

Kyrgyz Republic: Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

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KYRGYZ REPUBLIC

**Joint Staff Advisory Note on the Poverty Reduction Strategy Paper
(Medium-Term Development Program) 2012–14**

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and the International Development Association (IDA)

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I. OVERVIEW

- 1. The Joint Staff Advisory Note (JSAN) reviews the authorities' Medium-Term Development Program (MTDP), which covers the period from 2012 to 2014.** The MTDP was approved by the previous cabinet on April 12, 2012 and subsequently submitted to the International Development Association (IDA) and the International Monetary Fund (IMF). The new cabinet, which was approved by the parliament on September 5, 2012, endorses the MTDP and intends to update it as part of the Annual Progress Report.
- 2. The main focus of the authorities' comprehensive medium-term strategy is to raise living standards and reduce poverty.** These goals are to be achieved through high economic growth, improvements in the business environment and strengthening governance. The three-year strategy aims at: (i) achieving macroeconomic stability; (ii) consolidating public finances; (iii) reforming public financial management; (iv) improving access to finance; (v) strengthening the investment climate; (vi) managing public assets efficiently; and (vii) promoting employment.
- 3. Staffs of the Fund and IDA support the thrust of the strategy and its measures to promote economic development.** The MTDP recognizes the challenges associated with the transition to a parliamentary democracy following the political unrest and ethnic tensions in 2010. Moreover, the government has to grapple with the impact of the global economic crisis and with the post-Soviet legacy of economic mismanagement and limited reforms, which left the economy uncompetitive, living standards low and political stability elusive. The government therefore considers governance reform a top priority.

II. POVERTY TRENDS AND DIAGNOSIS

4. **Poverty reduction is recognized as one of the main goals of the government's MTDP to be achieved through economic growth, improvement in the business environment and development of an efficient system of governance.** The information presented on aggregate poverty rates and trends provides a useful overview of poverty dynamics in the urban and rural areas in the last few years as well as of access to public utilities. The incidence of poverty increased between 2009 and 2011 after a substantial reduction during 2006–08 associated with steady growth in GDP and in remittances. The share of population living below the poverty line which had fallen from 61 percent in 2006 to 32 in 2008 increased by 5 percentage points, reaching 36.8 percent in 2011. Given this increasing trend, the strategy would benefit from presenting a clearer link between its policies and economic growth to poverty reduction objectives that it intends to pursue. In particular, an analysis of the impact of the strategy on different income groups would improve the significance of the MTDP.

5. **The success of the development plan will critically depend upon how the poor are impacted by the actions or policies and whether they benefit compared to other income groups in the society.** Staffs advise the authorities to analyze the impact of the proposed sectoral policies, investment projects, and public expenditures on different groups and poverty/welfare of the households in an inclusive manner. This type of analysis would enrich the MTDP and allow the prioritization of policies and budget.

6. **The staffs encourage authorities to utilize the richness of the household budget surveys conducted by National Statistics Committee on an annual basis to identify the main determinants of the poverty trends in the country.** The Kyrgyz Republic has a good quality annual household survey that can be used to inform the government's policy choices. The authorities would need to take a closer look at the linkages between economic growth, policy actions, and poverty outcomes. In particular, an analysis of spatial/geographic and demographic variations in poverty, including data disaggregated by gender, would be useful. This will allow for identification of some of the main structural constraints to poverty reduction and economic growth, such that all vulnerable groups are included. The household survey also provides a valuable tool for monitoring progress and to determine whether growth benefits all sections of society.

III. MACROECONOMIC FRAMEWORK AND POLICIES

7. **The MTDP focuses on accelerating economic growth, consolidating macroeconomic stability, and advancing structural reforms.** It recognizes that improving the business environment to attract private investment, reforming the public sector, strengthening the financial system, and addressing infrastructure development needs are essential for maintaining high growth rates and thereby reducing poverty. The macroeconomic objectives for 2012–14 set in the authorities' scenario aim at: (i) raising

average annual real economic growth to 7.5 percent; (ii) containing inflation to single digits; (iii) halving the overall budget deficit by 2014; and (iv) maintaining foreign reserves at about 4 months of imports.

