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investment policy review

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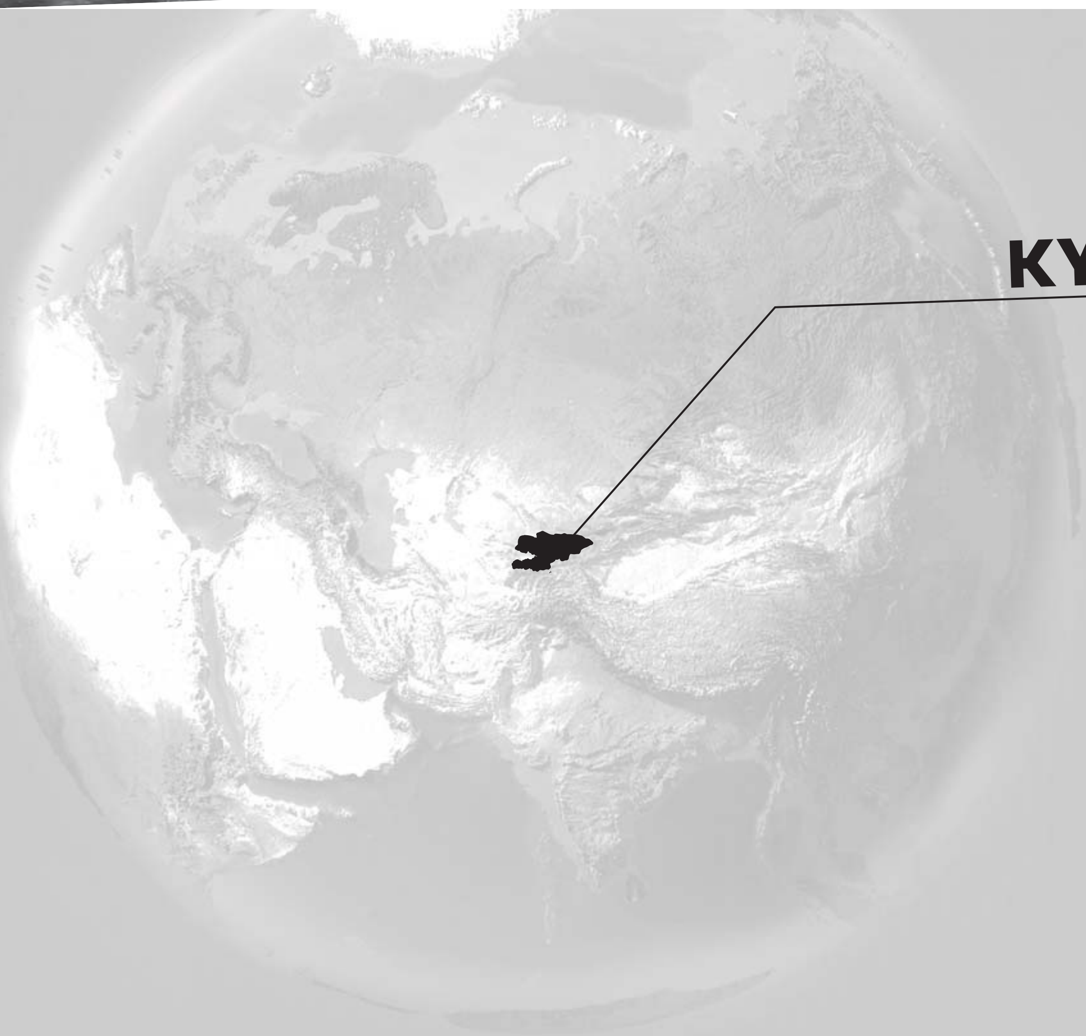

KYRGYZSTAN

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Note

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- **Two dots (..)** indicate that data are not available or not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row.
- **A hyphen (-)** indicates that the item is equal to zero or its value is negligible.
- **A blank in a table** indicates that the item is not applicable.
- **A slash (/) between dates** representing years – for example, 2009/10, indicates a financial year.
- **Use of an en dash (–) between dates** representing years – for example 2008–2010 signifies the full period involved, including the beginning and end years.
- **Reference to "dollars" ($)** means United States dollars, unless otherwise indicated.
- **Annual rates of growth or change**, unless otherwise stated, refer to annual compound rates.
- **Details and percentages** in tables do not necessarily add to totals because of rounding.

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Preface

UNCTAD Investment Policy Reviews (IPRs) are intended to help countries improve their investment policies and to familiarize governments and the international private sector with an individual country's investment environment. The reviews are considered by the Investment, Enterprise and Development Commission of UNCTAD. The recommendations of the IPR are then implemented with the technical assistance of UNCTAD. The support to beneficiary countries is delivered through a series of activities which can span over several years.

The Investment Policy Review of Kyrgyzstan, initiated at the request of the Government, was carried out through two fact-finding missions in November 2013 and February–March 2014, and is based on information that was current at that time and additional information made available to UNCTAD until August 2015. The mission received the full cooperation of the relevant ministries, departments and agencies, in particular the Department of Investment and Public–Private Partnerships within the Ministry of Economy. The mission also benefited from the views of the private sector, foreign and domestic, bilateral donors and development agencies. The United Nations Development Programme (UNDP) provided useful contributions as well as logistical support to the IPR process. A preliminary version of this report was discussed with stakeholders at a national workshop in Bishkek on 16 June 2015. The final report reflects written comments from various stakeholders, including ministries and agencies of the Government of Kyrgyzstan.

The analysis is based on the Investment Policy Framework for Sustainable Development (IPFSD, version 2015) of UNCTAD and its core principles (UNCTAD, 2015). It follows, to a large extent, the framework's national investment policy guidelines, which deal with concrete measures to formulate investment policies and regulations and ensuring their effectiveness, especially in terms of grounding investment policy in development strategy. The IPR also deals with institutional mechanisms for effective policy implementation.

This report was prepared by the Investment Policy Reviews Section under the supervision of Chantal Dupasquier, Chief of Section. Joerg Weber, Head of the Investment Policies Branch in the Division on Investment and Enterprise (DIAE), and James Zhan, Director of DIAE, provided overall guidance. The report was drafted by Ariel Ivanier, Ewen Peters and Anastasia Smirnova. It also benefited from substantive inputs and suggestions from UNCTAD colleagues, including Richard Bolwijn, Stephania Bonilla-Féret, Hamed El Kady, Maha El Masri, Kalman Kalotay, Ventzislav Kotzetzov, Nathalie Malanda, Massimo Meloni, Sergey Ripinsky, Irina Stanyukova, Elisabeth Tuerk and Paul Wessendorp. Juan Carlos Arguedas provided support with the international tax comparisons. Nurlan Abdyshev provided organizational support in Bishkek. The report was funded by the Government of Switzerland.

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Abbreviations

ADB	Asian Development Bank
BIT	bilateral investment treaty
CAREC	Central Asia Regional Economic Cooperation Programme
CET	common external tariff
CIS	Commonwealth of Independent States
CSM	Centre for Standardization and Metrology
CSR	corporate social responsibility
DIAE	Division on Investment and Enterprise
DSSES	Department of State Sanitary and Epidemiological Supervision
EAEU	Eurasian Economic Union
EAEC	Eurasian Economic Commission
EBRD	European Bank for Reconstruction and Development
ECE	Economic Commission for Europe
ECO	Economic Cooperation Organization
EIA	environmental impact assessment
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
FEZ	free economic zone
FESTI	Fuel and Energy Sector Transparency Initiative
GATS	General Agreement on Trade in Services
GDP	gross domestic product
GIZ	German Agency for International Cooperation
GPS	global positioning system
HACCP	hazard analysis and critical control points
HPP	hydroelectric power project
IBC	International Business Council
ICAO	International Civil Aviation Organization
ICSID	International Centre for Settlement of Investment Disputes
IIA	international investment agreement
ILO	International Labour Organization
IMF	International Monetary Fund
IPA	investment promotion agency
IPFSD	Investment Policy Framework for Sustainable Development
IPR	investment policy review
ISDS	investor–State dispute settlement
ITC	International Trade Centre
JICA	Japan International Cooperation Agency

KATO	Kyrgyz Association of Tour Operators
LLC	limited liability company
LRERP	land and real estate registration project
MIGA	Multilateral Investment Guarantee Agency
MNE	multinational enterprise
MOTC	Ministry of Transport and Communications
MW	megawatt
NES	National Export Strategy
NRF	Natural Resource Fund
NSSD	National Strategy for Sustainable Development
OECD	Organization for Economic Cooperation and Development
OSCE	Organization for Security and Cooperation in Europe
PPP	public–private partnership
PRAI	Principles for Responsible Agricultural Investment
R&D	research and development
SAAC	State Agency for Architecture and Construction
SAEPF	State Agency for Environmental Protection and Forestry
SAGMR	State Agency for Geological and Mineral Resources
SECO	Swiss State Secretariat for Economic Affairs
SER	State environmental review
SIDA	Swedish International Development Cooperation Agency
SIETS	State Inspectorate for Ecological and Technical Safety
SRRP	Silk Road Regional Programme
SME	small- and medium-sized enterprise
SOE	State-owned enterprise
SPS	sanitary and phytosanitary
SWF	Sovereign Wealth Fund
UAIS	Unified Automated Information System of the Customs Service
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNIDO	United Nations Industrial Development Organization
UNWTO	World Tourism Organization
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization

Key messages

- Kyrgyzstan has vast opportunities to attract foreign direct investment (FDI) across various sectors of the economy. The location advantages include low labour and electricity costs, abundant hydropower resources, good weather conditions for agriculture, attractive landscapes for tourism and overall competitive taxation and trade preferences that grant access to large markets in the Russian Federation and Kazakhstan.
- Important reform efforts have taken place since independence to establish effective institutions and move towards a market-based economy open to investment and trade. Nonetheless, policy instability, internal conflicts and the international economic and financial crisis have slowed down progress. Several critical challenges to socioeconomic development persist, including high indebtedness, rising unemployment and increasing trade imbalances.
- To address these challenges, the Government has adopted a National Strategy for Sustainable Development (NSSD 2013–2017) with the objectives of fostering economic diversification, stimulating private sector development, encouraging formality and ultimately reducing poverty. To this end, the NSSD recognizes a role for both domestic and foreign investors.
- An FDI boom started in the mid–2000s led by the exploration and exploitation of gold. Since then most FDI inflows have been driven towards mining-related activities. A significant pick up in FDI inflows occurred in 2013 that included also investments in other sectors (e.g. finance and manufacture of petroleum products); however, overall non-mining FDI remains low.
- The analysis of the Investment Policy Review (IPR) of Kyrgyzstan, as requested by the Government, focuses on diversifying the economy, improving the sustainability of economic activities and promoting linkages, including in the mining sector. It shows that by removing key bottlenecks, the country could attract more investment in sectors such as garments and textiles, where there is potential for value upgrading; tourism, where only one international hotel chain is in operation; and agro-industries, where restrictions on access to land have limited the expansion of foreign presence.
- The legal framework specific to FDI is in line with good international practice, but its implementation raises concerns. The loose enforcement of the law is a challenge compounded by recent episodes of political instability. In this context, the number of international arbitration cases has risen. As foreseen in the NSSD, improving the judiciary and overall governance, including adopting a balanced approach to protect the public interest and the right of investors, is essential.
- Other areas of the legal framework for investment have undergone major reforms in recent years, including business facilitation, taxation, land surveying, and several aspects of the labour legislation. For these reforms to translate into concrete gains in terms of investment attraction and development impact, the capacity of implementing institutions needs to be strengthened, in parallel with the level of transparency in public administration.
- Furthermore, improved access to skills and infrastructure will be essential to the ongoing diversification efforts. In this regard, the promotion of public-private partnerships (PPPs) should be anchored in a strategic plan coherent with national development objectives, resulting in a pipeline of bankable projects.
- The newly established investment promotion agency has a role to play in support of NSSD objectives. A phased approach to its development, focused on building expert capacity, is recommended and would allow it to effectively deliver on its mandate.

Context

Kyrgyzstan has substantial untapped economic growth and sustainable development opportunities. Strategically located at the crossroads between Europe and Asia, on the ancient Silk Road, this landlocked mountainous country is an established trading centre and has the potential to become a regional transport and logistics hub. Temperate weather and good pasture lands for cattle breeding have made agriculture a major economic activity. Abundant mineral resources have started attracting significant investment from foreign mining companies; and unpolluted natural landscapes attract increasing numbers of tourists. Furthermore, Kyrgyzstan has significant untapped potential in renewable energy generation.

Since independence in 1991, Kyrgyzstan has experienced a fast transition towards a market economy. Although challenges remain, Kyrgyzstan was one of the first former Soviet Republics to adopt a democratic constitution that enshrined basic individual liberties and freedoms in its domestic legislation. As a result, one of the most vibrant civil societies in the region has emerged. With regard to economic policy, the Government has embarked on several initiatives to abolish price and currency controls, review State subsidies, reform land ownership and privatize activities in some key industries. Kyrgyzstan also joined the World Trade Organization (WTO) in 1998 and has adopted open trade and investment regimes. Recently, the country also acceded to the Eurasian Economic Union (EAEU), which is expected to widen the country's export potential (see annex 1 for details on the accession process).

There are several challenges to socioeconomic development. With a population of 5.8 million people – of which about 64 per cent live in rural areas – and a gross domestic product (GDP) per capita of $1,250,[1] Kyrgyzstan remains a low income nation. With independence, the supply chain linking it with other Soviet Republics was cut. Over the last decade, the country has experienced high indebtedness, rising unemployment and increasing trade imbalances. The private sector is underdeveloped, its growth is constrained by key bottlenecks in infrastructure and human capital, and youth migration is a growing issue (in 2014, remittances accounted for about 30 per cent of GDP). Public infrastructure has suffered from decades of underinvestment and roads, for example, are in severe need of maintenance. While electricity supply exceeds local demand, the reliability of the grid is problematic. The country's population generally has a good level of education; however, due to a large outflow of workers, there is a shortage of skilled labour.

Strengthening the rule of law has been a key concern affecting the investment climate, and tackling it is a prerequisite to growth and diversification. Weaknesses in law enforcement as well as other legal and institutional shortcomings affecting the tax regime, border procedures, access to land or electricity, environmental monitoring and overall governance remain on top of the agenda to improve the investment climate, support economic diversification and tap national sustainable development prospects. Political and social unrest, ignited in 2005 and 2010 by protests against the concentration of powers and unpopular economic policies (e.g. hikes in tariffs for public utilities), were followed by policy reversals and expropriations. For instance, some privatized assets were renationalized after 2010, including assets in sectors such as finance, telecommunications and tourism, which contributed to costly litigation.

Recent development plans have targeted economic diversification, private sector development and export growth. The National Strategy for Sustainable Development (NSSD) for the period 2013–2017 calls for establishing a State governed by the rule of law and ensuring the end of internal conflicts as prerequisites for any successful development strategy. It also defines pressing socioeconomic development priorities, including stimulating growth in a number of key sectors, such as mining, agro-industry, energy, transport and communications, and tourism. The National Export Strategy (NES) is mainly focused on subsectors of the food industry, but also on clothing and tourism.

The Government has acknowledged that both domestic and foreign investors could play a key role to reach national development objectives and promote sustainable development in Kyrgyzstan. Investment is deemed critical to restore economic growth and to address some urgent economic constraints, including overdependence on development assistance, foreign debt and remittances. NSSD also highlights the need to specifically attract foreign direct investment (FDI)

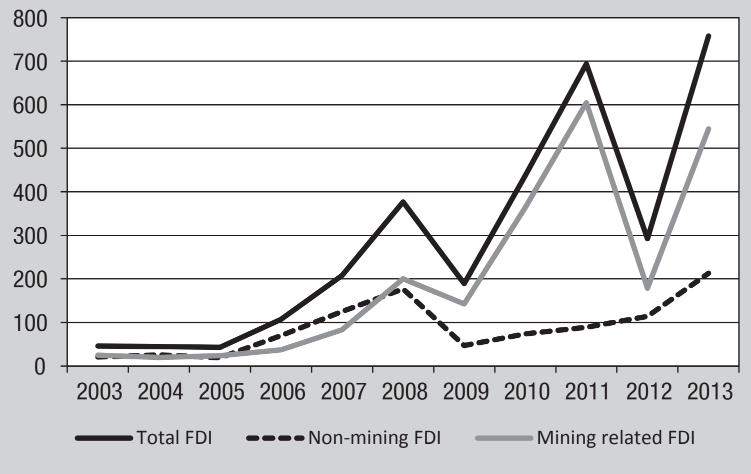
[1] Data for 2014, see http://data.worldbank.org/country/kyrgyz-republic.

as a potential source of technology and management skills that could enhance the overall competitiveness of the national economy and promote the country's increased integration into global markets. However, NSSD does not address the specific role that FDI could play in the target economic sectors, including related benefits and risks, nor does it identify existing constraints and bottlenecks to investment.

While FDI has been on the rise, it has mostly concentrated on mining activities. For more than a decade following its independence, Kyrgyzstan experienced only modest levels of FDI inflows, distributed evenly among a number of sectors including finance, construction, food industry and mining. Still in 2003–2007, FDI inflows averaged below $100 million per year. However, as shown in figure 1, during the second half of the 2000s, substantial investments were influenced by the surge in global prices for commodities that raised the profile of Kyrgyzstan's mining potential. Turbulence due to the international financial crisis and the incidents at the Kumtor gold mining site (box 1) did not significantly affect the overall FDI upward trend. In 2010–2011, total FDI flows in metal manufacturing exceeded $630 million. During the same years, over $300 million were invested in geologic and prospecting activities. However, the crisis triggered a slowdown in non-mining investment, which only exceeded the relatively low pre-crisis level in 2013. The recent progress in non-mining FDI is mainly due to the financial sector and manufacture of petroleum products.

The main investor countries include traditional sources of mining investment as well as neighbouring countries. Canadian investment has mainly targeted gold mining exploration and extraction, while in the case of China, FDI has concentrated on manufacturing and geological prospecting. Other source countries include the United Kingdom of Great Britain and Northern Ireland (geologic and prospecting activities), the Russian Federation (manufacturing, electricity, gas and water supply, trade and repair of motor vehicles, and finance) and Kazakhstan (trade, finance and geologic and prospecting activities). Turkey ranks first as country of origin for the largest number of enterprises with foreign capital in Kyrgyzstan.[2]

Figure 1. Growing inflows of foreign direct investment in Kyrgyzstan, 2003–2013 (Million dollars)



Source: National Statistical Committee

Note: Mining related FDI refers to FDI flows in mining and quarrying, manufacture of basic metals and fabricated metal products (except machinery and equipment), geologic and prospecting activities. FDI in other economic activities are classified as non-mining.

2 These enterprises tend to focus on trade activities and are generally of relatively limited size; thus Turkey's share in total FDI flows is small.

Table 1. Kyrgyzstan's comparative attraction of foreign direct investment

Country	Average inflows of foreign direct investment								Foreign direct investment stock		
	Absolute figures		Relative figures								
	Million dollars		Per capita (dollars)		Per $ 1 000 gross domestic product		As percentage of gross fixed capital formation		Total million dollars	Per capita (dollars)	percentage of gross domestic product
	2006–2010	2011–2013	2006–2010	2011–2013	2006–2010	2011–2013	2006–2010	2011–2013	2013	2013	2013
Kyrgyzstan	**279**	**581**	**53.4**	**106.1**	**64.8**	**87.3**	**24.6**	**33.3**	**3 473**	**626.0**	**48.1**
Bhutan	40	23	57.3	31.1	35.0	12.2	7.3	1.9	163	216.1	8.2
Bolivia, (Plurinational State of)	445	1 223	45.0	116.0	28.1	44.6	17.4	24.2	10 558	989.4	35.4
Botswana	353	476	183.9	238.9	32.6	31.5	11.4	9.5	3 337	1 650.9	22.5
Lao People's Democratic Republic	241	297	39.3	44.7	49.6	33.1	15.5	10.4	2 779	410.5	27.8
Mongolia	756	3 738	283.5	1341.5	143.8	383.1	43.8	75.8	15 471	5 449.1	134.3
Republic of Moldova	385	232	105.7	65.8	78.1	31.5	26.0	13.5	3 668	1 051.9	46.2
Tajikistan	236	137	33.0	17.1	62.0	18.0	31.3	6.9	1 625	197.9	19.1
Turkmenistan	2 210	3 192	444.5	617.4	108.0	96.6	29.2	18.4	23 018	4 392.7	56.7
Uzbekistan	812	1 134	29.7	39.8	26.3	22.8	11.2	7.4	8 512	294.2	15.1

Source: UNCTAD, FDI/MNE database

Note: Kyrgyzstan is compared with nine other landlocked countries at a similar stage of development according to the United Nations Development Programme (UNDP) Human Development Index.

Notwithstanding a marked increase in FDI attraction, Kyrgyzstan lags behind key comparators. Overall, when comparing Kyrgyzstan's average FDI attraction with other developing and transition landlocked countries during recent years (table 1), there is a substantial improvement in the period after 2010 (e.g. flows nearly doubled compared with the period 2006–2010), which helped Kyrgyzstan close the gap vis-à-vis many of its key comparators. However, the country still lags behind other destinations in Asia (such as Mongolia or Turkmenistan) in both absolute and relative terms.

Against this background, the purpose of this investment policy review is twofold: to provide advice to Government authorities on reforms to enhance the business environment and investment promotion capacities, and present a strategy for FDI diversification. Chapter 1 focuses on the legal and institutional framework affecting both foreign and domestic investors. Chapter 2 presents a strategy for FDI diversification which proposes general and sector specific measures as well as ways to enhance State capacities for investment promotion through the phased development of the newly created investment promotion agency (IPA) under the Ministry of Economy. The IPR strategy focuses on the following sectors: garment and textiles, agro-industry and tourism – which all have potential to attract foreign investors. Advice on how to improve the sustainability of mining activities is also presented. To assist the Kyrgyz authorities in fulfilling these goals, the IPR will draw on principles contained in the UNCTAD *Investment Policy Framework for Sustainable Development (IPFSD)*, a document that summarizes years of policy guidance on sustainable investment policymaking with regard to national and international policies (UNCTAD, 2015). The key recommendations of this IPR are summarized in a table (annex 2).

Box 1. Mining activities in Kyrgyzstan: The case of Kumtor Gold

The Canadian firm Centerra Gold Inc., through its subsidiary Kumtor Gold Company JSC, is a significant investor in Kyrgyzstan. Kumtor Gold has a dominant influence on the national economy through its gold extraction and basic refining activities. The mine has a production capacity of between 15 and 18 metric tons per year. In 2013, it accounted for 7.8 per cent of GDP, contributed to 48.6 per cent of industrial output and more than 30 per cent of exports. Given its size, investment decisions and regulatory changes affecting production in this mine can produce a signalling effect to all other foreign investors in the sector and beyond.

The Kumtor mine lies near the Chinese border at an altitude of 4,000 metres under the shadow of a glacier in an ecologically sensitive area. In 2012, Centerra Gold Inc. announced the expansion of the open pit, together with a 58 per cent increase in proven and probable gold reserves. The company also extended the expected life of the mine to 2023 and the term of ore processing at the gold extracting plant through to 2026.

However, the project has been a source of growing political tension. Over the last three years, the relationship between Centerra, the Government and the Kyrgyz population has become increasingly contentious, creating uncertainties about the future involvement of the State in the mining sector.

In 2012, Kumtor's workers went on a 10-day strike demanding an increase in wages and the mine lay idle resulting in a significant loss of output. In a separate dispute, 600 local residents protested over the size of the company's contribution to social needs and infrastructure projects in the region and over concerns on the company's environmental record in the past. After negotiations involving Government representatives, Centerra agreed to a number of the demands of local residents. Also, in the summer of 2012, the Government set up a State Commission on Kumtor composed of members of Parliament, ministers and civil society experts to assess the environmental, industrial and social damages caused by activities at the mine. The work of the Commission was supported by independent experts who evaluated the damages. After the Parliament's endorsement of the recommendations of the Commission in January 2013, the Government submitted a list of environmental damage claims worth $ 152 million. In parallel, a number of members of Parliament have called for the nationalization of the mine.

