



Center For Social and Economic Research

Comprehensive Development Framework for Kyrgyzstan

A Concept of the Final Document

(Final Report of the UNDP Consultative Mission)

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1. Implementation of the Mission Agenda

1. This report has been drafted by Marek Dabrowski (CASE – Center for Social and Economic Research in Warsaw), during the consulting mission carried out from August 18 to 28, 2000 in response to the request from President of Kyrgyzstan and the Government of Kyrgyzstan (GoK). The UNDP Office in Kyrgyzstan funded the mission. The objective of the mission was to assist in the preparation of the Comprehensive Development Framework (CDF), especially in its final stage of summarizing the results of individual experts' work and workshops, as well as drafting the final document.
2. During the mission I met with President of the Kyrgyz Republic Askar Akaev, Chief of the President's Administration Misir Ashyrkulov, State Secretary Naken Kasiyev, Governor of the National Bank of the KR Ulan Sarbanov and his first deputy Emil Abdumanapov, First Deputy Minister of Finance Emirlan Toromyrzayev, Deputy Ministers of Finance Chorobek Imashev and Kubat Kanimetov, Head of the CDF Department in the Ministry of Finance, Yevgeniy Lee and the expert group working on the CDF, Minister of Labor and Social Protection Imankadyr Rysaliyev and his staff, Chairperson of the Social Fund Ainura Kypchakbayeva, Chairman of the Goskominvest Urkaly Isayev, Acting Head of the Economic Department of the President's Administration, Kurmanbek Ukulov, Head of the Economic Analysis and Forecast Department in the Prime Minister's Office Leonid Komarover and his deputy Tsoj Man-Su, First Deputy Head of the State Property Fund Tursuk Turgumambetov, Chairman of the Budget Committee of the Assembly of People's Representatives, Marat Sulatanov, IMF Resident Representative Iqbal Zaidi, and ADB Macroeconomic Consultant to the President Alexander Agafonoff.
3. I especially appreciate the consultations with Mr. Terry McKinley, UNDP Senior Advisor on Poverty Alleviation who carried out parallelly a short-term mission in Kyrgyzstan, as well as with, members of the Working Group on the UNDP Public Administration Reform Project. I also made use of the outcomes of the four advisory missions of the UNDP Consultant Anders Aslund (1998-2000) and my previous mission in May 1999 (see M. Dabrowski, R. Mogilevskij and R. Brudzynski "The Kyrgyz Republic and the Global Financial Crisis", Final Report from the UNDP Mission, May 1999).
4. The author would like to deeply thank the UNDP National Advisor, Kulipa Koichumanova, without whose professional, informational and logistical support this mission would have not been possible. The logistical support was also provided by many employees of the UNDP Office in Kyrgyzstan, especially by Nazgul Jenish, Sagipa Jusayeva, Enkhtsetseg Miyegombo, Ainura Alymbekova, as well as by CASE Program Officer Elena Kozarzewska, and Executive Director of the CASE-Kyrgyzstan Roman Mogilevskij.

2. Proposals on the Form and Structure of the CDF and Methods of its Elaboration

5. During last year a serious conceptual and organizational job has been done in Kyrgyzstan on preparation of the CDF for 2000-2010. A number of reports and

studies have come out. A series of workshops has been held on CDF component subjects. Not only government officials, but also independent national and international experts have been involved. In parallel, the three-year National Poverty Reduction Strategy (NPRS) is being designed to serve as a basis for the extension of the IMF Poverty Reduction and Growth Facility (PRGF, formerly ESAF) and further World Bank loan programs. However, since the deadline for the CDF formulation is approaching (according to Kyrgyz government's decision, it is the end of 2000), it is high time to start to prepare the final document.

6. To define the character of the final document seems to be a complicated task for a simple reason: there are neither clear-cut recommendations from the World Bank on this matter, nor experience of other countries involved in this initiative (all of them have not advanced further than Kyrgyzstan). In this situation, the GoK, in whose intellectual ownership – under the World Bank concept – the CDF is, will have to tackle the issue on its own. The following proposals on the content, structure and form of the final document represent subjective views of the author of this report.
7. While formulating the CDF final document it is necessary to guarantee its conceptual coordination and consistency with NPRS and other GoK program documents. Besides, after CDF has been adopted, it is recommended to revise and update previous program documents in terms of their consistency with CDF. However, the form and the structure of CDF should be different from NPRS and other documents.
8. With the CDF ten-year time horizon, this document should focus on the identification of the country's strategic development objectives and methods of fulfilling those objectives, as well as on the existing development barriers and ways of overcoming them. It is advisable the document will not exceed 25-30 pages, and the language will be simple and popular, perceptible even for non-professionals. Only then CDF could play a role of an instrument to mobilize society. After the final document is adopted, it is recommended that PR specialists develop a concept of its popularization among various groups of the Kyrgyz society.
9. The CDF's degree of specificity will surely differ from that of the three-year NPRS. There is no sense to repeat the content of NPRS in CDF, all the more to "extrapolate" the measures proposed in NPRS for the remaining seven years. The task of CDF is different from NPRS. The latter document is a basis for a specific loan program of the IMF, World Bank and other donors. Hence, it should define key macroeconomic indicators, as well as specific tasks on reforming Kyrgyzstan's economy, the deadlines of its implementation and the institutions responsible for these tasks. A replication of such an approach in CDF would soon make it outdated, and the professional quality of a document like that will turn doubtful. Even the three-year IMF program is subject to permanent corrections due to changing external and domestic environment. With a ten-year time horizon it would be inevitable. Besides, due to a number of reasons, Kyrgyzstan (as other transition economies) lacks technical instruments of forecasting macroeconomic and social indicators for such an extended period.
10. While advising to preserve CDF's strategic nature and avoid its excessive and unreasonable specificity (which will result in the loss of its reliability, and transparency), I would like to emphasize a danger of an opposite extreme, i.e. limiting the final document to a number of ideological and program-type formulations of general character. In this light, CDF should be considerably more concrete document,

than, for example, the Declaration on Sustainable Human Development, accepted in May 1997.

