Kyrgyz Republic:

A resilient economy on a slow growth trajectory

With a special focus on Tax Reform

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Currency Equivalents: Exchange Rate Effective as of October 31, 2016
Currency Unit = Kyrgyz Som (KGS)
US$1 = 68.3568 KGS
Weights and Measures: Metric System

Abbreviations and Acronyms

BEEPS	Business Environment Enterprise Survey
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
ECA	Europe and Central Asia
EEU	Eurasian Economic Union
GDP	Gross domestic product
ICT	Information and Communication Technologies
NSC	National Statistics Committee of the Kyrgyz Republic
OECD	Organization for Economic Co-operation and Development
PIP	Public Investment Project
PIT	Personal Income Tax
SF	Social Fund
STS	State Tax Service
VAT	Value-added tax

Contents

Acknowledgements iv

Overview 1

A. Recent Economic Developments 1

B. Economic and Structural Policies 4

C. Outlook 7

D. Special Focus: Tax reform – a pre-requisite to fiscal sustainability and service delivery 8

Appendix 1 –Selected Macroeconomic Indicators 2013-2018 12

Tables

Table 1: Key macroeconomic indicators, 2014-2016 2
Table 2: State Government Budget 6

Figures

Figure 1. Real GDP growth (in percent) 2
Figure 2 : Contribution to growth (percentage points) 2
Figure 3: Inflation (in percent) 3
Figure 4: Exchange rate (soms per US$1) 3
Figure 5: Export and Import (in millions of US$) 4
Figure 6: Trade and Current account balances (in percent of GDP) 4
Figure 7: Loan rates (in percent) 7
Figure 8: Nominal and real effective exchange rates (index, 2010=100) 7
Figure 9: Tax revenue structure and performance (*Percent of GDP)* 9
Figure 10: Informality as a constraint 10

Acknowledgements

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The first part of the Economic Update analyzes recent macroeconomic trends and presents an assessment of the country's short- and medium-term outlook. The Special Focus Section discusses tax revenue reforms, presenting the findings of a recent World Bank Tax Administration Diagnostics Assessment (TADAT).

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Overview

The Kyrgyz economy has remained resilient to the adverse regional environment, but growth prospects are modest and adjustments needed. While real GDP growth is expected to remain positive, at above 3 percent in 2016 and 2017, this is lower than historical performance and the country's potential. Moreover, economic activity is supported by an expansionary fiscal stance that cannot be sustained indefinitely, given elevated debt levels, while private investment has been tepid.

Overall, the macroeconomic situation improved slightly since the shock stemming from Russia's recession hit in [late 2014]. The stabilization of the exchange rate—together with low international prices—have helped dampen inflationary pressures, while also driving a decline in the public debt-to-GDP ratio. However, the current account and fiscal deficits have widened.

In the medium term, growth prospects should improve as remittances and the external demand environment recover. Higher growth in Russia and Kazakhstan should drive exports growth (which was negative in the first 10 months of 2016) as well as remittances inflows, supporting domestic consumption. Moreover, as Kyrgyz producers gradually adapts to the Eurasian Economic Union (EEU) norms and standards, they should gain greater access to the common market.

However, although risks have moderated, they remain elevated. The main sources of risk relate to possible adverse developments in neighboring economies, principally related to oil prices and exchange rate dynamics. This implies the need to rebuild fiscal buffers over the next 2-3 years through a mix of expenditure consolidation and revenue mobilization. Policy recommendations to increase tax revenues are discussed in *the Special Focus Section* of this report.