8. **The authorities' targets for real GDP growth are ambitious.** Growth projections exceed historical levels (4 percent on average over the last ten years) and projections under the IMF-supported ECF arrangement (about 5 percent on average in 2012–14) by a wide margin. High economic growth is largely based on the assumption of strong inflows of foreign direct investment, which would raise private investment to about 29 percent of GDP by 2014 from 22 percent in 2011. In staffs' view, projections on private investment should reflect more conservative assumptions. The fragile external environment, which could affect the main economic partners of the Kyrgyz Republic, also represents substantial risks which are not reflected in the MTDP. Staffs commend the authorities for their commitment to prepare contingency measures and would welcome an analysis of risks and these measures in the annual progress reports.

9. **The MTDP recognizes that fiscal consolidation is key for maintaining macroeconomic stability.** Fiscal policy aims at halving the overall fiscal deficit by end-2014 through revenue and expenditure measures. On the revenue side, the MTDP focuses on broadening the tax base and further improving tax and customs administration, including simplifying the tax structure and rationalizing tax exemptions. Moreover, the authorities will introduce a risk-based approach to audit to improve the efficiency of tax collections and lower the administrative burden of the tax system. The MTDP also projects a substantial decline of expenditures (relative to GDP) by end-2014, based on the following measures that would improve the efficiency of spending: (i) strengthening budget planning; and (ii) stepping up monitoring and increasing transparency of government operations, including by modernizing the treasury and reforming public procurement. While sizable wage and pension increases in 2011 were critical for reducing poverty and preserving social stability, they are permanent in nature and therefore have reduced flexibility for accelerated fiscal adjustment. Staffs note that the MTDP falls short of presenting specific revenue and expenditure measures as well as a more detailed description of current and capital expenditure that are essential in addressing the medium term consolidation plan and the longer term fiscal sustainability.

10. **Maintaining debt sustainability is among the key objectives under the MTDP.** The MTDP's measures to strengthen debt sustainability include ensuring high concessionality of new external borrowing and increasing the share of domestic debt with a view to developing the domestic debt market and diversifying financing. These measures are detailed in the recently developed medium-term debt management strategy. Staffs welcome the authorities' pursuit of sound debt management principles but encourage the government to also focus on the main risks affecting the debt outlook. Staffs underscore the need for an assessment of feasibility of the domestic and external financing program of the government's strategy.

11. **The link between the medium-term budget and costing of the national projects presented in the MTDP is absent.** The MTDP contains a list of 40 national infrastructure projects with a total estimated cost of about US\$6.5 billion, which is assumed to be financed by private investment. Staffs note that while some of these projects could indeed be implemented with private sector participation, the majority will require public sector financing. However, mobilizing such large funding will neither be feasible nor consistent with fiscal and debt sustainability. Despite advantages, public-private partnerships pose significant fiscal risks. Progress reports will need to provide more detailed and realistic costing and financing of the MTDP.

12. **Staffs note that monetary and exchange rate policies are consistent with macroeconomic objectives.** The National Bank of the Kyrgyz Republic (NBKR) is committed to maintain inflation in single digits by keeping the growth of monetary aggregates under control. Staffs recognize that in the event of unanticipated upward pressures in international food and fuel prices, achieving inflation targets may be challenging, but encourage the authorities to continue to avoid administrative measures. Full pass-through of foreign prices and a strong fiscal and monetary stance continue to be the most effective measures to achieve moderate inflation and maintain undistorted and efficient markets. Staffs welcome the authorities' commitment to continue a flexible exchange rate policy which will help absorb potential external shocks while protecting international competitiveness.

13. **The authorities' efforts to strengthen its regulatory and banking supervision functions are welcome.** The MTDP envisages the following measures that will address vulnerabilities in the financial sector: (i) resolving Zalkar bank; (ii) preparing a new Banking Code that will consolidate and streamline all laws regulating financial sector activities and put in place an effective bank resolution framework; and (iii) developing a privatization strategy for the state-owned SSC bank. These reforms are supported by the ECF arrangement and will help restore confidence and credibility in the financial sector and reduce government intervention in the allocation of credit. Staffs emphasize that any initiatives should be thoroughly analyzed before being implemented to not undermine financial stability and intermediation. Staffs also note that efforts to increase the operational independence of the NBKR will be critical in this regard.

