

LABOUR AND SOCIAL JUSTICE

UNDERSTANDING INFORMAL ECONOMY IN KYRGYZSTAN

Better social justice for workers,
higher sustainability for the country

Dr Kanat Tilekeyev
June 2021



The informal economy persists as an established economic phenomenon in Kyrgyzstan. Estimates of the informal economy vary from 25 to 50% of the national economy in recent years. It erodes the sustainability of economic growth in the country.



71.8% of workers in the country work in the informal labour market. Economic sectors with the highest informality of workers – trade and services and construction.



Tax and social security systems provide better conditions for micro-businesses and special sub-sectors. As a result, most tax burden lies in the formal sector, preventing economic development in many economic areas in the formal sector – change in the economic paradigm is needed in Kyrgyzstan.

Contents

1.	INTRODUCTION	2
2.	INFORMAL ECONOMY – UNDERSTANDING OF THE PHENOMENA	3
2.1	Informal Economy – Definition and Scope of the Phenomena	3
2.2	Informal Economy Analysis Methodologies Review	3
3.	NATIONAL ECONOMY AND INFORMAL ECONOMY IN THE KYRGYZ REPUBLIC	5
4.	LABOUR MARKET STRUCTURE AND INFORMALITY IN KYRGYZSTAN	7
5.	REVIEW OF ECONOMIC SECTORS IN KYRGYZ ECONOMY WITH HIGH INFORMALITY LEVEL	10
5.1	Construction	10
5.2	Trade and Services	10
5.3	Processing Industry	11
5.4	Transport and Logistics	12
6.	NATIONAL POLICY FRAMEWORK IN THE KYRGYZ REPUBLIC	13
6.1	Tax System Review	13
6.2	Social Protection System	14
7.	PRINCIPAL FINDINGS AND POLICY OPTIONS DISCUSSION	16
	References	19
	Appendix 1 - Main Taxes in the Kyrgyz Republic - Definitions and Description	20
	Appendix 2 - Main Legislation of the Kyrgyz Republic on Social Protection	22

1

INTRODUCTION

Economic informality is an established reality observed in the last three decades of the Kyrgyz Republic's history. Activities based on economic operations where economic agents implement policies in the sphere of hidden (firms) and informal (households) production mainly aim to decrease tax burden and control from state bodies.

Official estimates cover at least 23-24% of the national economy (excluding agriculture) in 2014-2018 (NSC, 2020d). Besides the budget revenue aspect of the non-observed economy, one consequence of that informality is the heavily impacted labour market structure – 71.8% of all workers are in the informal labour market (NSC, 2020b).

Severe deficits in suitable work characterize work in the informal economy regarding income and productivity levels, labour rights and recognition, voice and representation, and social protection coverage. During the COVID-19 pandemic, the necessity to address issues related to informality became an urgent policy issue. Social protection schemes do not cover many people who need help today. Furthermore, the pandemic crisis has made adequate access to social security systems a core issue in preventing poverty crises in Kyrgyzstan's future.

The Informal economy phenomenon's presence in Kyrgyzstan has been confirmed by a series of studies during the last few decades. Different methodologies were applied for those studies and have brought positive results at different levels. There is a need to note that informal phenomena exist in all countries where statistical systems established and data for Kyrgyzstan are expectably higher than that of developed countries. Established economy structures define current levels of economic growth, which are highly vulnerable as shown by the dynamics of the Kyrgyz economy in 2020.

Labour market development in Kyrgyzstan is mainly driven by the demographic characteristics of the population. Population growth in the country has led to the growth of labour supply in Kyrgyzstan. Complicated dynamics of employment opportunities create dependence on creating jobs through self-employment and employment in microbusinesses.

The informal economy in Kyrgyzstan persists and is concentrated in specific sectors of the economy - trade and services, construction, processing industry, and trade and logistics. The prevailing informality of economic operations in the country has led to the high informality of the labour market, specifically in the mentioned sectors.

The complicated structure of tax and social security systems have created an uneven distribution of tax burden between the formal sector and the sector of individual entrepreneurs, micro-businesses, specialized sectors and self-employed people. Such distortion of public policy has led to the increase of informality by the specified beneficiaries, thus allowed to hide the particular level of activities and prevent the development of the formal sector, where the tax burden is significantly higher. An improvement of tax and social security policy is needed to provide more resistant and sustainable economic growth, and a more prominent labour market structure with the improved social security system, which will guarantee higher protection for people in the future.

2

INFORMAL ECONOMY – UNDERSTANDING OF THE PHENOMENA

2.1. INFORMAL ECONOMY – DEFINITION AND SCOPE OF THE PHENOMENON

Informal (unobserved, non-observed, or shadow) economy is a widespread economic phenomenon observed across the globe. The typical definition describes it as all currently unregistered economic activities contributing to the official national product if those activities were counted (Schneider, 2013). Unregistered informal economic activity brings many problems for the development of society: the execution of contracts is problematic; labour rights protection is problematic; violations of economic relations can lead to violent actions supporting criminal forces; business operations cannot grow normally; and finally, tax burden mainly sits on businesses operating in the formal registered economy. Informal economic activity includes underground, illegal sectors, or households' activity for their own use. However, the list is incomplete due to the lack of primary data collection in the national statistics. Types of informal activities include (OECD, 2002):

- underground production, defined as those activities that are productive and legal but are deliberately concealed from the public authorities to avoid payment of taxes or complying with different types of regulations;
- illegal production, defined as those productive activities that generate goods and services forbidden by law or that are unlawful when carried out by unauthorized producers;
- informal household sector production, defined as those productive activities conducted by unincorporated enterprises in the household sector that are unregistered and less than a specified size in employment and have some market production.
- production of households for their final use, defined as those productive activities that result in goods or services consumed or capitalized by the households that produced them.

In the study, the practical value is represented mainly by the first type of operation because of its crucial importance for the labour market. The second type of operation mainly includes activities related to criminal activities rather than economic operations and would need to be in the law enforcement bodies' interest. The latter two operations cover micro-entrepreneurial activities based on household produc-

tion. Such activities are small-scale, concentrated mainly in rural areas and mostly operate on a kinship basis. The development of formal institutions on the household level is an extreme challenge for policy improvement and needs to be the next evolutionary step after formalizing most of typical business. However, household production covered for the understanding the tax burden lies on micro-businesses and potential of the policy improvement on that level. Measurement of the informal economy is complex and requires an estimation of economic activity hidden from official transactions. In Europe, the share of informal economy varies from 10%, e.g. in the UK, while Southern European countries demonstrate more significant levels - around 15-20% of the economy is informal. The main incentives for informal economic relations are tax burden (including social security), tax morale, and state institutions' quality and labour market regulations (Schneider, 2013).

2.2. INFORMAL ECONOMY ANALYSIS METHODOLOGIES REVIEW

A separate body of studies analyses the informal economy phenomenon from different aspects of its functioning and impact on society and the economy. There are a few types of approaches to estimate the informal economy's size - direct, indirect and a mix of both. Direct approaches use surveys, samples, voluntary responses, tax audits, and other compliance methods to measure the non-observed economy. Surveys typically underestimate the informal economy's size because of the sensitive quality of the research tools. Indirect approaches (called indicator approaches) use indirect information (parameters) to estimate the informal economy's size. (Abdih, 2013). Therefore, statistical modelling techniques support informal economy size estimates through different econometric models using the informal economy's estimation as an omitted variable. Measurements based on the combination of the Multiple Indicator Multiple Cause (MIMIC) procedure and the currency demand method or, alternatively, the use of only the currency demand method are some of the practices used (Schneider, 2013). The discussion of the relevance of the MIMIC method has been raised in the literature (Feige, 2008). The United Nations Economic Commission for Europe compiled an inventory of national practices of national estimations of informal economies in 2008. It includes descriptions of the estimation procedures and an as-

Table 1
Estimations of the informal economy in the Kyrgyz Republic

#	Sources	Period	Method	The informal economy, % of GDP in Kyrgyzstan
1	Lacko, M. (2000)	1989- 1995	Indirect (electricity consumption)	35% (1995)
2	Feige, E. and Urban, I. (2008)	1991- 2000	Estimation (electricity consumption, currency deposit)	46.2- 49.5% (2000)
3	UNECE (2008)	1995-2003	Estimation (NIPA method)	17% (2003)
4	Schneider (2012)	1999-2007	Estimation (MIMIC model)	40.4% (average)
5	UNDP (2006)	2004	Indirect (electricity) Direct (survey)	33.5% (indirect) 46.3% (direct)
6	R. Akimkanov (2015)	1995-2013	Estimation (electricity consumption)	39.5%
7	Abdih, Y, and Medina, L. (2013)	2008	Estimation (MIMIC model)	26.3%
8	Medina, L. and Schneider, F. (2017)	1999-2015	Estimation (MIMIC model)	37.9% (Average)
9	Putniņš, T. and Sauka A. (2019)	2017-2018	Direct (phone survey of businesses)	46.1 and 44.5% (2017-2018)
10	SIAR (2019)	2017-2018	Direct (survey)	28.1 and 29.8% (2017-2018)

Source: author's representation

sortment of point estimates. However, it does not indicate changes in the informal economy's methodology over time and does not include information concerning assessing the data's completeness. Incomplete data and misleading methods may lead to the informal economy's systematic underestimation on the national level (Feige, 2016).

