Chapter 6. Intergovernmental Fiscal Relations

Effective design and implementation of intergovernmental relations are essential for good delivery of public services at the local level. Subnational governments (SNGs) play an important role in providing public services in Uzbekistan, but they have little autonomy over revenue management and resource allocation and act as an extension of the central government. The intergovernmental system remains highly centralized with discretionary transfers based on political negotiations and historical inertia. This setup does not create the incentives for efficient management of resources and improvements in the quality of public services. To address these challenges, as a first step, the government may consider increasing the predictability of transfers by introducing rule-based allocation mechanism, reviewing and clarifying expenditure assignments across the different levels of government, and providing greater fiscal autonomy to subnational governments. A clearer delineation of functional assignments will be a key step of a fundamental reform of intergovernmental relations progresses.

Context and Recent Developments

Uzbekistan has a highly centralized government structure. The administrative division comprises: (i) the central government; (ii) 12 regions (*viloyat*), one autonomous republic (Republic of Karakalpakstan), and one independent city (City of Tashkent); and (iii) 40 cities or urban districts and 162 rural districts, which are further subdivided into towns and villages. The President appoints directly the governors of the regions, who in turn appoint the heads of districts. Community self-governing bodies (*mahallas*) also play key role in carrying out government functions such as community policing and distributing social welfare payments. The regions are accountable to the President and central line ministries.

Figure 6.1. SNGs' Own Revenues as a Share of General Government Revenues
(in percent)

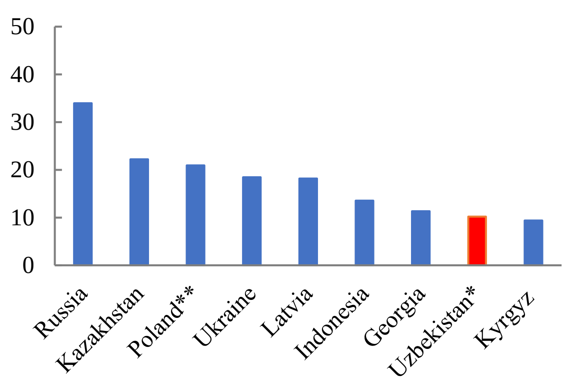
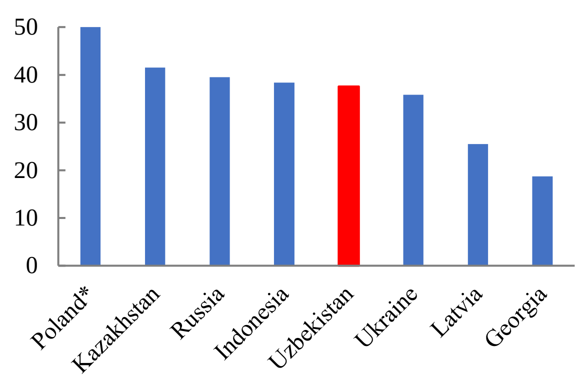


Figure 6.2. SNGs' Expenditures as a Share of General Government Spending
(in percent)



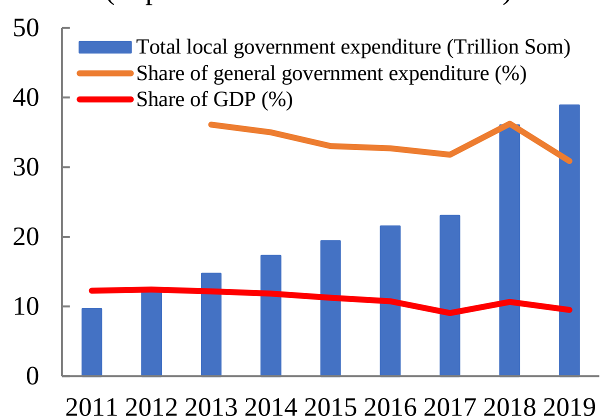
Source: MOF, IMF, and Bank staff estimates.
Note: The figure indicates the level of revenue collection by local governments and does not represent the degree of revenue autonomy (2016). *data are 2018; ** data are local tax revenue.

