Report No. 88977

Kyrgyz Republic

Public Expenditure Review Policy Notes

Strategic Setting

May 2014

Poverty Reduction and Economic Management Unit
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KYRGYZ REPUBLIC - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of April 30, 2014)

Currency Unit = Kyrgyz Som (KGS)
US$1.00 = KGS 53.9615

Weights and Measures
Metric System

ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
CA	Central Asia
CIT	Corporate Income Tax
COA	Chamber of Audit
CPI	Consumer Price Index
DFID	UK's Department for International Development
DSA	Debt Sustainability Analysis
ECA	Europe and Central Asia
ERSO	Economic Recovery Support Operation
EU	European Union
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GNI	Gross National Product
HP	Hodrick–Prescott
IMF	International Monetary Fund
JEA	Joint Economic Assessment
MoF	Ministry of Finance
MTBF	Medium Term Budget Framework
NBKR	National Bank of the Kyrgyz Republic
NSDS	National Sustainable Development Strategy
OECD	Organization for Economic Co-operation and Development
PER	Public Expenditure Review
PIM	Public Investment Management
PIP	Public Investment Program
PISA	Program for International Student Assessment
REER	Real Effective Exchange Rate
SECO	Swiss Economic Cooperation Organization
SEE	South-East Europe
TMIS	Treasury Management Information System
TSA	Treasury Single Account
VAT	Value-Added Tax
WEF	World Economic Forum
WGI	Worldwide Governance Indicators

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Acknowledgements

This note is part of the Kyrgyz Republic Programmatic Public Expenditure Review (PER) led by Evgenij Najdov (Task Team Leader) and K. Migara O. de Silva (co-TTL). The PER work was initiated by Orhan Niksic. Faruk Khan took over as task team leader from September 2012 to June 2013. K. Migara O. de Silva's co-TTL-ship was uninterrupted with primary responsibility for the sector notes on wage bill management, public investments management and intergovernmental transfers.

This note has been prepared by Evgenij Najdov and Helen Edmundson. The team has benefitted from advice and contributions of Faruk Khan, Ivailo Izvorski, and Bakyt Dubashev (Poverty Reduction and Economic Management Unit). Zakia Nekaien-Nowrouz, Sarah Nankya Babirye, Ewelina Lajch and Lilia Saetova provided technical and administrative support. The team is grateful for consultations with the government officials of the Kyrgyz Republic, primarily with the representatives of the Ministry of Finance (including Central Treasury). The analysis has been conducted in close coordination with government counterparts, with earlier drafts, power-point presentations, and workshops used to support a dialogue on public expenditure policy priorities facing the Kyrgyz Republic.

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Executive Summary

1. **The current approach to fiscal policy is delivering suboptimal outcomes for the citizens of the Kyrgyz Republic.** The past five years have been difficult for the Kyrgyz Republic, with one shock following another. Government spending ballooned to 39 percent of GDP in 2012 one of the highest ratios among developing countries globally, as the authorities tried to mitigate the shocks. However, despite increases in spending, the quality of health services remains poor; above 80 percent of 15 year-olds are classified as illiterate; wages in the public sector are low; and only 6 percent of social assistance reaches the poorest members of society. In addition, risks are mounting in the pension system, few instruments exist to support the vulnerable and the physical capital stock is depreciating, especially in the energy sector.

2. **Ad-hoc fiscal policy responses to frequent economic shocks has had limited success in mitigating the impact on living conditions**. During 2003 to 2012, GDP growth averaged just above 4 percent annually, but with widely varying year-to-year rates, ranging from 8.5 percent in 2007 to -0.1 percent in 2012. This volatility reflects frequent external and domestic shocks, the latest one being a glacier movement at the Kumtor mine, responsible for above 10 percent of GDP, which caused a sharp drop in gold output. Two world food price shocks during this period took an additional toll on economic outcomes and living conditions as did the political turmoil in 2010. The government introduced a number of measures in response to these shocks, including increases to public sector wages and pensions, the introduction of new social allowances, while increasing existing allowances at the same time, and the implementation of a much needed public investment program. Despite these measures, and increasing inflows of remittances from Russia, poverty increased to 38 percent of the population in 2012, up from 32 percent in 2008.

3. **The fiscal balance and debt indicators have suffered.** Fiscal buffers built up during the strong consolidation efforts between 2000 and 2008 have been eroded. By 2012, the Kyrgyz Republic registered one of the highest fiscal deficits in the Europe and Central Asia (ECA) region, accompanied by a sizable increase in public debt. The fiscal position remained solvent due to increased concessional external support and debt-write-offs, as well as ad-hoc measures to boost revenues and selected expenditure cuts. A structural deficit of 4-5 percent suggests that unless structural changes are made to fiscal policy, the government will need to continue relying on ad-hoc measures and external support to finance the budget – neither of which is sustainable in the medium term.

4. **Fiscal policy arrangements need to be re-aligned to better support the objectives of reducing volatility, supporting growth, and protecting the poor.** More specifically, the authorities need to: i) consolidate the fiscal position in order to safeguard sustainability and strengthen resilience to future shocks; ii) ensure that the adjustment does not adversely affect economic activity; iii) improve quality of public services and iv) allocate more resources for new technologies and infrastructure spending. A tax policy regime which creates incentives to stay within the informal sector, increasing the burden on the few who fall under the tax system, suggests the some gains can be achieved from broadening the tax base and more equitable taxation; however, most of the fiscal adjustment will need to come from expenditures. Currently, growth is constrained by the country's reliance on a few sectors and financing sources, exacerbating the country's vulnerability to shocks. A prudent fiscal policy, combined with sector policies that improve human, physical and institutional capital, will promote diversification and reduce vulnerability over the medium to long term.

5. **A no reform scenario is unsustainable and it may put at risk the significant achievements of the Kyrgyz Republic over the last few years**. The April 2010 violent revolution disrupted economic flows, created a power vacuum and threatened to escalate into a larger ethnic conflict. Instead, the country seized the opportunity by embarking upon a challenging process of building institutions and policies for a democratic state and market based economy. Three years down the road, the political achievements are considerable as is the unfinished agenda. A new Constitution was adopted at a referendum in 2010, the country was able to hold free and fair elections in 2011 and a non-violent power transfer took place in 2012. Despite frequent tensions, it appears that democratic norms are beginning to take hold and the country's capacity for democratic governance is increasing. However, institutions are still learning how to effectively use newly acquired powers, and institutional checks and balances are not always effective. Failure of fiscal policy to support growth, improve quality of public services and better protect the poor may re-ignite the tensions that were at the core of the 2010 turmoil.

6. **Medium term prospects for growth are good, providing the government with the opportunity to implement the necessary reforms.** The broader Central Asia (CA) region is expected to grow on the back of strong demand for its mineral resources and commodities. This should provide a boost for Kyrgyz Republic exports and keep remittances robust. Recently announced Russian and Chinese investments in energy infrastructure will also positively contribute to economic activity. Finally, the government has restated its commitment to accelerate structural reforms focused on improving the investment climate and strengthening public sector governance. This is expected to support growth of the vibrant, but generally small-scale and informal, private sector.

7. **The aim of this Public Expenditure Review (PER) is to share recommendations on how to reconcile the potentially competing objectives outlined above.** While this is indeed a very difficult task, the findings of the PER suggest that it is not insurmountable. It concludes that with concerted efforts in number of sectors, the authorities can simultaneously strengthen fiscal sustainability prospects, improve the quality of public services and address a number of constraints to social and economic development. This will require that the current reactive approach to fiscal policy is replaced with a proactive stance on tax policy and administration as well as measures aimed at smarter interventions and a focus on quality of delivery.

8. **This PER focuses on the effectiveness, level, and composition of public spending in number of sectors**. The objective of this synthesis note is to better understand the overall environment for fiscal policy as well as the nature and composition of public revenues and expenditures. The sectoral policy notes review the challenges and options in specific sectors, namely, education, health, pensions, social protection, and energy as well as cross-cutting themes such as the wage-bill and public investment management and intergovernmental relations. While more detailed sector-specific recommendations are contained in the sectoral policy notes, more general recommendations on fiscal policy will also contribute to sustainable fiscal consolidation (Table 1).

Table 1. Prioritized Set of Recommendations for Fiscal Policy

Recommendation	Priority
Reform the simplified taxation regimes to remove incentives for informality	High
Streamline tax and customs administration to reduce the burden of compliance	High
Eliminate the numerous VAT exemptions and gradually phase-out the sale tax	High
Advance reforms in public financial management, including budget execution, public procurement and internal audit to promote transparency and accountability in spending.	High
Strengthen links between the NSDS, sector strategies and the budget process to ensure that scarce public funds are effectively allocated to priorities.	Medium
Work closely with the National Bank of the Kyrgyz Republic to strengthen the effectiveness of monetary policy and ensure coordinated macroeconomic policies (improve cash planning and liquidity forecasting);	Medium
Strengthen monitoring and evaluation mechanisms for public programs and promote use of evidence-based policy making;	Low

9. **A communications strategy should be developed alongside any proposed changes to fiscal policy.** Fiscal consolidation packages can be met with unease by a country's citizens, as the world is observing in countries like Greece and Italy. In addition to concerns that welfare will be adversely affected, citizens in the Kyrgyz Republic may be skeptical of how any savings will be utilized, given the perception of corruption that pervades society. Ethnic and regional inequalities further underscore the need to clearly articulate government plans so that any tensions can be addressed at the outset.

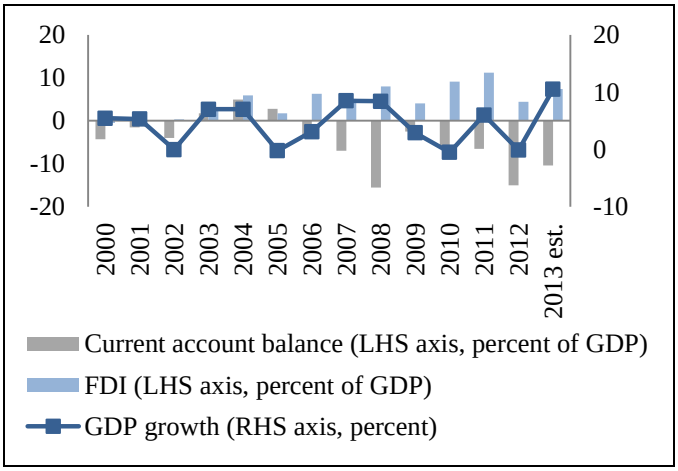
1. Macroeconomic Setting

OUTPUT, INFLATION, LIVING STANDARDS

10. **Despite reforms to attract investment and support economic activity, growth has been volatile and narrow-based.** The removal of price controls and the opening up of borders attracted Foreign Direct Investment (FDI) in the late 1990s. However, most of this FDI flowed into the mining sector, more specifically gold mining and one mine, Kumtor, in particular. Broader growth opportunities did not materialize as rampant governance issues prevented the Kyrgyz Republic from fully exploiting its mining potential, and undermined the development of the private sector. This legacy has continued to the present day, with Kumtor accounting for over 40 percent of total merchandise exports and 10 percent of government revenues. In the good times this has helped the Kyrgyz Republic attain growth rates of 10.5 percent. In the bad times, when gold production has faltered (in 2002 and more recently in 2012), the economy has fallen into recession (Figure 1). The uncertainty caused by these fluctuations makes it difficult for the authorities to budget, and can adversely affect welfare.[1] With a GNI per capita of around US$1,000 in 2012, the Kyrgyz Republic remains one of the poorest countries in the ECA region. A stronger public financial management framework, including measures proposed in this PER, could strengthen the ability of the budget to mitigate this volatility.

Figure 1. Growth and external indicators

(In percent and percent of GDP)



Source: Kyrgyz Republic Ministry of Finance.

11. **The Kyrgyz economy is reliant on Russia, for trade and remittances, heightening the economy's vulnerability.** Russia is an important partner for the Kyrgyz Republic, receiving almost 15 percent of Kyrgyz Republic exports and providing a third of imports (in 2013). In addition, in the absence of domestic job creation, Russia provides significant employment opportunities. Over 300,000 Kyrgyz are estimated to have immigrated to Russia, sending back around 30 percent of GDP worth of remittances (2012). These remittances have driven up consumption and helped bring poverty rates down to 32 percent in 2008, though it has increased to 38 percent in 2012. Workers' remittances are also helping finance a rising current account deficit, which reached 15.3 percent of GDP in 2012 and is likely to have remained in the double digits in 2013.

12. **Political disturbances have also impacted growth.** Widespread mistrust in the government, stemming from perceptions of corruption, nepotism, and misuse of assets, resulted in a revolution in April 2010 and social unrest in June of the same year. The financial sector was in disarray, and the closure of borders with Kazakhstan and Uzbekistan adversely affected cross-

[1] Hnatkovska and Loayza (2005) estimate that a one-standard-deviation increase in macroeconomic volatility can lower average annual GDP per capita growth by 1.28 percent. For more details on the model, and for an overview of links between macroeconomic volatility and growth in developing countries, refer to N. V. Loayza, 2007, "Macroeconomic Volatility and Welfare in Developing Countries: An Introduction", The World Bank.

border trade and other sectors relying on essential intermediate products (e.g. fertilizers for farming). Alongside these events, damage to both commercial and residential infrastructure negatively impacted welfare and economic prospects.

13. **The recent growth performance has been encouraging and prospects for the medium-term are generally favorable.** Growth recovered in 2013 to 10.5 percent, as the Kumtor gold mine returned to normal operations following the glacier movement that disrupted production in 2012. Gold output, which was more than double 2012 levels, contributed to half of overall GDP growth. Resilient remittances, increases in private sector wages and growth in credit to the private sector are helping keep domestic demand high and stimulating the non-gold economy, which has expanded 5-6 percent during the last 3 years (Table 2). Growth rates over the next few years are expected to moderate to a still strong 4-5 percent per annum, reflecting robust domestic demand. Gold output is projected to remain largely flat, having reached capacity in 2013. The slowdown in Russia may affect remittances and exports; still, more credit to the private sectors and strong public sector investment will keep demand strong.. At the same time, China is becoming an increasingly important source of investment (most notably in the transport and energy sectors); around US$3 billion is estimated to flow to the Kyrgyz Republic over the next few years. A strong reliance on a few sectors will continue to keep risks elevated, including from a slowdown in key partners and/or lower gold prices.

