

## Chapter 4. Financing social protection

*This chapter examines spending on social protection from a systemic and whole-of-government perspective. It locates social protection expenditure within the Government's overall budget and examines spending trends across the different pillars of the social protection sector, as well as across individual programmes within this sector. It also analyses the composition of government revenues and the financing of social protection in particular, identifying the increasing subsidisation of the social insurance system by the Republican Budget as a major cause for concern. It concludes with a fiscal incidence analysis showing the overall system of taxes and transfers significantly reduces inequality but its impact on poverty is less clear.*

Social protection is the largest component of public spending in Kyrgyzstan. Exceeding spending on health and education combined, social protection spending is particularly high for a country at Kyrgyzstan's income level. Within the social protection sector, spending on contributory pensions benefits dwarfs expenditure on all other programmes.

Social protection spending has grown in recent years and the modalities of financing are changing. Contributions to the Social Fund have not risen at the same pace as pension expenditure, with the result that the Social Fund is increasingly reliant on transfers from the Republican Budget to meet its obligations. The sustainability of the pension system is a concern not only for the social protection sector but also for public finances as a whole.

Strong growth in tax revenues and sustained support from donors have accommodated growth in social protection spending. However, donor support is declining now that Kyrgyzstan has attained middle-income status and the prospects for social protection to receive additional financing are low, given the proportion of expenditure already allocated to the sector and broader concerns about the country's debt level.

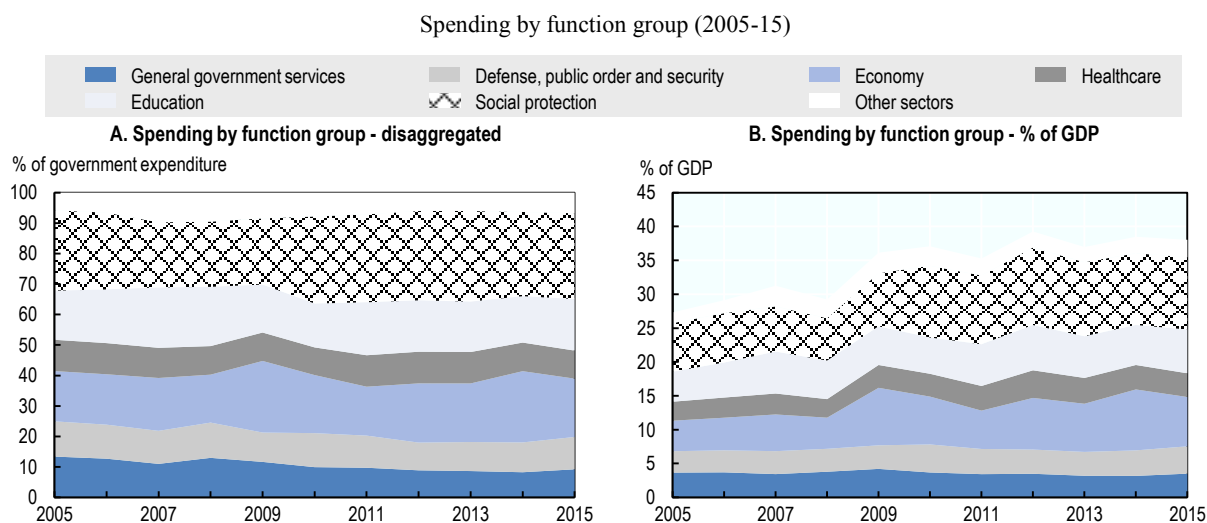
### Social protection dominates public spending

Public spending on social protection includes contributory programmes (financed by earmarked revenues) and non-contributory programmes (financed through general taxation) catalogued in Chapter 2.

Social protection, including both contributory and non-contributory programmes, is the largest function group in terms of public expenditure. It accounted for 28.0% of total public spending in 2015 (Figure 4.1A), more than spending on education (17.0% of total spending) and health (9.2%) combined. In 2009, social protection accounted for 21.7% of spending but this figure jumped in 2010 as a result of higher social assistance spending and has since stayed at an elevated level.

The next largest function group is economic spending (19.1% of expenditure in 2016), which had been the largest function group in 2009 (23.5%), but its allocation was reduced sharply the following year, in contrast to allocation to social protection.

**Figure 4.1. Social protection is the largest function group by spending**



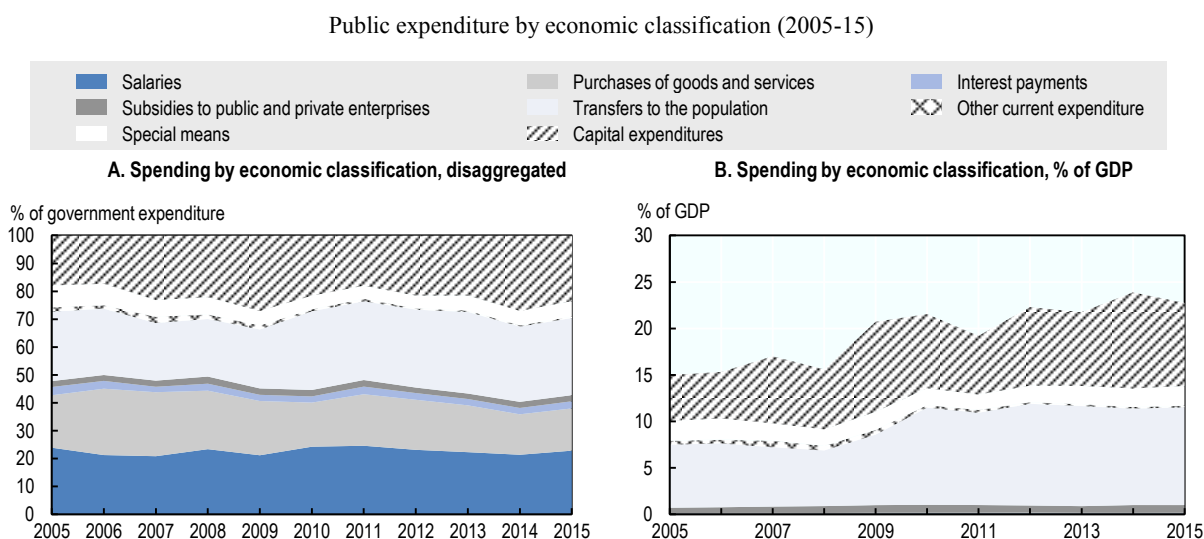
Social protection spending has also increased as a percentage of gross domestic product (GDP) (Figure 4.1B). In 2015, social protection spending equated to 10.7% of GDP, versus 7.8% in 2009. Over the same period, spending on the economic function group fell from 8.5% to 7.3% of GDP. In the years since 2010, functional allocations have remained relatively consistent, with only the education budget showing significant growth (rising from 5.4% to 6.5% of GDP between 2010 and 2015).

Kyrgyzstan's education spending is also high, allocating approximately 17% of spending to the sector in 2015 compared with Russia (7.3%), Uzbekistan (7.9%) and Kazakhstan (3.5%) in 2014.

In 2015, Kyrgyzstan spent between 3% and 4% of GDP on the health sector, a large proportion of which went towards outpatient and inpatient treatments (including those at primary health facilities). By comparison, Russia spent 6.2% of GDP, Uzbekistan 2.9% and Kazakhstan 2.2% in 2014.

The weight of social protection in the budget is reflected by the classification of spending. Transfers to households is the largest category of spending, accounting for 27.7% of expenditure and 10.5% of GDP in 2015 (Figure 4.2). This indicates that significant redistribution takes place through the budget, although the majority occurs between generations of workers rather than between income groups due to the preponderance of pension expenditure.

**Figure 4.2. A high level of transfers makes the fiscal framework highly redistributive**



Source: NSC (2016<sup>[1]</sup>), "Government budget expenditures", available at [stat.kg/en](http://stat.kg/en).

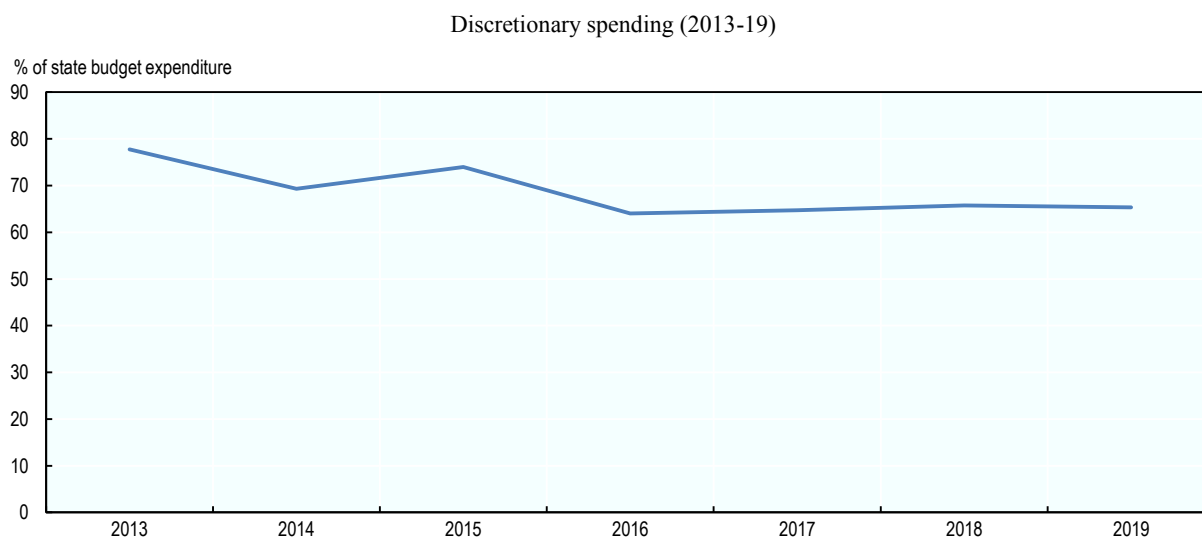
The next largest categories of spending in 2015 were capital spending (23.6%) and the public sector wage bill (22.8%), although capital spending fluctuates significantly over time. The wage bill fluctuated between 21% and 25% between 2008 and 2015, partly due to ad hoc salary increases; the GoK is currently aiming to reduce its wage bill. The goods and services budget (which in broad terms captures expenditure on the day-to-day activities of public servants) fell from 21.0% to 15.2% between 2008 and 2015.

