic development, but with a considerable cost to tax payers. Nevertheless, the best way to promote development at the local level is to use the scarce public funds now invested in commercial activities for the provision of badly needed public services and capital infrastructure. Local government commercial activities tend to compete unfairly with private businesses and can create opportunities for corruption among local officials. For these reasons local government should be strongly discouraged to be involved in activities that can be better run by the private sector on a marketable basis.

b. Expenditure Disparities Across Regions

31. One outstanding feature of local public expenditures in Kazakhstan is its considerable disparity across oblasts. In 1998, per capita expenditures in Astana city were over four times higher than in Zhambyl oblast (Table AIV.12). Astana city is an outlier in the distribution due to its status of special economic zone.<sup>93</sup> When Astana city is dropped from the sample, the disparities are considerably reduced, but remain nevertheless significant, with expenditures per capita in Kostanai oblast being two times larger than those in Zhambyl oblast. Expenditures per capita in Almaty city are a little over the average. The disparities across oblasts in expenditures per capita for education, health and social welfare, were still pronounced in 1998 and they are staying that way in 1999 (Tables B.8 and B.9). In 1998, expenditures per capita in education ranged from T6,147 in Kostanai oblast to T2,622 in Akmola oblast, expenditures per capita in health ranged from T1,986 in Almaty city to T810 in South Kazakhstan oblast, and expenditures per capita in social welfare ranged from T4,037 in Kzyl-Orda oblast to T1,796 in Aktyubinsk oblast. The coefficients of variation for the three distributions show that the per capita disparities for expenditures in education, health and social welfare are quite similar in 1998 (Table B.8). The execution of the budget for the first six months of 1999 shows the disparities in education and health are slightly decreasing and those in social welfare are slightly increasing (Table B.9). Thus, the recent changes in expenditure assignments does not seem to have caused drastic changes in horizontal disparities when these are measured in per capita terms. However, the existent high disparity levels across the oblasts remains a cause for concern. This issue is addressed in the evaluation of equalization grants below.

c. Autonomy of Expenditure Decision at Local Level

32. Divergence in expenditure composition across oblasts may be showing distinct patterns under which the local governments are using their autonomy on expenditure decisions. These patterns may be reflecting differences in local preferences and needs, differences in governance and administrative efficiency, even the existence of economies of scale and quality of public service delivery. In this sense the data in Tables B.8, B.9 and B.14 seems to reveal the following peculiarities:

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<sup>93</sup> Astana city has close-to-average expenditures per capita in most functional categories except for housing and amenities, culture and sports, public order, and particularly "others" (which includes construction of new facilities and support to various economic services); all these are significantly above the average. These categories of expenditures are related to the establishment of Astana as the new capital city.

(i) *oblasts appear to be using their autonomy to prioritize expenditures* per capita according to their particular preferences and needs. Almaty city spent 61 percent above the national per capita average on health but 5 percent below the average on education; Kzyl-Orda oblast spent 33 percent above the average on social welfare but 30 percent below the average on education; and Pavlodar oblast spent 24 percent above the average on education and 31 percent below the average on health.

(ii) *divergence in expenditure per capita tend to be more pronounced for lower priority items* such as housing, culture, and industry than for more essential social services such as education, health and social welfare. This may signal responsible decentralized governance, although this pattern may well be largely a result of the minimum expenditure requirements imposed by the central government on education and health from the local level.

(iii) *divergence in per capita general administration expenditures (i.e., "general public services")*, may be indicative of different degrees of administrative efficiency at the local level. Kostanai oblast, for instance, spent on administrative services close to three times per capita the amount spent by South Kazakhstan oblast. This divergence hardly can be explained by economies of scale in the delivery of public services (in average), since both oblasts have populations over one million. Although more detailed information is necessary for any definite conclusion in each particular case, their divergence in per capita expenditures in this item may well be reflecting differences in the quality of services.

#### d. Economic Structure of Expenditures

33. The scarce data on oblasts' economic structure of public expenditures indicate a poor mix of resources; too many resources concentrated on current expenditures, and extremely low capital expenditure (Chapter V).

34. *Current expenditures* are basically represented by wages and some utilities. Very little is spent in supplies and the operation and maintenance of facilities, such as teaching material, medical material, and even with the material assistance to the poor.

35. *Capital expenditures* by oblasts have been low since independence. Due to lack of proper maintenance and investment for many years, capital infrastructure is deteriorating although it is known that the cost of replacing it later on will certainly be much higher than the cost of maintaining it today. This situation at the local level arises from: a certain confusion in the assignment of capital expenditure responsibilities; existence of negative incentives for local governments; and lack of progress in capital financing for local governments.

36. Here is a case where responsibilities in Kazakhstan are not at all specified. Due likely to some inertia from the past—since under the Soviet Union all capital expenditure were a federal responsibility and controlled by the central plan—there still exists confusion on who should investment in infrastructures and who should maintain them. From an efficiency point of view, the local governments should be responsible for financing both maintenance and investment of local infrastructures. First, local governments know better the investment needs of their constituencies and can make the best decisions on how to satisfy them. Second, keeping capital

and maintenance responsibilities at different levels of government can lead to poor investment decisions and low levels of infrastructure maintenance. In practice, most of the capital expenditures at the local level have been financed by the republican budget, and most of the projects in the 1996-98 PIP and the 1999-2001 PIP are projects of local interest and could be the responsibility of subnational governments.<sup>94</sup> Shifting these capital expenditure responsibilities totally to the respective local governments would be an improvement, but for this to be effective adequate evaluation and administrative capacities have to be built at the local level.

37. Also, the incentive structure to the local governments to maintain and invest in infrastructures have to be improved. As long as the central government keeps providing all capital infrastructure, local governments will have no incentive to use their own resources either for investment or for maintenance. The paternalistic approach leads to a lack of ownership of local public infrastructure and a “moral hazard” behavior tends to prevail, since there will always be the local expectation that the central government will come to their rescue when the infrastructure proves to be obsolete or unusable. Unfortunately, for the near future, the central government will have to continue investing in local infrastructures but, in the meantime, two basic conditions should help remedy the incentive structure: (a) greater transparency in the eligibility of capital projects (evaluation under technical criteria for selection and inclusion in the PIP); and (b) matching contribution by local budgets.

38. Financing local infrastructure is not only necessary (for lack of liquidity in annual budgets), but can also be efficient and equitable (distribution of tax burdens among the different generations of tax payers who benefit from the projects). However, because of the failure of the domestic financial market, for most local governments the only supplier of credit has been the Ministry of Finance, and most of the time the loans have been to bridge financing during the execution of the annual budget and not for long-term projects. Facilitating the development of a supply of credit for local governments is a likely long-term proposition but one the government needs to start tackling (Section D).

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<sup>94</sup> Examples of these projects include the expansion and reconstruction of rayon boilers, construction of schools, completion of secondary schools, hospitals, local museums and clinics, and sewerage pumping stations.

## C. SHARING REVENUE SOURCES

### Statutory Revenue Sharing

39. The 1999 Budget System Law introduced significant changes in the revenue sharing scheme. Since independence, the most important taxes, including personal income tax (PIT), the corporate income tax (CIT) and excises until 1998, and VAT until 1997, were shared between the central and local government at rates that varied from oblast to oblast and from year to year, basically on a negotiated basis.<sup>95</sup> The 1999 reform introduced identical sharing rates for each taxes for all oblasts, and such rates are supposed to be stable for a number of years, so contributing for better local budget predictability. The following is the new sharing tax and fee arrangement affecting the local governments:<sup>96</sup>

- **the major taxes:** 100 percent of the PIT, 50 percent of the CIT, 50 percent of the excise on alcoholic beverages, 100 percent of the excise on gambling, 15 percent of excises on crude oil, including condensed gas, and 100 percent of the social tax;<sup>97</sup>
- **property taxes:** 100 percent of the land tax, the property tax and the vehicle tax;
- **fees:** including fees for use of local roads, registration of individual and collective firms, real estate titling and transaction, auctions and trading at market places, use of water and forest, and other administrative fees and penalties, as well as 20 percent of the environmental pollution fee.

40. Also the new Budget System Law designates the following non-tax revenue to local budgets:

- **capital transactions:** privatization of communal property, dividends from enterprises, production-sharing agreements, leases of communal property and land, and
- **transfers:** grants and subventions.

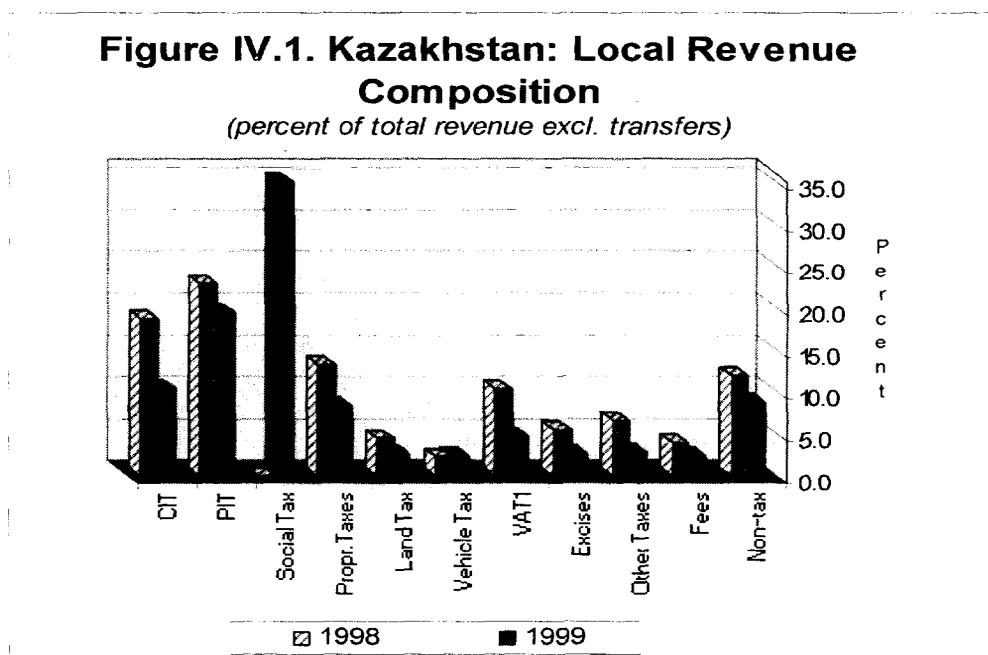
<sup>95</sup> In 1998, the CIT was shared with oblasts at the following negotiated rates : Akmola oblast 62 percent; Aktyubinsk, 56 percent; Pavlodar, 40 percent; Atyrau and Mangistau 10 percent each; and all the other oblasts received 100 percent except Almaty city which received nothing. In the case of the PIT, Atyrau oblast, received 20 percent; Almaty city, 58 percent; Mangistau oblast 71 percent; and the rest of the oblasts received 100 percent.

<sup>96</sup> Neither the Budget System Law nor the "Tax Code" makes a distinction between central government taxes and local government taxes. Rather, the Budget System Law *attributes revenue shares* from the existing taxes to the two levels of government. Conventionally, local own taxes are those for which local governments have some control over its rate or base. Thus, according to this interpretation, none of the taxes in Kazakhstan are local taxes, with the only possible exception of the land tax. In Kazakhstan the republican government has the exclusive right to legislate on (Constitution) and collect (Tax Code, Art. 173, par.3) tax in the country.

<sup>97</sup> The new Social Tax (a 21 percent payroll tax), contributed by employers now goes to local budgets. This compares to the payroll 31 percent employers' contribution which went to the previous-reform extra-budgetary funds. The new additional 5 percent payroll contribution imposed after October 1999 on employers goes directly to the republican budget.

## Patterns of Local Revenue

41. In 1998, local government tax revenues represented 35 percent of state (i.e., general) government revenues before transfers (Table AIV.13). With the new tax arrangement, as the revised budget for 1999 indicates, this share goes up to 51 percent. This increase basically reflects the total allocation of the social tax to the local budgets, despite the changes introduced by the reform in other important sources of local revenue. For instance, while the effective sharing rates for the CIT and PIT in 1998 (54 percent and 84 percent, respectively) remained quite close to the new statutory rates (50 percent and 100 percent, respectively), the effective sharing rate for excise tax on alcoholic drinks in 1998 were statutorily halved by the Budget System Law. Before the 1999 reforms PIT were the most important revenue sources for local governments, followed by property taxes and VAT (the latter only collected in the special economic zones (SEZ)). After the reforms, the revenue structure changed by the centralization of the VAT (because of the elimination of the SEZ, except for Astana city), and the social tax became, by far, the most important local revenue source (36 percent) (Figure IV.1).<sup>98</sup>



42. Across oblasts, the major sources of local tax revenues in 1998—PIT (18 percent on average), property taxes (17 percent), and the CIT (14 percent)—show significant variations in their relative importance (Table AIV.14a). For instance, in Atyrau oblast, the more important source of revenue was property taxes (47 percent of the oblast's total revenue), while in

<sup>98</sup> Prior to 1998, VAT collection was shared with all oblasts, but it was a highly important source of revenue mainly for the four special economic zones (Akmolinskaya, Kzyl'ordinskaya, Kostanaiskaya, and Astana city). With the new sharing arrangement and the elimination of special economic zones (except for Astana), VAT remained important only for Astana city.

Karaganda oblast it was CIT (39 percent), and in Mangistau oblast it was PIT (40 percent). These variations in revenue pattern largely reflect the country's regional diversities in terms of economic structure, relative degree of development and inter-jurisdictional relationships, which end up determining oblasts' tax and revenue collection capacities (Section C). Because of this, Almaty oblast, Zhambyl, North and South Kazakhstan, for different reasons, are heavily dependent on official transfers (Section C and D). In contrast, where the tax capacity is relatively large (Almaty city, Pavlodar, Mangistau, Kostanai, Atyrau and Aktyube oblasts), the dependence on transfers was non-existent in 1998. As a result, subventions, which were the most important source of revenue for local budgets in 1998 in the aggregate, were very unevenly distributed across oblasts.

43. With the 1999 reforms (introduction of the new Budget System Law, changes in the social protection system, and the elimination of the special economic zones), the subnational government financing structure changed in one fundamental way: a much larger social tax revenue replaced the previous VAT share (except for Astana). This replacement embodied an important difference: now the social tax collection is also more evenly distributed across oblasts than was VAT (Tables AIV.14a and AIV.14b). In the aggregate of the local budgets, this replacement more than offset the total subventions from the republican to the local budgets; i.e., in relative terms to the previous situation, the vertical fiscal imbalance was reversed (Section D). The latter allowed the central government to introduce a combined mechanism of withdrawals (negative transfers), alongside the traditional subventions (positive transfers), reflecting a move towards a "fraternal" equalization mechanism (Section D).

### **Disparities in Local Revenue Collections**

44. An important characteristic of revenue sharing in Kazakhstan is the large disparity in per capita revenue collections across oblasts. In 1998, per capita tax collection in Astana city was close to 15 times higher than those in Almaty oblast (Table AIV.15). When Astana city datum is dropped from the distribution because of its special status, the disparities in 1998 still remain as high as they were in 1997. In 1998, revenue per capita in Kostanai oblast and Almaty city were about 5 times larger than that in Almaty oblast.<sup>99</sup> In 1998, the coefficient of variation was 0.8 including Astana city, and 0.4 excluding it. During 1998, revenues from the two highest collection oblasts represented 22 percent of total local revenues and collections in the five highest collection oblasts represented 50 percent of total collection (Table AIV.16). In contrast, the two lowest collection oblasts represented under 6 percent of total collections.

45. Despite, and in some cases because of, the mechanism of regulating (i.e., "negotiated") sharing rates still fully operating in 1998, there were significant disparities in the distribution of per capita revenues from different tax sources. Revenues per capita for the CIT ranged from T 5,231 in Astana city to T 230 in Zhambyl oblast (Table B.10). In both these cases, local authorities were allowed to keep 100 percent of CIT revenues. Almaty city shared nothing of the CIT. Disparities in revenues per capita for the PIT were also large. In Mangistau oblast, PIT collections were 109 percent over the mean and in Zhambyl oblast, PIT collections were 32

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<sup>99</sup> Inter-jurisdictional relation is an important factor between Almaty city and Almaty oblast. Income sources of many people residing in the latter are located in the jurisdiction of Almaty city (which has independent administration and where most of the region's economic activities are concentrated).

percent of the mean. This happened despite the fact that in 1998 Mangistau was allowed to retain only 71 percent of PIT revenues and Zhambyl oblast 100 percent. The disparities in the distribution of per capita collections may indicate a very distinct revenue mobilization capacity among oblasts, and highlights the need for an equalization transfer system in Kazakhstan.

46. Because of distinct revenue mobilization capacity, it is expected that fiscal disparities will increase after the adoption of the identical tax sharing rates for all oblasts by the 1999 Budget System Law. In fact, tax collections for the first 6 months of 1999 already indicate that disparities are increasing (Table B.11). In the case of the CIT, revenues per capita in Atyrau oblast were more than 80 times higher than in Zhambyl oblast. In the case of the PIT, revenues per capita in Atyrau oblast were 20 times higher than in Zhambyl oblast.<sup>100</sup> During the first six months of 1999, the coefficients of variation for the distribution of CIT, PIT and excise collections across oblasts are all above one and way up from 1998. This increase in disparities, although expected as a result of moving to a more transparent and stable revenue sharing system, have now to be carefully re-examined by the government by considering options to improve both the revenue sharing arrangement and the equalization transfer mechanism that can make the new system more equitable and sustainable.

### **Options to Improve Revenue Sharing**

47. The 1999 reforms have introduced some very positive features to the revenue sharing system. One of them was the formalization of identical sharing rates across oblasts. The other was the assignment of 100 percent of VAT revenues at the central level. Despite the expected increase in revenue disparities the formal identical sharing rates entail (a problem now to be solved by equalization transfers), they improve predictability significantly. The 1999 reform move of VAT was the right one, because the structure of a VAT is ill-suited for revenue sharing due to the crediting and debiting of the tax in different jurisdictions.<sup>101</sup>

48. Nevertheless, while there has been progresses in the revenue sharing arrangement, some issues still remain and require further attention by the government. One general observation is that the sharing of tax proceeds should reflect the tax payer (or resident) effort/contribution in each region, i.e., should be made on a destination/consumption basis rather than on origin/production basis. For example, the excise taxes on alcohol beverages, and energy (including oil and gas) are to be shared with the oblasts where these products are consumed rather than where they are produced. In some cases, producing oblasts might have a "royalty" instead.

49. *(a) Centralizing or apportioning CIT revenues.* CIT is far from being an ideal tax for directly funding local governments. To create accountability and efficient management, local taxes should be non-exportable, stable, and should establish as much as possible a direct link between benefits received from public services and taxes paid. The CIT has basically none of

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<sup>100</sup> In the most extreme cases, part of the divergence during the first half of 1999 may be reflecting tax arrears collection from the previous year.

<sup>101</sup> The way to properly share the VAT with local governments would be by using a distribution formula, which could be based on population, as used for example in Germany, or based on estimates of value-added, as used for some Canadian provinces.

these properties, since it is easily exportable, its revenue yield is highly volatile, and its final incidence is likely to be outside the jurisdiction. In addition, the sharing of the CIT at the local level tends to exacerbate horizontal disparities because its base is more unevenly distributed than most other taxes (Tables B.10 and B.11). For these reasons, the CIT is a good candidate for re-centralization if the design of equalization transfers in the near future requires shifting of resources to fund it.

50. The second but inferior option is to improve the current CIT sharing arrangement. At least by apportioning the CIT revenue according to the places where the enterprises are operating (producing and selling) would tend to be fairer than the current system that leaves all revenue at the place where the tax is collected; this for administrative reasons has coincided with enterprise's headquarters or where they are registered. This situation has particularly favored places like Almaty and Astana cities. Kazakhstan's Tax Code does not provide any formula for the CIT revenue apportionment across oblasts and, although instruction no. 33/95 of the MSR regulates an apportionment based on the enterprises' payroll, assets and production, this has not been enforced. Some countries that have locally shared CIT use an apportionment formula based on one or more factors, such as the enterprise's share of labor, assets, and sales in each particular jurisdiction. In the meantime, if the government intends to enforce the apportionment option, it should review the formula by taking those factors into account as appropriate.

51. **(b) Splitting PIT: progressive rate(centralized), proportional rate(shared by place of residence).** PIT could be a well-fitted tax for sharing with local governments. This is a tax which tends to be stable, with a basis rather evenly distributed geographically, and promises to be an elastic source of revenue for local governments if economic growth takes hold. Nevertheless, there are two major weaknesses related to the current PIT sharing with local governments in Kazakhstan which should be reviewed: the basis for its apportionment, and the redistribution function.

52. The current apportionment of PIT is carried out by the place of work rather than the place of residence. This is a concern when there are either close boundaries of regional governments such as Almaty city and Almaty oblast, or relations among third tier governments (rayons and towns) where taxpayers are more likely to cross boundaries from their residences to their places of work. Apportionment of the PIT by the place of residency is more desirable because taxpayers tend to use the services of the jurisdiction where they reside more intensely. Paying taxes by the place of residence also helps to create a desirable link between taxes and benefits received from local public services. Nevertheless, sharing PIT revenues by the place of residence will require the MSR to collect information from enterprises about the local residence of their employees and reallocate revenues across jurisdictions accordingly.

53. The PIT in Kazakhstan, fully assigned to the local governments according to the place of work, has progressive rates ranging from 5 to 30 percent. The progressiveness of this tax has an explicit redistribution function, which should be better carried out at the national rather than at the local level. At present, if just a few regions have a concentration of high income individuals, it is these richer regions alone that benefit from this redistribution. With a national tax it would be the citizens in all regions that would benefit. Following international practice, Kazakstan

could consider splitting the PIT into a *central progressive tax* and a *local proportional tax*; the local proportional component being a piggyback rate to the national progressive tax.

54. **(c) Sharing Social Tax by place of residence.** In substance, the 100 percent allocation of this proportional payroll tax to local governments does not entail any harm. Its sustainability and implementation aspects though are of major concern. On the sustainability side, it is important that if the intention is so, this tax should be definitely and formally integrated into the Tax Code of the country as part of its normal, permanent tax structure in order to give it credibility. So far, the Social Tax still appears to be a short-term fix used to finance the budget in lieu of the payroll contributions to the previous extra-budgetary funds eliminated by the social protection system reform. The original idea (1997-98) was to phase out the tax over time (in tandem with the steadily declining residual PAYGO pension obligations), but this changed since early 1999, when the payroll contribution to the budget was turned into the Social Tax 100 percent shared among the local governments. Later, in October 1999, an additional “temporary” 5 percent rate on the payroll was introduced, but this time this additional rate was addressed to the republican budget. To make it credible and predictable for local administrations, it is important to make sure what is going to be the social tax structure in the early years ahead.

55. On the implementation side of the Social Tax, the problem now is that it has been paid at the place of work rather than at the place of residence, thus presenting the same difficulties as in the case of the PIT. Likewise, an option for reform could be amalgamating the Social Tax with the PIT and splitting it, with a proportional component being shared by local governments according to the place of residence of the contributors. Although not directly related with decentralization *per se*, the current Social Tax falls only on labor income and so it is likely to be regressive and distort the use of labor vis-a-vis other inputs of production.

### **Options to Enhance Local Autonomy on Revenue**

56. The most critical issue in revenue sharing and assignment is the lack of autonomy on revenues that in general local governments are provided with. This fact often limits the potential efficiency gains of fiscal decentralization, due to lack of autonomy local authorities tend sometimes to under-perform their functions and have a valid excuse for not being accountable for policy results. Kazakhstan is no exception on this front, and presently local autonomy on revenue policies (with the only exception for land tax) is almost non-existent.

57. Conceptually, revenue autonomy can be exercised by the ability of local authorities to introduce new taxes, to customize the bases and/or change tax rates of existing taxes. Out of these options, the least disruptive in terms of administration and compliance costs is the ability to change rates of some existing taxes. Some flexibility to set rates of taxation can provide local governments with the necessary autonomy to offer the local communities the possibility of choice on local decision at a cost at the margin. This connection between revenue and expenditure decisions tends to: (a) make local authorities more accountable to their constituents for spending decisions (in the sense that they have some control over resources); and (b) encourage the local authorities address the difficult problem of vertical imbalances in a responsible manner (in the sense that the community itself faces a more direct responsibility to raise resources to satisfy their local choices).

58. **(a) Introducing local revenue autonomy.** Enhancing local autonomy on revenue at the margin is an important decentralization issue that should be addressed in the next round of intergovernmental finance reform. In addressing this issue some basic criteria should be followed. First, as in the case of expenditures, a gradual approach should be adopted to avoid disruption and help create the necessary administrative and evaluation capacities for local governments to absorb new fiscal responsibilities. Second, it could be established that granting revenue autonomy to local governments should not necessarily increase overall tax burdens or lead to tax competition among jurisdictions. On the one hand, the reform can, if desired, be tax-burden neutral, so that if new taxes are introduced or the rates of existing taxes are increased, that would need to be accompanied by parallel reductions on rates or the elimination of other taxes—a local tax rate that piggybacks, for instance, a national income tax rate, instead of adding or partially replacing the national rate. On the other hand, to minimize the danger of destructive tax competition that might arise from the introduction of revenue autonomy, local governments can be granted a choice between maximum and minimum rates of a tax. These principles would minimize complexity and administrative problems later on.

59. **(b) Boosting property taxes.** Presently, in Kazakhstan, land tax (one of the property taxes) is the single really local tax, since it is the only one for which the local governments can move its rates up or down by 20 percent from the rates in the Tax Code, and thus offer some degree of local autonomy. Property taxes in general can be an adequate and powerful instrument available to local governments, and more autonomy should be given in this regard. Land tax, property tax, and vehicle tax are typical and appropriate local taxes because they have stable bases over business cycles of the economy, they are not easily exportable, and they have identifiable links between payment of the tax and the benefits from local public services. Moreover, their tax bases are unmovable and tend to be less distortionary of business activities.

60. As far as the current structure of land and property taxes in Kazakhstan, there is a need for the development of a full fiscal cadastre with clear and updated location and valuation of lots and structures. Land and property taxes should be integrated into the real estate tax with assessment based on market values. It should be acknowledged, however, that reforms in this area tend to take time to accomplish, and the MSR may consider preparing them well ahead of time so that they do not disrupt this reliable and important source of local revenues.

61. **(c) Making use of surcharges, surtaxes, and user charges.** Another option for giving local governments a meaningful degree of tax autonomy on revenue is to introduce a discretionary or optional *surcharge at the local level* on the central government personal income tax. Autonomy could be limited to adding a flat rate up to a maximum rate legislated in the law. A surcharge or piggyback personal income tax meets all the desirable requirements for the assignment of taxes to the local level. For this, however, the MSR have to be prepared to implement this local surcharge based on the place of residence, and gather the information needed on employees working and residing in different jurisdictions. Another option is to introduce *local surtaxes* on certain excise taxes, such as those falling on alcohol or petroleum products. These options may end up being difficult to administer, because: (i) now these taxes are levied at the place of production rather than at destination; and (ii) if surtaxes differ across local jurisdictions, taxpayers will tend to shop across borders for lower taxes. Finally, local

revenue autonomy can be improved by instituting local user charges as well for some services, like garbage collection, street lightening, parking places. User charges have already started being used in Kazakhstan for certain healthcare and education services (see Chapter V, Sections C and D).

### **Administration of Local Taxes**

62. Presently, according to the Tax Code (Art. 173, par.3), only the republican government (now through its agency the MSR) has the authority in Kazakhstan to administer all tax collection, shared or not with local governments, including local taxes. In many countries this assignment would raise questions about a lack of interest that a national agency may have for collecting local taxes. In Kazakhstan—as in other former Soviet Union republics—there seems to remain a *de facto* allegiance of regional and local tax inspectors to regional and local government officials, as opposed to their bosses in the central government. However, it is not well established to what extent the *de facto* dual subordination of tax inspectors has affected tax collections (and tax arrears) of central vis-a-vis local governments and the relative capacity of enforcement of different taxes.

63. With the proviso that the necessary administrative capacity should be in place, it would be desirable, in the medium term, to shift the administration of *local taxes*, such as the property tax and the land tax, to local governments. On the one hand, a sense of reality and pragmatism should guide this transfer of responsibilities to *local tax* administrations, which should be gradual, asymmetrical, according to local absorptive capacities, and recognize that not all local governments may have the capacity to administer taxes. On the other hand, the administration of PIT, CIT, and excises should continue to be centralized because they require information and administrative capabilities well beyond those available to local governments.

## **D. MATCHING RESOURCES WITH RESPONSIBILITIES**

64. The two initial steps in the design of fiscal decentralization—i.e., the assignments of expenditure responsibilities and revenue sources—invariably give rise to vertical and horizontal imbalances which need to be addressed through a system of transfers. This section looks into the fiscal imbalances in Kazakhstan, how well the system of transfers has worked to resolve the problem, and how it can be improved. The section also analyses the access to borrowing so local governments could meet their capital expenditure needs.

## Fiscal Imbalances

65. Sections B and C above have shown the existence of substantial disparities in both per capita expenditures and per capita revenue collections across oblasts in Kazakhstan. Perhaps a more relevant dimension of the inequality challenge is the mismatch between resource and responsibilities between the republican government and the oblasts (the vertical imbalance), and among the oblasts themselves (the horizontal imbalance).

