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Promoting Inclusive Growth in the Caucasus and Central Asia

*An IMF staff team led by
Mercedes Vera Martin, including
Dominique Fayad, Rayah Al Farah,
Sergejs Saksonovs, Wei Shi, and
Fang Yang*

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Executive Summary

Making growth more inclusive—creating opportunities for all—is a stated objective of all the countries in the Caucasus and Central Asia (CCA).

CCA countries achieved gains in inclusiveness over the past 20 years as incomes increased and poverty, inequality, and unemployment declined. Most of the progress occurred before the 2008–09 global financial crisis. Since then, poverty rates have barely moved and, for oil importers, remain elevated.

While much has been achieved, this is no time to slow down efforts. In fact, the opposite is true. The global financial crisis, combined with the external shocks of 2014–16 (low commodity prices and a fall in external demand in major trading partners), has put the gains at risk. The region's growth prospects are subdued, reflecting global headwinds, weaker productivity growth, and an aging population. In addition, the CCA economies rely heavily on a few sources of growth, notably oil, other commodities, and workers' remittances, making them vulnerable to external shocks. Lack of inclusive growth would be a recipe for political discord and backsliding.

Reinvigorating growth while making it more inclusive requires difficult, but doable, policy steps:

- Fiscal policy can facilitate inclusive growth by prioritizing investment in people and infrastructure. Education, health, and targeted social safety nets that protect the vulnerable should be priorities. With limited fiscal space, tax systems need to become broader-based and more equitable and must provide the right incentives to reduce informality. Bringing tax collection in CCA countries to the level of the region's best performer could increase tax revenues by 5–16 percent of GDP. This could be done by designing better tax policies and enhancing administrative capacity. Meanwhile, access to public services can increase by improving spending efficiency, including

by undertaking subsidy and civil service reforms. These efforts need to be accompanied by actions to strengthen fiscal governance and tackle corruption to enhance fiscal policy effectiveness and trust in institutions.

- Increasing financial inclusion—access to and use of financial services—would make growth more inclusive by allowing households and firms to invest in opportunities and build physical and human capital. Both households and firms are less financially included in CCA countries than in emerging market and developing economies on average. Women, youth, and small and medium enterprises are included even less. Policies to boost financial inclusion should aim at creating an enabling environment for private sector activity, including by improving financial literacy, credit information availability, and digitalization. Financial technology (fintech) could offer innovative ways to access financial services. These efforts should be accompanied by strengthening prudential regulation and supervision to support a healthy financial sector, while avoiding direct public intervention such as targeted lending, interest rate regulations, and credit guarantees.
- Improving governance and the business climate would lift productivity growth and allow the private sector—ultimately the engine of growth in the CCA—to play a larger economic role. Reducing the state’s dominance, improving governance (including by strengthening property rights and establishing an independent judiciary), and removing red tape would boost productivity and increase private sector participation.

Government actions alone cannot guarantee success in making growth inclusive—concerted efforts among stakeholders, including the private sector, civil society, and development partners, are needed. Collaboration and partnerships are key to designing effective policies tailored to country-specific circumstances. In addition, collaboration among countries through greater regional and global economic integration would bring about favorable dynamics for higher sustainable growth.

1 Introduction

Calling for Inclusive Growth in the Caucasus and Central Asia

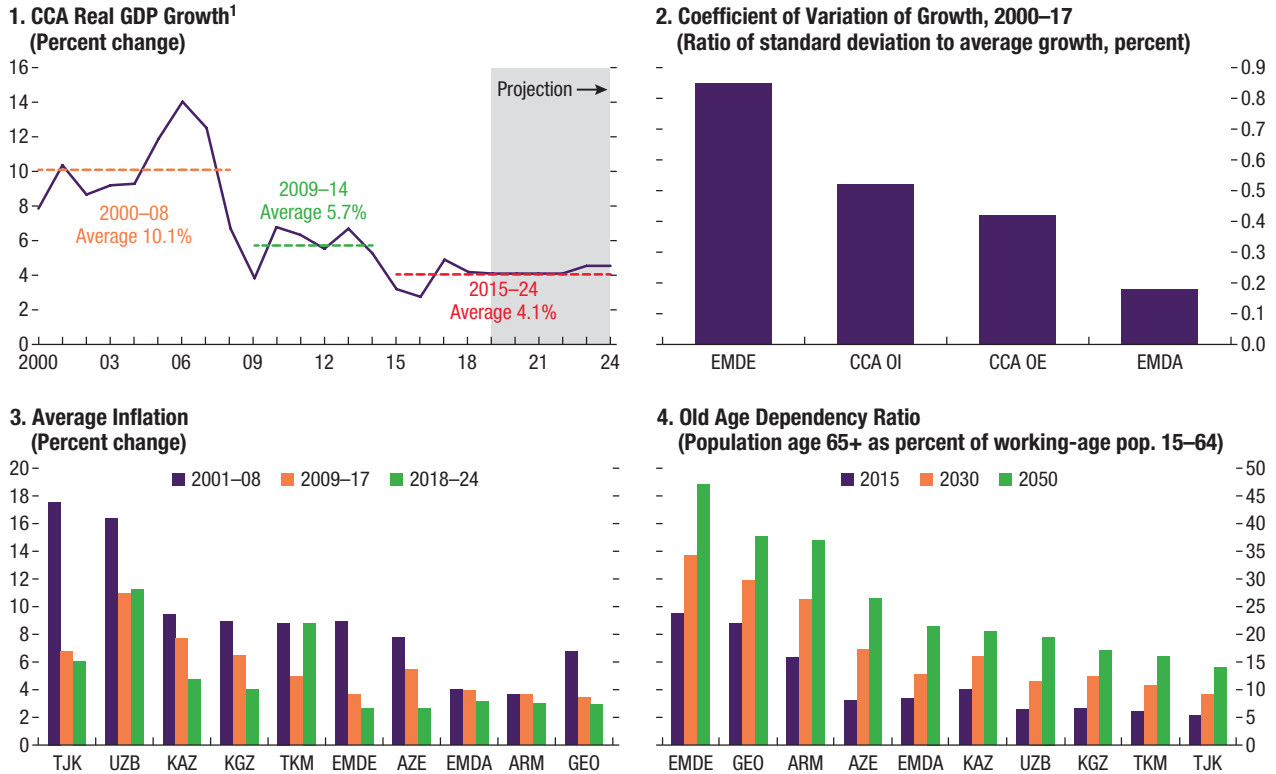
Growth is inclusive when it benefits all. The IMF defines inclusive growth as “broad sharing of the benefits of, and the opportunities for, economic growth, . . . that is robust and broad-based across sectors, promotes productive employment across the labor force, embodies equal opportunities in access to markets and resources, and protects the vulnerable” (IMF 2017a). Similarly, the Organisation for Economic Co-operation and Development (OECD) defines growth as inclusive if it “creates opportunities for all groups of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society” (OECD 2018).

Inclusive growth entails increasing employment, reducing poverty and inequality, and promoting private sector activity and diversification. First, by creating jobs, inclusive growth helps reduce poverty and inequality. Second, it increases labor force participation and employment, especially for those facing higher obstacles in accessing labor markets (women and the young). Third, inclusive growth encourages private sector activity by providing equal opportunities to access markets and resources. Fourth, inclusive growth is broad-based across sectors, entailing greater economic diversification and reducing vulnerability to external shocks.¹

Inclusive growth requires macroeconomic stability. High inflation, exchange rate and financial market volatility, and large swings in output can hinder job creation. Inflation is especially damaging for the poorest, who rely more on cash and fixed income and lack access to financial instruments to hedge

¹There is evidence that larger growth volatility worsens inequality (Huang and others 2015) and that the more complex a country’s economy (a measure of economic sophistication that considers how many products a country exports and how many other countries export these products) the lower the inequality (Hartmann and others 2017).

Figure 1. Growth, Inflation, and Dependency Ratios



Sources: United Nations World Population Prospects 2017; IMF, *World Economic Outlook*; IMF, *Regional Economic Outlook: Middle East and Central Asia*; and IMF staff projections.
 Note: CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.
¹Regional average is weighted by purchasing power parity-adjusted GDP.

against inflation. CCA countries successfully reduced inflation after the 2008–09 global financial crisis (Figure 1).

Promoting inclusive growth should be a policy priority for CCA countries because it helps raise living standards, supports social cohesion, and strengthens economic resilience.

- CCA growth has slowed. Average growth in the region fell by half after the global financial crisis, to 5 percent for CCA oil exporters and to 4 percent for CCA oil importers.² Medium-term growth prospects are also muted despite the recovery from the 2014–16 external shocks (lower commodity prices and trading partners’ growth). Making growth more inclusive would help maintain social cohesion in this lower-growth environment.

²It is customary to distinguish between these two groups in the CCA region. See also Annex 1.

- Greater inclusiveness supports productivity growth, which is critical to higher living standards and sustained income convergence. Inequality may prevent lower-income households from accumulating human and physical capital and leads to underinvestment in education. A shrinking labor force will also be a challenge. In all CCA countries, except Tajikistan and Uzbekistan, the labor force is expected to decline in the medium term, with a corresponding increase in the old-age dependency ratio. This will limit the contribution of labor to potential growth. Without sustained increases in productivity growth, catching up with emerging market income levels will be a daunting task.
- Inclusive growth makes economies more resilient. Growth in the CCA region has been relatively volatile, slightly more so for oil importers. Commodity exports account for 45 to 70 percent of export revenues for CCA oil exporters. CCA oil importers rely on other commodities for their export revenues (for example, 10 to 20 percent of revenues from nonferrous metals for Armenia and Georgia) or on workers' remittances (in particular, Tajikistan and the Kyrgyz Republic). With world growth already slowing, CCA countries are vulnerable to volatile oil prices, escalating global trade tensions, and deteriorating risk sentiment. This raises the urgency for diversifying economies. There is also evidence that growth sustainability is hurt by income inequality (Berg, Ostry, and Zettelmeyer 2012).

Countries across the CCA region have placed job creation and inclusive growth at the center of their reform strategies. Since the global financial crisis, policymakers around the world have emphasized policies to promote inclusive growth.³ CCA governments have also formulated national development strategies that stress inclusive growth as an important objective (Annex 2).

Advancing the inclusive growth agenda will require a concerted effort and a shared responsibility among stakeholders. Collaboration and partnerships are key to designing effective policies that consider country-specific circumstances. Policymakers should proactively consult the private sector and civil society to design better policies and garner support for policies and reforms that benefit growth over the medium term. Ultimately, policies should be geared toward a level playing field for all. It is important to translate development agendas into deliverables with time-bound action plans.

³For example, the Group of Twenty 2016 Hangzhou Summit communiqué stated: “We will work to ensure that our economic growth serves the needs of everyone and benefits all countries and all people including in particular women, youth and disadvantaged groups, generating more quality jobs, addressing inequalities and eradicating poverty so that no one is left behind.”

Way Forward

This paper proposes actions for CCA policymakers to promote inclusive growth in their countries. Since inclusive growth is a multidimensional concept, many areas of economic policy can help make growth more inclusive. The World Economic Forum (WEF 2017) lists seven pillars for a policy framework underpinning inclusive growth.⁴ This paper tackles three key policy areas, covering most of these pillars.⁵

- Reorient fiscal policy to invest in people and infrastructure (Chapter 3). Fiscal policy, through spending, can ensure that everyone benefits from economic growth. Infrastructure, education, health, and targeted social safety nets should be priorities for government spending. With limited fiscal space, more efficient spending and higher revenue (through broader-based and more equitable tax systems) should be used to support these priorities.
- Promote financial inclusion in a responsible and sustainable manner (Chapter 4). Increasing households' and firms' access to financial services creates opportunities to smooth consumption, manage financial risks, and invest in businesses and education. Financial inclusion promotes private sector development, especially when the banking sector is healthy and resilient, supported by adequate financial regulation and supervision. New technologies and digitalization could promote further financial deepening.
- Improve governance and the business environment (Chapter 5). This can help lift productivity growth and increase the role of the private sector. Priority actions include supporting fair competition, reducing the dominance of state-owned enterprises, and streamlining bureaucracy and business regulations.

⁴These are (1) education and skills, (2) basic services and infrastructure, (3) corruption and rents, (4) financial intermediation of real economy investment, (5) asset building and entrepreneurship, (6) employment and labor compensation, and (7) fiscal transfers.

⁵Other policies facilitating inclusive growth include those enhancing regional economic integration and diversification. These are discussed in IMF (2018a). Labor market reforms, also relevant for inclusive growth, are covered in Arias and others (2014), EBRD (2018), and ADB (2019).

CHAPTER

2

Progress in Promoting Inclusive Growth in the CCA Region

After remarkable progress before the global financial crisis, gains in inclusiveness slowed. The challenges to further progress stem from a slowdown in private investment and productivity growth. Labor force participation is already high, making further increases difficult.

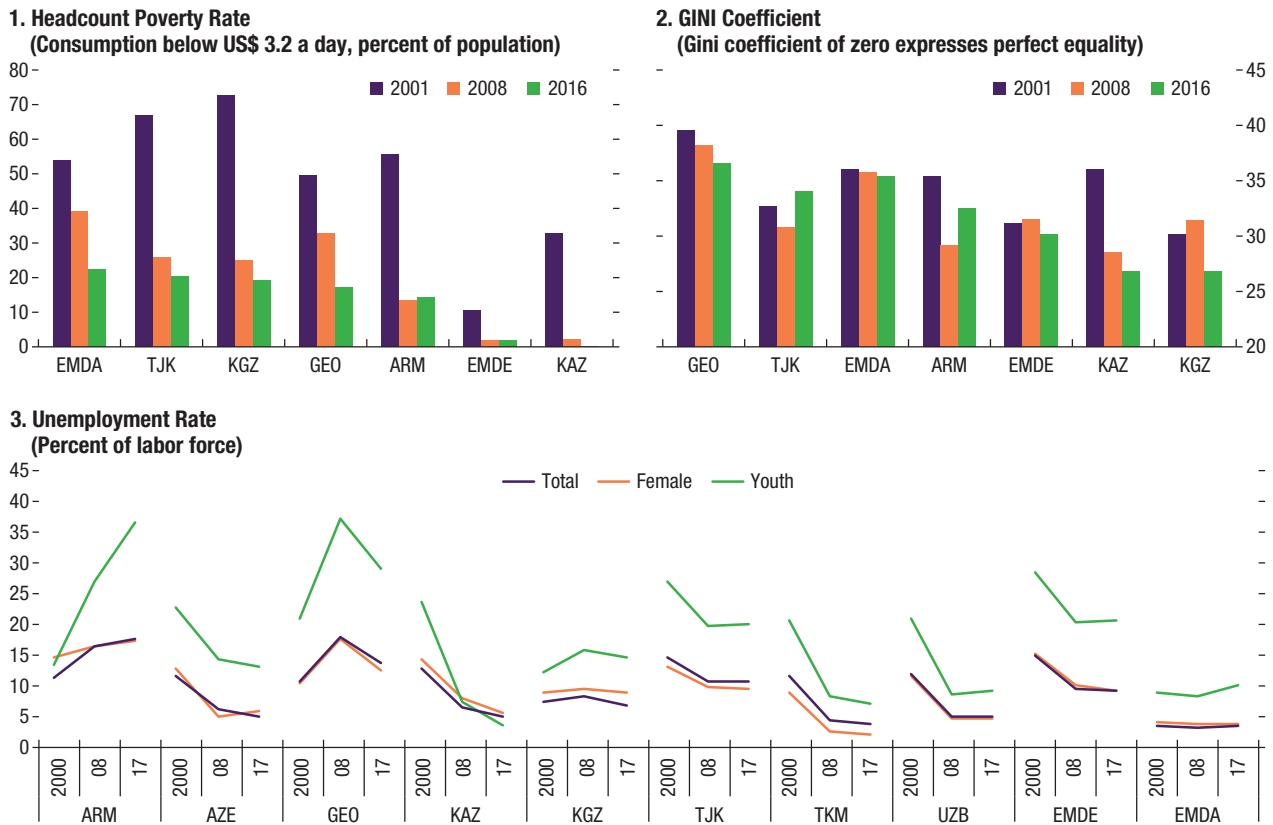
Poverty and Inequality

CCA countries have been successful in reducing poverty, but more needs to be done. The reductions in headcount poverty¹ before the global financial crisis averaged an impressive 36 percentage points, ranging from 17 percentage points in Georgia to 48 percentage points in the Kyrgyz Republic (Figure 2). Since then, however, poverty rates have barely moved and, for oil importers, remain elevated, ranging between 14 percent (Armenia) and 20 percent (Tajikistan). The highest share of people in extreme poverty (defined as consumption below \$1.90 a day in 2011 purchasing-power-parity prices) is still in Tajikistan (5 percent in 2015) and Georgia (4 percent in 2016). Aside from Kazakhstan, headcount poverty in CCA countries is higher than country averages in emerging and developing Europe (see Annex 1 for the choice of peers).

