

## ECONOMIC REFORMS AND FOREIGN INVESTMENT IN KYRGYZSTAN

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### Abstract

In this Article the author reviews reforms carried out in Kyrgyzstan since 1991, particularly from the point of view of a foreign investor, comments on major remaining problems for investors while reviewing some of the achievements and makes a prediction that the pace of change in future will be slower.

### Introduction

The views expressed here are personal and impressionistic reviewing my observations of the results of twelve years of reforms in Kyrgyzstan and focusing on the climate for foreign investment. I have been both a lawyer-consultant to many international organizations in which role I saw what these institutions wanted for Kyrgyzstan and also as a foreign investor who lived in Kyrgyzstan and who advised other investors, in which role I came to understand more directly what a foreign investor wanted<sup>2</sup>. I also worked closely with the International Business Council (IBC) in its period of formation. As an investor I have a personal interest in some of the policy issues discussed below.

Both the foreign institutions and foreign investors believe that what is good for foreigners is good for Kyrgyz citizens that is, that if a framework of policies, laws and practices is established which will be attractive to foreign investors, that framework will assist local investors and businessmen in exactly the same way. This is a key point. No-one thinks that Kyrgyzstan should discriminate against its own citizens in favor of foreigners (or the other way around), except *perhaps* in one respect. The possible exception relates to the provision of incentives for foreign direct investment.

On this, opinions differ. Most of the international institutions oppose special incentives, arguing that what is important are such things as economic and political stability, (including currency stability), stable and non-discriminatory policies and a legal system that is predictable and modern, recognizing property and contractual rights and providing for their enforcement in a rapid, impartial and predictable way. There is no one who would say that these things are not important. But some people, especially would-be investors, argue that special privileges should be given to attract foreign capital. They argue that Kyrgyzstan cannot develop without attracting large quantities of foreign capital but that since all of its close neighbours, as well as other countries are competing for the same capital, Kyrgyzstan must offer something more such as taxation incentives, reducing the tax burden on a foreign investor so that he will invest here rather than somewhere else. The institutions reply that this will simply lead to each country offering more and more incentives, competing in a way that will harm all of them. They would say that offering special benefits is a "zero-sum game" meaning that at the end of the day no country will benefit. Around the world, different countries take different views about this. Some offer special discriminatory benefits, though most of the richer countries do not. My own view is that while Kyrgyzstan's neighbours offer some special benefits, it also should do so, and as one of the weaker countries in the region it should not be asked to be the first in the region to eliminate special incentives while its richer neighbours, less dependent on the foreign institutions, are able to ignore these demands. The IBC prepared a paper on this, and I agreed with it.<sup>3</sup>

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<sup>2</sup> Asian Development Bank (ADB), World Bank, International Monetary Fund (IMF), International Finance Corporation, European Bank for Reconstruction and Development, and others.

<sup>3</sup> Until the law was changed in 1997, tax breaks were offered. I have no personal interest in the recommendation, as the tax-break for my own company has now expired.

I now turn to certain other features of the investment environment, although I only have space to mention a few matters.

**1. Currency stability.** An investor, local or foreign, does not want to borrow in dollars or another western currency, and earn in soms if the som will constantly depreciate against the foreign currency. Lately, the som has been fairly stable, particularly against the dollar<sup>4</sup>. This is the result of good monetary policies and low inflation, and partly because of world-wide dollar weakness. This is good for the foreign investor, but there remains a fear that because Kyrgyzstan's foreign debt is so high, well over 100 per cent of GDP, that the currency is susceptible to shocks, such as occurred in the Russian banking crisis in the later part of the 1990's, when the som fell sharply. While the som is still regarded as potentially unstable for this reason, the foreign investor will tend to favour investments here which earn foreign currency, such as tourism. The foreign debt must be reduced, and the Kyrgyz government is, of course, aware of the issue.

**2. Low Taxation.** Low general taxation is one non-discriminatory way that this country can compete with other countries. A couple of years ago, the Parliament decided to reduce profits taxation to 10 per cent but in face of opposition from the IMF, it changed its mind and increased it to 20 per cent. Looked at in isolation, this is an unreasonable figure for a profits tax, internationally, though one cannot ignore all the other taxes. Kyrgyzstan has a bewildering and excessive range of additional taxes which overall add up to a substantial burden. The IBC wrote a long and well-reasoned paper to the IMF<sup>5</sup> and expressed its opposition to the IMF's demands. The main reason given by the IBC for supporting a very low tax rate is the size of the "black" economy, which is thought to be huge. It is well known how widespread tax evasion is in Kyrgyzstan. The IBC supported the 10 per cent rate partly because it is only one element in a tax system which overall imposes too heavy a burden, but mainly because it is almost certainly low enough to encourage people to pay their profits taxes. It is low enough that the cost of

