

**Kyrgyz Republic:**

**PEFA  
Public Financial Management  
Assessment**



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## Foreword

There is wide agreement that effective institutions and systems of public financial management (PFM) have a critical role to play in supporting implementation of policies of national development and poverty reduction. The PEFA PFM Performance Measurement Framework has been developed as a contribution to the collective efforts of government, donors and other stakeholders to assess and develop essential PFM systems by providing a shared information pool for measurement and monitoring of PFM performance and a common platform for dialogue.

The PFM Performance Measurement Framework is an integrated monitoring framework that allows measurement of country PFM performance over time. It has been developed through concerted international effort by PEFA partners in collaboration with the OECD/DAC Joint Venture on PFM.<sup>1</sup> The framework incorporates a set of high level indicators which draw on HIPC expenditure tracking benchmarks, the IMF Fiscal Transparency Code and other international standards, and a PFM Performance Report that provides information on PFM performance as measured by the indicators. The Performance Measurement Framework identifies the critical dimensions of performance of an open and orderly PFM system for all countries based on a set of high-level indicators which measure the operational performance of key aspects of PFM systems, processes and institutions. It uses the indicator analysis to develop an integrated assessment of the PFM system against the critical dimensions of PFM performance and evaluates the likely impact of PFM weaknesses on the three levels of budgetary outcomes: aggregate fiscal discipline, strategic allocation of resources, and efficiency of service delivery.

The PFM Performance Report recognises efforts by government to reform its PFM system by describing recent and on-going reform measures which may or may not yet have impacted on PFM performance. The report does not, however, include any recommendations for reforms or any assumptions about the likely impact of on-going reforms on PFM performance. The report is meant to be a concise document, not exceeding 35 pages, with all relevant information included in the body of the report.

The focus of the PFM indicator set is on PFM performance at central government level, including the related central institutions of oversight. The framework does not measure factors impacting on performance (such as capacity of institutions or the legal framework) nor does it involve fiscal or expenditure policy analysis. This would require detailed country-specific data analysis. Instead, the framework focuses on the extent to which the PFM system is an enabling factor for the achievement of policy outcomes.

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<sup>1</sup> PEFA (Public Expenditure and Financial Accountability) is a multi-agency partnership programme sponsored by the World Bank, the International Monetary Fund, the European Commission, The UK's Department for International Development, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the Swiss State Secretariat for Economic Affairs, and the SPA Strategic Partnership for Africa

## Table of Contents

Summary Assessment.....	i
1. Introduction .....	1
Objectives.....	1
Methodology .....	1
Team.....	1
2. Background Information .....	3
2.1 Country Economic and Political Situation .....	3
2.2 Recent Budgetary Outcomes .....	4
2.3 The Legal and Institutional Framework for PFM.....	6
3. Assessment of the PFM system.....	7
3.1 Budget Credibility .....	7
3.2 Transparency and Comprehensiveness.....	10
3.3 Policy-based budgeting .....	15
3.4 Predictability and Control in Budget Execution.....	17
3.5 Accounting, recording and reporting.....	24
3.6 External scrutiny and audit.....	26
3.7 Donor Practices .....	29
4. Government Reform Process.....	31
Annex 1: Performance Indicators Summary	
Annex 2: Source of Information	
Annex 3: List of People Met	
Annex 4: Revenue & Expenditure	

## Abbreviations

CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CIS	Commonwealth of Independent States
DFID	Department for International Development
EC	European Commission
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GSAC	Governance Structural Adjustment Credit
HIPC	Heavily Indebted Poor Countries initiative
IMF	International Monetary Fund
MTBF	Medium Term Budget Framework
OECD/DAC	Organisation for Economic Cooperation and Development/Development Assistance Committee
OPM	Oxford Policy Management
PEFA	Public Expenditure and Financial Accountability programme
PER	Public Expenditure Review
PFM	Public Financial Management
PIP	Public Investment Programme
PPER	Programmatic Public Expenditure Review
PRGF	Poverty Reduction and Growth facility
PRSG	Poverty Reduction Support Grant
ROSC	Report on Standards and Codes
SC	Steering Committee
seco	Swiss State Secretariat for Economic Affairs
SIDA	Swedish Development Assistance
SIPU	Swedish Institute for Public Administration
SOE	State Owned Enterprise
TNBE	Technical Note: Budget Execution
TNBP	Technical Note: Budget Preparation
USAID	United States Agency for International Development

## Summary Assessment

This summary aims to provide an integrated and strategic picture of PFM in the Kyrgyz Republic.

Section (i) of the summary is structured according to the six core dimensions of an open and orderly PFM system identified by the PEFA Performance Measurement Framework. Section (ii) provides an assessment of the impact of performance across the six dimensions on the overall achievement of budgetary outcomes at the three levels of aggregate fiscal discipline, strategic allocation of resources and efficient service delivery. Section (iii) assess the extent to which institutional arrangements within the government support an appropriate and timely PFM reform process

### **(i) Integrated Assessment of PFM Performance**

#### *Credibility of the budget (indicators 1-4)*

Recent macro-budget management appears to have brought the fiscal deficit under control. The fiscal deficit has declined significantly in recent years, from 6.9% of GDP in 2000 to an estimated 2.5% in 2004. The Governments policy is to maintain the fiscal deficit at 2.5% over the medium term.

Revenue forecasts, formulated in collaboration with the IMF, are generally realised. Expenditure forecasts, however, tend to be less accurate: the average difference between budgeted and actual general expenditures (functional categories I to XIV) for the last three years has exceeded +20% of original budgeted expenditure. Ex post adjustments of this magnitude that do not adversely impact the deficit target appear to have only been possible because of the tendency to significantly over-estimate debt interest payments during budget preparation. The process by which budget funds are subsequently reallocated during budget execution is not clear and reportedly ad hoc. This reduces the credibility of the budget as the main policy instrument through which resources are allocated and utilised efficiently.

Expenditure arrears emanating from a number of sources have been reduced to zero under the IMF supported PRGF programme and monitoring of these is in place. However, there is no systematic process whereby the Government can monitor the entire stock of expenditure arrears. In principle, this puts at risk the ability of the Government to deliver its fiscal policy objectives (i.e. aggregate fiscal discipline).

#### *Comprehensiveness and transparency (indicators 5-10)*

The comprehensiveness of the budget has improved significantly in recent years but some significant fiscal operations are still outside the budget process, including the continued practice of offsets and pension fund liabilities. Arrears to normal suppliers of goods and services are not routinely monitored.

The transparency of the budget has also improved in recent years. Information on fiscal policy objectives and macroeconomic assumptions is publicly available and the Ministry of Finance publishes budget execution data on its website. However, the classification of the budget still impedes meaningful analysis and certain information (e.g. the operations of state owned enterprises) is not generally available. Year-end financial statements on budget execution consistent with modern accounting practice are not produced.

The Government's is planning to reorganise inter-governmental fiscal relations. These plans are not yet clear but they could have a significant impact on the PFM system.

*Policy-based budgeting (indicators 11-12)*

There have been notable improvements in budget management but there remains considerable scope for improvement in the budget preparation process. Budget preparation comprises a deeply-entrenched input focussed line item budget, where a large part of the budget is effectively protected (particularly wages and transfers), alongside a recently introduced policy-oriented, medium term budget process. The need to move towards a comprehensive medium term budget preparation process is recognised by the Government but pilots in this area are still in their early stages of development.

Medium term fiscal forecasts are prepared and ministry coverage is good. But there is not yet a general culture within line ministries of developing policy initiatives, costing policy changes and developing integrated (i.e. recurrent and capital) spending strategies although there are some exceptions, notably in health and social protection. Political involvement in the budget is limited. It tends to come at the end of the budget process and during budget execution.

*Predictability and control in budget execution (indicators 13-21)*

The Treasury has discretion in deciding the priorities for payments. However, the system fails to take into account outstanding line ministry commitments or cash flow requirements. This results in unpredictable cash flows which severely affects the ability of budget institutions to plan and implement the originally approved budget and, as demonstrated by budget execution data, results in numerous changes to the budget during the year. The Treasury has introduced new cash planning procedures but for these to be effective the system needs to be linked to a system which records all commitments entered into by Government.

Personnel and payroll functions are decentralised and there is an absence of effective control over both. It was noted that line ministries manage to increase and/or maintain their personnel expenditure through using money allocated to vacant posts or by concealing the exact number of staff to preserve the same personnel budget and use the funds to insure disguised increases of salaries.

A new public procurement law was introduced in 2004 which implemented most of the recommendations of the CPAR of December 2002 and introduced major improvements in transparency, economy and efficiency in public procurement. The country is now facing the challenge of implementation, which has been difficult at both national and sub-national levels due to lack of resources. Equipment and suitably qualified procurement staff. Moreover, early returns for 2005 show that procurement through the offset process, in which suppliers who owe government money supply goods and services in place of its debt thereby bypassing the official procurement process, amounted to 10% of all procurement - even though the offset process is 'officially' banned.

An important factor in the efficacy of the internal control framework in the Kyrgyz Republic is the absence of any clear legal requirement for ministries to maintain an effective internal control framework. Internal control is ineffective in practice. This reflects the fact that emphasis in the management of financial and other resources in Kyrgyzstan is placed on compliance with rules and procedures established by the central control ministries rather than in providing managers with financial information about their management of resources. Thus the "accounting" system is in fact a recording and reporting system designed to demonstrate and enforce compliance with these pre ordained rules and limits regardless of the level of risk involved. On the other hand, while line ministries are entitled to enter into commitments, no

record is kept of these and no control is exercised over these by Treasury nor is any record kept of them.

*Accounting, recording and reporting (indicators 22-25)*

Bank balances are reconciled monthly on both aggregate and detailed levels. As records on advance and suspense accounts are kept by individual Ministries it was not possible during the assessment to form a judgement on the quality of record keeping and timeliness of their reconciliation on a government wide basis.

The reporting system is based on aggregation from the bottom up, culminating in the analysis of expenditure over thirty six different items that are reported to the Ministry of Finance. Any tracking of expenditure at the lowest level would be difficult and time consuming. As the recording system is manual there are inherent problems with accuracy and timeliness.

Regular monthly and quarterly reports are produced by the Treasury on budget execution giving detailed information down to the fourth tier of economic and functional classification. Accounting in all budget institutions is a labour intensive, manual process requiring the maintenance of several registers and the production of numerous reports in paper form. There is an ongoing reform agenda which intends to focus on the modernisation of the Treasury.

*External scrutiny and audit (indicators 26-28)*

The Chamber of Accounts (CA), established in 1996 by the Law on Chamber of Accounts, is recognised as the Supreme Audit Institution in the Kyrgyz Republic. The CA largely remains an inspection and control unit that carries out periodic checks to ensure compliance with existing regulations, including public procurement law.

Financial statements showing the financial position of government are not produced and therefore no audit of the financial position of government can be undertaken. Auditing standards in respect of this process are therefore irrelevant as far as government accounts are concerned. Reports on budget compliance are generally submitted to Parliament within two months and in accordance with the legislation but these do not cover financial statements as none are produced.

Support to the external audit function is included in the GSAC support project. However, difficulties are being experienced in reaching agreement on the principles and strategies to be adopted.

**(ii) Assessment of the Impact of PFM performance**

At the aggregate level there have been noticeable improvements in the PFM system, in particular around the ability of the authorities to achieve and maintain fiscal discipline, the comprehensiveness and transparency of the budget, and in the identification of some significant areas of fiscal oversight (e.g. quasi-fiscal liabilities) which might put these achievements at risk.

However, although there is better control of the aggregate budget figures this has yet to be translated into the ability by the Government to reallocate resources from lower to higher priorities and from less effective to more effective programmes in any substantial manner. Sectoral policies need to reflect the priorities of the NSPR. But as long as important aspects of budgetary control (offsets, payroll) remain outside the control of central agencies and policy-oriented budgeting remains limited to a few more advanced ministries the Government's ability to use resources strategically will be significantly reduced.

**(iii) Prospects for reform planning and implementation**

The Kyrgyz Government is realising that despite some initial progress the PFM suffers from considerable shortcomings and the prospects for continued reform planning and implementation are at risk due to the (1) insufficient political leadership; (2) perverse institutional set-up and (3) weak coordination between donors and stakeholders. In addition, upgrading of the managerial and technical skills, has received inadequate attention during the reform implementation process.

