

**Challenges to Economies in Transition: Stabilization, Growth,
and Governance**

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the Fifth Anniversary of the Kyrgyz Som**

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**Foreign Investment during the Transition:
How to Attract It-How to Make Best Use of It**

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Mr. Isaev has provided a comprehensive overview of the positive affects of Direct Foreign Investments in the globalization of the world economy. He has also alluded to that fact that despite policy changes in the transition economies, a number of obstacles such as unstable tax regimes, lack of transparency, bureaucratic interference, weak legal and institutional framework, and high taxes tend to detract investors from a country.

I would, therefore, like to elaborate further on particular issues relating to foreign investment inflows in the Kyrgyz Republic.

The Kyrgyz Republic is a small landlocked country with a low income per capita. The macro investment climate in the country is favorable to FDI. The political system is stable with an active parliament. The constitution strongly supports private property rights and a legal framework that supports private businesses has been established. The Government also has recently approved a Foreign Direct Investment Law that has the support of International Organizations. There have been five Investors' conferences for the Kyrgyz Republic in Washington, Paris, Tokyo, Berlin and London. Yet, the flow of foreign direct investment toward the Kyrgyz Republic remains limited:

- Foreign Investment Flows over the past three years in the Kyrgyz Republic have averaged around 100 million dollars per annum. In net terms this figure amounts to not more than 70 million dollars per annum.
- On a per capita basis (\$20) as compared to other transition economies this level FDI inflows is one of the lowest
- Most of the FDI is in the mining, hotel, and banking sectors
- More than 90 percent of the FDI flows over the past three years has been in the gold mining project.
- Two large hotel projects account for an additional 5 percent and the four banks for most of the rest

A large number of factors can explain the lack, to date, of foreign investment in the Kyrgyz republic. The Kyrgyz Republic does not start with the blessing of abundant natural resources or a large internal market, or a geographically central location. The Government, therefore, must manufacture the reasons for foreign investors to come to

the Kyrgyz Republic. The country will have to rely on man-made attractions, such as fiscally sound economy, liberal investment laws and simple administrative procedures, if the country hopes to gain attention of international investors.

Creating these attractions will have a practical payoff. The Kyrgyz republic has the advantage, at least at present, of being a fast reformer. Foreign companies that are seeking an entry point into the wider Central Asian market may be persuaded to set up first in the Kyrgyz Republic, if they perceive an absence of bureaucratic obstacles and an otherwise friendly government environment

To succeed with this approach, the investment regime in the Kyrgyz Republic needs not just to be better than in surrounding countries. It has to be very much better. Only then will the country get the attention of foreign investors, who will be moved by the good reputation of the Kyrgyz Republic to consider investing in the country.

While much has been accomplished over the past three years in creating an investor friendly environment in the country, much work remains to be done. I would like to mention a number of constraints and bottlenecks which currently exist in the country that detract investors.

- Fear of Foreign investors by enterprise managers and workers
- Lack of knowledge and information on the market economy investment and management practices
- Valuation of Assets
- Privatization of Large State Enterprises (current fiscal constraints and the existing commitments to the social sectors, accentuates the relevance rapid privatization of large state enterprises.)
- High Costs and Supply Time of Transport Routes to the Kyrgyz Republic
- International Trade Agreements
- Free Economic Zones (FEZ)
- Tax and Incentives
- Registration, Licensing and Permits
- VISA and Local Registration Requirements

Fear of Foreign Investors

A recent survey of privatized enterprises suggests that most of them have limited experience and interest in FDI. The survey clearly reveals ignorance and fear of foreign investors by local enterprises because they fear the loss of control over the enterprise and their assets and the loss of their workplace.

- Only 17 percent of privatized enterprises had experience with foreign investors
- 30 percent of those that had experience thought that the foreign investors demanded too much control and the existing managers were afraid that the new investors would like to install their own management.
- 14 percent thought that the investors were not willing to pay enough for their interest in the company
- 11 percent said that the investor refused to commit themselves to a specific future investment into the company

- 10 percent said that the investors wanted to change the company's business or products in unacceptable ways.