Box 6.1. Fiscal Decentralization Reforms in Poland

Poland embarked on decentralization reform in two stages (1990 and 1999). The first phase of reforms decentralized central government tasks and some revenue-raising authority, giving local governments limited autonomy regarding real estate taxes, local fees, and other minor taxes. The second phase focused on administrative reforms that reduced the number of local governments (*voivodeship*) from 49 to 16, restored the counties as an additional level of government, and decentralized public programs and services to increase citizen involvement and improve public service delivery. Strong and accountable local governments contributed to Poland's successful transition to a high-income economy. Local governments have been effective across the country, without large regional disparities. They have increased local revenues, legitimized by greater local political accountability, while also absorbing large amounts of EU funds for investment, supporting regional growth. Local governments play a key role in improving education, health, and public investment.

Source: World Bank (2017) Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status. Washington, DC. https://openknowledge.worldbank.org/handle/10986/28960

Figure 6.3. Deconcentrated Subnational Expenditures
(in percent and in trillions of Som)



Source: MOF and World Bank staff estimates.

Uzbekistan's central-local government structure is one of administrative *deconcentration.* In such a structure, subnational governments play a role as the central government's agent in the regions and are accountable to the central government.[1] SNGs, also referred to as local or lower-level governments, have little independence in managing public finances. Resources are transferred to the local governments while allowing them little autonomy or discretion in decision making. Uzbekistan's system of subnational finance has changed little since independence. In contrast, many developing and transition countries have embarked on fiscal decentralization, including Poland and Indonesia, and neighboring peers such as Ukraine, Georgia, and Kyrgyz Republic (Box 6.1).

Uzbekistan's intergovernmental finance system is characterized by large vertical imbalances (limited own revenue sources combined with large spending mandates). Horizontal imbalances do not seem to be an issue, as indicated by the low ratio between the lowest and highest revenue per capita among the regions (about 1.4). This may mask fiscal disparities among districts

[1] Administrative decentralization can take different forms: deconcentration, delegation, and devolution. Under the strongest form of decentralization, the central government devolves functions, that is, transfers the authority for decision-making, finance, and management to quasi-autonomous units of local government with corporate status. For further information see: http://www1.worldbank.org/publicsector/decentralization/admin.htm

and cities which cannot be analysed due to data constraints. Given the lack of a system of equalization grants, two instruments are used to equalize financial resources among regions: (i) varying sharing rates across taxes and regions, and (ii) general budgetary support (subvention or targeted transfers). The two instruments aim to close the fiscal gaps between expenditure and revenue forecast prepared by the Ministry of Finance (MOF).[2]

Transfers -- mostly shared tax revenues -- are by far the most important source of revenues for subnational governments. These account for about 70 percent of subnational revenues. The balanced budget rule is key criterion in determining tax sharing rates and the size of targeted social transfers. This balanced budget rule with gap filling from transfers from the central government does not create local accountability and efficiency in the use of resources. This can create perverse incentives to underestimate revenues (or at least not increase collection of limited own revenues) and overestimate spending. In addition, parameters for both instruments are decided annually and tax sharing types and rates, the amount of targeted transfers, and number of receiving regions varies across years. This highly discretionary approach creates uncertainty for local governments.

Despite a highly centralized administrative structure, subnational governments play an important role in public services provision. During 2013-2019, subnational governments implement around 34 percent of national public spending (56 percent of total national spending excluding extrabudgetary accounts), equivalent to about 11 percent of GDP. These levels are higher than the average level for the rest of the world, which accounts for 25 percent of government spending or 9 percent of GDP (Figure 6.3).[3] Subnational spending is concentrated on education (43 percent), healthcare (21 percent), and general public services (15 percent). By expenditure type, on average 53 percent of spending went toward wages and benefits followed by other spending (28 percent). Capital spending accounted for only 7 percent of total subnational expenditure.

The planning and budgeting process are centralized, mainly led by central line ministries and the Ministry of Finance. The regional governments consolidate the lower level governments' requests and submit them to the MOF. SNGs and the Tax Committee in parallel prepare revenue forecasts. The Ministry of Finance reviews both revenue estimates. In addition, the subnational budget preparation process includes a negotiated procedure with the central government where SNGs could argue for higher tax sharing rates or subvention allocation to reduce the projected budget deficit.