11. Though the strategic program of the country's ten-year development being prepared by the government cannot fully avoid a political dimension, it must not be used for the current political purposes (election, for example). This could lead to a transformation of CDF into a set of political promises and slogans, on the one hand, and losing chance to build a wide consensus (above the current interests of individual political parties and movements) around this document, on the other. The latter seems to be very important since the CDF time horizon exceeds the constitutional terms of both the executive and legislative branches.
12. It is also imperative to avoid a sectoral structure of the document, typical for many government programs in Kyrgyzstan, since it is fraught with a loss of the CDF's strategic nature and its internal consistency. In this context, independent experts, not involved in sectoral or branch interests, should be more extensively involved in the preparation of the final document.
13. The following structure of the document is recommended:
 - very brief review of Kyrgyzstan's social and economic development and the progress in transition to a market-based economy for the last ten years (2 pages maximum);
 - strategic objectives of the country's development for the next 10 years; justification of their choice in terms of their expediency and reality (1 page);
 - characteristics of domestic and external conditions of country development; a focus should be placed on identifying the existing constraints and possible ways of their overcoming (up to 7 pages);
 - major directions of institutional reform (in economic, social and political areas) and government policies to achieve the strategic goals (15-20 pages);
 - a set of indicators (performance criteria), which should serve as the tool of monitoring CDF implementation (up to 2 pages).
14. As interpretation of many indicators of social and economic development has subjective character (for example, a set of the indicators determining a poverty level), it is recommended, as far as possible, to use the international criteria in their assessment.
15. Further in this report I will discuss some possible development objectives, internal and external conditions of country development, specific directions of institutional reform to be included in CDF, as well as the comments on the set of indicators to monitor the implementation of CDF

3. Strategic Objectives of Kyrgyzstan's Development

16. CDF will identify the strategic objectives of country's development for the next ten years. They cannot be limited to purely economic quantitative indicators (like GDP

growth rate) only, but also include a set of tasks to improve the people's living standards. The latter means the distribution of economic growth effects in the socially acceptable way, protecting the natural environment, guaranteeing a high quality of major public services, development of democratic mechanisms, civil rights and liberties, national security, overcoming the country's geographic isolation and the like.

17. Despite the need to have non-economic components into the development objectives, formulated in CDF, one should not underestimate the significance of GDP growth rates for the country's development perspectives. It is only a fast economic growth that can take out the country from the poverty zone, enable social and political stability and provide funds for other purposes. From this point of view, one should support the proposal to double GDP in 2010 comparing to 1998 level. This means annual growth rates at 7-8%. The international experience unequivocally shows that this is a real perspective for a developing country with an initially low per capita GDP, although a leap like that is impossible without an adequate economic policy. A sustainable annual growth of 7-8% requires, *inter alia*, a more open economy, a prevailing role of the private sector, simple and transparent business environment, low inflation, a stable currency and balanced budget, efficient and well-targeted system of social protection, solid public institutions and a stable financial sector. Some of these requirements will be analyzed in detail further in this report.
18. As for other targets, beside GDP, great caution is recommended in identifying their specific quantitative values. First, there is a political temptation (related to elections) to promise an improvement of the living standards indicators. I have in mind, in the first instance, the promise to significantly reduce poverty during the period of CDF implementation. It is a very risky promise not only because there is not a prognostic model yet, which would allow to translate the desired GDP growth rate into social indicators determining the poverty level. The notion of poverty itself is very subjective, and in many countries with a higher than Kyrgyzstan's per capita GDP, a considerable number of people consider themselves poor.
19. Aside from purely economic targets, I would like to make a special emphasis on the tasks related to the functioning of the state (good governance), such as: providing public services of good quality, development of democratic mechanisms, civil rights and liberties, national security and the like. First, they affect the rate of economic growth, which is vividly demonstrated by the experience of other transition economies. It is not accidentally that the countries leading in economic transition are also leaders in establishing mechanisms of liberal and democratic state, as well as in public institutions reform. On the other hand, weak, corrupt, and incompatible with market system public institutions in the CIS became a considerable obstacle on the path of transition and economic development. Secondly, the above political tasks have the autonomous value in the contemporary world, alongside with material living conditions. This should be especially stressed in case of Kyrgyzstan and other CIS countries where democratic mechanisms, if any, are very fragile. Many countries face either internal or external instability. The state very frequently does not execute its major function of provision of public goods, and its institutions are perceived by society as hostile structures.
20. Moreover, in the FSU countries the practice of primacy of abstract state interests over the rights and interests of its citizens (including a negligent attitude towards human life) prevails, this approach being inherited from the tsarist Russia and USSR. It

should be replaced by a subordinate role of the state vis-à-vis its citizens, human rights protection under UN norms, and by the citizens rights to participate in governance in their interests. Kyrgyzstan, as FSU country, is facing the above problems too, which is why the issues of human rights, democratization and a profound reform of the state itself should find an appropriate position in CDF.

21. It is not recommended to propose the changes in the economy's sectoral structure as one of the CDF objectives. In a market economy all production and investment decisions are made by economic entities (mainly, private). The international experience shows that the government attempts to interfere in this process, by granting, for instance, tax exemptions, subsidies and loan guarantees not only lead to serious structural distortions and implementing inefficient investment projects, but also seriously harm the fiscal balance. In Kyrgyzstan and other FSU countries one should also take into account the mentality of the past when industry was considered as more efficient economic activity than, for example, agriculture or services, and within the industrial sector the priority was given to heavy industry and machine-building. Furthermore, opening the discussion on identifying sector and branch priorities will threaten in distorting the final CDF document with various lobbies interests.

