

JUSTIFICATION OF POLICY-BASED ASSISTANCE

1. This supplementary document describes the basis for the determination of the amount for the Second Investment Climate Improvement Program (ICIP), following the guidance provided by the policies of the Asian Development Bank (ADB) on policy-based operations, specifically para. 32 of the Operations Manual Section D4/BP.¹ In line with the guidance, the assistance amount under the proposed program is justified based on its contribution to addressing development financing needs of the Kyrgyz Republic as reflected in the budget shortfall, with additional reference to key specific elements of the government's development expenditure program for which support is necessary to enable the Second ICIP outcome and impact to be fully realized. Sections 1 and 2 below provide detailed explanation for the justification of the policy-based assistance amount.

2. Section 1 (paras. 5–6) describes the development financing needs of the country at the broad macroeconomic level² from the perspective of the overall projected budgetary financing requirements of the Government of the Kyrgyz Republic.³ Other financing sources including supports by other development partners⁴ are also taken into account.⁵ These are summarized in Table 1.

3. Section 2 (para. 7) refers to the more specific elements of the development expenditure programs (within the entire public finance) for which the ADB grant under the Second ICIP will implicitly be counterpart funds.⁶ These expenditures are deemed to have broader objectives of contributing to the acceleration of the economic development of the Kyrgyz Republic. These are summarized in Table 2 and also highlighted in the development policy letter⁷ and are estimated at \$110 million in total for the duration of subprogram 1.

4. Although not used as a determinant of the grant amount, the implementation of the package of reforms supported by the Second ICIP also entails direct and indirect fiscal costs, i.e., costs of adjustment to the government. Section 3 (paras. 9–10) highlights the magnitude and criticality of the fiscal effort that the program supports.⁸ The benefits from these reforms will, in time, produce positive fiscal feedback in larger tax revenues from higher levels of economic activity, and are therefore expected to make the reforms financially sustainable. But for the duration of the Second ICIP, the balance between fiscal benefits and costs is estimated to be net negative based on a broad and multiyear calculation of the potential fiscal costs of adjustment. The costs are summarized in Table 3. A background note presenting the basis of these costs can be provided upon request.

5. **Section 1: Development financing needs.** Economic growth in 2014 slowed to 3.6% (from 10.9% in 2013) with the weakening of the economies of the Russian Federation and Kazakhstan, to which the Kyrgyz Republic economy is closely linked through trade, investment, and remittances inflows. Inflation accelerated to 7.5% and the current account deficit increased to 15.0% of gross domestic product (GDP) because of a decline in exports. The fiscal deficit increased to 4.3% of GDP in 2014 (from 4.0% in 2013) as slowing growth contributed to a

¹ ADB. 2013. *Operations Manual*. (Bank Policies) – Policy Based Lending. OM SectionD4/BP. Manila.

² Footnote 1, para. 32.

³ Footnote 16 of OM Section D4/BP (footnote 1).

⁴ Footnote 1, para. 32.

⁵ Grants are classified as a revenue item and contribute to reducing the budget deficit.

⁶ Footnote 1, para. 32.

⁷ Footnote 1, para. 5.

⁸ Footnote 18 of OM Section D4/BP (footnote 1).

shortfall in revenue. Remittances, constituting about 25% of GDP, are estimated to have declined by about 5% (to \$1.8 billion) in 2014, with a substantial drop during the last quarter of the year. This will put further pressure on the balance of payments and consumption-based tax revenue. The government will have to look for alternate sources to finance the growing current account deficit.

6. The growth expectation for 2015 is positive but is projected to decline to 1.7%, reflecting recession in the Russian Federation, sluggish performance in Kazakhstan, and a further decline in gold production. A slight recovery to 2.0% is expected in 2016, assuming some recovery in the external environment. Remittances are projected to decline by about 15% in 2015. The annual \$120 million nontax revenue, received as fees for the use of the Transit Center at Manas airport, ceased as of July 2014.⁹ In light of the conservative revenue forecasts due to the slowdown in economic growth, the government is restraining expenditure on low-priority items, which may exacerbate the slowdown in economic activity.¹⁰ The growing fiscal and current account deficits, along with the already limited fiscal resources, will further constrain the ability of the government to mitigate the negative impact of any additional external shock. This may also have negative implications for the sustainability of reforms in general. The budget support that the Second ICIP will provide is necessary to reduce part of the projected financing gap (Table 1).