Informal economy estimations have been implemented in many countries, including the Kyrgyz Republic, by different researchers and organizations (See Table 1). A variety of approaches have been applied to different results. The lowest estimation is equal to 17%, which lies within OECD countries' average level. Such estimates look undervalued. Other estimations mainly vary in the range of 26 to 46%. The difference between them might be explained by the estimation methods and structural changes in the national economy. Any similar exercise will likewise bring a similar range of results. Two essential thoughts need to be articulated based on

the source's analysis:

- Informal economy prevails in the country and occupies a significant share of the national economy. The informal economy's assumed level can be assumed to be approximately 30% of counted GDP.
- The main incentives for the informal economy's existence include tax and social security burden, combined with the weak tax morale and underdeveloped institutional policy.

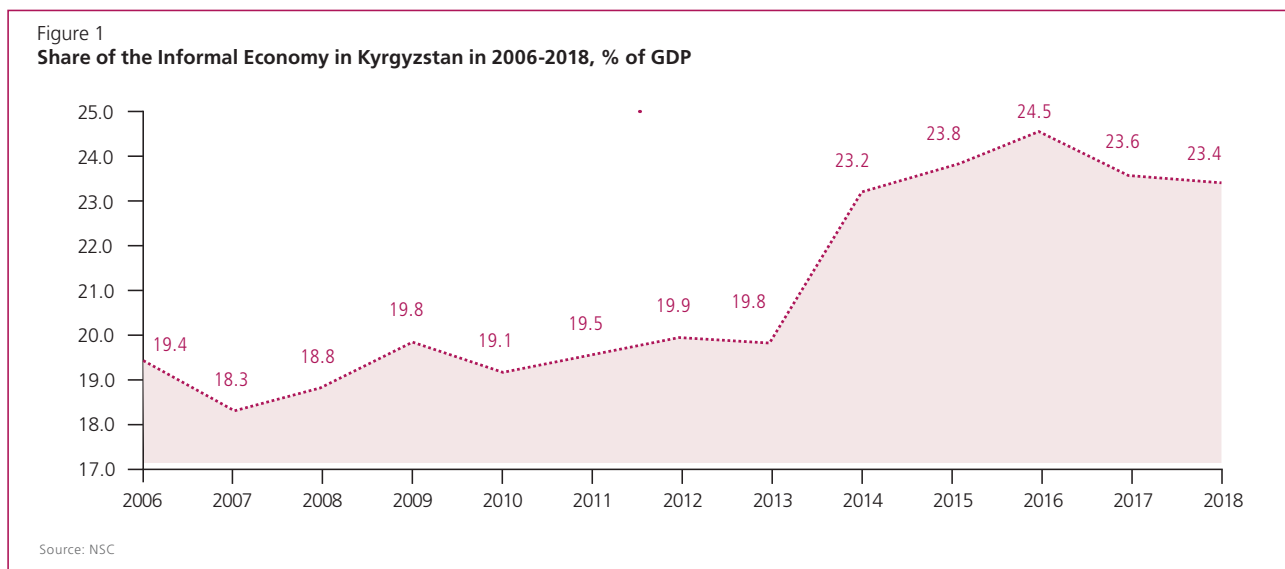
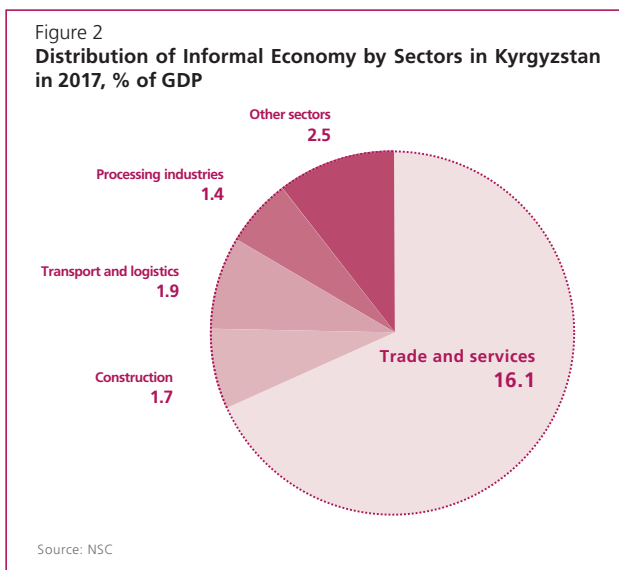
3

NATIONAL ECONOMY AND INFORMAL ECONOMY IN THE KYRGYZ REPUBLIC

The Kyrgyz Republic is one of the least developed countries in the Eurasian region, with a gross national income per capita of \$1,240 in 2019 (Atlas method). The Kyrgyz Republic's economy showed a decline in 2020 after relative stability and experiencing an economic growth of 4.2% in 2015-2019. Joining the Eurasian Economic Union (EEU) did not bring the expected growth of exports to the Russian Federation and Kazakhstan, but led to keeping labour migration at a high level. Remittance levels have reached one-third of the gross domestic product (GDP).

The Kyrgyz Republic has a declining share of agriculture in GDP, with 34% in 2000 and 14% in 2020. Simultaneously, employment in the agricultural sector fell from 53% to 29%. Growing sectors in the economy are construction, trade, transport, and communication. Stagnating sectors are manufacturing and energy, gas, and water. The long-term trend of the economy's growth rate lies in the range between 4% and 4.5%, with the high volatility caused by the different growth rates of construction, agriculture, and manufacturing. According to official estimations, due to COVID-19 the Kyrgyz economy fell by 8.6% in 2020. The main sectors impacted by COVID-19 are construction, manufacturing, trade, transport, the accommodation sector (hotels), and food services (restaurants).

The National Statistical Committee regularly provides an official estimation of the country's informal economy (Figure 1). By its estimate, the informal economy level (including hidden and informal activity) increased in 2014-2018 to 23-24% from 18-19% in 2006-2013. The sectors of the economy responsible for informal economic activity include trade and services, construction, transport and logistics, the processing industry and other sectors (Figure 2). The majority of the in-



formal economy is concentrated within the sector of trade and services. It provides 16.1% of the GDP or 68% of all informal economy volume. This sector is responsible for 16-19% of Kyrgyzstan's overall GDP and most of its economic growth in 2015-2020. The second and third sectors responsible for informal economic activity are construction and transport and logistics services. There is a need to notice that the share of informal activity in the specified sectors is substantial compared to their share in the economy. The selected sectors are the main areas where measures to decrease informal activities need to be addressed in alleviating the informal economy in the country.

4

LABOUR MARKET STRUCTURE AND INFORMALITY IN KYRGYZSTAN

More than half of the global labour force remains in the informal economy worldwide. Informal work often entails small, unsafe and unhealthy working conditions. It leads to low skills, low productivity, irregular incomes. Informal workers do not exist officially: they are not recognized, not registered, and not protected by labour legislation and social protection (ILO, 2020).

The country's labour market developed due to natural linkage with the demographic and social forces of Kyrgyz society. The labour force in Kyrgyzstan has increased by 5.2% during the last decade and has reached 2.58 million people. The majority of the labour force in 2019 is male; the male share force increased from 58 to 61% from 2010 to 2019. Consequently, it leads to the decline of the share of women in the observed period; most of them reside in rural areas. Most of the labour resides in rural areas (64%), the rest being urban residents. The share of urban and rural labour workers remained stable in the observed period. Between 2010 and 2019, the number of working people grew by 8.8% and reached 2.44 million. Most of them again are men, 62% compared to 38% of workers being women.

