

**Kyrgyz Republic Consultative Group Meeting**  
**Background Paper on NPRS Implementation and Key Issues Going Forward**  
*November 3, 2004*

**Introduction**

1. Two years into the implementation of the National Poverty Reduction Strategy (NPRS), encouraging progress has been achieved in three major tasks underlined by the strategy, which include: (i) fostering economic growth and creating employment opportunities; (ii) improving efficiency and equity of social protection and human development; and (iii) improving governance, public sector efficiency and institutional and human capacity. Broadly stated, progress is measurable by the strong record of macroeconomic management, a significant decline in the poverty headcount, and the general progressive stance on structural policies.
2. First signs of the surge in non-gold economic activity over the past decade and continued significant reduction in the poverty headcount have marked the NPRS implementation. Nevertheless, gains on the supply side of the economy are from a very low base and much needs to be done to expand and sustain them, without which economic recovery remains fragile. Living standards are low with about 41 percent of the population still below the poverty line. The external indebtedness is a heavy burden for the Kyrgyz economy—even considering expected further debt relief by Paris Club creditors in 2005. As noted by the recent joint Work Bank and IMF review of the Government’s first annual NPRS progress report, while the three-prong NPRS is consistent with the multi-dimensional nature of poverty alleviation, a more action oriented strategy is needed to address lingering policy and institutional deficiencies that limit the efficient restructuring of the economy and to provide for more rapid progress with poverty reduction.
3. The currently favorable nexus of a stable macro environment, relatively strong gold production and international prices, and fast-growing neighboring markets provides Kyrgyz policymakers with an excellent opportunity in this endeavor. This background paper focuses on issues that need analysis and more attention in NPRS implementation for mitigating risks to the sustainability of current growth rates and poverty reduction in the face of an expected decline in gold production by the end of the decade. The first section provides an overview of recent economic developments and the poverty profile against the background of NPRS targets. The second section discusses priority reform underpinnings of the NPRS’ three-prong strategy. The last section concludes.

**A. Recent Economic Developments and Poverty Profile**

4. ***Recent Economic Developments.*** The last two years have seen reasonable real GDP growth (GDP per capita in US\$ rose by 24 percent), continued low inflation rates (4 percent on average), a fairly stable currency<sup>1</sup>, and some moderation of excessively high interest rates (bank lending rates fell by 5 percentage points to 25 percent), with fiscal and external imbalances remaining below the NPRS targets (see Annex Table 1). On the supply side, although growth has continued to be led by primary agriculture, services (mostly trade and catering), gold mining and power, the last two years have seen the first signs of recovery in manufacturing (particularly in food processing, textiles, and construction material production) since the onset of the economic rebound. On the demand side, continued improvements in fiscal and external imbalances have

---

<sup>1</sup> After depreciating by about 20 percent in 2000 and exhibiting fluctuations in 2001-02, som/US\$ has been fairly stable, at around an average of 43, since 2003.

resulted in a more sustainable policy stance with a reduced reliance on external sources of savings. Public investment was reduced with tighter control over externally financed public investment expenditures. Nevertheless, the increase in private investments and savings has been smaller than expected under the NPRS, remaining far from providing tangible growth stimulus.

5. Export performance has been encouraging since 2003. Gold exports have responded to high world prices and non-gold export performance has shown signs of diversification, with increased exports of food processing and manufacturing products (dairy products, sugar, textiles, filament lamps and construction materials) especially in traditional CIS markets. Nevertheless, the surge in non-gold exports is from a very low base and much needs to be done to expand and sustain these gains. Data on regional trade patterns over the last five years (i.e., since the end of the Russian financial crisis) suggest that Kyrgyz exporters have failed to fully capitalize on opportunities created by strong growth in import demand by two neighbors—Kazakhstan and Russia—even compared to some CIS competitors that have reformed more slowly.<sup>2</sup> The sluggish performance of the non-gold exports is attributable to both internal and external factors. The acceleration in export growth can be accomplished by eliciting supply response to external markets and a reduction in transit and transport barriers. The former calls for bolder structural reforms (see next section for discussion on priorities), whereas the latter for exploiting the channels of regional cooperation already in place by using the WTO rule-based system as a departing point.<sup>3</sup> As for imports, demand has been strong, driven particularly by private consumption.

6. Improvements in the fiscal account reflected the combined outcome of strong tax collection (increasing from 15.8 percent of GDP in 2001 to 17.8 percent in 2003) and control over expenditures, particularly capital expenditures. Recurrent expenditure policies included significant stepwise increase in wages and salaries of selected public employees (mainly social sector employees such as teachers and medical personnel), bringing the total wage bill to 5.7 percent of GDP, up from 4.9 percent in 2001. Similarly, pension allocations were increased in a differentiated way to provide low pension earners with a more reasonable income (average pension income increased by 19 percent over its 2001 level). Although total social expenditure allocations have marginally increased in GDP terms, this is largely driven by the increase in salaries, with public funds allocated to health, education and social protection (other than pensions) remaining constrained.<sup>4</sup> On the other hand, budget allocations for operation and maintenance of basic infrastructure remained miniscule, continuing to affect such critical areas as irrigation networks, transportation, and education and health facilities. Furthermore, while there has been some progress in reducing the large quasi-fiscal deficit in the electricity sector (from 12.7 percent of GDP in 2001 to 11.1 percent in 2003) through a combination of price adjustments and improved collection, the cost-recovery ratio in 2003 remained far from being sustainable at low rates of about 60 percent.

7. Concerning tax policy reforms, efforts to further enhance revenue collection through the new tax schemes introduced in 2003 (VAT in agriculture as well as the real property tax) fell short of bringing expected outcomes. Overall, the tax burden and compliance costs remain high, which will only be partly addressed through ongoing efforts to streamline the Tax Code and

---

<sup>2</sup> While the value of total Russian imports increased by more than 60 percent during the period 1999-2003, the value of Kyrgyz exports to Russia increased by 37 percent. The value of Kyrgyz exports to Kazakhstan in 2003 stood 27 percent above its 1999 level, but Kazakhstan imports increased 135 percent over this time.

<sup>3</sup> For a detailed discussion on such a two-prong approach, see the World Bank's recent Country Economic Memorandum: An Integrated Strategy for Growth and Trade.

<sup>4</sup> For example, the average budget execution for the children's health insurance program between 2000-03 was 49 percent and for state guarantees and health insurance for vulnerable groups it was 57 percent)

introduce effective small business taxation (see para.21 for further discussion). While the fiscal reforms are far from complete, improvements to date are expected to underpin an external debt stock reduction by Paris Club Creditors in early 2005, which will increase flexibility and predictability in public expenditure management and help further strengthen the country's fiscal outlook. Nevertheless, the external indebtedness will still remain a heavy burden for the Kyrgyz economy, with future fiscal and debt sustainability calling for continued fiscal adjustment and reform. In this endeavor, greater attention will need to be given to resource requirements (particularly of critical special programs) and allocative efficiency implications of achieving Millennium Development Goals (MDGs) in key sectors.

8. Overall, growth has not yet led to commensurate increases in the number of jobs (the ratio of newly employed/total registered unemployed declined from 46.5 percent in 2001 to 45.3 percent in 2003). Trade and agriculture account for a disproportionately high share of total employment. Wages in agriculture and trade, on the other hand, remain very low, reflecting the presence of a large pool of jobless and discouraged workers. A good deal of activity continues to take place in the informal sector in services, street trading and subsistence farming. Clearly, addressing the problem of low formal job creation and promoting job creation outside agriculture are critical to furthering poverty reduction. Equally important is improving competitiveness of Kyrgyz goods and services in regional markets, which requires higher growth in labor productivity than local wages in order for the Kyrgyz Republic to capitalize on its presently competitive wages and real exchange rate (recent data suggest an opposite trend vis-a-vis CIS comparators).