The Ministry of Finance (MoF) calculates discretionary expenditure as total expenditure excluding debt service costs, external assistance and special means. By classifying the

public wage bill and social spending as discretionary, the Government of the Kyrgyz Republic (GoK) provides significant flexibility for reallocating spending within the existing resource envelope, although the extent to which pension spending is truly discretionary is worth considering.

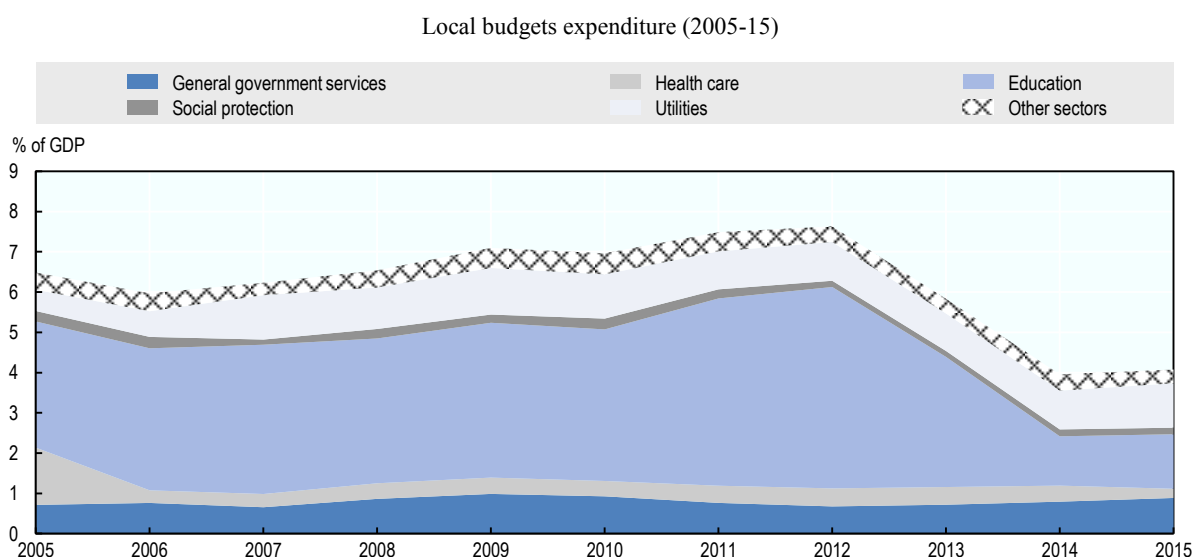
The share of recurrent discretionary expenditure in the state budget has been decreasing since 2013 but is expected to remain fairly constant between 2016 and 2019 (based on estimates from the Medium-Term Budgetary Framework) (Figure 4.3). Recurrent discretionary expenditure represented 64% of the Republican Budget in 2016, down from 78% in 2013.

**Figure 4.3. Discretionary spending is declining**



Source: NSC (2016<sup>[11]</sup>), "Government budget expenditures", [stat.kg/en](http://stat.kg/en).

The majority of expenditure is managed centrally through the Republican Budget (65% of total expenditure in 2015) and the Social Fund (24%). In 2015, local budgets managed 11% of total expenditure, equivalent to 4.1% of GDP (Figure 4.4). District budgets finance utilities (such as water and heating) and education, although education spending fell sharply in 2013, when financial responsibility for secondary education was transferred from the local level to the Republican Budget. Local administrations are also responsible for certain social protection activities.

**Figure 4.4. Centralisation of education spending greatly reduced local budgets**

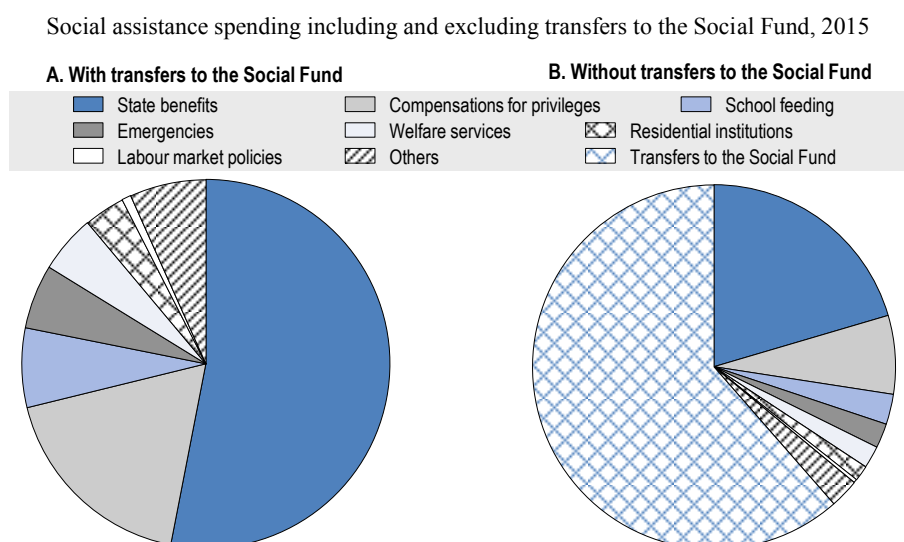
Source: NSC (2016<sup>[1]</sup>), "Government budget expenditures", [stat.kg/en](http://stat.kg/en).

### *Social protection spending is dominated by pensions*

The contributory pension and health-care programmes have different financing mechanisms, while non-contributory programmes comprise two categories of spending: state benefits and compensations for privileges.

### Spending on social assistance has shifted among programmes

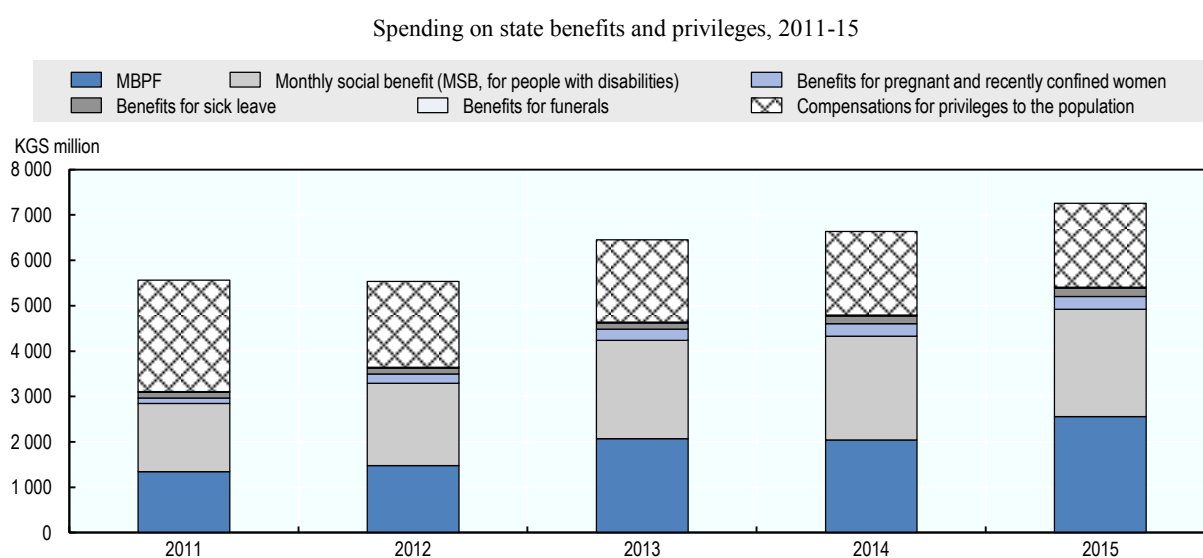
Expenditure on non-contributory benefits amounted to KGS 10.2 billion (Kyrgyz soms) in 2015 or 2.5% of GDP. Figure 4.5 shows this spending disaggregated by programme type. Figure 4.5A shows direct social assistance expenditure, which includes state benefits, compensations for privileges, school feeding programmes and labour market policies. Figure 4.5B shows this spending dwarfed by transfers from the Republican Budget to the Social Fund to fill funding gaps on the contributory side of the system. These transfers finance the basic pension component, military pensions and pension top-ups for other designated categories.

**Figure 4.5. Subsidies to the pension system dominate tax-financed social protection spending**

Source: NSC (2016<sup>[1]</sup>), “Government budget expenditures”, available at [stat.kg/en](http://stat.kg/en).

### State benefits

Expenditure on state benefits in 2015 amounted to KGS 5.4 billion, representing 3.5% of total government spending and nearly 1.3% of GDP (Figure 4.6). This expenditure was financed predominantly via the Republican Budget. Between 2011 and 2015, the composition of spending on state benefits changed: the Monthly Social Benefit (MSB) was the largest programme in expenditure terms between 2011 and 2014, overtaken in 2015 by the Monthly Benefit for Poor Families with children (MBPF).

**Figure 4.6. The MBPF is driving growth in social assistance spending**

Source: NSC (2016<sup>[1]</sup>), “Government budget expenditures”, [stat.kg/en](http://stat.kg/en).