A. Recent Economic Developments

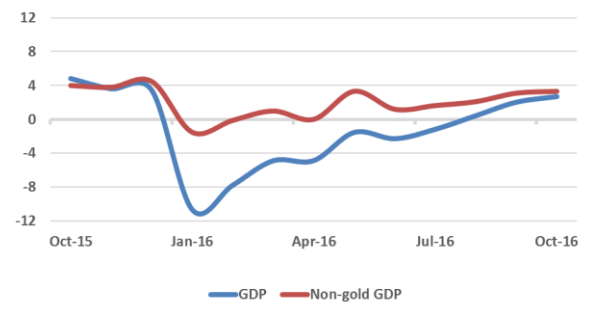
Growth in the Kyrgyz Republic remains moderate, yet resilient to a protracted adverse external environment. Real GDP grew at 2.7 percent in January-October of 2016 (vs. 4.8 percent growth in the same period a year ago), despite a decline in gold production by 3.3 percent (17.1 percent growth in the same period a year ago) (Figure 1). Real output excluding gold grew at 3.3 percent (4.0 percent growth in the same period a year ago) driven by higher public spending and increased inflows of remittances that have helped boost consumption.

Table 1: Key macroeconomic indicators, 2014-2016

	2014	2015	2016 proj.
Real GDP (growth in percent)	4.0	3.5	3.4
Non-gold real GDP (growth in percent)	5.0	4.5	3.9
Gold sector (real growth in percent)	-5.8	-8.3	-3.0
Consumption (real growth in percent)	2.4	-5.5	1.2
Investment (real growth in percent)	15.7	-4.9	1.9
Inflation (eop, in percent)	10.5	3.4	0.6

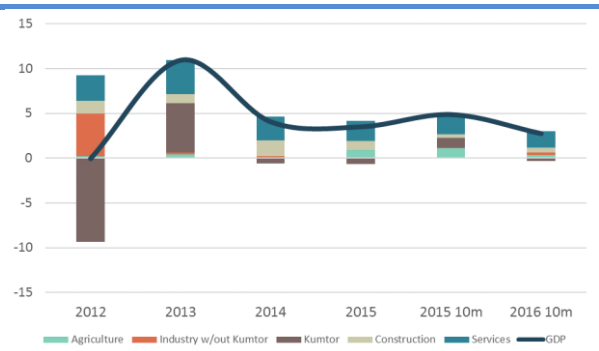
Source: National Statistics Committee and Bank staff projections

Figure 1. Real GDP growth (in percent)



Source: National Statistics Committee.

Figure 2 : Contribution to growth (percentage points)



Source: National Statistics Committee.

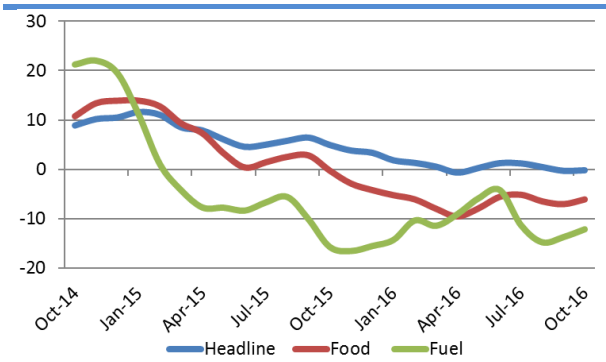
Growth has been driven by a relatively solid performance in agriculture, construction and services. These three sectors grew at 2.2 percent, 7.6 percent and 3.2 percent, respectively, making the highest contributions to growth in January-October 2016 (Figure 2). Compared to the same period a year ago, this represents a deceleration in agricultural growth by 4.1 percentage points, higher growth in construction by 1.9 percentage points and a stable growth in the service sector. At the same time, industry declined by 0.3 percent, as the gold sector dragged down the 3.1 percent growth rate in non-gold industry.

On the demand side, growth was supported by consumption offsetting negative contributions from investment and net exports. Backed by increased remittances and higher government spending, total consumption is estimated to have risen by 2.9 percent in the first half of the year. At the same time, investment contracted by 9.3 percent, mainly reflecting the off-loading of inventories. Meanwhile net exports fell by 9.6 percent, largely led by the collapsing exports, which offset the more modest decline in imports.

Developments in the region, mainly in Russia, continued to affect the macroeconomy. A slower growth contraction in Russia this year has supported an improvement in remittances (by around 10 percent over the first 9 months of the year) contributing to income and consumption growth. While still significantly negative, the trade deficit with Russia has narrowed slightly, as exports to Russia improved somewhat and imports fell due to lower world fuel prices.