To cope with these critical issues the KR, has decided to increasingly apply three principles of a strengthened approach to supporting PFM reforms: (i) a country led PFM reform strategy and action plan, (ii) a coordinated International Financial Institution-donor integrated, multi-year program of PFM work that supports and is aligned with the Government's PFM reform strategy and, (iii) a shared information pool based on common indicators.

Under this broad framework, the Kyrgyz Government has initiated developing a concrete action plan for the PFM reform planning and implementation. It is envisaged that this action plan will be elaborated further into a high-level roadmap of policy and operational reforms required to sustain and further strengthen PFM performance. Donors have also consolidated their positions and agreed on getting away from an earlier fragmented approach of providing TA to the KR to a better coordinated and harmonized assistance in support of a Government owned PFM reform strategy and action plan.

There seems to be a good prospect for enhancing reform planning and implementation. The Government's ability to effectively implement the main principles of strengthened approach depends on strengthening high-level political leadership for reform. The process is in its early stage and it is too early to assess its potential impact on the budgetary outcomes.

## **1. Introduction**

The Government of the Kyrgyz Republic has launched a process to assess systematically its Public Financial Management (PFM) system jointly with the donor community. A joint government-donor Steering Committee (SC) chaired by the State Secretary of the Ministry of Finance has been established to provide overall guidance to the assessment process. The SC has decided that an in-country PFM assessment should be conducted in the Kyrgyz Republic based on the guidelines and indicators developed by the PEFA Secretariat.

### **Objectives**

The overall objective of the assessment is to develop an up-to-date picture of the quality of the PFM system in the Kyrgyz Republic and to establish a baseline for monitoring the progress of PFM reforms in future. The assessment covers PFM central government level (i.e. the budget of the Republic).

This is a first attempt to provide a holistic and common assessment of the PFM system, agreed with the Kyrgyz authorities and the key donors supporting the Government's PFM reforms, which will facilitate forthcoming discussions between the government and its development partners on PFM reform.

The assessment will also provide the basis for the fiduciary risk analysis of the UK Department for International Development (DFID) and the Swiss State Secretariat for Economic Affairs (seco) in preparation of their potential co-financing of a programme of budgetary support.

### **Methodology**

The assessment was undertaken by consultants from Oxford Policy Management in collaboration with the Kyrgyz authorities and with the joint support of DFID, seco, SIDA and the World Bank. The IMF and EC participated as observers throughout the process.

The assessment involved a review of various diagnostic reports of the Kyrgyz PFM system (see reference list attached in Annex 2) and discussions of PFM performance with Government ministries and agencies, PFM oversight institutions and donors. In certain cases, the Government submitted its own assessment of PFM performance for discussion.

A joint Government-donor workshop was held on 23<sup>rd</sup> September, 2005, in Bishkek to present a summary and preliminary findings of the assessment. A consultation period followed the workshop during which the Government and other relevant stakeholders were invited to validate the assessment - in terms of the description of PFM performance across the indicator set, the indicator scoring and the description of ongoing PFM reforms. The review process, which was co-ordinated by the Ministry of Finance and DFID, has led to the current version of the assessment.

### **Team**

The assessment was conducted by David Hoole and Ian Lang, both from Oxford Policy Management. The consultant team was supported by Natalia Pisareva, Azamat

Abdymomunov and Junghun Cho from the World Bank, Finn Hedvall from SIPU (representing SIDA) and Marc Silings (GSAC Support Project). Sheetal Vyas, DFID, joined the mission to participate in the workshop. The team was supported during the assessment by Stefan Bruni (PFM consultant, DFID/seco).

## **2. Background Information**

This section provides information on country and economic context of the Kyrgyz Republic, to allow sufficient understanding of the core characteristics of the PFM system and the wider context to PFM reforms.

### **2.1 Country Economic and Political Situation**

The Kyrgyz Republic is a small, mountainous country with a predominantly agricultural economy and a population of 5.1 million of whom about 65% live in rural, mostly mountainous areas. It is one of the poorest countries of the former Soviet Union and one of the poorest countries in the world. In 2004, GDP per capita was US\$430.<sup>2</sup>

The country became independent when Soviet rule ended in 1991. In the early 1990s, the Kyrgyz Republic struggled with a substantial loss of transfers, adjustment in oil prices, collapse of economic relations with other former soviet republics and a sharp reduction in tax collections. The loss of transfers alone reduced revenues by half between 1991 and 1992. An institutional collapse was avoided, however, as spending was financed initially through domestic credit (i.e. inflation) and donor assistance and a policy of considerable cutting and restructuring of spending by the authorities. Since the mid-1990s, the economy has shown steady signs of recovery. Real GDP growth averaged over 5% p.a. in 1996-2000, despite the disruptions of the regional financial crisis of 1998, and over 4% p.a. 2000-2004. These growth rates were reflected in a significant decline in poverty rates, from an estimated 52% in 2000 to 35% in 2004<sup>3</sup>.

Macroeconomic performance since 2000 compares well with other countries in the region. Average consumer price inflation for the period 2001-2004 was below 5% p.a. and lower than in all but two CIS countries, reflecting a prudent monetary policy during a period of rapid remonetisation of the economy. There was also a strong turnaround in the fiscal position, from a primary balance of -6.9% of GDP in 2000 to an estimated primary balance of -2.5% in 2004. Recent economic growth rates have, however, lagged behind those experienced by most other CIS countries. The Kyrgyz Republic's economic circumstances differ in important ways from other CIS countries, mainly because of its small size, difficult mountainous terrain and distance from markets.<sup>4</sup>

The size and structure of the Kyrgyz government has changed considerably since independence. Government spending levels as a percentage of GDP, at around 27% in 2004, is now comparable to the average for 16 countries at similar income levels in Europe and Central Asia. Overall tax rates and contributions are at levels comparable with international practice. However, compliance is poor and results in low revenue outturns. Revenues and grants are only around 22 percent of GDP.

High public external debt continues to be a key policy constraint affecting the Kyrgyz Republic. At the end of 2004, this debt amounted to \$1.9 billion (92% of GDP). In March 2005, the Paris Club of creditors granted debt relief on Evian terms for the Kyrgyz Republic's bilateral public debt. This agreement is expected to result in a 36% reduction in the Net

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<sup>2</sup> Information supplied by Ministry of Finance.

<sup>3</sup> IMF staff estimates

<sup>4</sup> IMF, 6<sup>th</sup> Review under the PRGF, Feb. 2005.

Present Value of official bilateral debt . However, the authorities agree that even with Paris Club debt relief, fiscal consolidation will continue to be needed in the coming years to further reduce debt levels.<sup>5</sup> The Government has applied for HIPC debt relief. A decision on its eligibility for HIPC debt relief is expected by mid-2006.

On March 24, 2005, a popular revolt sparked by widespread allegations of government interference in the February parliamentary elections swept the country's long-time president, Askar Akaev, from power. The peaceful election of President Bakiev on July 10, 2005, and the appointment of Prime Minister Kulov on September 1, 2005, stabilised the situation to an extent but the political environment remains volatile and a new government has only recently been established. The interim government has made efforts to formulate a new strategic vision; President Bakiev and Prime Minister Kulov identified low living standards, unemployment, and high levels of corruption as the three key problems in the country. However, given its interim nature and the lack of unity within the new administration, it has, to date, failed to present a credible economic development programme. A new Cabinet was approved by Parliament in October 2005. PFM reforms are expected to focus on continued fiscal consolidation, building fiscal institutions, promoting fiscal transparency and improving public sector accountability.

## 2.2 Recent Budgetary Outcomes

In recent years the Kyrgyz authorities have made reasonably good progress in achieving aggregate fiscal discipline. Recent budgetary performance has been characterised by declining fiscal deficits, from 6.9% of GDP in 2000 to an estimated 2.5% in 2004. The government has forecast a financing gap of 2.5% of GDP over the period 2005-07 which is expected to be filled through debt relief by Paris Club Creditors and external assistance.<sup>6</sup>

**Table 1. Kyrgyz Republic: General Government Finances (%GDP)**

	2001 act.	2002 act.	2003 act.	2004 est.
Total Revenue	20.4	22.8	22.2	23.0
Tax revenue	15.8	17.6	17.8	18.5
Total Expenditure	25.9	28.0	27.3	27.3
Non-interest current	19.6	21.1	21.5	21.3
Capital	4.4	4.7	3.6	3.5
Fiscal Balance (Cash)	-5.1	-5.5	-5.2	-4.2
Primary Balance	-3.4	-3.9	-3.7	-2.5
Net Financing	5.1	5.5	5.2	...
External	5.7	5.2	4.2	...
Domestic	-1.1	0.0	0.7	...

*Source:* IMF. General Government comprises State Government and the Social Fund. State Government comprises central and local governments

While recent macro-budget management has been quite effective at improving fiscal discipline this has been done with only a marginal improvement in the allocative efficiency of the budget. Recent expenditure adjustment has relied on cash sequestration and across-the-board cuts. A major contributor to fiscal consolidation has been the contraction of the externally financed public investment programme, reducing key investments in education, health and transport as well as a reduction of expenditure on complimentary inputs.<sup>7</sup>

<sup>5</sup> Information supplied by World Bank

<sup>6</sup> IMF, 6<sup>th</sup> Review under the PRGF, Feb 2005.

<sup>7</sup> Information supplied by World Bank

Trends in the functional allocation of resources are shown in Table 2 below.

**Table 2. Kyrgyz Republic: General Government Expenditure (% total expenditure)**

	2002 act.	2003 act.	2004 act.
1. General Public Services	14.4	15.1	16.1
2. Defense	8.8	9.2	9.4
3. Public order & security	7.4	7.9	8.0
4. Education	9.6	9.9	10.9
5. Health	3.4	3.7	4.3
6. Social Protection	17.7	17.7	16.3
7. Housing and utilities	5.3	4.4	3.2
8. Recreation & culture	2.0	2.3	2.5
9. Fuel & energy complex	1.8	1.2	0.0
10. Agriculture & water	5.8	5.4	5.7
11. Mining	1.8	2.1	1.8
12. Transport	5.1	3.9	4.1
13. Other related services	0.0	0.0	0.0
14. Other	16.5	17.1	17.4
Memo:			
Total Expenditure (m som)	12271.0	13655.8	15021.1

Source: Ministry of Finance

The National Poverty Reduction Strategy (NPRS) presents an expenditure framework with a focus on poverty reduction, but linkages to the budget are broadly missing. The authorities are committed to strengthening the link between policies and budgets through the introduction of a medium term and programmatic approach to budgeting but these reforms are still in their early stages.<sup>8</sup>

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<sup>8</sup> TNBE, p4

### **2.3 The Legal and Institutional Framework for PFM**

The President is the highest State official and is responsible for forming the government, subject to parliamentary approval for the appointment of the Prime Minister. Following amendments in February 2003, the Constitution provides for a unicameral Parliament with 75 deputies elected by popular vote. The Constitutional provisions facilitate legislative scrutiny of executive actions. Parliament can reject the entire budget, but cannot amend the budget without an agreement with the government. Parliament cannot formally pass any legislation that has financial implications without prior approval of the government.

The country is divided into 8 oblasts (regions), including the city of Bishkek, which are subdivided into 43 rayons (districts). The President, in consultation with elected local councils, appoints the oblast governors (head of local state administration). Local government responsibilities include expenditures on education and health. The local self-governments are, to a significant extent, dependent upon resource transfers from the central government. Local governments use the treasury system for financial transactions and the financial administration of the local government is manned and supervised by the Ministry of Finance. The distribution of responsibilities between central and sub-national governments has been the subject of considerable debate since independence.<sup>9</sup>

The legal roles and responsibilities for the Government in respect of PFM are set out in the *Constitution of the Kyrgyz Republic* and the *Law on the Basic Principles of Budget Management (1998)* and the *Law on Treasury (1994)*. The 2001 ROSC concluded that the legal framework for fiscal management was relatively complete.

The Republican budget comprises recurrent expenditure by central government, the domestic counterpart of foreign-financed projects and intergovernmental transfers to the local budgets of oblasts and rayons.<sup>10</sup> Revenues collected at the local and central levels are shared between the Republican and local budgets on the basis of legislatively determined functions and responsibilities and annual budget negotiations. The consolidated republican and local government expenditure is known as the State Budget.

The budget incorporates the Social Fund, an extra-budgetary fund for managing social insurance revenues and expenditures. The fiscal operations of the Social Fund are presented to Parliament at the same time as the budget but in a separate document. The bulk of capital expenditure is foreign-financed and is also shown under a separate programme – the Public Investment Programme (PIP). The PIP is part of the budget documentation.