9. All in all, this picture highlights the importance of not only the level, but also the pattern of growth for poverty reduction. It also suggests that the growth agenda needs to address more carefully the constraints to greater supply-side response to ongoing reforms, one that can sustain and expand recent gains to facilitate the broad based growth of economic activity and exports. This is further discussed in the next section.

10. **Poverty Profile.** The Government has made significant progress in the reduction of overall poverty over the period 2001-03 (from 47.6 percent to 40.8 percent) as measured by preliminary monetary indicators.<sup>5</sup> Total poverty levels continue to fall in both rural and urban areas but poverty remains higher in rural areas (45.7 percent versus 31.5 percent in 2003), while high levels of poverty among people, particularly internal migrants, living in recently constructed settlements in urban suburbs (*novostroiki*) are of concern. The relatively strong improvement in the overall levels of poverty provides optimism for the likelihood of achieving NPRS poverty reduction targets (38.9 percent in 2005 and 26.5 percent in 2010).

11. Disaggregated data on poverty reveal two important developments. First, extreme poverty fell rapidly from 13.5 percent to 9.4 percent during 2001-03—the recent preliminary data show extreme poverty falling sharply in urban areas over the last year and with a significant but relatively more moderate decline in rural areas.<sup>6</sup> The MDG of reducing extreme poverty by half by 2015 appears achievable now. The second important development is that the reduction in extreme poverty in 2003 was higher than the reduction in overall poverty, reflecting an improvement in the Gini coefficient from 0.328 in 2002 to 0.295 in 2003.

---

<sup>5</sup> Poverty rates referred to in this section are based upon expenditures per capita and were received from the National Statistics Committee as of September 20, 2004. Results for 2003 are still preliminary and may be subject to further change.

<sup>6</sup> Extreme poverty in urban areas fell from 12.0 percent to 5.0 percent in 2002-03 while rural poverty fell from 14.7 percent to 11.7 percent. **These declines over one period are large, which may be a result of their preliminary status.**

12. Since poverty is multi-dimensional, non-monetary aspects of poverty such as health status, educational outcomes, and access to essential infrastructure services all impact the population's welfare. The 2001 indicators highlighted relatively strong performance on basic enrollment rates (96 percent at the national level) and virtual universal immunization against DPT and measles. But, urban access rates to key services such as running water, district heating, and public sewerage systems were far less than universal at 70 percent, 58 percent, and 70 percent respectively in 2001.<sup>7</sup> The existing indicators on non-monetary aspects are insufficient for a robust assessment of welfare due to their limited scope and inability to capture information on the quality of services. For example, it is difficult to assess the population's health status, especially as measured by infant and child mortality rates, maternal mortality, and child malnutrition due to unavailability of internationally comparable data. Furthermore, little is known about the quality of water or consistency of its supply (see Annex 2 for ways of improving analytical basis for the NPRS).

## **B. Three-prong National Poverty Reduction Strategy – Priorities for Expanding and Sustaining Outcomes**

### ***Fostering Economic Growth and Creating Employment Opportunities***

13. As well acknowledged in the NPRS, the prospects for successfully changing the growth pattern and trajectory depend fundamentally on accelerated investment and economic-cum-export diversification. A wealth of national and firm-level indicators point to the fact that this requires a growth strategy that would improve competitiveness by creating conditions for more rapid and sustained productivity improvement in the Kyrgyz Republic. Actions are needed to address both domestic and external policy issues. Clearly formal and informal transit and transport costs are a major constraint to expansion of trade within and beyond the Kyrgyz Republic. Poor regulatory-cum-legal environment and trade support services, limited competitive pressures and low-level corruption, however, combine to raise trading costs to often prohibitively high levels and pose severe challenges for efficiency and competitiveness.

14. *Three issues are crucial for improving competitiveness: (i) the investment climate; (ii) efficient technology transfer mechanisms; and (iii) effective trade support services.* Factors, such as stronger financial intermediation capacity, better infrastructure, and faster enterprise restructuring are also important for productivity growth. But, the solution starts with the strength of investment incentives and the way firms organize themselves and deploy their labor and capital. Furthermore, deepening of financial markets will not occur unless there are improvements in particular features of the investment climate, such as legal and judicial reforms to improve contract enforcement and better accounting standards.

15. The Government has taken major steps to improve conditions in all of these areas in recent years. But change has been gradual and implementation has sometimes been poor. What is needed is greater resolve and a focused, cooperative effort between government, businesses and donors to make greater progress in implementing reforms and to develop a richer learning environment for enterprises.

---

<sup>7</sup> Central provision of network services to rural areas would be prohibitively expensive. Alternative methods for provision of these services exist and would need to be evaluated for cost efficiency and environmental soundness.

## 1. Investment Climate

16. Although a great deal of progress has been made in improving the investment climate, recent analytical and industry case studies, and recent surveys of the business community show that significant obstacles remain in the areas of governance, administrative barriers, taxation, and commercial law that continue to raise business costs and increase uncertainty.

17. ***Governance.*** The biggest complaint of investors concerns the lack of consistency and predictability in the investment climate, caused by deficiencies in governance: *poor administration and enforcement of regulations and poor administration of laws and the justice system.* These deficiencies give rise to weak implementation of the many regulatory and legal reforms that are being enacted. Clearly, if reforms are implemented poorly or corruptly, efforts aimed at revising regulations and laws make little difference. Therefore, any reform program that does not deal with public finance and civil service reform issues has little chance of success.

18. Governance reforms need to be intensified, with an emphasis on results oriented action to: **first**, eliminate off-budget funding sources (special means) of public agencies;<sup>8</sup> **second**, implement the newly developed civil service reforms to facilitate a professional merit based civil service and phase in a program to improve salaries; **third**, partner with donors for effective and well coordinated capacity-building in the civil service to improve efficiency and effectiveness; **fourth**, introduce effective procedures and sanctions to reduce official corruption; **fifth**, clarify the functions and responsibilities of public agencies to improve efficiency and to separate policy and regulatory functions.

19. ***Administrative Barriers.*** Despite a good deal of reform in this area, three important challenges remain to be addressed: **first**, lack of clarity and consistency in regulations; **second**, excessive discretion of public officials in interpretation and enforcement of regulations; **third**, limited recourse against arbitrary enforcement. In parallel, bolder reforms are needed to address the following problems with results tracked vigorously:

- **Business registration** continues to be time consuming. There is a need to cut registration time further, particularly outside major metropolitan areas. The rationale for business registration should be for declarative purposes.
- **Licensing** procedures remain complex and there is a good deal of non-transparency in the process. This needs to be addressed and the validity of licenses in most cases should be extended to at least 5 years.
- The number of legal and illegal **permits** in place continues to be excessive. Permits need to be rationalized and a posted price list for legal permits should be made available to the public.
- There is still no effective means of preventing unjustified **inspections** and no tolerable means of appealing decisions of inspecting agencies. Unfortunately, there is little trust in courts and the judicial system has no clear set of rules to follow in adjudicating such cases. There is a need to enact the draft on “protection of rights of businesses during inspections and auditing by official agencies” and to develop rules on what constitutes a legal inspection—i.e., what constitutes compliance and non-compliance.
- **Regulatory Impact Assessment** has also been a problem. There is a need to institutionalize the new Presidential Decree on regulatory impact assessment by developing methods and establishing a strong system to administer its effective implementation.

---

<sup>8</sup> Ongoing efforts to this need to be complemented with adequate budget funding for agencies, of which special means accounts are eliminated.

20. **Commercial Law.** Additional reforms are needed in the areas of investor protection and property rights to address concerns on fairness or consistency in enforcement of legal rights, absence of which has a chilling effect on foreign and domestic investment. These reforms will need to be complemented with a through reform of the court system to provide the courts with greater independence both administratively and in resource management, and with introducing a system that will establish a “hierarchy” of laws to streamline the current law-making process.