14. **The MTDP considers establishing a state development bank (SDB) to accelerate economic development.** Staffs stress that the SDB's set-up and its operations will need to be in line with the principles of good governance and transparency. Staffs note that effective implementation of reforms that would encourage economic diversification are essential for boosting longer-term growth prospects and reducing poverty.

IV. STRATEGIC OBJECTIVES AND IMPLEMENTATION

15. **The MTDP places an important emphasis on developing the conflict-affected south.** This requires extending the participation of civil society in governance and ensuring equal access for representation for ethnic groups in political, economic and public life. The MTDP refers to the Concept of Ethnical Policy and Consolidation of the Society of the

Kyrgyz Republic until 2015, approved by the Decree of the President. It would benefit from defining specific measures and mechanisms to attain these important objectives, including engaging civil society organizations to enhance governance.

16. Staffs commend the authorities' commitment to improving governance and strengthening transparency and accountability in the public sector. The decree on the national anticorruption strategy was signed by the president in February 2012 and the anticorruption action plan for 2012–14 was approved in May 2012. In addition, a new anticorruption law was passed in August, 2012. Recent progress towards formulating an anti-corruption program and developing a supporting monitoring and evaluation system has been encouraging. This is an effort coordinated between various government ministries, state agencies, and the president's administration towards developing an institutional framework to address anti-corruption reforms through a prioritized action plan. However, the expectation that better governance can be achieved swiftly warrants some caution as reforms in these areas often face resistance and there is an inevitable lag in perceivable results. The staffs welcome the strong and consistent push for good governance throughout the MTDP as an essential element of the longer term development objectives of the Kyrgyz Republic.

17. Streamlining functions of the state bodies and eliminating duplication and overlap would greatly enhance the efficiency of public institutions. This would help reduce the excessive interactions with the public, which in the past has led to bribery and corruption. While moving to a career-based system with competitive selection only at entry-point appears to be the focus of the civil service reform in the MTDP, a more consistent and balanced approach to improve opportunities for internal career progression through revising the grading system, undertaking jobs evaluation and linking job to salary levels would be more appropriate in enhancing competence and professionalism of the public servants. This balanced approach is more in line with the draft strategy on civil service pay and grading reform developed by the State Personnel Services currently under discussion. This strategy addresses critical issues and proposes a clear reform plan, based on consultations with key policy makers on civil service and civil service pay. The staffs would encourage the adoption of such strategy.

18. The MTDP recognizes the importance of public financial management (PFM) reforms, including public procurement in strengthening accountability and transparency in the public sector but measures are incomplete. PFM reforms in the areas of budget planning and preparation, expenditure control and treasury management, accounting/fiscal reporting, auditing, and development and implementation of financial management information systems are critical to improve governance and increase efficiency in the use of scarce budget resources. The independence of the Public Procurement Methodology Department (PPMD) currently in the MOF, establishing a separate and independent complaint handling unit currently within PPMD, increasing transparency in the procurement system through adequate reporting on the use of state funds, building procurement capacity within public and private sectors, and strengthening the role of civil society in the oversight and monitoring of public procurement are key elements of public procurement reform.

19. **Staffs are encouraged by the prominence of the energy sector in the MTDP as one of the most important economic priorities.** The strategy gives a comprehensive analysis of the sector. Staffs note that the MTDP would benefit from clarifying the hierarchy of goals and objectives while indicating the timeline and prioritizing measures and objectives. Staffs also note that financial viability of the sector and the need for tariff adjustments could be reflected more prominently. Given poor investment and maintenance levels and low tariffs, improving financial viability by lowering companies' costs, as the MTDP envisages, will be difficult to achieve.

20. **The strategy rightly points that the tariff reforms would only be possible if improvements in social protection are implemented and proper targeting is developed.** However, the social protection section of the strategy is silent on this aspect and staffs advise that annual progress reports provide an analysis in this area. Another fundamental aspect of the sector, where the staffs believe not sufficient analysis has been carried out, relates to transparency issues, and more specifically, transparency of power flows. Staffs note that the MTDP would benefit from highlighting the earlier efforts by the government in adopting transparency initiatives.