4. Domestic and External Environment of Kyrgyzstan's Development

22. Following the description of the CDF strategic objectives, the final document should provide characteristics of domestic and external environment of CDF implementation in the next decade. In this report, I would like to focus only on some of them and their consequences for economic policies, namely: limited resources for financing economic growth and the rapidly growing external debt of Kyrgyzstan, lack of rich natural resources, a young demographic structure of the Kyrgyz society, not the best geographic and geopolitical location, and inconsistencies in the last decade's reform.

4.1. The limited financial resources and the debt trap

23. Kyrgyzstan is characterized by an extremely low level of gross domestic savings (GDS), which was even negative in some years. The reason is a low degree of the private sector savings (households and enterprises) and a chronic budget deficit (i.e., negative savings of the public sector). Naturally, so low level of GDS is not sufficient to finance the investments required to guarantee the desired high rate of economic growth. Thus, Kyrgyzstan must "import" external savings, which is reflected in the chronically high current account deficit.
24. Historically, this gap was closed by direct transfers from the union budget of the USSR and indirect price transfers in the form of cheap energy and other primary resources provided by Russia and other resource-rich former Soviet republics. After the break-up of the Soviet Union and leaving the ruble zone by Kyrgyzstan, the Soviet (Russian) transfers were replaced by huge loans from international financial organizations and bilateral donors. However, this resulted in a fast growth of foreign debt far exceeding 100 percent of GDP. Despite favorable terms of many investment loans, external default is looming over Kyrgyzstan. The debt trap may become the most serious obstacle in the path of doubling the GDP in the next decade. In any case, the government cannot count on foreign loans in the volume of the last years. Even if

it gets new loans, they should be allocated, first of all, to repay the existing external liabilities.

25. In this situation, the country has to seek for new sources of funding its ambitious growth objective (international experience shows that an annual growth of 7-8% should be accompanied by investment-to-GDP ratio higher than 20% of GDP). Two opportunities remain: an increase of domestic savings and import of foreign savings in the form of foreign direct investment. The latter must be associated with further external liberalization and creating favorable investment climate (see section 5.5). The growth of GDS seems to be a complex task for a number of reasons: many years of high inflation, chronic budget crisis, mistrust to the national currency and government economic policy in general, and weakness of the national financial sector as well as too big reliance of many groups of the Kyrgyz society on social support (excessive formal social entitlements not always equal to actual ones) and too big reliance of all the country on the external assistance. The mentality of the Kyrgyz political class is oriented towards searching for sources of external financial aid, rather than mobilization of internal resources and bringing private investors.

4.2. The country's potential resources and methods of their utilization

26. Unlike its neighbors and major trade partners in the region (Kazakhstan, Uzbekistan and Russia), Kyrgyzstan lacks rich natural resources. The hopes associated with gold mining projects, which stirred so much political emotions in the first half of the 1990s, turned to be very much exaggerated. Also, the hydro-energy potential of the country is unlikely to be easily tapped because of huge investment costs of building new power stations and energy transmission facilities (enabling its export). A rapid growth in agriculture is not necessarily the result of especially favorable natural conditions of Kyrgyzstan in comparison with its neighbors. This is rather a one-time positive effect of land privatization, which did not occur in other countries yet (not, at least, on such a large scale as in Kyrgyzstan).
27. Another unfavorable factor is the geographical location and political situation in the region. The country is far from major transportation routes of Europe and Asia, and the density and quality of the domestic transportation network (roads, railways, and airport facilities) is rather poor. Among the closest neighbors, Afghanistan and Tajikistan will remain the sources of regional instability for years to come. Last year's and this year's instability in Batken region may reoccur. The economic, and then internal political situation in Uzbekistan will most likely deteriorate due to the lack of major market and democratic reforms in this country.
28. To neutralize the negative external conditions, and also to persuade potential investors and partners that the country has a chance to remain an 'island' of stability, democracy and development in the unstable region, Kyrgyzstan should continue a large scale institutional reforms, as well as a consequent and prudent economic policy. On the other hand, overcoming geographic isolation is possible with modern transportation (air transportation) and communications means. For this, however, it is imperative to carry out fast privatization of infrastructure sectors and their opening to external competition.
29. In contrast to the natural conditions and geographic (geopolitical) situation, the human resources may be considered a comparative advantage of Kyrgyzstan. A

young demographic structure, cheap – and more mobile than in other transition countries – labor force create prerequisites for the development of labor-intensive production and services. Thus, Kyrgyzstan can find a similar niche in the international division of labor, like many developing countries in the Asia-Pacific region. This development option seems to be a more reliable than a strategy based on the use of natural resources prone to rent seeking and financing populist programs. A prerequisite of the success in this sphere, however, is the establishment of an adequate investment and business environment.