- **Contract enforcement** is a substantial problem and the Kyrgyz Republic is amongst the 10 most costly countries in the world in dispute resolution. The number of legal procedures needed to enforce a contract need to be reduced through judicial reform and the recently established third-party arbitration court should be administered well to function as a much-needed alternative dispute resolution mechanism.
- **Property rights for creditors and debtors** are being improved through the new draft Collateral Law, but draft provisions for non-judicial foreclosure need to be further strengthened to enable creditors to realize secured property after default other than through the courts. There is also a critical need to computerize the property registry.
- **Bankruptcy** procedures need to be improved. The recently amended Bankruptcy Law achieves some of the goals of insolvency, but it does not do well in terms of time (bankruptcy takes about four years to complete) and seldom results in an economically efficient outcome (in terms of a foreclosure and liquidation), or in successful rehabilitation (maintaining the business by hiring new management).
- Accurate **accounting information** continues to be a major problem, despite initiatives to improve the situation—lack of qualified accountants and auditors in International Accounting Standards, some legislative issues in the financial reporting area, and pending legislative actions for making the tax code consistent with the accounting law, and the Civil Code with the audit law are among the problems.

21. **Taxation.** Taxation is another cause of unpredictability, in particular because the tax regime is frequently changed, tax laws are open to differing interpretations, and tax administration is weak. Ongoing efforts to streamline and unify the laws in the Tax Code should help address part of this problem. But this needs to be complemented with proactive measures to: **first**, reduce incentives for abuse of official authority through investing in information technology and making organizational changes to reduce interaction and negotiation between the tax authorities and taxpayers as well as by providing positive incentives to professional tax administration through salaries and capacity-building programs; **second**, harmonize and coordinate the small business tax regime with other relevant elements of the tax regime and clarify the regime to eliminate the incentives for remaining small or splitting into smaller firms; **third**, improve VAT administration by exempting imports that are clearly for investment purposes, such as certain types of industrial machinery, and ensure timely VAT refunds for exporters; **fourth**, rationalize the tax burden and compliance costs through both eliminating cascading taxes and streamlining local taxes, and limiting the number of tax inspections.

## 2. Technology Transfer

22. Enterprise “learning” is a leading driver of productivity growth. Learning takes place in transition economies via the transfer of new technology (new ideas, machinery, management practices and so on) into the country from more advanced countries. A central tenet of economic growth analysis today is that without some degree of efficiency in importing suitably sophisticated technology, no transition economy can hope to achieve convergence toward more advanced economies. The main source of enterprise learning is via the private activities of firms

themselves, such as through interactions with buyers and suppliers, interactions with other firms in the industry, in-firm training, and hiring expert consultants.

23. Private technology transfer mechanisms in the Kyrgyz Republic are weak or in some cases missing. Few buyers and suppliers are coming to the Kyrgyz Republic, FDI is very low hence local firms cannot “benchmark” their operations against higher productivity foreign operators or copy their technologies. In-firm training is low, expert local consultants are often not available and foreign consultants are expensive. Government and donors can help by assisting in the growth of business development services, by offering matching grant schemes for firms to hire expert consultants and make visits abroad, and by providing funds for in-firm and external technical training. Fostering greater FDI, so that firms and local employees can learn from the “spillover effects” these foreign firms provide, is another important element. A better investment climate will be crucial in this respect. Finally, duties and VAT on imported technology (equipment, services and so on) should be kept as low as possible to provide incentives for technology transfer.

### 3. Trade Support Services

24. Efficient trade support services (customs, transport, handling and storage) assist exporters to lower supply-chain costs. There are major inefficiencies in *customs administration*. Long release times for inbound consignments; the absence of licensed customs brokers; mandatory inspection of all shipments; and lack of electronic data interchange between traders, customs administration, and other agencies, impose significant costs on exporters and importers alike. The new Customs Code will address some of these issues but intensive cross-border cooperation (including joint border controls, exchange of information between customs authorities, and regulatory cooperation regarding transport equipment) will be required with neighboring countries to address serious bottlenecks to trade. These arrangements exist among NAFTA members. They also exist between Central European countries on the EU accession path. South East European countries, which are part of the Stability Pact for the Balkans, have also been moving in that direction, albeit slowly.

25. *Standards*. The standard regime followed in Kyrgyz industries, inherited from former Soviet central planners, has two important implications: first, they were written outside of the international standards organizations and they are not considered to be valid by regulatory authorities in most countries. This puts Kyrgyz firms at a competitive disadvantage in supplying processed foods and technologically sophisticated products; second, and more significant in the short run, regulations requiring firms to demonstrate compliance with GOST standards through mandatory inspections and certifications, as opposed to market-oriented methods, significantly increase firms’ production costs as they require significant payments for tests and other procedures.

26. The recently intensified efforts to streamline the certification and inspection requirements and to improve standards and technical regulations are, therefore, important steps toward increasing the competitiveness of Kyrgyz firms. The following next steps are critical during the implementation of these new measures. **First**, shifting the burden of **standards development** task out of government agencies and into the hands of private sector bodies, especially those operating at regional or international levels. **Second**, promoting both **accreditation** of Kyrgyz conformity assessment providers to international standards and the acceptance of international accreditation of conformity assessment procedures; accelerating accession of Kyrgyz accreditation bodies to the International Laboratory Accreditation Cooperation and other multilateral arrangements, and accepting as valid laboratory results of foreign conformity assessment providers that are

accredited to international standards. **Third**, shifting the task of conducting testing for **conformity assessment** to the private sector and ensuring free trade in conformity assessment services; accepting manufacturers' self-declaration of conformity assessment; and expanding the validity of certificates so that fewer tests are required. **Fourth, recognizing** foreign governments' technical regulations that are based on international standards.

27. ***Backbone Services.*** The present Kyrgyz regulatory environment underpinning such backbone services as telecommunications, transport, financial services (banking, insurance, securities trading), distribution and business services (legal, accounting, consulting) fails to enhance competition, domestically and internationally. A range of domestic policy reforms is required. This includes rules for network access in telecommunication, licensing regimes, investment rules, rules on temporary movement of workers and competition policies and creating an environment hospitable for freight forwarders to reduce transport costs. Among these, addressing problems in the telecom sector (for instance, rules on network interconnection, the cost-based charges and the institutional separation of regulators and those who are regulated raise significant concerns) and in transport services (by promoting alliances of local forwarders, who offer intimate knowledge of their local market, with global forwarders, who hold regional and worldwide contacts) should be among the immediate priorities of the NPRS.

### **Other Critical Ingredients of Growth Strategy**

28. ***More Effective Financial Intermediation:*** The banking system has been on a gradually improving path over the last several years. Nevertheless, the limited financial intermediation capacity of the banking sector—with high real interest rates, expensive collateral-based credit, and very limited long-term financing—remain a considerable impediment to enterprise competitiveness. Among the factors explaining these weaknesses are an underdeveloped banking system, a small deposit base, and delays in the development of a sound regulatory framework for financial intermediation. In addition, incentives for firms to remain in the informal economy and operate outside the banking system keep monetary depth low, while both increasing costs and the risk of bank lending. Finally, the low disbursement rates of existing numerous donor-financed credit lines suggest that private credit might have been constrained by the lack of bankable projects. Effective implementation of several reform priorities highlighted above (e.g., property rights for creditors and debtor's, judicial and accounting reforms, and business development) as well as adoption of the amendments to the Banking Law (aimed at improving the legal and regulatory framework for banking and intermediation), will help address challenges in the system.