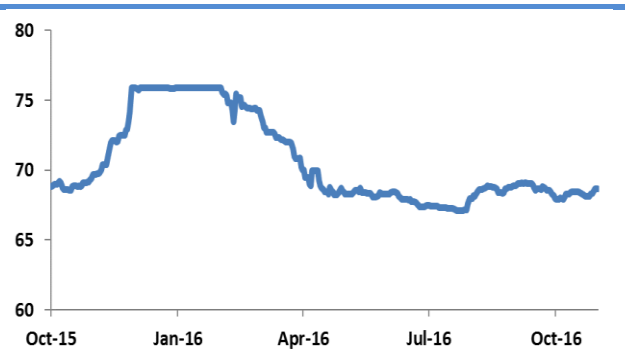
Slower growth and the absence of exchange rate pressures has led to a decline in consumer prices. Inflation was estimated at -0.2 percent as of October 2016, down from 3.4 percent in December last year (Figure 3), largely reflecting reductions in food and fuel prices by 6.1 percent and 12.1 percent, respectively. More generally, the negative inflation resulted from slow income growth and the stabilization of the exchange rate (Figure 4).

Figure 3: Inflation (in percent)



Source: National Statistics Committee.

Figure 4: Exchange rate (soms per US$1)



Source: National Bank.

Export performance was weak due to a fall in exports of gold and manufacturing goods. Total exports in US dollars are estimated to have declined by 15.1 percent in January-August 2016, with gold exports falling by 28 percent and non-gold exports by 13.4 percent (Figure 5). While the gold export performance principally reflected a decline in output, the weak export of manufacturing goods appears to be a result of enhanced standards of quality control used by the Eurasian Economic Union (EEU) member countries (banning goods not certified by the EEU accredited laboratories) as well as a loss of competitiveness due to the real appreciation of the som relative to the Kazakh tenge (since July 2015 by 43 percent). Thus, food and consumer goods exports to Kazakhstan, the largest non-gold export destination, are estimated to have declined by 28 percent. At the same time, exports of agricultural products to Russia increased, possibly owing to a substitution of supplies from Turkey and Poland—countries against which Russia introduced trade sanctions. Reflecting a good harvest, export of beans to Turkey increased.

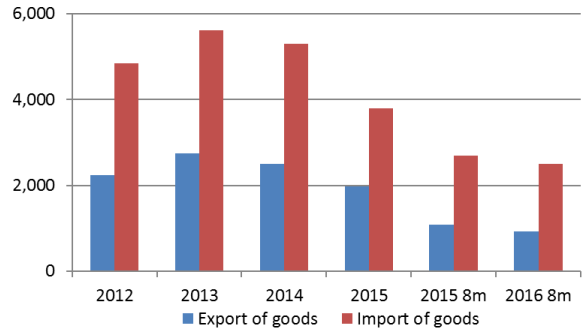
Total imports in US dollars are estimated to have fallen by 7.6 percent in January-August 2016. Imports of food and fuel declined by about 40 percent and 50 percent,

respectively, mainly reflecting lower prices and thus, explaining a fall in total import values from Russia and Kazakhstan. At the same time, there was an increase in imports of textiles, clothing and other consumer goods from China, which suggests a rebound of re-export activity, following contractions in 2014 and 2015.

Overall, the trade balance deteriorated. The trade deficit increased slightly to US$1.74 billion in January-August 2016, from US$1.72 billion a year ago, as both exports and imports fell with the former declining faster. However, as a share of GDP, the trade deficit increased more noticeably to 47.2 percent from 42.1 percent on account of slower nominal GDP growth and the som depreciation over the last 12 months (Figure 6).