The Government is currently considering changes to inter-governmental fiscal relations and administrative territorial structures which will have a significant impact on public financial management. Currently under consideration is the elimination of one of the tiers of local state administration - Oblasts or rayons and incorporation of their budgets into the Republican budget starting in 2007. The status of these developments is at present very unclear.

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<sup>9</sup>CFAA

<sup>10</sup> Wherever the word 'Republican' is used in this document it means 'of the Government of the Kyrgyz Republic'.

### 3. Assessment of the PFM system

This section provides an assessment of the key elements of the PFM system, as captured by the PEFA indicators, and reports on progress made in improving those where applicable.

#### 3.1 Budget Credibility

##### *Indicator 1: Aggregate Expenditure Outturn compared to original approved budget*

The deviation in actual expenditure, excluding interest payments, from budgeted expenditure was +28% in 2002, +11% in 2003 and +17% in 2004. Average deviation for the three fiscal years was 18.6%.

##### **Kyrgyz Republic: Republican Budget, 2002-2004 (million som)**

	2002 Approved Budget	2002 Actual Expenditure	2003 Approved Budget	2003 Actual Expenditure	2004 Approved Budget	2004 Actual Expenditure
A. Total Expenditure	11,170.9	12,934.5	13,968.4	14,396.1	14,952.0	15,984.9
Of which interest	1587.7	663.5	1,687	740.3	2066.7	963.8
B. Total Expenditure less interest	9583.3	12271.0	12,281.4	13,655.8	12885.2	15021.1
C. Difference (approved vs actual)		2687.8		1,374.4		2135.9
Difference (%)		28%		11%		117%

Source: Ministry of Finance

Indicator	Brief Explanation	Rating
1. Aggregate Expenditure Outturn compared to original approved budget	Deviation of actual expenditure from the approved budget has been greater than 15% in two of the last three fiscal years	D

##### *Indicator 2: Composition of expenditure outturn compared to original approved budget*

The composition of expenditure outturn varies considerably when compared to the original approved budget. Under the PRGF arrangement which the Kyrgyz authorities have agreed with the IMF, better than anticipated fiscal performance – due to higher revenue collections – allows expenditure increases consistent with programme targets. This results in higher spending than originally budgeted.

A comparison between approved expenditure allocations across the main functional categories of expenditure and actual expenditures in 2004 shows deviations ranging from -2% to +726%. The same significant variations were observed in 2002 and 2003. Differences between approved and actual expenditures are significant by administrative, functional and economic classifications. These adjustments usually take place without clear rules or guidelines or are undertaken informally.<sup>11</sup>

<sup>11</sup> TNBE, para 1.2 – 1.4

During the last three years actual expenditure has exceeded budgeted expenditure across the 14 main functional categories by an average of 30% in 2002, 14% in 2003 and 17% in 2004 as shown in the table below. Further details are provided at Annex 4.

**Kyrgyz Republic: Republican Budget, 2002-2004 (million som)**

	2002 Approved Budget	2002 Actual Expenditure	2003 Approved Budget	2003 Actual Expenditure	2004 Approved Budget	2004 Actual Expenditure
General Expenses	9583.3	12271.0	12281.4	13655.8	12885.2	15021.1
I General Public Services	1750.1	1764.1	1885.3	2055.7	1962.9	2420.7
II Defence	1077.4	1077.4	1134.0	1261.0	1285.6	1406.2
III Public Order	737.8	911.5	918.2	1072.7	897.8	1194.5
IV Education	820.0	1174.1	1188.0	1348.4	1147.2	1634.5
V Health protection	534.8	450.8	598.2	499.3	655.2	646.6
VI Social Protection	1772.3	2170.4	2298.6	2417.4	2401.7	2441.6
VII Housing and Utilities	329.3	645.1	322.1	597.3	322.1	479.0
VIII Recreation and Culture	177.9	245.0	278.6	314.8	301.7	370.9
IX Fuel and Energy	1.9	220.7	38.3	163.3	3.8	27.7
X Agriculture	665.3	712.3	663.8	743.6	687.0	854.2
XI Mining	58.1	219.4	68.7	281.1	68.4	268.0
XII Transport	457.8	621.3	560.3	529.4	517.0	617.1
Other	1200.6	2059.0	2327.3	2371.8	2634.8	2660.2

Source: Ministry of Finance

In recent years, debt interest payments in particular have been significantly overestimated in the annual budget (i.e. ex ante). Ex post 'savings' on interest payments appear to have been transferred to other functional categories of expenditure. In broad terms, this has been done in a way that maintains the shape of the budget in terms of allocations across functional categories. Some categories of expenditure do, however, appear to receive greater priority than others. This is reflected in the assessment of the PEFA indicator. Deducting the average deviation in expenditure by functional category from the deviation in overall primary expenditure for each year (shown in indicator 1) as required by the PEFA methodology provides the following absolute measures by which variances in expenditure composition exceeded overall expenditure variance: 2% in 2002, 2.3% in 2003, 0.1% in 2004%.<sup>12</sup>

Indicator	Brief Explanation	Rating
2. Composition of expenditure outturn compared to original approved budget	The variance in expenditure composition exceeded the overall deviation in primary expenditure by less than 5 percentage points each of the last three fiscal years.	A

<sup>12</sup> Information and calculations supplied by Ministry of Finance. See supplementary excel spreadsheet attached at Annex 4.

**Indicator 3: Aggregate revenue outturn compared to original approved budget**

General government tax revenues rose from 15% of GDP in 2000 to 18.5% in 2004.<sup>13</sup> At the aggregate level, total state government revenues have been in line with the original approved forecast in recent years. Actual domestic revenue collection compared to the original approved budget was 94.3% in 2002, 95.5% in 2003, 105.2% in 2004.<sup>14</sup> Failure to deliver forecast tax revenues in 2002, and to some extent 2003, was related to an accident at the Kumtor mine, one of the country's biggest tax payers.

As part of PRGF-supported programmes, budget planning including revenue forecasting is based on revenue policy changes and projections of relevant economic parameters (GDP-growth, inflation, wage growth, etc.) derived in cooperation with Fund staff. Non-tax settlements are still used, especially in the utility sector, to fulfil revenue targets.<sup>15</sup> Technical assistance to enhance revenue forecasting is being provided through USAID and DFID's Governance Structural Adjustment Support Credit (GSAC) support project.

Indicator	Brief Explanation	Rating
3. Aggregate revenue outturn compared to original approved budget	Actual domestic revenue collection has been equal to or greater than 97% of budgeted revenue collection in two of the last three fiscal years. The continued practice of offsets is of concern	A

**Indicator 4: Stock and monitoring of expenditure arrears**

There is no systematic process by which the Government can comprehensively monitor the level of expenditure arrears. Identification of the total stock of expenditure arrears cannot be determined without detailed and extensive analysis.<sup>16</sup> The Ministry of Finance has yet to develop a robust financial management system that could ensure excessive commitments do not lead to accumulation of outstanding liabilities and create a first charge on future cash flows.

There has, however, been a reduction in the stock and improvement in the monitoring of some expenditure payment arrears since 2001 under successive PRGF arrangements with the IMF. Under the IMF PRGF programme, central government budget arrears have been defined as an overdue payment obligation of the Republican budget arising since the start of the three-year program period (January 1, 2005) related to: (i) wages; (ii) Social Fund payroll contributions; (iii) mandatory transfers to the Social Fund; (iv) categorical grants; (v) payments of electricity bills; and (vi) allowances for poor families. These expenditure arrears were zero at end-2004 and are monitored.<sup>17</sup>

<sup>13</sup> PRGF, attachment II, para 5

<sup>14</sup> Consolidated information provided by Ministry of Finance and the State Tax Inspectorate

<sup>15</sup> Information supplied by the World Bank

<sup>16</sup> When asked, the Ministry of Finance confirmed that it was unable to provide information on expenditure arrears without considerable and time consuming further analysis.

<sup>17</sup> This definition of arrears excludes arrears to normal suppliers of goods and services. For the purposes of the PRGF arrangement, all debt-service obligations of the Government are also monitored and there is a ceiling on new debt service payment arrears. Source: PRGF, pp78-81

Further improvement in the monitoring of arrears by the Ministry of Finance depends on progress in introducing modern concepts of public sector financial accounting which will, in turn, require a modernisation of the accounting system in the Treasury. Currently, the accounting system does not provide for the capture and recording of information at the commitment stage. This is a major deficiency which prevents efficient cash and expenditure management and control.<sup>18</sup>

The introduction of a commitment accounting system is required to generate timely information on payment arrears. This is part of a Treasury Modernisation project currently under discussion between the Government and the World Bank.

Indicator	Brief Explanation	Rating
4. Stock and monitoring of expenditure payment arrears	There is no system for monitoring expenditure arrears and therefore no reliable and complete record on the total stock of arrears. Some specific types of arrears are monitored and have been reduced to zero under the IMF's PRGF programme	D

### 3.2 Transparency and Comprehensiveness

#### *Indicator 5: Classification of the budget*

The budget classification is largely consistent with the Government Financial Statistics (GFS) 1986 classification and can provide information by economic, administrative and functional classifications.<sup>19</sup> Revenue and expenditure data generally accord with GFS international standards although there are some misclassifications in both categories.<sup>20</sup> Unlike other countries, the economic classification is at a very high level (31 first level codes, six second level codes). This is not sufficiently detailed for internal control. The functional classification accords with COFOG requirements as contained in GFS 2001.<sup>21</sup>

A major impediment to the consolidation of the budget is the current use of a number of different classification systems. Different methodologies are used for: budget formulation; budget execution control in the Treasury; line ministry control; the PIP; Development Budget; and debt management. There is a limited application of functional classification at the budget preparation stage, where the focus is on economic and administrative classifications.

In parallel with the traditional budget preparation by economic classification, the Ministry of Finance has been receiving assistance on presenting the budget in a programmatic format. In 2006, there will be two approaches to budget preparation; a single line budget for the Ministry of Health, whose budget will be prepared on a programmatic basis, and a Chapter basis for all other ministries.

<sup>18</sup> ROSC, p14

<sup>19</sup> Information supplied by the Ministry of Finance

<sup>20</sup> CFAA, para 3.18

<sup>21</sup> Information supplied by GSAC project

Support to improvements in the Chart of Accounts is being provided through the GSAC support project .

Indicator	Brief Explanation	Rating
5. Classification of the budget	Budget includes administrative, economic, and functional classification of expenditures. The use of a number of different classification systems currently impedes consolidation of the budget.	C

**Indicator 6: Comprehensiveness of information included in the budget**

The information included in budget documentation (the annual budget and budget supporting documents) has improved in recent years but does not yet provide comprehensive information on public revenues and expenditures. According to the PEFA Guidelines, the annual budget documentation should include information on 9 elements as follows:

1. Information regarding macroeconomic assumptions. This **is** included in budget documentation
2. Information on the fiscal deficit, defined according to GFS standard. This **is not** included
3. Information on deficit financing **is** included. The medium-term budget forecast for 2006-08, which was the starting point for the 2006 budget, includes information on internal and external financing.<sup>22</sup>
4. Information on debt stock **is not** included
5. Information on the Government's financial assets **is not** included.
6. Information on prior year budget outturn **is** presented in the same format as the budget proposal.
7. Information on current year **is** presented in the same format as the budget proposal for the coming year
8. Summarised budget data, including revenue and expenditure data, for the main budget entities **is** included for the current and previous year
9. Information on the implications of new policy initiatives **is not** included, although an explanatory memorandum and analytical tables provide additional information to the annual budget proposal. MTBF instructions require line ministries to separately identify new policy initiatives but inclusion of this information in budget documentation is limited.<sup>23</sup>

While the Government has committed to revising the way in which the budget is presented to improve its comprehensiveness, the 2005 Budget was approved by Parliament in its old form. The GSAC support project and USAID are providing support to improvements in budget documentation.

