

KYRGYZ REPUBLIC

Country Economic Memorandum

Enhancing Productivity-Driven Growth in the Kyrgyz Republic

Synthesis Report

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WEIGHTS AND MEASURES

Metric System

Regional Vice President	Antonella Bassani
Country Director	Tatiana Proskuryakova
Regional Director	Asad Alam
Country Manager	Hugh Riddell
Practice Manager	Antonio Nucifora
Program Leader	David Stephen Knight
Task Team Leaders	Gohar Gyulumyan, Bakyt Dubashov, Karen Grigorian, and Mariana Iootti

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Abbreviations and Acronyms

GDP	Gross Domestic Product
AMS	Anti-Monopoly Service
CEM	Country Economic Memorandum
EAEU	Eurasian Economic Union
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
GVC	Global value chain
IFC	International Finance Corporation
LFPR	Labor Force Participation Ratio
LMIC	Lower middle-income country
LPI	Logistics performance index
NSC	National Statistics Committee
NTM	Non-tariff measures
NQI	National quality infrastructure
OECD	Organization for Economic Co-operation and Development
REER	Real Effective Exchange Rate
RIA	Regulatory impact assessment
SOE	State-Owned Enterprises
TFP	Total Factor Productivity
TRS	Time release study
UMIC	Upper middle-income country
WB	World Bank
WDI	World Development Indicators

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Introduction

The Kyrgyz Republic was among the first of the former Soviet Republics to adopt market-oriented economic policies in the 1990s; since then, macroeconomic management has generally been sound but the country's economy has yet to realize its full potential. Real GDP per capita in Kyrgyz Republic has grown modestly, by 2.7 percent since 2000, and lagged that of structural and aspirational peers such as Armenia, Moldova, and Uzbekistan. The economy has not generated high-quality, well-paying jobs on a significant scale, which has intensified incentives for Kyrgyz citizens to migrate abroad for work.

This Country Economic Memorandum (CEM) reveals that weak productivity growth, a skills gap of human capital and low-quality investments are hindering the Kyrgyz economy's ability to generate rapid, sustained real per capita GDP growth and good quality employment. Total factor productivity (TFP) growth fell to almost zero in from 2010-2020. While many factors explain weak TFP growth, institutional and policy weaknesses related to the business environment have been particularly problematic because they dampen competition and constrain entry by new firms and the expansion of the most efficient firms. Such conditions deter private investment, including high productivity foreign direct investment (FDI), and prevent the country's labor and capital from being put to their most productive uses.

The CEM presents new empirical evidence of productivity weakness in the Kyrgyz economy at both the aggregate and firm level. This analysis is based on detailed empirical data of the characteristics of all firms in the formal manufacturing and service sectors and informs a diagnosis of the causal factors of the weak productivity growth. The presentation of new empirical evidence is complemented by a thorough analysis of the institutional and policy factors shaping the business climate in the Kyrgyz economy, including a benchmarking of these factors against those of the country's structural and aspirational peers.¹

Based on the diagnosis, the CEM presents a coherent set of critical policy reforms which, if implemented, could unleash much faster productivity growth, lifting the real growth rate of the Kyrgyz economy, and generating high quality employment. Without these reforms, it will be very difficult for the Kyrgyz economy to reach upper middle-income status by mid-century. For the most part, the reforms recommended in this CEM do not require major outlays of public expenditure and therefore are not constrained by limited fiscal space.

The structure of this CEM Synthesis Report is as follows: Section A examines the fundamental problems facing the Kyrgyz Economy, notably the relatively low long-term real growth and weak job creation, especially of high-quality jobs in the formal sector. Section B diagnoses these problems by focusing on the sources of chronic weak productivity growth. Finally, section C sets out a roadmap of feasible policy reforms to increase productivity and real GDP growth and boost formal sector job creation over the medium to long term.

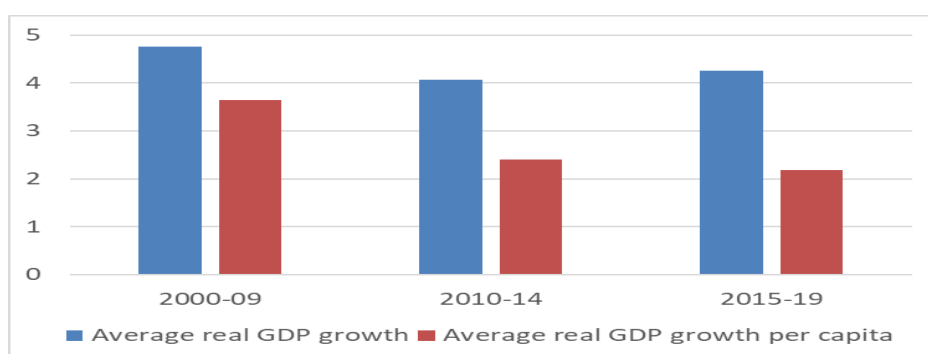
¹ The structural peers of the Kyrgyz Republic used in the CEM are Armenia, Tajikistan, Moldova, Zambia, Cambodia, Tanzania, Uzbekistan and Lower-Middle Income Country (LMIC) average. The main criteria for selecting the structural peers included their geographic location (landlocked), per capita income, and institutional development level. The aspirational peers are the Upper-Middle Income Countries (UMIC) average, Türkiye, Azerbaijan, Vietnam, Malaysia, Hungary, and Poland. The main criteria for selecting these aspirational peers refer to their development trajectory and, in some cases, similar initial conditions such as transitioning from a planned to market economy.

Section A. The Fundamental Structural Problems Facing the Kyrgyz Economy

Chronically sluggish growth and poor quality of jobs characterize economic performance

Long-term real GDP growth rates have fallen short of potential. To be sure, the Kyrgyz economy has generated significant improvements in living standards and reductions in poverty since the year 2000. These achievements have been supported partly by migrants' remittances that rose from a negligible amount in 2000 to 33 percent of GDP by 2019, before the onset of the COVID-19 pandemic. However, the CEM contends that the Kyrgyz economy could have achieved faster real economic growth and even higher living standards if it maintained the pace of institutional and policy reforms implemented during the first decade of transition in 1990s. Real GDP growth averaged 4.8 percent per annum during 2000-09 and fell to 4.1 percent in the following ten years. In per capita terms, real growth averaged 3.1 percent in the first decade of the century and only 2.3 percent in the second (figure 1).

Figure 1: Average Real GDP Growth Rates and Real GDP Growth Rates per Capita, 2000-09, 2010-14, and 2015-19 (percent)

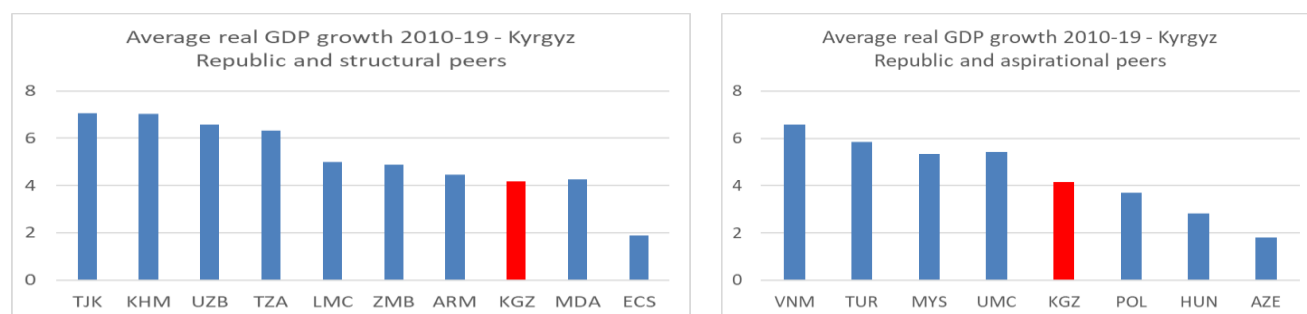


Source: World Bank based on [Kyrgyz Republic National Statistics Committee (NSC) data.

Convergence to higher income levels has been very slow. As shown in figure 2, average real GDP growth rates of the Kyrgyz economy from 2010-19 were lower than those of most of its structural and aspirational peers. Between 2000 and 2020, annual average per capita real GDP growth in the Kyrgyz Republic was almost one percentage point lower than the average for lower middle-income countries (LMICs) and two percentage points lower than the average for upper middle-income countries (UMICs).² As a result, Kyrgyz Republic's per capita income gap with its peers widened. Had the Kyrgyz economy been able to match the average per capita growth performance of UMICs over these two decades, it would have been almost 50 percent larger by 2019. In 2000, GDP per capita at purchasing power parity in the Kyrgyz Republic was 7.4 percent of the average level of high-income countries, and this edged up only to 10.7 percent over the past two decades.

² Data from the World Development Indicators (WDI).

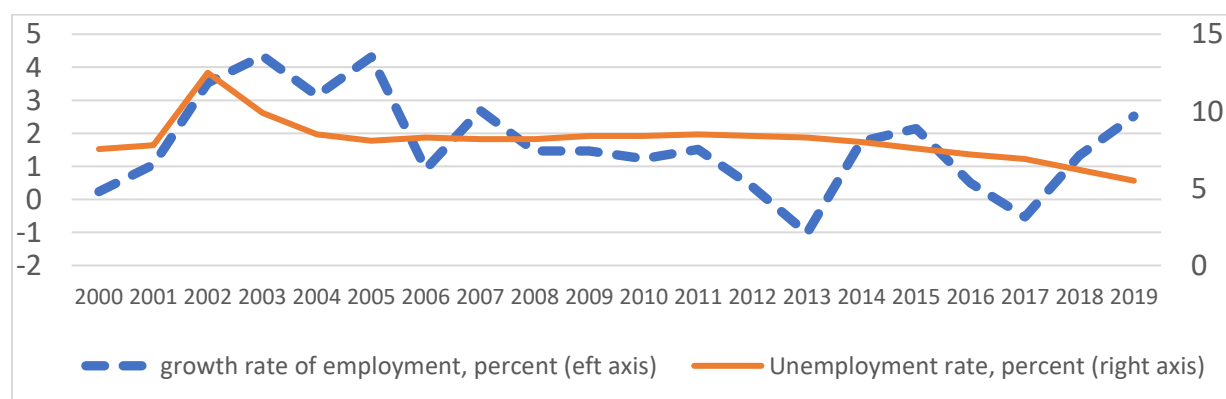
Figure 2: Average Real GDP Growth Rates of the Kyrgyz Republic and its Structural Peers (left panel) and Aspirational Peers³ (right panel) (percent)



Source: World Bank based on NSC and WDI.

The growth of employment declined in the 2010s. Annual growth in total employment averaged 2.5 percent between 2000 and 2009, in line with the growth of the labor force. Employment growth declined to only 1 percent per annum in the following decade, although annual growth of the labor force also fell sharply, reflecting both a fall in the growth of the working age population and a reduction in the female labor force participation ratio (LFPR). Consequently, although the unemployment rate declined by 3 percentage points between 2000 and 2019, it was still above 5 percent as of 2019 (figure 3). Without the safety valve offered by large-scale labor migration, which has contributed to the fall in the LFPR since the mid-2000s,⁴ unemployment would have been much higher.

Figure 3: Annual Growth Rate of Employment and the Unemployment Rate (percent), 2001-2019



Source: National Statistics Committee.