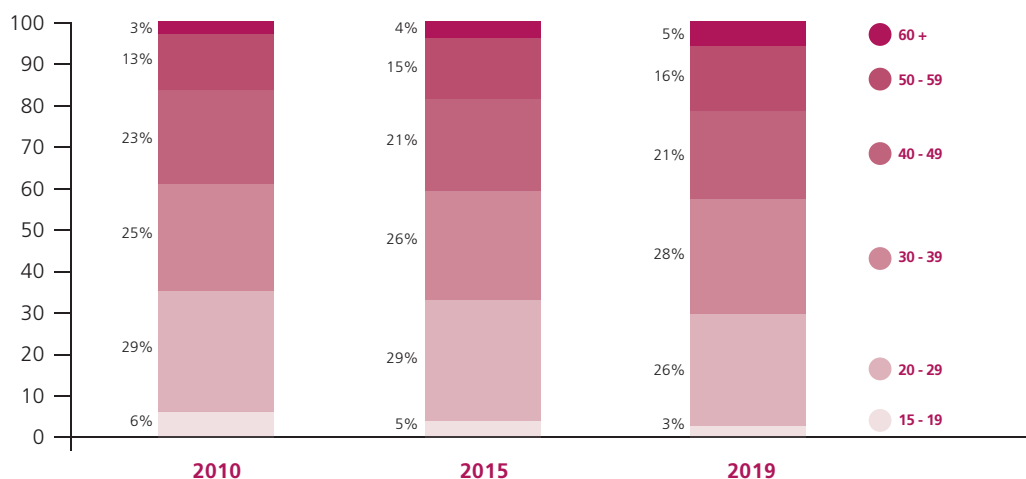
The age brackets of labour slowly changed between 2010

and 2019 (Figure 3). The labour force became more mature than a decade ago - the share of people in the age group above 50 increased from 16% in 2010 to 21% in 2019. Simultaneously, the labour force aged 15 to 29 years old declined from 35% to 29%. Such changes in the age structure demonstrate a demographic shift that occurred in Kyrgyzstan during the last decade. Two trends may explain such a shift - a slow growth of the labour market constraining the entering of the young jobseekers, and, on the other hand, an increase in the labour migration of young workers outside the country. In the next two or three decades, the country will face a gradual decline in population growth, and the trend of the ageing of the labour force will increase. The country's labour force's expected deficit could be resolved by increasing women's participation in the labour market.

There are several types of employment observed in the Kyrgyz economy (NSC, 2020b):

- People working in the formal employment sector - in enterprises and different types of organizations,
- People working on peasant farms,
- People working as individual entrepreneurs,
- People hired by individuals,

Figure 3
The Age Brackets of Working People in Kyrgyzstan between 2010-2019, %



Source: NSC

- People working in private households.

Over the last decade the structure of the labour market has changed. The share of the formal employment sector declined from 31% to 28%. At the same time, employment increased among private entrepreneurs (from 15 to 18%) and people hired by individuals (from 26 to 37%). Employment in farms and private households declined. The share of farm work declined from 21 to 15% of total employment. The share of people who work in their households declined from 7 to 2%.

The gender gap in access to employment is evident in the country. The share of women working in the formal sector is 10-15% higher compared to men. However, more men are working as private entrepreneurs, and the gap between men and women increased from 3 to 11% in the last decade. More men (approximately 10%) also work as workers hired by individuals. More women also work in farms compared to men – 17% vs 13% in 2019. In 2010 men were more represented on farms – 23% compared to 18% of women.

The difference also exists between urban and rural workers. More people work in the formal sector (36% in 2019), individual entrepreneurs (22%), and workers hired by individuals (41%) in the cities. In villages, people work more as workers hired by individuals (35%), formal employment sector (24%) and farms (23%)—the share of people working on farms declines. Simultaneously individual entrepreneurs and workers hired by individuals increased in rural areas.

About two-thirds of people have different forms of employment – hired on a constant or temporary basis, or with a written contract (NSC, 2020b). The share of people with a written contract increased from 7 to 19%. Most of these contracts are made in cities – 76%. However, a significant share of people work based on oral agreements – between 33% and 35%. That proportion significantly changes depending on the sector, with some having a number which is significantly higher:

- Agriculture – 64.4%,
- Processing industry – 41.6%,
- Construction – 63%,
- Trade and services - 49.5%,
- Hotels and restaurants – 41.1%.

The described employment types come in two categories: hired workers and non-hired workers. Hired persons include workers from the formal employment sector and persons hired by individuals. Thus, in the labour market structure, people who are considered as an employee form 57-64% of the total employment. The rest of the total national employment consists of non – hired workers, employers, self-employed individuals, members of production cooperatives, unpaid family workers and persons employed in private households. Self-employed people form the growing majority of non-hired workers – 61-71% in 2010-2019. The second biggest group are unpaid family workers (20-22%). It is noteworthy that in 2019 77% of that group consisted of women.

The share of people employed in private households declines from 16% to 5%. It demonstrates that economic activity commercialized over time. The share of the employers increased from 1 to 3% in the observed period.

The structure of the labour market allows for a high level of informality. It creates a situation where the majority of people in Kyrgyzstan work in the informal sector. The overall number of employed people working in the informal sector reached 71.8% in 2019. Urban areas demonstrate a lower level of informality (64.3%) than rural areas (76.1%). In general, men are more involved in the informal sector than women (77.2% vs 63.2%). It explained by the general prevalence of men in the labour market. At the same time, the share of women working in the formal sector is higher.

The distribution of people working in the informal sector is uneven, depending on the type of employment. More than half of the people (51%) working as informal workers are hired by private individuals. A quarter of them work as individual entrepreneurs, while another 20% of informal workers are employed in peasant farms. Informality found in the sphere of formal employment (1%) and private households (3%) in minor quantity.

In urban areas, the proportion of workers hired by individuals is higher (63.4%), with the rest of the informality mostly covered by individual entrepreneurship (32.6%). In rural areas, peasant farms make up 28.6%, individual entrepreneurship 20.6% and workers hired by individuals 45.3%.

Informality among hired and non-hired workers is almost equal - 51.5% vs 48.5%. More people work as hired laborers in urban areas (63.9%) than rural areas (45.5%). It can be explained mainly by the absence of peasant farms in cities.

Sectoral distribution of informal workers demonstrates an expected result. Agriculture is in the lead with 25% of all informal workers. Trade and services and construction occupy second and third places, with 21 and 15% respectively. Other important sectors include the processing industry (12%), transport and logistics (10%) and hotels and restaurants (9%).

The labor market in Kyrgyzstan demonstrates several essential features for consideration by public policy stakeholders:

- The labour market increases following the country's growth (5.5% in 2010-2019).
- The average age of workers has shown an increase over the past decade. The proportion of elderly workers will grow in the following decades.
- Women's participation in the labor market is low (38%). This trend may change with the decline in the number of young workers in the labor market. Gender difference exists in several other aspects - women primarily work in the formal employment market and unpaid family work.
- Informality in the labor market prevails in Kyrgyzstan – 71.8% of employment lies in the informal labor market.
- The main types of employment to consider for analysis

- hired by individuals and individual entrepreneurship are responsible for 76% of the whole informal labor market.
- The main sectors where informality in the labor market is concentrated: trade and services, construction, processing industry, transport, and logistics.
- The source of the informality of the labor force in Kyrgyzstan – small micro-business operating on the individual entrepreneurship base. It creates a high self-employment rate with numerous jobs being created in the specified sectors of the economy. It significantly contributes to the GDP, creates most of the jobs in the economy, but at the same time creates the highly fragmented structure of the national economy. The reserves of economic growth of the economic model based on micro-businesses have already been exploited. The recent crisis caused by the COVID-19 pandemic has demonstrated the high fragility of economic growth in Kyrgyzstan, and it requires changing the paradigm of economic development toward the decrease of informality in the country.

5

REVIEW OF ECONOMIC SECTORS IN THE KYRGYZ ECONOMY WITH A HIGH INFORMALITY LEVEL

5.1. CONSTRUCTION

The construction sector is one of the country's growing economic sectors, providing 8.7% of national GDP between 2015-2020. The number of firms working in construction has increased by 76% over the last 15 years – from 581 in 2005 to 1025 in 2019. However, most of the newly created firms have less than 50 workers per business entity. The share of such construction firms increased from 81% in 2005 to 92% in 2019. Annual turnover of construction work increased in 2015-2019 from 0.8 to 1.2 billion US\$ and expectedly declined in 2020 again to 0.8 billion US\$.

The construction sector structure has been stable for the last five years. The sector's core consists of new construction works - from 58 to 64% in 2015-2019. Repair work occupies the second place - 33 to 41%. The rest of the construction work is minor (~1%). There are two main construction centers in Kyrgyzstan: Bishkek and the surrounding Chui Province in the north of Kyrgyzstan, and Osh and the surrounding Osh Province in the south. Jointly, those two centers make up 70-77% of the construction sector (NSC, 2021a).

According to official statistics, new construction (houses and apartments) has more than doubled between 2005 and 2018 – from 539 to 1312 thousand square meters. The number of houses and apartments and overall construction area also more than doubled, and reached its peak for the last two decades in 2018 – 12613 units. In 2019 the amount of construction declined in the country, and the COVID-19 effect further contributed to the downturn in 2020 – 8225

units (NSC, 2021a).