Inequality has declined in most CCA countries. Between 2001 and the global financial crisis, the consumption-based Gini index fell by 3.1 points on average, with Kazakhstan and Armenia recording by far the largest reductions

¹This analysis uses the World Bank's lower-middle-income international poverty line of \$3.20 a day in 2011 purchasing-power-parity dollars. The World Bank's PovcalNet database contains results of household consumption surveys for different years and countries. For aggregation, country data were included if available either within two years in the future of a given year (for example, 2001) or, if not available, within two years preceding the given year. For emerging and developing Asia aggregates, only countries with data available for all three reference points were included (12 out of 33 countries). The latest data available for Azerbaijan, Turkmenistan, and Uzbekistan are from 2005, 1998, and 2003, respectively, so these countries are not included in the sample.

Figure 2. Poverty, Inequality, and Unemployment



Sources: International Labour Organization; World Bank, PovcalNet database; and IMF staff calculations.
Note: EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

in inequality (7.5 and 6.2 points, respectively).² Since the crisis, the Gini coefficient declined by only 0.3 points on average; Tajikistan and Armenia recorded significant increases of 3.2 and 3.4 points, respectively. As of 2016, inequality in CCA countries was broadly in line with emerging and developing Europe and emerging and developing Asia averages.

²The Gini index is a measure of statistical dispersion of a distribution most commonly used a measure of inequality. A value of 100 corresponds to the richest person having all the income of consumption, and a value of 0 corresponds to perfect equality. The World Bank's PovcalNet database contains information on income and consumption, with the latter more available for the CCA region. Hence this chapter focuses on inequality in reported consumption, not income, which is harder to measure. These concepts are related but not the same. Consumption inequality can be smaller than income inequality if poorer households borrow to temporarily sustain higher consumption or if richer households save more.

Accessing the Labor Market

Unemployment in the CCA region is not particularly high. In most CCA countries, International Labour Organization (ILO) estimates of unemployment are lower than the average for countries in emerging and developing Europe. In 2017 these rates ranged from 3.7 percent in Turkmenistan to 17.8 percent in Armenia (averaging 8.5 percent). Except in Armenia and Georgia, unemployment rates fell in CCA countries during 2000–17, with the most notable declines in Uzbekistan, Kazakhstan, and Turkmenistan. In most countries, progress stalled after 2008. Female unemployment rates are similar to those of men, while youth unemployment rates are significantly higher, reflecting lower labor force participation. The average youth unemployment rate in the CCA region (16.8 percent) falls between the averages of emerging and developing Asia (10.3 percent) and emerging and developing Europe (20.8 percent). Between 2009 and 2017, all CCA countries managed to raise employment, with the increases ranging from 6 percent in Georgia to 16 percent (of 2017 employment stock) in Uzbekistan.

Labor force participation is relatively high, including for women and the young. Based on the ILO estimates,³ 2017 total labor force participation rates range from 44 percent in Tajikistan to 71 percent in Kazakhstan.⁴ Most CCA countries surpass average labor force participation rates in emerging Europe and emerging Asia. Furthermore, almost all of them managed to increase labor force participation rates during 2000–17—between 1.3 (Tajikistan) and 4 percentage points (Georgia), in contrast to declines in peer averages. Youth (ages 15–24) and female labor force participation rates are also high. Declines in youth participation (in Kazakhstan and the Kyrgyz Republic) are not necessarily worrisome as they seem to be linked to increasing access to education.⁵ Owing to the relatively high labor participation rates, the prospects for higher growth from increases in the labor force are limited, though there may be more scope to reduce unemployment.

Despite the high female participation rates, persistent gender gaps may be a drag on growth (Figure 3). Female labor force participation in CCA countries has increased by 0.4 percentage point since the global financial crisis, compared with a 0.8 percentage point increase in emerging Europe. The ratio of female to male participation is 78 percent in CCA oil exporters and 68 percent in oil importers, compared with 77 percent in emerging Europe.

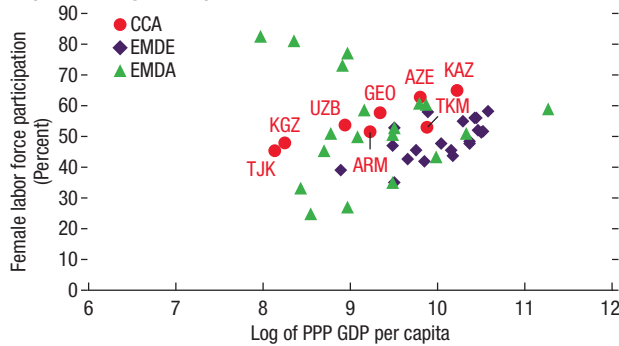
³As most CCA countries lack long (and/or comparable) time series of labor force participation, this paper relies on estimates by the International Labour Office (2017).

⁴Defined as all age bands. Results with ages 15+ and 15–64 are qualitatively similar.

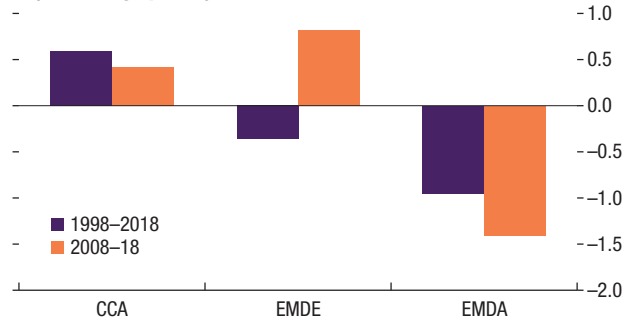
⁵The World Bank data suggest that the gross enrollment ratio in tertiary education increased from 32 percent in 2000 to 50 percent in 2017 in Kazakhstan. Similarly, enrollment rates for the Kyrgyz Republic increased from 35 to 44 percent.

Figure 3. Female Labor Force Participation

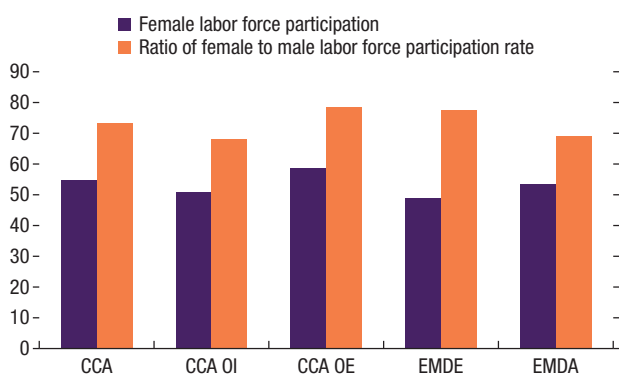
1. Female Labor Force Participation and GDP per Capita, 2018
(Females aged 15+)



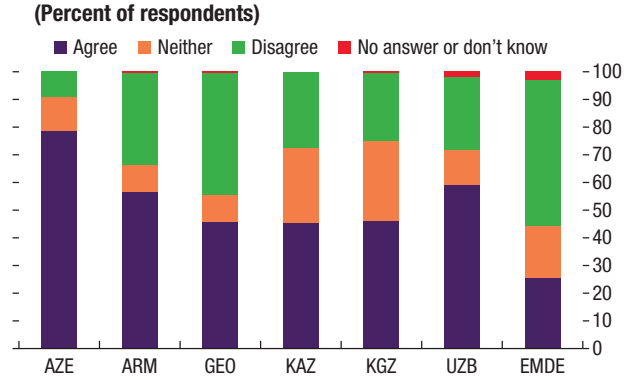
2. Change in Female Labor Force Participation
(Percentage points)



3. Labor Force Participation, 2018
(Percent, ILO-modeled estimates)



4. When Jobs are Scarce, Men Should Have More Right to a Job than Women
(Percent of respondents)



Sources: World Bank; International Labour Organization, World Values Survey; IMF, *World Economic Outlook*; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

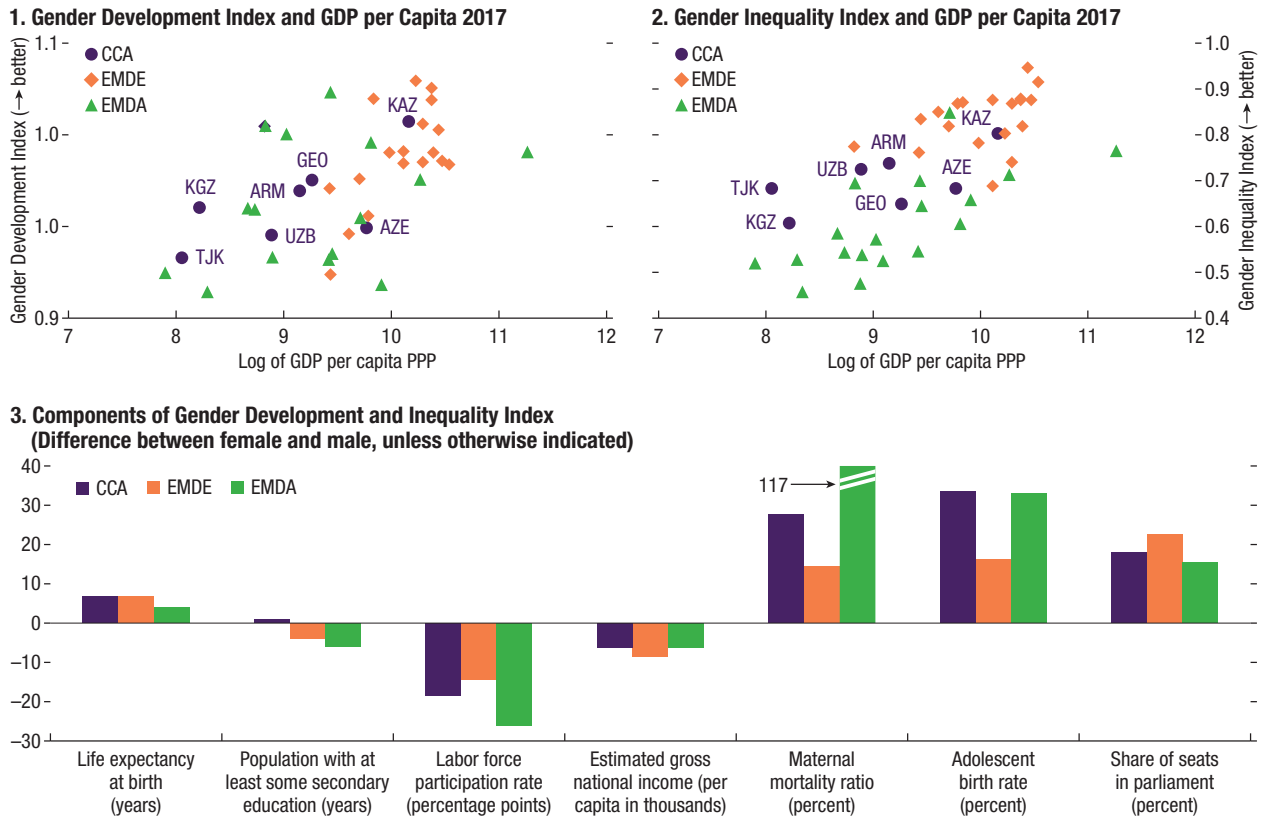
Attitudes toward female participation in the labor force are also mixed. About 55 percent of respondents to the World Values Survey agreed that when jobs are scarce, men should be hired before women, in contrast to respondents in emerging Europe (25 percent agreed). Such gender gaps in the labor market can have significant negative effects.⁶

More generally, CCA countries lag their peers when it comes to gender equality, which may hurt productivity and growth.⁷ The Gender Development Index measures disparities between women and men in health, knowl-

⁶Cuberes and Teignier (2016) estimate an occupational choice model in which people differ in entrepreneurial ability and find that excluding 5 percent of women results in a long-term loss of between 4 percent for Kazakhstan and 16 percent for the Kyrgyz Republic.

⁷See Cuberes and Teignier (2014) for a literature overview of the link between gender inequality and economic growth.

Figure 4. Gender Equality



Sources: IMF, *World Economic Outlook*; United Nations, *Human Development Report 2017*; and IMF staff calculations. Note: CCA = Caucasus and Central Asia; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

edge, and living standards.⁸ The CCA region lags its emerging Europe peers, but performs similarly on average to countries in emerging Asia (Figure 4).

Income Convergence and Its Drivers

Despite substantial progress before the global financial crisis, income convergence (catching up with comparators) in the CCA region has slowed, especially in oil importers. The GDP per capita in purchasing-power-parity

⁸The Gender Development Index is a composite that reflects gender-based disadvantages in health, empowerment, and representation and in labor market opportunities. It ranges from 0, which denotes that men and women are unequal, to 1, which indicates decreased inequality, and attempts to capture the loss in potential human development because of inequality between female and male achievement in the designated categories. It measures gender equality achievements in three basic dimensions of human development: health, knowledge, and living standards. It uses the following measures to construct the index: life expectancy at birth, expected years of schooling, mean years of schooling, and estimated earned income (2011 purchasing-power-parity US dollars). More details can be found here: http://hdr.undp.org/sites/default/files/hdr2018_technical_notes.pdf.

terms for oil exporters rose from 14 percent of the advanced economy level in 2000 to 24 percent in 2008, and to close to 30 percent by 2017. CCA oil exporters have exceeded emerging market average incomes, though they continue to lag the average of emerging Europe. Oil importers remain poorer relative to advanced economies or emerging markets—rising from 6 to 9.5 percent of advanced economies' GDP per capita during 2000–08 and to 11 percent by 2017. After the global financial crisis, lower economic growth, combined with higher population growth, slowed the process for both groups (Figure 5).⁹

Lower total factor productivity growth accounts for the slowdown. Although growth accounting for the CCA region is highly uncertain given unreliable data on capital stocks and investment, it mirrors trends in some countries in emerging Europe (Chiacchio, Gradeva, and Lopez-Garcia 2018).¹⁰ The slowdown in total factor productivity growth since the global financial crisis is especially pronounced in oil exporters. The contribution of capital accumulation to growth has increased, and in oil importers it is now the main engine of growth. The contribution of labor is small, especially for oil importers, reflecting stagnant employment ratios.

Private investment also slowed in the CCA region after the global financial crisis. While overall investment has held up, the share of private investment in GDP decreased in all countries except Uzbekistan and Turkmenistan (where it increased from a very low level). Azerbaijan, the Kyrgyz Republic, Tajikistan, and Turkmenistan in particular have room to boost private investment ratios, which could help achieve more inclusive growth. In Armenia, Kazakhstan, and Georgia, there is less room for increases: they are already close to emerging and developing Asia averages and above those in emerging and developing Europe (Figure 6).

CCA economies are relatively undiversified, making them vulnerable to shocks. In most countries, the top three industries account for more than 50 percent of GDP.¹¹ As of 2017, Azerbaijan was the most concentrated economy, with 58 percent of value added in the top three industries, and Georgia was the most diversified, with 37 percent of value added by the top three industries. Between 2010 and 2017, only Kazakhstan and Armenia achieved a material increase in the diversification of their economies.

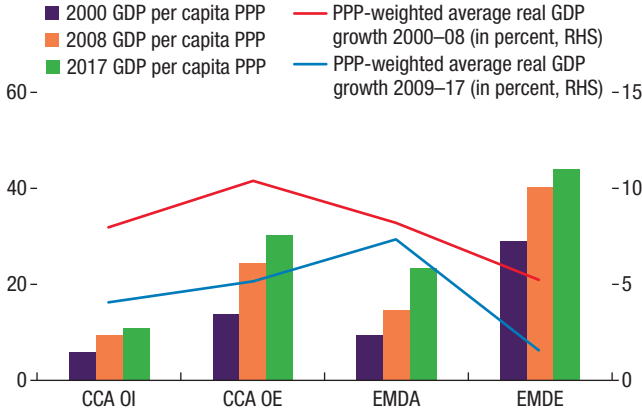
⁹Annual population growth accelerated from 0.8 to 1.3 percent for oil importers and from 1.1 to 1.7 percent in oil exporters.

¹⁰The contribution of capital and total factor productivity is sensitive to assumptions regarding the calculation of capital stock; however, the conclusion that total factor productivity growth is the key contributor to the slowdown is robust to changing such assumptions.