66. Horizontal imbalances results from differences in tax capacity and expenditure needs among regions. On the one hand, decentralized governments can differ in terms of their ability to raise revenues in a given tax structure. In Kazakhstan, except for the special economic zone of Astana city, differences in tax capacity are directly related to disparities in the regional economic base; and the country's industrial activity and natural resources are unevenly distributed. In 1997, gross value-added per capita in Atyrau oblast was T238,100 while in Zhambyl it was T43,900 (Table B.12). This is more than a five-fold difference in annual per capita income between these two oblasts. On the other hand, differences across oblasts in expenditure needs, caused by differences in costs of service provision (e.g., energy, water) and unequal shares of the population with special needs (e.g., to be educated, infected by AIDS, geriatric medical care, in poverty) also impinges on horizontal imbalances. For example, South Kazakhstan's share of the population that is under 15 years of age is almost twice as large as that in Astana city or the share of population of retirement age in North Kazakhstan oblast is twice that in Kostanai oblast (Table B.13). Actual (ex-post) revenues and expenditures, however, are not good measures for horizontal disparities, because they can simply be a result of unequal efforts exercised in enforcing and collecting taxes and because expenditure adjustment measures might have been applied with different intensity by the regions. In Kazakhstan, ex-post horizontal disparities are also augmented by the special fiscal incentives provided to some local governments—such as the existing free economic zone in Astana—and not because of genuine horizontal imbalances. Therefore, measuring and correcting for horizontal fiscal imbalances, it is important to focus on ex-ante (potential) tax capacity rather than the ex-post (actual) revenues, and on ex-ante expenditure “needs” rather than on ex-post “executed expenditures”.

67. Vertical imbalances result from a lack of correspondence between expenditure responsibilities and assigned revenue sources to levels of government. The magnitude of vertical imbalances is translated at the size of these governments' structural (ex-ante) deficits and reflects their relative ability to finance expenditures from own sources of revenues. However, in Kazakhstan the actual (ex-post) budget deficit measure of vertical imbalance is biased towards the central government because it can usually borrow more freely than local governments—and the former has often absorbed some responsibilities of the latter. Because of this, measuring vertical fiscal imbalance as the share of local government expenditures that is financed with sources of revenues over which local governments have discretion or autonomy is a preferable approach. By this more strict measurement definition, there would be an enormous vertical imbalance in Kazakhstan against local governments since they have little control over the taxes assigned to them. However, if one adopts a less narrowly defined vertical imbalance measurement—by considering own local revenue sources including all shared tax revenue (100 percent or less)—then the index of vertical imbalance for 1998 would be around 0.7, where a

value of 1 represents perfect vertical balance (Tables AIV.8 and AIV.13). This index of 0.7 would not compare badly with other decentralized systems in the world.

68. Nevertheless, after the 1999 fiscal reforms, the intergovernmental fiscal relations changed substantially, since: (a) the local budgets gained the revenue of the Social Tax (a new 100 percent local tax), which by itself increased the estimated local tax receipt in the aggregate by about 66 percent as compared to 1998 (Table AIV.13); but (b) the responsibilities of the local governments increased substantially with the reassignment of partial financing of the social sector expenditures (previously financed by the extra-budgetary funds). As perceived by the central authorities, a *vertical fiscal imbalance reversal* occurred after the 1999 reforms, since the approved budget withdrawals (i.e., transfers *from the local budgets to the republican budget*) from oblasts exceeded subventions (i.e., transfers *to poorer local budgets*) to the oblasts by T 5.8 billion in 1999 and by T 23.1 billion in 2000 (Tables AIV.17 and AIV.18).

69. In summary, Kazakhstan has a significant horizontal fiscal imbalance which the government needs to address. While the measurement of vertical imbalances can be more controversial and the system is still at a flux, the lack of revenue autonomy to local governments is an important area for improvement as discussed in Section C. The next Sections examine how the current system of fiscal decentralization addresses these fiscal imbalances, how effective it has been, and what are the options for reform.

## **The Transfer Mechanisms**

### **a. The Previous Gap-Filling Transfers and Negative Incentives**

70. From independence to 1998, Kazakhstan used gap-filling transfers in combination with “regulating” revenues to address horizontal and vertical fiscal imbalances. On the one hand, gap-filling subventions (i.e., transfers) were given from the republican budget to those oblasts which showed a budget gap between estimated expenditures (based on norms) and forecasted actual revenues. On the other hand, special revenue sharing arrangements (specially on CIT and PIT) were made with those oblasts which were to produce an ex-ante budget surplus. In this sense, both vertical and horizontal imbalances were simultaneously solved through republican budget transfers and regulating revenues, without leaving any planned deficit/surplus in the local budgets after transfers.

71. The main problems with the gap-filling subvention system were the lack of transparency in the decision process and the negative incentives it created. Information on cost of services and facilities were provided by local administrations, but all major decisions on expenditure norms and on resource allocation were taken centrally. While sharing revenue rates were renegotiated every year, on a case-by-case basis, the annual tax revenue were projected centrally by the Ministry of Finance. The incentives mechanism was perverse, since if local governments made an effort to reduce the costs of delivering public services, thereby reducing expenditures and the budget gap, in the future the budget would likely include a reduced subvention or reduced revenue sharing which meant that the benefits of frugality and efficiency would accrue mostly elsewhere. Similarly, greater revenue mobilization by any local government resulted in reduced gap-filling grants or reduced tax sharing rates in future years.

72. These problems were to a large extent acknowledged by the government in the 1999 package of reform. Article 5 (2) of the Budget System Law states that the government will enact rules stipulating the “long-term level of subventions and withdrawals.” It would seem it was understood that what was actually needed was an objective or formula-driven transfer system to go with the 1999 reform of revenue sharing which could be able to address horizontal and vertical imbalances, but at the same time should not discourage local expenditure optimization and revenue mobilization by local governments.

b. The “Fraternal” System of Transfers

73. The new mechanism of resource transfers intended to address both the horizontal and vertical fiscal imbalances that arose from the new arrangement of expenditure and revenue assignments. The government proposed methodology—which was informally used in 1999 budget formulations<sup>102</sup>—was supposed to simultaneously determine the size and distribution of *subventions* (transfers from the republican budget to the poorest oblasts) and *withdrawals* (transfers from the richest oblasts budgets to the republican budget). Both transfers (withdrawals and subventions) are made as general purpose transfers—although the state budget establishes specific provisions for local minimum spending on health and education. As perceived by the central government, the 1999 reforms entailed a vertical imbalance reversal in the intergovernmental fiscal relations in Kazakhstan, and the new computation methodology determined a *net* withdrawal of 0.7 percent of the GDP (2.1 percent of GDP total withdrawals and 1.4 percent of GDP total subvention) in 1999. Although not entirely transparent, and still involving some confusion, the estimation process of these transfers attempts to take into account the local expenditure “needs” (based on national “norms”), the *actual* revenue projections (based on Ministry of Finance parameters), and supposedly a given maximum limit of overall local indebtedness (the latter to be case by case negotiated with the central government *during budget execution*).

74. The intention of the government with the new transfer system was essentially to adopt a “fraternal” funding approach for its equalization objectives (or, a “Robin Hood” type of funding, by explicitly taking from the richest oblasts and giving to the poorest oblasts).<sup>103</sup> The system would also endogenously determine the size of the vertical imbalances, after matching oblast budget’s resources with corresponding expenditure needs. Further, as an attempt to reduce uncertainty, the initial government methodology proposed to fix these transfers for a period of three years, but this rule ended up not being accepted, and the 2000 budget subventions and withdrawals did not follow it.

75. ***The system in practice.*** The government used the basic methodology of Resolution 529/99 to compute subventions and withdrawals for the 1999 budget. The subventions and withdrawals originally budgeted for 1999 were almost identical to those in the proposed

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<sup>102</sup> This new methodology, outlined in the Government Resolution no. 529 of May 4, 1999 (see Annex IV.3), was once rejected by Parliament in 1999. The government intended to resubmit it in the near future.

<sup>103</sup> The equalization transfer methodology takes into account regional expenditure differentials which arise from natural and climatic conditions, among other factors. It also considers bringing the range of per capita expenditure among oblasts within the range of -10 % to +15% of the average in three years time.

Methodology (Table AIV.4 in the Annex IV.2). However, budget revisions late in 1999 changed the level and distribution of subventions. The total amount of subventions going to all but the Mangistau oblasts in 1999 is T32.1 billion with the largest recipients being South-Kazakstan and Almaty oblasts which are budgeted to receive over T6 billion each (Table AIV.17). There are seven oblasts, including the city of Almaty, subject to withdrawals in 1999. The total budget amount of withdrawals for 1999 is T37.9 billion, of which 16.2 billion come from the city of Almaty (Table AIV.18).<sup>104</sup>

76. It would be expected that the government should have again used the basic methodology in Government Resolution no. 529 for the 2000 budget. However, the actual subventions and withdrawals submitted with the 2000 draft budget (Tables AIV.17 and AIV.18) differ from those proposed in Government Resolution no 529 (Table AIV.4 in the Annex IV.2). The 2000 budget subventions and withdrawals are in the aggregate 4 percent and 26 percent higher, respectively. According to the Ministry of Finance, these differences would reflect in part the impact of expected inflation, and in part the republican budget needs to finance additional expenditures in the Republican budget, in particular foreign debt repayment. Unfortunately, the reality is that Resolution 529/99 is not being implemented anymore, and because the level of transfers still varies from year to year in a non-transparent way, uncertainty of financial flows to and from local budgets still exist, detracting local governments from their ability to plan ahead. Therefore, the perverse incentives against revenue mobilization at the local level that existed in the past are still in place.

77. ***Equalizing effect of intergovernmental relations.*** In 1998, disparities in the availability of fiscal resources were significantly reduced via the system of intergovernmental finance (Table AIV.19b). The first column in Table AIV.19b presents the distribution by oblast of per capita collections for all types of taxes regardless of the level of government to which they belong. These figures represent the potential extent of fiscal disparities.<sup>105</sup> The second column presents local revenues per capita before subventions. The third column presents the distribution of local per capita revenues after subventions. In each of these steps the disparities in resources by oblast are significantly reduced. The coefficient of variation shrinks from 1.1 in the case of total collections to 0.6 for local revenues and expenditures per capita in columns 3 and 4 of Table IV.13-B. The system of subventions and revenue sharing in 1998 was set to equalize resources and that objective was largely accomplished, although fiscal disparities still remain.

78. For 1997 and the first 6 months of 1999, data for total national tax collections by oblasts were not available. Thus, it is not possible for these two periods to establish the potential extent of fiscal disparities as done for 1998 in column one of Table AIV.19b. It seems reasonable to assume, though, that the distribution of total national tax collection by oblast has not changed that much over the last three years. If this has been the case, the reduction in fiscal disparities achieved by the local finance system in 1997 (Table AIV.19a) and the first 6 months of 1999 (Table AIV.20) is also quite notable, and the system may have worked in the direction of equalization during these two periods as well.

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<sup>104</sup> In the most recent 1999 revised budget data, seven oblasts have both (token) subventions and withdrawals.

<sup>105</sup> This potential is being based on *actual* revenues which may differ from *fiscal capacity* because of different efforts exercised in collecting taxes.

79. The distribution of total expenditure per capita shows less disparity than that of local revenues per capita before transfers. However, from 1997 to the first half of 1999, there has been a significant increase in disparities as measured by the coefficients of variation of per capita expenditures. The coefficient of variation for total local expenditures per capita in the first 6 months of 1999 is almost double the size of this coefficient for 1997.

80. In brief, on the upside, the 1999 intergovernmental fiscal relations reforms in Kazakhstan have managed to maintain flexibility to fiscal policy, some positive efficiency aspects, and seem to have marginally contributed to reducing disparities in regional resource distribution. The flexibility aspect of the system has certainly helped the republican government to adjust fiscal policy and preserve macroeconomic stability. There also was an improvement in allocative efficiency by fixing the ratio of oblasts per capita expenditures relatively to the national average, which ends up encouraging oblasts to make the best possible use of resources (because now transfers would not improve by, for example, keeping idle institutions open). As far as regional equity, apparently the new system has also contributed to reduce the per capita disparities of resources across oblasts.

81. ***The system's unresolved issues.*** While the current system has initially represented an evolution in relation to the previous intergovernmental relationship in Kazakhstan, it has not succeeded to address crucial issues inherited from the old system. The current system falls short of being transparent and getting rid of perverse incentives and uncertainties. The current system does not contemplate critical factors of regional differences (including fiscal capacity), its resource distribution is non-objective, and tends to create resentment and political friction.

82. In practice, the construction of the current indexes that differentiate oblasts by expenditure needs, is *non-transparent*. Lack of transparency also exist for the reasons behind the divergence between the 2000 budget transfers and the ones obtained by the methodology of Resolution 529/99. The system still generates *perverse incentives* on local revenue mobilization because the transfers are defined only for the current year; and, thus, it does not pay oblasts to strive for increasing revenue or reducing expenditures this year because of the threat that next year's subventions would decrease (or withdrawals would increase). *Uncertainties* on resource availability faced by oblasts did not reduce because the initially intended mechanism of pre-determined transfers for three years ahead was not put in place (e.g., the 2000 budget transfers differ considerably from what had been established in Resolution no. 529/99). The index of expenditure differentials among oblasts used by the current system does *not take into account important factors* that explain differences among regions, such as demographic composition and poverty indicators, and, particularly, the regional tax base which explain the *relative fiscal capacity*. The current transfer system *is not objective* (transparent or not), in the sense that it has already proved to be highly vulnerable to political pressures in determining the regional distribution of resources, such as the exceptionally favored allocation for Akmola and the treatment of Astana city as a special economic zone outside the system. Finally, the very nature of the "fraternal" system of funding, by forcing solidarity among regions, tends to be demoralizing to those oblast administrations which have to let go of "their" revenues after the central government has provided them with the revenue source. This is a highly negative factor for intergovernmental cooperation and policy implementation.

83. In brief, the present transfer system, although operating under a new revenue sharing setting (which reverted the previous vertical fiscal imbalance), in practice has basically ended up replicating the old “gap-fill” mechanism by still “regulating” withdrawals and subventions on a rather arbitrary basis by balancing the individual oblasts’ budgets. For the reasons mentioned above, the current transfer system has not satisfactorily resolved the problems of horizontal and vertical imbalances in Kazakhstan, and has been perceived by local authorities as a non-transparent and still confused micro-management tool arbitrarily operated by the republican government. In order to improve equity and create incentives for increased efficiency of a decentralized fiscal system in Kazakhstan, the next section discusses options for reform.

### c. Challenges and Options

84. The significant disparities detected both on per capita revenue collection and public expenditures across oblasts and the inability of the present intergovernmental fiscal relation system to satisfactorily correct them, present a major challenge to Kazakhstan. A more effective equalization transfer mechanism needs to be in place. The reform calls for a formal formula-based equalization mechanism which could (objectively, explicitly, and transparently) take simultaneously into account both revenue capacity and expenditure needs; thus neutralizing as much as possible political influences on the distribution of fiscal resource between government tiers and among oblasts. Such a mechanism should be entirely predictable and oblast administrations should have autonomy in establishing their own expenditure priorities (other than minimum expenditure requirements of national interest), as well as autonomy to adjust revenues at the margin.

85. Under the present circumstances, there are two options for improving the intergovernmental fiscal relation system that the Kazakhstani authorities may consider: (a) *Option I*, mending the current “fraternal” system, by improving the distribution formula of the transfer mechanism; and (b) *Option II*, reforming the whole system, by also restructuring the funding mechanism to create an effectively sustainable “equalization fund”. Option I may be more attractive since it does not require changes in the current tax sharing arrangement. But, mainly because of this, it has the disadvantage of maintaining many of the undesirable characteristics of the present system, including the “withdrawals” mechanism, which keeps reminding the donor oblasts of “their direct contributions”, and, thus, fail to remove this potential pervasive resentment. Option II, is more desirable in the sense that it exactly: (a) targets the elimination of the “withdrawals” component from the intergovernmental fiscal relations; and (b) creates the opportunity to adequately rearrange the present setting of revenue sharing between government tiers.

86. For the sake of macroeconomic stabilization, both options (I and II) presented below assume, at least for the time being, that, in the aggregate, resource distribution between both government tiers (republican and oblasts) should not change. The bottom line of the proposed reform options should be to improve efficiency and equity in intergovernmental fiscal relations; meaning that public resources should be better collected, distributed and spent regionally, with the standard levels of public services accordingly adjusted to the overall and regional fiscal capacities.

87. ***Option I: mending the distribution mechanism of the current “fraternal” system.***<sup>106</sup> Although not the best solution, this option could be an attempt at rescuing the current “fraternal” approach by restating at least some of the basic desirable principles back into the system (without changing its nature), such as more objectivity, transparency, predictability, and especially by introducing some of the more important missing regional differential factors (particularly the regional fiscal capacity). The funding of the “fraternal” system is explicitly financed by local governments themselves, as is currently the case with “withdrawals”. *Option I* maintains the double function of the current intergovernmental transfer system, i.e., compensating for vertical imbalances and equalizing spending needs, but improves it by equalizing fiscal capacities as well. As is the case presently, part of the “withdrawals” would flow to the central government budget to compensate for the vertical fiscal imbalance as perceived by the republican government. Also, the remaining part of “withdrawals” should flow directly into a special account and would be intended to simultaneously equalize differences in expenditure needs across oblasts as well as fiscal capacity. The total funds available for equalization purposes would be determined ex-ante. For instance, as a short-run proposition to keep unchanged the current resource balance between governmental tiers, the initial aggregate amount of the equalization fund should, for the time being, correspond to the present level of “subventions” (see Annex IV.2).

88. The proposed *Option I* will perform the simultaneous equalization of fiscal capacity (based on gross regional product—or regional value-added—as a proxy for the capacity of the population to pay tax to sustain a standard basket of public goods) and expenditure needs (based on a number of critical factors and costs, such as local demographic—population size, elderly, school-aged—natural and climatic conditions, infectious disease, unemployment, incidence of poverty, among others). Rather than comparing forecasts based on *actual* revenues to a notional budget expenditure need as is done in the current system to arrive at subventions and withdrawals, *Option I* uses the index of “relative” expenditure needs ( $K_i$ ) to “normalize” the measure of fiscal capacity ( $FC_i$ ) in order to arrive at the Normalized Fiscal Capacity (NFC<sub>*i*</sub>) measure for each oblast, which reflects the oblast’s fiscal capacity per unit of fiscal need (Annex IV.3).

89. Therefore, on the one hand, oblast governments for which the NFC<sub>*i*</sub> exceeds the average NFC pay a percentage of the excess amount into the equalization system. The rate of payment into the system can be endogenously determined once the total aggregate amount of the equalization fund and the vertical imbalance are fixed ex-ante, as this *Option I* proposes, or, more generically, it could be calibrated in such a way to reach different levels of desired equalization and vertical fiscal imbalances. However, too high a rate of payment out from the excess may not be desirable because of its perverse incentive effects on revenue mobilization, expenditure efficiency and economic development. On the other hand, those oblasts that have a Normalized Fiscal Capacity (NFC<sub>*i*</sub>) below average can be equalized up to a certain percentage of the difference between their NFC<sub>*i*</sub> and the average NFC. Also in this case, this percentage will be endogenously determined if the total size of the equalization fund is given exogenously.

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<sup>106</sup> This equalization mechanism option has some similarities with the one being introduced in the Russian Federation for the 2000 budget.

90. **Option II: reforming the tax sharing system and creating an effective “equalization fund”.** This alternative considers a vertically funded (from the center) equalization transfer mechanism, and reproduces the same (improved) distribution formula as proposed in Option I. Implementation of this alternative would require a change in the current assignment of revenues. As discussed in Section C, good candidates for reassignment at the central level would be the corporate income tax (CIT) and the progressive personal income tax (PIT). In this option, these taxes would be reassigned to the republican government, but a fixed proportion of them would instead directly flow into a common pool of resources at the center, say a special Regional Equalization Fund (REF) account, to be immediately redistributed according to formal and legally pre-established criteria (ideally in the Constitution, or in the Budget System Law) back to the oblasts.<sup>107</sup>

91. In Option II, the size of the fixed proportion of PIT and CIT (nationally collected, regardless of its geographical origin) to be allocated to REF must be large enough to generate a total amount of resources required to match the current “subventions” plus the net balance of the reassigned taxes (the local shares of PIT and CIT) and the “withdrawals”(Annex IV.3). This procedure would compensate for the vertical fiscal imbalance, at least as presently perceived by the government in the state budget. Once the corresponding *share of the overall CIT and PIT which flows to the REF* are determined, it should be *fixed* for the time being. This share should only be changed in the future if careful specific studies and/or policy formally recommend such a change (for the improvement of vertical balances), through amendment of the current legislation to be submitted to and approved by Parliament. With this criteria of funding the REF, the present overall allocation of public resources between tiers of government could at the beginning be kept intact, and the current “withdrawal” mechanism would be explicitly eliminated.

92. For the sake of completeness, two important supporting fiscal reforms should be conducted simultaneously in order to make the revenue sharing rearrangement consistent with the proposed REF and elimination of the “withdrawals”. The first supporting reform should promote a splitting in the current PIT rate (without necessarily increasing the overall tax burden) by reducing the new *national* progressive rate range, by say 2 percentage points in the average, and introducing a new *local* corresponding maximum proportional rate, which would piggyback the national one.<sup>108</sup> The second supporting reform should be the elimination of the Astana special economic zone. Thus, while the first supporting fiscal reform will be improving efficiency and autonomy at the margin locally, the second supporting fiscal reform will be improving economic efficiency in general, besides increasing the flow of resources to the republican budget without affecting the oblast budgets. Beyond improving transparency, it is important to stress the positive effects that the elimination of the SEZ can have on growth, stabilization, regional equity, and on intergovernmental fiscal relations.<sup>109</sup>

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<sup>107</sup> Ideally, the Law should also establish the criteria to be used in the distribution of resources between oblasts and lower level governments (rayons, cities and towns).

<sup>108</sup> The corresponding maximum level of local (piggyback) proportional PIT rate should be the one which keeps the current tax burden unchanged.

<sup>109</sup> Special programs of national interest (e.g., AIDS and TB control, poverty alleviation, construction of Astana) should be financed by the republican budget, either by a budget line allocation or by explicit *conditional grants*; the latter being completely separate from the normal *equalization transfer mechanism (the REF)* as proposed here (see Chapters II and III).

93. Some aspects on the implementation of the REF should be observed. To improve predictability and help stabilize subnational government revenues flows, the total amount of REF to be *available* for periodical distribution (say every quarter) could result from the average of past real inflows to the fund (say, an average of the last twelve-quarters, valued at current quarter price). Moreover, oblasts access to *available funds* at REF could be computed in a similar fashion as that suggested for Option I (Annex IV.3). The distribution of the funds would be adjusted for regional scale (population) and, possibly, costs (price index differentials). It can be anticipated that all this could be done by approximately following the steps indicated in Annex IV.3 for *Option II*. Nevertheless, the concrete implementation of REF will require the government to engage itself in a careful evaluation of its impact on actual redistribution and make sure that the rearrangement of the revenue sharing proposed still leave the bulk of the aggregate local budgets being financed on the basis of own sources. This preparatory work should be carried out through exhaustive numerical simulations of the different scenarios.<sup>110</sup>

94. Option II is superior than Option I to the extent that it will additionally improve: (a) allocative incentives and equity aspects of fiscal policy—by shifting CIT and progressive PIT out of local government spheres, and by eliminating the SEZ; (b) local government decision autonomy, by providing them with a proportional PIT; (c) objectiveness, transparency and predictability of the equalization transfer mechanism, by operating on the basis of fixed formal rules; and, more importantly; (d) collaboration between government tiers, by the elimination of the “withdrawals” mechanism, thus neutralizing the demoralization effect implicit in the current transfer system.

95. Once *Option II* is implemented and fully operational, the new equalization transfer mechanism should be considered as a dynamic system. Thus, the authorities may consider to proceed with evaluation studies to verify whether resources are adequately distributed according to responsibilities by level of government, thus providing a technical basis for further adjustments on the size of the REF, including possibly for correcting vertical fiscal imbalances, if need be. However, once the new system is in place, the general principle to be followed should be that the simplest and more effective guarantee against vertical imbalances is to provide each level of government with enough revenue autonomy so that they can make their own decisions regarding what services to cover and at what level.

96. ***Option III: combining the “equalization fund” with “conditional grants”*** to guarantee implementation of social safety net. This more desirable option simply builds on Option II, by using part of the reassigned tax revenue (CIT and PIT) to centrally finance the conditional grants for the specific components of the social safety net as well (i.e., primary education, basic healthcare, and social assistance to the poor). While more efficiently delivered and implemented by local governments, these are national priority programs whose funding should be provided centrally (Section B above). Presently the State Budget specifies some minimum provisions for expenditures on education and rural healthcare, but supposedly financed by local budgets (Chapter II and Chapter III, Section B). With the new tax sharing arrangement proposed under Option II and now the combination of the latter with specific conditional grants for the social

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<sup>110</sup> The preparation work for the implementation of this reform should not, however, be minimized, and technical and financial international assistance (including the World Bank) will likely be necessary.

safety net, the criteria for the computation of the minimum provisions for expenditures at the State Budget should be reviewed, also by the inclusion of social assistance.<sup>111</sup> For macroeconomic reasons, if Option III is chosen, the total resources of the centrally funded REF (Option II) could be reduced by the corresponding amount allocated to the social safety net conditional grant.

### **Access to borrowing**

97. Borrowing can be an efficient and equitable financing instrument for the long-lived capital expenditure responsibilities of local governments, and thus an important instrument to balance available resources with local government responsibilities.<sup>112</sup> However, unregulated and uncontrolled borrowing at the local level can easily become a problem of its own. Local officials can be tempted to overspend on popular programs by borrowing now and having future local officials and taxpayers pay the bill later. Moreover, uncontrolled borrowing at the local level can threaten macroeconomic stability when local governments default on their debts and the central government is forced to assume these liabilities. An important issue with borrowing, therefore, is whether there are sufficient legal and regulatory controls on local governments so that their borrowing activities are responsible. A second issue is whether local governments, behaving responsibly within an existing legal and regulatory framework, have access to long-term financing.

98. From the time of independence through 1998, there were no legal limits on local government borrowing, but there were no relevant private credit sources for local governments either. Most of the local government borrowing has been from the Ministry of Finance with a loan maturity less than a year. Many of these have been soft loans, since in general they have been interest-free and the payment of their principal eventually forgiven by the Ministry of Finance. In the last couple of years, the Ministry of Finance has been less inclined to forgive these loans, but several oblasts still hold considerable unpaid amounts.<sup>113</sup> The technical default of these loans is due likely to a mixture of irresponsible borrowing behavior by local governments and to a tradition of soft budget constraints resulting from bargaining between the oblasts and the Ministry of Finance.

99. Beginning in 1999, borrowing by local governments has been subject to limitations and controls in the "Budget System Law" and the "Law on Sovereign and Government Guaranteed Borrowing and Debt". The stricter controls are in the "Law on Borrowing". This law establishes

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<sup>111</sup> For the purpose of the social safety net to be financed centrally, the government may consider to include only the most essential elements of each component. For instance, in education, only primary education (including rural area); in health, the primary healthcare (including rural areas), but also safe water supply and basic sanitation; in social assistance, only the material assistance targeting the poor (including children in orphanages), the low-wage workfare program that encourages self-selection (See Chapter V). Certainly the amount to be centrally budgeted for each component for each region should be on a per capita basis. To be eligible for this conditional grant in the current year the region should show an efficient use of the grant in the previous year.

<sup>112</sup> See Section E. on local "accounting for capital investments".

<sup>113</sup> Data for outstanding debts of oblast governments with the Ministry of Finance were not available. According to the Ministry of Finance, oblasts with major debt problem include: Karaganda, Akmola, Aktyubinsk, West Kazakstan, Kostai, Pavlodar, and Zhambyl.

quite stringent procedures, conditions, and limits for borrowing at all levels of government. For local governments the Law stipulates the following:

- local borrowing is limited to financing capital investment programs only;
- total local borrowing will be limited annually in the Republican Budget;<sup>114</sup>
- borrowing in any year cannot exceed 10 percent of local revenues in that year;
- total debt cannot exceed 25 percent of local revenues in any year;
- expenditures on debt service must not exceed 10 percent of local revenues in any year;
- all local debt must be registered with the MF who shall control and monitor compliance;
- local debt cannot be guaranteed by the central government;
- all borrowing by local governments is subject to approval by the Ministry of Finance;
- local governments cannot borrow in foreign currency or abroad.<sup>115</sup>

100. Despite the absence of regulation in the past, local government borrowing in Kazakhstan appears to remain low. There are no official data on the total level of local debt outstanding but it seems to be low, since the local budgets show only quite low expenditures on debt service (payment of interest and principal).<sup>116</sup> Total debt service in the 1999 consolidated local budget is planned at T 587 million or about 0.2 percent of total planned expenditures. Increases in local government debt also remain small. The 1999 Budget Law established an aggregate limit for local borrowing of T 5 billion or 0.3 percent of GDP. Actual local government borrowing for the first six months of 1999 has been under T 1 billion.<sup>117</sup> With the actual low levels of local government borrowing and the strict limits and controls imposed in 1999, there is little chance that local government borrowing will become a threat to macroeconomic stability in the near future. Rather than excess borrowing, the more threatening fact to local budgetary discipline is the moral hazard or impression of a soft budget constraint created by the practice of central government loans to local governments that are eventually forgiven. This practice needs to stop. Central government loans to local governments, if they need to continue, should be carefully evaluated, carry a market interest rate, and their repayment enforced through the retention of revenue sharing or transfers, which should be treated as collateral.