Employment in the sector reached 287 thousand people in 2019, or 12% of the country's total labor market (Table 2). Almost all workers in the construction sector work informally (91%). Most informally working labor is hired laborers (90.9%). Most of the rest are self-employed (7.6%). It is interesting that 28.7% of the people employed in construction work outside of the country. Construction is the second sector with such a significant number of people working abroad, after hotels and restaurants. It probably explains the significant share of workers from rural areas. Most workers are men (98.5%) due to working operations requiring high physical strength.

5.2. TRADE AND SERVICES

The trade and services sector is the country's most significant economic sector, providing 17.6% of the national GDP in recent years. The number of business entities working in the sector increased by 12% during 2015-2019, and reached more than 120 thousand units. It can be explained by the extremely high level of fragmentation of trade in the country. At the same time, the number of markets in the country has followed a gradual decline – 350-360 markets of all types. The food, non-food and mixed types of markets sold 44% of all goods in 2019. The share of the markets in the trade sector has declined from 50% in 2015, but it is still a significant market channel for most of the country's population. Retail sales through trading entities have been increasing over time

Table 2
Structure of Employment in the Construction Sector in Kyrgyzstan in 2019, per thousand people and %

	Total working in the sector	from them working informally
Total employed in construction, per thousand people	287.4	261.7
- outside of the country, %	28.7%	
- urban, %	31.6%	28.9%
- rural, %	68.5%	71.1%
- men, %	98.5%	98.9%
- women,%	1.5%	1.1%

Source: NSC

Table 3
Structure of Employment in the Trade and Services Sector in Kyrgyzstan in 2019, per thousand people and %

	Total working in the sector	from them working informally
Total employed in trade and services, per thousand people	395.2	367.5
- outside of the country, %	17.5%	
- urban, %	47.8%	47.9%
- rural, %	52.2%	52.1%
- men, %	59.6%	59.3%
- women,%	40.4%	40.7%

Source: NSC

– from 50 to 56% in the observed period. Most retail trade occurred in cities (73% in 2019). Rural retail trade has been growing, from 22% in 2015 to 27% in 2019, but remains low. The value of goods sold in the country increased in 2015-2019 and reached 8.5 billion US\$, though it expectedly declined to 6.8 billion US\$ in 2020 due to COVID-19's impact and political instability (NSC, 2021b).

Retail trade occupies the most significant trade and services share – 51-53% in 2015-2019. Wholesale trade varies from 31 to 34% of the sector. The following important activity is the oil products trade - 11-13%. The last place in the sector is held by the trade of cars, spare parts and machinery repair services – 3% of the sector. The main center of trade and services sector is Bishkek (47.9%), Chui Province occupies 13.4%, and Osh, with the surrounding Osh Province, covers 16.8%. Again, the most populated centers in the north and south provide 77-78% of the sector's activity (NSC, 2021b).

Employment in the sector reached 395 thousand people in 2019, or 16% of the country's total labour market (Table 3). The trade and services sector is the second largest job provider by size, followed by agriculture. Workers in the trade and services sector almost entirely work in the informal sector (93%). Half of all informal working people are hired laborers (51.9%). Most of the rest of the workers are self-employed (45.7%). The percentage of people working outside the country in trade and services reached 17.5%. Almost half of the sector's workers are urban residents (47.8%), the rest come from the countryside. 20.1% of urban employed peo-

ple work in the trade and services sector. The proportion of males in the sector is 59.6%. This sector is the second by importance for women after agriculture - 17% of women are employed in trade and services.

5.3. PROCESSING INDUSTRY

The processing and manufacturing sector is one of the growing sectors in Kyrgyzstan. In 2020 it became the most significant economic sector contributor to the GDP, reaching 17%. The increase is due to the decrease in other sectors, namely trade and services. The number of processing industry entities varies between 1150-1200 enterprises in 2015-2019. Most enterprises belong to rubber and plastic production and food processing industries – 51% in 2019. The turnover of the processing industry has been increasing over time – between 2015 and 2019, it increased from 2.2 to 3.2 billion US\$ (NSC, 2021c).

The industry's structure demonstrates the source of this stable growth - metal production makes up 58 to 65% of all industrial manufacturing. It is mainly gold extraction and refining production from the Kumtor gold deposit. The processing industry's regional distribution supports that evidence - 65 to 73% of all industrial output is produced in Issyk-Kul and Chui Provinces, where mining and gold refining production is found (NSC, 2021c).

Analysis of formal employment shows that most people in

Table 4
Structure of Employment in the Processing Industry in Kyrgyzstan in 2019, per thousand people and %

	Total working in the sector	from them working informally
Total employed in the processing industry, per thousand people	289.3	215.2
- outside of the country, %	8.3%	
- urban, %	44.3%	46.1%
- rural, %	55.7%	53.9%
- men, %	59.5%	55.7%
- women,%	40.5%	44.3%

Source: NSC

Table 5
Structure of Employment in the Transport and Logistics Sector in Kyrgyzstan in 2019, per thousand people and %

	Total working in the sector	from them working informally
Total employed in the transport and logistics, per thousand people	200	169.2
- outside of the country, %	5.1%	
- urban, %	42.2%	40.1%
- rural, %	57.8%	59.9%
- men, %	96.1%	99.1%
- women,%	3.9%	0.9%

Source: NSC

the formal sector of the processing industry work in textile and garments enterprises - 46-47% in 2017-2019. For other subsectors of the processing industry the level of formal employment varies from 12 to 20%. Most textile and garment industry workers are located in Chui Province and Bishkek – its share reaches 93-95% of all people formally working in that sector in 2015-2019 (NSC, 2021c).

Employment in the processing industry reached 289 thousand people in 2019, or 12% of the country's total labor market (Table 4). Workers in the processing industry mostly work in the informal labor market (74%). Most informal workers are hired laborers (78.5%). The majority of the rest is self-employed (16.4%). The share of people working outside of the country in the sector is only 8.3%. Most people in this sector are rural residents (55.7%), the rest are urban. The share of men in the sector is 59.5%, the rest of the workers being women.

Employment in the transport and logistics sector reached 200 thousand people in 2019, or 8% of the labor market (Table 5). 85% of workers in the sector work informally. Of the informal workers, 81.7% are self-employed. Most of the rest of the workers are made up of hired laborers (17.7%). The share of people working outside of the country in transport and logistics is minor (5.1%). More than 50% of laborers working in the sector are rural residents (57.8%), the rest are urban residents. The share of men in the sector reaches 96.1%, women are minor in the sector – 3.9% only.

5.4. TRANSPORT AND LOGISTICS

The transport and logistics sector covered 3-4% of the GDP in 2019-2020. The annual turnover comes to approximately half a billion US\$, and the trend was positive in 2015-2019. Turnover growth reached 20% in the last five years. Most of the sector's worth is created by passenger transportation, which has grown from 68% in 2015 to 72% in 2019 (NSC, 2021e).

Analysis of freight and passenger transportation turnover shows that most of the services are provided by automobile transportation. In both types of transportation, its share varies between 64 to 72% of turnover. The second type of transportation by size is air passenger transportation. Railroad freight transportation occupies the last place.

Transport services are mostly provided in Bishkek. The combined share of the capital in transportation varied from 54 to 58% in 2015-2019. In freight transportation, Bishkek's share reached 59-63%, and in passenger transportation – 54-57%. The second most important region in terms of transportation is the surrounding Chui Province. Its share reaches 10% in freight transportation and 19-28% in passenger transportation (NSC, 2021e).

6

NATIONAL POLICY FRAMEWORK IN THE KYRGYZ REPUBLIC

6.1. TAX SYSTEM REVIEW

The tax system in Kyrgyzstan has been in development since independence, and still has not found an optimal structure and modality. The tax system’s basic concepts and principles are not articulated in the public policy domain, and are often shifted due to political economy reasons.

There are three essential types of taxes that might be distinguished: domestic consumption taxes (value-added tax, sales tax, excises, any turnover tax), international trade taxes (taxes and duties on imported goods and services) and income taxes (profit tax and personal income tax). Other types of taxes are smaller and defined by a particular country’s specificities and policy agenda (IMF, 1995).

National taxation and supporting regulatory legal acts form the country’s taxation system (Kyrgyz Republic, 2008). The competent authority exercising control over compliance with tax laws and complete and timely payment of taxes is the State Tax Service under the Kyrgyz Republic’s Government.

Business legal entities are divided into domestic and foreign entities for taxation purposes. Domestic entities are legal entities organized under the Kyrgyz Republic’s laws, and foreign entities are any types of companies organized under a foreign state or international organization’s laws. Since the study’s main target is domestic business operations, the par-

ticular peculiarities of foreign entities’ work will be skipped where it doesn’t align with domestic business entities.

There are three types of taxes paid under the general tax regime – national and local, based on the target budget destination, and special tax regimes (Figure 4). Some taxes – value-added tax and excise taxes- belong to two domains due to the supply’s origin – domestic or foreign. However, they are taxed based on the good or service consumption’s final destination in both cases in Kyrgyzstan.