Table 2. Selected Macroeconomic Indicators

(In percent of GDP, unless otherwise indicated)

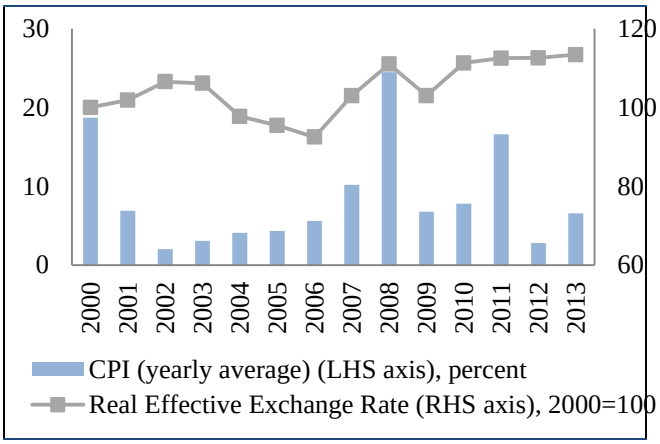
	2008 Act.	2009 Act.	2010 Act.	2011 Act.	2012 Act.	2013 Prel.	2014 Proj.	2015 Proj.
Real sector								
GDP, in US$ million	5,131	4,683	4,794	6,199	6,603	7,225	7,531	7,946
GDP per capita, in US dollars	972	864	875	1,120	1,182	1,280	1,321	1,380
GDP growth	8.4	2.9	-0.5	6.0	-0.1	10.5	4.4	4.9
Investment	20.2	22.9	23.9	24.0	26.2	25.6	27.3	29.3
Fiscal accounts								
Revenues and grants	29.9	32.1	30.5	31.8	33.8	33.9	32.1	31.2
Expenditures	29.3	36.1	36.6	36.3	39.0	37.6	36.4	34.7
Balance	0.6	-4.0	-6.1	-4.6	-5.3	-4.0	-4.3	-3.5
Public debt	48.5	58.1	59.7	49.4	49.0	47.7	51.9	51.9
External accounts								
Exports of goods and services	54.0	54.5	52.7	54.7	53.6	55.1	57.9	56.3
Imports of goods and services	92.8	78.9	81.7	82.3	97.7	95.9	99.7	96.4
Current account balance	-15.5	-2.5	-6.4	-6.0	-15.0	-13.5	-15.7	-14.5
External debt	73.3	89.3	92.7	76.7	81.3	84.4	81.3	83.0
Prices and exchange rates								
Inflation, period average	24.5	6.8	7.8	16.6	2.8	6.6	6.1	6.6
Exchange rate, KGS/US dollars	39.4	44.1	47.1	46.5	47.4	48.6		

Source: Bank staff calculations based on data from national authorities.

14. **World food price spikes have translated into large fluctuations in domestic inflation.** The Kyrgyz Republic is a net food importer and food accounts for around 60 percent of total consumption. In addition, food price pass-through rates in the Kyrgyz Republic are among the highest of countries in the Caucasus and Central Asia (IMF, 2012). The Kyrgyz Republic also imports all of its fuel. Repeated world food price shocks since 2008 have consequently translated into inflation rates as high as around 20 percent in 2008 and 2010 (**Error! Reference source not ound.**). Recently, average annual inflation has fallen to around 6.6 percent as pressures on global food markets eased during 2013. Relatively high core inflation (averaging 7.2 percent in 2013) suggests that macroeconomic policies may have added to inflationary pressures.

Figure 2. Inflation and the real effective exchange rate

(In percent and index 2000=100)



Sources: Kyrgyz Republic national authorities and World Bank estimates.

15. **Volatile growth and high domestic inflation have stunted poverty reduction in recent years**. The growth observed up to 2008 was significantly pro-poor with poverty falling from above 60 percent of the population in 2004 to 32 percent in 2008 (Table 3). However, a series of growth and inflation shocks reversed this trend and by 2012 the poverty rate had increased to 38 percent of the population. This increase in poverty comes during a period of significant increases in public social spending and suggests the need to re-think the current model of social protection services delivery (see Social Protection Policy Note for further details).

Table 3. Rising Poverty Rates

(Percent of population)

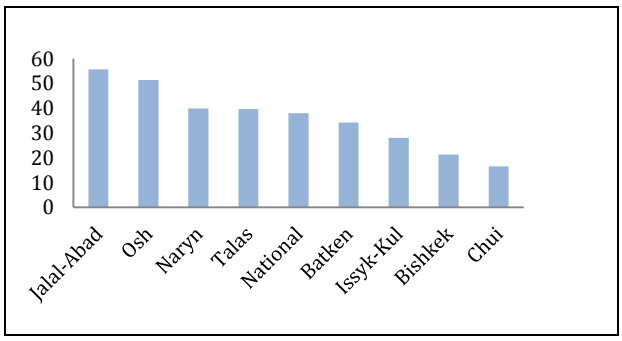
	2010	2011	2012
Total	33.7	36.8	38.0
Urban	23.6	30.7	35.4
Rural	39.5	40.4	39.6

Source: National Statistics Committee.

16. **Poverty continues to have a strong regional dimension in the Kyrgyz Republic with significant implications for public spending**. The urban-rural gap has narrowed in recent years, probably reflecting the smaller impact of higher food prices on the rural population (relative to the urban) given their access to subsistence farming and livestock. Still, most of the poor (around 65 percent) continue to reside in rural areas. The poverty rate in 2012 varied between 17 percent in Chui and more than 50 percent in Jalal-Abad and Osh (Figure 3). Some of the findings in the sector policy notes confirm that public spending patterns may be adding to these inequalities. For example, the Education Policy Note concludes that differences in education spending are contributing to the observed variation in student skills.

Figure 3. Poverty Rate, by Region

(Percent of population)



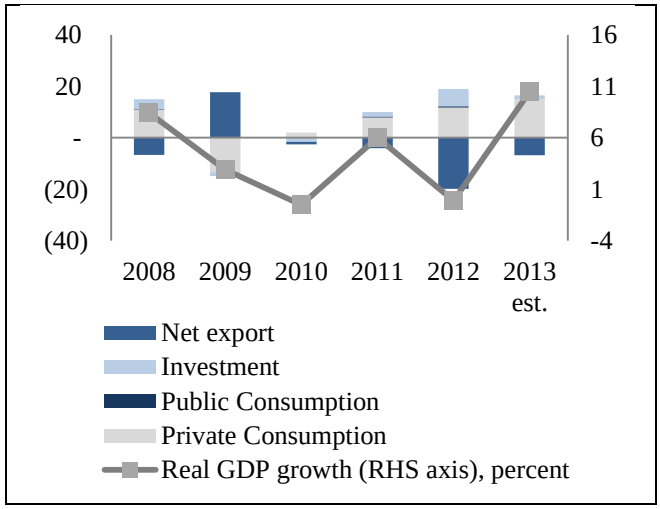
Source: National Statistics Committee.

BALANCE OF PAYMENTS AND EXTERNAL DEBT

17. **Volatile gold exports and buoyant domestic demand have widened the current account deficit**. From 2000 up until 2008, the average annual current account deficit was around 3 percent of GDP, compared to an average annual rate of 9 percent of GDP during 2008-2012. Much of this expansion can be attributed to an increasing trade deficit (Figure 4 and Figure 5). In 2012, the trade deficit was 59 percent of GDP – partly because of a fall in exports from the Kumtor gold mine, and partly stemming from large imports of vehicles, consumer goods and erroneously high levels of trade in oil. Preliminary data for 2013 shows a recovery in gold exports, but a fall in non-gold exports, especially of electricity, textiles and dairy products. At the same time, import growth remained buoyant due to imports of materials for the government's investment program and imports of consumer goods to meet growing domestic demand. Implementation of the recommendations of this PER (fiscal adjustment, sectoral spending reallocation etc.) would also help narrow the external deficit. Following a slight dip in 2009 - as a result of the global financial crisis - remittances have remained robust at between 25-30 percent of GDP.

Figure 4. GDP growth decomposition

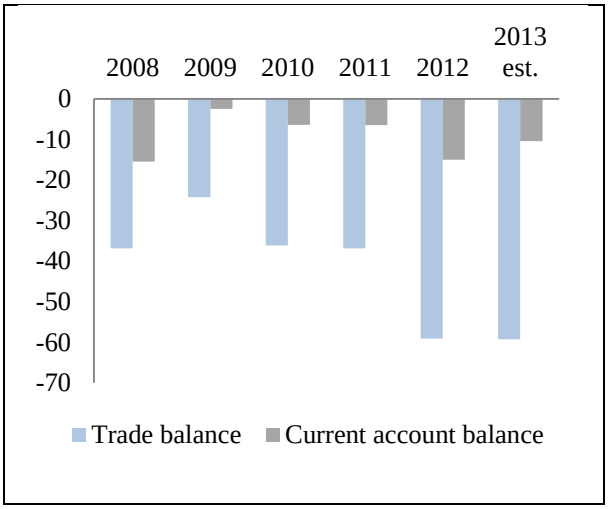
(In percent and contribution to GDP)



Source: Kyrgyz Republic Ministry of Finance.

Figure 5. Trade and current account balances

(Percent of GDP)



Source: Kyrgyz Republic Ministry of Finance.

18. **Capital and financial accounts inflows exceeded the current account, allowing for an increase in reserves**. Foreign direct investments averaged around 9 percent of GDP (mostly reinvested earnings from Kumtor god mine) in recent years, while trade credits and borrowing, including for large donor-financed infrastructure projects, provided additional capital inflows. Amortization needs remain low reflecting the concessional nature of most of the foreign debt. At the end of 2013, reserves reached US$2.2 billion, up from US$1.7 billion at the end of 2010.

19. **Foreign debt increased in response to the higher current account deficit, though a significant part remains under concessional terms.** Gross external debt reached US$6.8 billion at the end of 2013 or 94 percent of GDP. While this ratio is relatively high, the high concessionality of public debt (close to half of total external debt) lowers sustainability concerns. While nominal public and publicly guaranteed external debt was 44 percent of GDP at the end 2013, its present value was around 30 percent of GDP. According to the 2013 debt sustainability analysis update, all external debt burden indicators in the baseline scenario are below the thresholds for countries with large inflows of remittances. However, stress tests indicate that the Kyrgyz Republic remains

vulnerable to large external shocks, especially in light of increased borrowing for the Public Investment Program (PIP).

MONETARY AND FINANCIAL SECTOR DEVELOPMENTS

20. **While monetary policy has been largely accommodative, its effectiveness is limited, putting pressure on fiscal policy.** Despite gradual increases since mid-2013, the discount rate of the Central Bank is negative in real terms. Most recently, the discount rate was increased to 6 percent (up from around 4 percent in early-2014) in response to high core inflation as well fluctuations of the currencies of major trading partners. However, weaknesses in the transmission mechanisms raise concerns regarding the efficiency of monetary policy (Box 1). This adds to an already high spread between deposits and lending rates in the banking sector, reflecting both inefficiencies and the broader business environment, which keep risks high. This means that the brunt of any adjustment to shocks in the economy needs to, and indeed has been, borne by fiscal policy.

Box 1. Transmission mechanism of monetary policy in the Kyrgyz Republic

The main objective of monetary policy in the Kyrgyz Republic is to maintain price stability. The central bank uses its instruments (short-term NBKR notes, repo operations with government securities, foreign exchange market operations, reserve requirements) to balance the liquidity in the system, with the ultimate objective of maintaining prices stability. Until late 2013, the NBKR targeted monetary aggregates (M2 and reserve money). In December 2013, the NBKR board agreed to switch to a new operational framework for monetary policy, targeting interest rates instead of the monetary aggregates.

The efficacy of monetary policy appears to be limited in the Kyrgyz Republic. This reflects the low monetization of the economy (M2 to GDP of 32 percent at end-2012), the shallow financial system (bank assets at 30 percent of GDP at the end-2012), high dollarization (52 percent at the end 2012) and a predominantly cash-based economy (currency in circulation at 56 percent of broad money at the end of 2012) (International Monetary Fund, 2013). Consequently, signals from monetary authorities are not adequately reflected in decision making of economic agents and the link between the Central Bank's instruments and monetary aggregates, economic activity and inflation are often weak. The spread between NBKR rates and commercial banks' lending rates is very big and changes in policy rates are not reflected in either deposit or lending rates, limiting the ability of NBKR to influence demand for credit. The new operational framework should gradually strengthen the interest rate channel. On the other hand, the exchange rate channel appears to be more effective, which could be expected given the relatively small and open Kyrgyz Republic economy and large private transfers.

21. **The large external imbalance and weaker currencies of the Kyrgyz Republic's key trading partners put pressure on the som in early 2014**. The exchange rate of the Russian ruble, one of the Kyrgyz Republic main economic partners, depreciated significantly over the last few months and is being further affected by the developments in Ukraine. The currency of Kazakhstan, another important partner of the Kyrgyz Republic was devalued by around 20 percent in February 2014. These developments pushed up demand for foreign currency in the Kyrgyz Republic causing the som to lose more than 10 percent of its value against the dollar since the start of 2014. The central bank used around 2 percent of foreign exchange reserves to allow an orderly adjustment in the exchange rate. The situation appears to have stabilized recently and reserves remain above 3 months of imports. The coverage of monetary aggregates, at around 90 percent of broad money (M2) and 170 percent of monetary base, are more re-assuring.

22. **The real exchange rate was considered broadly appropriate prior to the recent exchange rate developments**. The real exchange rate has appreciated since 2007 (an 18 percent increase) as the depreciation of the nominal exchange rate was insufficient to compensate for spikes in inflation observed in 2008 and 2011. According to the IMF's assessment, as of late-2013, it was in line with the country's fundamentals. Policy responses following recent developments should ensure that Kyrgyz products remain competitive in traditional markets.

23. **The banking sector has continued to recover since the 2010 political upheaval and is well placed to support growth, providing key constraints are removed.** The 2010 crisis caused a large deposit outflow while the quality of the portfolio deteriorated and the sector incurred substantial losses. The National Bank of the Kyrgyz Republic (NBKR) responded by taking over seven banks (accounting for 45 percent of the system's assets) under temporary administration. While the sector has returned to growth, access to finance remains a large constraint to doing business. The NBKR still remains involved in complicated legal processes, and is trying to unwind its interventions, highlighting deficiencies in the bank resolution legal framework, some of which are being addressed in the new Banking Code currently being reviewed by parliament. With a capital to risk-weighted asset ratio in the banking sector of around 25 percent in December 2013, and a deposit-to-loan ration of around 100, the sector could support growth if opportunities emerge. However, further improvements in the business environment (e.g. credit information infrastructure) are needed to improve access to and reduce the costs of financing.