The MBPF accounted for 0.5-0.6% of GDP between 2011 and 2015, representing 4.1-5.6% of total social protection expenditure. Growth in the allocation to the MBPF coincided with a reduction in the number of beneficiaries. Between 2011 and 2015, spending on the MSB was between 0.5% and 0.6% of GDP and accounted for between 5.1% and 5.5% of total social protection expenditure; higher spending was driven by increases in benefits (for some categories) and higher coverage.

The three remaining types of state benefits (for pregnant women, sick leave and funerals) are much smaller, with a cumulative budget of 0.1% of GDP in 2015. Funeral benefits is the only state programme that receives funds from both the Republican Budget and local budgets, with the latter accounting for 43% of spending in 2015.

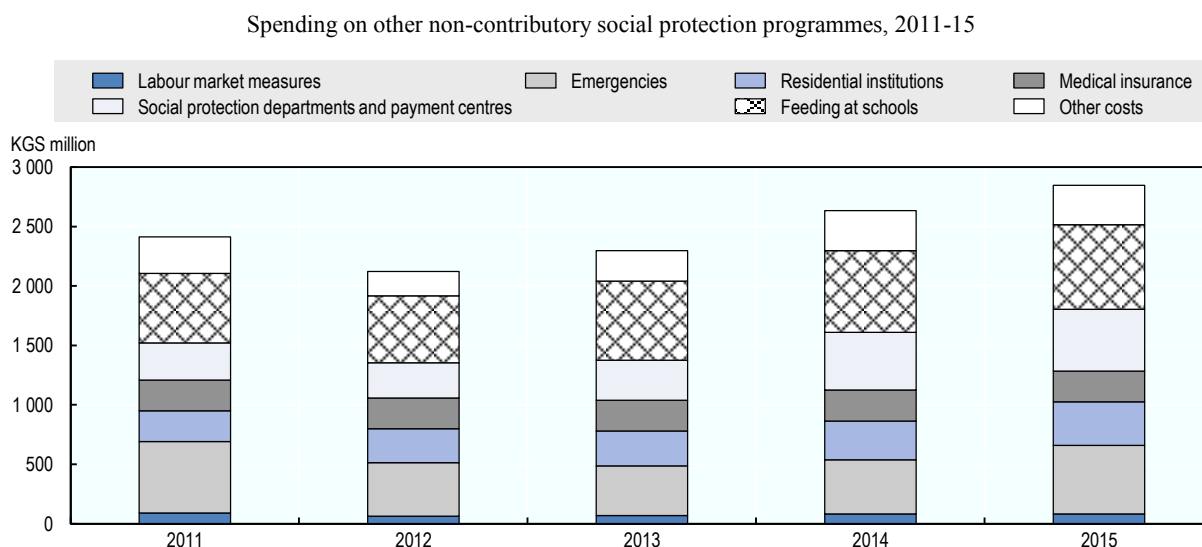
### *Compensations for privileges*

In 2011, spending on compensations for privileges was approximately 80% of the level of spending on state benefits in the same year. Since then, privileges spending has declined sharply in nominal terms, from KGS 2.5 billion to KGS 1.8 billion in 2015, falling to 34% of the level of spending on state benefits.

This decline reflects both policy choices and demographic trends. The value of compensations was frozen in 2012 in nominal terms; as a result, total spending on the compensations fell from 0.9% of GDP (2.3% of total expenditure) in 2010 to 0.4% of GDP (1.2% of total expenditure) in 2015. The decline is partly natural, as the number of surviving World War II veterans and invalids, who comprise a significant portion of recipients, declines with time.

### *Other social protection programmes*

Kyrgyzstan's social protection system also includes labour market policies, emergency assistance, social services and residential institutions. Expenditure on these programmes, which are managed by various institutions amounted to KGS 2.8 billion in 2015, a level that exceeded spending on the MBPF that year. Figure 4.7 disaggregates this spending from 2011 to 2015.

**Figure 4.7. Spending on other tax-financed social protection has declined in real terms**

Source: NSC (2016<sup>[1]</sup>), “Government budget expenditures”, available at [stat.kg/en](http://stat.kg/en).

### *School feeding*

All school children in grades 1-4 are entitled to breakfast at school, funded by the Republican Budget and local budgets. In 2015, the GoK spent KGS 7 million (less than 0.2% of GDP or less than 0.5% of total expenditure). Over the last five years, spending on the programmes has been relatively stable in real terms.

### *Social protection departments and payment centres*

Rayon-level units of the MoLSD and aiyl okmotu are active in the provision of social services and the implementation of social protection policies in rayons, towns and aiyl aimaks. The resources allocated to these activities are extremely low: spending by the social protection departments of the MoLSD averaged 0.1% of GDP or 0.3% of total public expenditure from 2011 to 2015. Information on social protection spending by aiyl okmotu is not available.

### *Natural disasters*

Aid for those affected by natural disasters is provided in the form of grants and loans. Chapter 1 noted the significant increase in such emergencies in Kyrgyzstan in recent years, but it has not been matched by increasing allocations. Between 2011 and 2015, expenditure on grants and loans combined fluctuated between KGS 417 million and KGS 600 million (0.1%-0.2% of GDP) or between 0.3% and 0.4% of total expenditure. On average, loan expenditure was about five times larger than grant expenditure over this period.

### *Health spending*

The Republican Budget finances the health insurance contributions of children under age 16, pensioners and the recipients of state benefits. Between 2011 and 2015, the quantum of contributions financed by the Republican Budget was frozen in nominal terms at



KGS 295 million, leading to a 20% decrease in real terms over the period. Currently, spending on the programme is less than 0.1% of GDP.

### ***Residential institutions***

Kyrgyzstan has several types of residential institutions for different vulnerable categories (discussed in Chapter 2): children under age 3 and their mothers (managed by the Ministry of Health), orphaned children and adolescents (Ministry of Education), children and adults with disabilities (MoLSD and local governments) and the elderly (MoLSD and local governments). Expenditure by the MoLSD on these institutions has increased each year in nominal terms but is below 0.1% of GDP, or 0.3% of total expenditure.

### ***Labour market policies***

The levels of coverage and funding for labour market policies (unemployment benefits, public works programmes and professional training) are very low. Allocations for unemployment benefits and public works programmes declined in nominal terms between 2011 and 2015, while expenditure on professional training declined in real terms and fluctuated significantly over the period. The allocation to public works programmes was the largest of the three labour market interventions in 2015. Local administrations occasionally contribute additional financing to public works projects.

## **Social insurance is increasingly reliant on transfers from the Republican Budget**

The Social Fund is the central financing mechanism for social insurance in Kyrgyzstan. Its annual expenditure in 2015 was KGS 37.3 billion or 9.2% of GDP – nearly four times the level of social assistance spending. The Social Fund comprises three components: the Pension Fund (which comprises contributory and non-contributory components as well as the quasi-contributory basic pension component); the State Cumulative Pension Fund ([SCPF], the funded pillar of the pension system) and the Fund for Health Improvement of the Working People (FHIWP). The Social Fund also collects contributions on behalf of the health insurance system.

The imbalance between benefits and contributions in the Pension Fund has worsened in recent years. Although pension coverage among pensioners is close to universal, a much lower proportion of today's workforce is contributing to the Social Fund, reflecting high levels of informality and emigration. Moreover, expenditure on non-contributory military pensions is rising at a steep rate.

As a result, the Social Fund's financial position is deteriorating, and ever-higher transfers from the Republican Budget are required. This trend undermines the contributory principle of the Social Fund and jeopardises the fairness of the social protection system as a whole.

### ***The Pension Fund***

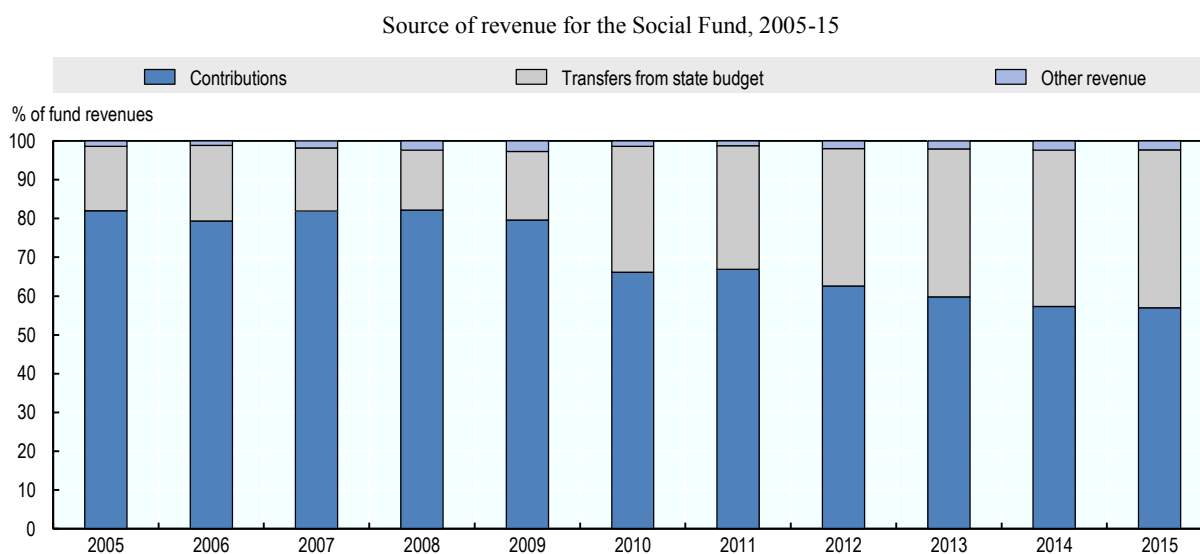
Payments by the Pension Fund (comprising benefits for old age, disability and survivors) totalled KGS 31.3 billion in 2015 and accounted for 89.9% of Social Fund spending. The Pension Fund's spending grew at an average annual rate of 7.1% between 2011 and 2015 in nominal terms, primarily due to an increase in the number of beneficiaries (from 575 000 pensioners in 2010 to 634 000 in 2014). The average pension benefit also increased, from KGS 2 886 to KGS 4 710 per month, over the same period.