Lack of Knowledge and Information on the Market Economy Investment and Management Practices

Sources of information for management within the enterprises are poor, especially now that the accounting system is changing from the old system to international standards. Under such circumstances, FDI process with the existing enterprises is very difficult. Foreign investors need detailed information and cannot develop an efficient and meaningful dialogue with the managers and current owners of enterprises.

Valuation of Assets

An additional problem in forming joint ventures with foreign investors is the valuation of assets. Since most of the assets of the enterprises are valued on cost basis and not on market values there are asset valuation problems between the parties which often lead to breakdown of negotiations with foreign investors.

Privatization of Large State Enterprises

Privatization of large state enterprises in the infrastructure sectors can create new opportunities for FDI. In order to attract strategic foreign investors in these sectors the process needs to be transparent. More importantly, current fiscal constraints coupled with the government commitment to social sectors as announced by the President yesterday, clearly underscore the relevance of rapid privatization of these enterprises.

High Costs and Supply Time of Transport Routes

Both importers and exporters complain about the high costs and long supply time of transport routes to the Kyrgyz Republic. Preliminary results of the survey of privatized enterprises reveal high expenses and delays in moving goods across the border (in and out of the country). Importers mentioned that it takes one to two and a half months to bring a container from the Black Sea. Exporters said that it takes them up to one month to move a container to Moscow by rail. Most of the problems are with the officials at the border crossing in each country en route. In response to the survey the enterprises mentioned arbitrary enforcement or interpretation of rules at the borders and claims of improper documentation. In some cases the problems are when crossing the borders of Oblasts in the countries concerned. The costs of moving the goods in the containers can accumulate to over US\$ 3000 for a standard size container because of payments to border officials and transit costs paid to oblasts. The long delays in the supply routes end up in high inventory costs especially in a country with high interest rates. And, more importantly, makes Kyrgyz products less competitive in world markets.

Furthermore, as Kyrgyz Republic has not yet formally joined the International Transport Association, Trucks registered in Kyrgyz Republic are subject to frequent stops and checks in other countries.

International Trade Agreements

The international trade agreements in the region do not function effectively. Goods and transport vehicles are stopped at border crossings for days and even weeks. The problems are of missing documents and lack of information and misunderstandings on how these agreements work. The customs authorities of the Customs Union countries do not recognize duty free entry of machinery and equipment to Kyrgyzstan that are in transit through their countries. Vehicles and driving documents are not recognized. The bilateral agreements to avoid double VAT payments in the Customs Union are not functioning well. These agreements are new and tax officials do not always recognize the destination principle. (VAT is paid only once in the destination market). The sale of products within CIS countries is not considered export and is not exempt (zero-rated) from VAT. Therefore, if the principle is not applied, export products pay VAT twice (in the exporting country and the importing country)

Free Economic Zones

The current system of FEZ discriminates against those enterprises and businesses that are export oriented but located outside of the FEZ. Businesses located within the zone enjoy exemptions from VAT and other taxes. While the FEZ's were established to boost export oriented production, in one such zone only 10 percent of the registered companies are involved in production activities. The remaining 90 % are involved in trading activities.

There are a number of large export oriented industries located outside of the Free zones employing thousands of workers, and cannot physically re-locate in the free zones. Consequently, the concept of FEZ presents an unequal playing field for export oriented industries located outside of the FEZ and tends to favor tax exemptions for mainly trading activities in the Free Zones.

This is a major disincentive for foreign investors who may be interested in joint ventures with large export oriented industries located outside of the Free Zones.

Tax and Incentives

The total tax burden on a legal entity in the Kyrgyz Republic is high with a profit tax of 30 %, withholding tax on dividends of 15%, turnover taxes of 2.3% (road tax of 0.8% plus Emergency tax of 1.5%), VAT of 20% and employer contribution of 39 % of the gross salaries of the workers.

(See attachment 1 for Comparison of TAX Burden on Company A in USA and Kyrgyz Republic)

In addition to these taxes, the businesses are charged with many forms of payments to government offices and institutions. (And unofficial payments to inspectors)

Inspections and license fees are high. It has been suggested that that total fees and payments can be as high as 15-20% of turnover.