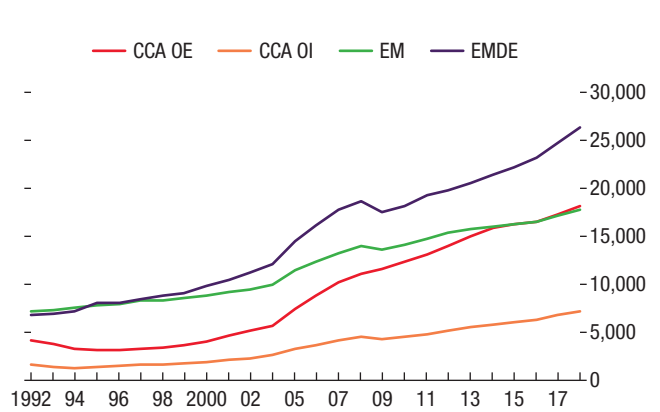
¹¹Data for Turkmenistan are not available. For Tajikistan, only a simplified decomposition is available.

Figure 5. Per Capita Growth, Productivity and Labor Force Participation

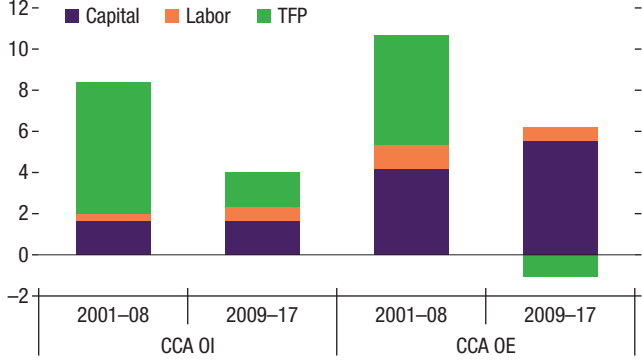
1. Real GDP Growth and GDP per Capita
(Percent of advanced economies GDP per capita)



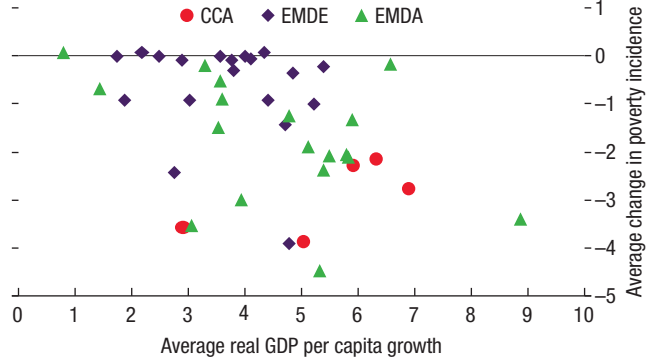
2. GDP per Capita
(PPP, in constant 2011 international dollars)



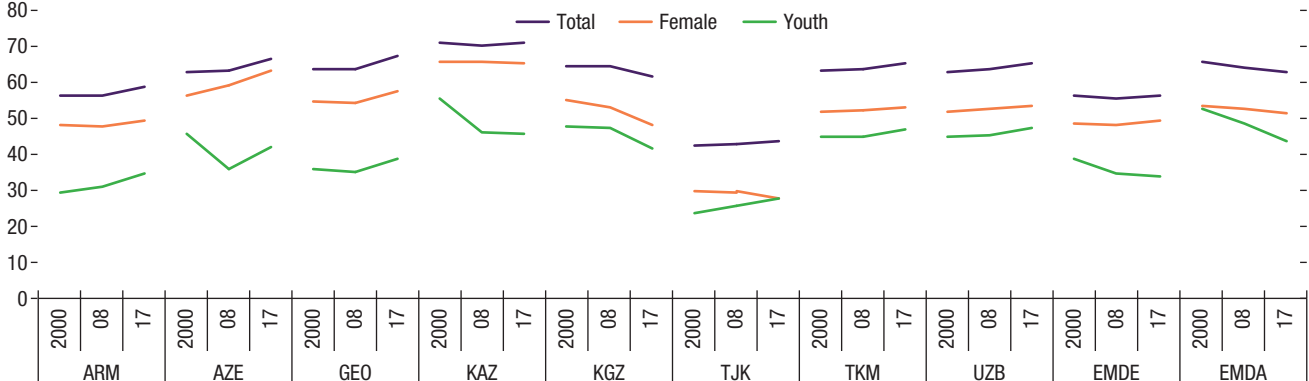
3. Growth Decomposition
(Average percent)



4. Real GDP per Capita and Change in Poverty
(Percentage points)



5. Labor Force Participation Rate
(Percent)



Sources: International Labour Organization; IMF, *World Economic Outlook*; and IMF staff calculations.
 Note: CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe; PPP = purchasing power parity; TFP = total factor productivity. Data labels in the figure use International Organization for Standardization (ISO) country codes.

Reorienting Fiscal Policy to Support Inclusive Growth

“Fiscal policy is the government’s most powerful tool to achieve distributional objectives. Tax and spending policies must be designed wisely to minimize any adverse effects on incentives to work, save, and invest. On the revenue side, this implies building wider, more reliable tax bases by reducing exemptions, combating tax evasion, and strengthening administration. On the expenditure side, priorities include expanding access to education and health—which will bolster equality of opportunity—and better targeting of social benefits to the poor.”

—Christine Lagarde, IMF Managing Director

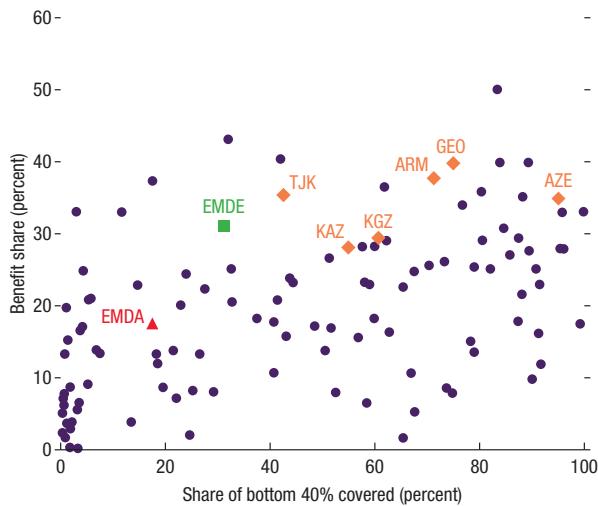
Governments face challenges in promoting inclusiveness and higher growth while safeguarding fiscal sustainability. Fiscal policy can play a major role in leveling the playing field for private sector development through redistributive policies and a fairer tax system. Higher spending for social and infrastructure priorities, however, needs to be balanced against medium-term fiscal sustainability. In response to the 2014–16 external shocks, CCA countries mostly resorted to countercyclical fiscal policies to stabilize growth. While appropriate in the short term, these policies widened fiscal deficits and public debt and reduced fiscal buffers, requiring consolidation in the years ahead.¹ Therefore, the challenge is to support inclusive growth through reorienting spending and raising revenue without undermining fiscal sustainability.

Both spending and revenue measures are needed to support inclusive growth.

- Spending: Health and education are high priorities since they improve employment prospects and increase productivity. Infrastructure spending can also make growth more inclusive by promoting private sector devel-

¹For a discussion about how to engineer a growth-friendly path for building fiscal buffers in the CCA region, see IMF (2018c).

Figure 7. Social Protection Spending, Bottom 40 Percent
(Latest available)



Source: IMF, *Fiscal Monitor*, October 2017.
Note: EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

opment, including in the regions. Finally, well-targeted social safety nets will help protect the most vulnerable. Although social protection benefits in the CCA countries are among the highest relative to emerging markets and emerging and developing Europe and Asia, the coverage remains uneven. The composition of public spending should be reviewed to identify whether it can be targeted more effectively toward these priorities (Figure 7).

- **Revenue:** To support fiscal sustainability, higher spending can be accompanied by increasing revenue mobilization and improving the fairness of the tax system. This can be achieved by broadening tax bases, making tax systems more progressive, and tackling corruption in tax administration, which hampers revenue collection (Table 1).²

Reorienting Public Spending to Promote Inclusive Growth

CCA countries generally have higher capital spending and lower current spending than their peers (Figure 8). Current expenditure relative to GDP has remained stable and below peer-country averages.³ The composition of spending varies widely across CCA countries, mostly driven by wages, social benefits, and purchases of goods and services. Although the wage bill for the general government is below the peer average (except in the Kyrgyz Republic and Uzbekistan), there is room for rationalization (see below). Subsidies are significant in Azerbaijan and the Kyrgyz Republic, where a subsidy reform, which should be accompanied by social protection measures, could generate up to 2 percent of GDP. Social transfers are below peer levels, but substantial in Turkmenistan (12 percent of GDP), the Kyrgyz Republic (9.3 percent), Georgia (8.7 percent), and Armenia (7.4 percent). In all countries, better targeting could help protect the most vulnerable while creating fiscal space.

Higher efficiency in health spending will be a first step to improve health services.

²The “Paying Taxes” assessment of the World Bank *Doing Business* report records the taxes and mandatory contributions a medium-size company must pay or withhold in a given year, as well as the administrative burden of paying taxes and contributions.

³Most CCA countries’ fiscal data focus on central government definitions and do not include state-owned enterprises, which are very active in quasi-fiscal operations.

Table 1. World Bank Doing Business Indicators 2018: Paying Taxes

	Paying Taxes Score (0–100) ¹	Payments (number per year)	Time (hours per year)	Total Tax Rate (percent of profits) ²	Postfiling Index (0–100) ³
Regions					
East Asia & Pacific	73	21	181	34	56
Europe & Central Asia	76	17	215	32	64
Latin America & Caribbean	60	27	330	47	47
Middle East & North Africa	75	18	197	33	50
OECD high income	83	11	159	40	84
South Asia	60	28	275	44	42
Sub-Saharan Africa	58	37	281	47	55
CCA Countries					
Armenia	74	14	262	19	49
Azerbaijan	85	6	159	41	84
Georgia	89	5	220	10	86
Kazakhstan	79	7	182	29	49
Kyrgyz Republic	57	51	225	29	37
Tajikistan	61	6	224	67	40
Uzbekistan	77	10	181	32	48
CCA Average	75	14	208	32	56

Source: World Bank, Doing Business 2018, and IMF staff calculation.

Note: CCA = Caucasus and Central Asia; OECD = Organisation for Economic Co-operation and Development.

¹A scale from 0 to 100, where 0 represents the lowest and 100 represents the best performance. Best performance for 2018 is Hong Kong SAR, China with a score of 100.

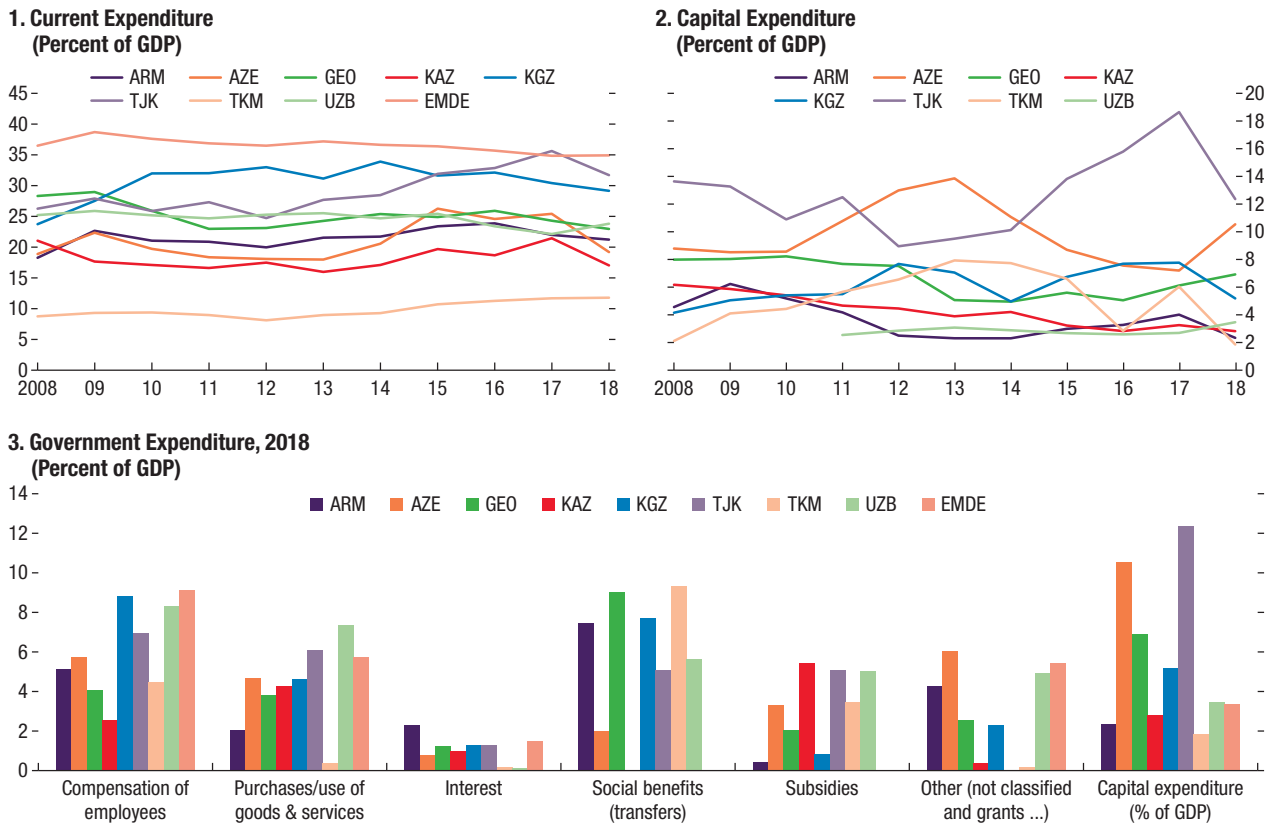
²The total tax rate measures the amount of taxes and mandatory contributions payable by a business as a share of commercial profits. The total amount of taxes is the sum of five different types of taxes and contributions after accounting for deductions and exemptions: corporate income tax, social contributions, and labor taxes paid by the employer, property taxes, and other small taxes.

³Based on the time to comply and obtain tax refunds, and to comply and complete a tax audit.

- Public health spending in the CCA region is relatively low, especially in per capita terms (Figure 9), averaging 2.5 percent of GDP, less than half the level in OECD countries (5.7 percent of GDP). Public spending (as a share of total health expenditure) ranges from 20 percent in Azerbaijan and Georgia to 70 percent in Turkmenistan. In turn, out-of-pocket spending, which represents a high poverty risk for the most vulnerable households, is much higher than in OECD countries, notably above 60 percent in Azerbaijan and Tajikistan.
- CCA countries could first focus on improving the efficiency of health spending. On average, life expectancy could increase by four years by enhancing hospital infrastructure, introducing service delivery innovations, and strengthening information about providers' performance.⁴ Lower pharmaceutical costs could be achieved by adopting more rational prescription practices and better procurement practices. Although the numbers of hospital beds, nurses, midwives, and physicians per 1,000 people for all

⁴World Bank (2013).

Figure 8. Government Expenditure



Sources: National authorities; IMF, *World Economic Outlook*; and IMF staff calculations.
 Note: EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

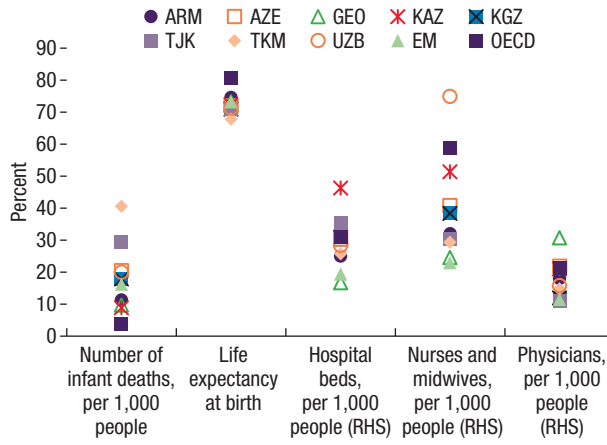
CCA countries are above the average in emerging market peers, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan have the most room for higher efficiency.

- Although Armenia and the Kyrgyz Republic—the CCA countries closest to the health efficiency frontier (showing the health outcomes of the best-performing countries at each level of health spending per capita)—have limited room to improve health outcomes within the current spending envelope (Figure 9), they would benefit from increasing health spending. Primary and preventive care could be priorities.