101. But perhaps the overall most worrisome part of local government borrowing in Kazakhstan is the lack of it. Local needs for capital infrastructure have accumulated during the transition to considerable levels because of the lack of maintenance and replacement of the existing infrastructure. Three possible reasons are behind the lack of sufficient borrowing and capital expenditures at the local level: (a) local government revenues have shrunk considerably over the transition and remain low. This can explain lower levels of capital maintenance and investment, but not the almost total lack of them; (b) most local governments lack creditworthiness because of non-transparent budgeting and accounting, and because of the lack of autonomous sources of

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<sup>114</sup> The Budgetary Commission determines the total local limit and the Ministry of Finance administers or apportions this limit among local governments.

<sup>115</sup> The initial version of the 1999 Budget System Law allowed local governments to borrow domestically and also abroad. The latter possibility was eliminated in a subsequent amendment.

<sup>116</sup> This assumes official accounting adequately reflects the *due* debt obligation flows.

<sup>117</sup> According to the Ministry of Finance, during this period, Mangystau oblast borrowed T300 million from private banks to develop a fertilizer factory, and several oblasts borrowed around T600 million from the central government.

revenue. The 1999 Budget System Law and accompanying reforms in the budget process, if properly implemented, tend to improve on the transparency front. Further reforms in revenue assignments and in the intergovernmental transfer system will be needed, as discussed above, to provide local governments with some degree of revenue autonomy, predictability and transparency; and (c) the country's financial system and capital markets remain underdeveloped and the level of domestic financial savings has stagnated at considerable low level. Thus, even if local government revenues and creditworthiness are improved, it does not mean that the necessary level of local borrowing and capital expenditure and maintenance can easily take place because of market failure on the supply side.

102. Ideally in the future, private financial markets will provide creditworthy local governments with their needs for long-term financing and help create fiscal discipline among local governments. In the shorter term, the lack of development of financial and capital markets leaves the government with very few options to support local government borrowing and capital expenditures. The central government may have to continue lending (on-lending) from the Ministry of Finance to local governments but, as discussed above, it should necessarily eliminate the soft budget constraint and moral hazard features of the past, by making local governments realize the true opportunity cost of their indebtedness. As the domestic financial sector reforms proceed and the financial system develops, the central government has to consider a medium-term strategy to phase out from directly lending to subnational governments.

## **E. STRENGTHENING LOCAL BUDGETING**

103. While budgeting at local government level has been undergoing reforms associated with the 1999 Budget System Law, the ongoing modernization of the Treasury system, and the draft legislation on internal and external audit, it still requires strengthening in many respects.

### **Budgetary Autonomy**

104. As a unitary country, all the budgetary authority of local governments in Kazakhstan is delegated by the central government. The 1999 Budget System Law delegates to local executives (Akimats) the drafting, and to local legislatures (Maslikhats) the approval of the local budget. This Law also grants autonomy to local governments on budgetary matters; since it prohibit interference in budget matters from the upper level government (for rayons and towns) or the central government (for oblasts).

#### **a. Implementing a Realistic Decision-Making Process**

105. In reality, however, the three level budgets are still hierarchically dependent. Oblast's budgets' formulation and approval cannot be completed until the republican budget is approved; and rayons' and cities' cannot be completed until the oblast budget is approved. Thus, delayed

approval of the republican budget affects in a chain reaction all the other budgets.<sup>118</sup> The problem is that each lower level government have two-weeks' time to reformulate and finally approve their budgets in accordance with the approved republican budget. This process leaves unrealistic time for the local executive formulation and a thorough discussion of the local budget by the Maslikhats, let alone any consultation with the local population.

b. Assuring Discretion and Accountability

106. In theory, local governments have discretion to formulate their budgets, but in practice there are circumstances that limit this discretion. On the revenue side, there is practically no autonomy at the local level, except for the land tax, to adjust revenue at the margin. Also the annually determined subventions and withdrawals is unpredictable and a source of instability on local revenues (see variations between 1999 and 2000, Tables AIV.17, AIV.18, and B.10 and B.11), although the new revenue sharing system was initially intended to ameliorate these instabilities. Also, for rayons and cities the old regulating taxes and negotiated gap-filling subventions system is still in place.<sup>119,120</sup>

107. On the expenditure side, the central government imposes minimum expenditure requirements for education and health. Although these minimum requirements are well justified from a national priority perspective, they nevertheless tied up approximately half of the local budgets in 1999. After paying wages and utilities, the typical local government is left with some discretion on about 20 percent of its budgets. There is, a lack of autonomy in wage setting that imposes a too inflexible input mix in service provision at local level, and detracts the local governments from the ability to keep more able employees or to take advantage of local labor market conditions.<sup>121</sup> This has been aggravated by the legal imposition that, under financial stress, wages payment has a precedence over other payments (Chapter V, Sections C and D).

108. Giving more budgetary autonomy to local governments will also require increased accountability of local public officials to local taxpayers and voters. Actually, in recent years, the local governments in Kazakhstan appear to have had some leeway in closing facilities and reorganizing them without prior approval of the line ministries. This seems to have paid off at least in terms of increasing efficiency, for example, in the health sector (Chapter V, Section C).

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<sup>118</sup> If the local budget does not get approved before the beginning of the year, local officials are authorized to start implementing during the first quarter a budget that is equal to one-fourth of the draft proposed budget.

<sup>119</sup> The Budget System Law establishes that the oblasts should introduce stable revenue assignments and long-term transfers, but it does not provide either a format or a deadline for their effectiveness.

<sup>120</sup> Starting with the 2000 budget, a multi-year state budget framework may significantly improve predictability

<sup>121</sup> Wages are nationally established in accordance with Presidential Decree no. 3436 (April 1, 1997), and Government Resolution no. 170 (February 6, 1997). Budgetary organizations can pay bonuses as long as they generate their own internal funds from cost recovery or money-making activities. This is a practice which requires careful examination and control. While cost recovery practices should be encouraged, budgetary organizations may abuse the practice especially if it is for personal gain, as wage bonuses. A way to preserve the incentive and avoid corruption is to prohibit the formation of any extra-budgetary fund, enforce all funds of public facilities be recorded on budget, and be submitted to the rigor of the normal budget procedures and evaluation.

### c. Avoiding Unfunded Mandates

109. Moreover, autonomy to perform mandates have to be properly funded, otherwise the expected outcomes can never be achieved. Unfortunately, unfunded mandates continues as a major problem in Kazakhstan. These unfunded mandates arise not only from wages and pensions being set at the central level without taking into account the local labor market conditions, but also from standards of service provision for local services without the corresponding means, as well as the general entitlements in the Constitution and central government laws, including the right to free of charge general secondary education, health care, and unemployment benefits. Responsible decentralization means that funding should follow the assignment of responsibilities, rather than just pushing down to lower level of governments new responsibilities without the necessary autonomy to perform and the adequate flexibility to adjust input mix and tax rates at the margin. The 1999 Budget System Law vaguely prohibits unfunded mandates, but an effective control to prevent them requires: (a) restraints by parliament and the central government; (b) watch-dog committees that permanently reviews draft legislation; (c) coordinated dialog between levels of governments; and (d) clearer assignment of responsibilities.

### **Budget Formulation Capacities**

110. The 1999 Budget System Law did take a significant step toward a budgeting approach based on available means rather than needs (as it used to be in the past). Now, for determining subventions and withdrawals for local budget, the Ministry of Finance projects the aggregated budgets for oblasts based on revenue projections prepared by the Ministry of State Revenue. Expenditure projections are based on national average per capita expenditure from the previous year, adjusted for regional conditions.

111. Akims establish the expenditure limits for each of the programs at the oblast level considering the anticipated revenues, limits on borrowing, and the minimum allocation for education and health as mandated by the republican budget. In principle, the new budget system intends to: (a) focus on programs and budget on a national average per capita basis, rather than on the old *norms* biased for the maintenance of existing capacities; (b) eliminate extra-budgetary funds, thereby increasing accountability of budgetary officials and their ability to prioritize expenditures; (c) consider the use of cost recovery approach, which tends to improve efficiency of service delivery; and (d) be easier to evaluate.

### a. Enhancing Revenue Forecasts

112. In practice, however, overly optimistic and poor revenue forecasts have led to unrealistic budgets, and to frequent expenditure sequestering and accumulation of arrears during budget execution.<sup>122</sup> Actually, unrealistic budgets has been used as an expedient to make its approval by the Parliament easier, they also open the door for negotiation during budget execution, and

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<sup>122</sup> For 1997, local governments executed 93 percent of planned expenditures, while for 1998 the level of execution dropped to 85 percent (Table IV.15). All main budget categories ended up being cut, but not equally: internal security and education were more protected than items such as social assistance and agriculture.

they create opportunities to undertake expenditures financed through budget arrears and borrowing, which could never have existed under a realistic and better balance budget.

113. Currently, the Ministry of Finance and the Ministry of Revenues make their own revenue projections for local budgets.<sup>123</sup> In general, local governments also make their own projections, but the final revenue estimate have to be approved by the Ministry of Finance. According to the Ministry of Finance, revenue projections by the oblasts are typically too optimistic. This is despite the fact that optimistic revenue projections penalize oblasts with lower subventions or higher withdrawals. Probably, optimistic revenue forecasts allow Akimats discretion in budget execution, vis-à-vis the budget approved by the Maslikhats, and the recourse to budget arrears and borrowing, with the tab being picked up by the central government at some point. The Ministry of Revenues and the Ministry of Finance understand the importance of accurate revenue forecasts and currently there are plans to improve the capabilities in this area.

#### b. Accounting For Capital Investments

114. The budgeting for capital investment at the local level remains a weak spot in the current budgetary process. Local governments do not have separate capital budgets and little is spent on capital investment projects. The state PIP only covers the republican budget, but it lists the guarantees provided by the central government including those to local governments (Chapter III, Section A). The current selection of projects is not entirely transparent and most of the projects of local interest in the PIP are funded domestically, as opposed to many other projects which are financed with external funds. The implication is that under budget shortfalls the first projects to be cut back are those of local interest.

115. In the future it would be desirable to use funds only in well defined sectoral programs and with explicit and clear guidelines for eligibility of local governments. More importantly, in the longer term the responsibilities for financing local investment programs need to be entirely shifted to local governments. In the shorter term, the local investment projects financed by the PIP need to incorporate co-financing by the local governments and make it consistently explicit in both the republican and local budgets. In this way local governments will be more likely to take ownership of the projects and maintain the infrastructure and equipment.

### **Budget Execution Control**

#### a. Eliminating Budgetary Arrears

116. One of the most serious problems in budget execution specially at the local level in Kazakhstan has been the lack of an effective control mechanism for budget expenditures. Arrears have accumulated because the control of budget execution has focused only on the payment stage (i.e., how much has been paid) rather than on the commitment stage (i.e., how much has been contracted).

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<sup>123</sup> The methodology used by the Ministry of Revenues for the forecasts uses the tax bases of major taxpayers and extrapolates from those data the overall tax collections.

117. Local budget arrears (on utilities, goods and services, and wages and salaries) continue to accumulate over time (T 28.9 billion in January 1998 and T 31.7 billion in January 1999) (Table IV.16). At early 1999, the republican government decision to absorb some of these arrears of the local governments set a bad precedent, by raising a moral hazard incentive and the expectation for future bail outs. During 1999, local government arrears continued accumulating to reach T 33.7 billion by July.<sup>124</sup> Oblasts uses arrears as a form of financing, and is being accumulating over time. However, budget arrears only provide temporary relief because suppliers tend to adjust prices up to offset the costs of delayed payment and eventually stop delivering if delays persist. Nevertheless, public servants and public utilities suppliers in general do not have the opportunity to do so, nor can they stop service delivery.

118. Part of the solution for expenditure control is the adoption of a treasury function at the local level. The current reform of the Treasury promises an effective ex-ante control of expenditures at the commitment and verification stages and not just at the payment stage, as it has been so far. It is not clear, however, that, without effective fiscal adjustment, even a fully developed treasury function can easily control arrears to public utilities or to employees as wage arrears, given the recurrent nature of these expenditures. The Treasury needs to have the authority to effectively suspend or control expenditures at the commitment and verification stages of the process and implement sanctions against transgressors.<sup>125</sup> The modernization project of the treasury system, which extends to the local level, will not be fully operational until 2001. If a modern treasury function is introduced at the local level, it should help with other aspects of budget execution including cash and debt management, accounting, and procurement.

#### b. Preventing Budget Sequestering

119. Budget sequestering has been used as an important tool to keep budget deficits contained at all levels. Although budget sequestering in Kazakhstan has been necessary and effective during all these years to contain budget deficits, this practice has not been cost free. Over the past few years, the annual Budget Law established an ex-ante list of protected items to be spared during budget sequestration, including expenditures on education, wages and other items. For those non-protected items, budget sequestration has *de facto* empowered officials in charge of budget execution to re-established budget priorities, sometimes with undesirable consequences. For example, during 1997 and 1998 (Table AIV.21), expenditures on “categorical” social assistance, and in 1999, assistance to the poor at the local level have been treated as residual budget items. As the 1999 the Budget System Law delegates to local maslikhats the power to establish protected budget items at the local level, it would instead be preferable for the maslikhats to vote for a *budget contingency plan* prior to the budgetary shortfall. The 1999 Budget System Law

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<sup>124</sup> Wage arrears are a small portion of total budget arrears at the local level, 7 percent as of July 1, 1999. Although wage arrears decreased by almost half during 1998 they were back on the increase in 1999 (Table AIV.22).

<sup>125</sup> The new system seems to stop short of introducing administrative sanctions for budget officials responsible for the occurrence of arrears. However, the draft of the 2000 Republican Budget announces “...a continued reform making both central and local government officials bear full responsibility for the development of cost estimates, including the conclusion of contracts and the approval of staffing in accordance with the estimated allocations, and the observation of bidding rules for procurement including placement of the order, control over its execution and compliance with procedures.” This will require the passage of a Fiscal Responsibility Law with clearly defined infractions and sanctions for budget officials.

requires that a formal budget amendment needs to be approved by the legislature (maslikhats) when the budget adjustment exceeds 10 percent. This also may contribute to reduce the current arbitrariness of changing the policy priorities during the execution of the budget.

### c. Flexing Budget Execution

120. The lack of flexibility of the budgetary process during execution diminishes the potential efficiency gains from decentralization. For example, in education, central government regulations leave little discretion to managers in the allocation of resources across economic uses (Chapter V, Section D). Between 80 and 90 percent of budget resources are spent on wages and salaries and utilities, and salary rates and payment priorities are still determined by higher level authorities. Other rules from the center, such as norms for weekly teaching loads, detract from management flexibility to reach technical efficiency in service delivery. Similarly, hospitals enjoy little expenditure discretion. Central norms require strict distribution of resources among wages, utilities, food, and medicines (Chapter V, Section C). In hospitals, salaries and utilities account for close to 80 percent of total resources, very similar to the case of education. To increase efficiency, the current system of oversight by central authorities needs to shift from the micro-management of inputs mix to the performance evaluation and outputs/outcomes, thereby increasing the flexibility in the use of inputs, and delegating authority to perform, as well as making local managers accountable for results.

### **Performance Evaluation**

121. Budget programs need to be evaluated both on the basis of spending performance and against their targeted outcome. The evaluation phase of the budget cycle is weak in Kazakhstan, specially at the local level. The internal audit and control are carried out by the Treasury Committee and will be soon strengthened and be more independent with the approval of a draft Law on Internal Audit which shall apply at the central and local level. In this respect it is significant that Government Resolution no. 934 eliminated the subordination of local budget finance officials to the Ministry of Finance but kept treasury officials in charge of budget execution and control at the local level as employees of the Ministry of Finance.<sup>126</sup>

122. Ex-post audit is not well developed at any level of government. According to the 1999 Budget System Law, external ex-post audit at the local level will be carried out by the “audit committee” of the maslikhats. But these organs have not yet been developed.<sup>127</sup> There is no independent external audit at the central level either. The Accounting Committee, which mostly responds to the President, carries an ex-post audit function providing quarterly reports to the President and an annual report to Parliament. The Accounting Committee (see Chapter III, Section A) does not carry out ex-post audits of local government budgets.

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<sup>126</sup> The amendments to the Budget System Law in July 99 clearly extended the control by the Treasury Committee of budget execution at the oblast level (article 25.) Treasury officials at the oblast level keep accounts of local budgets and transfer funds to spending units after authorization by local executives.

<sup>127</sup> The Law on Local State Government of 1999 (article 18) states that maslikhats shall elect an “audit committee” for the four-year term of the legislature, with its head a member of the maslikhat working on a full-time basis

123. At the present time, no budget evaluation is carried out, either at central or at the local level. There is no agency either at the central or local level that is in charge of analyzing the performance and effectiveness of public expenditure programs. However, with the adoption of a program-oriented budget in 1999 there is an opportunity to introduce this function both in the executive and legislative branches of government. Examining the performance of expenditure programs vis-a-vis the original program objectives will help decision makers to redirect and better prioritize budget resources.

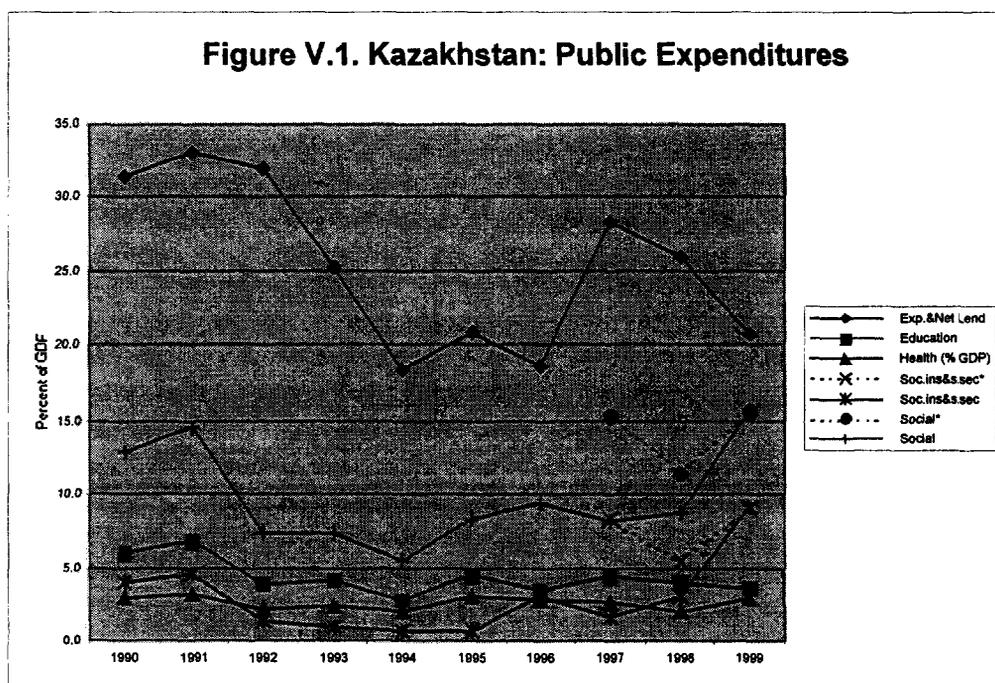
## CHAPTER V

### SOCIAL SECTOR ISSUES

#### A. INTRODUCTION

##### Social Expenditure Priorities

1. With the end of Soviet subsidies and the drop of revenue, government expenditures fell considerably after independence: from about 33 percent of the GDP at the beginning of the decade to 18 percent in 1994. From 1996, public expenditure has fluctuated around one fourth of the GDP (Figure V.1). Particularly, social sectors have experienced substantial retrenchment at the beginning of the transition process to market economy (1991-94). The broad state coverage and universal access to public services (health, education, and social security and welfare—including unemployment benefits) that characterized the previous regime could not be sustained anymore. Also, state enterprises that started facing market competition could not continue providing the same social services to their employees as they used to, and many of these services had to be transferred to the state, “corporatized”, privatized, or discontinued.



Note on Figure V.1: \* adjusted by consolidation of extra-budgetary funds.

SOURCE: Table B.7 (Statistical Appendix)

2. In the wake of these structural transformations, government expenditures on the social sectors dropped dramatically in the early 1990s. Measured as a share of the GDP, the fall was

substantial until 1994 (from about 15 per cent of GDP to 5.5 percent) when it started recovering to reach about 9 percent in the second half of the decade (Figure V.1). These fluctuations in the social sector expenditures were unevenly distributed among education, health, and social security and welfare.<sup>128</sup> On the one hand, health and education were rather “protected” as reflected in the

year/budget	Education	Health Care	Soc.Sec.& Welfare	Total Publ. Spending
<b>1997</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Republican	19.0	14.6	5.8	38.9
Local	81.0	65.6	13.5	32.0
Extra-budget	0.0	19.8	80.7	29.1
<b>1998</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Republican	20.8	22.6	9.5	48.0
Local	79.2	54.0	48.4	38.2
Extra-budget	0.0	23.4	42.1	13.8
<b>1999</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Republican	21.1	16.5	86.2	64.2
Local	78.9	83.5	13.8	35.8
Extra-budget	0.0	0.0	0.0	0.0

SOURCES: Ministry of Finance, IMF (SM/99/152)

relative stability of their GDP shares during the 1990s (3.5 percent and 4 percent, respectively)<sup>129</sup>. During most of the transition period, social security and welfare have clearly been used as a residual, important adjustment item, dominating the movements of the government expenditures during transition. In fact, “social security and welfare” expenditures have fluctuated directly with the crisis, and explain the general pattern of social expenditure. As a share of government expenditure itself, spending on social security and welfare fell from 14 percent of GDP in 1991 to 3.7 percent in 1995, but increased again since 1996 to reach 14 percent in 1998. As crises hit and public resources faulted, either social security and welfare allocations were cut or, when entitlements remained, arrears accumulated.<sup>130</sup> During the recovery, as benefit entitlements continued in place, allocation to this item remained, some payments resumed, and expenditure increased again.

3. In summary, in Kazakhstan health care and education have been the social expenditure components receiving relatively higher priority in government policy, while social security and welfare has been a residual adjustment item of public expenditures: relatively more compressed during crisis and more decompressed when the financial constraints slacken.

### Social Expenditure Funding and Equity

4. About one-fifth of health and education expenditures have been funded by the republican budget (Table V.1). Until 1998, extra-budgetary funds contributed another one-fifth for health financing, and the local budgets covered the rest (about 80 percent for education expenditure, and 60 percent for health care). Social security and welfare used to be mostly funded by extra-budgetary funds and local budgets. With the elimination of the extra-budgetary funds in 1998,

<sup>128</sup> The latter includes pensions, unemployment benefits, and social assistance (both “categorical” and for the poor).

<sup>129</sup> Although the share of resources allocated to education fell considerably right after independence, it stabilized afterwards.

<sup>130</sup> Because of inflation, however, the latter has tended to vanish over time and the due expenditure was never realized.

the republican budget absorbed all the pay-as-you-go pension liabilities as well as the responsibility for “categorical” State Special Benefit, while the local budgets increased their responsibilities for health care and poverty-targeted social assistance programs.

5. Until 1998, 42 percent of the state budget used to be spent on social sectors (Table V.2), but with the social protection system reform the republican budget assumed the old pension system liabilities fully, as well as the special benefits, thereby increasing its resource allocation to these sectors from 16 percent to 57 percent. The local budgets allocates about three-fourth of

year/budget	Social Sectors	Other Sectors	Total Publ. Spending
<b>1997</b>			
Republican	16.3	83.7	100.0
Local	74.6	25.4	100.0
State	42.4	57.6	100.0
<b>1998</b>			
Republican	15.7	84.3	100.0
Local	75.6	24.4	100.0
State	42.3	57.7	100.0
<b>1999</b>			
Republican	56.5	43.5	100.0
Local	74.4	25.6	100.0
State	63.0	37.0	100.0

SOURCES: Ministry of Finance, IMF (SM/99/152)

its resources to social programs. With the devolution of social assistance to lower level governments, the internal composition of social spending of the oblast budgets has also changed significantly, with the social security component assuming increasing importance (Table V.3) In 1998, social security was already the second most important expenditure item in the local budgets(about 29 per cent), only after education (35 per cent).

year	Education	Health Care	Social Security	Social Sectors
1997	41.5	20.1	13.0	74.6
1998	35.0	11.8	28.8	75.6

SOURCES: Ministry of Finance, IMF (SM/99/152)

6. As indicated in Chapter IV, per capita expenditure disparities across oblasts are high, especially in relation to local spending on social security (Table V.4). The recent decentralization move (devolution of fiscal responsibilities towards the local governments) may aggravate these disparities in the near future, because the unequal revenue capacities of the oblasts are negatively correlated to the distribution of poverty among regions (see Section B). The government may consider addressing these inequities by redesigning the tax sharing arrangement and the transfer mechanism (including the equalization transfer—see Chapter IV).

Table V.4. Kazakhstan: Per Capita Social Expenditures disparities among oblasts (coefficient of variation)				
year/c.v.	Education	Health Care	Soc. Sec.	Total Expenditures
1997	0.17	0.34	0.67	0.26
1998	0.16	0.31	0.42	0.28

SOURCES: Ministry of Finance, IMF

7. The following sections in this Chapter discuss public expenditure on and service delivery to each of the social sectors in turn, looking into their efficiency and equity dimensions.

## B. SOCIAL ASSISTANCE

### Overview

8. In Kazakhstan, as elsewhere in Central Asia, real value of the benefits provided by social assistance to the poor has declined dramatically since the early 1990s, and arrears of various welfare payments have accumulated. At the same time, as Kazakhstan becomes increasingly integrated into a global economy, individuals face greater risks of unemployment and job insecurity; to address these issues, the Government has rationalized the benefit structure and administration, clearly defined the fiscal responsibilities of the central government and the oblasts, and is currently introducing an approach to targeting social assistance that is based solely on the criterion of poverty.

9. While the recent devolution of responsibility to the oblasts for financing social assistance may enhance transparency and accountability, difficult equity and efficiency trade-offs have emerged. First, although the oblasts have planned their levels of expenditures, there appears to be no mechanism in place to ensure that execution corresponds to the budgeted levels. Actually, levels of spending realized across oblasts are below planned levels. Second, the expenditure across oblasts – both planned and actual – has not been sensitive to regional poverty distribution, so that expenditure per poor person varies widely across oblasts. Thus, aggravation of inter-regional inequity in social assistance has emerged as a major issue. Third, the discretion given to oblast administrations to determine the level of social assistance in accordance with their resource base may prevent accumulation of arrears and fiscal irresponsibility, but may also render social assistance for the poor a residual expenditure item. Fourth, devolution has not yet promoted better targeting inasmuch as “categorical targeting”, rather than “poverty”, continues to be used for purposes of identification of eligible households.

### Changing the Social Protection System

#### a. Structure and Financing

10. Until 1998, Kazakhstan’s social protection system comprised of pay-as-you-go (PAYGO) pensions for the elderly, a range of price discounts, pensions and subsidies for veterans and the disabled, unemployment benefits and other cash benefits including family or child allowances (see Table V.5). The system was characterized as having too many objectives, making the programs less effective and services inefficient. Moreover, the provision of social assistance was fragmentary, administration was difficult, and the costs were not transparent. As of December 1998, 47 categories of recipients received 202 different types of distinct price discounts (ranging from eyeglasses to public transportation and hospital care) imposing an enormous burden on the budget as well as administration.

11. The structure of the social protection system and sources of funding have changed substantially in early 1998: (a) extrabudgetary funds were eliminated; (b) responsibility for

pensions (PAYGO), State Special Benefits (categorical) and State Social Allowances were shifted to the republican budget; and (c) poverty-targeted Social Assistance and assistance to the unemployed were pushed down to local budgets.<sup>131</sup> This new assignment of responsibilities is well-defined and formalized in the 1999 Budget System Law. Previously, the benefits and allowances were paid either out of oblast budgets or from the pension fund or social insurance fund, but the system was not sustainable, and arrears have accumulated. *Inter alia*, the change in the funding of the *State Special Benefits* aimed at least to ensure that all the “privileged categories” (veterans of WW II, their families and survivors or other special categories such as victims of Chernobyl, former political prisoners or veterans of Afghanistan war) would receive their benefit payments on time. These changes reduced the cost of special benefits to 12 billion Tenge for the period April-December 1999, as against 28 billion Tenge in 1998.<sup>132</sup> Since April 1999, the various benefits and discounts were abolished and a single *State Social Allowance* has been introduced in lieu. This new cash allowance was reduced to 14 categories and calculated as a multiple of a base numerate<sup>133</sup>.

Table V.5: Kazakhstan: Structure of Social Protection (SSP)

Program	Before 1999		After 1999		
	Source of Funding	1997 *	1998 *	Program Changes	Source of Funding
1. Pay-As You-Go Pensions (PAYGO)	1. Republican Budget	5.8	9.5	1. Pay-As-You-Go program and Pensions transferred to the Republican Budget	Republ.Budget (100%)
2. Categorical Benefits	2. Local Budget (Veterans, Invalids, 47 categories, 202 benefits)	13.5	48.4	2. Categorical Benefits abolished and substituted by a Special State Allowance; categories reduced to 14.	Republ.Budget (100%)
3. Unemployment Benefits	3. Extra-budgetary Sources	80.8	42.1	3. Unemployment Fund and benefits abolished	
4. Social Assistance (SAP) (families with many children, orphan homes, etc.)				4. Social Assistance (benefits to certain categories, such as families with many children, orphan homes, material assistance to the unemployed registrants, etc.)	Local Budget (100%)
TOTAL SOC. PROT.		100	100		

\* percent of Social Protection budget.