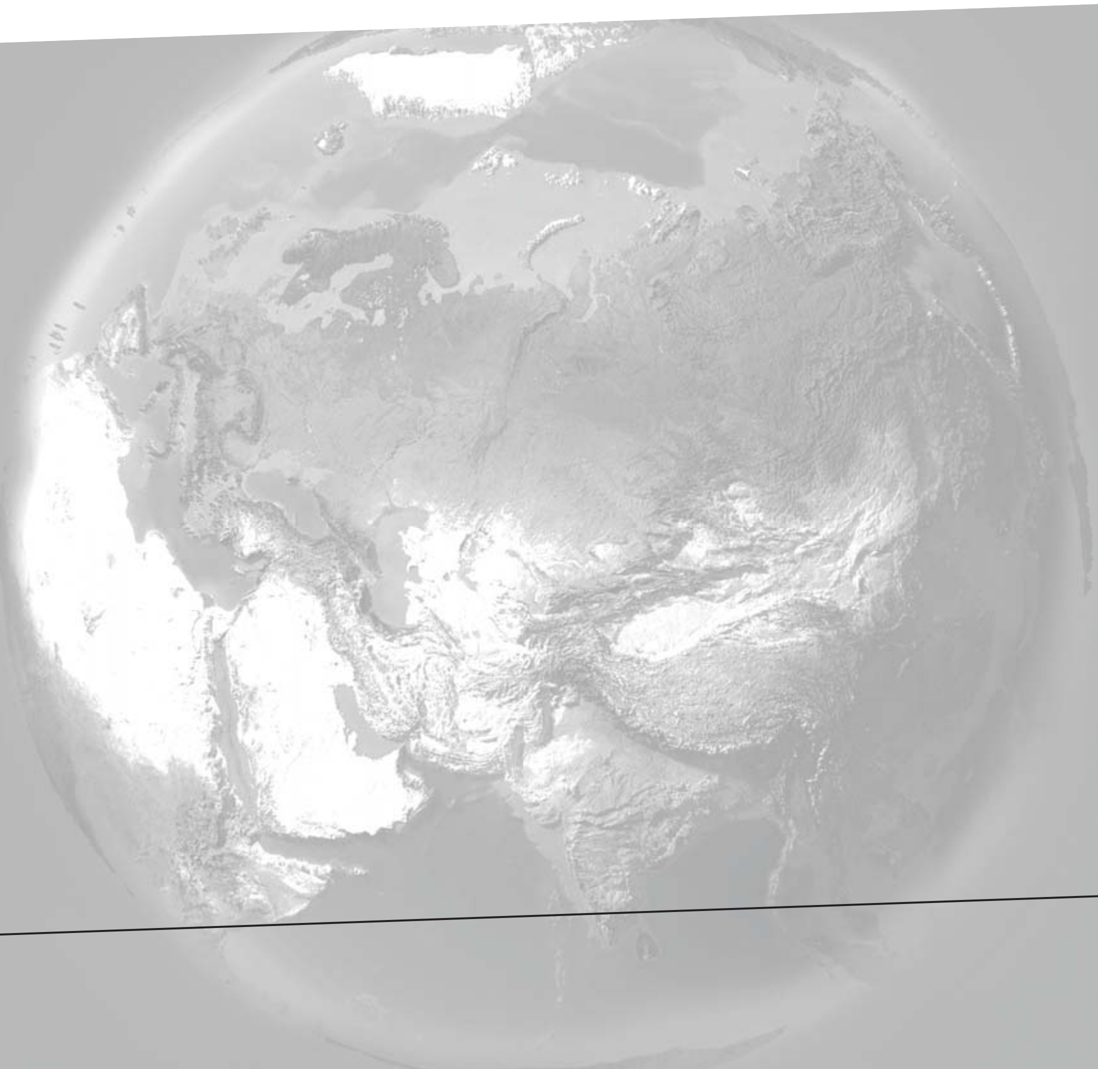
Against the backdrop of a rising budget deficit and Centerra's expansion plans, the Government has been looking for new ways to increase revenues from the project. A new draft Investment Agreement was signed in December 2013 under which the Government would swap its 33 per cent stake in Centerra Gold Inc. for 50 per cent of the Kumtor mine. This deal has yet to be finalized.

Sources: Kumtor Gold Company, JSC. http://www.kumtor.kg/en; NSO; and UNCTAD interviews during the fact-finding mission.

Note: The Kumtor Project is an integrated operation undertaking a spectrum of activities across the gold production cycle. The project was initiated after an investment agreement to exploit the Kumtor mine was signed in 1992 by Kyrgyzstan and the Canadian mining firm Cameco. The deal created Kumtor Gold Company (67 per cent ownership to Kyrgyzaltyn, a Kyrgyz State-owned enterprise (SOE), and 33 per cent to Cameco). Construction at Kumtor began in 1994 and commercial gold production started in 1997. The project was re-structured in 2004 with the signature of a new investment agreement which shifted the full ownership of Kumtor Gold Company to Centerra Gold Inc. The agreement was re-negotiated in 2009 and the decision made that Kyrgyzsaltzn would have an increased share ownership in the parent company. Since then, Kyrgyzstan owns a 33 per cent share in Centerra Gold Inc.

CHAPTER 1

Regulatory and institutional framework for investment



Since independence, the Government has enacted legislation to increase the attractiveness of Kyrgyzstan as an investment destination. Some of the most recent legislation includes Law 66 on Investments of 2003 and Decree 23 on the Protection of Investments of 2010, which establish the main principles of the country's investment policy. In this context, the objective of this chapter is to analyse the laws and regulations affecting the investment environment, both for foreign and local investors, and to propose a series of concrete recommendations to continue improving the investment environment in the country.

I. Foreign investment specific regulation

a. Entry and establishment

Kyrgyzstan presents overall an open FDI regime with some entry limitations. Most economic sectors and industries are open to FDI and there are no pre-establishment screening procedures in place. Restrictions exist only for a few activities. For instance, within air transport, companies that operate domestic commercial flights must be Kyrgyz-registered and have at least 51 per cent Kyrgyz ownership. The same ownership limitation applies to companies performing aircraft repair and maintenance services, although Kyrgyz commitments under the General Agreement on Trade in Services (GATS) stipulated its elimination by 2005 (WTO, 2013). Furthermore, Law 269 on State Regulation of Production and Sale of Ethyl Alcohol of 2009 prohibits the production and sale of ethyl alcohol by foreign legal entities; a public-health-related restriction that is common in other countries. Finally, in some sectors, the State remains the quasi-monopolistic operator, which may act as an informal barrier to foreign investors. State monopolies include companies operating in the mining and energy sectors; communication services (e.g. fixed-line communications, radio and television broadcasting and postal services); and airport management, among others.[3]

Some regulations impose establishment restrictions on foreigners, particularly affecting investment in agriculture and tourism. Despite a generally open regime, a number of regulations can create certain hindrances to FDI in agriculture and tourism. For instance, according to the Land Code, foreign investors cannot own land (article 5), with the exception of foreign companies involved in mortgage financing or foreign banks in case of recovery of pledged assets. Foreign entities can access land tenure under lease arrangements (up to 50 years), except for land plots on the borders with other States and land classified as agricultural (see section II.a in this chapter). Moreover, investors in the tourism sector in the Issyk–Kul region face another type of restriction because recreation facilities and tourism infrastructure in this region may not be handed over or transferred to foreign ownership. Instead, they can be leased for fixed periods of time under a specific procedure established by the Government (see Law on Sustainable Development of Issyk–Kul of 2004).

The definition of foreign investment is not homogeneous in the legislation, which creates confusion. Different Kyrgyz laws contain a number of discrepancies with regard to the definition of what constitutes a "foreign legal entity". Because the meaning of foreign investment varies across laws and regulations, one and the same company may be considered a foreign legal entity under one set of norms, and a local investor under another one. For example, under the terms of the Law on Investments, the foreign ownership threshold is set at the level of one third of a company's stock. But a lower threshold is defined in the Land Code (article 1), which defines foreign ownership as involving not less than 20 per cent of charter capital. This type of inconsistency has, at times, created a need for foreign investors to find local partners to form joint ventures with the only goal of avoiding potential controversies.

b. Treatment and protection

National legislation

Non-discrimination provisions characterize national legislation on the treatment of investment. Kyrgyzstan grants non-discriminatory treatment of foreign investors through the Law on Investments, which mandates that the Government shall apply to foreign investors the same legal framework for economic activities that applies to domestic legal entities (article 4.1). Other rights offered to foreign investors include freedom of movement in the national territory and access to government benefits. The country imposes no exchange restrictions on current transactions, except for those established for security and technical reasons (such as measures against financing of terrorism and money laundering). The Law on Investments equally

[3] State Republican Register of natural and permitted monopolies of the Kyrgyz Republic, adopted by Order 2 of the State Agency for Antimonopoly Regulation of 2012, available at: www.antimonopolia.kg/index.php/reestry/monopolisty, accessed 1 May 2015.

guarantees the absence of restrictions on repatriation of earnings, capital and capital gains in Kyrgyzstan.

The definition of direct expropriation is in line with international practice. With regard to expropriation, the Law on Investments authorizes it only when it is carried out in the public interest, on the basis of non-discrimination, according to due process, and against timely and proper compensation for real damage, including lost profits. Compensatory payment must be made at fair market value with interest and denominated in freely convertible currency. The Constitution also grants the State the right to nationalize private property and the process is governed in accordance with the Civil Code 15 of 1996.

Political instability, combined with the loose enforcement of the law, remains a challenge. Whereas the existing legislation sets the framework for a rather liberal investment regime that grants typical standards of protection to foreign investments, there is concern among private stakeholders with the de facto stability and security of existing investments (ADB, 2013). The Government is deemed to have failed to effectively protect property from expropriations or illegal seizing by private groups during times of social upheaval or after government changes. Also, in the mining sector, the revocation of a number of licences and recent changes in the taxation regime after the 2010 revolution raised concerns about the profitability of investments (see chapter 2, section II.d). Even though it is unclear whether expropriations and licence revocations were targeted in particular at foreign investors, the general situation is perceived as a deterrent to new investments.

Arbitration is available to investors at the national and international levels. The Law on Investments provides investors with access to procedures for dispute settlement. Although priority is given to consultations and negotiation, in cases when amicable settlement has not been achieved after three months, the investor has the right to either file a claim through domestic courts or to seek international arbitration in accordance with the rules of the International Centre for Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL). If the path of international arbitration is chosen, prior recourse to internal judicial procedures is not necessary. While the existing framework can be interpreted as a mean to ease the effect of political instability, it may also expose the country to increased risks of litigation by investors.

The number of international arbitration cases has risen since independence. As of April 2014, at least 11 investor–State dispute settlement cases have been initiated by investors before international arbitration tribunals. Each of these disputes involved breaches of clauses of different international treaties (see below section on international investments agreements). Recent litigations involved disputes over the non-performance of a sale contract of gas condensate by a State-owned enterprise, the expropriation of a hotel after the 2005 Tulip Revolution, the nationalization of the Asia Universal Bank and the revocation of permits in the mining sector. As of April 2014, Kyrgyzstan was facing eight pending international investor–State disputes with claims amounting to nearly $925 million, more than the average annual inward FDI flows to the country in any given year and around one third of the country's FDI stock.[4]

In February 2014, the authorities established the Centre for Legal Representation of the Government to manage the significant caseload. The Centre is entrusted with legal representation of governmental interests before international courts and tribunals as well as local courts. In addition, and in accordance with its statutes, the Centre ensures coordination between State bodies for the effective resolution of disputes brought against the Government (Decree 89 of 2014, Supplement). The establishment of this institution may defend State interests more efficiently and help gather experience in international arbitration proceedings.

International investment agreements

As of 1 April 2014, Kyrgyzstan had concluded 29 bilateral investment treaties (BITs), 20 of which have entered into force. International investment agreements (IIAs) are negotiated by the Ministry of Foreign Affairs in coordination

[4] See "Kyrgyzstan has won another lawsuit on 'Asia Universal Bank'", K-news, 26 December 2013; "Michael Nadel has lost to the Government in international arbitration", Vecherniy Bishkek, 15 November 2013; "Kyrgyz Republic Settles BIT Claim with UK Miner Oxus" Investment Arbitration Reporter 16 May 2008; "US [United States] $925 million is claimed from Kyrgyzstan in international courts", Stan Radar, 19 February 2014. It should be highlighted that the handling of ISDS through arbitration has become increasingly costly for developing countries and those with economies in transition, both with regards to amounts awarded and costs incurred in arbitration procedures: the OECD has estimated the average cost of legal fees and tribunal expenses to be above $8 million per party per case (Gaukrodger and Gordon, 2012).

with the Ministry of Economy. The Government signed its first BIT with Turkey in 1992 and its most recent one with Latvia in 2008. Most of the other treaties were signed in the early years of independence. Among major FDI source countries, agreements are in force with China and the United Kingdom; an agreement was signed with Kazakhstan, but it had not entered into force as of 1 May 2015.

In addition to BITs, Kyrgyzstan is a party to various plurilateral investment treaties. These include the Energy Charter Treaty (1994), the Commonwealth of Independent States (CIS) Convention on Protection of Investor Rights (1997), the Agreement on promotion and protection of investment among Economic Cooperation Organization (ECO) members (2005), the Agreement between member States of the Eurasian Economic Community (Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan) on Reciprocal Protection and Promotion of Investments (2008), among others.[5] Other relevant international affiliations include Kyrgyzstan's membership since 1998 in the World Trade Organization (WTO), the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the Multilateral Investment Guarantee Agency (MIGA). Although Kyrgyzstan signed in 1995 the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID Convention), it has never ratified it (although it has signed BITs that allow for ICSID arbitration under its Additional Facility Rules).

Treaty making has resulted in a network of IIAs with potentially far-reaching investment guarantees. Kyrgyzstan's IIA regime offers considerable guarantees to foreign investors. First, in line with the national legislation, most of the existing IIAs accord investors and their investments post-establishment most-favoured-nation and national treatment. Second, Kyrgyz IIAs generally include unqualified fair-and-equitable-treatment clauses and provisions to protect investors from both direct and indirect expropriation. Even though the inclusion of these provisions is common in many treaties, the lack of a common interpretation of what "fair and equitable treatment" and "indirect expropriation" actually imply has been the subject of much controversy and debate by investment stakeholders around the globe. It is notable that, unlike emerging practice in other countries, no Kyrgyz BIT under review defines these terms. Third, so-called umbrella clauses are present in half of Kyrgyz BITs. Such provisions expand the scope of BITs by incorporating non-treaty obligations (e.g. contracts) of the host State into the treaties, which has also contributed to a rise of conflicting interpretations by arbitral tribunals. Finally agreements are subject to automatic renewal and tend to include a survival clause, which effectively lock in treaty standards for up to 20 years after their eventual termination, a high limit when compared with international practice.

Sustainable development considerations have not been part of current treaty practice. Globally, sustainable development considerations are increasingly making their way into the negotiation of investment treaties. Kyrgyzstan's existing IIA regime, however, does not yet form part of this trend. For example, the country's IIAs do not highlight the importance of sustainable development in their preambles, they do not qualify and circumscribe key obligations (e.g. like fair and equitable treatment or indirect expropriation), they do not contain sector or industry-specific exclusions from the treaty scope (e.g. essential social services such as health or education) and do not include public policy exceptions (e.g. for the protection of the environment).

The country has limited institutional capacity to align investment treaty making with the country's development goals. Insufficient human resources, which specifically focus on investment treaty making, limit the capacity to effectively analyse IIA-related challenges and design ways to overcome them. This is even more so given the need for coordination between ministries on multifaceted matters that involve mining, environmental and social authorities. The accession to EAEU and the need to set up a viable investment attraction strategy will make this challenge even more urgent (see chapter 2).

Recommendations

Include all entry restrictions on FDI in the Law on Investments and clarify the mandate of investment promotion authorities. Future revisions of this law should combine all provisions on key features of the national regulation for investment. A periodic review should take

[5] Kyrgyzstan is also a party to the Partnership and Cooperation Agreement establishing a partnership between the European Communities and their Member States, of the One Part, and the Kyrgyz Republic, of the Other Part (1995); and the Framework Agreement Between the Government of the United States of America, the Government of the Republic of Kazakhstan, the Government of the Kyrgyz Republic, the Government of the Republic of Tajikistan, the Government of Turkmenistan and the Government of the Republic of Uzbekistan Concerning the Development of Trade and Investment Relations (2004).

place of the effectiveness of the law and the appropriateness of existing restrictions to achieve development goals. Furthermore, the revision of the law should also incorporate the recent approval to set up an investment promotion agency. In this sense, the Law on Investments should include specific information on the mandate of investment promotion authorities (see chapter 2).

Harmonize investment-related definitions across all laws and regulations. In particular, harmonized definitions will result in more clarity on existing restrictions related to access to real property for agriculture and tourism activities, two priority sectors in the Government's strategy for FDI diversification (see chapter 2).

Consider governance reforms to improve treatment and protection. Improving governance is a key aspect in reducing the country's exposure/vulnerability to claims by foreign investors. Accordingly, the Government should ensure that the existing framework of protection for investors is properly enforced, including by strengthening the local judiciary and enacting legislation against corporate raiding (see section II g. on access to justice).

Improve domestic capacity to manage the IIA regime. The Government may wish to consider a solid strategy for future treaty making (see below) and focus on building adequate institutional capacities in the Ministry of Economy as well as other affected entities. For this purpose UNCTAD could be of assistance in capacity-building and technical cooperation activities to improve the Government's IIA-related capacity, including on issues related to new-generation investment policies.

Adopt an approach to IIA negotiations that is compatible with sustainable development principles and the country's development strategy. The country could modernize its treaty network with a view to making it more conducive to sustainable development goals, fostering coherence between IIAs and other public policy goals and reducing the State's exposure to conflicts that may arise in the promotion and protection of legitimate public-interest objectives. Among others, this would require carefully focusing the scope of treaty application, defining and clarifying key provisions, including public policy exceptions and designing a more refined mechanism for settling investment disputes. Policy options contained in the *Investment Policy Framework for Sustainable Development (IPFSD)* could be instrumental in this strategy. The IPFSD proposes alternative options for treaty clauses that provide authorities with a broad choice of options to maximize the sustainable development benefits – and minimize related challenges – that foreign investment can bring (UNCTAD, 2015). In addition, the Government could establish a model BIT that would serve as the basis for future negotiations, promote consultations with affected stakeholders to ensure thoroughly informed decision-making and consider seeking UNCTAD assistance on training and advisory services.

Reduce the country's exposure to investor–State dispute settlement. Kyrgyzstan should revisit its system for settling disputes with foreign investors. This would include carefully analysing the pros and cons of granting foreign investors access to international arbitration through the country's domestic law and modernizing dispute settlement provisions in its IIAs based on lessons learned and international best practices. Strengthening dispute prevention policies, including by promoting consultation and investor–State dialogue, is of utmost importance, both at the domestic and international levels. With regard to IIAs, it is important to carefully circumscribe the range of disputes that can be subject to investor–State dispute settlement (ISDS) in IIAs and consider the requirement to exhaust local remedies or improve procedural and institutional aspects of ISDS. Again, IPFSD and its paths of reform for ISDS can offer guidance in this regard.[6]

II. General investment climate

a. Company operations and access to land and real property

Company registration

Standard forms of company registration exist for all types of business entities. Company registration and start-up procedures are regulated by Law 57 on State Registration of Legal Entities, Branches and Subsidiaries of 2009. The main legal forms of business operations available are as follows: individual ownership, limited liability company (the most common type, requiring a minimum

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[6] See Reform of the IIA Regime: Four Paths of Action and A Way Forward, 2014, UNCTAD IIA Issues Note, No 3, June, available at: http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d6_en.pdf, accessed 1 May 2015.

of two shareholders), joint stock company, partnership, branches and representative offices of foreign companies.[7]

The Government has successfully implemented business facilitation reforms. Businesses that are established as separate legal entities require registration with the Ministry of Justice through a process that is estimated to take five days. In 2009, the Government cancelled some requirements, such as the need for notarized signatures of the founders, a minimum stock capital for non-financial companies, and the requirement to open a bank account prior to a company's registration. As a result, the country has improved its ranking on the World Bank ease of doing business from 104 in 2005 to 68 in 2014 (World Bank, 2013; Chamber of Commerce and Industry and JICA, 2013). A one-stop shop was also set up at the Ministry of Justice that is meant to interact electronically with all agencies involved (i.e. the Social Fund, the State Tax Service and the National Statistics). However, in practice, it is still necessary to register with the State Tax Service and the Social Fund separately because instructions are still to be enacted by each of these agencies to make the one-stop shop operational. The only other procedure involves obtaining permission to issue a seal for use in official documents. The cost is between som 1,000 and som 2,000 (about $19 and $38).[8] Another requirement applies to foreign companies, which is to submit a legalized excerpt from the State registry of the country of origin certifying that the company is duly incorporated and in good standing; however, the Government has concluded a number of international treaties that exempt legal entities that are residents in certain countries from this formality (or else simplify it) (Chamber of Commerce and Industry and JICA, 2013; Law 57 on State Registration of Legal Entities of 2009, article 10).

Licences and permits

A reform process is under way to improve business facilitation. Licensing is regulated by Law 195 on the Licensing System of 2013. The State policy and coordination of licensing and permitting activities are under the aegis of the Ministry of Economy (for licences issued by the environmental authority, see section 2.e in this chapter). The full list of activities requiring licences and permits is contained in the Law (articles 15, 16 and 17). The Law has established a maximum period of up to 30 days for issuing a licence or refusing a licence application. If a competent authority has not issued the licence within this given period, the licence is automatically granted (article 20.5). The law also provides for conditions for the issuance, suspension or cancellation of licences and permits, controls and a uniform procedure for registering sanctions on violation of licensing requirements. The process has so far reduced the number of licences and permits from 490 to 101.

Reducing the time needed to obtain licences and permits is also a priority. Recent enterprise surveys have indicated that obtaining licences and permits is time consuming for businesses. The proportion of managers' time spent on dealing with regulations or with public institutions doubled from 6 per cent in 2008 to 13 per cent in 2013, and the average waiting time for operating licences increased between 2008 and 2013 from 18 to 32 days. This is more than in other countries of Central and Eastern Europe and the former Soviet Union (EBRD/World Bank, 2013). As of 1 August 2015, a draft amendment to Law 195 of 2013 had been proposed to further reduce the number of licensed activities as well as to introduce an automated information system of issuing licences online. This system will improve business facilitation and reduce opportunities for corruption by eliminating the direct contact between the licensor and the licensee.

Some bottlenecks remain in the construction sector with regard to access to electricity. Permitting and licensing in the construction sector has been subject to a more specific reform. In 2008, a one-stop shop to issue pre-design and building permits was opened by the State Agency for Architecture and Construction (SAAC). The reform relieved businesses of the burden of dealing with multiple State bodies at the stages of obtaining the design permit, construction licence and occupancy permits. But one missing link concerns access to electricity. Even though a business can submit an application for connection to SAAC, a visit to the electricity distribution company is needed to ensure that the application is properly processed and to pay for engineering specification services. In addition, after the completion of external connection works, the electrical installation will have to be inspected by the electricity distribution company and the State Energy Inspectorate. The overall procedure is complex and lengthy – about 159 days

[7] Branches or representative offices of foreign companies can be established without setting up a separate legal entity. Some restrictions apply: a representative office is limited to only representing the foreign entity, and it may not be licensed to perform certain activities (WTO, 2013).

[8] The average official nominal exchange rate for 2014 was som 53.65 per dollar (see IMF, International Financial Statistics).

– which leaves ample room for discretionary behaviour and explains why Kyrgyzstan is ranked 168 of 189 economies on the ease of getting electricity (World Bank, 2014a). Indeed, enterprise surveys have also reported increased bribe expectations during recent years (EBRD/World Bank, 2014; see also section g of this chapter).

Business inspections

Disruptions linked to business inspections are a challenge. A survey by the World Bank in 2011 estimated that small- and medium-sized enterprises (SMEs) and individual entrepreneurs experienced on average four and seven inspections per year, respectively, with the average duration of inspections being seven working days for SMEs and one working day for individual entrepreneurs. Overall, inspection coverage, which was above 70 per cent of SMEs in 2001, is higher than in other countries with economies in transition that have introduced risk–based mechanisms, such as Belarus and Ukraine (World Bank/IFC, 2013). Inspections cover subjects such as the environment, health, labour, competition, taxation, social security and industrial safety, among others (see also sections c and e of this chapter) and are carried out by 12 inspectorates. Among these, visits by the State Tax service, the Social Fund, the Fire Safety Agency, and the Sanitary and Epidemiological Service are reportedly the most common faced by firms. Inspections may be scheduled or unscheduled. Private sector organizations have noted that disruptions linked to excessive and unpredictable business inspections are an area of concern, especially in the garment sector (see chapter 2).

The Government is moving forward with substantial reforms to reduce the burden of inspections. Business inspections are regulated by Law 72 on Procedure for Conducting Inspections of Business Entities of 2007. A number of regulations have been adopted recently to improve this situation. In 2012, risk assessment criteria were introduced to focus inspections on high-risk companies and reduce the overall number of inspections. In addition, the number of agencies authorized to conduct business inspections were reduced from 21 to 12. These changes led to a significant decrease in the number of inspections (from 24,400 in 2011 to 13,500 in 2012). Also, in 2013 the Government introduced a new electronic database (proverka.kg) thus making the process of scheduling inspections and risk assessment more transparent (Decree 195 on the Single Automated Database for Inspections of Business Entities of 2013).[9] As of August 2015, the drafting of a bill containing amendments to Law 72 of 2007 was started (Bill on Amendments and Additions to the Law on Procedure for Conducting Inspections of Business Entities), which contains provisions to further reduce the burden of inspections. The goal is to eliminate potential corruption mechanisms and improve harmonization of legislation. The Bill provides for the exemption of new entrepreneurs from inspections for three years and a twofold reduction of the frequency of sanitary epidemiological inspections. It also sets a one-day limit for post-inspections controls. It should be noted, however, that regardless of the potential that these exemptions may have for facilitating company operations, business inspections serve a public-interest purpose, and exempting companies from inspections altogether could create safety risks.

