

KYRGYZ REPUBLIC
INVESTMENT CLIMATE ASSESSMENT

APRIL 2005



EUROPE AND CENTRAL ASIA REGION
FINANCE AND PRIVATE SECTOR DEPARTMENT

List of Acronyms

BEEPS	Business Environment and Enterprise Performance Survey
CEM	Country Economic Memorandum
CIS	Commonwealth of Independent States
EBRD	European bank for Reconstruction and Development
ECA	Europe and Central Asia Region of the World Bank
ECB	European Central Bank
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
GDLN	Global Development Learning Network
GDP	Gross Domestic Product
GSAC	Governance Structural Adjustment Credit
ICA	Investment Climate Assessment
ICT	Information and Communication Technologies
IMF	International Monetary Fund
MEDIT	Ministry of Economic Development, Industry and Trade
NBKR	National Bank of the Kyrgyz Republic
NGO	Non-Governmental Organizations
OECD	Organization of Economic Cooperation and Development
PRGF	Poverty Reduction Grant Facility
R&D	Research and Development
RIA	Regulatory Impact Assessment
SCC	Savings and Settlement Company
SME	Small and Medium Enterprises
TBT	Technical Barriers to Trade
TFP	Total Factor Productivity
ULC	Unit labor Cost
USD	United States Dollar
VAT	Value-Added Tax
WEF	World Economic Forum
WDI	World Development Indicators
WTO	World Trade Organization

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Kyrgyz Republic
Investment Climate Assessment

Executive Summary

1. In the recent past, the Kyrgyz Government has embarked on an ambitious reform program aimed at streamlining the investment climate and promoting entrepreneurship in the country. A result of these efforts has been the enactment of many laws and regulations governing the business environment. Nevertheless, such regulatory reforms have been significantly undermined by legal ambiguities and uncertainty, poor implementation capacity and lack of appropriate enforcement mechanisms. Despite advances, the outstanding reform agenda remains significant, and a concerted effort of reform implementation is required at this auspicious time, when citizens have demanded increased openness, transparency and improved governance. This study offers analysis and recommendations for increasing the effectiveness of investment climate reform implementation in the Kyrgyz Republic. This Investment Climate Assessment follows a recent World Bank Country Economic Memorandum that highlighted the growth challenges for the Kyrgyz economy to be fully integrated into international trade.

2. There is an urgent need to implement policy reforms aimed at ensuring sustainable growth, price stability and private sector development, while addressing the fiscal and external debt position of the country. While the Kyrgyz Republic has made considerable strides towards macro-economic stability since independence, its economy remains fragile and vulnerable to external shocks. Foreign investment, which has been sporadic, will not come without the existence of a ‘perfect’ business climate, to offset perceived risks related to both economic and political stability. To meet these challenges, the Government should focus on diversifying the economy and exports, on implementing liberalization reforms to attract investment in sectors other than mining, and to stimulate productivity. The World Bank supports the reform efforts of the Kyrgyz Government, also through an upcoming Poverty Reduction Strategy Grant that is currently being designed to sustain the Government in the challenging efforts of streamlining the investment climate.

3. Private sector development and growth remain hampered by a plethora of constraints that render the business climate unfriendly and constrain entrepreneurs from exploiting low wage levels and price competitiveness. These are major impediments which have come about as a result of the state’s overbearing role in interacting with the business sector. If the state can reduce its crowding out effect of private sector activities, and instead act as a facilitator to ensure an efficient and fair competitive environment, the value which growth and innovation could spur in a country of the size of the Kyrgyz Republic could be significant.

4. A significant problem underpinning all of the constraints faced by Kyrgyz entrepreneurs is the weak administrative capacity to properly implement regulation. Many legal and regulatory reforms are poorly implemented, and the regulatory burden becomes even heavier due to the many revisions, inspections and audits. These problems are compounded by the detrimental effects of corruption, largely attributed to the low pay scales of public servants and a lack of sanctions, and crony capitalism related to favoritism in drafting and especially implementing regulations. While the previous government had recently demonstrated considerable commitment to carry out governance reforms in public finance, for example by abolishing the special means accounts and requiring high state officials to declare income and assets as an important step for future anticorruption efforts, other reforms languish. And despite regular public/private collaboration which has resulted in a comprehensive investment climate ‘matrix’ of reform steps for the business environment, tasks have unrealistic deadlines and are not well prioritized, sequenced or connected.

5. Business risk is increased due to the lack of a judicial system which is well functioning and has the confidence of the business community. Kyrgyz enterprises feel they have little recourse, other than to make informal payments, when faced by unfair or abuses situations,. Trust in the court system is low, with 65% of enterprises surveyed indicating they do not believe the judicial system would uphold their contract and property rights in business disputes. In the absence of efficient courts and appeal mechanisms, fewer business transactions take place, and the opportunities for the private sector are constrained.

6. Tax administration, macroeconomic stability and regulatory certainty are ranked as the main concern for Kyrgyz companies, as indicated in the table below, together with cost of financing and access to finance. Regulatory uncertainty remains a major concern; the regulatory framework continues to be highly unpredictable due to ever-changing legislation.

Table 3. General Constraints to Business Operation

%age of firms evaluating constraints as “moderate” or “major”	
Tax Administration	59.41
Macroeconomic Instability	57.80
Regulatory Policy Uncertainty	56.73
Tax Rates	54.65
Cost of Financing	50.32
Corruption	44.58
Access to Financing	43.79
Anti-competitive or informal practices	31.93

Source: BEEPS 2002

7. Tax administration has been acknowledged by the Kyrgyz enterprise sector as one of the most problematic areas negatively affecting the business climate, though it is far more frequent a complaint from large firms rather than small. This is not surprising, given the streamlined taxation regime for micro and small enterprises, though preferential taxation treatment for small firms has encouraged them to remain small or to divide into separate companies. Reportedly, tax administrators have unnecessarily large powers of interpretation of tax laws and regulations, and apply them unevenly. Low enforcement capacity, lack of public awareness and accountability mechanisms in the tax administration generate a highly unclear environment in which entrepreneurs are not aware of their rights and guarantees, while inspectors abuse their powers for personal gain. This inevitably leads to tax avoidance and informality, as companies struggle to remain small and ‘out of sight’ of the tax administrators.

8. While significant progress has been made in streamlining the process of enterprise registration, a host of administrative barriers continue to consume a significant portion of the enterprise managers’ time and effort. For example, despite efforts to curb the proliferation of inspections and to protect firms from unnecessary inspections, the total number of inspections per year as well as the average number of days spent by enterprises dealing with inspections are considerably above those reported in several other countries in the region. Public agencies have unclear and duplicative roles, transparency and accountability are poor, and off-budget funding continues to provide incentives for corruption, despite government commitments for reform, while both entrepreneur and inspector are plagued by low awareness and understanding of the inspection process and relevant legislation. Reform of key agencies such Labor and Social Security, Sanitation, as well as the Tax Administration, should be undertaken immediately.

9. Similar difficulties surround the issuance of licenses and permits. Legal contradictions in the law on licenses impact businesses’ ability to obtain needed licenses and operate legally, while the definition of the licenses themselves and the parameters for their use are fraught with ambiguity. Furthermore,

analogous to the situation with inspections, the propensity to create licenses by state regulatory bodies in order to bolster budget revenues by use of ‘special means funding’ provides an incentive for corruption.

10. Entrepreneurs complain about difficulties in accessing finance and the cost of financing for business operations. Access to finance in the Kyrgyz Republic is constrained mainly by lack of long term financing, low banking skills and low transparency. Lack of depositor confidence in banks, compounded by low deposit rates, reduces the funding base and increases the overall cost of capital for banks, which remain generally uncertain of the growth and repayment capacity of borrowers. A flawed pledge system combined with a predominant focus on collateral-based lending only exacerbates the funding difficulties faced by enterprises, with most relying primarily on their own internally generated capital and loans from friends and family – a situation which is unlikely to change in the foreseeable future. A new pledge law recently enacted is expected to streamline collateral requirements and introduce out-of-court procedures for foreclosure of assets, but will be devoid of meaning if not accompanied by changes in enforcement mechanisms.

11. In summary, there are many factors preventing reform implementation and enforcement in the Kyrgyz Republic. Key among these are the **lack of legal consistency and certainty** due to the lack of a clear hierarchy of legal and normative acts in the Kyrgyz legal system. In addition, the **quality, depth and reach of legal reform** seem inadequate: in some instances, new laws and regulations are too ambitious, unrealistic or less relevant than expected due to lax legal definitions.

12. Of paramount importance is that the **institutional setting** for implementation remains insufficient: there are still too many institutions responsible to oversee implementation, and in most cases these bodies are not suitably endowed to properly carry out their functions. Finally, and perhaps most important of all, there seems to be an **overall lack of capacity** across implementing agencies to adopt relevant legal and regulatory changes, and a distinct **lack of easily available information** on legal, regulatory and judicial issues. This relates also to the lack of appropriate **Monitoring and Evaluation (M&E)** system for the overall reform process.

Recommendations

This investment climate assessment identifies the many bottlenecks of the Kyrgyz business environment and recognizes the need for the country to implement reform at two different levels. On the one hand, the Kyrgyz Republic needs to tackle the reform of the public sector and the judiciary. On the other, many challenges remain in the elimination of administrative barriers for enterprises.

The poor implementation and enforcement record calls for the need to establish predictability in the investment climate by improving governance. This requires sustained efforts in the ongoing public sector reform accompanied by hefty investments in capacity-building. The analysis provided in each chapter of this investment climate assessment culminates in a final section on recommendations intended to promote the effective implementation of business environment reforms in the Kyrgyz Republic. Key recommendations are highlighted in the matrix below.

Streamline the Institutional Framework

Refine the investment climate ‘matrix’:

- ④ Narrow the scope of the matrix
- ④ Improve prioritization and sequencing of implementation tasks
- ④ Provide more realistic deadlines at each step along the way.
- ④ All relevant agencies should adopt the matrix as part of their primary operational objectives.

Identify a single, high-level reform agency with ultimate responsibility for investment climate policy formulation and implementation.

- ④ Consolidate functions now spread amongst several bodies
- ④ Empower agency to coordinate other agencies to avoid duplication and ensure results.

Enhance the regulatory reform process

Gradually Introduce a system of Regulatory Impact Assessments (RIAs).

- ④ First, declare a moratorium on all new regulation.
- ④ Then, require all agencies to justify their regulations over a 24-month period
- ④ Abolish all regulations not justified and duly registered.
- ④ Identify/establish a single agency dedicated to conducting RIAs, and institute RIAs in key agencies.

Implement a program for judicial reform

Develop and publicize a routinized system of publishing court opinions and making them accessible to lawyers and others;
Improve the system for enforcement and satisfaction of court decisions, including making marshals responsible to the courts and enabling judges to instruct marshals on how to go about enforcement.
Continue the development of an appeals process that is efficient, insulated from outside influence, fair and final;
Develop informal enforcement mechanisms, such as credit reporting agencies and merchant associations, should be encouraged, and adoption of alternative dispute resolution mechanisms should be explored.

Initiate a study on options for the upgrading of the judicial environment that would:

study the deficiencies of the work environment in the courts, including an in-depth review of the pay scales for judges and those for private sector professionals, and of the conditions in which judges work throughout the country
Propose an appropriate compensation package must be created for judges.
Ensure sufficient training programs to raise judicial capacity.

Reduce administrative barriers

<p>Clarify functions and responsibilities of public agencies, to avoid duplication, to economize and improve efficiency; to separate policy and regulation functions;</p> <p>Improve standards of pay, in the context of the ongoing civil service reform;</p> <p>Eliminate off-budget funding sources of public agencies enforce the principle that all public funds (including regulatory and user fees) are channeled through the budget;</p>	<p>Easing business entry by streamlining the registration process</p> <p>reduce the time spent in business registration</p> <p>eliminate duplication among registration agencies</p> <p>improve access to information related to the registration process by establishing a publicly accessible register for all registration requirements</p> <p>following streamlining or process and procedures for registration,</p> <p>reform the one-stop shop by amending the current law on registration to clearly define its role and responsibilities while identifying a single agency with clear responsibility for its oversight and implementing a capacity building program for its staff.</p>	<p>Improve the efficiency and fairness of tax administration: Address ambiguities in tax legislation by conducting legal conformity assessments</p> <p>Improve information dissemination to tax administrators and businesses on tax rules and changes, utilizing electronic means supported by public information campaigns</p> <p>Streamline the appeals process for adverse decisions, permitting disputed tax payments to be made only after the appeals process is completed.</p>	<p>Streamline the regulatory framework for inspections:</p> <p>Ensure that all inspectorates comply with the law on inspections.</p> <p>Clarify the relationship between the inspectorates and the State Commission for Business</p> <p>Development (within MEDIT), so that the latter can carry out the screening and enforcement functions initially envisioned.</p> <p>Formalize and enforce sanctions against abuse of public official positions.</p>	<p>Improve the processes for obtaining licenses and permits:</p> <p>Rationalize the definition and uses of licenses</p> <p>Resolve contradictions in the law on licenses which impact a business' ability to obtain a license and operate legally</p> <p>Eliminate the "special means funding" and consider mandatory enterprise "user" fees to finance the inspections process in its place.</p>
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Consider adopting ICT applications for taxation, licensing and permitting, and other public services:

- ☞ to increase efficiency and transparency,
- ☞ to ease the interface between civil servants and enterprises,
- ☞ to ensure widespread access to rules and other information, including the legal rights of firms
- ☞ to reduce opportunities for corruption

Conduct a public information campaign

- ☞ to increase the awareness among government officials, entrepreneurs and civil society of recent changes in legislation, regulation and practices
- ☞ to reduce the possibility for firms to succumb to predatory behavior by enforcement agents as a result of their lack of knowledge of rules and their rights, particularly their rights of appeal
- ☞ to ensure enterprises are up to date on regulatory changes; amend current publicity requirements for new legislation to ensure the information reaches the target audience

Kyrgyz Republic
Investment Climate Assessment

I. Introduction

The ICA Program: rationale and objective

13. The Investment Climate Assessment program is part of the efforts of the World Bank Group to assess key elements of a country's investment climate. Investment Climate Assessments are comprehensive country reports that draw upon the results of firm-based Investment Climate Surveys and other sources to identify reforms that would result in the biggest gains in productivity and economic growth.

14. The findings of the survey, combined with other relevant information from other sources, provide a practical basis for identifying the most important areas for reform aimed at improving the investment climate. The assessments look in detail at policy, regulatory, and institutional factors that undermine private sector led growth.

15. Together with other resources, Investment Climate Assessments aim at informing Country Assistance Strategies, providing a strategic framework for strengthening the private sector development agenda in World Bank operations, and helping countries more broadly forge consensus on priority areas for reform. By analyzing the conditions for private investment and enterprise growth in a country, the Assessments provide a practical foundation for policy recommendations.

Kyrgyz investment Climate Assessment: Study Focus and Structure

16. The assessment for the Kyrgyz Republic provides an overview of the climate for doing business, identifies the most binding constraints to both large and small firms, and offers a set of recommendations with immediate impact and for the longer term. This assessment is intended to assist reform advocates within the government in making more persuasive arguments for change, and to build on the growing momentum among private sector stakeholders, who have recently become more vocal about the need to take fundamental steps towards improving the business environment.

17. The focus of this assessment is the legal, regulatory and administrative elements that form the foundations of an efficient business environment conducive to enhanced private sector growth. Other important issues for the development of the private sector, such as the need for improved infrastructure and for the restructuring of large, formerly state-owned enterprises, are beyond the scope of this study. This assessment is also meant to be an initial step in the long process of reforming the investment climate. The real impact of the ICA will come from having its recommendations being incorporated or transformed into reform programs

Sources of Data

18. This assessment builds on data and sources available to analyze the determinants of the investment climate in the country. A detailed description of the sources and resources used follows.

19. **Business Environment and Enterprise Performance Survey (BEEPS) 2002:** The Business Environment and Enterprise Performance Survey (BEEPS) is an analytical tool developed jointly by the

World Bank and the European Bank for Reconstruction and Development. The survey, conducted in 2002, appraised over 4,000 firms in 22 transition countries. The sample of firms was randomly chosen from both the manufacturing and services industries. In the specific case of Kyrgyz Republic, the BEEPS involved a total number of 173 interviews in 2002. The BEEPS analyzes the multifaceted interaction between firms and the state, through face-to-face interviews with firm managers and owners. BEEPS managed to capture measurements in areas crucial for private sector development such as corruption, state capture, lobbying, and the quality of the business environment.

20. In the year 2002, 80.35 % of the firms surveyed by BEEPS were small (with 100 employees or less) and 19.65 % were considered large enterprises (with more than 100 employees). A vast majority of the firms surveyed were non-exporters: only 15.03 % of the firms interviewed exported directly to foreign markets. A detailed breakdown of the firms' activity by sector is provided in Table 2 below.

Table 1. % of Firms Surveyed by Sector

Firm Activity (%)	Sample
Mining and quarrying	2.89
Construction	12.14
Manufacturing	28.32
Transport storage and communication	7.51
Wholesale and retail trade	30.06
Real estate, renting and business services	8.09
Hotels and restaurants	4.62
Other services	6.36

21. **BEEPS 2003:** is the continuation of BEEPS 2002. The survey for 2003 focused only on the manufacturing sector, being based on a random sample of firms selected from manufacturing sub-sectors excluding the services industry. In 2003 in the Kyrgyz Republic, the BEEPS involved a total number of 102 companies. The focus of the 2003 BEEPS on selected manufacturing sub-sectors aimed to derive sector-specific productivity measures that could be correlated to the climate investment. The 2002 BEEPS, on the other hand, focused on the economy as a whole. The results of both BEEPS are still relevant and representative of the reality of the Kyrgyz investment climate, even if they have been carried out now a few years ago. The lack of significant progress in many areas related to the investment climate make the BEEP survey still pertinent. In fact, other more recent surveys of the Kyrgyz private sector confirm that the situation has not improved significantly in the recent past.

22. **Focus Group Discussions:** Focus Group discussions were held in February 2004 to get the private sector's opinion on dynamics of the investment climate and critical constraints to the private sector growth. The Focus Group discussions were divided into three parts: (i) a "structured part" investigating legislation and regulatory agencies; (ii) a "discussion section" dealing with corruption, tax administration, governance; and (iii) a questionnaire to address more firm-specific issues related to productivity. A total of five focus groups were conducted, three in Bishkek and two in Osh (the second largest city after the capital). A detailed description of the Focus Groups follows in Table 3.