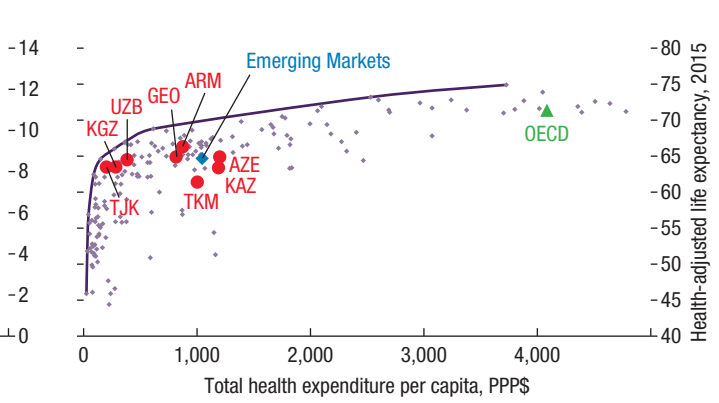
Similarly, more efficient education spending can improve education outcomes. Spending on education in the CCA ranges from 2 percent of GDP in Georgia to 6 percent of GDP in the Kyrgyz Republic, and some countries (Kazakhstan and Georgia) have announced education reforms recently. On average, bringing efficiency in public spending in education to the frontier (countries with the best education outcomes relative to their level of spend-

Figure 9. Health and Education Expenditure and Outcomes

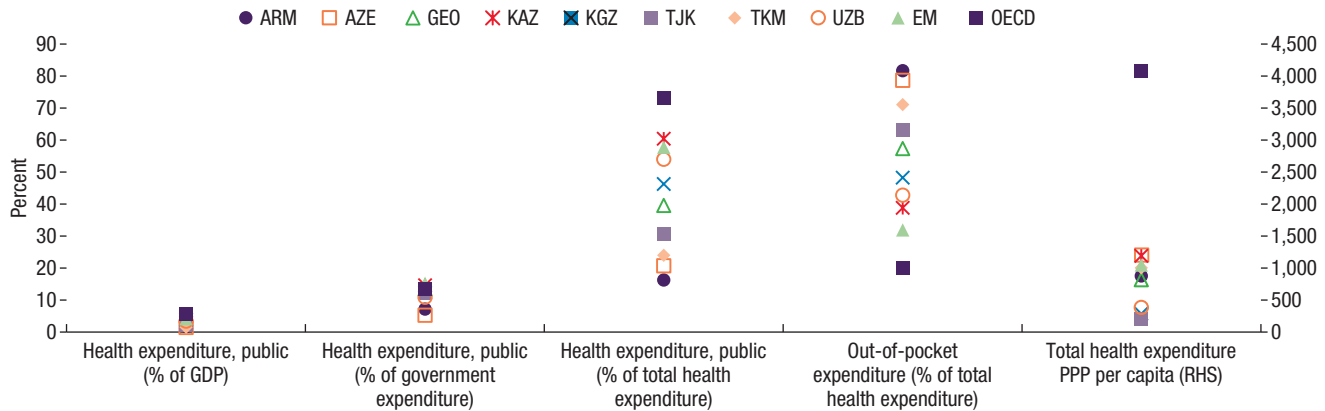
1. Health Indicators, Latest Available (Different metrics)



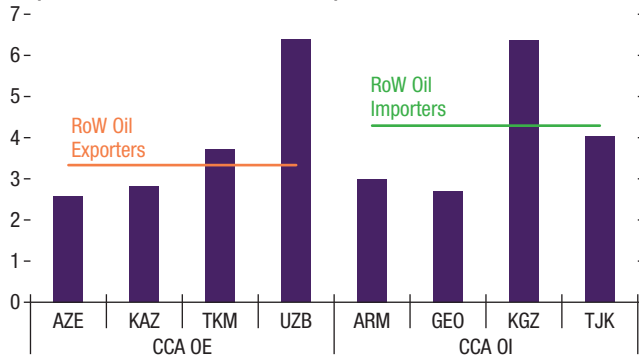
2. Health Efficiency Frontier (Latest value available)



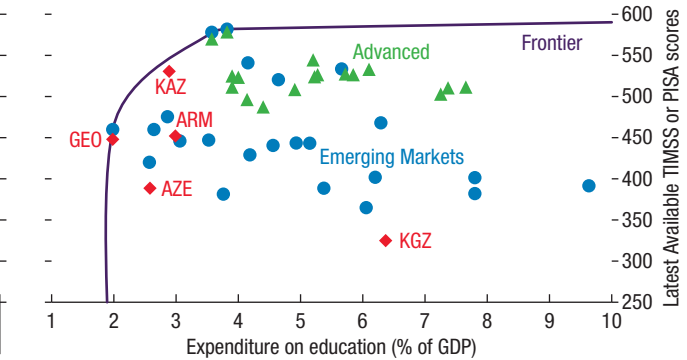
3. Health Expenditure, 2015 (Different metrics)



4. Government Expenditure on Education (Percent of GDP, latest available)

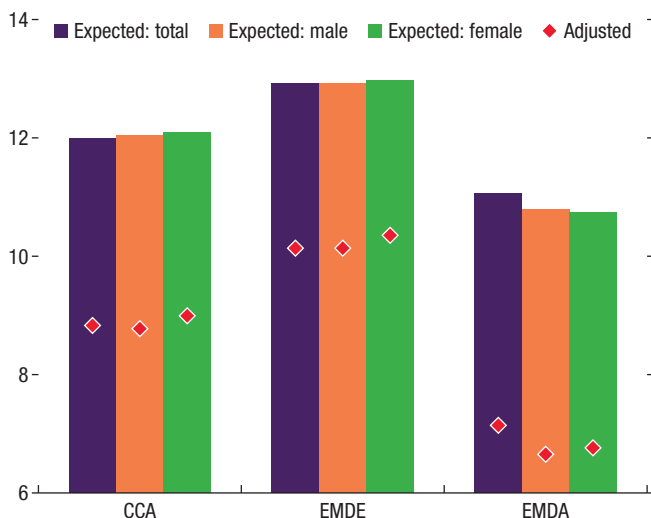


5. Student Performance and Education Spending



Sources: IMF, Fiscal Affairs Department Expenditure Assessment Tool; IMF, *Fiscal Monitor*, October 2017; TIMSS and PISA evaluations; and IMF staff calculations. Note: TIMSS and PISA scales are different, but both are centered around 500, with a standard deviation of 100. CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EM = emerging markets; OECD = Organisation for Economic Co-operation and Development; PISA = Program for International Student Assessment; TIMSS = Trends in International Mathematics and Science Study. Data labels in the figure use International Organization for Standardization (ISO) country codes.

Figure 10. Expected and Learning-Adjusted Years of Schooling, 2018



Sources: World Bank Human Capital Index; and IMF staff calculations.
 Note: The learning-adjusted years of schooling attempts to capture quality of education, reflecting that children in some countries learn less than others, despite being in school for the same time. It multiplies estimated years of schooling by the ratio of most recent harmonized test scores on the TIMSS. TKM and UZB not included in Caucasus and Central Asia (CCA) averages due to data availability. AZE not included in CCA average breakdown by gender. EMDA = emerging and developing Asia; EMDE = emerging and developing Europe.

ing in education)—by improving teacher quality and recruitment, training and deployment governance systems, school graduation exams, and multigrade teaching in rural areas—could improve students’ performance by 16 percent. Notably, the Kyrgyz Republic could improve student performance by about 60 percent (Figure 10). Actions to achieve this include monitoring the quality and availability of teaching materials, disseminating good teaching practices through classroom observation exercises and training, and introducing performance incentives, based on independent review.⁵

Expanding infrastructure can support economic activity and facilitate private sector development (Figure 11).

- The scope for infrastructure improvement in the CCA is large: the average logistic performance index—a composite of doing business indicators on infrastructure, transportation, and international trade—is the lowest among the peers. Transportation infrastructure is the largest need (Figure 11).⁶
- Enhancing public investment management will increase efficiency. CCA countries should define a standard methodology for maintenance requirements and track maintenance funding and establish standards for project selection procedures and implementation plans.⁷

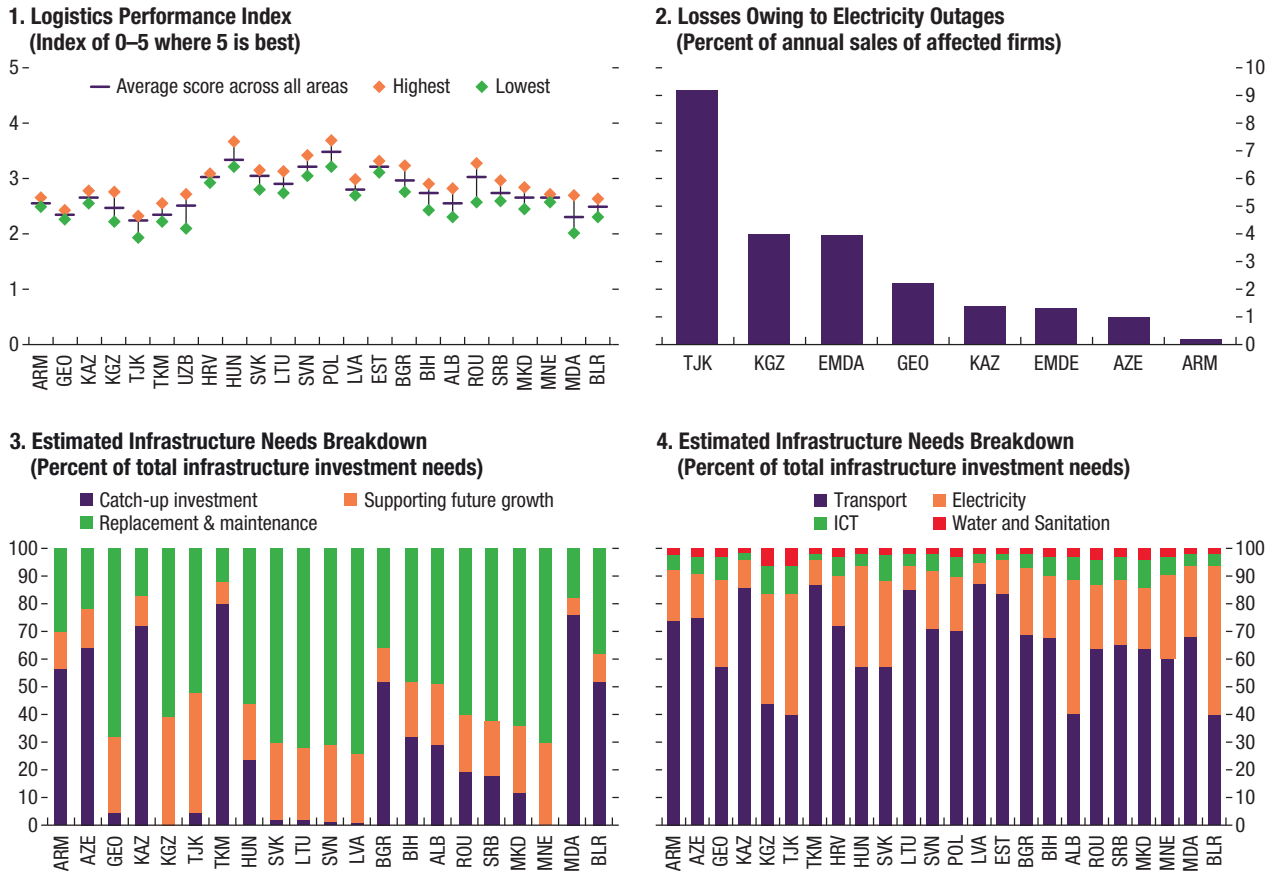
Energy subsidy reform could help finance priority spending. This can be achieved by adjusting pretax energy prices and the consumption tax on energy products. Although aimed at protecting consumers, subsidies aggravate fiscal imbalances, crowd out priority public spending, and depress private investment, including in the energy sector. Subsidies also distort resource allocation by encouraging excessive energy consumption and capital-intensive

⁵UNESCO (2009).

⁶EBRD (2017–18).

⁷For details, see IMF (2018b)

Figure 11. Infrastructure Investment Needs



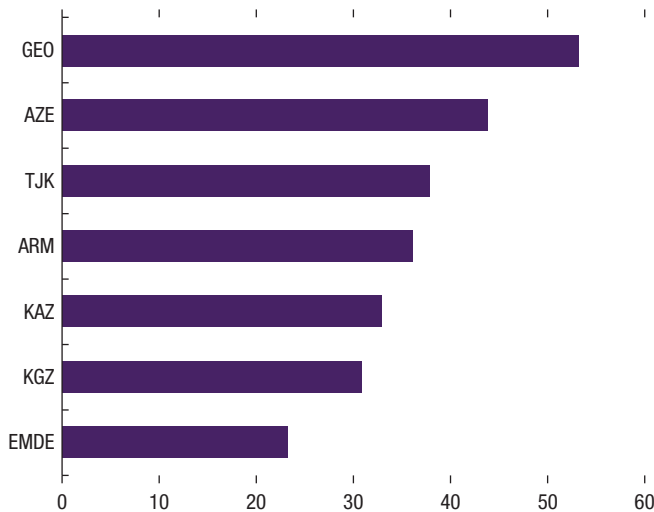
Sources: EBRD (2017–18); World Bank; and IMF staff calculations.
 Note: The Logistics Performance Index covers six areas—customs, infrastructure, international shipments, logistics competence, tracking and tracing, and timeliness. Data labels in the figure use International Organization for Standardization (ISO) country codes.

industries, reducing incentives for investment in renewable energy and accelerating the depletion of natural resources. When subsidies are universal, most benefits, are captured by higher-income households, reinforcing inequality. To protect the most vulnerable, targeted social protection measures should be implemented before subsidies are removed. For example, Tajikistan plans to enhance and expand its existing targeted social assistance program to protect poor households from increases in electricity prices.

Finally, although the wage bills in CCA countries are not out of line with peers, they mask structural weaknesses that should be addressed through civil service reform.⁸ The share of public sector employment is high in most CCA countries, particularly among oil exporters. In several countries, allowances

⁸IMF (2018c).

Figure 12. Size of the Shadow Economy, 2015
(Percent of GDP)



Sources: IMF 2018f WP/18/17; and IMF staff calculations.
Note: Size of the economy estimated using the multiple indicators multiple causes (MIMIC) approach, for more information on the methodology please see IMF 2018f WP/18/17. EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

have proliferated, recruitment standards are low, and the connection between performance and promotion is lacking. Reducing these inefficiencies, and raising public sector productivity and efficiency, requires a comprehensive reform of civil services and salaries.

Mobilizing Additional Revenues for Inclusive Growth Priorities

There is potential to increase revenues by broadening the tax base while creating a more level playing field for private sector development in the CCA region. Total revenues are below peer levels, except in Georgia and Azerbaijan, and taxes are the main source of fiscal revenues in most CCA

countries (see Figure 13). Tax revenues are highest in Georgia (at 26 percent of GDP) and lowest for oil and gas exporters. Bringing tax collection in CCA countries to Georgia’s levels could increase tax revenues by 5 to 16 percent of GDP. Social security contributions are also below peer averages, except in the Kyrgyz Republic and Uzbekistan, whereas they are not present in Georgia.

Making taxation fairer would be a key lever for private sector development and inclusive growth. Currently CCA countries rely mostly on consumption taxes (value-added tax [VAT] and excises), suggesting that there is room to increase the use of direct taxes. Relatively low collection of corporate income tax reflects large exemptions and special economic zones set up to attract foreign investment. Personal income tax revenue is below peer averages in most CCA countries, owing to narrow tax bases, low compliance and progressivity in the tax system, and lack of taxation on international transactions in some CCA countries. Property tax revenues are currently negligible (see Box 1 for policy actions to raise revenues).

Reducing special tax regimes, exemptions, and informality would broaden the tax base and improve tax revenues and fairness (Figure 12). Exemption regimes, lack of tax diversification, and low personal tax progressivity distort incentives and hamper private sector development. Corporate income tax

Table 2. Corporate Income Tax and Value-Added Tax Rates, Productivity, Efficiency, and Thresholds

	CIT Rates	VAT Statutory Rates	VAT Thresholds	CIT Productivity	VAT C-Efficiency	VAT Productivity
	Latest Available (Percent)	2017 (Percent)	2018 (Thousands USD)	Latest Available (Scale of 0–1, where 1 is best)		
Armenia	20	20	117.0	0.13	0.47	0.38
Azerbaijan	20	18	No threshold	0.20	0.58	0.36
Georgia	15	18	39.0	0.21	0.73	0.54
Kazakhstan	20	12	No threshold	0.21	0.42	0.27
Kyrgyz Republic	10	12	0.4	0.20	0.74	0.71
Tajikistan	24	18	No threshold	0.10	–	–
Turkmenistan	20	15	28.6	–	–	–
Uzbekistan	14	20	0.01	0.73	0.72	0.30
EMDE	15.8	19.8	15.9	0.15	0.61	0.44

Source: IMF FADTP Rates Database.

Note: EMDE = emerging and developing Europe.

