REFORMING ENVIRONMENTAL FINANCE INSTITUTIONS IN KAZAKHSTAN
CONCLUSIONS AND RECOMMENDATIONS FROM THE PERFORMANCE
REVIEW OF THE KAZAKH STATE ENVIRONMENTAL PROTECTION FUND

TWELFTH MEETING OF THE EAP TASK FORCE
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This paper has been prepared by the EAP Task Force Secretariat (OECD) following a performance review of the Kazakh State Environmental Protection Fund and financially supported by the EU Tacis Bistro Programme. The findings, conclusions and interpretations in this paper are those of the EAP Task Force Secretariat alone and do not necessarily reflect the policies and opinions of the Kazakhstan Government, the European Commission, the OECD or its Member Countries. This paper will support Item 5 of the Agenda.

ACTION REQUIRED: For information and written comments to the Secretariat (OECD) by 10 November 2000.
TABLE OF CONTENTS

Abbreviations and Acronyms ................................................................................................................................. 4

REFORMING ENVIRONMENTAL FINANCE INSTITUTIONS IN KAZAKHSTAN CONCLUSIONS
AND RECOMMENDATIONS FROM THE PERFORMANCE REVIEW OF THE KAZAKH STATE
ENVIRONMENTAL PROTECTION FUND .................................................................................................................. 5

I. BACKGROUND INFORMATION .................................................................................................................. 5
   Objectives of the Performance Review ............................................................................................................ 5
   Performance Review Process .......................................................................................................................... 6

II. LEGAL FRAMEWORK OF THE SEPF ..................................................................................................... 7
   2.1. Legal Status of the SEPF ..................................................................................................................... 7
   2.2. Stated Objectives of the SEPF .............................................................................................................. 10
   2.2.1. Analysis of the Legal Status of the SEPF ......................................................................................... 11
   2.2.2. Analysis of the Objectives of the SEPF ........................................................................................... 12

III. INSTITUTIONAL AND MANAGEMENT SET-UP OF THE SEPF .......................................................... 13
   3.1. Republican Fund ................................................................................................................................. 13
   3.2. Local Funds ........................................................................................................................................ 14
   3.3. Analysis of the Management Structure and Practices of the SEPF ..................................................... 14

IV. REVENUES .............................................................................................................................................. 16
   4.1. Revenue Sources ................................................................................................................................. 16
   4.2. Revenue Structure ............................................................................................................................... 18
   4.3. Revenue Distribution ........................................................................................................................... 19
   4.4. Analysis of the SEPF Revenues .......................................................................................................... 19

V. PROGRAMMING / PLANNING ............................................................................................................... 20
   5.1. Analysis of SEPF Programming ......................................................................................................... 20

VI. EXPENDITURE ......................................................................................................................................... 21
   6.1. Level of Expenditure ........................................................................................................................... 21
   6.2. Expenditure Focus ................................................................................................................................ 22

VII. DISBURSEMENT MECHANISMS ....................................................................................................... 23
    7.1. Analysis of Funds’ Disbursement Mechanisms .................................................................................... 23

VIII. PROJECT CYCLE MANAGEMENT ................................................................................................. 24
    8.1. Analysis of the Project Cycle Management ........................................................................................ 25

IX. CONTROL AND AUDITING ............................................................................................................... 26
    9.1. Accounting Procedures ...................................................................................................................... 26
9.2. Financial and Performance Audits ................................................................. 26
9.3. Public Disclosure and Access to Information ............................................ 26

X. OTHER SOURCES OF FINANCING FOR ENVIRONMENTAL INVESTMENTS IN KAZAKHSTAN .......................................................... 27

10.1. The Public Budget ..................................................................................... 27
10.2. Municipal Environmental Investments (Municipal Utilities) ................... 28
10.3. Private Sector Finance ............................................................................. 29
10.4. Foreign Sources of Finance ..................................................................... 29
10.5. Analysis of the Sources of Financing ....................................................... 29

XI. KEY CONCLUSIONS AND RECOMMENDATIONS .................................. 30
**Abbreviations and Acronyms**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
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<tr>
<td>EAP</td>
<td>Environmental Action Programme for Central and Eastern Europe</td>
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<td>EAP Task Force</td>
<td>Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IFI</td>
<td>International Financing Institution</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau (German Bank for Reconstruction)</td>
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<td>KZT</td>
<td>Kazakh Tenge</td>
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<tr>
<td>MOA</td>
<td>Ministry of Agriculture</td>
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<td>MNREP</td>
<td>Ministry of Natural Resources and Environmental Protection</td>
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<tr>
<td>NEAP</td>
<td>National Environmental Action Programme</td>
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<td>NEAP-SD</td>
<td>National Environmental Action Programme for Sustainable Development</td>
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<td>NGO</td>
<td>Non-Governmental Organisation</td>
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<td>NIS</td>
<td>New Independent States</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PIP</td>
<td>Public Investment Programme</td>
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<td>PPP</td>
<td>Polluter Pays Principle</td>
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<td>SEPF</td>
<td>State Environmental Protection Fund</td>
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<tr>
<td>TACIS</td>
<td>Technical Assistance to the Commonwealth of Independent States</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
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<td>USD</td>
<td>United States Dollars</td>
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REFORMING ENVIRONMENTAL FINANCE INSTITUTIONS IN KAZAKHSTAN
CONCLUSIONS AND RECOMMENDATIONS FROM THE PERFORMANCE REVIEW OF
THE KAZAKH STATE ENVIRONMENTAL PROTECTION FUND

I. BACKGROUND INFORMATION

Objectives of the Performance Review

1. The major objective of the Review was to conduct an independent and objective evaluation of all aspects of the performance of the Kazakh State Environmental Protection Fund (the Republican and 16 local/city funds) against internationally recognised standards, i.e. those contained in the “St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy”. The Review also contains recommendations, both short and long-term, for strengthening and improving the efficiency and effectiveness of the State Funds system.

Box 1: St. Petersburg Guidelines on Environmental Funds in a Transition to a Market Economy

The St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy (OECD/GD(95)108, Paris 1995), adopted by the EAP Task Force in 1995, recommend the key internationally recognised good standards for institutional set-up, management and performance of environmental funds. The criteria set forth in the St. Petersburg Guidelines have been used as a benchmark in assessing the performance of a number of environmental funds in Central and Eastern Europe. This framework was also used in the voluntary review of the State Environmental Protection Fund (SEPF) of Kazakhstan.

Main recommendations of the St. Petersburg Guidelines:

♦ To avoid or minimise the long-term economic inefficiencies inherent in earmarking of funds, expenditure should be targeted to environmental priorities and projects with large environmental benefits relative to their costs.
♦ Environmental funds should play a catalytic role in financing environmental improvements and support, not compete with, emerging capital markets.
♦ Environmental funds should reinforce other environmental policy instruments.
♦ Environmental funds should develop an overall financing strategy, follow clear procedures for selecting projects in order to ensure cost-effective use of resources, adopt effective monitoring and evaluation practices, and make effective use of internal and external expertise to enhance administrative efficiency.
♦ Environmental funds should leverage increased private sector resources and capital market financing for environmental investments.
♦ In designing and evaluating fund revenue mechanisms, environmental authorities should ensure environmental effectiveness, economic and administrative efficiency, equity and acceptability.
♦ Environmental funds should ensure transparency and should be accountable to government, parliaments, and the public for their actions.
Performance Review Process

2. In 1999 the Ministry of Natural Resources and Environmental Protection (MNREP) of Kazakhstan requested the EAP Task Force Secretariat to conduct a performance review of the State Environmental Protection Fund, and a review of existing sources of environmental financing. The Kazakh State Environmental Protection Fund is the first NIS Environmental Fund to be reviewed so far. The European Commission’s Tacis Bistro Programme supported financially the implementation of the project and a team of international consultants (Peter Faircloth (UK), Arunas Kundrotas (Lithuania) and Rafal Stanek (Poland), led by Michael Betts from Integrated Skills Ltd., have been contracted to implement the project.

3. The review was implemented in cooperation with the MNREP through extensive discussions with the Funds staff, MNREP officials, other ministries and state institutions, Funds clients and other organisations, all concerned with or directly involved in shaping the country’s environmental policy. The full co-operation of these parties is gratefully acknowledged.

4. A seminar to disseminate the results of the project, held in Astana on 6-7 July 2000, was attended by all major stakeholders. The discussions during the two-day meeting raised a number of issues. It was particularly emphasised that the funds, in their current form, have little potential to finance priority environmental investments. To play this role, the Funds system needs significant reforming and further strengthening. It was pointed out that this would require a high level political support and strong commitment by the Kazakh government to make relevant changes to bring it in line with international good practices.

5. The seminar proved to be an important first step in identifying the problems and providing a basis for discussion within the government on the possible options for reforming the funds. It was agreed that the MNREP in co-operation with the EAP Task Force Secretariat would seek to develop a demonstration project for reforming and strengthening the performance of the Funds system to help Kazakhstan more efficiently manage its scare domestic resources available for priority environmental projects. The project will be presented to the Kazakh government for consideration. Donor support will also be sought. The project is expected to provide useful experience and insight as to the obstacles to and opportunities for reforming the system of public environmental expenditure management not only in Kazakhstan but also in the NIS in general. Virtually all NIS countries that have established environmental funds face problems similar to those experienced by the Kazakh environmental funds.

6. The consultants’ report provides some background analysis of selected aspects of the operations of the environmental funds in Kazakhstan. This paper, prepared by the OECD Secretariat of the EAP Task Force, will provide the basis for discussion on the future institutional strengthening of the funds.

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1 Environmental investments are (typically large) capital outlays which create fixed assets that are expected to produce a flow of environmental benefits in the future (e.g. pollution abatement equipment, sewerage networks, waste water treatment plants etc.)
Box 2: The Polluter Pays Principle

Comprehensive environmental funds (i.e. funds providing subsidies for projects across all environmental media) do not exist in OECD countries. Earmarking is discouraged as it often leads to inefficient use of resources and institutional vested interests. However, in the transition period earmarking has been recognised as a mechanism that increases the stability and predictability of resource flow to some critical social sectors. Generally, OECD environmental policy is guided by the Polluter-Pays-Principle (PPP). This principle implies that polluters should bear the full cost of compliance with the goals established by the relevant administration without subsidies. The PPP provides for certain exceptions to its “no subsidy” philosophy. Specifically, a subsidy may be justified if it is well targeted (i.e. the environmental objectives to be achieved by the subsidy are clearly specified), limited in size and duration and does not introduce significant distortions in markets and trade. It can also be used where considerable external benefits or provision of public goods are involved. Thus, if subsidies are to be used, their need should be clearly demonstrated.