4.3. Negative effects of inconsistent reform

30. Though in mid-90s Kyrgyzstan was recognized by many experts (the author included) as the leader in economic and political transition in Central Asia, the reform process was not fast and consistent enough to overcome multi-century social and economic backwardness, as well as the heritage of the command economy and authoritarian political system of the Soviet era.
31. Worst of all, starting from 1997, the pace of reform became slower, and in some areas the situation even deteriorated. Probably, the reason was a complacency of the ruling elite calmed by relative success, achieved in the first years of transition, and positive assessment of the international organizations and foreign experts, and also an excessive inflow of the external financial aid. The country became a victim to two serious macroeconomic and banking crises: in 1996 and in late 1998 – early 1999. The public debt burden, especially to official external creditors, has quickly grown. The discipline of tax collection has gone down. The tax laws have been exposed to frequent changes as a result of the pressure from various interest groups. Privatization process, after the end of its voucher phase, has been practically frozen. Attempts to deregulate and liberalize economy have not given expected results. The degree of observance of the basic political and civil liberties has been worsened. Frequent turnouts of the cabinet and individual ministers have not promoted a consistent reform policy.
32. Slowing down reforms is not just a waste of time for the country. Inconsistency in reform and bad compromises have resulted in many pathologies: unequal conditions of competition; non-transparency of tax, custom, and other regulatory systems, emergence of clan and oligarchic structures in government, corruption and nepotism; poor quality of the basic public services; the excessive differentiation of incomes and wealth not justified by economic efficiency. Significant groups of society actually do not recognize the state as their own, and respond to the above pathologies by moving into the shadow economy and neglecting the basic rules of law.
33. To cure the above pathologies will not be a simple task because many of them had already managed to become cluttered with powerful interest groups. Experience of reform in many countries shows that it is easier to carry out radical changes quickly than gradually, wasting efforts and time on establishing intermediate institutes and instruments first, and then on cracking down on the related interests and institutional inertia. In Kyrgyzstan's case (as well as in other CIS countries) the most difficult task will be the reform of the state institutions, their structures and methods of functioning, on the one hand, and legalization of a large scale shadow economy, on the other.

34. As a result of slow and inconsistent reforms the confidence in the government policy both inside the country and on the international arena has decreased. Two currency and banking crises also undermined the confidence in the national currency and banking system. To make it up for, it will require time, consistent reform activities of the government and strong institutional guarantees. Before it happens, investors, especially foreign, will abstain from serious investment in the economy of Kyrgyzstan, and a bulk of the population and businessmen - from legalization of shadow activities.

5. Some Directions in Economic, Social and Political Reforms

35. The CDF should include the concept of key reforms and policies of the government in the economic, social and political spheres, essential for achieving the strategic goals. In this report some of them will be discussed, concerning, in first instance, the monetary regime, overcoming fiscal crisis, rationalization of the social policy, large-scale deregulation of business activities and improvement of the investment climate, as well as governance and political reform. The previous analyses of CASE, findings of Anders Aslund and my conclusions presented in May 1999 report have served to a certain degree as a source of my present proposals.

36. With rapidly progressing integration of the world economy (globalization), including financial markets, countries have to compete between themselves for an access to a private capital. Investors are willing to come only to such countries, which are considered politically and economically stable, and in which there is simple and transparent regulation and tax regimes, where their property will be effectively protected, etc. At the same time, domestic businessmen can move their capital and business activity abroad, if they consider the business environment in the country as adverse or unstable.

37. The above means a growing international competition in the sphere of regulatory and legislative systems, tax and customs policies, protection of the property rights, stability of currencies, reliability of the banking sector, and even in respect to characteristics of political regimes. Therefore, taking into account the extreme need of Kyrgyzstan's economy in attraction of foreign capital and incentives for internal savings and investments, it is necessary to assess each reform proposal from this point of view, i.e. how much it improves country relative international 'competitiveness' in the regulatory sphere and how it influences the investment rating of the country.

5.1. Evolution of the monetary regime

38. The first component of an economic system, which is constantly assessed by investors, is the national currency. If the currency does not enjoy sufficient credibility, owners of monetary assets prefer to keep them in a foreign currency, for example, in US dollars or Euro. Even if there is a stable currency and prudent monetary (and, more generally, macroeconomic) policy, but the country is small and a share of its foreign trade in GDP is high enough, many transactions are carried out in foreign currencies, anyhow. In general, it is possible to predict, that expanded integration of the world economy will increase gradually the significance of the main international currencies (the U.S. dollar, Euro, possibly the Japanese yen) and simultaneously reduce the role of other currencies, even the most reliable. More countries will give

up their independent monetary policies, introducing either currency boards (examples of Argentina, Hong Kong, Estonia, Lithuania, Bulgaria and Bosnia), or directly one of the main currencies, i.e. the dollar or Euro (examples of Panama, Ecuador, Kosovo and Montenegro).

39. In case of Kyrgyzstan chances to induce sufficient trust to Som, even among residents, seem to be a hopeless task by virtue of many circumstances. First, it is necessary to bear in mind fresh memories about a hidden hyperinflation of last years of the USSR and later the open hyperinflation of the ruble zone. Then not quite successful attempts to lower inflation in an independent Kyrgyzstan and to stabilize new monetary unit, the Som, came. Two currency and banking crises (1996 and 1998-1999) have undermined additionally trust to the Som. The high share of foreign trade in GDP naturally reduces demand for the domestic currency, as the majority of export and import transactions, even with the CIS countries, are performed in dollars. Also more serious domestic contracts concerning, for example, sale, purchase or renting a real estate, sale and purchase of cars, durable goods, and private loans are carried out in dollars. In these circumstances even a very tight and consistent monetary policy and high real interest rates can hardly induce more trust to the Som, at least, in short- and medium-term perspective. On the other hand, the costs of such policy for the real sector of economy can considerably exceed the doubtful benefits coming from an independent monetary policy (an opportunity of absorption of external shocks, stimulation of export and seigniorage revenues). In this context the idea of giving up an independent monetary policy should be seriously considered.
40. In the last year's report we proposed an introduction of a *currency board* regime in the perspective of maximum three years. The currency board seems to be a reasonable solution in the small open economy experiencing constant mistrust to the national currency and high dollarization level. However, the proposed regime should enjoy a full confidence of potential money holders, which in Kyrgyzstan and other CIS countries does not seem easily achievable (with low confidence to the state institutions and law). The experience of Argentina, Hong Kong or Lithuania shows that the currency board without full credibility is not capable to counteract a panic in the financial market and flight from the national currency in crisis situations.
41. Taking into account the above circumstances, I suggest to make one step further, i.e. introduce unilaterally the US dollar as the official currency in the Kyrgyz Republic. This decision would result, most likely, in a number of positive consequences:
 - would legitimate actual dollarization of Kyrgyzstan's economy (see above);
 - would lower transaction costs in the foreign trade;
 - would help to lower quickly inflation to a rate of a US inflation (plus a small extra margin connected with a gradual alignment of purchasing power parity);
 - both nominal and real interest rates would decrease to a level prevailing in the international credit market (for example, LIBOR), plus a country risk premium but without devaluation risk premium (!);
 - using the strongest international currency would improve the investment climate in the country and make it more attractive to foreign investors;