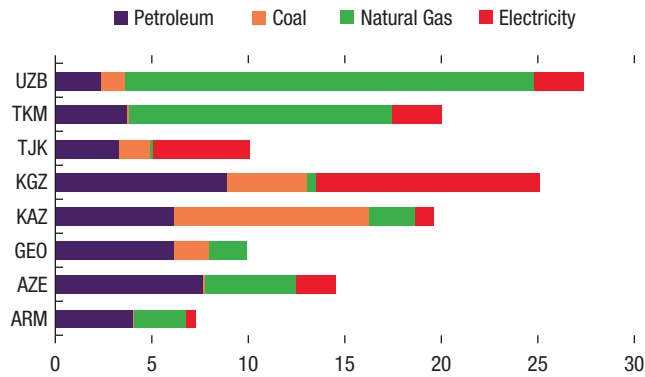
rates are on average above peer averages, suggesting that increasing tax revenue collection, productivity, and buoyancy hinges on enlarging the tax bases. VAT rates are in line with peer averages, but productivity and efficiency are underperforming, even though VAT is the main source of tax revenue, which suggests that the tax base is too narrow. Introducing VAT thresholds for small businesses would help raise compliance. Increasing corporate income tax and VAT productivity to the best CCA performers' level by enlarging tax bases could generate, on average, 0.6 and 0.3 percent of GDP additional revenues, respectively. Five out of eight CCA countries have a flat personal income tax rate, and two have no thresholds (Figure 13). More progressive personal income tax would enhance fairness, and introducing thresholds would protect the lowest segments of the income distribution (Table 2).

CCA countries need to improve tax collection efficiency. Despite progress in CCA tax policy and administration in recent years,⁹ there is still room for improvement in the following areas: (1) widespread exemptions in several countries; (2) low or no taxation of capital gains and dividends; (3) significant underreporting and tax avoidance by those not subject to the regular tax regime; (4) tax fraud and evasion as a result of limited tax administration capacity; (5) complex property tax systems that leave properties undeclared; and (6) limited collection enforcement and dispute resolution mechanisms. The taxpayer service also plays a crucial role in tax administration. Providing services that are accessible and understandable for all helps maintain and strengthen taxpayers' willingness to comply voluntarily.

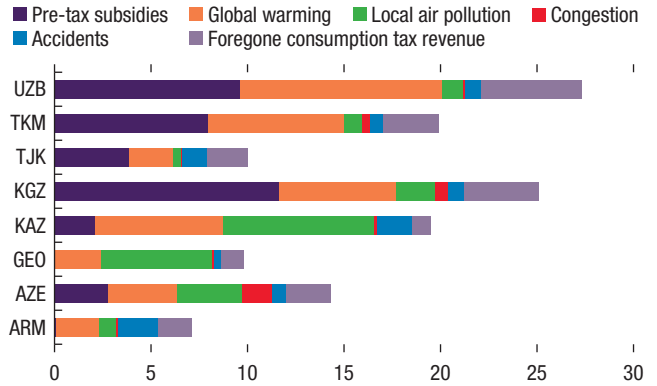
⁹For example, Azerbaijan has modernized its tax structure significantly, reducing the number of taxes and making it easier for taxpayers to understand and comply and for the tax administration to manage and administer the tax system. Armenia has recently introduced a modern digitalized cadaster to facilitate property tax collection. Georgia scores well on the Ease of Paying Taxes indicator and is addressing an accumulated stock of VAT refunds by introducing a full risk-based automatic VAT refund system.

Figure 13. Subsidies, Wage Bill, Taxes, and Revenues

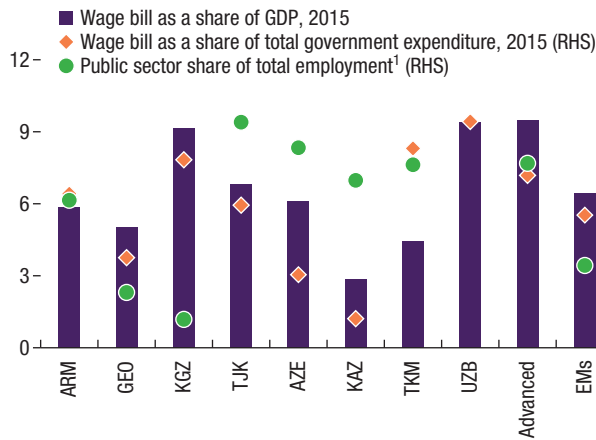
1. Post-Tax Subsidies by Product, 2017
(Percent of GDP)



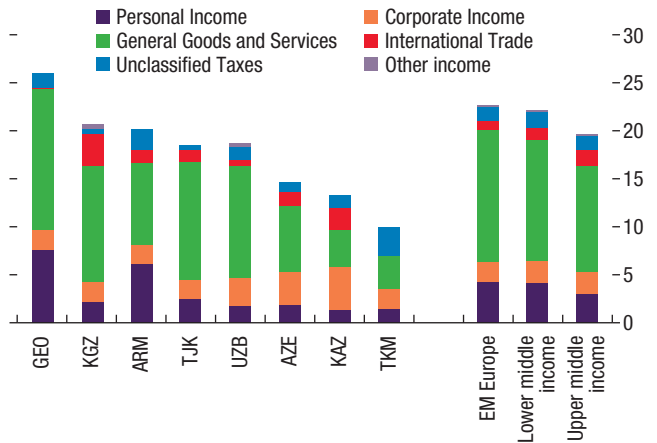
2. Post-Tax Subsidies by Component, 2017
(Percent of GDP)



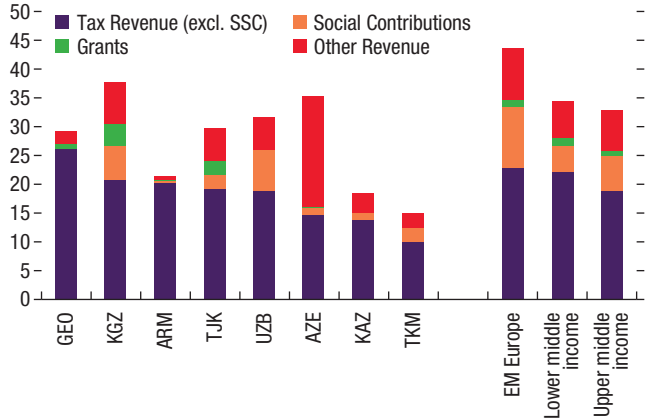
3. Wage Bill and Public-Sector Employment



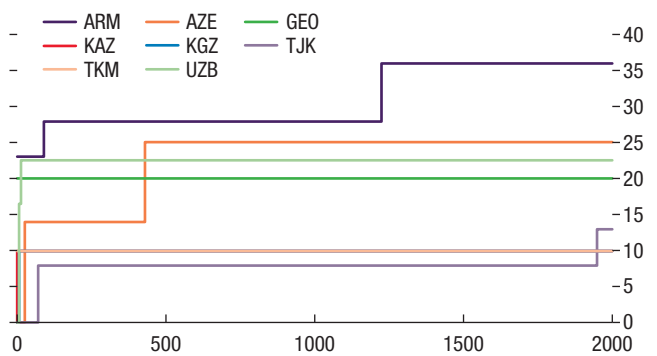
4. General Government Revenues
(Percent of GDP)



5. General Government Tax Revenues
(Percent of GDP)



6. PIT Rates and Progressivity



Sources: International Labour Organization; national authorities; IMF, Fiscal Affairs Department Revenue Analysis Tool and subsidies database; IMF, *World Economic Outlook*; and IMF staff calculations.

Note: EMS = emerging markets; EM Europe = emerging Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

¹Based on International Labour Organization 2013–14 estimates; the public sector comprises those employed by the general government and public corporations—unavailable for Uzbekistan. The source for the Turkmenistan share is the authorities; the source for the Tajikistan share is the World Bank.

Improving Fiscal Governance

More fiscal transparency and accountability would enhance fiscal policy effectiveness. Weaknesses in fiscal governance, manifested in corruption, hamper fair and effective government spending and revenue collection. Curbing corruption is a challenging task, but it can bring substantial benefits, including less revenue leakage, less waste in expenditures, and higher-quality public education and infrastructure.¹⁰ Steps to improve tax collection, reduce tax evasion, and implement more equitable tax systems, coupled with improved public financial management, could generate greater confidence in the government as an agent for higher and more inclusive growth and reinforce the social contract. Greater citizen involvement and budget openness can also increase the efficiency of public spending, address public resource mismanagement, and tackle corruption while making public policy decisions more inclusive. Expanding fiscal data coverage to broader government units, including state-owned enterprises; moving to the *Government Finance Statistics Manual 2014*; and introducing public sector balance sheet analysis will bring accountability to quasi-fiscal operations, contingent liabilities, and fiscal risks. Making state-owned enterprises more transparent, by requiring and publishing International Financial Reporting Standards audits (as Tajikistan does already) or by clarifying their commercial mandate as public corporations (as in Georgia) would improve public finance management.

More transparent budgets are key to improving fiscal governance. CCA countries have managed to improve budget transparency and comprehensiveness since 2015 in various ways: by publishing intra-year reviews online on budget execution and increasing the information provided in the prebudget statement (Georgia), the intra-year report (Tajikistan), the end-year report (the Kyrgyz Republic), and the Executive's budget proposal (Kazakhstan). Most CCA countries now rank in line or below peer averages on budget transparency. Georgia performs substantially better on budget transparency than its emerging and developing Europe peers, followed by Kazakhstan and the Kyrgyz Republic. Azerbaijan and Tajikistan are lagging (Figure 14).¹¹

There are some further measures to consider:

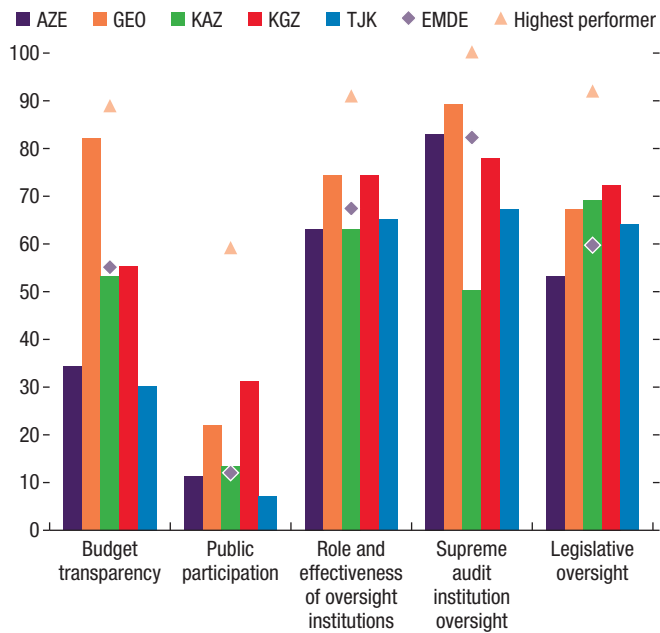
- *Transparency*: (1) publish audit reports online; (2) produce and publish a citizens' budget;¹² and (3) publish a prebudget statement and a mid-

¹⁰For details, see IMF (2019c).

¹¹The Open Budget Survey (OBS) is an independent assessment of the three pillars of public budget accountability: transparency, oversight, and public participation. In the 2017 assessment, OBS evaluated 115 countries and assessed budget transparency based on the amount and timeliness of budget information publicly available.

¹²The citizens' budget is a simpler and less technical version of the government Executive's budget proposal or enacted budget, designed to convey key information to the public.

Figure 14. Open Budget Index, 2017
(Scale of 0–100, where 100 is better)



Sources: Open Budget Survey 2017; and IMF staff calculations.
Note: EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

year review in a timely manner, with detailed information on macro-fiscal projections.

- *Execution:* (1) provide details on expenditures by administrative units and programs; and (2) increase monitoring on budget execution with respect to the approved budget.
- *Accountability:* Provide more information on macroeconomic forecasts, outcomes, policy actions, and the financial position of the government in the year-end report and the Executive’s budget.

CCA countries should provide opportunities for public engagement in the budget process. They can take the following actions:

- Set up pilot mechanisms for members of the public and the executive branch to exchange views on national budget matters,

both during the budget formulation and implementation.

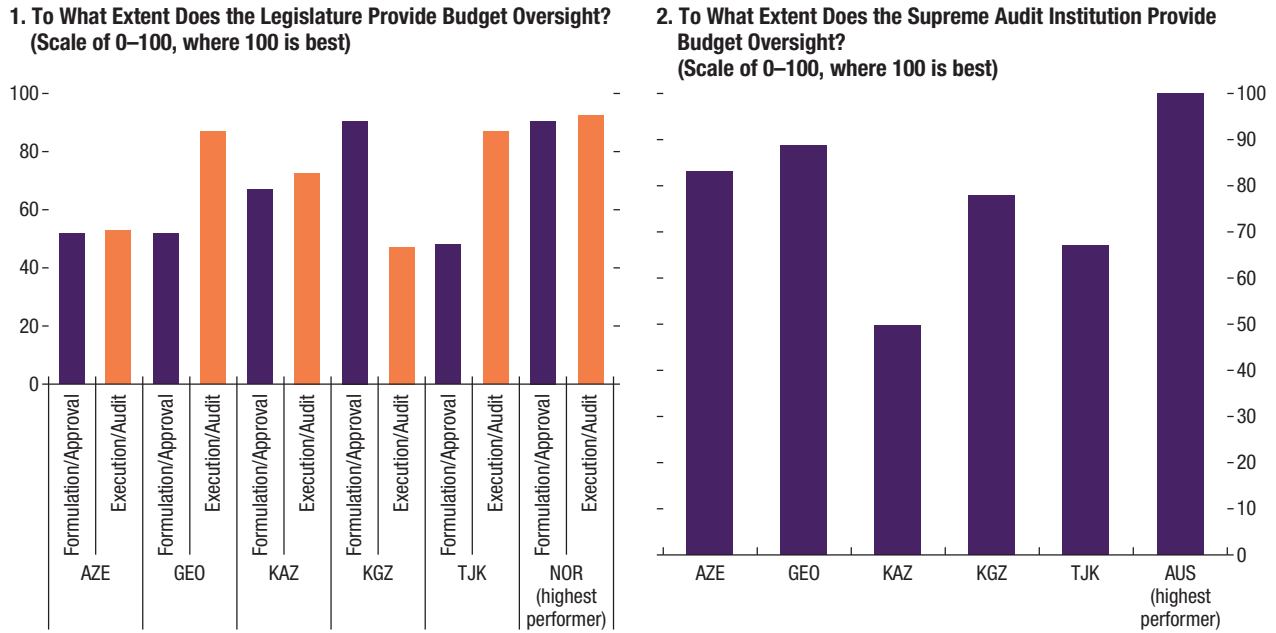
- Establish formal mechanisms and hold legislative hearings on the formulation of the annual budget and the audit report, during which members of the public or civil society organizations can participate and maintain public relations offices to answer questions.

Accountability and budget oversight, while broadly adequate, could improve. Oversight functions are generally adequately funded and split between the legislature and the audit institution (Figure 15).¹³ CCA countries should prioritize the following actions to make budget oversight more effective:

- Provide legislators the budget proposal before the start of the budget year, so the legislature (1) holds a debate on budget policies prior to the submission of the Executive’s budget proposal and (2) approves recommendations for the forthcoming budget.

¹³The exceptions are Azerbaijan, where the legislature’s role during the budget planning stage and the implementation is limited, and Kazakhstan, where the head of the audit institution can be removed without judicial approval, undermining institutional independence.

Figure 15. Budget Oversight by Legislature and Audit



Sources: Open Budget Survey 2017; and IMF staff calculations.
 Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

- The budget committee publishes online the audit report and the in-year budget implementation analysis.
- The audit institution has adequate funding to perform its duties, and audit processes are reviewed by an independent agency (for example, Parliament), whose chief is nominated with legislative approval and who can be dismissed only by a judicial decision.

Box 1. Policy Actions to Raise Revenues

CCA countries can take a broad range of measures to raise revenue in a growth-friendly way. The following list includes actions the countries mentioned have already taken.