STRUCTURAL REFORMS

24. **Progress in the implementation of economic reforms has been uneven**. While there are encouraging signs in certain sectors, including in the judiciary and financial sector, key reform decisions in critical sectors, including anti-corruption, public finance management and energy, are yet to be made. The 2013-2014 World Economic Forum Global Competitiveness Forum ranks the Kyrgyz Republic at 121st (out of 148 economies), an improvement of 7 positions compared to the previous year, reflecting the preservation of macroeconomic stability in the economy as well as some improvement in the functioning of institutions.[2]

25. **The implementation of the government's anti-corruption program is showing early results.** While the country scores poorly on key governance indicators it has made modest, but more importantly continuous gains on several Worldwide Governance Indicators (WGI), including voice and accountability, rule of law, and control of corruption (Figures 6 and 7). Still, according to the 2013 Global Corruption Barometer of Transparency International, most of the respondents believe that corruption is a major problem in the public sector and that it has not declined during the past two years.[3] The recent preparation of the Public Sector Reform Roadmap appears to be reinvigorating efforts in this important area.

26. **While the judicial system is underfunded, perceived as corrupt and an obstacle to doing business, recent steps are encouraging.[4]** These include reforms in the selection processes of judges and disciplinary procedures, as well as the piloting of internet publication of hearings and court decisions of the Supreme Court, and six other courts. An increase in the budget allocation for

[2] Available at: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf
[3] Available at: http://www.transparency.org/gcb2013/country//?country=kyrgyzstan
[4] 89% of respondents to the 2013 Global Corruption Barometer felt that the judiciary was corrupt or extremely corrupt. Available at: http://www.transparency.org/gcb2013/country//?country=kyrgyzstan

the judicial sector would allow for higher salaries for judges and judicial staff as well as provide funds for essential improvements in the depleted infrastructure of the sector.

Figure 6. Perceptions of government effectiveness

(Percentile ranking, government effectiveness)

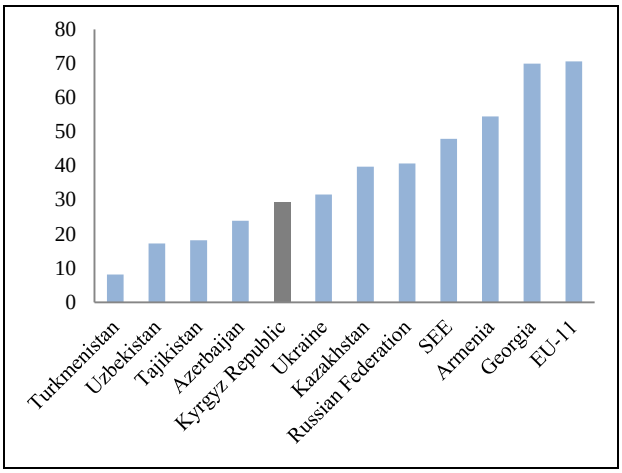
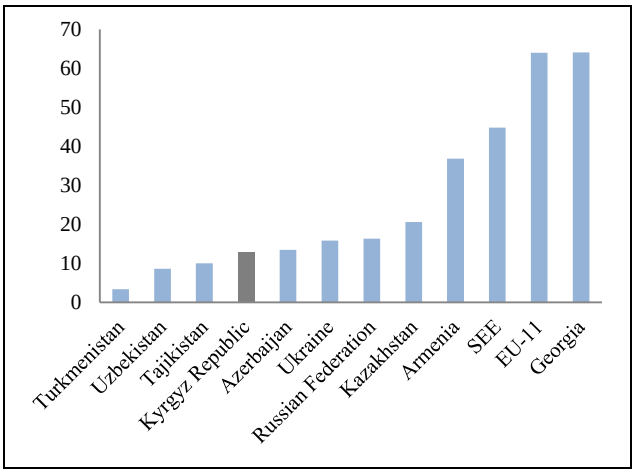


Figure 7. Perceptions of the control of corruption

(Percentile ranking, control of corruption)



Source: The Worldwide Governance Indicators, 2012, selected ECA countries and averages; SEE – Southeast Europe, EU-11 – EU members.

27. **Some progress has been made in tackling the constraints to the development of the financial sector**. Zalkar bank was recently privatized, following a number of failed attempts over the last few years. In addition, the Banking Code, currently in Parliament, will strengthen the powers of the NBKR in legal processes. Moreover, the credit registry established recently in the NBKR is expected to significantly improve the Bank's capacity to supervise the sector. Amendments to the deposit protection law are expected to further increase confidence in the system. However, several weaknesses in the supervisory and regulatory frameworks continue to exist, including the ability to implement existing regulations efficiently.

28. **Despite strong growth potential, the PER Energy sector note concludes that the power sector is a large contingent liability for the budget and a constraint to growth.** Weak governance, below cost-recovery tariffs and a poor regulatory environment stymie private investment and growth in the sector. Commercial and technical losses are high due to underinvestment and degradation of assets. As part of the recently-adopted action plan, the authorities have committed to address shortcomings in the legal framework and to improve accountability and transparency in the sector. In addition, adjusting tariffs to cost-recovery levels over the medium-term should help improve the financial position of the power sector and allow for badly needed investments. Any tariff adjustments will need to be accompanied by a properly designed communication strategy, as well as reforms in the social protection system, to ensure it adequately targets poor and vulnerable groups (see the Social Protection note for details).

29. **Recent reforms to the business environment have helped improve the investment climate**. The government passed legislation in October 2012 to streamline business licenses and inspection procedures. This was followed by legislation in December of the same year to re-define the roles and responsibilities of inspectors. Current amendments to the legal framework will further reduce the number of licenses required to do business, and during 2014 most inspections should move to a risk-based approach. These efforts are moving the Kyrgyz Republic in the right

direction, however, most business related surveys (e.g. the World Bank's Doing Business Survey, and the World Economic Forum's Competitiveness Index) still note that corruption and mistrust in the government and public authorities are the main concerns for businesses and investors. Continued efforts in these areas therefore remain paramount if progress is to be maintained.

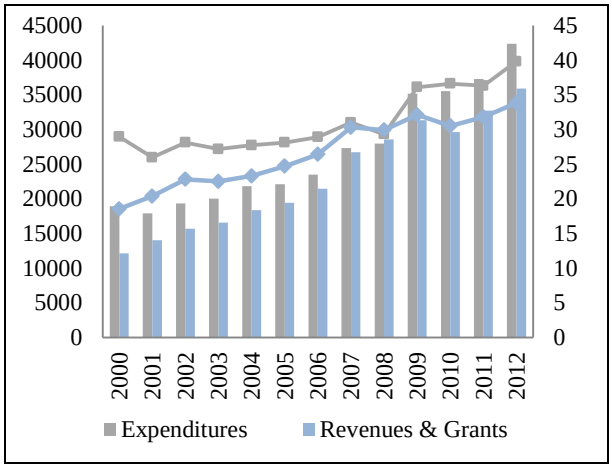
2. Fiscal Developments

30. **The government took advantage of the relative boom years during 2003-2008, strengthening the fiscal position.** Revenues increased by over 7 percentage points of GDP during this period to reach 29.9 percent of GDP in 2008. Rising consumption from large workers' remittance flows, and improved employment opportunities, helped drive up income tax, value added taxes (VAT), and customs duties. The improvement in revenues and grants and marginal increases in expenditure (by two percentage points) helped the government bring the fiscal deficit down from over 10 percent of GDP in 2000, to a balanced budget in 2008.

31. **However, ad hoc responses to various shocks resulted in a rapid rise in current expenditures during 2008-2012.** First, the government responded to the global financial crisis, with a fiscal stimulus in 2009. While capital expenditures increased by almost a percentage point of GDP, most of the fiscal stimulus came from permanent shifts in current expenditures, namely increases in wages and pensions. Second, the revolution in 2010, and the subsequent unrest in the south of the country resulted in additional outflows. Resources were channeled towards stabilizing the financial sector and safeguarding social protection.[5] Additional benefits were created for those affected by the 2010 events and benefits across the board were brought in-line with the cost of living – another structural shift in current expenditures. Third, in 2012, the legacy of 2009 and 2010 embedded itself into the fiscal accounts – one-off benefits meant to compensate the victims of 2010 have become permanent fixtures in the budget, and additional wage increases were negotiated with remaining public sector groups. Pensions have become an increasingly expensive component of the budget, requiring transfers of almost 3 percent of GDP to the Social Fund.[6] In recent years, capital spending, mostly donor-financed, increased significantly, especially in the energy and road sectors. Overall, expenditures were 39 percent of GDP in 2012, up from 29.3 percent in 2008 (**Error! Reference ource not found.**), and in the top 15 among low and lower middle income countries. Expenditures declined as a percent of GDP in 2013; however, this reflects exceptionally strong GDP growth as

Figure 8. Revenues and expenditures, constant prices (2000s) and as a share of GDP

[In percent (lines) and Soms, 2000 prices (bars)]



Sources: Ministry of Finance of KR.

[5] The government also financed infrastructure repairs, albeit at a smaller level than originally estimated. A Joint Economic Assessment (JEA) by the Bank and other development partners estimated the cost of building and structural damage at about US$130 million. Absorption capacity constraints meant that only US$82 million was eventually channeled towards restoration of the south.

[6] This figure is 8.2 percent when total public pension spending (including spending from the social fund) is included.

well as wage freeze for most of the public sector, neither of which can be counted on to sustainably reduce the size of budget spending over the medium term.

32. **These measures have burdened the Kyrgyz Republic with a large structural fiscal deficit, leaving little fiscal space to respond to future shocks, and making future adjustments difficult.** Recent fiscal policies have created spending commitments that the government is unable to fund under the current tax policy regime – irrespective of where the economy is in the business cycle. The structural deficit was 0.3 percent of GDP in 2008 and it is estimated at 4.5 percent of GDP in 2012 (Figure 9 and Figure 10).[7] While the response may have been an adequate reaction to the prevailing environment, current fiscal trends are unsustainable, and unless changes are made to fiscal policy, the structural deficit may increase further – for example, the government's share of pension spending is rising; and there are significant inefficiencies in the energy sector that require continued government support.

Figure 9. Fiscal deficits in the ECA region, 2012

(Percent of GDP)

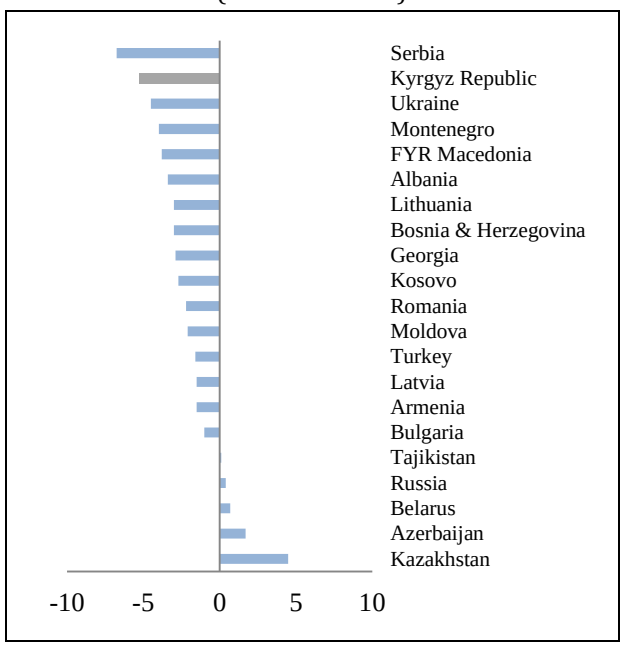
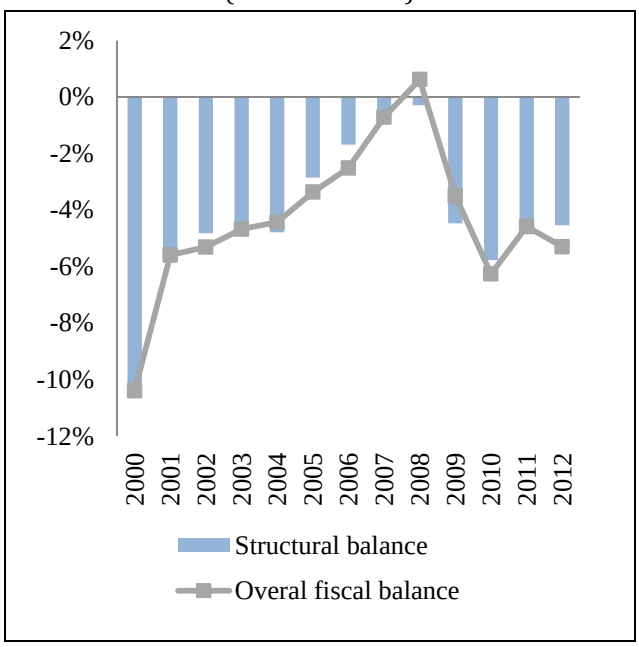


Figure 10. Kyrgyz Republic structural and fiscal balances

(Percent of GDP)



Sources: Kyrgyz Republic Ministry of Finance and ECA Fiscal database; World Bank staff calculations.

33. **Public debt is at moderate risk of distress, and critically depends on concessionality of borrowing.** Public debt had been on a declining trend until 2008, following the consolidation of the fiscal position. However, it increased to around 60 percent of GDP during 2009 and 2010, as the fiscal deficit widened and GDP stagnated. It has stabilized at around 50 percent of GDP since due to recent debt write-off from Russia, Turkey and Germany. The most recent debt sustainability analysis update concluded that the Kyrgyz Republic remains at moderate risk of debt distress, primarily due to its vulnerability to large exogenous shocks to growth, remittances, and gold prices. The concessional nature of most of the public debt as well as relatively high revenues means the

[7] The estimates used in this report are based on calculations using the Hodrick–Prescott (HP) filter. It should be noted that there are no definitive estimates of the Kyrgyz Republic's output gap. Given the volatility of GDP over the past 5 years, it is likely that there are different output gap estimates available, and thus also the structural balance.

debt indicators (present value of debt, debt servicing etc.) do not appear excessive. Nevertheless, a public debt burden of 47 percent of GDP is high for a country with relatively constrained access to external financing, a shallow domestic debt market and a large structural fiscal imbalance.