compliance is nearing the cost of avoiding compliance. Once people come into the tax net, they will find it harder to get out again. Such a low rate would also help combat the endemic corruption amongst a veritable army of tax inspectors, half of whom could be dismissed and the other half paid more, turning bribes into official payments. Moreover, at the present time the system discriminates *against* foreigners, since as the tax inspection will agree, foreigners are much less likely to try to avoid taxes than are local firms. I am not sure that 20 per cent is low enough to achieve all that. It is understandable that in its present economic condition, Kyrgyzstan has little option but to do what the IMF requires, but it is regrettable that so often IMF policy is "one size hat fits all". The advice of the IMF has often greatly assisted Kyrgyzstan, but it is not an infallible organization: a notable example being its opposition to Kyrgyzstan adopting its own currency in 1993, which today, the IMF itself would acknowledge as a mistake. I agree, therefore, with the letter sent by the IBC to the IMF.

**3. Other non-discrimination.** Kyrgyzstan recently introduced a new law which requires foreigners to pay into the social fund 100 per cent of the amount of a foreign worker's salary. For a country which is trying to attract foreign investment this is an absurd step to have taken and will be a huge disincentive to foreign direct investment. It is even more absurd because few foreigners will make any claims on the social fund. It is just a discriminatory tax, the very reverse of what should have been done. In my view, firms employing foreigners who rely on visa renewal to live here should be asked to state whether or not those foreign employees will make claims on the social fund. If the answer is yes, then they would pay the same non-discriminatory contributions as a local employee. If no, they should not contribute at all to the social fund. It is, after all, an insurance fund, and if someone is not covered by insurance they should not pay the premiums.

**4. Predictability.** Investors, foreign or local, want predictability. Laws here are constantly changing. Another example relates to the laws on Free Economic Zones (FEZ), where there are special tax privileges for any investor<sup>6</sup>. These laws have been

<sup>4</sup> The som was introduced in 1993 at the rate USD\$1 = 3.5 soms. At present (October 2003) it trades at about \$1 = 42 soms, but has been stable around this rate for over a year.

<sup>5</sup> This can be seen on the IBC website.

<sup>6</sup> Declaration of interest: I have a FEZ investment, which may be affected.

changed several times, affecting already established businesses. The whole of Naryn, for example, was a FEZ. Now it has been decided to cut down the size of the zone so that only a fenced in area will qualify. But what is an investor to do, if that investor has built a tourist hotel which was formerly in the FEZ and will now be outside it? He cannot demolish it and begin again in the fenced area. What kind of predictability does this type of change promise to an investor? Apart from anything else, it is probably unconstitutional, since the Constitution states that no change to a tax law can worsen the position of a taxpayer - i.e. cannot be retrospective. However, given the example of the tourist hotel, the law clearly seems retrospective in effect. The main point that I would make is that foreign investors will not believe that their investments are safe when this type of change is introduced in this way, affecting existing businesses which relied on the previous law when they established themselves.

**5. No corruption.** It is always unpleasant for a foreigner to talk about this, but the President and successive governments, as well as Parliament, have admitted the degree of corruption which exists. Some persons believe that every tax official, policeman, or bureaucrat looks constantly for ways to extract additional income. Transparency International put Kyrgyzstan almost at the bottom of its list in this respect.<sup>7</sup> Unfortunately, the corruption reaches the institution which most needs to be unimpeachable, the judiciary. In that context, we might define judicial corruption as bias. Judges may act on personal or family (clan) biases; biases against foreigners; biases produced by governmental influence because judges rely for promotion or reappointment on governmental officials; or biases produced by the offering and taking of bribes. So for all these reasons, laws are made, some of them to western standards, but are not then enforced. When I once complained to a senior judge that her subordinate had blatantly ignored a law, she rebuked me for my impertinence "You are a foreigner: you have no legal rights in Kyrgyzstan!" Well, foreigners do realize that fact from time to time. Some steps are being taken to try to combat all of this, promoted by the ADB and others, but they will take a long time to implement. Some blame must be attributed to some of the international

<sup>7</sup> Other studies for example, those of the EBRD or World Bank, point out the same factor.

institutions which for too long ignored the issue. I give just one example. While working in 1992 on a project for the World Bank which was selecting laws to reform as an element of loan-conditionality, I recommended the introduction of a law on arbitration. When asked why, I replied that it was of little use to have new western-style laws if they could not be enforced because of the state of the judiciary. The World Bank economist threatened to remove me from the program if I did not remove my recommendation. I remember her exact phrase: "We are the World Bank and we don't *do* courts!" That uncomprehending and ignorant attitude went on for far too long, and is partly responsible for the situation here now. It is now starting to change, but the issue should have been tackled much earlier. While on the subject of international organizations, it seems to me that the Asian Development Bank has had the most realistic approach to Kyrgyzstan's problems, trying to develop solutions appropriate to this country, as against the "one size fits all" policies of the World Bank and the IMF country missions<sup>8</sup>. Again, that is a purely personal view gained not as an insider in these organizations, but as an external consultant.

