

Budget Support for Decentralisation **in the Kyrgyz Republic**

A Roadmap for the Swiss State Secretariat for Economic Affairs (seco)

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A meeting on fiscal decentralisation with Atabekov Aiyl Okmotu

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Comments welcome
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Executive Summary

1. The terms of reference defined as overall **objectives of the mission** to the Kyrgyz Republic to

- Assess the overall context of local governance and fiscal decentralisation, its opportunities and risks;
- Prepare a framework and/or a roadmap for a future seco commitment in the area of local governance and fiscal decentralisation;
- Identify options for implementation of the seco support;
- Clarify the relationship of the project proposal to the World Bank and other donors working in the same area.

Context of local governance and fiscal decentralisation

2. The Government of the Kyrgyz Republic has a **clear commitment to local governance and decentralisation**. The new Kyrgyz Constitution of 2003 contains basic principles on deconcentration of the state administration and on local self-government. The legal framework for local self-governments includes 10 laws, 50 presidential decrees, over 30 government resolutions, and other legal documents. As a landmark event and unique in Central Asia, in 2001 the first elections of leaders and members of local councils were held in all villages and towns under rayon subordination. The election of totally 8'184 deputies of various levels were so competitive that 44 percent of the – formerly appointed – Ayil Okmotu heads were changed. The next round of local elections is scheduled for October 10, 2004. Even taking into account that reality is lagging behind legislation, these developments within few years only indicate a radical departure from the former Soviet type centralist system of governance.

3. As **major challenges** in fiscal decentralisation have been identified: Blurred delineation of responsibilities of and expenditure by sub-national governmental and administrative units; inappropriate revenue mobilisation and distribution across government levels; erratic and non-transparent system of intergovernmental transfers; unpredictable implementation of existing rules in fiscal decentralisation; weak capacities at the local Ayil Okmotus; insufficient revenues for the local entities. These challenges are known and substantial efforts are made to remove the weaknesses.

Framework for a future seco commitment

4. The overarching goal of seco interventions is poverty reduction to contribute to achieve the Millennium Development Goals (MDGs). Experience of local governance programmes demonstrates that specific and targeted measures are required to make decentralisation instrumental for poverty alleviation. More specific **objectives** are

- Capacity building in budget formulation, execution and monitoring at the level of Ayil Okmotus (local government, Kenesh, civil society);
- Enhancing legal literacy including legal instruments to defend the rights of Ayil Okmotus (local government, Kenesh, civil society) and their population;

- Strengthening the financial capacity and accountability of local government institutions to fulfil their key tasks;
- Contributing to a conducive framework for fiscal decentralisation and local governance at the national level (design, implementation and monitoring of laws, policies, transfers).

5. The Kyrgyz Republic is at an early stage of transformation from a highly centralised government to a decentralised system. This complex situation requires interventions at several entry points. External support should be tailor made which leads to the use of a **package of instruments** to increase the leverage and effectiveness:

- Technical assistance for capacity building in view of fiscal and legal literacy;
- Budget support at the national and local levels to enhance financial capacities and lead a meaningful policy dialogue at all levels;
- Support to civil society initiatives at the national and local level. Social mobilisation will keep the authorities accountable to the population.

6. The strategic orientation of Switzerland in **budget support at the national level** should aim at the creation of a group of donors providing programme aid. Among the bilateral agencies, potential bilateral partners are the European Commission, DFID and the German Kreditanstalt fuer Wiederaufbau (KfW). As the experience of other countries demonstrates, also the World Bank might join such a group. An inclusive approach of the World Bank towards interested bilateral agencies when preparing and negotiating the Poverty Reduction Support Credit (PRSC) could facilitate consensus among donors on key concerns and programme priorities. Even if the World Bank would choose not to join such a group for one reason or another, the creation of a group of at least three bilateral donors would still be a worthwhile parallel and non-competing but re-enforcing exercise with the potential of others joining later on. The World Bank's PRSC preparation and negotiation process provides an excellent vehicle to move forward. The PRSC is general budget support, linked to a number of conditionalities around which policy dialogue takes place. The World Bank envisages to have two sets of conditionalities in place with the PRSC in preparation. One of the two key topics is intergovernmental finance. Therefore, policy dialogue on fiscal decentralisation will take place related to the PRSC. PRSC preparations are only beginning, it is a real opportunity to participate in the upcoming process right from the start.

7. The **approach** recommended to seco includes three determining elements:

- The allocation of budget support to Aiyl Okmotus requires the fulfilment of five **preconditions** at the local level. The capacity has to be there to meet the following standardised requirements: (1) Baseline assessment is done; (2) the Aiyl Okmotu drafts annual budget, accounts and audit as well as the L-PAF (see below) and monitors the implementation of the annual programme; (3) the Aiyl Okmotu submits the annual budget, accounts, audit and L-PAF to the Aiyl Kenesh and reports quarterly on budget execution to the Aiyl Kenesh; (4) Public hearings on the budget take place in an orderly manner; (5) Full transparency of the public administration is guaranteed by the local authorities to all citizens at all times.
- The allocation of budget support requires a common understanding on the basis of a **Performance Assessment Framework (PAF)**. At the local ("L-PAF") and at the national (N-PAF) levels PAFs are the main instruments to shape transparency and accountability in order to increase development outcomes. Sustainability

should be taken into account and additionality secured by including targets for the collection of local revenue and intergovernmental transfers. The PAF is a proposal by the partner government, comprising a selection of key objectives, actions and indicators for the last, current and subsequent year, against which performance is assessed. It reflects the partner's local or national needs and priorities.

- **Gender sensitivity** across the package should make sure of a high degree of women's participation. Among the poor, the majority are women. Target audience of trainings are in particular women among authorities, staff and population. Gender sensitive budgeting is an issue in budget support.

8. A nationwide coverage is beyond the means of seco and a **regional focus** is indispensable. It is suggested that in application of a set of criteria two Oblasts are selected, one in the North and one in the South. Selection criteria to be taken into account in prioritising pilot oblasts/rayons and within them pilot Aiyi Okmotus are

- High poverty incidence
- Economic potential of the region
- Expressed interest by the beneficiaries
- Cooperative attitude of Oblast and Rayon administration
- Synergies with other efforts
- Mixed selection (North – South)

9. **Phasing:** In the pilot phase of 2005, within each Oblast two Rayons get priority for the provision of technical assistance, with the option to work with most – ideally all – of their Aiyi Okmotus. In 2005 or 2006, when the World Bank has a PRSC in place, a group of programme aid partners including Switzerland could negotiate an agreement to provide budget support at the national level. Civil society support at the local and national level is started. For 2006, the geographical coverage for technical assistance should be doubled by adding another two Rayons in each Oblast. Budget support at the local level is added on a pilot basis for Aiyi Okmotus. The civil society component is continued. If positive experience permits, another step forward in geographical coverage will be done in the scaling up exercise of 2007. The scaling up should remain within the selected Oblasts, if needs and effectiveness justify, and increase the number of Rayons to overall 14 (4/2005 + 4/2006 + 6/2007).

10. **Financial implications:** Very preliminary estimates indicate costs for
2004 of CHF 100'000 for programme preparation;
2005 of CHF 2'500'000 for technical assistance, PRSC contribution, civil society
2006 of CHF 3'500'000 for as in 2005, plus budget support at the local level
2007 of CHF 4'000'000 for comprehensive and scaled up package
Seco should see decentralised budget support as a long term commitment and therefore be inclined to continue beyond 2007. The volume of support would continue at about CHF 4 – 5 million per year.

11. **Beneficiaries:** The number of Aiyi Okmotus within a Rayon varies between 5 and 18, with an average of 12. The population living in Aiyi Okmotus varies again between 1'000 and 35'000, with an average of 6'500. Therefore, it is expected that the technical assistance component and local budget support of the seco package will cover 168 Aiyi Okmotus, benefiting indicatively around 1'000'000 people. The national budget support component indirectly benefits all 5'000'000 inhabitants of the Kyrgyz Republic.

Options for implementation of the seco support

12. Three **basic principles** are to be observed for implementation:

- The arrangements will have to make use of existing institutions and structures and should not weaken them by establishing competing programme structures;
- The arrangements should be flexible in order to be open to welcome other donors joining this new channel of decentralised budget support;
- The arrangements should take relevant experience made in other countries into account.

13. **Contracting partner(s)** in the Government of the Kyrgyz Republic should be the Ministry of Finance (MFKR) as the “natural” partner in intergovernmental finance. This choice will facilitate later on the transition to General Budget Support. The PRSC will also have the MFKR as a partner. However, the Ministry for Local Self Government (MLSGKR) should have a role in the arrangement with seco as well. It would be advisable to have them co-signing the agreement.

14. **Implementing partner(s)** have to identified as seco does not maintain an operational structure. Ideally, one strong national partner would tackle the implementation of all elements of the package with seco concentrating on the political issues (policy dialogue) and the strategic development of the interventions. The implementing partner should be identified through negotiation or a process of a public tender.

15. An alternative option is to **untie the seco package** and to have separate and specialised implementers for one or a combination of national technical assistance, local technical assistance, national budget support (PRSC?), local budget support, civil society initiatives at the national and local levels.

16. The creation of a small but highly profiled **advisory group** to the programme should be explored. Members are nominated in their personal capacity and not as representatives of their institutions (Government, NGOs, Universities, donors, other). Clear terms of reference for the advisory group will have to be developed to make sure an optimal use of their potential contribution. It could serve as a sounding board for its orientations and review.

Relations to other donors

17. During the discussions with the Kyrgyz Government steps forward in donor coordination were formulated as an urgent concern, and Switzerland was seen as a potential leader in such an effort. To get an overview on the on-going efforts in donor support to fiscal decentralisation in the Kyrgyz Republic the Swiss Cooperation Office invited DFID, the EC, KfW, USAID/Urban Institute, the IMF, UNDP and the World Bank to a donor round table for May 12, 2004. The **key messages** of the meeting were

- Quite a number of activities in fields relevant for fiscal decentralisation are on-going;
- Exchange of information and experience in decentralisation would be an asset for all agencies active in that field;

- There is a will for more coordination in (fiscal) decentralisation among donors;
- Switzerland is prepared to take the lead if the programme proposal which is in preparation will be accepted by seco.

18. Pending a positive decision by seco, Swiss Cooperation Office should make a serious effort to win the other donors who are working in the field of decentralisation as **cooperating partners**. A regular exchange of experience with the other agencies will secure in-country access to a wealth of information. Two special concerns:

- The World Bank's PRSC in particular is a vehicle and an opportunity to move donor coordination forward. DFID is considering to align to the PRSC. Switzerland should negotiate with DFID, the EC and KfW with the vision of a like-minded programme aid partners group in mind. The PRSC-linked policy dialogue on intergovernmental finance may attract other donors and encourage them to join the efforts.
- SDC is about to develop a new programme in Local Governance which is supposed to become operational in 2005. On the occasion of a presentation of the findings of this mission to SDC in Bishkek a spontaneous interest was shown to consider a project design which fits into the seco budget support approach in view of a well coordinated and complementary seco/SDC programme.