<sup>22</sup> Information supplied by Ministry of Finance

<sup>23</sup> Information on all 9 elements supplied by Ministry of Finance

Indicator	Brief Explanation	Rating
6. Comprehensiveness of information included in budget documentation	The 2005 budget documentation satisfies 5 of the requirements for information from the 9 listed by PEFA	B

**Indicator 7: Extent of unreported government operations**

The comprehensiveness of budget information has improved significantly in recent years but overall information is still limited. Full consolidation of extra-budgetary revenue and expenditure in the budget has yet to take place.<sup>24</sup>

Some budgetary activities are not reported on by the Treasury, in particular offsets. Special means (i.e. fees charged or revenues collected by budget agencies that are outside the budget process) were until recently outside the budget but are now recorded and reported on in full by the Treasury.<sup>25</sup> It is still common practice among budgetary organisations to make offsets for payments due. Offsets equivalent to 7.5% of total expenditure were incurred in 2004 (see indicator 19). Grants and in-kind contributions from donors are also not recorded within the Treasury. By definition, the magnitude of unreported revenue and expenditure is difficult to calculate. However, available information suggests that the extent unreported government operations (excluding donor funded projects) is in excess of 10% of total expenditure.

Steps are being taken to bring all extra budgetary operations of the budget institutions under the Treasury control. Several funds that were formerly outside treasury systems are now reported on as part of the PRGF agreed with the IMF. For example, four large extra-budgetary funds have recently been transferred to the Treasury – the fund for economic development, the fund of material reserves, the privatisation fund and the republican fund for nature protection. A number of other funds remain outside of the Treasury system. It is a requirement under the PRGF to consolidate the Social Fund budget with the 2006 State Budget.

Indicator	Brief Explanation	Rating
7. Extent of unreported government operations including those funded by donors.	The comprehensiveness of fiscal information has improved in recent years. The extent of unreported government operations is estimated to be in excess of 10% of total expenditure. Unable to score due to lack of overall information	Could Not Score

**Indicator 8: Transparency of inter-governmental fiscal relations**

Fiscal relations between different levels of government are still emerging. The Kyrgyz Republic has a federal structure with a strong central government. The existing system of intergovernmental fiscal transfers includes a tax-sharing system and a three-pronged grant scheme composed of an equalisation grant, a categorical grant and a relatively new matching grant for capital expenditures. However, the distribution of revenue and expenditure

<sup>24</sup> GSAC, p26.

<sup>25</sup> Information supplied by World Bank

responsibilities between different levels is not fully transparent.<sup>26</sup> At present the system of fiscal transfers is ad-hoc in its application and fails to provide stability or any reasonable level of certainty by sub-national and sub-regional governments (**first dimension - C**).<sup>27</sup> Estimates on transfers are not reliable. The aggregate deviation index between approved and actual expenditure for local budgets in 2003 was +15.5% for total revenue and +15.3% for total expenditure (**second dimension - D**). The deviation between actual and adjusted budgets for total expenditure was -4.4% in 2003<sup>28</sup> The Treasury produces monthly, quarterly, and annual reports on a timely basis, covering the republican and local budgets (**third dimension - A**).<sup>29</sup>

Fiscal transfer instruments are currently under a review by the Government along with the rest of the intergovernmental fiscal system. Support to the review of intergovernmental finances and the development of grant formulae is provided to the Ministry of Finance by USAID and the World Bank.

Indicator	Brief Explanation	Rating
8. Transparency of Intergovernmental Fiscal Relations	The distribution of revenue and expenditure responsibilities between different levels is not fully transparent and in its application unpredictable. Central government reporting of local government expenditure is comprehensive. The intergovernmental fiscal system is currently being reviewed.	C+

**Indicator 9: Oversight of aggregate fiscal risk from other public sector entities**

The budget does not include statements about the nature and magnitude of the government's contingent liabilities, tax expenditures, or quasi-fiscal activities. Some information is available to the Ministry of Finance. Over the past decade, the authorities have almost entirely cut out funding to state owned enterprises (SOEs) from the domestic budget<sup>30</sup> and efforts have been made to ensure transparency by bringing the fiscal activities of autonomous agencies onto the budget. Although SOEs control a significant amount of public funds and property, their financial positions are not routinely monitored and key stakeholders, including the Ministry of Finance and Parliament, do not have a consolidated picture of the SOE sector (**first dimension - D**).<sup>31</sup> The net fiscal position of sub-national governments is monitored and consolidated at least annually for the most important level of sub-national government (**second dimension - B**). The quality of analysis on pension fund liabilities is poor.<sup>32</sup>

A number of steps are being taken to bring extra-budgetary operations under the Treasury's control (see indicator 7). The quasi fiscal deficit strategy in the electricity sub-sector is presented in the 2005-2007 MTBF and as part of the PRGF arrangement, the IMF monitors

<sup>26</sup> ROSC, para 7

<sup>27</sup> PER, para 221

<sup>28</sup> TNBP, Table 1

<sup>29</sup> Information supplied by the Ministry of Finance. The scoring of this dimension should be considered preliminary. The extent of fiscal reporting of SN government activity by value as required for this indicator has not been separately verified.

<sup>30</sup> Some SOEs receive publicly guaranteed on-lending through government external borrowing. Source: World Bank

<sup>31</sup> Interviews with Ministry of Finance and State Property Fund. CFAA, p(x)

<sup>32</sup> Source: World Bank

the quasi-fiscal deficit of the energy sector. However, there appears to be no strategy to monitor comprehensively and to report on the SOE sector.

Indicator	Brief Explanation	Rating
9. Oversight of aggregate fiscal risk from other public sector entities	Oversight of fiscal risk has improved in recent years but the nature of the government's liabilities in the SOE sector is not routinely monitored. Sub national monitoring by the centre is in place	D+

**Indicator 10: Public access to key fiscal information**

The scope of central government statistics falls short of international standards in that it excludes data for the Social Fund and the externally financed PIP, although these data are published separately. Public access to key fiscal information is generally limited. The annual budget law is in the public domain and is required to be published but there are no specific provisions requiring publication of actual data. There is no systematic publication of a comprehensive set of budgetary data although this is clearly stated in the *Law on the Basic Principles of the Budget*.<sup>33</sup> The Ministry of Finance maintains a website and places general fiscal information on it on a quarterly basis. Data on public debt and state budget execution data is now being placed on the website on a quarterly basis ([www.minfin.kg](http://www.minfin.kg)).

The PEFA guidelines identify 6 types of information to which public access in a timely manner is essential, as discussed below:

- The approved budget together with annexes and explanatory notes is published as a printed document but it is difficult to obtain for public use (**first dimension - no**).
- The fiscal data on the National Statistical Committee's website provides some information on a consolidated basis and the Ministry of Finance has recently begun posting monthly information on budget implementation on its website (**second - yes**).<sup>34</sup>
- The Law on Budget Execution places the responsibility for preparation of a report on budget execution on the Ministry of Finance which is required to be submitted to the President and Parliament by 15<sup>th</sup> May of the year following the budget year. This date has been achieved for the last three years. However the report is not comprehensive and there is no system for producing consolidated year-end financial statements of government operations (**third - no**).
- The absence of year-end financial statements means that external audit is restricted to comments on compliance with the rules and regulations in respect of revenues and expenditures (see also indicator 25). (**fourth - no**)<sup>35</sup>.
- The award of all contracts with a value of the equivalent of approximately \$100,000 are published through the Governments Gazette as stipulated in the Public Procurement Law (**fifth - yes**).

<sup>33</sup> ROSC, para 15

<sup>34</sup> CFAA, para 5.18

<sup>35</sup> CFAA, para 6.20

- Information on resources made available to primary service delivery units is not generally available (**sixth - no**).

Provision of fiscal information on the internet by the Government is supported by USAID

Indicator	Brief Explanation	Rating
10. Public access to key fiscal information	The government makes available to the public on 2 of the 9 listed types of information	C

### 3.3 Policy-based budgeting

#### *Indicator 11: Orderliness and participation in the annual budget process*

There have been notable improvements in budget management in recent years but there remains considerable scope for improving the budget preparation process. A clear annual budget calendar exists and is available from the Ministry of Finance's website. The period between dissemination of instruction materials on the preparation of the budget and ceilings for ministries and agencies and the date for submissions by ministries/agencies is two months. Recent budget calendars have not allowed sufficient time for the Budget Commission to deliberate on issues before determining the expenditure ceilings and for line ministries to prepare draft budgets.<sup>36</sup> In 2005, Ministry of Finance workshops on budget preparation occurred in late June, in some cases after submissions were due. (**first dimension - B**).

There is lack of ownership in the budget formulation process by policymakers.<sup>37</sup> Policymakers get involved in budget formulation at quite a late stage – only after the line ministries and other government agencies have submitted their budget requests, including requests for new initiatives, and the Ministry of Finance has put together a complete first draft of the budget. The budget preparation process is fragmented. Currently, there are three parallel processes underway during the budget preparation process. First, a deeply entrenched input-focussed line item budget system which appropriates funds to line ministries in fine detail and features protection of a large part of the budget (particularly wages and transfers). Secondly, a vigorous but still developing medium term budgeting process which generates sector ceilings for the annual budget. Thirdly, the beginnings of a programme budgeting system including with preparation of budget submissions on a programme basis undertaken in parallel with the line item preparation.<sup>38</sup> (**second dimension - D**).

Parliament has approved the budget before the beginning of the year for each of the last three fiscal years (**third dimension - A**).

The GSAC support project and the World Bank Programmatic Public Expenditure Review process is providing support to the budget formulation process to bring these aspects together into a single integrated budgeting process

<sup>36</sup> CFAA, para 3.7. The Budget Commission was abolished in 2004 and its functions transferred to the Economic Policy Council

<sup>37</sup> TNBP, para 1.13

<sup>38</sup> TNBP, para 1.22

Indicator	Brief Explanation	Rating
11. Orderliness and participation in the annual budget process	A clear budget calendar exists but it does not allow sufficient time for either the MTBF or annual budget process. Parliament approves the budget before the start of the fiscal year. However, policymakers get involved in budget formulation only at quite a late stage.	B

**Indicator 12: Multi-year perspective in fiscal planning, expenditure policy and budgeting**

Multi-year fiscal forecasts and forward expenditure estimates are prepared. Ministry coverage of the MTBF is good, willingness to link budget planning to policy content is also good and the process is transparent. The MTBF is still in its early stages of development and the full benefits of the approach have yet to be realised. It is undermined by weak links to the annual budget process. Much information about ministry spending, which should be collected in the MTBF, is collected separately in a parallel process through the ministries annual budget submissions.<sup>39</sup> There are significant differences between the first year of the MTBF and annual budget ceilings.<sup>40</sup> Political scrutiny of MTBF proposals is perfunctory; political scrutiny is much more focussed during review of the annual budget.<sup>41</sup> **(first dimension - C).**

The Government's debt management strategy and debt outlook have improved significantly since the Paris Club flow rescheduling of March 2005. A Debt Sustainability Analysis was conducted by the IMF, most recently for the 6<sup>th</sup> Review under the PRGF. A revised DSA was carried out in August 2005 as part of the discussions for the first review under the new PRGF arrangement. **(second dimension - B).**

At present, the MTBF includes some basic descriptions of sector strategies. Most ministries and other spending agencies lack a well-defined sector analysis and explicit set of policy objectives. There are some exceptions: for example, a substantial amount of sector analysis exists, particularly in Health and Social protection, but these initiatives tend to be donor led.<sup>42</sup> There is not yet a culture within line ministries of developing policy initiatives, costing policy changes and developing spending strategies **(third dimension - D▲)**. The public investment programme accounts for around 15% of the total budget. The bulk of public investment is donor financed. The Kyrgyz authorities are now including information on budgeting of recurrent and capital expenditures into the annual budget document. However, the process of establishing linkages between recurrent and capital budgets remains at the embryonic stage. The separation of the recurrent and capital budget has resulted in under-financing of the operation and maintenance of public infrastructure.<sup>43</sup> **(fourth dimension - D▲)**.

A number of steps have been taken to integrate both the policy-making process and the budgetary planning process for recurrent and investment (PIP) budgets. A top-level Economic Policy Council has been established with responsibility for all budget preparation functions and progress has been made in improving both the budget format to enable

<sup>39</sup> TNBP, para 2.22

<sup>40</sup> Interviews with line ministries

<sup>41</sup> TNBP, para 1.14

<sup>42</sup> TNBP, para 1.17, 2.21, 2.16

<sup>43</sup> TNBP, para 3.18

Parliament to review budget policy priorities and in integrating PIP (including its external financing) into the budget process. The Ministry of Finance and the National Bank of Kyrgyz Republic have also been building steadily their debt management capacity. The GSAC support project is providing support to the MTBF and annual budgeting process.