The quality of jobs created was poor in terms of both productivity and formality. More than two-thirds of jobs created between 2000 and 2009 were in sectors with below average labor productivity and below average wages: mainly construction, retail and wholesale trade and

³ARM= Armenia; AZE= Azerbaijan; ECS= Europe and Central Asia; HUN= Hungary; KGZ=Kyrgyz Republic; KHM= Cambodia; MDA= Moldova; MYS=Malaysia; POL= Poland; TJK= Tajikistan; TUR= Türkiye; UMC= Upper-middle-income countries; UZB= Uzbekistan; VNM= Vietnam; ZMB= Zambia.

⁴Migration likely contributed to the steep decline in the labor force growth rate in the 2010s in two ways. First, migration reduces the number of persons of working age resident in the Kyrgyz Republic. Second, the receipt of remittances may have discouraged participation in the labor force by domestic residents of working age. The latter is probably a factor in the marked decline in the female LFPR.

repairs, hotels and restaurants, transport, and communication. In the following decade, a larger share of jobs created were in higher labor productivity sectors, such as manufacturing, but the overall rate of employment growth was very weak. Between 2013 and 2019, the share of informal employment remained at just over 70 percent which, given the slow rate of job creation in this period, implies that very few formal sector jobs were created.⁵ Furthermore, the private sector (excluding self-employed people) contributed little to formal employment, accounting for only 20 percent of total formal sector jobs in 2021. Formal employment comprised only 14 percent of total private sector employment in 2021.⁶

The economy has also failed to create a diversified and dynamic export sector. Exports of goods and services declined from above 50 percent of GDP before 2013 to about 30 percent in recent years. At the same time, exports became more concentrated in gold and minerals, which currently account for almost three-quarters of exports. This trend accompanied a decline in the export competitiveness of non-traditional exports such as textiles and vegetables, despite the country joining the Eurasian Economic Union in 2015. Kyrgyz export growth remains much slower and its export structure much more concentrated than most of its structural and aspirational peers.

The Kyrgyz economy has been unable to integrate into global value chains (GVCs) for manufactured products or advanced services. Global value chains provide a vehicle for developing, dynamic, export-oriented manufacturing industries in many of the Kyrgyz's aspirational peers. To date, the Kyrgyz Republic has mainly integrated into GVCs by exporting basic or slightly refined mineral products to be used in industrial and manufacturing processes abroad (known as 'forward participation'). By contrast, the Kyrgyz economy has little 'backward participation', which involves importing intermediate goods that are then used to produce higher value exports—a practice that is associated with the most successful export-oriented developing country experiences.

Weak productivity growth hampers more dynamic economic performance

Real GDP growth and high-quality employment creation were held back by subdued productivity growth. This also impeded the growth of higher value non-resource-based exports, because exporting firms must be highly efficient to succeed in competitive export markets. Kyrgyz Republic's recent economic growth is attributable mainly to growth in the factors of production—particularly capital—rather than to increases in the economic returns to factors. This is reflected in the fact that the economy has not generated high productivity growth. It is also one of the main reasons why the economy has not created high-wage employment on a large scale. Weaknesses in productivity growth are evident in both macroeconomic data and in firm-level data, as detailed below.

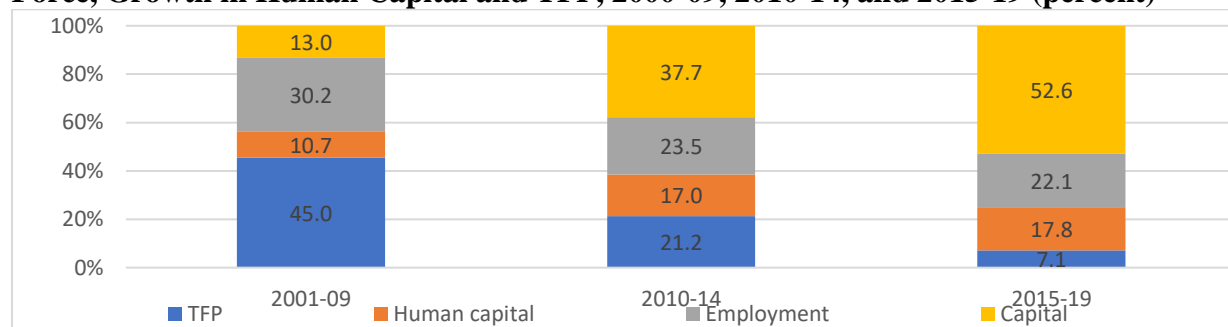
Total factor productivity (TFP) growth's contribution to real GDP growth declined in the 2010s. In the first decade of the century, TFP growth made the largest contribution to GDP growth, at 45 percent, followed by the growth of employment, which contributed 30 percent. The contributions of growth in human capital (i.e. the quality of the labor force) and physical capital

⁵ There are no time series data for these indicators before 2013.

⁶ Data from the International Labor Organization. The data are only available for 2021.

were relatively small in this period (figure 4). It is likely that the TFP growth recorded in the 2000s reflects large inter-sectoral shifts of labor (mainly out of low productivity agriculture), as discussed below.⁷ In the following decade, TFP growth declined sharply, accounting for 21 percent and 7 percent of GDP growth in the first and second halves of the decade, respectively. Growth in the 2010s was dependent much more on the accumulation of physical capital, which accounted for 45 percent of growth on average. The contribution of human capital growth to GDP growth increased slightly compared to the previous decade but remained very limited.

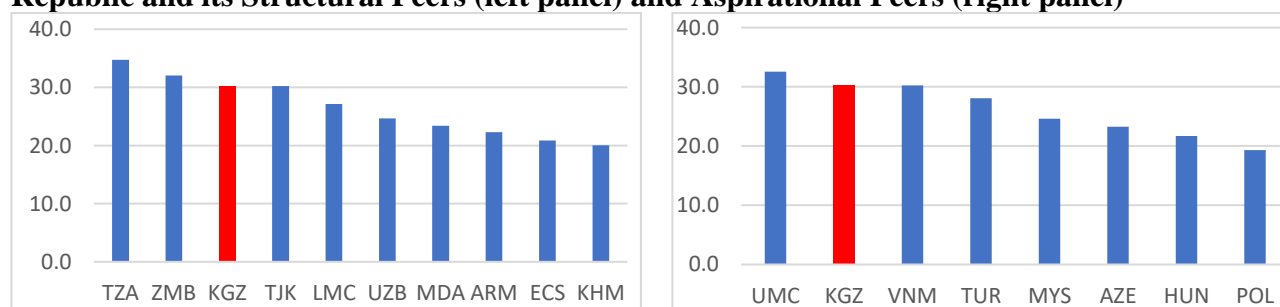
Figure 4: Contributions to GDP Growth from Capital Accumulation, Growth in the Labor Force, Growth in Human Capital and TFP, 2000-09, 2010-14, and 2015-19 (percent)



Source: World Bank based on Penn World Tables.

GDP growth in the 2010s was mainly driven by capital accumulation. Fixed capital investment rates increased in the 2010s to average 30 percent of GDP over 2010-19, which was one of highest investment rates among the peers of the Kyrgyz Republic (figure 5). While strong growth of capital mostly offset the declining contributions from labor force growth and especially TFP growth, high rates of investment in the 2010s may have led to a decline in the productivity of capital, which would help explain the fall in TFP growth. This is typical of diminishing marginal returns and illustrative of why productivity needs to be a key focus for sustained growth. High investment, without complementary improvements in other factors and TFP eventually leads to falling returns to investment.⁸

Figure 5: Gross Fixed Capital Formation, Average 2010-19 (percent of GDP), the Kyrgyz Republic and its Structural Peers (left panel) and Aspirational Peers (right panel)



Source: World Development Indicators.

⁷ Between 2000 and 2009, the number of workers employed in agriculture fell by 28 percent as workers shifted into services and construction or migrated abroad for work. Because there was substantial underemployed labor with very low marginal productivity in agriculture at the start of the century, the shift of labor out of agriculture did not reduce output, which actually increased by 2.7 percent per annum on average during the decade. The higher agricultural output accompanied by negative growth in the main factor input in the sector registers as TFP growth in growth decomposition estimates.

⁸ A stylized fact of economic development is that, as countries become richer and transition from low income to lower-middle income and then upper-middle-income status, the relative contribution of capital accumulation to output growth declines and that of TFP growth increases.

Growth in labor productivity relied mainly on the shift of labor out of agriculture. Average labor productivity growth (measured as growth in value added per worker) was a modest 2 percent per year in the 2000s and around 3.1 percent in the 2010s. This productivity growth largely due to a large-scale labor shift out of agriculture, the sector in which labor productivity was the lowest in the economy, to industry and services.⁹ However, although labor productivity in industry and services was much higher than in agriculture, which explains the increase in labor productivity in the economy, neither industry nor services recorded strong within-sector productivity growth over the course of the two decades. Average annual labor productivity growth in industry during 2000-19 was slightly negative while that in services was only 0.9 percent. Within the industrial and services sectors, there was some labor productivity growth achieved by formal sector firms, in part reflecting their increased capital investment, but these firms account for only a relatively small share of total output in the economy.¹⁰ Informal, small-scale and microenterprises dominate the services sector and labor productivity within these enterprises appears to have been stagnant.

Firm-level productivity growth

Formal sector firms offer the greatest potential to drive productivity growth in the economy, but this potential has not been fully realized. The CEM draws on detailed firm-level data from all incorporated businesses in the services and industrial sectors filing income tax returns to provide an empirical analysis of the performance of these firms in the 2010s, especially in terms of productivity and growth.¹¹ These firms are the most productive firms in the economy; during the 2010s their labor productivity (measured as value added per worker) increased by an annual average of 4.9 percent, triple the rate of productivity growth for all non-agricultural firms. Rising labor productivity of formal firms was the consequence of both capital deepening (average fixed capital per worker of these firms more than doubled in the 2010s) and TFP growth. Nevertheless, the empirical analysis reveals that productivity growth within the formal sector firms and the expansion of their output could have been faster were it not for serious impediments to business dynamism, which also likely contributes to informality.

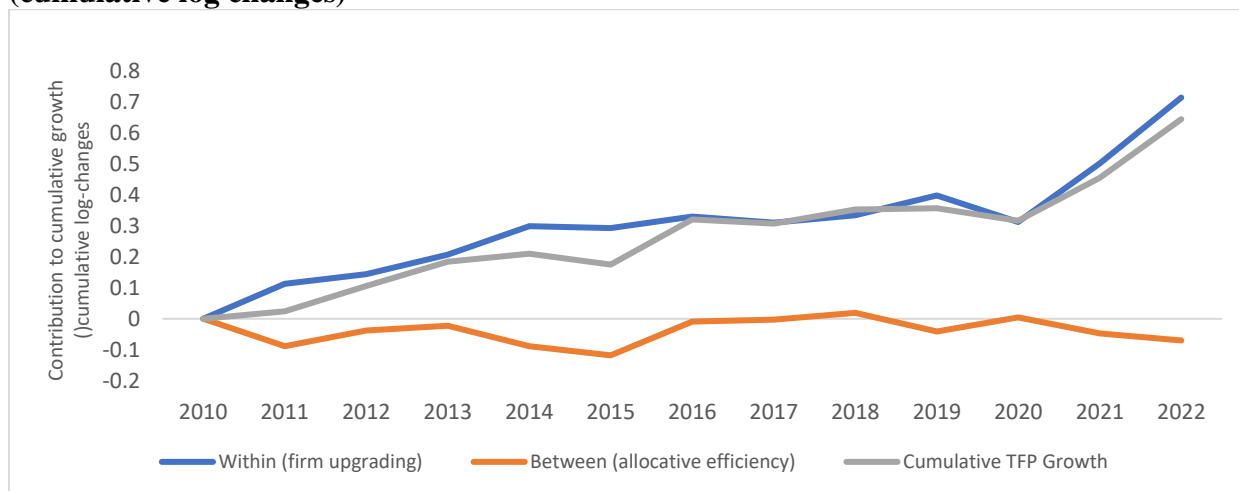
Productivity growth of formal sector firms was constrained by a lack of allocative efficiency across firms. The TFP of formal firms in the industrial and services sectors increased on average by 43 percent between 2010 and 2019, at an average rate of 3.6 percent per annum. As shown in figure 6, this TFP growth was entirely attributable to within-firm productivity growth, as firms raised their efficiency and/or used more productive inputs. There were no improvements in allocative efficiency across firms in this period; in other words, productive resources did not shift from less efficient to more efficient firms. Consequently, the more productive firms did not expand more quickly than the less productive firms. The lack of a reallocation towards more efficient formal sector firms largely explains why the actual productivity growth recorded in the 2010s was lower than it could have been. The constraints to allocative efficiency are analyzed in section B.