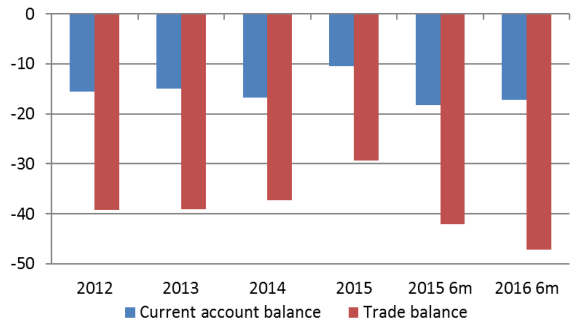
However, the current account balance improved slightly, thanks mostly to remittance inflows. In spite of the wider trade deficit, the current account deficit shrunk somewhat to 17.3 percent of GDP in the first half of this year from 18.2 percent a year before (Figure 6). This was solely due to increased private transfers, including remittances which grew by about 10 percent in US dollar terms. The current account deficit was financed by foreign direct investment, a reduction of financial assets abroad held by residents and public borrowing. FDI amounted to US$257 million in January-June 2016. The financial assets held by residents declined by US$213 million and public borrowing amounted to US$135 million.

Figure 5: Exports and Imports (in millions of US$)



Source: National Bank.

Figure 6: Trade and Current Account Balances (in percent of GDP)



Source: National Bank.

B. Economic and Structural Policies

Fiscal policy has been significantly expansionary as the authorities seek to support economic activity. The budget ran a deficit of 5.9 percent of GDP in January-September 2016, compared to a 0.7 percent surplus in the same period of 2015 (Table 1). This gap

resulted from increased current and capital spending, while total revenues declined just slightly.

Total revenues amounted to 34.5 percent of GDP, down from 35.4 percent in the same period a year ago. Tax revenues increased by 1.7 percentage points to 26.5 percent of GDP as a result of better VAT administration and increased custom revenues. At the same time, there was a sharp decline in non-tax revenues by 2.8 percentage points to 6.1 percent of GDP, largely reflecting the high base effect after one-off receipt in 2015. Grant support amounted to 1.9 percent of GDP, slightly higher than 1.7 percent in the same period a year ago.

Total expenditure surged to 40.5 percent of GDP from 34.7 percent by October, relative to the same period a year ago. The higher current spending reflects the wage rise for teachers adopted in September 2015 and increased expenses on goods and services related to hosting the World Nomad Games and the CIS Summit. On the capital spending side, the increase stemmed from more intense implementation of the road and energy infrastructure projects financed by both foreign and domestic sources.

The fiscal deficit was mainly financed by external borrowing and a drawdown of government deposits. In particular, capital spending was supported through external borrowing (amounting to 3.2 percent of GDP in the first three quarters of 2016). The remaining deficit was funded through a drawdown of government deposits, which declined by almost 30 percent to 10.6 billion of soms (2.3 percent of GDP). With this, the dollar stock of external public debt increased, by 4.3 percent during the first 9 months of the year. However, due to the som appreciation, its ratio to GDP declined to 63 percent from 68.3 percent in December 2015.

Table 2: General Government Budget
(in percent of GDP)

	2014	2015	2016 Proj.	Jan-Sep 2015	Jan-Sep 2016
Total revenues and grants	34.4	34.9	32.8	35.4	34.5
Total revenues	31.9	32.7	30.3	33.7	32.7
Current revenues	31.8	32.7	30.2	33.7	32.6
Tax revenues	25.1	24.6	22.8	24.8	26.5
Non-tax revenues	6.7	8.1	7.4	8.9	6.1
Capital revenues	0.1	0.1	0.1	0.1	0.1
Grants	2.5	2.2	2.4	1.7	1.9
Program grants	1.9	1.7	0.5	1.2	1.2
PIP grants	0.6	0.5	1.9	0.4	0.7
Total expenditure (incl. net lending)	38.3	38.0	40.1	34.7	40.5
Current expenditure	29.3	30.6	30.1	30.3	33.0
Wage	7.8	8.3	8.7	8.0	9.0
Transfer and subsidies	3.4	3.5	3.5	3.7	3.8
Social Fund expenditures	9.2	9.1	8.9	9.7	9.6
Interest	0.9	1.0	1.1	1.1	1.3
Purchase of other goods and services	8.1	8.8	8.0	7.9	9.3
Capital expenditure	8.4	7.3	9.8	4.3	7.9
o/w foreign financed	6.1	4.6	6.7	1.9	4.8
Net lending	0.6	0.1	0.2	0.2	-0.4
Overall balance	-3.9	-3.0	-7.4	0.7	-5.9
Financing	3.9	3.0	7.4	-0.7	5.9
External	5.5	3.8	6.5	0.7	3.2
Domestic	-1.6	-0.8	0.9	-1.3	2.7