Access to land and real estate

Since independence, the Government has implemented land reform as an integral part of privatization of State property initiatives. With the help of international cooperation agencies (Swedish International Development Cooperation Agency (SIDA), United States Agency for International Development (USAID) and the World Bank) legal amendments and institutional changes were introduced. Importantly, the land cadastre and land registration systems have been unified since 1999 under the single State Registration Service (Gosregister). The Department for Cadastre and Registration of Property Rights is a subdivision of this service, which maintains the land cadastre, cadastre mapping, and registration of property rights. As part of the privatization process, the Land Redistribution Fund, now known as the State Fund of Agricultural Lands, was created (ECE, 2010). In the course of the reform, 75 per cent of agricultural lands were transferred into private ownership, and the remaining 25 per cent was allocated to the Fund for public administration. These lands are intended for a number of uses: expanding the territory of rural settlements, setting up agricultural enterprises, leasing to agricultural producers, making allocation to citizens and other purposes. The Fund's lands are State property and cannot be sold (Law

9 See Decree 422 on Criteria for Assessment of Degrees of Risk in Business Activities of 2012, Decree 166 on the List of Competent Bodies Entitled to Carry out Inspections of 2012 and Ministry of Economy, Analytical Note on Completed Inspections of Business Entities in 2012, available at: http://proverka.kg/media/uploads/files/gko/news/analiz_po_proverkam_2012.pdf, accessed 1 May 2014.

4 on Management of Agricultural Lands of 2001, articles 2 and 20, and Decree 199 on Strategy for the Use of Lands of the Agricultural Land Redistribution Fund of 2009).

An automated registration of land plots is operational and the introduction of new surveying technologies is under way. Since 2000, the World Bank, in cooperation with Gosregister, launched the Land and Real Estate Registration Project (LRERP). The project established 50 local offices around the country and provided them with the necessary equipment and training for officials and real estate professionals, and supported the systematic registration of over 2.7 million land plots and real estate objects in an electronic database. The automated system of registration of property rights is operational, and a single database of real estate has been created. Reforms already under way include the creation of electronic cadastre maps and the introduction of new global positioning system (GPS) technologies in cadastral surveying.[10]

A well-functioning land market is not yet fully in place. According to article 35 of the Land Code, it is possible to transfer land titles (buy, sell and lease) without authorization by the Government. However, the primary land market is not fully developed due to a scarcity of available land plots and high prices.[11] In addition, there are also restrictions on the use of agricultural lands as collateral (Law on Management of Agricultural Lands, article 23), according to which agricultural lands can only be pledged in certain banks and specialized financial institutions. These restrictions prevent development of the land market. Also, with regard to access to agricultural land, a moratorium was set up to prevent the transformation of irrigated agricultural land into other categories of lands (Law 257 on the Moratorium on the Transformation of Irrigated Lands into Other Categories of 2009). The goal of the Government was to prevent abuses linked to the construction of private housing on farmlands.

Foreign investors face additional challenges, especially in the agricultural sector. As mentioned above in section I.a, land legislation is unclear with regard to access to agricultural lands for foreign persons. The Land Code (article 5.1) forbids the provision and the transfer into ownership of agricultural land to foreign persons. The word "provision" could be interpreted as an outright ban on foreign access to agricultural land, including leasing. However, the same code (article 5.3) states that land outside urban settlements can be provided to foreign persons for temporary use, which could be interpreted as a temporary leasing right. However, it is not specified that land "outside urban settlements" could freely be used for agricultural activities. Finally, the Regulation on Conditions and Procedure for Leasing Lands of the Farmland Redistribution Fund adopted by the Resolution of the Parliament 1997-III of 2007 states that lands of the Farmland Redistribution Fund cannot be provided to foreign persons (article 6). Thus, the scope of the restriction is not consistent across the regulations.

Recommendations

Move forward with company operations reforms to reduce administrative barriers; improve coordination among Government entities involved in the investment process, including the following:

- **Improve business facilitation through increased transparency.** The Government should consider introducing further measures to foster transparency, such as the Business Facilitation Programme of UNCTAD. The programme helps simplifying administrative procedures based on 10 principles, which generally allow Governments to reduce the number of steps and requirements by more than 50 per cent, without changing the laws. Also, the UNCTAD web-based tool, eRegulations, can also help to streamline business processes.
- **Work to make the one-stop shop for company registration under the Ministry of Justice fully operational.** The one-stop shop principle is not functioning, and there is still a need to register with the Social Fund and the State Tax Service. To ensure expediency, all existing regulations should be brought into conformity with the Law on State Registration of Legal Entities.
- **Simplify procedures for access to electricity.** The procedures for obtaining access to electricity are burdensome for companies. It is recommended to reduce the time frames for procedures and enhance coordination between SAAC and the electricity

[10] Department for Cadastre and Registration of Property Rights, "Second Project on Land and Real Estate Registration", available at http://www.gosreg.kg/index.php?option=com_content&view=article&id=136&Itemid=77, accessed on 1 May 2014.

[11] See the following article: In 2013, a volume of transactions on the real estate market in Kyrgyzstan amounted to $1.8 billion, 22 January 2014, available at: http://www.kyrtag.kg/news/detail.php?ID=2321, accessed 9 June 2014.

distribution companies so that businesses would not need to additionally contact the distribution company at the stage of application for connection.

- **Continue reforms to improve access to land.** The Government should work to harmonize definitions in all legislations concerning access to land, land use and existing restrictions for either ownership or leasing. It should also clarify provisions regarding access to land by foreigners in agriculture and specify the duration of lease periods. Given that the Government wishes to attract foreign investment in agriculture, the authorities may consider implementing a land bank programme to identify land appropriate for investment, including the possibility of converting the status of land use to facilitate leasing to interested investors. As discussed in chapter 2, the impact of foreign investors in agriculture is related to the type of development model chosen. UNCTAD and other international organizations have put together a set of seven principles for responsible agricultural investments that respect rights, livelihoods and resources. They could serve as guidance on this respect (chapter 2, box 2.1).

b. Taxation

The authorities have set up a competitive tax regime for foreign companies but that remains burdensome for SMEs. Overall, the corporate taxation rates are low, compared with countries at a similar stage of development (see chapter 2 for sector comparisons). Indeed, the favourable tax rates have been one of the main drivers for foreign investment since independence in the views of many interviewed investors. The taxation regime underwent a complete overhaul in 2008 with the introduction of the new tax code that reduced tax rates and increased available incentives.[12] The reform overall eased the burden of doing business through simplified taxation rules and it is deemed to also have contributed to higher State revenues. Nevertheless, it has left in place some serious biases against domestic SMEs, which explains the relatively large size of the shadow economy and widespread tax avoidance and evasion practices.

The corporate tax rate is relatively low and accompanied by generous allowable deductions. The standard corporate tax rate is 10 per cent, except for companies engaged in mining golden ore, concentrate, alloy and refined gold activities. These companies have a special regime (see chapter 2 section on mining). The tax applies to the annual aggregate income less allowable deductions. Taxable income comprises all forms of income from business activities, plus income from property, dividends, interest and royalties and subsidies (Tax Code, article 188). Losses of economic activity can be carried forward for up to five years following the period in which the loss was incurred and deducted from taxable income. Losses that were incurred during the tax period when the taxpayer was exempt from taxes cannot be carried forward (Tax Code, article 206).

The value added tax (VAT) rate is relatively low, with a low company revenue size threshold to qualify for exemptions. The VAT is levied at the rate of 12 per cent but numerous exemptions apply (e.g. sale or lease of residential buildings, agricultural goods and machinery, fertilizers and vaccination for cattle, financial services, insurance services and transportation services). Exports are zero rated. In order to comply with the VAT payment rules, firms have to file a monthly declaration and the tax must be paid within 25 days after the end of the previous tax period. Interviews with SMEs confirmed that there are cumbersome administrative procedures to file the VAT tax and that the monthly VAT declarations remain particularly burdensome.[13] It is worth noting that the company revenue size threshold to qualify for VAT exemption was set at som 4 million a year (approximately $74,500) (Tax Code, article 229). This threshold, which is significantly lower than equivalent ones prevalent in the Russian Federation and Kazakhstan (as of March 2014), is detrimental to the evolution of enterprises – particularly the graduation from individual entrepreneurs to SMEs – and has had a negative impact on production and employment creation.

The sales tax overlaps with the VAT on its tax base, but existing fiscal constraints prevent a rapid phaseout.

[12] See Tax Code 230 of 2008 (effective 1 January 2009). Major changes were the reduction of the number of taxes from 16 to 8, the lowering of the rate of VAT from 20 to 12 per cent, the introduction of a new property tax and a sales tax (the latter replaced the retail sales tax, the road tax and an emergency fund).

[13] On 4 August 2015, Law 96 on Amendments to the Tax Code was adopted, which changed the frequency of reporting and payment of taxes. This reform relieved the burden for small enterprises. Accordingly, for firms with a turnover up to som 4 million per year, both reporting and payment of taxes are done on a quarterly basis. For medium-sized enterprises (turnover from som 4 million to 30 million) reporting is done on a quarterly basis and tax payments are monthly.

During the reform of 2009, the sales tax was put in place to complement the VAT with rates that vary between 1 per cent and 5 per cent. The reform resulted in an overlap in the tax base of the VAT and sales tax. Following International Monetary Fund (IMF) recommendations, Kyrgyzstan has committed to gradually phase out the sales tax. An adjustment of 0.5 per cent was made in 2010, but budget constraints prevented further reductions (see Law 231 on the Entry into Force of the Tax Code of 2008).[14] As of 1 August 2015, the Government has been considering further amendments to taxation that will provide for increasing the company revenue size threshold to qualify for VAT exemptions to som 6 million and eliminating the sales tax on exports (except for banking, insurance and telecommunications services).

The tax legislation provides for a number of incentives. They apply equally to local and foreign firms, such as VAT exemptions (referred to above) or tax allowances for research and development (R&D) expenditures (100 per cent) linked to the economic activity of a company (Tax Code, article 197). Furthermore, the agricultural sector enjoys additional preferences: a number of food processing companies are exempt from the corporate income tax for three years (see list in Decree 37 of 25 January 2013). In addition to free economic zones (see below), the Tax Code also sets out five special tax regimes which are targeted to companies (box 1.1). Finally, tax stability regimes are provided in investment and mining legislation. The Law on Investments (article 2.2) states that in case of amendments to tax and customs legislation, investors can choose the more favourable conditions during 10 years from the beginning of their investment activities. The Tax Code also provides for the stability of the tax regime for subsoil users, who are guaranteed against increases in tax rates for up to 20 years. However, regulations to implement these tax stability regimes have not yet been enacted.

Transfer pricing provisions are of a limited scope and there are no explicit anti-avoidance rules. Rules on transfer pricing are set up in the Tax Code (articles 120–121). Notably, the internationally recognized best-method rule and profitability methods are not part of Kyrgyzstan's legislation. In addition, the existing rules for application of the available methods are not elaborate: for instance, there is no threshold for transactions subject to monitoring. Neither does the Tax Code detail the modalities for the monitoring of transactions or interaction between authorities.[15] Thus, legislation does not effectively protect the country from aggressive tax planning. As the Kyrgyz economy becomes more internationalized, the challenge will become more acute. The Government is aware of these challenges and the concept note on fiscal policy for 2015–2020 prepared by the Ministry of Economy envisages the implementation of legislative regulation to improve clarity in transfer pricing rules for transactions between related parties.

Insufficient coordination among ministries involved in taxation issues prevents an efficient implementation of fiscal policy. After the 2008 amendments to the Tax Code, reforms aimed at streamlining tax payment procedures, tax monitoring and control were introduced. The efficiency of these reforms was, however, diluted by the absence of a holistic national strategy for tax policy. The functions of tax policy planning were transferred from the Ministry of Economy to the Ministry of Finance in 2013, but they were transferred back to the Ministry of Economy one year later. Tax administration, however, is a responsibility of the State Tax Service, an independent agency. The Ministry of Economy has laid down plans for further reforms, including an assessment of the efficacy of existing incentive schemes. These plans have been included in the concept note on fiscal policy for 2015–2020.

Efforts to further simplify tax payments and reduce corruption among tax authorities are under way as a key to combat tax avoidance and evasion. The Government has made some progress through the introduction of electronic systems for tax return in two formats: via a third party (operator company) and the website of the State Tax Service (only for VAT-exempt entities). As of the beginning of 2014, the submission through the government website was working in pilot mode and is expected to become operational during the course of the year. Because the majority of taxpayers using electronic submission are SMEs, these reforms should facilitate the regularization

[14] The turnover tax negatively affects the competitiveness of businesses because the effects are multiplied when goods pass from one business to another, thus causing distortions to economic activity. IMF has recommended to gradually phase it out and considering replacing it with increases in VAT rates (IMF, 2013).

[15] According to articles 120–121, the methods used for determining the market price include the comparable uncontrolled price, resale price method and cost plus method. See also PWC 2013, Tax Code 146-FZ of the Russian Federation of 1998, Law of the Republic of Kazakhstan 67-IV ZRK on Transfer Pricing of 2008 and United States Internal Revenue Code of 1986.

Box 1.1. Overview of company taxation in Kyrgyzstan

The principal taxes affecting companies are the corporate income tax, VAT, sales tax and social insurance contributions. There is no net worth tax or separate tax on capital gains.

Depreciation of productive capital assets is subject to a scale that ranges annually from 20 per cent (buildings and constructions, railroad, sea and river transport; equipment for the energy sector) to 30 per cent (exploration works and licences for the use of subsoil; fixed assets of mining and/or mining processing enterprises). Depreciation rates for motor cars, computers and phones is set at 30 per cent, and 25 per cent for buses, trucks and special vehicles, industrial equipment and office furniture. Rates for all other depreciable assets not included in any category are set at 20 per cent.

The withholding tax on interest is 10 per cent but some exemptions apply to the interest paid to the Kyrgyz Social Fund, resident banks and resident lessors under a financial lease agreement (articles 221 and 223).

The rates of the sales tax are 1 per cent for commercial activities and 2 per cent for other activities (except for mobile services, taxed at 5 per cent). For taxpayers who are not subject to VAT, the rates are higher: 2 per cent for commercial activities and 3 per cent for other activities.

The rates of social insurance contributions are calculated based on the gross pay of each hired employee: 10 per cent for national employees, 2 per cent for employees with disabilities, 3 per cent for foreign citizens and persons without citizenship (Law 8 on Rates of State Social Insurance Contributions of 2004).

The fiscal year coincides with the calendar year, but tax payment periods differ, depending on the tax and can vary from monthly (VAT, excise tax and sales tax) to quarterly (single tax regime) or annual (corporate income tax). The terms of payment are also established for each tax and can vary. VAT, for example, must be paid within 25 days after the end of the previous tax period, and corporate income tax shall be paid on a quarterly basis.

In addition to free economic zones (see below), the Tax Code includes five types of special regimes:

Special tax regime	Description
Mandatory patent regime	It applies to 11 types of service providers such as companies providing saunas, billiards and disco clubs. The regime replaces the corporate income tax, sales tax and VAT for supplies. Tax rates range from som 100 to som 100,000 depending on the service and the number of inhabitants in the locality. Single payments shall be made before the start of the activity and can run for the periods of 30, 90 or 180 days. The longer the term of the permit, the more advantageous the tax rate.
Voluntary patent regime	Sole entrepreneurs, engaged in activities included in a list approved by the Government in coordination with the core committee of the Parliament, have the right to pay tax on the basis of a voluntary patent. Individuals who pay the voluntary patent tax shall pay the taxes established by the Tax Code, except for income tax and sales tax. Taxpayers withhold from payroll employees and pay a fixed amount, calculated on the basis of the estimated minimum income (chapter 2, section II.a, for the case of voluntary patents as they apply to production of garments).
Simplified tax regime based on the single tax (for SMEs)	The regime for SMEs applies only if the company has not reached the threshold for VAT and is not a VAT taxpayer (Tax Code, article 359.1). It allows companies to pay a single turnover tax instead of the sales tax and the corporate income tax. The rate for processing of agricultural goods, industry and commerce is 4 per cent, and for other types of activities, 6 per cent.
Contract-based tax regime	Enterprises and individual entrepreneurs can pay taxes (corporate income tax, sales tax and VAT) in the form of the fixed sums determined on the basis of the highest annual tax payments during the previous three years with a premium of 25 per cent. The contract grants the taxpayer an exemption from one planned annual tax inspection. Currently, very few companies operate under this regime (mainly health resorts).
Tax regime for high-technology parks	The first high-technology park started operation in 2013, and so far only IT companies have been registered there. The residents are exempt from revenue tax, sales tax, and VAT and benefit from a special income tax rate of 5 per cent for employees. The directorate of the park charges 1 per cent of the turnover of the resident companies to provide for the needs of the park.

Source: Tax Code 230 of 2008 (effective 1 January 2009).

of companies operating in the informal sector. Another challenge is linked to bribing and the related harassment in tax collection which, as it was revealed in several interviews during the UNCTAD fact-finding mission, primarily targets SMEs. To address this issue, the State Tax Service has launched a programme to combat corruption inside the agency. The programme is based on streamlining the tax legislation, simplifying the filing of tax returns, raising awareness among taxpayers of their rights and obligations, and reducing the instances for direct contacts between tax officers and taxpayers.

Investors in the free economic zones benefit from a generous regime. As of 2014, there are five free economic zones (FEZs) in Kyrgyzstan. The zones include Bishkek, located in the proximity of the capital; Maimak, on the Kyrgyz–Kazakh border; Naryn, on the Kyrgyz–Chinese border; Karakol, near Issyk–Kul Lake; and Leilek. FEZs have attracted investment from more than 30 countries. The biggest one is Bishkek, which accounts for more than 76 per cent of total investments in FEZs of the country (Chamber of Commerce and Industry and JICA, 2013). Residents of FEZs are exempt of all taxes, but the sale of goods to the territory of Kyrgyzstan requires payment of VAT, and the Directorate of each zone levies a fee ranging from 0.1 per cent to 2 per cent of turnover (Law 6 on the FEZs of 2014, article 6). As is usually the case, mining activities and the production of goods subject to excise taxes (alcoholic drinks, tobacco, cigarettes and oil) are prohibited in FEZs.[16]

Recommendations

Improve transparency in the tax collection system. The internal anti-corruption project within the State Tax Service is a positive development and shall be continued. An external audit of the State Tax Service is also recommended, for example, by the Anti-corruption Service under the State Committee for National Security responsible for implementation of the State Strategy for Anti-corruption Policy (see section II.h on governance). As in other countries, the Government could also consider the adoption of client charters detailing the quality of the services to be expected from government officials dealing with the public (UNCTAD, 2006). Furthermore, the introduction of transparency focal points in fiscal collection outposts is another way to improve the efficiency of the tax collection system.

Ease the administrative burden for investors with a focus on the needs of SMEs and the need to increase formalization of the shadow economy. The introduction of electronic submission of tax returns is a welcome step in the direction of simplification of tax payment procedures, and the practice of e-filing should be further promoted among taxpayers. With regard to formalization, the need to address the needs of SMEs should be a priority. A series of measures could be considered to reduce the tax burden: for instance, the authorities may move forward with the reform to increase the company revenue size threshold to qualify for VAT exemption and consider extending the application of the simplified tax regime based on the single tax to activities that are currently exempt from VAT. In turn, some VAT exemptions could be eliminated (or the phasing out of the sales tax extended over time) to account for related lost revenues.

Streamline the incentives in the form of tax exemptions. Kyrgyzstan has extensively used tax incentives to attract investors. However, a large number of incentives create an additional administrative burden for the tax authorities. In particular, the authorities might consider abolishing the contract-based special tax regime which is currently used by few taxpayers. A large number of VAT exemptions eroding the tax base should also be avoided. With regard to free economic zones, the Government may consider the possibility of gradually transforming them into multiple-facility zones relying on the quality of infrastructure and investment facilitation rather than on tax incentives. This would contribute to reducing the risks of enclave effects and support the strategy to promote local linkages through FDI diversification (see chapter 2).

Improve transfer pricing rules. With the entry of new foreign investors into the market, opportunities for tax engineering are also likely to increase. Thus, it is advisable for Kyrgyzstan to consider adopting precise transfer pricing and anti-avoidance rules in line with international best practices.

c. Labour

Overall, Kyrgyzstan has adopted labour legislation that balances the rights of the employer and the employee, while preserving labour market flexibility. Labour Code

[16] Although in the past it was ambiguous whether the activities in FEZs were restricted to foreign companies, the new law on FEZ of 2014 provides that one of its objectives is attraction of investment in general (i.e. it is not limited to foreign investment). The Directorate of the FEZ of Bishkek indicated that out of all the companies registered in the FEZ, only 20 per cent have foreign capital.

106 of 2004 sets the basic legal framework for labour regulations. In addition, labour relations are regulated by Law 167 on Labour Protection of 2003 and Law 30 on Trade Unions of 1998. With regard to international commitments, Kyrgyzstan has ratified the 8 core International Labour Organization (ILO) conventions and 42 technical ILO conventions.[17] The Labour Code stipulates that the terms of employment be determined through employment contracts. Legislation distinguishes between fixed-term contracts (with duration of no longer than five years) and contracts of indefinite term. Probationary periods are also possible and may not exceed three months for all workers and six months for high-level managers (Labour Code, articles 55 and 62). Severance payments can vary between one and two monthly wages, which is low by international standards for senior employees. If termination is linked to poor performance, compensation is not mandatory (article 86). In addition, in cases of dismissals for economic reasons, workers are entitled to an additional three month wages of redundancy payments during the period of job search, provided they register within 10 working days after dismissal as jobseekers with the State employment service (article 87).

The collective agreement bargaining system is comprehensive, but does not cover minimum wage negotiations. Besides legislation and contracts, labour relations are regulated by collective agreements concluded by the representatives of the employer and employees (usually trade unions). Collective agreements may include provisions on remuneration, pensions, additional payments, safety rules, strikes, working hours and health care. Law 210 on the Minimum Wage of 2008 stipulates that the minimum wage is set on the annual budget with a view to gradually increasing it in line with the cost of living. Importantly, the Government determines the level of the minimum wage unilaterally, without consultations with the trade unions or employers. This procedure is not in line with ILO Minimum Wage Fixing Convention No. 131, which has been ratified by Kyrgyzstan. In addition, the Labour Code provides that the minimum wage as set by law cannot be lower than the minimum cost of living rate in Kyrgyzstan (article 154). In reality, however, the latest Government budget sets a minimum wage for 2014 amounting to a monthly salary of som 900 (about $17), which is five times lower than the minimum cost of living rate (som 4,694 as of the first quarter of 2014).[18]

A limitation on workers' right to strike is in force, which is not in line with Kyrgyzstan's international commitments. The Labour Code provides for mechanisms of dispute settlement. Individual disputes can be settled, according to the employee's preference, either by having recourse to internal commissions set up within companies, filing claims at the State Inspectorate for Ecological and Technical Safety (SIETS) or using the Court system. Resolution of collective disputes should go through a number of steps, which include a conciliation procedure between the trade union and the employer and mediation involving a third party (if conciliation fails). Under article 30 of the Constitution, workers are guaranteed the right to strike in the following cases: if conciliation procedures do not resolve the dispute, if the employer avoids conciliation, or if the employer does not comply with the reached agreement. The right to strike is, however, subject to certain limitations: strikes are prohibited in railway and water transport, civil aviation and communication services, the stoppage of which is deemed to cause hazardous consequences. However, these services are not considered essential services according to the internationally recognized definition of the term.[19] Overall, there are no official statistics on the number of strikes, but they are common. For instance, according to information gathered in interviews, the trade unions of the mining sector exercised their right to strike in 2006, 2010 and 2012, where disputes related mostly to remuneration, social insurance contributions and additional payments.

Insufficient supply of skilled labour hampers the country's capacity to grow and diversify. According to some studies, 40 per cent of the unemployed cannot find a job because their profession is not in demand, a sign of mismatch between the education system and the labour market.[20] Interviews with stakeholders during the UNCTAD fact-finding mission revealed a list of skills-related

[17] ILO, Ratifications for Kyrgyzstan, available at http://www.ilo.org/dyn/normlex/en/f?p=1000:11200:0::NO:11200:P11200_COUNTRY_ID:103529, accessed 1 May 2014.