The roadmap ahead

20. The **preparation period 2004** includes the following steps:

- Swiss Cooperation Office in Bishkek works on the pending issues and provides the information required, in particular on the regional focus and its implications;
- Swiss Cooperation Office explores terms and conditions of cooperation with potential development partners (Government at central, oblast and rayon levels, cooperation with other donors, partnering with NGOs for the implementation of specific parts and/or the overall package);
- An entry decision ("Eintretensentscheid") by seco is taken in October 2004;
- With the perspective of a start early in 2005, preparation is taken at hand: Working on first drafts of formal agreements, drafting terms of reference for implementing organisations, finalizing technical assistance concepts based on experience made by other actors, reviewing and improving teaching material; etc.
- Seco uses the opportunity of the Consultative Group meeting in October to make its entry decision known, to deepen discussions with the Government and donors, and to lobby for a strong statement on the Kyrgyz' Government commitment to decentralised governance and fiscal decentralisation;
- Seco takes a formal decision not later than December 2004;
- Formal agreements are negotiated with the Government and the implementers; if needed, a public tender to decide on an implementing agency is done early 2005;
- Implementation starts in spring 2005.

21. Fiscal decentralisation and local governance are not only an excellent area for a Swiss intervention. It is also very timely to contribute to the fast moving process. Seco has been considering for almost two years to resume budget support after the C-SAC-contribution and its independent evaluation. There is an **urgency for decision making** now. Explorative missions create expectations and it is necessary to clarify Swiss intentions towards the Government of the Kyrgyz Republic as well as towards the development partners.

1 Introduction

Decentralisation targets the devolution of resources, tasks and decision-making power on the mobilisation and use of budgetary funds to lower-level authorities. These are largely or wholly independent of central government and accountable to local political leadership. Devolution is a political process and has to be distinguished from administrative decentralisation, the “deconcentration”, which is characterised by the transfer of resources and responsibilities to sub-national governmental agencies, where decision-making authority remains with the central government and local staff answer to their upstream superiors.

Budget support is an instrument of development cooperation which provides support to the overall budget of a government, based on an agreed programme and related performance indicators. On the occasions of assessing performance policy dialogue takes place. Partner governments usually are at the central level but can also be at provincial or local levels.

According to the terms of reference, overall **objectives** of the mission to the Kyrgyz Republic were to

- Assess the overall context of local governance and fiscal decentralisation, its opportunities and risks;
- Prepare a framework and/or a roadmap for a future seco commitment in the area of local governance and fiscal decentralisation;
- Identify options for implementation of the seco support;
- Clarify the relationship of the project proposal to the World Bank and other donors working in the same area.

The **methodology** of the mission embraced the following steps:

- The mission was prepared by analysis of relevant seco documents and related studies (see references in Annex 1).
- The mission took place between May 4 and 14, 2004. It consisted of 22 interviews and consultations with representatives of national government, civil society and donor organisations (see Annex 2).
- A donor round table took place on May 12, 2004 with a presentation of preliminary findings to interested agencies.

The mission would like to **acknowledge** the extensive support received from the Swiss Cooperation Office (SCO) in the Kyrgyz Republic. In particular, the author would like to thank Stefan Bruni, economist, and Esenbek Turusbekov, National Programme Officer, who shared their knowledge and rendered support in every respect. Gratitude is also expressed to all the interview partners for their time and the information shared.

2 Background of seco involvement

2.1 Rationale of decentralised budget support

Overarching goal of seco interventions is poverty reduction in order to contribute to achieve the Millennium Development Goals (MDGs). The seco Strategy 2006 defines

– among others – macroeconomic stability, structural reforms and the quality of public finance as strategic objectives. Policy dialogue should be strengthened. On that background, programme aid including general budget support as one of seco's instruments unfolds its strengths¹:

- It provides a key opportunity for policy dialogue;
- It increases leverage beyond the financial contribution by Switzerland to the whole budget;
- It is a focal point for harmonised donor coordination and cooperation.

The added value of fiscal decentralisation and the provision of budget support at decentralised levels can be described in a nutshell:

- The efficiency and effectiveness of public service provision at the local level is enhanced through decentralisation;
- Decentralised revenue mobilisation may contribute to higher revenues due to context specific knowledge;
- Intergovernmental competition and comparison of revenue collection and public service provision at the local level strengthens public financial management and stimulates quality and targeting;
- Democratic processes are strengthened as visible links are facilitated between political participation and the delivery of public goods and services.

It should be mentioned here that decentralisation does not automatically translate into enhanced poverty reduction. Experience with decentralisation programmes clearly demonstrates that specific and targeted measures are required to make decentralisation instrumental for poverty alleviation². This insight is of significance in view of the implementation of the National Poverty Reduction Strategy (NPRS) in the Kyrgyz Republic and in the pursuance of the Millennium Development Goals.

2.2 Seco programme assistance in the Kyrgyz Republic

Swiss programme assistance in the Kyrgyz Republic has been limited to a Social Structural Adjustment Credit (SO-SAC) co-financing operation in 1999, and a co-financing arrangement of seco with the World Bank under the **Consolidation Structural Adjustment Credit (C-SAC)**³. Discussed as early as 1996/1997, the C-SAC specifically targeted reform and restructuring of the Kyrgyz energy sector. The C-SAC specifically related to the energy sector because this area was the only one not covered in the three-year Country Assistance Strategy (CAS 1998-2000) of the World Bank.

The CSAC agreement between the Kyrgyz Republic and the IDA specified an amount of US\$ 35 million to be given in three tranches to the Kyrgyz Republic, represented by the Ministry of Finance. The credit provided budget support subject to a range of conditionalities. They included specific energy sector reforms, such as tariff increases, restructuring of the state energy company (Kyrgyz Energy), and privatisation of one distribution company. Other benchmarks covered the reform of

¹ See Baumann/Bruni 2003

² See below chapter 4.1

³ See Sabates-Wheeler 2002, 19-20

Economic Free Zones, facilitation of the private sector and social protection initiatives.

When the Russian crisis effects were being felt within the economy, a meeting organised by the World Bank was held where donors were invited to pledge additional aid to the C-SAC agreement in response to the crisis. The Swiss and the Dutch responded favourably, with seco making a grant commitment of USD 5 million. Out of it, USD 2 million were allocated for general budget support and USD 3 million to a social fund. The social fund did not imply an extra-budgetary fund, but reflected the mechanism of earmarking budgetary funds. Due to delayed reforms in the energy sector, the C-SAC operation is still not closed for the World Bank.

In 2001/2002, seco called for an *independent evaluation* of the programme aid operations in all countries, including the Kyrgyz Republic. The British Institute for Development Studies came to the conclusion that the co-financing arrangement with the World Bank did not give much policy space for Switzerland. If seco intends to have some influence in policy dialogue and on outcomes it should look for bilateral or multilateral donors which take Switzerland as a “genuine partner in terms of dialogue, policy negotiations and information sharing”⁴. The chances of being heard can be increased when targeting well chosen areas of policy where Switzerland has a comparative advantage or a specific interest.

In the spirit of this evaluation, the *Swiss Regional Mid-Term Programme (RMTP) Central Asia 2002 – 2006* stipulates in the domain “macroeconomic framework and conditions” to provide general budget support in order to promote macroeconomic stability, sustainable and consistent policies of structural reforms and regional integration. Moreover, the RMTP mentions as an explicit option “Through decentralised budget support, efforts of decentralisation would be especially supported”⁵. In March 2003, a mission was sent to study budget support options for the Kyrgyz Republic⁶. Later that year, an internal study further refocused seco’s budget support strategy in the light of decentralisation⁷.

3 The Kyrgyz Context

3.1 Local governance

The Government of the Kyrgyz Republic has a *clear commitment to local governance and decentralisation*. The President, Askar Akayev, decreed a first plan of decentralisation as early as 1994, and in 1996 the creation of local self-government executive bodies in communities (Ayil Okmotus) was established, the boundaries corresponding in many cases to those of former collective farms. In the year 2000, the President created a new Ministry of Local Self-Government and Development⁸. The Comprehensive Development Framework (CDF) of the Kyrgyz

⁴ Sabates-Wheeler 2002, 30

⁵ SDC/seco 2002, 16

⁶ Ugaz 2003

⁷ Baumann/Bruni 2003

⁸ However, the Ministry of Local Self-Government and Development has 11 staff members only.

Republic to 2010, published in 2001, includes reflections on decentralisation and re-organisation of the executive branch and rational use of public resources⁹. Again, the National Poverty Reduction Strategy (NPRS) 2003 - 2005, prominently describes the history, expectations and concerns related to local self-governments¹⁰. The new Kyrgyz Constitution of 2003 contains basic principles on deconcentration¹¹ of the state administration and on local self-government¹². Meanwhile the legal framework for local self-governments includes 10 laws, 50 presidential decrees, over 30 government resolutions, and other legal documents¹³. What matters more than this legislative abundance is that in December 2001 the first elections of leaders and members of local councils (“keneshes”) were held in all Ayil Okmotus and towns under rayon (district) subordination¹⁴. Overall a total of 8’184 deputies of various levels were elected throughout the country, out of some 90’000 candidates. Elections were so competitive that 44 percent of the – formerly appointed – Ayil Okmotu heads were changed. The next round of local elections is scheduled for October 10, 2004.

These developments within few years only indicate a **radical departure** from the former Soviet type centralist system of governance. One of the driving forces¹⁵ behind the decentralisation effort was the desire to mobilize resources at the local level and remove burdens from the national government. In Soviet times, collective farms took also care of public services like housing, schools, health care. With their re-orientation to the market an entity was lacking to take care of social services which lead to the degradation of infrastructure. The key feature of creating independent local governments was the transfer of ownership and responsibility over social infrastructure assets to the Ayil Okmotus. More than 9’300 objects of social infrastructure for a total value of more than CHF 300 million (Som 7’935 million¹⁶) became municipal property of local self-governance bodies. Equally, far-reaching changes have been taking place in the economic sphere. The vehicle of privatising public enterprises reduces the role of central government as well as political decentralisation. In 1991 26 percent of the Gross Domestic Product (GDP) were produced in the private sector. At present, the share has risen to 85 percent¹⁷. The mindset of the people involved – in particular those in government service – does not yet fully cope with this fast changing environment. Even taking into account that reality is lagging behind legislation, the achievements in confronting a top-down society with a bottom-up approach within just a decade merit admiration.

Sub-national government in the Kyrgyz Republic consists of three tiers of territorial units:

- 7 Oblasts (provinces) and Bishkek city
- 45 Rayons (districts) and 9 oblast sub-ordinated cities
- 12 rayon subordinated cities and 458 Ayil Okmotus (communities)

⁹ Government 2001, 35-37

¹⁰ Government 2002, 38-44

¹¹ Art. 76-77

¹² Art. 91-95

¹³ Government 2002, 39

¹⁴ The leaders of the towns subordinated to oblasts (provinces) are appointed by central government.

¹⁵ Urban Institute 2001

¹⁶ This figures are from EC sources. Kurmanbek Dyihanbaev, Chairman of the Association of Local Self-Government Institutions of the Kyrgyz Republic (ALSGI), mentions a transfer of property of over Soms 15 billion since 1996. Local inventories are needed.

¹⁷ Government 2002, 38

All levels have kenshes (locally elected councils). Oblasts and rayons are deconcentrated wings of central government, directly reporting to the upper level with little oversight and influence by the kenesh. The rayon subordinated cities and the Ayil Okmotus, however, are local self-government bodies, formally independent from the governmental structures, owning own property, and directly accountable to the local kenesh. The Association of City Municipalities and the Association of Village Municipalities have been established as NGOs to represent and lobby for the interests of their membership.