29. ***Upgrading Infrastructure.*** Despite the Government's efforts of the past few years in addressing reforms in infrastructure service provision, more needs to be done. Firm level studies report that, notwithstanding low user costs policies in the Kyrgyz Republic, infrastructure deficiencies reduce operating efficiency and raise distribution costs considerably. Deficiencies in water and in particular electricity supply are reportedly the biggest problems, with some areas across the country much worse than others. In spite of seemingly abundant endowments of hydro-power and water, the prevailing problems with their accessibility reflect the lack of a coherent sector policy and poor management. Another infrastructure problem is roads, particularly local roads, which raise transport costs, cause distribution delays and limit access to some markets. The poor accessibility/quality of such key services make for an unattractive climate for both foreign and local investors.

30. While there is a need to prevent the continued deterioration of infrastructure services, fiscal resources needed for this are beyond the current fiscal capabilities of the Government. The sustainability of infrastructure services will depend on the extent to which they could be self-

financing, and ensuring that local governments have adequate resources to provide them. Setting the right incentives and options to this end should be top priority of the NPRS:

- For urban infrastructure, under-pricing of basic communal services (which includes water, sanitation, heating, power etc.) need to be addressed by establishing: **first**, a regulatory framework for consumption based billing of basic infrastructure services; and **second**, adequate pricing for basic services with the objective of moving toward meeting full costs of operation and maintenance. There has been some progress towards addressing these issues in power sector, although reform process remains slow and volatile. Action is needed to introduce already planned measures for minimum adjustments in electricity tariffs and for financial discipline and for introduction of the key pieces of legislation on enabling private sector participation in the electricity and gas sectors.
- In provision of rural water supply, the foundation for community management of water supply provision has already been laid. The critical next steps would be to ensure the long-term sustainability of such services by defining and formalizing the communities' role in operation and maintenance, clarifying and adopting a transparent subsidy program to poorer communities that may be unable to afford basic water services (currently such subsidies are provided on an ad-hoc basis).
- Evolving intergovernmental fiscal reforms will need to effectively set the conditions for efficient and longer-term expenditure decisions in infrastructure service provision. These efforts must deal with the problem of the large stock of arrears held by communal services companies for local governments to be able to make a credible start in taking greater responsibility for service provision.

31. ***Consolidating Gains in Agriculture.*** The policies and programs that have driven agricultural growth to date facilitated creation of a diversified private farm sector and emergence of markets for land and finance. They have also improved the resource base and strengthened the physical and institutional infrastructure for agriculture. Sustaining this performance in the period ahead requires government strategy to adapt to the new agrarian realities (i.e. the specific technology and marketing needs of the new private farms). This—in addition to major improvements in resource management and service delivery in the sector<sup>9</sup>—calls for the following actions—all consistent with the CDF/NPRS framework and the three must-be-priorities of the growth strategy discussed above:

- **Complete Land Reform and Farm Privatization.** Approximately 22 percent of arable land and 30 percent of pastures is still held by large and inefficient agricultural enterprises. Until these enterprises are restructured and their land is included in the land reform program, the efficiency gap between these enterprises and private farmers will continue to widen and sectoral growth will be compromised;
- **Increase Transfer of Appropriate Technologies to Peasant Farms.** There is much scope for furthering recent productivity gains through the adoption of improved technology, including through better seed varieties, fertilizer and crop protection techniques. Livestock production will benefit from improved pasture management and access to water, better

---

<sup>9</sup> Along with increased cost-recovery, especially for irrigation, limited public resources for agriculture need to be channeled into sectoral priorities rather than traditional programs by the Ministry of Agriculture. Modernization and cost-effective provision of essential public services are also necessary, which the government should consider addressing through some level of private cost-recovery and service delivery. Re-organization of the Ministry of Agriculture, Water Resources and Processing Industries is the starting point for action. More effective donor coordination, with focus gradually shifting to well-targeted programs for private sector development, will help facilitate implementation.

husbandry (feeding and health), and genetic improvement. In addition to pre-requisites discussed above in paras 22-23, increasing technology transfer will require scaling up of agricultural extension activities developed with donor support over the past several years.

- **Strengthen Agricultural Markets.** Agricultural markets are high-cost, risky and poorly integrated, due to poor physical and institutional infrastructure and inadequate access to finance. This reduces farmer incentives to commercialize their production. Government needs to develop a supportive legal framework for marketing associations and cooperatives, support the establishment and adoption of appropriate grading and quality standards, and strengthen contract enforcement. It also needs to abstain from interfering in markets.<sup>10</sup> Improvements in these fronts will stimulate agricultural growth and increase opportunities for off-farm employment, with major benefits likely to be occurring to poor rural households.

### ***Improving Governance, Public Sector Efficiency and Institutional & Human Capacity***

32. ***Strengthening Public Resource Management.*** Reform of resource management is at the core of the NPRS strategy, since it is fundamental for allocating scarce resources to priority activities, which will improve both service delivery and business/investment climate. The Government's existing reform direction addresses key areas where ongoing efforts will need to be deepened and broadened as follows:

- **Improve Resource Allocation.** Progress with the development of a medium term budget framework (MTBF) over the past two years improved the Government's ability to make fiscally viable choices in allocation of resources. There are three important steps to further these efforts:
  - **First**, expand the currently three-sector coverage of the MTBF (Health, Education and Agriculture), in order to allow the policy makers to understand trade-offs across all sectors not only in the MTBF context but also in NPRS and annual budget processes. This could result in significant reallocation of resources across sectors under all three processes and require re-consideration of some NPRS priorities.
  - **Second**, integrate the Public Investment Program (PIP), including its external financing, into the budget process in order to facilitate integration of the MTBF, annual budget and NPRS process—the Ministry of Finance's (MOF) ongoing efforts to achieve this by 2006 fiscal year should be supported;
  - **Third**, integrate the MTBF process with the policy-making process in order to assure strategic direction from senior management in the annual budget allocations with due consideration to resource constraints. The transfer of all budget preparation functions to the Economic Policy Council (EPC) has paved the way for this. This process needs to entail an EPC review, early in the budget/MTBF process, of the sector strategies—submitted to the EPC and MOF in a costed manner, even if roughly, by line ministries. The EPC should then indicate, on behalf of the Government, strategic priorities for the allocation of resources to guide the detailed budget ceilings to be developed by the MOF;
- **Improve Liquidity Management.** Effective linkage of the NPRS policies to resource allocations is necessary but not sufficient to ensure targeted outcomes. Budget execution plays a key role in this respect. At present, budget execution has largely been governed by monthly meetings of a cash management committee within the MOF, which can effectively override priorities set in the budget. This problem was particularly severe in the last quarter

---

<sup>10</sup> Such as selling or buying at non-market prices, imposing mandatory marketing arrangements or prices for commodities.

of 2003 and the first quarter of 2004—e.g. health sector resources were significantly reduced. This problem needs to be effectively addressed by developing:

- a system of short term liquidity management (possibly based on a revolving fund to be replenished at the end of the fiscal year) to avoid dependence on monthly revenues;
- a transparent system of priorities for budget allocations and reductions in the event of a revenue shortfall.

➤ **Increase Accountability and Transparency in Public Resource Management.** The newly enacted Law on the Chamber of Accounts supports major increase in accountability in the public resource management (through the introduction of audit function) and in the reduction of corruption (through the reduction of the role of the Chamber of Accounts as a controller and inspector of private enterprises). However, its impact hinges on:

- Substantial training at and technical assistance to the Chamber in modern audit practices;
- Adequate budgetary financing to the Chamber to replace lost revenues from special means.

33. **Strengthening local governance.** De-centralization has become increasingly central to the policy agenda over the past two years. The presidential decree on the national decentralization strategy have committed to far reaching changes in the inter-governmental system, including the possibility of re-structuring the sub-national administrative structure. At present the Government’s reform efforts directed at strengthening the local self-governments (LSG—the bottom-tier, comprising cities, villages and settlements) through clarifying their service responsibilities and improving their resource base and its predictability, with the implementation expected in January 2006.