The development of an effective environmental finance system, based on the Polluter Pays Principles, is constrained during the transition to a market economy. This is due to several factors including weak environmental management and enforcement, underdeveloped capital and financial markets, scarce private financing, uncertain political and fiscal systems and weak civil society. Though not a “first best” mechanism, funds have been internationally accepted often as a useful supplementary instrument of environmental policy in the transition period, provided they are properly designed, managed and apply certain good performance standards, e.g. those included in the St. Petersburg Guidelines.

II. LEGAL FRAMEWORK OF THE SEPF

2.1. Legal Status of the SEPF

7. Over the period of approximately seven years since the establishment of the SEPF, the system of Environmental Protection Funds in Kazakhstan has undergone frequent legal and regulatory changes, culminating in the present situation where the Republican Fund only exists as a legal entity without any revenues or resources of its own. The history and current status of the Funds indicate that there is no real consensus between the Ministry of Natural Resources and Environmental Protection, the Ministry of Finance, oblast/municipal authorities and other stakeholders on the role of the Funds in environmental financing vis-à-vis other sources of finance in Kazakhstan. However, it should be pointed out that there is a clear tendency towards streamlining the system of funds in Kazakhstan: starting as a system for simply earmarking resources for environmental measures and developing into a system of funds as established legal institutions with functions of collecting and disbursing resources.

8. The system of environmental funds was initially established by Government Decree No. 1024 of 15 October 1993. This Decree defined the Funds as "extra-budgetary" and stipulated that the revenues from pollution charges and fines would be allocated to environmental funds. Ten months later the amendment of 24 August 1994, stipulated that all references to the "extra"-budgetary” nature of the Funds should be taken out from the language of the Decree. Immediately afterwards, the next amendment, adopted by the Government on 5 October 1994, stated that the revenues from pollution charges and fines were part of the government budget and created a special budget line No. 32, called "Proceeds to the Fund for Environmental Protection". On a Republican level, the Fund was an integral part of the MNRE, and the staff were regular government employees. Similar relations were established between the local funds and local administration (Akhimats).
The legal status of the SEPF was fully determined four years later, by the parliamentary Law on Environmental Protection, adopted in July 1997. Article 33(2) of the Environmental Protection Law establishes the Republican and the local funds as legal entities. No mention is made in the Law whether the Funds have a budgetary or extra-budgetary status. Therefore, the Law implicitly maintained the budgetary status of the Funds leaving the budget line "Proceeds to the Environmental Protection Fund" intact.

The Environmental Protection Law does not elaborate in detail what the status of a "legal entity" implies in the context of the legal system of Kazakhstan. The Civil Code sheds more light on this issue. According to Article 33 of this Code, a legal entity is an organisation which possesses or manages property, is able to enter into property and non-property obligations and related rights, can sue and be sued in a court of law, and which has independent accounts and a corporate seal bearing its name. Legal entities may be commercial or non-commercial. A non-commercial legal entity, which is financed exclusively from the State budget, can be established only as a State institution. A State institution is an institution established by the State in accordance with the laws of the Republic of Kazakhstan or decisions of the President, the Government, the Akhims of the capital, oblasts and the cities of republican significance and can be financed only by the state budget unless specific legal acts define them otherwise. However, the Civil Code does not specify how resources available to such institutions will be used. Decisions on this matter are left to the founder (owner) of the institution. The Code also notes that the state institution has no right to use the resources allocated to it independently. The meaning of "independently" is not further specified.

The Law of Environmental Protection does not directly require earmarking of revenue from pollution charges for environmental purposes. However it does it indirectly, through the mechanisms of the funds. Article 33(4) stipulates that funds shall be created from revenues generated from pollution charges, fines and other related penalties, while Article 34(2) stipulates that "It shall be prohibited to spend money from Environmental Protection Funds for purposes not connected with environmental protection".

Besides, Article 33(2) allows the establishment of environmental funds not only as governmental institutions but also as "public" or "civil" (obstchestviennyje) funds. However, this latter option has never been used.

As foreseen in the Law on Environmental Protection, Government Decree 280, adopted on 1 April 1998, replaced Decree No. 1024 of October 1993 and later amendments. The new Decree brought into effect new regulations governing the Republican and the local funds. The Decree established both the Republican and Local Funds as legal entities with certain rights as defined in the Republican Fund Regulation and Model Regulation for Local Funds attached to the Decree. The Ministry of Natural Resources and Environmental Protection is appointed as the Supervisory Body of both the Republican and local Funds. Until now (October 2000) this Decree remains the regulatory basis for the funds' institutional set-up and operations.

A Presidential Decree on earmarking and extra-budgetary funds, issued on 17 December 1998, abolished almost all extra-budgetary funds in Kazakhstan and consolidated them back into the Republican and local budgets. In part, this was related to allegations of corruption voiced by IMF and the Ministry of Finance and the fiscal risks such funds posed on the fragile fiscal consolidation in the country. Environmental funds are not explicitly mentioned in this Decree. In fact there was no reason to do so, as they were not extra-budgetary funds in legal terms. However, this Decree reflects the "mainstream" state of thinking about managing government resources outside of the budget and provides an important context for possible scenarios for the future development of environmental funds in Kazakhstan. Thus, while all other extra-budgetary funds ceased to exist, the legal status of environmental funds remained unaffected.
15. The years 1998 and 1999 brought fundamental changes to the situation of the Republican Environmental Fund. First, in December 1998 Article 34 (2) of the Law on Environmental Protection (about the exclusive use of the Funds’ resources for environmental purposes) was repealed by the law prepared by the Ministry of Finance and intended to pave the way for the new framework law on the budgetary system (see below). As an immediate consequence Budget Line 32 “Proceeds to the Fund for Environmental Protection” disappeared from the Annual Budget of the Republic of Kazakhstan for 1999 and onwards.

16. The second profound change in the system of environmental funds took place with the enactment of the framework Law on the Budgetary System adopted by the Parliament on 29 November 1999. This Law explicitly determined that the revenue generated from pollution charges and fines belonged to the Government Budget. Article 7 (“Republican Budget Revenues”) stipulates that 50% of the resources shall go the State budget, while the remaining 50%, as stipulated by Article 11 (“Revenues for the Local Budgets”), shall be allocated to the local budgets, and specifically to the Local Environmental Protection Funds. The Republican Fund, as a budget line or a mechanism for managing budgetary resources at the Republican level, is not mentioned in the Law on the Budgetary System, although the expenditure line “measures for environmental protection undertaken on a Republican level” is explicitly written in Article 9. This just explains the absence of the budget line for the environmental fund in the Republican budget. The resources, which would have otherwise been allocated to the Fund, became an indivisible part of a comprehensive State Budget, although the MNREP can still claim them for financing specific projects and programmes to be approved together with the annual government budget.

17. Since the beginning of 1999, the Republican Fund has no longer been able to derive any revenues from the pollution charges and fines levied and collected at a local level, although it has continued to exist as a legal entity. Therefore, it still is obliged to perform functions stipulated by the Law on Environmental Protection and the related Government Decree No. 280, mainly concerned with supervising and controlling the activities of the Local Funds.

18. This recent development in budget legislation has not so far resulted in any major changes to the Local Funds, the main consequence being that local funds can now receive up to 50% of the revenues from pollution charges and fines. The budget of local Funds became subject to approval by the local authorities as part of the Local annual Budgetary Laws.

19. As a consequence of these legal changes, the MNREP has prepared a Draft Government Decision on the Management of the State Environmental Protection Fund which is intended to replace Government Decree No. 280 of April 1998. The new draft Decree proposes to establish a Republican Committee for Management of Environmental Protection Funds. The Committee is proposed to be a "government institution", having a non-commercial character and an independent legal status. The Government, represented by the MNREP, is to be the founder of the Committee and will play the role of its supervisory body. However, the Committee would have assets of its own, be separate from the Ministry, would have independent balance sheet and accounts. Along similar lines, the draft Decree proposes to establish local Departments for Management of Environmental Protection Funds on a regional level. The competencies and responsibilities of these new bodies are, in many respects, similar to those of the Republican Fund and Local Funds, as they currently exist. However, there are some important differences, particularly with respect to the new role envisaged for the Funds in managing foreign assistance to the environmental sector in Kazakhstan.
2.2. Stated Objectives of the SEPF

Republican Fund

20. Government Decree 280 states that the goal of the Republican Fund is to provide financial support for the realisation of state environmental policy, and that the Fund’s activities shall be guided by the following priorities:

- financing of projects, following the environmental policy of the State and its strategic plans in the environmental protection field;
- development of a positive public attitude towards ecological problems by providing support to ecological education and public awareness, ecological tourism and the development of green areas;
- financing of environmental protection and management of the resources for environmental protection, including international financial assistance.

21. Under the Republican Fund Regulation, attached to Government Decree 280, the Republican Fund has the following objectives:

- to disseminate information concerning its activities;
- to co-ordinate and control the activity of local environmental funds;
- to co-ordinate financing of projects and programmes implemented with the support of international organisations in the environmental field;
- to conclude agreements and contracts;
- to provide economic incentives for environmental protection;
- to assist the authorised state organisations in collecting all the fees and payments due to the Fund, specified by the legislation;
- to execute other rights and obligations in the environmental protection field, not conflicting with national legislation.

Local Funds

22. Local funds have similarly defined objectives as the Republican Fund but the focus is on regional programmes and projects. According to the above Decree, Local Funds shall have the following main objectives:

- financing priority local and regional programmes directed towards improvement of environmental quality and securing ecological safety for inhabitants;
- collection of revenue and disbursement of resources for environmental protection measures;
- provision of incentives for the effective use of resources and implementation of conservation measures;
- promotion of implementation of resource conservation and clean technologies;
- co-financing of construction and reconstruction of environmental protection objects;
- assistance in the development of ecological education, tourism, extension of green areas;
- assistance in the development of legal acts in the environmental protection field;
- other environmental protection objectives, not conflicting with national legislation.
2.2.1. Analysis of the Legal Status of the SEPF

23. Legally, environmental funds in Kazakhstan are established through a Parliamentary Act. This is a more solid legal basis than a government decree alone. However, as the example of the Republican Fund shows this is not a sufficient condition for the Fund to deserve its name, being an institution without any resources to spend.