3.2 Fiscal decentralisation

As mentioned above, the **legal base** for local governance is laid down in a large number of laws, decrees and resolutions. For fiscal decentralisation, the following legal documents matter most:

- Law of the Kyrgyz Republic on Basic Principles of Budget Law, June 24, 1998;
- Law on Local Self-Government and local State Administration, January 2002
- New Constitution of the Kyrgyz Republic, February 2, 2002 (Art. 76-77, 91-95);
- Law on communal ownership of property (2002?);
- Presidential decree on the National Strategy for the Decentralisation of State Government and the Development of Local Self-Government in the Kyrgyz Republic to 2010, December 17, 2002
- Law of the Kyrgyz Republic on the Financial and Economic Basis of Self Government, September 25, 2003;
- Law on the Delineation of Functions and Authorities between State Administrative Bodies and Local Self-Government Bodies, draft to be expected in July 2004;
- Amendments to the Law on basic principles of budget law, adopted in Parliament April 19, 2004, signing by the President expected for July 2004

In the recent past, in average the Rayon carried out the bulk of **expenditures at the sub-national level**¹⁸. However, the spending structure exhibited a high level of variability across and within regions. The role of the Ayil Okmotus and rayon subordinated cities in total spending is, however, increasing. Sub-national levels of government are in general responsible for the bulk of expenditures in health and education. Education represented 45 percent and health care 26 percent of total expenditure of sub-national governments in 2002. Sub-national expenditure responsibilities also include funding of the apparatus of the Ayil Okmotus the keneshes, and the maintenance of administrative facilities for education, health, social protection. Responsibility assignment among Ayil Okmotus and rayons or oblasts is informal and fluid.

Three **types of revenue** are assigned to sub-national levels of government¹⁹:

- shared national taxes;
- own revenues (local taxes plus fees);
- transfers from central to sub-national levels.

¹⁸ An overview on fiscal decentralisation in the Kyrgyz Republic, its expenditure assignments, the revenue assignments, the intergovernmental transfers is given in Baumann/Bruni 2003, 7 - 13.

¹⁹ See Baumann/Bruni 2003, 7-13

Tax sharing arrangements. These taxes are uniformly collected throughout the country. Revenues from national taxes are shared between the national and the sub-national budgets. Tax sharing rates remain fixed for three years. Currently 35 percent of revenue collection goes to the oblast level to be further distributed to the rayons and the local self-governments, and 65 percent to the central budget. Shared taxes represent around 24 percent of total oblast revenues in 2002.

Local own revenues. Local self-governments have 16 local taxes (among them the land tax) and non-tax revenues. Non-tax revenues are generated through charges and penalties and through special means. Local taxes don't represent an important source of income. The disparities across oblast are very pronounced. Local taxes represent only 13 percent of total revenues in Naryn. In Bishkek the share of local taxes on total revenues is 61.5 percent.

Transfers are the most significant source of revenue for sub-national authorities (73 percent in average in 2002) except for Bishkek City and Chui Oblast. Transfers from the Central Government are of three types – categorical, equalizing and stimulating (matching):

- **Categorical grants** are provided to finance a minimum of specific services. However, there are problems with the definition of minimum standards. In practice, categorical grants are used to pay salaries of education and health workers. Categorical grants represented 43 percent of total oblast revenues in 2002.
- **Equalising grants** are provided to compensate for different fiscal capacity between levels of government and across regions. It represents around 4.7 percent of total revenues²⁰.
- **Stimulating grants** are defined in the Law as a complement to budgets of LSGs and to provide incentives for revenue mobilisation at the local level. For 2003, stimulating grants were introduced in the Central Budget for the first time, but they remain insignificant.

Again, the distribution of revenues is made following a principle of subordination. Each hierarchically superior government level decides the amount of resources its directly subordinated government levels receive (see Table below). The system of resource and transfer assignment is fluid and perceived as being ad-hoc. There is limited regional and local revenue authority and budgetary autonomy.

The system of fiscal decentralisation is in revision (independent central – local budgeting, land tax 100 percent local revenue, transparent equalisation according to new formula, fixed shares of shared taxes for three years). The above mentioned amendments to the budget law were delayed compared to the original schedule. The budgeting process for 2005 has already started but neither is the amendment signed by the President nor has the Ministry of Finance the rule and regulations ready which are needed for an orderly processing²¹. Therefore, 2005 will become a transition year during which all the regulations will be put in place in order to have a proper budgeting exercise for 2006 following the new rules and regulations.

²⁰ As this type of grant is designed to compensate for differences in fiscal bases across sub-national governments not all oblasts (compensation at AO level as not all AO in Oblast receive this grant) receive it.

²¹ In the interviews it has been mentioned that the Government may perceive it as an advantage to delay the restructuring until the elections of 2005 are over.

4 Key Issues of Fiscal Decentralisation & Local Governance

4.1 Best practices from an international perspective

The Development Assistance Committee (DAC) of the OECD published in 2004 in its Evaluation Series “Lessons Learned on Donor Support to Decentralisation and Local Governance”. The comprehensive and broad-based effort contains also a substantial chapter on support to fiscal decentralisation reviewing a wealth of experience. In a nutshell: “The success of decentralisation reform hinges on the way fiscal decentralisation is designed and implemented”.²² The following selection of lessons learned and best practices are of interest when shaping the seco support to fiscal decentralisation in the Kyrgyz Republic:

- Successful decentralisation may take more than a decade when taking place in a context of financial and political instability.
- Ensure sustainability of donor support and formulate exit strategies and plans for scaling-up at early stages of the programme.
- Make sure that central government is committed to decentralisation; a strong ministry for local government is important to provide advocacy and support.
- Improve coordination between donors and partner government, and establish joint government-donor forums for reviewing and implementing reforms.
- Enhance donor coordination, establish forums for coordination and dissemination of information and, when appropriate, establish systems of basket funding.
- Focus on local governments’ own financial development and design programs in a holistic way not undermining local governments’ incentives to improve.
- Channel funds to local governments through central government institutions which is more sustainable in the long run despite short term delays, bureaucracy, and lack of transparency.
- Provide effective and institutionalised feedback from programme activities at the local level to national policy-makers.
- Capacity building is most successful when coupled with extra resources to local government, i.e. capacity building should not be initiated as a stand-alone activity.
- Earmarking of donor funds may create massive transaction costs undermining downward accountability and increasing demands on the weak local capacities.
- Refrain from project specific audit systems and support instead general audit and control institutions to improve accountability and sustainability.
- Support coupling multiple control authorities (audits, inspectors, accounts committees) with improved downwards accountability aimed at citizens and strong follow-up measures in case of mismanagement.
- Strengthen poverty focus by ensuring that service delivery support targets underprivileged groups and stimulate bottom-up, grassroots-based governance like citizen-based budget watch and service delivery monitoring.
- Combine support to local government with support to civil society groups to strengthen accountability.

²² OECD 2004, 33

- Prevent a crowding out of local governments' revenue sources by co-funding requirements when central government/donors increase funding.
- Programmes with co-funding requirements should be designed in a way that makes the contribution sustainable, fair, equitable and long-lasting.

4.2 Challenges²³ in the Kyrgyz Republic

The brand new research done by the German Development Institute on decentralisation in the Kyrgyz Republic and its impact on participation puts it into a nutshell: The ability of local governments "to cope with the manifold challenges they are facing is very limited. Especially the rural communities (Aiyl Okmotu) lack financial resources, skills and a clear cut delineation of their own sphere of competences"²⁴. More in detail, the key issues for fiscal decentralisation and local governance are:

Formal institutions at the local level often are **lagging behind the aspirations** of the people which undermines in return their perceived legitimacy. Strengthening the Aiyl Okmotus is, therefore, an opportunity as well as a necessity. Many donors in the Kyrgyz Republic have supported social mobilisation programmes in most of the parts of the country, usually bypassing the local governmental structures and directly targeting the village population for reasons of short-term effectiveness and efficiency.

Despite the large number of legal documents, a **weak legal framework** prevails for local governance in the Kyrgyz Republic. There are areas with contradicting norms which may reflect different interests. Amendments are pending to remove contradictions and to fill gaps. Like a moving target, it is difficult to keep up with and to implement the new laws.

Inadequate professional capacities of the local self-governments are widespread. They do not correspond to the skills and knowledge required to provide satisfactory services to the population. This lack of skills particularly applies to the public financial management at the local level.

Severely **limited legal literacy** of the population as well as parts of the local government staff is a barrier to make use of all the rights and opportunities opened up by the revised legislation. Transfer of information but also advise and representation in cases of conflict are needed.

A **blurred delineation of the functions and responsibilities** between the bodies of state government and local self-governments creates problems. Expenditure responsibility in practice becomes discretionary and subject to (annual) negotiations among the different levels of sub-national governments. Mechanisms for the transfer of power and responsibility need to be refined.

Local governments do not (yet) holistically develop their own territory or develop such **long term perspectives** for the future. This deficit is not only due to weak skills or a

²³ The identification of these challenges is based on interviews; World Bank 2004, PER I, 80-95; GDI 2004; Baumann/Bruni 2003; Government 2002, 40

²⁴ GDI 2004 (preliminary findings)

lack of will. Local budgets have so far left little or no room to shape perspectives and policies.

Resource mobilisation by the local government is to be reviewed. 16 different taxes are assigned to the local level. Some of them are unattractive to collect. More attractive sources of revenue are assigned to the central level or are shared revenues. Incentives for revenue enhancement at the local level should be built into the system²⁵.

Dependence of the Ayil Okmotus on the rayons seriously hampers their development space. They collect the land tax, which is the main source of revenue in rural Kyrgyzstan, have to channel it to the treasury of the rayon, instead of getting back their share of 93 percent according to the tax law, the rayons pay an arbitrary amount²⁶ and keep the rest.

Non-transparent and arbitrary transfers from central government provided through the oblast and rayon administrative channels make revenues for the local budget unpredictable. Volumes and allocation criteria need to be based upon a simple and transparent formula.

A simple **lack of adequate financial means** at the local level prevents most of the Ayil Okmotus from properly maintaining the infrastructure and providing services to their people.

There is a serious **gender imbalance** at all levels. In the national parliament, women representation equals 7 percent²⁷. Two out of 12 ministers are women, one governor (Issik-Kul) at the oblast level is female. Out of 45 rayon administration one is headed by a women. Of 455 Ayil Okmotus, 21 are chaired by women.

There are **serious geographical imbalances** in resource endowment and revenue mobilisation among the oblasts, among the rayons, among the Ayil Okmotus and even between villages within the Ayil Okmotus. Equalization to reduce these imbalances is an issue.

Only **limited people's participation in decision making and weak accountability mechanisms** of the local governments to answer concerns of the Ayil Kenesh or the people are in place. Not only the supply side but also the demand by the population to hold the local government accountable is weak. Under the new decentralisation policy empowerment should deliver.

Often, there is a **lack of trust** between the local government and the population or the business community. "Among business people, the most widespread attitude is not to expect any help from the local authorities Above all, they want the authorities to ensure stable property rights and refrain from carrying out arbitrary inspections and demanding bribes"²⁸.