Indicator	Brief Explanation	Rating
12. Multi-year perspective in fiscal planning, expenditure policy and budgeting	Some basic elements of a MTBF process have been introduced. Further developments are required to improve the quality of the MTBF and enhance its linkage with the annual budget.	D+

### 3.4 Predictability and Control in Budget Execution

#### *Indicator 13: transparency of taxpayer obligations and liabilities*

All taxes have an explicit legal basis, but there are many amendments and discretionary provisions. The Tax Code, which set out the general procedures related to taxation, remains in certain cases ambiguous and unclear, despite having undergone frequent changes. An improved Customs Code was introduced in 2005. (**first dimension – C**).

Articles in the tax code define taxpayer rights. The State Tax Inspectorate supplements this with some active taxpayer education such as newspapers and government websites (**second dimension - C**).<sup>44</sup>

The present tax code does not fully specify the tax appeals procedure. There are frequent ad hoc tax exemptions. Case-by-case negotiations between officials and tax payers are not unusual. The State Tax Inspectorate has established a division with responsibility for improving the functioning of the tax appeals system (**third dimension – C**).<sup>45</sup>

A draft new Tax Code has been prepared which comprehensively explains and defines: terms used in the legislation; to whom the code applies; and relations between taxpayers and authorities. The new Code clearly establishes principles of taxation and is expected to lead to more consistent and predictable outcomes. Other business concerns addressed in the code include introducing greater consistency in the drafting, addressing the lack of incentives for investments and legalisation of incomes and achieving harmonisation between previously disparate taxes.<sup>46</sup>

Indicator	Brief Explanation	Rating
13. Transparency of taxpayer obligations and liabilities	Legislation and procedures are clear but substantial discretionary power of tax authorities still exists. Reforms are underway to address some of these issues.	C

<sup>44</sup> ROSC, para 11

<sup>45</sup> Information supplied by State Tax Inspectorate

<sup>46</sup> Information supplied by USAID

**Indicator 14: Effectiveness of measures for taxpayer registration and tax assessment**

A taxpayer information system provides taxpayer information, including taxpayer registration (dimension 1). The Government has established a Large Taxpayer Unit to improve the effectiveness of the tax administration. The tax administration has started to implement a computerisation process to improve the processing of tax administration data.

**[Further information is required on the effectiveness or comprehensiveness of this system or its links to other relevant databases (dimension 1) and on the effectiveness of penalties for non-compliance (dimension 2)]**

Systematic taxpayer audit takes place but it is not always based on clear risk assessment (dimension 3). The audit that does take place shows little evidence of credibility testing of taxpayer declarations and instead focuses on vouching and transactional cross-referencing.<sup>47</sup>

The GSAC support project is supporting improved revenue administration

Self-scoring by State Tax Inspectorate: Dimension (i) B; Dimension (ii) C; Dimension (iii) C. Further information required to independently verify performance.

Indicator	Brief Explanation	Rating
14. Effectiveness of measures for taxpayer registration and tax assessment	Self-scoring by State Tax Inspectorate: Dimension (i) B; Dimension (ii) C; Dimension (iii) C. Further information required to independently verify performance.	Could Not Score

**Indicator 15: Effectiveness in collection of tax payments**

The tax collection percentage was 89% in 2003 and 83% in 2004 (**first dimension – B**).<sup>48</sup> All tax revenues are required to be transferred daily by the collecting banks to the treasury account with one of the four agent banks (**second dimension – A**). Tax reconciliations take place monthly (**third dimension – B**).<sup>49</sup>

Indicator	Brief Explanation	Rating
15. Effectiveness in collection of tax payments	The debt collection ratio for the last two fiscal years was 86%. Revenue collection procedures are adequate from an accounting control perspective.	B+

**Indicator 16: Predictability in the availability of funds for the commitment of expenditure.**

The Treasury has discretion in deciding the priorities for payments. This is implemented through its “Monthly Financing Plan” based on predicted revenue flows and monthly expenditure applications from spending units which are usually based on one third of their quarterly budgets. This plan is not prepared until the middle of the month concerned. (**first dimension – D**). The plan does not take into account commitments and no ceilings are

<sup>47</sup> Information supplied by State Tax Inspectorate. Also GSAC p37

<sup>48</sup> Information supplied by State Tax Inspectorate

<sup>49</sup> CFAA, para 5.15

provided for future commitments (**second dimension - D**). The failure to take into account outstanding commitments either in total or by spending unit means the cash flow system, which should underpin the issues, is inherently flawed and cannot accurately predict where or when cash is likely to be needed and deliver it accordingly. This results in unpredictable cash flows which severely affect the ability of the budget institutions to plan and implement the originally approved budget and, as demonstrated by an analysis of the budget execution data, results in numerous changes to it during the year (**third dimension - D**)<sup>50</sup>. A further corollary is that valuable management time is diverted from its policy implementation function to ensuring delivery of cash management allocations and re-assessing policy implementation in the light of their adequacy.

The government has introduced regulations for preparing and approving financial plans and the Treasury has introduced cash planning procedures and created a special unit for cash planning. However, for these initiatives to be effective a system will be required which provides a speedy and reliable flow of information on all commitments entered into by government and capacity building on cash management and treasury procedures.

**[Details of the regulations and procedures have not been seen. Further details are required]**

Indicator	Brief Explanation	Rating
16. Effectiveness of cash flow planning, management and monitoring.	There is an absence of sound cash planning and management. The government has introduced measures aimed at addressing this issue but fundamental system changes are required for these to be effective.	D

***PI-17: Recording and management of cash balances, debt and guarantees***

By end-2000, the face value of public sector debt and its net present value (NPV) had reached unsustainable levels. The NPV of the debt was equivalent to 506 percent of revenues. In 2000, the debt service burden of public sector debt before rescheduling was estimated at 31 percent of revenues.

The Public Debt Department in the Ministry of Finance is responsible for keeping detailed records on external debt. Comprehensive information on the level and composition of external debt is maintained on a database and balances are reconciled with those of the creditors when transactions occur. Domestic debt comprises the government's debt to the National Bank, debt related to some deposits of Kyrgyz citizens, Treasury bills and restructuring bonds. All past NBKR loans have been fully reconciled with the Treasury. A web site is maintained giving detailed and up to date information on Public Debt (**first dimension - A**).

Under current legislation, only the Ministry of Finance is allowed to incur debt and issue guarantees. Such borrowing and guarantees must be approved by Parliament during the process of approving the State Budget. A public debt strategy has been adopted which

<sup>50</sup> TNBE Para. 16, 20, 24

regulates the procedures, structure and content of public debt. Under this no new guarantees are allowed. Only three guarantees remain and information on these is updated regularly and available on the web site. **(third dimension - A)**

While there is, in theory, a Single Treasury Account, in practice Treasury operates fifty different accounts at the Central Bank and some have significant balances<sup>51</sup>. These are aggregated for cash management purposes. Reconciliation between the treasury balances and the agent banks is performed on a monthly basis<sup>52</sup> but the system does not allow for the physical consolidation of bank accounts<sup>53</sup> **(second dimension - C)**.

Indicator	Brief Explanation	Rating
17 Recording and management of cash balances, debt and guarantees.	There have been significant improvements in the handling of public debt but there is still a weakness in the consolidation of government's bank accounts.	B+

**Indicator 18: Effectiveness of payroll controls**

Employee salaries and social insurance contributions account for more than 35% percent of the total recurrent expenditures<sup>54</sup>.

Both the personnel and the payroll processes are decentralised to line ministries who are responsible for their implementation within set establishment and remuneration standards. No central personnel database is maintained and it was thus impossible, in the time available, to arrive at an overall assessment of the quality of reconciliation, the consistency of the data, the timeliness of data changes and the quality of the management and record keeping across the whole of government **[first dimension – insufficient data to score: second dimension – insufficient data to score: third dimension insufficient detail to score]**. The rayon Treasury office receives a position list or an employee list from each budget institution at the beginning of each year and checks the accuracy of the monthly employee payroll prepared by the budget institution by comparing it with the previous month's statements and with the list received at the beginning of each year<sup>55</sup>.

It was noted that line ministries manage to increase and/or maintain their personnel expenditure through using money allocated to vacant posts or by concealing the exact number of staff to preserve the same personnel budget and use the funds to insure disguised increases of salaries<sup>56</sup>. This was confirmed at a meeting with the Ministry of Labour and Social Protection<sup>57</sup>. This is facilitated by the decentralisation of the personnel and payroll functions. This points to the absence of effective and consistent controls over payroll and that, while independent payroll audits may be undertaken, they do not result in compliance with regulations. It also raises questions as to the quality of the authorisation and audit trail

<sup>51</sup> TNBE p39

<sup>52</sup> Information supplied by Treasury

<sup>53</sup> Information supplied by Treasury and CFAA 4.9, 5.10

<sup>54</sup> Information supplied by IMF

<sup>55</sup> CFAA 4.14 and 4.15

<sup>56</sup> EU Public Finance Assessment Report

<sup>57</sup> Interview with Ministry of Labour and Social Protection

procedures. All of this is compounded by the absence of effective internal audit services throughout government.

Indicator	Brief Explanation	Rating
18. Effectiveness of payroll controls	The process is decentralised and personnel and payroll functions are carried out by the line ministries' accounting units. This has facilitated informal adjustments to approved establishment and salary levels and demonstrates a lack of effective control. Unable to score due to lack of overall information.	Could Not Score

**Indicator 19: Competition, value for money and controls in procurement**

A new public procurement law was introduced in 2004. This law (effective as of May 24, 2004) implemented most of the recommendations of the CPAR of December 24, 2002 and introduced major improvements in the transparency, economy and efficiency aspects of public procurement, as well as in the selection of consultants' services<sup>58</sup>. However, the country is now facing a challenge of implementation and enforcement. Procuring entities at both national and sub-national levels have been finding it difficult to apply provisions of the new law due to lack of resources, qualified procurement staff and adequate equipment.

One of the key CPAR recommendations related to the development of detailed implementation regulations to serve as a guide to the staff of procuring entities but these have yet to be implemented. Standard bidding documents are being prepared and are expected to be finalised before the end of 2005. According to figures supplied by the government, total procurement in 2004 amounted to 5,430m soms of which 2,592m soms or 48% was procured through competitive open tender. This may not be wholly reflective of the overall situation as it refers to value of tenders as opposed to the number of tenders. Nevertheless it represents a significant improvement (**first dimension - C**).

In the same year, procurement through other, more restricted, methods amounted to 970m soms or some 18% of all tenders. Early returns for 2005 show a decrease in these figures. Authority for this is contained in the Public Procurement Law and a government decree passed in 1999. Of this, procurement through the offsetting process by which suppliers who owe government money supply goods to government in place of its debt, amounted to 549m or 10% of all procurement. This bypasses the procurement procedure. Until this is effectively abolished (it is apparently "officially" banned at the moment), the transparency and effectiveness of a substantial proportion of government procurement is compromised (**second dimension - C**).

The legal provisions for the complaints process are, in general, clear and of a satisfactory standard. The only exception is the lack of a provision for appeal to a higher authority on the decision reached (**third dimension - B**).

<sup>58</sup> HSFA p8

The GTAC is currently financing services of international and national legal consultants to the State Commission on Public Procurement and Material Reserves (SCPPMR) who are assisting with both tasks. Finalization and introduction into practice of the implementation regulations and standard bidding documents will have a direct positive effect on procurement arrangements and practices<sup>59</sup>.

Indicator	Brief Explanation	Rating
19. Competition, value for money and controls in procurement	The legislative framework is satisfactory but still has to become fully effective in practice. There are notable weaknesses in the use of offsets and the lack of appeal in the complaints process	C+

***Indicator 20: Effectiveness of internal controls for non-salary expenditure.***

An important factor in the efficacy of the internal control framework in the Kyrgyz Republic is the absence of any clear legal requirements for line ministries to maintain an effective internal control framework<sup>60</sup>. This reflects the fact that emphasis in the management of financial and other resources in Kyrgyzstan is placed on compliance with rules and procedures established by the central control ministries rather than in providing managers with financial information about their management of resources. Thus and the “accounting” system is in fact a recording and reporting system designed to demonstrate and enforce compliance with these pre ordained rules and limits.

Accordingly, internal control within Treasury typically focuses on identifying and reporting on non-compliance with the payment authorisation process (an internal control objective) and this occurs regardless of the level of risk involved. On the contrary while line ministries are entitled to enter into commitments, no record is kept of these and no control is exercised over these by Treasury; nor is any record kept of them by it (a management objective)<sup>61</sup> (**first dimension - D**).