**6. Enforcement of laws.** Under this heading, I refer to all the things that investors object to in the way that they are treated by officials. The constant demands for bribes so that officials will do the jobs they should do anyway (registering documents, giving information and so on); the excessive verifications by officials such as tax inspectors and others, and so on. As a recent example, I give the case of a foreign enterprise visited in mid-2003 first by a lady from the Prosecutor's office claiming authority she turned out not to have asking why the enterprise claimed to have rights to land. With breathtaking disregard of the Land Code and its 50 year provision she asserted that foreigners cannot have rights to land.<sup>9</sup> The same enterprise was also visited within the same month by a representative of the Accounting Chamber of Parliament, which demanded financial information and accounts even though it has the right to examine

<sup>8</sup> I would exempt IMF specialist missions - for example, those on banking, the effectiveness of which is obvious compared with such World Bank programs as FINSAC which was supposed to resolve the problems of the banking sector, but signally failed to do so.

<sup>9</sup> Foreigners cannot own land but can own buildings and have a right of use of land for up to 50 years.

only state-owned bodies. This, however, compares quite favorably with another larger foreign-owned company which recently reported to the IBC that it has endured literally *hundreds* of these time-consuming "verifications" over a period of a few years. The President constantly issues decrees to attempt to prevent such abuses, but like so many of the other laws in this country, these decrees are ignored.<sup>10</sup>

**7. Some Positive Factors.** The brief review above has been relatively negative, but it has aimed at showing some reasons why foreigners might *not* want to invest in Kyrgyzstan and why local investors are also dissuaded. Such a negative account on its own is not a fair way to treat Kyrgyzstan, and must be balanced by some positive factors.

I mentioned relative currency stability and this is very important if it can be maintained and the susceptibility to external shocks reduced.

- Some stable banks have been established, including KICB and DKIB<sup>11</sup> as well perhaps as others. The banking system may perhaps be through the worst of the crises, though it is hardly yet in excellent shape.

- Kyrgyzstan has engaged in a *huge* effort of law-making, modernizing its laws. The size of this task and the achievements can hardly be over-exaggerated. This country had to invent a whole legal system in a few years and that has involved an enormous amount of work. Despite some remaining problems which need to be addressed, it has flawed but reasonable laws on such key areas as banks<sup>12</sup>, on security for lending<sup>13</sup>, on bankruptcy, and other economic laws. One barrier to proceeding with this work is the ability and attitude of Parliament, which has a large number of new laws and amendments to existing economic laws to consider, but which appears unwilling to

proceed with many of them. Eventually, the Constitution and Land Code will have to be reformed to allow foreigners to own land outright.<sup>14</sup> I would suggest that the first step should be to allow land associated with a building to be owned outright by foreigners, provided that the main point of the enterprise is focused on the building (e.g. a hotel, factory, shop, hospital) and that the land associated with it is not excessive having regard to the needs of the business. The more sensitive issue of agricultural land may require other solutions but will eventually have to be dealt with.

- Efforts are now being undertaken, prompted particularly by the ADB, to try to reform the judiciary and the way the judges are appointed and the way the courts work. It will be a long, slow task but is absolutely essential and probably the single most important thing that could be done; associated with a proper law on arbitration, to attract foreign investors. Civil Service reform is also under consideration and is much needed, since there appears to be some evidence that one major reason that progress is impeded is the inertia or sometimes outright hostility of the middle ranks of the bureaucracy (not so much departmental heads or junior staff). It is certainly arguable that large numbers of these bureaucrats should be dismissed and replaced with new and competent people elected on merit and not on the basis of family connections, though regretfully, this is unlikely to happen.
- A very intelligent, interested and active deputy Prime Minister has been placed in charge of promoting foreign investment, and is achieving some results with support from the President. Although many agreed items in the "policy matrix", which is revised each year, have not been

<sup>10</sup> The IBC has a paper on its web site which lists many instances of cases where foreign investors have been harassed or treated illegally. It is interesting reading.

<sup>11</sup> Kyrgyz Investment and Credit Bank and Demir Kyrgyz International Bank.

<sup>12</sup> And has a generally competent and respected central bank supervisor, the National Bank of Kyrgyzstan.