⁹ The share of agriculture in total employment fell from 53 percent in 2000 to 19 percent in 2019, whereas the share of services increased from 36 percent to 55 percent.

¹⁰ Formal sector firms (incorporated businesses) accounted for 14.4 percent of value added in the non-agricultural sectors (industry and services) of the economy in the 2010s.

¹¹ The National Statistics Committee provided the anonymized data, which covers 23,559 firms employing 155,000 workers.

Figure 6: Decomposition of Aggregate TFP Growth into within-Firm TFP Growth and TFP Growth from Allocative Efficiency, in Formal Sector Non-Agricultural Firms, 2010-22 (cumulative log changes)

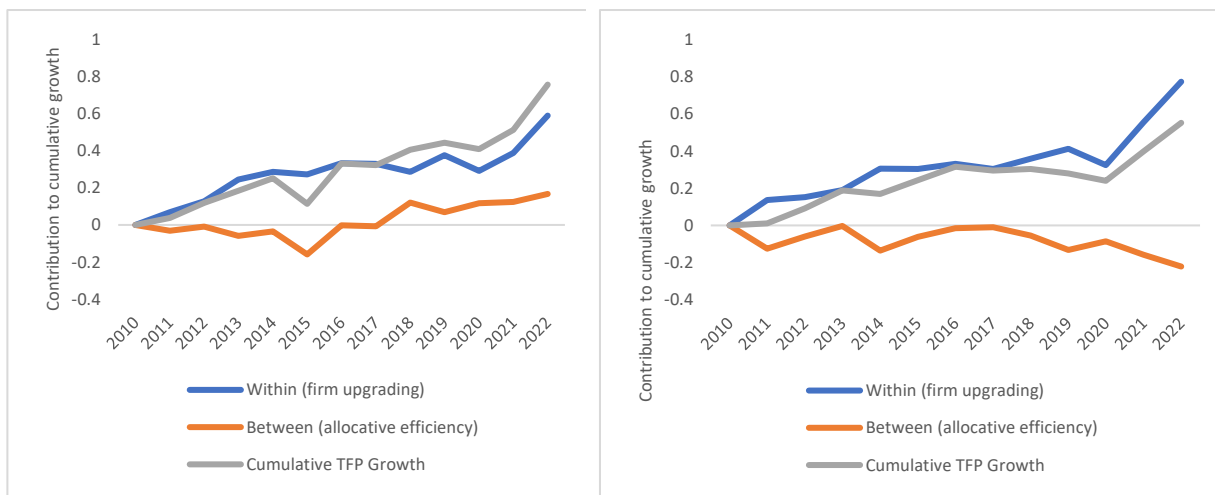


Source: Firm-level data by the National Statistics Committee.

Note: The graph plots the results of the Olley-Pakes decomposition of TFP growth, where the average log TFP is normalized to zero over the period within each 1-digit sector. The blue line corresponds to the evolution of the simple average of TFP across firms, the gray line plots the evolution of the weighted average TFP across firms (weighted by employment levels), and the orange line is the difference between gray and blue lines. The between component (captured by the orange line) is a measure of the covariance between firms' TFP and firms' employment shares. The lines plot changes in the measure relative to 2010. TFP is measured in logs.

In the pre-pandemic decade, the industrial sector achieved faster productivity growth compared to the services sector due to an improvement in the industry's sector allocative efficiency (figure 7). Between 2010 and 2019, the productivity of the formal corporate sector grew by a cumulative 43 percent (35.8 log points). The industry sector (including construction) contributed disproportionately to this trend, recording a cumulative productivity growth of 55.8 percent (44.4 log points), versus productivity in services, which recorded a cumulative growth of 32.3 percent (28 log points) over the period. The difference in the performance of the industry and services sector was driven by the different trends in the allocative efficiency in these two broad sectors of the economy. While allocative efficiency increased in the industry sector—a sign that productive resources were increasingly allocated to the most productive firms—it declined in services. The improvements in allocative efficiency contributed 6.9 log points to the cumulative productivity growth of the industry sector over the period, implying that the sector's productivity growth would have been equal to 45.5 percent had allocative efficiency stayed at its 2010 levels, 10.3 percentage points below the observed performance of the sector. Conversely, the decline in allocative efficiency observed in the services sector was responsible for an 18.5 percentage points drop in the cumulative productivity growth of the sector over the period.

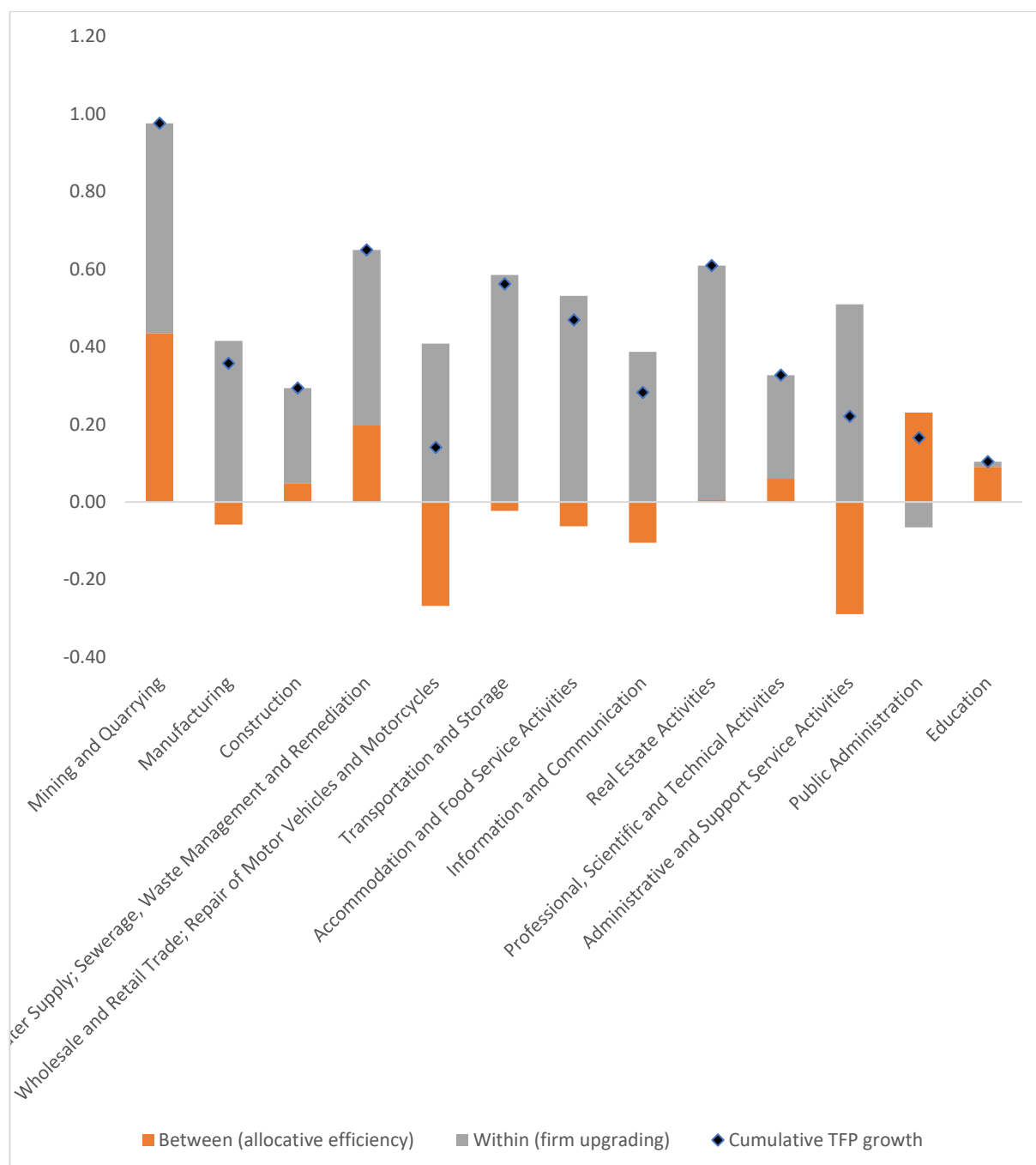
Figure 7. Decomposition of Aggregate Productivity Growth in Industry (cumulative, left panel) and in Services (cumulative, right panel)



Source: Firm-level data by the National Statistics Committee.

However, there was considerable heterogeneity in sectoral performances within industry and services (figure 8). Results based on a more disaggregated sectoral classification highlight considerable heterogeneity in the productivity performance within the industry and services sectors. The comparatively positive performance of the industry sector was driven primarily by the mining sector, while manufacturing and construction saw average or below average productivity growth over the period. Similarly, the increase in allocative efficiency is primarily observed in the mining sector, while it was muted in construction and negative in manufacturing. Services sectors also exhibit heterogeneous patterns, with stronger productivity growth in utilities, real estate, and transportation, and more muted growth in retail, public administration, education, and knowledge-intensive sectors such as information and communications technology (ICT) and professional services. Half of the services sectors saw a decline in allocative efficiency, with the decline being more pronounced in retail and administrative services.

Figure 8. Decomposition of Aggregate Productivity Growth (2010-19, selected 1-digit sectors)



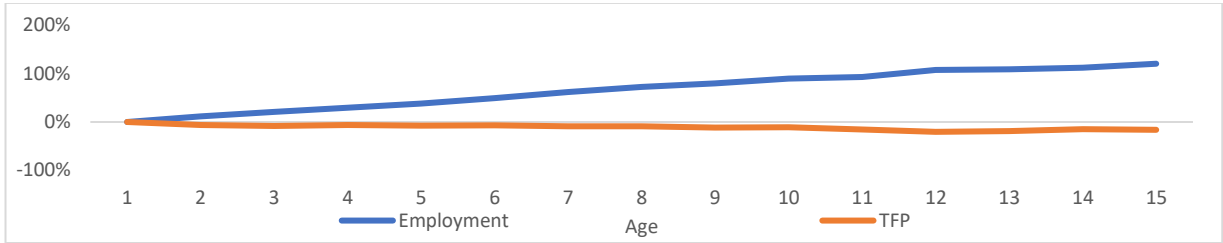
Source: Firm-level data by the National Statistics Committee.

Notes: Electricity, gas, steam and air conditioning supply; financial and insurance; human, health, and social work activities; arts, entertainment, and recreation sectors are excluded due to the limited number of firms available in these sectors.