Table 1: Budget Performance in 2014 and Projected State Budget for 2015–2017
(\$ million)

Item	2014	2015	2016	2017
Total Revenues + Grants	2,253.1	2,222.9	2,350.3	2,577.5
Revenues	2,065.2	2,016.7	2,194.5	2,434.5
Grants	187.9	206.2	155.8	143.0
Other grants ^a	166.4 ^b	186.2 ^c	155.8 ^d	120.0 ^e
ADB	21.5	20.0	0.0	23.0
Total Expenditures	2,586.2	2,826.9	2,867.9	3,001.5
Overall Fiscal Balance (without grants)	(521.1)	(810.2)	(673.4)	(567.0)
Overall Fiscal Balance (with grants)	(333.2)	(604.0)	(517.6)	(424.0)
Financing Fiscal Deficit	333.2	604.0	517.6	424.0
External Sources	416.7	559.8	536.8	427.0
Internal Sources	(83.6)	44.2	(19.2)	(3.0)
		(% of GDP)		
Total Revenues	30.1	26.9	25.1	24.2
Total Expenditures	34.5	34.2	30.6	28.2
Overall fiscal balance (without budget support)	(7.0)	(9.8)	(7.2)	(5.3)
Overall fiscal balance (with budget support)	(4.4)	(7.3)	(5.5)	(4.0)
Memo items				
GDP	7,495.8	8,276.8	9,376.5	10,642.9

ADB = Asian Development Bank, GDP = gross domestic product

^a Excluding Asian Development Bank budget support.

^b Including budget support from the World Bank (\$34.65 million), Turkey (\$20.16 million), European Commission (\$14.88 million), International Monetary Fund (\$14.46 million), and the Russian Federation (\$92.94 million).

^c Including budget support expected from the World Bank (\$31.55 million) and European Commission (\$18.20 million), and budget support approved by the International Monetary Fund (\$13.20 million).

^d Including budget support expected from the World Bank (\$13.63 million).

^e Including budget support expected from the World Bank (\$9.96 million).

Source: Ministry of Finance of the Kyrgyz Republic.

⁹ The Transit Center at Manas airport, which closed in July 2014, was used for the North Atlantic Treaty Organization (NATO) troop operations in Afghanistan. In 2014, the loss of nontax revenue from the closing of the Transit Center was partly offset by higher grants and expenditure cuts, reflecting lower current and capital expenditures.

¹⁰ Teachers' salaries and social protection are priority expenditures, and increases in these costs by 50% have already been announced. ADB. 2015. *Asian Development Outlook: Financing Asia's Future Growth*. Manila.

7. **Section 2: Key specific development expenditures.** Specific development expenditure programs (within the entire public finance envelope) that the ADB budgetary support will implicitly help finance, are summarized in Table 2. These are key programs that will enable a fuller impact of the Second ICIP reforms, and help lead to more sustained development spending. The execution of these programs will be monitored during implementation of the Second ICIP subprograms.

Table 2: Key Specific Development Expenditures within the Overall Public Finance Envelope, 2015–2017
(\$ million)

Public Investment Program	2015	2016	2017
1. Ministry of Energy and Industry	69.75	114.03	146.53
2. Ministry of Agriculture and Land Reclamation	15.62	11.88	9.50
3. State Agency for Architecture, Construction and Housing	24.64	61.33	33.05
Total	110.01	187.23	189.08

Source: Ministry of Finance of the Kyrgyz Republic.