SOURCE: Ministry of Finance and Ministry of Labor and Social Protection

<sup>131</sup> The pension reform was a far-reaching policy undertaken by the government. The republican budget took full responsibility for all benefit-certain, pension liabilities accumulated until December 1997, while a State Accumulation Pension Fund (SAF) and independent Non-State Accumulation Funds became responsible for the new contribution-certain, individual accounts of the employees. After the reform, two pension systems run in parallel: (a) a phasing-out, residual PAYGO system (maintained by the republican budget); and (b) the new accumulation system, fully funded by a 10 percent contribution paid by employees.

<sup>132</sup> In May 1999, the government paid off T3 billion arrears to privileged categories due until April 1999.

<sup>133</sup> The base numerate, currently 715 tenge a month, is a factor to benchmark various forms of social assistance. It is a subsistence level indicator and, at the time of its creation in 1995, roughly represented the cost of a loaf of bread and a liter of milk a month. Its value is determined only from time to time by the Ministry of Finance, and has no indexation purpose.

12. These changes were intended to monetize benefits, simplify benefit structures, and ensure more timely payments, as well as to encourage more efficient use of utilities. Moreover, the bias against rural areas was reduced, since in the new system recipients in rural areas will be receiving the same cash benefit as other beneficiaries in their various categories, irrespective of the existence of special services in rural areas.

13. The new system, however, retained a major weakness of the previous one: allowances are not exclusively poverty-targeted. Of the almost one million recipients, fewer than 100,000 are in the privileged categories (the State Special Benefits). The majority of beneficiaries are invalids in one of three levels, varying from people who are totally and permanently incapacitated to those who are temporarily disabled. While some of these recipients might be poor (without this assistance), many of them may not be. The *State Special Allowance* is not exclusively addressing poverty, and means-testing the eligibility would lead to significant program savings since not all families are in need of these supplements. Because of this, there is a perception that the screening process for claiming disability is rather lenient.

14. The Employment Fund and Unemployment Benefits have been abolished and the Government has indicated that the emphasis should now be on active labor market programs, specifically on public works programs and on retraining.<sup>134</sup> The *unemployment assistance*, including cash assistance, has been transferred to oblast budgets, which now counts on the payroll "Social Taxes" as supplementary funding to support newly-assigned responsibilities, including the new *Social Assistance Program*. As part of the Social Assistance Program, the oblasts are required to pay cash benefits only to designated categories of *unemployed registrants* in lieu of unemployment benefits.

#### b. Social Assistance For The Poor

15. To the extent rayons and oblasts are closer to the population in need, devolving the responsibility for the management of Social Assistance Program (including unemployed registrants) to lower level governments was, from the efficiency viewpoint, a step in the right direction. *The Social Assistance Program* comprises of three components: (a) a variety of cash transfers (e.g., birth grants, funeral allowances); (b) the maintenance of special institutions for the indigent, such as orphan homes; and (c) a public works program. Until 1998, the *cash* transfers, though intended only for the poor, were nevertheless awarded to specific categories (e.g., parents with more than four children, parents with disabled children). By mid-1999, although the intention of Government policy in the area of social assistance was to move towards targeting the allowance solely on the criterion of poverty, its practical implementation had not begun. In fact, in August 1999, the Government was still issuing temporary guidelines which specified five categories, such as allowances for *families with children*, material assistance to *unemployed*, birth grants, funeral allowances to *employed*, and others.

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<sup>134</sup> Art. 24 of the Constitution guarantees "social protection against unemployment", but the Supreme Court determined that: (a) unemployment benefits is only one among many forms of protection that the state might provide against unemployment; and (b) it is not unconstitutional to assign this responsibility to local governments.

16. The extent of poverty in Kazakhstan in the mid/late 1990s (head count ratio of 34.6 percent) was at least twice as big as it was by the time of independence (Table V.6). The depth of poverty (poverty gap of 11.4 percent) indicates that the average consumption of the poor is nearly a third below the poverty line (the latter representing the subsistence minimum). Poverty is quite severe, especially in rural areas.<sup>135</sup>

Poverty indicators	North	Center	East	West	South	Country	Urban	Rural
1. Extent of Poverty <sup>1</sup>	9.2	26.4	31.3	37.8	69.2	<b>34.6</b>	30.0	39.0
2. Depth of Poverty <sup>2</sup>	1.9	9.0	9.0	10.8	26.4	<b>11.4</b>	8.9	13.7
3. Severity of Poverty <sup>3</sup>	0.7	4.4	3.6	4.2	13.0	<b>5.2</b>	3.8	6.6

SOURCE: Kazakhstan, Living Standards During the Transition, World Bank, Report no. 17520-KZ, 1998

<sup>1</sup> head count ratio: percentage of people for whom consumption per capita is less than the poverty line

<sup>2</sup> poverty gap index: how far below the poverty line the poor's consumption falls. I.e., average poverty shortfall in the population as a proportion of the poverty line

<sup>3</sup> weighted "Poverty Gaps" (weights are the poverty gaps themselves). I.e., severity of poverty gives more weight to individuals further away from the poverty line

17. Given the extent, depth and severity of poverty in the country, a public works program should have a good take-up rate and be a significant tool in combating poverty. The public works programs currently in operation, however, are inefficient wage subsidy programs. Subsidies are provided to employers supplying public works on the understanding that the Government will make up the participant's pay at the going wage rate. Programs of this nature are highly inefficient, and create distortions in the labor market; such wage subsidy schemes should be discontinued and replaced by a well-designed, low-wage workfare program that encourages self-selection.

### **Expenditure on Social Assistance**

18. Actual aggregate spending by the Social Protection System fell from 8.2 percent of GDP in 1997 to 5.3 percent of GDP in 1998, largely due to the breakdown of extra-budgetary sources of funding (Table V.7). As entitlements were not correspondingly adjusted, arrears have accumulated. The arrears on pensions and benefits of the Republican budget grew from 8.09 billion Tenge in 1998 to 29.3 billion Tenge by July 99. The local arrears on benefits were 28.9 billion Tenge and 33.7 billion Tenge for the corresponding periods respectively. While the republican budget allocation to Social Protection in 1999 amounted to 7.2 percent of GDP, including arrears payments, it did not restore the 1997 expenditure execution. Data on the break up of local arrears to social protection are not available.

<sup>135</sup> According to the most recent National Statistical Agency estimate, the 1998 head-count and poverty gap ratios were 43% and 27% respectively.

Table V.7: Kazakhstan: Expenditure by Social Protection System

Program	1997	1998	1999	1999	2000
	Actual	Actual	Budget	Actual(July)	Budget
1. A. PAYGO	5.9	7.7	102.3	47.8	100.5
B. Extrabudgetary Pensions	111.4	38.3			
2. Special State Allowance		29.2	9.0	2.2	13.6
3. Social Assistance <sup>1</sup>	20.8	16.8	16.8	6.6	18.8
<b>Total</b>	<b>138.2</b>	<b>91.9</b>	<b>128.1</b>	<b>56.6</b>	<b>132.8</b>
% of GDP (1+2+3)	8.19	5.28	7.18		6.50
% of GDP - SA only	1.23	0.96	0.94		0.92

SOURCE: Ministry of Finance and Ministry of Labor and Social Protection

<sup>1</sup> Includes all types of categorical benefits, unemployment benefits, family allowances and other social assistance payments

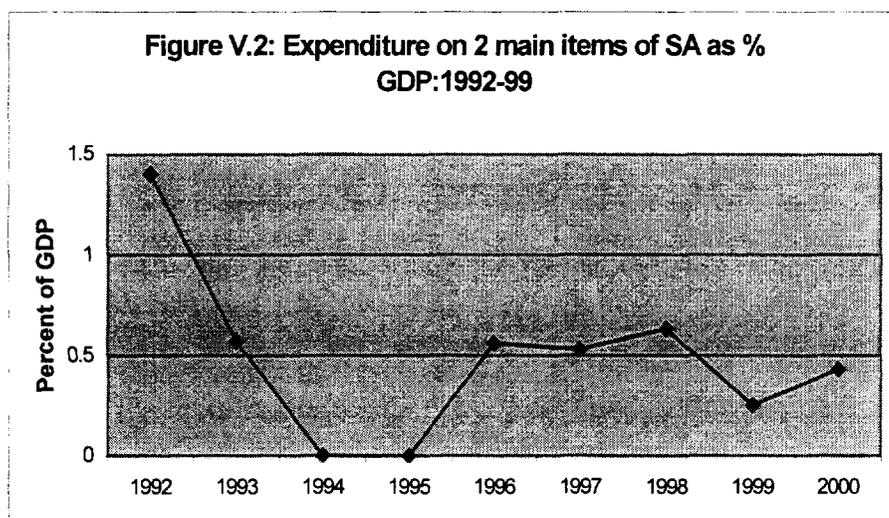
19. Though there is a “categorical” element to social assistance programs, a number of beneficiaries may be from relatively poorer segments of society (Box V.1). However, while it is claimed that some of the allowances and transfers are given only after a means-test (recipient’s total income less than two base numerates, especially for programs under item 7), there are still some categories whose substantial proportion of recipients may not be the poor (e.g., line items 8 and 10).

#### Box V.1: Kazakhstan: Main Components of Social Assistance Programs

1. Safety net delivered through boarding schools at local level (largely for orphans).
2. Benefits to mothers having four or more children under seven years old.
3. Benefits to children infected with AIDS.
4. Social assistance in the form of allowances.
5. Social assistance to individual categories of citizens (under the discretion of oblast administration).
6. Employment programs (public works and retraining of the unemployed).
7. Social assistance to poor citizens (birth and funeral grants, housing allowance to low income families, assistance to families with four or more children, and material assistance to the unemployed).
8. Manufacturing of prosthesis, orthopedic footwear, reimbursement of expenditures on wheelchairs, etc.
9. Material assistance to families with disabled children.
10. Training the disabled to drive and funding the payment center services.
11. Other actions on social protection.

SOURCE: Ministry of Labor and Social Protection

20. Because of the elimination of some categories and changes in sources of funding, it is not possible to obtain a consistent time series of the expenditure on social assistance components separately from the social protection budget. However, time series of expenditure on two important components of social assistance spending – line items 2 and 7 in Box V.1 – are available and are comparable over time. Expenditures on these two line items as a percent of GDP are shown in Figure V.2. Immediately after independence, there was a significant contraction of expenditure on these two components, but since 1996 they have been fluctuating at around 0.4 percent of GDP. On the total oblast allocation on social assistance for 1998 (executed), 1999 and 2000 (budget) as a percent of GDP, Table V.8 shows a gradual decline below the minimum critical level.



21. Whether or not a particular level of expenditure on social assistance is adequate depends on how much of the poverty gap the Kazakhstan society wishes to fill. Nevertheless, estimation of technical parameters can inform political decision-making. Therefore, if the aim is to assist first the poorest of the poor, two simple approaches can be useful to derive estimates. One is to compute the expenditure requirement to fill a percentage of the poverty gap, say, half of it. Under this assumption, the expenditure requirement estimate situates between 1.4 percent and 2.4 percent of GDP, depending on the size of the poverty gap prevailing in 1999 (i.e., the same poverty gap that existed in 1993-94, or the 27 percent poverty gap—almost the double—estimated by the NSA survey in 1998).<sup>136</sup>

Budgets	Billion Tenge		
		GDP	% of GDP
1998 (executed)	16.76	1720.9	0.97
1999 (budget)	16.77	1894.8	0.89
2000 (budget)	18.71	2184.8	0.86

SOURCE: Ministry of Finance

22. The other simple (cruder) approach to estimate the social assistance expenditure requirement would be to start with a *minimalist* strategy, by assuming that: (a) the target group for social assistance is the bottom half of the poor (about 2.56 million people in 1998); and (b) the proposed social assistance transfer is limited to 25 percent of the poverty threshold

<sup>136</sup> Although progress has recently been made, the NSA survey's sample is not a strictly random sample.

consumption expenditure in 1998. This approach would generate an amount of required social assistance expenditure equivalent to 1.2 percent of GDP in 1999.

23. While the executed expenditure on social assistance in 1998 was about 1 percent of GDP, the 1999 and 2000 budgets planned a slight decline, apparently departing from that expenditure level. Until July, the social assistance expenditures executed by oblasts was about 0.4 percent of GDP, pointing to a possible significant shortfall even in comparison to the budgeted level.

### **Devolution and Regional Inequity**

24. Table V.9 assesses pre- and post-devolution allocations on social assistance. Two main patterns may be observed from these data: (a) a considerable inequality at the level of social assistance expenditure across oblasts (1998 execution, 1999 and 2000 budgets); and (b) a possible considerable shortfall of social assistance expenditure as compared to the budgeted allocation (1999 budget). On regional inequality, budgeted expenditures for 1999 for the two *southern* oblasts of Kyzylorda and Almaty (where poverty and the poverty gap ratio are the highest) are substantially lower than actual levels in 1998. On budget execution, the *actual* expenditures until August 1999 were in many oblasts substantially lower than the expected ones according to the budget for the year. It is particularly low (at 12.7 percent execution) in West Kazakhstan. In Kyzylorda, the budget level itself was at 73 percent of the 1998 actual; and the executed expenditure until August was at 27 percent of the annual 1999 budget. These observations mean that many oblast administrations may be unable to execute the required social assistance expenditures. It is possible that since the new system was introduced only in April 1999 uncertainties regarding resource availability exist, forcing oblasts to treat social assistance as a residual item on which expenditures could be incurred if financing becomes available towards the close of the year.

**Table V.9: Kazakhstan: Expenditures on Social Assistance By Oblast**

Oblasts	Social Assistance (thousands Tenge)				
	1998 Actual	1999 Plan	Actual (08/01)	Actual as % Of Plan	2000 Plan <sup>1</sup>
North					
Kostanai	1,001,858	818,740	287,697	35.14	703,583
Pavlodar	890,972	1,539,219	427,003	27.74	1,399,595
North Kaz.	1,047,087	847,347	307,785	36.32	976,660
Akmola	459,881	816,619	333,306	40.82	943,094
Central					
Karaganda	1,044,237	1,065,363	539,120	50.60	3,423,996
West					
Mangistau	239,331	222,897	125,564	56.33	357,706
Atyrau	472,338	609,978	366,737	60.12	571,053
Aktobe	412,479	613,534	390,633	63.67	1,130,175
West Kaz.	526,703	1,189,040	151,003	12.70	792,508
East					
East Kaz.	1,707,733	1,999,112	751,325	37.58	2,172,629
South					
Kyzylorda	2,022,639	1,495,165	409,360	27.38	2,763,332
South Kaz.	1,596,246	1,587,453	552,983	34.83	1,834,321
Zhambyl	966,112	964,078	412,078	42.74	1,135,650
Almaty	2,059,941	1,045,274	439,642	42.06	2,142,846
Astana City	363,271	517,635	328,823	63.52	455,190
Almaty City	1,652,381	1,429,346	730,635	51.12	1,785,170
<b>Kazakhstan</b>	<b>16,463,209</b>	<b>16,760,800</b>	<b>6,553,694</b>	<b>39.10</b>	<b>22,587,508</b>

<sup>1</sup> The 2000 forecast by oblast has been provided to the PER Mission. Our understanding is that this estimate has been subsequently revised, and, at the moment, constitutes T18,781 million. However, oblast wide distribution of this revised estimate are not yet available

25. The under-spending observed in some oblasts translates itself into low spending levels per poor person. For the country as a whole, the budgeted expenditure per poor person in 1999 was 11 percent in nominal terms, higher than the actual expenditure in 1998, but the actual expenditure per poor person until the end of July 99 was only 37% of the annual budgeted amount (Table V.10). In 1998, actual annual expenditure per poor person ranged from a low 1,455 Tenge (South Kazakhstan) to a high 6,112 Tenge in Kyzylorda oblast. In the first half of 1999, actual expenditure ranged from a low 504 Tenge (South Kazakhstan) to 1,682 Tenge

(Karaganda), 4,738 Tenge in Astana city and 3,514 Tenge in Almaty city. The coefficient of variation of the actual expenditures is quite high and in the first half of 1999, as compared to 1998, shows that inequality in expenditure levels across oblasts has risen—the distance between the highest and lowest levels rose from 6 times in 1998 to 9 times in 1999. Unless expenditures in Kostanai, South Kazakhstan, Zhambyl, West Kazakhstan and Almaty oblast had substantially increased in the remainder of the year, the inequality in social assistance per poor person will persist high.

Table V.10: Kazakhstan: Expenditures on Social Assistance Per Poor Person By Oblast

Oblasts	Population <sup>1</sup> 000	% Poor <sup>2</sup>	Poor Population	Social Assistance per Poor Person (Tenge) <sup>3</sup>				
				1998 Actual	1999 Plan	Actual until July 31	1999 (at 1998 prices) <sup>4</sup> Plan	Actual
North								
Kostanai	1,019.60	34.3	349,723	2,865	2,341	823	2,194	771
Pavlodar	805.90	34.3	276,424	3,223	5,568	1,545	5,218	1448
North Kazakhstan	725.90	34.3	248,984	4,205	3,403	1,236	3,189	1158
Akmola	835.7	34.3	286,645	1,604	2,849	1,163	2,670	1090
Central								
Karaganda	1,411.70	22.7	320,456	3,259	3,325	1,682	3,116	1576
West								
Mangistau	316.80	39.4	124,819	1,917	1,786	1,006	1,674	943
Atyrau	439.90	39.4	173,321	2,725	3,519	2,116	3,298	1983
Aktobe	682.8	39.4	269,023	1,533	2,281	1,610	2,138	1509
West Kazakhstan	617.70	39.4	243,374	2,164	4,886	620	4,579	581
East								
East Kazakhstan	1,530.80	27.1	414,847	4,117	4,819	1,811	4,516	1697
South								
Kyzylorda	596.30	55.5	330,947	6,112	4,518	1,237	4,234	1159
South Kazakhstan	1,976.70	55.5	1,097,069	1,455	1,447	504	1,356	472
Zhambyl	983.90	55.5	546,065	1,769	1,766	755	1,655	708
Almaty	1,559.6	55.5	865,578	2,380	1,208	508	1,132	476
Astana City	319.30	18.9	60,348	6,020	8,578	5,449	8,039	5107
Almaty City	1,130.10	16.0	180,816	9,138	7,905	4,041	7,409	3787
<b>Kazakhstan</b>	<b>14,952.70</b>	<b>43.4</b>	<b>6,489,472</b>	<b>1,909</b>	<b>2,122</b>	<b>785</b>	<b>1,989</b>	<b>736</b>
<b>Standard Deviation</b>				<b>2046.61</b>	<b>2117.92</b>	<b>1288.31</b>	<b>1,985</b>	<b>1207</b>
<b>Mean</b>				<b>3,405</b>	<b>3,762</b>	<b>1,632</b>	<b>3,526</b>	<b>1,530</b>
<b>Coefficient of Variation</b>				<b>60.10</b>	<b>56.29</b>	<b>78.96</b>	<b>52.76</b>	<b>74.00</b>

<sup>1</sup> Population information according to 1999 NSA Population Census.

<sup>2</sup> Bank estimate of percentage of Poor according to the latest preliminary NSA estimates. The *subsistence minimum* as defined by SNA ("Standard of Living of Population of Republic of Kazakhstan", Internal Report, 1999) was taken as a *poverty line* indicator. Although very tentative, these estimates of the number of poor were the only ones available in the country. The Ministry of Labor and Social Protection disputes these estimates and have started an inquiry directly with the Oblasts' Akims to verify how robust these estimates are. By the time of this report, the results of this inquiry were not available.

<sup>3</sup> These are derived by dividing the total actual social assistance in each oblast by the corresponding number of people below the poverty line.

<sup>4</sup> By deflating nominal figures by the average inflation rate of 6.7 percentage 1998.

26. During the first half of 1999, both total spending and spending per poor person are generally lower in oblasts where the number of the poor are higher. Thus, in South Kazakhstan, where the incidence of poverty is 55.5 percent, and where the absolute number of the poor is highest in the country, the actual expenditure per poor person is the lowest in the country (504 T per annum). While Almaty *oblast* with a similarly high incidence of poverty gave only 508 T as social assistance, Almaty *city* (with an incidence of poverty of 16 percent) expended 4041 T per poor person. This seems to indicate that devolution may have rendered the position of social assistance precarious in oblasts housing disproportionately large numbers of the poor<sup>137</sup>. To the extent the poor in resource-rich oblasts fare much better than the poor in resource-poor oblasts, devolution has accentuated inter-regional inequity in social assistance.

27. Likely, shortfalls in social assistance are occurring mainly in relatively poorer oblasts because the devolution of responsibility has not been backed by an assurance that adequate funds are available to meet the obligations. The resource inadequacy problem seems to remain even after taking into account that oblasts now have access Social Tax (21% of payroll), because the distribution of this revenue source is bound to be inequitable across oblasts; i.e., poorer oblasts may collect relatively less revenues from the social tax.

28. A review of the components of social assistance for the first seven months of 1999 shows that the amount spent on material assistance for the unemployed is negligible.<sup>138</sup> This poor outcome may have serious consequence to the social assistance program, because social assistance has tended to become a residual category in the spending pattern of local oblasts. Consequently, important components within the rubric of social assistance may not be executed. For instance, a boarding school for invalid children in Petropavlosk city of North Kazakhstan received until July only 18 percent of the annual budgeted amount for 1999, which may affect the quality of services provided.

29. As a measure to counteract any potential accumulation of arrears in social assistance, the rules governing social assistance gives oblast administrations the freedom to adjust the level of benefits commensurate with their revenue-raising capacities. While such flexibility tends to help arrest the accumulation of arrears at oblast levels, it also tends to push social assistance down to the bottom of oblasts' expenditure priorities, rendering it as the residual category. The trends of

<sup>137</sup> Two linear regressions were estimated with actual expenditure on social assistance per poor person during the first half of 1999 as the dependent variable (Y), against the share of each oblast in total poor population ( $x_1$ ), total net revenues available to each oblast ( $x_2$ ), and per capita net revenues available to each oblast ( $x_3$ ) as independent variables. The results are as follows:

$$Y = 1032.9 - 134.8^* X_1 + .0001^* X_2, \bar{R}^2 0.40 \quad \text{---(1)}$$

$$Y = 175.1 - 93.45^{***} X_1 + 0.01^{ns} X_3, \bar{R}^2 0.13 \quad \text{---(2)}$$

\* Coefficient significant at less than 5% level; ns: coefficient not significant.

\*\*\* Coefficient significant at 12% level.

Thus, it seems that while total revenue availability positively influences expenditure per poor person, a higher share of oblast in the nation's poor population tends to reduce the size of assistance per poor person.

<sup>138</sup> Data source: MOF. Ministry of Labor and Social Protection informed that implementation of this program only started in the third quarter of 1999.

early 1999 seems to confirm this observation, and should be taken into account by authorities as a serious early warning of increasing worsening of social conditions in the country.

### **Institutional Issues**

30. *Promoting inter-regional equity:* Balancing inter-governmental responsibilities for financing and delivering social transfers is a tricky task and, unless necessary care is taken, the poor are bound to be hurt in the process. Institutional solutions need to be found to address the above-mentioned emerging inadequacies and inequities. Thus, the under-spending on social assistance by individual oblast administration can be checked by: (a) legal measures such as sequestering; and/or (b) adequately designed incentives. In practice, legal measures work better if backed by incentives. In this case, transfers/subventions to resource-poor regions/oblasts can be made conditional upon measurable performance in spending on social sectors including social assistance, and allocate the conditional grants to oblasts bearing in mind the regional variations in the incidence of poverty and the size of the poor population, the oblast's revenue raising capacity and other economic conditions.

31. *Targeting efficiency:* The problem of how to target social assistance within each oblast on the criterion of economic need is still to be solved. The sole eligibility criterion for social assistance should be "poverty".<sup>139</sup> In reality, while the Ministry's declared policy objective is to provide social assistance only on the basis of poverty, there appears to be a disconnect between this intent and the formal instructions being issued by the Ministry from time to time. For instance, a government resolution issued in July 1999, specifies five distinct categories of beneficiaries to whom social assistance is to be delivered. The continuation of a litany of categories for targeting social assistance at the local level is at variance with the avowed approach of using poverty as the sole criterion, and may not prevent the system of running into arrears soon.

32. Once poverty is adopted as the sole criterion for targeting social assistance, the Government may address the issue of how the poor should be identified for targeting purpose. It is relatively easy to identify a category such as the unemployed, but poverty requires a multi-dimensional approach to identification. Adoption of means tests is problematic in a situation where informal sector activity is increasing owing to the difficulties in measuring income accurately. Other approaches such as non-income welfare indicators which predict a household's poverty situation, or community targeting, seem more appropriate to Kazakhstan's current situation. The Government, somewhat along the lines of the mahalla system in Uzbekistan, has recently passed a resolution to the effect that at the oblast and rayon levels, "Commissions" be formed to identify the poor. These commissions have indeed been formed, but have not become a pronounced force so far.

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<sup>139</sup> Poverty, as the sole criterion for social assistance does not imply that means tests be exclusively resorted to this purpose. Whatever be the targeting method – administrative targeting, means tests, indicator-based targeting or community targeting – the basic principle, viz., social assistance only for those who are considered poor, is upheld.

33. The Commissions are expected to play an increasing role in identifying the eligible for social assistance. Since the Commissions are an institutional innovation intended to promote better targeting, it is highly desirable that the Government collect base line data for monitoring poverty as well as efficiency of the new identification system. For this, a household survey based on a random sample is a priority to be expeditiously implemented. In the interim, it is desirable that an independent body (outside the Government) is assigned the responsibility to conduct a survey of household characteristics of recipients of social assistance. After assessing the targeting effectiveness of the new system in the wake of decentralization, the government may change the procedures for identification of the needy.

### Summary and Options

34. *Summary.* In the process of devolution, the position of social assistance as a residual item in spending priorities of local governments has been aggravated. Because needs are inversely proportional to local financing capabilities, the existing inter-oblast disparities in the level of expenditure on social assistance per poor person also tends to be more accentuated after the devolution. In fact, trends of actual expenditure by oblasts during the first half of 1999 indicates that shortfalls to the minimum desirable one percent of GDP on social assistance are to be anticipated. Thus, in the wake of devolution, lower priority and regional inequity have surfaced prominently as the issues in the social assistance area.

35. *Options.* Under-spending on social assistance by oblast administrations can be checked by: (a) legal measures such as sequestering; and/or (b) adequately-designed incentives. The best route may be a combination of incentives and compulsory minimum spending levels to ensure that: (i) budgeted expenditures are effectively executed by oblast administrations; and (ii) expenditure levels be responsive to regional differences in the incidence of poverty.

36. In the medium term, social assistance cash transfers should be limited to those who are unable to work (including the single elderly with no support and poor mothers with many children). For those who are able to work, the best form of safety net is a self-targeted, low-wage public workfare program. The currently subsidized public works programs should be discontinued, and be replaced by a well-designed public workfare program that promotes self-selection of the poor into the program.<sup>140</sup>

37. Because social assistance is in flux, it is imperative to monitor both poverty and the targeting effectiveness of programs. Two initiatives are recommended: (a) introduce a module on "social assistance" in the National Statistical Agency's new household survey that is about to be launched—aimed at collecting information on the profile of the poor, and the incidence and depth of poverty in the country; and (b) let an independent body carry out a random sample survey of the recipients of social assistance and evaluate the targeting effectiveness of the program by carefully documenting exclusion and inclusion errors.

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<sup>140</sup> Absence of such a well-designed public workfare program is bound to place pressures on the cash transfer program, contributing to the present inadequate and ineffective targeting.

## C. HEALTH CARE

### Sector Overview

38. Since independence in 1991, public expenditure on health care in Kazakhstan has fluctuated between 2 and 3 percent of GDP (down from the Soviet Union average of 6 per cent in the mid-1980s<sup>141</sup>), situating the country slightly above the middle-income countries (1.8 percent) but considerably below the Europe/Central Asia and high-income country averages (3.9 and 6.0 percent, respectively) (Table V.11). As in many Central Asian countries, the health sector in Kazakhstan underwent a severe retrenchment and experienced a major transformation after the break up of the Soviet Union. The health care sector had to adjust to the enormous impact of the economic crisis, reflected in a GDP fall in real terms of about 47 percent and its negative effects on government revenue.<sup>142</sup> The extreme scarcity of resources has spurred a diversification (including a decentralization move) in health care financing, administration and service delivery, with public spending priorities being dictated mainly by ad hoc decisions conditioned by emergency situations, rather than by planned deliberate policies. These developments ended up aggravating the allocative and technical inefficiencies inherited from the old system and impinged on the health sector's outcomes (Chapter II).

#### a. Health Care Inputs and Outcomes

39. During the 1990s, the Kazakhstan health care system experienced a significant structural transformation. On the input side, the number of doctors and paramedical personnel fell 22 and 40 percent, respectively. Despite this, there are indications of over-employment in the sector as the number of doctors employed (3.4 per thousand population in 1998) is considerably beyond that of high income countries. Since the mid-1990s, about 40 percent of the hospitals and 14 percent of the outpatient and dispensary aid facilities were closed, and hospital beds were reduced from about 14 per thousand population to 8. While the latter trend indicates that significant rationalization is taking place, the indicator is still well above both the low/middle income and high income country averages.

40. On the outcomes side, evidence indicates that the health status of the population has not improved, and in many important areas has deteriorated. Morbidity indicators have in general worsened, in some cases dramatically. For example, patients infected by syphilis, HIV and tuberculosis have been deteriorating at alarming rates (Table V.11). Currently, life expectancy has fallen from the pre-independence 68 years to 64, below the low/middle income country

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<sup>141</sup> Sari, Langenbrunner and Lewis (1999), and Telyukov (1994).