21. **The MTDP recognizes the importance of a dynamic and competitive private sector as the main driver of growth.** Staffs welcome policies and structural reforms aimed at revitalizing the business environment and creating conditions that are conducive to private sector investment. The recently established Private Sector Development (PSD) Working Group has developed the PSD strategy roadmap and the short term action plan and aims at preparing the PSD strategy and the medium/long term action plans within a year. Other recent steps to promote the private sector include the enactment of the Public Private Partnership (PPP) Law and a number of amendments to the laws, codes and by-laws to facilitate implementation of the PPP law, a new automated system for business registration in the Ministry of Justice, and amendments to the law on inspection and introduction of risk based inspections.

22. **However, some reforms remain incomplete.** For example, in the potentially important sector of mining, recent legislative changes have fallen short of standards necessary to attract investors, particularly at the exploration stage. Staffs note that the MTDP would benefit from a broader approach and vision to ensure that the recommended measures do not appear random and ad hoc in nature. Prioritizing reforms and monitoring their implementation, while providing adequate policy solutions to address the gaps between laws and their implementation would also strengthen the MTDP.

23. **Strengthening public asset management is also a key objective under the MTDP.** The government's efforts—supported by the ECF arrangement—to better monitor state-owned enterprises have helped increase nontax revenues from dividends. Further steps in this direction, including tightening the qualification criteria for managers of state-owned companies and their supervisors and ensuring a robust financial reporting framework on their

activities, will help increase operational efficiency and profitability. Revamping regulations governing privatization in line with best international practices, and increasing transparency is also a priority to end past corrupt practices.

24. **The MTDP rightly points out the two key problems in social protection.** These are weak targeting of social assistance and its poor adequacy and the high level of institutionalization in the area of social care. The set of measures identified need to: (i) prioritize poverty-targeted social benefits (monthly benefit for poor families with children—MBPF) over categorical ones; (ii) shift to a flat rate benefit in MBPF away from the current model of the benefit as the gap between per capita income and the Guaranteed Minimal Income (GMI) level; and (iii) reform the system of financing of social services to shift from the current budgeting focused on residential institutions to case- and result-based financing.

25. **The government strategy makes a number of proposals regarding the pension system, which taken individually seem sensible.** However, as the strategy itself notes, the goals are both the fiscal sustainability of the pension system and adequacy of pension benefits. The main proposed measures include coverage expansion, raising contributions paid by farmers and self-employed, improvement of indexation mechanism for individual account balances in the notional defined contribution (NDC) pillar, reduction of pension supplements for privileged groups, improvement of collection of contributions and pension fund asset management. The MTDP would benefit from a comprehensive analysis of the entire pension system, looking at the basic component, the notional accounts component, and the funded component together to see whether the system as a whole provides both adequacy of benefits and fiscal sustainability as well as old age security. This comprehensive analysis should include whether all three components in fact add value to the overall goals of the pension system.

26. **Staffs recognize the significant improvement in the approved strategy in terms of key priorities and reforms in pre-school, school education, vocational education, and training and higher education.** To facilitate effective implementation of the strategy, the document could benefit from further elaboration and clarity in several areas: (i) strengthening the sector capacity (technical staff) and system (Education Management Information System) for education statistical reporting, analysis, monitoring, measurement, and evaluation of results—this is crucial for the success of governance and financing reforms as well as for measuring and reporting results; (ii) textbook policy and provision is a key element for improved learning to support implementation of the modernized curriculum and content, and currently the government lacks and needs a sustainable textbook financing system which needs to be part of the strategy; and (iii) there seems to be a 40 percent gap in the attached budget allocation for education for 2012–14 compared to actual needs which needs to be revisited and or clarified. Additionally, elaboration of the strategy to improve teacher training, ensuring affordability and alternative provision and the PPP for pre-school education should bring clarity on its targets and activities.

27. **The staffs are encouraged that the health sector is featured prominently in the MDTP.** Given that the burden on the population and the health sector has shifted from communicable to non-communicable diseases, it would be essential to revisit co-payments and provide incentives for both providers and patients who comply with preventive services and control their chronic diseases. Market mechanisms envisaged in the MDTP 2012–14 need to be designed with care. The scheme planned will result in an adverse selection of the lower risk population into private providers, and lead to greater public burden in the public sector. It is mentioned that infrastructure is deteriorating and is in very poor condition. Despite achievements in rationalization of the oversized hospital network there is still large space for gaining efficiencies and renewing infrastructure.