Increased expenditure has not been matched by increased contributions. Although Kyrgyzstan's demographics are favourable for a pay-as-you-go arrangement, high levels of emigration and informality have resulted in the ratio of contributors to pensioners declining to between 1:1 and 2:1. This situation is exacerbated by the non-contributory pensions and pension top-ups paid by the Social Fund as well as by the design of the basic pension component, which accounted for 27.4% of all pension payments in 2015; the benefit is based on the duration of contributions rather than the value.

In 2015, these supplementary pension payments were almost as expensive as basic pensions (KGS 7.7 billion vs. KGS 8.6 billion). The strongest growth is in expenditure on military pensions, which is the fastest-growing category of social protection spending.

To finance the basic and additional pension components, the Social Fund is increasingly reliant on transfers from the Republican Budget (Figure 4.8). In 2005, contributions represented 82% of the Social Fund's total revenue, while transfers amounted to 16.6%. The share of contributions dipped sharply in 2010 to 66% and has kept declining since. In 2015, contributions accounted for 57% of revenues.

**Figure 4.8. The Social Fund is increasingly reliant on transfers from the Republican Budget**



Source: NSC (2016<sup>[21]</sup>), "State budget revenues", [stat.kg/en](http://stat.kg/en).

The proportion of Social Fund revenues coming from the Republican Budget are expected to continue over the medium term due to the GoK's commitment to finance 100% of basic pension expenditure via such transfers. According to the MTBF, adopted in May 2016, the Republican Budget achieved this target in 2017.

In total, transfers from the Republican Budget to Social Fund programmes amounted to KGS 16.3 billion in 2015, 60% more than was spent on social assistance. These transfers are disaggregated in Figure 4.9, which reflects the high growth in transfers needed to finance the basic pension component. Old-age pensions absorbed 53% of these transfers in 2015, up sharply from 36.4% in 2011.

**Figure 4.9. The basic pension component is a growing burden on the Republican Budget**

Transfers from the Republican Budget to the Social Fund by spending item, 2011-2015

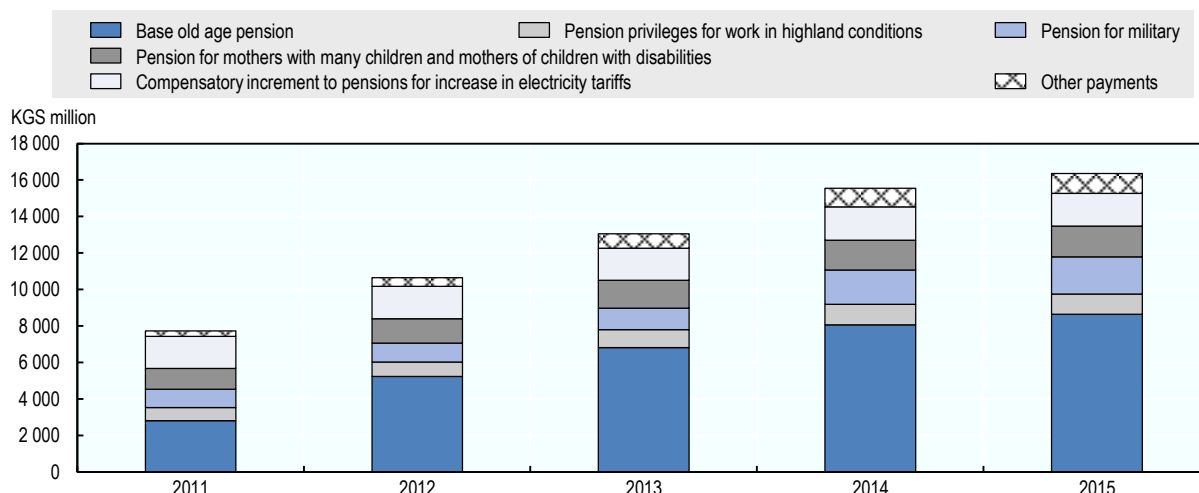
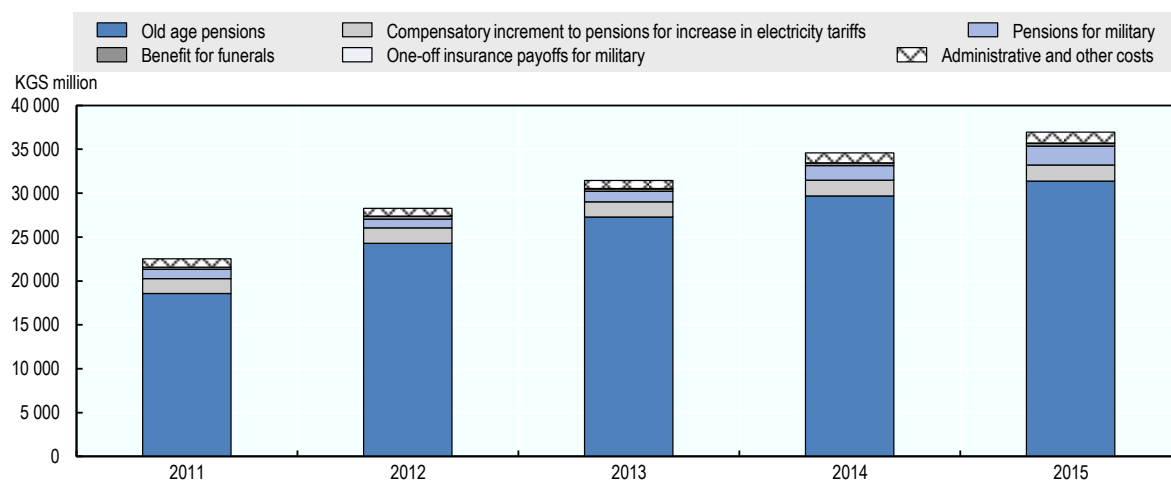
Source: NSC (2016<sub>[2]</sub>), "State budget revenues", [stat.kg/en](http://stat.kg/en).

Figure 4.10 shows total expenditure on pensions by the Social Fund (including both spending financed by contributions and Republican Budget transfers). The increase in pension spending moderated after strong growth between 2011 and 2012, but military pension spending grew strongly over the period. Old age pensions accounted for 85% of total spending.

**Figure 4.10. Pension spending is growing in nominal terms**

Social Fund expenditure by spending item, 2011-15

Source: NSC (2016<sub>[1]</sub>), "Government budget expenditures", [stat.kg/en](http://stat.kg/en).**State Cumulative Pension Fund**

Established in 2010, the SCPF is a fully funded component of the Social Fund. It receives contributions worth 2% of payroll from male workers born after 1964 and female workers born after 1969. Older workers are excluded from contributing, as they will not make

sufficient contributions before retiring to generate a meaningful income when they do. SCPF expenditure is presently very low at just 0.3% of Pension Fund expenditure, but it had accumulated assets worth KGS 8.2 billion by the end of 2015.

### *Fund for Health Improvement of the Working People*

The Social Fund collects contributions for the FHIWP, a small contributory arrangement managed by the Federation of Trade Unions of the Kyrgyz Republic. The FHIWP is financed by employer contributions of 0.25% of payroll and its spending is earmarked for recreational activities, such as sanatorium and spa treatment and recreation centres for children. In 2015, spending by the FHIWP amounted to 0.05% of GDP.

### *Health spending*

In addition, the Social Fund budget collects contributions from the population for the MHI at a rate of 2% of salaries, paid by employers. The rate for farmers depends on how much land they own: in 2016, the rate ranged from 0.05% to 0.3% of the average monthly wage in each district. For individual entrepreneurs, it ranged from 0.3% to 1% of the average monthly wage. Other informal workers can also enrol in the MHI with a flat rate contribution of KGS 550. As with the Pension Fund, health insurance also has a non-contributory element as the SGBP covers everyone for primary care with no co-payments; the funding for this is largely provided by transfers from the government budget (see Table 4.1).

The MHIF manages its funds through a single pooling system, which consolidates the financial resources for health care from government budgets (Republican Budget and Bishkek's local budget) and mandatory contributions, as well as from co-payments from the population. Table 4.1 presents the budget for 2015.

**Table 4.1. The MHIF relies largely on budget transfers to provide primary care services**

Single Payer Systems Budget (2015)	
Revenue	Million KGS
Transfers from the Republican Budget and Bishkek's Local Budget	8 551.9
Transfers from the Social Fund (contributions to FCMI + transfers from the Republican Budget for children, pensioners, and social benefit recipients)	1 855.7
Patients' Co-payments	389.2
Special Means	580.4
<b>Total</b>	<b>11 377.2</b>
<b>Expenditure</b>	
In-patient services	6 682.4
Tuberculosis hospitals	683.4
Out-patient services	3 020.8
Dental care	341.3
Ambulance/Emergency aid	423.3
Medicines	22.0
<b>Total</b>	<b>11 377.2</b>

Source: Authors' calculations based on data of the Treasury Department of the MoF, Social Fund.