- would help to remove one of risk factors in the banking sector, connected with potential asymmetry of assets and liabilities denominated in foreign currency. Besides, the official dollarization would probably stimulate more foreign banks to come to Kyrgyzstan;
 - would discipline the fiscal policy.
42. To successfully implement dollarization, it is necessary to solve, at least, two economic problems: (1) to accumulate net foreign assets of the NBKR in the amount allowing to make an exchange of the circulating cash Soms and banks' reserves into dollars; (2) to overcome all consequences of the banking crisis of early 1999 to create solid institutional conditions for the development of the banking sector, as well as the institution replacing the function of the lender of last resort, currently carried out by NBKR (in the form of special reserve fund or the credit line). Besides, respective amendments to the Constitution of the country and other legislation (the Civil Code, foreign exchange, labor, and the tax laws, etc.) are necessary.

5.2. Consolidation of public finance

43. The size of public debt accumulated for the last years requires the serious tightening a fiscal policy. The government (and the country as a whole) has no opportunity to continue borrowing in the previous amounts even if the majority of received new credits would be allocated further on favorable terms and would be channeled towards the Public Investment Program (PIP). A default, or a situation close to a default, i.e. a forced restructuring of debt obligations, would undermine the reputation of the country for many years and would make prospects of attraction of the foreign private capital improbable. It would also lower potential benefits from the proposed introduction of the US dollar as the national currency (see 5.1).
44. The analysis of Kyrgyzstan's fiscal sustainability prepared by the World Bank (The Kyrgyz Republic. Fiscal Sustainability Study, The World Bank, June 2000) specifies, among others, conditions under which the further growth of a ratio of the public debt to GDP could be stopped. With annual GDP growth rate of 3%, inflation of about 10 % and the same, as so far, preferential terms of borrowing, general government deficit (i.e., PIP included) can not exceed 5% of GDP on average. Theoretically, with higher rates of growth (for example, 7-8% annually, as proposed in the CDF strategy), the maximum level of fiscal deficit could increase. However, taking into account an expected reduction of preferential financing, and the necessity to gradually reduce (not just stabilize) the ratio of the public debt to GDP, it is hardly possible to allow a higher deficit.
45. One could consider two possible scenarios for the fiscal policy. First of them is a fast achievement of a deficit-free consolidated budget (without PIP) and sharp restriction of new borrowing within PIP. The second one is about achievement a surplus in the consolidated budget (without PIP), allowing to repay a part of the debt. In this case, additional preferential borrowing on PIP would be possible, in reasonable limits, of course. In any case, the present policy of restructuring the debts to Russia, Pakistan and Turkey, as well as obligations connected with government guarantees issued in the past, and rolling over these obligations to the next years when it will be necessary to repay debts to the international financial organizations, seems to be very doubtful and short-seeing.

46. According to the analysis of the World Bank quoted above, in 1998 the expenditures on PIP reached a record level of 5.6% of GDP, of which 4.7% of GDP was financed from external sources, and 0.9% of GDP directly from the state budget. Hence, in the very near future, Government should seriously reassess the PIP from the point of view of its priorities, and efficiency of separate investment projects. Many of them (for example, in agriculture, energy sector, communications and air transportation) should be realized only on commercial bases, without the state borrowing and guarantees. In general, the government should abstain from new sovereign guarantees. The supervision over the existing and new public debt obligations should be carried out in the Ministry of Finance.

5.3. Tax Reform

47. The Tax Code at the moment of its passage in 1996 was considered as the exemplary law for other CIS countries. After that, however, a process of its erosion began quickly, through continuous expansion of tax privileges. As result tax revenues in Kyrgyzstan remain at a low level - below 15% of GDP. The tax system again became complicated and nontransparent, creating favorable ground not only for tax evasion, but also for corruption and arbitrariness of tax authorities. It does not provide conditions for equal competition. The small group of lobbyists and shadow economy benefit from it only.

48. The Kyrgyz economy needs another phase of tax reform. It is necessary to simplify the tax system and remove the distortions and loopholes, which have amassed in the last years, so that to achieve its transparency and improve fiscal efficiency. It is also necessary to distribute the tax burden more fairly: agriculture, the most quickly growing sector of Kyrgyzstan's economy, pays only one tax (land tax), which is symbolical.

49. In case of Kyrgyzstan where agriculture, individual labor activity and small and medium-size businesses prevail, and the significant part of business activity is in the shadow, indirect taxes (the VAT, excises and customs duties) should play the main role in budget revenues. The advantage of indirect taxes is that they partially cover the shadow economy. Besides, a well working mechanism of VAT credit can create pressure on businesses to move from the shadow to the official economy as the buyer is interested in purchasing goods or services at a legal source in order to be eligible for VAT credit. Unfortunately, this advantage of the VAT is not quite used in Kyrgyzstan because of various exemptions and badly working VAT credit mechanism. Besides, additional turnover taxes (contributions to the Fund of Emergency Situation, Road Tax, local sales tax) create a partial cascading of the indirect taxation. In this situation a priority task is to clean up the VAT of existing exemptions, raising its fiscal efficiency and, at the same time, creating a fiscal room for a gradual cancellation of cascade turnover taxes and reduction of direct taxes. In the latter area it is recommended, first of all, to reduce the highest rates of the personal income tax and make PIT construction proportional (flat) using the experience of Estonia and Russia. Then it is possible to start to reduce gradually the rate of the profit tax. In both cases (the PIT and the profit tax), it is also necessary to eliminate existing exemptions.