<sup>142</sup> Although real GDP grew in 1996 (0.5%) and 1997 (2%), it fell in 1998 (-2.5). Real GDP index stagnated during the period 1996-98.

average.<sup>143</sup> Although infant mortality has steadily fallen since 1993, the present level of about 25 cases per thousand births still remains high, even compared with the other European/Central Asian countries. Maternal mortality increased from 67 per 100 thousand live births in 1991 to 77 in 1997.

Kazakhstan: Table V. 11: Basic Health Sector Indicators, 1989-98 (key inputs and outcomes)										Comparator Income Level Country			
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Low & Middle	Eur. & Centrl Asia	High
Public Health Expenditure (% GDP)	2.5	2.9	3.2	2.1	2.3	2.0	3.0	2.8	2.6	2.0	1.8	3.9	6.0
Employees													
Doctors (thousands)	68.0	66.3	65.1	66.4	64.5	63.3	60.1	57.9	54.5	53.2			
Doctors (per ths. population)	4.2	4.1	4.0	4.0	3.9	3.8	3.8	3.8	3.6	3.4	1.2	3.6	2.5
Paramedical personnel (ths.)	202.1	207.3	196	194	187	175.4	168.4	150.1	129.5	120.4			
Paramedical personnel (per ths. pop.)	12.4	12.7	11.9	11.7	11.3	10.6	10.1	9.4	8.2	7.8			
<b>Number of Institutions</b>													
Hospitals (units)						1651	1518	1244	1006	991			
Hospital beds (ths.)	225	228	230	228	225	206	193	164	136	124			
Hospital beds (per ths. pop.)	14	14	14	14	14	13	12	10	9	8	3	10	6
Outpatient and dispensary aid (units)						3531	3405	3155	2976	3034			
(Poly)clinics: Prenatal, children's (units)						2104	2145	2030	1792	1803			
Beds for pregnant women (ths.)						18	17	14	12	11			
Hospital beds for sick children (ths.)						41	37	31	25	23			
<b>Facility Utilization</b>													
Admissions (100 ths. Population)		24	23	22	21	19	17	16	15				
Av. Length of stay (no. days, all hospitals)		16	16	16	16	17	17	17	17				
Av. Lgth. of stay (no. days, acute care hosp)		14	14	14	14	14	15	15	14				
Occupancy rate (% acute care hosp. beds)		79	79	78	76	74	72	74	81				
<b>Morbidity</b>													
syphilis (patients infected per 100 th. Pop)						34	127	240	271	239			
HIV (newly registered cases)	...	2	1	1	2	0	5	46	429				
Tuberculosis (notific. rate per 100 th. Pop)						60	67	83	91				
Cancer (case incidence)													
Heart diseases (case incidence)													
Respiratory diseases (case incidence)													
<b>Life expectancy (years)</b>													
Births per thousand	68	68	68	68	67	65	64	64	64		65	69	77
Deaths per thousand						19	18	16	15	15			
Maternal mortality (100ths. live births)						10	11	11	10	10			
Infant mortality per thousand	67	26	27	26	28	27	27	25	25	22	60	23	6

SOURCES: Nat. Stat. Agency ("Statistical Yearbook", 1999); UNICEF ("Women in Transition", 1999); UNDP ("Central Asia 2010", 1999); SIMA (HNPSStats); WHO; WCI, 1999.

41. Given limited resource availability, the above input and outcome indicators show that Kazakhstan can only satisfactorily resolve the challenge of improving the health status of its population on a sustainable basis by substantially increasing the efficiency (both allocative and technical) of the present health system. Health care policies should aim at enhancing resource management—by restructuring financing and eliminating the existing excess capacity and employment in the sector—and improving spending priorities and service delivery systems.

#### b. The Inherited System

42. Although all the sector's experienced transformation, Kazakhstan's health care system still retains traits of the old Soviet system. On the one hand, the old system had the basic feature of offering universal access to a common health care network while keeping central financial control. On the other hand, the system had the weakness of providing little authority to local

<sup>143</sup> For males, life expectancy falls more severely: from 64 to 59 years.

managers, being highly inefficient, and embodying perverse incentives for resource allocation and service delivery. In the immediate post-independence era, Kazakhstan lost the basic feature but retained some of the weaknesses of the old system.

43. The old Soviet system was characterized by large quantities of inputs, high rates of hospital use, over-employment, too many specialized doctors and institutions, and a sheer lack of incentive for efficiency gains. These characteristics were a result of the poor budget allocation system, which was based on quantitative national “norms” to determine each health care institution’s specific needs (translated into 18 detailed budget line items). Fundamentally, the number of beds in an inpatient institution determined the number and type of staff required, the meals, medicines, equipment, furniture and fixtures, and maintenance expenditures. Other operating expenditures were historically determined. The number of staff in a polyclinic was based on the size of the population served in the area, and each institution wage bill was determined by staffing and a general pay scale.

44. The system was administered by central agencies, except for state enterprises and the party elite, which usually had their own health care schemes. The incentive mechanisms embodied in the system were highly perverse, because they generated a permanent interest in promoting construction of new infrastructures and multiplying specialization, in order to increase the number of beds and staffing (and thus have additional resources allocated automatically), regardless of the quality of services. The result was indeed an extensive infrastructure (hospitals, specialized clinics), large number of inputs (beds, doctors, paramedicals), high rates of hospital use (high average length of stay, at least 50 percent higher than the European Union), and too many physicians and clinic specialists. Independent Kazakhstan inherited this inefficient, extensive, over-specialized health care system with less attention to preventive and primary health care. From the outset, the economic rationale of the system was not justifiable, its financial control was lost, and it rendered itself unsustainable.

### c. The Transition Stage

45. Because of the severe resource constraints during the transition to a market economy, diversification (including decentralization and private sector participation) have increased in the financing, management and health service delivery in Kazakhstan.<sup>144</sup> Nevertheless, the public sector still remains the major provider of health care at all levels of services. The public health care decentralization move to oblast and rayon levels, however, has been rather spasmodic, with intermittent periods of re-centralization, according to the alternative models with which the country has experimented for the financing and health services provision from time to time.

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<sup>144</sup> For instance, Sari, Langenbrunner and Lewis (1999) estimate that out-of-pocket payments already represent at least 32 percent of total health spending in Kazakhstan.

46. With the failure of the old Soviet system and sector disorganization, the health care system reform of 1996 created the Compulsory Medical Insurance Fund (CMIF), an independent, centrally-administered extra-budgetary fund.<sup>145</sup> The CMIF was financed by an earmarked payroll contribution of three percent (intended to cover health care of workers and their families), and by oblast budget contributions to support the health care for the registered unemployed and poor families (including children, the elderly, and the disabled). The upside, and the most important innovation, of the CMIF was the introduction of the ideas of Medical Insurance and of the separation between the financing and service provision functions of health care.<sup>146</sup> With the new system, financing was centrally-administered by CMIF (by pooling the available funds), and provision of services was decentralized at oblast/rayon levels. The Fund, a non-profit organization directly reporting to the Prime Minister, was separated from the Ministry of Health and the budget, and service purchasing was, in principle, to be selective and independently made at the local level.

47. The down side of CMIF were the inefficiencies retained from the previous system, the perverse incentives and ineffectiveness of the revenue collection system, and corruption. First, the allocation mechanism based on the national quantitative norms remained as before; and thus, all the previous allocation and technical inefficiencies continued as before the reform. Second, although resource allocation was centralized, the financing of the Fund was locally based. On the latter, while the central administration of the system did not have enough clout (including institutional power and technical capacity) to enforce collection, oblasts' governments tended to be reluctant to make contributions to a fund that was operated outside their direct control. Also subnational governments tended to have little interest in encouraging state enterprises to comply with their obligations to the Fund. Consequently, arrears piled up, the system lost its credibility, and failed to accomplish its original objectives.

48. Since January 1999, all the extra-budgetary funds were amalgamated into the state budgets, including the CMIF. With the termination of the Medical Insurance Fund, health care provider payments were pushed back to the Treasury system, and the CMIF was replaced by the Central Health Purchasing (CHP) mechanism.<sup>147</sup> The new allocation and payment mechanism was designed to operate in two tracks: (i) direct budgetary allocation for *state institutions* and for *family doctors* (in principle, on a capitation basis); and (ii) competitive *State Order* ("GosZakaz") procurement system for provider corporations, both private and state-owned enterprises (in this case, still quantitative-norm-based, but enterprise-specific instead of national-average).<sup>148</sup> On the revenue side, the new system assigned the totality of the payroll-based

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<sup>145</sup> Presidential Edict "On Health Insurance of Citizens", June 1995. Also to survive the collapse of funding, user fees for health sector services in state hospitals (as complementary fees for special services, as well as for the self-employed and non-working sections of the population not eligible as any socially-protected group) were legalized in 1995.

<sup>146</sup> As early as 1996, the CMIF introduced the idea of health insurance in Kazakhstan more quickly and comprehensively than has been done in any of the FSU countries.

<sup>147</sup> Government Decree number 1387, December 31, 1998.

<sup>148</sup> *State institutions* are fully-funded by government budget and provide health services free of charge, while *state enterprises* can legally supplement their funding by charging user fees for some of their services. Measured in terms of aggregate financial flows, State enterprises are three times as big as state institutions.

*Social Tax* (now 21 percent) to the local government to help finance the new responsibilities, including their transfers to the CHP.

49. On the upside, the new health care financing system: (a) kept the separation between the financiers and providers of health care services; (b) started moving the system towards resource allocation and service purchase on a capitation basis (at least in the case of family doctors and *institutions*); and (c) introduced competition in the sector—through the concept of *State Order*—as a mechanism to improve allocative and technical efficiency in the delivery of health services. On the latter, state enterprises no longer have guaranteed funds from the government budget and, in principle, have to compete with each other and with the private sector if they want to be awarded a *State Order*.<sup>149</sup>

50. The downside of the CHP system is that it fell short in solving the revenue collection weaknesses faced by the previous system, which threaten the full effectiveness of a centrally pooled allocation/payment system as initially intended. In fact, since the outset of the new system in 1999, there were instances of medical service payments being made directly by local government finance departments to the providers. Because of latter developments, the financing function of CHP was officially terminated and transferred, since January 2000, to local budgets.<sup>150</sup> The government reorganized CHP by limiting its functions to: (i) assessing the quality of medical services; (ii) providing scientific and informational support; and (iii) collecting and analyzing statistical material on health sector. With these measures, the health care system in Kazakhstan became substantially decentralized.

### Sources of Funding

51. Total resources allocated to the health sector in Kazakhstan are estimated at about 50 billion Tenge in 1998, i.e., 2.9 percent of GDP, which compares unfavorably to the region and to European countries (Tables V.12 and V.13). The sources of funding are the following: public sector (74 percent), private sectors (23 percent), and donors (3 percent).

Table V.12: Total Resource Allocated to the Health Sector, 1998

Financing Sources	Tenge Billion	US\$ Million	US\$ Per capita	% of total
<b>1. Public Sector*</b>	<b>37.8</b>	<b>451.1</b>	<b>30.0</b>	<b>75.6</b>
Republican government	3.8	45.3	3.0	7.6
Local government	18.9	225.5	15.0	37.8
Comp. Health Insurance	15.1	180.2	12.0	30.2
<b>2. Private Sectors**</b>	<b>11.0</b>	<b>131.3</b>	<b>8.8</b>	<b>22.0</b>
<b>3 Donors***</b>	<b>1.2</b>	<b>14.3</b>	<b>1.0</b>	<b>2.4</b>
<b>Total</b>	<b>50.0</b>	<b>596.7</b>	<b>39.8</b>	<b>100</b>

SOURCE: \*Ministry of Finance, \*\* NSA, \*\*\*World Bank staff estimations.

52. The republican budget has restricted its financing to public health programs of national significance, such as AIDS prevention and control, tuberculosis and vaccines programs, and health promotion programs. By 1998, the republican government was already financing less than 10 percent of the total sector's expenditures.

<sup>149</sup> These are characteristics of the new *State Order* mechanism, which in general apply to other sectors as well, such as education.

<sup>150</sup> Government Decree number 1364, September 10, 1999.

53. Recently, health care financing responsibilities have shifted towards the local governments. Government Decrees no.737<sup>151</sup> and no.1314<sup>152</sup> specify programs and subprograms to be funded by local budgets, including local specialty hospitals, institutions for tuberculosis and AIDS, vaccinations, and blood banks. The state budget law also requires that local governments allocate minimum funds for primary health care in rural areas.<sup>153</sup> As a result of these reforms, 90 percent of the public sector 37.8 billion Tenge component was jointly financed by local budgets and the health insurance fund in 1998.

54. Donors' contributions are estimated to have been about \$15.6 million in 1997 (i.e., \$1 per capita), corresponding to around 1.2 billion Tenge (2.4 percent of total health sector resources).<sup>154</sup> Many donors and development agencies have been actively supporting the health sector in Kazakhstan, including Asian Development Bank, the European Union, the International Red Cross, UNICEF, UNDP, USAID, DFID, WHO and the World Bank.<sup>155</sup>

55. Other sources of health financing include private health insurance and patients' direct payments. The market for private health insurance in Kazakhstan, however, has not yet been fully developed, and only a few people have access to private health insurance. Nevertheless, the recent policy has further expanded the scope for cost-recovery through user fees. Health care services have increasingly relied on financing by the patients themselves, particularly for pharmaceuticals. Sari, Langenbrunner and Lewis estimated that out-of-pocket payments in 1996 was about 33 percent of total health expenditure.<sup>156</sup> Other estimates indicate that, at a minimum, one-third of health sector revenue comes from patient payments under many forms.<sup>157 158</sup>

56. Based on the National Statistical Agency's (NSA's) annual survey on household consumption, it is also possible to estimate the out-of-pocket health spending in 1998 as a

<sup>151</sup> Degree #737 "On the Approval of Programs and Sub-programs of the Ministry of Education, Culture and Health of the Republic of Kazakhstan for Development of State Budget for 1999". August 4, 1998.

<sup>152</sup> The Government Resolution #1314 "On the approval of the Instruction on the development of standard rules of the state order funded from the national budget" issued on December 22, 1998.

<sup>153</sup> The budgetary and extra-budgetary share (in %) of health financing, during 1997-99 was as follows:

Year	Republic government	Local Government	Extra-budget	Total
1997(executed)	15	65	20	100
1998(budget)	23	54	23	100
1999(budget)	16	84	00	100

<sup>154</sup> Donor support in 1997 includes IBRD \$1.26 million, UNDP \$114,000; UNFPA \$683,000; UNICEF \$1.04 million; WHO \$54,000; ADB \$12.3million; bilateral agencies: CANADA \$40,000; FRANCE \$85,000 and GERMANY \$19,000, besides USAID and DFID.

<sup>155</sup> UNDP, 1997: "Human Development Report, Kazakhstan".

<sup>156</sup> Sari, Langenbrunner and Lewis, 1999. "Out-of-pocket payments for health services: evidence from Kazakhstan".

<sup>157</sup> Ensor, T. and Savelyeva, L., 1998: "Informal payments for health care in the former Soviet Union-Some evidence from Kazakhstan"; and World Bank, 1999: "Health Project in Support of the First Phase of the Health Reform Program", February 22.

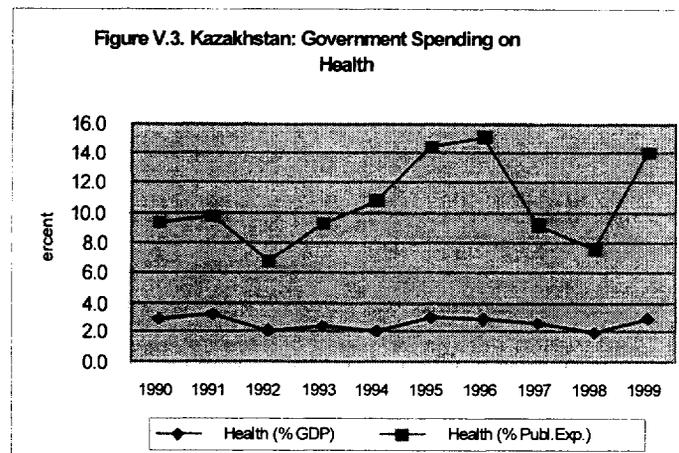
<sup>158</sup> Anecdotal evidence obtained from field visit shows a hospital in Kokhshitau that had financed only four percent of the medicine prescribed during January-July, 1999. Patients' out-of-pocket payments financed the rest.

minimum of \$9.3 per capita, or 11 billion Tenge (Table V.12).<sup>159</sup> As NSA data survey is likely underreporting the actual household spending on health, because the survey did not capture in-kind family expenditures (in-kind payment to doctors is especially common in rural areas in Kazakhstan), the private sector component of health care financing is likely to be highly understated by the survey. As a consequence, the present share of public sector contribution to the health care financing is likely to be considerably lower than the three-quarters of the total as indicated in Table V.12.

## Public Expenditure Pattern

### a. Size and Trends

57. Public spending in the sector during the 1990s fluctuated between two and three percent of GDP, one of the lowest in the region (Table V.13). As a result of a more severe retrenchment in other sectors (Figure V.3), health care spending as a share of total public expenditure increased until 1996 (to reach about 15 percent). Since then it has fallen (to 9 per cent in 1997 and to less than 8 per cent in 1998) and was budgeted to about 14 percent in 1999. In real terms, public spending on health fell dramatically with GDP just after independence, improve moderately until 1996, and then stagnated.



58. In 1998, total health care expenditure per capita was 3,340 Tenge (about \$40), while public expenditure per capita was about \$30, comparing less favorably with the central Asian (Table V.13).

<sup>159</sup> This estimate is consistent with the one by "University of York, 1998: *Project preparation for the Kazakhstan health sector project: final report*", but it is much lower than what Sari, Langenbrunner and Lewis estimated for out-of-pocket expenditure (\$17.9 per capita, in 1997).

Table V.13: Comparison of health expenditure

Countries	Year	Total health expend. % of GDP	Public health expend. % as GDP	US\$ per capita public health expenditure	US\$ per capita total health expenditure
Kazakhstan	1998	2.9	2.2	29	40
Kyrgyz Republic	1997	..	2.9	..	..
Moldova	1994	..	4.9	16	..
Russia	1995	4.8	4.2	83	96
Turkey	1995	4.2	2.7	65	99
Ukraine	1994	..	5.0	35	..
Macedonia, FYR	1995	8.3	7.4	..	171
Egypt, Arab Rep.	1995	3.7	1.7	..	38
United Kingdom	1997	6.7	6.6	..	1454

SOURCE: Kazakhstan information is based on Bank staff estimates; other country estimates are from the World Bank: Health, Nutrition & Population, Sector Strategy 1997 and the World Bank database.

## b. Economic Composition

59. Public capital expenditure on the health sector has been very low during the 1990s, with recurrent spending accounting for 92 percent on average of the government health care budget (Table V.14). Capital expenditure as a share of public expenditure in the health sector fell from approximately 10 percent in the early and mid-1990s to only 4-5 percent in the second half of the decade.<sup>160</sup> This pattern of public expenditure may be reflecting on one hand, the perception that this sector has been operating with an aggregate over capacity, and thus investment in new physical infrastructures is not in general considered a priority;<sup>161</sup> and/or, on the other hand that, owing to a lack of substantive structural reform in the sector, the available resources have hardly been enough to sustain the inefficient operation and maintenance of the existing facilities.

60. The old facilities and administrative systems operate inefficiently and maintenance costs are high (e.g., staffing, meals, energy costs). Moreover, after almost a decade of little construction, repair and replacement of major equipment and facilities, infra-structures are quickly deteriorating. Therefore, prioritizing implementation of the public service reform and a selective rehabilitation program of existing infrastructure are urgently required for a sustainable recovery of health care quality. While little has been done so far in the health sector's administrative/employment area, there are indications that recently resource allocations for facility rehabilitation started improving. Health sector investment/rehabilitation projects, which represented only 2.4 percent (\$95.5 million) in the total 1996-98 Public Investment Program (PIP), increased to 3.9 percent (\$149.6 million) in the 1999-2001 PIP.<sup>162</sup> Nevertheless, an overall coherent restructuring of the sector is still to be seen.

<sup>160</sup> Table V.14 reflects only *direct* public administration expenditures. Data on consolidated expenditures by both state and private enterprises on the health sector were not available. With the corporatization/privatization move since the mid-1990s, information on the latter are central for a complete evaluation of the sector capitalization.

<sup>161</sup> At independence, Kazakhstan's hospital beds per population ratio was one of the highest in the world.

<sup>162</sup> Source: Economic Planning Agency Ministry of Finance "Public Investment Program for 1999-2000."

Table V.14: Local government health care expenditure, by economic category, 1990-1998  
(in percentage of total)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Salaries	0.45	0.51	0.50	0.50	0.41	0.41	0.38	0.71	0.70
Drugs	0.08	0.08	0.08	0.11	0.16	0.14	0.09	0.07	0.08
Other <sup>163</sup>	0.47	0.41	0.40	0.38	0.42	0.46	0.53	0.22	0.22
Recurrent expenditure	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
% of recurrent expenditure	0.89	0.90	0.88	0.91	0.91	0.89	0.95	0.96	0.95
% capital expenditures	0.11	0.10	0.12	0.09	0.09	0.11	0.05	0.04	0.05
Total expenditure	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Note: salaries exclude deductions.

SOURCE: Bank staff estimates based on the data from Ministry of Finance

61. The *Wage bill* still represents a disproportionately large component of recurrent expenditures in the health sector. During the first half of the 1990s, until 1996, its share in recurrent expenditure fell because of inflation and a dramatic increase in energy costs (due to both price increase and the removal of government subsidies). This is confirmed by the estimates in Table V.14 (using data from local government budget execution), which shows a substantial decrease in the share of wages from more than 50 percent to only 38 percent in the mid-1990s, and a substantial increase from 1997 to 70 percent. Also arrears accumulation on wages until 1996, and on energy from 1997, may be a factor explaining the extreme fluctuation in the recurrent expenditure components' shares. Likewise, the repayment of wage arrears may be a magnifying factor for the wage shares since 1997. To a large extent, however, these fluctuations reflect the government's policy orientation to the managers of health facilities for them to prioritize wage payments. As a consequence, in many cases, even where hospitals and hospital beds were reduced, staff were retained, aggravating the expenditure mix situation. This policy is reviving the old criterion of resource allocation (of sustaining existing facilities and personnel) and increased inefficiency by re-introducing an element of rigidity in the health care system. In order to stop accumulation of arrears and to introduce rationality in the system, it is absolutely fundamental that the authorities proceed expeditiously with the administrative reform and effectively adjust the number of employees in the health sector.

62. Table V.14 shows that *drugs* as a share of public health expenditure was cut by half since the mid-1990s. To a large extent, this data may also reflect the impact of the privatization of pharmacies that has been carried-out in Kazakhstan since 1995 on local government budgets.

63. Table V.15 indicates the importance of *energy consumption* necessary to run the old inefficient health facilities in Kazakhstan. One-eighth of the recurrent expenditures has been spent only on energy (without counting for arrears accumulation). This is a major area of concern, since the operation of large inefficient facilities have to cover this "fixed cost" item, and imposes considerable rigidity to the sectoral cost structure. Even in such cases, however, simple interim innovative solutions—like installation of water and electricity meters—should be

<sup>163</sup> "Other" includes utilities, maintenance, meals, transportation costs, and supplies.

encouraged for their considerable impact on reducing costs and increasing efficiency in the sector. In this respect, the government may consider expanding nationally the successful experience already implemented in some oblasts with World Bank support.<sup>164</sup>

64. *Meals* provided in hospitals have absorbed more resource from the public health budget than capital expenditures as an individual budget item (Table V.15). This is another area of potential savings, because of the extremely high admission rate and average length of stay in hospitals (see below).

### c. Functional Composition

65. Until 1998, almost half of the total public spending in the Health sector was carried out through extra-budgetary funds (45 percent in 1997 and 47 percent in 1998), and executed on a decentralized basis.<sup>165</sup> Reliable statistics on the breakdown by functions and by facilities are not readily available for the extra-budget fund component. Nevertheless, anecdotal evidence obtained from field visits confirms the perception that the sheer scarcity of resources has barely maintained some of the existing facilities and dealt with emergency situations. In general, little attention has been paid to restructuring of the existing health sector institutions (e.g., hospitals and clinics), by optimizing employment, and prioritizing expenditures on basic public health packages and preventable diseases.

66. Even after the effort to close facilities and reduce the number of beds (in the mid-1990s), hospitals still absorbs about two-thirds of government spending in the health sector (Table V.15). The rationalization program closed or privatized 47 percent of public hospitals and 20 percent of polyclinics in the period 1993-97.<sup>166</sup> The reduction was more intense in rural districts, where the number of hospitals was diminished by 70 percent, from 684 in 1994 to 208 in 1997.<sup>167</sup> However, as was the case of almost all the FSU countries, Kazakhstan's rationalization of the hospitals did not result in corresponding reduction of government spending in the Health sector.<sup>168</sup> Between 1994 and 1998, public resource allocation into hospitals as a share of the sector expenditure reduced only by six percentage points, from 73 percent to 67 percent<sup>169</sup>.

<sup>164</sup> "Health Reform Project", World Bank, 1999

<sup>165</sup>

**Public Expenditures on Health Sector, by source and facility:**

	1997					1998					1999		
	Budgets				Extra-Budget Funds	Budgets				Extra-Budget Funds	Republ		
	Consolidated	State	Republican	Local		Consolidated	State	Republican	Local		State	Republican	Local
Health Expenditures	46123	35270	6441	28829	20573	36131	26024	7728	18298	16905	53597	8939	44658
Hospitals		15636	3141	12495			17825	5320	12505		3417	3020	397
Clinics&Med,dental & param.practit.		783	123	660			602	88	514		3676	3676	
Medical,prot.,med. equip.&appliances		1297	1297				0				8097	1223	6874
Others		17554	1880	15674			7597	2320	5277		38407	1020	37387

Source: Ministry of Finance (1997-98: Annual Budgetary execution; 1999: Budget

<sup>166</sup> "Health Reform Project, World Bank, 1999 .

<sup>167</sup> "Health Care System in Transition: Kazakhstan", Regional Office for Europe, WHO, 1999.

<sup>168</sup> "Hospital Structure Rationalization", USAID/CAR, ZdravReform, 1999

<sup>169</sup> "Kazakhstan: Transition of the State", World Bank, 1997

67. Public Health Units, including sanitary-epidemiological stations, tuberculosis sanitary stations, and AIDS centers, shared six percent of the budget in 1998 (Table V.15); a share increase from the 4.5 percent in 1994, but mainly due to reduction in hospitals' and polyclinics' shares. These Public Health Units play an important role in dealing with the increasing problems related to drug addiction, smoking, and alcohol abuse. Because they tend to produce substantial externalities, they should be given higher priority in resource allocation.

**Table V.15: Local Government Health Expenditure, 1998**  
(by economic category and facility level)  
(In percentage of total)

	<i>PITALS</i>	<i>LINICS</i>	<i>ULATORY</i>	<i>Public health Units ER</i>	<i>TAL</i>	
Wages (excl. deductions)	68.2	78.3	79.1	73.2	31.1	67.0
Utilities	12.1	12.0	6.0	8.1	13.8	11.7
Meals	6.6	0.0	0.0	3.8	2.9	4.9
Medicines	7.6	7.1	4.2	6.5	7.0	7.3
Maintenance	0.6	0.5	1.0	1.3	0.7	0.7
Other expenses	2.3	1.8	7.2	4.4	16.7	3.8
<b>Total recurrent</b>	<b>97.3</b>	<b>99.8</b>	<b>97.5</b>	<b>97.2</b>	<b>72.2</b>	<b>95.4</b>
Capital	2.7	0.2	2.5	2.8	27.8	4.6
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<i>Facility share Gov. spending</i>	<i>67</i>	<i>14</i>	<i>4</i>	<i>6</i>	<i>9</i>	<i>100</i>

SOURCE: World Bank staff estimates based on data from MOF, GOK.

#### d. Regional Dimension

68. The resource allocation system inherited from the old regime basically used national average expenditure norms to ensure equality across regions. As health spending responsibilities have increasingly been pushed down to local governments, expected per capita health expenditure tends to vary with local capacity of revenue mobilization and oblasts' government policy priorities among sectors.

69. In fact, the range of per capita expenditures among oblasts has widened since the mid-1990s until 1998 (Table V.16). The coefficient of variation has increased from 0.29 in 1995 to 0.33 in 1998. The planned budgets for 1999 and 2000 project a reduction in these disparities and coefficients of variation, but recent experience has shown that budget execution rarely coincides with projections. In 1998, per capita health spending in South Kazakhstan oblast was only about one-third of that in Almaty City. South Kazakhstan, Zhambyl, Almaty, and Aktyu oblasts have regularly spent less on health than the national per capita average. On the other hand, health expenditure per capita in the oblasts of East Kazakhstan, Kzyl-Orda and Mangistau, and the cities of Almaty and Astana were usually above national average. These expenditure patterns are by and large positively related to local fiscal capacities. A well-designed equalization transfer mechanism is necessary to promote equal access to health care across regions (Ch. IV).