An Accounting and Reporting Analyses Department within Treasury is responsible for developing and issuing accounting and reporting guidelines and formats for budget institutions. A comprehensive “Regulation on Accounting by Budget Institutions” dated February 2001 contains formats of registers and supporting documents, and instructions for performing accounting in a budget institution, as well as a Chart of Accounts. The instructions are excessive in some areas and incomplete in others. Generally, within their limitations, the rules are well understood.

However, there are concerns over their implementation. An important factor to be taken into account in all reporting and recording systems in Kyrgyzstan is that record keeping is a labour intensive, manual process which has inherent weaknesses in accuracy and timeliness which in turn compromise their effectiveness. Accordingly, internal control within Treasury typically focuses on identifying and reporting on non-compliance with the payment authorisation

<sup>59</sup> HSFA p8

<sup>60</sup> The Law on Budget has a vague reference to the responsibility of managers and public officers for the “maintenance of the budget funds” (Article 22) Source CFAA 4.6

<sup>61</sup> CFAA 5.12

process and this occurs regardless of the level of risk involved. Though established by law, these rules have failed to detect and prevent instances of misuse of budget funds, and instances of illegal use of funds and waste are reported year after year by the external auditor in fulfilment of its perceived inspection and control role<sup>62</sup>. **(third dimension - C)**.

As will be seen in Indicator 21 there is an effective absence of effective Internal Audit which means that such Internal Control mechanisms as are in place will not be routinely tested and thus are unlikely to be fully effective. This, in turn, means that not only the current regime of internal control is less than fully effective but also that the management has no means of detecting and resolving these issues as a regular part of their management responsibilities<sup>63</sup>. **(second dimension – C)<sup>64</sup>**.

Indicator	Brief Explanation	Rating
20. Effectiveness of internal controls.	Internal control is ineffective in practice and not supported by the legal and regulatory framework	D+

***Indicator 21: Effectiveness of Internal Audit***

There is no internal audit in the Kyrgyz Republic, except for small units in the MoF, which carries out compliance tests for the Treasury transactions, and in the Ministry of Labour and Social Protection which largely carries out pre-audits of claims submitted. There is reported to be a unit in the Ministry of Agriculture but there is some doubt about its status and role<sup>65</sup>. In June 2000, the government abolished the State Financial Inspectorate (SFI) and the majority of the staff were transferred to the Chamber of Accounts. The main reason for this decision was the perceived overlap between the internal audit and external audit functions, as the concept of providing audit services for management use was not understood (see Indicator 26). In the absence of internal audit staff, line managers ask the technical or accounting staff to perform some rudimentary internal audit functions but these are often of a pre-audit nature rather than that of assessment<sup>66</sup>.

As no effective internal audit exists, the default score of D has been applied.

The GSAC support project covers this area but difficulty is being experienced in finding common ground on principles and objectives.

Indicator	Brief Explanation	Rating
21. Effectiveness of internal audit	There is no effective internal audit function.	D

<sup>62</sup> Information supplied by the Chairman of the Chamber of Accounts

<sup>63</sup> HSFA Para.26

<sup>64</sup> CFAA 4.8 and HSFA para. 24

<sup>65</sup> Interview with Internal Audit Unit in Treasury

<sup>66</sup> CFAA 4.18

### 3.5 Accounting, recording and reporting

Note: There is an ongoing reform agenda which intends to focus on the modernisation of the Treasury. A consultancy has produced an inception report on the future shape and functions of the Treasury and this is currently being considered internally by Treasury management.

#### *Indicator 22: Timing and regularity of accounts reconciliation*

Bank balances are reconciled at least once a month on both aggregate and detailed levels usually not later than the third working day of the following month (**first dimension - A**).

As records on advance and suspense accounts are kept by individual Ministries we were unable, in the time available, to form a judgement on the quality of record keeping and timeliness of their reconciliation on a government wide basis. Information from the head of the accounting unit in the Ministry of Health indicated that, at least in that Ministry, the process was carried out in a regular and timely manner<sup>67</sup>.

Indicator	Brief Explanation	Rating
22. Timeliness and regularity of accounts reconciliation	Unable to score due to lack of overall information on suspense and advance accounts	Could Not Score

#### *Indicator 23: Availability of information on resources received by service delivery units*

The reporting system is based on aggregation from the bottom up, culminating in the analysis of expenditure over thirty six different items that are reported to the Ministry of Finance. Any tracking of expenditure at the lowest level would be difficult and time consuming. As the recording system is manual there are inherent problems with accuracy and timeliness. In addition, the current classification system in Ministries will need to be more detailed than that currently in place in order to ensure that service providers can track expenditures properly and report on them<sup>68</sup>.

There is no formal system for reporting aid in kind and no information is available on tracking surveys over the last three years

**[Further information is needed on what tracking surveys have taken place in the last three years.]**

Indicator	Brief Explanation	Rating
23. Availability of information on resources received by service delivery units	No comprehensive data collection has been undertaken in the last three years. There are weaknesses in the capacity of the accounting and classification systems to report financial resources transferred accurately.	D

<sup>67</sup> Information supplied by Head of the Accounting Unit, Ministry of Health

<sup>68</sup> HSFA p36

**Indicator 24: Quality and timeliness of in-year budget reports**

The Treasury produces monthly and quarterly reports on budget execution on a timely basis and generally by the 25<sup>th</sup> of the following month (**second dimension - A**). Quarterly reports are very detailed giving information at the fourth tier of functional and economic classification. Reconciliation with appropriations and bank accounts is effective and timely but recording against the classification of transactions is not fully observed as large amounts are lumped under “other expenditures”. The reports are prepared by aggregating returns from subsidiary units, which can, themselves be aggregates of returns from other units. They are designed and used for reconciliation and cash control purposes rather than as a management control and decision-making tool<sup>69</sup>. (**first dimension - C**).

Accounting in all budget institutions is a labour intensive, manual process requiring the maintenance of several registers and the production of numerous reports in paper form. This methodology has inherent weaknesses in accuracy and timeliness. Another concern is that it has been a common practice to make offsets for payments due among budgetary institutions and to allow the use of “special means” for institutions with revenue resources. These two facts complicate record keeping leading to a higher than acceptable level of error (**third dimension – C**)<sup>70</sup>.

Indicator	Brief Explanation	Rating
24. Timeliness, quality and dissemination of in-year budget execution reports.	In-year reports on budget execution are generated on a regular and timely basis. The reports are not comprehensive and are not compatible with budget estimates. The quality of the information is compromised by the manually based system and various other practices. The reports are designed for control purposes and are not used to provide useful management information to the line ministries.	C+

**Indicator 25: Quality and timeliness of annual financial statements**

**As no financial statements are produced, the default score of D has been awarded.**

Consolidated financial statements showing the financial position for the government as a whole using on its adopted cash basis of accounting<sup>71</sup> are not prepared<sup>72</sup>. Legislation only requires that a report on budget execution comparing cash spent and received against that budgeted for, together with an explanatory note, is submitted to the President and the Parliament no later than 15th May of the year following the budget year and this date was complied with in each of the last three years. This report includes government but not the

<sup>69</sup> HSFA Para. 25

<sup>70</sup> ROSC Para. 21

<sup>71</sup> IPSAS Cash Accounting Basis 1.3.6 The general purpose financial statements comprises the statement of cash receipts and payments and other statements that disclose additional information about the cash receipts, payments and balances controlled by the entity and accounting policies and notes.

<sup>72</sup> CFAA 5.1

Social Fund which reports separately. Quasi-fiscal activities are not included and there is no systematic review of the effectiveness of public activities<sup>73</sup>. Although line ministries compile annual "balance sheets" by updating the previous "balance sheet" from their accounting records and submit them to the MoF, these are not consolidated except as and when required for statistical purposes.. No reconciliation is carried out between these statements and the cash based budget execution reports submitted to the President and Parliament.

As financial statements are not produced, the requirement to provide in legislation for the standard or basis of accounting to be adopted has not been considered necessary. The view of government is that it is sufficient that the annual budget execution statement is based on the "GFS manual of 1986 which provides for accounting on a cash basis" and that "International standards of accounting are used by only private enterprises"<sup>74</sup>. However, GFS manuals do not set accounting bases and international standards are now available for the public sector on both the cash and accrual bases of accounting. Accordingly, the Treasury records only cash transactions and its inward reports are designed to support this process.

Indicator	Brief Explanation	Rating
25. Timeliness of the presentation of audited financial statements to the legislature.	Financial statements are not submitted, only statements of aggregated cash transactions measured against budget lines.	D

### 3.6 External scrutiny and audit

#### *Indicator 26: Scope, nature and follow up of external audit*

No audit standards are applied in respect of transactions and, in the absence of financial statements, no audit of the financial position of government can be undertaken. Accordingly the default score of D has been applied.

The Chamber of Accounts (CA), established in 1996 by the Law on Chamber of Accounts, is recognised as the Supreme Audit Institution in the Kyrgyz Republic. It evolved from the State Financial Inspectorate, established in 1992, which in 1995 became the Chamber of Control until it was formed as Chamber of Accounts in 1996. Although the Constitution does not contain core principles of the CA, it does specify that it reports to Parliament and provides for the President and Parliament to appoint its members<sup>75</sup>.

The roles and responsibilities of the CA are defined in the Law on Chamber of Accounts, 1996. Recent legislative changes to the legal framework governing the CA has resulted in changes to the process of appointment of the Chairman, the right to set up its own staffing structure, and the role of the Parliamentary committee to determine the budget requirements for the CA. The new law on the Chamber of Accounts (No.117 of August 13, 2004) attempted to clarify the role of the CA by, among other things, replacing the word "control" with "audit", requiring the CA to provide an opinion on any annual financial statements issued by the government, and authorizing the CA to carry out interim ex-post audits<sup>76</sup>.

<sup>73</sup> ROSC 24

<sup>74</sup> Information supplied by the Treasury

<sup>75</sup> CFAA Section 6

<sup>76</sup> HSFA Para. 34 and 35

Despite these changes, the CA largely remains an inspection and control unit that carries out periodic checks to ensure compliance with existing regulations, including public procurement law. Financial statements showing the financial position of government are not produced and therefore auditing standards in respect of this process are considered irrelevant as far as government accounts are concerned. . In respect of transaction auditing, no standards are specified. Staffing levels and skills are still based on the previous structure and remedying this will present a difficult challenge to the implementation of the change to the nature and scope of the work of the CA. This factor will continue to restrict the capacity of the CA to measure and comment, on a timely basis on the quality of internal control and audit and, in the event of the production of financial statements, the ability to pass an opinion on them.

Reports on budget compliance are generally submitted to Parliament within two months and in accordance with the legislation but these do not cover financial statements as none are produced. Their format and presentation could be greatly improved; it is difficult to discern major issues amidst the vast amount of detailed factual information. The law authorises the CA to provide information regarding its activity to the mass media. However, there is no requirement to provide copies of the annual report on the performance of the CA to the mass media. The CA has a website that can be accessed by civil society or the mass media.

There is no specific legislative approach for ensuring matters arising from the audit are followed up. However, good working relations with the MoF and the Parliament and the degree of persistency of the CA provide an alternative vehicle for this function although its success is difficult to judge other than by hearsay.

Support for this function is included in the GSAC support project. However, difficulties are being experienced in reaching agreement on the principles and strategies to be adopted. Further amendments to the legislation have been proposed by the Chamber of Accounts but these are likely to increase these difficulties.

Indicator	Brief Explanation	Rating
26. The scope, nature and follow up of external audit reports.	Effectiveness of external audit is handicapped by its emphasis on its compliance and policing function rather than that of assessment.	D

**Indicator 27: Legislative scrutiny of the annual budget law**

The macroeconomic framework underlying the budget is not formalised in the public domain and not open to assessment by independent experts. There is no independent domestic expert assessment of the fiscal forecasts<sup>77</sup> (**first dimension C**). Parliament has separate Budget and Economic Policy committees for each house of parliament to review budget proposals and budget implementation reports. The committees rely on analytical reports prepared by the MoF and are required to review budget proposals within twenty days (**third dimension D**). The CA does not audit the submissions on economic policy or budget requests and

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<sup>77</sup> ROSC Para. 26

accordingly there is no independent assurance as to the integrity of any economic data submitted. Each committee presents its reports to the plenary session of Parliament. The capacity of these committees to conduct an effective review of the reports submitted is restricted by capacity restraints (**second dimension C**). Parliament has the right to reject but not to amend the budget. This, combined with the fact that ex post facto approval of expenditure is common, means that in year budget amendments are often a formality (**fourth dimension – D**) and that the fundamental dual control over expenditure by the legislature and executive envisaged by the constitution is significantly weakened.