3. Challenges for Fiscal Policy

34. **The authorities have started introducing measures to reverse a growing fiscal deficit.** Current fiscal trends cannot be sustained. Fiscal accounts have been kept solvent by generous concessional external financing and debt write-offs, which are less likely to be available going forward. As income levels grow, the Kyrgyz Republic will need to rely less on concessional and more on market based borrowing. Ensuring robust macroeconomic fundamentals is critical to building creditworthiness and ensuring borrowing at affordable terms. Preliminary data suggest the authorities were able to bring the fiscal deficit down to around 4 percent of GDP in 2013, much below the 5.3 percent of GDP deficit in 2012. Further adjustment is envisaged over the medium term with the deficit projected to decline to below 3 percent of GDP by 2016. However, there are concerns about the sustainability of the 2013 fiscal deficit reduction, as one-off measures, such as the wage freeze on public sector salaries, are unlikely to maintained, especially in an environment of 5-7 percent inflation. As this PER shows, achieving sustainable fiscal adjustments will require systemic measures in number of areas.

35. **At close to 35 percent of GDP, the space for raising revenues further is limited.** Tax policy and administration reforms could help create a more equitable share of the taxation burden, which currently appears to be concentrated on a small proportion of the formalized economy, thus incentivizing informality (Box 2). The Policy Note on pensions concludes that the existing policy framework has resulted in a high taxation burden on official employment, further contributing to informality. While a more detailed revenue assessment is beyond the scope of this PER, some preliminary observations are provided in the remainder of this chapter.

36. **The Kyrgyz Republic has limited ability to respond to shocks and protect the poor**. Volatility is likely to remain a defining characteristic of the Kyrgyz Republic economy, at least over the medium term, reflecting its heavy reliance on gold production, consumption fuelled by remittances, and political instability. It is necessary therefore for fiscal policy to effectively perform its stabilization function, i.e. create fiscal space (either reserves or borrowing room) to respond to unplanned events. However, the ability of fiscal policy to mitigate and absorb shocks has been reduced greatly over the last few years and fiscal buffers need to be re-built. Similarly, improved protection of the poor requires a stronger redistribution function, i.e. having tools and resources to identify and support the vulnerable. Again, in this regard, the Kyrgyz authorities only have limited options.

Box 2. Estimates of informality in the Kyrgyz Republic and implications over size of budget

Fiscal aggregates are likely to overstate the size of the budget in the overall economy given the sizeable shadow economy. According to the National Statistics Committee, the unobserved economy accounted for around 20 percent of GDP in 2011 and this adjustment is included in the GDP number used to derive the revenue and expenditure to GDP ratios. Similar rates for the unobserved economy have been reported by other national statistics institutions, including Kazakhstan (21.6 percent in 2003), Russia (24.3 percent in 2003), Macedonia (16.3 percent in 2003), and Azerbaijan (20.7 percent in 2003). However, these adjustments fail to capture a significant part of informal activity - a 2010 World Bank report estimated the informal sector in the Kyrgyz Republic to be closer to 42 percent of GDP during 2000-2007 (Schneider, Buehn, & Montenegro, 2010).

Even with adjustments to GDP, the size of the budget in the Kyrgyz Republic is still likely to be relatively high compared to its peers. Such large differences between estimates of the informal sector are not uncommon in other countries. For example, the World Bank's model's estimates for the shadow economy in Kazakhstan, in Russia, in Macedonia are 45.3 percent of GDP, 48.6 percent and 36.2 percent, respectively. The relative comparison of the size of the budget in the Kyrgyz Republic is not therefore expected to be impacted by adjustments to GDP. Such a large informal sector increases the tax burden on the formal economy. Implementation of some the recommendations in this note could help create a more equitable tax burden and reduce incentives for informal sector activity.

Source: Schneider, F., Buehn, A., & Montenegro, C. E. (2010). Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007. World Bank Policy Research Working Paper 5356.

37. **Fiscal policy reform will support competitiveness and growth.** Being a small and open economy, the Kyrgyz Republic will have to rely on stronger exports to finance growing consumption and living standards of its citizens. This in turn critically depends on maintaining an adequate real exchange rate, and fiscal policy can help in at least two way: i) by being an employer it can ensure that wage growth remains in line with productivity and ii) by being a consumer it can ensure that consumption levels are not putting excessive pressure on domestic prices.

38. **Increasing the capital stock will require maintaining high rates of capital spending and improving its effectiveness.** Currently, 20 percent of expenditures are allocated towards capital expenditures, an uptake from the earlier period (it was 15 percent in 2011) and largely due to foreign financing of projects. At the same time, the Kyrgyz Republic has a number of infrastructure deficits, as well as a huge backlog of operating and maintenance spending, not least in energy and roads – two areas that could boost growth and welfare.

39. **The quality of public education and health provision is not commensurate to the level of spending.** While the Kyrgyz Republic spent 7.1 percent of GDP on education in 2011 (second only to Moldova among countries in ECA region), the PISA assessment found that 83 percent of the 15-year-old population of the Kyrgyz Republic is functionally illiterate while the 2013-2014 Global Competitiveness Report of the World Economic Forum ranks the quality of the Kyrgyz primary education at 113th, out of 148 countries. Furthermore, there large variations in unit costs of food and energy delivered to schools. The country spends significant resources on purchases of goods and services, but due to weaknesses in the public procurement system it remains a high risk country for the prevalence of sub-standard and counterfeit medicines. Generous exemptions to co-payment policies in the health sector are increasing costs without a significant improvement in outcomes while cost-effective ways to deal with cardio-vascular diseases at the preventive and primary care level are not utilized. Stringent norms on employment in various sectors, including health and education, give relatively little autonomy to managers to efficiently allocate resources.

40. **In summary, the challenge for fiscal policy in the Kyrgyz Republic is to address a number of competing objectives**. It needs to: i) consolidate the fiscal position; ii) ensure that the adjustment does not adversely affect economic activity; iii) improve quality of public services and iv) allocate more resources for new technologies and infrastructure spending, while ensuring future O&M costs are appropriately budgeted. While this is indeed a very difficult task, the findings of this programmatic public expenditure review suggest that it may not be insurmountable. It will require concerted efforts towards structural reforms that improve efficiency of spending and quality of public services in a number of areas.

4. Budget Process

41. **The budget preparation process follows many good international practices, but capacity for proper budgeting is only gradually evolving.** The process starts by setting spending ceilings for budget users by the Government's Coordination Council on Macroeconomic and Investment policies. Main aggregates are shared with the broader public. Spending agencies submit their budget proposals to the MoF, which reviews these submissions to ensure compliance with guidelines from the Coordination Council. The MoF then consolidates the Budget and submits to the government for approval, no later than by mid-August. The draft Budget should be submitted to the Parliament, at least four months before the start of the fiscal year. Capacity issues along each step of this process are significant. The organic Budget code, submitted to the parliament, includes a number of good international practices. It will be important to ensure these improvements are not diluted during the approval stage.

42. **The budget remains a single year document.** The Kyrgyz Republic has gradually introduced some medium-term budget framework (MTBF) principles in Budget planning, but important elements of the MTBF are still missing. Fiscal aggregates of the main categories of revenues and spending are included, although the forecasting remains weak. The links between the MTBF and subsequent setting of annual budget ceilings are not yet formalized. At present, only a one-year annual budget is approved by the Parliament.

BUDGET LINKS TO POLICY PRIORITIES

43. **Policies and priorities need to be better reflected in the annual budget**. Sector strategy documents are developed separately from the budget process and without due consideration for cost implications. Consequently, expenditures do not correspond with the strategic programs of the ministries. For example, the PER's Public Investment Management Policy Note confirms the poor links between capital spending and the budget process, with operating and monitoring costs often omitted from the original plans. Better implementation of medium term budget framework (MTBF) principles would help address this issue.

44. **The comprehensiveness of the budget is gradually expanding**. There has been progress over the last few years in consolidating off-budget transactions with most special accounts currently integrated into the budget. Still, a number of challenges remain. The planning process for recurrent and capital expenditures remains separated, though as of 2009, the budget execution

reports of the Treasury include information on funds disbursed under donor financed projects.[8] The government is yet to link the Social Fund budget to the general government budget.

EFFECTIVE FINANCIAL MANAGEMENT SYSTEMS

45. **Budget execution needs to improve**. Most of the key budget execution decisions are taken by a cash management committee, and the release of funds depends on the day to day availability of cash while the capacity to forecast liquidity (revenue and expenditure) remains limited. In addition, an IT Audit of the Treasury's information systems found several shortcomings in the current system. The authorities recently withdrew from the implementation of the Treasury Management Information System (TMIS) which was expected to improve the reliability of data, operationalize the Treasury Single Account (TSA) and improve cash management.

46. **The practice of frequent revisions to the budget allocations undermines its credibility.** The Law on the Main Principles of the Budget allows in-year revisions of the budget, which are often approved by the Parliament post factum. As a result, the draft budget and even the initially approved budget do not appear to be binding. Deviations of actual expenditures from the originally approved budget are significant (on average 4.1 per cent during 2009-2012 based on staff calculation). There were two amendments to the Law on annual budget in 2012.

47. **The authorities are taking steps to improve the system of internal controls and internal audit**. For example, internal audit units have been established across the public administration; the internal audit department has been re-instated in the Ministry of Finance; and regulation on the establishment of the Internal Audit Council has been drafted. Nonetheless, the country has yet to develop a modern system of internal audit and capacity is limited, both in terms of skills and staff numbers. Reform efforts in this area can take time to show results, suggesting long term planning and action are needed.

FISCAL REPORTING

48. **There has been progress in providing more information on budget execution but full financial reporting does not conform to international standards**. The 2014 budget was made available to the public for comments prior to its adoption by the government. The MoF launched the internet portal "Open Budget" in 2012 providing data on revenues and expenditures of the republican and sub-national government budgets (http://budget.okmot.kg/en). The MoF also produces monthly reports on budget execution; though, these could be improved by providing comparison against budgets as well as by providing user-friendly summaries. Annual budget execution reports are also produced by the MoF. These are published, submitted to the Parliament and audited by the Chamber of Accounts (COA). However, the set of annual financial statements are not prepared in accordance with internationally recognized accounting and reporting standards. Follow up on implementation of recommendations provided by the COA appears to be limited. Finally, financial reports of autonomous government agencies and public enterprises are not easily available, thereby making it difficult to determine the overall position of the public sector in the Kyrgyz Republic.

[8] Information is entered manually, based on data provided by the MoF's department responsible for Public Investment Program monitoring.

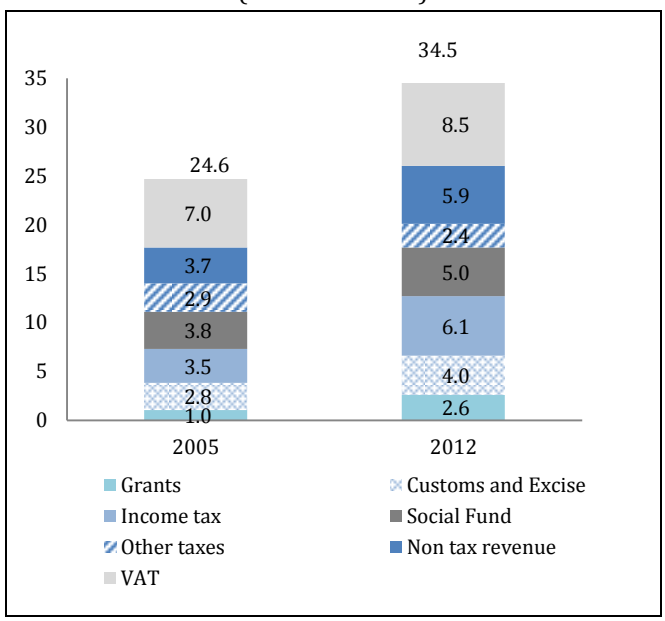
5. Revenues and Tax Administration

49. **There have been solid gains in revenue collection in recent years**. Recent changes to tax policy include increasing sales tax rates and excises on selected goods and services; shifting from import duties based on weight to duties based on value for some goods while increasing the duty per kilogram for others; and tax administration improvements. These measures have helped improve revenue collection with tax revenues (excluding social contributions) reaching 21 percent of GDP in 2012, up from 16 percent of GDP in 2005 (Figure 12). With this, the Kyrgyz Republic went from being the country with the third lowest tax collection in 2005 in ECA (out of 28 countries) to being the 16th in 2012. Only three countries in the region (Georgia, Armenia and Croatia) managed to increase tax collection more. This also brought tax collection in line with most comparators in the region, though it is worth noting that the ECA region is a relatively high-tax area compared globally.

50. **Tax policy and administration reforms should focus on expanding the tax base, promoting more equitable taxation and removing incentives for informality.** Further increasing revenues (as percentage of GDP) in the current setting will incur a cost on society, especially as revenues are already relatively high. When compared to other low and lower middle income countries in Eastern Europe and Asia, the Kyrgyz Republic's revenue to GDP ratio is one of the highest (Figure 13). With high levels of informality it is likely that taxes are relatively burdensome for those sectors of the economy that are paying taxes. Tax policy changes could result in a more equitable distribution of tax, and remove distortions in the system.

Figure 11. Revenues as a share of GDP – 2005 and 2012

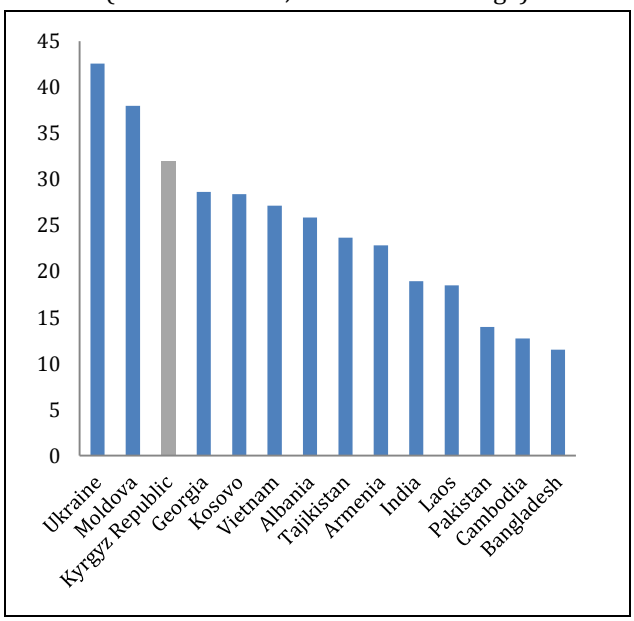
(Percent of GDP)



Source: Kyrgyz Republic Ministry of Finance.