Table 2. Description of Focus Group Discussions.

Location	Number of groups	Group composition by size and sector	Number of participants
Bishkek	3	Small and medium enterprises/ various sectors	8
		Medium and large enterprises/ various sectors	8
		Small and medium enterprises/ textile	7
Osh	2	Small and medium enterprises/ various sectors	9
		Small and medium enterprises/ food processing	7

23. **PROMA National Business Opinion Survey:** This survey was carried out by Proma, a local consulting firm, and was co-sponsored by the European Commission and the OSCE Center in Bishkek. The business size and registration profile of the respondents reflect the real situation in the Kyrgyz Republic: 68% have 1-5 employees, 16% have 6–10 employees, 0.4% have over 500 employees; while 69% are individual businessmen, 9% LLCs, 12.5% land holders, 3% not registered, 4% JSCs

24. **Doing Business in 2005:** The Doing Business 2005 is jointly published by the World Bank, the International Finance Corporation and Oxford University Press. It follows the 2004 edition by adding new indicators useful to understand the role of regulation as a driver or inhibitor to business activities across 145 countries. The Doing Business 2005 report analyzes economic and social outcomes (such as productivity, investment, informality, corruption, unemployment, and poverty) using a set of specific indicators: starting a business, hiring and firing workers, enforcing contracts, getting credit, closing a business, registering property and protecting investors.

25. **World Development Indicators (WDI): World Development Indicators database** contains statistical data for over 550 development indicators and time series data from 1960-2002 for over 200 countries. The WDI covers specialized topics such as social indicators, economic indicators, education, and population projections. It is prepared by the World Bank on sources from various international organizations and institutions.

Organization of the Study

26. The report is organized as follows. Chapter II presents an overview of the current macroeconomic context, also linking firms' productivity with the investment climate and describing the recent reform process changes in the Kyrgyz investment climate. Moreover, Chapter II discusses the most binding constraints for enterprises operating in the Kyrgyz Republic: not only the main administrative barriers, such as inspections and licensing, but also issues related to state tax administration and access to finance. The implementation and enforcement challenges are discussed in Chapter III that describes the depth and reach of corruption and the legal and judicial environment. Chapter IV describes the institutional framework for the investment climate. Chapter V provides policy recommendations to streamline the investment climate in the Kyrgyz Republic. The concluding Chapter VI describes an innovative approach to capacity building that is proposed as a follow-up to this assessment.

Kyrgyz Republic
Investment Climate Assessment

II. Regulatory and Administrative Constraints:

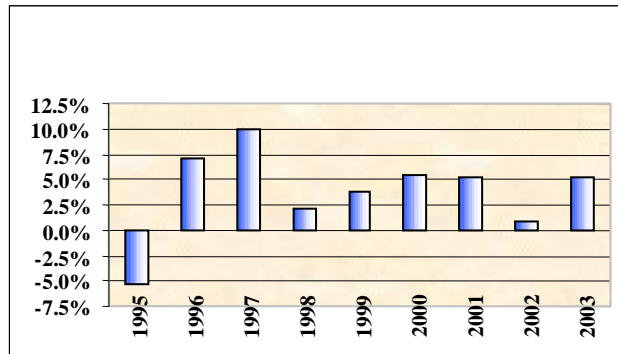
Review of Key Constraints

28. The Kyrgyz Republic has made significant strides in the past decade in its transition to a market-based and globally integrated economy, a complex challenge exacerbated by its small size and landlocked nature, and by the lack of natural resources, with the exception of gold and water. Nevertheless, the Kyrgyz Republic will face difficulties in continuing along its present trajectory, which is characterized by little investment, abundant informality, corruption and modest growth. In this environment, entrepreneurs are beset by requests for informal payments at almost every juncture of interface with the Government; firms must navigate through a myriad of regulations and regulatory obstacles, most of them are inconsistent or open to discretion by public officials. Conversely, the Government can make real steps towards reforming the investment climate, by fundamentally changing the manner in which the public and private sector interact. The Report highlights the benefits of a policy change, and the perverse effects of the current incentives system.

The Macro-Economic Context

29. After the collapse of the Soviet Union, cumulative GDP declined by 54 % over the 1991-1995 period and inflation exploded (Figure 1). After a short recovery in 1996, the Kyrgyz economy was then badly hit by the Russian Financial Crisis of 1998: GDP growth fell to 2.1 %, inflation rate reached 36 % and Kyrgyz Som depreciated against dollar by 43 %.

Figure 1 Real GDP growth (%)



30. *Progress towards macro-economic stability.* There is a general consensus that the Kyrgyz Republic has made substantial progress in achieving overall macroeconomic stability (World Bank, 2004). The economy started showing signs of recovery in 2000, with GDP growth rebounding to more than 5 % in 2001 and stable foreign exchange and declining inflation. This growth was mostly the result of the Government's structural reform efforts and the improved fiscal position supported by prudent monetary stance during a period of remonetization of the system. Growth was also due to the expansion of the gold production at the Kumtor gold mine¹, and partly to the increased demand for irrigation water in Uzbekistan

¹ Kumtor accounts for about 35 % of industrial output. In 2004, the company was privatized to a Canadian mining consortium, Centerra.

and Kazakhstan. Growth in agriculture and services sector contributed positively to the economy, increasing employment and absorbing the labor shed from state – owned enterprises. Currently, the economy is growing at an average rate of 4-to-5 %.

31. ***Economic growth has trickled down to the population.*** Growth appears to be relatively pro-poor; the overall percentage of the population living below the poverty line declined from about 55 % in 1999 to 41 % in 2003 (IMF 2004), and improving. However, the Kyrgyz Republic still remains the second poorest country in the former Soviet Union, after Tajikistan, with almost half of its population living below the poverty line, with poverty being concentrated in the rural communities. The capital city of Bishkek and nearby Chui oblast are substantially less poor than the rest of the country, while remote, mountainous Naryn oblast is the poorest, with nine residents out of 10 living in absolute poverty according to 2002 data (Kyrgyz Republic Enhancing Pro-Poor Growth, World Bank, 2003).

Table 4: Selected Macroeconomic Indicators

	2000	2001	2002	2003	Est.	Projections		
					2004	2005	2006	2007
Nominal GDP (in billions of soms)	65.4	73.9	75.4	83.4	92.3	100.8	111.1	121.7
Nominal GDP (in millions US\$)	1,367	1,525	1,606	1,911	2,167	2,399	2,646	2,898
Per Capita GDP (in US\$)	278	309	324	378	425	465	508	551
Real GDP (growth in percent)	5.3	5.4	0.0	6.7	6.0	5.0	5.9	5.5
Primary Balance (excl. grants)	- 4.5	- 4.3	- 5.0	- 4.2	- 3.2	- 3.0	- 2.7	- 2.7
Unemployment Rate	3.1	3.2	3.1	3.1	n.a.	n.a.	n.a.	n.a.
CPIs (percent change, average)	18.7	6.9	2.1	3.1	4.1	4.0	3.7	4.0
Poverty rate	52.0	48.0	44.0	41.0	35.0	n.a.	n.a.	n.a.

Source: IMF staff updates and projections.

32. Despite the positive macroeconomic performance, growth has lagged behind other CIS countries, and its economy remains fragile and vulnerable to external shocks. Gold mining production is trending downward, and there are no many alternatives to facilitating the much needed diversification of the economy and export in the medium-term. These are major challenges for the country, which cannot grow internally due to scarce resources, geographic isolation, small domestic market and difficult trade relations with its neighbors. As a result, the economy would need to attract external investment to maintain price and exchange stability and to steadily increase productivity in non-gold sectors to contain unit labor cost and thus improve competitiveness.

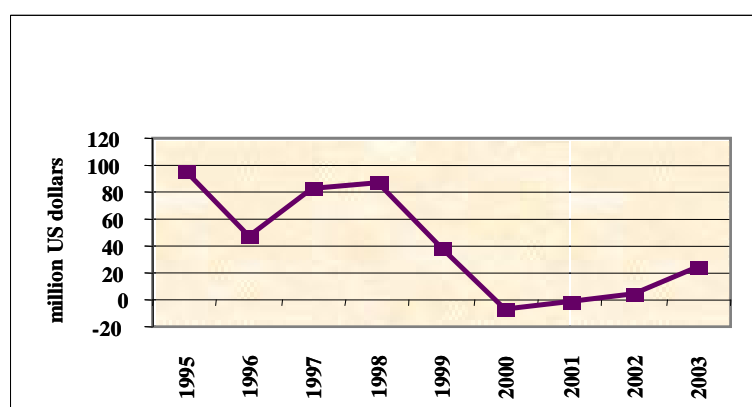
33. The high level of external indebtedness remains problematic despite debt relief from the Paris Club (March 2005). In the course of transition the Kyrgyz Republic became heavily indebted, with the debt burden remaining excessive and being a major drain on the government's finances, external debt was estimated at \$1.7bn at the end of 2002 or 112 % of GDP. Such high levels of external indebtedness have seriously impaired the country's ability to effectively implement a social/economic agenda for reform and to access foreign funds. Just recently the Paris Club announced the rescheduling of EUR 431 million and the cancellation of US\$ 124 million of the country's external debt following the successful implementation of the three-year Poverty Reduction Grant Facility (PRGF) program of the IMF. However, debt levels are still worrisome, and the Kyrgyz republic will have to attract more resources through market based channels in order to achieve a sustainable growth path. Due to its remoteness and unattractive business environment, neighboring countries are more likely to be the source of investment in the immediate future.²

² In fact a sizeable increase in the foreign direct investment in 2003 came from Russia, which has invested in light manufacturing and agro-progressing. Kazakhstan has also expressed interest in investing in the Kyrgyz industry in 2004.

34. The foundations for sustainable development in Kyrgyzstan are diversification of the economy and private investments. The Kyrgyz economy structurally hinges on basic agriculture and gold mining, and only to a lesser extent, on the slowly growing service sector (Table 5) and industry (mostly hydropower and electricity). These sectors are all vulnerable to worldwide demand and prices, and to weather conditions and natural disasters.

- **Gold production.** Until 2002, the Kumtor mine provided a vital engine for growth over the period of 1996-2001, and production was particularly important to balance the losses suffered by more traditional parts of the industrial sector. But in 2002, a major landslide caused GDP to flatten for the first time since 1996. According to the IMF projections, gold production is expected to decline and cease entirely by 2010 (IMF 2004).

Figure 2. Foreign Direct Investment, net (in MI US\$)



- **Electricity** is one of the most important components of the industrial sector, but it is not a reliable source of sustained growth as its output is a function of the demand for electricity and irrigation from neighboring Uzbekistan and Kazakhstan³. Furthermore, the sector is hampered by high quasi-fiscal deficit and inefficiencies in distribution and collection.

Table 5: Growth by Sector (volume by %)

	1996	1997	1998	1999	2000	2001	2002
Industry	3.9	39.7	5.3	-4.3	6.0	5.4	-13.1
Construction	0.0	-17.0	-27.7	-2.0	29.7	15.6	-0.1
Agriculture	15.2	12.3	2.9	8.2	2.6	6.8	3.2
Transport and communications	9.8	4.6	-1.8	3.1	5.7	-3.0	2.0
Services and other	5.3	9.8	6.9	3.5	5.7	3.2	3.4

Source: IMF Country Report, February 2003

- **The service sector** contributed 34.8 % to GDP in 2002, though its contribution to overall growth in the economy has been somehow negligible. The sector is dominated by micro and small enterprises that have suffered from excessively bureaucratic regulatory processes as well as from restricted trade relations with the neighboring countries that affect both exports and the domestic market.

³ The production hydroelectricity fell by 13 % in 2002, as a result of low demand in Uzbekistan and Kazakhstan.

- ***A vulnerable manufacturing sector.*** Non-gold parts of the manufacturing sector started showing signs of revival in 2002 with light industry growing at 8.8 % on a year-to-year basis and food processing by around 9 %. These two sectors account for majority of non-gold manufacturing output, but together only contribute about half as much as gold to total industrial output.

35. ***The Kyrgyz Republic has failed to attract investment in sectors other than mining.*** In the gold sector the construction of the Kumtor gold mine has not triggered any further major investments in the mining sector in the country. Although growth in the agricultural sector has been sustained, this sector has not seen much investment and development. There has been very little expansion of the agro-processing industry, which would be vital to increasing the export potential of the country to the rest of the world and which has been doing well in the rest of CIS.

36. The unattractive investment climate has limited FDIs and capital inflows. In 2002, FDI in the Kyrgyz Republic accounted for a mere 0.2 % of all FDI in Central Asia, with the majority of FDI going to Kazakhstan; FDI per capita in the Kyrgyz is less than US\$1 (Figure 2). Over the last few years, Kyrgyz capital stocks has also declined steadily, and gross fixed investment (under 20 % of GDP), is insufficient to boost the competitiveness of the non - gold sectors of the economy.

37. ***Delays in implementing the development reform agenda also contributed to the low levels of private and foreign investments.*** Despite the Government's successes in addressing macroeconomic stability, the Kyrgyz economy and investment climate have been hampered by critical weaknesses in the legal and regulatory framework supporting creditors and property rights, financial intermediation, transparency and governance, labor flexibility, education and infrastructure. Furthermore, considerable informality suggests that the business environment suffers from excessive administrative barriers, coupled with a corrupted and weak judiciary and enforcement system.

38. ***Progress on privatization has slowed.*** The Kyrgyz Republic has achieved significant progress in both small-scale privatization and the mass privatization of medium and large-scale companies, in which it sold off (entirely or substantially) approximately 1,200 companies for cash and privatization vouchers during the 1990's. It still also holds minority positions in many of the least attractive of these companies, for which potential purchasers have been difficult to identify, and many have subsequently been liquidated. Many of these enterprises are non-competitive due to imbedded non-market pricing, obsolete equipment, heavy indebtedness and asset stripping. It has made less progress in the privatization of its largest infrastructure companies, including monopolies in the energy, gas, communication and aviation sectors. The poor environment for private sector development, absence of strategic investors and low commitment of the government to displace various political and social elites are the major reasons for this limited progress. Other problems relate to the country's weak property rights, contract enforcement, corporate governance, financial information and information disclosure in general (World Bank CAS, 2003).

Productivity and Investment Climate

39. The market-oriented reform policies introduced by the Government since independence have promoted multiple sources for competition in the Kyrgyz Republic. The demonopolization of specific sectors in the 1990's, such as wholesale trade, transport and agro-processing, including the dismantling of large state-owned conglomerates, allowed for the creation of a fairly competitive markets and the liquidation of some non-viable firms. The concurrent lowering of import duties and the elimination of import quotes and non-tariff barriers to foreign trade made imports a source of competition to domestic producers. As a result, according to BEEPS 2002 74.9% of companies claimed to have four or more

competitors and 57.3% of companies had four or more suppliers, in both cases roughly in line with other countries in the region and just below figures for Poland and Romania.

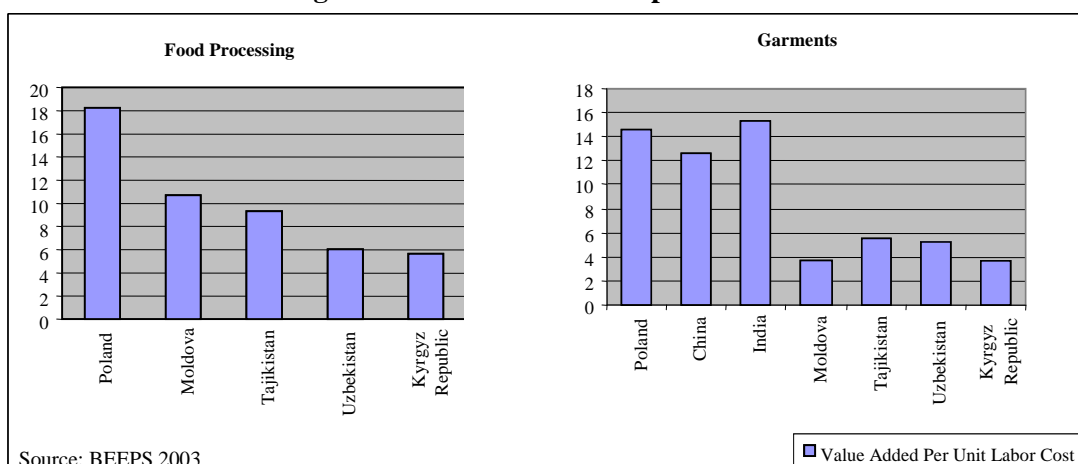
40. **Despite these far-reaching reform efforts, private sector growth has been hampered by a number of factors.** Markets are small and dispersed; the cost structure is high and the number of risk-takers small. There are important sectors with still significant government ownership, where competition could be an importance stimulus of private sector development. Foreign investors, who could offer new technologies, modern management methods and access to world markets, are present in only a handful of companies, and the securities markets lack sufficient liquidity to facilitate ownership change. Given the influence of vested interests and the range of administrative barriers discussed in this assessment, the promise of dynamic private sector growth has yet to be realized.

41. The main competitive challenge in the long term for the Kyrgyz Republic is the creation of conditions for rapid and sustained productivity improvements. This would enable the country to sustain current growth performances. It can be achieved either by firms improving their efficiency, and/or by an overall better investment climate (Ghosh and Kraay, 2000; Easterly and Levine, 2000). Looking at current (labor and total factor) productivity, it seems that Kyrgyz is seriously lagging behind, compared to neighboring countries.

42. **A Firm-level Survey to Proxy Productivity.** To understand the determinants of Kyrgyz’s low industrial productivity BEEPS 2003 was conducted in a manner that allows comparison to China, India and other countries where investment climate surveys have recently been completed. The samples were drawn from the garments and food processing sectors and covered firms in all size classes. The reason the survey focused on these two sectors is because they are found in almost all countries and use similar technologies, which makes it easier to make cross country comparisons and to estimate total factor productivity.

43. **Poor Labor Productivity Performance.** Labor productivity in the Kyrgyz sample for the garment sector is significantly lower than that found in other countries.⁴ Kyrgyz labor productivity is less than 30 % of Chinese value added per worker and substantially less than in India, Poland, Tajikistan and Uzbekistan. When valued using nominal exchange rates, the median value added per worker in the Kyrgyz Garments sector was less than 20 % of the Chinese sample and less than 50 % of what was reported in Moldova. Looking at the food sector, a similar pattern can be observed. Again the Kyrgyz Republic lags significantly behind the other countries (**Figure 3**).