24. Given the current predominant functions of both the Republican Fund (co-ordination and supervision) and the local funds (revenue collection), their legal status of budgetary entities seems sufficiently clear and functional. The clarity of the legal basis would always be improved, if the Environmental Protection Law or, at least, subsequent Government Decrees made specific references to other “core” framework laws of the Republic of Kazakhstan, such as the Civil Code or the Law on the Budgetary System. Such references would make environmental funds more firmly rooted in the existing legislative order of the country and more transparent and predictable to potential foreign partners. For example, potential foreign partners need to know clearly what the legal basis for contractual relations with the Fund is, as they need to fully understand the standards of accounting and financial management.

25. The more fundamental legal problem, however, will appear if the Funds in Kazakhstan want to effectively fulfil the other -- so far disregarded -- part of their written legal mandate, namely managing environmental expenditure, including financing investment projects. In such instance, their status of budgetary entities may pose some constraints. As such, the Funds have to sacrifice their operational autonomy for the benefit of being shielded, through the budget, from undue political interference. Another drawback of the Funds' budgetary character is that usually under such an arrangement the contractual obligations of the funds are poorly defined. Certainly, for potential foreign financiers and other partners contractual relations with budgetary institutions are always risky, because contracts can easily be overridden by political decisions. However, legal independence and operational autonomy can also lead to a waste or even misuse of public money, if sufficient provisions for accountability, transparency and cost-effectiveness are not provided for in the legal basis.

26. The draft Decree, prepared recently by the MNREP, is yet another creative attempt to re-establish the environmental funds in Kazakhstan on a sustainable basis under the changing external circumstances. This Draft deserves serious attention, but also careful analysis and review. It introduces a lot of improvements as well as some potentially interesting elements that could lay a good basis for the establishment of effective and efficient mechanisms for managing public environmental expenditure and for leveraging additional finance. For the first time in this draft Decree the financing of environmental investments and mobilising external finance are seriously considered as priorities at a government level. However, it also contains some provisions that could potentially undermine the credibility and effectiveness of the institutions and persons involved in running the Committee.

27. The fact that the Republican Fund still exists as a legal entity firmly based on a parliamentary Act is an important potential asset. Although the Fund is legally unable to derive revenues from pollution charges and fines, this does not mean that the Fund is unable to derive revenue from other sources. The current legal and regulatory framework of the Kazakh Funds allows them to have other revenue sources which are not prohibited by the Law. These other revenues are not part of the Budget, unless they fall under definitions included in the 1999 Law on the Budgetary System. For instance, if some foreign financier decided to channel resources for environmental projects in Kazakhstan through this institution, there are no legal obstacles for the Fund to enter into a legally binding grant agreement with such a foreign institution. Under the current legal framework, the Treasury would not appropriate this grant to the general budget. In CEE countries, there are a number of environmental funds that successfully operate and finance significant environmental investments without deriving revenues from domestic pollution charges and fines. Such examples are the Polish and Bulgarian debt-for-environment swap funds, the Slovenian
Environment Development Fund or the Lithuanian Environmental Investment Fund (during the first few years of its operations). The Russian NPAP is another, although not so successful, example. These funds are capitalised by donors, IFIs or through individual budgetary transfers. Some of them manage successful programmes for disbursing grants for large environmental investments. Others, that exist in the most developed and stable financial markets, operate as revolving funds on-lending money in order to keep the real value of their initial capital unchanged over time.

2.2.2. Analysis of the Objectives of the SEPF

28. The objectives, as currently defined in the Funds’ legislation, are written in very broad terms. They may be interpreted to include almost any form of environment-related activity. Many of them are ambiguous (e.g. to provide economic incentives for environmental protection). Such objectives do not provide the Funds with clear guidance as to what the real priority measures to be financed are. Having been given such unclear objectives, the funds find it difficult to develop well-targeted expenditure programmes. Their scarce resources are under many competing pressures and are likely to be thinly dispersed over a large number of projects without bringing significant environmental benefits in any single problem area. The practical experience of the Kazakh Funds (as well as of funds in other countries) confirms that this is indeed the case.

29. Some of the current objectives or roles of the local funds, such as revenue collection, which is their legal obligation, tend to crowd-out other roles of the Funds envisaged by law. By giving this role to the funds, the legislator in Kazakhstan has exposed them to a tremendous pressure, which requires them to focus most of their staff time and resources on increasing revenue rather than managing expenditure to “finance priority environmental projects”. In reality, indeed, very few local funds have financed environmental projects of regional significance. Collection of revenues from environmental charges and fines has dominated their operations. It should be noted that this is a very untypical function for environmental funds world-wide. CEE funds, for example, are not responsible for collecting their revenues. This allows them to focus on managing public environmental expenditure.

30. It is difficult to hold the Funds accountable for achieving so vaguely specified objectives, to evaluate Funds’ effectiveness, and therefore, to evaluate whether they are really needed. It seems that both the Republican Fund and the Local Funds effectively play, at least, some roles they are obliged to by the Law and by Government regulations. However, this is not a good argument to defend the need for the funds, because other, existing institutions are well, if not better, suited to fulfil these functions. For instance, the Republican Fund, in fact, has mainly supervisory and co-ordination functions. Even if the Fund seems to do this effectively, this could as well be done by a regular Department of the Ministry. The “Fund” (financing institution) is not needed for this purpose. Another example is the revenue collection by the local funds. Again, other government institutions (tax authorities supported by environmental inspectorates) are well equipped to play this role and they do it better in other countries.

31. In conclusion, it is important to recognise that the lack of clear spending programmes and narrow, well targeted priorities is one of the main underlying weaknesses of the environmental funds in Kazakhstan. It could be one of the major causes for the current ambiguous status of the Funds and the lack of resources for the Republican Fund. This could also have led to the situation where the central Ministries (Finance and Economy) are not convinced that environmental funds could manage public expenditure for environmental measures better than the general budget.
III. INSTITUTIONAL AND MANAGEMENT SET-UP OF THE SEPF

32. The Republican and local funds have a two-tier management structure, as specified in Government Decree 280. The MNREP is the Supervisory Body of both the Republican and local Funds (or, at least, the obligations of the MNREP, as defined in Government Decree 280, in many respects come close to what an internationally recognised role for a Supervisory body is). Local Funds are additionally supervised by local administrations. Their day-to-day activities are managed by the respective executive Fund Boards headed by Directors.

3.1. Republican Fund

33. The Ministry of Environment and Natural Resources, as the Supervisory Body of the Republican Fund, takes the main decisions regarding the Fund’s activities and is responsible for:

- approval of Statute and internal normative documents of the Republican Fund;
- approval of the Annual Action Plan (budget) and Annual Report of the Fund;
- deciding on external audits of the Republican Fund’s and inviting independent auditors;
- approving the composition of the Fund’s Board;
- other issues related to the Republic Fund’s activities.

34. The Board of the Fund is an executive body and manages the day-to-day activities of the Fund. The Board of the Republican Fund consists of the Chairman of the Board – Director of the Fund and 4 members of the Board. The Minister of Natural Resources and Environmental Protection appoints the members of the Board. The Director of the Fund is appointed by the Prime Minister upon the proposal of the Minister.

35. The Board has the following general responsibilities:

- managing the Fund’s day-to-day activities;
- presenting the state of accounts and Annual Report of the Fund for approval by the Supervisory Body;
- preparing the draft Annual Action Plan (budgets) and control of its implementation;
- managing the Fund’s assets including its financial resources;
- employing the Fund’s staff and approving of the Fund’s personnel structure;
- opening of accounts;
- concluding and implementing agreements on behalf of the Fund;
- other activities according to the tasks of the Fund.

36. The Regulation governing the Republican Fund (and local funds) is unclear about the division of competence between the Board and the Director of the Fund. The Regulation states that the Director of the Fund is responsible for managing the Board’s activities, but at the same time states that the Director is accountable to the Board.

37. Prior to 1999, the Republican Fund employed its own staff who were appointed by the Fund Director upon approval by the Fund Board. However, following the 1998 and 1999 changes in the law, the Republican Fund was reorganised at the beginning of 1999 into a Department for Management of State Environmental Protection Funds under the Environmental Protection Committee (which is subordinated to the Ministry). The existing staff were all transferred to this Department and, after subsequent reorganisation, to the Department of the Economics of Nature Use at the Environmental Protection Committee. The Fund Director became Director of the Department of the Management and Finance of the...
Ministry and these two Departments jointly share the responsibilities previously assigned to the Republican Fund. The Republican Fund, therefore, has no longer any staff of its own even though it continues to exist as a legal entity. Currently, 14 persons of the former Fund personnel are engaged on tasks relating to the supervision and monitoring of local funds along with other routine administrative responsibilities they have. Their salaries are met from the Ministry’s regular budget.

3.2. Local Funds

38. The Ministry of Natural Resources and Environmental Protection, as the Supervisory Body of the Local Funds, has essentially the same responsibilities as with respect to the Republican Fund. The MNREP approves the Statute (using template regulation approved by the Government) and all internal regulatory acts. The Ministry approves annual budgets and annual reports of local funds, takes decisions about external audits and selects auditors, appoints the Funds’ Director, approves the composition of the Board and is entitled to intervene in "other issues related to the Funds’ activities".

39. Management of the Local Funds’ activities is a responsibility of the Boards of the Funds. The Board of each Fund consists of 5 persons, including Director of the Fund, who at the same time is the Chairman of the Board. Each Board, within its administrative area of activity, has responsibilities corresponding to those of the Board of the Republican Fund.

40. The Directors of the local funds are appointed by the Minister of Natural Resources and Environmental Protection upon the proposal of the respective oblast/municipal authority. The staff of the local funds is appointed by the Fund Directors upon the approval of the Board, and their salaries are paid from the Funds’ budgets. The number of staff employed by the Local Funds varies between 7 and 15, depending on the size of the particular Fund and the scale of the tasks and activities which it performs. Both "Government Decree on Funds" (No. 280, 1 April 1998) and "Government Decree on Pollution Charges" (No. 1213, 1 December, 1998) and the later "Instruction on the Order of Payment of Pollution Charges and Non-compliance Fines” (July, 1999) give the local funds a very important role in developing pollution charge rates and assisting the State revenue authorities in collection of pollution charges and non-compliance fines. Most of the management and staff time in the local funds is devoted to these activities. Local funds are also used by the local administration as their procurement offices. Direct procurement on behalf of local government, in accordance with the Government Procurement Law, also absorbs significant resources of local funds in terms of time and people. Local funds usually have a few experts jointly responsible with the Boards for organising tenders, selecting suppliers of goods and services and managing contracts. Other functions performed by local funds staff include disbursing and controlling the use of Fund resources, and accounting.