**[More detailed information required on what the committees review and on the scrutiny and approval of supplementary estimates].**

Indicator	Brief Explanation	Rating
27. Legislative scrutiny of the annual budget law	There are active committees but their ability to function effectively is compromised by lack of capacity and the practice of ex post facto approval of expenditure.	D+

***Indicator 28: Legislative scrutiny of external audit reports***

While there are clear and specific provisions on the types of audit that can be undertaken by the Chamber of accounts<sup>78</sup>, this does not extend to the preparation and submission of audit reports on the annual budget by the external audit body (the Chamber of Accounts) to Parliament in the law on the Chamber of Accounts. The Law on Basic Principles of Budget has an indirect provision that requires the Parliament to review the report of the Chamber of Accounts (CA) before approving the government’s report on execution of the budget [**first dimension: more information required on the detailed workings of the committees**]. The CA does not provide an opinion on the budget execution statements as these are of a factual nature but produces an annual report on its activities and findings in respect of the implementation of the budget execution process.

Similarly, there is no legislative provision that empowers Parliament or its committees to call the Chairman or members of the CA to the meetings while discussing the audit report or the budget execution report. Since Parliament is the recipient of the audit reports, it is essential that it has adequate capacity to conduct a detailed review of the audit reports, including the ability to ask for clarification from the executive and the CA, to provide directions to the government based on this review, and to conduct follow-up required to ensure that adequate actions are taken to address the issues (**second dimension D**). There is a need to clarify the role and authorities of the Parliament in the review and approval of annual audit report of the CA. There is no information from current sources on any formal response to audit findings. The legal framework appears to preclude any expectation of a response from the executive (**third dimension D**).

**[More information is required on the detailed functions of the committee]**

<sup>78</sup> Source: World Bank

Indicator	Brief Explanation	Rating
28. Legislative scrutiny of external audit reports.	While committees are in existence and active, there are restraints which restrict the capacity of Parliament to review critically audit reports. The authorities of Parliament for reviewing the audit report need to be clarified.	D

### 3.7 Donor Practices

#### *Indicator D1: Predictability of Direct Budget Support*

The total direct budget support received in the period 2002 – 2004 amounted to \$89m. Of this total the EU FSP accounted for \$35m, the CSAC support project for \$17m, the GSAC project \$5m<sup>79</sup> and the ADB Trade and Customs programme \$15m. The balance consisted of assistance from various bilateral donors under the GSAC project. During the same period the amount funded through the PIP amounted to \$223m. In addition there are unknown but significant amounts supplied by other donors particularly for TA projects. In 2003 actual direct budget support experienced a shortfall of 17% from that budgeted due to a EU tranche being carried over to the following year (**first dimension A**). In the other two years there were surpluses of 23% and 22.5% respectively. This was attributed to exchange rate fluctuations in the US\$ and the SDR.

With the exception of the EU food support programme, direct budget support programmes are based on the fulfilment of policy matrix conditions. While forecasts are given of expected disbursement dates these may not be fulfilled for various reasons connected with implementation conditionalities. (**second dimension C**).

**[These figures were supplied by government. Independent confirmation from donors is needed.]**

Indicator	Brief Explanation	Rating
D1 Predictability of Direct Budget Support.	Forecasts are not provided but only one year fell short of that budgeted for	C+

#### *Indicator D2: Financial Information provided by donors for budgeting and reporting on project and programme aid*

All donors with projects covered by the PIP supply information on a regular basis to the government. This covers the withdrawal and use of all project funds. However, a substantial number and value of projects are not covered by the PIP including virtually all of the technical assistance projects. (**second dimension D**)

**[Insufficient information is available on the first dimension ]**

<sup>79</sup> Information on CSAC and GSAC supplied by the World Bank

Indicator	Brief Explanation	Rating
D2 Financial Information provided by donors for budgeting and reporting on project and programme aid	There is insufficient data to score this indicator	Could Not Score

***Indicator D3: Proportion of aid that is managed by use of national procedures***

As stated in the previous indicator not all aid is channelled through government. Where it is, with the exception of goods and services provided under direct budget support, virtually none use national procedures.

We understand that, given the recent progress in improving the procurement system (see Indicator 19), donors are considering using it for the procurement of project goods and services.

Indicator	Brief Explanation	Rating
D3 Proportion of aid that is managed by use of national procedures	Donors own procedures are the norm. There is insufficient data to score this indicator	Could Not Score

## 4. Government Reform Process

### 4.1 Description of Recent and On-Going Activities

In response to urgent spending needs on one hand and budget deficit reduction imperatives on the other, the Kyrgyz authorities have been implementing comprehensive public financial management reform since mid - 1990s. The National Poverty Reduction Strategy (NPRS) of the Kyrgyz Republic states that improving Public Financial Management (PFM) is one of Government's priorities in its fight for poverty reduction and growth objectives.

The Government's PFM reform strategy is designed to improve the transparency and responsiveness of the public sector through: (i) improving personal accountability of political officials and civil servants; (ii) improving public access to official information; (iii) reducing financial incentives for misuse of regulatory and enforcement powers; and (iv) strengthening external audit and reforms aimed at increasing efficiency, effectiveness and accountability within the public sector through: (i) strengthening public expenditure management; (ii) improving the internal control environment; (iii) improving transparency, value for money and accountability in public procurement; (iv) improving service delivery in the health and education sectors; (v) enhancing the effectiveness of the civil service; and (vi) streamlining the structure of government ministries and agencies.

The Government's reform strategy in the PFM area has been supported by a comprehensive Donor assistance (Box 1).

#### **Box 1. Major Donor Programs in Public Expenditure Management Reform**

- IMF is providing assistance in macroeconomic/fiscal policy formulation and management.
- The World Bank and DFID through GSAC and GTAC are supporting activities for establishing more strategic and transparent budget formulation process; strengthening accountability and transparency in budget execution through removing constraints to resource management and reducing budget fragmentation, and modernization of the Treasury system; improving external and internal control environment; and improving transparency and accountability in public procurement.
- USAID is providing support for the government agencies in building the capacity in areas of revenue forecasting and gradual introduction of program based budgeting.
- EU TACIS and Food security program supports reform of PEM in social assistance and agriculture.
- Integrated donors assistance (WB, DFID, WHO, USAID, Swiss Development Agency) is provided for strengthening public expenditure management in health sector.

To date many of these reforms have been given a legislative basis, with implementation broadly on track. The basic elements of PEM institutions are in place and/or are being expanded, and efforts to further improve the budget management process are underway. Number of steps have been taken or are in the process of being taken to reduce discretion and non-transparent practices in the disbursement of budget funds by improving financial planning and cash management within the Treasury; by bringing all extra budgetary operations (except the Social Fund) of the budget institutions under the Treasury's oversight; and by initiating actions to phase out non-cash settlements in the budget and the Social Fund. These improvements in budget execution are being complemented by the modernization of the Treasury.

Continued Treasury reforms have improved capacity to control budget execution through better commitment control and cash management although substantial improvement is still

required in this area. The Central Treasury (CT) became the major government body responsible for the budget execution process; cash management procedures have improved; and a Cash Projection Unit, responsible for cash management, was established within the CT. The Central Treasury has improved cash flow forecasting, control of obligations and putting state financial accounts in order.

Some elements essential for introducing policy based budgeting have been put in place, including introduction of multi-year expenditure planning and budgeting and increasingly more organized participation of government agencies in the budget formulation process. Budget comprehensiveness and transparency has also been improving, especially comprehensiveness of information included in budget documentation and improvement of public access to key fiscal information.

Measures to ensure transparency of state procurement system are envisaged. To date, restructuring and strengthening of functions of State Committee on State Procurement and Material Reserves have been conducted. A respective bulletin is regularly published.

To strengthen external audit, restructuring of the Chamber of Accounts is being conducted. The restructuring is directed towards defining its role and organizational structure as supreme audit body in accordance with a new law adopted in 2004 to improve independence and streamline external audits. The COA needs training and exposure to modern auditing practices in order to perform effective audits. Adoption of standards of International Organization of Supreme Audit Institutions (INTOSAI) is envisaged.

It has also been possible for government to achieve shifts in expenditure toward social sectors. This was done primarily through both significant stepwise increase in wages and salaries of social sector employees and in pension allocations. Budget allocations for operation and maintenance of basic infrastructure, however, remained repressed, continuing to lead to rapid depreciation of capital assets in such critical areas as irrigation networks, transportation, and education and health facilities.

Overall, there remain major weaknesses at the level of actual expenditures and service delivery, which need to be addressed through cross-cutting PEM reforms, besides ongoing sector level reforms.

## **4.2 Institutional Factors Supporting Reform Planning and Implementation**

The institutional arrangements supporting timely and adequate reform planning and implementation process in the Kyrgyz government suffer from considerable shortcomings, including (1) insufficient government leadership; (2) adverse institutional set-up; (3) weak coordination between stakeholders. In addition, upgrading of the managerial and technical skills, has received inadequate attention during the reform implementation process.

### **A. Government leadership and ownership**

Policy makers take a relatively limited part in the Kyrgyz PFM reform planning and implementation process. There is a lack of top level ‘champions’ who are inclined to hold senior bureaucrats accountable for the success of the reform, and who know how to request and use the information it can provide. While there are specific individuals who support the reform agenda, this support is limited to a small core group in the MOF. At present, the extent of high-level leadership beyond the MOF is not clear.

Both the authorities and donors recognize that the lack of success in critical areas of the PFM reform largely reflects weak leadership and ownership, with many aspects of reform

implementation suffering from insufficiently coordinated donor assistance. Kyrgyz authorities, particularly in the MOF and the line ministries, are aware of the current PEM shortcomings and are committed to the PFM reform and to working closely with the donors involved in the PFM area to strengthen reform implementation.

The Government established a top level Economic Policy Council with responsibility for all budget preparation functions. Significant progress has been made in both improving the budget format to enable the Parliamentary review of budget policy priorities and integrating PIP (including its external financing) into the budget process. The basic elements of PFM institutions are in place and/or being expanded, and efforts to further improve budget management process are underway.

Reform on the scale required is unlikely to be successful without strong political commitment and government leadership. The reform agenda is unlikely to be implemented on the required scale if there is no demand for it at the political level or pressure to maintain the pace of progress over an extended period of time.

## **B. Coordination across Government**

Despite the progress so far, the PFM reform suffers from poor coordination amongst the PEM institutions. There is a risk stemming from lack of coordination among line ministries in implementing the policy measures supported by the donors. In particular, despite the progress so far, the MTBF suffers from poor coordination.

Sectoral departments within MOF currently play a dominant role that sometimes acts as a disincentive for the line ministries in accepting full responsibility within the MTBF and program budgeting framework. The MOF needs to continue to serve as a major coordinating body for the PFM reform, but at the same time it has to become more effective in providing better and clearer guidance and assistance to the line ministries.

Taking into consideration the weak capacity across the government levels and the importance of the donor technical assistance for the reform efforts, there is a strong need for a coordinated capacity building plan for both the MOF and line ministries. Such a plan would provide a broader context and coordinating mechanism for donor assistance for capacity building.

## **C. Sustainable reform process**

The Government has decided to increasingly apply three principles of a strengthened approach to supporting PFM reforms: (i) a country led PFM reform strategy and action plan, (ii) a coordinated International Financial Institution-donor integrated, multi-year program of PFM work that supports and is aligned with the Government's PFM reform strategy and, (iii) a shared information pool based on common indicators.

As a first step, the Government has initiated developing a concrete home-grown reform action plan. It is envisaged that this action plan will be elaborated further into a high-level roadmap of policy and operational reforms required to sustain and further strengthen PFM performance. Donors have also consolidated their positions and agreed on getting away from an earlier fragmented approach of providing TA to the KR to a better coordinated and harmonized assistance in support of a Government owned PFM reform strategy and action plan.

There seems to be a good prospect for enhancing reform planning and implementation. The Government's ability to effectively implement the main principles of strengthened approach

hinges critically on the ability to strengthen high-level political leadership. The process is in its early stage and it is too early to assess its impact on the budgetary outcomes.