KEY CHALLENGES

Uzbekistan's government structure – and the resulting fiscal structure between the central and local governments – is highly centralized. The intergovernmental transfer system lacks proper incentives for efficiency and improved service delivery.

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[2] Expenditure needs are based on forecast using historical spending adjusting for inflation and new programs from line ministries.
[3] OECD-UCLG. 2016. Subnational Governments around the World: Structure and Finance.

Transparency and Predictability in the Allocation of Transfers

The current system of intergovernmental finance arrangements is highly discretionary and creates uncertainty for subnational governments. The system is based on varying rates of taxes shared and *ad hoc* budgetary transfers. For effective planning and budgeting, subnational governments need predictability for the resources they will receive every year. The absence of rule-based and transparent transfer system discourages efficient and transparent public financial management. The *ad hoc* approach to resource allocation has additional shortcomings, including: (i) the transfer is likely to be influenced by political manipulation; (ii) subnational governments are perceived as a lower priority and more likely to experience reduction when fiscal retrenchment is needed; (iii) the link between expenditure responsibilities and revenue resources is broken, which can negatively affecting the level of service delivery; (v) subnational governments are likely to be discouraged from increasing efficiency.

Clarity and Certainty in Deconcentrated Functional Assignment to Subnational Governments

There is no law that regulates functional assignments and administrative sharing between levels of government. The general divisions of responsibility are specified in the Budget Code, but these are not clearly defined and may change during the annual budget process. The deconcentrated expenditure responsibilities assigned to the region and districts/cities include social spending (education, health, and social support) and other outlays, but they involve specific task assignments rather than functional responsibilities. For example, the budget code explicitly specifies that only maintenance and renovation of healthcare facilities are the responsibility of SNGs. In education, various level of governments (republic, region, and district/city) are all involved in delivering secondary school services. Unclear functional assignment may undermine local accountability and efficiency of expenditure and service delivery.

Subnational Revenue Autonomy

Subnational governments have little autonomy over revenue collection. Major local taxes have their rate and tax base established and reviewed by the Cabinet of Ministers or in the annual budget resolution.[4] Local tax rates (except for the property tax, whose rate has been fixed at four percent by the tax code) are subject to annual review by the Cabinet of Ministers.[5] However, subnational governments are now allowed to keep locally collected revenues (own revenue) that exceeds planned revenues. Nonetheless, limited revenue autonomy, combined with the gap filling features of the transfer system design, reduces the incentives for increasing own revenues.

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[4] According to current legislation, local taxes include property tax, land tax, advertising tax and motor vehicles sales tax. Local fees include the fees for trading licenses (such as fees for goods-specific licenses), fees to register as a legal entity or individual engaged in entrepreneurial activities, fees for motor transport parking and fees for urban and rural development activities.

[5] Leschenko, Natalie and Manuela Troschke. (2006). Fiscal Decentralization in Centralized States: The Case of Central Asia, Osteuropa-Institut München, München.

POLICY OPTIONS

Improving the overall design of intergovernmental transfers will require careful review of the existing system and comprehensive reforms; even without such reforms, the authorities could take steps to improve intergovernmental relations towards more transparency and predictability. Intergovernmental transfers should be part of a comprehensive fiscal decentralization policy and may not be effective if implemented without reforms of other important elements of intergovernmental fiscal relations such as revenue and expenditure assignments (Box 6.2).

Box 6.2. Features of a Good Intergovernmental Transfer System

There are various approaches for designing transfer scheme depending on program structure, and the method used to divide its funds among eligible subnational governments is ultimately a political choice, but the design of the mechanism should be guided by sound economic principles. Thus, independently of its final structure, all transfer formulas should obey several universal principles.