Source: Ministry of Finance

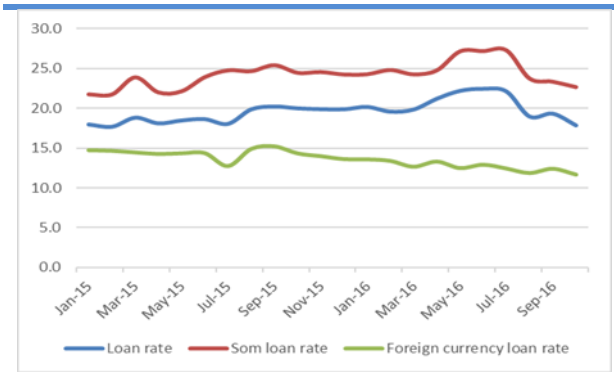
A declining inflation trend provided space for loosening the monetary policy through 2016, though this counter-cyclical policy was ineffective. The central bank interest rate was reduced twice during the first 9 months of the year—to 8 percent (from 10 percent) at the end of March, and to 6 percent at the end of May. Money supply growth accelerated to 15.2 percent as of September 2016 from 14.9 percent in December 2015 and 10 percent in September 2015. However, this did not translate into growth of credit to the economy, which declined by 2.5 percent. This reflected, on the one hand, a subdued demand for loans and, on the other hand, more cautious lending policies by the commercial banks stemming from continuing uncertainty.

The monetary policy easing had limited impact on interest rates for loans in the market. The transmission mechanism has been weak, with an average lending rate declining only by 2.1 percentage points between December 2015 and September 2016. The breakdown of interest rate by currency showed a slightly higher decline for loans in foreign currency (by 1.9 percentage points) compared to som loans (by 1.6 percentage points) (Figure 7).

The management of the exchange rate was tightened, reducing its flexibility. The central bank kept intervening in the foreign exchange market. As of October 2016, the central bank sold US$118 million and bought US$192 million. However, these interventions may

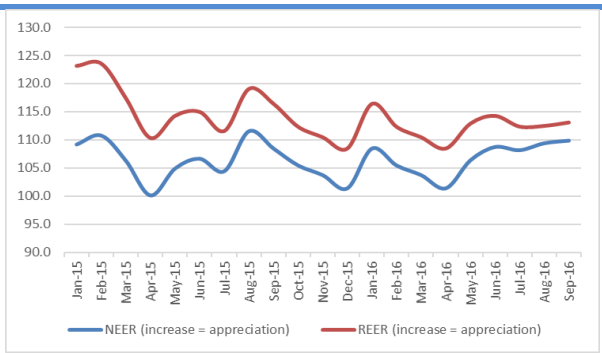
have gone beyond the traditional aim of smoothing fluctuations and kept the exchange rate artificially stable during April-October. As the main trade partners' currencies appear to have weakened over the same period, this has resulted in som's appreciation in nominal and real effective terms since April 2016(Figure 8).

Figure 7: Loan rates (in percent)



Source: National Bank.

Figure 8: Nominal and real effective exchange rates (index, 2010=100)



Source: National Bank.

C. Outlook

Growth is expected to be modest over the next two years. Real GDP is projected to expand moderately at 3.4 in 2016 and 3.1 percent in 2017 with non-gold output growth projected to grow by 3.9 percent in both years. These projections are based on Kumtor's gold production forecasts and growth assumptions for agriculture, non-gold industry, wing a contraction over the last two years through a stronger export performance and increased remittances. Growth is also expected to benefit from high government capital spending as in the previous years.