3.3. Analysis of the Management Structure and Practices of the SEPF

Supervisory Body

41. The Supervisory body of Kazakh Funds consists of representatives of one government agency only. This does not add to credibility of the funds to other stakeholders. Moreover, this leads to the isolation of the environmental funds from the mainstream government policy. Other stakeholders can not easily see the benefits the environmental funds can bring for the entire Republic of Kazakhstan. They perceive them as an "internal pot of money" serving parochial interests of environmental authorities. Since 1998, the Republican Fund has been very active in public relations and out-reach activities aiming to change this perception and to demonstrate the benefits of the funds to the entire country. However, these efforts have not been particularly successful, as the recent Parliamentary Acts have clearly proven. Such
efforts are likely to fail in the future too unless, among other reforms, the supervisory body is restructured to include other essential stakeholders as well. On a republican level this could involve representatives of the Ministry of Finance, Economy, the Parliament, local governments and non-government organisations. Foreign stakeholders can be invited as well if the Republican Fund would be considered to manage some foreign finance. This is the usual practice in CEE Funds making them better understood and appreciated in their home countries. The most successful environmental funds have their supervisory bodies with wide, carefully balanced representation without any single stakeholders group dominating.

42. It is difficult to see, from the existing legislation, who exactly is responsible for selecting individual projects for financing. In the letter of the legislation, at a republican level the Board is responsible for preparing annual budget (which typically consists of the list of specific projects), while the MNREP approves it. Because the Republican Fund is an integral part of the republican budget, its budget has to be approved also by the Government and included in the annual Budget Law of the Republic of Kazakhstan. At the same time however, the Ministry employs the Board members and effectively it is the Ministry administration, which also selects projects to be included in the annual budget. This violates the internationally recognized good practice that those who supervise should be separate from those who are supervised. Otherwise, situations of conflict of interests are likely to occur. Good international practices suggest that the role of the government bodies should be limited by law to programming and supervising. However, appraisal and selection of individual projects for financing is best vested with a professional, independent executive management body, held accountable for performance and established results.

43. In addition, if the Funds are to co-operate with bilateral donors and international financing institutions in the future, it is essential that responsibilities regarding appraisal and selection of individual projects are clearly defined. This is always a major requirement of donors and IFIs when they choose their partners. Hence, there is a need for a clearly identified body within the Fund’s structure to deal with the project cycle management, while the responsibility of the MNREP could be reduced to formal endorsement of the projects appraised and selected by professionals.

44. On a local level, subordination of funds to many agencies can lead to the so-called "common agency problem", a situation where it is difficult to hold anybody individually liable for decisions. This is particularly likely because the supervisory competencies of local administration versus the MNREP are not clear in legal terms. For example, Decree 280 identifies the supervisory body (i.e. the MNREP) as the body approving annual budgets of all 16 local funds. But according to the budgetary laws, local funds are part of the independent budgets of local administrations. Therefore, local administration has the sovereign power to allocate its own budgetary resources. These tensions have so far been resolved by the "chain rubber stamping" practice where the draft annual budget, prepared by the Fund Board, is sent for stamping by the local department of environmental protection, local department of finance and the Akhim of the local administration. Only then is the draft budget sent for official approval by the Ministry. The MNREP has little real influence on the projects included in the local budget. This is quite rational because the Ministry can provide very little value added in determining what the local priorities in all 14 regions and 2 main cities are. However, the maintenance of this legal fiction still holds the MNREP administratively liable for the quality of the local funds’ budgets. It is very risky for the MNREP, or any other supervisory body, to be held liable for decisions on financing individual projects in the meaning of the civil code, criminal or administrative codes, as the MNREP cannot have access to all information to make fully-informed judgements and indeed, have no real influence on these decisions.

Funds’ Boards

45. Under current arrangements, the Funds’ management units -- Directors and the Boards -- enjoy little degree of institutional autonomy or operational independence. The Republican Fund is now
effectively an integral unit of the MNREP and the competencies of the Fund Director are not different from any other middle-level official in the very hierarchical administrative structure. The decision-making authority of the Fund managers is strictly constrained. Management time is preoccupied with struggling for several rubber stamps from different government bodies to legalise, often detailed, decisions. This culture of rubber-stamping by "Superior Authorities" is probably comfortable for some fund managers as it releases them from accountability for decisions. A clever manager can always easily manipulate bureaucrats because of the information advantage (s)he has. However, several fund managers, interviewed during the review mission, have expressed the willingness to work under different, modern management practices. These practices are based on establishing clear objectives, responsibilities and performance standards up-front, giving Managers significant operational autonomy for current decisions and holding them strongly accountable for results and performance in the end. Not only is current management culture inefficient and vulnerable to corruption but it is also unacceptable for most potential foreign sources of finance, with whom the MNREP would like to co-operate.

46. The Regulation governing the Republican Fund is unclear about the division of competence between the Board and the Director of the Fund. The Regulation states that the Director of the Fund is responsible for managing the Board’s activities, but at the same time states that the Director is accountable to the Board. This situation creates potential conflicts of interest. The same holds true for the local funds.

47. By virtue of Decree 280, the Board of the Republican Fund has the right "to conclude and implement agreements on behalf of the Fund", which is a legal entity separate from the Ministry. However, in reality, the Fund Board does not select projects for financing. Effectively, this is done by various Departments of the MNREP and approved by the Government together with the annual State Budget, to which the Fund belongs. This renders the legal obligations of the Fund meaningless. For the Fund clients and potential partners it is essential that the party that signs the contract has the real power and the assets to fulfil the obligations without having to rely on third parties that are not tied by contractual relations.

48. It seems that the Boards of the funds visited, fulfil their everyday responsibilities as well as possible under the present regulatory framework. The inconsistencies and ambiguities existing in this framework, as discussed above, do not make life of good managers easy. As long as the Funds do not really finance significant investment projects, these ambiguities may not be a major concern. However, if the Funds are to become real managers of significant domestic and perhaps even foreign environmental expenditure, there will be a need to reconsider and clarify the roles and responsibilities of the Management Boards and the Supervisory Bodies with respect to project appraisal and selection. In CEE funds, management (executive) units are typically responsible for project cycle management, including project identification, appraisal, selection, contracting and monitoring of implementation. They are also liable for financial transactions, invoicing and reporting. Management units are accountable for these decisions to the supervisory bodies within the framework of clear objectives and performance standards.

IV. REVENUES

4.1. Revenue Sources

49. The template Regulation for the Local Funds, an annex to Government Decree 280, lists five revenue sources of the environmental funds in Kazakhstan which are the following:

- pollution charges;
- non-compliance fines;
- revenue from compensation for damage caused to the environment and other illegal activities;
• international assistance for environmental protection;
• other revenue not conflicting with national legislation.

50. The same Decree stipulates that revenue sources of the Republican Fund are the deductions from the revenues received by the Local Funds, international assistance for environmental protection and other revenue not conflicting with national legislation. The first revenue source was indeed active until 1999.

51. All Funds revenues are received in cash, i.e. according to available data there are no non-monetary receipts or transactions. No information was provided on the scale of non- and delayed payments on the sectors/polluters that are usually in arrears on a republican level, although penalties for delayed payments are envisaged in the current legislation. However, the Annual Report of the Almaty City Fund for 1999 shows that the Fund failed to collect about 25% of expected revenue largely due to non-payments. One of the major reasons for the non-payments is the insolvency and liquidation of the enterprises.

52. Available data on the total revenues collected from pollution charges and fines for the years 1995 – 1999 are shown in Table 1. The volume of revenue from pollution charges and fines has been steadily increasing in real (dollar) terms between 1995 and 1998 but dropped by almost 40% in 1999. The rate of the revenue collected versus revenue expected is reported to be very high, sometimes as high as 100% or more. However, the collection rate (i.e. the rate of revenue collected versus billed) was not made available to the review team.

Table 1: Revenues Collected from Pollution Charges and Fines, 1995 - 1999 (millions)

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<tr>
<td>Total revenues in KZT</td>
<td>455.7</td>
<td>1354.9</td>
<td>2312.1</td>
<td>2896.2</td>
<td>2720.2</td>
</tr>
<tr>
<td>Total Revenues in USD (at current exchange rates)</td>
<td>7.5</td>
<td>19.9</td>
<td>30.4</td>
<td>36.7</td>
<td>22.5</td>
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Source: Ministry of Natural Resources and Environmental Protection

53. Data showing total revenues actually received by the Funds over the same period are not available. However, as the legislation does not allow any revenues that remain unspent at the end of the financial year to be carried forward to the following year, all that can be said is that the revenues received by the Funds were approximately equal to their expenditure (see next chapter). Generally, the revenue data available at national level are rather poor, and often inconsistent or conflicting. Unfortunately, the MNREP knows very little about revenue at the local level. The review team has not received consistent financial data on the revenues of local funds by different profiles.
4.2. Revenue Structure

54. Pollution charges and fines so far seem to have been the only revenue source of the Funds. Most of the revenues collected are derived from pollution charges, of which air pollution charges and waste charges together account for a very large proportion of total revenues (88%). Air pollution charges accounted for around 53% of total revenues collected in 1999, waste charges for about 35%, and wastewater charges for about 10%. By comparison, revenues from fines account for only 2% of total revenues. Air pollution fines were only about 0.6% of total revenue, wastewater fines about 0.7% and waste fines also 0.7%. This general pattern has prevailed for the past 5 years, although the amounts of revenue derived from air pollution charges relative to other pollution charges have increased significantly during the last 2 years. None of the other sources, legally allowed to the Funds, were reported as generating revenues.

55. In Kazakhstan, there are as many as 3620 air pollutants from stationary sources that are subject to charges. In water effluents, 2312 substances are charged. Charges are also levied on 5 classes of solid waste (data from the Survey on the Use of Economic Instruments for Pollution Control and Natural Resources Management in the New Independent States). In reality, however, only few pollutants are monitored on a regular basis (for example, 14 major pollutants from stationary sources in Almaty). Charge rates differ across the 16 administrative regions. For example, the charge rate on NO\textsubscript{x} and SO\textsubscript{2} emissions from stationary sources vary from the lowest rate of 600 KZT (USD 5) up to the highest of 6400 Tenge (USD 53). The top rates are significant as compared even with OECD countries (higher than in the USA and France) but below the marginal costs of significant emissions reductions. The rates for CO emissions are respectively - 10 and 106.6 KZT (USD 0.10 to 0.90).