**Table V.16: Local health expenditure per capita by Oblast 1995–2000**  
(In nominal Tenge)

	1995 actual	% of mean	1996 actual	% of mean	1997 actual	% of mean	1998 actual	% of mean	1999 budget	% of mean	2000 budget	% of mean
Akmolinskaya	2204	1.40	3238	1.69	3434	1.27	1774	0.79	3800	1.18	3803	1.16
Aktyubinskaya	1493	0.95	1525	0.80	1787	0.66	1609	0.72	2761	0.86	4160	1.27
Almatinskaya	1203	0.76	1362	0.71	1976	0.73	2064	0.92	1827	0.57	1839	0.56
Atyrauskaya	1752	1.11	2514	1.32	2935	1.08	2040	0.91	3628	1.12	2521	0.77
East Kazakhstan	1844	1.17	2126	1.11	3545	1.31	2438	1.08	3503	1.08	3543	1.08
Zhambylskaya	1040	0.66	1284	0.67	1988	0.73	1741	0.77	2437	0.75	2684	0.82
West Kazakhstan	1610	1.02	2274	1.19	3027	1.12	2114	0.94	3963	1.23	3329	1.01
Karagandinskaya	1877	1.19	2107	1.10	3141	1.16	2039	0.91	3169	0.98	4646	1.41
Kzyl-Ordinskaya	2015	1.28	2665	1.39	3964	1.46	3448	1.53	4207	1.30	4743	1.44
Kostanaiskaya	1784	1.13	2055	1.08	3025	1.12	1397	0.62	3021	0.94	3021	0.92
Mangystauskaya	2133	1.35	2050	1.07	4065	1.50	3282	1.46	4050	1.25	3933	1.20
Pavlodarskaya	1601	1.01	2152	1.13	2908	1.07	2081	0.93	3911	1.21	3637	1.11
North-Kazakhstan	735	0.47	857	0.45	2398	0.89	3601	1.60	3020	0.94	3088	0.94
South Kazakhstan	1125	0.71	1385	0.72	1233	0.46	1298	0.58	2002	0.62	2141	0.65
Almaty city	2325	1.47	2686	1.41	3740	1.38	3916	1.74	3423	1.06	3802	1.16
Astana city							2973	1.32	3731	1.16	5046	1.54
<b>Kazakhstan</b>	<b>1578</b>	<b>1.00</b>	<b>1911</b>	<b>1.00</b>	<b>2708</b>	<b>1.00</b>	<b>2248</b>	<b>1.00</b>	<b>3229</b>	<b>1.00</b>	<b>3287</b>	<b>1.00</b>
<b>Stand. Deviation</b>	<b>453</b>		<b>615</b>		<b>843</b>		<b>732</b>		<b>766</b>		<b>963</b>	
<b>Coef. of Variation</b>	<b>0.29</b>		<b>0.32</b>		<b>0.31</b>		<b>0.33</b>		<b>0.24</b>		<b>0.29</b>	

SOURCE: Bank staff estimates based on information from the Ministry of Finance.

Note: The estimate for per capita expenditure data of the year 2000 used 1999-population census.

## Managing Health Care Expenditures

### a. Decentralization of Decision and Policy Implementation

70. **Policy formulation and implementation.** Until the recent past, oblast and city or rayon budgets, including health, used to be determined at the republic level. Presently, conditional to a minimum health expenditure amount to rural areas, subnational governments determine and manage the bulk of public expenditures allocated to health care. Since the mid-1990s, with the Law of local self-government (1995), implementation of the CHIF (1996), and the Budget System Law (1999), the intended role of republican government in the health sector has been one of coordination rather than formulation and implementation. In reality, pushing down the financing and management of health care to the subnational government level have not yet been satisfactorily resolved.

71. Starting in 1999, decisions on the aggregate subnational government budgets (revenue, expenditure, and withdrawals/subventions projections), including health, are to be initiated by individual local government proposals, and finalized at the central level. This budgetary process is intended to reflect negotiations among oblast and city administrations, on the one hand, and with the Budget Commission—advised by the Committee of Health and the Ministry of Finance—on the other. Once decisions on the budgets' totals are approved with the annual State Budget Law, the specific allocations, financing and policy execution are to be taken and

implemented by the subnational governments. In practice, however, insufficient autonomy for managers to perform, disparities in fiscal and administrative capacities, and limited political accountability are presently major constraints to a fully-accountable decentralized health care system in Kazakhstan.

72. ***Provider selection and payment.*** The newly institutionalized “State Order” financing/payment mechanism, is potentially a powerful instrument for controlling overall spending and inducing efficient resource allocation in the sector. With this system, state enterprises are to be selected through a competitive State Order tendering process, where private providers can also participate (Box V.2).<sup>170</sup> Rural family practitioners, in their turn, are to be selected and paid on a capitation basis for a defined health care package.

73. Nevertheless, where a local large hospital dominates one region, its monopoly position renders the new system ineffective, since real tendering cannot actually take place. A state order for hospitals is intended to be based on the number of treated cases categorized according to diagnosis-related groups. Due to the lack of adequate information on unit costs per type of medical treatment, however, most state orders are still calculated on the basis of respective hospital’s average cost and previous year’s number of cases treated. A state order for polyclinics is based on estimated number of visits and an established schedule of fees per type of medical procedure.

74. There is an explicit cost recovery policy, which encourages state enterprises to complement their financing by charging user fees. For instance, the present regulations are that state enterprises competing for state order should have 30 percent of its costs financed through user charges. Cost recovery is in principle an important positive initiative, but should be carefully conducted by the Kazakhstani authorities. On the one hand, this initiative is supposed to give more administrative flexibility to public enterprises, particularly in respect to its payment policy to doctors, who are now allowed to receive a complementary remuneration according to the number of patients treated and services provided.<sup>171</sup> It is also highly positive in the sense that it helps limit/ optimize the use/consumption of health care services. On the other hand, however, given the country’s conditions, this initiative, if not properly monitored and frequently evaluated, can be highly pernicious for the development of the sector. The existence of a dual system of service provision (based on cost recovery and public financing) in the same public entity might: (a) add a burden on the poorly-managed, over-stretched information system, which tends to facilitate corruption; and (b) confuse incentive signals, by artificially lowering the cost of privately-financed services at public facilities, which creates unfair competition and prevents the development of the incipient independent private sector in Kazakhstan.

75. Since the time of CHIF, subnational governments have been reluctant to transfer funds to an institution over which they have no control. Actually, some oblasts have bypassed CHP and payments have been made directly by the oblasts’ finance departments to health facilities. As a

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<sup>170</sup> Until end-August 1999, twenty-two percent of the 1780 state order contracts executed by CHP were signed with private providers.

<sup>171</sup> This dual financing system started in 1996 with CHIF.

consequence, the new regulation now establishes that from January 2000 onwards, payments are to be made by local governments' finance departments.

76. As the State Order tendering system is in its early stage of implementation, rules are not yet well known by local administrations, and interpretation of criteria still vary from region to region. Many facilities, including all the so-called State Institutions are still being paid on the basis of the old "norms". However, in order to protect a minimum level of funding and ensure equity, the payment system for Health Primary Care is now being built on a per capita basis, instead of the previous financing of inputs demanded by facilities. This change introduces efficiency incentives and more flexibility in resource allocation for primary care providers.

#### **Box V.2: The Process of financing a hospital in Karaganda through the State Order Mechanism**

In Karaganda, the documentation required for a state enterprise to participate in a tender includes: license to practice medicine; basic information about the facility; lists of types and volume of the services provided for the last three years; overhead budget; business plan; certificate from the rayon department of statistics on the size of the catchment population; bank certificate on the financial status of potential suppliers and a certificate from the tax office on past tax payment.

A working group consisting of 12 people – representatives of the CHP and oblast health department – is responsible for evaluating the bids. The working group calculates a unified base rate for hospital visits (in Karaganda oblast it is 7,500 tenge per patient treated in 1999), the rate per visit to polyclinics and capitation rate for family practices. The working group evaluates the quality and compliance of tender documents over a twenty-day period.

The working group reports to the oblast economic council—that consists of 15 people, representing oblast health department, CHP and health facilities. Within one week the council reviews all proposals, defines the size of state order for each type of medical service and for each facility. The size of a state order is determined on the basis of the volume and case-mix of the services provided during the previous year with review of justification for hospitalization and complexity of case treated.

The amount of a state order for in-patient care is case-based and calculated by multiplying the number of treated patients in the previous year, by weighted coefficient, and by a base rate. Base rate is an oblast average cost of one case treatment. It is computed from an estimate of the total pool of funds available for inpatient facilities in the system divided by an estimate of the total number of cases in each department over the period.

The tender commission, chaired by the deputy oblast akim, consists of representatives of the oblast finance control department, head of the oblast economic department, head of health care establishments' association, representative of the oblast maslikhat, center for health services purchasing and oblast health department, carries out the tender process for 2-3 days. Criteria used for defining the winners of the tender include a combination of price and quality of medical services, quality reports of CHP experts, access to hospital services in remote areas and technical equipment of the hospitals. After winner selection, CHP issues the contracts.

#### **b. Budget and Policy Executions**

77. Health departments in oblasts/cities are key administrative bodies that implement policies and regulations, and supervise hospitals and clinics. At present these departments are still in transition to adapt themselves to the scarcity of resources, to the recent changes in the financing system, and to the fiscal policy decentralization drive. Policy execution has flawed because of diverse local interpretations of regulations and of the working of a more fragmented/decentralized system, which has led to frequent disruption and delays in payments.

78. A major recurrent hurdle faced by the health sector in Kazakhstan is associated to the fact that expenditure execution has systematically fallen short of the planned budget. For instance, in 1997, expenditure execution was 88 percent of budget (Table V.17). Also budget execution has varied considerably among regions. In 1998, while South Kazakhstan executed 98 percent of its budgeted allocation, Mangistauskya reached only 78 percent. In general, Almaty City and the new capital Astana rank on the high side of the execution spectrum, and the poorest oblasts on

the low side. Because of diverse local preferences and disparities in fiscal and administrative capacities, decentralization of policy decisions may lead to even more unequal budget execution in the near future. Out of the total planned government health spending for 1999 and 2000, about three-fourths are allocated to "State Order".

**Table V.17: Kazakhstan: Planned and Execution of Health Sector Budget, 1998-2000**

Table V.17: Kazakhstan: Planned and Execution Budget, by oblast and institutions, 1998-2000												
Oblasts	1998 Budget			1999 Revised Plan					2000 Projected Budget			
	Rev.Budget	Execution	Execution	State Inst.	St. Order	Total	St. Order	Exc.%	State Inst.	St. Order	Total	St. Order
	Mil.Tenge	Mil.Tenge	%	Mil.Tenge	Mil.Tenge	Mil.Tenge	% share	until Jul.	Mil.Tenge	Mil.Tenge	Mil.Tenge	% share
Akmolinskaya	1800	1531	85.0	681	2495	3175	78.6	24.0	644	2534	3178	79.7
Aktyubinskaya	1300	1109	85.3	425	1460	1886	77.4	23.2	648	2192	2840	77.2
Almatinskaya	3432	3228	94.1	628	2221	2849	78.0	28.7	767	2101	2868	73.2
Atyrauskaya	1106	895	80.9	350	1246	1596	78.0	26.5	333	776	1109	70.0
East Kazakhstan	4290	3772	87.9	1019	4343	5362	81.0	24.7	1458	3965	5423	73.1
Zhambylskaya	1849	1718	92.9	460	1938	2398	80.8	24.3	649	1992	2640	75.4
West Kazakhstan	1538	1319	85.7	471	1977	2448	80.8	16.7	496	1560	2056	75.9
Karagandinskaya	3215	2931	91.2	1138	3336	4474	74.6	26.7	2087	4472	6559	68.2
Kzyl-Ordinskaya	2135	2048	95.9	683	1825	2508	72.8	25.9	880	1948	2828	68.9
Kostanaiskaya	2292	2008	87.6	854	2227	3080	72.3	29.3	854	2227	3080	72.3
Mangistauskaya	1321	1036	78.4	3233	919	4151	22.1	5.3	324	922	1246	74.0
Pavlodarskaya	2172	1712	78.8	707	2445	3152	77.6	19.4	707	2224	2931	75.9
North-Kazakhstan	2910	2672	91.8	423	1770	2192	80.7	33.5	577	1665	2242	74.3
South Kazakhstan	2610	2557	98.0	821	3136	3958	79.2	14.6	948	3285	4233	77.6
Almaty city	4735	4405	93.0	723	3145	3868	81.3	40.8	956	3341	4297	77.8
Astana city	106	949	895.5	350	842	1191	70.7	28.5	458	1153	1611	71.6
<b>Total</b>	<b>37712</b>	<b>33888</b>	<b>89.9</b>	<b>12965</b>	<b>35324</b>	<b>48289</b>	<b>73.2</b>	<b>23.9</b>	<b>12786</b>	<b>36357</b>	<b>49143</b>	<b>74.0</b>

SOURCE: Ministry of Finance

79. The low budget execution rate and the considerable regional disparities in per capita health care expenditure indicate a poor fiscal policy coordination and a lack of expenditure prioritization at the planning phase of the budgetary process. The budget execution shortfalls seem to reveal, on the one hand, the reluctance of local governments in establishing an effective expenditure prioritization and in carrying out the corresponding fiscal retrenchment (by promoting an adequate input mix adjustment at health care facility levels), and, on the other hand, the existence of a rather passive attitude of the central authorities in overlooking the consequences of often optimistic local revenue projections (at the budget formulation phase). The latter has been a frequent expedient to easy budget approval by Parliament, however, with serious negative consequences. Procrastination in resolving oblasts' structural fiscal imbalances, including health sector financing, in the appropriate planning phase of the budgetary process, has only resulted in frustrations during budget execution and accumulation of arrears.

## Efficiency and Equity in Health Service Delivery

### a. Improving Efficiency

80. During the financial crisis and transition, the health sector reforms struggled to improve allocative and technical efficiencies of service delivery. Kazakhstan can still significantly improve allocative efficiency in the health sector by prioritizing and reallocating resources to primary health services, preventive care, and treatment of infectious diseases. There are two

obvious reasons for the authorities to pay increasing attention to and select these areas of priorities: (a) they involve substantial positive externalities, and if provision is left only to the private sector the country may face under-supply of services (as it is now the case), since the private financier/provider cannot internalize all the social benefits adequately; and (b) expenditures in these areas tend to mostly benefit the poor, and thus they can be justified on equity grounds.

81. On the technical efficiency side, traditional budgeting by maintaining the medical facilities' needs based on "norms" only resulted in highly inefficient service delivery systems with excess number of hospitals, medical staff and hospital beds, over-specialization, high admission rates, and long hospital stays. Except for the admissions rate (which may have fallen as a result of the reduction in the number of hospitals), performance indicators (e.g., average length of stay in acute care and in general hospitals, occupancy rate) have been either stagnant or shown insignificant improvement (Table V.11).

82. There are indications that improvement in Kazakhstan's health status and service quality are necessary and possible. As in other FSU countries, the average length of stay in hospitals is still excessively longer than Western countries. For example, outpatient visits are relatively low and, while in Kazakhstan the average length of stay is 14 days, in the EU and UK the averages are 8.7 and 4.8, respectively (Table V.18).

Table V.18: Health Services Performance Indicators Comparison

	Kaza- Khstan	Kyrgyz Republic	Moldova	Russia	Turkey	Ukraine	Georgia	Mace- donia	Egypt	UK	EU Average
Beds per 1000 population	10.3	8.8	12.1	11.7	2.5	9.9	4.8	5.2	2.1	4.7	4.6
Physicians per 1000 population	3.6	3.3	3.6	4.1	1.1	4.5	3.5	2.3	1.8	1.7	2.9
Av. distance to PHC facility (km)	20.4	6.9		17	3.7						20.1 (Finland)
Average length of stay	17.3	14.9	18.1	16.9	6.4	16.5	13	15.1	8.0	9.9	12.2
Average length of stay (acute hospitals)	14.5	12.4			5.7					4.8	8.7
Occupancy rate	70.3	79.3			55.6						76.7
Inpatient admission rate	15.1	20.7		21.6	5.9					15.2	17.6
Acute inpatient admission rate	16.0	17.7			5.7					11.7	14.3
Immunization, DPT(% children < 12 mths)	96	98	97	87	79	96	92	97	94	95	..
Births attended by health staff (% of total)	99	98	..	..	76	..	95	95	46	..	..
Outpatient visits per capita	0.7	0.6	8.1	8.1	..	9.5	2.1	2.7	3.5	..	..

SOURCE: Kazakhstan data from Ministry of Health, Education and Sports. Other indicators from World Bank, Project Appraisal Document, 1999 and the World Bank Live Data Base, of the latest year between 1994 and 98.

83. Technical efficiency in hospitals are particularly affected by the choice of technology in diagnosis and treatment. It has been shown that in Kazakhstan some treatments (e.g., hyperbaric oxygenation and low frequency laser therapy) have produced poor results; however, hospitals continue purchasing such technologies to attract paying patients (Ensor and Rittmann, 1997). Also, while directly observed therapy on outpatient care is a cost-saving approach, the traditional

inpatient care treatment for tuberculosis is still commonly used in Kazakhstan. To change the focus from in-patient care, alternatives such as day hospitals and nursing homes should be considered.

84. The newly-established State Order tendering mechanism intends to promote competition among health service providers in order to improve service quality and cost-effectiveness. However, because of structural conditions, the lack of appropriate market regulation, and prevailing deficiencies in the information system, the risks of elusive results are high. For instance, competitive State Order often cannot be applied to the larger and more specialized hospitals; because of their monopoly position in one region they always end up being awarded, regardless of their efficiency level of operation.

85. Among medium and small providers, several factors are presently operating against efficiency improvement. A first factor is the design of the State Order mechanism, which basically focuses on output, rather than on outcomes. Health providers have been chosen more on the basis of potential quantity achievements (number of patients treated) rather than quality (the best treatment possible with the minimum cost). Although the Committee for Health formally monitors quality of services and procedure implementation, the incentive and penalty mechanisms are not clearly specified.

86. A second factor is the limitation of the intended decision-making autonomy at the level of the local health service provider. With the new system, it would be expected that once health enterprises had won a State Order, they would have the necessary autonomy to define their own input mix (including the powers for hire and fire) in the most efficient possible way. Instead, these enterprises are submitted to regulatory constraints, which still strongly interfere in their management (for instance, Decree no. 1314/98 which enforces priority for salary payment). This is a major constraint impinging on technical efficiency on the health service delivery, since state facilities end up allocating large proportions to salaries, leaving medicines and other essential operational items (e.g., energy and equipment maintenance) without financing (and on arrears) or being unduly cut from the production process. A third factor affecting technical efficiency of the health care services may result from decentralization of decision-making and responsibilities to a low level of subnational government. In some cases, where economies of scale are a factor, decentralization beyond oblasts (down to rayon and city levels) may duplicate functions and thus may not be efficient.

#### b. Reducing Inequities

87. About thirty-five percent of Kazakhstan's population is below the poverty line.<sup>172</sup> Living conditions are complicated by climate and large portions of the country are in remote, scarcely inhabited areas. Disparity of fiscal capacities across regions is quite large and during the transition, low income areas and rural health care have suffered disproportionately from financial difficulties and budget cuts (Table V.19). Although the Constitution guarantees a basic package of health services to every citizen free of charge (Art. 29 of the Constitution), the country's

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<sup>172</sup> Head count ratio. "Kazakhstan: Living Standards During the Transition", Report no. 17520-KZ, World Bank, 1997.

physical and financial conditions have not yet permitted everyone to have the desired equal access to minimum medical assistance.

Table V.19 Regional variations in health expenditure and health status, 1998

Regions	Per capita expenditure (% of mean)	Infant mortality (per 1000 live births)	Maternal mortality (per 100,000 live births)	Viral hepatitis morbidity (per 100,000 pop)
Akmolinskaya	129.5	22.9	78.6	338.5
Aktyubinskaya	50.3	26.4	74.8	345.5
Almatinskaya	83.2	20.4	55.4	296.2
Atyrauskaya	78.6	26.3	69.5	380.8
Eastern Kazakhstan	125.8	27.0	146.2	299.8
Zhambylskaya	73.3	30.8	48.1	595.4
Western Kazakhstan	134.0	22.6	66	490.1
Karagandinskaya	98.1	26.8	85	397.1
Kzylordinskaya	183.3	29.9	39.5	858.3
Kostanaiskaya	105.0	22.3	98.9	214
Mangistauskaya	112.1	41.4	44.9	799.2
Pavlodarskaya	104.5	23.8	69.6	181.6
North Kazakhstan	102.5	20.2	72.5	177.4
South Kazakhstan	54.8	23.4	57.9	664.2
Almaty city	135.3	20.4	134.3	415.1
Astana city	116.6			
Kazakhstan	100	24.9	76.9	407.1

SOURCE: UNDP, Human Development Report 1998

88. By and large, lower fiscal capacity regions have larger concentrations of the poor population with more difficult access to health care services. Without adequate monitoring and regulation, disparities in health expenditures across regions may expand, and inequities tend to increase as fiscal decentralization proceeds. In this regard, the authorities may consider reviewing the equalization transfer mechanism by taking into account both the region's fiscal capacity and its priority expenditure needs accordingly.

89. Authorities may also consider improving the implementation of the system of cost recovery, by exempting the poor from user fees and guaranteeing his/her access to the basic health care services. According to recent estimates, the poor spent a much higher proportion of their income on health care<sup>173</sup> and have so far been disproportionately hurt by the recent move to the dual financing/provision system (public resource and user charge) in the public health facilities.

### Improving Service Delivery

90. Health indicators in Kazakhstan have been deteriorating since the early 1990s (Section A), indicating that the health policy and service delivery system should be reviewed with the aim of checking negative trends and creating conditions for improvement in the health status of the population.

<sup>173</sup> Sari, Langenbrunner and Lewis, 1999. "Out-of-pocket payments for health services: evidence from Kazakhstan". World Bank.

### a. Restructuring Health Services

91. Under the current system, primary care is delivered through a three-tier system: feldsher posts (FAP), rural clinics (SVAs), and rural hospitals. Feldsher post is the first point of contact for the rural population, rural clinics function as the second level—receiving referrals from the feldsher posts—and rural hospitals also provide secondary care to the rural population. Urban primary care is provided by physicians located in polyclinics. Oblast and city hospitals and specialized institutions, having more advanced technology, offer specialized care.

92. There is, however, a generalized tendency of referring patients to a higher level of care, unnecessary duplication of services and excess capacity in the facilities, which makes the system operate inefficiently. This *modus operandi* places a heavy burden on hospitals and specialized institutions, the most costly segments in the system. Usually, the first level of treatment is bypassed and problems that could be solved at FAP or SAV are transferred to hospitals. Also, specialists are frequently designated to provide services that could more easily be managed by general practitioners or nurses. Moreover, unnecessary specialization permeate the health service delivery system, leading to excessively high fixed costs and loss of economy of scale. For example, urban polyclinics are often separated for adults, children and women, and in general managed by specialists, which created duplications and frequent referrals to other specialists. This system is not only highly inefficient, but it is also financially unsustainable under the present circumstances of resource scarcity.<sup>174</sup>

93. The delivery of health services is currently being reorganized with financial support of the World Bank.<sup>175</sup> The basic strategy is to redirect funds from hospitals to primary care, by making more intensive use of family doctors to deliver primary health care services. The idea is to promote primary care entities (FGP), consisting of a group of general practitioners from which the government contracts basic services provision on a capitation rate basis. Although the reorganization of primary health care is still at an early and experimental stage, about 200 FGPs has been mobilized under the pilot project. The reform, which also aims restructuring polyclinics, secondary, and tertiary facilities, seems to be a very promising and cost effective strategy.

### b. Prioritizing a Basic Health Care Package

94. Packages of services have undergone changes since the termination of CHIF. Nevertheless, the health administration still funds the broad, free-of-charge, guaranteed package for urgent care and specialist care, which includes oncology, narcology, tuberculosis and psychiatry, as well as the sanitary and epidemiological service, blood transfusion and certain

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<sup>174</sup> See, for instance, "Health Care Systems in Transition: Kazakhstan", Reg. Office for Europe, WHO, 1999.

<sup>175</sup> "Kazakhstan: Health Reform Program", Report no. 19007-KZ, World Bank, 1999.

other services.<sup>176</sup> This “basic” package of services, that used to be funded by the Health Insurance, is now financed under the State Order system.

95. Although information on the coverage of basic services under the State Order is not yet available, indications are that, unfortunately, funding is still based on specific institutional needs rather than on services provided under the basic package. Nevertheless, the on-going reform has made an effort to develop a priority package of PHC services, including diseases with high incidence/prevalence rates. Since diseases are treated at the primary care level, this approach is cost effective and will contribute to reduce the national burden of diseases. In this vein, there are recommendations that treatments for acute respiratory infection for children under 5, anemia for women in child-bearing age; diarrhea diseases, tuberculosis and viral hepatitis be included in a priority package.<sup>177</sup> Funds would be allocated to PHC on a per capita basis to cover those services.

### c. Promoting Private Sector Participation

96. To optimize public medical service delivery, the government essentially has to focus on solving the problems of public goods and market failures, including externalities, while ensuring access to basic health care services to the poor and vulnerable. The objective of government intervention in the sector should be to rationalize the use of inputs in the most cost-effective way, in order to obtain a desired outcome (in quantity and quality) that the private sector cannot deliver.

97. Private sector participation (on financing and provision) is intended both to increase efficiency in health care delivery and to ease the financial crisis of the public health sector. As such, it is an important additional instrument for improving the health status of the Kazakhstani population. Recently, progress has been made by: (a) promoting private medical practice; (b) authorizing public health facilities to operate with user charges on some health service delivery; and (c) privatizing some health facilities.

98. By and large, the pace of developing real private practices has been slow. While private medical practice has been permitted since 1991 (*Law on the Protection of People's Health*), by 1997 less than two percent of the country's physicians were private practitioners. On the other hand, at mid-1990s, privatization of health facilities was limited to pharmacies and dentistry, and by end-1997 over 90 percent of drugstores were privatized.<sup>178</sup> In relation to hospitals and other health facilities, a corporatization policy was instituted, and the government policy was to provide incentives to restructuring, increasing efficiency or pushing privatization forward. In this regard, various practices exist among oblasts ranging from the facilities that are both owned and managed by the private sector to a private wing developed inside the public facilities or proportion of doctors totally financed by user fees. However, presently the bulk of the

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<sup>176</sup> In 1996, in Almaty oblast, infectious diseases, particularly tuberculosis, accounted for above 50 percent of the total outlays of the guaranteed package, and pregnancy related care and treatment for respiratory and digestive diseases accounted almost the other half.

<sup>177</sup> “Project Preparation for the Kazakhstan Health Sector Project”, The University of York, 1998.

<sup>178</sup> UNDP, 1998.

ownership of health facilities is still at governments' hands, although, in principle, managers are given more autonomy to manage resources, such as autonomy to hire and fire. In reality, this autonomy has not been satisfactorily exercised, and facilities continue to be operated inefficiently with excess capacity.

99. The new government policy continues to rightly separate financing from management and from ownership, and is opening an opportunity for the private sector to compete for public funds in public health service provision. This is a significant undertaking to encourage the private sector to participate and help increase efficiency in the health sector. In principle, the government, as a purchaser of health care services, is procuring cost-effective services (low cost, high quality) no matter who provides such services. In practice, it is still too early to evaluate how the private sector will react to the government policy initiatives. Nevertheless, if implemented properly, this policy can promote competition and increase efficiency in service delivery; especially among small- and middle-sized providers, since the scope for competition among the large hospitals (oblast and some rayon hospitals) is still too narrow.

100. Apparently, the government has been cautious on the privatization push, and is trying to protect some priority programs that have large positive externalities. In the 1997 Decree *on Privatization Programs by Sectors*, the government defined thirty types of health facilities *not* subject to privatization. The argument for this is to avoid under-supply if service provision would be entirely left (financing and deliver) to the private sector.

### **Main Issues and Options**

101. **Main issues.** Financial crisis and scarcity of public resources has induced a reduction on health care expenditure in real terms and a diversification (including decentralization) of health services (decision, financing and management) towards local governments and private sector. Since independence, the health status of the population has deteriorated, disparity in per capita expenditures across regions accentuated (probably because of unequal fiscal and administrative capacities), and the poor have been affected disproportionately. Despite some important government initiatives to reform the health care system, the operational inefficiencies inherited from the Soviet system have been aggravated. While some privatization/closure occurred since mid-1990s, no relevant public employment and wage reforms have been carried out, repair and replacement of equipment has been inadequate, and infrastructures has deteriorated.

102. Insufficient autonomy for managers to perform, disparities in revenue collection and administrative capacities among regions, and limited political accountability are still major hurdles to a fully accountable decentralized health care system, as well as to fiscal policy in general, in Kazakhstan.

103. Low execution rates of budgeted expenditures has resulted from overoptimistic revenue projections in the planning phase of the budgeting process, and has led to payment delays and accumulation of arrears including in the health sector. Because the sector lacks clear policy priorities, in general sectoral expenditure allocation end up emphasizing: (a) curative, rather than preventive health care; and (b) hospitals and specialized clinics inpatient care, rather than family doctors and outpatient care.

104. Efficiency has being low on account of: (a) excess capacity and employment, and because of lack of enough autonomy for managers to perform and limited accountability of local authorities for the outcomes; (b) private practice in public enterprises, which facilitates corruption and the uses of scarce public funds to subsidize privately provided services; (c) payment to service providers on the basis of actual running costs of respective health facilities, instead of based on the lowest per capita cost of primary health care packages; (d) monopoly position of some local (oblast/rayon/city) hospitals, which prevent the State Order tendering mechanism to fully operate in practice; and (e) excessive decentralization beyond the oblast level (down to rayon/and cities), which may duplicate functions, preventing resource pooling and economy of scale.

105. **Policy Options.** The government's recent reform program<sup>179</sup> acknowledges that the objectives of improving the health status of the Kazakhstani population, as defined in the Health of the Nation State Program (1998), can only be achieved through a financially sustainable, performance-oriented health system. The findings of this PER report suggest that, any reform strategy of health care in Kazakhstan should necessarily include a phased implementation of the *public service reform* and a selective *rehabilitation of infrastructures and equipment*, while carrying on *privatization/ conversion/ consolidation/ closure* of facilities to optimize capacity, increase competition, and improve efficiency and the quality of services delivered in the sector.