The life-cycle dynamics of firms in the Kyrgyz Republic reveal market distortions, with firms growing larger as they age without becoming more productive. While firms expanded in size by an average of 120 percent over 15 years (blue line in figure 9), their productivity as measured by TFP actually declined with age (orange line in figure 9). The fact that older firms

grew in size despite losing competitiveness suggests limited market pressures and rewards for the most productive firms.

Figure 9: Average Employment and TFP of Formal Sector Firms by Age of Firm (in years); Measured as Percentage Difference of TFP and Employment Relative to the Respective Levels at Age One Year

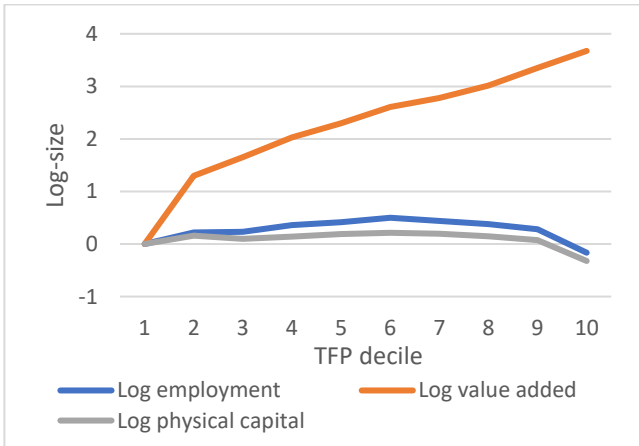


Source: Administrative data.¹²

The signs of market distortions and their impact on the productivity-size relationship among Kyrgyz firms are further highlighted by markup dynamics. As shown in figure 10, formal sector firms with higher TFP do not employ more capital or workers than firms with lower TFP. Instead, these firms convert their higher productivity into increased markups and profits. This suggests that highly productive firms in Kyrgyzstan shield themselves from competition, charge excessively high prices, and keep their input demand below the socially efficient level, reducing overall allocative efficiency in the economy. Figure 11 illustrates the markup dynamics.

Figure 10: Average Size of Formal Sector Firms (Measured by Employment and Physical Capital) by TFP Decile (log size, 1st decile = 0)

Figure 11: Markups by Productivity Deciles (relative to the 1st decile)



Source: World Bank based on National Statistics Committee Data.

Foreign-owned firms exhibit higher productivity and pay higher wages than domestically owned firms. As is the case in many countries, firms which have full or significant foreign ownership achieve higher levels of productivity than firms which are purely domestically owned, both in terms of TFP and value added per worker. This higher labor productivity translates into substantially higher wages for their workers, which on average were 91 percent higher (i.e.,

¹² Data cover formal, non-agricultural, incorporated businesses. The graph plots the projected percent difference between the average size of firms aged one year and older after controlling for year and cohort effects. Results are based on the 2010-2019 period.

almost double) than the average wages paid by domestic firms. In general, this is because foreign firms employ more advanced technology and more advanced management practices than is often the case with domestic firms. However, as discussed below, the Kyrgyz Republic has not been able to leverage the full potential of foreign direct investment (FDI) to accelerate productivity growth and generate high quality jobs.

Foreign-owned firms provide a significant boost to productivity and wages in the economy, but foreign direct investment (FDI) has been limited in magnitude and diversity. Net FDI inflows have declined since the mid-2010s (from 17 percent of GDP in 2015 to about 3 percent of GDP in recent years) and FDI been concentrated in natural resources sectors. These trends mean that the Kyrgyz Republic is not making the most of FDI's potential to boost productivity and wages. Capital investment in commodities (mainly metals, notably gold) accounted for 55 percent of greenfield FDI related capital investment during 2013-22, while regional processing, which includes the processing of gold, accounted for another 15 percent.¹³ “Efficiency seeking” foreign direct investment¹⁴ in sectors such as non-resource-related manufacturing was much more limited. Investment in knowledge-intensive goods and services, such as information technology and higher value manufacturing accounted for only 11 percent of announced greenfield FDI capital investments in this period.¹⁵ The concentration of FDI in commodities was much greater in the Kyrgyz Republic than in almost all of its structural and aspirational peers.

Lack of business dynamism underpins poor economic performance

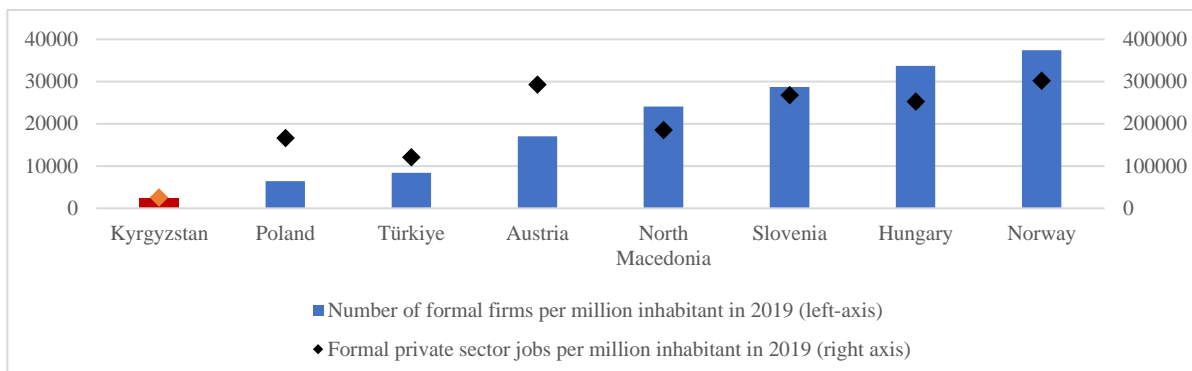
The Kyrgyz private sector is still predominantly composed of informal firms. Relative to the size of its population, the Kyrgyz Republic has far fewer incorporated formal sector businesses (termed formal sector business density) than its aspirational peers, such as Türkiye, Hungary, and Poland. As of 2019, there were 2,426 registered incorporated firms per million inhabitants in the Kyrgyz Republic, compared to 8,372 in Türkiye. This translates into far fewer formal private sector jobs per size of population in the Kyrgyz Republic compared to its peers. The number of jobs in formal incorporated private sector businesses per million inhabitants was six times fewer in the Kyrgyz Republic than in Türkiye in 2019 (figure 12). The lack of high-quality employment in the Kyrgyz Republic reflects the weak formalization of the private sector. Informality also impedes productivity growth because informal firms are usually too small to realize economies of scale and lack the access to financial resources to invest in efficiency raising capital equipment.

Figure 12: The Number of Formal Companies Relative to the Country's Population Is Low in the Kyrgyz Republic

¹³ The estimates are based on announcements of investments by firms.

¹⁴ “Efficiency-seeking” foreign direct investment refers to firms that come to the Kyrgyz Republic because of its potential to produce competitively and export to global markets. FDI often brings significant upgrades to technologies and productivity, with spillover effects for the entire economy.

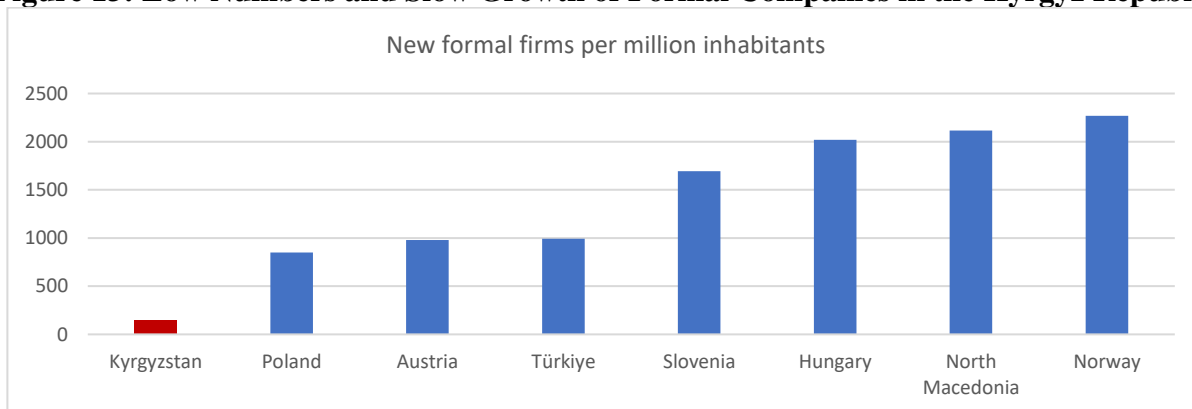
¹⁵ This reinforces the point made above about the nature of global value chains in which the Kyrgyz economy is involved. FDI in commodities links the Kyrgyz economy into global value chains with forward integration.



Source: Administrative data, Eurostat, and World Bank Enterprise Survey 2023.

The low level of formal business density is linked to low rates of entry of new formal firms. Over the period 2010-19, an average of just under 150 new formal sector firms per million inhabitants were registered each year in the Kyrgyz Republic, versus 850 in Poland, almost 1,000 in Türkiye, and over 2,000 in Hungary (figure 13).

Figure 13: Low Numbers and Slow Growth of Formal Companies in the Kyrgyz Republic



Source: Administrative data and Eurostat.

Several indicators of business dynamism and competition in markets deteriorated in the 2010s. Formal sector firms in industry and services recorded a rise in average mark-ups and profits during the decade. The average profits of formal sector firms, as a share of their value added, increased by 22 percent between 2010 and 2019, indicating an increase in their market power. Over the same period, there was a marked fall in the dispersion between firms of the growth rates of key firm-specific variables—sales, value added, and TFP. This indicates that there was a decline in the degree to which firms were challenging each other and competing for market share. The trend was accompanied by a rise in the persistence of the status of the market leader in each sector; market leaders were increasingly able to hold onto their dominant position in the market during the 2010s. All these metrics indicate that competitive pressures waned in the markets in which formal sector firms operated, and this has likely weakened the pressures on, and incentives for, formal sector firms to become more efficient while at the same time affording protection to the less productive firms.

To summarize, there is strong macroeconomic and firm-level evidence that subdued productivity growth has held back economic growth and the creation of well-paid, formal sector jobs since 2000. In the first decade of the century, structural shifts of labor out of agriculture and employment growth contributed the most to GDP growth. In the 2010s, GDP growth relied heavily on capital accumulation while TFP growth fell to almost zero. While formal sector firms were able to achieve reasonably strong rates of within firm productivity growth in the 2010s through capital investment and more efficient use of inputs, a lack of allocative efficiency across firms meant that productivity growth was lower than it could have been. Because capital and labor did not flow from less productive to more productive firms, the most productive formal sector firms in the economy are sub optimally small, and firms become less productive as they mature. Larger firms enjoy substantial market power shielding them from competition, which also results in a lack of improvement in their own (i.e., within-firm) productivity. The constraints to the growth of productive formal sector firms have impeded economy wide productivity growth and thus the growth of GDP. They also explain why the private business sector remains dominated by small-scale, informal firms, and why the private sector has created few formal sector jobs. The following section diagnoses the underlying causes of these problems.

Section B. The Fundamental Causes of Weak Business Dynamism and Low Productivity Growth

Multiple institutional and policy related weaknesses have combined to dampen business dynamism and productivity growth. This section analyzes the causes of weak productivity in the Kyrgyz economy, a factor that helps to explain the economy's chronically subdued growth and failure to create high-quality, formal sector jobs. The causes of weak productivity are multifaceted, but institutional- and policy-related weaknesses in the business environment pertaining to business regulations, tax administration, the preferential treatment of some state-owned enterprises (SOEs), and competition policy have played key roles in dampening competition and constraining business dynamism and the expansion of the most efficient firms. These factors have also deterred private investment, including potentially high productivity FDI, and prevented the most efficient allocation of labor and capital in the economy. The CEM contends that these institutional- and policy-related constraints have combined to create a business environment that lacks dynamism and instead features low rates of firm entry, low density of formal sector businesses, a negative relationship between firm size and productivity, and high and rising markups, especially for the larger firms, as described in section A.