[18] Law 227 on the Republican Budget of 2013, article 13. National Statistical Committee, 2014, Minimum cost of living for main social and demographic groups of population as of the first quarter of 2014, 10 April, available at http://stat.kg/images/stories/docs/Express/Uroven/PM%202012/proj.minim%201q.2014.pdf, accessed 1 May 2014.

[19] ILO, 2014, Substantive provisions of labour legislation, 18 January, available at www.ilo.org/legacy/english/dialogue/ifpdial/llg/noframes/ch5.htm#6, accessed 1 May 2014.

[20] Kyrgyzstan has a young labour force; every year 90,000 graduates join the workforce (UNDP, 2011b).

concerns in key economic sectors such as mining, tourism, garments and textiles (see chapter 2).[21] Furthermore, the gradual deterioration of the quality of education adds to the problem. Many programmes are outdated and do not meet the requirements of the market. Other challenges relate to the absence of a unified national qualification framework. The Government has recently created new institutional mechanisms to involve the private sector in defining the standards of training programmes. However, trade unions and SMEs remain underrepresented in these processes.[22]

Child labour and gender disparity at the workplace remain a pressing social challenge. The Kyrgyz Constitution bans the use of child labour, and the Labour Code allows for employment starting only from the age of 14. However, in 2012 around 50,900 children were working in Kyrgyzstan according to official estimates.[23] The types of work they performed range from loading and sweeping to car washing. Some of the most alarming cases involve coal mining and scavenging scrap metal from uranium waste dumps. A particularly difficult area for the police to monitor is agriculture, where it is not always clear whether children perform the task of their parents or they routinely work as employees.[24] Although Kyrgyzstan has ratified key international instruments banning the use of child labour, implementation has lagged. The Government is aware of this; recently the Ministry of Social Development, with the support of ILO, launched a study on the incidence of child labour, which is scheduled to be completed by 2015.[25]

Kyrgyzstan passed Law 184 on State Guarantees of Equal Rights and Equal Opportunities for Men and Women of 2008, which seeks to achieve equal treatment in the workplace. These efforts have contributed to reducing the levels of gender inequalities, but women still do not enjoy equal pay and career opportunities. As of 2012, although the number of female workers amounted to 40.9 per cent of the labour force, only 32.3 per cent of managerial positions were held by women. Also, wages of female workers reach only 74.3 per cent of wages paid to male workers (National Statistics Office, 2013).

Finally, corporate social responsibility (CSR) initiatives, including the avoidance of corrupt business practices, are at a very early phase of development. Large-scale companies in the gold mining subsector, mobile communication services and financial services recognize the important role of CSR. However, social responsibility practices are underdeveloped in small and medium-sized businesses. The practice of disclosing non-financial information and publishing CSR reports is not yet common. Recently, the International Business Council (IBC) set up a CSR committee to address this challenge, which is a sign of growing awareness among private sector stakeholders.[26]

Recommendations

Set up regular consultations between the Government, trade unions and employers associations to improve labour market conditions. Such consultations should

[21] Information is based on interviews with employers and trade unions (ILO, 2009; Government of Kyrgyzstan, 2009).

[22] Vocational institutions offer training for approximately 150 professions. The system of vocational education is divided into three categories (primary, secondary and higher). Primary vocational education is within the competence of the State Agency for Vocational Education under the Ministry for Labour, Employment and Migration, which oversees 110 training institutions. The other two categories are regulated and administered by the Ministry of Education and Science, overseeing 36 training institutions. (Ministry of Education and Science, Primary Vocational Education, available at: http://edu.gov.kg/en/obrazovanie/nachalnoe-professionalnoe-obrazovanie.html; Government of Kyrgyzstan, 2009; OECD, 2012a).

[23] Strategy for Development of Social Protection of Population for 2012–2014.

[24] Perseverance and child labour win all? Word of Kyrgyzstan, 20 November 2013, available at http://slovo.kg/?p=27559, accessed 1 May 2014; Child labour: In tobacco slavery, 24 March 2013, available at http://www.24kg.org/community/174984-detskij-trud-v-tabachnom-rabstvehellipnbsp.html, accessed 1 May 2014.

[25] Problem of child labour to be examined in Kyrgyzstan, Tushtuk, 18 January 2014.

[26] See Open Kyrgyzstan interview with Asel Arstanbekova, Director of CSR Business Network, available at www.csrkz.org/en/csr-practice/interview-with-an-expert/120-corporate-social-responsibility-just-a-show-or-the-reality.html; IBC, Members of IBC attended training course entitled "Non-financial reporting: from decision to publication", which took place in Bishkek on 10 April 2014 available at www.ibc.kg/index.php?option=com_k2&view=item&id=918:члены-международного-делового-совета-прошли-обучение-на-тему-нефинансовая-отчетность-от-решения-до-публикации-который-прошел-в-бишкеке-10-апреля-2014&Itemid=1; Interview of IBC Executive Director Aktilek Tungatarov for CSR Central Asia, 15 April 2014, available at www.ibc.kg/index.php?option=com_k2&view=item&id=921:интервью-исполнительного-директора-мдс-для-портала-csr-central-asia&Itemid=1.

be the norm, for instance in the process of setting the minimum wage.

The authorities should aim to better align university education and vocational training with labour market needs. To do so, development of curricula should include consultations with the private sector and trade unions. Vocational schools should also have sufficient flexibility to adapt part of their curricula independently to respond to changing market circumstances. The Government may also consider putting in place monitoring and evaluation mechanisms such as tracer studies to know where graduates find employment and which skills they use most on the job.[27]

Increase efforts to harmonize the implementation of legislation with ILO standards, improve statistics collection (e.g. on strikes), and address pressing social challenges concerning child labour and gender equality. Reviewing the limitations on the right to strike so as to bring legislation in line with the Freedom of Association and Protection of the Right to Organize Convention should be considered. The Government should also take action to implement policies to reduce the incidence of child labour and promote gender equality at the workplace in line with the existing international commitments, and to mainstream the use of CSR practices by the private sector, including labour and workplace safety standards.

d. Employment of non-residents

There is a quota system for non-resident workers, which is allocated without transparency. Employment of foreigners (by both local and foreign-owned companies) is regulated by Law 4 on External Labour Migration of 2006 and Regulation 639 on Procedure of the Labour Activity by Foreign Citizens of 2006. A company can only employ foreign nationals if the employer has obtained a permit to hire foreign workers from the Kyrgyz authorities. The issuance of permits is limited by annual quotas. The actual quota is determined by the Ministry of Labour in consultation with the Ministry of Economy and the Ministry of Energy and Industry; they are allocated by economic sector and can vary by region. There is no officially published methodology to determine the size of the quota, nor are private stakeholders (i.e. business associations, trade unions) involved in the overall process of quota setting. For 2014, the Government set a quota for foreign workers amounting to 12,990 people.[28] The Ministry of Labour, Migration and Youth has the prerogative to redistribute the quota between the regions and sectors throughout the course of each given year. If the quota for a specific region in the country is exhausted, employers need to negotiate informally to persuade the authorities to redistribute the quota.[29]

The application process for permits is burdensome and not always consistent. Individual work permits are needed for each worker and are awarded on a case-by-case basis. The decisions on the granting of permits are made by an interdepartmental commission consisting of representatives of the Ministry of Labour, the Ministry of Economy, the State Security Service, the Ministry of Internal Affairs and the Ministry of Foreign Affairs. Permits are issued by the Ministry of Labour, Migration and Youth. According to the Regulation on Procedure of the Labour Activity by Foreign Citizens, the expected time for issuance of permits should not exceed 35 days for employers and 15 days for a foreign employee (items 11 and 29). In order to employ a foreigner, the employer must provide evidence that the company's need of skills cannot be satisfied by employing Kyrgyz nationals. Even though authorities give preference to issuing permits for highly skilled workers, this is not explicitly mentioned in the legislation. Permits are issued normally for the period of one year and can be renewed. However, for low-qualified workers and sole entrepreneurs, the total period of stay in Kyrgyzstan is limited to two and three years, respectively (item 19). Interviewed stakeholders noted that the application process was burdensome. Indeed, the list of required documents is not publicly available, and in practice, authorities can request additional documents, which may delay the overall process. As a result, investors sometimes resort to informal hiring of foreign workers with short-term tourist visas.

Although a fast-track application process for large investors is in place, it does not include key managers or board members. The Government has set up a special

[27] For a broader discussion, see ADB, 2009; OECD, 2012a; and Cedefop, 2009.

[28] The quota was distributed between regions and six economic sectors as follows: (a) industry and construction (4,992 workers); (b) agriculture, forestry and processing industry (283 workers); (c) transport, communication, mining (1,903 workers); (d) trading activities, the service sector and catering (4,322 workers); (e) health care, education, science, culture and art (940 workers); and (f) the banking sector, insurance and financial services (550 workers).

[29] Decree 704 on the Quota on Workforce Migration of 2013.

application system that grants simplified entry for large foreign investors through the issuance of investment visas. Accordingly, investors who invest more than $500,000 and have spent more than one year in Kyrgyzstan have the right to apply for a visa, which is valid for five years. This investment visa is issued individually and entitles the holder to multiple entries for business management activities.[30]

Recommendations

Substitute the existing quota system by a scarce-skills-list approach. The existing legislation fails to prioritize economic sectors where foreign skills are more urgently needed. Importantly, there are serious skills shortages in certain sectors, such as the textile industry and mining (see chapter 2). While preserving employment opportunities for nationals, Kyrgyzstan should ensure that companies are able to attract foreign skills that are scarce on the local labour market. A number of measures are advisable: the Ministry of Labour could determine the annual number of foreign workers on the scarce-skills list. A periodic survey of business and labour representatives could be conducted in order to draft such a list. The list could determine categories of workers who can be granted permits subject to economic needs and allow for a fast-track application process.

Improve transparency of the application process and allocation of the quota. An exhaustive list of documents necessary for the application for permits should be published, and the government should refrain from resorting to ad hoc requests for information. Efforts should be made to reduce time frames and discretionary elements in the allocation of quotas and granting of permits as well as on any exceptions that may apply. Extending the provision of fast-track applications may be considered to include not only the investor, but also key management positions and/or up to three board members of the same firm.

In the long term, consider establishing a skills-attraction programme. The programme could aim to attract new entrepreneurs to settle in Kyrgyzstan and invest in new businesses or in the development of existing businesses, as well as skilled workers in those areas identified as being in short supply. The programme could also include training requirements or other measures to ensure the transfer of skills to the local labour force. The existence of a large diaspora of Kyrgyz families living in former CIS countries could provide ample opportunities for such an initiative. UNCTAD has assisted developing countries, such as Rwanda, with this type of initiative (UNCTAD, 2006), which can build on successful experiences in advanced industrialized countries such as Australia or Canada.

e. Environment

Kyrgyzstan's natural environment, known for its mountainous landscape and the second-largest saline lake in the world, is currently facing significant challenges. These include overgrazing of pastureland and soil erosion; climate change and the related melting of glaciers; and environmentally unsustainable mining practices. In particular, mills and tailing ponds left behind after the shutdown of the mining operations – both during and after the Soviet period – pose a considerable hazard to the environment. Development of hydropower has also caused a number of problems, such as flooding of agricultural lands below reservoirs of the plants.

Overall, the legal framework for the environment is fragmented and comprises more than 150 regulations with some of them dating back to the Soviet period. The basic law regulating the environment is Law 53 on Environmental Protection of 1999. Other important pieces of legislation include Law 54 on Environmental Review of 1999, the Land Code, the Forestry Code and the Water Code. An initiative to rationalize environmental legislation by the introduction of the Environment Code in 2009 was not approved. However, Kyrgyzstan has partially modernized its environmental legislation with the adoption of Law 160 on Subsoil of 2012, Law 195 on the Licensing-permitting System of 2013 and other regulations. The Law on Environmental Protection establishes the main environmental requirements for companies operating in the country, such as the State environmental review (SER), environmental impact assessment (EIA) and waste-management requirements. The law requires compulsory insurance for the types of activities that are dangerous for the environment. It also subjects companies to environmental audit and control.

A fragmented permitting system combined with short-term validity is expensive for companies and creates administrative burdens to the State agencies involved. The State Agency for Environmental Protection and Forestry (SAEPF) is in charge of issuing environmental licences and permits. It also assesses EIAs within the framework of SERs (see below). SAEPF issues three types

[30] Ministry of Economy, 2012, Investment visa, 22 September, available at www.mineconom.kg/index.php?option=com_content&view=article&id=2056&Itemid=722&lang=ru, accessed 1 May 2014.

of licences: for hunting birds and fowling, for recycling of toxic wastes (including radioactive) and for transportation of toxic wastes (including radioactive) as well as a number of environmental permits; but permits for trade activities (such as the exportation of used tyres and exportation/importation of plants and animals) are issued via the electronic single window (see section II.f on trade facilitation). Licences are granted for periods of not less than two years, and permits are valid for one year. In contrast, in countries of the Organization for Economic Cooperation and Development (OECD), environmental permit validity can vary between 5 and 10 years and can remain in force unless specific incidents trigger a revision (OECD, 2007). Long validity periods simplify the permitting system and reduce the administrative burden on both the Government and industry. In Kyrgyzstan, the relatively short validity period for permits puts an administrative burden on SAEPF and the private sector. Another peculiarity of the existing permitting system is that pollution is not considered holistically as affecting the ecosystem. As a result, separate permits are issued to authorize pollution of water, atmosphere and soil up to acceptable levels. International trends indicate, however, that pollution of various media should be considered holistically to take into account cross-media transfer of pollutants (OECD/EAP Task Force, 2003; SAEPF, 2013).

A mandatory system of environmental permitting is in place, but it does not discriminate between levels of potential environmental damage. State environmental reviews are conducted by the Government and are mandatory before the start of implementation of any project that affects the environment (Law on Environmental Review, articles 4, 9 and 15). Such reviews should not take more than three months to be finalized. In addition, there is a list of over 20 activities for which an EIA, conducted by the company, is also mandatory before a review can be completed. The results of the EIA are to be assessed as part of the review to determine the final authorization (see General Technical Regulation 151 for Ensuring Environmental Safety in the Kyrgyz Republic of 2009). The cost of undertaking EIAs is borne by the companies requiring project approval. For all other activities for which EIA is not mandatory, a company has still to consult with SAEPF to decide whether some form of impact study may be required. Notably, the instructions on EIA procedures of 1997 were repealed in 2009, and new instructions have yet to be adopted by the Government. This situation creates uncertainty for companies about how to conduct EIAs and about the prospects of ultimate project approval. Overall, the existing legal framework seems to be too restrictive and burdensome for both companies and the State. As a result, compliance with environmental performance requirements has also been unsatisfactory. Some mining companies managed to start operation in the 1990s without having carried out an EIA, and only later did the State Inspectorate for Ecological and Technical Safety (SIETS) intervene to enforce the law. A more common approach for environmental permitting is to classify projects by the risks involved, which will determine the type of required assessment (e.g. full, partial or none), depending on the size and potential environmental impact of individual projects. Different types of impact category (i.e. significant impact, limited impact, no impact) will determine the extent of the study to be undertaken and should result in streamlined procedures that can be applied more consistently (UNCTAD, 2010).

A scattered monitoring of environmental performance among different State agencies has led to inefficiencies. Monitoring environmental performance is scattered among a number of agencies, including SAEPF, the Ministry of Emergency Situations, the Ministry of Health Care, the Ministry of Agriculture and Melioration, and other State agencies. In an attempt to separate regulation and monitoring functions, a new agency was set up in 2012 – SIETS – to which SAEPF handed over the functions of environmental control. However, coordination between SAEPF and SIETS is insufficient and slow, and interviewed stakeholders noted the lack of trained professional staff in the newly established agency. The division of competences between the two agencies has also led to staff cuts and a resulting inadequacy of human resources: only six staff in SAEPF are currently in charge of assessing EIAs in its central office. Its authorities have reported the need for more training of its personnel.

There is a need to move forward with the Law on Glaciers. Another challenge is linked to the location of many mining sites adjacent to glaciers in Kyrgyzstan. There are 6,582 registered glaciers, which account for 4.2 per cent of the territory of Kyrgyzstan and represent an important source of fresh-water feeding rivers. Apart from the climate change costs that result from the melting of glaciers, industrial activity linked to mining can pose other risks. For example, mining activities at the Kumtor site have led to the complete destruction of two glaciers owing to the discharging of mining waste in their vicinity. A third glacier (Lysyi) has also been damaged (Human Development Center *Tree of Life*, 2000). For the first time, the Parliament is considering a bill on glaciers. The bill would prohibit a number of activities on the glaciers and in adjacent zones, including storage and dispersion of substances; chemical agents and tails of any character and volume; exploration and exploitation of subsoil; and construction and operation of industrial sites (article 4). In addition, the bill seeks to subject all activity on the glaciers and around them to the EIA requirement and calls for the development of a methodology for quantifying damage (articles 3, 5, 6 and 8).

Recommendations

Rationalize the legislative framework for environmental permitting and improve compliance. The Government should consider setting up risk-based criteria for the SER process and for determining in which cases EIAs will be required. This will bring clarity and certainty to EIA implementation, ensuring that it neither entails excessive review nor overlooks proposals that warrant examination. In addition, efforts should be made for a prompt enactment of the new instructions on environmental impact assessment, clearly detailing the depth of the impact studies required and ensuring adequate monitoring and compliance.

Improve the institutional capacity of the environmental authorities. Kyrgyzstan should ensure that SAEPF and SIETS coordinate their work effectively, and that the availability of human resources is adequate. It is also recommended that training of newly hired SIETS staff be conducted.

Extend the period for environmental permitting. The period of validity of the permits could be extended to 5 and 10 years in order to reduce the administrative burden for companies and SAEPF. Also, in line with international trends, environmental impact should be assessed holistically, as it affects ecosystems, including moving towards an integrated permitting system.

Enact legislation on the protection of glaciers. If the bill on glaciers is passed, Kyrgyzstan will become the first country in the region to have such legislation. Efforts should be made so that the regulations linked to developing a methodology to quantify damage are enacted and that the monitoring is properly undertaken within the existing institutional framework.

f. Trade facilitation

Trade facilitation initiatives are being implemented, but customs clearance remains expensive to investors. Although Kyrgyzstan has very low tariff barriers after the country acceded to WTO in 1998, non-tariff barriers can be quite burdensome for companies engaged in trading activities, especially owing to the costs of trade clearance. According to the *Doing Business Report* 2015, customs clearance procedures still take 73 days for import and 63 days for export. Kyrgyzstan stands at 183 out of 189 economies in the ranking, denoting inefficiency in the system (World Bank, 2014). A single-window project was initiated in 2007 and it is currently being managed as a State enterprise. It links 11 agencies responsible for issuing documents for trading operations. The performance of customs services is also expected to be improved through the introduction of the Unified Automated Information System (UAIS) of the Customs Service, developed with the support of the Asian Development Bank (ADB), which is soon to become operational. Thanks to these projects, customs procedures have been streamlined, and the number of required documents has been reduced (WTO, 2013). However, some private stakeholders interviewed indicated that ground trade costs can still lead to an increase of up to 20 per cent in the value of merchandise because of bribes (see below). Other inefficiencies at the borders are also troublesome. For instance, as a result of a recent decision aimed at levelling the customs duties applying to fabrics and garments (Decree 573 of 2012), customs officials no longer have to inspect every shipment. This adjustment, meant to reduce the cost of customs inspections, has on the other hand led to a massive inflow of garments from abroad, which deceptively denoting Kyrgyzstan as the place of production, are able to cross the border unchecked. This situation has resulted in burdensome economic losses for Kyrgyz textile producers. In response, the Government is considering a regulation to reinforce customs controls on imported textiles.[31]

Customs administration is burdened with high levels of corruption. Bribe taking at the borders plays a role in delays and has an impact on the high costs of trade. This view was acknowledged by both the Government and private sector stakeholders. As a result, investors have faced the need to resort to expensive customs brokers and freight forwarders' services although Customs Code 87 of 2004 does not impose this obligation. It has been estimated that the high cost of intermediaries to facilitate transit and

[31] Draft Decree of the Government on Measures for Protection of Domestic Textile and Garment Producers, available at http://energo.gov.kg/ru/normativnaja_baza/proekty/70, accessed 1 May 2014.

clearance services includes sums for bribing (ADB, 2013). Also, the authorities of the Bishkek Free Economic Zone have indicated that the recent replacement of staff at the customs office – as part of an anti-corruption initiative – led to the increase of customs duties collection by 44 per cent in one year.

Recommendations

Improve efficiency of border controls. The Government should accelerate the implementation of the single window and UAIS projects. These tasks become particularly important in light of the new WTO Agreement on Trade Facilitation, signed in Bali in December 2013, which establishes compulsory rules for streamlining and making customs procedures more transparent. In this respect, the Government may consider requesting assistance to improve the efficiency of customs and border controls, by implementing for instance UNCTAD solutions for multi-agency risk management, customs risk management, valuation control, anti-corruption and performance measurement, which can be flexibly integrated with UAIS or other existing systems.[32]

Combat corruption at customs. Corruption at customs is a significant problem for exporters, as it leads to additional expenses and uncertainty. Building on the experience of the Bishkek FEZ, Kyrgyzstan may consider replacing personnel at the borders. In addition, an anti-corruption review, by for example the Anti-corruption Service under the State Committee for National Security, may also be applied to the customs authorities (see section II.h on governance). Furthermore, the use of information technology (IT) and comprehensive customs modernization results in increased transparency and lowers the risks of informal transactions.

g. Access to justice

Security of tenure, contractual stability and transparency of Courts remain an unfulfilled objective. A collateral effect of the unstable political situation in the country has been that contractual stability and security of tenure remain an unfulfilled objective in the protection of property rights. Even when discrimination between nationals and foreigners does not appear to be a problem in judicial proceedings, as manifested by consulted stakeholders for this Review during the UNCTAD fact-finding mission, investors emphasized that one of the major problems affecting commercial justice concerns the corruption in courts, as well as the incidence of politically motivated influence on decisions affecting the economy. Although the Government has acknowledged the existence of corruption as a key challenge, the implementation of effective policies has been undermined by a lack of adequate institutional capacities (see section II.h).

An ongoing judicial reform has opened the doors to alternative modes of dispute resolution. The judicial system of Kyrgyzstan has been under reform since 1994. Notably, in 2004, commercial *arbitrazh* courts were integrated into the system of general jurisdiction, and economic disputes are currently considered by civil courts. Alternative mechanisms of dispute resolution have also been incorporated to the system after enactment of Law 135 on Courts of Arbitration of 2002, which stipulates that parties can agree to resolve civil disputes in ad hoc arbitration tribunals or permanent courts of arbitration. The Government has also undertaken other initiatives to promote alternatives to litigation. For instance, with the assistance of USAID, the Organization for Security and Cooperation in Europe (OSCE) and ADB, an international court of arbitration was set up in 2003 under the Chamber of Commerce of Kyrgyzstan.

A special commission proposed substantial reforms, but the Government has yet to act upon them. In 2012, the President launched a new judicial reform and entrusted a special commission with preparing recommendations. In its conclusions, the commission emphasized that the judicial branch in Kyrgyzstan was politicized and not fully independent, the process of selection of judges was imperfect and led to influencing of judges by different political forces, the level of competence and specialization of judges needed improvement; and the courts were overloaded with cases. In addition, the commission found that the judicial system lacked adequate funding and wages of judges and court employees were too low, leading to a quick turnover of staff. Although no legislation has so far been enacted to act on the conclusions of the commission, some initiatives have been taken to address the training of judges. For instance, training programmes have been set up, such as the Study Centre under the Supreme Court. The Intellectual Property Service of Kyrgyzstan has also been providing training to judges under the project, *Law School on Intellectual Property Issues*. But mere training activities will not entirely remedy the lack of adequate competence.

32 See presentation “About Risk Management”, UNCTAD Automated System for Customs Data (ASYCUDA), available at http://asycuda.org/slideshows/risk.ppt, accessed 15 August 2015.

Thus, the establishment of specialized courts could be a way to promote specialization of judges and raise their level of expertise.

Legislation against raider takeover is necessary. A key pending issue in the judicial reform agenda concerns the improvement of corporate law. A common form of criminality affecting post-Soviet States has been defined as raider takeover and consists of the forceful acquisition of property or businesses through seemingly legal transactions that involve the help of corrupt government authorities (from the tax service, to the police or judges). This type of crime can affect successful companies that become the target of individuals or gangs who are politically influential and powerful enough to twist the law in their favour. The development of legislation against corporate raiding was one of the recommendations by the special commission (Decree 147 on Measures for Improvement of Administration of Justice of 2012, Supplement), but the Government has so far failed to substantially act upon it. One positive reform, however, has been the adoption of an amendment to the Civil Procedural Code that was passed in 2012 and lifted all limitations on filing for reconsideration of a judgment based on newly discovered circumstances, which were previously time bound. The change is important for combating raiding because in some situations entrepreneurs had found evidence of a criminal takeover only after the time for reconsideration had already expired, thus reducing the chances of getting their business or property back (see "A law against raiders", *Russian Gazeta, 1* August 2012).