34. Clearly, these reform initiatives provide opportunities to improve not only the service delivery but also effectiveness, transparency and accountability across both central and local governments. Enabling local governments accomplish these many tasks, however, require much more than designing a structure of governance. Among many other steps it is dependent on establishing an environment where local people are able to bring pressure to bear on local political leaders to use their resources well, developing appropriate skills in local public servants, and putting the right incentives in place at every level of government. Success in these fronts hinges on recognizing that these reforms will be achieved over many years through continuous evolution and, hence, designing a consistent, policy-cum-institution building reform program that can keep the reform process on a right track. Over the next two years key priorities are:

- Determining the specific responsibilities for LSGs and “an intermediate” government<sup>11</sup>;
- Reforming intergovernmental transfer system;
- Reforming local tax system;
- Establishing and/or enhancing the LSG’s budget management system.

35. There are several important decisions that need to be given in each of these areas in a coordinated way (see Annex 3). What will greatly facilitate this process is the united effort by the central and local government, local citizens and donors. This has started emerging under the

---

<sup>11</sup> While need for two intermediate levels of government appears questionable in a country with a unitary structure and the size of the Kyrgyz Republic, there remains an important service delivery role to be played for an intermediate government. This is because many services generate benefits that cross a number of local self-governments, but do not require national participation in their delivery (e.g. certain aspects of water and sewer systems, and social services). Shared taxes or other mechanisms can be used to finance the intermediate governments, but the important first step is laying out their role and responsibilities prior to determining resource allocations. *To this end the Law on Territorial Design needs to be legislated very early in the process.*

framework of the Poverty Reduction Strategy Project, launched by the World Bank in coordination with the key stakeholders (see Annex 3).

36. ***Improving Institutional and Human Capacity.*** One of the fundamental links between governance and poverty reduction in the Kyrgyz Republic hinge on low public sector human and institutional capacity, which impedes public sector's ability to deliver policies and services critical to foster business development and growth. The Government has embarked on an ambitious program of reform both to create a de-politicized merit based Civil Service and to review the functions and structures of government institutions.

37. If further improved and fully implemented, the new Civil Service Law (June 2004) will increase the professionalism of the Civil Service both for service delivery and policy formulation. This calls for following actions:

- The newly created Civil Service Agency (CSA) is demonstrably independent and its senior officials are persons clearly committed to the reform of the public service;
- Unambiguous regulations for the appointment, dismissal and rotation of Civil Servants are developed by the CSA and implemented in all public sector agencies;
- The CSA monitors and enforces the implementation of its regulations;
- Effective training, including particularly knowledge of existing laws and regulations in their spheres of competence and in the ethics of public service is introduced for civil servants.

38. The ongoing functional reviews of the structure and staffing of a number of ministries and their subordinate agencies (assisted by a number of donor agencies such as the UNDP, DFID, TACIS), have so far had little impact in eliminating duplication of responsibilities within and across ministries. Among key reasons for this is the lack of real ownership by the ministries involved and, to a lesser extent, the differing methodologies. The first step in addressing this problems is: providing clear political leadership from the highest levels of the government to build a consensus on the need for structural reforms of central and local administration.

### ***Improving Efficiency and Equity of Social Protection and Human Development***

39. ***Education.*** Notwithstanding with virtually universal school enrolment for the compulsory cycle, and increasing enrollment rates for secondary and higher education, limited sector resources adversely affect access to and quality of education. The NPRS needs to prioritize education interventions to deal with these two challenges in addition to inadequate infrastructure and teacher incentives. In this endeavor, it needs to build on successful community-based initiatives to monitor and improve school performance. Following actions are needed:

- Efficiency of education spending needs to be improved. Public expenditures on primary education benefit primarily the poor, while expenditures on upper secondary and higher education primarily benefit higher-income groups. Nevertheless, educational quality is heavily dependent on the level of household expenditures on education, which adversely affects educational quality in poorer areas. The cost of education deters a large share of poor children from progressing to upper secondary and higher education. Budgetary expenditures should be concentrated primarily on the compulsory cycle. The ongoing move to capitation financing should lead to improved efficiency in use of education resources, but care needs to be taken to ensure that local governments are well prepared to implement it;

- Rural education, where inadequate resources and teacher shortages are particularly severe, needs to be better targeted<sup>12</sup>. The government's intensified efforts to this end, assisted with several donors (e.g. the World Bank's Rural Education Project, ADB's Third Education Project and USAID-financed PEAKS project), along with the improved School Grant program, developed by the Ministry of Education, are all expected to lead to major improvement in efficiency of resource management and in access to and quality of education;
- Privatization of higher education should be encouraged, gradually replacing the current reliance on contract places in public higher education institutions.

40. **Health.** The NPRS' health sector objective is to improve access to quality health services in general and specific health problems (such as brucellosis, TB and HIV/AIDS) in particular. Success with implementation of this strategy hinges on continuation of the health reforms, which are broadly on track, with both the legal framework for supporting the health financing reforms and the single-payer system in place. The overall policy environment for the implementation of the reforms is currently supportive.<sup>13</sup> Budget execution for the Ministry of Health's program for vulnerable groups has improved (from 29 percent in the first quarter this year to 142 percent in the third quarter). The new and improved methodology for calculating categorical grants to local governments for health<sup>14</sup> is expected to be endorsed by the MoF in the coming months. The financing that the Government received from the Global Fund will help in addressing HIV/AIDS and TB, which will be further supported by the government's participation in an IDA financed Regional HIV/AIDS Project. Despite these achievements, significant challenges remain:

- One of the most critical challenges is the inadequate public financing for health, especially for the Program of State Guarantees and for the MHIF program for vulnerable groups.<sup>15</sup> This is seriously jeopardizing efforts to improve primary care, which in turn affects the achievement of the MDGs (maternal and child health, TB and HIV/AIDS). It also has a negative impact on reducing out-of-pocket payments for health care. Among the key issues requiring attention is the application of the revised formula for categorical grants at the oblast level and defining the roles, responsibilities and accountability of local governments for delivering the Program of State Guarantees.
- Improving the intra-sectoral allocation of resources is another challenge. This requires the Government to pay greater attention to accelerating restructuring in Bishkek and Osh and also ensuring that any increases in the Ministry of Health budget including Republican Institutes of Health in Bishkek are justified and aligned with the poverty and health priorities under the NPRS. Achieving and sustaining the MDGs will require concerted action on HIV/AIDS and TB, including among the prison population, and nutrition initiatives (addressing problems such as anemia in women, iodine deficiency). Cross-sectoral actions that address problems with safe water in rural areas are also needed.<sup>16</sup> Some progress is being made in these areas under public health and health promotion initiatives, but these could be accelerated, including through public-private partnerships for health promotion.
- Improving the monitoring and evaluation capacity and the comprehensiveness of health indicators create a third challenge. Among other actions, this requires, increased efforts to

---

<sup>12</sup> Studies on monitoring of learning achievements (MLA), supported by UNESCO and UNICEF, have revealed that the quality of education is poorest in rural areas, where the majority of the school-age population lives.

<sup>13</sup> As indicated by the positive results of the President's Collegium in June 2004.

<sup>14</sup> On the basis of needs rather than health infrastructure and personnel.

<sup>15</sup> The latest estimates for the 2005 budget and the 2005-07 medium-term expenditure framework for health suggest critical gaps between needs and expected allocations under both programs.

<sup>16</sup> UN data indicates that more than 75 per cent of the households do not have adequate sanitation and one sixth of households (mostly rural) do not have access to clean drinking water. The serious outbreak of typhoid among communities in Batken oblast during the summer of 2004 resulted from extremely poor sanitary conditions.

follow through with encouraging steps the government has taken by adopting the WHO live birth definition and by committing to a nationwide revision of IMR statistics and increased financing for maternal and child health. It also requires addressing implementation challenges of multiple programs (health reform, Global Fund, IDA-financed Regional HIV/AIDS, other donors programs) by coordinating synergies between the programs and seeking strong coordination between the key stakeholders.