56. Both Government Decree on the Collection of Pollution Charges (No 1213, December 1998) and the later Instruction on Procedures for Calculation and Collection of Pollution Charges and Non-compliance Fines (July, 1999), assign an important role to the Local Funds in developing pollution charge rates and assisting the State revenue authorities in revenue collection. Pollution charge rates are to be calculated each year by the Local Funds and have to be approved by local governments (Akhimats) after co-ordination with the Ministry of Natural Resources and Environmental Protection (Government Decree on the Collection of Pollution Charges, Article 8). Control of the calculation and payment of pollution charges is to be performed by the State revenue authorities and the Local Funds (ibidem, Article 12). Non-compliance fines are to be imposed and collected after presentation of information by the Local Environmental Protection Funds (ibidem, Article 13). Every year the MNREP circulates the rates recommended as benchmarks in attempt to decrease regional differences. However, it is the local administration (Akhimat) that ultimately establishes the rates through formal decision and submits this decision for a rubber-stamp by the Ministry. In principle, the charge rates are related to a human toxicity index. In reality, there is also another important factor, namely the level of revenue expected to be generated. Local environmental funds together with local environmental administration calculate the proposed rates so that the total revenue generated covers estimated total expenditure for environmental protection measures to be financed from the fund in the following year.

57. Polluters report their emissions, calculate their own payables and present them to the local funds that verify the accuracy of the calculations. For example, the Almaty City Fund supervises about 14 – 15 thousand enterprises which have to pay pollution charges, the Almaty Oblast Fund – 6000 enterprises, the Astana City Fund – 1840 enterprises, the Akmola Oblast Fund – 900 enterprises. This environmental revenue supervision function requires local funds to keep considerable number of personnel. Some of the Funds (e.g. the Astana Oblast Fund) have developed sophisticated computer software to track down even the smallest polluters and calculate the revenues due from pollution charges and fines, which facilitates the process and reduces the burden on the staff. Following likely negotiations, local funds rubber-stamp the polluters' charge declarations and polluters submit payments to the State revenue authorities.
58. Although not officially permitted, it seems that informal negotiations with polluters concerning the charge base often takes place (mainly over the levels of reported emissions). Also, offset arrangements with polluters are sometimes practised, whereby charges are reduced or waived in return for a commitment by the polluter to implement certain agreed environmental improvement measures. As in other NIS countries, such discretionary schemes significantly reduce the stability of the revenue stream. They also suffer from a number of other serious defects that may raise legitimate concerns by the authorities responsible for the integrity of the public finance. For example, such schemes may provide a window for corruption, tax evasion and cause important fiscal risk.

4.3. Revenue Distribution

59. The amount of revenues at the disposal of the funds each year, has been ultimately determined by the annual budget law. For instance, for 1998, the State budget law envisaged that 30% of total revenue would go to the State budget and the remainder would be distributed between the Republican Fund and the Local Funds in proportions 40% and 60% respectively. The 1999 budget law has not envisaged any resources for the Republican Fund but 50% of revenue was left to the local funds. As discussed above, the new framework Law on the Budgetary System of 1999, stated that since its adoption 50% of these revenues should go the State budget and 50% to the local budgets and further to the local Funds.

60. The available data suggest that actual transfers are usually less than envisaged in the Law. The proportion of the total revenues received from pollution charges, which was actually allocated to and spent by the Funds, amounted to around 24% in 1998 and 25% in 1999.

4.4. Analysis of the SEPF Revenues

61. The revenue flow to the Environmental Funds has not been stable and predictable. The legal basis for charge rates and revenue distribution changes almost every year. A number of discretionary elements in the process of determining the charge rates, charge base and revenue collection, has been also adversely affecting the predictability of disposable resources of the funds. Determination of the receivables is subject to significant discretion. Rates change every year by discrete decisions of Akhimats and the Ministry. The charge base is subject to possible negotiations between polluters, local authorities and funds staff. All this decreases revenue predictability. Such a situation does not help and encourage the Funds to prepare realistic programmes and budgets.

62. The charge base in some respects is too broad, in others too narrow. Too broad, because about 6,000 pollutants are charged. No authorities in the World could effectively monitor or supervise self-monitoring of so many pollutants and enforce payments of all charges. The heavy burden that this system imposes both on polluters and authorities is not worth the negligible revenue that most probably 99% of these pollutants generate. As in other countries, it is most likely that only few emissions generate almost all revenue. This revenue must cross-subsidise the collection of several thousands other pollution charges for which the cost of collection is larger than the amount of revenue collected. Rationalising this system, by focusing on fewer charges for revenue raising or incentive purposes and replacing other charges by different instruments to reduce emissions, is worth considering.

63. On the other hand, the base of the funds’ revenue can be considered narrow because no other instruments but pollution charges and different environmental fines generate revenue. Other revenue sources are worth considering as well, such as charges on environmentally damaging products or transactions. These charges are typically easier to monitor and enforce and can ensure a more stable and predictable revenue stream. Removing obstacles to effective mobilisation of foreign finance is another option for consideration.
64. Involvement of the State revenue service in the collection process increases the revenue stability due to comparative advantages in enforcing collection. But dependence of the funds on discrete annual transfers from the local budgets work in the opposite way. Current revenue distribution scheme tacitly allows local administrations not to comply with existing laws and to regularly allocate to the Funds less than envisaged. Also, the stability of the revenue stream of the Funds has been hindered by the frequent changes in legislation concerning the proportion of revenues generated from pollution charges and fines.

65. Pollution charge rates, as currently set and enforced, are still very low although they have been increased several folds over the past few years. For example, in Almaty the rate per tonne of air pollutant from stationary sources determined for the year 2000 was about USD 3-4. It may well be the case that most regions choose to keep lower rather than higher charge rates. In such a case, pollution charges appear to be primarily revenue-raising instruments and do not provide significant economic incentives to economic agents to modify or mitigate environmentally-damaging behaviour. Therefore, in practical terms, they do not differ fundamentally from most other taxes and charges imposed by the state.

V. PROGRAMMING / PLANNING

66. The term “programming”, as used here, refers to the process by which the Funds establish their environmental spending priorities from year-to-year and for a longer-term. Programming also involves the definition of eligibility criteria (who and what types of projects can receive financing from the funds).

67. The programming of the environmental funds in Kazakhstan is very closely linked to the budget cycle. Having no resources of its own, the Fund on a republican level does not seem to participate in the preparation of that part of the annual Republican Budget which is allocated to the MNREP. The existing planning system by the MNREP is based entirely on annual budgeting. Proposals for the budgetary expenditure are prepared by different Departments and are finally approved by the Minister before submission to the Ministry of Finance.

68. The financing of specific environmental measures by the Local Funds is undertaken in accordance with the Annual Action Plans, which are prepared in co-operation with the regional/municipal authorities, and approved by the MNREP. The Annual Action Plans, reviewed in this project, were based on various national and local programmes as well as on various orders of the MNREP.

69. Annual Action Plans effectively are detailed annual expenditure budgets. Their structure is generally organized according to the classification of expenditure categories established in the Fund’s Regulation. They contain a list of specific projects and their anticipated costs, a short (one sentence) background description of each project, the planned implementing agency or the method to be used for selecting an implementing agency (e.g. by tender), the planned implementation period, and a brief description of the expected results.

5.1. Analysis of SEPF Programming

70. The absence of well-defined spending programmes with clear, specific and realistic objectives is one of the major weaknesses of the environmental funds system in Kazakhstan. The Funds' objectives are written in very broad terms. A very wide range of potential activities and beneficiaries can be supported by the Funds. Such objectives provide very little guidance as to what the real priorities are and encourage unrealistic expectations. They also expose the Funds to a lot of pressure from a great number of potential beneficiaries. Under these pressures funds have tended to spread resources thinly in an effort to satisfy too many stakeholders. As a result the funds have been insignificant players in solving the major
environmental problems identified in the NEAP. These solutions typically require a critical mass of investment capital which funds have been unable to accumulate.

71. Both the NEAP and Strategy 2030 provide important insight into priority problems as well as a long-term vision for the country’s social and economic development. However, they are not, and indeed have not been intended to be implementation and financing strategies which could provide the basis for strategic decisions on how to allocate public finance and what the best "niche" for environmental funds could be. They lack clearly identified targets, robust cost estimates and analysis of available financing sources. According to some people interviewed, the "back-of-the-envelope" crude estimate of investment needs based on the collection of specific, donor-driven projects listed in the NEAP, identified the figure of USD 2 billion but no written evidence was provided.

72. It seems that the spending priorities of the environmental funds have so far been generally determined by the local bargaining and current perception of “urgent measures”, rather than "strategic considerations". Currently Kazakhstan is developing an environmental finance strategy within the framework of the EAP Task Force. This strategy, among other things, also aims to analyze the role of environmental funds within the overall system of environmental financing sources available to the country and identify the most useful "niche", or targets, for the funds in financing future environmental improvements.

73. The future spending programmes of the funds will need to be derived from a realistic environmental strategy which should follow up the NEAP and, among other things, should consider the role and purpose of the funds in addressing priority environmental problems of the country. The solution of many of the problems may not require public financing, and therefore funds. On the basis of such strategies the funds will be able to develop strategic multi-year spending programmes narrowly focusing their scarce resources on projects and project owners that critically need subsidies. Eligibility criteria will define the characteristics of the priority projects and the target groups that can receive funding.

74. Introducing a strategic, multi-year perspective in the Funds' planning will allow them to more effectively allocate their extremely limited resources among competing projects. Improved programming and planning by Funds will further help the MNREP in its discussions with the Ministry of Finance and the Ministry of Economy on the future of the Funds. Possibly, environmental funds' priorities can be linked to those identified in the Public Investment Programme of the Government.