Recommendations

Move forward with the recommendation of the special commission on judiciary reform. Also, work to approve more comprehensive legislation to reduce the incidence of corporate raiding.

In order to promote specialization of judges, consider devoting more resources to training activities. The focus should be on judges in economic courts and chambers, dealing in particular with economic disputes.

h. Governance

There are governance challenges in Kyrgyzstan, and the legal and institutional framework to combat corruption could be strengthened. Political instability generated by the two recent revolutions was accompanied by accusations of graft affecting Government and civil service. The perception that corruption remains endemic and that bribing is common in the undertaking of everyday economic activities is widespread in the private sector. In 2005, Kyrgyzstan ratified the United Nations Convention against Corruption and it has taken steps to implement it since then. Nevertheless, the OECD Second Round of Monitoring of the Implementation of the Istanbul Anti-corruption Action Plan that took place in 2012 identified a number of areas where national legislation falls short of existing standards. In particular, the corruption offences as defined in the Criminal Code are ambiguous and too general; it does not clearly differentiate between active and passive acts of bribery, which leaves room for broad interpretation. In addition, liability for foreign bribery is not defined; nor does the legislation set up effective liability of companies for bribery and money laundering. Also, comprehensive whistle-blower protection for witnesses does not exist in actual legislation (OECD, 2012b).

Anti-corruption is under the remit of multiple institutions that could improve coordination. Two anti-corruption bodies have been placed within already existing State bodies (i.e. the Anti-corruption Service under the State Committee for National Defence and the Department for Policy on Prevention of Corruption under the Ministry of Economy). International best practices show that tackling systemic corruption and corruption of high-ranking officials requires the highest possible level of independence. Placing the anti-corruption body under an existing government body may increase the risk of it being unable to cope with vested interests (OECD, 2008; OSCE, 2004). Also, the new Strategy on Anti-corruption Policy does not specify the body responsible for each aspect of its implementation, including prevention (OECD, 2013b). Nor have any of the institutions been selected to perform educational and public awareness functions. Many interviewed stakeholders during the UNCTAD fact-finding mission noted that the Anti-corruption Service under the State Committee for National Security has been fruitful in exposing corruption schemes inside some State bodies. Nevertheless, the range of State bodies examined has not yet included the tax service and the customs administration. Improving the governance of these two State bodies is critical for ensuring enhanced national competitiveness and a better investment climate. Furthermore, in line with international best practices, many anti-corruption agencies also have independent prosecution powers.

Some initiatives to address Government corruption resulted in policy change, but civil society was not sufficiently involved in the process. The Government has reported that the Anti-corruption Service recently exposed corrupt schemes in the State Agency for Geology and Mineral Resources and in the Road Police. It also took the decision to dismantle the Kyrgyz Agri-product Corporation after it was found that it had been involved in embezzlement. With regard to monitoring, the interim Government in 2010 took a number of measures, including the introduction of polygraphic testing for State officials in the Tax Service, Customs Service and the Finance Police. The measure has been implemented, not without controversy about its effectiveness. But the results have shown that more than 80 per cent of tested tax officials had accepted illegal payments.[33] Also, in 2012, the new State Strategy on Anti-corruption Policy was passed, which reiterates the political will to combat corruption and lays down the goals and plans of the Government in this sphere. The Law 153 on Counteracting Corruption of 2012 broadened the number of persons subject to anti-corruption legislation to include, for example, the management and employees of the National Bank. Further amendments concerning corruption offences are to be introduced into the Criminal Code in the near future. These measures are taken in the right direction, but they could have benefited from more civil society involvement in law making. Given the saliency of the anti-corruption agenda, it is regrettable that the 2012 State Strategy on Anti-corruption Policy was developed without much public participation.

33 Business Anti-corruption Portal, 2015, Country profile of Kyrgyzstan, available at http://www.business-anti-corruption.com/country-profiles/europe-central-asia/kyrgyzstan/show-all.aspx, accessed 1 May 2015; BBC Russian Service, 2012, Corruption in Kyrgyzstan: Polygraphs and the Georgian experience, 26 June, available at http://www.bbc.co.uk/russian/international/2012/06/120625_kyrgyz_georgia_corruption_fight.shtml, accessed 15 May 2014.

Recommendations

Bring national legislation in compliance with the United Nations Convention against Corruption. Amendments should be made to include full coverage of corruption offences and avoid ambiguities among different pieces of legislation. This will facilitate both the investigation and prosecution of corrupt practices. Kyrgyzstan should also consider including criminal responsibility of legal persons in the Code.

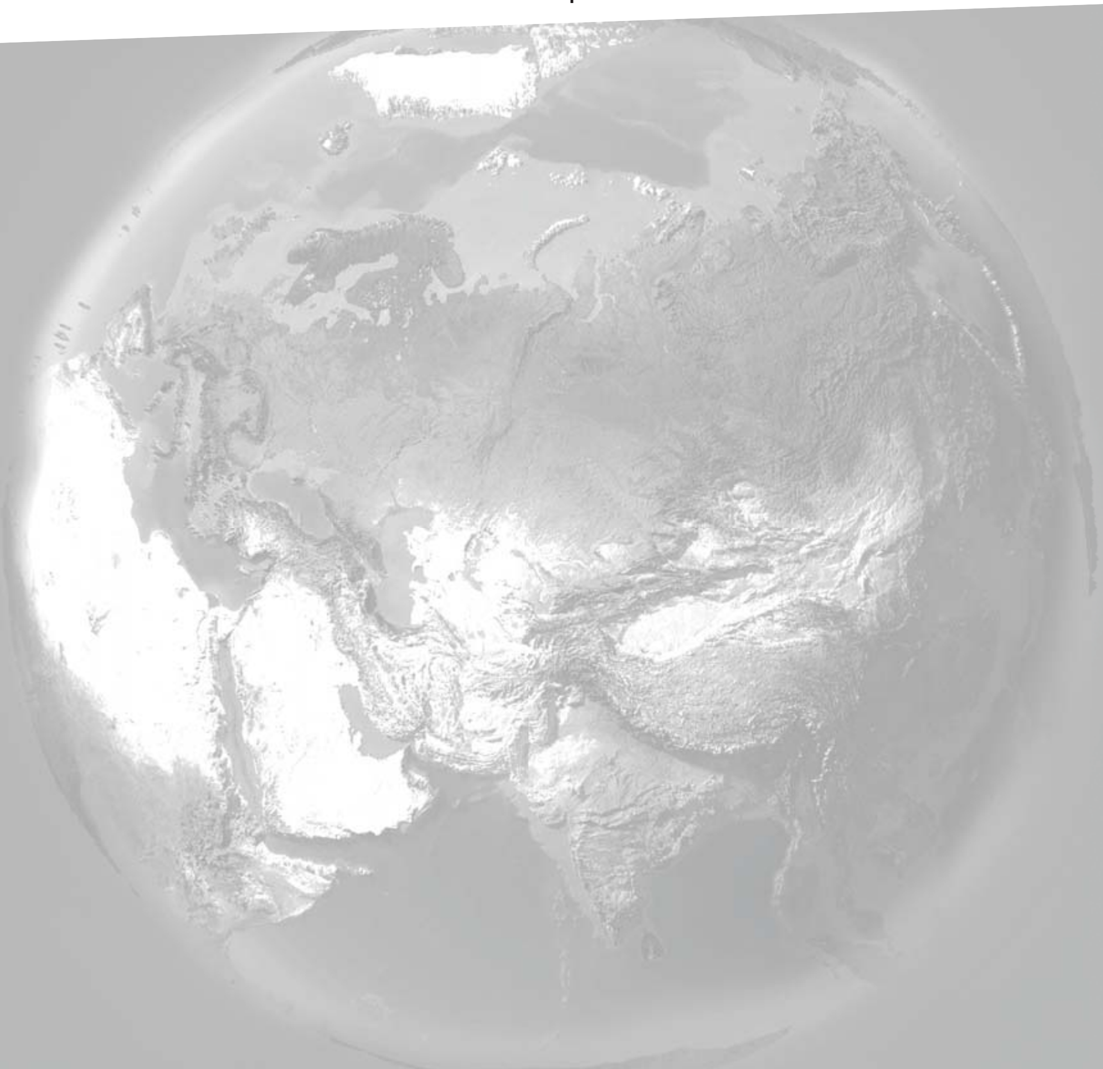
Improve functioning of anti-corruption bodies. Responsibilities of the two anti-corruption bodies currently overlap in terms of the prevention function. In addition, neither institution has a mandate detailed enough to provide a sound legal basis for undertaking anti-corruption activities. Ideally any agency should function independently and should be accountable to the Parliament and insulated from political pressure. Kyrgyzstan may also consider establishing separate anti-corruption courts staffed with judges selected specifically for this purpose.

Increase public participation. Reforms should be considered in terms of raising public awareness and involving civil society actors in the implementation of anti-corruption policies. Communication channels need to be improved and the public should be encouraged to report corruption cases. Kyrgyzstan may build on the experience of Mongolia that established a hotline for complaints available around the clock under its Anti-corruption Agency and has done outreach work to increase awareness about its functions (UNCTAD, 2013a). Introducing a similar hotline in the Anti-corruption Service under the State Committee for National Security may be a solution to increase civil involvement.

Improve whistle-blower protection. The Government should consider introducing comprehensive legislation on whistle-blower protection and focus on the implementation of legislation on the protection of witnesses.

CHAPTER 2

Strategic priorities to diversify FDI attraction and promote sustainable development



This chapter presents a strategy for Kyrgyzstan to increase FDI inflows, foster economic diversification and achieve sustainable development outcomes. Experience from developing and transition economies shows that several benefits can be attached to projects involving FDI (e.g. higher fixed capital formation, employment, the stimulation of SMEs, transfers of skills and technology, increased tax revenues and opportunities to upgrade production along value chains) but there are also risks (e.g. environmental degradation, the displacement of local firms and interference with the rights of local communities). Thus, countries should adopt strategies that foster optimal contributions from FDI.

In order to provide actionable policy advice, the analysis focuses on opportunities for FDI in public infrastructure and selected industries, and on the institutional framework for investment promotion. The first section discusses challenges regarding public infrastructure, in particular electricity and transport. Improvements in the reliability of electricity supply as well as of road and air connectivity, through FDI and PPPs, could enhance the country's general investment attractiveness. The second section considers the need to foster diversification and achieve sustainable development outcomes through FDI in selected industries (i.e. garments and textiles, agro-industries and tourism). Investments in these industries are known to have significant potential for job creation and direct poverty reduction and transfer of knowledge to local firms. The section also advises on how to improve the sustainability of mining activities and foster linkages. Finally, the last section analyses the institutional framework for investment promotion with a focus on the newly created IPA, which has a central role to play in setting up investment attraction goals at the general and sector-specific levels. A plan for the phased development of its investment promotion functions is proposed.

I. Fostering FDI in infrastructure through public–private partnerships and small projects

a. Electricity

Kyrgyzstan has vast reserves of unexploited hydropower, with high potential for developing a cost-effective export-oriented industry. Kyrgyzstan is ranked third among CIS countries in terms of hydropower potential, after the Russian Federation and Tajikistan (ADB, 2013), and it is estimated that less than 10 per cent of the sector's capacity has been developed.[34] Its hydrocarbon reserves also reveal a potential for thermal power.[35] If harnessed properly, these resources could guarantee the long-term supply of renewable energy at relatively low cost for domestic and regional markets.

However, no major investments have occurred to increase supply during recent years, raising energy security concerns. Access to electricity is nearly universal in Kyrgyzstan, but the power system runs on equipment that is old and unreliable. A significant share of the installed generating capacity is over 30 years old and, on average, 60 per cent of the system's plants and equipment is worn out (Government of Kyrgyzstan, 2012). This situation has resulted in increased power outages, especially during the winter, when energy consumption increases threefold. Although a production surplus has led to exports over recent years (table 2.1), domestic demand for electricity is growing at 3 to 5 per cent annually, while supply has stabilized. Indeed, only one facility generating 120 megawatts (MW) has been commissioned since 1991. Without new generating capacity, the electricity surplus is forecast to fall in the long run from 2,500 MW to 400 MW (CASA, 2011). Also, the dependency on neighbouring transmission lines to access certain national customers is perceived as a security concern requiring continuous agreements on international transmission fees.[36]

The electricity industry is mostly State owned, with some small private companies involved in generation and distribution. After independence, in order to introduce

34 Existing export markets include Kazakhstan and Tajikistan but the country expects to also sell to Pakistan and Afghanistan in the future, pending the construction of transmission lines (CASA, 2011).

35 Kyrgyzstan counts with considerable hydrocarbons reserves (mainly coal, but also oil and gas), although at present it is a net importer of these products. Recent Chinese investments will increase oil-refining capacity and lower reliance on imports for certain products. For instance, Zhongda, an oil refinery in the northern Kyrgyz city of Kara-Balta, was launched in 2013 and will produce Euro 4 or Euro 5 grade petrol, diesel and fuel oil. Another sister facility is being built in Tokmok in Chui province (see https://www.chinadialogue.net/article/show/single/en/7165-China-s-energy-footprint-in-Central-Asia, accessed 1 October 2013).

36 The Kyrgyz transmission system connects the South to the North via a 500-kilovolt line and a separate one that crosses Uzbekistan and Kazakhstan (ADB, 2013).

Table 2.1. Power generation and utilization in Kyrgyzstan, 2006–2012

Million kilowatts per hour	2006	2007	2008	2009	2010	2011	2012
Generation	14 527.2	14 831.7	11 790.3	1 092.2	12 073.9	15 194.8	16 393.3
Consumption	7 192.2	7 672.7	7 334	7 134.5	7 447.3	9 131.8	11 680.1
Net exports	2 673.3	2 575.7	766.1	1 199.5	1 711.8	2 673.8	1 508.3
Transmission loss	4 661.7	4 583.3	3 690.2	2 758.3	2 914.8	3 389.2	3 204.9

Source: Ministry of Energy and Industry (adapted from WTO, 2013).

competition and improve efficiency, the Government developed an unbundling plan along functional lines as a first step towards incorporating private capital. Still, the State holds over 93 per cent of shares in the companies in charge of generation (the Electric Power Plant, which generates over 99 per cent of electricity), transmission (the National Power Grid of Kyrgyzstan) and distribution (four regional electricity companies). In addition, there are four small privately managed generation plants (Chakan HPP, Koshoi, Kalinin HPP Ltd, and Ark Ltd) and 27 privately owned companies that hold wholesale distribution licences (WTO, 2013; Abdyrasulova, 2009). Between 2005 and 2010, the four distribution companies were marked for privatization. Two of them were successfully privatized, but the decision was reversed.[37] Although the Government does not envision further privatizations, the development of small and medium-sized hydropower plants and distribution companies is allowed, including through FDI and PPPs.[38]

The existing regulatory regime fails to generate adequate funding for needed maintenance and reduces the sector's attractiveness for new investors. The Ministry of Energy and Industry is responsible for policy and regulatory functions, but the establishment of a State agency to regulate the fuel and energy sector was recently approved by decree, which will imply a shift in responsibilities.[39] Historically, the revenues from electricity exports and industrial consumers have been used to subsidize below-cost tariffs for urban and rural consumers and the Government is yet to set up a means-tested subsidy system (UNDP, 2011a; UNCTAD, 2013b).[40] Inefficiencies and theft linked to poor metering and billing affect the whole system, and the lack of transparent mechanisms for settling transactions among wholesale and retail contributes to poor accounting (WTO, 2013). Thus the attractiveness of the sector to private capital remains limited.[41]

Steps have been taken by authorities to improve industry governance and efficiency. According to NSSD, policy measures for the financial rehabilitation of the electricity sector aim at limiting energy losses to less than 12 per cent and reaching a 100 per cent bills collection rate by 2017. In June 2011, the Fuel and Energy Sector Transparency Initiative (FESTI) was set up to increase transparency and accountability of energy activities. The institution, which is part of the Ministry of Energy, has a mandate to assist authorities in reducing corruption in the sector, modernizing billing and other financial management processes, strengthening the institutional capacities for regulation and modernizing power metering, among other

37 ADB estimates that the poor financial situation of the firms, combined with performance conditions linked to the bidding, may have explained the paucity of bids (ADB, 2013). The two successful cases for Severelectro and Vostokelelectro were reversed owing to public discontent over substantial hikes in tariffs — they reached 200 per cent in 2010. These failed privatizations are deemed to have fuelled the social protests that contributed to overturning the Government in April 2010 (UNDP, 2011a).

38 Privatization of the major generation company and the transmission companies has been prohibited by legislation (Law 31 of 2002, art. 4; Programme for Privatization of State Property for 2012–2014, Decree 1877-V of 2012, Supplement 1).

39 The goal was to create an independent regulator (Decree 650 of 2014 on Matters of the State Agency on Regulation of the Fuel and Energy Sector).

40 As of March 2014, the tariff for electricity consumption by residents is set at som 0.70 / kWh (1.4 United States cents) and for industrial consumers som 1.32/kWh, while the net cost of production of electricity is som 1.24 (Ministry of Energy and Industry). Recent reported losses estimated in the range of 20 to 31 per cent of gross electricity values in a sector where the international benchmark fluctuates between 7 and 10 (WTO, 2013; UNDP, 2011a).

41 Because most HPPs are built on the Naryn river and are linked to the quasi-monopolistic SOEs, they have limited attractiveness for private investors. However, new investments elsewhere could be considered under the PPP regime.

functions.[42] Other improvements occurred with the Law on Renewable Energy of 2011, which imposes penalties on public companies that fail to acquire electricity from private renewable energy firms (Saaduev, 2012). Finally, an action plan for the energy sector was adopted in 2013 and approved by the Parliament during the summer of 2014.[43] It includes a midterm tariff policy for the period 2014–2017 aimed at improving cost reflection.

In the Energy Strategy for 2012–2017, the Government has identified over $4 billion of large-scale investments that are needed to expand and upgrade the nation's power system. These investments are expected to be undertaken mainly through government funding, international cooperation and donor assistance.[44] An agreement was signed with the Russian Federation to construct power stations through joint SOEs created for this purpose. Additional capacity is expected from the introduction of the second unit of Kambarata-2 HPP and the construction of the Upper-Naryn HPP cascade. There is also one agreement with China on the reconstruction of a thermal station at the Bishkek Thermal Power Plant (see NSSD). A third project (CASA 1000) should be implemented to sell energy to Pakistan and Afghanistan.[45] However, no major work has yet started for any of these initiatives. Finally, the rehabilitation of the Toktogul hydroelectric power plant (1,200 MW) is a priority to reduce technical losses. Work has been undertaken with government funding and loans from ADB.[46]

NSSD also considers the need to attract smaller-scale energy projects, where private investment is foreseen. In 2011, incentives were set up to exempt legal entities and individuals engaged in renewable energy from customs duties on import of equipment for HPPs and other renewable energy sources. But the Government has yet to move forward in adopting regulations for the production and operation of small and medium-sized hydropower plants. If allowed to sell small quantities of energy at market price, such investments could increase generation and reduce the pressure on transmission lines to supply villages in remote areas. They could also augment export capacity in the long term.[47] However, there is no legal definition of "small" and "medium-sized" plants in the Law on Electric Energy of 1997, which only regulates tenders for projects above 30 MW with burdensome licensing requirements. Thus, no investments in small projects can take place until by-laws are enacted defining specific procedures for licensing of small projects.

Improving the country's energy efficiency through the promotion of renewable energy technologies is also envisioned. Identifying appropriate technologies and adopting programmes to accelerate their use is also a priority for the authorities. One area where progress has been made through FDI is the manufacturing of energy-efficient electric appliances. The country has already attracted a mid-size regional manufacturer of low voltage insulators and porcelain heating systems for housing, industrial and agricultural businesses (i.e. Electrofarfor limited liability company (LLC), a Russian-Kyrgyz joint venture). It supplies major firms in the energy and telecommunications industries of Kyrgyzstan, but also exports to CIS countries and Europe.

b. Transport

Distance from export markets and high transportation costs remain key strategic challenges for Kyrgyzstan. The mountainous terrain adds to the costs of being landlocked by making travel more difficult. The country is also vulnerable to natural disasters, such as rockslides and landslides, which put an additional burden on road connectivity. The situation is compounded by the lack of adequate maintenance; as a result, many roads, bridges and other infrastructure are in poor shape and need refurbishing or full reconstruction. This situation adds to the cost of businesses, especially for companies engaged in export activities (for related challenges linked to border procedures, see chapter 1).

42 See FESTI website, available at http://www.energoforum.kg/new/index.php, accessed 18 September 2014.

43 Other measures of the action plan include the establishment of a settlement centre for the transparent operation of the wholesale market and the establishment of escrow accounts for electricity exports (World Bank, 2014b).

44 See the following article: The Kyrgyz Republic's power sector rehabilitation project receives $55 million in ADB funding, available at http://www.carecprogram.org/index.php?page=kyrgyz-republics-power-sector-rehabilitation-project, accessed 1 October 2014.

45 See Pakistan, Kyrgyzstan, Tajikistan, Afghanistan sign CASA-1000 Project agreement, Pakistan Today, 19 February 2014.

46 See http://www.carecprogram.org/index.php?page=carec-project-details&pid=391, accessed 12 May 2015.

47 Indeed, some projects could be built near sites were dams have already been built or need restoration, thus reducing construction costs for new investors, e.g. Kirov in Talas region, Ortotokoi in Issyk–Kul region, Papan in Osh region and Toktul in Batken region (Saaduev, 2012).

Construction and maintenance of major transport corridors are critical for regional trade. The road network of 35,000 km is the key element of the ground transport system, since railways and water transport in Issyk–Kul Lake are not in high demand. Road construction is performed by domestic and foreign private sector contractors, and the Ministry of Transport and Communications (MOTC) oversees road maintenance. Public works have largely been funded by the State and the assistance of development partners.[48] Opportunities to attract new investments in road and highway constructions will increase in the context of major regional initiatives. For instance, some of the most heavily used routes in the Silk Road region are located in Kyrgyzstan, including the East–West routes connecting Kazakhstan and Kyrgyzstan with China. In 2012, under the coordination of the Central Asia Regional Economic Cooperation Programme (CAREC), participating countries, including Kyrgyzstan, have agreed to undertake more than $23 billion in infrastructure works in new regional transport infrastructure projects, which will contribute to six major corridors linking ports in eastern China with the Caucasus, Kazakhstan to Karachi and Gwadar to Pakistan (UNCTAD, 2014).

With regard to air transport, overall poor maintenance and limited air connectivity are key constraints to exports. Manas International Airport near Bishkek is the main airport for international destinations and boasts one cargo terminal. In addition, there are two other regional airports in Osh and Jalal-Abad (Osh operates some limited international flights), of a total 11 under responsibility of MOTC. All airports and the national carriers (over 20 of them) are managed or controlled by the Government. Although Manas Airport has generated increased trade flows in recent years, the small number of domestic and international routes, limited competition and high cost of tickets prevent further expansion (USAID, 2013). These bottlenecks pose severe constraints to many export-oriented activities in particular with respect to tourism (see section II).

The need to promote private investment in the management of State assets in transport infrastructure has been acknowledged by authorities, with the decision to promote PPPs. NSSD includes projects worth $2.1 billion for the period 2013–2017 to upgrade the transport infrastructure. Among these, the Government is keen on prioritizing works on the Bishkek–Almaty highway that would link with the multibillion Euro–China highway, which gives direct access to East European, Russian and Chinese markets. Other priority projects include the rehabilitation of five international corridors.[49] Although these projects are deemed essential to increase the country's competitiveness across sectors, they will also imply immense costs for the State budget. According to interviewed officials at the Ministry of Transport, the Government can meet about 60 per cent of budgeted expenses. To overcome this constraint, one of the objectives of NSSD is to "introduce PPP principles into management of government enterprises" with particular focus on road transport services.

Provided that they are well structured to serve public needs and commercially viable, PPP projects can be powerful instruments of cooperation between the State and the private sector to address key investment gaps. PPPs are an alternative to public procurement for building and modernizing infrastructure, which rely on sharing responsibilities and risks between government and private contractors. They can provide efficient solutions for operation, maintenance and financing of infrastructure projects. However, they can only succeed when the activity under concession is commercially viable to attract investors' interest in the first place, even if differing degrees of Government support are needed to partner in project risk. Whereas a complete discussion of the challenges with regard to the involvement of private investors through PPPs in Kyrgyzstan's transport sector is beyond the scope of this report, a number of general indications can nonetheless be provided.

c. Setting up a framework for public–private partnerships

Successfully implementing PPPs often implies having capacities to select and prepare projects, preferably within the framework of a long-term multimodal transport plan. Multimodal transport planning implies a holistic view of transport priorities based on the impact of improved access by firms to export markets as well as

48 Some foreign-owned firms have entered the construction sector, including the Kazakh United Cement Group, which controls the largest cement plant in Kant. By 2010, 765 km of regional corridors had been rehabilitated with support from ADB, and an additional 310 km will have been rehabilitated by 2015. See http://www.donors.kg/en/agencies/48-adb#.VF5uQfnF9ic, accessed 12 May 2015.