Figure 3. Value Added per Worker



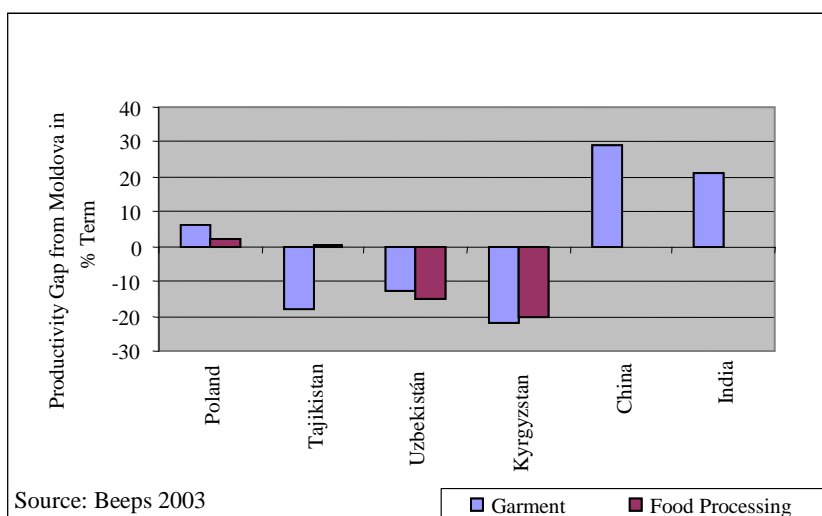
⁴ Values are converted using purchasing power parity to account for distortions in the official exchange rate and the true cost of living.

44. **Low capacity to exploit low wage levels to improve competitiveness.** The Kyrgyz Republic has low average labor costs relative to the rest of the world. However, cheap labor is not enough to offset the low labor productivity level. Using the survey results, value added over total cost is used to proxy unit labor cost. There are several findings. First, India and China remain significantly more competitive in the garments sector than Kyrgyz. Second, the magnitude of the competitive advantage of China and India over Kyrgyz is striking. The median Indian firm in the sample is able to extract more than USD3.40 per dollar spent on labor costs compared to USD1.51 in Kyrgyz, which is the worst among all the selected comparator countries in Central Asia and East Europe.

45. **Which Factors do matter for productivity improvements?** Using results from the BEEPS 2003, total factor productivity (TFP) is estimated. TFP measures the contribution to output of capital, labor and material inputs and provides a measure of how efficiently firms are using all resources. After estimating TFP performances in a set of countries, an econometric regression was run to explain cross-country differences in TFP against a set of variables, which are indicative of the quality of the investment climate (inspections, power, finance, exports and foreign ownership). In other empirical work, these variables have been shown to significantly explain cross-country TFP performances. There are many additional factors that impact TFP but not all could be put into one regression since they tend to be correlated. While these variables are only “symptomatic” of problems in the investment climate, their significance in the TFP regression shows the importance of improving the investment climate for firms’ performances.

46. **Productivity Gap.** Figure 4 shows the percentage difference in total factor productivity between countries in the garment and food processing sectors. The Kyrgyz Republic shows the lowest level of overall efficiency for both garment and food processing industries. While it is not surprising that its performance in garments and food processing falls substantially short of Poland, it is alarming that overall efficiency is also lower than other Central Asian economies such as Tajikistan and Uzbekistan.

Figure 4. Estimates of TFP (using Moldova as Base Point)



47. Despite the reforms enacted at the legislative level in the recent past, the Kyrgyz investment climate is still affected by major barriers. In the Kyrgyz Republic, gaps between the *de jure* and *de facto* legal environment create opportunities for malfeasance by both the public and private sector operators. This

chapter highlights the legal, regulatory, and administrative gaps that give rise to an unstable equilibrium. In this sense “gap” refers to the disconnect between the spirit of the law or regulation, and the manner in which it is de facto administered or enforced. Broad policy constraints identified by firms as a priority (e.g. tax administration) are reviewed according to this paradigm. The underlying legal/regulatory framework surrounding each issue is explained, the disparity between the normative legal structure and the manner in which it is (or is not) administered is highlighted, and the implications for the governance environment and investment climate are discussed.

Why are Taxes so Taxing?

48. In determining its tax policy, the government struggles to strike a balance between increasing the state budget revenues and engendering private sector growth. These are interrelated objectives, achievement of one being dependent on the other. Aiming at immediate and large budget revenues might induce higher tax rates, which suppresses private investment and risks shrinking the tax base in the long run. On the other hand, by foregoing current revenues through lower tax burden on businesses, the government can spur private sector activities, though excessive submission to the interests of businesses may also be harmful in terms of reduced revenues.

49. In the Kyrgyz Republic, taxes are at the top of the list of complaints from the private sector. In general, businesses are never happy to pay taxes, but most surprising for someone looking at prima facie evidence of an overly burdensome tax system is that tax rates are generally reasonable compared to other countries, and smaller enterprises in particular are subject to a very “light” tax system, with a minimum of financial and bureaucratic burden. So, why are taxes considered so taxing in the Kyrgyz Republic? Are the perceptions of a burdensome tax system exaggerated?

50. The answer very much depends on to whom one speaks: according to the BEEPS 2002 results, 47.1% of large firms consider tax administration a major constraint, while only 19.1% of small firms have similar views. This schism between small and large firms on tax issues is not surprising given the multi-tiered system that exists in the Kyrgyz Republic. For small and micro firms that operate under the patent system, the tax burden is minimal; there is no need to keep official books, and tax inspections are nonexistent⁵. Because life under the patent system is much less cumbersome and expensive, there is now a very large segment of the business sector (especially trade, tourism, and restaurant businesses) extensively using this system and paying small, almost symbolic taxes.

51. ***Preferential tax treatment for small firms encourages them to remain small.*** For larger firms that operate above the threshold of what the patent system allows, the formal tax rates are also not particularly onerous, with the exception of the Social Fund contribution. (Though the Social Fund contribution was recently lowered from 33% to 25%, a ceiling on the maximum contribution per employee was removed.) For example, the VAT rate is 20 %, the profit tax rate at 20 %, and personal income tax has a progressive scale with the highest marginal rate 20 %⁶. As seen in Table 3.1, these rates compare favorably with nearby countries such as Kazakhstan and Tajikistan. In addition, a special law on simplified taxation of small businesses was enacted in 2002. Under this law, all incorporated and unincorporated small businesses with an annual turnover of less than KGS 3,000,000 (about \$70,000) may choose to pay a single tax at flat rates of 5%, 6% and 10% of revenues depending on the type of business activity they carry on, instead of paying

⁵ The patent system was initially introduced to simplify collection of personal income tax from small traders, service providers and other self-employed. These types of businesses operate almost exclusively on a cash basis, do not issue invoices or receipts, and so it is impossible to register their income. Since the system was created for small traders and those with low incomes, the patent cost is very low.

⁶ Two other revenue taxes – the road tax (0.8 %) and contribution to emergency situations fund (1.8%) – are not included in the tax code but have been retained from other laws. Their abolition has long been anticipated.

a profit tax, road tax, emergency fund tax, sales tax, and income tax (for individuals). This system, however, is not well harmonized with other elements of the tax regime, providing firms an incentive to remain small or divide businesses into smaller firms.

52. *Administrative abuses encourage tax avoidance and informality.* The key challenge for all firms, other than those operating under the patent system, is not their compliance with the normative tax rates, but dealing with the insidious combination of ambiguous tax legislation and unchecked enforcement and discretion by government agents. This combination leads to the misapplication of laws, unchecked inspections, and the diversion of revenue into the hands of inspectors⁷. In addition, conflicts in interpretation between legislation and the Tax Code are reported to be a frequent problem this is partly explained by the absence of a single organization responsible for interpreting tax disputes, as interpretations of the Ministry of Finance and the Tax Inspectorate often contradict each other. Numerous bureaucratic procedures are also reported to hamper VAT refunds for imports reasonably soon after the completion of required documentation (a problem, which appears to particularly hurt the re-exporters). Firms also report that using credits for VAT paid earlier in the production chain is also a problem. Tax inspectors are reported to have disallowed credits for many purchased inputs based on claims for improper invoices.

53. An additional problem that many respondents noted was the difficulty of offsetting excess payments accumulated on some taxes against other tax arrears, even though the Tax Code allows for offsetting without assessment of penalties and fines (World Bank, 2004). A new version of the tax code has been in preparation for some time, long beyond the expected May 15, 2004 ratification date. While no significant changes are expected, the new version is meant to eliminate some of the ambiguities and contradictions in the tax code and make it consistent with other statutory acts.

54. The key vehicle used by the tax administration for collection and auditing is through tax inspections. However, according to the law there should not be more than one tax check in an enterprise per year, and the inspector must have to have a special order from the head of rayon tax service to conduct an inspection. The only time that inspectors can legally make repeated checks is if there is evidence of a violation.

55. Nevertheless, unplanned checks that are not procedurally justified are extremely common: on average Kyrgyz firms spend more than 16 working days per year in inspections with tax officials. There is little by way of recourse for these firms to challenge the validity of the inspection, and many entrepreneurs consider it less costly to pay unofficial payments in order to avoid any conflict with the tax service. The size of these unofficial payments is subject to negotiations and may vary in a very wide range depending on quality of bookkeeping, skills of the inspector and his ability to find serious violations.

56. Even if an enterprise would like to stay formal and pay all taxes in full, it is not immune from attempts by tax officers to extort bribes. Using inconsistencies in the tax law or incorrectly interpreting it, tax officers can calculate additional tax liabilities and impose penalties on such enterprises. The enterprise has to pay the required amount and then appeal, if it wishes. However, the appeal process is long and, for most enterprises, prohibitively expensive.

⁷ Tax rates, base and administration rules have been set by the Tax Code, which was adopted in 1996 and has been amended literally hundreds of times since then. Because of all of the amendments, the tax code has lost most of its internal logic and consistency and is contradictory in a number of instances, particularly with respect to 'special tax regimes' such as patent system and free economic zones. Despite the original intent to make the Tax Code to be a law of direct action, many instructions and clarifications are needed for tax collection; these documents are issued by the Legislative Chamber of Jogorku Kenesh (parliament), the Ministry of Finance and its subdivision the State Committee on Revenues.

57. **The implications for the investment climate of the dysfunctional tax administration system are deep and injurious.** Firms do not have the incentive to grow or to increase productivity, because any outward manifestation of additional revenue attracts regulatory scrutiny, and in the Kyrgyz Republic regulatory scrutiny is very costly⁸.

58. The Ministry of Finance has demonstrated considerable commitment to carrying out governance reforms in the area of public finances, for example through the abolition of special means accounts, the reform of the Chamber of Accounts and the requirement for High State Officials to declare their income and assets are important steps forward and will support future anti-corruption efforts, if they are fully and effectively implemented. However in some central areas of governance reform such as the civil service recent appointments to the Civil Service Agency have raised serious concerns as to the degree of commitment of the government to establish a truly merit-based professional civil service which will be essential to improving the quality of service delivery, reducing corruption and improving the business environment to support growth and development.

Box 1. Outline of Public Service Reform Program

The Government is keenly aware of the need for a well-qualified, professional civil service that would assist it in formulating and implementing policies for effective governance and poverty reduction. It has taken various measures in the recent past towards this objective. Merit-based competitive recruitment was launched in 2001; the compression ratio of salaries in the CS was increased to improve motivation; a process of assigning Class Ranks to civil servants was initiated in 2001; in order to trim the size of the civil service 1,200 civil servants were retrenched in 2001 and 1750 civil servants and managers in budgetary entities are expected to be retrenched in 2002; a Presidential decree on Ethics of Civil Servants was issued and Ethics Commissions were created at the level of the President's Administration and other Ministries and Central agencies. In continuation of its efforts, the Government has initiated discussion of draft amendments to the Law on Civil Service with relevant stakeholders. *By second tranche, the Government will: (i) enact amendments to the Law on Civil Service, satisfactory to IDA, with a view to separate political appointees and career civil servants; increase competitiveness in recruitment and promotion; reduce political interference in personnel management decisions; improve incentives for performance and integrity; and improve institutional arrangements for management of the civil service. By third tranche, the Government will: (i) establish the Civil Service Management Agency (CSMA) and ensure that it is fully operational, by appointing management and staff, providing adequate budgetary resources, and developing rules and regulations for the functioning of the agency.* In addition, before third tranche, the Government will take measures to ensure that all civil servants recruited for the first time to 'main' and 'senior' positions are recruited on the basis of open competition and merit, in accordance with the Civil Service Law and that all persons promoted to "main" and "senior" positions are promoted on the basis of results of performance evaluation or attestation. Further, the Government will implement a revised remuneration structure for the civil service, satisfactory to IDA, before the third tranche.

Excerpt from the World Bank's Governance Structural Adjustment Credit (GSAC) Program Document

Inspections and Overzealous Public Officials

59. Despite the introduction of legislation streamlining inspections, the process remains costly and inefficient. The table below depicts the implementation gap in the country, which despite recent legal reforms, still lags behind because of low implementation. As indicated in Table 8, the total number of inspections per year and the average number of days spent by entrepreneurs operating in the Kyrgyz Republic are even more striking when compared to other countries.

⁸ The World Bank, Kyrgyz Republic, Country Economic Memorandum, An Integrated Strategy for Growth and Trade, June 1, 2004, Report No. 29150-KG

Table 6. Average Days Spent in Inspections and Total Number of Inspections per Year

Inspections	Kyrgyz Republic	Poland	Moldova	Tajikistan	Uzbekistan
Tax inspectorate	16.4	8.5	8.6	6.2	
Labor & Social Security	7.8	2.8	1.6	1.1	1.8
Fire & Building Safety	2.1	0.88	2.2	1.4	1.3
Sanitation/ Epidemiology	4.9	3.4	5.2	1.9	2.3
Municipal police	1.2	0.4	2.0	1.1	1.3
Environmental	2.2	0.75	1.8	0.7	0.7
Total Number of Inspections Per Year					
	33	16.73	21.4	12.4	15.0

Source: BEEPS 2002

60. Not only is this high degree of inspections costly both in terms of management time, where the Kyrgyz Republic managers spend up to 8 % of their management time dealing with public officials, but it is also a very efficient vehicle to extract bribes. Approximately 75 % of firms report having had to bribe tax officials during the course of inspections, 57 % for licenses and permits and approximately 50 % for other inspections, such as fire, building or environmental. At the root of this problem are the low capacity level of the public administration and the overall low salary levels of public employees, which generate distortionary incentives to misbehave. Large firms are disproportionately hit by inspections and the informal payments that accompany inspections. The problem is exacerbated by the overlapping authority of various regulatory agencies, which can result in multiple inspections by different agencies for similar purposes.

61. *The government has attempted to curb the number of inspections, and to set up rules and procedures to be followed in order to protect firms from unnecessary inspections.* The most recent decree, in 2000, was focused on developing procedures for the regulation of inspections, to reduce the number, frequency, and duration of inspections, to prohibit inspections by the same government departments, and set up a mechanism to penalize state employees that breach established rules.⁹

62. According to the law, entrepreneurs do have safeguards built into the inspection system that should protect them from illegal and unnecessary inspections.¹⁰ Private firms are however often unaware of the regulatory norms applicable to them, their rights and obligations when they are subjected to inspections by state regulatory agencies, or the areas of criminal liability to inspectors for abusive behavior. The lack of

⁹ The decree also ordered a list of inspecting bodies that have required authority for inspections as granted by laws and make payment of fines levied only through bank accounts. Moreover, in theory, all inspections, *except* for tax and social fund inspections, have to be carried out with the consent of the Ministry of Economic Development, Foreign Trade, and Industry. The inspector must have a mandate for a specific inspection, which should be accompanied by a list of issues that the inspector should look at. After the inspection, a coupon from the mandate is returned to the inspecting body for recording of inspections and monitoring the activities of inspectors. The coupon must bear the signature of both the inspector and the entrepreneurs.

¹⁰ Entrepreneurs that are being inspected have rights to 1) ask for the mandate and identification of inspectors, b) refuse inspection if proper documents are not provided, 3) request that the inspector shows copies of legal and normative acts relevant for inspections, 4) refuse to abide by inspectors' requests that go beyond the list stated in their mandate, 5) appeal to the Ministry or the court against illegal inspections.

information campaigns undermines the ability of businesspeople to exercise their rights and demand fair treatment.

63. ***Firms do not have effective means of preventing unjustified inspections or appealing the decision of inspecting bodies.*** There is little trust in the courts and most firms fear they will suffer negative consequences if they appeal against an inspecting agency. As a result, although the total number of officially reported inspections appears to be on the decline (43,000 in 2003 compared to 56,000 in 2002), businesses continue to cite inspections as one of the major obstacles to doing business.

64. There are also legal consequences for illegal inspections for inspectors, which, if fully enforced, would likely prove to be a reasonable deterrent to the inspection-extortion phenomenon. For example, illegal inspections carried out with the purpose of extorting personal benefits to the inspectors or other persons can cost 200 to 500 times the minimum salary rate or sentencing for three to five years with or without confiscation of the convicted property.¹¹

65. A draft law to reform inspections is currently under consideration in the parliament. The law would establish a presumption of innocence and allow for a period of remedy before fines or sanctions could be levied. The law would also eliminate the “gatekeeper” role in the inspection process currently played by MEDIT, which has been shown not to be productive.

Creative Destruction of Licenses and Permits

66. While in theory, licenses are meant to protect state security, the environment, property, and the lives and health of citizens. In practice, however, licenses and permits are also frequently used as a way of attracting additional budgetary resources into specific line ministries. The set-up of the financial structure allows specific ministerial bodies to support their budgets by issuing licenses and permits, thus giving incentives to government agencies to issue as many as possible.

67. The problems associated with issuing licenses and permits stem from three main issues:

- flawed definition and use of licenses;
- the incentive to create licenses by state regulatory bodies in order to bolster budget revenues by use of ‘special means funding’; and
- the contradictions that exist in the articles of the Law on Licenses which can impact a business’ ability to obtain a particular license and operate legally.