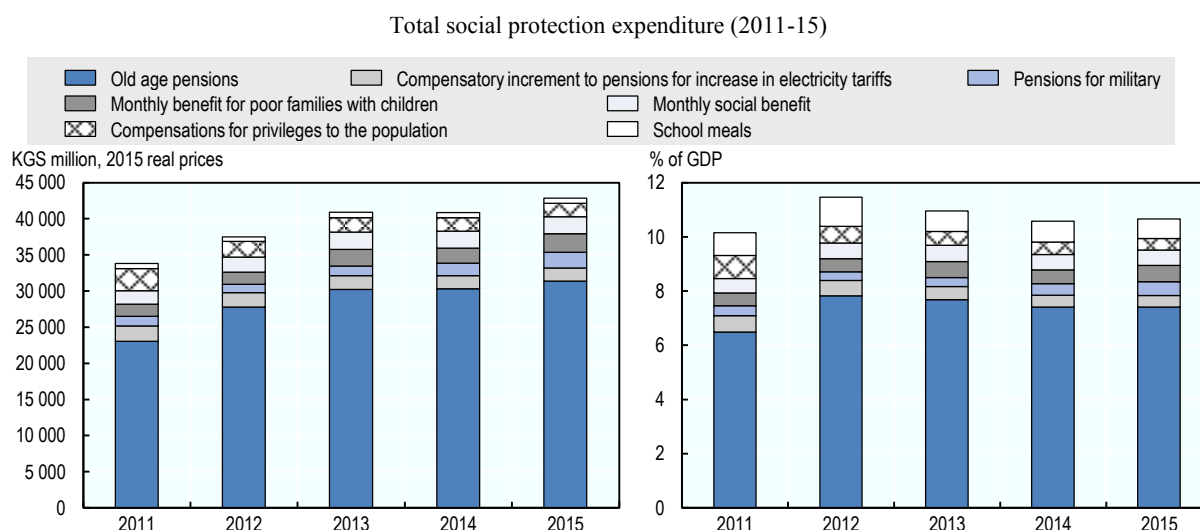
## Social insurance is crowding out other social protection spending

Figure 4.11 shows total spending on social protection between 2011 and 2015 as a proportion of GDP (right-hand panel) and in KGS in real 2015 prices (left-hand panel). Social protection spending increased by an average of 5.7% per year over this period in real terms but fluctuated as a proportion of GDP.

Spending on old-age pensions accounted for 78% of the increase in social protection spending between 2011 and 2015, while pensions for the military accounted for 7.9% of the increase and the MBPF for 8.4% of the rise. Military pensions were the fastest-growing spending item in the social protection budget, increasing by 13.3% per year on average in real terms between 2011 and 2015, while the MBPF averaged 11.3% growth in spending per year and old-age pensions 8.0%.

Overall, old-age pensions accounted for 68.4% of social protection spending in 2015, up from 62.8% in 2011, while military pensions rose from 3.6% to 4.7% and the MBPF from 4.5% to 5.6%. The MSB increased only slightly (from 5.1% of social protection spending to 5.2%) while compensations for privileges declined sharply, from 8.3% to 4.0%, and the electricity subsidy for elderly pensioners fell from 5.8% to 4.0% of social protection spending.

**Figure 4.11. Old-age pensions dominate social protection spending**



Source: NSC (2016<sup>[11]</sup>), "Government budget expenditures", [stat.kg/en](http://stat.kg/en).

Social protection spending fluctuated as a proportion of GDP over 2011-15. Social protection spending accounted for 10.7% of GDP in 2015, up from 10.2% in 2011 but below a peak of 11.5% in 2012 (a year in which GDP contracted). Social protection spending was 11.0% of GDP in 2013.

As the number of elderly increases, pension spending (both old-age and military) will continue to crowd out other components of social protection expenditure. The decrease in spending on compensations for privileges created fiscal space for an increase in MBPF expenditure between 2011 and 2015. However, spending on pensions will reduce or even eliminate the scope for further growth in social assistance spending because pension

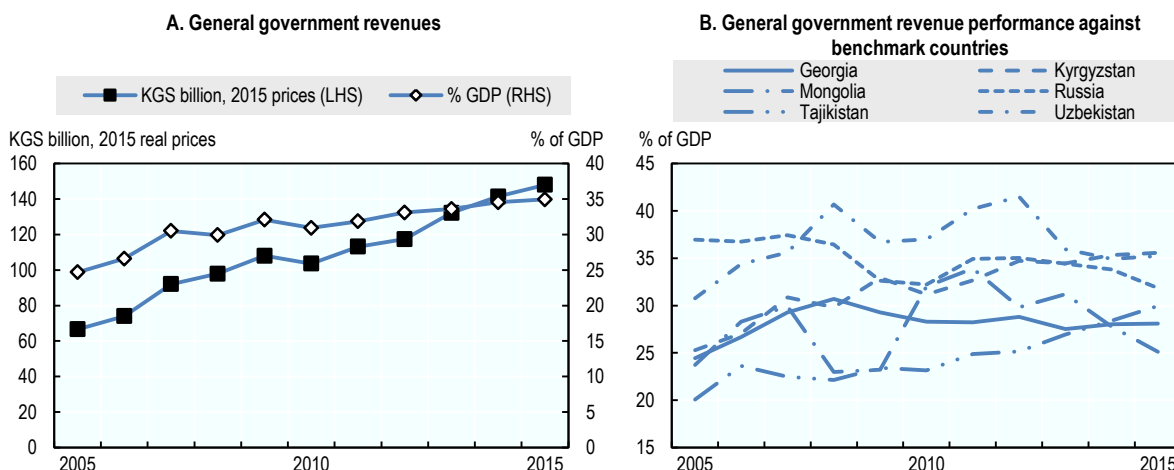
payments represent entitlements (meaning there is relatively little scope for discretion in adjusting benefit levels) and because pensioners are a highly influential group politically.

### Government revenues are high but Kyrgyzstan relies heavily on foreign support

Growth in government revenues has accommodated increases in social protection spending. Figure 4.12A shows the long-term increase in general government revenues, which comprise tax revenues, contributions to the Social Fund, non-tax revenues, capital revenues and foreign grants. Between 2005 and 2015, revenues more than doubled in real terms and increased from 24.7% to 34.9% of GDP. Kyrgyzstan's revenues have grown significantly relative to the benchmark countries (Georgia, Mongolia, Russian Federation, Tajikistan and Uzbekistan); in 2015, Kyrgyzstan generated the highest amount of revenues as a proportion of GDP (Figure 4.12B).

**Figure 4.12. Public revenues are growing strongly and lead the region**

Kyrgyzstan's general government revenues, 2005-15



Source: NSC (2016<sup>[2]</sup>), "State budget revenues", available at [stat.kg/en](http://stat.kg/en); IMF (2016<sup>[3]</sup>), *World Economic Outlook, October 2016* (database), available at [imf.org/external/datamapper/datasets/WEO](http://imf.org/external/datamapper/datasets/WEO).

Kyrgyzstan's revenue buoyancy exceeded 1.00 between 2005 and 2015, meaning government revenues outpaced GDP. Estimates indicate a buoyancy of 1.62 for general government revenue and 1.44 for total tax collections (including contributions to the Social Fund). However, these high buoyancy rates may not extend into the future. Between 2005 and 2015, the economy witnessed a revenue catch-up from a very low level (typical for periods of economic transition) to the current revenue as a share of GDP. This current level is high by international standards, given the level of per capita income.

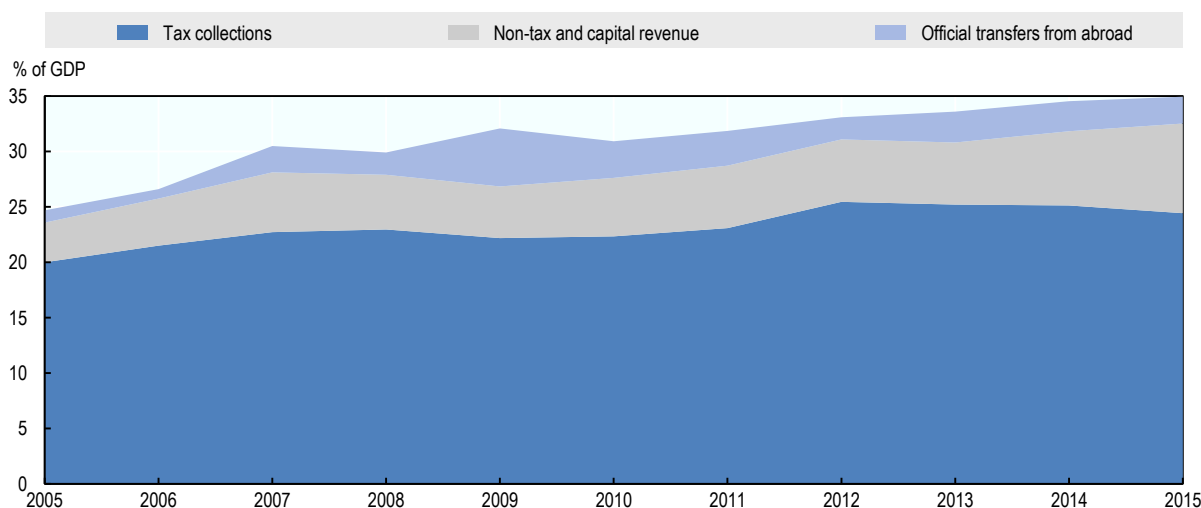
As Figure 4.13 shows, the increase in general government revenue has been driven by growth in all three major components: tax collections (including contributions to the Social Fund); non-tax and capital revenue; and official transfers/foreign grants. Although tax collections account for the majority of revenues, their share fell from 81.0% in 2005 to 69.9% in 2015.

Tax collections peaked in 2012 at 25.5% of GDP, falling to 24.4% of GDP in 2015. By contrast, non-tax revenues have grown strongly in recent years: from 5.6% of GDP in

2013 to 8.1% in 2015. Rents from mineral (gold) deposits have substantially boosted non-tax revenue growth; in 2015, the GoK auctioned mining rights for the country's second-largest gold deposit, Jerui.