49 Among corridors, the Bishkek–Naryn–Torugart and the Osh–Batken–Isfana motorways involve the largest forecasted expenditures. Also, the construction of a new railroad connecting Uzbekistan and China via Kyrgyzstan is considered a priority (Government of Kyrgyzstan, 2012).

Table 2.2. Best practices for foreign direct investment in infrastructure

Stage	Lesson
Laying the foundation for FDI in infrastructure	• Develop a strong legal and regulatory framework prior to the entry of FDI • Secure the capacity and skills to facilitate and regulate private investment in infrastructure • Empower high-level task force to catalyse necessary reform • Develop an integrated strategic infrastructure plan identifying key needs • Proactively address community and stakeholder expectations
Promoting and facilitating the entry of FDI	• Create a pipeline of pre-assessed, commercially attractive projects that can be actively promoted • Open the bidding stage to as many investors as possible • Ensure that contracts take into account key issues over the project lifespan • Help mitigate political and regulatory risks faced by foreign investors
Ensuring effective and efficient project implementation	• Monitor and follow up on project implementation • Understand and pay attention to competition issues • Private and State-owned players can co-exist within a competitive framework

Source: Adapted from UNCTAD, 2009a and UNCTAD, 2009b.

meeting general public transport needs. Synergies between the transport modes (roads, rails and airports) should be considered at the time of setting priorities and timelines. In addition, attention should be paid to the supporting institutional framework for overall planning, project selection, financing and expert impact assessment. In the case of road infrastructure, for instance, UNCTAD advice based on successful experiences has emphasized the need for a holistic plan and disciplined project assessment. A pipeline of projects with a clear timescale for delivery is also important to increase the attractiveness for foreign investors (table 2.2).

The new PPP law sets up a clear and coherent framework for project initiation, selection of private partner and project management. With the help of the ADB, the Government undertook a review of its PPP-related institutional set-up and regulatory environment. As a result, new legislation was enacted: Law 7 on Public–Private Partnership (2012). The law defines the economic activities appropriate for PPPs.[50] To ensure transparency, the selection of the private partner is conducted through a two-stage tender process, and there are no provisions for direct negotiations. The related regulations determine that projects can be initiated by the national Government, including ministries and other State bodies of the executive branch, and local administrations.

However, the overall framework to implement PPPs requires further strengthening. The law could still be improved by specifying a description of each of the legal forms available for PPP projects. Some sector laws need to be harmonized to allow for PPPs, such as the health law, which does not allow for PPPs, and the energy law, which restricts such partnerships to greenfield investments only (ADB, 2013). Also, the resources devoted to future PPP undertakings are limited.[51] In countries with successful PPP experience, there is a national PPP agency that centralizes all concession functions. Senior ministerial groups are empowered to cut red tape when needed and speed up decisions dealing with unforeseen events during implementation. Neither of these has yet been established in Kyrgyzstan. The PPP unit in the Ministry of Economy

50 These include: generation, transmission and distribution of electricity; processing, storage, transmission and distribution of oil and gas; transportation; public utilities; health care; education and culture; tourism and sport facilities; telecommunications; and water resources. The law does neither restrict nor discriminate against foreign investors in access to PPPs (i.e. it does not contain any performance requirements).

51 The authority responsible for PPP policy, assessment of initiated PPP projects and tender documentation is the Ministry of Economy. The Ministry of Finance has been appointed as the risk management body (Law 7 on Public–Private Partnership of 2012, article 7; Decree 616 on Determination of the Authorized State Bodies in the Area of Public–Private Partnership of 2012).

has been set up as part of the Department of Investment and PPP. In addition, there is also a PPP development unit in the Investment Promotion Agency, which has four staff members and is engaged in the preparation and promotion of PPP projects (see chapter 2, section III).

Available government capacities do not appear sufficient to undertake intensive work on project development. The Government has yet to incorporate PPPs in the context of a comprehensive multimodal transport plan and begin project promotion and implementation. These activities require high expertise on market studies, technical feasibility and impact assessments, negotiation skills and specific knowledge of regulatory issues. The staff should be able to interact with the relevant line ministries on issues related to project assessment and delivery, for which training is also needed. For instance, road concession projects should pass stringent cost–benefit assessments and receive environmental approval before they can be considered for selection, which is a time-consuming process.

Some 15 projects have been pre-selected for PPPs, but tenders for many of them have not yet been undertaken. Since the new law was passed, the authorities have identified a list of potential PPP projects, not ranked by priority.[52] Projects include the reconstruction and building of logistic centres in the airports in Osh and the Issyk–Kul region, road constructions, health-care projects and catering services, among others. Some of these projects have gone through pre-feasibility studies by international partners (e.g. ADB). However, the Ministry of Economy has published only partial information about their costs and timeline/stages for implementation. An assessment of the level of competition, State intervention or regulation that will prevail in each market segment for each specific project is also necessary. For instance, considering the low social tolerance for increases in fees paid for public services, the availability of toll-free public alternatives might need to be considered when planning the expansion of highways, which will have an impact on revenue forecasts.

Without a clear vision of which projects are most likely to produce good social and economic results, the possibility of conflict between the Government, companies and communities during the implementation period will increase. Given these risks and the long-term commitment that PPP require from investors, the involvement of multilateral investment guarantee agencies (like MIGA) or home-country credit agencies might prove indispensable in the short run. Looking forward, it is crucial that selection focuses on projects that are bankable, and thus potentially attractive to FDI, and not on those needs that can best be financed through public funding or donor assistance. Cooperation with the IPA will be necessary to promote projects once selection is made (see section II.3 below). Kyrgyzstan's recent record of expropriations and social unrest make it clear that a comprehensive approach is needed in order to minimize costs that could result of subsequent renegotiation, court litigation or divestment.

Recommendations

Formulate a long-term strategy for the development of the power sector that focuses on exports growth. The Government should consider developing a long-term strategic plan that includes generation, transmission and distribution, and incorporates cost-reflection mechanisms for new investments, the social needs for affordable tariffs, and the potential to supply export markets. Some of the infrastructure projects that are needed have been included in NSSD. A plan for implementation should also include a complementary fast-track programme to address the refurbishment of strategically vital power industry assets. Licensing procedures, tender requirements and bid-evaluation criteria for small projects should be set up.

Ensure the independence of the State agency on regulation of the fuel and energy complex. This should fully conform to international best practice. In this regard, the regulator should be staffed with high-level professionals and specialists; members of the regulating body should be prohibited from having any economic interest in the regulating enterprises or any consumer group, and the regulatory process should include public participation (UNCTAD, 2009a).

Promote the long-term development of alternate renewable energy, including through small FDI projects. Policies could include the promotion of solar water heaters, biogas plants and wind-power plants in remote areas, among others. The plan should also include measures to increase awareness of energy-efficiency concerns among the public. Introducing tax incentives for the adoption of energy-efficient technologies could also be considered.

[52] A list of PPP projects as of December 2012 is available at http://mineconom.kg/index.php?option=com_content&view=article&id=2034&Itemid=717&lang=ru, accessed 1 October 2015.

Prepare a pipeline of projects in line with a multimodal transport plan. Such plan should be done in parallel to broader development goals, and focus on projects around major transport corridors and airports.

Adopt reforms towards adequate implementation of PPP legislation. In addition to harmonizing sector regulations to make them compatible with PPPs, other secondary regulations will be needed, for instance, with regard to establishing a method for cost–benefit analysis. Completing the assessment of the commercial viability of the projects on the priority list should be the next step, with the goal of creating a pipeline of projects as suggested above.

Continue strengthening the institutional capacities of the PPP unit within the Ministry of Economy with the help of development donors. Enhancing State capacities will be fundamental to any successful implementation. Concessions in public infrastructure often involve much knowledge that can be best accumulated through institutionalizing, retaining and nurturing expert staff. A substantial increase in human and financial resources will be required to turn the existing units into a specialized concessions agency. The long-term goal to set up a national agency that centralizes PPP planning should remain a priority.

II. Tapping the potential of FDI in specific industries and niches

a. Promoting FDI for value upgrading in garments and textiles

Driven by exports, the garment industry in Kyrgyzstan has boomed during recent years. The bulk of production is women's dresses (blouses and shirts) as well as uniforms for enterprises and schools. Nearly all enterprises producing garments were set up after independence and are privately owned (largely SMEs). The impressive growth in garment manufacturing was linked to exports to regional value chains in the Russian Federation and Kazakhstan, which have augmented tenfold in the period 2002–2012. In 2013, the totality of apparel exports to these countries was worth $156.8 million (equivalent to 9.3 per cent of total exports). This boom had significant employment impact. According to official statistics, around 114,000 workers, of which over 90 per cent are women, are involved in garment manufacturing (ITC, 2013). Most businesses are located in big cities and their suburbs, including Bishkek, where 54 per cent of firms are concentrated (OECD, 2013b).[53]

The involvement of foreign investors in the sector has not been significant and non-equity modes (i.e. contract manufacturing) are prevalent. It is estimated that production is split in near equal quantities by a small number of medium-sized sewing and knitwear manufacturers that have their own design capability; and a high number of micro and small businesses that perform cut-make-trim activities and provide different types of subcontract services to foreign traders and retailers. With regard to foreign equity investments, according to official statistics, there were 45 registered companies in 2012 of a total 124 in the textile and apparel industries. These figures are likely to underestimate actual FDI stock given the size of the informal economy. However, the fact that only two Russian-owned, larger-size firms undertook substantial investments in apparel and textiles during the period 2010–2012 (Efor JSC and Glorius JSC) is indicative of a slowdown in FDI, mainly due to political instability and governance issues (Birkman et al, 2012; see also chapter 1 of this Review).

Relatively low costs of production and deep market knowledge are location advantages that could attract more investments in the future. Electricity costs are low in Kyrgyzstan. So are labour costs: the monthly average rates for sewing workers ranges from $173 to $500 (USAID, 2011) and the average wages for 2010–2012 in textiles and wearing apparel subsectors was $91.2 according to official statistics, which is estimated to be below the costs of competing locations, even if productivity lags behind salary pay.[54] Market knowledge comes from wholesale retailers in bazaars, who often act as sales partners and play a key role identifying tastes and providing good marketing strategies (ILO, 2012). Most

[53] Although during the Soviet period there was an integrated clothing industry in Kyrgyzstan, after the country's accession to WTO in 1998 textile production almost disappeared as a result of competition with Asian imports. Most businesses source through bazaars, where Chinese intermediaries (largely originating from the Xinjiang Uyghur Region of China) sell imported fabrics.

[54] Comparisons are complicated by the seasonality of production and the fact that Kyrgyz apparel pay is piece work and varies by productivity. Worldwide estimates of the cost of labour put Kyrgyzstan ahead of China and India and slightly behind Indonesia, Viet Nam and Bangladesh (OECD, 2013).

production has been directed to low- and middle-income consumers of the Kyrgyz diaspora in target markets, although stakeholders agree that there is space for much more market expansion and segmentation.

In the future, more FDI will be needed to foster product differentiation and operational efficiency. The sector suffers from poor quality of buildings and inefficient use of space, which is compounded by limited access to reliable skills and poor management.[55] Although the skills problem exists across sectors, certain aspects are particular to production cycles of the apparel industry. For instance, a high level of seasonality (with order peaks between April and October) forces producers to resort to periodic layoffs, which prevent the development of efficiency and knowledge in the labour force. These hindrances could best be addressed through increasing the scales of production and promoting more fixed capital formation.

Kyrgyzstan's accession to EAEU will likely increase the industry's attractiveness to regional investors. Because labour costs are comparatively lower than in other member States, after accession Kyrgyzstan is likely to attract more regional capital flows in the form of FDI, which could support industrial development.[56] Another positive impact concerns export outbound logistics. Exports are impaired by a small number of freight-forwarding companies that provide customs clearance services at expensive prices and to limited destinations. This situation prevents adequate customer order fulfilment in target export markets. Thus, the removal of internal border controls will help promote more competition in trade logistics and reduce costs.

However, interviewed stakeholders also agreed that increased sourcing costs will hit the sector in the short term. Indeed, implementing the common external tariff (CET) of EAEU will lead to higher average tariff levels for fabric imports from China. Upon entry into force of the treaty of accession of Kyrgyzstan to EAEU, all imported raw materials will be brought under the single customs tariff of EAEU. A gross estimate of expected tariff increase for textiles, machinery and appliances is above 3 per cent. In addition, the abandonment of Kyrgyzstan's weight-based system for calculating tariffs and expected wage increases mean the overall transition costs could result in between 10–20 per cent total production costs for garments. Overall, the exceptional measures needed to avoid major slumps in employment are estimated to last between five and seven years, depending on the speed of Kazakhstan's negotiations for accession to WTO (Jenish, 2014; OECD, 2013b; Birkman, 2012; ILO, 2012; Mogilevskii, 2012).

In the medium term, more FDI flows could help address existing bottlenecks to upgrading along the value chain, including the following:

- ***Limited sourcing options for fabrics, yarns and accessories, which reduce opportunities for product differentiation.*** Reliable access to inputs is crucial for upgrading along regional garment value chains. The majority of imports sourced from abroad are synthetic and of low quality. Access to EAEU will open opportunities to attract tariff-jumping FDI to promote import substitution of fabrics. Since Kyrgyzstan produces good quality cotton and wool, there is ample room for existing companies integrating vertically or for new entrants to set up weaving or knitting mills.
- ***Lack of fixed capital investment to modernize technology.*** Maintenance of obsolete equipment is poor, and breakdowns are frequent. There is little specialized equipment (e.g. for stitching pockets, buttons and undertaking overstitching), and manual skills have to be relied on. A lack of business finance to procure new equipment exacerbates the problem. An enlarged market will create incentives for larger investors to inject new capital, refurbish existing facilities and thus increase productivity. It will also allow for functional upgrading, with new companies focusing on more capital-intensive functions such as laundry, embroidery and dying.
- ***Limited design capabilities and lack of compliance with international quality standards.*** The lack of original design and reliance on replicas of foreign models (e.g. from Turkey, China or the

[55] In the case of the garment industries, interviewed stakeholders expressed that the curriculum in technical education requires upgrading in pattern-making and sewing technology, for example. Management is also deemed weak. Overall, technical knowledge is poor and the lack of foreign language skills, especially English, means many managers are unable to keep up to date with advances in technology or to take advantage of networking opportunities.

[56] Compared with neighbouring countries Kyrgyzstan is competitive. Average monthly salaries in manufacturing for the period 2010–2012 are estimated to be $719.8 for the Russian Federation, $747.5 Kazakhstan, $292.6 for Kyrgyzstan, and $448.2 for Belarus (Statistical Committee of CIS).

Republic of Korea) limits the ability to diversify towards niche markets with more demanding consumers. Regional value chains, in contrast with global ones, are more likely to demand customized merchandise with quicker response to fashion, resulting in more complex products. Thus, opportunities will be higher under EAEU for value capture and upgrading along such activities as pattern making, fabric management and logistic coordination (Staritz and Morris, 2013). Also, expanding the network of existing laboratories involved in the testing of inputs to improve compliance will be more likely in a context of larger production scales.

Accession to EAEU will also increase regional competition. Joining EAEU prioritizes the need for the Kyrgyz garment, hosiery and knitting industries to seek new markets in the Russian Federation and Belarus. Value upgrading will also imply more intense competition for sales partners in efforts to tap into finer market segments; further, there will be a premium advantage for early movers. In this regard, the case of Belarus, which also experienced export-led growth in garment production during recent years, deserves attention. In that country, the authorities provide intensive support to the garment industries, not only through subsidies and tax exemptions, but also through certification, privileged government procurement, financial assistance, training, and research and development assistance.[57] In Kyrgyzstan, limited government resources call for smart promotion strategies. Strategic collaboration on market intelligence to fill knowledge gaps with key partners and stakeholders from the public and private sectors will be needed. These include the Department of Light Industry of the Ministry of Energy and Industry and prominent business associations.

The tax system will also need reconsideration. The favourable tax treatment of small garment manufacturers was pivotal to the boom in clothing production. Thanks to a so-called patent system, enterprises were allowed to produce with a significantly lower tax burden, which helped bring a substantial number of apparel SMEs out of the informal economy.[58] However, with regard to the taxation of larger companies the Kyrgyz sector is not particularly competitive. Annex 3 compares taxation in the garment manufacturing sector for different locations. The results show that the current regime does not have specific advantages compared with other countries. In particular, depreciation rates are not favourable, and incentives in terms of promoting technological innovation and investments are not provided, which will be necessary to upgrade production towards more capital intensive activities.

Some progress has been made to improve the country's attractiveness to foreign investors. NSSD identifies a number of important initiatives for immediate policy action (e.g. projects to create and develop industrial and logistics centres at the Dordoi and Kara-Suu markets). Some successful partnerships are in place with international donors, including the International Trade Centre (ITC), USAID, the German Agency for International Cooperation (GIZ) and the Swiss State Secretariat for Economic Affairs (SECO), which have been involved in specific projects in the areas of skill development, financing of equipment and developing firm strategies. Also, the Programme for the Textile and Clothing Industry in Kyrgyzstan for 2013–2015, whose main objectives are to increase the competitiveness of textile and clothing production, sets out in more detail the Government's rationale for supporting the clothing sector. It foresees setting up a large industrial park (technopolis) in the Bishkek area to reduce industry fragmentation and increase quality and product design capacities. However, the initiative has yet to be implemented due to problems in identifying an appropriate land plot.

In the future, market access privileges in EAEU and targeted tax incentives will not be sufficient to guarantee the long-term competitiveness of existing garment industries, let alone promote value upgrading. Instead, efforts should concentrate on boosting labour force productivity, tapping into the opportunities for vertical integration and improving the organizational efficiency within factories, for which attention should shift to attracting investments that could improve transfer of technology.

[57] Garment producers from Belarus increased their exports threefold in the period 2002–2012, which is less impressive than the Kyrgyz experience. But their market share is much larger, totalling $438 million in 2012. Belarusian production also includes a wider range of products, including clothing, fur and leather goods and shoes, knitted products, sportswear and lingerie (Jenish, 2014).

[58] The patent system exempts sole entrepreneurs from paying VAT and sales tax. The price of a patent is som 2,000 ($38) per month for the first 10 sewing machines, and som 1,000 ($19) for an additional 10 machines. The system also includes a payment of som 280 ($5.2) per worker and a contribution to social security of som 350 ($6.5), which is shared with the employee (Jenish, 2014; OECD, 2013).

Recommendations

Prioritize the attraction of medium-size firms from regional countries, which could help exploit and further expand existing market segments along regional value chains. A working group should be set up involving key Government and garment industry stakeholders to identify key segments in the value chain where regional investors and non-equity partners could be targeted. The group should assess the implementation of the programme for development of the textile and garment industry of the Kyrgyz Republic in 2013–2015. Necessary work would include detailed benchmark studies of businesses in Kyrgyzstan against competing locations for specific products, a research study to identify new matchmaking and partnering opportunities in manufacturing, product design and marketing; and a formal analysis to establish the scope for creating SME clusters around specialized FEZs and industrial parks, and for developing linkages strategies).

Assess opportunities for promoting the production of textiles and the role of regional FDI in such process. The potential for vertical integration with the textile industry in activities such as fabric production and yarn manufacture should also be assessed by the working group in the short term. The possibility to attract investors from neighbouring provinces in China should be considered. The approach should be national in perspective, including rural regions where labour supply is more abundant, and where skills related to cotton and wool production remain from before independence.

Adopt an incentives scheme to promote technological upgrading. Such a scheme would also facilitate upstream integration with textile industries. Tax changes that could be considered include accelerated depreciation for upstream investment as well as full rebates of duties on imported machinery. A refundable training programme could also be considered, if not implemented across sectors.

Consider seeking the cooperation of UNCTAD to promote entrepreneurship. The Government should consider setting up an Empretec centre with UNCTAD technical assistance. The centre could be based in Bishkek and could organize training activities across the country. To undertake such an initiative, discussions should be held with potential national partners, preferably institutions with an established history in promoting private sector development.[59] If set up in Bishkek, the centre could first focus on training women entrepreneurs to upgrade along the value chain for garment manufacturing. In the longer term, the Empretec centre could build on linkage development and training programmes in other sectors, including agriculture, tourism and mining (see below).

b. Attracting FDI in agriculture and food processing

Kyrgyzstan has a mountainous terrain favourable for livestock breeding and agriculture. Significant arable land exists near the Fergana Valley in the Southwest, and the Chui and Talas valleys along the Northern border. Overall, it is estimated that there are 1.3 million hectares of arable land and 9.3 million hectares of pastureland in the country. Production is split in almost equal parts between cattle breeding and crop growing.[60] The sector also has a high social impact: it is estimated that over 30 per cent of the local population is employed in rural areas, accounting for nearly 20 per cent of GDP. Main agricultural and food exports include dried vegetables, fruits, tobacco, sugar and dairy products. However, the country is a net food importer (except for dairy products) and is vulnerable to commodity price fluctuations.[61]

Increasing productivity in the agricultural sector has been a challenge since independence. During the 1990s, land reform and privatization resulted in impressive growth. However, yields have stagnated since the 2000s, and productivity is below the sector's potential. Farmers

[59] The UNCTAD Empretec programme is a comprehensive capacity-building initiative in operation in 36 countries through a series of national training centres. The programme was established in 1988, and over 200,000 people – from sole entrepreneurs to SMEs and start-up companies – have received training. Empretec centres are flexible in that they can adapt to meet national country priorities. Their goal is to train entrepreneurs in sector-specific programmes in line with a country's development strategy. They can build synergies with universities seeking to develop new managerial curricula as well as with vocational training institutions serving groups with low education levels. In the context of Kyrgyzstan, capacity-building and upgrading need to be a core element of any sector strategy, and Empretec could build synergies with such initiatives as well as broader reforms on the education system as suggested in chapter 1.

[60] In addition to animal fodder and cereals, the country also produces vegetables, fruits and berries, and potatoes. Significant animal products are derived from poultry, sheep, goats and cattle.

[61] In 2012, the value of food and agricultural imports amounted to $655 million; the trade deficit for the sector was over $100 million (Government of Kyrgyzstan, 2012).

have limited access to finance and cannot afford to buy necessary inputs for the production process (e.g. fuel, machinery, fertilizers), nor can they invest in technological upgrading.[62] They also face decreasing returns to their investments because of inadequate irrigation as well as a high incidence of animal diseases. Poor storage facilities reduce farmers' capacities to market and receive fair prices for their products.[63] For the purposes of this Review, the analysis that follows focuses on the role that investment policies and FDI attraction strategies could play to improve productivity in the sector.

Foreign investors have the potential to contribute to structural changes that affect the productivity of the agricultural sector, but their involvement can also have drawbacks that call for careful policy planning. A prudent approach is needed when debating the costs and benefits of individual projects. Whereas foreign investments in agro-industry can be a direct source of capital and contribute to technology transfer and skill development, there are also risks. These include, in particular, aspects related to food security, displacements, environmental degradation and speculation linked to underuse of land by big investors. The impact of FDI and non-equity modes of involvement (e.g. contract farming) will be related to the chosen development model as well as the regulatory and institutional framework for agriculture in host countries. UNCTAD and other organizations have developed options for promoting responsible investment in agriculture, which could help assist the Kyrgyz authorities in the design of future investment policy for the sector (box 2.1).

FDI in agriculture could improve the sector's productivity and environmental performance by increasing production scales and upgrading technology, but its prospects are limited because of restrictions on access to agricultural land by foreigners. Kyrgyzstan is not self-sufficient in staple foodstuffs, which results in a high dependence on imports. In addition, the small size of farm plots and unsustainable production practices have contributed to land degradation and desertification, which is estimated to affect 88 per cent of arable land (ECE, 2009; Toktonalieva, 2011). If adequately regulated, FDI could play an important role in addressing these challenges by increasing production scales, promoting crop rotation and assisting in technological upgrading and innovation. However, as discussed in chapter 1, the use of agricultural land is reserved to Kyrgyz nationals, and the entry of foreign investments is limited to joint ventures or non-equity forms of production.[64]

In spite of constraints to accessing land, FDI has played a catalysing role in fostering the food-processing industry in recent years. Foreign investment in food processing amounts to nearly 5 per cent of the country's cumulative FDI flows. Next to mining and finance, the industry is the third top FDI recipient. Significant FDI occurred in the following activities: manufacturing of noodles and other uncooked farinaceous products, meat and poultry products, dairy products, soft drinks and other beverages such as tea and coffee. Foreign-owned companies tend to be middle sized, although some of them are included among the largest ones in the country. As estimated by interviewed stakeholders, only 10–12 per cent of agricultural production is processed. There is thus ample room for further growth. The country also has some potential to develop export-oriented industries, especially with regard to dairy and organic agricultural products.[65] But given their perishable nature and existing infrastructure constraints, the industry's attractiveness to global multinational enterprises (MNEs) has been limited, and most investors are from the region.