VI. EXPENDITURE

6.1. Level of Expenditure

75. As already noted, since the beginning of 1999, the Republican Fund has not received any revenues of its own, and consequently the Republican Fund has not had any expenditures of its own over this period. Thus, the revenues and expenditures which previously had been received and made by the Republican Fund now form part of the regular annual budget of the Ministry. The total value of the budget line items allocated to the Ministry in the 1999 Republican budget amounted to KZT 3635 million (~ USD 26 million at current exchange rates), of which KZT 2640 million (~ USD 19 million) related to administrative and geological expenditures of various kinds. The remaining KZT 995 million (~ USD 7 million) was allocated for financing environmental protection measures, and roughly corresponds to the portion of the budget which would have been allocated to and administered by the Republican Fund, if it had still been functioning.
76. The data available in the MNREP suggest that the aggregate disbursement of all the 16 local environmental funds in 1999 was probably only USD 4.6 million. The data also suggest that the total expenditures of the Funds represent a relatively small and declining proportion of the total revenues collected from pollution charges and fines (from 35% in 1995, 25% in 1996/7, to 20% in 1999). Unfortunately, the MNREP did not provide the review team with reliable data on the expenditure by the local funds. The financial data, aggregated at a national level, are inconsistent and of poor quality.

6.2. Expenditure Focus

77. A major part of local funds’ resources goes to meet the Funds’ overhead and administrative costs. It appears that the local funds’ overhead and administrative costs represent a very high proportion of their expenditures by international standards. Available data suggest that administrative costs amounted to about 39% in 1999, primarily because of the resources needed to undertake the tasks of assisting tax authorities in collecting pollution charges. The Funds’ activities and resources are concentrated on revenue generation and collection rather than on efficient and effective disbursement.

78. Most of the non-administrative expenditures of local funds have been focused on non-investment projects, such as research and studies, nature conservation and various forms of support to the local Environmental Protection Department. Sometimes small-scale investments have also been supported, for example purchasing environmental monitoring equipment. Funds’ revenues have been too low to be sufficient to finance environmental investments in pollution control equipment, where a single such project (e.g. waste water treatment plant) would cost many times more than the aggregate spending of all the Funds in the country. The line in the expenditure classification called "co-financing of construction and reconstruction of environmental protection objects", which contains mainly investment projects related to emissions reduction, accounted for only around 12% of total expenditure in 1999.

79. The largest share of the Funds’ expenditures in 1998 (31%) was allocated to the Funds’ participation in the development and implementation of programmes and projects directed towards improving environmental quality and securing ecological safety for inhabitants. Unfortunately, this title of the budgetary expenditure line is not very transparent. From the analysis of the original financial reports of Astana and Almaty city funds, it seems that eligible projects for this type of expenditure include, for example monitoring, city transport management, extension of green areas, inventory of hazardous waste or development of cleaner technologies.

80. Another large item of Funds’ expenditure relates to the strengthening of the material and technical base of executive organisations in the environmental protection field which, in many cases, means the provision of direct support to the local Environmental Protection Departments of the MNREP (about 16.1%). However, no reliable and consistent data was provided on a Republican level.

81. The Funds’ expenditures on the air and water sectors as a share of non-administrative expenditure accounted respectively for 17.5% and 22.1% of all expenditure in 1999. Expenditures related to waste management have increased significantly in the past year in percentage terms, but remains insignificant in monetary terms. Once again, we would remind that these numbers need to be treated with caution because the expenditure data available at the MNREP are poor and inconsistent (e.g. the total sums by different categories can vary ± 30%).
VII. DISBURSEMENT MECHANISMS

82. All disbursements made by the Funds are in the form of direct grants. In fact it is even difficult to call them “grants” in the internationally understood meaning of this word. The financing done by the funds resembles rather direct purchases on behalf of the government. The distinction between beneficiary (the one who benefits from the project) and the contractor (the one who is paid to implement the project or deliver goods and services) is blurred. It is the Funds themselves that usually purchase goods and services according to the public procurement procedures and transferring them to beneficiaries (authorities or institutes). Since the resources of the funds are part of local budgets, local administrations remain the owners of purchased goods. Usually 100% of a project’s cost are covered by Funds' resources.

83. Decree 280 does not allow the Funds to disburse resources through loans or equity investments. However, the new draft Government Decree, that is being prepared by the MNREP, provides the funds with the opportunity to provide loans as well.

84. There are no signs that the Funds in Kazakhstan are threatening to crowd out private sector financiers from the (almost non-existent) environmental investment market. Currently, most banks offer loans at interest rate of 15-26% for usually a 2-year period (more rarely for 5 years). It seems that the funds have not co-financed any projects with commercial financing institutions, either. The Funds do not have any relations with the banking sector and are not explicitly required by law to leverage private sector finance for environmental projects.

7.1. Analysis of Funds’ Disbursement Mechanisms

85. Eligibility to use only grants has so far prevented the funds from serious financial and fiscal failures. Given their legal status, management structure and staff expertise, the funds are not yet prepared to use more sophisticated and more risky financing instruments, such as loans or equity investments. Direct grants are the simplest instrument of transferring subsidies. Grants are transparent and relatively easy to manage. They allow Funds’ staff to accumulate experience and develop basic skills with financial management, contracting, project appraisal and implementation monitoring. International experience shows that disbursement mechanisms should be few and transparent. They should be adjusted to the needs of the projects as well as best adapted to the institutional and managerial capacity of the Funds.

86. In fact, a great deal of capacity building is needed even to manage grants effectively. As noted earlier, the Kazakh funds do not disburse resources in a way typical of public environmental funds worldwide. They do not offer grants to beneficiaries who then could pay contractors or vendors to implement environmental projects. Instead, the funds just organise tenders for goods and services that the authorities want to purchase. Fundamental organisational and management reform as well as awareness raising and capacity building will be needed before the funds in Kazakhstan are ready to operate competitive grants (let alone loans) in a manner that is understandable to foreign institutions.

87. The Kazakh funds have not used their resources in a way that could mobilise additional finance for environmental projects. As little as USD 4-5 million available in 1999 could have been used to leverage as much as additional USD 15-20 million, if the funds had financed only up to 20%-30% of project capital costs (as for example, the Polish Ecofund does) instead of financing 100% of the cost. These additional sources could have included local budgets, retained earnings of enterprises or foreign funds.
VIII. PROJECT CYCLE MANAGEMENT

88. The project cycle applied by the Kazakh Funds is simple and has a small number of formal elements. No formal project appraisal stage in the project cycle management exists.

89. On a republican level, it is the Ministry of Natural Resources and Environmental Protection that determined the types of projects selected (usually monitoring and studies). As a result, there were no applications and the Republican Fund did not use any disbursement mechanisms to attract recipients (not even grants). Instead, the Fund only spent money directly purchasing goods and services. Project selection is still commonly understood as a process of selection of a contractor, vendor or an implementing agency. All fund managers emphasise that the Public Procurement Law regulates the contractor selection stage. This selection is conducted by the MNREP staff and is subject to final approval by the Minister.

90. On a local level, because of the bigger number of stakeholders, the project cycle management is a bit more sophisticated but the general idea remains the same as with the Republican Fund. An additional stage is project selection, where a list of projects is prepared by the Fund Board during the regional budget preparation process, submitted for approval to Akhimsats and further to the MNREP. There are no formal project selection criteria and no definition as to what an "environmental protection project" or "object" is. In its approval, the MNREP makes attempts to question projects that are "not environmental by its judgement" but the lack of legally-binding definitions renders Ministry's protests less effective. Akhimsats’ projects, that are not considered environmental by international standards (e.g. road construction), have happened to receive financing from local funds.

91. Portfolios of projects financed through local funds are dominated by projects, such as: purchase of monitoring equipment and provision of services; environmental impact assessment of public projects (the so-called environmental expertise); small-scale nature protection activities; documentation, consultancy or research projects. Regional Funds reported some infrastructure projects but these were not part of the Funds’ budget line and were not managed directly by Fund but rather by Akhimsats.

92. The elements of a typical project cycle of the Kazakh Funds are:

- **project selection** - there are no formal applications or other requirements at this stage; actual selection of projects is conducted outside of the funds, by government administration at the local level;
- **project documentation** - accompanied by a detailed explanation on how project documentation should be prepared, including engineering, cost estimates and environmental expertise;
- **public tender** - organised in accordance with the Public Procurement Law. This is the best-defined element of the project cycle management. It seems to be a formal and transparent mechanism. The Fund staff are involved in all stages of this process, beginning with the preparation of the Term of Reference;
- **contractor selection** - contractor selection criteria are practically reduced to just one: lowest cost. Sometimes Fund staff uses two criteria, but low cost is still the most significant (with a weight of about 90%). The other criterion (about 10% weight) may be additional service, better material base or preference to national manufacturing. Because of the type of projects, there are a lot of public schools, NGOs and law firms selected as contractors;
- **project implementation** - the contractor is responsible for project implementation. The role of the MNREP and the local funds is to provide sufficient financing under the contract. Sometimes, because of cash-flow problems, the Ministry delayed payments. When a project is completed, after inspection of project implementation, an official approval (document) is prepared by a specially appointed committee;
• internal report - the Fund personnel prepare a final internal report on how the money has been spent.

93. The project cycles applied by the Ministry and the Local Funds are similar, and are very simple and straightforward. In both cases, potential projects are not subjected to any detailed appraisal and evaluation against clearly-defined selection criteria e.g. cost-effectiveness. Project cycle management is mainly based on the procedures established in public procurement legislation, namely Public Procurement Law of 1997 and, in particular, the Instruction on Procedures for the Procurement of Goods, Works and Services by the State. These two documents define the rules for the appointment of a Tender Board and regulate the procurement of all goods, works and services financed from the State budget. The Instruction defines the rights and duties of the Tender Board, and the tendering and contracting procedures which must be followed under specified circumstances. Therefore, the project cycle is thus focused on the processes of tendering projects and selecting contractors for implementation.

8.1. Analysis of the Project Cycle Management

94. Direct purchasing through competitive tenders is actually the activity where Funds’ staff have developed excellent skills and seem to have achieved very good results. But this focus on direct purchasing rather than selection of projects for financing is very unusual by international standards. Typically in other countries, the comparative advantage of environmental funds and public banks (including international development banks) is in financing and the comparative advantage of final beneficiaries is in purchasing goods and services that they need in order to achieve environmental improvements. They know best (as users) what and how to choose. Because beneficiaries do not use their own, but public, money, the funds or the banks provide financing only if beneficiaries purchase goods and services from contractors according to the requirements of procurement laws and procedures. By international standards, a fund or a bank typically supervises the procurement process but does not enter into contractual relations with a contractor or a vendor. The contract signed by a fund or a bank is a credit, loan or grant agreement with a beneficiary, sometimes supported by an agreement with institutions that guarantee beneficiary’s obligations.