Inflation is expected to pick up gradually. Estimates suggest that inflation remained low throughout 2016 (at around 0.6 percent), and will increase to around 4 percent in 2017 as private consumption demand grows in response to higher remittances. These forecasts assume no international and food price shocks and exchange rate stability.

Decisive and steadfast fiscal consolidation will be required to ensure macroeconomic stability and rebuild fiscal buffers. Fiscal policy is quickly running out of space as revenue growth is limited and public debt is already fairly high—even when partly offset by the recent currency appreciation. While tax policy and administration reforms could generate

an increase in revenues (as discussed in *the Special Focus Section*), a major adjustment should come from reducing spending, in particular expenditures on goods and services.

A shift towards export driven growth is the main challenge. Job opportunities are likely to open up for Kyrgyz workers in EEU economies—particularly Russia—and, more generally, the growth model to continue to rely of remittances enabled consumption, the challenge for the authorities is to press ahead with structural reforms to develop other sectors of the economy that are labor intensive and offer the most potential for export and productivity growth.

D. Special Focus: Tax reform – a pre-requisite to fiscal sustainability and service delivery

While fiscal consolidation will necessarily imply expenditure rationalization, a lot can be achieved by strengthening the revenue effort a pro-growth equitable way.

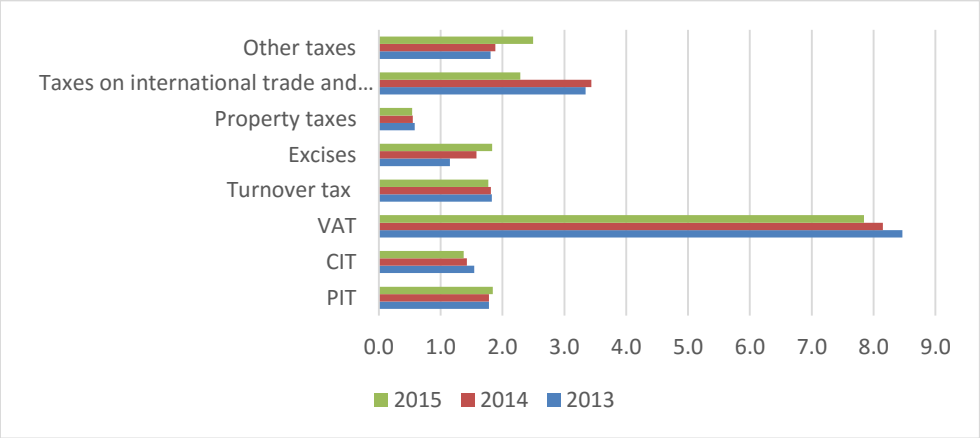
In turn, tax administration reform is a pre-requisite for success of overall tax reforms. Eliminating corruption opportunities, making systematic efforts to reduce the informal economy, and creating a modern administration process based on strong data analytics using third party information and risk profiling is key.

Why is Tax Reform needed?

High development needs require financing and the most sustainable way to finance required investments is through enhancing domestic resource mobilization. The Poverty Reduction Strategy of the Kyrgyz Republic estimated required funding at around 355 billion som (around 75 percent of GDP), but only half of the financing sources were identified. Public debt can hardly be a major source of financing given the already high and growing debt-to-GDP ratio. Under such circumstances raising tax revenues from the current 20 percent of GDP to higher levels becomes a priority and the main source of funding to cover investment needs and social programs.

The current tax system relies primarily on indirect taxes and income taxes on individuals and corporations, but exemptions and special regimes reduce the tax base and undercut budget revenues. The Kyrgyz Republic collects over 50 percent of its tax revenue from indirect taxes such as VAT and Turnover Tax, and about a quarter of revenues from direct taxes. Some of the other taxes bring a very insignificant revenue amount, such as property tax at 0.5 percent of GDP. There are a number of exemptions and special regimes for different tax payers in particular in corporate income tax and VAT.

