



Recommendations for Improving the Kyrgyz Business Climate in 2006

In compiling this list of ten proposed changes to Kyrgyz law, we have strived to make our suggestions specific, measurable, and realistic. As a result of these guiding principles, we have chosen not to include some worthy but impracticable measures that have been proposed by other organizations. In discussions with our members and independent experts we have determined that the main obstacles to Kyrgyz economic development relate to the following:

- 1. Unpredictable Enforcement of the Law and Preexisting Agreements**
- 2. Endemic Corruption**
- 3. Lack of Independent and Effective Judiciary**
- 4. Excessive Tax and Regulatory Compliance Burden**
- 5. Obstructions to International Trade**

Not all of these problems are easily solved by the implementation of new laws, especially in a country where arbitrary legal enforcement is one of the main barriers to economic growth. For this reason, the changes we advocate in the following brief are designed to remedy specific problems that we believe are appropriate for implementation during 2006, and the cumulative of which would bring this country from the depths of stoneage poverty.



Inspections and Licensing

Proposal #1: Inspections

Background: businesses report frequent, expensive, and unprofessional inspections by various government agencies to be one of the main barriers to successful operation in the Kyrgyz Republic. Currently, inspectors have the power to issue bogus citations and collect fines on the spot, and it is commonly held that inspections are seen as a way of raising money instead of a way of preventing infractions of the law. Additionally, due to excessive corruption amongst inspectors and inspection agencies, only a fraction of the money raised by the inspection process ever finds its way into government coffers.

Proposal: we recommend that the Jorgurku Kenesh pass the "Amendments to the Law on the Procedures for Inspections of Business Entities by Authorized Bodies." The law defines the purpose of inspections as simply the prevention of infractions. Its most useful feature is a provision whereby during initial inspections, inspectors are permitted to collect no fines, but merely issue notifications of infractions. Upon receipt of a notification, a business then has between 3 and 30 days (depending on the seriousness of the infraction) in which to come into compliance. If the business does in fact rectify the violations, then it avoids paying any penalty or fine.

Proposal #2: Licensing

Background: the 1997 "Law on Licensing" set basically appropriate conditions for the issuance of licenses for business in the Kyrgyz Republic. However, since that time, more than 50 laws have been passed that contradict or violate that law, thereby introducing dozens of sector-specific licenses. In addition to licenses, businesses must receive a host of permits from multiple government agencies in order to do business in the Kyrgyz Republic. Most of these permits are not included in the published normative acts and are not controlled in any meaningful way.

Ministries and agencies of both the national and local governments have broad powers when it comes to permits and create them without any rigorous study or approval process.¹ Although the creation of new permits without their passage into law was supposedly halted by Official Decree #100, there is significant resistance to this new policy as these permits and licenses give corrupt officials opportunity for graft.

Proposal: we suggest that the Jogurku Kenesh adopt the "Amendments to the Law on Licensing" that were first proposed in October 2004 and have languished in parliament since. Developed in conjunction with Pragma and the private sector, these amendments would require that all licenses and permits must be officially passed as law and published before they can take effect, thereby eliminating the power rogue agencies have to devise extortionist permits.

¹ World Bank, January 2005: *Kyrgyz Republic Country Economic Memorandum*



Property Rights

Proposal #3: Land Ownership

Background: the Kyrgyz Republic's laws impacting land ownership and use rights, transactions, regulation, and markets in real property were developed in a fractured and incoherent manner. Each of the laws was drafted seemingly in isolation from other laws and the Civil Code. As a result, frequent conflicts between these laws and unanswered questions regarding things like municipal land governance, sale of state owned lands, zoning, takings and eminent domain, easements and servitudes, registration, and the role of disparate state agencies and ministries in the regulation and management of land issues have created a vast grey area in which corruption thrives. Additionally, the growing development and construction industries and the tens of thousands of skilled jobs these industries provide are placed in jeopardy by all of this ambiguity.