V. PARTICIPATION, MONITORING, AND EVALUATION

28. **The authorities are encouraged to broaden the consultative process in further elaboration and monitoring of the MTDP.** This is the first strategy document developed with participation of a broad political spectrum that was represented in the coalition governments. The consultative process included the development partners but not civil society. The MTDP implementation, however, envisages full participation of all stakeholders under the general coordination of the prime minister. A recently introduced initiative that involves participation of civil society in anti-corruption efforts is expected to improve the effectiveness of law enforcement bodies to ensure public order and crime prevention. Staffs strongly believe that the consultation process needs to encompass much broader areas of the MTDP. In particular, the annual progress reports would need to be undertaken through a consultation process with various stakeholders and civil society to ensure the stated reforms are supported and owned by the country as a whole. Similarly, dissemination and communication of reforms to the broader public would need to be reflected in the strategy. The communication strategy with the public is a welcome step in this area.

29. **Regular monitoring and evaluation of the program's implementation is underscored in the strategy.** These are yet to be developed specifically to measure both interim results, final results towards achievement of goals and objectives, and national indicators reflecting broad macroeconomic performance including the MDGs. Staffs believe that given the institutional capacity in the country, significant coordinating support from within the government and donor community is required to carry out the design and development of a regular monitoring and evaluation system. The monitoring department of the president's office is leading the effort in building a regular monitoring and evaluation system. The staffs recommend that a review of the previous national strategies (and the JSANs) and recognition of the shortcomings and challenges in their implementation could provide useful lessons for the implementation of the MTDP.

VI. CONCLUSIONS, RISKS, AND ISSUES FOR DISCUSSION

30. **Staffs welcome the preparation of the MTDP, which is an important tool for poverty reduction, but see some areas for improvement.** The MTDP provides an adequate assessment of development challenges facing the Kyrgyz Republic and presents an ambitious agenda to accomplish growth and poverty reduction objectives. Maintaining macroeconomic stability, improving the business climate, developing infrastructure, and strengthening governance and transparency in the public sector are all key elements of the strategy. In addition, the MTDP envisages strengthening the financial sector to promote growth and development. Staffs recommend that the MTDP presents more realistic growth scenarios. Structural reforms need to be prioritized to ensure sustainable progress toward attaining the objectives of the MTDP.

31. **The successful implementation of the MTDP will depend on strong ownership and sustained commitment to reform.** Strong coordination among various ministries and government agencies is required to achieve the expected objectives. Moreover, concerted efforts in prioritizing key reform areas and more realistic costing and financing of the MTDP would ensure more credibility in the strategy. It will be equally important to build in strong monitoring mechanisms to ensure transparency of implementation. This will also facilitate the MTDP's integration into the budget process and provide feed-back and options for policy adjustments.

32. **The successful implementation of the MTDP could be hindered by a number of downside risks.** A worsening external environment and risks associated with terms-of-trade shocks would adversely affect growth and delay reforms. The volatility of gold production may also result in a significant output variation. In addition, the Kyrgyz Republic is vulnerable to political risks, including changes in the cabinet and coalition, and natural disaster risks such as droughts and floods. Spikes in international food and fuel prices could enhance the need to protect the vulnerable at a time when fiscal space is limited.

33. **Staffs advise to focus on the following issues of the MTDP, as highlighted above, in the annual progress reports to strengthen the implementation of the strategy:**

- Setting realistic macroeconomic assumptions, in particular on growth and private investment.
- Providing a deeper analysis of risks stemming from the fragile external environment.
- Analyzing spatial and demographic variations in poverty and assessing the impact of measures set in the MTDP on income groups.
- Clarifying the goals and objectives of the MTDP while indicating the timeline and prioritizing measures and objectives.

- Providing more realistic costing and financing of the MTDP.
- Defining specific measures and mechanisms to ensure engaging civil society organizations in governance.
- Reflecting more prominently on financial viability of the power sector.
- Providing a comprehensive analysis of the pension system.
- Presenting effective mechanisms of regular monitoring and evaluation of the MTDP.

34. In considering the MTDP and the JSAN, Executive Directors' views are sought on whether they agree with areas identified by staffs, particularly:

- Do Executive Directors concur with staffs on priorities for strengthening implementation of the MTDP?
- Do Executive Directors concur with staffs' views on risks?