50. VAT exemptions have especially harmful consequences as they contradict a principle of a neutrality and universality of this consumption tax. Creation of a loophole in the

initial or intermediate stage of a production chain deprives the purchaser from an opportunity to get a tax credit and stimulates pressure to exempt VAT in the subsequent stage of production. Experience with agriculture where VAT was replaced with the land tax and the subsequent, partially successful, pressure to exempt VAT in the agriculture processing industry convincingly shows a harmful logic of the development of this process when it starts.

51. The policy of expanding simplified taxation for small business and individual business activity (including agriculture) should be considered as a step in the right direction. However it should not mean a reduction of the overall budget revenues and further "erosion" of the VAT. The problem is to define a reasonable ceiling of an annual turnover, below which it will be possible to apply simplified taxation rules.
52. Following last year report we recommend to reduce sharply the number of free economic zones, improve administration in those of them, which will temporarily remain, and their full liquidation in the future.

5.4. Social Reform

53. In the country with a high level of poverty, social policies and social services will always play a key role. Moreover, many politicians have temptation to expand social obligations of the state in order to fight poverty. However, it is an irrational way because of the limited financial opportunities of the state. Today various types of social programs absorb already the bulk of budget expenditures in Kyrgyzstan. According to the WB analysis quoted above, overall social expenditures in 1998 (including public health services and education) amounted to 19.3% of GDP. Though the level of these spending has decreased from 27% of GDP in 1991, it is still an excessive burden for the state budget of Kyrgyzstan.
54. At the same time, the efficiency of social programs remains rather doubtful. Targeting of social assistance is not sufficient. As a result, the limited funds are allocated not to the most needy, but to those who has the social privileges fixed in the legislation. The pension system works the same way: the highest pensions are received by young pensioners continuing professional work in the shadow sphere. To put it briefly, the present direction of social programs does not solve social problems, and it also harms economic development, encouraging social dependence and creating favorable conditions for various pathologies and corruption. Besides, the quality of basic social services, such as education and public health services, is very low and continues to deteriorate. The excessive network of institutions in this sphere and over-employment absorb the bulk of allocated budgetary funds and hinder necessary restructuring.
55. Public pension benefits, amounting to 7.3% of GDP in 1998 constitute the largest item of the social spending. This is the highest indicator in the Central Asia and one of the highest among the FSU countries, despite of a young demographic structure in comparison with other countries. The low retirement age, an early retirement privileges for many groups of the population, excessive number of disability pensioners and too generous formula of defined benefits can be considered as the main reasons of relatively high pension expenditures. The 1997 pension reform has made a step in the right direction, having raised a retirement age (though this process stretches for many years), having introduced a personified pension accounts and having strengthened insurance principles in the pensions formula. There is no

guarantee, however, that the reform will provide sufficient reduction of expected pension expenditures to balance the Social Fund, especially at the end of the first decade of the 21st century when the demographic structure of society will start to deteriorate. Additionally, it is worth to remember that the level of most pension benefits is low, not able to guarantee a minimal living standard, especially for the most elderly group of pensioners.

56. The existing situation in the pension system demands continuation of reforms, which would provide an increase in individual pensions by a sharp reduction of the number of pensioners and a introducing a tighter link between the size of pension benefit and amount of pension contributions accumulated for the period of the professional activity. The way to implement this strategic objective is to further increase both formal and actual retirement age, equalize retirement ages of women and men, and cancel existing pension privileges (for example, rights of early retirement at the age of 45 for women having many children). The proposed measures will provide social support for those really not capable to work and needing pension allowances. On the other hand, reducing the number of young pensioners will help to struggle with shadow economy. Besides, the present situation when the retirement age of women is 5 years lower than that of men, with a longer life expectancy of women, actually means professional and social discrimination against women.
57. In the further prospective, Kyrgyzstan should start to build the fully funded, defined contribution segment of the pension system, using the experience of the reforms in many countries of Central Europe, the Baltics and the Balkans. However, prior to the beginning of this process it is necessary to reduce excessive obligations in the PAYG system (see above), finish the process of establishing personalized pension accounts, and, first of all, to develop a healthy financial sector. As this last task is not easy, appropriate time for launching the fully funded pension system will come, most likely, in second half of the next decade.
58. Carrying out any pension reforms requires serious improvement in the pension administration. In the last year's report we put attention on a critical financial situation of the Social Fund, low discipline in paying pension contributions, pension arrears, a significant role of netting out operations and payments in kind. We emphasized, that the Social Fund can not turn into the state procurement agency trading grain, flour, vegetable oil or coal. Unfortunately, the present situation seems only a little bit better than last year. Though in the first half of this year the financial balance of the Social Fund, especially in its pension part, was improved, the recent political decision to increase pensions by 20% (after the same increase of the salaries in the budgetary sphere) may cause a bigger deficit in the pension system in 2001.
59. Despite of long-term efforts, Kyrgyzstan does not have an effective and well targeted system of social aid yet. On the one hand, there are no the tools, allowing to identify the persons who actually need support. The system of social passports can hardly solve this problem, despite the huge costs of introducing it. On the other hand, the social policy is overloaded with the old type obligations inherited from the command economy. It concerns, in first instance, the so-called social privileges (legal entitlements to obtain certain goods and services free of charge or at the reduced price), and also subsidies to housing and municipal services. The empirical studies carrying out by the CASE - Center of Social and Economic Research in 1998, confirm a bad social targeting of budgetary spending on these purposes. They provide benefits

to middle- and high-income families rather than to the poorest ones. Besides, these privileges encourage various abuses, development of the shadow business (for example, the use the rights on reduced energy and gas prices or telephone charges by unregistered businesses), and also complicates preparation of the infrastructure sectors for its future privatization. That is why it is necessary to eliminate these privileges, and channel a part of the economized money towards the targeted social aid and use the other part to reduce the fiscal deficit. Better targeting of social programs requires more intensive using institutional capacities of local communities and local self-government.