- **Providing revenue adequacy**. A transfer formula should provide a source of adequate resources to local governments to achieve its policy objective.
- **Preserving budget autonomy**. As much as possible, a transfer system should preserve budget autonomy at the subnational level. While there are sound policy arguments for conditional (targeted) transfers, general purpose **transfers** and equalization funding should be lump-sum in nature and unconditional. After all, the benefits from decentralization arise due to increased flexibility and spending discretion at the subnational level.
- **Enhancing equity and fairness**. The transfer mechanism should support a fair allocation of resources. For instance, an equalization transfer should provide more resources to districts with lower tax capacity and greater fiscal needs. While fairness is a subjective social concept, transfer systems that provide disproportionately more resources to wealthier local governments are often considered “unfair.”
- **Stability**. **Transfers** should be provided in a predictable manner in a dynamic sense. The formula should be stable over a period of years to promote revenue predictability and overall budget certainty.
- **Simplicity and transparency**. Transfer formulas should be, to the extent possible, simple and transparent. An important way to keep transfer programs simple is to limit their objectives and to only pursue one policy objective with **each** transfer program. The formula should also be understandable to all stakeholders, in particular to regional officials and legislators, and not be subject to political manipulation or negotiation in any of its aspects.
- **Incentive compatibility**. The transfer system should not create negative incentives for revenue mobilization by subnational governments, neither should they induce inefficient expenditure choices. To avoid these negative **incentives**, it is critically important that the formulas do not try to equalize actual revenues and expenditures but instead fiscal capacity and expenditure needs.
- **Avoid sudden large changes**. During the introduction of the new transfer mechanism, the transfer system should avoid sudden large changes in funding for local governments.

Changes in the existing formula should strive to hold local government "harmless" during the transition to a new allocation mechanism.

Source: Bahl, Roy, Jamie Boex, Jorge Martinez. 2001. The Design and Implementation of Intergovernmental Fiscal Transfers. https://www.researchgate.net/publication/265572590.

Improve transparency and predictability of transfers through rule-based system

Annual decisions on the transfers to SNGs should be predictable and timely to inform budget planning. SNGs need to know the amount of resources they will receive from various sources. This will contribute to better quality budget planning and will help limit the need for budget revisions due to lack of resources. The decisions on transfers involve two dimensions:

- The vertical dimension, which relates to the distribution of revenues between the central government and SNGs. The size of the transfer pool to SNGs can be determined as a share of central government revenues.
- The horizontal dimension, which is the distribution of resources from the pool among the SNGs. Each SNG's share could be determined based on agreed percentages or a formula based on estimated fiscal gaps.

Review and clarify the assignments of functions across government levels

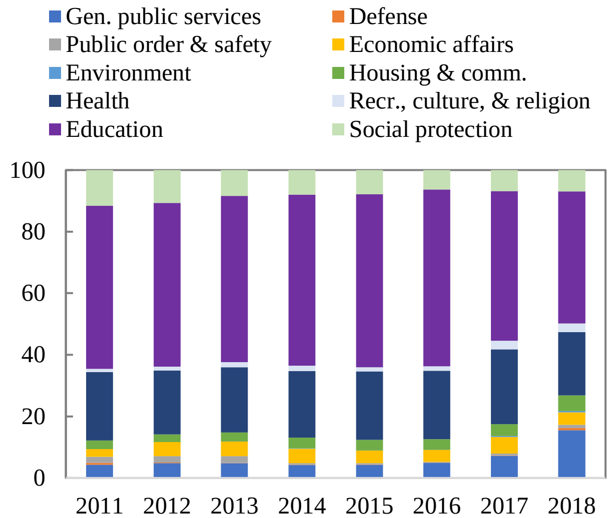
Clear assignment of functions between government levels is critical for improving the efficiency in local service delivery and allowing the central government and citizens to hold SNGs accountable. In addition, clear expenditure assignment is important to inform the design of the subnational financing system, including intergovernmental transfers. To ensure certainty and clarity of expenditure assignments between levels of government, it is preferable that they are regulated by law rather than via decrees, as commonly implemented in other countries. In the case of Poland, the functions of the different levels of subnational governments are defined in legislative acts and in accordance with good practice. Similarly, in Indonesia, functional assignments between levels of government are specified in the law on administrative arrangement between the central government and SNGs.

Consider providing greater revenue autonomy for subnational governments

Consider giving greater local revenue autonomy to SNGs by allowing subnational governments to set different rates for some taxes, at least in cities within certain thresholds. Land and property taxes are good examples. Greater revenue autonomy is expected to make local officials more accountable for the public services that they deliver, leading to better public services and more revenue. The increased fiscal autonomy should be accompanied by reforms incentivizing revenue collection at the subnational level, or at the minimum, limiting the hitherto perverse incentives to underestimate revenues.