²⁵ Currently the Tax Code is being revised. Deadline given by President for submission to parliament is August 2004.

²⁶ In the cases met in Jalalabat Oblast it was between 13 and 36 percent instead of 93 percent.

²⁷ Figures UNDP

²⁸ GDI 2004 (preliminary findings)

5 On-going Efforts

5.1 Overview

To get an overview on the on-going efforts in donor support to fiscal decentralisation in the Kyrgyz Republic, a number of interviews were held (see Annex 2) and the Swiss Cooperation Office invited DFID, the EC, KfW, USAID/Urban Institute, the IMF, UNDP and the World Bank to a donor round table for May 12, 2004. All invitees attended with one exception (IMF). In order to structure the different areas of activities, a distinction was made between

- Social mobilisation to create a favourable environment for fiscal decentralisation and accountability;
- Legal support to local self-governments to have their legal rights implemented;
- Technical assistance and capacity building to local self-governments;
- Technical assistance and capacity building for central government;
- Legal framework of inter-governmental finance;
- Budget support to local self-governments;
- Budget support to central government.

The **key messages** of the meeting were

- Quite a number of activities in fields relevant for fiscal decentralisation are on-going;
- Exchange of information and experience in decentralisation would be an asset for all agencies active in that field;
- There is a will for more coordination in (fiscal) decentralisation among donors in future;
- The scope of participating agencies/organisations may have to be extended in view of effectiveness;
- Switzerland is prepared to take the lead if the programme proposal which is in preparation will be accepted by seco.

Donor Round table on Local Governance and Fiscal Decentralisation

Date: 12.05.04

Venue: Swiss Cooperation Office in Bishkek (initiator and organiser)

Participants of the round table:

SCO (3),
DFID (2),
EC (1),
KfW (1),
USAID (1),
UNDP (3),
WB (3)

Abbreviations:

IGF – Intergovernmental Finance
TA – Technical Assistance
CB – Capacity Building
LSG – Local Self-governance
VIP – Village Investment project
ASSP – Agricultural Service Support Programme

Organisation	Social mobilisation	Legal support To LSG	TA/CB for LSG	TA/CB for Central Government	IGF Legal Framework	Budget support To LSG	Budget support To Central Government
Swiss	X proposed	X proposed	X proposed	X proposed		X proposed	X proposed [PRSC?]
DFID	X	X 3 rd party arbitration	X	X GTAC	X		In future [PRSC?]
EC	X		X	X TACIS project	X Functional Analysis/TACIS		X Food Security program
KfW	Planned		Planned			Quasi optional Quasi?	
USAID Urban Institute	X Condominiums	X	X	X	X		
IMF							X PRGF
UNDP	X		X	X	X Functional analysis LFEBSG		
World Bank	X VIP		X VIP, Small towns	X GTAC	X ASSP	Quasi VIP, Small Towns	X PRSC? GSAC

Organisations not included in the matrix (Mainly focused on Rural development/social mobilisation):

Asian Development Bank, GTZ, SOROS Foundation, Eurasia Foundation, Hans-Seidel Foundation; Aga-Khan Foundation, Allavida [UK], Mercy Corp, ACDI/VOCA

5.2 Department for International Development (DFID, UK)

DFID supports the Sustainable Livelihoods for Livestock Producing Communities (SLLPC) project which has been started in 2002 and will last until December 31, 2005. From 2006 onwards, the newly created **Rural Development Centre (RDC)** is supposed to take over. It promotes income generating activities in a number of Ayil Okmotus in Osh, Chui and Talas Oblasts. The approach is strongly based on capacity building and community mobilisation through the creation of village working groups. At the national level, the SLLPC has a joint steering council. In case of regional overlap, RDC offered its interest in implementation of the seco package. RDC could also be a partner in channelling bottom up proposals for improvements in tax legislation to parliament.

DFID is funding consultancies in favour of the World Bank's **Governance Structural Adjustment Credit (G-SAC)**, including the provision of institutional support.

DFID supports a programme of **Third Party Arbitration Courts** in 12 of 44 rayons. In view of legal support to Ayil Okmotus the experience and the services of this programme might be of interest.

According to its corporate policies, DFID prioritises **budget support** if the prevailing environment permits. In the Kyrgyz Republic, DFID considers starting budget support through co-financing the Poverty Reduction Support Credit (PRSC) of the World Bank which is in preparation. DFID favours a harmonised approach with joint missions, etc. and is very much open for collaboration.

5.3 European Commission (EC)

The EC is pursuing programme assistance since 1999. Euros 9,5 million per year are transferred to the Government of the Kyrgyz Republic as **balance of payments** support. The countervalue in local currency has to be credited to the agreed "food aid" budget lines in the Ministry of Agriculture and the Ministry of Labour and Social Protection. This programme aid is linked to an extensive set of conditionalities, the Policy Reform Matrix for 2003 comprising 35 different measures related mainly to food security and the social sector, but also public finance and transparency. In addition, Euros 0,5 million are allocated for technical assistance. In future, the EC programme assistance will move more towards sector support. The EC representative would very much welcome if other donors start with budget support and is prepared to share experience.

Under the TACIS programme, the European Union provides **technical assistance** in view of a functional analysis in the Ministry of Agriculture and the Ministry of Labour and Social Protection between the centre, oblast and rayon levels.

In cooperation with the Ministry of Local Self-Government and Regional Development the European Union prepares a new TACIS project to **strengthen local governance** in the Kyrgyz Republic, in support for institutional, legal and administrative reform. There are components of support to the central level to support the partner ministry in policy making and implementation, to spread decentralisation across all relevant ministries, and to clarify the division of statutory services provision between central

and local self-governments. It targets Batken and Issyk Kul Oblasts as pilot regions. Goals are, among others, to strengthen the capacities of the pilot local self-governments in human resource terms, to strengthen budgeting in the pilot oblasts and work with local administrations to develop local sources of revenues.

5.4 International Monetary Fund (IMF)

The Poverty Reduction and Growth Facility (PRGF) of the IMF is the umbrella for all structural reforms. The current PRGF will end in September 2004. Negotiations have started for a new 3-years' arrangement.

5.5 KfW (Germany)

Negotiations with the Ministry of Finance are in the final stage to start a **parallel programme to the World Bank's Village Investment Project (VIP)**. An unresolved issue is whether the Ministry of Finance will offer the KfW credit received at grant terms to the implementing agency. The programme will last for four years, starting 2005 at the earliest, and concentrate on Osh and Jalalabat Oblasts. Exchange of experience and in case of regional overlap cooperation regarding social mobilisation will be opportunities.

In a longer term perspective, KfW is interested to remain informed on the experience of **budget support** at the national and decentralised levels. In view of a potential partnership, it will be important to stay in contact.

5.6 United Nations Development Programme (UNDP)

UNDP's decentralisation programme is operational in the Kyrgyz Republic since 1998. It combines top-down and bottom-up approaches. The programme was reoriented 2003 and renamed **Local Self-Governance Programme**. It has the following components: advocacy and policy support, institution building, transferring tools for self-governance, gender and empowering civil society as crosscutting areas. At the central level, UNDP has been assisting in the drafting of the National Strategy of Decentralisation. UNDP provides support to parliament, including publishing guidelines for the national and local budgets; the functional analysis was carried forward at the central level and now a new exercise is going on at the territorial level regarding the delegation of functions; a pilot Ayil Okmotu tests out how delegation works in practice; UNDP also supports a seminar on delineation on request of the Ministry of Local Self-Government. At the local level, in selected rayons and villages an information system has been created; training in participatory planning; social mobilisation through community based organisations (CBOs); micro-credits and grant schemes for CBOs; training for CBOs and local self-governments (heads, staff, deputies). Two training centres are in Bishkek and Osh.

The UNDP programme on Increasing Effectiveness of National Government incorporates transparency and accountability tools as integral part of decision making, budgeting and expenditure processes. Functional review, advisory support in

the elaboration of laws on self-governance, round table meetings, public hearings are part of this UNDP programme. UNDP is open for cooperation.

5.7 U.S. Agency for International Development (USAID)

The **Urban Institute** is implementing a programme funded by USAID to build constituencies for decentralisation, develop responsive relationships between local governments and citizens, and strengthen local governments capacity to deliver services. Decentralisation policy, asset management, strategic planning, public hearings, financial management, social partnership, housing associations, community grants, Development of training capacity and networking among cities are the primary areas of activity. The Urban Institute is targeting the 24 cities in the country. The Urban Institute expects a renewal of its mandate for another three years in June 2004. The revised approach may also include legal assistance for cities. The Urban Institute are very much interested in seco's package proposals as its rural orientation is entirely complementary to the USAID/Urban Institute programme focusing on cities. They are also prepared to share their teaching material which should be adapted to village conditions.

United States development cooperation is building technical capacity at the local level all over the Kyrgyz Republic through the **Barent Point** organisation and under the label of a joint Ministry of Finance and USAID programme. Until June 2004 they will have trained at least one person out of all 550 administrative and financial units all over the country. Training centres were launched in Bishkek, Jalalabat and Osh. The teaching material in Russian and Kyrgyz is available if needed. Under another technical assistance programme, a consultant is drafting a formula for the allocation of equalisation grants for the Ministry of Finance. Drafting will be finished very soon.

5.8 World Bank

The **Governance Structural Adjustment Credit (GSAC)** is to improve the personal accountability of political officials and civil servants, to strengthen voice and participation by improving access to official information, to improve the interaction between regulatory agencies and business enterprises, to strengthen external audit, to establish a more strategic and transparent budget formulation process, to strengthen accountability and transparency in budget execution, to improve transparency, value for money and accountability in public procurement, and to improve service delivery in the health, education and social protection sectors. Specifically, adopt an appropriate legal act to define capitation-based formulae for calculating categorical grants in the health and education sectors; issue decrees defining the methodology for developing minimum service standards in the education sector and refining those in the health sector.)

The **Village Investment Project (VIP)** pursues three objectives: improving governance and capacity at the local level, strengthening the provision of essential infrastructure services, and supporting private small-scale group enterprise development. The World Bank provides an IDA-grant of USD 15 million. The VIP supports income and employment generating investments in village infrastructure and in group managed small and medium-sized enterprises. The VIP strengthen their

internal cooperation to achieve key public goods. Capacity building and empowerment as well as village investments are the key components of the VIP which is supposed to reach every second Ayil Okmotu in the country. Until now, the VIP covered 79 Ayil Okmotus. Another 30-40 will be added in the remaining part of 2004, and another 80 next year. The Community Development and Investment Agency (ARIS) is responsible for the VIP implementation. The VIP responsible World Bank staff is open for collaboration. In particular, seco is welcome to start in VIP villages and to build on their social mobilisation efforts.

After a mission to the Kyrgyz Republic in September/October 2003, the World Bank produced a concept note on “Strengthening Accountability Mechanisms and the ***Demand Side for Local Governance***”. This early concept note has been followed up by revised draft concepts “World Bank Assistance for Piloting New Mechanisms for Local Intergovernmental Finance”, and “seco Partnership Proposal - Strengthening Accountability Mechanisms and the Demand Side for Local Governance in the Kyrgyz Republic”. It is the project idea to increase the accountability and capacity of local government and to improve the transparency of the budget process in selected pilot areas, mainly by a training effort. The staff responsible for the project in the Kyrgyz Republic as well as in Washington is keen to assist in starting the seco package, to exchange experience and documentation.