68. The *Law on Licensing* sets the principles for licensing, and broadly defines the types of activities that need to be licensed (about 30 in all), but does not clearly define a license itself; it is simply described as a permission to carry out a specific business activity. The exact procedures necessary to issue licenses are often left to other regulatory bodies. This allows various state agencies to set new procedures and requirements for licensing which go beyond the boundaries of good practice licensing principles.¹² Furthermore, the implementing regulations for licenses are supposed to authorize certain agencies to issue

¹¹ Article 304-1 of the Criminal Code.

¹² A good example of how contradictions in the Law on Licensing can impact a business: Article 7 states that if other permits for undertaking a business activity are required (e.g. allotment of a land plot), then they can be granted *only on receipt of the license*. However, under Article 13 of the law, a license can only be issued upon compliance with relevant requirements set forth on normative acts regulating a given type of business activity. So, the business can easily be caught in a vicious cycle – it can’t start its activities until it gets licenses. But, the license cannot be issued until the business proves that it is in compliance with all the norms and regulations, which is sometimes not possible to do until all operations are in place.

licenses, and specify provisions for how this should be done. The problem is that this issue has largely been ignored up until now because there is no capacity to actually enforce implementing regulations. Additionally, the *Law on Licenses* also contradicts a variety of other related laws on licensing. This is extremely problematic since all of these various laws and secondary legislation carry the same force of law.

69. In order to protect citizens from over-zealous creation of special licenses and permits, any new law or regulation that intends to impose a new license is required to be prepared and submitted in accordance with rules established by Article 4 of the Government resolution #260, amended in February 2004.¹³ It is too early to determine whether or not these procedures will be followed, and whether there will be a real public-private dialogue about the creation and need of additional permits and licenses.

70. Many regulatory agencies are partially financed by ‘special means funding,’ which includes fees from licenses, permits, certificates and fines levied for infraction of regulations. This obviously creates incentives for regulatory excesses because budgets are then directly linked to agencies’ ability to generate revenues. As a result, the Government has issued a decree to prohibit the formation and use of special means funding of Governmental institutions through fees from issue of permits, and has directed all revenues collected this way to be directed to the state budget.¹⁴

71. In theory, this type of statute should eliminate the incentives for state agencies to issue licenses and permits, since the revenue generated would be directed to the state budget rather than the particular agency: in short, the agency would not be able to keep the money. In practice, however, the state budget continues to direct resources back to regulatory agencies directly in proportion to the amount of revenue generated by licenses, permits, inspections and fines. So, in the end, the decree is meaningless; regulatory agencies continue to financially benefit from the practice of license and permit creation, and the imposition of fees and fines and the perverse incentive system remains in place.

72. A draft law on licensing is also being discussed in the parliament. The new draft clarifies the definition of permissive document, clearing the ground from legal uncertainty regarding definition of what constitutes a license. The draft also extends the validity of licenses and prevents administrative revocation, requiring court action instead.

Land and Construction Permits: The Burden of Building

73. The process of buying or leasing land can be lengthy and expensive in the Kyrgyz Republic, since it involves multiple state agencies and sometimes the approval of local communities. Once a business has

¹³ Rules under Article 4 of Regulation #260 include: (1) a draft law or regulation is developed by an ad hoc commission represented by relevant state officials, experts, academicians, and entrepreneurs; (2) the full text of the first draft is published through mass media for public discussions, comments and suggestions; (3) the final draft has to pass through specialized legal, financial, economic, and subject field assessments; (4) the draft should be accompanied with exhaustive explanation about the necessity for licensing, problems it is intended to address, and why market forces fail to resolve the issues; and (5) a forecast of possible economic, social, legal, and other consequences of the proposed document such as incremental budget expenditures for administration, additional burden on entrepreneurs, etc.

¹⁴ A similar action will be taken with regard to fees from the issue of certificates and receipts from the imposition of fines resulting from inspections. Special means funding has been addressed at the legal level through the general Law “On General Principles of the Budget Law” and the Resolution of the Government from October 30, 2004 #798 “On Stage-by-stage Transition of Budget Institutions and Organizations to the Full Budget Financing” which requires all funds be transferred to the national budget. The Parliament is the body invested of oversight powers for this budgetary regulation, but the mechanism of enforcement has proved to be weak so far, allowing some governmental agencies to avoid compliance and retain earnings.

secured land, its next regulatory challenge is to obtain permits for site and building development. Those generally require pre-approvals, multiple site inspections (health, security, labor, etc.) and final approvals.

74. Participants in the focus group discussions conducted in connection with this assessment were particularly vocal in expressing their frustration with the permitting process, characterizing it as corrupt and beset by the perception that the best land plots go to those with the best connections, or those “in power”.

75. In addition to the above, the purchase or lease of land plots is characterized by four main issues:

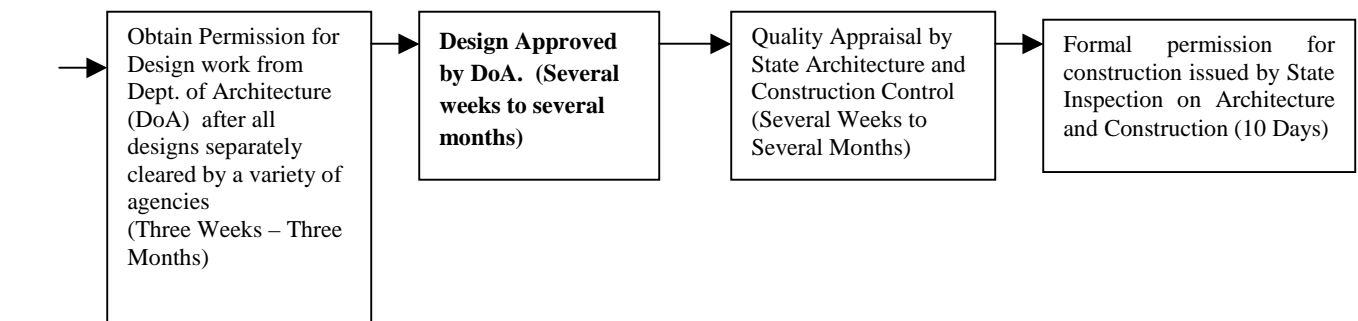
- difficulties in land plot appraisal (for purchase of land);
- auctions that are not transparent (for purchase of land);
- the scope of land use is limited (for leasing and purchase); and
- short periods for lease (for leasing).

76. The allocation of land plots for construction by firms is done by the Land Reform Center. It organizes sales (through auctions) or leases (through bids) of land plots for business activities. For property sales by the state, there appears to be no consistent or transparent process in place for the appraisal of a property. This introduces a high amount of uncertainty into the process, as firms do not know if the land is valued properly, whether or not returns generated by the business will be sufficient to cover the land investment.

77. Additionally, much speculation revolves around the valuation process; most entrepreneurs believe, rightly or wrongly, that appraisers set values arbitrarily, and that the pricing mechanism often depends on whether there is a pre-ordained purchaser. The auction process is completely lacking in transparency. It is usually unclear to other bidders how the purchase came about, and for what price the land is sold. Again, this increases the speculative value of the land, and makes holding land a more risky proposition.¹⁵ Furthermore, the scope of the land use is pre-determined by municipal authorities. While it may be necessary for urban planning purposes to set certain criteria for types of buildings/businesses, the specificity of the municipal order appears to go beyond what is in the normal realm of urban planners to ensure a competitive and aesthetic city plan.

78. If purchasing land plots is mostly an issue of transparency, obtaining construction permits is more about procedural bureaucracy. The process of obtaining construction permits is complicated and time consuming. The main steps required to do so are highlighted in Figure 5 below. However, the speed at which each step can be accomplished is idiosyncratic to the entrepreneur. There is no way to tell in advance when the process will be complete.

Figure 5. The Bureaucratic Chain



¹⁵ Finally, it appears as if there is no mechanism to document a purchase and sale transaction following the official procedures.

79. At issue is the numerous steps needed to be gone through by the applicant in order to start, and to complete construction work. These steps are not clearly identified and documented, and much time is expended in trying simply to find out what is needed to be done. The official fee schedule is not available so that advance planning of expenditures is also an unknown to the entrepreneur.

Access to Finance

80. The Kyrgyz financial sector is growing, but at a slow pace. Recent reform efforts of both the government and the central bank have improved the soundness of the overall financial system: privatization and regulatory reform allowed for improved competition and entry of foreign banks, which now account for about 60 % of banking sector assets. Almost all of the foreign banks are now from Kazakhstan, with the exception of Demir Bank, which is the largest bank in terms of deposits. At present, 20 commercial banks operate in the Kyrgyz Republic, of which only the Savings and Settlement Company (SCC) – the former Sberbank or Savings bank - is state owned. SSC remains a ‘narrow’ bank with no license for lending. Foreign-owned banks actively participate in the banking sector, bringing capital, new banking products and competition, and more modern practices that are expected to further improve the domestic banking system.

81. Nevertheless, the Kyrgyz financial sector is still rather small and characterized by low levels of intermediation. As can be seen in Table 9 below, despite significant growth since 2000, total assets remain low and both deposit and credit growth has been negligible.

Table 7. Structure of the Kyrgyz Banking System

	2000	2001	2002	2003	Jun-2004
Assets to GDP %	7.2	6.8	10.4	13.6	15.0
Credits to GDP %	2.2	2.1	2.7	3.5	5.0
Deposit to GDP %	4.2	3.4	4.7	5.7	6.8
Total Assets (Ml. Soms)	4,721	5,029	7,860	11,385	12,518

Source: NBKR, 2004

82. Banks in Kyrgyzstan are still reluctant to extend credits to the economy. Despite improved asset quality, with the percent of non-performing assets below double digits, the ratio of credits to deposits remains low, at around 60 %. Furthermore, interest rate spreads in nominal terms are still high, considering that some banks apply a zero-percent policy on deposits. There are a number of reasons behind the lack of commercial bank intermediation in the economy, including: a) the lack of long-term financing, due to low depositors confidence, low degree of governance in banks and lack of capital financing, with the exception of foreign-owned banks; b) difficult medium-term economic prospects in the SMEs sector, considering the low level of private capital inflows and FDIs; c) considerable informality, dollarization and lack of transparency in the enterprise sector; d) low levels of banking skills in assessing risk and pricing loans; and e) weaknesses and gaps in the legal and regulatory framework supporting banking and intermediation in general. In addition to the above, there are critical delays in the accounting reform for enterprises, weaknesses and corruption in the judiciary, a non-conducive collateral and contract enforcement regime, and gaps in the legislation protecting the authority of the National bank in regulating, supervising and resolving banks. These shortcomings, coupled with a significant degree of politicization of the system, contribute to high transactions costs, high collateral requirements and high interest rates that further undermine access to finance.

Table 8. Interest Rates

		2001	2002	2003	Jun-2004
In Soms	Lending Rates	36.4	30.2	25.1	22.6
	Deposit Rates	8.1	4.1	2.5	1.6
	Spread	28.3	26.1	22.6	21.0
In Foreign Currencies	Lending Rates	25.0	22.6	19.2	18.8
	Deposit Rates	1.0	0.6	0.5	0.5
	Spread	24.0	22.0	18.7	18.3

Source: NBKR, 2004

83. While commercial bank lending in the Kyrgyz Republic is largely based on the value of collateral, Kyrgyz banks have made progress in moving away from collateral-based loans to lending based on the capacity of the borrower to generate cash flows. This can be seen in the table below, indicating that Kyrgyz has the lowest percentage of loans requiring collateral, in a comparison to other several other countries in the region.

Table 9. Collateral requirements – Country Comparison

	Kazakhstan	Kyrgyz Rep.	Moldova	Poland	Tajikistan	Uzbekistan
Share that required collateral	85.1	75.6	98.8	68.8	63.0	81.4
Average value of collateral required (as % of the loan)	127.3	112.1	140.3	145.4	137.0	113.7

Source: BEEPS 2002

84. Nevertheless, the majority of loans is collateral based, and a flawed pledge system undermines the lending process. Enterprises report that banks may require up to 200% collateral coverage (i.e., collateral as % of loan value), generally higher than other countries in the region. The situation has improved somewhat thanks to the entry relatively more sophisticated foreign banks.. Nevertheless, even foreign banks are taking a prudent approach to lending in Kyrgyzstan, recognizing the difficulties in accessing reliable financial information on clients and in enforcing their contractual rights. Certain administrative barriers also make the loan application process lengthy and costly for both the borrower and lender. Despite improvements in the registration process to pledge an asset, the system is reportedly still considered to be too bureaucratic and costly, with needed notary certifications and frequent visits to the registries.

85. More importantly, foreclosure procedures remain unpredictable due to weaknesses in the judiciary and corruption, which contribute to increasing lending risks for commercial banks and thus transactions costs for enterprises. The authorities are trying to address these shortcomings and approved a new Pledge Law in March 2005. The law is expected to streamline collateral requirements and introduce out-of-court procedures for foreclosure of assets, and will help speed up the process, although it will be devoid of meaning if not accompanied by changes in enforcement mechanisms. In all cases, changes in the collateral regime and foreclosure procedures are much needed, as Kyrgyzstan scores as one of the countries with the highest costs to create collateral in the region, as seen in table 12 below.

Table 10. Getting Credit – Country Comparison

Country	Cost to create Collateral (as % of income per capita)
Armenia	0.9
Azerbaijan	9.2
Georgia	30.0
Kazakhstan	4.1
Kyrgyz Republic	12.4
Moldova	1.5
Uzbekistan	1.0
OECD Av.	5.2
Europe & Central Asia Region	7.7

Source: *Doing Business* Database, 2004

86. Other impediments to intermediation include lack of banking skills, delays in establishing the infrastructure for crediting and lack of alternative intermediaries. Despite the entry of foreign owned banks, banks' product base remains limited to investment and working capital lending services. Credit cards are still in their infancy, and few banks provide housing finance products. No banks have credit scoring systems, due to the lack of reliable financial information, and other lending techniques and practices are still rudimentary or underdeveloped. There is a private credit information bureau in the country, but it is weak and its operations and regulations need to be revised, and as a result, only three banks so far have joined the bureau. The accounting and auditing profession is not yet developed to acceptable standards, with few accountants certified for IAS audits. Other sources of financing are limited due to weaknesses in the supervisory framework and lack of skills: insurance and capital markets are illiquid, and there are no active investment funds. The stock exchange records very few trades per year.

87. As a result of these various constraints to lending, as highlighted by table 13 below, the Kyrgyz private sector does not heavily rely on, or conversely is unable to access resources from bank and other intermediaries to finance its operations. The share of domestic credit to firms has remained stable at a meager 5%, making the Kyrgyz Republic the country with the lowest growth in credit in the region. As a result, enterprise will continue to rely on internal funds and capital from friends and family for the foreseeable future – preventing the Kyrgyz private sector to be able to react quickly and efficiently to perceived opportunities.

Table 11. Domestic credit to private sector (% of GDP)¹⁶

	1999	2000	2001	2002	2003
Azerbaijan	3	6	5	5	7
Kazakhstan	8	11	16	19	23
Kyrgyz Republic	5	4	4	4	5
Moldova	12	13	15	17	20
Russian Federation	13	13	16	18	21

¹⁶ Definition: Domestic credit to private sector refers to financial resources provided to the private sector, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries these claims include credit to public enterprises.

Source: *World Development Indicators* database, 2003, on sources from International Monetary Fund, International Financial Statistics and data files, and World Bank and OECD GDP estimates.

88. In developed economies, companies tend to rely on commercial banks to provide much-needed short term working capital to smooth out seasonal cyclicalities, accommodate the production cycle and fill the financing gap between investment in inputs and receipt of inflows. In the Kyrgyz Republic, however, such instruments as working capital credit lines and overdrafts, collateralized by short-term assets such as customer receivables and inventory are not common instruments, given the difficulties associated with collateralizing such assets. Large firms, which include the greatest portion of exporters, try to make use of trade credit, both from suppliers and customers, to fund their working capital requirements. This route is more difficult, however, for small firms, which tend to settle accounts immediately; trade credit comprises 18.2% of large firm working capital but only 8.8% of the working capital of small firms. As a result, small firms must turn to other, more familiar sources of credit, such as loans from family and friends (9.3% of working capital of small firms vs. only 2.4% for large ones).

89. Exporters tend to view access to financing as less of a constraint (34.6%) than do non-exporters (45.5%) or small companies in general (42.2%) – as commercial banks may favor exporters at the expense of other firms. While exporters tend to have more commercial bank debt than others, at 5.2% of working capital, this amount is still very low. This may in part be because even firms such as exporters, which have greater access to banking, limit their borrowing due to the perceived high cost of credit – fully 73.9% of exporters rank the cost of financing as a major or moderate constraint, as compared to small firms (46.0%) and non-exporters (45.6%).

90. The exception to this is the largest firms (over 250 employees) which, according to BEEPS 2003, utilize as much as 20% bank debt to finance new investment. These firms, which typically have established borrowing relationships with their banks, are seen as known quantities with perceived higher probability of repayment. But with audited financial statements and higher levels of disclosure, they are also viewed as less risky credits.

91. Nevertheless, in the absence of other significant sources of financing, as shown in Table 14 below, most firms, large or small, must rely most heavily on their own internally generated funds and/or retained earnings, which generally remain unrecorded, informal and unbankable. Differences in the extent to which firms rely on internal funds relate to their ability to mobilize trade credit and marginally greater access to bank financing (except for the largest firms), and so we see that exporters finance 35.4% of new investment from internal funds/retained earnings, as compared to 50.9% for small firms.

Table 12. Sources of Finance for All Firms

Category	Type	Financing of new investments
1) Own resources	Internal funds/Retained earnings	49.16
2) Equity	Equity (i.e. issue new shares)	0.00
3) Borrowing from banks	Borrowing from local private commercial banks	3.21
	Borrowing from state-owned banks, including state development banks	1.16
	Borrowing from foreign banks	0.43
4) Informal sources	Loans from family/friends	5.00
	Money lenders or other informal sources (other than family/friends)	0.87
5) Commercial means	Trade credit from suppliers	1.73
	Trade credit from customers	2.57
	Credit cards	0.00
	Leasing arrangement	0.06
6) Public funding	The government (other than state-owned banks)	2.11
7) Other	Other	3.64

Source: BEEPS 2002

92. As in other spheres of the investment climate, enforcement and implementation issues affect access to finance as well. Court procedures are lengthy, expensive and unpredictable. In a number of occasions, even the decisions of the National Bank were reversed in court based on rather questionable reasons. In addition, enforcement of court decisions is highly inefficient, making it difficult if not impractical to enforce property and creditor rights through the court system.