- *Simplify the value-added tax (VAT).* There should be fewer rates (ideally a single rate, for example, the Kyrgyz Republic) and a broader base (reduce exemptions).
- *Broaden the tax base by rationalizing exemptions.* Move large agrobusinesses (Armenia), higher education and medical services (Armenia), and special economic zones (Azerbaijan, Kazakhstan) to the regular tax system in which they pay taxes on income and VAT. Review taxation of free economic zone firms by targeting tax incentives on investment and employment rather than on profitability, limiting tax preferences to indirect taxes but not to direct (profit taxes).
- *Increase revenue productivity of excise taxes.* Limit excises to a selected list of products while improving its targeting for cellular airtime and gambling (Armenia), besides the usual taxes for tobacco and beverages (the Kyrgyz Republic). Increase the excise on petroleum products (Georgia, the Kyrgyz Republic).
- *Eliminate broad-based turnover tax on all businesses.*
- *Simplify corporate taxation by eliminating multiple rate structures at the firm level.*
- *Simplify taxation of small businesses through flat rates,* with two regimes for small and microbusiness: a patent system for microbusinesses and a presumptive tax based on turnover for small business, including for small farmers (Armenia, Georgia).
- *Reform taxation of mineral resources* in conformity with best international practices to capture a fair share of the rent for the budget.
- *Diversify revenue collection* for oil and gas exporters.
- *Improve the progressivity of personal taxation* by raising the threshold for exempt income and introduce graduated rates (Armenia).
- *Tax capital income (Armenia).* *Enhance property taxation with a modern and simplified system* that focuses on the taxable asset (land and property) instead of on income and rate graduation. Substitute the current system with an appropriate value threshold to protect the poor (Georgia) and by aligning cadastral value more closely with market levels to increase revenue productivity (the Kyrgyz Republic).
- *Revamp the tax and customs administration*—including through strengthening large taxpayer units and introducing risk-based compliance systems—which must accompany the changes in tax policy (Georgia, the Kyrgyz Republic).

Supporting Financial Inclusion

“A better financial sector is more important than ever to help deliver on what our 21st century so badly needs: higher employment, greener growth, and good living standards for all.”

—Christine Lagarde, IMF Managing Director

Greater financial inclusion can contribute to inclusive growth. Financial inclusion—access to and use of formal financial services—starts with households and enterprises obtaining a deposit or transaction account at a financial institution or a mobile account through a money service provider, and using it for payments and savings.¹ Coupled with financial literacy, financial inclusion helps people invest in business and education, build up capital, smooth consumption, and manage financial risks. Financial inclusion can stimulate entrepreneurship, private sector development, and economy-wide growth and productivity (Demirguc-Kunt, Klappner, and Singer 2017). Better household financial inclusion, especially among women, can also lower income inequality.²

Financial inclusion must be supported by a sound financial sector under adequate regulation and supervision. Efforts to improve financial inclusion should be accompanied by competition among financial service providers, strengthened payment infrastructure, and improved financial regulation and supervision. The latter should focus on risk-based and consolidated supervision, implementing macroprudential frameworks, and improving credit risk valuation.³ Moreover, tailoring financial services to new segments of the population requires upgrading supervisory capacity, developing well-functioning payment systems, and improving transparency in credit information.

¹See Sahay and others (2015) for details.

²For instance, see IMF (2015b, 2015c) and Sahay and others (forthcoming).

³For more discussion on building resilient financial sectors in the CCA, see IMF (2018d).

Financial Inclusion in the CCA

CCA countries lag peers in household financial inclusion. According to the Global Financial Inclusion database, only 45 percent of adults in CCA countries had an account at a financial institution or through a mobile money provider in 2017, almost 20 percentage points lower than the emerging and developing Europe average. Mobile money accounts (at 3 percent) contribute only marginally—lower than in several developing economies in Africa and Asia—despite elevated mobile phone ownership (ranging from 71 percent in Tajikistan to 92 percent in Azerbaijan). This is likely due to several factors, including unstable mobile connections and prevalence of prepaid practices. Moreover, borrowing remains largely informal—only 17 percent out of 40 percent of borrowers in 2017 did so formally, although the share of formal borrowing is higher in Armenia, Georgia, and Kazakhstan.

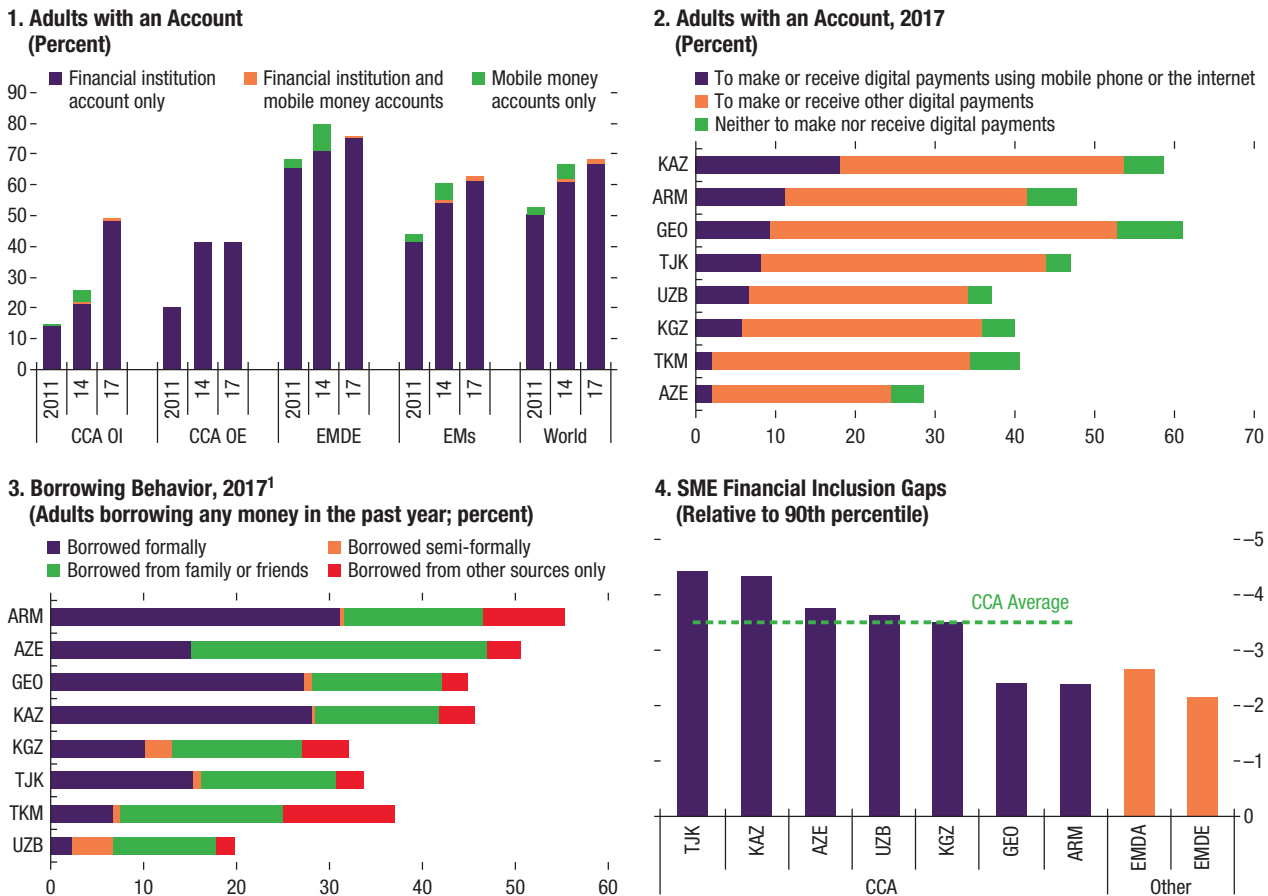
Women and, especially, the poor are less financially included. On average, 47 percent of men had a bank account in 2017; 43 percent of women did. The gender gap in account ownership, though half that of emerging market economies, has doubled since 2014. Georgia and Kazakhstan report consistently higher female account ownership. There is a more substantial gap between the poor and the well-off. In 2017, fewer than one-third of the poorest households had a bank account, compared with more than half in the richest 60 percent of households.⁴ The gap widened in 2011–17 (by 8 percentage points), compared with a narrowing of the gap in emerging and developing Europe (by 6 percentage points).

Similarly, businesses, especially small and medium enterprises, are less financially included. Indeed, even though small and medium enterprises account for 97 percent of firms and generate 45 percent of employment in CCA countries, they make up less than 7 percent of credit to the economy. The share of investment and working capital financed by banks in the CCA region is, on average, 2–3 percentage points lower than the emerging and developing Europe average. Though many firms seem to have bank accounts, not as many have access to bank credit (25 percent versus 31 percent in emerging and developing Europe). According to a composite index built on these access and usage indicators,⁵ CCA countries show a sizable negative gap, on par with the Middle East, North Africa, Afghanistan, and Pakistan and sub-Saharan African regions, the regions with the largest gaps in finan-

⁴Account ownership in emerging Europe is almost 80 percent; hence even well-off households in the CCA region need to catch up with their peers.

⁵Since banks remain the key players in financial sectors around the world, the financial inclusion index is constructed with respect to financial services provided by banks. Financial inclusion gaps are defined with respect to best performers. For more details about the construction of the small and medium enterprise financial inclusion index and the gap analysis, see Annexes 1 and 2 of IMF (2019b).

Figure 16. Household and Small and Medium Enterprise Financial Inclusion Indicators



Source: Global Findex Database 2017; World Bank, Enterprise Survey; and IMF staff estimates and calculations.
 Note: CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMs = emerging markets; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.
¹People may borrow from multiple sources, but categories are constructed to be mutually exclusive. "Borrowed formally" comprises all adults who borrowed any money from a financial institution or using a credit card. "Borrowed semi-formally" includes all adults who borrowed any money semi-formally (from a savings club) but not formally. "Borrowed from family or friends" excludes adults who borrowed formally or semi-formally.

cial inclusion. Nonetheless, among CCA countries, Georgia and Armenia do relatively well (Figure 16).

Low financial inclusion in CCA countries stems from several factors.

- **Households:** According to the Global Financial Inclusion database, the unbanked have too little money (46 percent of respondents), lack documentation (25 percent), or have family members with a bank account (23 percent). Lack of trust and cost also limit financial inclusion. Only 13 percent of the unbanked said the financial institutions are too far away.

Religious considerations are reported by 6 percent of the unbanked—higher in the Kyrgyz Republic (11 percent) and Tajikistan (16 percent), suggesting a need to further develop Islamic banking.⁶

- Small and medium enterprises: Lack of information to assess credit risk is a key obstacle to small and medium enterprises' access to formal financing: they usually have a vague credit history or none at all and limited assets to use as collateral. Lack of information results in high collateral requirements (in Armenia, Azerbaijan, and Georgia more than 200 percent of the loan amount) and large interest rate spreads (10 percent and higher in the Kyrgyz Republic and Tajikistan, respectively). Concerns about governance and the business environment also play a role (see Chapter 5). High dollarization could also block small and medium enterprises from financial inclusion, although empirical evidence is not conclusive.⁷

Greater financial inclusion would benefit growth, create more jobs, and enhance the effectiveness of macro policies.⁸

- Economic growth: Closing the small and medium enterprise financial inclusion gap vis-à-vis emerging and developing European countries would raise growth by 0.3 percentage points (Figure 17, Macro-Level Analysis). Removing constraints to the financial inclusion of small and medium enterprises leads to higher economic activity (Figure 17, DSGE simulation).⁹
- Job creation: Access to formal financial services is positively related to employment growth, and the impact is stronger for smaller firms (Figure 17, Firm-Level Analysis). Better access to financial services tends to be associated with higher labor productivity.
- Inequality: The impact on inequality depends on the specific constraint being addressed (Figure 17, bottom two panels). For example, easing participation barriers could lead to more equal income distribution, while relaxing collateral requirements could intensify income inequality.¹⁰

⁶For a discussion of Islamic banking, see IMF (2017b).

⁷See, for instance, Bannister, Gardberg, and Turunen (2018), which does not find a statistically significant relationship between dollarization and financial inclusion (measured by account ownership) using cross-country macro data.

⁸Cross-country empirical analysis uses the small and medium enterprise financial inclusion index. Firm-level analysis is based on World Bank Enterprise Survey data. Details can be found in Annexes 3–6 of IMF (2019b).

⁹Based on country-specific analysis from a dynamic stochastic general equilibrium (DSGE) model simulation. See Dabla-Norris and others (2015) for the detailed DSGE modeling. Calibration details can be found in Annex 5 of IMF (2019b). Results shown in Figure 16 are likely to illustrate the upper bound of the actual benefits of improving small and medium enterprise financial inclusion as the simulations make highly ambitious assumptions about the removal of financial frictions.

¹⁰However, such results are highly sensitive to specific modeling and calibration and may not be generalized without further scrutiny into the channels at play.

Figure 17. Impact of Small and Medium Enterprise Financial Inclusion on GDP, Employment, and Inequality



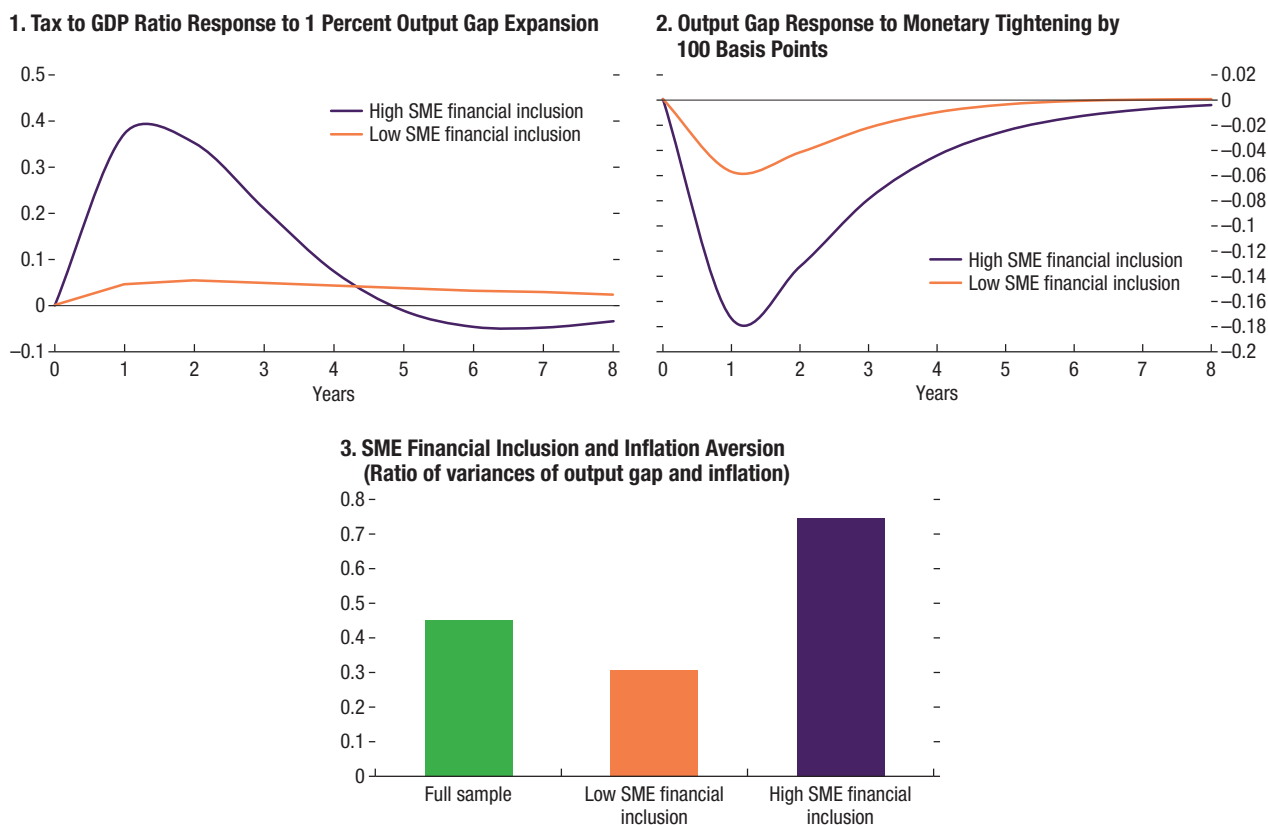
Source: Haver Analytics; World Bank, Enterprise Surveys; and IMF staff calculations.

Note: DSGE = dynamic stochastic general equilibrium; SMEs = small and medium enterprises. Data labels in the figure use International Organization for Standardization (ISO) country codes.

¹Details on the estimates can be found in Annex 5 of IMF (2019b).

²The bars illustrate the changes in GDP/Gini relative to the steady states calibrated according to the 2013 enterprise survey (the latest available firm-level information). Participation costs of 0 in most countries correspond to 100 percent of firms having access to bank credit. Minimum collateral corresponds to a loan-collateral value of 100 percent.

Figure 18. SME Financial Inclusion and Macroeconomic Policy Effectiveness



Sources: Haver Analytics; World Bank, Enterprise Surveys; and IMF staff calculations.

- Macroeconomic policy effectiveness: Greater financial inclusion of small and medium enterprises is associated with more responsiveness to fiscal and monetary policies and lower central bank risk aversion toward inflation (Figure 18).¹¹ It could also help broaden the tax base and improve revenue collection as more businesses operate formally (Chapter 3).