There is a difference between national taxes and special tax regimes in their level of tax burden. National taxes are significantly higher compared to specific tax regimes constructed to support small and microbusinesses, with the threshold of an annual turnover of not more than 8 million som, e.g. patent regime, simplified regime and tax contract regime, and special regimes for specific sectors - the textile sector and IT cluster (High technologies park). The effective tax rate in those regimes varies from 1 to 6% of the business’ operations. In contrast, the national tax burden reaches 20-25% of annual turnover. Thus, there are two different regimes for the formal sector and for small/micro-business. The description of the definitions and tax base are provided in Appendix 1.

An overview of the tax revenue dynamics highlights the importance of taxes as the primary source of budget revenues

Figure 4
Typology of taxes in Kyrgyzstan

National taxes	Local taxes	Special tax regimes
Profit tax (10%) Income tax (10%) Value-added tax (12%) Excise tax Mining tax Sales tax (6%)	Land tax ... (2.5-4.5 US\$ / ha / annum) Property tax	Patent tax (6-50US\$/month) Tax contract Simplified tax system (3-6%) Special economic zones

Source: author’s representation

Table 6
Tax revenues dynamics in Kyrgyzstan in 1995-2020, % of GDP

#		1995	2000	2005	2010	2015	2020
1	Budget revenues, total	17%	15%	20.2%	26.3%	29.8%	25.4%
2	Tax revenues, total	15%	12%	16.2%	17.9%	19.7%	17.9%
a	Income tax	1.8%	1.2%	3.0%	2.0%	2.2%	2.0%
b	Profit tax	2.7%	0.9%	1.3%	0.8%	0.9%	0.8%
c	VAT on domestic production	4.6%	1.9%	1.3%	1.9%	2.1%	1.8%
d	VAT on import	0.0%	2.7%	5.7%	4.7%	5.6%	4.8%
e	Sales tax	1.0%	0.4%	0.6%	1.7%	1.7%	0.6%
f	Excise taxes	1.9%	2.3%	1.1%	0.8%	1.8%	1.5%
g	Import duties	0.8%	0.4%	1.6%	2.0%	2.2%	2.9%
h	Emergencies situation tax	0.9%	0.9%	0.9%	0.0%	0.0%	0.0%
i	Tax on automobiles	0.5%	0.7%	0.5%	0.2%	0.2%	0.1%
j	Tax on Kumtor operations	0.0%	0.0%	0.0%	2.0%	1.4%	1.6%
l	Other taxes	0.9%	0.4%	0.1%	1.8%	1.5%	1.7%

Source: National Statistical Committee of the Kyrgyz Republic (NSC)

– more than 70% of all revenues came from taxes in 1995-2020 (Table 6). The importance of separate taxes has changed over time. For example, profit tax importance declined from 2-3% of the GDP in 1995-2005, to 0.8-0.9% over the last decade. At the same time, income tax collected from individuals reached a peak in 2005 (3% of the GDP) and then declined to 2% in 2010-2020. VAT on domestic production declined from 4.6% in 1995 to approximately 2% of the GDP in 2010-2020. Concurrently, VAT on import varied from 4.4 to 5.7% of the GDP in the last two decades. It is the leading tax, providing 26-27% of all tax revenues over the last decade. The initial tax rate for VAT was 20%. Later, in 2009, it was decreased to 12% (Kyrgyz Republic, 2008). As the data shows, overall revenues of VAT have not declined over time.

Sales tax collection dynamics are not stable due to the ongoing changes in tax legislation. Excise taxes were significant during the first decade of the transition period. Later it declined to 1-1.5% in the last twenty years. Tax on automobiles declined significantly in the observed period. Over the last decade, tax on the Kumtor gold mine operations was separated as its own category and showed its significance as a tax revenue source, collected from the biggest taxpayer enterprise in Kyrgyzstan. The role of import duties as tax revenue increased in the last five years due to Kyrgyzstan entering the Eurasian Economic Union (EAEU). Most of that sum was transferred from the EAEU authorities to the Kyrgyz budget as part of the Kyrgyz Republic's share in the customs duties collected from all EAEU countries. In 2020 this transfer reached 16.4 billion som, 15% of all tax revenues. Some taxes were abolished during the observed period, e.g. the emergency situations fund tax taxed as a share from enterprise turnover. Central taxes, necessary for forming the state budget's core, are national taxes collected from consumption taxes, international trade, and income. Other taxes (local taxes and special tax regimes) are less critical for the country's budget.

6.2. SOCIAL PROTECTION SYSTEM

The social protection system consists of the social revenues income (social taxes) and social expenditures parts. Social security legislation forms the legal framework for the operating of the economic entities in the country. The primary legislative documents regulating the social protection system listed in Appendix 2.

Payers of state social security contributions include legal entities, regardless of their structure or type of ownership, and their standalone subdivisions (branches and representative offices), peasant (husbandry) farms, individuals. The payers send all payments of social security taxes to the Social Fund of Kyrgyz Republic. At the same time, social security expenditures distributed by the Social Fund and the Ministry of Labour and Social Protection of the Kyrgyz Republic¹.

Rates of social payments (social tax regimes) to the Kyrgyz Republic's Social Fund are presented in Figure 12. There is a specific peculiarity that can be noticed. The social security tax regime differs between registered legal entities, farmers, textile and garment industry entities and special tax regimes - patents, simplified tax regime, tax contract. It means that business entities working in one economic sector may have different social taxation regimes.

For example, an employee working in a big mill will be taxed with the joint social tax rate of 27.25% (17.25% + 10%) of the salary paid. However, if that employee is registered as an individual entrepreneur working on a patent base, the social security tax rate will be 10% of the region's average salary, but not taken from the actual income. Such difference in taxation, social securities and special tax regimes creates a preferential tax regime for small entrepreneurs. It decreases the tax burden and operation for individual entrepreneurs

¹ Ministry of Labour and Social Protection currently under reorganization and merged with the Ministry of Health Care.

Figure 5
Social Tax Rates in Kyrgyzstan

Legal entities	Employers (17.25% of the salary) Employees (10% of the salary)
Agriculture	Peasant farms = land tax (2.2 - 4.5\$ / ha / annum)
Special tax regimes	Simplified tax regime, patents, tax contract - 10%, 6%, 3% of the average monthly salary

Source: excerpts from the legislation

and family-based business operations and sub-sectors with favorable tax regimes, e.g. garment industry, restaurant business or IT clusters. On the other hand, it may also create room for corruption due to the existing limits of turnover or other thresholds, and may lead to shadow (unregistered) activities.

As a direct implication of the uneven tax burden, it may also lead to a decrease in investment flows (domestic and foreign) in the national economy's major sectors that require industrial operations. Economic development in Kyrgyzstan in the existing tax regime prevents gain from the economy of scale, except for some sectors (infrastructure state-support projects and mining sector) or sectors with favorable tax regimes.

Social security contributions collected by the Social Fund form the core budget dedicated to social payments spent through the Social Fund. However, collected social taxes do not fully cover the needs of the social security system. Thus, the gap between the collected revenue and needs covered by the state budget (Table 7).

It is noticeable that the proportion of social payment from the Social Fund covered by the state budget has increased over time. In 1995 it was 15% of the total revenues of the Social Fund, in 2010 it reached 25%, and over the last five years has stabilised at 39%. The growing level of contribution from the state budget demonstrates that the Social Fund's revenues, which are responsible for most of the country's social payments, is not sustainable. Collected social security revenues are not sufficient, and the whole approach needs to be revised and follow a more sustainable model considering the humanitarian crisis caused by the impact of

the COVID-19 pandemic in 2020.

The overall cost of social payments distributed through the Social Fund demonstrate a trend towards growth – varied the last decade, it varies between 9-10% of the GDP. If the overall tax burden (joining together all tax collections and social security payments) is a part of GDP, it reaches a high 35-38% of the GDP when compared with average OECD countries' values, and is higher than most developing countries.

Table 7
Social Fund Revenues Dynamics and Structure in 1995-2019 in Kyrgyzstan, % of GDP

	1995	2000	2005	2010	2015	2019
Social Fund Revenues, total	8.1%	5.2%	6.4%	10.1%	9.7%	9.0%
- Social security payments	6.9%	4.4%	4.9%	5.5%	5.6%	5.4%
- Transfers from the state budget	1.2%	0.6%	1.0%	2.5%	3.8%	3.5%
- Other revenues	0.0%	0.0%	0.1%	0.1%	0.0%	0.1%

Source: NSC

7

PRINCIPAL FINDINGS AND POLICY OPTIONS DISCUSSION

Analysis of informal economy development in Kyrgyzstan allows for a few essential conclusions. The informal economy is an established economic phenomenon in Kyrgyzstan, occupying a significant share of the national economy. According to numerous estimations, its share varies in different periods from 17 to 50% of the national economy (Table 1). The figures' difference depends on the estimation method and the current state of the economy at the moment of analysis.