60. A demand for the basic social services, i.e. public health services and education, most likely, will grow in the nearest decade. To meet this demand in both sectors it is necessary to start privatization (municipalization) of the supply side, with a simultaneous continuation of public financing of the consumption of basic services, especially for the most vulnerable group of population. The Medical Insurance Fund should contract suppliers of medical services on a tender basis and conduct a rigid cost control in this sector. In education sector it is necessary to introduce uniform norms of budgetary financing per one pupil/student depending on a level and profile of education (voucher type financing). All schools, irrespective of their type of ownership (public, municipal or private) could receive this financing. All government and municipal schools would get the self-financing status.

5.5. Deregulation, privatization and improvement of business environment

61. With limited natural resources and not the most favorable geographical (geopolitical) position, Kyrgyzstan can attract investors only by creating very liberal business environment, solid protection of property rights, a stable and transparent legislation. Only then there will be a possibility to fully exploit the comparative advantage of young, educated and mobile labor force.
62. Despite Kyrgyzstan's much more liberal regulatory regime in comparison with other CIS countries, many serious barriers for business activity are still in place. The parliament and the government should continue deregulation, both for domestic and foreign businesses. First, it concerns a consistent introduction of non-licensing registration rules for most businesses. Only few and very precisely defined exceptions can be accepted, being limited to cases when licensing is necessary from the point of view of protecting public interests (for example, banking and insurance activity, manufacture of weapons, medicines, etc.). Second, the registration procedure should be maximally simplified and performed in one agency only – a tax inspectorate. All other government institution should find the necessary information in this one source instead of demanding a separate registration procedure. Third, the number of government agencies having the right of inspection and control in enterprises, should be sharply limited. For example, there are no grounds for granting such rights to militia or Ministry of National Security. Fourth, where possible, the inspection and control should be conducted on post-fact and not prophylactic basis.
63. If Kyrgyzstan wants to attract foreign investors, businessmen and tourists (and tourism is one of the potential chances for the country), the government should simplify its visa procedures, particularly that the country has no a big network of its embassies abroad. One of the opportunities is to cancel unilaterally visas to citizens of the developed countries and the countries with which Kyrgyzstan has the closest

economic relations. The second one is to issue non-expensive visas directly on the border, as it is done in Turkey. Aside from simplifying the visa procedures, a positive psychological effect would be achieved by a cancellation of registration procedures for foreign citizens at OVIR, suspension of humiliating practice of control of foreign citizens by the militia on the streets, and also price discrimination against foreigners. What concerns business activities, it is simplification of registration procedures for foreign firms or their representations, an opportunity to use the English language in registration documents, etc. Kyrgyzstan should also continue the process of signing bilateral agreements on avoiding double taxation and supporting investments.

64. In general, for attracting foreign investment the following basic factors have matter: liberal domestic and external economic regime, macroeconomic and political stability, transparency and relative stability of the legislation, including tax and custom systems, simple administrative procedures, an opportunity of effective judicial protection, precisely defined and well protected property rights, absence of administrative harassment, discrimination and corruption, well working transportation and communication infrastructure, etc. Special tax privileges for foreign investors will not substitute these conditions (it is, very frequently, indirect subsidization of foreign budgets since the taxes paid in Kyrgyzstan are usually deducted from tax obligations in the country of investor's origin). Therefore, a return to a special tax treatment of foreign investors is pointless, it is much better to pursue a consistent policy of favorable regulatory climate, both for foreign and domestic investors.
65. Many of proposed liberal measures, for example, simplifications of business registration or visa regime, limiting the power of the ministries of Internal Affairs and National Security in relation to business activity, were already discussed in the past and even were approved at the highest political level. However, their implementation either did not start at all, or a setback took place, and situation came back to the starting point. It demonstrates an absence of a sufficient political consensus around the proposed reforms and serious bureaucratic inertia of the government machinery.
66. One of Kyrgyzstan's advantages comparing to other CIS countries is the privatization of land. I have in mind the results of the 1998 constitutional referendum, which legalized private ownership of land. Now a reduction of the five-year moratorium period on land purchases and sales is a priority task, which would promote a fully free land market. It would speed up the process of agriculture restructuring (inevitable integration of private farms) and would help to attract foreign investment in many sectors, for example, in agriculture, infrastructure or tourism.
67. Overcoming the backwardness of technical infrastructure (energy generation, transmission and distribution, communications, airlines, airports, natural gas and water supply, the railways) is impossible without their privatization with participation of strategic foreign investors. In most cases privatization should be associated with restructuring and demonopolization of the existing monopolies. Privatization of these so-called "strategic" sectors can bring simultaneously many benefits: significant fiscal revenues (potential source of repayment of the part of public debt), improvement in the balance of payments, serious improvement in a quality of infrastructure services, strengthening the payment discipline in these sectors, an increase of the investment rating of the country. At the same time, the experience of the Kyrgyztelecom tender, which was planned but failed this year, has shown a need for realistic planning of financial requirements to the future investors.