Proposal: we recommend that the Jogurku Kenesh adopt the Land Reform Package, commonly known as the "Green Book." This Land Reform Package has been sitting in parliament since autumn, 2004. Developed by a consortium of USAID projects, "The Green Book" represents a comprehensive, integrated proposal for harmonizing and improving a wide-ranging package of proposals for all key laws regarding land ownership and use. Passage of "The Green Book" laws will solidify real property rights and greatly stimulate real estate development in the Kyrgyz Republic.

Proposal #4: Pledge Law

Background: current pledge law in the Kyrgyz Republic overwhelmingly favors the borrower over the creditor in disputes over collection of collateral when borrowers have failed to repay loans. In most cases, it takes 6 to 10 months from the date of filing for the creditor to receive a decision from the courts regarding collection of the pledge.

Thanks to a loophole in Kyrgyz law, a borrower can avoid paying back his collateral if he refuses to sign a notice of collection or skips his court date. Additionally, just to file a claim in the first place the financial institution has to pay the court a nonrefundable fee equal to 10% of the disputed pledge, at which point the case can still be refused. These conditions go a long way to explaining why the cost of capital in the Kyrgyz Republic is so high.

Proposal: we recommend that the parliament develop and pass amendments to the Pledge Law facilitating the collection of collateral on defaulted loans. This will bring the rights of Kyrgyz creditors into line with those enjoyed by creditors in the developed world. A strong and fair Pledge Law would be good both for the financial sector of this country and for borrowers, who would enjoy much lower interest rates. This would spur both investment in the banking sector and investment by small businesses.



Taxation

Proposal #5: The Draft Tax Code

Background: the Jogurku Kenesh is currently considering a draft of the new Tax Code developed by the government taxation agency in cooperation with projects such as the IMF and Bearing Point. While this new tax code represents real progress in several areas, there is still work to be done to improve its operation within the framework of the laws of the Kyrgyz Republic. In a few places, the tax code either conflicts with or fails to recognize other key laws governing commercial activities. This places business in the unfortunate position of having to choose either to jeopardize the legal enforcement of their transactions or face onerous penalties under the tax regime.

Additionally, the new Tax Code as written plans to do away with the Kyrgyz Republic's progressive patent system, which has proved a boon to small business because it creates a simplified flat tax for SME's. The new draft tax code replaces the patent system with a new tax collection scheme which would require more interaction between SME's and the tax inspectorate. If SME's are required to meet all of the tax regulations under the new Tax Code, it will drive many of them back into the shadow economy.

Proposal: we recommend that the draft Tax Code be rewritten to take into account the recommendations of private sector tax experts such that it doesn't eliminate the effective patent system or conflict with current laws or with other policies we advocate here.

Specifically, the new Draft Tax Code as written would conflict with the "Amendments to the Law on Normative Legal Acts," the "Amendments to the Law on Licensing," the "Amendments to the Law on the Procedures for Inspections of Business Entities by Authorized Bodies," and the Law "On State Registration of Legal Entities, Branches or Representative Offices and Individual Entrepreneurs" (a law designed by Pragma to ease the process of registering a business).



Trade Competitiveness

Proposal #6: International Standards Acceptance

Background: instead of internationally accepted standards, the Kyrgyz Republic currently relies on the old Soviet System of Standards (GOST) for technical specifications and mandatory inspections of goods. This has two important implications: first, the standards followed by Kyrgyz industries are not compliant with those of international standards organizations, which means they are invalid in most other countries. Second, because local firms must demonstrate compliance with GOST standards through mandatory inspections and certifications, as opposed to market-oriented methods, production costs are significantly increased. Furthermore, these superfluous mandatory inspections create opportunities for graft.

Proposal: we recommend that the following changes be effected in the Kyrgyz Standards regime:

Standardization: Shift the burden of standards development out of government agencies (and other entities under substantial state control or direction) and into the hands of private sector bodies, especially those operating at the regional or international levels.

Accreditation: The government should promote both accreditation of Kyrgyz conformity assessment providers to international standards and the acceptance of international accreditation of conformity assessment procedures. Additionally, the Kyrgyz Republic should accept as valid all laboratory results of foreign conformity assessment providers that are accredited to international standards.