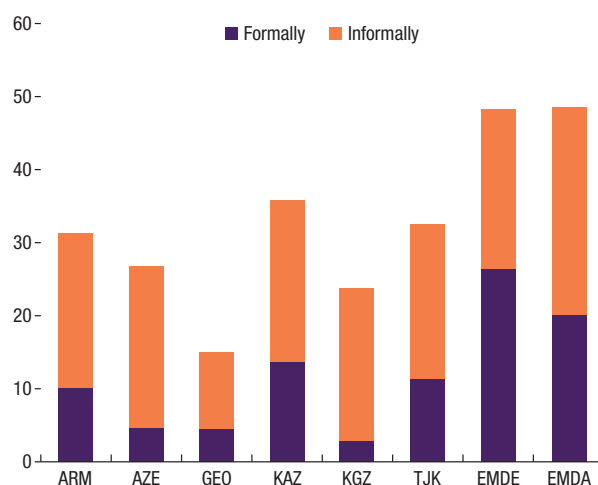
Policy Recommendations

Greater financial inclusion requires removing structural obstacles, with public intervention aimed at creating an enabling environment for the private sector. This involves, on the one hand, ensuring financial stability to foster the population’s trust in the financial sector and, on the other hand, mitigating constraints, such as credit information availability, the lack of a well-functioning payment system, and a weak investment climate and governance. Policies

¹¹High and low small and medium enterprise financial inclusion groups are countries in the top and bottom quartiles according to the small and medium enterprise financial inclusion index.

such as targeted lending by state banks, interest rate regulations, and credit guarantees can boost lending to the underserved only in the short run, at the expense of distorting markets and hampering the long-term development of the financial market, while generating fiscal or quasi-fiscal costs and risks. Policies should instead focus on creating conditions for private sector development, with the aim of creating a competitive financial sector with market-driven credit allocation.

Figure 19. Adults Saving by Method Used, 2017¹
(Percent)



Sources: The Global Findex database 2017; IMF staff estimates.

Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

¹Average calculated by regions with all the country data points available in The Global Findex database 2017. Formal savings are saved at financial institutions.

Financial literacy is essential to boosting demand for financial services. Georgia and the Kyrgyz Republic have already started educational programs to promote financial literacy (Figure 19). Other reforms may include creating credit reporting systems, regulating electronic payments, and adopting new technologies to reduce costs and diversify financial products.

Reducing informality, encouraging use of accounts, and leveraging digital payments would also boost household financial inclusion.

- *Promoting formality*: Only one-fifth of adults received at least one wage payment from a private employer. Informal jobs hinder households' regular income and dampen their demand for formal financial services for savings and consumption. Therefore, policies toward financial inclusion should be integrated into a broader strategy to reduce informality. More specifically, the authorities also need to reform the tax systems to make them more business-friendly (Chapter 3), reduce red tape, and more generally improve the business climate (Chapter 5).
- *Encouraging electronic payments*: Most payments for agricultural products are made in cash, and fewer than half of regular payments for utilities are made from an account. The share of adults having made at least one financial transaction using a mobile phone or the internet remains well below

that in developing economies (8 versus 19 percent). Therefore, the authorities need to develop and improve the infrastructure for electronic payments and mobile and internet service quality, and continue financial education to disseminate the benefits of making routine payments electronically.

Enhancing financial sector governance and the business environment, credit information, and financial regulation and supervision would also facilitate financial inclusion, especially for small and medium enterprises.

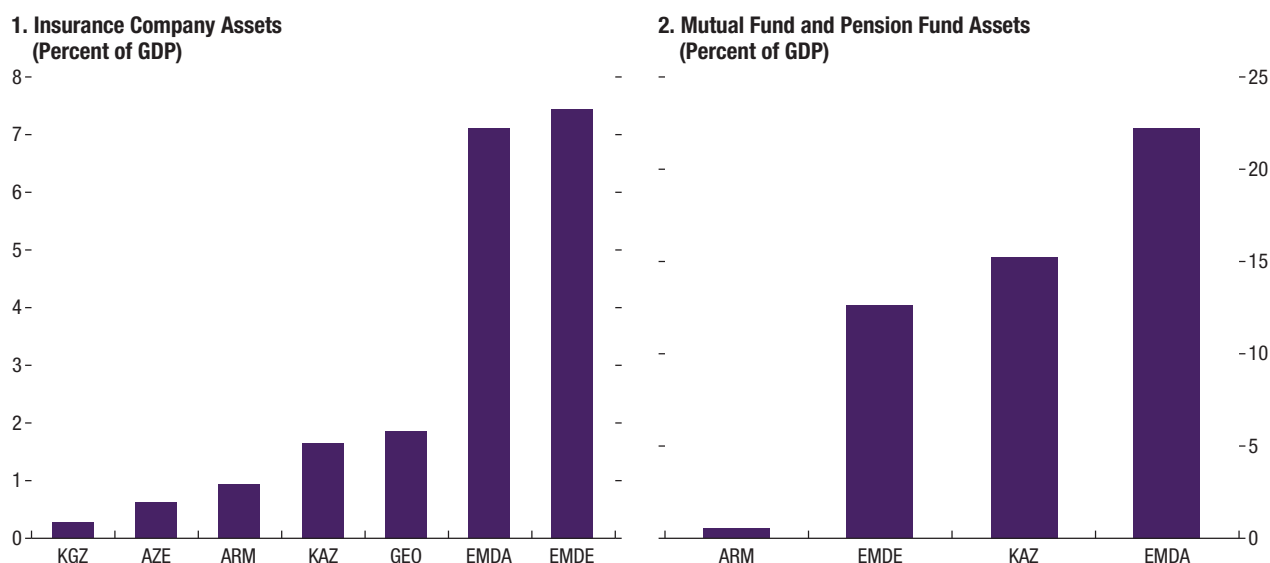
- **Business environment and governance:** Policymakers have taken actions to strengthen the legal rights of borrowers and lenders (Azerbaijan by introducing a functional and secured transaction system); facilitate contract enforcement (Kazakhstan by expanding court automation); strengthen the insolvency framework (Kyrgyz Republic and Georgia); and easing the tax burden (Azerbaijan by introducing an enhanced electronic system for paying taxes and Georgia and Uzbekistan by reforming tax laws). Efforts should continue to fight corruption, promote public sector transparency, and enhance corporate governance at the firm level.¹²
- **Credit information:** Easing access to credit information requires multiple steps. Small and medium enterprises should work to improve financial accounting and reporting and governance, while credit registries and bureaus should expand coverage. It is also important to overcome collateral constraints. For example, Azerbaijan created a unified collateral registry for movable property and expanded the range of movable assets eligible for collateral; Georgia has incorporated credit bureaus under the supervision of the central bank, moving toward a unified registry.
- **Creating room for small and medium enterprise financing:** Capital markets, though at an early stage of development (Figure 20), could help mobilize savings and diversify funding sources for larger firms, thereby creating room for traditional bank financing for small and medium enterprises. More innovative solutions targeting small and medium enterprises and start-ups have also been piloted in other countries, such as venture capital, small and medium loan securitization, and equity trading systems specific to small and medium enterprises. Some of these could be of interest to CCA policymakers.

New technologies (fintech) can ease access to finance. Fintech can offer a more competitive process for small transactions; enable alternative financing sources through peer-to-peer lending or crowdfunding; and ease credit information constraints via new methods to gather and process micro data, build credit history, and produce real-time credit scores. Such innovations are already supporting small and medium enterprise financing globally and have potential for the CCA region.¹³ Some countries in the region have already

¹²See World Bank (2019a).

¹³For a more detailed discussion, see IMF (2019b).

Figure 20. Capital Markets in the CCA Region



Sources: World Bank, FinStats 2018; and IMF staff estimates.

Note: EMDA = emerging and developing Asia; EMDE = emerging and developing Europe. Data labels in the figure use International Organization for Standardization (ISO) country codes.

taken steps. For example, in Azerbaijan data processing centers and mobile network operators help expand cashless payments for the rural population. In Georgia, one bank has enabled its customers to make quick, convenient, and safe payments with mobile phones. While the benefits of the opportunities offered by fintech are evident, it can pose risks to financial stability and hamper consumer and investor protection. This calls for establishing a proper regulatory and supervisory framework.¹⁴

Efforts to promote financial inclusion need to be accompanied by policies to strengthen financial stability. Authorities with distressed financial institutions should continue their efforts to restore financial stability. Special attention should be paid to related-party lending, a significant risk for banks in CCA countries. In Kazakhstan, the authorities envision addressing existing banking problems and strengthening its competitive position, including by consolidating and increasing capitalization; improving bank liquidity management; advancing a risk-based approach in financial regulation and supervision; and increasing financial literacy. In Georgia, the central bank has strengthened capital requirements and prudential regulation to reduce dollarization, tightened lending standards, and expanded financial oversight to nonbank financial institutions.

¹⁴See IMF (2018e) for details.

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Strengthening Governance and the Business Environment

In addition to reorienting fiscal policy to invest in people and infrastructure and promoting financial inclusion, policymakers need to actively promote private sector development. This will require improving governance and the business climate, including through reforms to strengthen judicial and legal institutions and property rights, support fair competition, streamline bureaucracy, and promote innovation.

The business environment in the CCA has improved over the past decade. On average, the region fares better in many areas than the global mean, except for access to electricity and streamlined processes to pay taxes. For instance, in Georgia, it takes two days and one procedure to register a business. Armenia managed to reduce the number of days to start a business from 105 in 2004 to 4½ in 2018.

But further improvements are needed to lift productivity growth and the share of the private sector in the economy. The most problematic factors for doing business in the CCA are access to financial services, overregulation, lack of macroeconomic stability, weak governance (corruption), and inadequate labor force skills. The CCA region lags emerging Europe in the Global Competitiveness Index and has a long way to go to fill the gap with advanced economies. To illustrate, implementing reforms that would raise competitiveness by 1 percentage point would raise productivity growth 1.4 percentage points on average in emerging market economies (IMF 2016).¹

Improving the business climate will help enhance competitiveness and attract private investment, including foreign direct investment. Specific policy actions should focus on the following:

- Adapting the labor force to new skills: Governments need to prepare the labor force, particularly the young, for new business and labor market

Table 3. Development and Inclusion Gaps

	Education	Labor Markets	Business Skills
Armenia	Medium	Medium	Large
Azerbaijan	Small	Large	Large
Georgia	Small	Medium	Large
Kazakhstan	Medium	Small	Large
Kyrgyz Republic	Small	Large	Large
Tajikistan	Small	Large	Large
Turkmenistan	N/A	N/A	Large
Uzbekistan	Medium	Small	Large

Source: EBRD Transition Report, 2016–17.

opportunities. In addition to addressing shortcomings in the education system, the school-to-work transition, vocational education, and job-related training are not adequate (Chapter 3). This is reflected in large labor market and business mismatches (Table 3). With high youth and rural unemployment, and employment concentrated in a low-productivity agricultural sector, it will be important for governments to ensure the development of skills increasingly in demand in the global labor market (for example, skills in information technology and critical thinking).¹ Efforts in some countries (for example, Tajikistan) have focused on improving prospects for migrant workers to maintain access to external markets. Labor market regulation could be improved in several countries to support flexibility and protection.

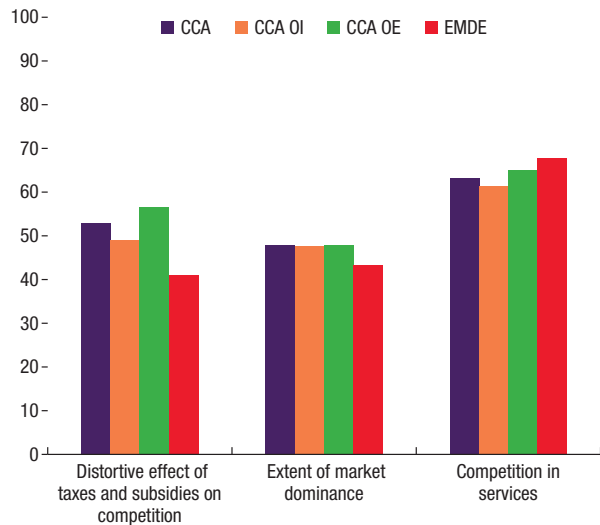
- Enhancing skill and technological transfers and innovation: Putting in place policies that improve macroeconomic stability, business confidence, and public-private partnership frameworks can help attract foreign direct investment to the region, especially to address significant infrastructure and energy gaps. In turn, countries in the CCA will benefit from technology and skill transfers that would ease economic diversification efforts. In this direction, Georgia approved a new public-private partnership framework in 2017 that needs to become operational.

Improving governance and tackling corruption will support inclusiveness. While CCA countries have made progress in improving governance, they still lag in governance compared with the average emerging market and developing economy. The perception of corruption is high; the control of corruption, accountability, and the rule of law are weak. Further progress would support inclusiveness. Strong governance can encourage trade, investment, and entrepreneurship, which in turn, would create jobs and raise income levels. While measures would differ from country to country, these are the priority actions:

¹For example, in Azerbaijan, the agricultural sector is the largest employer, absorbing about 37 percent of the workforce, but constitutes only 5 percent of GDP. The mining sector on the other hand contributes 40 percent of GDP, but employs only 1 percent of the population.

- Strengthening judicial and legal institutions and property rights and administration: The CCA region scores low in terms of the incidence of corruption, judicial independence, and efficiency of the legal framework in settling disputes. There is also scope to improve property rights and intellectual property, corporate governance, and the quality of land administration. Improving accounting, auditing, and reporting standards will help promote access to financial services.

Figure 21. Product Market
(Score of 0–100, where 100 is best)

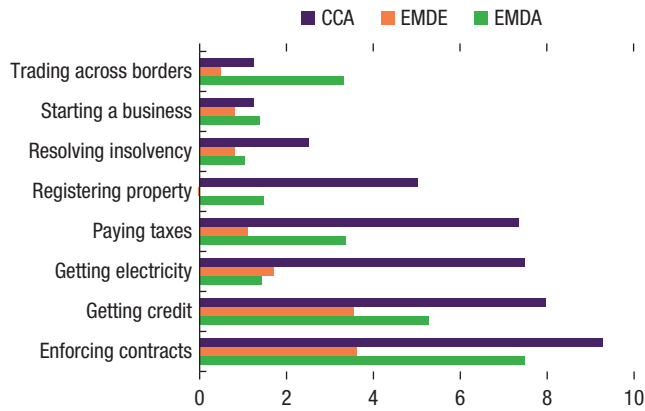


Sources: WEF Global Competitiveness Index; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMDE = emerging and developing Europe.

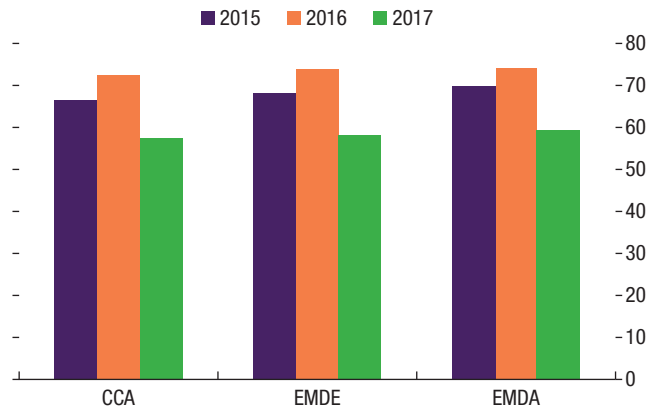
- Enhancing competition: CCA countries do better in terms of competition in the service sectors, but actions are needed to enhance competition and reduce market dominance (Figure 21). These include (1) establishing and enforcing a well-designed competition framework, (2) deregulating and liberalizing product and service markets, (3) promoting trade, (4) supporting entry and exit of firms and firm growth in a competitive setting, and (5) reducing tax distortions on competition.
- Improving business dynamism and innovation: Strengthening the insolvency framework and innovation would enhance business dynamism. In innovation, the CCA will benefit from research and development, developing industry clusters, and partnering with international companies (Figures 22 and 23).