The income tax authorities do not accept tax returns based on international accounting standards (IAS), in spite of the fact that the enterprises were required to introduce international accounting standards earlier this year. This results in major problems with tax inspectors and anxiety in the foreign investors.

Another major problem that is faced by export oriented industries is the payment of VAT on raw materials. Enterprises that are located outside the Free Economic Zones have to pay VAT for raw materials or are required to provide collateral. In addition to providing a collateral the enterprise has to pay 0.3% per day to the customs authority for the duration of the collateral. For three months the cost of the collateral to the enterprise can be 27%. Moreover, there is currently no mechanism in place to provide refund of VAT to an exporter. The tax authority claim that they do not have budget allocation for these refunds and no personnel is assigned to this task.

The lack of a mechanism for refund of VAT is significantly undermining the VAT system and amounts to an imposition of a TAX on exporters.

(See Attachment 2 for comparison of Incentives in Other Countries)

Registration, Licensing and Permits

Establishing a business the Kyrgyz Republic appears to be an obscure and time-consuming process for most foreign investors. The process of registration of new enterprises and licensing is a lengthy and cumbersome process. Many state and local government offices and organizations impose fees on licenses and inspections which place a heavy burden on businesses and especially on SMEs (small and medium enterprises). It has been reported that the Swiss-run Cheese factory at the Issyk-Kul Lake needed over 100 licenses of which 50% have to be renewed yearly.

VISA and Local Registration Requirements

Obtaining a visa for entry into the Kyrgyz Republic also presents a number of obstacles for foreign investors. Only single entry visas are issued by the Embassies. Many investors complain that it is impossible to get multiple entry visas. The process is also lengthy requiring invitation letters, and in countries where there is no Kyrgyz Embassy.

In addition, under newly introduced registration procedures for foreigners, visitors to the country have to register their passports within three days after their arrival. Registration must be completed at local district offices depending on where the visitor is staying. The visitor must first go to a local commercial bank, AKB Kyrgyzstan (opposite the Ministry of Finance) to pay Soms 50 registration fees and then to the visa and passport registration office to obtain a stamp on their passports by showing the receipt from the Bank. In addition, the visitor must produce a letter from (blank forms should be obtained from the visa and passport registration office) an organization that had extended an invitation to the visitor. The entire process can

sometimes take up to half a day to complete. Failing to comply with this requirement, the visitor must pay a penalty of about \$100.

Foreign Investment promotion in the Kyrgyz Republic is an extremely important function. The function is important because of the need

- to initiate and push for policy changes that will encourage FDI
- to develop investment opportunities
- to provide or initiate the provision of essential information
- to assist investors in the investment process

In this regard the role of the Agency for Foreign Investment in the Kyrgyz Republic should be strengthened. It should be able to assume the international marketing role of the privatization process. And be provided with resources to produce a large number of publications and will provide investors with necessary information to invest in the country.

Thank You

**The analysis of the competitive position of a Kyrgyz exporter
versus an American exporter**

	<u>Company A</u>	<u>Company "A"</u> <u>with Kyrgyz</u> <u>Tax system</u>
Revenue	<u>1,000</u>	<u>1,000</u>
Normal Pre-Tax Profit	75	75
Normal Pre-Tax Profit, %	7.5%	7.5%
Average Profit Tax	<u>19</u>	
Average Profit Tax, %	25%	
Normal After Tax Profit	<u>56</u>	
Normal After Tax Profit, %	5.6%	
1. Social Fund Incremental Tax Burden:		51
a. assume total labor \$s are 20% of revenue in Kyrgyz business;		
b. 25.5% incremental burden over US competitor;		
2. Calamity Tax Burden:		23
a. Calamity tax rate is 1.5% of revenue;		
b. Road tax is 8% of production. Assume all production is sold in period produced;		
3. New Tokmok city Tax:		20
a. tax rate is 2% of revenue		
Total additional taxes under the Kyrgyz tax system versus American competitors.		94
Kyrgyz Company Pre-tax Profit (Loss)		(19)

(Note)

Attachment 1

This is a simple analysis of two companies, one an exporter located in the Kyrgyz Republic and one located in America. Both are manufacturing and selling in the international markets. Assumptions made in the attached analysis are as follow:

1. Competition is very high therefore pricing is also competitive;
2. Company "A" represents a typical small to medium sized American company that manufactures and exports products;
3. Items included in the analysis are those incremental taxes that are different from those in the American tax system. For example, property taxes are not included in the analysis since both countries have this type of tax and they are in the same relative proportion.
4. The Social Fund tax was included at only 25.5% since this is the incremental increase over the American company paid payroll tax rate that averages 11%;
5. There is no competitive advantage to either company due to shipping charges.