**Figure 4.13. Contribution of taxes to total revenue is declining**

Dynamics of state budget revenue components, % of GDP (2005-15)

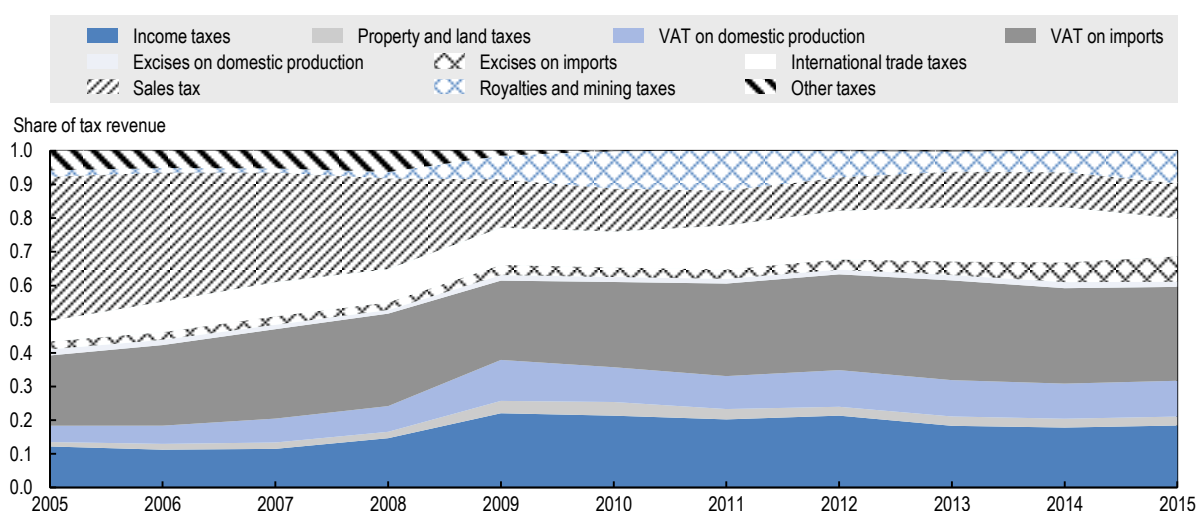


Source: NSC (2016<sub>[2]</sub>), "State budget revenues", [stat.kg/en](http://stat.kg/en).

Indirect taxes provide 70% of Kyrgyzstan's tax revenues. Value-added tax (VAT) on imports contributed 28.4% of tax revenues in 2015, while VAT on domestic production accounted for 10.8% of revenues (Figure 4.14). A sales tax provides 10.7% of tax revenues and excises contributed 9.3%. International trade taxes accounted for 11.4% of total taxes.

**Figure 4.14. Indirect taxes account for the majority of tax revenues**

Structure of tax revenues, 2005-15



Source: NSC (2016<sub>[2]</sub>), "State budget revenues", [stat.kg/en](http://stat.kg/en).

Direct taxes on income provided 18.8% of total tax revenues in 2015. These include a flat-rate 10% personal income tax (PIT) for individuals (mostly workers in formal, non-agricultural enterprises), a profits tax for large formal legal entities and a simplified taxation regime for small and medium-sized enterprises (SMEs) and those employed in the informal economy. Taxation of the mining industry includes a separate income tax for the country's largest enterprise, Kumtor gold mine, as well as bonuses and royalties for other mineral deposits. In 2015, taxation of mining activities yielded nearly 9.8% of total tax revenues.

The statutory rates for many taxes are currently set very low, with the objective of improving taxpayers' compliance. PIT and profits tax are set at a flat rate of 10% while VAT is 12% (having been 20% until 2009). The sales tax ranges between 1% and 5%.

There are also many tax exemptions for different types of taxpayers or tax bases. Farmers are exempt from all taxes except the land tax, while the only tax for the self-employed and SMEs in the informal economy – the patent – is a lump sum set at a low level, which varies by sector. These rates stand in marked contrast to the required contribution to the Social Fund by legal entities (27.25% of payroll), which is very high by international standards and deters many enterprises from entering the formal economy.

Kyrgyzstan has a two-tier budget system: the upper tier consists of the Republican Budget and the Social Fund. The lower tier combines the budgets of all local governments. The sources of revenues for local budgets are:

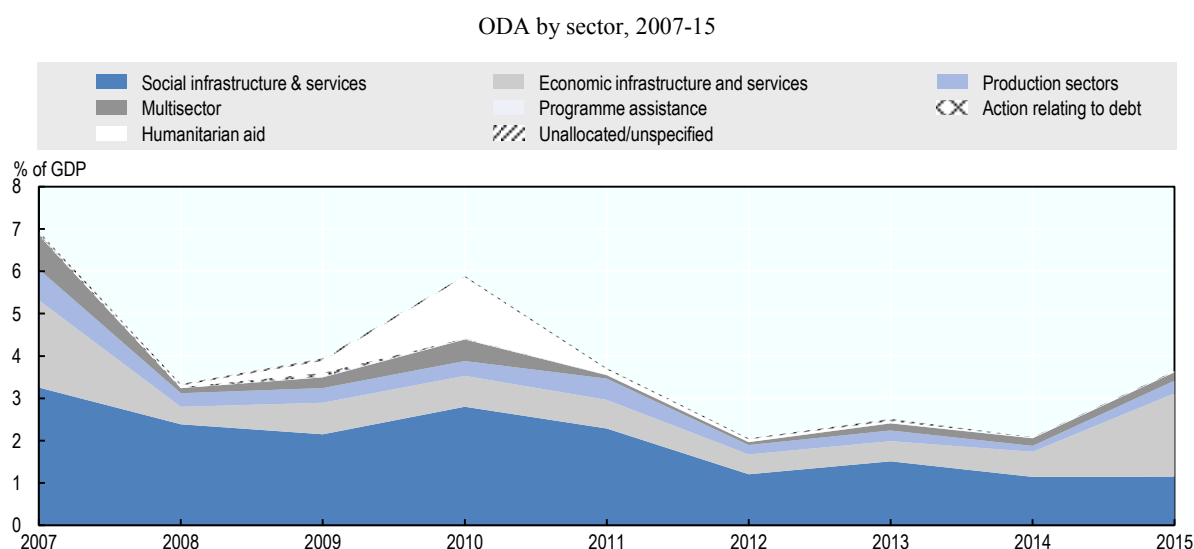
- Local taxes – mostly land and property taxes – and non-tax revenues assigned to this level of government;
- Shared taxes (income tax, sales tax and royalties); and
- Transfers from the Republican Budget – categorical, equalising grants and mutual settlements.

In practice, only Bishkek has independent budget revenue sources. All other local governments rely heavily on transfers from the Republican Budget. The size of transfers from the Republican Budget has fallen sharply in recent years following the elimination of categorical grants; in 2014-15 these transfers amounted to 0.5-0.6% of GDP, compared with 4.5-4.6% of GDP in 2011-12.

### *Foreign assistance*

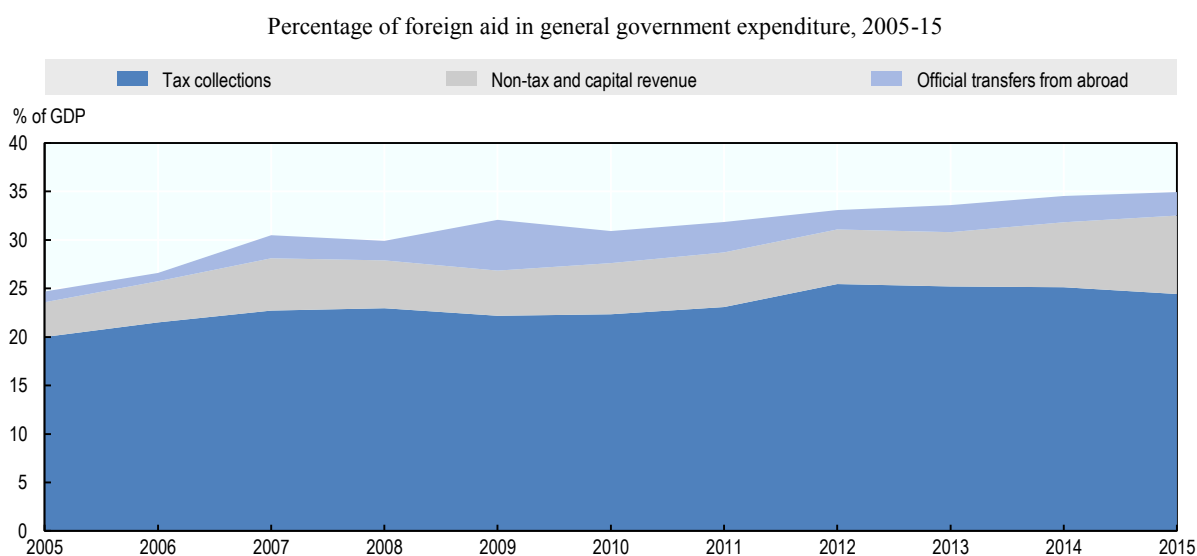
Official transfers from abroad (Official Development Assistance [ODA], considered part of non-tax revenue) and foreign borrowing together meet a substantial part of GoKR financing needs (Figure 4.15). Since 2009, foreign aid has exceeded 16% of total general government expenditure, reaching 20% of government resources in some years, indicating a high degree of aid dependency (Figure 4.16). Having recently attained middle-income status, Kyrgyzstan's access to grants and lending on highly concessional terms will be significantly reduced.



**Figure 4.15. Official Development Assistance is declining**

*Note:* Includes only ODA from member countries of the Development Assistance Committee.