## Annex 1: Performance Indicators Summary

INDICATOR	BRIEF EXPLANATION	RATING
<b>Budget Credibility</b>		
1. Aggregate Expenditure Outturn compared to original approved budget	Deviation of actual expenditure from the approved budget has been greater than 15% in two of the last three fiscal years	D
2. Composition of expenditure outturn compared to original approved budget	The variance in expenditure composition exceeded the overall deviation in primary expenditure by less than 5 percentage points in each of the last three fiscal years	A
3. Aggregate revenue outturn compared to original approved budget	Actual domestic revenue collection has been equal to or greater than 97% of budgeted revenue collection in two of the last three fiscal years. The continued practice of offsets is of concern.	A
4. Stock and monitoring of expenditure payment arrears	There is no system for monitoring expenditure arrears and therefore no reliable and complete record on the total stock of arrears. Some specific types of arrears are monitored and have been reduced to zero under the IMF's PRGF programme.	D
<b>Transparency and Comprehensiveness</b>		
5. Classification of the budget	Budget includes administrative, economic, and functional classification of expenditures. The use of a number of different classification systems currently impedes consolidation of the budget.	C
6. Comprehensiveness of information included in budget documentation	The 2005 budget documentation satisfies 5 of the requirements for information from the 9 listed by PEFA	B
7. Extent of unreported government operations including those funded by donors.	The comprehensiveness of fiscal information has improved in recent years. The extent of unreported government operations is estimated to be in excess of 10% of total expenditure. Unable to score due to lack of overall information	Could Not Score
8. Transparency of Intergovernmental Fiscal Relations	The distribution of revenue and expenditure responsibilities between different levels is not fully transparent and in its application unpredictable. Central government reporting of local government expenditure is comprehensive. The intergovernmental fiscal system is currently being reviewed.	C+
9. Oversight of aggregate fiscal risk from other public sector entities	Oversight of fiscal risk has improved in recent years but the nature of the government's liabilities in the SOE sector is not routinely monitored. Sub national monitoring by the centre is in place	D+

INDICATOR	BRIEF EXPLANATION	RATING
10. Public access to key fiscal information	The government makes available to the public information on 2 of the 9 listed types of information	C
<b>Policy-based Budgeting</b>		
11. Orderliness and participation in the annual budget process	A clear budget calendar exists but it does not allow sufficient time for either the MTBF or annual budget process. Parliament approves the budget before the start of the fiscal year. However, policymakers get involved in budget formulation only at quite a late stage.	B
12. Multi-year perspective in fiscal planning, expenditure policy and budgeting	Some basic elements of a MTBF process have been introduced. Further developments are required to improve the quality of the MTBF and enhance its linkage with the annual budget.	D+
<b>Predictability and Control in Budget execution</b>		
13. Transparency of taxpayer obligations and liabilities	Legislation and procedures are clear but substantial discretionary power of tax authorities still exists. Reforms are underway to address some of these issues.	C
14. Effectiveness of measures for taxpayer registration and tax assessment	<u>Self-scoring by State Tax Inspectorate:</u> Dimension (i) B; Dimension (ii) C; Dimension (iii) C. Further information required to independently verify performance.	Could Not Score
15. Effectiveness in collection of tax payments	The debt collection ratio for the last two fiscal years was 86%. Revenue collection procedures are adequate from an accounting control perspective.	B+
16. Effectiveness of cash flow planning, management and monitoring.	There is an absence of sound cash planning and management. The government has introduced measures aimed at addressing this issue but still has a considerable distance to go in making it effective.	D
17. Recording and management of cash balances, debt and guarantees.	There have been significant improvements in the handling of public debt but there is still a weakness in the consolidation of government's bank accounts.	B+
18. Effectiveness of payroll controls	The process is decentralised and personnel and payroll functions are carried out by the line ministries' accounting units. This has facilitated informal adjustments to approved establishment and salary levels and demonstrates a lack of effective control. Unable to score due to lack of overall information.	Could Not Score

INDICATOR	BRIEF EXPLANATION	RATING
19. Competition, value for money and controls in procurement	The legislative framework is satisfactory but still has to become fully effective in practice. There are notable weaknesses in the use of offsets and the lack of appeal in the complaints process	C+
20. Effectiveness of internal controls.	Internal control is ineffective in practice and not supported by the legal and regulatory framework or by recent reforms	D+
21. Effectiveness of internal audit	There is no effective internal audit function.	D
<b>Accounting, Recording and Reporting</b>		
22. Timeliness and regularity of accounts reconciliation	Unable to score due to lack of overall information on suspense and advance accounts	Could Not Score
23. Availability of information on resources received by service delivery units	No comprehensive data collection has been undertaken in the last three years. There are weaknesses in the capacity of the accounting and classification systems to report financial resources transferred accurately.	D
24. Timeliness, quality and dissemination of in-year budget execution reports.	In-year reports on budget execution are generated on a regular and timely basis. The reports are not comprehensive and are not compatible with budget estimates. The quality of the information is compromised by the manually based system and various other practices. The reports are designed for control purposes and are not used to provide useful management information to the line ministries.	C+
25. Timeliness of the presentation of audited financial statements to the legislature.	Financial statements are not submitted, only statements of aggregated cash transactions measured against budget lines.	D
<b>External Scrutiny and Audit</b>		
26. The scope, nature and follow up of external audit reports.	Effectiveness of external audit is handicapped by its emphasis on its compliance and policing function rather than that of assessment.	D
27. Legislative scrutiny of the annual budget law	There are active committees but their ability to function effectively is compromised by lack of capacity and the practice of ex post facto approval of expenditure.	D+

INDICATOR	BRIEF EXPLANATION	RATING
28. Legislative scrutiny of external audit reports.	While committees are in existence and active, there are restraints which restrict the capacity of Parliament to review critically audit reports. The authorities of Parliament for reviewing the audit report need to be clarified	D
<b>Donor Practices</b>		
D1 Predictability of Direct Budget Support.	Forecasts are not provided but only one year fell short of that budgeted for	C+
D2 Financial Information provided by donors for budgeting and reporting on project and programme aid	There is insufficient data to score this indicator	Could Not Score
D3 Proportion of aid that is managed by use of national procedures	Donors own procedures are the norm. There is insufficient data to score this indicator	Could Not Score

## **Annex 2: Sources of Information**

PRGF - 6<sup>th</sup> Review under the PRGF, 2005

HSFA – Health Sector Fiduciary Assessment, World Bank, 2005

PER – Public Expenditure Review, World Bank, 2004

CFAA – Country Financial Accountability Assessment, World Bank, 2001

ROSC – Report on Standards and Codes, IMF, 2002

TNBE – Technical Note on Budget Execution, World Bank, 2005

TNBP – Technical Note on Budget Preparation, World Bank, 2005

European Commission Public Finance Assessment Report, 2004

GSAC – GSAC Project Inception Report, 2005

### Annex 3: List of people met

Name	Position	Institution
M. Malatiev	Adviser to the Minister	Ministry of Finance
K. Asangulov	Deputy Minister	Ministry of Finance
K. Nadyrbekov	Head, Department of Revenue	Ministry of Finance
D. Ishalina	Head, Revenue Analysis Department	Ministry of Finance
A. Kojoshev	Head, Budget Policy Department	Ministry of Finance
M. Mambetjanov	Director, Budget Department	Ministry of Finance
A. Tynybekova	Head, MTBF Unit	Ministry of Finance
D. Shaydieva	Deputy Director, Central Treasury	Ministry of Finance
S. Mukanbetov	Director, Investment Policy Dept.	Ministry of Finance
A. Azimov	Head, Public Debt Statistics Division	Ministry of Finance
U. Danikeev	Deputy Head, Economic Policy Dept.	President's Administration
Z. Musakojoeva	Deputy Head, Finance Department	Prime Minister's Administration
U. Abdullaeva	Deputy Minister	Ministry of Labour and Social Protection
K. Kasymov	First Deputy Minister	Ministry of Agriculture
A. Guljigit	Deputy Minister	Ministry of Health
A. Kasymaliev	Deputy Head	State Tax Inspectorate
K. Kulmatov	Deputy Head of Inspection	State Customs Inspectorate
I. Ulianov	Deputy Head	State Statistics Service
<u>2</u>	Deputy Chairman	State Property Fund
A. Jamankulov	Deputy Chairman	State Comm. on Public Procurement
A. Ryskulova	First Deputy Chairperson	Social Fund of the Kyrgyz Republic
J. Lane	Head of Office in the Kyrgyz Republic	DFID
S. Bruni	PFM Consultant	DFID
C. Cudre-Mauroux	Deputy Country Director	Swiss Cooperation Office
E. Turusbekov	National Programme Officer	Swiss Cooperation Office
R. Ganguli	Financial Management - QA, ECA Region	World Bank
N. Pisareva	Economist	World Bank
A. Abdymomunov	Economist	World Bank
R. Clarke	Sr. Public Sector Specialist	World Bank
M. Silins	Consultant, GSAC support project	
B. Paniec	Prog. Manager, GSAC support project	
A. Hoitink		USAID
M. Mastrogeorgopoulos		EU Food Security Programme

## Annex 4: Revenue &amp; Expenditure

## Actual expenses of the republican budget in comparison with approved budget from 2002 till 2004

	2002 appr.	2002 actual	deviation	Deviation %	2003 appr.	2003 actual	deviation	Deviation %	2004 appr.	2004 actual	deviation	Deviation. %
<b>General expenses</b>	<b>9583,3</b>	<b>12271,0</b>	<b>2687,8</b>	<b>128,0</b>	<b>12281,4</b>	<b>13655,8</b>	<b>1374,4</b>	<b>111,2</b>	<b>12885,2</b>	<b>15021,1</b>	<b>2135,9</b>	<b>116,6</b>
<b>Option1: functional classification</b>												
I. General public services	1750,1	1764,1	14,1	100,8	1885,3	2055,7	170,4	109,0	1962,9	2420,7	457,75	123,3
II. Defence complex	1077,4	1077,4	0,0	100,0	1134,0	1261,0	127,0	111,2	1285,6	1406,2	120,62	109,4
III. Public order and security – total	737,8	911,5	173,6	123,5	918,2	1072,7	154,5	116,8	897,8	1194,5	296,7	133,0
IV. Education	820,0	1174,1	354,1	143,2	1188,0	1348,4	160,4	113,5	1147,2	1634,5	487,4	142,5
V. Health protection	534,8	450,8	84,1	84,3	598,2	499,3	98,9	83,5	655,2	646,6	8,5	98,7
VI. Social protection and security	1772,3	2170,4	398,1	122,5	2298,6	2417,4	118,8	105,2	2401,7	2441,6	39,9	101,7
VII. Housing and utilities infrastructure	329,3	645,1	315,8	195,9	322,1	597,3	275,2	185,4	322,1	479,0	156,9	148,7
VIII. Recreation and culture	177,9	245,0	67,1	137,7	278,6	314,8	36,2	113,0	301,7	370,9	69,2	122,9
IX. Fuel and energy complex	1,9	220,7	218,8	11441,8	38,3	163,3	125,0	426,6	3,8	27,7	23,9	726,0
X. Agriculture and water economy, forestry, fishery, hunting	665,3	712,3	47,0	107,1	663,8	743,6	79,8	112,0	687,0	854,2	167,2	124,3
XI. Mining industry	58,1	219,4	161,2	377,2	68,7	281,1	212,4	409,4	68,4	268,0	199,5	391,5
XII. Transport	457,8	621,3	163,6	135,7	560,3	529,4	30,9	94,5	517,0	617,1	100,1	119,4
XIII. Other services related to economic activities	51,0	36,9	14,1	72,4	49,3	39,8	9,5	80,8	48,4	49,5	1,1	102,2
XIV. Expenses not related to main groups – total	1149,5	2022,1	872,6	175,9	2278,0	2332,0	54,0	102,4	2586,4	2610,7	24,2	100,9
Amount of absolute values of deviations			<b>2884,1</b>				<b>1653,0</b>				<b>2153,0</b>	
% of the total amount of primary expenses			<b>30,1</b>				<b>13,5</b>				<b>16,7</b>	
Surplus of structural discrepancy from total deviation			<b>2,0</b>				<b>2,3</b>				<b>0,13</b>	
Average deviation for 3 years of actual expenses from approved budget						<b>18,6</b>						
<i>Payment of interests</i>	1587,7	663,5	-924,2	41,8	1687,0	740,3	-946,7	43,9	2066,7	963,8	-1102,9	46,6
External	1153,0	444,0	-709,0	38,5	1133,5	373,5	-760,0	33,0	1420,5	485,5	-935,0	34,2
Internal	434,7	219,4	-215,2	50,5	553,5	366,8			646,2	478,3		

Source: Ministry of Finance