41. ***Social Protection.*** The overall social protection objective of the NPRS has been alleviating the most severe manifestations of poverty. Over the last two years, the levels of both pension benefits and unified monthly benefit (UMB) have been increased in real terms; a decree has been issued to eliminate and/or cash out poorly targeted privileges for certain categorically eligible groups; social insurance collections performance has been improved significantly; arrears in payment of pensions and of all or most benefits have been eliminated, and energy-linked social protection benefits have been increased and/or streamlined.

42. These efforts need to be broadened to address a series of unresolved social protection challenges (as identified by the MoLSP) in NPRS implementation: **first**, declining program funding at a time of rising need; **second**, poor targeting of privileged pricing for, or access to, goods and services; **third**, inadequate energy-related social protection measures; **fourth**, lack of an implementation framework for social services; and, **fifth**, faster growth of spending than of revenues within the pension system. Progress in these fronts hinges—in addition to addressing capacity limitations for development and implementation of measures to address these challenges—on the following:

- Completing recent social assistance reforms in privileges (for broadly defined categories of people) by creating an explicit and better-targeted social assistance mechanism to provide compensation for those in greatest need among the former recipients of these privileges. This policy initiative could further other recent changes in benefit levels and energy-related assistance by introducing a more streamlined and more “unified” benefit structure, with one focus on income that is low relative to needs and a second focus on protecting against sharp energy-related expenditures for low-income households;
- Building a more efficient administrative system for assessing the relative living standards of households in differing circumstances. This could entail strengthening the current system of “social passports” for assessing household resources and, in the process, developing improved methods for imputing income values to ownership of productive land and ownership of livestock. It could also entail addressing the absence of an implementation framework for social services for most vulnerable, including for children, young people, and families at risk;<sup>17</sup>
- Maintaining improvements in, and strengthening further, the fiscal sustainability of the current pay-as-you-go pension system, while completing numerous prerequisites for pursuing the Government’s foreshadowed gradual move toward implementation of a funded or accumulative element within the pension system. Developing and phasing in a financially sustainable payroll tax reduction policy should be an integral element of pension reform strategy.

---

<sup>17</sup> Institutional care for children has tripled during the last ten years, representing an unsatisfactory solution with adverse long-term social consequences to a problem that is greatly exacerbated by poverty levels. Women and girls are also vulnerable to rising levels of violence and exploitation.

## C. Conclusion

43. In sum continuing success of the NPRS in stimulating growth and reducing poverty depends critically on accelerating and broadening reforms in the following priority areas, all influencing efficiency and competitiveness in domestic and international markets:

1. *A better climate for investors and business managers*—through regulatory and legal reforms;
2. *Development of trade support services (telecom and transport are priorities)*—including through regulatory reforms;
3. *Support to productivity growth*—through technology transfer, skills training and better education.

Through complementary reforms to facilitate:

1. *Improvements in the public resource management and service delivery*—through policy and institutional reforms;
2. *Efficient supply of critical public inputs (energy and water are priorities)*—through policy and institutional reforms and partnership with private sector;
3. *Investment in human capital*—through better education, health and well-targeted social assistance.

44. Factors, such as stronger financial intermediation capacity, better across-the-board infrastructure, and faster enterprise restructuring are also important for productivity growth. But, the solution starts with the strength of investment incentives and the way firms organize themselves and deploy their labor and capital. Furthermore, deepening of financial markets will not occur unless there are improvements in particular features of the investment climate, such as legal and judicial reforms to improve contract enforcement, and better accounting standards.

45. There are several important decisions, which need to be given in each of the above-noted areas either to deepen or broaden the ongoing reform efforts under the current NPRS process as a matter of priority. The paper highlights these decisions, which require parallel actions across sectors consistent with the multi-dimensional nature of poverty alleviation. The paper also highlights the need for greater resolve and a focused, cooperative effort between government, businesses and donors to make greater progress in implementing reforms and, hence, achieving intended outcomes, which will ensure continuous evolution of the reform program.

46. Clearly, at the current and more advanced phase of the Kyrgyz Republic's transition reforms, developing institutional capacity and putting the right incentives in place both for public and private sectors' operations, are becoming increasingly more critical to the success of the NPRS implementation. Equally important is putting in place monitorable benchmarks for measuring the implementation performance and timely action for remedies. These are areas, where government and donors could work together more effectively and engage in soliciting greater feedback from the civil society for making a difference.

**ANNEX 1**

**Table 1. The Kyrgyz Republic: Medium Term Macro Parameters**

	2001	2002	2003	2004	2005	2006	2007
Poverty level (%)							
projections: PRSP (2002-2003)/ MTBF (from 20	47.6	...	...	38.6	36.0	32.9	30.2
actual	47.6	44.4	40.8				
Real GDP growth rate (%)							
projections: PRSP (2002-2003)/ MTBF (from 20	5.3	0.8	5.2	4.0	4.5	5.3	5.2
actual	5.3	0.0	6.7				
GDP per capita (USD)							
projections: PRSP (2002-2003)/ MTBF (from 20	308	330	359	403	433	469	508
actual	308	322	383				
Inflation rate (CPI %, Dec. to Dec.)							
projections: PRSP (2002-2003)/ MTBF (from 20	3.7	3.6	4.4	3.8	4.0	4.0	4.0
actual	3.7	2.3	5.6				
Gross investment(% GDP)							
projections: PRSP (2002-2003)/ MTBF (from 20	18.0	17.6	19.3	18.1	19.8	20.3	20.6
actual	18.0	17.6	16.2				
General government budget balance (% GDP)							
projections: PRSP (2002-2003)/ MTBF (from 20	-5.5	-5.6	-4.7	-4.4	-4.0	-3.2	-2.9
actual	-5.8	-5.2	-4.6				
External current account balance (% GDP)							
projections: PRSP (2002-2003)/ MTBF (from 20	-1.2	-2.8	-4.2	-6.2	-7.7	-6.3	-4.9
actual	-1.2	-1.7	-1.3				
Public External debt (% GDP)							
projections: PRSP (2002-2003)/ MTBF (from 20	94.2	...	...	85.1	82.6	79.3	74.0
actual	94.2	98.2	86.3				

Source: PRSP, PRSP progress report, MTBF, NSC, NBKR, WB staff's estimations

**Table 2. The Kyrgyz Republic: General Budget, Main Fiscal Parameters**

	2001	2002	2003	2004	2005	2006	2007
		(Actual)	(as share of GDP)		(Projections)		
<b>Total revenue</b>	20.4	22.7	22.9	22.0	22.1	22.2	22.2
of which tax revenue 1/							
(projections: PRSP (2002-2003)/ MTBF (from 2004)	12.4	13.6	14.6	14.3	14.8	15.1	15.4
actual	12.4	13.9	14.3				
<b>Total expenditure</b>	26.2	27.9	27.5	26.3	26.1	25.4	25.1
of which:							
salaries	4.9	5.3	5.7	6.0	6.0	5.8	5.7
<b>Education expenditure2/</b>							
total	3.9	4.6	4.8	4.2	4.6	5.0	5.3
of which							
budget means	3.1	3.4	3.5	3.4	3.5	3.8	4.2
of which salaries and SF deductions	2.0	2.2	2.4				
special means	0.8	1.1	1.0	0.7	0.9	0.9	0.8
foreign financed PIP	0.0	0.2	0.3	0.1	0.2	0.3	0.3
<b>Health expenditure2/</b>							
total	2.1	2.4	2.8	2.4	2.4	2.7	2.9
of which							
budget means	1.7	1.9	1.8	1.9	2.0	2.2	2.3
of which salaries and SF deductions	0.9	1.0	1.0				
special means	0.1	0.1	0.1	0.1	0.1	0.1	0.1
MHIF	0.2	0.2	0.3	0.2	0.2	0.2	0.2
foreign financed PIP	0.0	0.1	0.5	0.2	0.1	0.2	0.3
<b>Social protection expenditure2/</b>	6.4	7.7	7.3	7.6	7.6	7.5	7.5
of which labor pensions	4.2	4.8	4.7	4.8	4.9	4.9	4.9
<b>Total deficit</b>	-5.8	-5.2	-4.6	-4.3	-4.0	-3.2	-2.9