[62] The average size of private farms is 2.7 hectares with no significant variance across the country (Government of Kyrgyzstan, 2012). Total production is spread across 344,492 small farms, accounting for 93.5 per cent of total output, and 1,164 State farms, collective farms, agricultural cooperatives and their subsidiaries, accounting for 6.5 per cent of production (OECD, 2014a).

[63] Several studies have been conducted by experts and partners that draw important conclusions with implications for public policy (ECE, 2009 and 2010; FAO/EBRD 2011; OECD, 2014a).

[64] Some interviewed stakeholders emphasized that, although uncommon, foreign investments can occur through joint partnerships with local farmers. Still, even when joint ventures can have certain advantages for foreign companies, in the case of Kyrgyzstan their occurrence is more likely the result of adaptation to an uncertain legal framework than an option resulting of any strategic decision by firms.

[65] According to experts, organic farming is most suitable to countries with generally small farms and a shortage of capital such as Kyrgyzstan, but the country lags greatly behind in promoting certification among producers. Indeed, only a small portion of cultivated land (0.03 per cent) was certified as organic as of 2014 (FIBL and IFOAM, 2014). The exception is cotton production, where with the help of international partners, the Bio-farmer cooperative in the Jalal–Abad region was able to integrate smallholders in the international value chain on organic cotton through fair trade certification, which allowed producers to export cotton to Switzerland and Germany (Kaseeva, 2013; IBC, 2012).

Box 2.1. Principles for responsible agricultural investments

At the request of the Group of 20, UNCTAD and other development organizations have worked together to develop options for promoting responsible investment in agriculture, which were summarized in seven principles for responsible agricultural investments that respect rights, livelihoods and resources (PRAI):

- Existing rights to land are recognized and respected;
- Investments do not jeopardize food security but rather strengthen it;
- Processes relating to investment in agriculture are transparent, monitored, and ensure accountability by all stakeholders;
- All those materially affected are consulted and agreements are recorded and enforced;
- Investors ensure that projects respect the rule of law, reflect industry best practice, are viable economically, and result in durable shared value;
- Investments generate desirable social and distributional impacts and do not increase vulnerability;
- Environmental impacts of a project are quantified and measures taken to encourage sustainable resource use, while minimizing the risk or magnitude of negative impacts and mitigating them.

A report has been published that summarizes lessons learned on responsible investment from 39 mature agribusinesses in Africa and South-East Asia and assesses their performance in terms of respect for local rights, transparency with stakeholders, support of livelihoods and environmental sustainability, among other criteria.

Source: UNCTAD/World Bank, 2014a.

Major drivers of investments are the low cost of production, the good quality of soil and pastures for cattle breeding; and the possibility of accessing the large Kazakhstani market. In addition, a favourable tax regime, including VAT exemptions for food products as well as generous corporate income tax incentives, has contributed to sector's growth. These schemes, however, may not be sustainable in the long run, especially since most investment incentives that apply to large companies are limited to FEZs (annex 3).

FDI projects have generated jobs, input supply, management advisory services and credit support. Of a total 436 enterprises in the sector, there were 101 enterprises with foreign equity in 2012, which created 4,183 jobs. Some of these investments have also generated a positive impact through the promotion of inclusive business models regarding access to finance, transfer of technology, and skills development of farmers, which were possible thanks to the introduction of vertical contracting for input sourcing (box 2.2).

Accession to EAEU will increase opportunities for targeting larger investments and will foster technological upgrading. According to interviews with business associations and in line with the priorities included in NES, investment strategies for integration in regional food value chains should focus on prioritizing investments to address major bottlenecks. A non-exclusive list would include the following:

- Large-scale processing plants with sanitized storage facilities for fruits and vegetables;
- Greenhouse agriculture;[66]
- Modern packaging and design (for fruits and vegetables) to improve marketing;
- Modern cooling systems (i.e. freezing and/or refrigeration) to eliminate weaknesses linked to the perishable nature of products;
- Cattle breeding to improve milk and meat quality: investment could be attracted to advanced feeding plants, modern identification systems for cattle and capabilities in artificial insemination (ITC, 2013).

66 Given the seasonality of production and the disappearance of many crops in winter, such investments would contribute to improving the regularity of the supply chain.

Box 2.2. Promoting inclusive business models in milk processing: The case of Siut Bulak

One major benefit of contract farming schemes for both farmers and agribusinesses is the possibility to receive reliable and timely payments for farm produce, which ensures market access for farmers and allows for better planning in the use of processing capacity by food industries. Also, the contractual relationship can be a substitute for credit when other sources are unavailable. If a fair mechanism is set up for determining pricing, such contracts can result in inclusive business models that facilitate reinvestments in farming infrastructure and increased productivity over time. Although contract farming schemes are still rare in Kyrgyzstan, some successful experiences have taken place.

JSC Siut Bulak started operations as a cheese producer in 1996 and introduced a year later its “Dairy Spring” brand in the Kyrgyz market. Farmers in Kyrgyzstan face hindrances such as weak economies of scale, inability to comply with quality standards, poor equipment and lack of finance. Siut Bulak helped alleviate these problems by committing to buying around 50,000 litres of milk per day from more than 2,000 farmers in the Tyrup region. Furthermore, the company provides training and technical assistance to its affiliated farmers and it has created a fund to offer loans to support investment in cattle, milking machinery, equipment and infrastructure.

At present, the company produces more than nine different types of cheeses and fresh milk products such as butter, yoghurt, sour cream, drinking cream and pasteurized milk. The processing plant in Jyluu-Bulak employs around 100 workers and features advanced equipment imported from Europe that allows the use of hazard analysis and critical control points (HACCP) quality control. Its employees have also had the possibility to learn in Europe (i.e. Switzerland and Poland). The company has also successfully expanded its market and currently exports half of its production to Kazakhstan.

The project was developed after a seminal investment and technical support from the Swiss Government. In 2008, the project received additional funding (€1.1 million) from the European Bank for Reconstruction and Development (EBRD), which became its second shareholder (it holds 34 per cent of shares).

Source: EBRD and UNCTAD interviews during the fact-finding mission.

However, major challenges concerning sanitary and health standards need to be overcome to fully exploit the sector's investment potential. The challenges in infrastructure mentioned above (i.e. insufficient transport connectivity, slow border procedures and poor electricity supplies) can be even more acute in the food industry, given the perishable nature of products. In addition, the inability to meet international quality standards on health, safety and food hygiene is seriously constraining exports. Failure to control animal disease and political instability has resulted in repeated border closings (e.g. with Uzbekistan in 2005, with Kazakhstan in 2010 and 2012), which has damaged sales to neighbouring markets in recent times. Indeed, the national network of laboratories for soil testing, product quality and export compliance is currently inadequate owing to broken equipment, insufficient drug supplies and staff shortages. Interviewed stakeholders in the food industry emphasized that these risks severely hamper profitability and impose externalities that cannot be accommodated in their business models.[67] More importantly, accession to EAEU will bring even bigger challenges related to the adoption of its entire legal framework and sanitary and phytosanitary (SPS) technical regulations (the latter will apply to nationally produced and consumed goods as well as to exports to EAEU member States).[68]

67 There are 89 public and private testing laboratories, 30 of which specialize in food products. Laboratories controlled by the State operate mostly under the mandate of either the Department of State Sanitary and Epidemiological Supervision (DSSES) at the Ministry of Health or the Centre for Standardization and Metrology (CSM) at the Ministry of Economy (ITC, 2013). Whereas some laboratories do meet the standard ISO/IEC 17025 and are accredited by the Kyrgyz Accreditation Centre, the centre did not receive international accreditation until October 2013. See http://www.intracen.org/news/Kyrgyz-businesses-to-benefit-from-international-standards-accreditation-agreement/, accessed 31 March 2013.

68 In accordance with the Laws on the Fundamentals of Technical Regulation of 2004, certification is required only for products that can potentially endanger consumer health (e.g. alcohol, tobacco products) after an amendment in 2009 reduced obligatory standards coverage from 70 per cent to 22 per cent. Other goods can be certified on a voluntary basis, but only to confirm product quality (FAO, 2013).

Another area of concern relates to growing conflicts between food processing companies and farmers because of poor contract compliance. Interviewed stakeholders indicated that due to the small-scale nature of production, information asymmetries as well as practices linked to nomadic farmers' traditions, there is often a mismatch between industry needs and farm production. Although the food industry has an interest in developing long-term customer relationship with farmers, in many cases producers are likely to default on the terms of contracts (for instance, when there are market price changes in favour of other crops) and thus create disruptions in the supply chain. This constraint is more burdensome for foreign firms, given that restrictions on access to land referred to above make contract farming the only available option to source locally. The Ministry of Agriculture has tried promoting cooperatives of producers to foster more reliable supply to the processing industry, but most initiatives have fallen short of the business sector's expectations. Some companies were nevertheless able to create such a network of producers or else find sufficient partners to lease land directly.

The Government has adopted strategies to encourage productive investments in agriculture and food industries, but they are not specific enough to consider their suitability to foreign investors. With regard to development strategies, NSSD and the Strategy for Agriculture Development (2013–2020) include a series of goals aimed at improving agricultural efficiency. The measures promoted are as follows: upgrading technologies and product quality through irrigation and veterinary services; developing rural infrastructure; ensuring food security through price stabilization mechanisms; promoting the development of land markets; providing assistance in the formation of export-oriented clusters; and upgrading in the value chain through increased value added food processing. However, neither strategy assigns a precise role to FDI or non-equity modes of production in achieving these objectives. For instance, NSSD lists 24 projects worth $141 million where investments will be sought, but these are mostly focused on agriculture, not on food processing, where FDI is most likely to occur.[69]

[69] Agricultural and food policy is designed by the Ministry of the Economy and policy implementation and regulatory functions are under the auspices of the Ministry of Agriculture.

Recommendations

Clarify what involvement is expected of foreign investors in agriculture and amend legislation and policy documents accordingly. The options for foreign involvement in agriculture include contract farming and joint ventures (with foreign equity below 20 per cent). Given major risks linked to contract compliance, it is unlikely that these formats will suffice to attract significant investment flows in the near future. Alternatives to be considered include removing restrictions on the leasing of agricultural land and creating a land bank to allocate specific plots to equity investors, as suggested in chapter 1.

Devise strategic targeting of foreign involvements in food processing with a focus on sectors that are export oriented and have clear competitive advantages (i.e. dairy products, fruits and vegetables). Matchmaking and investor targeting will require coordination mechanisms between the newly created IPA, the Ministry of Economy and the Ministry of Agriculture. The strategy should also build on open dialogue with business associations and help gather business intelligence to improve market-penetration capabilities. Targeting can consider both large multinational companies and medium-sized firms. In view of existing trade patterns and regional initiatives, it would be a priority for the dairy products sector to focus on the Russian Federation and Kazakhstan in the short run.

Develop a detailed action plan to rapidly improve product standards across the Kyrgyz agro-industry, including measures to enhance the availability of vaccines and veterinary services. Health and sanitary restrictions to exports constitute a major bottleneck to the development of the food industry. The Government should consider joining forces with private sector enterprises (including also foreign investors) to increase investments in modern laboratory facilities and thus facilitate a more rapid international certification of food products. In addition, tax incentives, such as tax rebates could be offered to major MNEs providing training to farmers to enable them to comply with health and sanitary standards. At the intergovernmental level, international agreements on technical regulations and standardization should be signed to directly apply the technical regulations of the EAEU countries in Kyrgyzstan.

Tackle the need for improvements in air transport infrastructure, including through synergies with tourism development policies. Policies may include approaching new airlines to increase flight frequency to

Europe and East Asia, as well as negotiating the availability of cargo space in passenger flights for dried food exports. Other synergies could be considered in name branding for organic agriculture.

Undertake initiatives to empower local producers and better promote their interests. The creation of producer clusters around major regions remains a priority to increase economies of scale and allow better deals in price negotiations with processing industries. In addition, the Government may consider developing a model contract for farmers that could be used as a reference to reduce uncertainty among businesses and producers. The PRAI principles could be used as guidance to ensure the terms accommodate multi-stakeholder interests concerned. Also, training and capacity-building activities to create awareness among local farmers will be needed, not only about the implications and benefits of contracts, but also about negotiation skills and the advantages of creating cooperatives.

c. Targeting niche markets in the tourism sector

Tourism has been growing steadily in recent years. In 2011, more than 800,000 tourists visited Kyrgyzstan, and the World Tourism Organization estimates that the country could attract up to 2.5 million foreign visitors. Also, tourist-related activities are believed to provide employment to around 118,000 people (38,000 directly and 80,000 indirectly) representing 5.2 per cent of total employment.[70] Overall, the sector is also an important source of foreign exchange, worth $630 million (Government of Kyrgyzstan, 2012).

Some FDI has been attracted, but it has not been central to the sector's development. Growth occurred mainly in the business and traditional leisure segments, with major investments circumscribed to Bishkek, Osh and the Issyk–Kul lake area. The country has successfully targeted a major player in the business segment, Hyatt Hotel, which set up operations in 2001 and has already received global awards for its performance. Major drivers quoted by foreign investors are the geographical attractiveness of the location and a favourable taxation regime (annex 3) However, according to official statistics, in the period 2003 and 2007, total FDI in the tourist sector amounted to a mere $16.2 million (UNCTAD, 2013b). Since 2008, FDI flows to the sector have suffered due to the international economic and financial crisis and political instability in Kyrgyzstan.[71] Interviews with stakeholders, however, suggest that there is real scope for furthering expand hotel accommodation for business in Bishkek at the high-end level, as business tourism demand from the Russian Federation, China and elsewhere in Eastern Asia is expected to be the main driver of growth over the next few years. However, in the short run, this segment will also likely suffer from the dismantling of the United States air base at Manas.

Kyrgyzstan also has unexploited potential for attracting FDI in cultural, adventure and ecotourism, but the Government has not targeted these segments. Kyrgyzstan is located at the crossroads of the ancient Silk Road, with its legacy of cultural monuments spread between Uzbekistan and China, including major United Nations Educational, Scientific and Cultural Organization (UNESCO) World Heritage Sites, such as Sulaiman-Too Sacred Mountain in Ferghana Valley. In addition, its landscapes and diverse nature of high mountains, lakes and rivers are ideal for adventure and ecotourism. Indeed, the country has been referred to as the "Switzerland of Central Asia", given opportunities for mountain climbing, white-water rafting and hiking (UNCTAD, 2014b). Consumers in these segments are known for undertaking longer travel, spending more and interacting with local communities, which create additional impact through demand of local products and more job opportunities (e.g. local tour guides and sales of local handicrafts). Looking ahead, FDI and other forms of involvement could bolster sector growth in these segments. Thus, investments could be more actively promoted in the

70 Over 90 per cent came from CIS countries: Kazakhstan (50 per cent), the Russian Federation (33 per cent) and Uzbekistan (11 per cent) (ITC, 2013).

71 FDI flows regained an upward trend in 2013, with flows amounting to $13.4 million (a 124 per cent increase over 2012). Traditional source countries are Kazakhstan, the United States of America and the Russian Federation, although the United Arab Emirates topped the ranking in 2013. In most cases, investments occurred through the rehabilitation of State-owned Soviet constructions. According to official statistics, the total number of persons directly employed in hotels and restaurants with foreign equity decreased from 1,743 in 2008 to 1,366 in 2012. It must be highlighted, however, that tourism statistics underestimate the impact of foreign investors because much transnational activity in tourism takes place through non-equity modes, even though it may have effects that are equivalent to those achieved through equity ownership, such as managerial control, technology and knowledge transfer, and access to markets (UNCTAD, 2010).

surroundings of national parks and mountains (e.g. peak Lenin, Tokmok, the Pamir Alai Transboundary Conservation Area near Tajikistan) or even in economically depressed mining villages (e.g. Kadjy-Sai, Ak-Tuz, Kadam-Jai) with unpolluted landscapes (Shokirov et al., 2014).[72]

A number of obstacles need to be removed in order to fully take advantage of tourism potential. Previous sections referred to bottlenecks in road transport, which are particularly relevant for promoting tourism in rural areas. Lack of signage in multiple languages is also a visitor concern. Also, there is no reliable system of registering tourists for statistical purposes, which is crucial to estimate the economic impact of investments. In addition, three issues deserve specific attention: the policy and regulatory environment surrounding tourism, insufficient international marketing of tourism product strengths and inadequate hospitality skills.

The policy and regulatory framework surrounding tourism activities is deficient, particularly with regard to safety and environmental concerns. Across the country, there is widespread violation of the laws regulating safety, the protection and preservation of historical monuments and the environment. This has resulted in the pollution of national parks and reserves. Government efforts are needed to ensure compliance with international sanitary standards by industries in the tourism sector i.e. with regard to food safety; sewage disposal; cleanliness of rooms, dining areas and toilets in hotel facilities, and waste removal near natural beauty spots, beaches, roadsides and adjacent public areas. In addition to improving regulation in each of these areas, investment promotion policies could also focus on creating guidelines for new investors to minimize their environmental impact, especially considering that the market niches to be targeted will be environmentally sensitive.

The Government has yet to develop a marketing strategy for high value added segments of tourism referred above. Business associations in the tourism sector are wary of limited marketing efforts by the Government and believe that a more competent marketing approach is needed than one that focuses on presenting Lake Issyk–Kul as a traditional destination for leisure. For instance, in the case of ecotourism, which is often targeted at wealthy Europeans, it is important to market whole tourist experiences that require coordination between hotels, transport and catering companies. Attracting young foreign tourist backpackers requires offering a very different set (e.g. graded bed and breakfast accommodation, discount travel through internet websites, and specific health and safety policing networks). Accordingly, institutional capacities may need to be created to design marketing strategies in line with good international practice (UNCTAD, 2010).

Tourism also suffers from a shortage of skilled professionals. Managers in travel agencies prefer hiring experienced professionals rather than high-school graduates who lack specific theoretical knowledge. While there are enough middle and senior tourism managers in the country, the sector faces problems with the lack of well-trained tour guides, hotel cleaning personnel and waiters. Also, more technical experience is needed in climbing or mountaineering, for which specific training is required (IBC, 2013).

With regard to Government planning, a lack of long-term strategy for the sector, combined with a weak legal framework, has trumped policy continuity. There is no broad-based strategy for the tourism sector. No modern law on tourism exists, and the lack of clear policy planning prevents fruitful interaction with private stakeholders and investors (ITC 2013). Indeed, no major input from stakeholders has been sought to inform NSSD (IBC, 2014). Also, regulatory inconsistencies concerning access to real property in the Issyk–Kul region may affect FDI (see chapter 1). With regard to the institutional framework, tourism policies and initiatives have since the country's independence been dealt with by different ministries (i.e. the Ministry of Economy, an independent State agency and currently, a Department within the Ministry of Culture, Information and Tourism). This situation has resulted in poor policy continuity and high staff turnover. In addition, the tourism budget remains very modest and has been cut in recent years, with professional staff being reduced from 50 to 10 within a period of five years.

Lack of dialogue and capacity support for tourism stakeholders is seen as having played an important role in preventing more rapid development of the sector. For instance, there are no established consultations between the Ministry of Economy, the Ministry of Tourism and related agencies such as the Civil Aviation Agency and the State Agency on Environment, let alone major tourist associations (e.g. Kyrgyz Association of Tour Operators (KATO) or the Association Hotel and restaurant business).

[72] In addition, winter resorts around Bishkek and Issyk–Kul that cater to domestic tourists seeking ski holidays could also be further promoted and expanded, as the existing facilities need much upgrading (e.g. for guest houses and camping sites).

Successful targeting strategies will depend on creating better synergies among all these stakeholders.

In spite of constraints, positive steps have been taken to improve the situation, such as visa reform measures to facilitate entry by tourists. In 2012, the Government introduced a regime of visa-free travel for citizens from 44 countries addressed mainly to increase tourism from Europe and East Asia. At least 50 per cent of the world's population lives at a three-hour flight distance from Bishkek, thus visa liberalization could go a long way to promote air travel. However, the fact that only three significant international airlines make regular flights to and from Kyrgyzstan at relatively high prices will greatly limit the short-term impact of this measure. In addition, the lack of direct flights to the lucrative target markets in Europe implies long waiting times (especially with main targets in Germany, France, England and Scandinavia); the situation is further complicated because these destinations cannot be reached by local air companies (a black-list restriction by the European Commission is in place due to poor safety standards).

The upcoming liberalization of the aviation sector through the introduction of fifth and sixth freedoms seeks to increase air travel, although the long-term effects are still uncertain.[73] Growing competition in the airline markets will create pressure to lower ticket prices and could increase tourism and business travel. Real change, however, will depend on whether the reform is accompanied by urgent investments in travel logistics and airport infrastructure that could attract foreign airlines and accommodate increased air traffic. Also, the policy will likely bring short-term costs to the State budget through decreased tax revenues and potential job losses related to the restructuring pressures on local companies (for different perspectives, see IBC, 2014).

73 The International Civil Aviation Organization (ICAO) defines the fifth freedom of the air as the right or privilege, in respect of scheduled international air services, granted by one State to another State to put down and to take on, in the territory of the first State, traffic coming from or destined to a third State The sixth freedom of the air is defined as the right or privilege, in respect of scheduled international air services, of transporting, via the home State of the carrier, traffic moving between two other States. The sixth freedom of the air, unlike the first five freedoms, is not incorporated as such into any widely recognized air service agreements such as the "Five Freedoms Agreement" (ICAO http://www.icao.int/Pages/freedomsAir.aspx, accessed 1 October 2014).

Recommendations

Set as a priority to produce a tourism development plan and a legal and institutional framework for the tourism sector in line with it. The Government should set up a tourism development plan defining the intended direction of tourism development in Kyrgyzstan, including required support policies, institutions and targets for FDI attraction and contribution. Based on this plan, a revision of all legislation affecting tourism will be necessary. The priority should be to clarify establishment restrictions and lessen the burden of permitting and administrative procedures and inspections (see chapter 1). Tourism development and promotion should also be assigned adequate funding and professional staff so that they can properly meet the requirements of the plan.

Set up better channels to communicate and assist tourism stakeholders. The Government should consider establishing a national tourism board for the sector. The board would be a public–private forum where stakeholders can voice concerns, provide input to the sector plan, as well as help coordinate country branding and marketing strategies with the Government. Key priorities will include informing and educating tour operators and other stakeholders about compliance with international sanitary norms. In addition, the board should work to promote the development of direct air connections with a number of foreign countries from/to the airport at Issyk–Kul; and the establishment of a centralized online reservation system that could assist visitors to better plan their arrivals and contribute to improved statistics collection.

Prepare guidelines for sustainable tourism investment to be applied in rural areas. A growing number of countries are embracing best practices in physical planning for tourism by adopting requirements on environmental impact assessments before developing tourism facilities. Such an approach would be preferable to the outright restrictions to foreigners in the Issyk–Kul area, although it may create burdens on monitoring authorities. In parallel, the Government may wish to consider drawing on the experience of other countries that are increasingly preparing guidelines on sustainable tourism as part of their investment attraction strategies (box 2.3).

Consider engaging in joint promotion with regional partners. Given the level of resources required for a proper marketing strategy for niche segments (e.g. website development for bookings, advertising in specialized

Box 2.3. Lao People's Democratic Republic: Guidelines for investors in ecolodges

Adventure and ecotourism have high-growth potential in countries with unpolluted landscapes, but the arrival of tourists from different geographical backgrounds can also bring certain risks linked to environmental sustainability and the preservation of local culture. IPAs could play a role in minimizing these risks through the creation of investment guidelines that could help marketing eco-friendly investments. For instance, the Lao People's Democratic Republic has set up such guidelines for ecolodges. Investors should observe the following guidelines:

Use Lao architecture and building materials: Investors must build the lodge to look like a traditional home or house.

Minimize the use of energy: Investors should avoid air conditioning and other electric devices that use too much electricity and should install solar energy to meet some power needs, such as lighting and hot water.

Use local products and minimize the use of chemicals in daily operations: Investors should use local food products and locally produced bed sheets, tablecloths and other items in the lodge. Chemical bug sprays, poisons or toxic cleaning fluids should be avoided when there is a suitable substitute.

Minimize and manage waste: Investors should not use products that leave a great deal of waste, such as disposable water bottles, canned foods, or foods wrapped in plastic. Investors are also expected to recycle and reuse items when possible.

Employ local people and support their community: The lodge should give work opportunities to nearby villagers. Investors can also support the community by helping with activities at a local school.

Minimize negative impacts on nearby villages: Investors should provide information to tourists on local cultural norms. They should also speak regularly with local villagers to learn how they can help them, and to learn if there are any problems created by tourists staying at the lodge.