Official estimations of the informal economy in recent years vary from 23 to 25% of the GDP. Informality in the economy is mainly found in the trade and service sector (16%), and is significant in other sectors, e.g. construction, transport, and processing industry sectors.

The labor market in Kyrgyzstan increases based on the growth of microbusinesses and self-employment. Formal employment, therefore, is not increasing in the country. The average age of workers has shown an increase during the past decade. The ageing of working people will increase in the future. Men are prevalent in the labor market (62%), which signals the insufficient access of women to jobs. Informality in the labor market is extremely high (71.8% of all jobs in the country).

The structure of the labour market (small micro-business operating on individual entrepreneurship) defines the high level of self-employment and microbusinesses. The micro-SMEs sector contributes to the national economy and creates a small-scale, highly fragmented structure of the national economy. Therefore, such an economic model has primarily led to the growth of the service sector, while specific sectors requiring economies of scale, high investments, and the rule of law develop insufficiently. A new economic development model is needed to boost economic growth and decrease informality in the country.

A sector-by-sector review of the sectors with a high level of informality emphasizes several critical facts:

- The service sector (trade and services) demonstrates the highest informality level in the labor market – 93%; construction - 91%; processing industry -78.5%; transport and logistics - 85%.
- Most economic activity (except the mining sector) is found in Bishkek and Osh with the surrounding peri-ur-

ban territories. Two urban clusters create a significant share of added value for the country, and the level of informality of the operations is high.

- The sectoral labor market structure is different for different genders: males are prevalent in construction and transport and logistics sectors; females are more represented in trade and services, and some of the processing industry sub-sectors, e.g. the textile industry.

Tax and social security systems demonstrate that working in particular tax regimes make it possible to gain from the lowered tax and social security payments burden compared to the formal sector. The difference in taxation allows small business entities or qazi-micro business groups² to be formally taxed less than formal business entities. Such a regime creates a severe distortion of economic operations in the country and creates incentives to be informal in the labour market.

The theoretical framework suggests several policy options regarding the informal economy alleviation (Schneider, 2013):

- Remain situation unchangeable – do nothing;
- Eradicate informal economy;
- Legitimizing informal activities.

The 'doing nothing' policy option exists because any policy change requires additional costs and investment and potentially may lead to the decline of economic operations. The arguments regarding supporting the current status quo includes the rationale of providing jobs for smallholders, and any taxation might bring about the decline of income of the population. Business entities also gain from the low entrance barrier for launching a business, high flexibility of production processes, low transaction costs.

However, in the Kyrgyz labor market, profound negative implications of saving the status quo exist. The negative consequences of the informal economy include a high level of labor rights insecurity, low stimulus for the growth of qualification of workers, demanding access to new technologies, problems with reaching quality standards, disincen-

² It means, for example, a situation with the one central company, which 'outsources' most of the operations to the individual entrepreneurs or self-employed patent-holders.

tives for investment and growth of businesses due to uneven tax regimes for small businesses compared to medium and big business entities (Mogilevskii, 2020).

Maintaining the current situation has led to social injustice in the country. There are two distinct groups of workers in the labor market:

1. A minority of formally employed workers (around 30% of people) with labour rights provisions,
2. A majority of working people (more than 70%) who work informally and cannot sustain fundamental labor rights.

Informal workers cannot demand safe and better working conditions. They do not have the right to vacation. Usually, workers without a contract cannot get compensation if they are sick or injured in the workplace. Providing more decent work is impossible without decreasing the share of people employed in informal jobs, as stated by the ILO (International Labour Organization) Resolution on Decent work and informal economy (ILO, 2002). Social justice and sustainable development are closely linked with the elimination of informality in the economy.

Another implication of being in the informal market is the absence of social security after retirement. People who do not pay to the Social Fund will only receive a minimal pension once they retire. In the long term, sustaining the current pension system will lead to the critical decline of the size of pensions in the country. The labor market structure already demonstrates the ageing trend of workers (Figure 3). In the future, the share of people who need to work after retirement to survive due to low pension will probably increase.

The essential argument against saving the current tax and social security regimes is the erosion of the equity principle between taxpayers. It means that taxation for the different taxpayer's burden should be equitable, "e.g. taxpayers who earn the same amount of income or capital should be taxed in the same way" (IBFD, 2019). A review of the taxation and social security systems demonstrates that micro businesses gain from the current taxation plan. It was a good strategy when this system was introduced in the early 2000s, a period with high poverty, but with the current development stage, it already brings more negative effects than positive, and constrains the development of industrial sectors, demotivates inflow of investments in the formal sector, and the loss of labor rights.

Thus, the eradication of the informal economy is one of the main directions of desired tax reform. It will bring an increase in tax revenues, an improvement of enforcement of the law, and better labor regulations, i.e. norms of the safety of workers, payments in case of illness, labor protection in case of people being made redundant.

The sustainable development of the Kyrgyz Republic is inevitably linked with the decline of informality in the economy. It includes a wide variety of measures to support both parts of

the process - businesses and the labor force. The Kyrgyz state's role in the process of legitimization of the national economy to reach sustainable development consists of the following steps:

- Developing a complex analytical framework for the elimination of informal economy;
- Defining the variety of measures to increase the tax base and social security payments;
- Defining measures to encourage the informal economy to legitimize, i.e. decreasing tax rates, conditional tax vacations, and other incentive measures;
- Practical public policy discussions are needed; the discussions should include representatives of business circles, academia, trade unions and civil society organizations.

The following critical issues need to be taken into account by policy decision-makers: a cost-benefit analysis needs to be done to develop a detailed policy intervention aimed at decreasing the informal economy. Otherwise, the benefits of the promoted policy will bring less profit than the state body's costs, and overall social welfare. An example of the potential costs might be a loss in the entrepreneurship development sector, which provides sustainable economic growth. Therefore, all programs for decreasing the informal economy should be accompanied by the appropriate analytics, policy discussions and consultations to support a better policy which is fruitful for all stakeholders. The most optimal strategy needs to include measures that will compensate for the increase of tax pressure. For example, a tax base increase due to tax reform needs to be compensated by decreasing the tax rates for the formal business sector. Then a decline of operations in the special tax regimes sector will be compensated by the growth of the formal sector value-added and employment.

Informal economy legitimization is a way of defining the strategy for adopting a policy for a country's specific conditions. Two approaches exist - the push approach and the pull approach (Schneider, 2013).

The push approach proposes improved detection methods and an increase of penalties and risks of arrest. Better detection methods include better data analysis and matching, joint work of different state bodies and private stakeholders. The push approach's second direction includes increasing business and population penalties, and raising awareness of the new penalties and the final goal of the informal economy's decline.

The pull approach aims, firstly, to decrease the complications for new businesses: compliance simplification, tax incentives, support for micro-businesses development – training and consultations. The pull approach's second direction proposes measures to encourage businesses working in the informal economy to formalize. It might develop direct and indirect tax regimes for high informality sectors (similar to the textile industry or IT clusters), voluntary disclosure, and amnesties. The last option is to support businesses working in the formal economy by promoting formal work, supporting fairness of

taxation, peer-to-peer surveillance, educating business circles, and procedural justice support.

The informal economy's current level has brought about a situation where a significant proportion of the economy operates in an informal modality. It seriously erodes the sustainability of the country's economic growth. Therefore, maintaining the current tax and social security systems has halted Kyrgyzstan's further development, leading to the economy's stagnation and worsening human development.