93. Due to the low density of the Kyrgyz economy, much intermediation happens through microfinance and other specialized lending institutions, including credit unions. The microfinance sector is growing rapidly, especially in the rural areas. A new law on microfinance organizations (MFOs) allows them to register also as deposit taking institutions. Though very few institutions having applied for this type of license, deposit taking among MFOs that qualify would help them deepening access to finance and intermediation by mobilizing savings of the poorest and in the cities and in the most remote areas of the country. Other specialized lending institutions, such as KAFC, are filling the intermediation gap in the rural/agro sector, where private banks are generally unwilling to engage. Despite these positive developments, microfinance and specialized lending remain scattered and not sustainable without the intervention of donors and IFIs.

Kyrgyz Republic
Investment Climate Assessment

III. Implementation, Enforcement, and Capacity

Reforms to date - mixed results.

94. Despite the considerable efforts of the Kyrgyz government towards improving the investment climate, the effectiveness of such regulatory reform has been eroded by low implementation capacity among public agencies and ministries, spread of corruption, low enforcement record and legal uncertainty due to an ever-changing legal framework¹⁷.

95. *Enhanced dialogue between the government and private sector has helped propel investment climate reform.* Roundtables on investment climate issues have been systematically organized with representatives from the business community, government, and donor agencies to discuss the changes and new laws, and investment climate matters have made it to the top of government's agenda. The Presidential decree # 254 created two new investment bodies: the Consultative Council on Foreign Investments and the Investment Roundtable. As a result of the Investment Roundtables, five investment climate matrices have been developed. These matrices represent action plans for improving the business environment and investment attraction, with the main focus on eliminating administrative barriers.

96. *Most notably, business registration has been streamlined thanks to considerable improvements in the process.* Both individual entrepreneurs and firms can now easily and cheaply register – at least in theory– at the State Statistics Committee (at a cost of about 220 som or approximately US\$5), the State Tax Inspectorate (free of charge) and the Social Fund (free of charge). Legal entities need to register with the Ministry of Justice, which is bound by the law to provide a registration certificate within ten days of receipt of all required documents. More recently an entrepreneurship facilitation office has been established within MEDIT, self defined as a “one-stop shop” to further facilitate business registration and improve entry conditions for entrepreneurs to be. This facilitation center has not proved to be extremely successful, and it risks adding additional “facilitation” costs for business or conceal underlying inefficiencies without true process reform.

97. The reform of business registration should be enhanced by a draft law expected to be submitted to Parliament in the near future. By eliminating technical review and allowing the point of registration to issue a unique identification number for firms, registration would become a clerical function performed by a single body instead of a control function conducted by many agencies, as it currently exists. It would reduce the registration time to a day or so and eliminate the paternal role of government in deciding whether a particular business is necessary.

98. These recent improvements have formally reduced the number of procedures and days required to register a business, such that the Kyrgyz Republic nowadays has one of the best entry conditions among the ECA region countries, coming near OECD averages, as shown in Table 6. Nevertheless, the registration process remains complex, time consuming and expansive, as it requires visits to multiple agencies, each following its own statutory rules, in violation of the recently enacted legal changes.

¹⁷ The Country Economic Memorandum (CEM) offers a good overview of recently enacted legislation to reform the investment climate. The World Bank, Kyrgyz Republic, Country Economic Memorandum, An Integrated Strategy for Growth and Trade, June 1, 2004, Report No. 29150-KG

Table 13. Starting a Business Statistics, 2004

Country	Number of procedures	Time (days)	Cost (% of income per capita)
OECD: High income	6	25	8.0
Kazakhstan	9	25	10.5
Kyrgyz Republic	8	21	11.6
Moldova	10	30	18.6
Poland	10	31	20.6
Russian Federation	9	36	6.7
Ukraine	15	34	17.6
Uzbekistan	9	35	17

Source: *Doing Business Database*, 2004

99. *Amendments to the legislation regulating licensing have reduced the number of activities subject to licensing from 64 to 29*, although since then, this number has increased to 32, with additional licenses expected as new private customs brokers are allowed to open businesses. In addition, the licensing process has been rationalized by issuing one single procedure for licensing. Yet, most of the regulatory innovations have been eroded by legal uncertainty created by new regulations and procedures emanated by the Government. In addition, poor enforcement and implementation capacity in the public administration jeopardizes the implementation of the new legislation.

100. *The Tax Code of the Kyrgyz Republic is generally satisfactory for the functioning of the market economy while the tax administration remains a key hindrance.* Self-assessment of tax liability has replaced the official assessment, withholding has been introduced, and there is a more coherent tax rate on profits. In January 2004, the President requested the development of a new version of the Tax Code for the purpose of creating maximum favorable conditions to foster of entrepreneurial activity and inflow of investment. Although there will be no major changes in the tax code, it is expected that the new code will eliminate contradictions and ambiguities in the current system. Nevertheless, the benefits of the revised Tax Code will not be realized without further reform of the Tax Administration.

101. *A revised Customs Code is largely consistent with international best practices, such as the WTO rules and revised Kyoto convention.* The new code is based on the International Convention on Simplification and Harmonization of Customs Procedures and aims to balance the interests of the state and cross border traders. The new Code corrects problems of the previous regime that blocked emergence of licensed customs brokers. Yet, without simultaneously addressing bottlenecks in neighboring countries through intensive cross-border cooperation, the expected payoffs from this effort might fail to materialize.

102. *Various laws and decrees have been passed in favor of the business community*, such as the law on protection of the rights of entrepreneurs. The procedures for inspecting enterprises are stipulated in the government's resolution # 194 of April 4, 2002, which clearly states that the State Commission on Development of Entrepreneurship must authorize all inspections, with unauthorized inspections being punishable by law. It has also taken action towards curtailing the number of inspections by passing the presidential decree and the government's resolution on "Measures for reducing the number of unjustified inspections of enterprises". In February 2004, a further step was taken in improving the regulatory environment for enterprises: the President approved the Concept of Deregulation of the Economy,

according to which inspectors are to treat businesses as “bona fide” until the opposite is proven. Ultimately, however, curtailing inspection abuses rests with reform of the civil service, by reducing bloated public payrolls, releasing funding to provide “living” wages to agencies’ employees, thereby reducing incentives for bribe taking.

103. ***Labor and labor legislation are one of the most significant constraints to businesses in the Kyrgyz Republic.*** A new Labor Code is being drafted to make it more business friendly. For example, it is planned that maternity leave will be shortened while the termination of employment in certain cases will be made easier. However, the controversial clause in the Law on Employment, which requires that employers pay into the Employment Facilitation Fund amounts equal to remunerations paid to foreign employees has not yet been revoked causing some degree of nervousness among foreign investors, despite it is not being enforced.

104. The government is trying to address labor mobility and skills as main elements to foster productivity. However, the legislation on labor entry and exit need considerable streamlining. The Labor Code establishes basic rights and responsibilities of employers and employees, including termination of contracts, wages, leave, conflict resolution, etc. The Labor Code is relatively pro-workers, an inheritance of Soviet times, although in some instances employers can still apply negligible minimum wages not indexed to inflation or cost of living.

105. The cost of labor remains generally very low, even for skilled workers, and especially in the former state owned enterprises and in the public administration. Many private businesses also pay low salaries officially, meanwhile compensating their skilled workers with off-the-book contributions and premiums. This is due to the high contributions to the Social Fund, the stringent legislation on terminating contracts, with businesses preferring to keep workers on perennial leave [maternity leave in Kyrgyzstan for example allows for two years re-entry] instead of terminating the contract, and the lack of enforcement mechanisms to protect workers rights. The situation with labor safety is also quite alarming, especially for locally owned enterprises.

Weak administrative capacity to implement reform

106. **A significant problem faced by Kyrgyz entrepreneurs is the weak administrative capacity to properly implement regulation.** The lack of such capacity is persistent in many state agencies and institutions with many implications for the domestic investment climate. First and foremost, many legal reforms are poorly implemented. Second, the regulatory burden becomes even heavier due to the many revisions, inspections and audits. Finally, there is a problem of crony capitalism related to favoritism in drafting and especially implementing regulations.

107. This chapter reviews firms’ perceptions regarding the governance dimension of the investment climate. Governance can have many dimensions ranging from state capture to service delivery to public administration. This chapter will primarily focus on three aspects of governance: (a) the frequency or intensity of administrative corruption (Bribe Tax);(b) the link between governance and public administration (Corruption and Regulatory Enforcement); and (c) the implications for firm behavior at the micro level (Corruption and Firm Performance). The chapter will also review the state of the judiciary sector and contract enforcement in the Kyrgyz Republic as they are important factor in influencing firms’ attitude towards the rule of law and creating a secure business environment.

108. Why is corruption, particularly administrative or ‘petty’ corruption, so problematic? Many might argue, in fact, that it is not - that being able to make ‘informal payments’ to public officials is a Pareto improvement over having to adhere to regulatory norms and obligations, which can have high direct and transaction costs (‘greasing the wheels’ argument). Furthermore, bribes and rents to first and second tier

levels of government officials are often not prohibitively expensive for most firms. Finally, most ECA countries function in such a way that petty corruption is the norm, rather than the exception, so why the focus on this as an issue in Kyrgyz Republic?

109. ***Why is governance so important?*** The governance situation is important in the Kyrgyz Republic for a number of reasons. Firstly, corruption is costly to government revenue because it creates incentives for firms to stay out of the formal sector, therefore depriving the state of needed tax revenues. Instead of registering their activities, managers prefer not to pay taxes and not to benefit from key publicly provided services, such as legal enforcement of contracts. This scenario leads to a downward spiral in which firms leaving the official sector reduce state revenue, which reduces publicly provided services and further reduce the incentive to register in the official sector. The result is a negative equilibrium with low tax revenue, a high unofficial economy as a %age of GDP, and low quality of publicly provided services.¹⁸

110. For example, Johnson et. al. (1999) analyze a sample of 49 countries and find that it is the ineffective and discretionary administration of tax and regulatory regimes as well as corruption that increases the size of the unofficial economy. They look at the relationship between taxes and regulations, government budgets and the provision of public goods and examine the consequences of the condition of public finances for the unofficial economy and economic growth. And, they go on to show that countries with larger unofficial economy grow more slowly.

111. Secondly, petty corruption can create distortions in product and factor markets and therefore is a drag on innovation, productivity, and firm growth. Why is corruption distortionary? The secretive nature of corruption means that different activities have different chances of detection for bribes. Hence there will be some substitution effect following from corruption by which corrupt officials try to induce investment and transaction in the direction of lower-detection activities.¹⁹ In this same vein, Murphy et. al. discuss how rent-seeking, particularly public rent seeking by government officials, is most likely to hurt innovative activities,²⁰ while Johnson et. al. (1997) also show that in the face of high regulation, taxation or corruption, entrepreneurs choose not to start firms or expand less rapidly than they might otherwise.²¹ Corruption has also been empirically linked to firm growth in Russia, where firms that grow most rapidly, are much more vulnerable to predatory officials.²² Similarly, Fisman and Svensson find that the rate of taxation and the rate of bribery are negatively correlated with firm growth in Uganda. And, they show that a one %age point increase in bribery rate is associated with a three %age point reduction in firm growth – an effect about three times that of taxation.²³

112. Finally, corruption exacerbates poverty. Gupta et. al. demonstrate that high and rising corruption increases income inequality and poverty by reducing economic growth, the progressivity of the tax system, the level and effectiveness of social spending, and the formation of human capital. Corruption perpetuates an unequal distribution of asset ownership and unequal access to education, and their findings hold for countries with different growth experiences, at different stages of development, and using various indices of corruption.²⁴ Furthermore, because bribes are often imposed as a flat tax, the poor pay disproportionately more of household income, and informal payments can exclude the poor from access to basic services, and lost revenue to corruption reduces opportunities to provide social safety nets to the poor.²⁵

¹⁸ Johnson, Kaufman, and Zoido-Lobaton, 1998.

¹⁹ Shleifer and Vishny (1993).

²⁰ Murphy, Shliefer, and Vishny, 1993).

²¹ Johnson, Kauffman, and Schleifer, 1997).

²² Safavian, Graham, and Gonzalez, 2001.

²³ Fisman and Svensson, 2000 and Svensson, 2000

²⁴ Gupta, Davoodi, and Alonso-Terme, 1998.

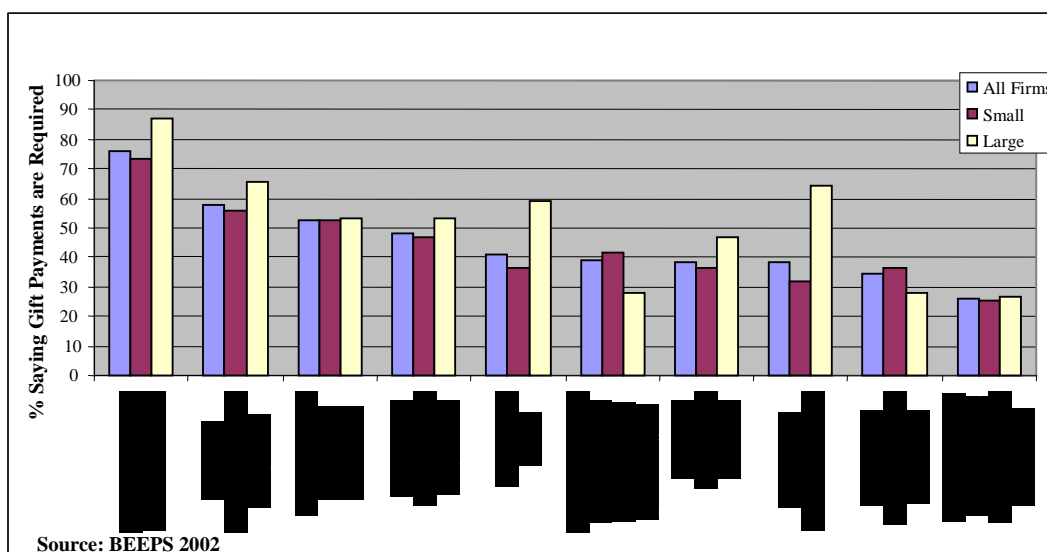
²⁵ Governance paper for the Kyrgyz Republic.

113. Chertwynd and Spector²⁶ propose a different link between poverty and corruption, arguing that corruption affects poverty by impacting economic growth factors, which in turn, impact poverty levels and exacerbate income inequality. Essentially this occurs through discouraging foreign and domestic investment, taxing and dampening entrepreneurship, lowering the quality of public infrastructure, decreasing tax revenues, diverting public talent into rent-seeking, and distorting the composition of public expenditure. In whatever manner one perceives the poverty-corruption nexus, the implications of the link between them has major distributional implications in a country like the Kyrgyz Republic, which continues to experience systemic poverty and sluggish improvement in reducing poverty levels.

Bribe Tax

114. Corruption and governance issues that affect the investment climate have many dimensions. One can view corruption as part of a “Bribe Tax” that is an add-on to the cost of doing business (petty corruption).²⁷ In the Kyrgyz Republic the bribe tax is pervasive. Making informal payments is compulsory for doing business, and firms are held hostage to fulfill personal interests of public sector employees (Figure 6). Note that, on average, large firms appear to be paying bribes more often than small firms. This is consistent with the notion that predatory officials will target those firms from which they can extract the most. Furthermore, large firms have fewer opportunities to operate in the gray economy, making it more difficult to avoid paying rents to public officials.

Figure 6. Government Services Requiring Bribes



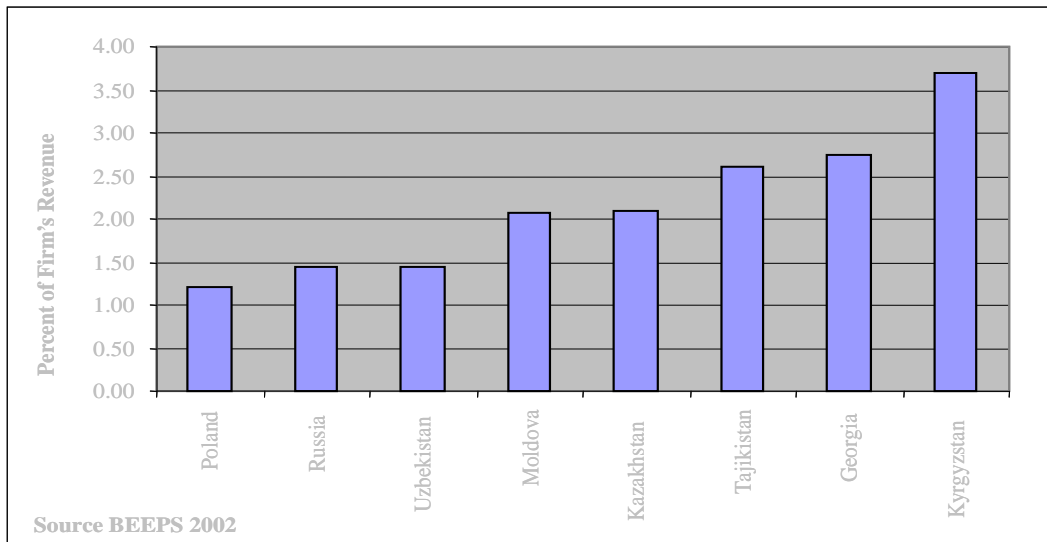
115. In addition to being ubiquitous, informal payments are costly. Kyrgyz firms suffer from the highest bribe tax (as a percentage of firm revenue) in the region, and the Kyrgyz Republic ranks at the bottom of

²⁶ Chertwynd and Spector, 2003.

²⁷ One can also think of corruption in terms of State Capture, which is the manner in which the government is ‘captured’ by the vested interests of the private sector, and no longer acts in the public interest, but in the private interests of those in power. We do not address State Capture here, not because it is not as important as petty corruption, but because instances of very high-level corruption are less likely to be revealed in surveys.