As can be seen by the attached competitive analysis, Company "A" cannot compete in world markets due to the current tax structure. Because of the level of competition, the Kyrgyz Company cannot raise prices to help pay for the additional tax burden.

Foreign Investment Incentives in Kyrgyzstan and other countries

Kyrgyzstan

- Accelerated depreciation allowances;
- Loss carry forward for five years

Mauritius

- No customs duty on production equipment;
- Customs import duty exemptions;
- Income Tax credit of 10% (spread over 3 years) of investment in new plant and machinery;
- 5% corporate tax;
- Registration dues for land purchase: 50% exemption;
- No tax on dividends;
- Capital allowances which amount to 125% of capital expenditures;

Northern Ireland

- **Tax incentives:**
Rapid write-off of fixed assets and zero property tax;
Grants on new buildings and machinery are tax free up to 45% of the asset cost;
- **Depreciation allowances:**
Depreciation allowances are calculated at 25% per annum for machinery and at 4% per annum for industrial property;
- **Property taxes:**
Manufacturing property taxes are zero;
- Cash grants for buildings;
- Cash grants for machinery and equipment;
- Grants towards start-up costs;
- Interest relief grants;
- Factory rents grants;
- Company development program support;
- Marketing development grants;
- The provision of government loans and share capital investments;

Thailand

Tax exemptions:

- 50% import duty reduction for a period from 1 to 5 years;
- Corporate income tax exemption from three to 8 years;
- Exemption of import duty on raw materials used in export products;
- Double deduction from taxable income of utilities and transport costs for 10 years from the date of first sales;
- Double deduction from net profit of 25% of the costs of construction of the project's infrastructure facilities;

Mexico

- Raw materials, fuels, machinery and equipment may be imported without paying tariffs or value added tax;
- Refund for import duties paid on inputs used to produce goods to be sold abroad;
- Immediate investment depreciation;
- Venture capital programs;
- Facilities to purchase land with reductions on price in some Federal States;

Ghana

- Customs import duty exemptions;
- Tax holidays (from start of operations) from 5 to 10 years;
- Capital allowances;
- Accelerated depreciation allowance;
- Locational incentives;
- Loss carry over for the period of five years;
- Exemption for the minimum chargeable income tax;
- Capital expenditures for research and development of a company is fully deductible;

Uzbekistan

- Income tax exemptions
Income tax rates for enterprises decreased since 04.01.1996 by 20-50% depending on export portion in total production output;
- Annual increase in revenues obtained from export are exempted from income tax;
- Income of the joint venture companies with foreign investments more than 30% in statute fund, as well as foreign companies is charged 25% tax rate;
- Joint ventures investing to projects of Investment Program of Uzbekistan and in agricultural production and processing are exempted from taxes for the period from two to five years

Kazakstan

- Enterprises are exempted from income tax, land tax, property tax for five years after registration for up to 100% of the tax rates; after five years exemption from these taxes is up to 50% of tax rates;
- Joint ventures are exempted from import duties for equipment, raw materials, and inputs necessary for investment projects;
- Provision of property grants (buildings, facilities) for foreign investors by the State Property Fund;

Czech Republic

- **Fixed assets accelerated depreciation:**
(Fifty percent of new machinery can be depreciated within 3 years);
- **Investment relief:**
10% investment allowance may be claimed on most new plant and machinery in the year its acquired;
- **Tax loss carryover:**
Losses incurred after January 1, 1993 are available for carry over against profits generated in the following years;
- **Inward Processing Relief:**
It is available in respect of material, components and sub-assemblies imported for processing and export;