*Source:* OECD (2016<sup>[4]</sup>), *OECD.Stat* (database), [data.oecd.org](http://data.oecd.org) (accessed June 2017)

**Figure 4.16. Foreign aid finances a sizeable proportion of public spending**

*Source:* NSC (2016<sup>[1]</sup>), "Government budget expenditures", [stat.kg/en](http://stat.kg/en).

Kyrgyzstan's ability to mobilise resources through domestic borrowing is limited, and it can only borrow externally on concessional terms. Programmes implemented by the International Monetary Fund (IMF) almost uninterruptedly since 1993 do not allow for any borrowing on non-concessional terms on the basis that Kyrgyzstan could not afford to service commercial debt. However, there are positive signs in this regard; in December 2015, Kyrgyzstan received credit ratings (for the first time in the country's history) of B and B2 from S&P and Moody's, respectively. These speculative grades are associated with high interest rates, should the GoK issue sovereign bonds.

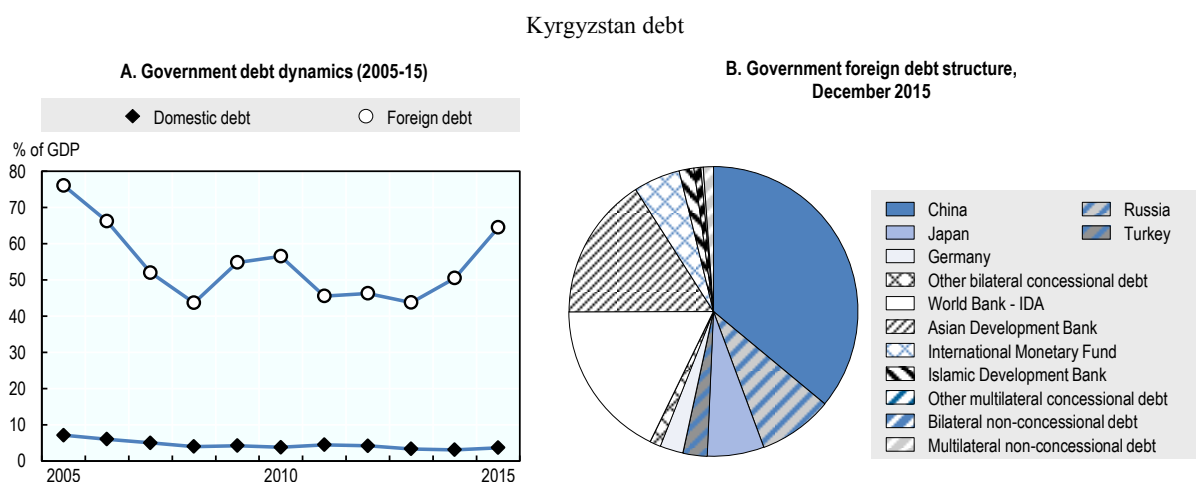
External financial support has created a benign fiscal environment. Debt service costs are relatively low and interest payments constitute a small share of general government expenditure, equivalent to 0.8-1.0% of GDP. For the last three years, the GoK has maintained a small positive primary balance of between 0% and 0.7% of GDP.

Kyrgyzstan's debt situation is less positive, reflecting both long-term debt burdens and short-term macroeconomic dynamics. Despite having no debt when it gained independence, Kyrgyzstan's foreign debt level rose quickly in the 1990s, in part because international donors were so keen to support its rapid economic transition. Foreign debt reached 134% of GDP in 1999.

Having received debt relief in 2001 and 2005, the debt situation improved, thanks to improved economic performance and the depreciation of the US dollar (the currency in which Kyrgyzstan's debt is denominated) against many currencies. In addition, after the debt crisis of 2005-06, many donor organisations switched to providing a larger share of aid in the form of grants instead of loans. As a result, foreign debt continued increasing in USD terms but fell dramatically in relative terms to just above 40% of GDP in 2012, before rising again (Figure 4.17A).

In 2014, the GoK introduced a ceiling of 60% of GDP for the total level of foreign debt. Recently, the GoK resumed larger foreign borrowing, mostly from the Government of China on International Development Association (IDA)-comparable terms. As a result, its foreign debt accumulation rose to 64.5% of GDP in 2015, exceeding the 60% ceiling.

**Figure 4.17. Kyrgyzstan has breached its debt limit**



Source: Ministry of Finance/NSC.

Analysis of the foreign debt structure (Figure 4.17B) illustrates that 98.6% of total debt is concessional. The main sources of this debt are China, World Bank IDA and the Asian Development Bank. Other major lenders include Russia, Japan and the IMF. These six lenders account for almost 90% of the total government foreign debt of Kyrgyzstan. The long-term reliance on the IMF weighs upon the GoK's capacity to determine its own policy agenda, including with respect to social protection policy (see Chapter 5).

Debt Sustainability Analysis (DSA) carried out in 2017 concluded that Kyrgyzstan's external public and publicly guaranteed debt will remain at a moderate risk of debt distress and recommended immediate action to contain it. Currency depreciation, a

slowdown in GDP growth and a deterioration of the fiscal balance represent the greatest risks to debt sustainability. The DSA recognises remittances to be a key source of financing and expects these to increase in the coming years.

### The fiscal framework reduces inequality but has little impact on poverty

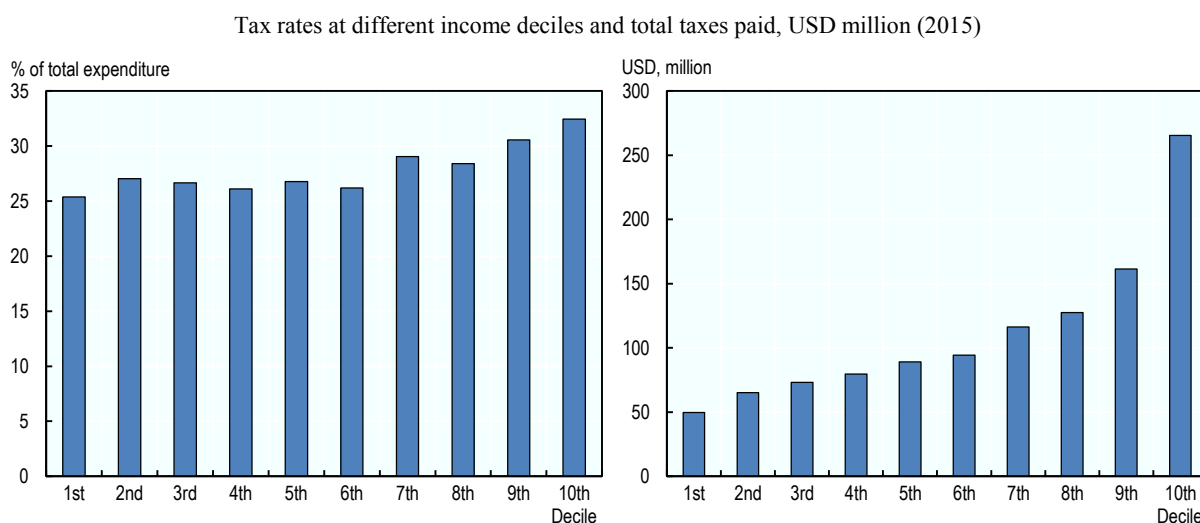
To understand the impact of social protection on poverty and inequality, it is necessary to analyse not only who receives social protection benefits but also who pays the taxes that finance them. By calculating the distribution of taxes and transfers across the income distribution, it is possible to identify both the distributional impact of the fiscal system and its overall impact on poverty.

This section uses data from the 2015 Kyrgyz Integrated Household Survey (KIHS) to identify this “net social protection” effect by examining the impact of direct, indirect and trade taxes, as well as contributions to the Social Fund<sup>1</sup>. It distinguishes between formal and informal workers for the calculation of personal income taxes and applies differential contribution rates for the Social Fund. The analysis then compares the incidence of taxation to the distribution of the four largest social protection programmes: pensions, the MBPF, the MSB and privileges.

Taxes paid by the population are relatively high; even among the poorest decile tax payments equate to more than one-quarter of expenditure (Figure 4.18), reflecting the preponderance of indirect taxes among government revenue instruments. There is little difference in the effective tax rates for much of the population; it is only for the ninth and tenth consumption deciles that the tax rate increases significantly. This might reflect that participation in the formal economy (and thus the payment of PIT) is skewed towards those at the upper end of the distribution: 67% of those working in the formal sector belong to the top five consumption deciles.

The total taxes paid by each decile vary significantly more than the tax rate (Figure 4.18). In 2015, the top consumption decile faced a tax bill that was just less than the total taxes paid by the bottom four deciles combined.

**Figure 4.18. The tax system is only progressive at upper income levels**

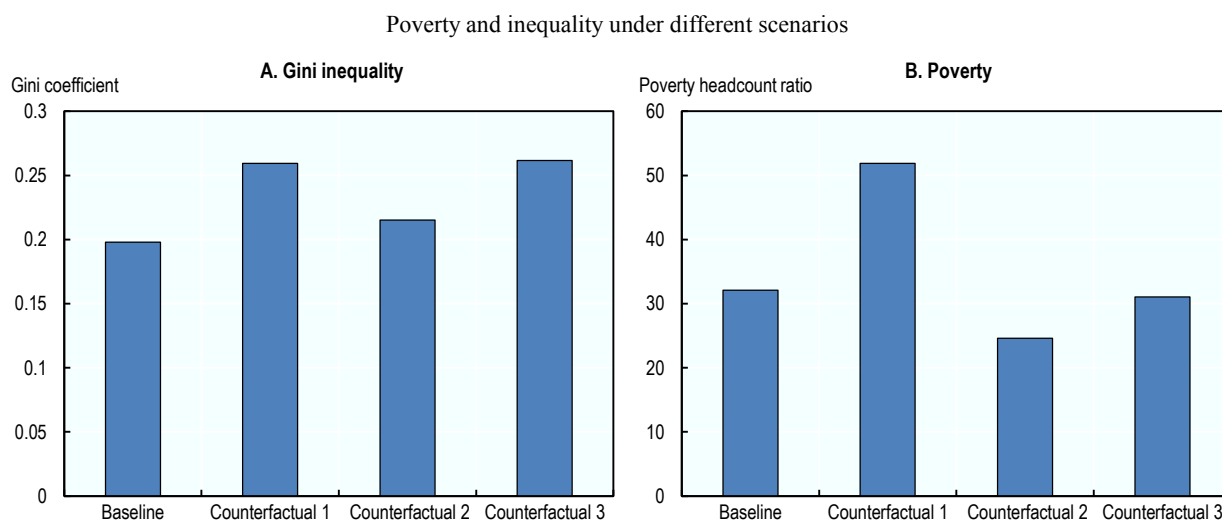


Source: Authors' calculations based on the NSC (2015<sup>[5]</sup>), *Kyrgyz Integrated Household Survey* (database).