Transparency International Corruption Perception Index.²⁸ Presently, Kyrgyz firms pay 3.7 % of sales revenue in bribes, higher than any other country in the CIS 7 (Figure 7 below). While the reason for this is not clear from the data, it may be related to the general pervasiveness of corruption and level of accountability and enforcement. Firms appear to be at most risk for rent-seeking when dealing with tax officials (more than 75 % report that bribes are necessary), obtaining business licenses and permits (57 %), and dealing with other inspections such as fire, building, or environmental (47-52 %). Again, one sees a similar pattern; large firms are disproportionately constrained by bribes compared to small firms.

Figure 7. Bribe Tax across the Region



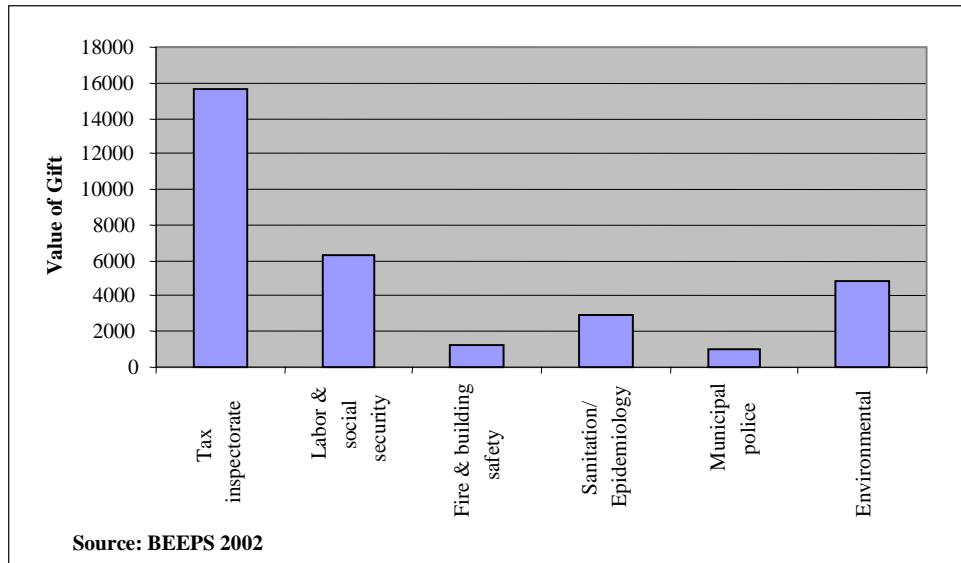
116. Which activities are most highly “taxed”? It appears from Figure 8 that the tax inspectorate imposes the highest bribe tax, more than three times the cost of any other required agency payments.²⁹ This is troublesome, given that tax inspectors are a fact of life for nearly all Kyrgyz firms, so weaknesses in this area can have enormous aggregate effects.³⁰

²⁸ Kyrgyz ranks 119 out of 133 countries in terms of being corrupt. Source: TI Corruption Perception Survey, 2003.

²⁹ This finding is consistent with the results of other BEEPS surveys across the ECA region.

³⁰ Customs is similarly beset by governance problems, and fines go into the private pockets of these public servants in the form of unofficial payments rather than into state coffers as they should.

Figure 8. Average Value for Informal Payment (LCU)



117. But, how costly are these bribes really for firms? Don't the informal payments actually make firms better off, because they are spared from having to comply with heavy and unnecessary regulation? Firms participating in one enterprise survey were asked hypothetically the value to their firm of the elimination of crime, corruption, and excessive regulations. Most firms indicated that the value of such imaginary scenarios was high enough that they were willing to pay a non-trivial percentage of their revenues (between 10 and 12 %) to achieve them, weakening the argument that corruption is efficiency enhancing for the private sector.³¹

Corruption and Regulatory Enforcement

118. In the Kyrgyz Republic, bribes are usually extracted under the guise of regulatory enforcement or complying with regulatory red tape. Regulation in and of itself is not bad – in fact good regulation is an important component of public health and safety, stability of the financial sector, preventing market failures such as monopolies, and allowing for the efficient use of public goods.

119. However, whenever there exists ambiguities in legislation or in instructions on enforcement, whenever public officials are able to use their discretion in deciding how to enforce legislation and regulation, and whenever there is little public sector accountability, opportunities for rent-seeking exist.³² Rent-seek opportunities are bound to be exploited when civil servants receive meager government salaries that are barely above the subsistence level. In fact, bribes are considered a normal supplement to the salary of most officials.

120. Figures 9 and 10 below show that unchecked authority in the Kyrgyz Republic appears, in part, to manifest itself through the high number of inspections compared to other countries, and the transactions costs (in time) associated with these inspections. Again, the issue of bureaucratic burden goes to the heart of firm performance, because it implies that scarce resources are diverted away from innovation, managerial capacity, operations, and redirected towards unproductive activities, such as regulatory avoidance.

³¹ Source: Governance and Service Delivery in the Kyrgyz Republic

³² Klitgaard, 1998.

Productivity analysis shows that high levels of inspections are significantly correlated with reduced firm productivity. In this measure Kyrgyz stands out as a poor performer, with highest levels and intensity of inspection regime in the sample.

Figure 9. Total Number of Days Spent in Inspections, by Inspecting Agency Kyrgyz Republic

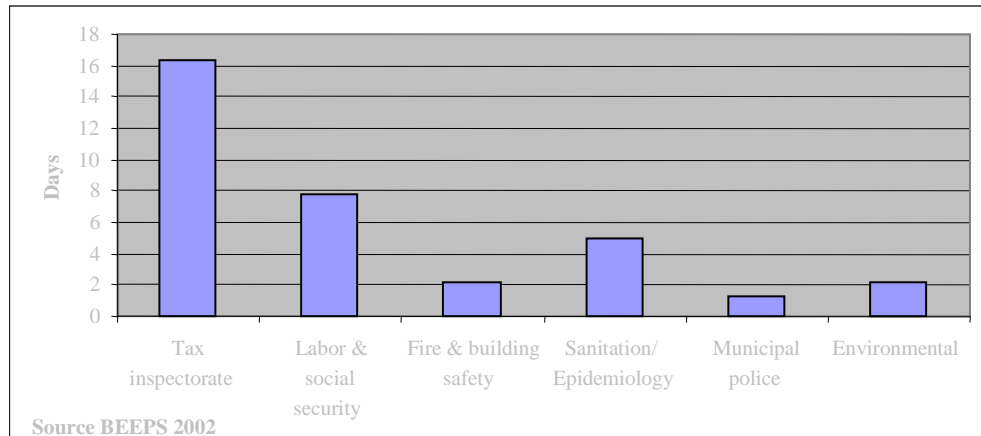
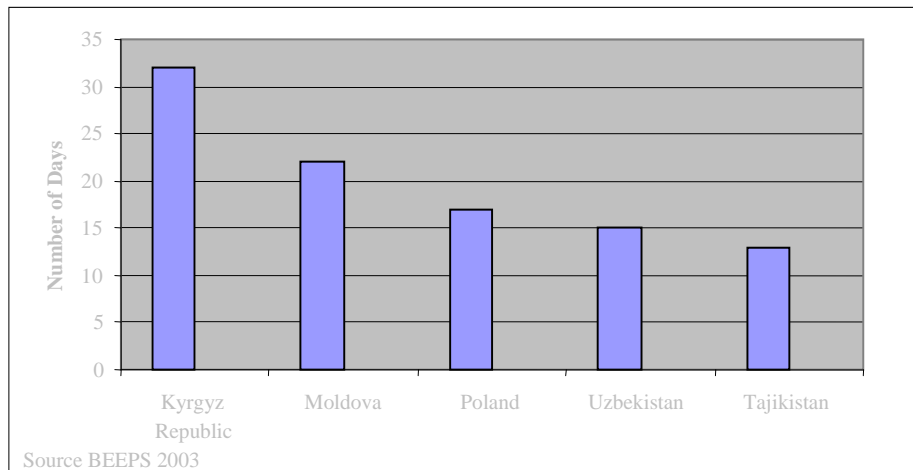


Figure 10. Total Number of Days Spent in Inspections – Country Comparison



121. Bureaucratic burden, red tape and other administrative barriers increase the cost of doing business and lower productivity.³³ Firms in the Kyrgyz Republic experience an extraordinarily amount of red tape in their day-to-day operations. While it is very easy in the Kyrgyz Republic to open a business, once a firm is operational, it faces a burdensome system, which includes unchecked inspections, an ever-increasing number of licenses or permits, and a messy certification system.³⁴

122. Inspections in general are perceived by the private sector as being the easiest manner for public sector officials to extract rents. But, not all inspecting agencies are equal (Figure 9), and tax authorities are the most notorious for their misuse of authority in the public administration system.

³³ Insert citations here, and reference following productivity section.

³⁴ Insert figures from DB on days to open a firm in the Kyrgyz Republic.

123. But what is driving this dominance of tax issues as a constraint from a firm perspective, given that tax rates *per se* do not appear to be particularly onerous for firms, particularly compared to other tax policies in the region. While there are specific taxes that are considered problematic for certain firms (e.g. VAT, social insurance), the overall environment for tax rates is reasonable. This is especially true for firms operating under the patent system.³⁵

124. What is driving the level of dissatisfaction among firms is a confluence of government abuses: the abuse of office by tax inspectors to extract bribes from firms, the lack of clarity and inconsistency in the laws which allow this abuse to take place, and the lack of recourse for firms to protect themselves from a system which favors under-the-table payments and credible threats to firms that do not comply with the demands of public officials.

125. The fact that tax regulations are numerous, inconsistent, and are constantly being amended (over 300 times since 2000) coupled with inconsistencies peppered throughout the tax code, create the opportunities for tax inspectors, auditors, and tax police to extract bribes and other rents. Data from both BEEPS surveys and focus groups reveal that the tax inspectorate is perceived to be the most corrupt administrative body in the government. Furthermore, evidence suggests that this situation is deteriorating. Focus group respondents indicate that the situation is worsening, compared to two years ago, even though the overall investment climate is improving. The primary vehicle by which bribes are extracted appears to be through unplanned tax inspections.

Corruption and Firm Performance

126. An important question is to ask how administrative corruption affects firm behavior and firm performance. Are all firms treated equally by regulatory predators? Do firms behave differently under regimes where there is a high bribe tax? Is firm productivity affected by rent-seeking? The answer to these questions has important implications for the investment climate, firm productivity, and the size of the informal sector in the Kyrgyz Republic.

127. The economic literature on corruption and rent-seeking cited earlier does suggest that generally firm productivity is affected by the regulatory environment, and that corruption is strongly correlated with heavily regulated economies, which are generally less productive, grow more slowly, and have a larger informal sector. Does this story also hold true for the Kyrgyz Republic? If so, how strong are these correlations?

128. Evidence suggests that there are high correlates between regulatory predation and firm characteristics, suggesting that, in fact, regulators in the Kyrgyz Republic do discriminate across firms in their efforts to extract bribes. Firstly, corruption is linked to firm size. On average, large firms report higher bribe taxes than smaller firms (3.85 % versus 3.6 %). Large firms are much more likely to cite corruption as a major or moderate constraint to their businesses than small firms (66 % versus 39 %). Large firms are also subject to a much higher rate of inspections than small firms.³⁶

129. Corruption is also linked to formality. For purposes of discussion, formality is defined as the degree of transparency with which the firm interacts with the public sector. While formality is impossible to measure objectively, a good proxy is the degree to which firms are honest in reporting their revenues to government authorities. There is a very high and significant correlation (0.76) between the corruption

³⁵ An in-depth discussion of the regulatory issues surrounding the tax code is presented in Chapter Three.

³⁶ Large firms are defined as those firms employing more than 150 workers.

constraint and the % of firm revenue reported for tax purposes.³⁷ This supports the commonsensical notion that the more enterprises report in income, the more likely they are to have difficulties with regulatory authorities.

130. Finally, rent predation is linked to firm productivity and growth for Kyrgyz firms. Although causality is not established, the findings of the empirical analysis show that for a subset of firms, problems with corruption are linked to lower productivity (measured either by total factor productivity or value added per worker), and lower growth in firm sales.³⁸ In this analysis, corruption is positively correlated with the ‘time tax,’ the amount of time managers spend dealing with public officials, which is consistent with the notion that regulators use inspections or other means of interacting with entrepreneurs to collect rents.

131. What do these findings say about rent-seeking and governance in the Kyrgyz Republic? Evidence is consistent with the notion that bribes are harmful to firm productivity and firm growth. The links between corruption and productivity are important. Kyrgyz Republic has the lowest firm level productivity measures (for a subset of garments and textiles firms) compared to a number of other central Asian and East European countries (see Chapter I). Firm productivity matters because it is strongly linked to economic growth, and because countries that grow experience lower levels of poverty. In this sense, the relationship between governance and firm productivity is of paramount importance for the Kyrgyz Republic.

Judicial Sector and Contract Enforcement

132. *Despite continued reform efforts, the judicial system is functioning poorly.* Since independence the Kyrgyz government has been working towards reforming its legal system and aiming at changing the inherited Soviet mind-set toward the rule of law; it adopted its first post Soviet constitution in 1993, which since has been amended several times and most recently in 2003. The government has also strived to create an adequate commercial legal framework for the economic sphere; it has adopted a new Civil Code in 1996 (amended in 1998) which governs all economic affairs, such as property rights, contract enforcement, protection of investors rights, land code and rule of agency.

133. *Trust in the court system is rather low in the Kyrgyz Republic, lower than in many other countries in the region.* As seen in Table 15 below, according to BEEPS 2002, when managers of companies were asked the degree to which they agreed with this statement, *I am confident that the legal system will uphold my contract and property rights in business disputes*, in the Kyrgyz Republic 65 % responded that they disagreed with the statement, compared to 49 % in neighboring Kazakhstan and 33 % in Tajikistan.

³⁷ Source: BEEPS 2003

³⁸ Source: BEEPS 2003. An ordinal logit model was used, with the dependent variable as the ranking of corruption as problematic by firm managers – i.e. managers were asked to rank, on a scale of 1 to 4, the degree to which corruption was problematic for firm operations. A number of specifications were tested (see Annex X). Productivity was consistently and significantly negatively correlated with the corruption index, regardless of whether TFP or Value added per unit of labor were used as measurements of productivity. Similarly, for all specifications of the econometric model, the log of change in sales (or sales growth) was significantly and negatively correlated with the corruption index. Finally, for all specifications, the time tax (the % of management time spent dealing with public officials) was significantly and positively correlated with the corruption index. Significance in this analysis was measure at 10 %. Firm size, measure either by number of employees, or by small/large designation did not appear to be significant, nor did the %age of taxes reported. Sample size varied, but ranged from 67 firms to 87 firms.

Table 15. Confidence in the Judiciary

Country	% disagree
Kazakhstan	48.47
Kyrgyz Republic	64.04
Moldova	70.18
Poland	28.00
Russia	65.30
Tajikistan	33.33
Uzbekistan	24.12

Source: BEEPS 2002

134. Lack of trust in the legal system limits the number of opportunities available to businesses and encourages inefficiency in the economy. In the absence of efficient courts, fewer transactions among businesses take place, and those transactions involve only a small group of people linked through kinship, ethnic origins and previous dealings. An entrepreneur who does not trust that his/her rights will be protected will refrain from engaging in new or complicated transaction. This naturally limits the number of available choices to businesses in terms of business transactions and business deals and thus limited opportunities for the private sector.

135. The Doing Business in 2005 study lists the Kyrgyz Republic in the group of countries that impose the greatest number of procedures. As seen in Table 16, it takes 46 procedures and 492 days to enforce a business contract through a court. Additionally it will cost around US\$ 730, which is more than double the income per capita. When courts are inefficient, procedures are very time consuming and costs are exorbitant, very few people are willing to go to court to settle their commercial disputes.

Table 14. Enforcing a Contract

Country	Number of Procedures	Time (days)	Cost (% of debt)
Armenia	24	195	17.8
Belarus	28	250	20.7
Kazakhstan	41	400	8.5
Kyrgyz Republic	46	492	47.9
Russian Federation	29	330	20.3
Ukraine	28	269	11
Uzbekistan	35	368	18.1

Source: *Doing Business Database*, 2005; and *Courts*, by S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, in *Quarterly Journal of Economics*, 118, pp. 453-517, May 2003.

136. The contract enforcement issues also make lending in the Kyrgyz Republic extremely risky and the Kyrgyz Republic stands out in the region as one of the most challenging places to enforce a contract. Court proceedings are too long and decisions are unpredictable – anecdotal evidence show that sometimes it takes 15 hearings for a bank to repossess collateral.

137. *Low confidence in the judiciary is in part due to lack of transparency and openness to public scrutiny.* The administration of justice also suffers both from poorly developed procedures for modern commercial practice and isolation from the enforcement process. Although formal provisions exist in the operative procedure code for preliminary, prejudgment relief (such as temporary restraining orders), clear standards for granting such relief and clear guidelines for effectuating them are still lacking.

138. A more general problem for courtroom justice is that there is disconnect between a judicial decision and its enforcement. Often, judges do not have at their disposal enforcement mechanisms, such as court injunctions and contempt of court to ensure enforcement. This creates delays, as frequently the only remedy is initiation of criminal proceedings.

139. Firms often complain that judges cannot force losing parties to comply with the court's judgment. This is partially due to the need for commercial courts to rely on enforcement mechanisms of the courts of general jurisdiction, which require a long and uncertain process. In addition, by the time this process is completed, the losing party may have abandoned its capacity to compensate the winning party. In addition, the inability of any court to instruct marshals on how to enforce and collect on judgments resulting from adjudicated cases is a serious problem and a detriment to the judicial system. (Judges sometimes do not even know if their judgments are being executed.) The result is that there are often judgments rendered by the courts that are not enforced at all. The development of informal enforcement mechanisms, such as credit reporting agencies and merchant associations, should also be encouraged.

140. The low efficiency of the judiciary is not only due to procedural deficiencies, but also to lack of skilled and trained judges to ensure proper decision. The current pay scale and work environment are not adequate to attract qualified individuals to become judges. Judges require not only improved compensation but appropriate facilities and resources.

141. Alternative dispute resolution mechanisms have been recently introduced in the Kyrgyz Republic. An arbitration center is already functioning in Bishkek, and a few cases have already been discussed and decided. The availability of extra-judiciary dispute settlement is an encouraging sign, since it will expedite the process of solving disputes between entrepreneurs who agree to rely on a cheaper, faster yet reliable system. Yet, some issues remain concerning the reliability of extra-judiciary dispute settlement in the Kyrgyz Republic: out of court procedures are often based on general legal concepts of trust and confidence, very low in the country among civil society and the business community.