Investment plus infusion drive the transition of a developing economy from lower middle-income to upper middle-income status

Experience indicates that the growth needed to raise an economy from low- to middle-income status is largely driven by capital accumulation. This has been the experience of the Kyrgyz economy over the last two decades. High rates of investment—averaging 30 percent of GDP in 2010s—strengthened the economy's capital stock and provided the main impetus for real GDP growth in that period. However, continued capital accumulation alone is not sufficient to drive development from lower middle-income to upper middle-income status.

Rather, for a lower middle-income country (LMIC) to achieve sustained and rapid economic growth, capital accumulation must be combined with infusion (World Bank 2024).

Infusion entails the import of modern technologies and business models from more economically developed countries and their adoption on a wide scale within the domestic economy to upgrade and transform production structures. This infusion of modern technologies and business models accelerates productivity growth, thereby enabling domestic businesses to become competitive as exporters of goods and services to regional and global markets.

One of the main channels for infusion in LMICs is FDI across broad sectors of the economy. The main vehicle for infusion is high quality investment, especially from foreign firms looking to enter markets where high productivity is essential to compete successfully. In addition, successful infusion requires a business environment that promotes competitive markets and upskilled human capital to enable businesses to adopt the more sophisticated technologies and business models that typically accompany infusion. Therefore, LMICs need to deliver widespread access to high-quality secondary education as well as technical and vocational training to be able to transition to UMIC status (World Bank 2023a).

The Kyrgyz Republic has yet to reach this stage of development—investment combined with infusion. As discussed in section A, FDI in the Kyrgyz economy has been confined to sectors that offered limited opportunities to utilize more advanced technologies (such as retail trade), or that are of enclave nature (such as the extractive industries), which has limited the scope for diffusion of any FDI-related technologies in the broader economy. Continued high rates of investment are necessary to propel the Kyrgyz economy to upper middle-income status, but there needs to be much greater emphasis on business investment by highly productive private enterprises, and especially by foreign enterprises that can bring more sophisticated production technologies and business practices into the Kyrgyz economy. These generally include firms that operate in highly competitive sectors globally. The policy reforms needed to attract FDI into efficiency-seeking sectors to strengthen the business environment and enhance competition in domestic markets are discussed later in this section.

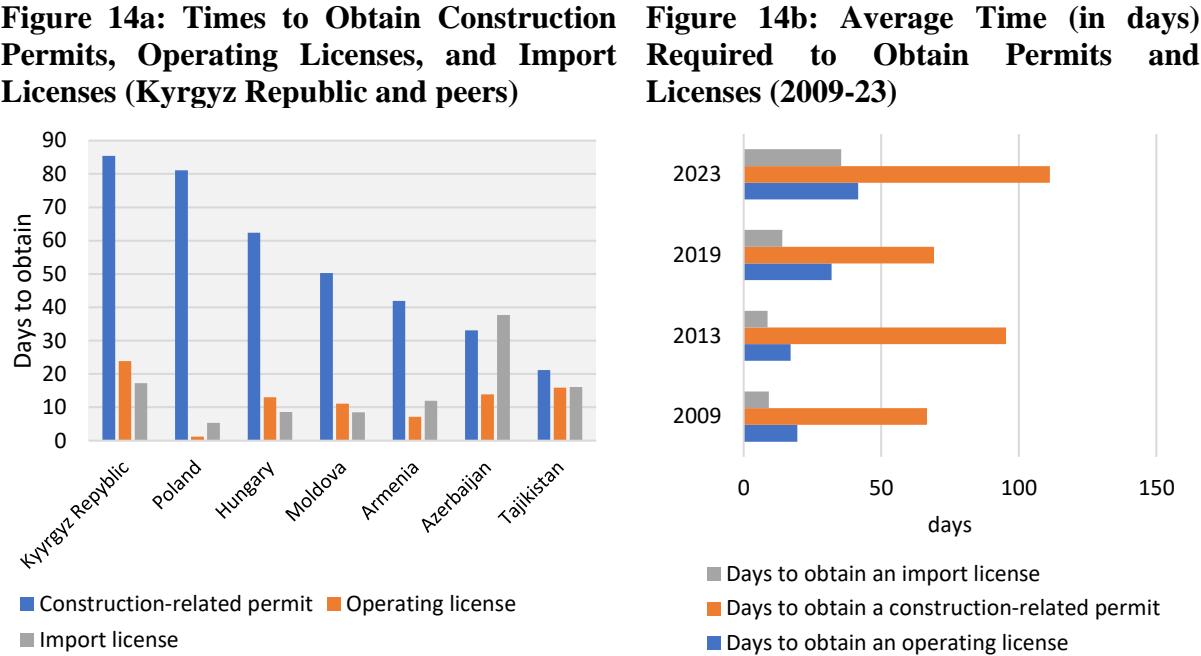
Targeted policy measures to strengthen human capital formation are needed to facilitate an infusion-driven development strategy. Although the Kyrgyz Republic scores relatively well in the World Bank’s Human Capital Index, human capital needs to be strengthened. In particular, there are significant gaps in foundational learning achievements evident in test results for 2017 Early Grade Reading Assessment (EGRA) and National Sample-Based Assessments (NSBA). The latter indicated that about 60 percent of grade 4 students perform below basic proficiency in reading comprehension and mathematics (World Bank 2023a).

In addition, there are gaps between the skills of the labor force and those required by the labor market. The 2019 Enterprise Survey indicated that 65 percent of businesses regard an inadequately educated workforce as a problem, with a third of businesses citing this as a major concern. Only a small percentage of the labor force has the skills necessary to use modern technology, such as IT. This issue is likely to become more salient once other constraints to raising productivity are alleviated. The World Bank has thoroughly analyzed the challenges of human capital development in other reports (World Bank 2023a), so the CEM does not cover this aspect in detail.

Business environment constraints to private sector growth

The barriers to new entry and expansion by firms include excessively costly, time-consuming, complex, and often opaque regulatory requirements to enable a firm to do business in formal sector markets. Firms have to obtain numerous permits and licenses from many different government agencies and there is inadequate coordination between the relevant

agencies to facilitate the processes. For example, as shown in figure 14a and 14b, it takes much longer to obtain construction permits, operating licenses, and import licenses in the Kyrgyz Republic than in most of its structural and aspirational peers. Furthermore, the time required to obtain these licenses and permits increased markedly since 2009 in the Kyrgyz Republic.



Source: World Bank Enterprise Survey 2023.

The cost structure of regulatory fees is not transparent, and charges are amongst the highest in the region. The cost structure of regulatory fees varies from agency to agency as well as from region to region. There is also a lack of transparency. Most regulatory agencies do not publish price schedules for fees and the fees charged by them are often decided through “informal agreements”. This imposes costs, often exacerbated by corruption, which can be prohibitive for small firms. The 2023 Enterprise Survey data show that the average cost of obtaining an electricity connection is about 143 percent of GDP per capita;¹⁶ and for water connection it is about 32 percent of GDP per capita;¹⁷ and for internet connection over 5 percent of GDP per capita. These are some of the highest rates in the region. The costs which firms incur to obtain connections to electricity and water supplies are among the highest in the region. Most administrative processes are opaque and require laborious in-person information gathering by firms.¹⁸

Moreover, firms are also subject to excessive and often arbitrary inspections. The regulatory burden on firms is exacerbated by excessive and often unlawful ad hoc inspections by regulatory agencies, which occur without any coordination across the relevant agencies. More than half of all tax inspections result in cumbersome tax audits. In about a third of these inspections, the taxpayers are requested to provide ‘informal payments’ to tax officials (World Bank 2023b). These inspections are often motivated by corruption, with the burden falling more heavily on

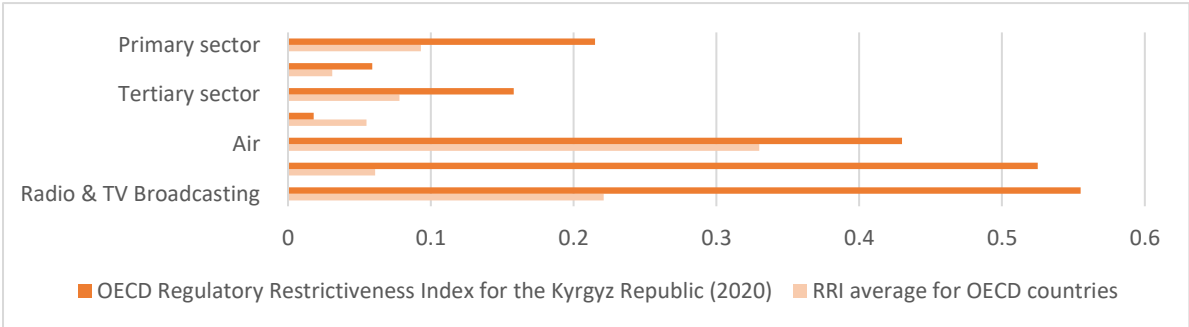
¹⁶ One unexplained outlier has been dropped from the sample.
¹⁷ One unexplained outlier has been dropped from the sample.
¹⁸ World Bank assessment based on field mission observations.

smaller firms. Business associations have persistently expressed concerns about the abuse of power and regulatory functions by public officials.

Reforms to streamline business regulations and regulatory processes have not yet been fully implemented. In recent years, reforms have been introduced to improve the business environment, including through the digitalization of regulatory processes such as for company registration and tax filing. But these reforms have not been fully implemented and therefore have been only partially successful. For example, while the Ministry of Economy and Commerce hosts an e-portal which provides information on 750 licenses and permits across all industries, only six of these licenses and permits are fully digitized for online submission and application processing. The disconnect between stated policy ambitions and practice further impedes business by creating a more uncertain and incoherent regulatory landscape. In addition, the legally mandated timeframes for the completion of specific regulatory processes, such as company incorporation or the issuance of operational licenses, are usually not adhered to in practice.¹⁹

Foreign investors face restrictions on entry into a few major sectors. While there are few general restrictions on FDI, statutory sector restrictions apply in media, air transport, agriculture, and tourism, according to sectoral legislation. In the media sector, radio and television broadcasting companies may only be established by citizens of the Kyrgyz Republic and legal entities with no more than 35 percent of foreign capital. In the air transport sector, ownership in local airlines by foreign individuals and legal entities is limited to 49 percent of the charter capital. In tourism, foreign persons are prohibited from owning recreational facilities and tourism infrastructure. In case the recreational facilities and tourism infrastructure are inherited by a foreign person, the property rights for such assets must be transferred to the citizen of the Kyrgyz Republic within one year. Apart from these restricted sectors, the general position is that 100 percent foreign equity is permitted in a sector or sub-sector. There are also legal restrictions on the right of foreign persons to own land in the Kyrgyz Republic. For example, foreign persons cannot own agricultural land, and foreclosed agricultural land may be owned by foreign banks and specialized financial institutions for no more than two years. Unlike the investment law, the land code does not apply a foreign investor definition of foreign ownership above 33 percent but applies in its Article 1 the lower threshold of 20 percent. In addition, the public procurement law grants “local content” and “local labor” advantages to local companies over foreign suppliers. As shown in figure 15, FDI in these sectors faces much greater regulatory restrictiveness than is the case on average in Organization for Economic Co-operation and Development (OECD) countries.