Figure 12. Revenues as a share of GDP of selected low and lower middle countries

(Percent of GDP, 2009-2011 average)



Sources: ECA Fiscal Database and IMF staff reports.

PERSONAL AND CORPORATE INCOME TAXATION

51. **Collection of income, profits and capital gains taxes accounted for more than half of the improvement in tax collection between 2005 and 2012**. These taxes increased rapidly in the post-2009 period to reach 6.2 percent of GDP by 2012, before declining to 4.9 percent of GDP in 2013. Two factors have been driving this: a) larger payments from the Kumtor gold mine and b) the introduction of simplified income taxation schemes for small businesses and the self-employed, aimed at facilitating formalization.[9]

52. **Income tax, both corporate and personal, is taxed at a flat rate of 10 percent, a relatively low rate compared internationally**.[10] There are some exemptions from corporate income tax (CIT), most notably the agriculture production and processing sectors, estimated to account for close to a quarter or GDP. In addition, a number of regimes exist aimed to simplify the tax payment for smaller business and encourage formalization.

53. **The simplified corporate income taxation schemes may be undermining the incentives for formalization and firm growth**. Simplified tax regimes have their advantages, including lower compliance burden, and reduced discretion and interactions between entrepreneurs and the tax inspectors (Box 3). However, the simplified schemes in the Kyrgyz Republic may have outlived their usefulness or are not-properly designed as they are undermining the effectiveness of other taxes; creating incentives for underreporting (informality); and preventing firm growth. According to a recent IFC assessment on the reform directions for small business taxation, the "… misaligned and non-respected system thresholds and non-alignment of the tax burden in different simplified regimes (Patent, Simplified, Contract based) currently result in over- and under-taxation, a negligible revenue yield, encourage abuse and evasion, and are a strong disincentive to growth and graduation for firms in the overly generous patent regime …". More specifically, taxation is not equitable – given the very high thresholds, smaller business are taxed significantly more than businesses close to the threshold. This also undermines incentives for formal business growth (above the threshold). There is anecdotal evidence that businesses are being split once they reach some size in order to ensure that they remain below the threshold. Also, determining the "fair" patent payment is almost impossible given the difference in businesses. There are also administration issues, including non-registration of sold patents.

54. **Reforms to the simplified regimes are needed to remove incentives for informality**. Good international practice suggests that patent taxation should be restricted, typically to micro enterprises. However, small enterprises should be taxed based on turnover, though at a rate smaller than currently in the Kyrgyz Republic. Finally, larger companies should use the general profit tax regime, which would mean elimination of the tax contract in the case of the Kyrgyz Republic.

[9] Both Personal and corporate income tax amounted to 2.3 percent of GDP; gross revenue tax from Kumtor came to 1.5 percent of GDP.

[10] Only a few other non-oil rich countries have a top marginal rate of income tax below 10 percent (for example: Albania, Bosnia and Herzegovina, Bulgaria, Macedonia and Paraguay).

Box 3. Simplified income tax regimes

A simplified **turnover-based tax** introduced in 2001 combined income/profit tax, the road fund tax, the emergency fund tax and the retail sales tax. Businesses and individuals with a turnover of less than KGS4 million can use this scheme. As of 2009, the tax is levied at 4 percent or 6 percent of turnover depending on the main activity of the business. These rates are relatively high and assume profit margins of around 30 percent, which is probably optimistic. Under a more realistic assumption of 10-15 percent profits margins, this would be equivalent to a profit tax rate of 20-30 percent (compared to the general rate of 10 percent) which probably explains the low take up of the scheme. This scheme currently only contributes 0.1 percent of total tax revenue.

A **patent** scheme is mandatory for a list of business activities and can be used voluntarily by businesses in around more than 120 sectors, which cover key sectors of small business activity in the Kyrgyz Republic, and which have a turnover of less than KGS4 million. Payments are determined for every sector and in some cases try to account for the size of the entity. Payments under the patent cover CIT and turnover tax. Around 50 percent of Kyrgyz Republic individual businesses in 2008 used the patent scheme. No bookkeeping is required for businesses using the patent system.

The 2009 Tax code also introduced a new **tax contract** scheme open to all business in the economy irrespective of their size. It requires that payment of a fixed amount based on the tax liability (CIT, VAT and sales tax) in the previous three years and increased by 25 percent. The payment covers profit tax liabilities as well as VAT and sales tax.

55. **The Kyrgyz budget relies on one single entity for around ten percent of its total revenues, which is creating risks to the budget process**. The 2009 agreement between the Kumtor gold mine and the Kyrgyz Republic stipulates that Kumtor will pay 13 percent of its gross revenues to the authorities. While these are related to the entity's revenues rather than income, these inflows are reflected in the Kyrgyz Republic budget as corporate income tax receipts. A similar, gross revenue based tax has been introduced recently for all gold mining companies, in lieu of CIT. The new tax is progressive, depending on the international price of gold. Such a design of the tax represents a balance between the ease of administration, the transparency of the process, as well as risk-sharing between the government and the investor. However, it may not necessarily be an optimal solution. According to recent research, good international practice suggests that the most appropriate method of taxing mining activities is adherence to the general Corporate Income Tax (CIT) code, combined with a modest royalty to safeguard some basic revenues flow to the budget even when prices are low and a modest windfall gains tax to provide additional revenues when profits are extraordinarily high (see Box 4). In addition to income tax, companies are required to pay 2 percent of revenues for maintenance and development of local infrastructure.

56. **Taxation issues only add to the other constraints of developing the mining sector in the Kyrgyz Republic.** A difficult business environment and problems in granting of concessions are keeping the tax base low. While the Kyrgyz Republic has substantial occurrences of gold, geological work is generally not complete so substantial investments will have to be made to move these to economically viable reserves. Non-transparent and inadequate procedures for issuing exploration and mining concessions have also distracted potential investors. For example, the exploration and mining license for the Jerooy gold deposit were auctioned at a starting price of US$300 million. At the same time, the fees for retention of licenses have not been calculated, preventing license holders from paying these taxes. As a result, only around 30 percent of the mining potential is

currently being used and only four mining companies are in operation.[11] The 2012 Subsoil Act and amendments to the Tax and Land codes addressed some of the bottlenecks; however, further improvements are needed (including to remove contradictions in the current legal framework) and secondary legislation and implementing regulation is still missing in number of areas.

Box 4. Taxation of the gold sector

Most countries with large mining sectors tax the mining sector differently from the rest of the economy. Proponents of special regimes usually justify this by the general notion that the country and its people own the mineral deposits, the size and timescale of investments, the high sector-specific risks and the instability of world market prices. On the other hand, economists have objected on the grounds of the complexity that a non-uniform system brings and the distortions it creates in the economy. The adoption of special taxation regimes has resulted in the introduction of a number of tax instruments, including:

- **Royalties historically been the most common instrument for taxing the extractive sector and are still widely used**. Their appeal lies in the perceived ease of administration as taxes are levied either on the volume ("unit" royalty) or, more usually, the value ("ad valorem" royalty) of production or exports. They ensure a relatively stable revenue stream to the government, as they do not take into consideration the profits of mining companies. More recently, some countries, including the Kyrgyz Republic have linked the royalties to gold prices which could be used as a proxy of the profits of the company.
- **Corporate income tax is based on profits and shares risks between the investor and the government**. In addition to not guaranteeing stable revenues to the budget, corporate income tax may be difficult to compute in countries with weak tax administration and could be distorted by transfer pricing.
- **Windfall profit taxes are taxes on gross revenues levied when a certain threshold, such as a given world market price, is reached**. Some countries also apply a progressive tax regime, using stepped tax rates linked to world market prices. The Kyrgyz Republic's taxation of gold mining companies has elements of this as the percent of gross revenues paid to the budget depends on the international gold price (except for Kumtor).
- **Various other taxes and charges add to the tax revenues from the extractive sector.** They include concession charges, duties on imported equipment, payroll taxes, value added taxes and environmental taxes. Some countries retain ownership stakes in mining companies giving them access to dividends when operations are profitable.

Global experience is converging on the idea that a mix of various taxes is most appropriate. Similar to the rest of the economy, the tax regime for the mining sector should strike a balance between adequate revenues for the government and a reasonable tax burden that still attracts private investment. A tax mix, based largely on the general corporate income taxation code but also including modest royalties and windfall profits tax components may best respond to the objectives of policy-makers.

However, getting a good tax deal requires sound governance in the mining sector and the overall economy. Good understanding of the geological content and mining potential can significantly improve the negotiating position of countries. Improving the transparency of the process and reducing discretion of officials will also help. Given the long-term nature of exploration and exploitation, reducing the country risk premium can significantly improve investment prospects. This requires a sound public administration, policy predictability (including on taxes), political stability and good infrastructure. In the absence of these prerequisites, the authorities may have to give more favorable terms to potential investors. Later investors can be given hardened terms once the situation improves. However, regardless of the agreement, changing it unilaterally is not recommended.

57. **Mining taxation is a heavily politicized issue in the Kyrgyz Republic**. Lack of transparency in the sector has fueled speculation about excessive rents and corruption and has given rise to political populism. Consequently, perceptions that the country is not getting its fair

[11] Kyrgyz Republic: Mining sector needs assessment; to be published.

share of its natural resources are widely shared and there are pressures to increase the revenues flowing to the budget, with a potentially detrimental impact on prospective investments. The increased number of protests by the local population against exploration and mining activities has resulted in the closure of access to exploration and mining sites and loss of working seasons in recent years. Rather than appeasing vested interests, probably the most powerful tool the authorities have to reduce populist pressures and citizen dissatisfaction is to fairly distribute and efficiently use the revenues they already receive. This is especially important for resource rents from extractive industries given these industries are removing non-renewable assets from the country.[12]

TAXATION OF GOODS AND SERVICES

58. **Taxes on goods and services provide more than half of all taxes collected in the Kyrgyz Republic's budget**. The Kyrgyz Republic collected 12.4 percent of GDP in taxes on consumption of goods and services in 2008 but this ratio fell to 9.1 percent of GDP in 2010 as tax policy changes were introduced and the political turmoil affected economic activity. This ratio has since recovered to 11 percent and including the sale (turnover tax) introduced in 2010 reached 14 percent in 2013.

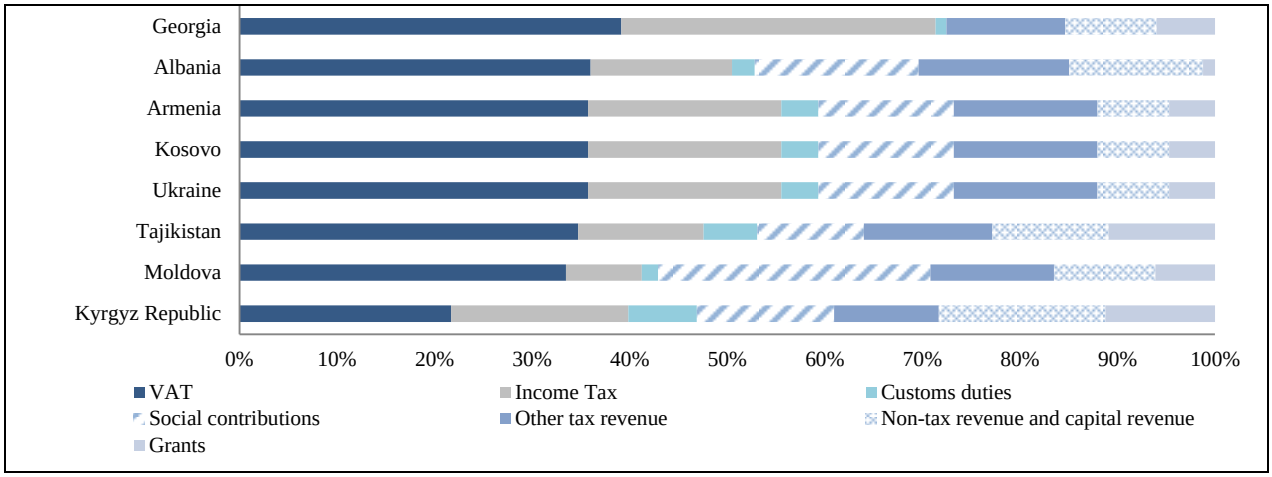
59. **Consumption is taxed with a single-rate Value Added Tax (VAT), which was reduced from 20 percent to 12 percent in 2009**. While in line with its richer neighbor in the north, Kazakhstan (which can afford to have such low VAT rates due to strong inflows of other revenues), a VAT rate of 12 percent is low when compared internationally. There is no preferential (lower) VAT rate for certain goods and services, however, the list of VAT exemptions is extensive, including utilities, the agriculture sector, medical activity, and residential buildings. Furthermore, the threshold for mandatory VAT registration, currently set at KGS4 million (or US$85 thousands) is at the high end. Finally, VAT revenues collected on imports cleared through the simplified regimes (see discussion on customs below) are recorded as customs revenues. Despite this, VAT collection is just slightly below what ECA countries with much higher rates collect (Figure 13). The higher productivity of VAT could also reflect problems in the VAT refund mechanism. Options for reform could focus on further reducing exemptions or increasing the VAT rate. Introducing a preferential VAT rate could help preserve social policy objectives, however, this would need to balanced against increasing the complexity of the system.

60. **All transactions in the Kyrgyz Republic are subject to a sales tax**. Businesses liable for VAT payment should levy a tax rate of 1.5 percent for commercial activities and 2.5 percent for other activities. Such taxes are not typical for the broader region. For businesses not in the VAT system, these rates are increased by 1 percent to 2.5 percent and 3.5 percent, respectively. Even at these low rates, due to its cascading nature, the sales tax is translating into a significant burden on Kyrgyz Republic businesses and added around 1.9 percent of GDP to tax revenues in 2013. Given the distorting nature, the authorities are considering options to eventually phase it out.