Poor Institutional Capacity

142. The Kyrgyz government has made sizeable efforts in placing investment-related issues high on the agenda. Two new agencies responsible for investment attraction and facilitation were created by presidential decree³⁹. These are the Consultative Council on Foreign Investment and the Special Representative of the President on Attraction of Foreign Investment. Following investment roundtables, investment matrices outlining an action plan for enhancing the business environment and the investment climate were developed. However several problems remain. First, there is limited institutional capacity inside the government to implement policy changes in the investment climate. Second, the private sector has played, so far, a limited role in lobbying for improvements in the investment climate.

143. Perhaps more crucially, there is no single agency charged with overseeing and implementing investment climate-related reforms. The number of agencies in charge of the Investment Climate in the Kyrgyz Republic is abundant, they have vaguely defined responsibilities and share overlapping functions. For example, the Ministry of Economic Development and Trade, the Consultative Council on Foreign Investment and the Investment Summit all have similar duties in terms of drafting legislation, proposals and

³⁹ Decree # 254 of August 22, 2001

lobbying the government⁴⁰. The work of these agencies is not coordinated or monitored, and it is not clear who monitors, evaluates and assesses their performance and to what extent the work of these agencies enter the overall policy debate on investment promotion. While they are authorized to fulfill ambitious functions, however they lack clear implementation plans and neither have neither the human nor financial resources to carry out their responsibilities.

Institutional Structure

144. The agencies responsible for promoting investment climate reform and private sector development include the following:

145. ***The Ministry of Economic Development Industry and Trade*** MEDIT was formed on February 7, 2004 by Presidential decree by merging several bodies: the State Anti Monopoly Committee, the Ministry of External Trade and Industry, the Center for Economical and Social Reforms under the Ministry of Finance, the Center for Attraction of Direct Investments of the State Property Fund, the Center on Corporate Governance of the Prime-Minister's Office, and the State Commission on Entrepreneurship Support. The merge of these various agencies into a single ministry was aimed at reducing the number of government officials through streamlining the government structure and eliminating duplicative functions.

146. While the new ministry is responsible for a wide range of activities and functions, most of which relate to the drafting and implementing of investment climate-related legislation, negotiating with foreign investors and monitoring FDI, it is be poorly endowed to properly tackle such challenging functions. The number of civil servants has not been reduced, and the staff that has been transferred from former agencies does not have the experience or the formal training to work with the private sector or draft investment related legislation. All together, the overall capacity of the ministry on policy formulation and implementation remains low.

147. ***Consultative Council on Foreign Investment***. This quasi-governmental agency, which is an influential body chaired by the president and includes the Prime Minister, the Special Representative of the President on Attraction of Foreign Investment, a representative of an international financial institution, one ambassador and three foreign investors. The council is responsible for holding discussions on FDI attraction, directing government bodies on investment issues and developing proposal for the President and government institutions dealing with FDI on legislation and investment promotion. The council has an important role in developing general investment policy and influencing decision-making at the top policy level. The council has also coordinated a number of technical assistance projects of the World Bank, UNIDO and other organizations.

148. The position of ***Special Representative of the President on Attraction of Foreign Investments*** does not grant any specific political or administrative powers and functions. The Special Representative is intended to play a role of policy advocacy. This position is meant as a preferential and direct link between the government and foreign investors. In addition, the Special Representative has become the linkage between the Presidential Office and the Investment Summit

149. ***Investment Summit Secretariat*** coordinates the annual Investment Summit, which is a forum for dialogue between the public and private sectors, engaging also foreign investors, representatives from the central and local government and donor organizations. The result of each Investment Summit meeting is the development of an investment climate matrix that prioritizes the actions to be undertaken by the government to improve the investment climate. The organization has a legal status of a private foundation

⁴⁰ There was also a conflict of interests with the (former) President chairing the Consultative Council on Foreign Investment, which is in charge of presenting proposals on investment promotion to the Parliament and the President himself.

and is funded by the USAID. Despite its efforts and high-level backing, the Secretariat may have suffered from deficiencies in the institutional setting, as it is a quasi-government entity without the authority and legitimacy to push reforms within the public administration and ministries.

150. While the Investment Summit process has proven to be a best practice of inclusion and dialogue, having paved the way for important legislative and regulatory reforms in the business environment, the poor implementation capacity of the government undermines the viability of the investment climate matrix mechanism. The five editions of the investment climate matrix have dealt with an overwhelming reform agenda, coping with complex and multiple issues simultaneously. Inevitably, the volume of tasks and the relatively short time frame allotted for their completion have tended to overwhelm the responsible agencies, with their limited implementation capacity. The mixed implementation results thus produced as unrealistic deadlines are routinely missed thus undermines the validity of the investment matrix initiative. As a result, the investment climate matrices are limited to the drafting of new legislation and/or regulation that afterwards is not properly implemented.

151. More generally, the factors that lay behind the phenomenon of “patchy” implementation reflect the broad range of issues constraining reform implementation today, including the following.

152. First, there is an issue of **legal consistency and certainty**. In many instances, the regulatory and legal changes contradict existing legislation without specifically stating the legal priority in the new legal/regulatory act. This generates room for legal uncertainty with many legal and normative acts often contravening each other. On this, a major bottleneck is the lack of a clear hierarchy of legal and normative acts in the Kyrgyz legal system (i.e. an explicit legal hierarchy or a general one based on the principles of time, source or character of the law). The need to clear the ground for this legal uncertainty has been recognized by the government

153. A second concern is the **quality, depth and reach of legal reform**. In some cases, the new laws and regulations to be enacted are too ambitious, unrealistic or less relevant than expected due to lax legal definitions. In addition, despite the publicity requirements of new legal and normative acts (through publication), neither the public official that have to enforce them nor the general public that has to abide by them seem to know about these legal changes. The situation is exacerbated by (i) an overall declarative nature of many laws that do not specify clear implementation mechanisms; (ii) duplication of norms and regulations; and (iii) adoption of new norms along with the operation of the old ones.

154. Third, the **institutional setting** established to manage investment climate reform implementation is not suitably endowed to properly carry out these functions. They do not have sufficient capacity and authority (financially, logistically and administratively) for reform implementation or to push forward reforms in the line ministries. In addition, there is not a clear reporting system between agencies, making it difficult to track the progress of implementation.

155. Fourth, there seems to be an **overall lack of capacity** in implementing relevant legal and regulatory changes along the line ministries. Any legal reform needs to be implemented at the ministry and/or agency level, and the situation in the Kyrgyz Republic is such that not all the ministries and agencies interested by these legal changes have the capacity to implement these much needed reforms. In addition, the low capacity is not only due to lack of financial resource, but also to low technical and human capacity.

156. Finally, the overall reform process is hindered by **inadequate Monitoring and Evaluation (M&E)** systems that would allow for ex-post assessment of both the relevance and suitability of new legal and normative acts. Thus the government is unable to fine-tune the legal reform process to the actual needs and characteristics of the investment climate.

157. There is an evident risk of generating “**reforming fatigue**” onto the implementing agencies and line ministries. Apart from being undermined by the above mentioned factors, the Investment Matrix initiative suffers from the overall constraint of being a bit unrealistic in both its scope and timing. Unquestionably, all of the assignments and activities included in the matrices are of utmost importance. Yet, it sounds sometimes unrealistic to expect the accomplishment of such critical and deep changes as scheduled in the matrices. This has been the case, for instance, of many items included in the previous editions of the investment climate matrix that still have to be implemented – or have been poorly implemented with mixed results.

158. In spite of the best intentions from the Government, the change in the business climate that is required for significant private sector led growth will require longer time and more resources, particularly to build capacity of the staff. A review of the list of actions expected to overcome the business climate rigidities may lead to believe that the activities may not have been planned properly and that the resources necessary to achieve them may not be in place. This is stressed also by the fact that among the deadlines that have been set more than a few have not been met yet.

159. These drawbacks have the potential of jeopardizing – or seriously delaying – the reform process as a whole, and require a better prioritization and sequencing of reforms that need to be remodeled to accommodate the capacity of implementing agencies and line ministries.

Private Sector Lobby

160. Various bodies, such as the Chamber of Commerce, International Business Council and Local Business Associations, are potentially acting as agents for changes in the investment climate. Apart from the International Business Council, it appears that these bodies often do little to influence the policy debate. For example, the Chamber of Commerce is responsible for organizing fairs and exhibitions and promoting Kyrgyz companies abroad, establishing contacts between the Kyrgyz businesses and their foreign counterparts, but taking no role in the domestic policy debate and policy formulation.

161. The International Business Council consists of representatives of the largest foreign and local companies and international organizations. The Council is responsible for determining the position of foreign investors and communicating it to the government, and preparing proposals on investment climate improvement. The Council has access to high-level government representatives and is effective in communicating concerns of its members. The IBC was established as a non-profit organization in 2000, grouping the major investors in the Kyrgyz Republic to promote good business legislation and efficient business practices. Since then, the IBC has grown to include both domestic and foreign members operating in a wide range of sectors.

162. Local business associations, of which there are more than ten with mainly sectoral focus, protect the interests of business community through organization of public campaigns and negotiating with government agencies, as well as lobbying desirable changes in tax legislation, regulations, licensing and other areas. These associations are becoming increasingly active in protecting different business groups against attempts of the government to increase its control over the private sector. Though, they have recently made noticeable steps towards coordinating their activities, their lobbying capacity are limited.

163. After the recent changes following the upheavals of March 2005, the private sector has become increasingly active. Recently, many sector specific business associations have become more vocal, elaborating general and specific demands for reform of the investment climate. The growing participation of the private sector in the social and political life of the country is being translated by a number of

associations jointly presenting an elaborate policy reform program. Such program has been published in newspapers and presented to the public at a recent forum in April 2005.

164. The private sector is increasingly becoming vocal on the need to reform the investment climate and streamline the many interactions between the private sector and the public administration, especially for what it pertains with inspections and tax administration. Moreover, sector specific business associations are allowing the private sector to become more proactive in putting forward sector specific strategies for consideration of the government, as is the case for tourism.

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IV. Moving Forward: Reform Implementation

165. The enforcement and implementation challenges in the Kyrgyz Republic call for much needed reforms in the sphere of public administration and judiciary. Public sector reform would allow shifting the current pattern of interaction between public and private sectors from rent seeking to service provision. Similarly, judicial sector reform will provide for a sound and reliable system for proper enforcement. Currently, the Kyrgyz Republic is engaged in reforms of the public administration (under the aegis of the World Bank GSAC program). Such challenging reforms usually require long term commitment and will bear fruits only in the medium and long term. Following are a few areas off intervention that can sustain this reform process and address in the short term some of the rigidities highlighted in this assessment.

166. Regulatory hurdles top the investment climate barriers faced by enterprises operating in the Kyrgyz Republic. Firms recognize business registration, licensing, inspection and corruption as the main impediments to entrepreneurship in the country. The innovative means developed to cope with regulatory reform seem appropriate to tackle the challenge of designing, proposing and initiating legal reform: the investment climate matrix brings together representatives from the legislative and executive powers, international organizations, private sector and civil society. Yet, the efforts and results of legislative reform are undermined by low enforcement capacity.

Streamlining the Institutional Framework for Investment Climate Reform

167. *A more focused approach in the design stage would provide an improved foundation for reform implementation.* To accomplish this, the investment climate matrix should be narrowed in scope, with specific implementation tasks better prioritized and sequenced, with more realistic deadlines at each step along the way.

168. *To ensure success, the investment climate matrix should be adopted by all relevant agencies of the government as a truly government-owned agenda.* The government needs to rationalize the institutional setting for investment climate reform by consolidating functions and empowering a single high level agency with responsibility for policy formulation and implementation. This agency would also be responsible for coordination of other ministries and agencies to avoid duplication and overlapping and ensure the success of the reform process. While this report hesitates to identify a particular agency for this role, given its broad focus on private sector issues, MEDIT could function in this capacity, provided it implements a plan for restructuring of its various units and a program of staff capacity building.

169. Since the impact of investment climate reform has also been diluted by the lack of monitoring functions, the above mentioned agency should be empowered to monitor implementation. This would allow it to fine-tune legislation, ensuring consistency, and guaranteeing proper enforcement of the overall reform process. Such monitoring functions will allow the agency to oversee the reform programs by calling upon the line ministries and agencies responsible for implementation and hold them accountable against binding timeline and action plan.

Enhancing the regulatory reform process

170. **Introduce a system of Regulatory Impact Assessment (RIA)** for government regulations affecting the investment climate, with the aim of analyzing the impact of new regulations by providing a framework for cost-benefit analysis of new legislation at its development stage before enactment. RIA would allow Kyrgyz legislators to evaluate the viability of proposed legislation and its impact on entrepreneurship.

171. RIA is nowadays widely used in many OECD countries to improve regulatory decision making. As any assessment program to review the costs and benefits of new regulation, RIA requires appropriate capacity of public servants to properly assess regulation, collect data and carry out public consultation with key stakeholders.

172. RIA would greatly benefit the Kyrgyz Republic as a means to evaluate existing regulations. To this extent, the Kyrgyz Republic should also consider the possibility of a wider legal review to ensure legal consistency among the many laws enacted since independence.

Box 2. The “Guillotine” system to ensure legal certainty.

In 1984, the Swedish government realized that it was unable to compile a list of the laws and regulation in place and decided to start a regulatory reform based on the “guillotine” system. The Government instructed all government agencies to establish registries of their ordinances by July 1, 1986. While preparing their lists, governmental agencies screened their regulations having to justify the relevance of regulations to be registered.

The system was extremely effective in reversing the burden of proof for keeping regulations in place: ministry officials commented on rules deemed unnecessary or outdated and had to provide justifications to maintain other regulations deemed adequate. When the “guillotine” went into effect, hundreds of regulations not registered were automatically cancelled without further legal action. All new regulations and changes to existing ones were henceforth to be entered in the registry within one day of adoption.

173. The introduction of RIA in the Kyrgyz Republic would bring institutional and capacity challenges. Potentially, RIA could be introduced gradually and on a pilot basis. In addition, donor assistance could be requested for establishing a RIA unit within the Government, developing the methodology, providing training and other technical support. As best practice from international experience shows, RIA requires a peculiar institutional setting. In most cases, successful implementation of RIA systems has been supported by the establishment of a body solely dedicated to the implementation of the RIA in the country.

Box 3. Institutional Implications for RIA: the Example of Mexico

Different countries have adopted different institutional solutions to successfully implement RIA system. For instance, the USA delegated RIA functions to a presidential office while in Great Britain a ministerial panel oversees RIA implementation. Mexico is often referred to as best practice for the establishment of a commission at federal level: the Comisión Federal de Mejora Regulatoria (COFEMER).

By law, COFEMER plays the crucial role of overseeing the regulatory process developing cost-effective regulations, mainly by carrying out the following functions: (i) eliminating or simplify reporting requirements of citizens and firms; (ii) reviewing legislative drafts and carrying out RIAs; (iii) assessing existing regulation and proposing amendments; and (iv) developing and running programs for regulatory improvements at the state and municipal levels. Hence, COFEMER represents the key oversight body to ensure regulatory quality and legal consistency in Mexico. In addition, COFEMER plays a vital role of developing analytical expertise, providing guidance and training across the public administration. COFEMER ensures that transparency is widely applied to the legislative process: upon submission of draft laws from other agencies, COFEMER publishes both the proposal and comments.

174. Ensuring legal certainty and predictability through a ‘guillotine’ and RIA approach may prove challenging for the Kyrgyz Government at both practical and institutional levels. Any initiatives of this kind should be properly planned and tailored to the needs of the country. The efforts to enhance the regulatory reform process could be phased, with sufficient time provided to ensure implantation.⁴¹ At first an immediate moratorium on new regulations could be introduced to avoid the overwhelming effects of the many draft laws and regulations currently pending for approval. Hence, a guillotine process should then, over the following six to eight months, be employed to discard irrelevant, contravening and obsolete regulations. Finally, the introduction of RIAs could strengthen the overall legal framework and ensure consistency and quality of regulation.

Reducing Administrative Barriers.

175. An effective reform program aimed at eliminating or drastically reducing administrative barriers should focus on:

- Clarifying functions and responsibilities of public agencies, in particular those of inspection agencies and regulatory bodies, to avoid duplication, to economize, and to improve efficiency; and to separate policy and regulation functions;
- Improving standards of pay with measurable benchmarks in the context of the ongoing civil service reform;
- Eliminating off-budget funding sources of public agencies and enforce the principle that all public funds (including regulatory and user fees) are channeled through the budget;
- Improving transparency and accountability.

Easing business entry.

176. *Company registration needs to be streamlined* by (i) reducing the time spent in business registration; (ii) avoiding duplication among registration agencies; and (iii) increasing access to information related to the registration process, for instance by establishing a publicly accessible register for all registration requirements detailing the rules, procedures, timing and costs.

177. *A key step would be reforming the current one-stop shop* as it is rather dysfunctional due to limited capacity and scope. A properly designed one-stop shop would streamline the process for entrepreneurs to meet registration requirements (Statistical Office, Ministry of Justice, Tax Administration, Social Fund) through interaction with a single public body. The unified process would allow the company to obtain a single identification code for all these agencies.

178. The government will have to address many challenges for the one-stop shop to be functional:

- Legal consistency: *amend the law on registration* to clearly define the role and responsibilities of the one-stop shop;
- Institutional implications: *a single agency needs to be responsible and accountable* for the one-stop shop. Such agency needs to be empowered to coordinate the activities and provide guidelines to the other agencies involved;

⁴¹ For example, the guillotine process in Sweden and Hungary took two to three years; Russia gave seven years for its stock of 40,000 or so "technical regulations" (including all industry standards) and Korea had a goal (after its financial crisis in the late 1990's) of reducing regulations by half in one year.

- **Capacity building:** the one-stop shop initiative will require a comprehensive program to train public officials among agencies.

179. Once established and properly functioning, the one-stop-shop can be enhanced by technology tools to further improve efficiency and transparency of the registration process, i.e. by setting up a dedicated web-site with various degrees of interaction among government agencies and entrepreneurs (from simple information dissemination to more sophisticated two-way interaction like electronic submission of forms).