Figure 9: Tax revenue structure and performance (*Percent of GDP)*



Tax administration is inefficient and imposes an unduly high burden on taxpayers. The 2017 Doing Business report ranks the country at a low 148th place on the *Paying Taxes* indicator, down from 145th in 2016 report. While the total tax rate in Kyrgyz Republic is at 29 percent, lower than ECA average of 33.8 percent and 40.9 percent in OECD high income countries, the Kyrgyz Republic lags behind all regional comparators on number of payments (51 payments per year compared to 17.6 in ECA); time to file and pay taxes (225 hours compared to 221 hours in ECA), time to obtain refund and deal with audits (the post-filing index[1] is at 36.9 compared to 71.9 in ECA and 85,1 in OECD).

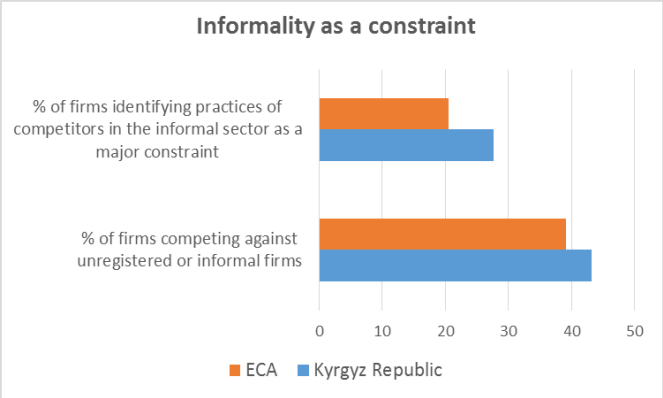
There are a number of issues in the performance of the tax administration system. The use of electronic filing is limited with an e-filing rate of 10.1 percent for CIT, 12.8 percent for VAT, and 9.7 percent for PIT in 2015. Paper filing increases interaction between taxpayers and tax officials, and is a potential source of corruption. The absence of risk management practices and extremely limited access to third party information of the State Tax Service limits intelligence on tax compliance in the economy. This results in poor tax compliance and low revenue collection, and creates opportunities for corruption. According to the 2013 Business Environment Enterprise Survey (BEEPs), 54.8 percent of firms reported that they were expected to give gifts in meetings with tax officials, as compared to 13.4 percent in ECA. Small companies are disproportionately affected with 59.1 percent reporting the need to pay bribes.

There is a large informal economy in Kyrgyz Republic complicating tax collection. Weaknesses in tax administration such as inadequate focus on large-taxpayers, the resources assigned to assessments of small taxpayers and a focus on minor compliance matters as well as lack of integrity of taxpayer registration and underdeveloped risk management throughout registration, filing, payment and audit stages do not allow the

[1] The index value ranges from 0 to 100 with 100 as a best result

Government to effectively combat informality in the economy. This leads to unfair competition between legitimate and unregistered companies. In the 2013 BEEPs, around 50 percent of companies reported that they had to compete against unregistered or informal firms.

Figure 10: Informality as a constraint



Policy gaps and administration issues result in low productivity of the main taxes. The low tax productivity comes from both policy gap and administration gap (issues with compliance and the large informal sector). VAT productivity is fairly low (at 39 percent) compared to the ECA average of 66 percent (Tax at a Glance, 2013). CIT and PIT productivities are also below regional average at 5 and 9 percent compared to 7 and 16 percent respectively. In addition, the cascading impact of the turnover tax appears to be damaging to competitiveness of the economy with limited gain in revenue performance.

What needs to change in tax policy?

Tax reform is needed to boost domestic revenue mobilization and create fiscal space for development. Raising tax revenues can include broadening the tax base of personal and corporate income taxes by eliminating exemptions and special regimes. There is a potential to increase revenue from all direct taxes, including the property tax which is currently at just about 0.5 percent of GDP.