[12] If resource rents are not re-invested into another form of wealth (physical, human or social capital) than the country is essentially dis-saving, resulting in a net wealth loss

Figure 13. Revenues as a share of GDP of low and lower middle income ECA countries

(Share of total revenues, in percent, average 2009-2011)



Sources: Kyrgyz Republic Ministry of Finance, Article IV IMF reports.

61. **Excises appear to be underutilized and could provide significantly more resources to the budget in the future**. In 2013, the Kyrgyz Republic collected 1.2 percent of GDP in the form of excises, largely reflecting both low rates as well as smaller the coverage of goods (for example vehicles are not covered in the Kyrgyz Republic). On average, countries in ECA collect around 3 percent of GDP in the form of excises, though countries in the immediate neighborhood do have much lower excise revenues. In addition to higher revenues, higher excises on tobacco and alcohol will also help reduce consumption of these products, positively contributing to health outcomes (see Policy Note on Health for more details). Increasing excises would be best tackled from a regional perspective, so as to prevent smuggling of goods across the region's porous borders.

62. **Despite having significantly lower tariff rates, the collection of customs duties in the Kyrgyz Republic has been high**. Customs revenues were 3.4 percent of GDP in 2013, up from 2 percent of GDP in 2010 and above the ECA average of 1.5 percent of GDP. However, comparisons are made more difficult by the prevalent use of the simplified customs procedures in the Kyrgyz Republic which levy a single charge in lieu of customs and VAT. The increase in customs collection in recent years is due to one-off factors such as re-exporting of Russian oil to Tajikistan in 2012, but also more systemic reforms, such as a move from weight-based duties to duties based on value for some goods as well as an increase in the duty per kilogram for others. The practice of calculating duties based on weight remains frequent.

63. **The customs duties burden for formal businesses may actually be relatively high, exacerbated by an inefficient trade facilitation infrastructure.** The Kyrgyz Republic, in essence, applies a dual regime for customs clearance of goods. The simplified customs regime applies only to individuals, though there is anecdotal evidence that businesses find loopholes and widely make use of this scheme (around 70 percent of all customs revenues are collected through the single custom duty). At the same time, the standard import regime faced by formal businesses that import goods is more costly. The applied weighted tariff rate of the Kyrgyz Republic calculated using trade data reported by the Kyrgyz Republic's trading partners (so-called "mirror statistics"), is actually closer to ten percent, compared to the applied weighted tariff rate of around 2.4 percent reported by the Kyrgyz officials. Interviews with businesses have confirmed that the regular import regime is complex (including requests for an excessive number of documents) and expensive, forcing companies to find loopholes and use the simplified system. This is also causing problems with

collection of other tax revenues, including VAT and income tax, as businesses cannot claim VAT refunds or deduct expenses to calculate profits. All of these issues reinforce the incentives for informality. From an investment attraction point of view, there may be room for a reduction in tariffs and removing the burden of customs procedures for businesses. Recent research suggests that the economic impact of trade facilitation improvements is significant; the authorities may be well advised to focus their attention on these measures (see section on tax administration).[13]

SOCIAL CONTRIBUTIONS

64. **Despite a low personal income tax, high social insurance contributions are keeping the tax burden on labor high**. Social insurance contributions are levied on formal labor income at the rate of 27.5 percent of the gross salary, which brings the total tax wedge on labor income (social insurance contributions and personal income tax) to around 32.5 percent of gross income. While social insurance contributions rates are not excessive compared to the average for the ECA region, they are high compared to low income countries in other regions. Social insurance contributions are split with employers covering ten percent and the employees being liable for the remaining 17.5 percent. Most of the funds, 25 percent of gross income, cover the pension insurance contributions of employees, a rate that is high when compared to the ECA average (around 22 percent) as well as the average for low income countries. The remaining 2.5 percent are earmarked for health insurance, which is not excessive when compared internationally. Social insurance is administered by the Social Insurance Fund.

65. **The high tax burden is encouraging informality and options for its reduction should be carefully considered**. Pension benefits are not generous and links between contributions and benefits are weak (see Pension Note for details). Health insurance is relatively easy to get, while the quality of service is poor and out-of-pocket payments large (see Health Policy Note for details). These factors are reducing incentives to contribute to the social insurance system and are encouraging informality. Finally, a weak tax and social insurance administration is facilitating this. A mix of measures to strengthen compliance and to improve the services citizens get from social insurances (including better linking pensions to contributions and better health care services) may open up the door for reductions in social insurance contribution rates.

TAX ADMINISTRATION

66. **Relatively complex tax administration creates a significant burden for formal businesses in the Kyrgyz Republic**. Tax regulations were the seventh biggest obstacle to doing business in the Kyrgyz Republic in 2013, just after tax rates (World Economic Forum, 2013). At the same time, the same source ranked the Kyrgyz Republic 131st (out of 148 countries) for the indicator "burden of customs procedures". This is due to relatively complicated compliance procedures, which penalizes those businesses in the formal sector, thus encouraging businesses to stay under the radar of the authorities in the informal economy. As a consequence, the tax base remains relatively narrow, with a small proportion of the formal economy contributing to government revenues. According to the 2014 Doing Business indicator, businesses need to pay taxes 51 times a year, compared to only 26 times a year in the ECA region.

[13] See for example the WEF's recent report: "The Global Enabling Trade Report 2012" which looks at the measures Costa Rica has put in place to improve the trading environment, and the impact they have had. The report also presents the findings from an OECD report, which estimates a 10 percent reduction in trading costs, in developed countries, should the WTO's proposals on Trade Facilitation be adopted. This reduction could be much higher in developing countries.

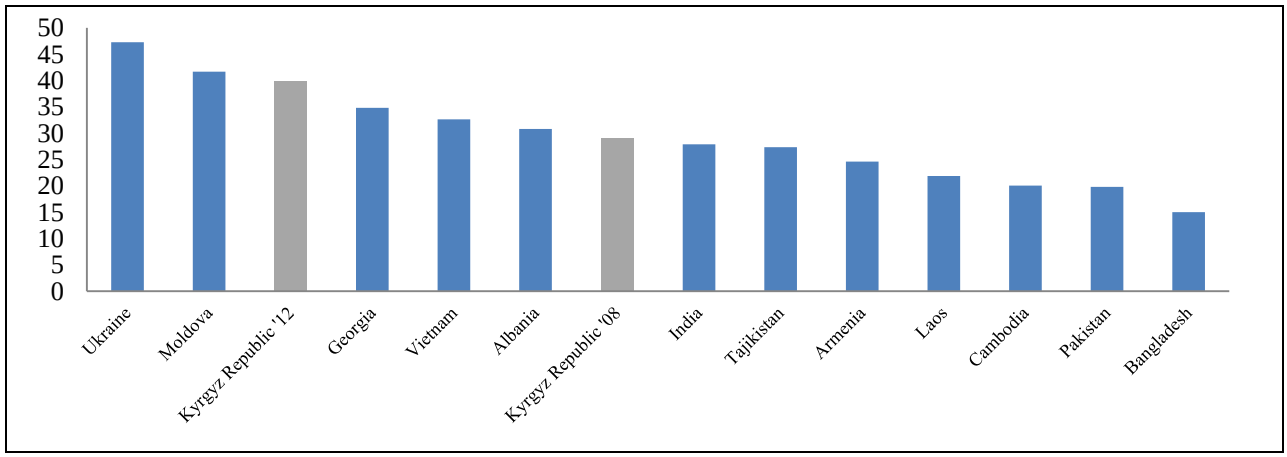
67. **The taxation compliance burden could potentially be reduced via tax administration reforms**. The full roll-out of e-filing of taxes could significantly improve tax administration, as well as allowing companies to file taxes quarterly rather than monthly.[14] As of 2014, all individuals will need to submit tax returns. In order to increase the likelihood of success of these reforms, the process will need to be simple. Synergies could potentially be achieved between the payment of personal income tax and social insurance contributions, (for example, by unifying income definitions) however, the process needs to be carefully managed taking into account the capacity of the agencies involved. Also, full introduction of a single window in dealing with the customs will also help improve tax administration.

6. Government Spending, Levels and Efficiency

68. **Ad hoc responses to various shocks have resulted in a rapid rise in expenditures during the last five years**. At close to 40 percent of GDP in 2012 and 37.4 percent in 2013, the expenditure to GDP ratio in the Kyrgyz Republic is high. The shocks of the past four years have eroded the fiscal space that had been built up in the mid-2000s. While most other low and lower middle income ECA countries (all bar Tajikistan) have cut spending following the fiscal stimulus programs adopted during the global financial crisis, expenditures in the Kyrgyz Republic have continued to rise (Figure 14), with one off stimuli becoming embedded in current spending.[15]

Figure 14. Expenditures as a share of GDP of selected low and lower middle income economies

(Percent of GDP)



Sources: IMF staff reports; using annual average expenditure to GDP ratios from 2009-2011.

69. **The composition of expenditures, however, is not supportive of growth.** Despite high overall expenditure levels, a number of sectors remain underfunded. Years of under-spending on maintenance and infrastructure have left a large maintenance backlog and depleted infrastructure in many sectors, which the authorities are trying to tackle now. For example, the quality of electricity supply is ranked 122nd (out of 148 countries) in the 2013-2014 Global Competitiveness report. Investment in modern equipment could improve the quality of services and may generate savings in the long-run, but will require significant outlays in the short term, as noted in the health and energy chapters of the programmatic public expenditure review. At the same time, outlays on

[14]Azerbaijan, for example, has provided accounting software to assist with the calculation of tax payments.

[15] While the fiscal stimulus was deemed necessary, its effectiveness has been mixed. Current spending levels have remained high, while poverty levels have increased.

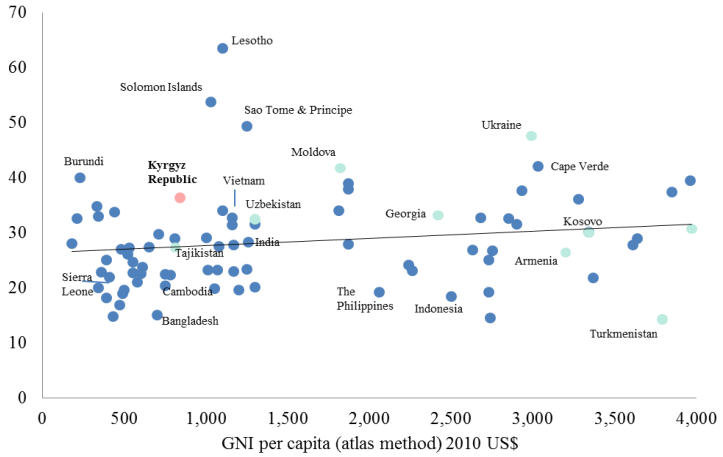
wages and social transfers are higher than regional averages, yet poverty levels increased between 2008 and 2012.

Box 5: Cross-country experiences on growth and government spending

Maintaining high levels of expenditure as a proportion of GDP is unusual in high growth countries. The 2008 Growth Commission report identifies 13 countries that have sustained high levels of growth (annual GDP growth of 7 percent or more for 25 years or longer) during the post war period.[1] Out of these countries, only the small states (Botswana, Malta, and Oman) have expenditures that have exceeded 40 percent of GDP since 1980 and perhaps reflect the high fixed costs and indivisibilities of providing public goods facing small populations (less than 1.5 million). [1] Notably, the countries that have transitioned all the way to high income status (Hong Kong, Japan, Korea, Malta, Singapore, and Taiwan) have much lower levels of expenditures (aside from Malta). Over the past thirty years, the Asian Tigers have spent closer to 20 or 30 percent of GDP on public services and capital expenditures.

Government expenditures of Low and lower middle income countries

(In percent, general government expenditure to GDP ratio)



Sources: World Development Indicators, IMF Government Financial Statistics, and ECA regional database. General government expenditure has been averaged over three years (2009-2011) to smooth out unusual spending patterns.

FUNCTIONAL CLASSIFICATION

70. **Social protection and social assistance spending account for nearly half of total expenditure growth since 2008.** In the immediate post conflict period, significant support was provided to affected households and businesses.[16] Some of these benefits, originally envisaged as one off payments, have become permanent fixtures in the budget. At the same time, former privileges have been monetized, categorical benefits have increased, additional support has been granted to certain groups affected by the increase in residential electricity tariffs (2009) and there has been a rapid increase in preferential early retirement. All these events have contributed to a rise in social fund expenditures from 5.0 percent in 2008 to 9.5 percent of GDP in 2012 and 2013. Inclusion of basic pensions and transfers from the Central Budget brings total social protection and assistance spending to 11.4 percent of GDP.[17]

[16] The government provided a one off payment of 1 million soms (equivalent to US$20,000) to families where an immediate member had been killed, and introduced an additional monthly benefit for those families affected by the violence e.g. those made disabled as a result of the violence.

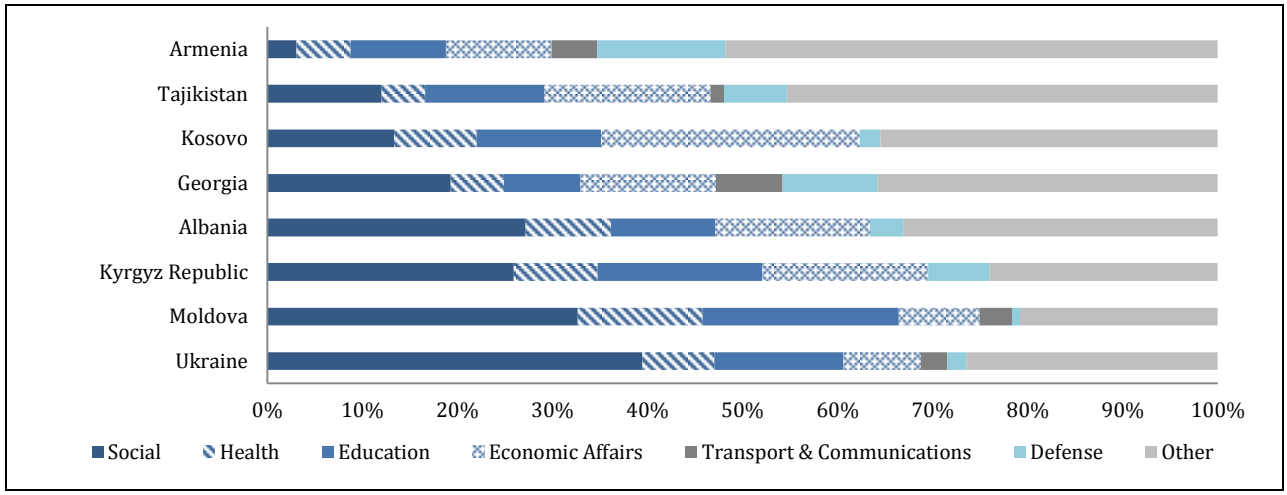
[17] Basic pensions used to be funded through the Social Fund.