The World Bank will be starting negotiations shortly on a ***Poverty Reduction Support Credit (PRSC)***. A pre-identification mission took place from January 5-19, 2004. The Kyrgyz authorities proposed the intergovernmental system beside the social protection reform as key issues for future support by the PRSC. For the optional relations between the PRSC and the proposal developed here for seco, see below chapter 6.3.3.

6 The Framework for a seco contribution

6.1 Introduction

6.1.1 Preconditions

There are two very basic preconditions that have to be fulfilled that a seco contribution may become possible:

- The Government of the Kyrgyz Republic must have a serious commitment to (fiscal) decentralisation and local self governance. The President is personally committed to decentralisation²⁹. Also a majority of the Parliament is supportive to it. A good number of legislative steps have already been undertaken and some of them still in process. They show a clear will to move away from the past centralised system to decentralised governance. It will be a huge task now to implement the legislative reform all over the country.
- The people themselves must have a vivid interest in self governance in general and fiscal decentralisation in particular. The field visit showed a keen interest by the participants to take more responsibility in village development. It also

²⁹ See chapter 3.1

demonstrated how desperately needed information sharing about legislative changes as well as the provision of basic skills are to make effective use of the new opportunities. Fiscal decentralisation makes social mobilisation deliver. The impressions of the (short) field mission are in line with the experience made by other donors already working on decentralisation. The success of the decentralisation reform will be decided at the local level.

6.1.2 Objectives

The overarching goal of the seco programme for decentralised budget support is to contribute to poverty reduction and empowerment of rural communities and small municipalities. More specifically, it contributes to

- Capacity building in budget formulation, execution and monitoring at the level of Aiyl Okmotus (local government, Kenesh, civil society);
- Enhancing legal literacy including legal instruments to defend the rights of Aiyl Okmotus (local government, Kenesh, civil society) and their population;
- Strengthening the financial capacity and accountability of local government institutions to fulfil their key tasks;
- Contributing to a conducive framework for fiscal decentralisation and local governance at the national level (design, implementation and monitoring of laws, policies, transfers).

Would it make sense to target the **Rayons instead of the Aiyl Okmotus**? This alternative option cannot be seriously taken into account. It does not correspond to the spirit of the decentralisation strategy of the Government which has a long term perspective for the central and the local levels whereas intermediate levels – Rayons and Oblasts – will lose their budget authority and be reduced to deconcentrated centres of Government administration. It may even be the case that either the Rayon or the Oblast level are eliminated.

6.1.3 A package deal

The Kyrgyz Republic is at an early stage of transformation from a highly centralised government to a decentralised system. This complex situation requires interventions at several entry points. External support should be tailor made which leads to the use of a **package of instruments**. Such a package as an interrelated combination of different instruments increases their leverage and effectiveness compared to applications in an isolated form.

Fiscal decentralisation is a means to enable local communities to better serve their citizens and to produce local economic and social development. Only the mobilisation of the communities' own resources leads to sustainable development. All instruments used, in particular budget support, will have to be shaped in way that sets **mobilising incentives in revenue collection** as well as in stimulation of economic activities. Ill-designed, budget support might substitute own efforts and induce complacency in Aiyl Okmotus.

The sole reliance on the classic form of general budget support (GBS) to the central government would **strengthen the central level** and such give at present the wrong

signal. At a later date when decentralisation is firmly underway, more emphasis on GBS and less on decentralised budget support can be considered. In this sense the package proposed here for 2004-2007 is an intermediate step to more GBS in 2008 onwards. When favouring decentralisation now, direct budget support to the Aiyl Okmotus is the key component. The capacity at the local level is, however, in most of the places not yet there to absorb such transfers in a transparent and accountable manner. That is why technical assistance is required to prepare the ground.

6.2 Technical assistance

6.2.1 Local level

The bulk of technical assistance will be used for capacity building at the local level, Aiyl Okmotus and Rayons. Important objectives are fiscal literacy and legal literacy in budget formulation, budget execution and budget monitoring. Gender sensitive budgeting is an issue. Basics on transparency and accountability rules will have to be included in order to create an understanding of checks and balances. Why and how planning and assessment tools are used as are the baseline study mentioned below need to be dealt with. Methodology matters much for all the subjects: Presentations and teaching materials should allow for an approach which is context specific and which is dialogue oriented.

Target audiences are

- the authorities of Aiyl Okmotus, in particular the chairperson and the head of the financial department, other Ayil Okmotu staff, the members of the Aiyl Kenesh, selected members of community based organisations in the Aiyl Okmotus in question and other interested individuals; this part of the target audience requires thorough skills to perform in their jobs professionally;
- the population of the Aiyl Okmotu at large, in particular members of community based organisations in the Aiyl Okmotus in question; the people do not have to become fiscal or budget specialists but they require a basic knowledge to hold the authorities accountable in general, to participate more particularly in a budget hearing in a meaningful way, and to make use of access to budget information and perform participative monitoring;
- participants from the Rayon administration, the Rayon Kenesh and community based organisations;
- women among authorities, staff and population; a gender sensitive approach should contribute to strengthen women's participation.

Usually it may be advisable to have separate trainings for the three different target audiences to ensure that the differing needs of participants are met and they feel free to speak out. As far as feasible, training activities should be aligned to the budget cycle in a way that the participants can make use of the new skills immediately. The seco package should provide training and assistance throughout the three year period of duration (2005 – 2007). Those Aiyl Okmotus which have gone through the whole training cycle will be assisted on a consultation basis for the application of the newly learned skills and knowledge. In addition, in 2006 and 2007 new batches of Aiyl Okmotus will be served.

Regarding technical assistance, the seco programme can heavily draw on the work already underway by the Urban Institute, the World Bank, Barents Point, and others. Seco should negotiate for the right to use their training documents. The contents and format (duration etc.) should be reviewed, adapted to local conditions if needed, extended with the legal assistance dimension. This cooperation should permit an early start in 2005.

There is an urgent need to provide **legal assistance**. Aiyl Okmotus collect the Land Tax from individuals and legal entities. In rural areas the Land Tax is by far the most important source of own revenue for Aiyl Okmotus. They transfer the collected amount to the rayon and are entitled by law to get 90 percent of it returned. It is a widespread feature that the Rayon – contrary to the law – retransfers just a minor percentage. In the cases met in the Jalalabat Oblast it varied between 13 and 37 percent. Aiyl Okmotus should be informed about their legal position including judicial procedures and those willing to defend their legal rights should get legal assistance by consultation and representation. SDC, Swiss Agency for Development and Cooperation, funds together with USAID a nationwide program “Legal Assistance to Rural Citizens (LARC)” which is implemented by Helvetas. LARC is a land reform and good governance project. The primary aim is to find extra court solutions, but if all other means have failed cases are taken to court. So far out of some 200 cases none has been lost. There is also DFID funded arbitration project with a more limited scope in geographical and thematic orientation. A close cooperation with such existing NGOs will have to be negotiated. Already a few showcases might fundamentally change the frequent misguidance of funds at the Rayon level. The spontaneous reactions by people interviewed was very positive. The Urban Institute will have legal assistance to cities in its future and extended programme.

In view of an impact review at a later date, each Aiyl Okmotu cooperating under this programme should agree to and establish a **baseline assessment** of where it stands at the start of budget support. This study should be done during the phase of capacity building before budget support is launched locally. As a learning exercise, the responsibility should be with the Aiyl Okmotu but it the programme implementing partner should offer external technical assistance. There are good examples already on the table, e.g. the profile of Belovodskoe Aiyl Okmotu, prepared by the local authorities with assistance of the Urban Institute.

6.2.2 National level

The provision of technical assistance should strictly be demand driven. The Ministry of Finance as well as the Ministry for Local Self-Government and Regional Development made both a number of suggestions where they see a need for technical assistance:

- support to better anchor the Medium Term Expenditure Framework (MTEF) in the administration;
- support to implement Public Financial Management (PFM) guidelines;
- support to review the regulations on stimulating grants.

These proposals should be reviewed and prioritised by seco, in coordination and cooperation with other multilateral and bilateral donors delivering technical

assistance in that field. Other support demands of the Government might come up and relate to a better understanding of the N-PAF and key issues of decentralisation.

6.3 Budget support

6.3.1 Local level

The **rationale** for budget support at the local level is to match their own efforts with an external contribution in order to strengthen their own implementation capacity. Capacity building alone by technical assistance is not enough – the improved system should also deliver additional products otherwise committed people start to feel frustrated. At present, there is consensus that the lack of capacity at the local level is one of the main obstacles to the implementation of local governance reforms. Capacity building is an imperative precondition, therefore, for effective budget support. Emirlan Toromurzaev, Deputy Minister of Finance, warmly welcomes the idea of decentralised budget support but also warned that this instrument might create conducive conditions for corruption if it meets the Aiyi Okmotus unprepared. Capacity building through technical assistance is a prerequisite, therefore, before moving on to budget support.

Sustainability is an issue. External support is a temporary measure and not a permanent solution. The period of support should be used to develop the internal revenue base of the Aiyi Okmotus to reduce dependency. For the time being, there is no international budget support at the local level. The Kyrgyz system of intergovernmental finance has, however, equalizing grants in place through which better off regions via the central government support the poorer parts of the country. Only one out of ten Aiyi Okmotus do not receive an equalizing contribution. Only about 15 - 20 percent³⁰ of the Aiyi Okmotus are potentially financially sustainable and can cover their expenditure in the long term out of their own revenue base³¹. In other words, 85 percent of Aiyi Okmotus will continue to depend on external transfers. Decentralised budget support will have to watch that it does positively contribute to the financial sustainability and does not increase instability. Performance assessments of Aiyi Okmotus will have to be shaped in way that they provide incentives for a favourable local framework of private sector development and resource mobilisation.

As targeted support, it must be a major concern by the development partners to secure **additionality**. Additionality does not only matter from a donor's perspective but it also works as an incentive for the Aiyi Okmotus to continue with their efforts. Appropriate legislation should provide transparency of the intergovernmental transfer system. Transparency includes a clear delineation of the functional tasks of the local government, clear criteria for the allocation of intergovernmental transfers – in particular categorical and equalising grants – as well non-arbitrary rules for revenue splitting of locally collected taxes, in particular the land tax. Close monitoring of the application of the law, rules and regulations is a must. Despite persisting gaps in policy making it can be said that the legal base is developing fast whereas

³⁰ Figure given by the Association of Local Self-Government Institutions (ALSGI)

³¹ It is not clear whether this statement is valid within the current tax sharing arrangements or only if more taxes can be kept locally.

implementation lags behind. The issue of additionality is absolutely crucial for the success of the programme and should be also a contract clause between the Government of Kyrgyz Republic and Switzerland. Further creative thinking is required how to prevent the system at the central Government, Oblast and Rayon levels from undermining additionality.

Closely linked to additionality is the issue of **predictability** of external transfers to local governments. Financial sustainability at the Aiyl Okmotu level is only possible if the transfers from the central government are predictable. The present situation was described as “bazaar based budgets”³² at the local level. A predictable support will become possible if based on a long term strategy governing the relationship between the central and local governments as well as a reliable Medium Term Fiscal and Expenditure Framework (MTEF/MTFF) for the central Government. The predictability concern should also require the seco and the other donors providing decentralised budget support to commit and disburse their contributions in a predictable way.