Figure 15: Regulatory Restrictiveness Index (RRI) for FDI by Sector

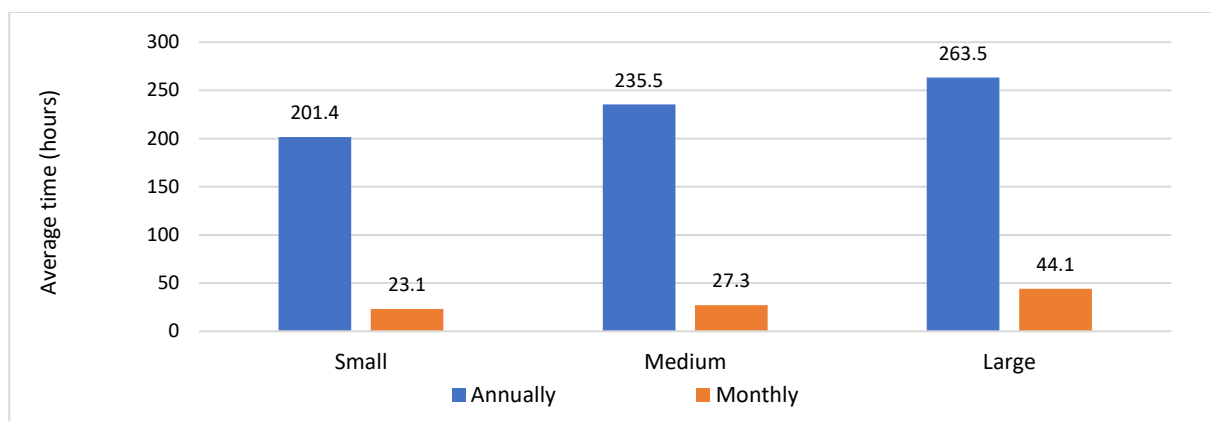


¹⁹ Based on interviews with representatives of business associations.

Source: OECD. 0=open, 1=closed.

Tax compliance is especially problematic for firms. Most firms now file and pay taxes electronically but they nevertheless still face a high burden of tax compliance,²⁰ having to allocate over 200 hours per year on average to tax compliance (figure 16) which, especially for a small firm, represents a significant cost. Over 80 percent of firms report that lack of access to up-to-date tax compliance information and regulations significantly negatively impacts their ability to file taxes. Tax inspections frequently require costly tax audits for firms.

Figure 16: Average Time (in hours) Spent on Tax Compliance by Company Size



Source: World Bank Enterprise Survey 2023.

Complex administrative processes, rent-seeking by public officials, and a lack regulatory transparency all deter local business from formalizing and growing. In a country with a widespread informal sector there are few incentives for firms to join the formal economy if, as a result, they expect to be subjected to abusive inspections, high regulatory compliance costs, and highly bureaucratic regulatory processes where bribes have to be paid to get things done. This helps to explain why the Kyrgyz economy has much lower rates of new entry by formal firms and rates of formal business density than some of its peers such as Türkiye, Hungary, and Poland. Similarly, foreign firms are deterred from investing in the Kyrgyz economy because of the unpredictable and hard to navigate business environment. The consequence is that many markets in the economy are still dominated by small scale, informal firms which lack the resources to finance productivity enhancing investments and thus are unable to realize the economies of scale that would enable them to be more productive and expand their market share. That is also the reason why most of the new job have been informal sector jobs, as noted in section A.

An efficient process for meaningful public-private sector dialogue is also lacking. Effective public-private sector dialogue could help to obviate some the negative impacts of the institutional and policy related weaknesses in the business environment (pertaining to regulations, tax compliance costs, the competition framework, and protection of foreign investments), by giving a voice to the concerns of private businesses with regard to the formulation and implementation of business-related policies. However, only a small minority of Kyrgyz businesses are represented in business associations that take part in policy reform consultations with the government. There are no enforceable notice and comment procedures that regulatory agencies are required to follow when drafting reforms, despite this being mandated in the 2009 Law on Regulatory Legal Acts. Many regulatory impact assessments (RIAs) are deficient, and some

²⁰ The tax compliance burden includes the time for tax accounting and any other financial costs incurred to meet tax administration requirements.

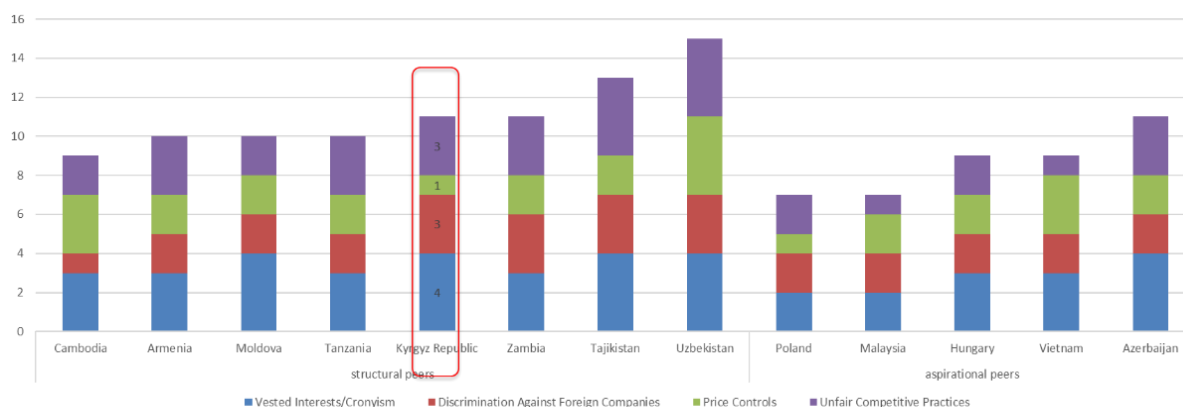
regulatory agencies carry out only superficial RIAs after the new regulations are fully drafted or have already entered an implementation phase.

Impediments to more competitive markets

By deterring new business entry and expansion of existing businesses, the impediments discussed above also dampen competition in markets. If new entry is restricted, incumbents face fewer challengers for market share. In addition, multiple other factors restrain competition in markets, including the large presence of SOEs, some of which enjoy preferential treatment in key markets, as well as weak enforcement of competition law, which has allowed anti-competitive practices to take place. Together these factors shield incumbents—whether private firms or SOEs—from competition from potentially more efficient and productive firms.

Kyrgyz firms perceive that constraints on competition increase the risks of doing business. This is illustrated in figure 17, which is based on data from the Economist Intelligence Unit (EIU) Risk Tracker Dataset (December 2022). Although the Kyrgyz Republic is not markedly worse than its structural peers in terms of perceived competition-related business risks, it ranks much worse than its aspirational peers such as Hungary, Malaysia, Poland, and Vietnam. Firms in the Kyrgyz Republic regard the impact of vested interests and cronyism as the most important source of competition-related risk for business, followed by unfair competitive practices, and discrimination against foreign companies.

Figure 17: Index of Competition-Related Risks for Business in Kyrgyz Republic and Peers
0 (very little risk) to 16 (very high risk) score



Source: World Bank based on the Economist Intelligence Unit (EIU) Risk Tracker data (December 2022).

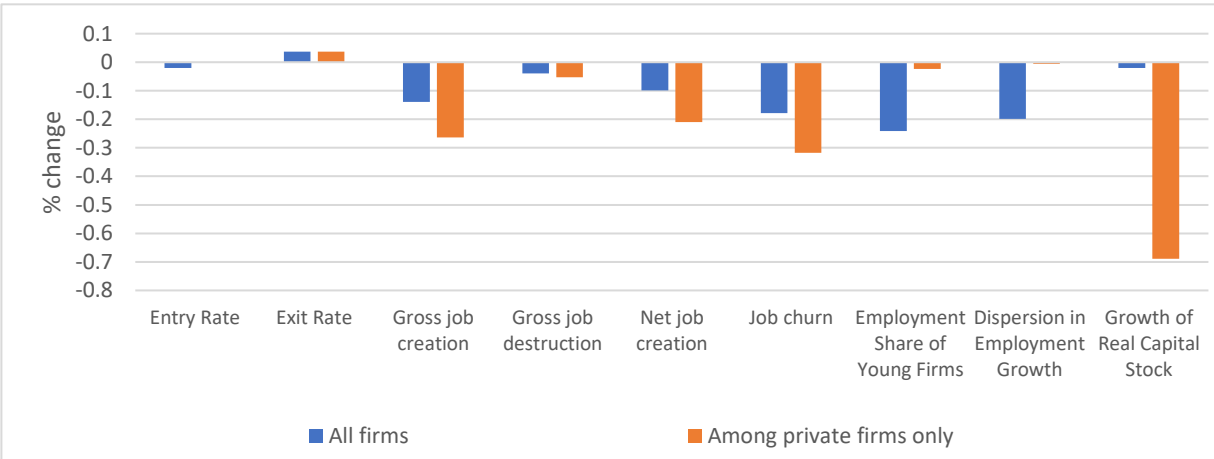
Preferential treatment of SOEs undermines competition. The Kyrgyz economy has a relatively large presence of SOEs, the revenues of which amount to the equivalent of 27 percent of GDP. Some SOEs operate in markets characterized by natural monopoly, but many others operate in contestable markets (e.g. telecommunications, banking, civil engineering). While the presence of SOEs in contestable markets is not inherently a constraint on competition, competition is undermined when SOEs receive privileges not available to their private sector competitors. Preferential treatments for SOEs include tax exemptions, subsidized loans from state-owned banks, the on-lending of concessional external loans contracted by the government to SOEs, government guarantees of SOE debt, exemptions from certain regulations, and preferential treatment for public procurement, et cetera. Moreover, the government maintains

discretionary authority to provide tax advantages, special insolvency and restructuring conditions and procedures for SOEs, and access to land resources. SOEs also receive preferential treatment in cases of bankruptcy and economic insolvency; specifically, they are given a longer administration period to help avoid liquidation and a longer period to clear their tax arrears.

Conflicts of interests impede fair competition in contestable markets in which SOEs operate. Government ministries control SOEs and are responsible for regulating sectors in which the SOEs operate (examples refer to energy and telecom sectors). This puts other private firms in the same market at a disadvantage as a relevant ministry will seek to protect the SOEs under its purview. In fact, there is a lack of regulation to ensure fair access by private investors to key infrastructure networks such as in energy and telecommunication. Together with the preferential treatment for SOEs noted above, this not only distorts the playing field and sustains inefficient firms, but it also discourages more efficient private sector investors from entering markets with a large presence of SOEs, thus constraining the efficient allocation of resources and impeding private sector development.

Empirical evidence confirms that significant SOE presence in contestable markets weakens competition and reduces productivity. The results of econometric analysis based on the firm-level data for the Kyrgyz Republic indicates that SOEs in contestable markets have lower productivity (TFP) than private sector competitors despite having a larger market share and that aggregate TFP at the sectoral level is inversely related to SOE market share. Greater SOE presence in markets also is associated with both lower job creation and lower capital investment in those markets, especially among private sector firms. These findings are illustrated in figure 18, which shows the impact of an increase in SOE market share on various aspects of business dynamism.