71. **Budget spending on economic affairs has been continuously increasing over the last few years, following the launch of a number of, mainly foreign financed, infrastructure projects**. This brought expenditures on economic affairs to around 7.7 percent of GDP in 2012 and 7 percent in 2013, considerably above the ECA average of around 5 percent of GDP. Still, given the large infrastructure gap, the country will need to continue to invest significantly in this area while also allocating funding for maintenance of the existing capital stock.

72. **Health spending increased significantly, with wages accounting for most of the increase**. Spending on health increased by around 1.4 percentage points of GDP between 2008 and 2012 – the largest increase in health budgets in the ECA region. Even with this increase, health spending in the Kyrgyz Republic, at below 4 percent of GDP, remains below the regional average.

Figure 15. Functional classification of expenditures of low and lower middle income ECA economies

(Share of total expenditures)



Source: ECA Fiscal database, 2009-2011 average spending.

73. **The education budget saw a significant increase over the last few years and is now an outlier in ECA and globally**. Spending increased by 1.9 percentage points of GDP at a time when most countries in ECA were actually cutting spending.[18] Similarly to health, most of the budget increase was allocated to wages, however, with the recent increase the Kyrgyz Republic became an outlier in ECA on public spending on education. Averaging around 6-7 percent of GDP over the last few years, spending on education in the Kyrgyz Republic is substantially above the 4-5 percent of GDP observed in ECA (Figure 15).

ECONOMIC CLASSIFICATION

74. **Public sector wages increased from 6.5 percent of GDP in 2008, to 8.7 percent in 2012, accounting for almost a third of total expenditure growth (Figures 16 and 17).**[19] If special and health funds are included, public sector wages account for more than 12 percent of GDP. Wage increases are implemented on an ad hoc basis, with little, if any adjustment for inflation in the interim. For example, a wage freeze in 2013 reduced the wage-bill to 7.9 percent; while this helped reduce the deficit, it is not likely to be a sustainable policy going forward. Comparisons with other

[18] Spending increased from 5.1 percent of GDP in 2008 to 7.0 percent of GDP in 2012.

[19] Some health salaries are included in the goods and services budget line, which pushes the total wage bill up even further.

ECA and OECD countries suggest that the increase in the wage bill is not from new recruitment, rather it stems from salary increases. Nominal wages in the civil service, however, remain relatively low. A reform strategy would need to deliver higher and decompressed salaries within a tighter financing envelope.

Figure 16. Expenditures (2000 constant prices) 2008-2012

(Soms, millions 2000 prices)

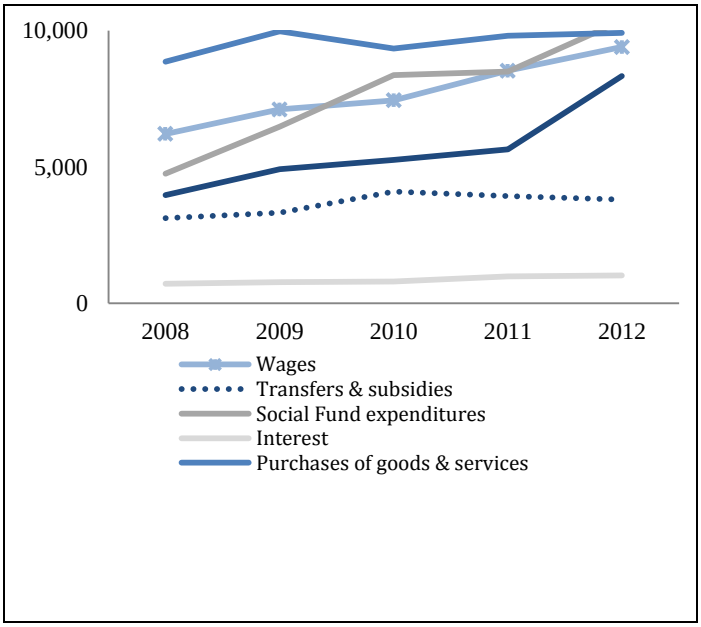
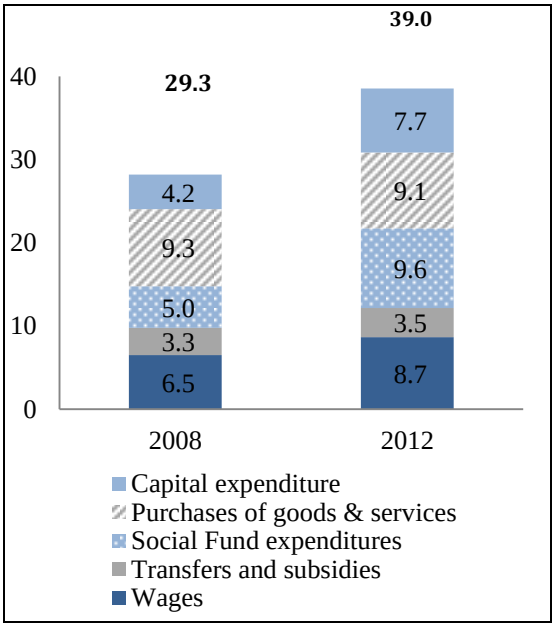


Figure 17. Expenditures as a share of GDP - 2008 and 2012

(Percent of GDP)



Source: Kyrgyz Republic Ministry of Finance.

75. **Reported expenditures on goods and services are very high at over 9 percent of GDP, the highest in the ECA region.** This has been a persistently high expenditure item since 2006, before which it was close to 6 percent of GDP, in line with the ECA average. However, a number of classification issues make comparisons difficult. For example, capital repairs are included under goods and services spending whereas some of these should probably be captured under capital spending. In addition, this category also includes the purchase of medical services under the output-based financing model, which are largely used to finance wages of health staff. Adjusting for these issues lowers the amount spent on genuine goods and services. Given the poor quality of services there is probably room for savings through improved procurement practices.

76. **In the medium term, pension expenditures are going to become increasingly difficult to manage without reform.** In 2011, half of social fund expenditures were channeled towards pensions and when government spending on pensions is included, total pension expenditure was 8.2 percent of GDP. While current spending in not excessive given the large coverage of the system, this figure is on a rising trajectory. The government's share in pension compensation has also risen from around 5 percent in 2007 to 17 percent in 2011, owing to a shift in basic pension financing. This, coupled with a falling replacement ratio, means pension spending could be as high as 10 percent of GDP in 15 years.

77. **Capital expenditures have only recently reached levels observed in other countries in the ECA region (Figure 19).** At 5.9 percent of GDP over the last four years, capital expenditures are above levels registered earlier (4.5 percent of GDP during 2005-2009) but still relatively low

compared to the levels seen in the high growth Asian economies, which averaged around 5-7 percent, or higher and over a longer period of time in China, Vietnam and Thailand.[20] Moreover, capital expenditures are often the first expenditure item to be cut when revenues fall short. As a low income country, the Kyrgyz Republic has a number of infrastructure gaps, exacerbated by the turmoil in 2010, but also by continual cuts and delays to capital spending. The Public Investment Program (PIP) covers the majority of the Kyrgyz Republic's capital spend, although it is unclear what this covers. The Kyrgyz Republic authorities classify PIP as current expenditures, and include this in the budget as a single line item, rather than providing a breakdown of projects (Figure 20). The Policy Note on Public Investment Management (PIM) estimates that around 15 percent of the PIP are current expenditures (e.g. capacity building). In addition domestic spending on capital has fallen to less than 3 percent in 2012, from almost 11 percent in 2007.

Figure 18. Capital spending of low and lower middle income ECA countries

(Percent of GDP)

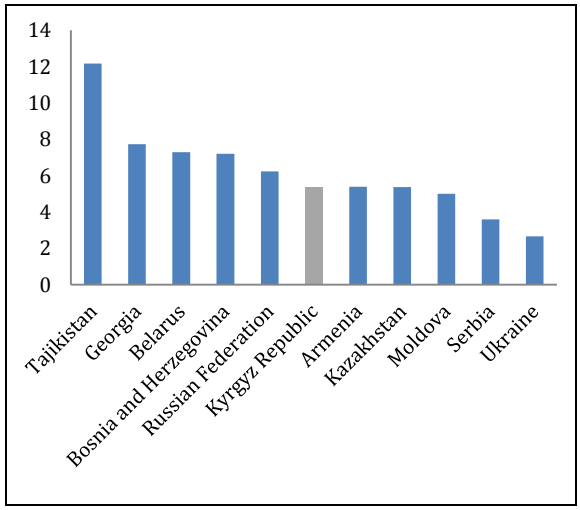
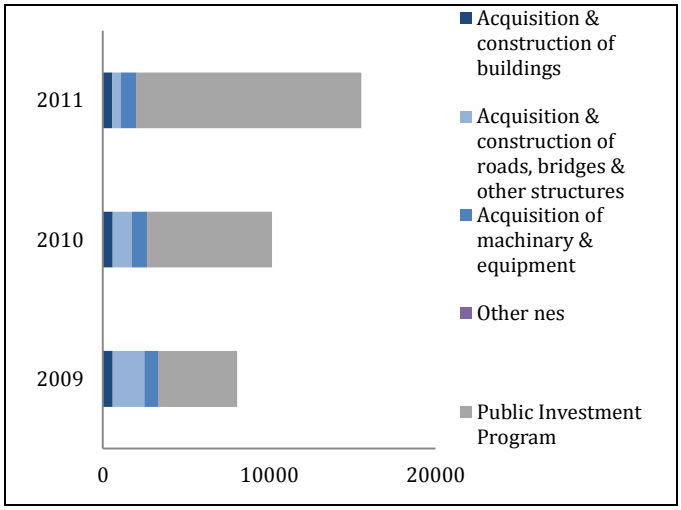


Figure 19. Disaggregated capital spending in the Kyrgyz Republic

(Millions soms - 2011 prices)



Sources: Kyrgyz Republic Ministry of Finance and IMF Staff reports.

78. **A strong PIM system would help the Kyrgyz Republic authorities ensure capital expenditures are efficiently spent, and prioritized, especially when resources are limited.** Responsibility for managing the PIP is spread across three institutions, complicating management of public investment. The Policy Note on PIM found that the PIP lacks proper prioritization of projects; monitoring is weak; data for appraisals and evaluation is limited; and linkages among sector strategies are almost non-existent.

79. **Clarifying roles and responsibilities, and expediting the implementation of a project database are two areas that would greatly increase effectiveness of public investment.** Other areas the Kyrgyz Republic may want to consider strengthening are public procurement; training in project appraisal, management and implementation; and data collection of on-going projects that covers physical as well as financial progress. International partners have a role to play in enhancing the Kyrgyz Republic's PIM by ensuring local staffs are an integral part of any project design, appraisal and evaluation.

[20] The Growth Commission (2008) identifies investment in public infrastructure as an important component of high growth economies (p.35).

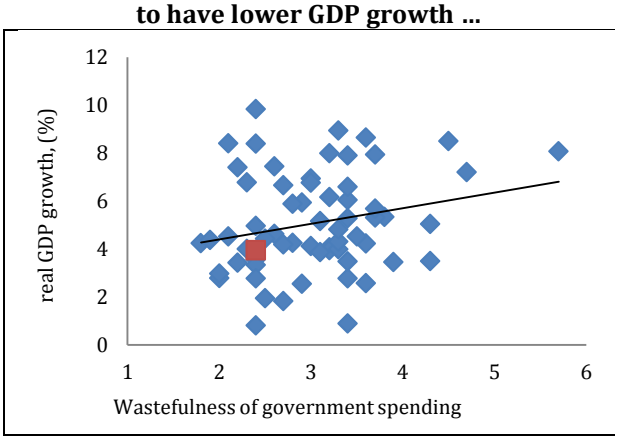
EFFICIENCY OF FISCAL POLICY

80. **While the debate on the size of the public sector may be inconclusive, there is a relatively robust relation between efficiency of fiscal policy and economic outcomes.** Simple correlations for a set of low and low-middle income countries, while not confirming causality, do indicate a link between "wastefulness of government spending" on one hand and GDP growth and its volatility on the other. Somewhat weaker links appears to also exist between "wastefulness of government spending", and inflation and investments levels (Figures 21-24). The Kyrgyz Republic appears to fit this pattern, with low efficiency in spending, modest and volatile growth, high inflation and low investments.

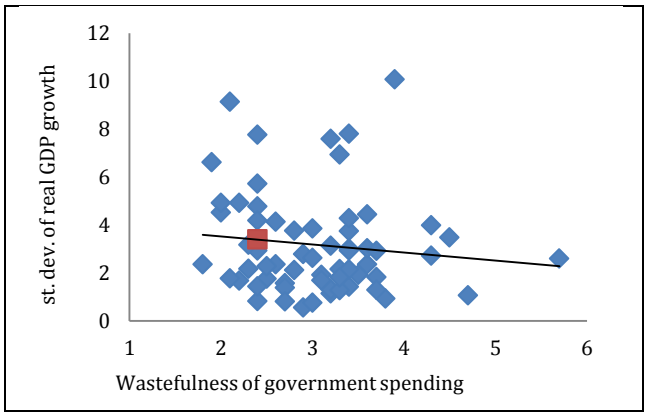
Figure 20. Wastefulness of government spending and selected economic indicators

(In percent)

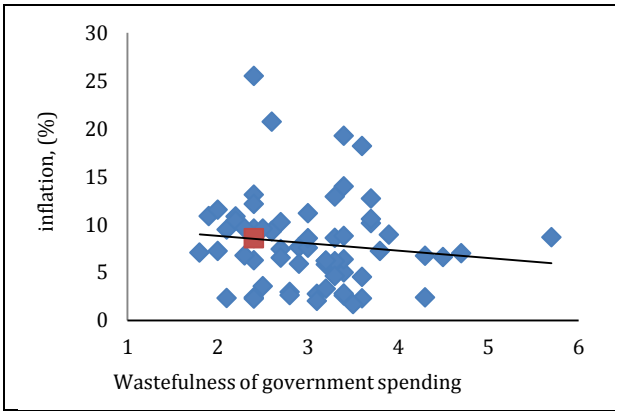
Countries with inefficient public spending tend to have lower GDP growth ...