REFERENCES

- Abdih, Y. and Medina, L.** (2013) Measuring the Informal Economy in the Caucasus and Central Asia, IMF Working Paper Series WP/13/137.
- Feige, E. and Urban, I.** (2008) Measuring Underground (Unobserved, Non-Observed, Unrecorded) Economies in Transition Countries: Can We Trust GDP? William Davidson Institute Working Paper # 913
- Feige, E.** (2016) Reflections on the Meaning and Measurement of Unobserved Economies: What do we really know about the "Shadow Economy"? Journal of Tax Administration, 2016, Vol. 2 No. 1.
- ILO** (2020). Informal Economy (DECENT work for sustainable development (DW4SD) Resource Platform). Retrieved May 01, 2021, from <https://www.ilo.org/global/topics/dw4sd/themes/informal-economy/lang--en/index.htm>
- ILO** (2002). *Resolution concerning decent work and the informal economy* (General Conference of the International Labour Organization, meeting in its 90th Session, 2002 ed., Vol. Report VI, Decent work and the informal economy, pp. 52-61). Geneva: ILO. https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---relconf/---reloff/documents/meetingdocument/wcms_080105.pdf
- IMF** (1995) Tax policy handbook, IMF, Washington, DC.
- Kyrgyz Republic** (2008) Tax Code of the Kyrgyz Republic, No. 230 of October 17 2008
- Lackó, M.** (2000) Hidden Economy - an Unknown Quantity? Comparative Analysis of Hidden Economies in Transition Countries, 1989-95. Economics of Transition 8(1):117-149
- Medina, L. and Schneider, F.** (2017) Shadow Economies around the World: New Results for 158 Countries over 1991-2015, CESifo Working Paper No. 6430
- Mogilevskii, R.** (2020) Labour market and technological development in Central Asia, University of Central Asia, IPPA, Working paper # 58. Bishkek. Kyrgyzstan
- NSC** (2020a) Consumer market of Kyrgyz Republic 2015-2019. Bishkek. Kyrgyzstan
- NSC** (2020b) Employment and unemployment. Results of the integrated survey of the households' budget and labour force in 2019. Bishkek. Kyrgyzstan
- NSC** (2020d) National accounts. Bishkek. Kyrgyzstan
- NSC** (2021a) Construction sector indicators. Timeseries Tables. Bishkek. Kyrgyzstan
- NSC** (2021b) Trade and services sector indicators. Timeseries Tables. Bishkek. Kyrgyzstan
- NSC** (2021c) Industry sector indicators. Timeseries Tables. Bishkek. Kyrgyzstan
- NSC** (2021d) Transport and logistics sector indicators. Timeseries Tables. Bishkek. Kyrgyzstan
- NSC** (2021e) National accounts. Timeseries Tables. Bishkek. Kyrgyzstan
- OECD** (2002) Measuring the non-observed economy. A Handbook.
- Putniņš, T. and Sauka A.** (2019) Shadow Economy Index for Russia 2017-2018: comparison with the size of the shadow economies in Ukraine, Kyrgyzstan, Kosovo, Moldova, Romania, Latvia, Lithuania, Estonia, and Poland. The Centre of Sustainable Business at SSE Riga
- Schneider, F.** (2012) The Shadow Economy and Work in the Shadow: What Do We (Not) Know? IZA Discussion Paper No. 6423
- SIAR** (2020) Shadow Economy Index in Kyrgyzstan. Bishkek. Kyrgyzstan
- UNDP** (2006) The Shadow Economy in the Kyrgyz Republic: trends, estimates and policy options. Bishkek. Kyrgyzstan.
- UNECE** (2008) Non-Observed Economy in National Accounts. Survey of Country Practices. UN, New York, and Geneva
- Schneider, F. and Williams, C.** (2013) The shadow economy, The Institute of Economic Affairs, London

APPENDIX 1 - MAIN TAXES IN THE KYRGYZ REPUBLIC - DEFINITIONS AND DESCRIPTION

Profit Tax

Payers of profit tax include companies, sole proprietors, entrepreneurs, and legal entities paying income from a source obtained in the Kyrgyz Republic. The object of taxation is the income received from business activities by all types of business owners. The tax base is calculated as a positive difference between a taxpayer's gross annual income and expenses deductible under tax law as assessed for the tax period.

Gross annual income includes all types of income identified, eg. sale of goods, works, or services, any types of incomes, gains, dividends and royalties, subsidies, and compensations. Expenses fully or partially deductible from the gross annual income include all cost items - credits and loans, depreciation costs, social security costs, losses, R&D costs, costs on training, travel, charity costs (with limitation), other documented income generation expenses. Tax legislation sets forth a list of expenses not deductible from the gross annual income, including tax sanctions, penalties to the state, expenses of fixed assets, national taxes, natural losses, and other non-documented expenses. The profit tax rate is 10%. For special activities the rate is lower – gold production, refining and sale, credit unions, charitable organizations, agricultural producers.

Income Tax

Payers of income tax are the country citizens, resident and non-resident non-Kyrgyz citizens receiving income in the Kyrgyz Republic. The object of taxation is an economic activity, except for business activity, resulting in the country's income. The tax base is income estimated as the difference between the gross annual income received by a taxpayer and deductions required by Kyrgyz tax legislation. The income tax rate is 10%.

Value Added Tax

Value-added tax (VAT) is a tax collected and remitted to the Government on the value of VAT-taxable goods in the Kyrgyz Republic's territory, including taxable import goods to the Kyrgyz Republic. Payers of VAT are taxable entities and entities performing taxable import operations. Under Kyrgyz tax legislation, an entity is subject to taxation if it has been or must be registered for VAT. A business entity must register for VAT if, for 12 consecutive months or less, it has been making taxable supplies of goods, works, or services in the Kyrgyz Republic's territory for an amount exceeding 8 million KGS (about USD 94.1 thousand as of December 31, 2020). Entities which are not required to register for VAT may register for VAT voluntarily. The object of VAT taxation includes taxable supplies of goods and services and taxable import. The tax base includes the value of taxable supplies and the value of a taxable import.

Taxable supplies are subject to 12% VAT, except VAT taxable supplies subject to a zero tax rate. Zero VAT taxable supplies include export of goods, except the export of gold and silver alloy and refined gold and silver, international carriage of passengers, luggage and cargos, except carriage by rail, transit flights and related international carriage catering services, except international carriage by rail, services related to the supply of electricity to pump stations supplying irrigation water to fields and drinking water to the population.

Exempt goods include exempt supplies and supplies outside the scope of VAT: supply of land, except for the allocation of trading spaces and parking areas, the supply of residential buildings and premises, except for the lease of hostels, boarding houses, resort and health centres, supply by agricultural producers, including cooperatives, of its agricultural products, supply some agricultural processing production, supplies of services of logistic centres and machinery services in agriculture, feed supply for poultry and fish production, communal services, leasing supplies, certain medicines and medical goods, financial and education services, railroad transport services, insurance services, pension funds services, non-commercial activities and some other supplies and services.

Excise tax

Payers of excise tax are entities manufacturing excisable merchandise, including on a give-and-take basis, within the Kyrgyz Republic, and importing excisable merchandise to the Kyrgyz Republic such as ethyl alcohol, malt beer, other alcoholic drinks, mixtures of alcoholic and non-alcoholic drinks, tobacco products and other products containing tobacco, jewellery and other items with parts made of precious metals or metals plated with precious metals, oil and oil products. The objects of taxation are the manufacture or import to the Kyrgyz Republic of excisable merchandise. The tax base includes the physical volume of excisable merchandise, the sale price of excisable merchandise, the net value of VAT, sales tax and excise tax, customs value of excisable merchandise determined by the Tax Code of the Kyrgyz Republic, the merchandise market price net of VAT, sales tax and excise tax at the time of transfer by a manufacturer of excisable merchandise as an in-kind payment or gift at the time of transfer of title to guaranteed merchandise to the guarantor or at the time of exchange operation on a free-of-charge basis. The Tax Code approves the rates of excise tax of the Kyrgyz Republic.

Sales Tax

Payers of sales tax are domestic entities, foreign entities operating through a permanent establishment in the Kyrgyz Republic and sole proprietors. The objects of taxation are the sale of goods, performance of works, rendering of services. The tax base includes the proceeds from the sale of goods, works or services, the net value of VAT and sales tax.

The sales tax rates defined for different types of activities:

For the sale of goods, works or services by VAT payers and for the sale of goods or services exempt from VAT:

- 1% for trading activities and industrial processing of agricultural products.
- 2% for other activities, aside from trading and industrial processing of agricultural products.
- 5% for mobile communication activities.

For the sale of goods, works or services by non-VAT payers if such sale of goods, works or services is not a VAT-exempt good:

- 2% for trading activities.
- 3% for non-trading activities.

Mining taxes

Mining taxes are bonuses and royalties. Bonuses are one-time payments for the right to engage in mineral exploration and mining activities. Payers of bonuses are domestic entities or foreign entities operating through a permanent establishment in the Kyrgyz Republic or sole proprietors holding mineral rights. The tax base is the number of geological reserves and inferred resources included in the Kyrgyz state cadaster of mineral deposits and occurrences and the depth of water wells. Also, a bonus is paid in the event of a change in the shareholders and their shareholdings at the rate of 10% or more in proportion to the shareholding change, except shareholdings in companies listed on stock exchanges. The Kyrgyz Government establishes rates of bonuses and procedures for their calculation for all types of minerals. Regarding the mineral deposits put out to tender, the bonus rate is determined by the Kyrgyz Government individually for each deposit.