The allocation of budget support to Aiyl Okmotus requires in each case the fulfilment of a number of **preconditions** at the local level. The capacity has to be there to meet the following standardised requirements:

- Baseline assessment is done;
- The Aiyl Okmotu drafts annual budget, accounts and audit (?) as well as the L-PAF (see 6.7.1) and monitors the implementation of the annual programme;
- The Aiyl Okmotu submits the annual budget, accounts, audit (?) and L-PAF to the Aiyl Kenesh and reports quarterly on budget execution to the Aiyl Kenesh;
- Public hearings on the budget take place in an orderly manner;
- Full transparency of the public administration is guaranteed by the local authorities to all citizens at all times.

The **implementation** has to be elaborated in detail. Three shaping principles should be kept in mind:

- The arrangements will have to make use of existing institutions and structures and should not weaken them by establishing competing programme specific structures;
- The arrangements should be flexible in order to be open to welcome other donors joining this new channel of decentralised budget support;
- The arrangements should take relevant experience made in other countries into account. Because of being a pioneering exercise, not many comparable cases could be identified. However, the fiscal transfer strategy with a joint donor basket fund (“Implementation Support Fund”) in Uganda³³, and implemented jointly by the key ministries, association of local authorities and interested donors will be worthwhile to be looked at more closely.

Phasing of local budget support should be aligned to programme progress. During the provision of technical assistance in 2005, a first batch of pilot Aiyl Okmotus can be selected for budget support in 2006. In view of predictability of support, the annual overall commitment should be transparent from the outset. Disbursements, however can be phased according to needs and performance in order to reduce risks. Taking into account the on-going experience and the continuing technical assistance, in

³² Charles Undeland, Urban Institute

³³ OECD 2004, 41

2006 another batch of pilots will be selected during 2006 for budget support from 2007 onwards. If things move well and based on the L-PAF (see 6.5.1) achievements, an extension into 2008 and beyond should be considered.

6.3.2 National level

General budget support (GBS) at the national level requires also a number of **preconditions** to be fulfilled to be effective. Transparency of budget formulation, execution and monitoring is key, linked to accountability of the government to the parliament. A Medium Term Fiscal Framework³⁴ is required to embed the annual budget in a pluri-annual perspective. There are serious concerns about the transparency and accountability of resource allocation in the national budget³⁵, and also doubts whether the capacities of Public Financial Management are sufficiently developed. On the other hand, in other countries like Mozambique with well established budget support schemes today the situation at the start had also been an extremely high risk³⁶.

It is important that at the national level a well designed framework of intergovernmental finance is in place. It should define the responsibilities between the different levels of Government on the expenditure side and the splitting arrangements on the revenue side. Key concerns for which reasonable answers are to be found are³⁷:

- Clarification of expenditure assignments at all levels of government (including definition of minimal standards)
- Enhancement of sub-national revenue mobilization
- Rationalization and institutionalisation of a stable transfer system (formula for categorical, equalizing and stimulating grants)
- Building administrative and institutional capacity to manage the budget process and intergovernmental finance system at all levels of government.
- Ensure good governance through increased transparency and accountability (including social mobilisation).

The reforms move into the right direction but have not yet arrived at this point. Switzerland has basically three options for budget support at the national level.

(1) Co-financing the World Bank's Poverty Reduction Support Credit (PRSC): The first PRSC for the Kyrgyz Republic is in preparation. The PRSC is a World Bank instrument to support the implementation of the Poverty Reduction Strategies of the

³⁴ See World Bank 2004, PER I, 24 - 33

³⁵ The Public Expenditure Review 2004 of the World Bank cites an example of an off-budget Japanese grant which was first used to purchase diesel fuel from Kazakhstan. When delivered with a delay, it was no longer needed and the Government decided to sell the fuel and to procure cotton from Kyrgyz farmers. The cotton was sent to Belarus in exchange for tractors. There was no demand from the farmers' side, however, and they are now in the state-owned Kyrgyz Aiyi Tech Service. See World Bank 2004, PER Vol. II, p. 28

³⁶ A recent independent fiduciary risk assessment on Mozambique came to the conclusion that it has moved from an „extremely high risk country to a high risk country” which obviously is acceptable for 14 bilateral donors and the World Bank, the G-15, who participate in the joint budget support scheme.

³⁷ Baumann/Bruni 2003, p. 24

partner countries. It is General Budget Support, linked to a number of conditionalities around which policy dialogue takes place. It has a duration of one year and may be renewed.

An exploratory PRSC mission took place in January 2004, and a first substantive mission again in June 2004. It is hoped to have the PRSC finalized in mid-2005. The parliamentary elections scheduled for February 27, 2005, should have been passed. Presidential elections will follow on October 24, 2005, and might also become an issue relevant for the PRSC. There are also some unfulfilled conditions out of the preceding C-SAC programme in the energy sector reform which have to be settled before moving on to the PRSC. They relate to politically and socially hot issues of energy tariffs and energy concessions. There are voices saying that the unfulfilled C-SAC conditions which have been an issue for a long time already might be further delayed into 2006. For political reasons C-SAC conditionality might not be met before the elections. Therefore, first PRSC disbursements can be expected at best in 2005 or rather 2006.

The PRSC related process is highly relevant for seco for a number of reasons:

- The World Bank envisages to have two sets of conditionalities in place with the PRSC in preparation. One of the two key topics is decentralisation. Therefore, policy dialogue on fiscal decentralisation will take place related to the PRSC.
- The senior manager of the World Bank³⁸ in Bishkek mentioned that the World Bank is very open and takes even an active interest in cooperating with bilateral donors.
- As PRSC preparations are only beginning, it is a real opportunity to participate in the upcoming process right from the start and to participate in this broader policy dialogue.
- It is important that donors speak with one voice, instead of sending differing or even contradicting messages to the Government. Moreover, it would add to the burden of transaction costs born by the Government to have several fora of policy dialogue on fiscal decentralisation.
- The PRSC is a vehicle and an opportunity to move donor coordination forward. DFID is likely to align and is considering to co-finance the PRSC. In the longer run others might be joining. If Switzerland is on a separate track, it risks to marginalize itself instead of channelling its experience into the mainstream policy dialogue.

It is suggested to seco to play an active role as a bilateral partner in the PRSC preparation process. Switzerland should use its influence that the World Bank in the PRSC context moves away from the orthodox conditionality system to a performance assessment framework (PAF), with goals and indicators proposed and owned by the Government (see below 6.5.2). In Mozambique the World Bank has aligned to such a new approach, jointly with a large number of other bilateral donors.

(2) *Creation of a Programme Aid Partners' group:* Switzerland's strategic orientation should aim at the creation of a group of donors providing programme aid. Among the bilateral agencies being present in the Kyrgyz Republic, a limited number

³⁸ Chris Lovelace. The PRSC manager is in Washington and it was not possible during the time of the mission to have a direct discussion. An e-mail consultation and a phone call followed during the week after the mission.

only may take that road. Potential bilateral partners are the European Commission, DFID and the German Kreditanstalt fuer Wiederaufbau (KfW). As the experience of other countries demonstrates, also the World Bank should be invited and might join such a group in view of a maximum of harmonisation and cooperation among donors. An inclusive approach of the World Bank towards interested bilateral agencies when preparing and negotiating the PRSC could lay the ground for consensus among donors on key concerns and programme priorities. Even if the World Bank would choose to stay off that group for one reason or another, the creation of a group of at least three bilateral donors would still be a worthwhile parallel and non-competing but re-enforcing exercise with the potential of others joining later on.

In relation to the PRSC, the general budget support provided by the group of bilateral donors would be a contribution of its own right, but parallel to the PRSC. Such a construction strengthens the position of the bilateral donors much beyond what could be achieved by just co-financing a World Bank credit. An independent evaluation³⁹ of the previous seco experience in co-financing the C-SAC produced mixed results. Despite co-financing, policy influence remained severely limited, Switzerland was related to unpopular reforms whereas positive visibility was not there. The situation has evolved since then in as far as the World Bank today is more actively trying to integrate policy experience from bilateral agencies than before. Taking the C-SAC experience into account as well as the overall assessment of co-financing multilateral funding, seco and its programme aid partners should negotiate a parallel agreement to the PRSC⁴⁰. The PAF/conditionality should be limited to the jointly agreed PRSC menu of conditions which can be influenced during the preparation process; and ideally, Swiss conditionality would be reduced to an overall positive appreciation of the macroeconomic situation, a positive review of the NPRS implementation being on track and adding specific elements on decentralisation out of the PRSC menu.

(3) ***Provision of earmarked budget support.*** A third way to provide budget support would be to start with budget support but earmarked for decentralisation purposes, more precisely to link it to the budget line for equalising grants or – as an alternative option – even more specific to those equalising grants of the pilot Rayons with direct seco TA support. If other donors would join the scheme, targeting individual Rayons should be given up in favour of either the equalisation budget line as such or at least pooling all support for all pilot Rayons altogether. Earmarking carries three main disadvantages:

- Earmarking ultimately does not improve the overall effectiveness of public financial management. On the contrary, outspoken donor priorities may undermine the allocative efficiency of the system.
- Money is fungible. Earmarking is a misleading concept, therefore. It may rather facilitate donor accountability at the home front.
- Earmarking narrows down a legitimate policy dialogue to those fields where the budget support contribution is targeted at.

³⁹ See chapter 3 and Sabates-Wheeler 2002

⁴⁰ It is one of the recommendations of an independent evaluation of Swiss Cooperation with transition countries covering 1992 – 2002 to go for parallel agreements rather than co-financing multilateral credits. See Unabhängiger Expertenbericht 2003, pp.153, 155

Conclusion: The preferred strategic option for budget support at the national level is the creation of a like-minded programme aid partners' group, including or parallel to the World Bank's PRSC. Co-financing experience has been discouraging, and earmarking is not a promising alternative.

6.4 Policy dialogue

Local level: The non-earmarked local budget support should be linked to policy dialogue of the Aiyi Okmotu. The dialogue focuses around the Local Performance Assessment Framework (L-PAF), see below 6.7.1. The annual joint review and outlook is an opportunity to discuss all burning issues of local development which are in the hands of the Aiyi Okmotu. The semi-annual review may have a more limited scope of discussion. During the field visit the mission was several times asked how local government is organised in Switzerland. The practical Swiss experience in local government is well received and understood by the population and provides credibility as well as legitimacy to seco's active involvement

National level: The national budget support, earmarked to decentralisation, should be linked to policy dialogue of the central Government. The dialogue focuses around the National Performance Assessment Framework (N-PAF), see below 6.7.2. There is the narrow option to concentrate on decentralisation issues only. What is prioritised here, however, is to include the broader issues of macroeconomic performance and implementation of the NPRS as frameworks for the decentralisation process as well. The national poverty reduction policies as well as the MTEF co-determine the space for intergovernmental transfers to the local level and their use. Such a broader scope of dialogue may also ease the way to General Budget Support (GBS) later on. In the more focused policy dialogue on decentralisation Switzerland can draw on its own political traditions and know how and make use of this comparative advantage.