68. A special focus should be placed on fast liberalization and privatization of the air transportation. In Kyrgyzstan's geographical conditions, air transport is probably the only realistic mean to visit the country by foreign businessmen, tourists and others, and also for a portion of the country's foreign trade. Nevertheless, it will be hard for the Bishkek Manas airport to compete with the Almaty airport. Further delay in the separation of airport facilities from the Kyrgyzstan Airlines, privatization of both, and introducing the open sky policy (i.e. full liberalization of air transportation) will not help to develop this important sector. In the next stage it is necessary to create favorable conditions for technical reconstruction of the regional airports (with participation of the private capital).
69. After the period of actual suspension of privatization process in industry and other sectors, it is necessary to develop a realistic program of fast transfer of state owned packages of shares to private owners. When it is difficult to privatize an enterprise via an open commercial tender or investment competition, it is necessary to make use of the Georgian experience of "zero" auctions. In Georgia, in 1997-1998, the government owned shares were offered for sale with a zero starting price. Domestic and foreign investors could bid at any price above zero, by depositing simultaneously the declared amount on a special bank account. Shares were then distributed proportionally to the sums deposited on a purchase of the given enterprise.

5.6. Government reform

70. The implementation of many of the proposed reforms is impossible without a radical reform of the basic institutions of the state and administrative structures of the government. The Kyrgyz government institutions have inherited too much from a peculiar philosophy and the methods of behavior typical for the Soviet system. Certainly, they do not meet the needs of an open market economy and a free democratic society yet. The experience of last years (not only in Kyrgyzstan, but also in other CIS countries) shows that it is just the bad quality of the state institutions that hinders the further course of economic and political transition, in spite of a reform-minded political management of the country.
71. The development of the comprehensive project of a public administration reform obviously goes outside the limits of this report. I basically support the proposals in this area already submitted by Professor Anders Aslund. Within the framework of the present analysis I will focus only on some key issues closely connected with my previous recommendations.
72. The constitution of Kyrgyzstan has created a presidential-parliamentary republic, with a strong position of the President. However, the experience of other CIS countries shows various shortcomings of this system. First, very much here depends on the personality of the leader and a level of political development of the country. Without firm democratic and reform oriented views of the leader and with a weakness of civil society institutions, the presidential system, without sufficient system of "checks and balances", can easily degenerate into the authoritarian regime. Second, it very frequently leads to the fundamental conflict of the executive and legislative branches and irresponsible behavior of the latter. Third, it does not promote a system of political parties (also the 'first past the post' election system is here to blame). Instead of political parties there are implicit oligarchic and clan structures and interest groups. All these arguments suggest an idea of a revision of the constitutional system in

Kyrgyzstan to achieve a precise balance of powers among the President, the cabinet and parliament. The parliament should be responsible for the formation of the cabinet and its unhampered work; only then it is possible to expect responsible behavior of the legislature. In the election law it is necessary to strengthen the role of party lists and the proportional principle (at least a half of deputies should be elected in such a way), keeping a respecting threshold of a minimum of the votes cutting off small parties.

73. The judiciary of Kyrgyzstan requires radical reform.
74. In Kyrgyzstan the capacity of the local and regional self-government, strongly implanted in grass roots communal traditions remains untapped (though, on the other hand, the degree of development of local self-government institutions in Kyrgyzstan surpasses other countries of the region). The creation of well working system of local self-government requires parallel reforms in the following fields: inter-governmental fiscal relations, territorial division of the country, and structures of the national government. What concerns the territorial division, the question is whether the regional (*oblast'*) level of a territorial division of the country is needed.
75. The UNDP's Public Administration Reform Project creates an opportunity of a profound functional analysis of the existing structures of the national government and preparing the necessary corrections. The reduction of overlapping government agencies and their employment would enable to channel the economized budgetary means towards increasing the civil servants' salaries and an establishment of a stable civil service. It would result in a higher quality and consistency of economic policy, a better climate for private businesses, which are now exposed to excessive bureaucratic harrassment coming from incompetent and corrupt civil servants.
76. While restructuring the administrative apparatus of the state, it is necessary to bear in mind a necessity of its "demilitarization" as well. In comparison with democratic countries, too many agencies in Kyrgyzstan is organized according the military or quasi-military pattern, what is an obvious Soviet heritage. It concerns, for example, customs office or the Office of the Prosecutor General. On the other hand, the army, and other military or paramilitary formations (particularly of the Ministry of Internal Affairs, the Ministry of National Security) are not subject to a sufficient civil control as in other democratic countries.
77. Despite a relatively developed institutions of civil society in Kyrgyzstan, in comparison with other countries of post-Soviet Central Asia, the country faces the long way to reach at least East European level of self-organization of the society. However, this process cannot be managed administratively. It is closely related to the progress in developing democratic rights of citizens, with the freedom of speech and mass media, existence of political parties, mechanisms of rule of law, etc.

6. Indicators

78. While monitoring the CDF implementation a set of economic and social indicators of medium- and long-term development analysis should be applied. The economic indicators include: GDP growth rate, per capita GDP, changes in the sectoral composition of GDP, public debt to GDP ratio (including its external component),

fiscal deficit to GDP ratio, general government revenues and expenditures to GDP ratio, structure of budget revenues and expenditures, inflation, changes in the exchange rate, level of monetization, trade balance, balance of payments, dynamics and structure of exports and imports, employment and unemployment, a share of the private sector in GDP, total employment and fixed capital, changes of the real wages and many others. In designing the system of social indicators and parameters of quality of life, it is possible, in part, to make use of the experience, which has been accumulated in developing the indicators for monitoring the National Strategy of Sustainable Human Development.

79. In evaluating the CDF implementation, it is recommended to use the international comparative analyses of different indicators, and also existing international ratings of the countries done annually by the European Bank of Reconstruction and Development, Freedom House, Transparency International, World Economic Forum and by other organizations. The comparative approach enables a more objective evaluation of the country's development and the progress achieved in its transition.

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