To understand the overall effect of the fiscal system, a counterfactual analysis was carried out by modelling scenarios whereby taxes and social protection benefits are eliminated from individuals' consumption. The microsimulations start from a baseline that reflects taxes paid and social protection benefits received. Counterfactual 1 reports household consumption in the absence of social protection benefits. Counterfactual 2 shows household consumption in the absence of tax payments (but with social protection benefits included). Counterfactual 3 shows an individual's market income (their income before they pay taxes or receive social protection benefits).

Figure 4.19A shows the distributive impact of the fiscal system. The Gini coefficient increases from 0.19 under the Baseline scenario to 0.26 in Counterfactual 1, demonstrating the progressive nature of social protection transfers. At 0.22, Gini inequality under Counterfactual 2 is also higher than under the baseline, indicating that the tax system is progressive as well. As is to be expected given these results, inequality is significantly higher under Counterfactual 3 (which excludes taxes and transfers) than the Baseline measure. The difference between the Baseline and Counterfactual 3 is 6.4 percentage points.

**Figure 4.19. The fiscal system reduces inequality but slightly increases poverty**



*Note:* Counterfactual 1 = no transfers; counterfactual 2 = no taxes; counterfactual 3 = neither transfers nor taxes.

*Source:* Authors' calculations based on NSC (2015<sup>[5]</sup>), *Kyrgyz Integrated Household Survey* (database).

### **Poverty impact**

Figure 4.19B shows poverty headcount ratios, calculated using the national poverty line for the same scenarios used for the distributional analysis. Poverty jumps from 32.1% under the Baseline scenario to 51.9% under Counterfactual 1, indicating that social protection benefits play an important role in mitigating poverty. Under Counterfactual 2, the poverty rate decreases to 24.6%, implying that taxes push about 7.5% of the population below the poverty line. Counterfactual 3 produces a poverty rate of 31.0%. This is slightly lower than the baseline and shows the burden of taxes exceeds the monetary benefits poor individuals receive.

However, neither the distributive nor the poverty analysis includes in-kind transfers, such as public spending on education or health. According to the World Bank, education

spending in 2011 was slightly regressive while spending on health in 2009 was slightly pro-poor (World Bank, 2014<sup>[6]</sup>). However, it is not clear what the overall effect would have been in 2015 given the policies implemented since this analysis was conducted.

Another important point to bear in mind is that taxes and transfers will vary along the lifecycle, thanks in part to the preponderance of pay-as-you-go pensions in social protection spending. The fiscal system might be more advantageous for the elderly than the working-age population (especially as pension payments are not taxed), such that the most significant redistribution is horizontal (between groups of individuals at a similar income level) rather than vertical (between groups at different income levels).

Such a finding would be consistent with the results of fiscal incidence analysis in Russia (López-Calva et al., 2017<sup>[7]</sup>). In the case of Russia, whose social protection system is also dominated by pensions spending, working-age individuals (including both those with and without children) are net payers to the fiscal system while pensioners are net beneficiaries, meaning they get more out of the system than they put in.

### Social Fund imbalances constrain increases in social protection spending

This report identifies three major reforms as necessary for the establishment of a functioning social protection system: partial universalisation of state benefits, a scaling-up of social services and a substantial increase in the provision of labour-market programmes. It is important to note that the need to increase allocations to state benefits and social services does not allow for an either/or approach: investing in the local social workforce is essential for achieving value-for-money from spending on state benefits, whether these are increased or not.

The analysis in this Chapter indicates these major reforms would have to be phased in very gradually due to overall fiscal constraints and because of imbalances in the Social Fund. Fiscal transfers to the Social Fund were 160% larger than spending on social assistance and labour-market programmes in 2015. These transfers will need to keep increasing as the Social Fund's contribution base shrinks and the elderly population grows. The imbalance between contributions and expenditure is likely to worsen, requiring one or more of the following policy responses:

- an increase in the contribution rate to the Social Fund
- lower benefits for current and future pensioners
- larger transfers from the Republican Budget to the Social Fund.

None of these represent a long-term solution. Increasing the already high contribution rate is likely to disincentivise enterprises from operating or employing in the formal sector, risking further reduction in contributions and lower tax receipts overall. Lowering benefits will have significant welfare consequences, given the average replacement rate has already fallen below the ILO minimum. Higher transfers from the Republican Budget, the current approach, will crowd out other social protection spending.

The GoK's potential to increase revenues to finance higher social protection spending is limited. Its revenues are high relative to those of its neighbours but foreign grants and concessional lending are falling away thanks to the country's graduation to middle-income status. Maintaining public spending at its current level will thus be a challenge and might put pressure on the poor, since the GoK currently relies primarily on indirect taxes. Shifting the tax mix towards taxes on income could make the tax system more

progressive, but this approach risks incentivising informality in the same way as higher social security contributions would.

The high proportion of spending already allocated to social protection creates the possibility for reprioritisation of resources within the sector. However, to fully exploit this potential would require shifting resources between programmes managed by the Social Fund and those managed by the MoLSD. This would be made more straightforward if the non-contributory and quasi-contributory pensions managed by the Social Fund (but financed by the Republican Budget) were moved to the MoLSD.

Bringing these programmes under the budget of the MoLSD would make the system more transparent by distinguishing between different sources of financing for the different programmes. This in turn would promote the overall sustainability of social protection provision and make it easier to understand and optimise its distributive impact. It would also be an important step in rebalancing social protection from being primarily a set of contributory arrangements to a system that achieves an appropriate balance between contributory and non-contributory programmes according to the needs of the population and the structure of the labour force. However, as will be discussed in Chapter 5, such a reform would be highly contentious politically.

Another means of increasing per capita expenditure on social protection lies in growing the overall economy, thereby increasing the quantum of resources available for redistribution. An important overarching question, therefore, is whether higher expenditure on social protection would improve growth in the long-term. To answer this question, a detailed understanding of the impact of social protection through robust monitoring and evaluation is of great importance, as will be discussed in Chapter 5. Even if additional resources were made available, social protection must compete with other government priorities and expenditures, including health, education and (unsustainable) electricity subsidies.

## Notes

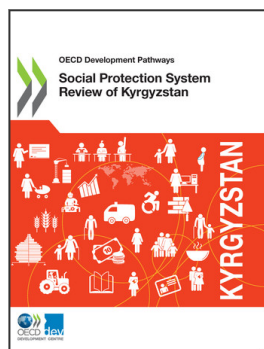
<sup>1</sup> This methodology is based on that employed by the Commitment to Equity (CEQ) initiative, which has to date been completed in 39 countries. The methodology is described in the CEQ Handbook, Edition June 2017 (CEQ, 2017<sup>[8]</sup>).

## References

- Nora Lustig (ed.) (2017), *Commitment to Equity Handbook: Estimating the Impact of Fiscal Policy on Inequality and Poverty*, Brookings Institution Press and Commitment to Equity (CEQ) Institute, New Orleans. [8]
- IMF (2016), *World Economic Outlook*, <http://imf.org/external/datamapper/datasets/WEO> (accessed on 01 April 2017). [3]
- López-Calva, L. et al. (2017), “Who Benefits from Fiscal Redistribution in the Russian Federation?”, in Inchauste, Gabriela, A. (ed.), *The Distributional Impact of Taxes and Transfers: Evidence From Eight Developing Countries*, World Bank, Washington DC. [7]
- NSC (2016), *Government budget expenditures*, Finance statistics webpage, Bishkek, <http://stat.kg/en>. [1]
- NSC (2016), *State budget revenues*, National Statistics Committee of the Kyrgyz Republic, Bishkek, <http://stat.kg/en>. [2]
- NSC (2015), *Kyrgyz Integrated Household Survey*, National Statistics Committee of the Kyrgyz Republic, Bishkek. [5]
- OECD (2016), *OECD.Stat*, OECD Publishing, <http://data.oecd.org> (accessed on 01 June 2017). [4]
- World Bank (2014), “Kyrgyz Republic Public Expenditure Review Policy Notes: Education”, in *Public Expenditure Review Report No. 88978*, World Bank, Washington DC. [6]







From:

## Social Protection System Review of Kyrgyzstan

Access the complete publication at:

<https://doi.org/10.1787/9789264302273-en>

### Please cite this chapter as:

OECD (2018), “Financing social protection”, in *Social Protection System Review of Kyrgyzstan*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/9789264302273-8-en>

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to [rights@oecd.org](mailto:rights@oecd.org). Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at [info@copyright.com](mailto:info@copyright.com) or the Centre français d'exploitation du droit de copie (CFC) at [contact@cfcopies.com](mailto:contact@cfcopies.com).