95. The experience of the funds’ personnel in managing tenders is likely to be very useful to the Kazakh authorities in their regular procurement. But this is a secondary skill for the staff of the funds, if they are meant to be truly financing institutions by international standards. Skills and capacities in appraising and selecting beneficiaries and projects would be essential. If the Kazakh authorities envisage their environmental funds to become serious partners to foreign financing institutions, they will have to, among other things, transfer explicitly the mandate for project appraisal and selection to these institutions, and build related capacities.

96. Kazakh environmental funds do not have written and transparent project appraisal procedures and criteria. This is one of their most serious weaknesses. Well-defined appraisal and selection criteria are usually the crucial elements in shaping trustworthiness, accountability and transparency of successful funds in other countries. At best the procedures and criteria of project appraisal and ranking should be generally defined in the law, specified in the Funds’ Statutes and further operationalised in documents approved by the Supervisory Body. These operational documents should describe detailed procedures and criteria of applications, appraisal and selection of beneficiaries and projects. Ideally, the criteria should apply equally without discretion to all projects and beneficiaries. The most successful CEE funds have a two-stage appraisal process. At the first stage, simple “pass-fail” initial screening criteria help identify and select out projects that are in principle eligible. Later, a more sophisticated comparison and ranking criteria are applied to a smaller number of selected projects in order to choose which projects should be finance first thus forming the most cost-effective portfolio of projects.
IX. CONTROL AND AUDITING

9.1. Accounting Procedures

Existing regulation on the Funds does not determine the accounting procedures of the Funds or the applicable standards of financial management. It can be assumed that the accounting standards and financial discipline that apply to all budgetary entities are also binding to environmental Funds. An important development in the accounting standards in Kazakhstan is the 1995 Accounting Decree, signed by the President of Kazakhstan. Since then, the accrual method of accounting has been gradually replacing cash-flow based standards inherited from the Soviet Union. The wording in the Decree suggests that this method is applicable only to commercial/non-government entities (Investment Guide to Kazakhstan, OECD, 1998). The Funds have not developed an accounting system that could be comparable with international accounting standards. This may not be a problem as long as the funds manage small budgetary resources. But this will need to be changed if the funds are to finance environmental investment programmes, in particular in co-operation with foreign financing institutions.

9.2. Financial and Performance Audits

Government Decree 280 requires the Funds to have financial audits by the fiscal (treasury) authorities and external audits conducted by independent chartered accountants. The Funds are subject to annual legal audit by the State Auditor. If the Supervisory Body decide they may choose to appoint private auditors but this has not occurred in practice. Performance audits (evaluation against stated objectives and good performance standards) are not required from the State Auditor. The current performance audit was entirely voluntary. Subsequently, except from pure conformity with the law, current legislation does not contain any criteria against which the Funds’ activities can be checked and assessed.

9.3. Public Disclosure and Access to Information

The Republican Fund prepared its first (and last) report on activities in 1998. While the Regulation of the Funds requires that the results of Funds’ activities should be announced in mass media, it does not clearly specify requirements for reporting to the MNREP, the Government, the Parliament and the public. There are no guidelines and procedures for fulfilling such requirements. The Funds’ policies toward public disclosure and access to information by the public and other interested parties are not documented. However, the 1998 report signals the intention and the willingness of the Funds to undertake the way towards a more open public disclosure policy. On a local level, information disclosure policy varies from fund to fund. The Funds visited during this review (the City Funds in Astana and Almaty, the Oblast Fund in Akmola) provided very open access to their financial statements and all internal documentation and regulations requested.
X. OTHER SOURCES OF FINANCING FOR ENVIRONMENTAL INVESTMENTS IN KAZAKHSTAN

101. Kazakhstan has inherited a number of severe environmental problems from the centrally-planned economy. These problems are well identified and documented in the country’s NEAP. If not resolved, they might significantly hinder the future development and economic growth of Kazakhstan. Hence, potentially there is a huge need for environmental investments. However, at present, effective demand (that is willingness and ability-to-pay) for environmental investments in Kazakhstan relative to the needs seems to be negligible. This shows in the current situation where the share of urban water expenditure in the total expenditure from the public budget in 1999 is less than 0.5% (Water Sector Finance Strategy for Kazakhstan, COWI). Very few environmental projects have found their way to the Government Public Investments Program (PIP), which may, among other things, reflect the lack of capacity of environmental authorities to prepare good, viable projects. Also, very few external loans and grants for environmental investments have actually been disbursed. Few polluters have made any significant environmental investments and these are mainly enterprises with international participation (mainly in the oil and gas industry). In short, supply of finance mirrors the low demand for environmental investment expenditure. On the other hand, effective demand can be created. For this to happen it is necessary to put in place and subsequently enforce environmental legislation based on clearly defined objectives further specified into realistic, measurable and time-bound targets.

102. On the supply side, the major sources of finance for environmental investments in Kazakhstan, with their terms and conditions for access to them, are described below.

10.1. The Public Budget

103. The Kazakh Government has made significant efforts to increase the efficiency of revenue collection. However, public sector revenue, as percentage of national income, still remains low by international standards. For example, the revenue collected in 1998 represents 16.1% of GDP (OECD/EBRD), versus NIS average 21%, CEE average 34.4%, OECD average 36.6%.

104. To better control its public deficit and government spending, Kazakhstan, the first among the NIS countries, has developed a Public Investment Programme (PIP). PIPs were successfully used in the small Baltic countries. PIP is a mechanism through which funding from the Republican budget is allocated to public sector investment projects. PIPs have the potential to introduce a rational, multi-year perspective into the allocation of scarce budgetary funds for long-term investments. PIPs are intended to streamline limited domestic and international resources and allocate them as efficiently as possible in order to achieve maximum economic and social benefits and to support the Government’s long-term development strategies. The planned government commitments under PIPs are incorporated into the annual budgets.

105. Preparation of the PIP in Kazakhstan is a responsibility of the Ministry of Economy. The PIP is a rolling three-year priority investments programme, renewed annually and finalised only after that year’s budget has been approved by the Parliament. The PIP forms part of the Republican budget. A major justification for projects to be included in the PIP is co-financing through loans or grants from foreign sources. Currently, the share of the Republican budget has been constantly diminishing and the share of financing covered through external sources has been increasing.

106. The 1999-2001 PIP identifies three projects prepared by the MNREP. Two of them involve external loan financing and the third one is grant funding, provided by the World Bank. The two loan projects amount to USD 12.5 million of which the external loan component represents USD 9.63 million (77% of the total funding). The projects reflect priority actions identified in the NEAP. The 1999-2001 PIP
also lists further six ‘water resources’ projects that have significant environmental components reflecting priority actions identified in the NEAP. The total investment costs of the projects is estimated to be USD 180 million. All six projects are to be implemented by the Ministry of Agriculture (MoA). The PIP shows that water is one of the sectors, along with transport and territorial development, which receives the highest share of resources allocated under the 1999-2001 PIP (almost 32%).

107. The 2000-2002 PIP shows a slightly different picture. The MNREP is responsible for the preparation of five new projects of which one is proposed for funding entirely from the Republican Budget, one (prepared jointly with the Kazakh Oil) is to be exclusively financed through a grant provided by the Japanese Government (USD 50 million) and the rest - mainly through external loans. The sources of the external loans are the World Bank, Kuwait Fund for Arabic Economic Development, the Government of France. The three new projects, included under the category "Water Sector", amount to total USD 90.41 million of which the external loan component represents 75.8%. Disbursements (under "Water" and "Environmental Protection"), envisaged for 2000, are very small and amount to only USD 3.37 million.

108. There are also four "water" projects, containing considerable environmental components, prepared by local governments (Ahkimats). The projects amount to USD 438.36 million of which external loans represent 93.4%, to be provided mostly by the Japanese Government.

109. Of all environmental infrastructure investments, usually water supply and sanitation projects represent the heaviest burden on the public budget. This is reflected in the Kazakh PIP as well. While in the previous 1999 - 2001 PIP it is the MoA which was mainly responsible for "water" projects, with the new PIP this function has been shifted to the MNREP. This may be partially explained by the restructuring of the MNREP, which in 1999 underwent significant changes and took over some of the MoA functions. More specifically, the Water Committee, previously under the MoA supervision, was transferred to the MNREP.

10.2. Municipal Environmental Investments (Municipal Utilities)

110. Main sources of finance for municipal governments are central government transfers and local taxation. Currently central government transfers are constantly diminishing. Available information suggests that municipalities have difficulty in meeting the normal operating and maintenance costs of municipal services, and that they are unable to generate additional funds to finance capital investments for rehabilitation and renovation of extensive but inefficient infrastructure.

111. Under such conditions, user charges seem to be the single feasible revenue source available to help finance municipal services. For example, in the water and sanitation sector, the Government now requires all vodocanals to be self-financing and allows them, through the Anti-Monopoly Committee of the Ministry of Finance, to set tariffs that cover operations and maintenance costs and depreciation. The preliminary results from the Water Sector Finance Strategy in Kazakhstan show that the average level of tariffs, as a share of household disposable income, of about 3.8%, comes very close to the affordability level of 4% (a World Bank benchmark). Currently, the rates for water supply and wastewater discharge fees are the same for households, enterprises and public organisations. On average, the collection of revenue from user charges is about 60% for households and about 70% for enterprises and budget organisations. All payments by households are made in cash only while enterprises and budget organisations pay in other non-cash means as well (about 70%).
10.3. Private Sector Finance

112. Structural reform in Kazakhstan has forced enterprises to rely on their own retained earnings and on the commercial banking system for investment funds. The commercial banking system is still very poorly developed. Commercial credit is commonly available only on very short-term loans (6 months to two-year loan periods are typical) and at high interest rates (15-25% or higher). Environmental investment projects usually do not bring short-term profits, and therefore are not attractive to commercial banks.

10.4. Foreign Sources of Finance

113. IFIs and bilateral donors are important sources of funds for financing public projects in Kazakhstan for both (non-investment) technical assistance and capital investments. Several donors are active in Kazakhstan, such as the UNDP, USAID, EU Tacis, some bilateral donors - Canada, Germany, Japan, Korea, the Netherlands, Turkey, the UK. However, the availability of international grants for environmental investments is extremely limited. Available data show that grant disbursements in the environment sector had decreased significantly from USD 6.0 million in 1996 to USD 2.7 million in 1997 (Source: UNDP Development Report). A total grant commitment for the environmental sector for 1997 is quoted to be USD 41 million with total disbursements of USD 2.4 million (Source: UNDP Development Report).