106. While full implementation of this strategy may take time, its design and preparation should start soon, by considering the following policy and management principles: (a) *prioritizing programs* on preventive care, treatment of infectious disease, and primary health service packages; (b) separating private practice from public facilities, by *privatizing the facilities and/or contracting out services*; (c) providing managers of state health facilities with enough *autonomy to perform* (particularly on determining the input mix) and make them *accountable for the results* (output and service quality); (d) specifying *clearer responsibilities for local authorities* on their sectoral resource allocation decision spheres, and making them *fully accountable for policy outcomes*; (e) awarding *State Order to providers competitively*, allocating resources on a per capita basis for a minimum standard cost of primary health care package; (f) *monitoring service delivery* according to output, service quality, and outcomes; and (g) encouraging *private sector participation*, by assuring the proper legal and regulatory framework that create an enabling business environment for the development of private initiative in the sector, including health insurance markets.

107. The short-term policy actions recommended include:

(i) *improving the central-government-led health care policy coordination*<sup>180</sup> with the Oblasts' Health Departments and health facilities' managers, as a mechanism to identify and anticipate problems, and as an instrument for conflict resolution and dissemination of best practices on healthcare management among regions;

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<sup>179</sup> Supported by the World Bank through the "Health Project in Support of the First Phase of a Health Reform Program", Report No. 19007-KZ, February 22, 1999.

<sup>180</sup> Central Agency for Healthcare, Committee of Health, and the Ministry of Finance.

(ii) *redesigning equalization transfer mechanism*, taking into account each region's needs and fiscal capacity, in order to create the conditions for access to equal level of health services, and reduce disparities in per capita spending across oblasts;

(iii) *optimizing the level of decentralization in health care service delivery* according to regions, in order to preserve competition among providers, permit economy of scale, and avoid duplication of functions, aiming at maximizing the potential benefits of decentralization;

(iv) *reviewing government regulation that interferes with facilities' management* (including Decree 1314/98), providing managers with freedom to optimize resource mix and making them accountable for results;

(v) *exempting the poor from user fees* in order to promote guaranteed access to basic health care services.

## D. EDUCATION

### Sector Overview

108. Kazakhstan still maintains the main features of the education system inherited from the FSU. Presently, it consists of the following levels and types of education: (i) preschool education (in kindergartens and other preschools for children between 1-6 years of age); (ii) general secondary education (grade 1-11)<sup>181</sup>; (iii) vocational and technical education<sup>182</sup>; and (iv) higher education. According to the Constitution, basic education (grades 1-9) is compulsory and free of charge in public schools. Although Kazakh is the state language, the Constitution also guarantees the use of Russian in public education institutions. Table V.20 presents trends in basic education indicators by level of education between 1991-1998.

109. At present, education is provided predominantly by the public sector, though the number of private institutions at all levels of education has been growing rapidly since the early 1990s.<sup>183</sup> Kazakhstan's education system is highly fragmented due to the devolution of the responsibility for education to separate government bodies.<sup>184</sup> The Ministry of Education has the responsibility for the overall policy and planning, curriculum and textbook development, teacher training, and monitoring for preschool education, general education, and vocational and technical schools. The Ministry of Science and Higher Education is responsible for overall policy and planning for science and higher education institutions. The Ministries of Labor, Health, Agriculture, and several other ministries and state committees are responsible for the remaining vocational and technical schools and higher education institutions, largely in the fields of agriculture, health or in other specialized fields.

### Main Issues and Challenges

110. At independence, Kazakhstan inherited a well-developed education system from the FSU and had comparatively high enrollment rates. Its historically impressive education indicators at all levels of education placed Kazakhstan in the ranks of middle and high-income countries. For example, the adult literacy rate was nearly universal (97.5 percent at early 1990s) and enrollment in basic education (from age 6 to 15) was more or less universal. Of the population aged 15 years and older, over 90 percent have attended eight years of schooling. There was broad

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<sup>181</sup> General secondary education spans grades 1 through 11, and includes three levels: primary education (grades 1-4), lower secondary (grades 5-9), and upper secondary (grades 10-11).

<sup>182</sup> Vocational and technical education consists of two main types of schools: (i) vocational schools (the duration of these programs varies between 1-2 years after the completion of grade 9); and (ii) secondary professional schools (technicums). The duration of a technicum program varies between 3-4 years after completion of grade 9 or 2 years after completion of grade 11. Completion of the technicum provides a certificate of secondary general education, which is also an entrance requirement for higher education.

<sup>183</sup> In 1999, there were 94 private higher education institutions, enrolling about 20 percent of all higher education students. There were also 75 private technical colleges (specialized secondary schools).

<sup>184</sup> In 1997, 23 republican departments had educational institutions subordinated to them (World Bank, 1997, p.156).

equality between the genders in terms of access to education at all levels, unlike the case in many other developing countries. The quality of education as measured by some crude input indicators was satisfactory. The country had an extensive network of educational institutions at levels of education with a large number of highly trained teaching and non-teaching staff. The state financed the provision of free textbooks and teaching materials, clothing, and school meals up to the fourth grade. Teachers were well trained and provided with the necessary educational materials as well as free housing and transport.

Table V.20: Basic education indicators, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998
<b>Pre-School</b>								
Institutions	8,881	8,578	8,053	6,551	<b>5,058</b>	...	<b>1,533</b>	<b>1332</b>
Teachers (000)	86.0	97.6	86.7	70.4	54.9	...	22.2	
Enrollment (000)	1,023	868	747	538	<b>407</b>	<b>323</b>	<b>174</b>	<b>164</b>
								9.1
<b>General Secondary*</b>								
Institutions		8,311	8,395	8,383	<b>8694</b>	<b>8552</b>	<b>8114</b>	<b>8104</b>
Teachers	270.2	282.3	287.5	278.4	<b>274</b>	<b>262</b>	<b>242</b>	<b>246</b>
Enrollment (000)*	3,147	3,127	3,114	3,112	<b>3089</b>	<b>3,122</b>	<b>3,108</b>	<b>3123</b>
					11.2	11.8	12.8	12.6
<b>Vocational</b>								
Institutions	446	439	415	422	<b>404</b>	<b>339</b>	<b>307</b>	<b>319</b>
Teachers (000)				26.2				
Enrollment (000)	203	189	160	160	<b>154</b>	<b>133</b>	<b>111</b>	<b>95</b>
<b>Secondary Special</b>								
Institutions	244	248	247	247	<b>251</b>	<b>245</b>	<b>179</b>	<b>175</b>
Teachers (000)	14.3	13.9	18.6	13.5				
Enrollment (000)	238	231	222	214	<b>199</b>	<b>175</b>	<b>138</b>	<b>121</b>
<b>Higher Education</b>								
Institutions	61	63	68	70	<b>71</b>	<b>59</b>	<b>62</b>	<b>56</b>
Teachers (000)	23.2			27.2				
Enrollment (000)	288	281	272	267	<b>260</b>	<b>256</b>	<b>234</b>	<b>255</b>

SOURCE: Statistical Yearbook of Kazakhstan and Ministry of Education.

\* Includes students in evening general education (1995-98).

111. Nevertheless, at present, Kazakhstan struggles to retain past positive educational achievements, while reforming the education system on the basis of the principles of an independent state and a market economy. The education sector in Kazakhstan is facing five major challenges associated with public education expenditure and financing: (i) increasing inequities in the access to education; (ii) deterioration of the quality of education; (iii) inadequate funding due to sharp declines in budgetary allocations to education; (iv) considerable inefficiencies in the use of resources; and (v) an inappropriate education output mix for an emerging market economy.

a. Enrollment Trends: Declining Public Schooling.

112. Access to education at all levels has become one of the major issues in the education sector during the transition period in Kazakhstan. Table 2 presents trends in enrollment rates by level of education between 1990 and 1997. Enrollment rates have declined at all levels of education except the tertiary level. Preschool education has experienced one of the most dramatic declines in student enrollments in the region during transition. The schooling ratio of the preschool age population dropped from 52 percent in 1990 to 11 percent in 1997, which is one of the sharpest declines in preschool enrollment rates in the region. In 1998, about 143 thousand students attended preschools, dropping from 353 thousand students in 1995. Both demand and supply-side factors are likely to explain these trends. On the supply side, a large number of schools controlled by state enterprises and farms have been closed due to financial difficulties. For example, the number of schools dropped from 4,019 in 1995 to 1,136 in 1998. On the demand side, it is likely that the parental demand for pre-schooling has declined because of increased school fees and unemployment (especially for women).<sup>185</sup>

113. Public schooling in basic education (primary and lower secondary levels) is compulsory and free of charge. According to UNICEF data, the gross enrollment rate in basic education for the relevant age group (6-14) showed a slight drop from 93 percent in 1990 to 89 percent in 1997. Similarly, the gross enrollment rate of the relevant age group (15-18 years) attending upper secondary grades also dropped significantly from 32 percent in 1990 to 27 percent in 1997.

114. At the vocational and technical education level, in 1998 there were 319 vocational schools, enrolling 94,000 students. In addition, 175 state-owned and 71 private specialized technical colleges trained more than 140,000 students. Similar to other FSU countries, Kazakhstan's vocational and technical education system has also experienced sharp declines in student enrollments. The gross enrollment rate in vocational education dropped from 19 percent in 1990 to 11 percent in 1996; and the number of students in vocational education dropped from 154,000 to 95,000. Similarly, the gross enrollment rate in technical education dropped from 20.9 percent in 1990 to 12.6 in 1997. Both supply and demand-side factors appear to have adverse effects on enrollment rates at this level. On the supply side, many vocational-technical schools, controlled by state enterprises were closed during the transition period since state enterprises were closed or reduced their production because of financial difficulties. Between 1995 and 1998, the number of schools dropped from 404 to 319 in vocational education and 251 to 175 in technical education. On the demand side, students for vocational and technical education were less inclined to study in schools which have old-fashioned curricula, lack of basic education materials and supplies, worn-out equipment, and insecure labor market possibilities.

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<sup>185</sup> Klugman, J (1999. Financing and Governance of Education in Central Asia. In Central Asia 2010: Prospects for Human Development. New York: UNDP.

**Table V.21: Trends in enrollment rates (%), 1990-98**

Level of Education	1990	1991	1992	1993	1994	1995	1996	1997
Preschool	52.7	52	45.9	40.9	30.7	24.6	n.a	11.7
Basic	93.1	92.7	91.7	91.5	90.9	90.5	90.0	89.2
General Secondary	31.7	32.3	31.0	28.4	27.0	25.5	24.8	26.5
Vocational	19.1	17.9	16.7	15.0	13.0	12.6	11.0	n.a
Technical education	20.9	20.0	19.0	18.2	17.5	16.4	14.7	12.6
Tertiary Education	13.0	13.4	13.1	12.7	12.6	12.5	12.9	13.4

SOURCE: UNICEF – TransMONEE Database 3.0.

115. In higher education, enrollment rates have fluctuated around 13 percent of the college age population between 1990 and 1997, but the total number of students in higher education has risen by about 15 percent, from 273,000 in 1995 to 313,000 in 1998. The growth in the number of students in higher education can be explained by the exceptional expansion of the private sector. The public higher education has been restructured during recent years, and the number of public institutions has declined from 71 in 1991 to 56 in 1998. During the same period, the number of private institutions has increased from 41 to 88 and the share of private sector students in the total number of students has increased from less than 5 percent in 1995 to 20 percent in 1998. The majority of these new private institutions offered programs in economics, business, law, and foreign languages.

b. Quality of Education: Deteriorating Standards.

116. During the past decade, a range of indicators suggests sharp declines in the quality of education. First, most students lack basic textbooks and other essential instructional materials as the system has failed to invest in these with severe effects on student learning achievement. Some schools do not even have the approved textbooks to implement the syllabuses, even though the textbook is the basic education material. Most schools also lack basic education materials and equipment. Better-resourced schools, mainly in Almaty, appear to have computer rooms, school libraries, and science laboratories. However, computer rooms often contain a small number of old computers supplied around 1986 and science laboratories are often very poorly equipped by Western standards. Schools appear to have adequate libraries, but they often have not received any recent reading materials or books over the last several years. On the other hand, poor schools often do not have even these resources. As a result, both teachers and students are demoralized and have fewer incentives to remain in schools, as physical infrastructures have become more impoverished.

117. Second, a major concern for the quality of education is the continuing use of outdated and overcrowded school curricula and the excessive use of traditional teaching methods, which are not responsive to the needs of a market economy. The education system also lacks a modern student assessment and monitoring system. The assessment is geared primarily towards ascertaining what students can remember and the final examination at the end of schooling is not sophisticated. If the Kazakhstan education system is to prepare students to participate in an international market economy, students' abilities to apply their learned knowledge and skills in

realistic situations must be assessed. The monitoring of the system should focus on students at all levels of achievement, and not only elite students. This is consistent with international trends in assessing student achievements, which are moving from sole emphasis on the top students (e.g. in Olympiads, etc) to the achievements of students across the board (through Third International Mathematics Science Study (TIMSS)).

118. Third, physical infrastructure has been deteriorating over the past decade because the system has failed to invest in physical infrastructure since the breakup of the FSU. The majority of schools, particularly in rural and impoverished areas, need substantial rehabilitation and refurbishment. Many schools have leaking roofs, non-functional heating systems, broken windows, deteriorated blackboards, desks and chairs. Therefore, many schools and teachers particularly in urban areas are trying to cope with the number of students as the system failed to maintain the facilities during the transition period. In the 1998-99 school year, about 41 percent of all general schools operated on two or more shifts. About 33 percent of all students were studying in schools operating on two or three shifts. Two or more shifts make it particularly difficult for many teachers to implement innovative teaching methods. Schools operating on shifts, in an effort to cope with the increased workload, tend to adopt teacher-centered, passive teaching methods.<sup>186</sup>

### **Sources of Funding**

119. Prior to independence, education was largely financed from general revenues. The Ministry of Finance provided all the revenue for all educational institutions based on a set of centrally determined budget norms. Each oblast (and rayon) used to obtain its education budget according to the centrally determined norms.

120. At present, the main sources of funding for the education sector include public sources (i.e., the Republican and local budgets) and non-budgetary resources. In 1999, total public resources (both republican and local) allocated to the education sector is estimated at about 62.7 billion Tenge, i.e., 3.4 percent of GDP, which is slightly lower than the OECD average.

#### **a. Public Funding: Decentralization Towards Local Governments.**

121. The state (consolidated general government) budget is comprised of the republic and local (oblasts and rayons) budgets. Line ministries prepare spending requests in accordance with the relevant budget norms, and submit them to the Ministry of Finance for approval. The national legislature approves the budget law annually, which specifies republic as well as local (oblast and rayon) spending by function as well as subventions for each district. The purpose of the central (Republican) budget is to finance national education institutions controlled mainly by the former Ministry of Science and Higher Education (including higher education institutions, boarding schools, etc). The oblast education budget is used to finance vocational and technical schools. The rayon education budget is used to finance the general education system

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<sup>186</sup> For an overview of deterioration of the quality of education during the transition see Bauer, A., Boschmann, N., Green, D. and Kuehnast, K. (1998). *A generation at Risk: Children in the Central Asian Republics of Kazakhstan and Kyrgyzstan*. Manila. Asian Development Bank.

(preschools, primary and secondary education schools) administered by rayon education departments.

122. Table V.22 presents education expenditures by level and by source of funding between 1997 and 1999. There has been an increased share of the republican budget in the funding of primary and secondary education. For example, the share of the republican budget in the total public primary and secondary education funding has increased from one percent in 1997 to 9 percent in 1999. The republican budget financed 100 percent of expenditures in higher education.

**Table V.22: Education expenditures by level and by source of funding, 1997-1999**

Level of Education	Percentage of Education Budget								
	1997			1998			1999		
	Total	Republican	Local	Total	Republican	Local	Total	Republican	Local
Pre-school	8	0	9	7	0	8	1	0	1
Primary/Secondary	71	5	78	68	19	79	82	72	83
Vocational	4	0	5	2	0	3	4	0	5
Secondary Special	5	2	6	6	3	6	7	4	7
Personnel Training	0	0	0	0	1	0	0	1	0
Higher Education <sup>187</sup>	5	55	0	11	62	0	1	13	0
Other	7	38	3	6	15	4	4	9	4
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
	Percentage of Education Budget by Source of Funding								
	1997			1998			1999		
	Total	Republican	Local	Total	Republican	Local	Total	Republican	Local
Pre-school	100	0	100	100	0	100	100	0	100
Primary/Secondary	100	1	99	100	5	95	100	9	91
Vocational	100	0	100	100	0	100	100	0	100
Secondary Special	100	3	97	100	10	90	100	7	93
Personnel Training	100	9	91	100	50	50	100	33	67
Higher Education	100	100	0	100	100	0	100	100	0
Other	100	53	47	100	43	57	100	22	78
<b>TOTAL</b>	<b>100</b>	<b>9</b>	<b>91</b>	<b>100</b>	<b>18</b>	<b>82</b>	<b>100</b>	<b>11</b>	<b>89</b>

SOURCE: Ministry of Finance.

123. During the transition period, the share of education funding coming from local budgets (oblasts and rayons) has increased substantially, mainly due to a decentralization of education financing. For example, the share of local governments in the total education budget increased from 66 percent in 1990, 75 percent in 1995, and 89 percent in 1999.<sup>188</sup>

<sup>187</sup> The sharp decline in the funding of higher education in 1999 reflects the change in the Government's policy of fully covering the costs of public higher education institutions. The budget stopped funding of higher education institutions and offered students financial aid. However, at the present, it is not clear to what extent the Government has accomplished its cost recovery policy since no data exist to examine the net effects of this change in higher education funding. This warrants further examination in the area of higher education finance.

<sup>188</sup> Bauer, A., Boschmann, N., Green, D. and Kuehnast, K.: *A generation at Risk: Children in the Central Asian Republics of Kazakhstan and Kyrgyzstan*. Manila. Asian Development Bank (1998), page. 58.

b. Non-Budgetary Funds: Cost Recovery by Formal and Informal Student Fees.

124. In recent years, the share of non-budgetary resources has been growing considerably in total education expenditures even though education services are still financed predominantly by the public sector. This practice has been encouraged by both central and local officials to reduce the adverse effect of the sharp decline in public resources for education. For example, in 1994, the government could finance only about 57 percent of the estimated costs of operating the education sector.<sup>189</sup> The recent policy in higher education finance has further expanded the scope for cost-recovery through user fees in higher education. Unfortunately, the present use and extent of non-budgetary resources in the education sector is not yet known. Nevertheless, as a detailed examination of non-budgetary sources of funding is outside the scope of this report, only a brief overview of these sources are presented below.<sup>190</sup>

125. The main source of non-budgetary education funding is formal and informal student fees. Formal student fees have been introduced in public vocational/technical schools and higher education institutions. Public institutions accept a proportion of their students on a fee-paying basis (i.e., contract students). The percentage of students who pay fees in higher education has increased from 10 to 35 percent between 1991 and 1998 (see Table V.23). In 1997, on average, students paid about \$1,000 per year in tuition fees at specialized education and \$1,200 per year at universities.

**Table V.23: Number of students in public higher education by fee payment**  
(thousand)

Type of student	1994	1995	1996	1997	1998
Budgetary	162.5	225.1	207.2	185.9	164.2
Contract (fee-paying)	16.5	28.6	41.8	65	86.7
TOTAL	179.0	253.7	249.0	246.4	259

SOURCE: Ministry of Science and Higher Education.

126. In recent years, many schools also introduced school fees to finance school operations and maintenance or basic educational materials and supplies (e.g., textbooks, school uniforms, school meals) since they are no longer provided free of charge by the state. Local and central education officials have encouraged the collection and spending of these fees at the school level. Private tutoring (i.e., shadow education) has also become very common among middle and upper income families particularly in urban areas to prepare their children for university entrance examinations. Teachers are increasingly subsidizing their negligible salaries through private tutoring after school hours. Some schools also offer "extra-curricular" activities including private tutoring classes to raise additional revenue for financing operation and maintenance. Anecdotal evidence also suggest that some parents are also paying teachers in public schools for extra lessons, or even bribing them to secure good exam marks, or making contributions to get

<sup>189</sup> Akanov, A. & Suzhikova, B. (1998). Kazakhstan. In D. H. Brooks and M. Thant, *Social Sectors in Transitional Economies of Asia*. New York. Oxford University Press.

<sup>190</sup> An analysis of extra budgetary funds and their net effects on education funding and equity are prevented by data constraints.

their children into good schools. The prevalence and extent of such payments raise questions about transparency and accountability in the use of school fees and equity in access to education.

127. The other sources of non-budgetary funding include various traditional and non-traditional sources (such as facility rental, farming, etc.). In response to the fiscal squeeze, all education institutions, including universities and research institutes, are encouraged to raise revenue through consultancies, research or other non-traditional methods. Some public schools, for example, generate resources from communities and parents or by using unorthodox methods of self-financing to provide the minimum inputs for the functioning of schools. Contributions from local enterprises and parents (both in cash and in-kind) have also increased during the transition period.<sup>191</sup>

128. In the case of increasing fiscal difficulties, the Government needs to maintain policies related to non-budgetary funding in the education sector, especially in upper secondary and postsecondary education. However, the question is how the current finance policies can be made more efficient and equitable. In this regard, three funding policies need to be examined. First, it is likely that students from poor and rural families are affected adversely from the increased direct costs of education as suggested by the considerable declines in enrollment rates at the preschool and upper secondary education levels. Second, informal fees raise questions about the transparency and accountability for these revenues and equity for the poor. Attempts need to be made to introduce a more formal student fee policy. Third, cost recovery policies should be accompanied with targeted student financial aid policies.

### **Trends in Public Education Funding**

129. Real GDP in 1995 relative to 1990 declined about 45 percent. Similarly, the share of government revenue as a share of GDP has declined from 36.6 percent in 1996 to 17.6 percent in 1999, as a result of the fiscal retrenchment during the transition.

130. Table V.24 presents the evolution of public education spending as a share of GDP and as a share of total government expenditures between 1991-1999. Although the education budget was relatively protected from budgetary cuts in the mid- and late-1990s, real public spending on education has fallen dramatically as a consequence of the overall decline in GDP. Compared to pre-independence, public spending on education dropped from 7.6 percent of GDP in 1991 to 2.8 percent in 1994, but since 1995 it has fluctuated around 4 percent. In 1999, public spending on education was budgeted to 3.4 percent of GDP. Similarly, the relative priority of the education budget in the total government budget has fallen from about 20 percent in 1991 to about 12 percent in 1992, and since then it has ranged between 16 and 22 percent. In 1999, it was budgeted to about 18 percent of the total government budget.

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<sup>191</sup> Data on the extent and use of private contributions in the education sector are unavailable.

**Table V.24: Evolution of public education expenditures, 1991-99**

<b>Public Education Expenditures</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
As % of GDP	7.6	3.6	4.6	2.8	4.5	4.6	4.4	3.9	3.4
As % of total gov.expend.	20.4	12.2	16.5	15.3	21.6	18.5	15.4	15.3	17.6
In constant prices (1992 = 100)	177	100	100	51	63	49	62	-	-

SOURCE: Statistical Yearbook, 1999, pp. 347-348; Ministry of Finance; World Bank (1997) Kazakhstan Living Standards during Transition.

131. Nevertheless, Kazakhstan compares quite similarly with OECD countries, which have spent, on average, 12 percent of total expenditures and 4.8 percent of GDP on education. This suggests that Kazakhstan has made significant budgetary efforts to keep some resources flowing to education even during the financial crisis. Despite the effort, this meant a sharp decline in real resources available for education compared to pre-transition times (Table V.24). As a consequence of shortage of resources some restructuring (in terms of closure and rationalization of education facilities) has taken place, but there is still a long way to go for the education sector to reach a proper balance between its expenditure needs and resource availability.

### **Patterns of Public Education Expenditures**

#### **a. Education Expenditures by Category.**

132. Except for capital repair and capital expenditures, all other categories of budgetary allocation of education expenditure are based on *norms*, set by the central government. Norms vary by type of institution (e.g., kindergartens, general schools, vocational schools, specialized secondary schools, higher education institutions, out-of-out schools, and internats). Since the collapse of public revenues, the government protects certain items of budget allocation, particularly salaries and social contributions, food, and stipends. The number of staff and salary scales determine the total amount of staff salaries.

133. During the transition, there has been a great concern about the efficient allocation of resources, since almost the entire education budget has been allocated for recurrent expenditures with a particular focus on staff salaries and utilities with little or no funds available for other essential education inputs. For example, data available show that, overall, expenditures on new capital expenditure between 1995 and 1999 accounted for one percent of total public higher education expenditure as the construction of new buildings has almost stopped as the sector has been adjusting to reduced resources (Table V.25). This may indicate that the sector has already had an extensive network of physical infrastructure capacity and new capital investment was not a priority during transition. Nevertheless, anecdotal evidence also suggests that the issue of space availability has become a particular problem in urban areas because of overcrowding. About one-third of schools, mainly in urban areas, are coping with the problem of overcrowding by offering double or triple shifts a day.<sup>192</sup>

<sup>192</sup> Agency of Statistics of the Republic of Kazakhstan. Statistical Yearbook, 1999, p. 83.

**Table V.25: Structure of higher education budget by economic category, 1991-98**

<b>Economic categories</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999*</b>	<b>2000 **</b>
Wages and salaries	36	37	34	44	46	49	44
Utilities	22	29	12	11	13	15	20
Travel expenses	00	00	00	00	00	01	01
Scholarships	24	24	26	31	37	19	18
Meals	02	01	01	01	02	02	04
Equipment and furnishing	01	00	00	01	01	01	01
Repairs and rehabilitation	00	00	00	00	02	01	01
Other	15	08	27	12	00	12	12
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

SOURCE: Ministry of Science and Higher Education.

\* Estimated; \*\* Budget.

134. As shown in Tables V.25 and V.26, available expenditure data also suggest that the structures of recurrent expenditures in education by category have changed dramatically, raising concerns about the increased inefficiency in the use of resources.

135. **Salary expenditure.** In Kazakhstan, wages and payroll contributions accounted for about 50 percent of the total higher education budget in 1999. In primary and secondary education, wages and payroll contributions accounted for between 75 and 90 percent of total education expenditures for a sample of seven selected oblasts. When utility expenditures are also included, around 95 of the local education budgets is spent only on staff salaries and utilities (Table V.26), which contributed to a squeeze on expenditures, crowding out other essential inputs such as textbooks, teacher training, educational materials, and maintenance and operations of schools.

<b>Table V.26: Structure of Oblasts Education Budget *</b>					
<b>(by economic categories of expenditures - in percent of total)</b>					
	1997		1998		Average
	Bil.Tenge**	% of total	Bil.Tenge**	% of total	
Total	4.15	100	3.94	100	<b>100</b>
Salaries and Contr.	3.31	80	3.28	83	<b>82</b>
Meals	0.10	2	0.09	2	<b>2</b>
Utilities	0.44	11	0.27	7	<b>9</b>
Other	0.30	7	0.30	8	<b>7</b>

SOURCE: Ministry of Finance  
 \* sample of seven oblasts: Aktobe, Almaty, Zhambyl, Magystau, Karaganda, Kostanai, and S.Kazakhstan  
 \*\* average of the sample

136. While teacher salaries accounted for a significant share of the total education budget, the level of teacher salaries is low and has also declined considerably since the 1990s. In 1997, salaries in the education sector averaged approximately 6,319 tenge per month (i.e., \$83.80) or 75 percent of the national average compared to 88 percent in 1995. As expected, a sharp decline in teacher salaries had considerable adverse effects on the quality of teaching staff and on the quality of learning, since the deterioration of working conditions reduced the incentives for

teachers to be effective. This situation resulted in a high turnover rate among teachers, particularly among male teachers, as many have left the education sector to earn better incomes in the private sector or in other countries. Low teacher salaries also result in poor teaching because many teachers work for a short time in their jobs or are on extended unpaid leave to hold multiple positions or seek employment elsewhere (e.g., private tutoring, and farming) to supplement their official incomes. It has also been suggested that the poor earning capacity of secondary teachers makes them susceptible to accepting bribes to boost students' marks and to teach below their capacity in order to gain extra money by private tutoring their own students outside school hours.

137. **School meals.** Food used to be a major component of the education budget at different levels of education, i.e., kindergarten, primary schools, boarding schools, vocational schools. Other education institutions also provided subsidized food. However, the budget allocation for food has been declining considerably since independence, though there was a slight increase on school meal expenditures in higher education during the past three years, from one percent to 4 percent. School meal programs are often protected in boarding schools, but they almost disappeared in general and vocational schools. There were some regional variations in meal spending in primary and secondary education. For example, in Almaty, school meals accounted for 1.4 percent of the education budget in 1998, while school districts in South Kazakhstan spent about 4 percent of their education budget on school meals. Similarly, school meals accounted for 1.7 percent in higher education.

138. **School supplies, materials and equipment.** Since independence, the shortage of basic teaching and learning materials is chronic. In the education budget, expenditures on school supplies and materials have been reduced to a very low level. Their cost has been switched to families, many of whom are also facing serious difficulties not only for finding basic instructional materials, but also to pay for them, given the increased rate of poverty during the transition. Similarly, spending on furniture and equipment has also been very low. Very few schools, mostly in urban areas, have access to computers or office equipment, such as copiers and faxes.

139. **Personnel training.** Spending on teaching training has also been declining in recent years. In 1997, spending on personnel training accounted for about one percent of the education budget. Sharp budget declines on teacher training is a concern since the quality of teaching and learning is primarily dependent on a well-qualified and motivated teaching staff, especially to introduce new curricula and teaching methods to meet the new skills needs of a market economy.