Source: MOF, PRSP, PRSP progress report, MTBF, NSC, NBKR, WB staff's estimations

1/ excluding deductions to SF

2/ including deductions to SF

**Table 3. Kyrgyz Republic: GDP, consumption, and poverty, 1996-2003**

	1996	1997	1998	1999	2000	2001	2002	2003	2000-03 Avg
Real GDP growth rate (%)	7.1	9.9	2.1	3.7	5.4	5.3	0.0	6.7	4.4
GDP per capita US\$ (average ex. rate)	392	374	343	255	279	308	322	383	323
GDP per capita growth rate (%)	5.5	8.3	0.6	2.3	4.3	4.5	-0.6	6.1	3.6
Consumption growth rate (%)	6.3	-8.1	15.1	0.9	-2.9	1.4	3.7	7.0	2.3
Consumption per capita growth (%)	4.7	-9.4	13.4	-0.5	-3.9	0.6	3.1	6.3	1.5
Consumption per capita index (1996=)	100	91	103	102	98	99	102	108	102
Poverty headcount (% of population)	43.5	43.0	54.9	55.3	52.0	47.6	44.4	40.8	46.2
Officially estimated unemployment	7.8	5.7	5.9	7.4	7.5	7.8	8.6	na	8.0

Source: World Bank staff estimates based on official data.

Note: Consumption data for 2003 is preliminary. It is projected residually, based on actual data on GDP and foreign savings, and projected data on investments, and could, therefore, be subject to overestimation.

**Table 4. The Kyrgyz Republic: Output and Labor Indicators**

	Employment structure		Relative wages (agriculture=1)	Average growth rate 99-2002		
	1996	2002		GDP	Wage	Employment
Total	100.0	100.0	2.2	3.6	3.7	1.5
Agriculture, hunting, fishery and forestry	47.1	52.7	1.0	5.3	3.1	3.4
Industry	14.6	10.3	3.4	0.1	3.3	-4.3
Mining 1/	0.6	0.4	2.6	0.9	-3.9	5.1
Manufacturing 1/	9.3	6.2	3.7	-2.1	4.1	-6.3
Production & distribution of electricity, gas and water	1.2	1.2	4.4	4.1	8.4	2.0
Construction	3.5	2.5	2.6	8.3	0.0	-2.4
Services	38.3	37.0	2.0	4.3	3.8	0.9
Trade, repair services, hotels and restaurants	10.2	12.0	1.9	7.5	3.1	2.8
Transport and communication	4.9	3.8	2.4	1.7	5.6	-2.2
Public administration	3.8	3.7	3.1	0.7	6.5	1.3
Social services	13.8	12.5	1.2	12.9	1.4	0.2

Source: World Bank staff estimates based on official data.

1/ Manufacturing in GDP in 1996-1999 includes mining, as according to the old GDP classification it was not separated from industry. From 2000 manufacturing includes only Kumtor-related gold mining, as gold mining and its initial processing is one process

## Strengthening Analytical Basis of the NPRS

1. The NPRS preparation and implementation is a data-intensive and analytically challenging process that depends on the statistical capacity and analytical ability to deliver, measure and evaluate the data. The Kyrgyz government, with donor support, is making progress to address the weaknesses in these areas; however much remains to be accomplished.
2. Reasonable progress has been made in basing the NPRS on a feasible medium-term macroeconomic and fiscal framework. Less progress has been achieved in linking expected outcomes with underlying reform prerequisites as well as in alternative reform scenarios and sensitivity analyses to simulate the impact of lower than expected outcomes. This is particularly important given the slow progress with improving the strength of implementation of reforms, the vulnerability of the country's economic performance to external and natural shocks, and an expected decline in gold production by the end of the decade. The development of long-term output targets would also help to ensure linkage between planned medium-term actions and long-term goals such as links between growth and poverty reduction, growth and employment. These efforts should focus on clearly spelling out linkages among key policy actions and the NPRS targets for important sectoral policies.
3. The Government has devoted significant efforts over the last three years to improving its monitoring of poverty both at the national and oblast levels in support of the NPRS process. The most important measure it has taken to improve the robustness of the data is the adoption of a new and improved questionnaire and sampling technique. However, inadequate tools exist for interpreting this rich data to understand the impact of structural policies and reforms on people's welfare.
4. In order to address the weaknesses in the poverty monitoring system, the Government can take several steps, which will significantly improve the usefulness of the information received in evaluating the implementation of the NPRS. First, it is essential to adopt a framework, which identifies the potential channels through which people's (monetary) welfare are affected. Consequently, greater consideration should be given to the link between employment (including in the informal sector) and poverty and urban/rural migration issues. Second, it is important to better monitor changes in people's access to and the quality of social and physical infrastructure services. In order to carry out both of these changes, the household questionnaire should be reassessed in light of its role in monitoring structural policies. Also, the Government may want to consider implementing community surveys to monitor developments in the provision of services, which impact non-monetary aspects of poverty at the regional level. Third, for better monitoring of impact on the ground, a special attention has to be paid to establishing the monitoring and evaluation systems at sub-oblast levels.
5. As discussed in the main text (para 32), there has been some progress made in identifying and linking financing requirements for NPRS objectives with annual budgets and the priorities of the MTBF, which needs to be consolidated over the medium-term. These efforts will need to be complemented with gradual expansion of the NPRS indicators to allow the Government evaluate and adjust NPRS policies in a more informed manner. In this process, particular attention will need to be given to greater dis-aggregation to capture rural urban inequities, regional differences, income disparities, gender imbalance, and the more comprehensive review of public expenditure outcomes.

6. Finally, much needs to be done to strengthen the monitoring and evaluation system itself. Despite efforts to develop a process for measuring the delivery of services and development outcomes, the government's expenditure planning/monitoring is still focused on traditional input control. The existing public expenditure reporting systems provide an incomplete basis for monitoring poverty-related expenditure, in part because the classification of expenditure does not cover all categories of pro-poor spending with particular difficulties in measuring implicit subsidies provided through the utility pricing and payment systems. Success of current efforts to deal with these issues hinges on additional actions to deal with weak coordination and information sharing in the government, lack of information at sub-national level, weak analytical capacity in government agencies and limited independent monitoring processes.

7. To support this process, institutional arrangements would need to be built to allow the information flow among data producers, analysts, and decision makers. More co-ordination is also needed between the Natstatcom and the line ministries/agencies in utilizing the new household survey for effective monitoring and evaluation. These efforts will need to be complemented by capacity-building programs to assist the executives to analyze and use available data for policy making. In addition, greater efforts are needed for civil society involvement in the monitoring and evaluation process, which requires capacity-building support to civil society organizations to help them contribute to policymaking and to engage in a constructive debate on policy reforms. The ongoing public expenditure management reform and fiscal decentralization reform provides opportunities for addressing these difficult issues with assistance from donor community.