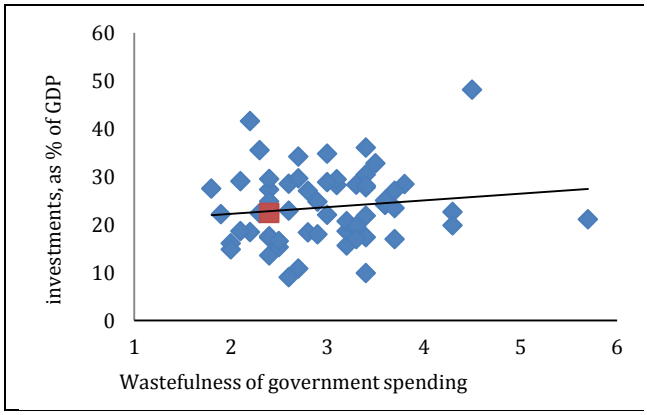
... larger fluctuations in growth patterns ...



... higher inflation ...



... and lower investment levels.



Source: Staff calculations based on WDI and WEF GCR data.
Note: Wastefulness of government spending is ranked from 1 (wasteful) to 6 (highly efficient).

81. **The Kyrgyz Republic has a large public sector with low levels of operational efficiency.** A composite index taking into account developments in education, health, infrastructure and institutions, ranks the Kyrgyz Republic in the lower half of the distribution of a group of low and lower middle income countries and ECA comparators (Table 4).

82. **One of the main findings from the PER is that social protection measures need to be better targeted towards the poor**. The Kyrgyz Republic has numerous "rights-based" categorical benefits based on various criteria, not necessarily linked to poverty. The World Bank supported the government under the Economic Recovery Support Operation (ERSO) to reduce these benefits from 35 to 25, however, progress seems to have stalled. There is only one benefit that is targeted to poor families, and this represents the smallest share of social benefits. Reducing spending on "rights-based" compensations and shifting some of these savings to the poor would help consolidate expenditures while simultaneously improving poverty outcomes.

Table 4. Measures of efficiency in government outcomes

(Rank)

	Education Country		Health Country		Infrastructure Country		Institutions Country		Overall Country
1	Ukraine	1	Czech Rep.	1	Slovenia	1	Rwanda	1	Slovenia
2	Slovenia	2	Slovenia	2	Malaysia	2	Estonia	2	Estonia
3	Malaysia	3	Estonia	3	Croatia	3	Malaysia	3	Malaysia
4	Poland	4	Slovak Rep.	4	Turkey	4	Bhutan	4	Turkey
5	Slovak Rep.	5	Poland	5	Estonia	5	Morocco	5	Croatia
…		…		…		…		…	
45	Nepal	35	Kazakhstan	64	Lesotho	74	El Salvador	55	Senegal
46	Uganda	36	Morocco	65	Liberia	75	Paraguay	56	Tanzania
47	Kyrgyz Rep.	37	Kyrgyz Rep.	66	Kyrgyz Rep.	76	Kyrgyz Rep.	57	Kyrgyz Rep.
48	Azerbaijan	38	Indonesia	67	Pakistan	77	Mali	58	Timor-Leste
49	Bolivia	39	Mongolia	68	Tanzania	78	Yemen	59	Kenya
…		…		…		…		…	
79	Angola	79	Lesotho	79	Angola	79	Guinea	79	Chad
80	Chad	80	Sierra Leone	80	Madagascar	80	Chad	80	Angola

Source: Staff calculations based on data from WDI, WEF, DB.

83. **Education outcomes are low and overall perception of the education sector is poor.** While access appears adequate and spending is very high (although with considerable variations), Kyrgyz students' scores on international assessments are very low, and businesses rank the quality of the education sector as very poor. More than 80 percent of 15 year olds in the Kyrgyz Republic score below level two in the Program for International Student Assessment (PISA) reading test i.e. are classed as functionally illiterate. In addition, the Kyrgyz Republic ranks 113th (out of 148 countries) on the quality of primary education indicator of the 2013-2014 WEF Global Competitiveness Report (WEF GCR).

84. **Health service coverage is satisfactory but popular dissatisfaction with the quality of healthcare is high.** Life expectancy is generally higher than countries with similar levels of income (hence the relatively high ranking in Table 4), though they still lag the more advanced transition economies. Increasing budgets in recent years have not translated into improved outcomes.

85. **The Kyrgyz Republic's public sector does not provide quality infrastructure.** Outlays on infrastructure have increased in recent years. Still, the legacy of underinvestment is significant with a number of sectors facing a depleted infrastructure stock. The Kyrgyz Republic is ranked 108th (out of 148 countries) for the quality of overall infrastructure indicator of the 2013-2014 WEF GCR with the quality of road and electricity ranked 133rd and 122nd, respectively. As the PER Energy sector note shows, low tariffs have limited the ability of energy companies to invest in infrastructure, leading to increased disruptions of supply.

86. **The performance of institutions is the weakest link for the Kyrgyz Republic**. The biggest impediment to economic activity in the Kyrgyz Republic (as reported by businesses) is the inefficient functioning of institutions. Corruption, government instability, policy instability and inefficient government bureaucracy are four of the five most problematic factors for doing business in the Kyrgyz Republic (2013-2014 WEF GCR). Encouragingly, while the country scores poorly in on key governance indicators, it has made modest, but more importantly continuous, gains in several Worldwide Governance Indicators (WGI), including voice and accountability, rule of law, and control of corruption.

7. Public Debt Sustainability

87. **Risks to public debt sustainability are moderate, but depend critically on fiscal consolidation going forward as well as concessionality of new borrowing.** Public debt amounted to slightly above 50 percent of GDP at the end of 2012. Most of it is concessional resulting in a present value of around 37 percent of GDP. Under the baseline scenario (strong growth and fiscal consolidation), public debt is projected to fall to 45 percent of GDP by 2018. However, preserving the current fiscal policy results in unsustainable public debt dynamics.

88. **Rising expenditures have adversely impacted debt indicators.** Public debt to GDP was over 100 percent during 2000-2003. A combination of improved revenue collection, a favorable adjustment to the exchange rate, and debt write-offs as a result of the 2005 Paris Club negotiations, helped bring this level down to 48 percent in 2008. However, rising expenditures and the collapse in growth brought total public debt close to 60 percent of GDP in 2010 (Figure 25). Some recovery in output as well as debt write-offs stabilized the public debt ratio to around 50 percent of GDP recently.

Figure 21. Public debt to GDP and debt service indicators, 2000-2012

(Percent of GDP and debt service ratios)

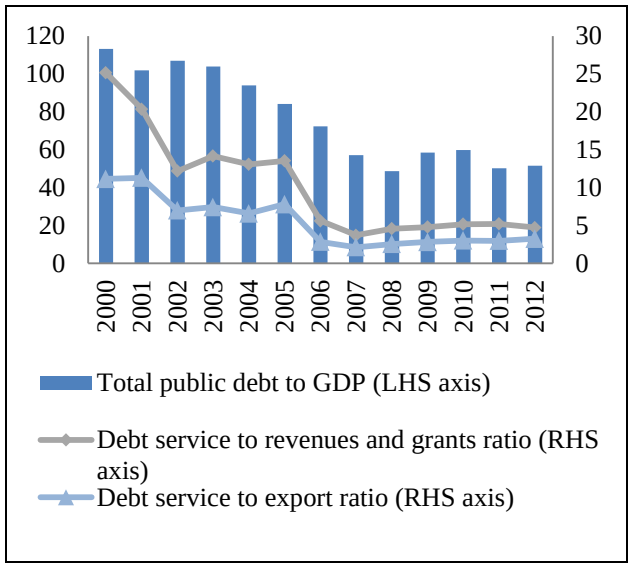
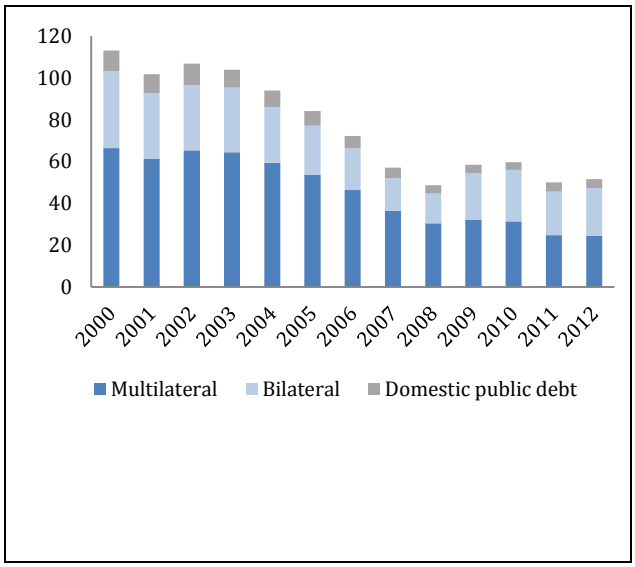


Figure 22. Decomposition of debt as a share of GDP

(Percent of GDP)

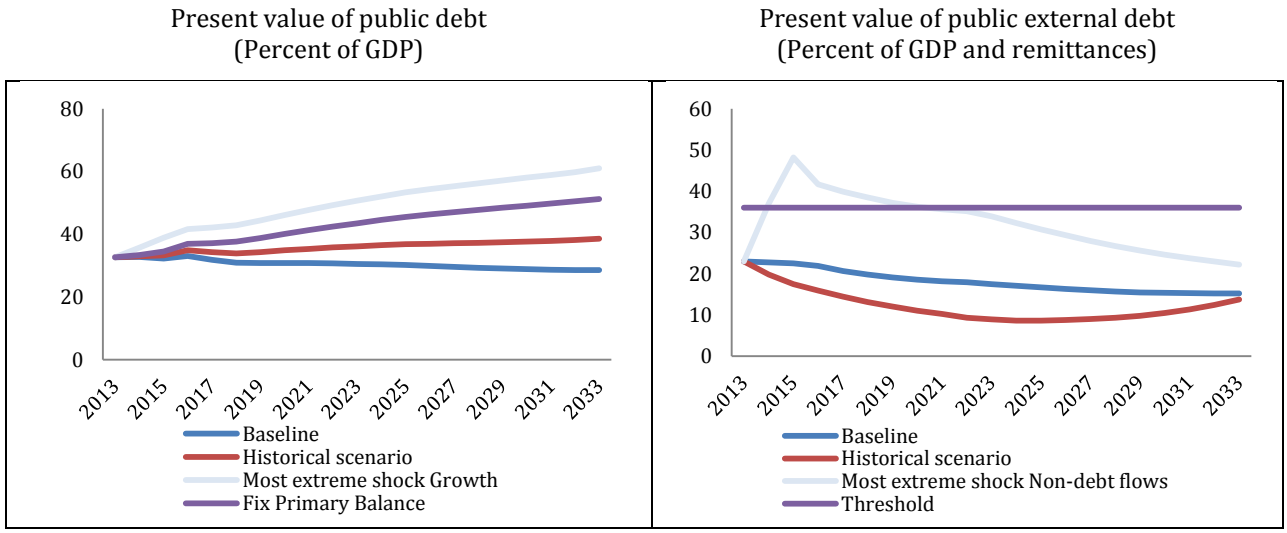


Source: Bank-Fund calculations.

89. **Most of the Kyrgyz Republic's debt is held in foreign currency, divided almost equally between multilateral and bilateral donors.** External debt is overwhelmingly concessional (over 90 percent), with low interest rates and favorable grace periods. The IMF, the ADB and the World Bank are the country's main multilateral donors, with Russia, Japan, China and Turkey forging strong bilateral lending relationships (Figure 22). Having such a high reliance on foreign currency debt is not unusual in a low income country, where domestic markets are not fully developed. A skewed, rather than a diversified debt portfolio does however pose a threat to debt management. A large terms-of-trade shock could for example lead to a depreciation of the real effective exchange rate (REER), increasing the levels of debt service and thus overall expenditures. Strengthening of the financial sector should help the Kyrgyz Republic slowly shift towards longer-term, fixed-rate, domestic-currency denominated securities. Until such time, prudent monetary policy to keep the REER in check is essential to alleviate the risks from the current debt portfolio.

90. **The 2013 debt sustainability analysis (DSA) update confirmed that the country is at moderate risk of debt distress**. Under the baseline scenario, public debt is on a downward trajectory with the present value (PV) of debt projected to decline from 33 percent of GDP in 2013 to 31 percent in 2018. Failure to consolidate fiscal accounts will test fiscal sustainability. External debt burden indicators are below indicative thresholds for countries with large remittances, like the Kyrgyz Republic. External debt is vulnerable to extreme shocks such as significantly lower non-debt flows (FDI or transfers). Steady growth of remittances and maintaining a prudent borrowing strategy is essential to mitigate risks and to keep the debt outlook sustainable.

Figure 23. External debt burden indicators



Source: Bank-Fund 2013 DSA update.

8. Conclusions

91. **The current reactive approach to fiscal policy needs to be replaced with a proactive stance on fiscal consolidation.** The past five years have been very difficult for the Kyrgyz Republic, with one shock following another. Fiscal space accumulated in the mid-2000s has been used to offset the consequences of the global financial crisis, political disturbances and social unrest, and fluctuations in the country's main driver of growth – gold mining. This leaves the country in a vulnerable position should another shock materialize. Furthermore, securing concessional financing for a large fiscal deficit is likely to become more difficult going forward. To get back on a sustainable footing, the government needs to build up resources, reduce the fiscal deficit, and maintain debt levels.

92. **This PER makes a number of recommendations that could help reduce spending, while at the same time improve the quality of public expenditures**. Fiscal consolidation does not need to be associated with lower welfare and outcomes. Indeed, this PER highlights a number of areas where more focused spending could lead to better outcomes in education, health, energy and social protection. Improvements in these sectors could also help with overall governance and transparency, two key areas for the government as highlighted in their recent National Sustainable Development Strategy (2013-2017).

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