8. The expenditure programs in Table 2 are linked to the areas that are being covered under the Second ICIP: private sector participation in infrastructure and services, trade and investment diversification (in particular, from gold), access to finance for export-oriented small and medium-sized enterprises (SMEs), and transparency. Infrastructure, particularly the low reliability of electricity supply, has been identified as one of the key constraints on private sector development and hence sustainable economic growth.¹¹ Funds are needed to rehabilitate existing infrastructure assets and undertake new investments, along with overall sector reforms including governance of utilities.¹² Investments are also needed to develop agriculture and livestock value chains, including product quality assurance infrastructure, to capitalize on the enlarged Eurasian Economic Union (EEU) market as well the European Union's Generalized System of Preferences Plus (GSP+) trade privilege. Infrastructure and services (such as water supply, sanitation, electricity, city roads, and transport) need to be better planned and implemented, particularly outside Bishkek, to help reduce geographic disparities in access to basic economic infrastructure.

9. **Section 3: Estimated adjustment costs.** The fiscal costs to the government of implementing and monitoring the reforms under the Second ICIP include indirect and direct costs.¹³ Indirect costs are staff time and related expenses.¹⁴ The direct costs are

- (i) the costs of capitalizing the risk-sharing facility for SME finance;
- (ii) annual budget allocations to ensure rollout of the full e-procurement system in all central government agencies and sustaining it after the supporting ADB technical assistance ends in December 2015;¹⁵
- (iii) expenses for tax administration system enhancements;

¹¹ ADB. 2015. *The Kyrgyz Republic Strategic Assessment of the Economy: Promoting Inclusive Growth*. Manila.

¹² The government has undertaken tariff reforms under the Midterm Tariff Policy for 2014–2017 (Government Resolution No. 660 dated 20 November 2014) and an independent regulator for the energy sector has been established (Decree No. 650 dated 14 November 2014).

¹³ These costs would not be incurred if the Second Investment Climate Improvement Program reforms were not to be undertaken.

¹⁴ Approximate total overall cost to the government for one person for 1 day, covering basic salary, pension contributions, health insurance, and a per-person share of the office operating costs.

¹⁵ ADB. 2012. *Technical Assistance to the Kyrgyz Republic for Implementing the e-Procurement System*. Manila (TA 8297-KGZ).

- (iv) investments needed for software, accreditation laboratories, and upgrade of existing warehouses to establish the commodities exchange;
- (v) public–private partnership (PPP) transaction advisory fees and prefeasibility and feasibility study expenditures supported by the Project Development Support Facility;
- (vi) guarantees and/or equity support for PPPs;
- (vii) payments to member countries as part of World Trade Organization (WTO) obligations;
- (viii) infrastructure upgrades (laboratories, testing equipment, etc.) for product quality assurance (for exports);
- (ix) operation of the investment dispute redress mechanism; and
- (x) annual sovereign rating review.

10. The Ministry of Economy (MOE) and the Investment Promotion Agency (IPA) are responsible for implementing and monitoring the majority of the program reforms.¹⁶ The budget allocation for the MOE is \$7.3 million for 2015, \$3.9 million for 2016, and \$3.8 million for 2017. The estimated allocation for the IPA is only \$0.3 million for 2015. The IPA does not have an estimated budget for 2016 and 2017. The impending expenditure cuts (para. 6) and any further worsening of the regional economic situation could lead to further reductions in the already small budget allocations of the MOE and IPA. The Kyrgyz Republic acceded to the EEU on 8 May 2015, putting it firmly in the sphere of influence of the Russian Federation. Non-EEU-related reforms, particularly if not accompanied by support for the costs of undertaking, implementing, and monitoring the reforms, could be deferred as a result.

11. In parallel with its EEU accession, the government sees the value of the Second ICIP reforms in realizing the commitments under the National Sustainable Development Strategy 2013–2017. Reforms to enable private sector development and diversify the economy will help create a wider and more diversified tax base. Combined with effective tax administration, the reforms will also incrementally generate increased revenues for the government and help narrow its projected fiscal gaps. If the experiences of other countries are any indication, the GSP+ policy action alone is likely to benefit the Kyrgyz Republic in several multiples of \$20 million after acquiring GSP+ status and implementing its technical requirements.¹⁷

12. The Second ICIP programmatic approach is spread over the period July 2014–October 2018 and focuses on upstream reforms followed by their downstream effective implementation and monitoring. This will allow monitoring of expenditures and help mitigate the risks of the budget support not being used for the intended purposes and not achieving value for money.