Figure 18: Average Impact of SOE Presence on Market Dynamism, 2010-2022 (percent)



Source: World Bank based on National Statistics Committee administrative data.²¹

The competition framework does not effectively prevent anticompetitive practices. The effectiveness of the Competition Law is undermined by poorly defined rules and the limited enforcement tools available to the Anti-Monopoly Service (AMS). The rules set too low a market share threshold (35 percent) for what is considered to be market dominance, which risks wrongly

²¹ The bars in the visual representation correspond to coefficients on the SOEs (employment based) market share in a NACE 2-digit sector. These coefficients are derived from regressions where specific business dynamism measures serve as the outcome variables. The regressions control for average firm size and age, sector’s size, NACE 2-sector, year fixed effects.

penalizing legitimate business practices. The Competition Law also fails to adequately sanction cartels and the rules covering mergers are incomplete. Effective enforcement of the law by the AMS is constrained by shortages of skilled staff, who are often employed on low priority cases rather than investigating and sanctioning high-impact competition enforcement cases. The deficiencies of the competition framework enable larger incumbent firms to restrict competition from smaller and more productive firms by engaging in monopolistic and anti-competitive practices.

Institutional weaknesses, regulatory restrictions, and inadequate investor protections deter FDI. Moreover, while regulatory restrictions curb FDI in some specific sectors as discussed above, FDI has been constrained by an obsolete legal framework even in sectors where regulatory restrictions do not apply. The legal system does not provide adequate investor protection, there is weak enforcement of existing laws and regulations, and decision-making processes lack transparency. Furthermore, the government lacks a coherent strategy for targeting and promoting FDI.

Non-tariff barriers, institutional deficiencies, and inadequate “quality infrastructure”²² raise the costs of international trade, making it expensive for businesses to import inputs and undermining the competitiveness of exports. Inefficient customs procedures contribute to border congestion and delays. Almost a fifth of exporting firms cite problems involving customs as a significant barrier to exports. The lack of effective digital, one-stop-shop processes for exports and imports also contributes to the administrative costs of international trade. More than half of imported goods to the Kyrgyz Republic are subject to non-tariff measures (NTMs), most notably price or quantity controls (via consumption taxes and licensing requirements), and technical measures. The average product in the Kyrgyz Republic is subject to six technical NTMs, with some products subject to as many as 17 measures. The Kyrgyz Republic also applies price or quantity controls to about 18 percent of products. The country’s national “quality infrastructure” ranked 114 of 137 countries rated by the recent United Nations Industrial Development Organization (UNIDO) in 2022 benchmarking of national quality infrastructures across the world.²³

Serious weaknesses in the logistics infrastructure also undermine the Kyrgyz Republic’s trade competitiveness and diminish the role of trade in boosting productivity and economic growth. The World Bank’s Logistics Performance Index (LPI)²⁴ shows deterioration in Kyrgyzstan’s trade logistics and ranks the country in a lowest quintile of LPI on its measures of logistics performance. The LPI score declined from 2.55 in 2018 to 2.3 in 2023, bringing the country’s global LPI position from 108th to 123rd out of 139 countries observed during the same period. The lowest sub-scores referred to customs processes, international shipments, tracking and tracing, and timeliness dimensions, all of which are crucial for seamless trade.

Business dynamism is also constrained by low levels of financial intermediation. Access to finance is cited by firms in business surveys as one of the three most important barriers to doing business in the Kyrgyz Republic and is cited as the most important barrier by small- and medium-sized firms. Only around 20 percent of Kyrgyz firms have access to a loan or line of credit from

²² “Quality infrastructure” refers to the system comprising the organizations (public and private) together with the policies, relevant legal and regulatory framework, and practices needed to support and enhance the quality, safety, and environmental soundness of goods, services, and processes. Quality infrastructure is required for the effective operation of domestic markets and its international recognition is important to enable access to foreign markets. It relies on metrology, standardization, accreditation, conformity assessment, and market surveillance.

²³ <https://hub.unido.org/qi4sd/?year=2022>

²⁴ The LPI measures a country’s efficiency and effectiveness of logistics and supply chain and includes the efficiency of clearance processes (such as customs), trade and transport-related infrastructure, ease of arranging competitively priced shipments, competence and quality of logistics services, ability to track and trace consignments, and timeliness of delivery.

a financial institution, although firms' access to credit has improved since 2009. More than a quarter of all firms report that they are fully credit constrained, i.e., they have no access to credit from any source and the percent share of such firms in Kyrgyz Republic is three times the regional average. The ratio of bank credit to GDP, at only 26 percent in 2023, is far lower than most aspirational peers, such as Türkiye (67 percent) and Poland (46 percent). Over 90 percent of loans require collateral, typically in the form of immovable property (real estate) (World Bank 2023b). Moreover, the value of collateral demanded for loans often exceeds 200 percent, which is 1.4 times higher than the regional average. The high collateral requirements raise questions about why financial institutions do not more frequently employ traditional lending practices based on cash flow analysis. A partial explanation for this phenomenon may be that many firms are unable to provide reliable financial information. For example, in the 2023 Enterprise Survey (World Bank 2023b), only 36 percent of firms reported that their financial statements were audited and verified by external auditors, which is below the global average of 46 percent. There are other reasons for the low levels of bank lending in the Kyrgyz Republic, including the low deposit to GDP ratio (29 percent of GDP compared with 69 percent in Türkiye and 56 percent in Hungary), and underdeveloped alternative financing channels. For example, the ratio of stock market capitalization to GDP is only 8.3 percent compared to 15.4 percent in Uzbekistan, 22.1 in Kazakhstan and 36.4 percent in Türkiye.

Macroeconomic constraints to productivity growth

Macroeconomic factors have exacerbated the institutional and policy constraints to business dynamism and thus to growth and job creation. Since the early 2000s, the expansion of natural resource exports and large-scale inflows of workers' remittances have boosted national income and induced an appreciation of the real effective exchange rate (REER) by around 20 percent over the period 2003 to 2019. This has reduced the international competitiveness of Kyrgyz exports, made imports relatively cheaper, and shifted the structure of production towards non-traded sectors, notably services and construction. At the same time, it has deterred private investment in export industries, such as food processing and light manufacturing. The share of non-traded goods²⁵ in GDP rose from 43 percent in 2000 to 70 percent in 2019, while the trade deficit widened sharply, by around 23 percentage points of GDP to accommodate the economy's demand for traded goods. As such, the Kyrgyz economy exhibited classic symptoms of "Dutch disease".²⁶

Dutch disease impedes productivity growth. The contraction of traded goods production as a share of GDP (to accommodate the increased demand for non-traded goods) matters for productivity growth because other than natural resources, most traded goods face intense competitive pressures on global markets. This forces firms in these industries to continuously raise productivity to compete. Hence, because Dutch disease hinders the development of dynamic export sectors, it stifles the potentially most dynamic and productive parts of the economy that could drive growth, as has been the case in many of the fast-growing developing economies of Asia. As noted in section A, the Kyrgyz economy has not been able to integrate,

²⁵ The non-traded goods sectors are defined as services, construction, and utilities.

²⁶ The term "Dutch disease" connotes macroeconomic phenomena in which a boom in a natural resource sector of a small, open economy (caused by an expansion of production or an increase in global prices for the natural resource) raises national income and aggregate spending in that economy, thereby inducing an appreciation of the real exchange rate. The latter weakens the external price competitiveness of domestic tradeable goods industries (outside of the booming natural resource sector), causing these industries to contract and shed employment (hence the use of the word "disease" to describe this phenomena). A seminal reference in the Dutch disease literature is Corden and Neary (1982). The concept has been extended to include economies characterized by booms in workers' remittances, as large-scale remittance inflows can have similar macroeconomic effects to natural resource booms.

through backward linkages, into global value chains for high value manufactured products. The decline in external price competitiveness through the real exchange rate appreciation induced by Dutch disease has also contributed to this, although it is not the main reason.

Dutch disease is both a cause and effect of weak productivity growth. Dutch disease exacerbates the adverse effects on productivity caused by the institutional and policy constraints to private investment and competition discussed above, but it is also partly caused by them, in that the failure of the economy to generate high productivity formal sector jobs is a major driver of large-scale worker migration and the inflow of remittances.

Summary of the constraints to business dynamism and productivity growth

The CEM contends that productivity growth has been constrained by a lack of dynamism in the business sectors of the Kyrgyz economy resulting mainly from institutional and policy weaknesses in the business environment. While some of the business-related policies themselves are suboptimal, a more important problem for private sector firms is the manner in which business regulations, tax administration, preferences granted to SOEs, and competition policies are implemented in practice. These practices are often done in an opaque manner that creates uncertainty and provides scope for corruption. For example, the practice of excessive tax inspections raises the costs to business of complying with regulations and with their obligations to pay tax; it also generates uncertainty for business, not least because they cannot be sure that they will always be able to operate on a level playing field with their competitors. This uncertainty is a critical deterrent to private investment. The various weaknesses in the business environment which are identified in the CEM combine to produce a highly deleterious impact on business dynamism, restricting new entry by formal sector firms and the expansion by existing firms, and thereby dampening competition in domestic markets.

The consequence of the subdued competition is that firms face only limited incentives to strengthen their productivity. Instead, established incumbents can often expand and dominate markets even though their productivity declines as they grew larger. In addition, because firms face only weak incentives in domestic markets to become more efficient, they do not attain the higher levels of efficiency which would enable them to expand and compete on export markets, which closes off a potentially important engine of rapid economic growth. The constraints on new entry and expansion by formal sector firms also explain why so few formal sector jobs are created in the private sector.

Shortages of critical skills in the labor force, deficiencies in the logistics infrastructure, and the low level of financial intermediation also constrain business. These issues need to be ameliorated, but even if this is accomplished, business dynamism is likely to remain subdued, with adverse effects for productivity growth, output growth, and formal sector job creation, unless the constraints arising from the business regulations, tax administration and competition policies can be rectified. Section C of this synthesis report provides policy recommendations for tackling these constraints and thereby creating a business environment more conducive to dynamic growth.

Section C. Policy Recommendations

The CEM recommends a program of key structural and policy reforms to reinvigorate the private sector, stimulate sustainable growth in productivity and output, and catalyze the creation of high-quality jobs. The reform program needs to be comprehensive and coherent to effectively mitigate the constraints to business entry, business expansion, competition, foreign investment, and trade that were highlighted in section B. The proposed reforms will support a shift in the economic growth strategy from one primarily driven by high rates of capital investment to one in which capital investment is complemented with the infusion of modern technology and business practices to enable higher rates of productivity growth. Such a strategy will also require targeted measures to enhance human capital with the skills required to adopt more sophisticated technologies and business models. Given the multiple constraints on business dynamism, reforms should be implemented in a comprehensive manner, as tackling only specific constraints is unlikely to be effective. The key recommendations are discussed below and summarized in table 1.

Major improvements are needed in the implementation of business regulations and policies. In many cases, the most serious constraints to business dynamism are the results of poor, untransparent, and often arbitrary implementation of business-related policies. Consequently, many of the reforms that the CEM recommends do not entail major changes in “de jure” business-related legislation or regulations, but they do require substantive and qualitative changes in the way in which the legislation and regulations are implemented and enforced by government agencies.

The first step in the reform program should be to develop a comprehensive reform agenda, including necessary actions to improve the business environment in the short and medium terms. The reform agenda should be guided by substantive and well-structured public-private dialogue. This will require reinvigorating the institutions and processes of public-private sector dialogue; for example, there must be enforceable procedures for regulatory agencies to follow for consultation with the private sector when drafting reforms in line with the 2009 Law on Regulatory Legal Acts. The Investment Council should be strengthened. When new regulatory reforms are planned, compliance with the requirements of Regulatory Impact Assessments and notice and comment protocols should be enforced. A communications strategy should accompany the reform program to clearly explain to the public what the reforms will entail in practice, their rationale, and their intended benefits.