<sup>13</sup> The laws on pledges are still quite flawed, partly because of conflicts with the Civil Code which some government officials oppose amending.

<sup>14</sup> The present law has surprising effects. Foreigners may own a building outright, but cannot own the land on which it stands (the Civil Code appears to contradict the Land Code). What happens to rights to the building after 50 years and to whom does the right of ownership of the land revert? If a foreign investor buys 20 per cent of the shares in a Kyrgyz company, that company apparently loses its rights to own land, and obtains a 50 year limited right. This may affect a bank which in good faith has loaned money to the company on security of the land. What happens if the bank takes the land and sells to a Kyrgyz person – is the 50 year right converted back to a right of ownership?

implemented. Visas, for example, can now be obtained at the airport, though there is some confusion about such matters as the requirement for an invitation for anyone except a tourist, which suggests an error of priorities.

This list of positives factors is small and somewhat qualified but might be added to. That is disappointing. Nevertheless, as evidence of reform and development, I would point out the obvious changes which I observe each time I visit Kyrgyzstan. Since my last visit only a year ago, new cafes and businesses have burgeoned, especially in the outlying parts of Bishkek, but also in places like Naryn. Erkindik Avenue in Bishkek now has a whole series of children's playgrounds along its length and streets in the city are under repair. Many of the old restaurants are still there, a sign of stability, although I personally am sorry to see Lenin moved. When I first came here in 1991, it was possible to walk across the road without looking, the few cars or buses could be heard well off in the distance before they approached. On my first visit, we could find only one restaurant open, though I remember that at one stage a three course meal for two cost me 65 cents, as the rouble was deflating rapidly. Either on that or a later visit I had enough money with me, a few hundred dollars, to open a bank, according to the 1991 Law on Banks. There were very few goods in the shops, international telephone calls had to be ordered well in advance, and there was no internet service or even any shops to sell computers, let alone any supermarket. Mobile phones were western fantasies and for hotels the visitor had the choice of the Dostyk, Bishkek or the Issyk Kul, all of them much more primitive than they are now. Naturally, there was only one airline Aeroflot, although then there were no customs or immigration checks on arrival from Moscow.

Comparing these factors and the way that matters have now changed, and considering all the bustle and activity in the larger cities, compared with the way it was, I continue to feel a sense of optimism, despite all the many things which remain to be done. *It must be acknowledged how much Kyrgyzstan has changed in these twelve years.* Much of these changes mentioned above affect the city dwellers most of all, as is evidenced by the growing trend towards depopulation of the countryside, where much poverty persists. The loss of so many skilled members of ethnic groups such as Russians and Germans, their departure partly

prompted by nationalistic policies, is also to be regretted.

Those foreign observers who have arrived more recently may not feel much optimism, partly because they have not seen for themselves all those changes occurring, but also because at the present time, Kyrgyzstan has clearly reached a point of "donor burn-out." The early enthusiasm for making the changes which the foreign institutions recommend has to a large extent disappeared. This is both good, to some degree Kyrgyz counterparts are attempting to find local solutions and not simply to adopt ready made foreign ones which may not fit, but is also bad because some of the lack of enthusiasm now is due to resentment or to bureaucratic inertia while many of the things which still have to be done remain vital to attracting the necessary amounts of foreign investment<sup>15</sup>. **My prediction for the future is that because of this "donor fatigue" and pervasive corruption and bureaucratic indifference reform will now proceed more slowly. It would be unfair to end this article without saying that through huge (if flawed) efforts over more than a decade now, Kyrgyzstan compares quite favorably with some of its neighbours and has developed an imperfect but reasonable base on which to complete the building of its future.**

<sup>15</sup> In my view, some of the resentment is justified. Some programs, especially of the World Bank, are standard programs tried everywhere, often with little success, and yet the World Bank economists keep trying the same failed formulas, apparently in the hope that one day they will succeed. FINSAC, for example, (for the banking system) was in its own terms reasonably successful (in dealing with failed banks), but spent a large amount of money on those banks while ignoring those which had not yet failed, which then in turn encountered problems, requiring further intervention (from the IMF, thankfully). PESAC, the privatization project on which I worked in 1995-96, was also in a sense reasonably successful in its own terms, but judged objectively, achieved little in the long term because of the way it was originally designed by the Bank's economists. To give just one example, it offered dollar loans to unsophisticated enterprises which did not appreciate currency risks and could not then repay their loans when the som fell sharply (as predicted by some of the Bank's economists!). Many local persons regard such programs as having created a large debt burden but with few other long-term effects to Kyrgyzstan's benefits and in my view there is some justification for this attitude.