6.5 Civil society initiatives

At the **local level**, best practices⁴¹ clearly require a link between technical improvements of fiscal decentralisation with a strengthening of civil society to keep local governments accountable. Transparency and accountability are prerequisites to make good governance sustainable but they are not sufficient. The accountability mechanisms need also to be used by informed and empowered groups or individuals of citizens. It is of strategic importance to initiate and strengthen such processes in those Aiyi Okmotus and Rayons where the seco supported programme will be active.

This "watchdog" function of civil society with a special focus on fiscal decentralisation and local governance is new to the Kyrgyz Republic. Its development will require time. As has been mentioned earlier, donors have focused their efforts so far on direct social mobilisation and rather neglected the formal structures, at best cooperating with them but hardly working through the Ayil Okmotus. It is likely to base seco supported efforts on previous social mobilisation activities by other donors

⁴¹ See chapter 3.1

and their partners. Making use of such synergies is one criteria of geographical prioritisation among others.

Relevant programmes with such a partnering potential are

- A number of SDC supported programmes, including the Rural Advisory Service (RAS, co-financed by the World Bank and implemented by Helvetas); what else?
- The Village Investment Project (VIP) of the World Bank whose task manager is very much interested in cooperating;
- The parallel programme to the VIP drawn up by the KfW which is in preparation
- UNDP's Local Governance Programme (LGP) and other UNDP supported activities;
- The DFID funded Sustainable Livelihoods for Livestock Producing Communities (SLLPC) project created the Rural Development Centre (RDC) in view of replicating the approach which as well is open for cooperation;
- Others will have to be identified which are relevant for the priority oblasts.

In addition to the local level, at the ***national level*** a partnership with a respected NGO which is already active or interested in fiscal decentralisation should be developed. The objectives of such a cooperation at the national level are (1) to coordinate and support the local initiatives in the Aiy! Okmotus, and based on the experience of the local level (2) to lobby for improvement and enforcement of the legislation for decentralised governance.

Building on past social mobilisation efforts of others can facilitate the start of the seco supported programme. It does not, however, make overall superfluous a targeted civil society component in the seco package ***implementation***. Potential partners are to be found. Also for the cooperation with an NGO, a budget support approach should be explored. The NGO partner will have to deliver according to performance criteria what is needed as support of the seco programme but could get in return a compensation which includes a provision for the overall organisational development.

SDC is about to develop a new programme in Local Governance which is supposed to become operational in 2005. On the occasion of a presentation of the findings of this mission to SDC in Bishkek a spontaneous interest was shown to consider a project design which fits into the seco budget support approach in view of a well coordinated and complementary seco/SDC programme. Such a joint moving forward would be perfectly in line with the intention to develop a joint SDC/seco Governance strategy for Central Asia.

6.6 Regional Focus

Given the extension of the country and the innovative step to be mastered, a nationwide coverage is beyond the means of seco. Distributed all over the Kyrgyz Republic, the support would become ineffective and hardly make any difference. Regional focus is indispensable, therefore.

Selection criteria to be taken into account in prioritising pilot oblasts/rayons and within them pilot Aiy! Okmotus are

- High poverty incidence

- Economic potential of the region
- Expressed interest by the beneficiaries
- Cooperative attitude of Oblast and Rayon administration
- Synergies with other efforts
- Mixed selection (North – South)

It is suggested that in application of this set of criteria two Oblasts are selected, one in the North and one in the South. In the pilot phase of 2005, within each Oblast two Rayons get priority, with the option to work with most – ideally all – of their Aiyl Okmotus. For 2006, an internal assessment of the experience made so far will have to be done whether to review (1) the selection criteria, (2) the geographical focus, and (3) the number of Rayons to be included. For 2006, the geographical coverage should be doubled by adding another two Rayons in each Oblast. If positive experience permits, another step forward in geographical coverage will be done in the scaling up exercise of 2007. The scaling up should remain within the selected Oblasts, if needs and effectiveness justify, and increase the number of Rayons to overall 14 (4/2005 + 4/2006 + 6/2007). It should be kept in mind that the provision of technical assistance is not just a one time affair but in order to effective needs to be followed up when the former trainees will apply the new skills in practice.

The number of Aiyl Okmotus within a Rayon varies between 5 and 18, with an average of 12⁴². The population living in Ail Okmotus varies again between 1'000 and 35'000, with an average of 6'500. Therefore, it is expected that the technical assistance component of the seco package will cover 168 Aiyl Okmotus, benefiting indicatively around 1'000'000 people.

6.7 Effectiveness

6.7.1 Local level

The allocation of budget support to Aiyl Okmotus requires also a common understanding on the basis of a **Local Performance Assessment Framework (L-PAF)**. The L-PAF is the main instrument to shape transparency and accountability at the local level in order to increase development outcomes. Long-term sustainability should be taken into account by including targets for the collection of local revenue. The L-PAF is a proposal by the Aiyl Okmotu, comprising a selection of key objectives, actions and indicators for the last, current and subsequent year, against which performance is assessed. It reflects the local needs and priorities. The L-PAF is commented by the implementing programme partner but must remain a framework with ownership of the Aiyl Okmotu and is not to be transformed into a conventional conditionality. The Aiyl Okmotu is supposed to report quarterly on budget execution and L-PAF achievements to the Aiyl Kenesh, and the reporting documents are shared with the programme implementing partner. In case the present format of reporting excludes crucial information, tripartite negotiations between Aiyl Okmotu authorities, the Aiyl Kenesh and the programme implementing agency on behalf of the donor(s) should strive for an improved format, thereby enhancing the local

⁴² Oral communication by Kurmanbek Dyihanbaev, Chairman of the Association of Local Self-Government Institutions of the Kyrgyz Republic (ALSGI)

authorities' accountability to the Aiyyl Kenesh. There are joint reviews on a semi annual basis, being in line to the rhythm of local budgeting and accounting. One of the two joint reviews is the occasion to look back over the last 12 months, to review the current year and to plan for the next year, including to find a consensus on the PAF.

In order to give local budget support a strategic dimension and to extend learning effects on long term planning, it may be discussed with the Aiyyl Okmotu authorities whether they are interested in developing a Comprehensive Development Framework (CDF) 2010 or 2015 – taking the Millennium Development Goals particularly into account – for their area. Such a local CDF should be more than a wishlist; it is supposed to prioritise the most urgent concerns. The development of such a holistic and long-term framework should become a condition to continue budget support beyond the first three years.

6.7.2 National level

In order to ensure effectiveness of budget support, a **National Performance Assessment Framework (N-PAF)** is to be developed and agreed. The N-PAF is the main instrument to monitor development progress in general and decentralisation progress in particular. The variables should be under control of the Government. Policy dialogue takes place around the N-PAF. It is a proposal by the Government, comprising a selection of key objectives, actions and indicators for the last, current and subsequent year, against which performance is jointly assessed by the development partners. The N-PAF achievements and perspectives are commented by the donors (and/or the implementing programme partner) but must remain a framework with ownership of the Government. Care must be taken not to transform the N-PAF into a scheme of conventional conditionality. The Government reports quarterly on budget execution and N-PAF achievements to the national parliament, and the reporting documents are shared with the donors and the programme implementing partner. In case the present format of reporting omits crucial information, tripartite negotiations between Government, Parliament and donors should strive for an improved format, thereby enhancing the Government's accountability to parliament. There are joint reviews on a semi annual basis, being in line to the rhythm of national budgeting and accounting. One of the two joint reviews is the occasion to look back over the last 12 months, to review the current year and to plan for the next year and agree on the PAF.

From a seco perspective, the **N-PAF indicators** should be as simple as possible and not add to the reporting burden of the Kyrgyz Government. The N-PAF might basically rely on the continued satisfactory performance in the implementation of the economic reform process, the implementation of the NPRS, and the satisfactory progress in decentralization. As an indicator for the performance of the economic reform process can be taken compliance with the conditions laid down in the Arrangements under the Poverty Reduction and Growth Facility (PRGF) between the IMF and the Government ("on track" situation). The framework for NPRS reporting is also already in place. So the only new element are the PAF-indicators to measure performance in decentralization. They may include indicators like the establishment of a long term framework for intergovernmental transfers to increase their predictability, the volume and allocation criteria of equalizing grants, etc.

As a vision, the N-PAF is valid for the option to align with the Poverty Reduction Support Credit (PRSC) of the World Bank as well as for the option of budget support earmarked for equalisation or stimulating grants. In both cases, seco should link its disbursements only to goals and indicators which are part of the PRSC menu. As the PRSC has decentralisation as a key topic, this alignment should be feasible even to cover the decentralisation performance. In view of acknowledging and strengthening the role of the parliament, disbursement can be made dependent on the approval of the budget and/or the annual NPRS implementation report to parliament.

It is obvious that the creation of the N-PAF mechanism is also an instrument to enhance **donor coordination** because it focuses policy dialogue on the essentials and a joint dialogue increases leverage. In case seco takes the decision for the co-financing or parallel PRSC option, seco should negotiate with the World Bank to agree on a N-PAF approach.

6.8 Financial implications

What follows are very rough estimates of the financial implications of the seco package outlined. All figures are tentative and subject to revision.

Financial implications (in CHF) 2004 - 2007

	2004 (package preparation)	2005 (piloting period)	2006 (partially on budget)	2007 (scaling up)
TA/PD central level	-	250'000	250'000	250'000
TA/PD local level ⁴³	-	400'000	400'000	650'000
BS central level ⁴⁴	-	1'500'000	1'500'000	1'500'000
BS local level ⁴⁵	-	-	1'000'000	1'200'000
CS initiatives	-	100'000	100'000	150'000
Studies, workshops, evaluation	100'000	100'000	100'000	100'000
Preparation & implementation	50'000	150'000	150'000	150'000
Total CHF	150'000	2'500'000	3'500'000	4'000'000

⁴³ The revised draft (February 21, 2004) for "Piloting New Mechanisms for Local Intergovernmental Finance" of the World Bank budgets for a full TA coverage of two rayons during two years USD 156'000 (CHF 210'000). This corresponds to CHF 50'000 per rayon/year. In the seco programme, TA will also cover legal literacy, address partially a broader audience of the population and probably be of a longer duration (to be prepared in detail). These changes will lead to higher average costs of CHF 80'000 per new rayon/year. In addition, the TA component includes also follow up consultations and trainings on request for those rayons covered by trainings in previous years, with estimated costs of CHF 20'000 per rayon covered earlier. 2005 includes a special allocation of CHF 80'000 to train the trainers.

⁴⁴ Assumption of a contribution of USD 1 million (minimum) per year.

⁴⁵ Calculation basis: Suzak Aiyl Okmotu has had actual expenditures in 2003 of 1'490'000 soms (CHF 60'000) with a population of 32'000 people. Roughly, the expenditure is CHF 2 per person/year. It is assumed that an additional budget support of CHF 1 – 1.50 per person/year may be a reasonable calculation basis (to be verified).

Seco should see decentralised budget support as a long term commitment and therefore be inclined to continue beyond 2007. The volume of support would continue at about CHF 4 – 5 million per year.

6.9 Implementation

The implementation of the package for fiscal decentralisation and local governance should observe the following **principles**:

- Package implementation should follow along the lines of existing institutions and strengthen them instead of establishing a new parallel delivery structure;
- Package implementation should avoid any mixed messages to sent to the central Government as well as the local authorities, requiring negotiations with other donors in case of disagreements and contradictions;
- Package implementation may become a vehicle for strengthening donor coordination in order to increase capacity and leverage in decentralisation policies and their implementation.