Indirect taxation needs to be streamlined. Increasing the VAT rate, which is the lowest in the region, may be considered. Combined with improved compliance of VAT it could allow to phase-out the turnover tax, which would simplify administration and ensure a level playing field for all sectors and companies.

What needs to change in tax administration?

Redesigning the tax policy system may not be effective if ongoing issues in tax administration are not addressed in tandem. The reduction of exemptions in the VAT should be accompanied with improved administration. Tax audits, which currently are mainly ad-hoc can benefit from broader utilization of risk based methods to ensure that different segments of taxpayers are dealt with according to the risk profiles. In the cases of the PIT and social security contributions, the pilots on joint administration by the State Tax Service should be expanded to ensure higher compliance in all wage income taxes. It is also important that the legal liability towards the social security financing remains separate from the liability of the personal income tax. This is largely due to significantly different administration requirements of these forms of payments.

In order for tax administration to ensure a better level of compliance there are several important pre-requisites:

- Improve the integrity of the taxpayer database through systematic initiatives to detect unregistered taxpayers and improved registration and deregistration processes;
- Ensure better access of the State Tax Service (STS) to third party information, including banking, and other government agencies (property registers, social security funds) to enable effective risk management across key tax administration functions;
- Based on the third party information, improve the targeting of the audit program;
- Improve e-filing rates to allow for better data and ease of compliance by taxpayers;
- Improve tax arrears management functions of the STS.

A better, more efficient use of risk management techniques requires better use of ICT tools. An ADB project which concluded in 2012 provided a complement of ICT software and hardware. However, to truly exploit risk-based methods to sharpen enforcement capabilities, a comprehensive ICT system and data center to collect and mine data from third party sources on an automatic and regular basis is needed.

Appendix 1 –Selected Macroeconomic Indicators 2013-2018

Selected Indicators	2013	2014	2015	2016	2017	2018
			Prel.	Projections		
Income and Economic Growth						
GDP (current LCU, billions)	355.3	400.7	423.6	456.1	495.1	542.3
GDP Growth (% change, y-o-y)	10.9	4.0	3.5	3.4	3.1	4.1
Non-Kumtor GDP Growth (% change, y-o-y)	5.8	5.0	4.5	3.9	3.9	4.6
Gross Investment (% of GDP)	26.2	26.9	28.1	29.3	29.3	29.0
Prices and Exchange Rates						
Inflation, Consumer Prices (% change, y-o-y, end of year)	4.0	10.5	3.4	0.6	4.0	4.0
Inflation, Consumer Prices (% change, y-o-y, period average)	6.6	7.5	6.5	1.4	2.3	4.0
Nominal Exchange Rate (LCU/US$, end of period)	48.4	53.7	75.9			
Real Effective Exchange Rate Index (2000=100)	106.9	120.3	108.4			
Fiscal (% of GDP, unless otherwise indicated)						
Revenues	33.4	34.4	34.9	32.8	32.6	33.2
Expenditures (incl. net lending)	37.1	38.3	38.0	40.1	37.7	36.2
Current	30.1	29.3	30.6	30.3	28.2	27.4
Capital	7.1	9.0	7.4	9.8	9.5	8.8
Overall Fiscal Balance	-3.7	-3.9	-3.1	-7.4	-5.1	-3.0
Primary Fiscal Balance	-2.9	-3.0	-2.0	-6.6	-4.1	-1.8
Total Public Debt	46.1	52.6	65.0	62.1	64.2	65.5
External Accounts (% of GDP, unless otherwise indicated)						
Export growth (nominal US$, % yoy)	13.5	-8.8	-21.0	-10.1	8.5	12.1
Import growth (nominal US$, % yoy)	16.1	-5.8	-28.2	-7.2	6.7	7.8
Current Account Balance	-15.0	-16.7	-10.4	-13.3	-12.4	-10.4
Foreign Direct Investment, net inflows	8.5	3.1	9.5	7.5	5.7	6.1
External debt, total	72.9	80.5	94.5	92.6	91.8	90.9

Source: Kyrgyz authorities and Bank staff estimates and projections