140. **Utilities (heating, electricity and water).** In 1999, about 20 percent of the total higher education budget was spent on utilities, which increased from 12 percent in 1996. Similarly, local governments spent a significant share (about 9 percent) of their education budget on utilities, though considerable variations existed by oblast. For example, while in 1998 the Almaty oblast spent about 15 percent of its education budget on utilities, the South Kazakhstan oblast spent only 2 percent. While there is no information explaining the reason for this significant variation in utility spending, it is likely that many of these oblast data are not accounting for the considerable amount of energy arrears accumulated during the last years. Since the sector has a larger number of inefficient physical facilities to operate and maintain, it is

expected that a significant share of the education budget will continue to be spent on utilities unless the issue of inefficiency in the sector is addressed.

141. **Operations and maintenance (O&M).** Although the data do not permit us to analyze the trends in operations and maintenance spending, both education officials and anecdotal evidence suggest that the budget allocations for school operations and maintenance are far from sufficient. The lack of proper maintenance of school buildings for the past decade has been the cause of a serious deterioration of a significant number of school buildings. Especially in rural areas, there are a large number of schools which need to be repaired for leaking roofs, broken windows, leaking pipes etc. This is a serious concern not only because some buildings are accident prone but also because of the impact of delayed maintenance on the future education budget. Furthermore, the allocation of O&M expenditures based on physical norms such as notional class sizes may result in inefficiencies when capacity is not utilized.

b. Education Expenditures by Level of Education.

142. Primary and secondary education accounts for the bulk of total public education expenditures. In 1998, about 63 percent of the total public education budget was allocated to primary and secondary education compared to about 14 percent to higher education (see Table V.27). This is in line with international standards. It should be also noted that the higher education finance policy in 1999 introduced a full cost recovery policy in higher education through student tuition fees and reduced considerably the direct institutional budgetary support. The new policy also included a student loan scheme to support students. As such, there was a sharp decline in the share of higher education in total education expenditures in 1999, though the use and net effects of this new finance policy is still unknown and warrants further examination.

143. Apparently, education resources have been allocated rather inadequately among different levels and types of education during the time of drastic declines in education spending. This is a particularly important outcome, since public investment in basic education is in general expected to generate higher social rates of return as compared to vocational/technical and higher education.<sup>193</sup> The share of public expenditure on primary and secondary education in the total public education expenditures increased substantially from 44.7 to 62.3 percent between 1994 and 1998 (Table V.27). During the same period, preschools and vocational schools have experienced considerable declines in their share in total public education expenditures. The share of public education expenditure on preschool declined by 50 percent from 11.7 to 5.7 percent during the same period. Similarly, the share of public expenditures on vocational education declined from 16.6 to 9.3 percent. Higher education has experienced a slight increase in its share in the total education budget from 11.2 to 14.4 percent, though there was a sharp drop in the past several years. Given the higher social returns to basic education and its role in poverty reduction, it is recommended that the Government should continue to increase its investment in basic education by reallocating resources from preschools, vocational and technical education (including specialized secondary), boarding schools, and higher education.

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<sup>193</sup> The problem is to know whether these expenditure allocations can be really considered investment, or have they just been dissipated in "consumption" of the sector, e.g., over-employment, excess use of energy etc...

**Table V.27: Distribution of public expenditure on education by level of education - 1994-1998**

Level of education	1994	1995	1996	1997	1998
Preschool	11.7	9.8	15	6.8	5.7
Primary and secondary schools	44.7	47.5	52.1	62.5	62.3
Boarding schools	3.0	2.7	2.4	2.4	2.6
Vocational schools	16.6	13.3	13.2	11	9.3
Higher education	11.2	12.5	12.1	12.1	14.4
Other institutions	11.6	12.5	7.5	4.3	4.1
Textbooks	1.0	1.6	1.3	1.8	1.6
Total	100	100	100	100	100

SOURCE: Kazakhstan education authorities, IMF.

144. Although there is not enough data to properly examine trends in unit costs by level and type of education institutions, Kazakhstan's education sector unit costs by level of education appear to diverge considerably as compared to OECD countries, suggesting potential cost savings. For example, Kazakhstan spent about 10 times more per student in higher education than in primary education, compared with 2.5 times in OECD countries.<sup>194</sup> Interestingly, it appears that the unit cost variation between general and higher education was much smaller in 1998. In 1998, Kazakhstan spent about two times more per student in higher education than in general education. Obviously, this may not reflect cost savings in higher education due to increased efficiencies in the delivery of higher education services, but it may simply reflect the shift in higher education funding from public resources to increased extra-budget resources through student fees.

145. In summary, the recent resource shifts in the sector appear to be in line with basic principles of allocative efficiency for maximizing the overall social return of public spending in education. First, the protection of public spending in basic education is likely to help to maximize social rates of return to education spending. As international evidence suggests, social rates of return as well as externalities in basic education tend to be greater than those in other levels of education. Second, the reduction of spending at the preschool level may have not entailed major social costs, since the level of employment, especially for women, is still high. More importantly, the costs of preschool education were likely reduced substantially without any significant adverse effects on students learning since preschool levels also included nursery and childcare for ages 1- 5. Third, the adjustment in public investment in vocational and technical education is also in the right direction to reduce subsidizing inefficient, narrowly specialized training programs. Fourth, the new financing scheme by the republican government for higher education implemented in 1999, which introduced a cost-recovery policy in the form of student tuition fees coupled with a student loan scheme is also in line with achieving a socially efficient and equitable higher education financing system. Providing loans to students instead of institutions also provides incentives for institutions to improve their quality to attract students. In terms of technical efficiency, however, reduction in unit costs across the board (forced by the shortage of resources) have not resulted in improved efficiencies or quality of education services. As discussed later in this section of the report, over-employment and an inefficient use of larger, outdated facilities continues as in the old times.

<sup>194</sup> IMF (1997). Kazakhstan: Public Expenditure Policy. Washington, DC: IMF.

c. Education Expenditure Disparities Among Regions.

146. As noted, the provision of primary and secondary education is primarily the responsibility of local governments. Available data suggest that the current financial crisis has led to growing inequalities in resources for education across regions largely due to extreme fiscal disparity. In 1998, about 43 percent of the local revenue was spent on education, though the poorer regions spent a higher share of their revenues on education. Since local education financing is largely dependent on local revenue capacity, significant regional differences in education spending in real per capita terms have also emerged with a decentralized system of education financing. The range of per student spending on general education was 71 to over 200 percent of the national average. However, there has been a relatively equitable allocation of expenditures between rural and urban areas, since the transfer formula protected rural and sparsely populated areas.<sup>195</sup>

147. Education expenditure as a share of local revenue ranged in 1994 from 23 to 204 percent, with an average of 66 percent and six of the oblasts had education expenditures that exceeded their local revenue.<sup>196</sup> Education expenditure as a share of total local expenditures ranged from 18 to 42 percent, with a national average of 30 percent. Because of wide differences in local revenue capacity and expenditures, the allocation of central transfers based on a funding formula will continue to have a critical impact on the net amount of resources for education available in a particular region. There are no empirical findings on the effect of changes in education funding or financing arrangements on outcome indicators of education.<sup>197</sup>

d. Main Findings in Public Education Expenditures.

148. The public education adjustment to the fiscal crisis has been taking place as follows: (a) budgetary allocation to and spending on education physical capital investment have declined dramatically, and practically became insignificant; (b) recently, recurrent public expenditures have been sustained as a share of GDP, but declined considerably in real prices; (c) a large number of schools (especially preschools, vocational schools, and specialized secondary schools) have been closed; (d) there has been a substantial increase in direct parental expenditures on education (both formal and informal fees and in-kind contributions); and (e) there has been a rapid growth in the number of private institutions.

149. As a response to a sharp decline in resource allocation to the sector, the education budget structure has also changed, as follows: (a) while wage rates remain too low, the share of wages and salary expenditures in the budget have increased and remained too high; (b) outlays on basic education materials and supplies remains too low; (c) expenditures for operations and maintenance have declined dramatically; and (d) recently staff training has received an insignificant share of the education budget, jeopardizing the professional standards of teaching staff and the quality of education.

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<sup>195</sup> Klugman, 1999, p.164.

<sup>196</sup> ADB, 1995.

<sup>197</sup> Klugman, 1999, p.169.

## Managing Public Education Expenditure

150. This sub-section draws attention to public education expenditure management in Kazakhstan by focussing on budget formulation, execution and monitoring, setting the stage for the assessment on how efficient and accountable this process is.

151. **Budget formulation process.** Over the past decade, local governments have been increasingly responsible for managing and financing both general education and vocational education schools. However, local authorities are largely bound by centrally-determined standards and budget norms since the Ministry of Education and Science still has the overall responsibility for determining them, including curricula (types and number of subjects, programs, schools), and physical budgetary norms (e.g., average class size, number of teachers).

152. Despite recent innovations, budgetary formulation of both republican and local education authorities continues to a large extent depending on the system of planning *norms*.<sup>198</sup> The Ministry of Education and Science (MOES) prepares spending requests in accordance with the centrally determined budget norms, and submits them to the Ministry of Finance for approval. Out of the total resource allocation, the Ministry of Finance determines the education budget, according to what was requested but constrained by expected revenues. Since, during the last decade, expected revenues in general fell short requested expenditures, funding was often available for a limited number of budget items (basically, salaries, payroll contributions, and a few protected budget items such as food).

153. Based on local information and budget norms (e.g., class size<sup>199</sup>, staffing, and building norms), the MOES drafts the education budget. For example, the number of notional class size determines the number of teaching positions required. Wage scales are set by presidential decree for the entire country. As a result, local administrations have little flexibility to formulate and execute budgets at the local level even though they are formally independent of central government ministries.

154. Since local expenditure responsibilities generally exceed their own revenues, local governments receive categorical grants or transfers to finance the difference (between revenues and expenditures). For example, in 1996, education expenditure as a share of local revenue ranged from 21 percent to 204 percent of a national average of 66 percent.<sup>200</sup> Therefore, the central government has a critical role in making central transfers to help finance education and also in minimizing regional disparities in expenditure.

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<sup>198</sup> During the Soviet era, norms were applied strictly to allocate resources to ensure the provision of similar quality of services across regions.

<sup>199</sup> "Class-complexes or "notional class size" is notional rather than on the basis of actual student enrollment. The main purpose of the use of notional class sizes in determining the education budget is to take into account the disparities in population density. Through this method, rural schools with small average class sizes (e.g., 5-7 students per class) will receive about the same amount of revenue from public resources as urban schools with large class sizes (e.g., 35-40 students per class). (World Bank, 1997, p.169).

<sup>200</sup> Klugman, 1999.

155. **Budget execution.** Actually, the gap between initially-planned education budgets and actual expenditures tended to be large because of further revenue shortfalls during the course of budget execution, reflecting significant budget cuts and payment arrears. Education budgets are executed at the oblast and rayon levels, according to budgeting guidelines prepared at the central or oblast levels. Full payment of wages and food (especially for boarding schools) are among priorities in both budget planning and budget execution, although payment of arrears have been reported in many regions over the past several years.<sup>201</sup> Arrears to state-owned utility companies (fuel, power and water) are also reported. While the budget should in theory be implemented strictly according to the centrally determined norms and budget categories, local authorities appear to exercise some autonomy in budget execution. For example, they have been flexible in reallocating “non-protected” budget resource items and in changing the centrally set class size norms, especially in urban areas.

156. This decentralization process has not been smooth however, and several problems have emerged in the delivery of education services. First, although a minimum level of expenditure allocation on education is enforced on local authorities by the annual state budget law, the poorest local governments are not always able to meet this financial obligation, and have to engage themselves in negotiation with the Ministry of Finance for subventions.

157. Second, tensions and frustrations have been created because the funding formula, which determines the amount of subventions, is not based on transparent and objective criteria. As a consequence, in general, education resource availability has not been predictable as desirable and largely depends on the negotiation skills of oblast administrators.

158. Third, while financing and implementation is decentralized, education policy decisions still remain fairly centralized, despite the insufficient technical capacities for budget formulation, monitoring and evaluation for the sector as a whole. The MOES has direct control over education policy (by determining budgetary norms and standards) and over management-related issues, which determine local budget and spending priorities. Probably because of insufficient technical capacity, the MOES has made decisions with major financial implications but in isolation from the MOF, and without full and accurate assessment of the costs and benefits associated with alternative education service production decisions. Consequently, the MOF and the local oblast and rayon departments of finance appear to have the decision-making power in terms of resource allocation, even though they have very weak technical capacity for examining the use and impact of resources or monitoring performance of education institutions.<sup>202</sup>

159. Fourth, despite the attribution of increased responsibilities on education management and finance, local authorities are generally constrained in their decision making and lack of right incentives to introduce efficient use of scarce resources. For example, budgeting based on physical norms still provides perverse incentives for local authorities and schools to maintain overly specialized schools, and schools and programs with small enrollments. As a result, in

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<sup>201</sup> In addition to the public budget, some schools may have additional non-budgetary revenues to supplement teacher salaries or to procure school supplies and materials. However, these non-budgetary resources are not reflected in the formal local or state education budget and are difficult to quantify.

<sup>202</sup> ADB, 1995, Annex 2; World Bank, 1997.

reality, there has been very little effort to rationalize the excess physical capacity at local levels, and the number of teachers has increased considerably during the past decade despite the fact that Kazakhstan has one of the lowest student-teacher ratios in the world.<sup>203</sup> The legal obligation to prioritize wage payments in case of resource shortfall is another example of undue micro-management from the top.

160. Finally, local administrators are, in principle, not permitted to reallocate expenditures between budget categories under the present funding system, preempting any incentives to reallocate resources between items, especially from wages and utilities to other essential inputs (such as textbooks and teaching materials).<sup>204</sup>

### **Efficiency and Effectiveness in the Delivery of Education Services**

161. One of the legacies of the FSU education system is its operational inefficiency in the context of a market economy. The main source of inefficiency arises from the excessively large number of both teaching and non-teaching staff that the sector employs, without adding too much to the quality of education. The same is also the case with regard to the extensive use of outdated infrastructures. Since the recurrent budget is almost entirely consumed by salaries and utility expenses, it is essential to evaluate staffing and infrastructure expenditure patterns of public education aiming at improving efficiency in the use of resources and enhancing the quality of education services.

#### **a. Staffing Patterns.**

162. Student-teacher ratios at all levels of education are low by international standards. At the primary and secondary education level, the student-teacher ratio in 1998 was 12.6 students per teacher as compared with an average of 16.3 in OECD countries (see Table V.28).<sup>205</sup> This low student-teacher ratio is also a reflection of small-scale schools in rural and remote areas and over-crowded and specialized school curricula. For example, the ratio varied from 10.3 in Western Kazakhstan to 17.6 and 15.4 in Astana City and Almaty, respectively. Similarly, student-teacher ratios are also very low in vocational/technical and higher education by international standards. For example, the student-teacher ratio in the 1998-99 school year was only 9.7 in vocational schools as compared with 16.7 in OECD countries. Student-teacher ratios in vocational education also varied by oblast, from 7.0 in the Almaty oblast to 16.7 in the Kostanai oblast. In higher education, the student-teacher ratio was 9.9 as compared with 14.4 in

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<sup>203</sup> Introduction of Kazakh as the language of instruction after independence is likely to have contributed for an increase in the number of teachers (Klugman, 1999).

<sup>204</sup> Despite this restriction in budget guidelines, it is reported that many local authorities reallocate the "non protected" budget items (largely operating expenses except salaries and food) between line items (World Bank, 1997, p.155).

<sup>205</sup> Student-teacher ratios are based on the number of teacher positions, not on the actual number of teachers. It is likely that this ratio will be higher if teacher positions are replaced by the actual number of teachers. For example, it was estimated that in 1997 the student-teacher ratio would be 16.7 if the national average of 1.5 positions per teacher is used (IMF, 1997, p.60).

OECD countries. These low ratios also reflect the existence of a large number of narrowly specialized programs and institutions.

163. Teaching loads are also very low by international standards, although the government increased the teaching load from 14 hours a week to 18 hours a week in 1997 at the secondary level and from 16 hours a week to 20 hours a week at the primary level in 1997. However, these working loads are still below other OECD countries (e.g., in Germany, 24 hours per week).<sup>206</sup>

**Table V.28: Student/teacher ratios for selected countries by level of education**

Country	Primary and Secondary Education <sup>(a)</sup>	Vocational Education	Specialized Secondary Education	Higher Education
Kazakhstan <sup>(b)</sup>	12.5	9.7	9.5	9.9
Kyrgyz Republic	15	15	n.a.	7
Japan	16.1	n.a.	n.a.	n.a.
USA	16.7	n.a.	n.a.	14.4
UK	15.5	n.a.	n.a.	n.a.
Turkey	23.7	n.a.	n.a.	21.5
OECD Average	16.3	16.7	n.a.	14.4

SOURCE: OECD (1997). *Education at a Glance: OECD Indicators 1997*; Rysaliev and Gibraeva, G. (1999); *Educational Financing and Budgeting in Kyrgyzstan*, IIEP, Ministry of Education.

<sup>(a)</sup> The data are for general education, which includes primary (grade 1-4), lower secondary (grade 5-9) and upper secondary (grade 10-11).

<sup>(b)</sup> The data are for the 1998-99 academic year.

164. In Kazakhstan, the composition of staffing in the education sector is also a source of inefficiency. The high share of non-teaching staff is one of the main factors contributing to the inefficient use of resources available for education. A reduction in the number of non-teaching staff, and the use of the savings with an improvement in teachers' wages and non-wage items such as training, textbooks and educational materials, could improve the performance of those teachers who remain and of student learning achievement.

165. In response to the budget squeeze, necessary adjustments have taken place through the combination of reduced real wages and wages arrears without any significant change in staffing patterns (employment level and composition). The numbers of both teaching and non-teaching staff have been broadly maintained during transition. Yet, the share of personnel expenditures in the total education budget is around international averages of 80-90 percent since teacher salaries are very low. There are two likely explanations for the absence of a teacher drain despite a dramatic decline in teacher salaries. First, most teachers engaged themselves in secondary income generating activities on a part-time basis without leaving their positions. Second, there is also lack of employment alternatives in the labor market, especially for women, who account for about 80 percent of the teaching staff. In order to improve the quality of teaching and learning, attempts should be made to reduce the share of salaries within total education expenditures in

<sup>206</sup> IMF (1997). *Kazakhstan: Public Expenditure Policy*. Washington, DC: IMF.

favor of other essential education inputs (teaching materials and equipment) and other items, such as school repair and rehabilitation.

b. Physical Infrastructure.

166. There are two main aspects of efficiency in physical infrastructure. First, *space utilization* can be a source of inefficiency. Some official data suggest the existence of the shortages of schools particularly in urban areas. For example, about one-third of schools, especially in urban areas, operate on double or even triple shifts because of the shortage of school buildings. Anecdotal evidence, however, also suggests that space utilization is inefficient, large school buildings, small-class sizes (resulting from over-specialized subjects, programs, and institutions) all contribute to inefficiencies in space utilization.

167. Second, the *cost of utilities* is a major source of inefficiency and a concern for the education sector. Like in the other ex-Soviet republics, operation and maintenance costs of most educational facilities in Kazakhstan are very high since most school buildings generally operate inefficiently. In many cities, public buildings (including schools) were heated through a central public heating system, but schools are not insulated well enough for heating. Water and heat pipes are often rusted and leaking. Electricity and water are also wasted due to a lack of proper price incentives and appropriate measurement instruments (e.g., individual meters). Since independence, utilities have been included in school expenditures, and have risen at the expense of other educational input, causing a shift in the pattern of expenditures.

168. There are various policy options that the authorities could consider to reduce the cost of utilities under the given circumstances. In the short run, installation of measurement instruments for electricity, water, and gas should improve control and provide incentives for reducing the operational costs in the sector. In the medium term, policy options include: (a) rationalization of the existing physical facilities; and (b) improving space and heating efficiency in the remaining facilities. In this regard, a government physical infrastructure strategy needs to be developed.

### **Main Issues and Policy Options**

169. In Kazakhstan, both the coverage and quality of education have deteriorated as a result of the fiscal retrenchment the country underwent over the past decade. Given the importance of education for both poverty reduction and economic development, policy reforms must be implemented soon to increase efficiency in the use of the scarce given resources, improve the quality of education services and reduce inequities in access to education. The government has already addressed some of the problems in the education sector by reprioritizing a significant share of its education budget.

170. It should be observed that the required alleviation of the current financial constraints for a significant, sustainable improvement of the education sector crucially depends on the resumption of economic growth and on the distribution of the gains across the population. In the meantime, the policy focus should be to improve efficiency in the use of the scarce available resources, aiming at preventing further deterioration in the coverage and quality of education services, particularly in basic education, while improving equity.

a. Improving Equity in Education.

171. The evidence of the last decade seems to suggest that in Kazakhstan the sharp increase in poverty rates and the changes in education funding (reduction of public resource availability and introduction of formal and informal fees for many education-related services) have reduced school participation rates particularly for children coming from poor households.<sup>207</sup> To revert this trend and to contribute to reducing poverty in the medium term, it is fundamental that the poor have guaranteed access to quality education, especially at the basic educational level. In this sense, it is important to plan education expenditure priorities having in mind the special educational needs of the poor, and the conditions required for their access to education services.

172. ***The educational needs of the poor.*** About one-third of all households are considered to be below the poverty line.<sup>208</sup> Children from poor families and rural areas face considerable problems of access to education, including due to recent changes in funding patterns. Poor families are increasingly unable to meet the rising direct costs of education. The same is true of children in many rural areas where school quality has deteriorated dramatically by shrinking public resources. Policy options targeted to the poor include provision of: (i) free of charge basic education materials (e.g., textbooks and school uniforms); and (ii) a student loan scheme for higher education students.

173. ***Regional and rural/urban variations in access to education.*** There are growing inequities among regions as a result of a sharp decline in central government funding and an increasing dependence on private contributions from parents and community sponsors to meet essential costs. Budgetary allocation mechanism needs to be reformed to address regional variations in the adequacy of fiscal capacity for education funding. If funding is provided to schools on a per pupil basis, consideration could be given, for example, to weighting the capitation formula according to the poverty level of the local community.

b. Improving the Quality of Education.

174. Preliminary evidence has suggested that the quality of education at all levels has deteriorated during the transition period. To improve the quality and relevance of education, priority should be given to the following options.

175. ***Provision of basic education materials and supplies.*** New curricula and teaching methods are yet to be introduced to meet the new skill demands of a market economy. They must also be supported with appropriate textbook instructional materials, which necessitate the development of new textbooks to meet current standards. Sufficient resources need to be allocated at the primary and secondary education levels to address the shortage of basic instructional materials and supplies by reallocating resources from preschools, boarding schools, vocational schools, and higher education.

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<sup>207</sup> Klugman (1999).

<sup>208</sup> Kazakhstan Living Standards During the Transition. World Bank. Report No. 17520-KZ.

176. **Provision of teacher training.** Continued influence of the Soviet system of passive teaching methods needs to be changed and to achieve this it requires exposure to teaching practices in overseas countries. As new teaching methodologies require a significant change of the educators' 'mind set', it is important to provide mentoring support in developing and implementing the teacher in-service program. Another concern related to teacher training is the nature of training necessary for implementing the integrated curriculum. Most current secondary teachers have a single subject teaching, which means they can teach either mathematics or chemistry but not both. Both pre-service and in-service teacher re-training programs have to consider an appropriate combination of subject areas and prepare sufficient numbers of teachers to handle the new integrated subjects.

177. **Introduction of a new system of student assessment and monitoring.** The overall thrust of these reforms should be to reorient student and school assessment from mainly monitoring inputs to education (e.g. teachers, number of students) to a system which monitors inputs, teaching and learning processes (e.g. teaching and learning methods and their flexible application) and outcomes (what knowledge and skills are acquired by students and how these are relevant to the labor market, the requirements of the higher education system, and societal goals). Shifting from input-based assessment and monitoring to a system based on inputs, processes and outcomes will take time, as it requires a major change from rigid administrative measures of control to a more flexible system of standard setting and guidance suited to the needs of a market economy.

178. **Improving management capacity.** Overall, the Ministry of Education and Science or local education departments appear to have weak institutional capacity to support tasks such as policy development and planning, curriculum development, monitoring and assessment. This leads to considerable inefficient use of available resources in the education sector. Most importantly, the fragmentation in the management of education institutions hampers the formulation and implementation of a consistent education policy and leads to duplication of facilities, particularly for vocational and technical education (VTE) and higher education. As a result, considerable potential scale and scope economies are lost. In response to these problems, efforts need to be made to improve management and policy development capacity of the Ministry of Education, local education departments, and schools.

c. Improving Efficiency and Ensuring Financing Sustainability.

179. Recovery of public resources for education on a sustainable basis is crucially dependent on the resumption of economic growth, but immediate and increasing attention needs to be given to the existing policy opportunities to improve efficiency in the use of available resources. Better use of these resources can provide much leeway to improve the quality of education on a sustainable basis. Some policy options may include the following:

180. **Improving efficiency in the use of available educational resources.** The government has begun restructuring the education system by reducing the number of staff and inefficient schools (e.g., the closure of a larger number of preschools). However, there is still much scope for exploring the several available policy options, such as:

*Reducing the number of teaching and non-teaching staff.* Implementation of a public service reform to reduce the number of teaching staff to increase student/teacher ratios, average class sizes and the actual teaching load at all levels of education. This option should be accompanied by a corresponding increase in the average compensation levels of those who remain. A radical reduction in the number of non-teaching staff at all levels of education can also be a significant source of cost savings.<sup>209</sup>

*Continuing to reduce the existing excess physical capacity.* Despite some progress, there is ample room to further rationalize the existing educational facilities through merging or eliminating some schools or programs with no or low student demand (e.g., vocational schools, boarding schools, and higher education institutions that are underdeveloped with declining enrollment or that significantly overlap with other institutions). Consolidating or eliminating some educational and research institutions with no or low student demand can achieve economies of scale and scope. Scope economies (e.g., sharing common resources such as common curricula, library, and laboratory facilities, across various vocational/technical education and higher education institutions) are likely to be achieved by restructuring the delivery and organization of public secondary specialized, higher education, and research centers, many of which are small scale, narrowly specialized institutions across the country.

*Improving space utilization and heating efficiency.* This can be achieved through several initiatives: (i) rationalizing the existing educational facilities through consolidation and closure; (ii) rehabilitating a selective number of the remaining educational facilities which are often in poor operational condition; (iii) improving the efficiency of the existing educational facilities through more efficient use of space (e.g., reconfiguration to reduce hallway space), increasing energy efficiency of structures (e.g., use of insulation; examining alternative heating options such as independent boilers and space heaters; improving workmanship on windows and other areas); (iv) designing and reconfiguring existing schools into multifunctional schools – particularly in rural areas – so that general schools incorporate rooms for kindergartens, schools, community centers and other functions; and (v) examining school locations and alternative options for school provision (e.g., bussing students between villages which are accessible to one another).

181. *Improving budgeting and the resource allocation process.* Public educational resources can be allocated on the basis of students (inputs) rather than notional class sizes or physical norms. Implementing a more flexible and decentralized school finance policy as well as a system of accountability in the use of resources is needed to improve efficiency in the use of resources. The education system clearly needs improved financial management processes and skills. Transparent financial reporting processes also need to be incorporated into the management information system. A new education finance policy also needs to pay particular attention to the development of an equitable funding formula to ensure that children in rural impoverished regions will not be disadvantaged.

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<sup>209</sup> Anecdotal evidence suggests that Kazakhstan may not differ significantly from the regional standard that about one third of labor cost is spent on non-teaching staff.

182. ***Reducing excessive reliance on state funding.*** Although the new law and reform proposals promote the possibility of raising additional non-state revenue by state schools and the developing private sector, the education sector is still predominantly dependent upon public resources. Policy options include the diversification of sources of revenues in the sector to move away from an excessive reliance on the state. Alternative funding sources, some of which are already in place, are:

*Cost-sharing through user charges*, including: (i) introducing selective user charges and tuitions, particularly in higher education; (ii) charging students for boarding, meals, educational materials, and other student activities; and (iii) introducing a student loan and targeted need-based financial aid for higher education students.

*Income generation from goods and services*, including: (i) teaching services to non-students (e.g., extension or continuing courses for working adult students); (ii) sale of education and research-related products (e.g., books, inventions, farm products); (iii) selling of consultancy services; and (iv) privatization of various non-education related services (e.g., dorms, cafeterias, health care).

*Increased parental and community resources.* Parental and community support may include not only cash or in-kind gifts or donations, but also after-school activities, the restoration of other aspects of schools' social support, and maintaining school quality particularly in rural areas.

183. ***Creating conditions for the development of the private sector.*** Significant progress has been achieved in the development of private institutions in the education sector. But further encouragement of the private sector to provide education services is an attractive policy option without any burden on the public budget, while offering parental choice and competitiveness in the education sector. The share of students in private education institutions can also be increased through continued promotion of student loan schemes. There is also a particular need to expand the private sector in general and vocational/technical education, since there are only a few private general schools. Public policies addressing issues related to the development of the private sector include the establishment of an appropriate regulatory framework that would be conducive to encouraging private sector investments in the education sector in Kazakhstan. Currently, private institutions are required to have licenses from the Ministry of Education, but the Ministry does not have the technical capacity to regulate private education institutions in terms of accreditation or quality control. Policy actions need to focus on refining and reforming the framework for private sector participation in education at all levels of the system, including quality assurance procedures (e.g., accreditation), tax treatment of private sector schools and universities, and admission procedures and policies.