Regulatory processes should be streamlined and made more transparent. To reduce excessive costs, time required, and opportunities for rent seeking, the process to apply for permits, licenses, company incorporation and other business administrative processes should be streamlined, fully digitalized, and given clear published fee structures and timelines for completing the processes. The number of business licenses and permits should be condensed from the current level of around 750 to at most 300. In addition, the number of agencies involved in approving any single license or permit should be reduced. A single e-portal to apply for all

permits and licenses should be established. Tax administration reforms should aim to simplify tax compliance for businesses to reduce the costs and time involved.²⁷

Inspections of businesses by all regulatory agencies, including the tax authorities, should be subject to clear, unified, and binding legal criteria. It is critical to curb the excessive and abusive inspections of firms which raise the costs of doing business and heighten the risks of private investment. This can be done by revising the Law of the Kyrgyz Republic No. 72, “On Procedures for Inspecting Business Entities”. The number of inspections should be reduced and decisions as to which firms to inspect, especially for tax inspections, should be risk-based. In addition, the criteria and protocols used for inspections should be published.

Access to finance could be improved by addressing legal and regulatory gaps in the use and valuation of movable and immovable collateral. The latter may refer to setting the minimum value of the real estate to be used as a collateral by financial institutions and by approving secured transaction legislation to expand the pool of collateral and by upgrading the current regulation on collateral valuation.

Although the fundamental elements of a competition framework are already in place, the Competition Law needs to be modernized and strengthened to make it much more effective in ensuring genuine competition in markets. Key terms and provisions in the law need to be clarified and the operational rules for competition enforcement should be strengthened. This should include stronger rules against cartels. The Anti-Monopoly Service (AMS) requires institutional strengthening, including by making it more independent and improving the transparency of competition enforcement. The operational focus of the AMS should be directed against cartels, the abuse of market dominance and other anti-competitive practices, rather than attempting to control, ex-ante, the business strategies of firms.

Government interventions are pivotal in shaping market functioning and competition dynamics across firms. Government interventions can directly or indirectly impact the incentives for firms to enter, compete, and expand, consequently influencing the allocation of productive resources across various sectors. This, in turn, can either foster or impede market efficiency. Direct interventions involve the government's participation as a supplier by providing goods and services, particularly through SOE operations. Additionally, the government can act as a buyer through public procurement. The current extensive use of the single source procurement method by both SOEs and budget institutions is a problem because it allows the state to give preference to selected firms which may not be the most productive. SOEs' procurement is especially a problem as there is no proper oversight of their procurement practice, which needs to be brought in line with the principles under the Public Procurement Law and the government's regulation on SOE procurement.

Comprehensive reform of SOE oversight—especially of SOEs operating in potentially competitive markets—is required to ensure that they operate on a level playing field with the private sector and do not receive preferential treatment from the state. The government should put in place a state aid control framework (which should be applied to all businesses where applicable, and not just SOEs) with transparent criteria for determining under what circumstances and for what purposes state aid can be given to businesses, with a clear definition of what constitutes state aid. The state aid control framework should foster competitive neutrality principles to ensure that the government's direct interventions in markets (through production of

²⁷ The CEM does not focus on tax administration reforms. For more specific and detailed recommendations on tax administration reforms aimed at reducing the cost of tax compliance please look at the World Bank report on the Tax System Review (2024) and the Overview of Tax Compliance Cost Survey (2024) .

goods and services via SOEs or acquisition of goods and services via public procurement), and indirect interventions in markets (through fiscal subsidies, including subsidized loans, tax exemptions, or different regulatory oversight) do not distort a level playing field and adhere to competitive neutrality. A comprehensive database of all forms of state aid, direct and indirect, should be maintained and be available online. The AMS should be given the responsibility for determining whether state aid has a market distorting impact.

SOEs in competitive markets should be subject to competitive neutrality principles. This will entail making them subject to minimum performance targets which correspond to market benchmarks. Within the operations of SOEs there should be a clear separation of commercial and non-commercial activities. The public service obligations of SOEs (e.g., provision of subsidized services for targeted beneficiaries) can be funded with transparent costs transfers from the government budget with clear rules to prevent the cross subsidization of commercial activities. Independent regulators should be established for the energy and transport sectors, which are dominated by SOEs, to ensure competitive neutrality.

To make the Kyrgyz economy more attractive for FDI, targeted reforms are required to upgrade the legal framework governing investment and enhance investor confidence. The existing Investment Law and bilateral investment treaties should be modernized to align with international good practices and standards related to investor protection, thus reducing uncertainty and risks for the state and investors. Entry procedures for FDI should be streamlined and clarified, and comprehensive, up-to-date information on regulations affecting investors, in relevant foreign languages, should be made available online. Discriminatory restrictions on foreign investments, such as those pertaining to acquiring land, should be removed in all but exceptional cases where there is an overarching policy rationale for them. The government should establish a mechanism at the National Agency for Investment (NAI) to address investor grievances with the state as an effective alternative to the domestic court system or international arbitration courts. The NAI should be strengthened, aligning its institutional organization and operational procedures with international good practice, to target and attract foreign investment in priority sectors; this should be complemented by developing a national investment strategy to enhance cooperation among all relevant agencies.

Reforms to reduce barriers to imports and exports could provide a powerful impetus to productivity growth, especially by improving the competitiveness of Kyrgyz exporters. The CEM recommends three categories of trade reforms: trade policy, regional integration, and trade facilitation and logistics. An institutional framework that includes the private sector should be established to review and streamline tariff and non-tariff measures (NTMs). NTMs which are unnecessary or fail to achieve their intended objectives should be eliminated. Regional trade integration can be strengthened by removing any deviations of import tariffs from the Common External Tariff of the Eurasian Economic Union. The government should coordinate with its regional partners to simplify and streamline border requirements, including by establishing common customs procedures. At the regional level and with bilateral trade partners, the government should negotiate regulatory cooperation on technical requirements for product standards and quality (e.g., mutual recognition or equivalence) to lower impediments to exports.

Comprehensive reform of the administrative, technical, and physical components of the trade-related infrastructure is required. Implementation of the Trade Facilitation Roadmap should be completed. This should include the integration of all government trade-related agencies into the Single Window information system for digital information and document exchange. Digitized services for exporters should be introduced to streamline export processes, including the requirements for obtaining licenses, permits, certificates and others. Customs inspections

should be reduced and conducted only on a risk-based approach to minimize routine inspections and scope for corruption. Accredited laboratories for inspecting and certifying product standards, in line with international requirements, should be established, to facilitate the export of higher value products. The physical infrastructure used to transport goods also needs to be upgraded over the medium term. It is also critical to approve a procedure for conducting time release studies (TRS) for monitoring trade processes, as well conduct and publish TRS results to improve timeliness of trade transactions.

The education and training system needs to be restructured so that it can provide young people with the relevant skills for a modern labor force. Reforms to primary and secondary education should aim to ensure that students acquire stronger foundational skills, for example, by introducing a competency-based curriculum which emphasizes proficiency in literacy and numeracy and basic digital skills. A dual technical and vocational training program should be established, with links to industry for job placements and apprenticeships, to train mid-level professionals and technicians. The higher education ecosystem should be re-engineered to better support the economic modernization; this will entail, inter alia, focusing the curriculum on developing skills relevant for the labor market, making professional education more attractive to students and relevant to the needs of business, and establishing, within universities, centers of excellence and hubs for research and technological innovation.

Key recommendations are summarized in table 1. The first step is to develop a comprehensive reform agenda and communications strategy focused on simplifying the business environment, enhancing competition and market contestability, maximizing the spillovers from FDI, and realizing the potential from greater trade integration.

Table 1: Summary of Recommendations for the Short to Medium Term

Policy Area	Policy Recommendation	Technical Complexity	Political Feasibility
Streamline Business Environment	Mandate that (i) all regulatory agencies transparently publish business regulatory processes and the relevant, required administrative fees; (ii) create a website that centralizes this information in one place, and that is maintained and regularly updated.	Low	Medium
	Enforce compliance with RIA regulation.	High	Medium
	Improve access to finance by approving secured transaction legislation to expand the pool of collateral and by upgrading the current regulation on collateral valuation.	Medium	High
	Update the Law on Inspecting, publish inspection protocols, criteria for selecting businesses, enhance coordination across inspecting institutions and enforce in-practice compliance with notice and comment protocols.	Medium	High
	Sharply reduce the number of licenses and permits for economic activities from the current 750 to a minimum, less than 300 at most. Make the issuance of all permits and licenses fully digital.	Low	Medium
Sharpen Competiti	Adopt a state aid control framework and foster competitive neutrality principles to ensure that the government's direct and indirect markets interventions do not distort the playing field and adhere to competitive neutrality.	Medium	Medium to Low

	Publish and maintain an online, comprehensive, and up-to-date database of all forms of state aid, direct and indirect.	Medium	Medium
	Formulate a comprehensive state-owned enterprises (SOE) ownership policy to: (i) separate commercial and non-commercial activities of SOEs; and (ii) introduce minimum performance targets for SOEs in competitive sectors.	Medium	Low
	Introduce independent sector regulators, particularly for energy and transport, to ensure competitive neutrality extends to sector regulation.	Medium	Low
	Complete the modernization of the legal and institutional framework of antitrust, including by clarifying key terms and provisions and enhancing operational rules for competition enforcement.	Medium	High
	Strengthen the institutional arrangements of the Anti-Monopoly Service to: (i) increase its independence and enforcement capacity; and (ii) refocus AMS resources on the detection/investigation of anti-competitive practices, e.g., cartels abuse of dominance, as opposed to controlling market strategies ex-ante (e.g., registry monitoring).	Medium	Low
Maximize FDI spillovers	Develop a FDI strategy with priority areas identified for investment promotion to attract high quality FDI.	Medium	High
	Modernize the legal framework governing investments to eliminate entry restrictions for foreign investor in key sectors and align regulations for acquiring land for foreign investors, among other improvements.	Medium	High
	Improve the quality and accessibility of relevant information by establishing a reliable central focal point for investors and creating an online comprehensive database on investment related legislation and regulations in key languages.	Medium	High
	Align the existing investment law and bilateral investment treaties (BITs) with evolving international good practices and standards related to investor protection to reduce uncertainty and risks for the state and for investors.	Medium	High
	Fully operationalize the newly established investor grievance mechanism at the National Agency on Investments to avoid court and investor-state dispute settlement cases.	Medium	High
Materialize Trade Potential	Review tariff deviations from the Eurasian Economic Union list to reduce or avoid tariff peaks, in particular for key inputs.	Medium- to high	Low to Medium
	Inventorize and streamline non-tariff measures in collaboration with the National Trade Facilitation Committee.	Medium	Medium
	Develop and implement a Trade Facilitation Roadmap listing the priority reforms, including strengthening risk management and post clearance audits, and advancing digitalization at the National Single Window one stop shop.	Medium	High
	Eliminate remaining paper-based procedures and foster digitalization at the National Single Window.	Low	Medium to Low

	Improve the national quality infrastructure (NQI) by: (i) preparing a detailed diagnostic of gaps in NQI and a strategy to strengthen NQI; (ii) Investing, either domestically or regionally in collaboration with the Central Asian countries, in technical accredited laboratories for conformity assessment; and (iii) enhancing the NQI for certification of niche products with strong export potential, such as organic agriculture.	High	High
	Develop strong institutions and a regulatory environment for the transport and logistics sector, including modernization program for the freight industry and cargo development and a road investment plan where needed.	High	Medium

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