114. The conditions of loans vary with the IFIs. As in other low-income countries, IFIs loans are the only available source of long-term debt. Typically, World Bank loans are offered at interest rates of around 6%, repayable over 20 years with a 5-year grace period. To date, the Bank has approved USD 1,819 million for 21 projects in Kazakhstan of which about 2% was for environment and water and sanitation projects (Source: World Bank web-site). The minimum size of loans is high. The German Bank for Reconstruction (KfW) will lend at more concessionary interest rates of around 3.5% but the amounts involved are much smaller. Highly concessional Japanese loans (1.5% interest) are available for specific environmental funding purposes, but these also have not been disbursed to date in Kazakhstan. Overall, the average interest rate is 3-4% for long term soft loans (repayable in the currency in which borrowed). Currently, Kazakhstan manages to service its debt obligations but its capacity to take on new loans is severely limited. Every year, the Ministry of Finance sets "safe borrowing limits" for the central Government and for each of the 16 regions. This is so far one of the most effective and mature systems of supervision of public debt, including municipal debt, in the NIS. Although this may limit the absorption of new loans in a short term, these borrowing limits help Kazakhstan maintain relatively high borrowing capacity in the longer perspective.

10.5. Analysis of the Sources of Financing

115. Currently, the level of finance for environmental investments is low in Kazakhstan. It is constrained by a number of factors, among which are: weak environmental policies and legislation as well as their enforcement; lack of clearly identified environmental strategy; lack of well-designed viable projects to be implemented; severe financial difficulties facing the country today. Given the current economic situation it is difficult to expect that substantial resources will be made readily available for environmental investments in the short-to-medium term. However, removing major policy and institutional obstacles can help attract additional resources from both domestic and external sources.

116. The new competencies assigned to the MNREP with regard to water management have significant implications for its capacity to prepare water infrastructure projects. This is reflected in the most recent PIP where the Ministry is responsible for the implementation of a number of water projects. The increased responsibility for such projects of republican importance requires special skills in this area.
that currently may not be readily available in the Ministry (including the staff of the former Republican Fund). A specialised project preparation unit, with trained and professional staff, may help the Ministry better allocate its resources and prepare well-designed projects for the PIP, with better chances to be funded from external sources. This may also take the burden off the Ministry’s staff who are now involved, among other things, in the preparation of projects.

117. In this context, the Environmental Funds in Kazakhstan may play a more prominent role. Provided they are reformed in accordance with international best practices and focus on managing environmental expenditure rather than revenue collection, they can be used to leverage other as well as attract new sources of finance. By identifying and selecting viable projects environmental funds can help develop and further strengthen the project preparation capacity in the country.

118. One tool for matching demand for environmental investments with the supply of required finance is the Environmental Finance Strategy of Kazakhstan, currently prepared by the Kazakh authorities and experts within the framework of the EAP Task Force and with the financial support by the Danish Government. The strategy can help to identify and quantify expenditure needed to implement priority environmental investments in the country by specifying the costs of alternative environmental targets. It can also help realistically match these expenditure requirements with the available financing under different policy choices, explicitly taking into consideration the affordability constraint - both on national and household levels. Environmental financing strategy will give environmental authorities in Kazakhstan a powerful tool to find a unique niche for the environmental funds in the system of financing environmental protection in Kazakhstan. This process will provide answers to a few fundamental questions. For example: For what purposes and projects are the Funds really needed? What kinds of Funds are needed? How much money the Funds should have at their disposal?

XI. KEY CONCLUSIONS AND RECOMMENDATIONS

119. The review of the Kazakh environmental funds has not found any significant disparities between what the funds were required to do by the authorities and by the laws and what they had actually done. But the review did found significant disparities between what the funds were required to do by the authorities/laws and what the good international practices are. Funds were required mainly to collect revenue and manage direct purchases for environmental authorities through competitive tenders. All available evidence has suggested that the funds have done these tasks really well. Funds’ officials and staff have developed excellent skills in revenue collection and tendering procedures. But none of these tasks is performed by environmental financing institutions as understood by international standards. On the other hand, environmental funds in Kazakhstan have not been required, and even permitted, to perform the tasks that are essential for environmental funds or development banks world-wide, which include mainly identification, preparation, appraisal and selection of projects and beneficiaries according to transparent, objective procedures and criteria. This biased legal mandate has so far prevented the funds from developing capacity in effective financing of priority environmental investments. It has also led to the situation where the Central Ministries and the Parliament could no longer see the value added of the Fund at a Republican level. As a result, in 1999, the Fund, while having its legal identity preserved, found itself without resources, an institutional identity and staff of its own. In this context, this review has concluded that the environmental funds in Kazakhstan do not comply with many of the good international practices that are contained, inter alia, in the "St. Petersburg Guidelines on Environmental Funds in a Transition to a Market Economy".

120. On the other hand, environmental Funds in Kazakhstan have contributed significantly to raising the profile of environmental issues and have helped to increase the resources available for environmental improvements. A positive aspect in the Funds’ development is the fact that after 1998 Funds’ resources
have been increasingly allocated for environmental measures versus administrative costs. However, this seems not enough to make environmental funds attractive to foreign partners and acceptable to the Kazakh Ministers of Finance and Economy. In the countries where environmental funds have been successful they have been established to finance investment projects that are difficult to finance both by the regular government budget and by the private sector. Reform of environmental funds in Kazakhstan would need a strategic perspective to clearly demonstrate their unique "niche" or true value added compared to existing government institutions.

121. The present legal framework is sufficient to establish an effective, operational mechanism for preparing and financing environmental investments on a Republican level. The preparation of the draft new Government Decree provides a good opportunity to design a professional and internationally credible institution with strong capacity to identify and select good projects and manage environmental expenditure programmes funded by domestic public budgets and/or possibly by donors or foreign financing institutions. A careful and transparent process is needed to draft the final version of the new Decree. This process should involve key Kazakh stakeholders including representatives of the central ministries (Finance and Economy), relevant international institutions and potential donors. However, before the financing institution at the Republican level is ready to manage resources successfully, a great deal of improvement will be needed in the area of transparency, accountability, establishing real (narrow) priorities, efficiency and skills in project cycle management. Similar improvements are recommended for the existing local funds. These reforms would also be a necessary condition for the Funds to be internationally recognised as potential partners for foreign sources in financing environmental investments in Kazakhstan.

Short-term Improvements to Be Implemented through Internal Organisational Restructuring (Executive Orders of the MNREP)

1. Identify a specific narrow niche and fewer priority types of projects to be financed by the Funds on the basis of priorities contained in the Kazakhstan NEAP and the National Environmental Financing Strategy.

2. Establish a 2-4 person unit within the structure of the MNREP responsible for identification and appraisal of environmental investments to be financed from the budget line "measures for environmental protection undertaken on a Republican level", and for management of MNREP projects identified in PIP. Strengthen the capacity of this unit in project cycle management.

3. Separate organisationally three different units in local environmental funds: revenue-raising units, government procurement units and expenditure management (project financing) units. Allocate clear responsibilities for project appraisal and selection to the third unit. Strengthen the capacity of this unit in project cycle management.

4. Increase transparency and consistency in revenue and expenditure data. Improve the financial and environmental reporting system. Increase MNREP knowledge of how local Funds spend their resources.
Medium-term Recommendations for Reform in the Legal Basis and Institutional Framework of the Funds (for consideration in the Draft Government Decree)

**Legal Status and Objectives**

- Specify narrowly targeted and non-overlapping mandates for local funds and the financing institution at a Republican level. Establish real (few) priorities. Limit eligible projects and beneficiaries to those ones that critically need subsidies and those that cannot be financed either from the regular budget or from commercial sources.

- At a local level - shift the responsibility for revenue collection and direct government procurement to the local administration (together with experienced staff and equipment), while making funds responsible exclusively for project financing and expenditure management.

- Clearly specify the Funds’ legal status, accounting and auditing standards by explicit references to other “core” laws of Kazakhstan. Harmonise book-keeping, financial management and reporting with international accounting standards.

**Institutional Set-up and Management System**

- Establish multi-stakeholders’ Supervisory Bodies for environmental funds. Clearly define the structure and distinguish the separate responsibilities and liabilities of the MNREP, local administration, Supervisory and Management Bodies, in accordance with standards established for other similar, internationally recognised public organisations. Specify the appointment procedures of the Supervisory Bodies and Management Boards and performance criteria, against which they can be evaluated.

- Eliminate from the draft Decree all situations involving conflict of interests and incentives for corruption.

- Distinguish Funds’ institutional identity and management systems from that of the Ministry and local administrations. Ensure institutional autonomy and operational independence of the Fund Managers, subject to strong accountability for performance. Ensure that project cycle management is professional and non-political.

**Revenues**

- Eliminate discretionary elements from the process of determining the charge rates, charge base and revenue collection. Enforce strict prohibition of individual negotiations with polluters and of pollution charge offsets (full or partial charge waivers against internal environmental expenditure).

- Limit the number of revenue raising environmental charges from 6000 to less than 10. In parallel legislation, introduce credible emissions monitoring system for these charges.

- Consider implementation of charges on environmentally damaging products or transactions (e.g. on oil extraction) which can ensure a more stable and predictable revenue stream for the Funds.

- Remove obstacles to effective mobilisation of foreign finance through, among others, implementing reforms outlined in this paper.
Expenditure

- Focus expenditure of local funds on investment projects by, for example, introducing the minimum percentage limit of annual expenditure that must be used to finance investments in environmental infrastructure.

Programming

- Develop a financially realistic environmental strategy to follow up the NEAP. Use this strategy to identify the limited role and purpose of the funds versus other sources of financing, in addressing priority environmental problems of the country.

- Establish multi-year investment programmes/strategies for the funds. Once established, do not change them.

Disbursement Mechanisms

- Phase-out direct procurements conducted by the funds and introduce direct grants.

- Do not permit funds to use direct loans or equity investments for a few years until required capacity in risk management is developed. If loans need to be considered earlier, out-source loan management to commercial banks selected through a competitive process.

- Require co-financing by, for example, introducing percentage limits on the maximum share of investment expenditure that can be financed by the funds.

Project Cycle Management

- Make Managers of the funds responsible and accountable for project cycle management, including project identification, appraisal and selection.

- Establish specific, objective and transparent appraisal criteria, binding for Managers. Make cost-effectiveness (achieving environmental results at minimum costs) a prominent appraisal criterion.

- Strengthen the capacity of the executive units in project appraisal. Particular improvement is needed in engineering, economic/financial and legal skills of the personnel.