## Kyrgyz Fiscal Decentralization

### Matrix of Main Issues and Options/Recommendations

Areas	Main Issues	Specific Actions	Timing
<b>I. Assignment of Local Self Government Responsibilities</b>	<ol style="list-style-type: none"> <li>1. Need for clear assignment of responsibilities for local self-governments.</li> <li>2. Continued reliance on non-cash transactions as a means for payments.</li> <li>3. Need for avoiding conflict between sectoral strategies and the decentralization agenda, through close coordination between relevant government bodies and clarification of overall policy sequencing.</li> </ol>	<ol style="list-style-type: none"> <li>1. <b>Assess service delivery capacity and implementation requirements for delivery of services of local significance:</b> (i) identify the extent to which proposed services are currently delivered by local self-governments and assess the service delivery performance; (ii) assess the capacity to undertake any new assignments; (iii) where appropriate consider asymmetrical assignment of responsibilities between ayl okmotus, city-type settlements and towns; (iii) develop an implementation program to guide the new service delivery system as of 2006.</li> <li>2. <b>Determine the relative responsibilities of local self-governments, intermediate government and the republican government for undertaking the joint service delivery functions</b> by undertaking the tasks laid out in Point. 1 for the joint functions.</li> <li>3. <b>Determine the relative responsibilities of local self-governments, intermediate government and the republican government for the delegated state responsibilities</b> by undertaking the tasks laid out in Point. 1 for the delegated state responsibilities.</li> <li>4. <b>Identify objective criteria for measuring costs of meeting local self governments expenditure needs</b> (including but not limited to population, land area, topological features).</li> <li>5. <b>Establish a criteria for service standards where appropriate and clarify the organization that would develop, monitor and evaluate the standards.</b></li> <li>6. <b>Review and assure consistency between sectoral strategies and the government's decentralization strategy.</b></li> </ol>	<p>Near-term (next 6 months)</p> <p>Short to medium term (next 18 months)</p> <p>Short to medium term (next 18 months)</p> <p>Near term</p> <p>Near to medium term, based on the progress in points 1-3.</p> <p>Near to medium term,</p>

Areas	Main Issues	Specific Actions	Timing
<p><b>II. Own-Sources Revenue Assignment and Revenue Autonomy</b></p>	<p>1. <b>Many local tax and non-tax revenues are not buoyant (i.e. they do not grow as fast as the economy).</b></p> <p>2. Existing local tax regime often does not generate tangible revenues while entailing administration and compliance costs.</p> <p>3. <b>Continued reliance on non-cash transactions as a means for revenue collection.</b></p> <p>4. <b>Limited autonomy in determining own-source revenues, particularly for aily okmotus.</b></p> <p>5. <b>Need for significant improvement in collection efficiency of local revenues.</b></p>	<p>1. <b>Assess local self government revenues</b> in terms of (i) revenue generating potential and buoyancy; (ii) administration and compliance costs; (iii) collection efficiency; and (iv) implicit distortions leading to changes in businesses and individual practices</p> <p>2. <b>Identify objective criteria for measuring local government own source revenue generation capacity</b> (including but not limited to population, fertile land area, topological features, a measure of income of gross product).</p> <p>3. Identify necessary changes to local revenue regime—<b>based on analysis under point 1—for (i) streamlining local revenue system by eliminating poorly performing local taxes and fees; (ii) monetizing non-cash collection of revenues; (iii) upgrading local capacity for local tax administration; and (iv) consider giving local self governments exclusive responsibility for collection of “own-source revenues.”</b></p> <p>4. <b>Consider giving local self governments additional control over their revenues</b> by allowing autonomy to differentiate selected tax rates and bases within set margins.</p>	<p>Near-term (next 6 months)</p> <p>Near term</p> <p>Near to Short-term</p> <p>Medium-term</p>
<p><b>III. Intergovernmental Transfer System</b></p>	<p>1. <b>Non-transparent transfer of revenues</b> generating perverse incentives for soft budget constraints; discouraging collection of local revenues and limiting ability for efficient delivery of services.</p>	<p>1. <b>Determine the overall resources that need to be transferred directly to local self- governments</b> (i.e. re-define vertical distribution/balance between local self governments and oblast and raions). This is to be done based on the assessment of the costs of meeting expenditure responsibilities in item I and the own-source revenue capacity in item II.</p> <p>2. <b>Establish objective transfer mechanisms for channeling necessary resources to local self-governments</b> through (i) categorical</p>	<p>Near-term</p> <p>Near-term</p>

Areas	Main Issues	Specific Actions	Timing
		<p>grants and (ii) equalization grants (defined as positively related to expenditure needs and negatively related to revenue capacity). The equalization grant should be designed not to discourage local revenue generation from own sources, which is achieved if the grant is determined by the capacity to raise own source revenues and not the actual amount of own source revenues raised.</p> <p><b>3. Consider an interim hold harmless provision</b>, which prevents any local government from receiving less transfer revenues in the first year of the new financing system than it received during 2005, and hence prevent reduction in their revenues under the new grant-based transfer system.</p> <p><b>4. Identify an objective measure for determining the total equalization transfers</b> from the republican budget to local self - governments to grow with the tax revenues—such as by allocating a fixed percentage of total tax revenues for equalization grants.</p> <p><b>5. Consider a tax sharing system and/or categorical grants for those local self-governments, which receive asymmetric assignment of responsibilities.</b></p> <p><b>6. Consider modifying the newly introduced matching grant system for capital projects</b> to (i) identify eligibility criteria for local self governments and types of projects; and (ii) set matching rates consistent with objective measure of ability to generate own source revenues (such as per capita capacity to raise own source revenues).</p>	<p>Short term</p> <p>Short to medium term</p> <p>Near to short term</p> <p>Medium Term</p>
<p><b>IV. Budget Management</b></p>	<p><b>1. Poor incentives for local self governments to raise local revenues or rationalize expenditures.</b></p> <p><b>2. Low budget management capacity across the government.</b></p> <p><b>3. Poor incentives for the local-self governments to provide accurate accounts for their</b></p>	<p><b>1. Provide local self-governments with independence to prepare, enact and execute their own budgets</b> in line with their expenditure assignments and revenue sources as legislated.</p> <p><b>2. Develop a plan for implementation of the new resource transfer system by the Ministry of Finance.</b></p> <p><b>3. Develop a plan for assessing budget management capacity building needs in local self- governments and addressing them through TA, training, etc.</b></p>	<p>Near term</p> <p>Near term</p> <p>Near term</p>

Areas	Main Issues	Specific Actions	Timing
	<p>expenditures and revenues.</p>	<p>4. Preclude local self-governments from borrowing across fiscal years or running annual deficits.</p> <p>5. Allow local self- governments to retain excess own-source revenue collections across years.</p> <p>6. Develop a mechanism for reporting and monitoring local self-government revenues and expenditures systematically.</p> <p>7. Develop and action plan for modifying the operating rules of the Treasury system to ensure full control by the local self governments over their financial management within the rules set by the Budget Principals Law.</p> <p>8. Implement external audit function at local self-government level; phase-in internal audit system.</p>	<p>(Budget Principals Law)</p> <p>(Budget Principals Law)</p> <p>Near-to medium term</p> <p>Short term</p> <p>Short to medium term</p>
<p>V. Reform Process</p>	<p>1. Unanticipated difficulties and constraints will develop as the decentralization process goes forward and as the Kyrgyz economy and government structure evolve.</p>	<p>Strengthen coordination by setting up a Steering Committee on Intergovernmental Relations, composed of national and local officials, that will assist in monitoring the reform process and guiding the evolution of the decentralized system</p>	<p>Short to long term</p>

Areas	Main Issues	Specific Actions	Timing
<p>VI. Reform of the Administration Structure</p>	<p>1. Lack of clarity about the new role of intermediate level of local government—whether it will be devolved or remained largely as de-concentrated.</p>	<p>1. Determine the service responsibilities for the intermediate government aiming at greater efficiency (allowing for economies of scale, and efficient use of resources) and accountability.</p> <p>2. Define the revenue sources for the intermediate government if it is devolved. If de-concentrated, financing should fully come from the republican budget (i.e. no tax sharing or transfer systems are appropriate).</p> <p>3. Determine the nature of relationships between the different levels of government under the new system—such as whether there is a hierarchical, parallel or some other.</p>	<p>Medium term (next two years – for the 2007 fiscal year)</p>