Royalties are the current payments for the right to engage in the production and extraction (recovery) of underground water. Payers of royalties are domestic entities, foreign entities operating through a permanent establishment in the Kyrgyz Republic and sole proprietors engaged in the mining of mineral resources, extraction (recovery) of underground water, by-product extraction of oil and gas during test prospecting and exploration of hydrocarbons, occasional extraction of minerals for industrial experiment and testing and disaster prevention and recovery. The tax base includes proceeds, the net value of VAT and sales tax, from the sale of mineral resources or products resulting from the processing of mineral resources,

the volume of sold products in species, or volume of water extracted from subsoil according to water gauge. Rates of royalties are outlined in the Tax Code as a percentage of proceeds or as the amount in national currency per unit of volume depending on the type of a mined (extracted) mineral and the number of mineral reserves.

Land tax

Payers of land tax are entities treated as landowners or users whose land-use rights are certified by standard-title documents and actual owners and users of land plots. The taxation objects are the ownership right and the temporary possession and use of the right to agricultural lands and areas subject to land tax. The tax base is the area of the land plot. Basic rates of land tax are outlined in the Tax Code depending on the land plots' location and purposes. Land tax is calculated according to the formula outlined in the Tax Code for each of the land types (agricultural lands, settlement lands and non-agricultural lands, orchards and gardens) by multiplying the land plot area by the basic rate of the land plot and applicable coefficients.

Property tax

Payers of property tax are entities and individuals that own taxable property such as residential property, boarding houses, holiday hotels, health resorts, resorts, production, administrative, industrial and other buildings and structures used for private and business purposes, temporary structures made from metal or other materials and used for business purposes and transport vehicles. The objects of taxation are the ownership and use rights to the taxable property. The tax base includes the taxable value of the property and engine capacity or value of the transport. The property tax rates are for private property; the rate is 0.35%. For business property, the rate is 0.8%. For transport, used special rates on the engine volumes or 0.5% of the value.

Special Tax Regimes

In addition to the general tax regime, Kyrgyz law establishes special tax regimes for taxpayers' specified categories. These regimes are simplified single tax-based tax regime, mandatory patent-based tax regime, voluntary patent-based tax regime, contract-based tax regime, free economic zone tax regime, special means tax regime, high-tech park tax regime.

Under a simplified single tax-based tax regime, small and medium enterprises may pay the single tax instead of profit tax or sales tax on their taxable income. Single tax is charged at the following rates: for agricultural product processing, production and trade, the rate is 4% of earnings, and for other activities, the rate is 6% of earnings. The taxpayer is engaged in several undertakings; a single tax is assessed and paid separately for each undertaking at the rates established for these undertakings. The simplified tax regime is optional for all business entities, except payers of VAT, excise tax, or patent-based tax, providers of financial and insurance services, investment funds, professional securities market participants and providers of catering services.

The mandatory patent-based tax regime applies instead of income tax, VAT on taxable goods and sales tax only to the providers of the following services: saunas and baths, except municipal ones, billiards, currency exchange offices, discotheques, all-day parking, pawnshops, hair and beauty salons, private dentistry, billboard advertising, bookmaker or betting—mandatory patent-based tax rates are decided by the State Tax Service.

A voluntary patent-based tax regime applies instead of profit tax and sales tax only to individuals who are not VAT payers and only in respect of activities determined by the Kyrgyz Government. The Government also determines the base rates of voluntary patent-based tax.

The contract-based tax regime applies to organizations and individual entrepreneurs engaged in business. Under this tax regime, a taxpayer and a competent tax authority execute a contract setting forth fixed amounts of profit tax, sales tax and VAT expected to be paid by the taxpayer in the next calendar year. The contract-based tax regime does not apply to payers of the mandatory patent-based tax, providers of lending, financial, and insurance services, investment and pension funds, professional securities market participants, delinquent tax debtors, payers of the mining tax, payers of excise tax, entities engaged in business for less than three years, except

providers of catering services, providers of catering services operating less than three months.

The free economic zones tax regime applies only to residents of the Kyrgyz Republic's free economic zones engaged in producing and selling goods (works, services) except excisable goods in free economic zones. Residents of free economic zones may be only organizations registered with the General Directorate of free economic zones. Residents of free economic zones are exempt from all taxes except income tax and other taxes withheld and paid at source regarding activities carried out by them in free economic zones. For the above tax benefits, residents of free economic zones pay up to 2% of earnings to the General Directorate of free economic zones. Concerning activities carried out in the rest of the Kyrgyz Republic and abroad, residents of free economic zones are subject to the general tax regime.

The high-tech park tax regime applies only to residents of high-tech parks engaged in business or international trade, provided that they comply with the requirements outlined in Kyrgyz law on the high-tech parks. Residents of high-tech parks are exempt from profit tax, VAT and sales tax for the period determined by Kyrgyz law on the high-tech parks, while employees of residents of high-tech park pay income tax at a reduced rate of 5%.

APPENDIX 2 - MAIN LEGISLATION OF THE KYRGYZ REPUBLIC ON SOCIAL PROTECTION

Table 2.1

Social Protection Legislation in Kyrgyzstan

#	Legislative document	Type of the law
1.	Law of the Kyrgyz Republic About Social fund of the Kyrgyz Republic, No. 103 of August 02 2004,	Social expenditure
2.	Law of the Kyrgyz Republic On provision of pensions for military personnel, No. 1194-XII of May 07 1993,	Social expenditure
3.	Law On state benefits in the Kyrgyz Republic No. 318 of December 29 2009,	Social expenditure
4.	Law On facilitation to the population's employment No. 214 August 03 2015	Social expenditure
5.	Regulation on the assignment, payment and the amount of the burial benefit approved by Government Decree No. 308 of June 04 2014	Social expenditure
6.	Government Decree on payment of monthly monetary compensations instead of privileges No. 795 of December 22 2009	Social expenditure
7.	Law On state pension, social insurance No. 57 of July 21 1997	Social expenditure
8.	Law On foundations of social services in the Kyrgyz Republic No. 111 of December 19 2001	Social expenditure
9.	Law On the rates of insurance contributions for state social insurance No. 08 of January 24 2004	Social tax
10.	Government Decree on approval of instructions on the procedure for calculating and paying insurance payments for state social insurance No. 278 of May 22 2013	Social tax

Source: Ministry of Justice of the Kyrgyz Republic

ABOUT THE AUTHOR

Dr Kanat Tilekeyev has been a senior research fellow at the Institute of Public Policy and Administration of the University of Central Asia since 2012. He works in many research projects of the World Bank, USAID, FAO, GIZ, other donor and research organizations in agriculture development, poverty, SME development, food security and nutrition issues, labour market, and policy impact evaluation. He obtained his PhD in Economics from the University of Giessen, Germany, in 2012. Previously, he worked in the private sector and on development projects in fiscal reform, rural development, and the food sector.

IMPRINT

Friedrich-Ebert-Stiftung | Representative office of the Friedrich Ebert Foundation in the Kyrgyz Republic [Friedrich-Ebert-Stiftung in der Kirgisischen Republik]
33/1 Razzakov, apt. 2 | Bishkek, 720040 | Kyrgyzstan

Responsible:
Alexander Rosenplänter, Regional Director in the Kyrgyz Republic and the Republic of Tajikistan
Phone: +996 312 663077, 620016

info.bishkek@fes.kg
www.fes-centralasia.org

Commercial use of all media published by the Friedrich-Ebert-Stiftung (FES) is not permitted without the written consent of the FES.

UNDERSTANDING INFORMAL ECONOMY IN KYRGYZSTAN

Better social justice for workers, higher sustainability for the country



The informal economy comprises up to 50% of the national economy in Kyrgyzstan, while official estimates vary from 23 to 25% of the GDP. The trade, construction, transport, and processing industries provide a significant role in forming informality.

Labour market informality covers 71.8% of all jobs in the country, mostly in the sphere of microbusinesses and self-employment, while formal employment is stagnating. At the same time, the average age of workers has shown an increase over the past decade. This ageing will accelerate in the future. Men prevail in the labour market (62%), which signals an insufficient access of women to jobs.



Tax and social security systems make it possible to gain from a lowered tax and social payments for certain types of microbusinesses and self-employed people when compared to formal business entities. Distortion of economic operations in the country creates incentives for high informality in the economy and consequently in the labour market.

The negative impact of the informal economy includes a high level of labour rights insecurity, a low stimulus for the increase of qualification of workers, need for the use of more technology, problems with reaching quality standards, disincentives for investment and growth of businesses due to uneven tax regimes for small businesses compared to medium and big business entities. The essential argument against maintaining the current tax and social



security regimes is the erosion of the equity principle between taxpayers. Eradication of the informal economy is one of the main directions of desired tax and social security reforms. It will result in an increase in tax revenues, an improvement of enforcement of the law and better labour regulations.

The proposed tax system and social security reform should include a complex set of measures to increase taxation base through better control of the economy, incentives for businesses and workers to legitimize their activities, detailed analysis of the proposed actions' consequences, and wide public discussion of the reform with the inclusion of business circles, trade unions, academia and civil society organizations.