Conformity Assessment: Shift the burden of conducting testing out of the government to the private sector and ensure free trade in conformity assessment services. Expand the validity of certificates so that fewer tests are required.

Recognition: Accept as equivalent foreign governments' technical regulations that are based on international standards, even when those governments have not entered into formal mutual recognition treaties with the Kyrgyz Republic.² This reformation of the standards regime will not only remove the disadvantage under which firms in the Kyrgyz Republic have been laboring; it will also be an important step towards WTO compliance.

² Ibid.



Proposal #7: Competitive VAT Rate

Background: currently, the Kyrgyz Republic has set VAT at 20% while Kazakhstan's VAT is 16%. This discrepancy makes the Kyrgyz Republic comparatively tax disadvantaged, and therefore discourages investment. Contrarily, if the Kyrgyz Republic were to employ a lower VAT than its neighbor, historical economic evidence suggests that international corporations might favor the Kyrgyz Republic over Kazakhstan as a place to do business.

Proposal: we suggest lowering the VAT rate of the Kyrgyz Republic below that of Kazakhstan. Firms interested in tapping into the rich Kazakh market will be more likely to set up their businesses in Bishkek if the tax conditions here are more favorable than in Almaty, thus contributing to the GDP and budget of the Kyrgyz Republic.

Proposal #8: Development of Export Potential

Background: Kyrgyz companies have not been successful in profiting from the strong growth in demand from Kazakhstan and Russia. According to the World Bank, even though the total imports of Russia have doubled during the years 1999-2003, the value of Kyrgyz exports to Russia during that period actually fell 7 percent. And while Kyrgyz exports to Kazakhstan have increased a meager 24 percent between 1999 and 2003, Kazakhstan's total imports have increased 156 percent.

The Kyrgyz Republic should diversify its economy to become a producer of value-added goods. Kyrgyzstan already has comparatively low labor costs, and if it lowers its profit tax and VAT rates, we will also have a comparatively favorable tax structure. Now what is needed is the development of export capacity.

Proposal: create a tax moratorium on imports of raw materials and heavy machinery clearly intended for processing or investment purposes. This single measure will greatly encourage investment in value-added goods processing capacity and have a great impact on exports.



The Legal System

Proposal #9: Legal Hierarchy

Background: the Kyrgyz legal system is often redundant and contradictory. Truly fundamental questions, such as the hierarchy of laws; how to deal with laws and regulatory acts that were adopted in violation of prescribed procedures; and how to resolve conflicts between and within laws are not established in legislation. The result is inconsistent application, disorder, and opacity in the legal system that leads many businesses to complain of unpredictability. Furthermore, contradicting laws are routinely used by various agencies and individuals of the Kyrgyz Government to extract bribes from business, as it is impossible for businesses in some industries to meet the conflicting requirements of all the applicable laws.

Proposal: to remedy this, we recommend that the "Revision of the Law on Normative Legal Acts" be passed into law. This revision was developed out of the Investment Matrix and with cooperation from ARD/CHECCHI. The law will provide a more consistent, organized and logical basis for the application and implementation of all legal instruments, as well as a basis for a clear and harmonized understanding of the interrelationships of laws, thereby leading to much greater predictability in the application of law. ARD/CHECCHI has been trying to elevate the "Law on Normative Legal Acts" into Constitutional Law through the ongoing Constitutional Convention. We believe this is a good option provided that the constitutional reform process is not irredeemably hamstrung.

Proposal #10: Independent Judiciary

Background: In most countries, businesses can rely on the courts to equitably resolve issues that arise between individual businesses and between businesses and regulatory agencies. However, the Kyrgyz court system suffers both from endemic corruption and a dependence on the executive branch of the government such that businesses are wary of taking their issues to court for fear that rulings will be determined by the whims of politicians rather than the rule of law.

Proposal: we suggest that reforms to establish an effective, independent judiciary be given highest priority in the process of constitutional reform. The establishment of an independent judicial branch of government would cause a sea change in the investor climate of this country, the benefits of which would extend throughout all sections of the economy.