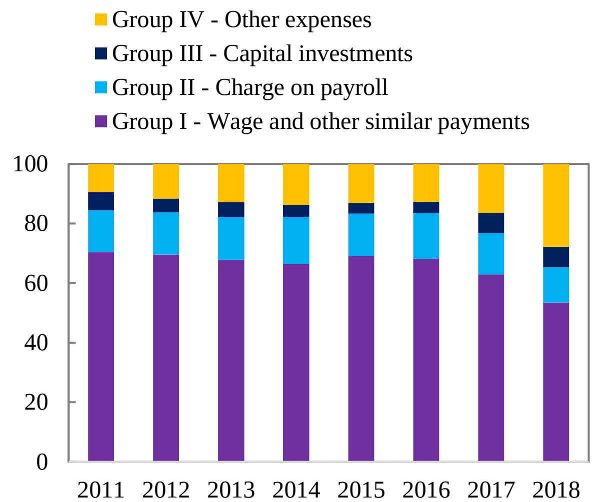
ANNEX.

Figure A6.1. Deconcentrated Subnational Expenditure by Function
(in percent)



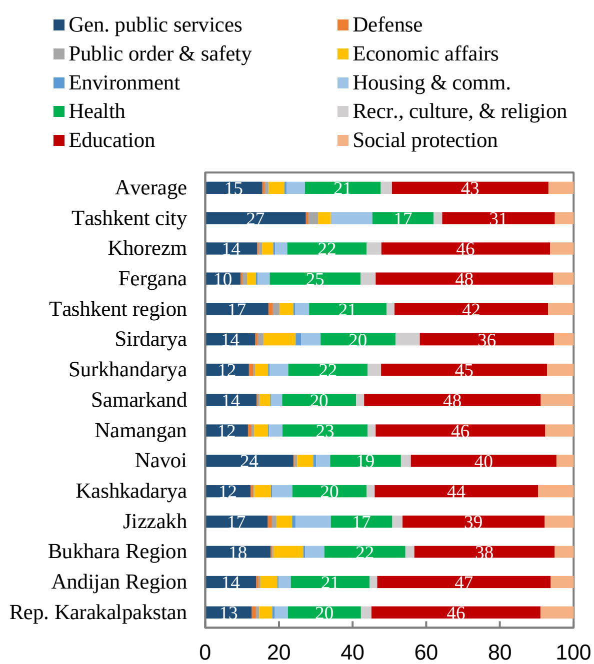
Source: MOF and World Bank staff calculations.

Figure A6.2. Deconcentrated Subnational Expenditure by Type
(in percent)



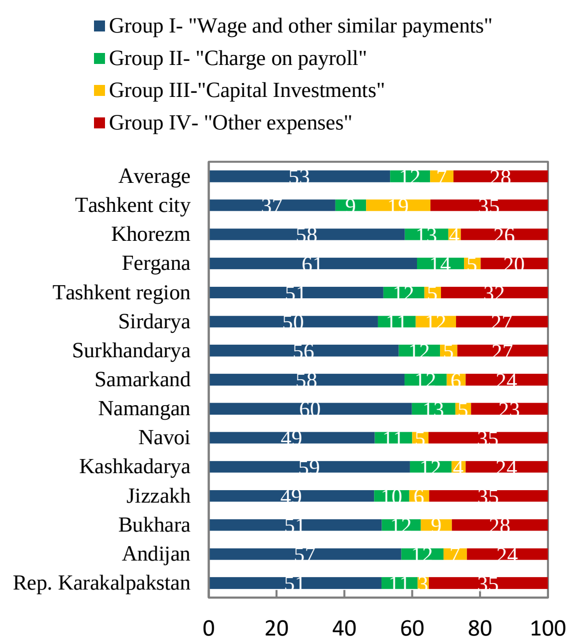
Source: MOF and World Bank staff calculations.

Figure A6.3. Functional Classification of SNG Expenditures, 2018
(in percent)



Source: MOF and World Bank staff calculations.

Figure A6.4. Economic Classification of SNG Expenditures, 2018
(in percent)



Source: MOF and World Bank staff calculations.