¹⁶ The Ministry of Finance is the responsible agency for e-procurement reforms.

¹⁷ The Philippines, awarded GSP+ status in December 2014, estimates a 35% increase in exports to the European Union (EU) and the creation of 200,000 jobs from 2015–2017 (an earlier study by the Department of Trade showed additional exports worth \$600 million, from the current \$1.69 billion, during the very first year of GSP+ implementation). Pakistan's exports to the EU surged by \$1.08 billion during January–October 2014 compared to the same period in 2013. Armenia, also an EEU member, has doubled its exports to the EU after acquiring GSP+ status.

Table 3: Matrix of Estimated Costs of Policy Reform Measures, 2014–2018
(\$ million)

Item		2015	2016	2017	2018
Output 1. Increasing financial deepening and access to finance					
Staff time	Establishing, maintaining enabling legal framework for MFS and e-payments	0.13	0.08	0.07	0.08
Staff time	Strategic plan for development of payments systems	0.02	0.03	0.03	0.04
Staff time + equity	Establishment and funding risk-sharing facility for SMEs owned by women	0.03	3.03	0.09	0.10
Staff time + equity + infra investment	Establishment of Agricultural Commodities Exchange	0.03	5.03	8.88	10.39
Staff time + expenses	Prudential supervision and creating conditions for financial deepening	0.08	0.12	0.17	0.20
	Subtotal (a)	0.28	8.28	9.24	10.81
Output 2. Comprehensive PPP framework					
Staff time	PPP program, including capacity development	0.13	0.20	0.20	0.20
Staff time + likely capital investments	Sector strategies, including PPPs	0.05	5.06	11.24	15.07
Staff time	Amendments to strengthen legal and regulatory framework	0.10	0.10	0.10	0.10
Staff time + expenses	PPP website and multiyear communication plan	0.20	0.20	0.20	0.10
Staff time	Fiscal risk guidelines	0.03	0.05	0.03	0.02
Staff time + advisory fees	Prefeasibility and feasibility study funding and tender	0.85	0.99	1.50	2.00
Staff time + advisory fees	Transaction advisory	1.25	1.87	3.64	5.16
Government financial support	Grants/loans/guarantees	3.50	5.50	6.50	7.50
	Subtotal (b)	6.10	14.00	23.40	30.10
Output 3. Trade and Investment facilitation					
Staff Time + technical support for export SMEs	National Export Development Program	0.66	0.84	0.22	1.60
Staff time + expenses	EEU help desk	0.99	1.29	1.56	2.05
Staff time + expenses	NQI (staff time) upgrades	0.05	0.28	0.54	1.20
NQI investments	NQI (labs, equipment, software, infra: EEU-specific and other markets)	9.00	30.00	30.00	30.00
Staff time	GSP Plus	0.06	0.12	0.48	0.88
Staff time	Investment Promotion Agency	0.60	0.79	1.01	1.70
Staff time + expenses	Investment dispute resolution	0.98	1.71	1.42	1.56
Staff time + rating agency fees	Sovereign credit rating	0.21	0.14	0.16	0.15
Staff time + possible support for paid apprenticeships	Vocational education and market skills development	0.07	0.13	0.24	0.12
Staff time	WTO Obligations	0.06	0.10	0.27	0.56
Expenses	Annual membership fees (EEU)	1.00	1.00	1.00	1.00
WTO payments	Compensation to WTO members		40.0	40.00	40.00
	Subtotal (c)	13.68	76.39	76.90	80.82
Output 4. Increased transparency and efficiency of doing business					
Staff time + infrastructure/software	E-procurement mainstreaming	1.50	2.54	1.44	0.90
Staff time + infrastructure/software	Tax administration reform and functional enhancements	0.75	2.88	3.28	2.48
	Subtotal (d)	2.30	5.40	4.70	3.40
TOTAL		22.30	104.04	114.26	125.17

EEU = Eurasian Economic Union, GSP = Generalized System of Preference, MFS = mobile financial services, NQI = national quality infrastructure, PPP = public-private partnership, SMEs = small and medium-sized enterprises, WTO = World Trade Organization.

Source: Asian Development Bank staff estimates.