Contracting partner(s) in the Government of the Kyrgyz Republic should be the Ministry of Finance (MFKR) as the “natural” partner in intergovernmental finance. This choice will facilitate later on the transition to General Budget Support. The MFKR can directly influence the fiscal decentralisation and grant transfers from the centre to the local level. The PRSC will also have the MFKR as a partner. They are more used to a top down approach which should be kept in mind. The role of the Ministry for Local Self Government (MLSGKR) in the arrangement with seco will have to be defined. It would be advisable to have them co-signing the agreement. For the transfer of direct budget support to the selected Aiy! Okmotus the Deputy Minister of Finance has offered to open a special account at the central level which remains under the control of the donor. The Food Security Project of TACIS/EU has such a mechanism in place and lives well with it.

Implementing partner(s) have to be identified as seco does not maintain an operational structure. Ideally, one partner would tackle the implementation of all elements of the package with seco concentrating on the political issues (policy dialogue) and the strategic development of the interventions. Indeed, a strong implementing partner with considerable human resources is required as the package is demanding. It would include

- the delivery of technical assistance at the local level, including legal literacy and assistance (in cooperation with LARC or another specialised partner) and participatory baseline studies for all Aiy! Okmotus to be covered;
- the organisation of delivery of technical assistance at the central level (?);
- the administration of budget support and the lead in policy dialogue at the local level (L-PAF);
- the administration of budget support at the national level (?) and support in policy dialogue at the national level (?);
- cooperation with the implementing partner for civil society activities, including the administration of the agreement;
- support in the donor coordination.

The implementing partner should be identified through the process of a public tender or tender on invitation.

Seco should make a serious effort to win the other donors who are working in the field of decentralisation as **cooperating partners**. During the discussions with the Kyrgyz Government steps forward in donor coordination were formulated as an urgent concern, and Switzerland was seen as a potential leader in such an effort. On May 12, 2004, the Swiss Cooperation Office organised a well attended donor roundtable on fiscal decentralisation⁴⁶. Pending a positive decision by seco to further develop this package, the Swiss Cooperation Office should actively pursue enhanced donor coordination in this area. A regular exchange of experience with the other cooperating partners will secure in-country access to a wealth of information.

The creation of a small but highly profiled **advisory group** to the programme should be explored. Members are nominated in their personal capacity and not as representatives of their institutions (Government, NGOs, Universities, donors, other). Clear terms of reference for the advisory group will have to be developed to make sure an optimal use of their potential contribution. It could serve as a sounding board for its orientations and review.

7 Opportunities and Risks

This package proposal to provide budget support creates a number of major **opportunities** which are relevant for the overarching goal of poverty reduction and achieving the MDGs:

- First of all, technical assistance and budget support **strengthens central and local governments in its core functions** to serve the population: making more effective and efficient use of public resources, strengthen mobilisation of local resources, improving the legal system and its implementation, thereby contributing to a favourable environment for SME development and improving basic services of health, education, etc.. In a decentralised state, these core functions will also include the concern of better balancing regional differences.
- As outlined, fiscal decentralisation will only unfold its development potential if accompanied by efforts to **strengthen political participation of the population and the accountability of their authorities**. This close link is indispensable to secure the effectiveness of the programme and equally is a great opportunity.
- The rationale of budget support is its major opportunity: When shaping policies and their implementation in policy dialogue and related technical assistance, **budget support creates leverage beyond the direct contribution** which extends to the much larger rest of the budget.
- In providing decentralised budget support and strengthening local governance, **Switzerland can build on its comparative advantage** emanating from its political tradition. This comparative advantage is widely recognized by the Kyrgyz partners as well as the other donors. Decentralised budget support in the way proposed may be an innovation but Switzerland enjoys credibility in that area.

⁴⁶ See chapter 5.1

- Budget support at the central level has become in a number of countries already the **focal point of donor coordination**. The same opportunity is also within reach in the Kyrgyz Republic in relation to decentralisation and budget support. The Deputy Minister of Finance would welcome a leading and coordinating role of Switzerland.

Linked to the instrument of budget support, there are **five risks** which have to be closely monitored:

- Budget support essentially being non-earmarked funding increases the fiduciary risk of an **abuse of funds, including corruption**. This risk is acute at the central government level as well as at decentralised levels. The main measure to mitigate this risk is strengthening the regular accounting services, audits of the (local) government accounts, selective value for money audits, a policy dialogue which includes the prevention of breeding grounds for corruption, a N-PAF or L-PAF addressing specific cases, what else?
- Everywhere in the world elites play an influential role not only in private issues but have also a special say in the public domain. Non-earmarked budget support runs the danger of **servicing the local elites**. Untargeted budget support interventions may miss the poverty reduction objective and its contribution to the MDGs. Poverty reduction and distributional issues may become part of the policy dialogue around the L-PAF. This risk can be countered by building development efforts on popular participation and meaningful accountability mechanisms. It is of utmost importance, therefore, to complement the more technical training on financial and budgetary issues to the local authorities (including the keneshes) with offering budgetary education and understanding to the population in the Ayil Okmotus, and, as a second step, to ensure that budgetary hearings or similar efforts are made.
- When a donor provides budget support to individual Ayil Okmotus, it is a risk to **crowd out central government transfers**. If central government – including its deconcentrated oblast and rayon levels – as a reaction reduces categorical grants, equalisation grants, matching grants or adjusts tax and cost sharing arrangements, the external support is just negatively compensated on the internal side. Instead of an incentive for good performers and additionality of the external budget support frustration and a disincentive might result. This risk should be openly addressed with government at all levels, the agreements between seco and the government should include clear-cut clauses, and the level of central government transfers for the last three years should be part of the baseline study which will be done for each Ayil Okmotu getting TA and budget support of the seco package.
- External donors providing additional budget support at the local level might unwillingly **discourage local revenue mobilisation**. Local authorities might consider it easier to go for external support instead mobilising their own resources. To prevent such a destructive attitude, the L-PAF should include targets for revenue mobilisation and the development of the local private sector as the economic base. The policy dialogue will regularly deal with that issue. The same risk is also present at the national level and should as well be addressed in the policy dialogue with the central government and in the N-PAF.
- From various angles the risk of **non-sustainability of the arrangements** may become an issue:
 - (1) If implementation is done by a newly created programme implementing agency, it will disappear at the end of the programme. If implementation is

mandated to an existing institution (NGO), institutional sustainability has a better chance as the partner organisation will continue to exist and work;

- (2) The strengthened financial capacity may induce an inflation of Ayil Okmotu staff numbers which is not sustainable. Up to now, the president approves staffing lists of the Ayil Okmotus, the number of staff being based on the population figures. Opportunities and risks of staffing will have to be part of training, of policy dialogue and probably of L-PAFs.
- (3) If turnover of trained staff is high, fluctuation of professional personnel in the Ayil Okmotus and at the rayon, oblast and central levels may undermine the sustainability of the whole exercise. There was contradicting information on the staff turnover. It should be clarified and will influence the target number of people to be trained from each Ayil Okmotu.
- (4) Last but not least, donor dependence of local budgets might also undermine the sustainability of budget support. The requirement to mobilise local resources and create a favourable environment for small and medium enterprises has already been mentioned. Ayil Okmotus should not later than three years of joining that programme develop long-term perspectives for their territory. Within such a local Comprehensive Development Framework (CDF) the concern of donor dependence can be addressed in a systemic way.

Overall, the opportunities clearly outweigh the risks which can be addressed in a meaningful way.

8 A Roadmap

Overview: The remaining months in 2004 should be used as preparation period. The proposed seco package itself should be tied up in a three years' parcel, lasting from 2005 – 2007:

- At the local level, 2005 is an year of piloting technical assistance; 2006 will be for extension of technical assistance and piloting local budget support; 2007 scaling up technical assistance as well as local budget support.
- At the national level, 2005 covers technical assistance and budget support if PRSC-related negotiations are successful; 2006 again technical assistance and budget support; 2007 as the year before.
- Reviews: An institutionalised exchange of experience among development partners involved will go on a permanent basis (advisory group and/or donor coordination); a more formal but internal review should be done at the end of 2005 in view of planning for 2006; an independent evaluation is to be scheduled for mid 2006 to found the scaling up in 2007 on well established experience.

Preparation period 2004

- The mission report is available as a draft end of May 2004, and in a revised version end of June 2004.
- Seco makes an assessment of the situation not later than June 2004, and identifies what additional clarifications and preparations are required to pursue the way forward;
- Seco participates in the PRSC-mission of the World Bank in June 2004;

- Swiss Cooperation Office in Bishkek works on the pending issues and provides the information required, in particular on the regional focus and its implications;
- Swiss Cooperation Office explores terms and conditions of cooperation with potential development partners (Government at central, oblast and rayon levels, cooperation with other donors, partnering with NGOs for the implementation of specific parts and/or the overall package);
- An entry decision (“Eintretensentscheid”) by seco is taken not later than October 2004;
- With the perspective of a start early in 2005, preparation is taken at hand: Working on first drafts of formal agreements, drafting terms of reference for implementing organisations, finalizing technical assistance concepts based on experience made by other actors, reviewing and improving teaching material; etc.
- Seco uses the opportunity of the Consultative Group meeting in October to make its entry decision known, to deepen discussions with the Government and donors, and to lobby for a strong statement on the Kyrgyz’ Government commitment to decentralised governance and fiscal decentralisation;
- Seco takes a formal decision not later than December 2004;
- Formal agreements are negotiated with the Government and the implementers; if needed, a public tender to decide on an implementing agency is done in early 2004;
- Implementation starts in spring 2005.

Being an innovative package and in view of predictability of support, it is important to identify potential **exit options** on the donor side and to anchor them in the cooperation agreement:

- Negative results of the independent evaluation in mid 2006 are an exit option for the overall commitments, at the national and local level;
- Unsatisfactory results of the N-PAF (national budget support) are an exit option for the part of national budget support, in a coordinated response with World Bank and other bilateral donors;
- Unsatisfactory results at the local level depending on L-PAF achievements are fine tuned exit options in view of a withdrawal from specific AiyI Okmotus.

9 Recommendations

- 1 Seco should take a **positive decision** to contribute to decentralised budget support in the Kyrgyz Republic.
- 2 Seco should take such a decision with the informal perspective of a **long term commitment** of 10 years plus, corresponding to the OECD/DAC lessons learned.
- 3 Seco should adopt the **package approach** as outlined for 2005 - 2007, combining technical assistance, budget support and social mobilisation at the local and central levels, and address the open questions.
- 4 Seco should actively use the decentralisation and budget support package as a **vehicle for donor coordination** among bilateral and multilateral agencies working in the decentralisation domain.

- 5 Seco has been considering for almost two years to resume budget support after the C-SAC-contribution and its independent evaluation. There is an ***urgency for decision making now***. Explorative missions create expectations and it is necessary to clarify Swiss intentions towards the Government and the development partners.

Local governance and fiscal decentralisation are priority concerns of the Kyrgyz Government. It is a sound response to basic needs of the population. Because of its political tradition, Switzerland has a comparative advantage and enjoys high credibility in local governance. Fiscal decentralisation and local governance are an excellent area for a Swiss intervention. And it is very timely to contribute to the fast moving process.

Annex 1

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Annex 2

Interviews

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