Figure 22. Ease of Doing Business, Competitiveness, and Governance

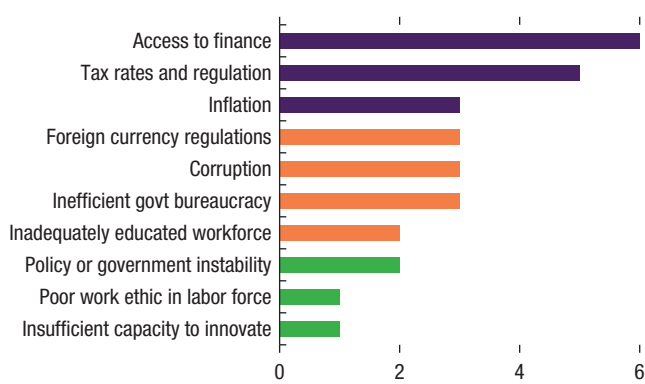
1. Ease of Doing Business Indicators
(Change in score, 2015–18)



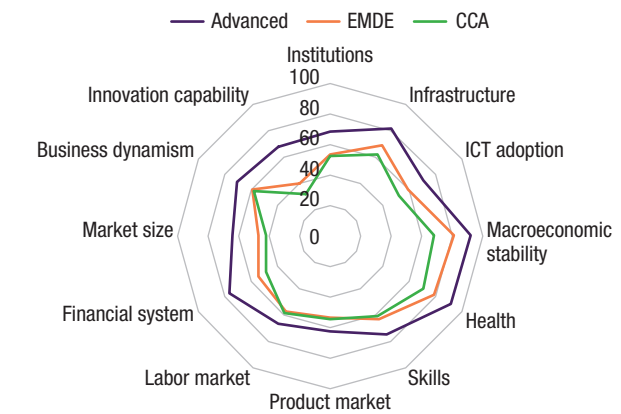
2. Ease of Doing Business: Distance to Frontier
(0 = lowest performance to 100 = frontier)



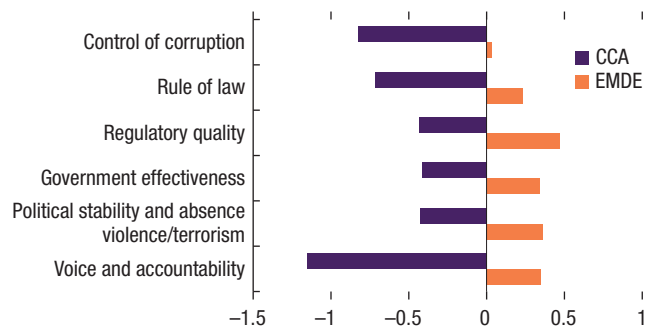
3. Challenges to Doing Business in CCA
(Number of countries identifying the constraint among the top five)



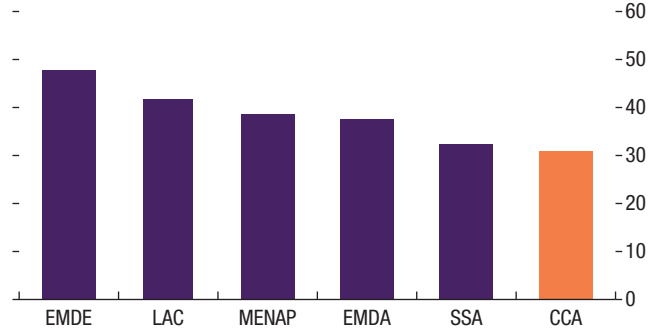
4. Global Competitiveness Index
(0–100, where 100 is best)



5. Governance Indicators, 2017
(In units of a standard normal distribution)



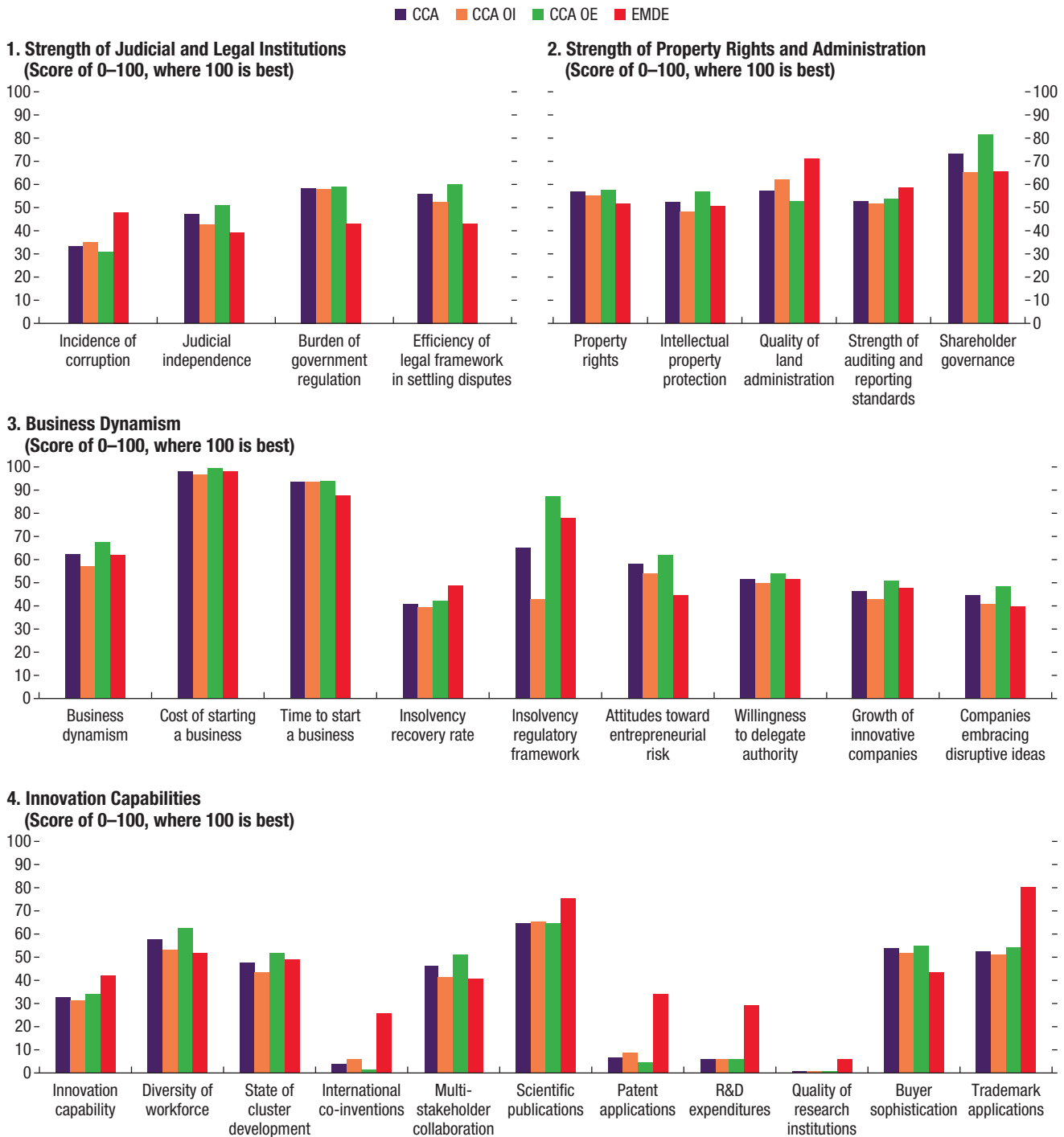
6. Corruption Perception Index
(Lower score indicates high perceived level of public corruption)



Sources: Transparency International; World Bank, *Ease of Doing Business*; World Bank, *Worldwide Governance Indicators*; World Economic Forum, *Global Competitive Report*; and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe; LAC = Latin America and the Caribbean; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SSA = sub-Saharan Africa.

Figure 23. Institutions, Competition, and Innovation



Sources: World Economic Forum, Global Competitiveness Index; and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; EMDE = emerging and developing Europe.

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Concluding Remarks

Making growth more inclusive requires difficult, but doable, policy steps. While much has been achieved in reducing poverty, inequality, and unemployment, renewed efforts are needed as the region's growth prospects are subdued, reflecting global headwinds, weaker productivity growth, and aging population. While the agenda is broad and ambitious, we hope this paper has provided useful recommendations to help policymakers guide the journey to a future of prosperity and inclusion for all people in the region.

Implementing the inclusive growth agenda is a shared responsibility. While international financial institutions can assist countries, they need to do so in partnership with country authorities and the private sector. This would ensure policies are better tailored to country-specific needs. Working in tandem with other stakeholders would better leverage respective expertise and ensure synergy and complementarity to improve the design and implementation of reforms. Firms and civil society also need to do their part, not only for private sector development and to ensure accountability, but also to work collectively with policymakers to propose and design solutions that can drive economic prosperity for all.

At the IMF, our efforts will continue to focus on supporting countries to implement policies that generate opportunities for all. Building on cross-country experiences and analytical work, we have already made efforts to deepen policy diagnosis and capacity building in the IMF's core areas of expertise to reflect the key components of this agenda. For example, Article IV consultations have covered issues such as women's economic role, education, inequality, and governance in countries in the CCA region. In IMF-supported programs initiatives to address inclusive growth challenges included higher social spending, and support for structural reforms that increase economic resilience to external shocks and medium-term potential growth.

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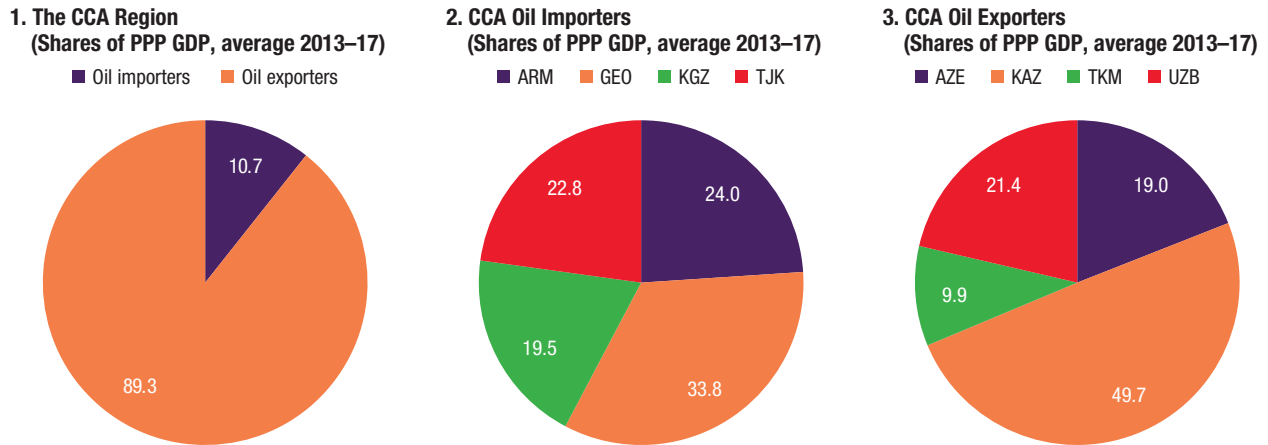
Annex 1. The CCA Region and Peer Comparisons

The CCA region consists of two distinct subgroups. It is customary to distinguish between oil (and gas) *exporters* (Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan) and *importers* (Armenia, Georgia, the Kyrgyz Republic, Tajikistan). The four oil-exporting economies are about seven times larger than the four oil-importing economies (Annex Figure 1.1). The composition importing economies are of similar size, while among oil exporters Kazakhstan's is by far the largest economy.

Choice of peers: This paper relies primarily on two peer groups for comparison to place CCA developments in a global context: emerging and developing Europe and emerging and developing Asia. Emerging and developing Europe, as defined by the European Bank for Reconstruction and Development, comprises, where data are available: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, North Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, the Slovak Republic, Slovenia, and Ukraine. Emerging and developing Asia comprises 30 countries as documented in the *World Economic Outlook* Statistical Appendix.¹ When analyzing efficiency in health and education spending and outcomes, the Organisation for Economic Co-operation and Development is used as a reference group as countries in this group are often considered in studies to be the benchmark for progress (Annex Figure 1.2).

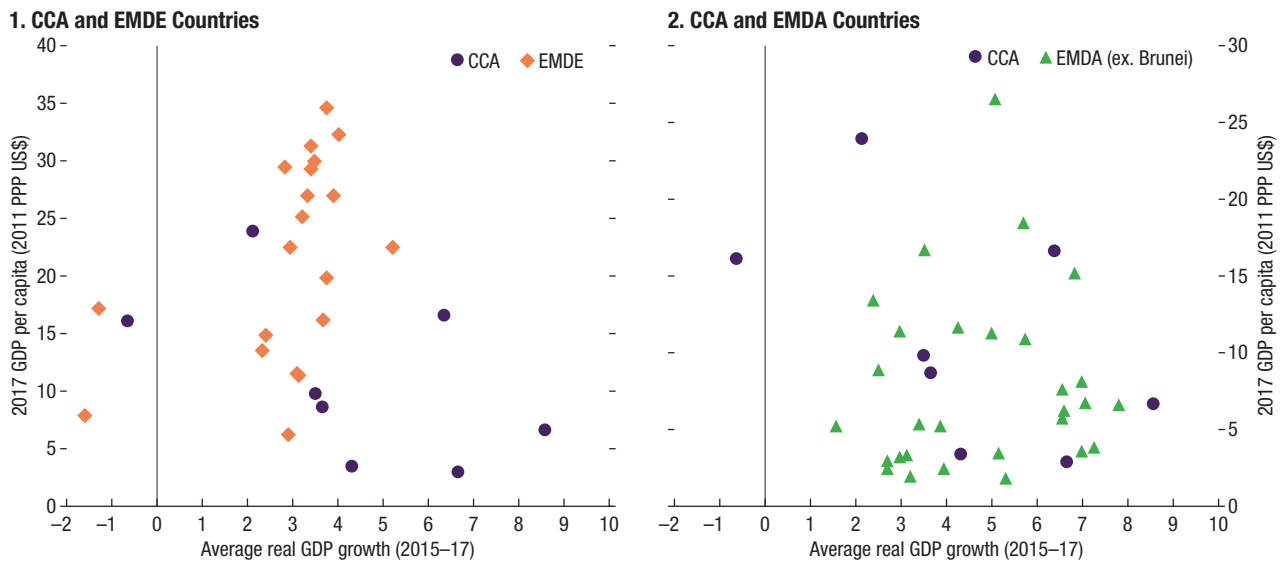
¹<https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018>

Annex Figure 1.1. Composition of CCA Region by PPP GDP



Source: *World Economic Outlook*.
 Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

Annex Figure 1.2. CCA and Choice of Peers: Growth and GDP per Capita



Source: *World Economic Outlook*.
 Note: CCA = Caucasus and Central Asia; EMDA = emerging and developing Asia; EMDE = emerging and developing Europe.

Annex 2. Inclusive Growth Strategies in CCA Countries

Country	Summary	Source
Armenia	The government program emphasizes protecting human rights and creating favorable conditions for people to live a life with dignity and happiness. The inclusive growth agenda highlights job creation and poverty reduction, improving public education and social security, and protecting the environment.	Government Program of the Republic of Armenia of 2019
Azerbaijan	The program aims at economic diversification and developing Azerbaijan into a globally competitive player, creating opportunities for investment, particularly from the private sector. It envisages improvements in efficiency and transparency of public services.	Azerbaijan 2020—Turning Strength into Sustainability
Georgia	The inclusive growth agenda emphasizes improving education, supporting youth activities, improving human rights, democratic governance, and the rule of law. It envisages a small yet effective, efficient, and flexible government that empowers local self-government and regional development.	Freedom, rapid Development and Welfare—Government Program for 2018–2020
Kazakhstan	Inclusive growth is a key objective for the development plan. The government emphasizes accessible and inclusive education, as well as more inclusive social protection. The government also aims to lower barriers to private sector development and expand available financing by increasing the credit-to-GDP ratio and developing alternative financing sources.	Strategic Development Plan of the Republic of Kazakhstan until 2025
Kyrgyz Republic	The inclusive growth strategy aims at improving the quality and standard of living with emphasis on human capacity development. Consistent with inclusive growth, the economic policy focuses on providing employment and stable income and creating productive jobs, supported by governance reforms.	National Development Strategy of the Kyrgyz Republic
Tajikistan	The goal of the long-term development plan is to improve the standards of living of the population based on sustainable economic development, with the objective to ensure food security and people's access to good-quality nutrition and to expand productive employment. The development strategy incorporates the United Nations Sustainable Development Goals, with an emphasis on human development, including education, health care, employment equality, combating corruption, food security and nutrition, governance, social welfare, prevention of conflicts, energy security, environmental protection, and management of demographic processes.	National Development Strategy for The Period up to 2030
Turkmenistan	The authorities attach great importance to social development and align the national economic strategy with social developments and achieving the United Nations Sustainable Development Goals. The strategy focuses on social spending, modernizing the education and health systems, and adopting information technology and the digital economy.	Turkmenistan is on the Way to Achieving the Sustainable Development Goals
Uzbekistan	The authorities have prioritized increasing real income and employment; improving education, social security and health care; and creating more opportunities for women and youth. Targeted programs to build affordable housing, development and modernization of road transport, engineering, communication, and social infrastructure will be implemented to ensure the improvement of living conditions of the population.	Uzbekistan's Development Strategy for 2017–2021

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