Box 4. Japanese Online Services for Start-up Companies J-Net 21

The Japan Small and Medium Enterprise Corporation (JASMEC), a public agency that plays a significant role in implementing Japan's SME policy, ventured a portal service called portal site J-Net 21. (<http://j-net21.jasmeac.go.jp/index.html>) It functions as a one-stop shop for SMEs, connected electronically to various administrative bodies as well as private entities, where all the necessary procedures to create a business can be completed for start-ups as well as valuable information to expand a business can be obtained for SMEs at their early stage. The integrated system provides a variety of information and guidance, such as initial examination of business concepts, information on permits and licenses required for establishing a business, investors and necessary contacts, referral to additional information sources and more. It also provides training session like how to, such as preparing business plans, money management, foreign investment, ISO certification, tax planning and more.

180. While one-stop shops are suitable in eliminating some administrative barriers, they are second generation reform tools to be implemented after processes have been properly streamlined. A one-stop shop would be a single government agency with the necessary authority to grant the various licenses, permits, approvals and clearances. Without such an all-embracing authority, the agency could in fact not wield much control over the process⁴².

181. In the case of the Kyrgyz Republic, a one-stop shop approach should follow the reform of unclear and non-transparent processes and procedures for business registration. One-stop shops are most successful for simple, basic registrations, where an applicant fills in a single form, and the information is then sent by the one-stop shop to all the relevant agencies that want the information: company registry, tax registry, statistical registry, municipal authorities, etc. with no further responsibility on the part of the applicant. Given the present environment, a one-stop shop may simply become a coordination mechanism where various agencies still maintain their powers, hence invalidating the purpose of the one-stop shop.

182. Before embarking on the establishment of a one-stop shop, the Kyrgyz Government should address the structural weaknesses of the business environment. Then, a close relationship needs to be developed among the staff of the many agencies, starting a cooperation that should result in strong linkages among the agencies. On the basis of such cooperation, common standardized procedures could be developed to sustain the transition towards an effective one-stop shop that can capitalize on cooperation and dramatically reduce administrative barriers⁴³.

Improving Tax Administration

183. The key bottlenecks of legal uncertainty and low awareness (both in the Tax Administration Office and private sector) of the latest amendments and legal changes can be addressed by addressing ambiguous

⁴² Do "one-stop shops" work?, F. Sader, Foreign Investment Advisory Service (FIAS), the World Bank Group, 2002

⁴³ From Red Tape to Smart Tape, Administrative Simplification in OECD Countries, OECD, 2003

tax legislation through appropriate legal conformity assessments and by improved information dissemination, utilizing electronic communications, supported by public information campaigns. It is crucial that both entrepreneurs and tax inspectors are aware of the most recent changes in the legislation and procedures for the enforcement of tax policies and regulations.

184. *The adoption of technology components now widely employed in other countries would improve the efficiency and transparency of the tax collection and inspection system.* Information and Communication Technology (ICT) can be useful not only to facilitate information sharing and awareness, but also to introduce “electronic” filters in the tax administration process.

185. ICT offers a means of increasing public awareness on tax rules and procedures, most commonly through a web site with information available to the general public without time or location constraints. In addition, a completely restructured and electronic tax filing and payment systems could be introduced to reduce contact between tax collectors and taxpayers. A Tax Integrated System could accumulate all tax-related information, creating profiles of enterprises and electronically select candidates for audits and inspections based on preset criteria. The system could considerably reduce the influence of tax officials in selecting firms to be audited.

Box 5. Cameroon: Web-Based tax information

The Cameroon Department of Tax developed a web-based mechanism for publishing and interacting with citizens and businesses. The department uses the Internet and a variety of database and web publishing software to make the tax processes more transparent and reliable.

The Cameroon tax service faced a number of challenges related to a highly inefficient system undermined by paperwork, long processing delays, poor management and tracking of revenue collection. Businesses were particularly exposed to corruption due to unclear and opaque regulations of the tax system and their implementation. Recent regulations were never made public on a timely basis and therefore businesses had to visit the local tax offices for information frequently.

The Cameroon government embarked on a project to modernize the tax system using ICT to: (i) provide timely and accurate information to citizens and businesses about tax regulations; (ii) reduce the cost and increase the accuracy of tax collection; and (iii) reduce corruption

As a first step, the tax department created a website to provide taxpayers (especially firms) with quick, transparent and easy access to information. The site provides details of corporate tax structures, laws, guidelines and procedures, and information about the annual business tax calendar and responsibilities. The website also provides guidance on writing and presenting tax declaration. A particular effort has been made to provide information on payment and refund procedures and locations, and details of the tax tribunal system.

Low Internet penetration represented the main challenge for the implementation of the project. Less than 3% of Cameroonians have Internet access, and there is no access in rural areas. Workshops and awareness campaigns have been organized by government agencies and private organizations to provide appropriate skills to end users who access the website mainly through cyber-café and telecenters.

Source: <http://www1.worldbank.org/publicsector/egov/cameroontax.htm>

Simplifying the inspection regime

186. While ultimately the reform of the inspections regime depends on the reduction of the number of civil service staff, increases in salaries of inspectors and others, and elimination of duplicative agency functions, the following actions should be undertaken in the near term.

187. The regulatory framework needs to be streamlined so that the different inspectorates comply with the norm of the Law on Inspections. At present, some inspectorates have their own operational guidelines that often do not take into account the innovations brought about by the new law. This is an issue of legal conformity that undermines regulatory certainty in the area of inspections.

188. Clarify the institutional relationship between the inspectorates and the State Commission for Business Development (within MEDIT). This would enable the unit within MEDIT to carry out the screening and enforcement functions initially envisioned. In addition, sanctions against abuse of public official position should be formalized.

189. A twofold reform program is needed. On the one hand, the program will need to address the training needs of inspectors through capacity building on how to implement new regulations and move towards a “client orientation” in their work. On the other, the reform program will need to address the information needs of entrepreneurs. Any such program will need to make more information available to entrepreneurs about the inspection process and guarantees. This could be achieved by establishing registers to make available to the public the rules and procedures for conducting all inspections, specifying clearly what constitutes compliance and non-compliance and the rights of entrepreneurs

Box 6. Reforming the Inspection Process: an Example from Latvia

Many firms in Latvia complained about the inspection regime, representing a major administrative barrier to growth, inspections being costly and time consuming.

In 1999, the government of Latvia embarked on an ambitious reform program by approving a strategy for an inspectorate improvement program. A set of instructions on internal guidelines addressing the legal aspects of inspection was designed. This also allowed for standard guidelines for the inspection process and introduced new provisions, such as a requirement for written inspection reports after all inspections. Simultaneously, an inspection Coordination Council was established to streamline the interaction between the various agencies and inspectorates.

Capacity building and public information campaigns represented a crucial component of this reform process. Training programs were developed and delivered to inspectors on how to improve strategic focus and develop a “client orientation”. Information to businesses about the inspection process was made available.

The reform program also envisaged a monitoring system to evaluate the pace of reform and potentially fine-tune it. A few performance indicators were developed to monitor key inspectorates, while public annual performance reports were established for inspectorates at large.

These hefty reform efforts paid off in the short term, with tangible outcomes, such as drastic reductions of 50% or more in the number of inspections across many inspectorates, in just two years, from 2001 to 2003.

Streamlining the Licensing Process

190. In order to eliminate problems associated with licensing and permits, the definition and uses of licenses needs to be rationalized, the “special means funding” needs to be eliminated; and contradictions in the law on licenses which impact a business’ ability to obtain a license and operate legally need to be resolved.

191. In addition, the “special mean funding” needs to be eliminated, and in order to provide a rational, transparent and fair means of funding the inspections process, a system of mandatory enterprises “user” fees

should be contemplated. Such a system should provide sufficient funding to inspectorates, reducing incentives for bribe taking – and thereby not overly burdening enterprises.

192. Particularly, sector-specific statutes and sub-regulations related to licenses and permits should be aligned to the letter of the law, so that the Law on Licenses is the only legal basis regulating this important component of the business environment. This regulatory rationalization needs accompanying measures in the enforcing agencies to clear the ground from institutional uncertainties.

Implementing Judicial Reform

193. A program to reform the judicial system needs to be designed and implemented which would develop and publicize a routinized system of publishing court opinions and making the accessible to lawyers and others; improve the system for enforcement and satisfaction of court decisions, including making marshals responsible to the courts and enabling judges to instruct marshals on how to go about enforcement; and continue the development of an appeals process that is efficient, insulated from outside influence, fair and final.

194. Such reform program should also include measures to upgrade the judicial environment. As a first, the program should study the deficiencies of the work environment in the courts, including an in-depth review of the pay scales for judges and those for private sector professionals, and of the conditions in which judges' work throughout the country. The study should propose an appropriate compensation package for judges in which the government would consider increasing the salaries of the most qualified judges and at the same time eliminating the least qualified. This should be accompanied by an appropriate training program for judges.

Adopting ICT to increase government efficiency and improve transparency.

195. Electronic government – a comprehensive approach to leveraging information and communication technologies (ICT) for more effective and efficient governance – can be a powerful instrument for improving the Kyrgyz investment climate and addressing some of the key impediments identified in this assessment. In operational terms, e-government is a tool whose sophistication can be adjusted to the degree of development of the recipient country. E-government should be used as a flexible and versatile tool to cope with the needs of the stakeholders and the level of readiness of the country in terms of capacity, access and affordability of ICT. At early stages of mainstreaming the use of ICT in the public sector, governments can focus on information disseminating information about laws, regulations, procedures, etc. through the Web, spelling rights and obligations of the entrepreneurs. At more advanced stages of e-government maturity, “transactional” government-to-business services, such as e-taxation, e-registration, e-procurement, can be launched, presupposing two-way communication between governments and business entities by electronic means. Finally, government can develop “single-window” services allowing an entrepreneur to perform a procedure, say a business registration, at a single entry point, without a need to apply to multiple government agencies. It should be noted that e-government is not about technical change alone but more importantly about a complementary set of government process changes to induce governance that is more client-oriented, transparent, effective, efficient, and empowering.

196. Starting from the late 1990s, the Kyrgyz government has been exploring ways of adopting ICT application in key sectors of economy and society, particularly in the public sector. A political commitment to the ICT agenda is reflected in the *National ICT Strategy* (more precisely, National Strategy “ICT for Development of Kyrgyz Republic”) adopted by a Presidential Decree in 2002 and the subsequent Action Plan adopted in 2003. The National ICT Strategy covers the period of 2002-2010 and addresses, in particular, improvement of public governance and local self-government on the basis of ICT (e-

government). The Government Portal (www.gov.kg), whose function is currently limited mainly to featuring links to individual ministries' Web sites, is intended to be the main vehicle for implementing this strategy and to evolve into the one-stop-shop for e-government services. Approximately 80 per cent of Kyrgyz government agencies have their own Web sites. Yet, the quality of information available is very uneven and often quite poor. The action plan lists several high-priority e-government projects to be implemented by 2010.

197. Based on the finding of this study, it can be recommended that the Kyrgyz government focuses its efforts on developing and enforcing strict guidelines and standards for publishing information on the Web by the government agencies. Simultaneously, the Kyrgyz government should launch Web resources addressing the most acute problems faced by the entrepreneurs and mentioned in this study:

- lack of clear interpretations of laws and regulations;
- improper application of streamlined regulatory framework for business registration;
- rights and duties of entrepreneurs;
- lack of transparency in obtaining land and construction permits;
- pervasive bribery.

Box 7. Comparative Country Experience for ICT in Government

The Municipal Government of Seoul, South Korea, crafted the OPEN system (Online Procedures Enhancement for Civil Applications) to target corruption. The system publishes a variety of information related to the services, permits and licenses issued by the local government. The status of an application can be tracked by the applicant on a web site.

Hanoi and Ho Chi Minh City in Viet Nam each launched Web development projects for business service agencies in 2000. The two websites (Hanoi Ministry of Planning and Investment and Ho Chi Minh Department of Planning & Investment) are designed to serve as the first point of contact for potential investors, especially foreign investors. The sites are now interactive, content rich, and have the potential to set standards for related agencies elsewhere in the country. The implementation challenges in these two cities varied, but were mostly of a non-technical nature, including an over-reliance on outside consultants.

Singapore Startup e-Advisor portal provides information on available government-assistance schemes for new businesses. It also functions as a one-stop-shop service center and helps new businesses get registrations, licenses and permits online.

Several countries (USA, India) have launched Web sites aimed at disclosure of assets and income of election candidates, elected representatives, ministers or civil servants, thus creating a disincentive for corruption due to a fear of exposure.

198. The government can consider following the example of other countries by setting up a business development portal providing business support and legal information services in an integrated manner and gradually incorporating more sophisticated services such as e-customs, e-taxation, etc. This portal could be designed around specific business-related services to provide guidance and vital information for businesses as well as coordinate and integrate the services of different government agencies. In other words, the portal should provide a single interface for different transactions and inquiries. It would be a “one-stop-shop” window, whereas particular transactions, such as registration, tax reporting and licensing will be performed by the relevant agencies and possibly on their websites under the umbrella of the portal. It is also recommended that the Kyrgyz Government revisits its ICT Strategy Action Plan by aligning it more closely with the objective of improving the investment climate. E-registration, e-customs and e-registration applications will definitely be central from the investment climate perspective.

199. In order for this agenda to be a success, the government will have to address the related issues of low teledensity, the gaps in the legal framework for ICT use, and the need to strengthen the institutional capacity for mainstreaming the use of ICT in the public sector.

Bridging the information gap.

200. A major problem of the current Kyrgyz investment climate is the low awareness among government officials, entrepreneurs and civil society of recent changes in legislation, regulation and practices. Reportedly, in many instances even the representatives of the enforcement agencies are not aware of the latest regulatory changes. In addition, the low awareness of entrepreneurs exposes them to predatory behavior by enforcement agents. The current publicity requirements of new legislation seem to be inappropriate to keep the target audience up to date with the continuous changes in the investment climate regulation.

201. The Kyrgyz Republic benefits from a fairly open media and active public dialogue, which would be conducive to the delivery of public information campaign aimed at informing enterprises as well as the general public of their rights and responsibilities under the law, and what appeals processes are at their disposal to counter adverse actions or decisions. Enterprises require more information about what rights they have to counter abusive public agents, be they inspectors, tax administration employees or others who may prey on poorly informed businesses and individuals to extract rents. A local firm specializing public relations issues could be retained to help design the program.

202. A public information campaign may take advantage of a variety of media -- radio, television, press, internet, etc. -- to disseminate its messages to different audiences. (For example, TV programs featuring interviews with public officials may provide the general public with basic information on their rights vis-a-vis the tax inspectorate, while articles in the business press might focus on more in-depth information of interest to businesses, and radio could be used to reach the more remote audiences.) While the government has in the past attempted to keep citizens informed by publishing new laws and regulations, a public information campaign would instead summarize key provisions and provide an analysis and recommendations. The result of such campaign should be a much better informed private sector -- not only regarding laws and regulations, but about the many changes to these, which has been a source of frustration to businesses.

203. As the Kyrgyz populace has become increasingly adept at the use of the Internet, this means should be also be used to ensure an open flow of information and advice to businesses. For example, business associations can utilize lists of email addresses of its member to provide the latest on regulatory reform, and organize electronic discussion spaces to encourage dialogue on regulatory issues. At present, many websites of ministries and agencies exist in the Kyrgyz Republic, yet are not fully updated and not user friendly enough to allow for proper dissemination of information. Such websites can be revamped and better used to channel information to the target audience.

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V. Kyrgyz ICA Follow Up: An Innovative Approach to Capacity Building

204. A key to improving the investment climate in the Kyrgyz Republic lies in increasing the competency of public sector employees. Often those charged with particular tasks, such as inspectors and tax administrators, have insufficient knowledge of the rules and regulations of the very areas they are expected to oversee. Staff need not only improved skills in their areas of competence, as well as an understanding of relevant laws and regulations, but need to have a much greater understanding of international best practice in their field. Those in technical capacities need to bring their skills up to international standards. For those in policy making capacities, the experience of other countries, particularly those in the CIS, in their own areas are of particular importance.

205. How can capacity building be efficiently and effectively accomplished in the Kyrgyz Republic? The traditional means to build capacity in the public sector is to provide classroom training, and frequently donor funding is used to bring international experts to teach classes, at significant expense. In recent years, however, modern technologies have made distance learning a more common and efficient means of instruction. The Global Development Learning Network (GDLN), a World Bank initiative, aims to improve development effectiveness by enhancing the capacity of development practitioners through the use of Information and Communications Technologies (ICTs) and distance learning methodologies in support of knowledge sharing between and within countries. GDLN is a partnership between the World Bank and public, private and nongovernmental organizations which facilitates cooperation between affiliated Distance Learning Centers (DLCs) that provide services and support to government agencies, development organizations and other development practitioners. These affiliated Centers deliver seminars, training events, and meetings using a full range of learning tools and technologies to connect country clients with their counterparts around the world through videoconferencing and web-based activities. The GDLN currently interconnects over 70 Distance Learning Centers spanning over 50 countries, numerous time zones and more than 30 languages.

206. The options for the Kyrgyz Republic are many. Distance learning courses in public administration management issues can be developed, as can interactive video conference dialogues with experts and practitioners in other countries, bringing the reform experience and best practices from countries around the world to the Kyrgyz Republic. In the Kyrgyz Republic, the World Bank has delivered numerous GDLN courses and virtual seminars through the video conferencing facilities located at the Bank's Bishkek offices. These programs have covered a range of subjects of importance to the public sector, including public expenditure reform, pension reform, corporate governance, HIV/AIDs prevention, education and health sector reform, anti-money laundering, disaster management, communicating reforms, and small-scale mining, to name just a few. Though programs have been delivered to date through the World Bank's facilities, complete GDLN centers, including email, internet and CD-ROM access for all students, in a classroom setting, is not available in the World Bank offices. Ideally, such a distance learning center would be located within a civil service training institute, such as the Management Institute.

207. As an initial pilot steps, a series of GDLN interactive seminars on the issues and recommendations set forth in this investment climate assessment could be presented using the video-conferencing facilities of the World Bank Country Office in Bishek. Participants in these sessions would primarily be civil servants involved in the various aspects of investment climate reform. Such sessions would include World Bank and other international experts on the particular topics, and will feature practitioners from other countries (possibly Russian speaking) that have tackled similar issues and faced similar challenges.

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