Source: UNCTAD, 2010.
Note: An ecolodge is a small hotel or guesthouse that incorporates local architectural, cultural and natural characteristics

journals, attending fairs and exhibits in target markets of Europe and Asia), it is recommended that the Government engage in joint promotion with neighbouring countries and regional authorities, including through PPPs. The Silk Road Regional Programme (SRRP), which has joined forces with the World Tourism Organization (UNWTO), UNDP, UNCTAD and the Governments of China, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan to promote FDI in tourism and preserve cultural heritage, could be used as a framework for further cooperation (UNCTAD, 2014b).[74]

d. Towards more sustainable mining and linkage development policies

The mining sector is the largest source of exports in Kyrgyzstan and has much unexploited potential. The Tien Shan Gold Belt is the second largest gold deposit in the world. Despite the vast amount of confirmed reserves of precious metals and minerals, only four large mining companies operate in the country. Among these, only Kumtor mine is privately owned and managed by foreign investors (see box 1 in context).[75] There is no major foreign involvement in coal, the second most important mining subsector. Other subsectors with more limited potential

[74] The programme organizes study tours and round-table discussions, and offers support to strengthen business associations. Cooperation could be further deepened through the adoption of joint marketing planning, advertising and promotion. For instance, Internet-based solutions providing visitors with easy access to comprehensive pre-visit information needed for planning purposes should be a priority. This would include, for example, the creation of tourism portals providing online reservations, trip planners, three-dimensional tours of top visitor attractions — supported by appropriate published information (e.g. tourism catalogues, directories and brochures).

[75] The other mines are the Makmal Gold Mining Combinate (output capacity of 0.2–0.5 metric tons per year), Khaidarkan Mercury Plant (output capacity of 300–320 metric tons per year), and the Kadamjay Antimony Mining Plant (output capacity of 1.5 metric tons per year) (Government of Kyrgyzstan, 2012).

include oil, iron ore, rare earth metals, non-ferrous metals, radioactive elements, local building materials and mineral waters. The potential for investments is estimated at $8 billion, worth $121 billion in economic output; $12 billion in tax revenues; 20,000 new direct jobs per year; and indirect and induced employment of around 32,000 people (Ministry of Economy, 2014).

However, the expansion of mining activities has been subject to major controversies involving overall governance, environmental protection, social issues and taxation. A prerequisite to ensure further growth is to improve the governance of the sector, which has been prone to much regulatory instability, both with regard to Kumtor and beyond.[76] In addition, mining companies are increasingly becoming a target of social discontent due to their poor social and environmental performance. The fiscal system has also been controversial. While mining activities involve various investment risks, including challenges in accessing financial markets and high cost of credits, these are compounded by the impact of the sector on government revenues. Whereas it is beyond the scope of this Review to provide a full assessment of the multifaceted regulatory constraints affecting mining policy, the following paragraphs discuss major constraints to sustainable development and define important priorities for policy action.

The basic regulatory framework for the mining sector has changed several times since Kyrgyzstan's independence in 1991, creating uncertainty.[77] The legal framework for mining is regulated by Law 160 on Subsoil Resources of 2012 and subsequent by-laws. In addition, over 100 other norms are in place governing other sectors that can have implications for mining, with mandates that include aspects of industrial safety, the environment, water and land, among other policy areas. This situation has resulted in contradictions among some legal provisions and ambiguity in determining their legal hierarchy. In this regard, the drafting of a mining code that harmonizes legislation and provides a comprehensive framework for the sphere of subsoil use should be considered. Such reform could strengthen guarantees to investors.

In addition, the design of mining policy involves a complex institutional set-up where coordination problems have negatively impacted effectiveness. The Ministry of Economy guides policy on the use of subsoil resources, but policy implementation is performed by the State Agency for Geological and Mineral Resources (SAGMR), which has specific responsibility for confirming reserve estimates, licensing activities and the supervision of exploration and exploitation. Monitoring of compliance with industrial safety and ecological standards is undertaken by SIETS; and environmental impact evaluations are conducted by SAEPF (see chapter 1, section on the environment). Eight other public bodies interact with mining companies for permitting or consultation purposes. Over time, the division of management functions has created coordination problems and communication difficulties. It is compounded by the recent dismissal of more experienced staff, the setting up of overly demanding mandates for small government units, duplication of powers and inadequate interaction with local authorities.

With regard to the environmental performance of the sector, conflicts over mining activities have recurred in the history of Kyrgyzstan. In the past, companies were not required to internalize the costs of damages linked to poor wastewater treatment, and air and soil pollution. Thus, mining activities were not up to international environmental sustainability standards. Notably, environmental concerns have been at the core of controversies around the Kumtor mine (see section on context), which preceded the arrival of Centerra and can be traced back to the 1990s, when operations only started). More recently, grievances linked to poor environmental monitoring are becoming interlinked with wider discussions on resource nationalism on the political scene (Shishkin, 2013; Gullete and Kalybekova, 2014).[78]

Another feature that characterizes the mining sector is the growing number of social conflicts between local communities and foreign companies. There is a widespread perception among local communities that the mining sector is detrimental to their economic interests and

[76] For instance, the Fraser Institute's Annual Survey of Mining and Exploration has published results from the most recent survey of mineral potential, which placed Kyrgyzstan thirty-sixth out of 112 mining countries, although on policy attractiveness the country was ranked last. Concerns include uncertainty about the interpretation and enforcement of existing regulations, lack of transparency and corruption of legal processes and uncertainty concerning disputed land claims.

[77] Overall, the Law on Subsoil was amended seven times between 1997 and 2012.

[78] The most prominent among these incidents occurred in May 1998 when a truck fell into the Barskoon River, which flows into Issyk–Kul, and leaked 1,762 kilogrammes of sodium cyanide, with detrimental consequences for water resources and the health of local populations.

that big mining projects are a risk to their livelihoods. In some cases, social unrest resulted in violence and requests for the termination of subsoil licences, which in turn led to either licence revocations or closure by the companies. A lack of sufficient dialogue with local populations has made mining companies more vulnerable to community demands, since there are no institutionalized mechanisms to ensure positive interaction between local governments, central government agencies and companies.

Recently, the Government has taken important steps to improve the attractiveness and sustainability of the sector by introducing wide-ranging amendments to the Law on Subsoil. The latest amendments to the Law made important contributions to set up a more transparent licensing regime. Rights for mining are now awarded through licences whose length of validity fluctuates between 5 and 20 years depending on the type of activity. The reform is expected to reduce the scope for arbitrariness that characterized direct negotiations in the past,[79] and the new regime is generally considered to be an improvement by mining stakeholders. Another goal of the new Law on Subsoil is to minimize passive speculation, which had been rife in the past, by introducing mandatory annual payments for licence holders.

Other amendments include more stringent expert examination requirements. Since 2012, the Law requires three examinations in preparation of geological and mining projects (technical, industrial safety and environmental impact assessments). In the past, expert examinations were purely formal procedures and the lack of mandatory deadlines for expert opinions gave way to corruption. Although the latest amendments seek to address these concerns, further specification is needed with regard to procedures, for State expert examinations, including defining requirements, timing, costs, progress reports, and the role of experts. The same applies to the set-up of mandatory reclamation funds and procedures for liquidation of mining sites. Missing specifications are needed to define the conditions and formulas to calculate the allocation of funds, to secure the funds for the period of mineral deposit development; and to determine maximum allowances for waste disposal (Ministry of Economy, 2014).

The new Law also imposes a system of local redistribution of income generated from mining but its implementation has created concern among stakeholders. The Law on Subsoil now requires mining investors who participate in projects requiring bidding processes to contribute 2 per cent of mining revenues to specific local development funds. The goal is to finance training and employment programmes for local residents, as well as infrastructure development. Other measures envisioned include involving local communities in licensing committees; and increasing the budgets of local communities in affected areas. However, secondary regulations for the distribution of these revenues have yet to be enacted, to ensure that such funds are actually spent in local development projects.

No systematic approach is in place to promote business linkages between MNEs and domestic companies. Although mining projects have limited direct employment impacts because of their capital-intensive nature, there are a number of other routes through which benefits may accrue. Mining activities often create demand for a range of intermediate goods ranging from food supplies, security services, construction materials and delivery of public utilities to packaging materials and transport; and higher value activities such as IT services, accounting and auditing. The extent and depth of these linkages in a given national context will depend on the absorptive capacities of local firms, particularly SMEs, as well as the technological and skill barriers to entry (UNIDO, 2011). The Kyrgyz authorities have yet to design clear policies to unleash the potential of the mining sector through initiatives aimed at backward linkage development.[80]

79 In total, the Government has issued 258 licences over the last 20 years, including 225 for gold prospection; exploration and development. The new Law reduces the conditions under which suspension and revocation of licences can take place and specifies guidelines for licensing. Accordingly, three types of licences are defined: prospecting licences (up to five years), exploration licences (up to 10 years) and exploitation licences (up to 20 years). All licences are renewable. Methods of awarding licences include invitations to tender (for projects of national importance), open-bid auctions and direct negotiations (for small deposits). Annual fees for licences vary depending on the type, resource, and size of the surface area (Decree 12 of 2013).

80 The Government undertook some measures aimed at promoting domestic content production in mining. Kyrgyzsaltyn JSC, for instance, was set up as a State monopoly for gold refining and could be classified as a case of forward downstream linkage. However, promoting forward linkage interventions (which often require economies of scale and high capital investments) is likely to involve devoting scarce government funds that are beyond the country's capacity, or may imply joint venture requirements that could deter investors for other reasons (see also chapter 1).

The tax system for mining is complex, difficult to administrate and subject to arbitrary changes. According to mining stakeholders, the complexity of the system has resulted in both the imposition of ineffective rates and successive unplanned changes over time that neither helps attract investors nor guarantee sustainable revenues for the Government. The situation is compounded by a lack of planning and broad-based consultation with stakeholders in the design of tax policy. For instance, the latest tax reform in 2013, which introduced a new revenue-based corporate tax based on a sliding scale for gold mining instead of the standard corporate tax (based on profits), was approved without much consideration for the needs of new investors, especially small and medium-sized gold mining companies (annex 5).

In addition, there is no fiscal strategy in place to address the mounting risks of a "resource curse". As more investors are attracted and the mining industry scales up its activities, the Government faces the growing challenge of how to avoid the resource curse phenomenon.[81] Good practice shows that countries can tame the effects of a resource curse through a spectrum of policies. Sovereign wealth funds (SWFs) are a mechanism by which the foreign exchange surpluses arising from resource revenues can be absorbed and deployed through a mix of strategic investments that match long-term development goals (box 2.4). Other mechanisms include revenue management laws, which restrict or ring-fence the spending of revenues over time or special legislative approval and referenda requirements for revenue management-related changes. The Kyrgyz Government has yet to consider any of these options, which could help fund some of the initiatives proposed in this report to promote diversification (e.g. PPPs in general, marketing strategies for tourism and linkage programmes).

The Ministry of Economy has commissioned a draft medium and long-term strategy of mining industry development of Kyrgyzstan. The strategy covers technical issues concerning the management of mining activities, legal framework on licensing, tax system, social and environmental concerns, as well as skill development and relations with local communities. It also includes a forecasting for the development of the gold mining industry, nonferrous and rare metals and coal mining, including strategic plans for whole investment cycles up to 2035. If adopted by the Parliament, the strategy will be the first of its type in the country's democratic era that provides vision and direction for the phased development of the mining industry over the next 20 years.[82] However, the strategy will not in itself suffice to address most of the issues referred to above, and the Government will need to build consensus on key priorities to ensure that sustainable development objectives receive due attention.

Recommendations

Address the need for greater expediency and fairness in licensing in a more comprehensive manner. Further legislation is needed to set up objective conditions for issuing licences, including clear post-award funding requirements, environmental protection requirements and the nature, extent and cost of social obligations. The drafting of a mining code should be considered. Overall, future amendments to the legal framework should draw on best practice experiences in successful mining countries, such as Canada or Chile (table 2.3).

Consider introducing technical and financial capacity requirements on licence applicants to address the challenge of passive speculation in exploration. Surrender requirements could also be introduced.

Expand the regime of expert examinations for extraction licences comprised in the Law on Subsoil to also include community consultations. Best practices in the mining sector suggest that not only technical, safety and environmental assessments be undertaken, but also improved consultation with local populations throughout the whole mining project cycle (UNCTAD, 2011). Such consultations could be translated in requirement for a formalized mechanism as part of the expert review process.

Following international best practice, include the need of community development programmes at the time of evaluation for the granting of extraction licences. Such a programme may include local supplier development and an employment and skills development plan based on a formal social-impact assessment. Considering private

[81] The resource curse refers to the paradox that countries and regions with an abundance of natural resources tend to have less economic growth and worse development outcomes than countries with fewer natural resources. The phenomenon can arise for a number of reasons including a decline in the competitiveness of other economic sectors (caused by appreciation of the real exchange rate), volatility of revenues and mismanagement of resources by weak, ineffectual, unstable or corrupt State institutions (Humphreys et al, 2007).

[82] The draft was finalized in 2014 after it was commissioned by the Ministry of Economy to a consortium of experts guided by the Kyrgyz Mining Association.

Box 2.4. Sovereign wealth funds as a tool for diversification

Sovereign wealth funds (SWF) are special-purpose funds owned by Governments that invest in different classes of assets. SWFs are generally funded from foreign exchange reserves, balance of payments surpluses, proceeds from privatizations or revenues from commodity exports, in which case they are also known as natural resource funds (NRF).

Given that the revenues from commodities or natural resources are often large, temporary and volatile, establishing an SWF facilitates the accumulation of these proceeds when times are good and will help stabilize future public spending when State revenues are insufficient to meet expenditures.

SWFs can have different institutional and legal structures and (e.g. fiscal stabilization funds, development funds and special types of pension funds). In general, SWFs are run by professional investment managers who allocate the funds in foreign assets, hence lowering the risks of a Government liquidating the fund or handpicking specific sectors or firms to direct the money.

Best practice indicates that SWFs need clear expenditure rules, defined separation of powers and transparency in management. By separating powers in the institutional structure of the fund, negotiations that may lead to intertemporal agreements are easier, and they can lead to more efficient expenditure. Successful wealth funds include those from oil-rich States such as the Government Pension Fund Global (Norway) or the Qatar Investment Authority. But smaller funds have also been created in mineral-rich developing States (e.g. Pula Fund of Botswana).

Source: Humphreys and Sandbu, 2007.

sector concerns in Kyrgyzstan about the suitability of local workers and firms, such a programme can only be effective if implemented in parallel with a linkage development policy and training schemes (see below).

Although so-called "resource nationalism" is a trend affecting many other resource-rich countries, the Government should strive to make sure that increased State participation in the exploitation of any deposit that is considered of national interest minimizes future conflict with investors. In this regard, any further changes in legislation should be based on clear definitions of the stakes reserved to the State in mining activities, specifying objective criteria to be applied at the time of granting extraction licences as well as the conditions that may trigger ownership changes.

Aim for a more stable taxation regime. The Government could consider reinstating profit taxation for gold mining in line with international practice (annex 5). The scheme that is ultimately designed should contribute to guarantee sustainable tax revenues, competitive rates and reduced uncertainty for companies.

Consider taking active measures that can tame the impact of commodity price volatility, including the setting up of funds for long-term development. It is suggested that the Government undertake a preparatory study to consider the utility and viability of adopting such a fund in Kyrgyzstan. The study should draw fully upon best international experience and practice as embodied, for example, in the Santiago Principles (IWG, 2008).

Consider setting up a linkages programme to improve the capacity of local firms to become suppliers of MNEs and reduce reliance on imported goods and technologies. Such a programme should focus on the establishment of long-term linkages between domestic enterprises and international mining companies.[83] The programme would include the identification of supplier/buyers through the creation of databases and matchmaking opportunities. The Government may consider embedding these functions within the mandate of the recently created Investment Promotion Agency within the Ministry of Economy, and build synergies with the proposed Empretec programme (see chapter 1). In addition, the programme would also encompass training of consultants and transfer of technology initiatives. Lessons learned by other countries are available in UNCTAD publications (UNCTAD, 2012b), and further technical assistance might also be provided through a specific programme.

[83] Successful linkage programmes require prior capacity-building and upgrading of local entrepreneurs to ensure they qualify for rigorous selection mechanism. They also often involve an assessment of needs and services that existing mining companies more urgently demand to identify sectors where linkages could be developed. Overall, capacity-building for local business associations to be more involved in policymaking through multi-stakeholder consultations is also often a prerequisite.

Table 2.3. Best practice lessons of UNCTAD for sustainable mining

Areas	Lessons
Policy stability	Use multi-stakeholder consultations to create social and political consensus and sustainable mining policies Adjust tax and regulatory policy when necessary, but do so gradually and transparently, taking into account investments under previous regimes
Industry and local enterprise development	Ensure that the concession laws facilitate competitive mine development Assist the efforts of MNEs to develop local workforce and supplier capabilities, and facilitate the development of mining clusters
Environmental and social impacts	Require comprehensive EIAs for project approval and ensure government follow-up on commitments by project developers Implement a legal framework that protects the rights of local communities and ensures their participation in mineral development

Source: Adapted from UNCTAD, 2011.

III. Addressing key institutional challenges for successful investment promotion and retention

a. Context of investment promotion in Kyrgyzstan

Since 2010, the Department of Investment and PPPs within the Ministry of Economy has been responsible, among other issues, for investment policies and promotion in Kyrgyzstan.[84] Key functions of the Department include drafting and negotiating legal acts in the sphere of investment and PPPs, reviewing draft legal acts for compliance with the principles and mechanisms for PPPs, signing of international agreements on the encouragement and mutual protection of investments with other countries, coordinating and monitoring the implementation of activities in the framework of programme grants, coordinating and monitoring the implementation of projects of the Ministry and assessing the effectiveness of the implementation of development programmes financed by international financial institutions and donor countries. With regard to staffing, the Department has 11 professionals (civil servants) – 6 in the investment policy area and 5 to coordinate foreign assistance. These figures are relatively low, given the broad mandate of the Department.

[84] The Department of Investment and PPPs also has a remit for the coordination of official development assistance.

The Ministry receives advice and guidance from the Council for Development of Business and Investment, established in 2010. The main role of the Council is to analyse the investment landscape and issue recommendations to the State organs on possible improvements to legislation (Decree 149 of 2010). In particular, the Council has been involved in drafting amendments to corporate legislation, the Tax Code and legislation on inspections of legal entities. The Council works as a consultative-deliberative body designed to voice investors' concerns. It is chaired by the Prime Minister and includes representatives of the State organs, international development partners and business associations, including IBC, the key business grouping for foreign investors. It also comprises national and local chambers of commerce, among other associations. The Council Secretariat filters through the concerns of the member associations and elevates systemic issues to the meetings with the Prime Minister, which take place on a quarterly basis.

The recent creation of an IPA in Kyrgyzstan is a welcome decision. Although investment promotion dates back to the mid-1990s, the institutional set-up requires strengthening.[85] As a result of policy discontinuities, the

[85] During the 1990s, the State Committee on State Property of the Government of Kyrgyzstan established an investment promotion centre (IPC). This institution existed for several years, during which it published a number of promotional booklets and liaised with embassies and investors. However, it lacked the necessary authority and capacities to implement long-term promotion policies and was eventually closed down due to budget constraints. In October 2009, a new attempt to create an IPA was made with the establishment of the Central Agency for Development, Investment and Innovation, but it was also abolished by the Provisional Government (Decree1

country has lacked a coherent and well-focused national strategy for FDI attraction and retention as well as a stable structure of supporting institutions and partner organizations staffed by dedicated investment professionals. In March 2014, the Government brought forward a regulation for the establishment of a new IPA (Decree 158 on the Investment Promotion Agency under the Ministry of Economy of 2014). The State-funded agency became operational in September 2014. It reports to the Ministry of Economy and is tasked with the attraction and promotion of investment by foreign and domestic investors.

The new IPA will prioritize investment promotion in selected sectors in order to diversify the national economy. It is envisaged that the new IPA will (a) build the international image of Kyrgyzstan (e.g. through the organization of seminars, exhibitions, investment fairs and dissemination of promotional materials); (b) promote investment opportunities and target potential investors; (c) match local companies with foreign investors; (d) create and maintain a database of investment projects of local companies which need finance; (e) develop investment proposals for investors (short summaries, presentations, investment memos and teasers); and (f) promote PPP projects and review the investment proposals of foreign investors to determine their economic feasibility, impact and contribution to regional development. The director of the agency will be appointed by the Prime Minister and granted powers which include developing the structure of the agency and approving the annual plan for its activities. In order to further strengthen links with the investor community it is anticipated that the new IPA will work alongside the Council for Business Development and Investment. It will also become a significant institution to foster public–private sector dialogue as a means to effect changes in policy environment relative to investment.

b. A template for the phased development of the IPA activities

The focus of IPA activities, its scale and scope is expected to increase over time; therefore, it will be necessary to match the legal mandate of the IPA with the country's priorities and available resources at any given time. The proposal that follows is not meant to be a one-size-fit-all template for the Government to follow step by step. Indeed, the stages are very broadly defined (in some cases alternative paths are described) and the Government may feel more or less inclined to emphasize some specific functions over others. Rather, the goal is to present an ordered description of common aspects each promotion function entails. Each of the functions described is a core component of leading IPAs in the world today, and the Kyrgyz authorities will need to observe over time how best to embed them in the changing national context.

Stage I: Functions to be developed during the first two years

Start-up and early development (first two years): A key goal in this phase is to improve investment facilitation, carry out image building and develop an investor-targeting strategy. Already at this stage, the IPA should also establish its role as policy advocate for the improvement of the investment climate. From inception and during the first two years of its establishment, therefore, the new IPA should have the resources and competence to undertake the following core tasks:

Investment facilitation

a) *Dedicated enquiry-handling services for investors.* Proactive marketing can increase both directly and indirectly the number of investor enquiries that the IPA and its partner network will receive. Indeed, investors often use enquiries to test the efficiency and effectiveness of the IPA and of the host country's FDI support network. Setting quality standards (i.e. ensuring that enquiries are fully understood and answered within a reasonable and guaranteed response time) is therefore important in helping to build and reinforce a positive professional image. Moreover, a network-wide enquiry-handling system should be established based on common procedures and protocols that ensure the quality and reliability of information handling. This requires a high level of cooperation across the host country's FDI support network.

b) *Visit support services.* The quality of services supporting country and site visits by investors is important. As a rule, international investors will

of 2010). Since that time, the Department of Investment and Public–Private Partnerships within the Ministry of Economy has been responsible for a unified State investment policy and investment promotion activities.

generate a short list of up to four country options to be visited and will be looking for several site options within each country. Site options are evaluated in terms of overall costs, investor needs and preferences. The timely provision of well-customized intelligence (e.g. on the availability and cost of suitable sites and premises, skills, supplies and services, power (including availability of renewable energy), water, waste disposal facilities, warehousing, transport and communications) is fundamental. Much of this intelligence will come from the IPA project partners.

c) *Supporting investor entry on regulatory issues.* This often starts with the investor's need to obtain all the regulatory approvals necessary for the business. The IPA has a potentially important role in steering the investor through the regulatory approvals process. This will require that the IPA establish reliable and productive relationships with all relevant regulatory authorities. It can also prove helpful if the key regulatory authorities (e.g. on taxation, building approvals, health and safety, environmental protection) are able to send appropriate staff on secondment to the IPA to provide regulatory guidance and advice to investors directly; and to gain a deeper appreciation of the needs of investors and the everyday work of the IPA.

International branding and image building

This involves measuring (through market research) the country perceptions of international investors, deciding upon brand themes and images that will resonate well with potential investors and determining the mix of marketing and promotional activities (e.g. direct/indirect advertising, participation in exhibitions, trade missions) that best ensures key branding and imaging messages are delivered and understood. But creating a positive and distinct international country brand and image can take time, expertise and money. Given that government resources are scarce, there may be benefits in sharing costs with other government departments engaged in international marketing (e.g. in exports and tourism) and/or neighbouring countries engaged in joint initiatives to internationally brand the wider region to potential investors, as suggested for tourism.

Development of an investor-targeting strategy

There is often political pressure on new IPAs to produce fast results and to focus on generating early investment leads. Considering the limited resources available for investment promotion, a focused approach should be followed based on an investor-targeting strategy. This strategy should be directed at sectors and industries that support national economic development objectives, such as employment creation or regional development, and for which the location has a competitive offer for FDI. This Review highlights some of these priority sectors (i.e. regional investors on textiles and garments manufacturing and food processing, as well as leading firms in the high-value segments for tourism). The strategy should define goals and targets, and include marketing activities which detail the approach to target firms.

Investment policy advocacy

It is recommended that the IPA be assigned a clear mandate from the Government to identify problems in the investment climate and recommend remedies. For policy advocacy to be effective, the agency should be in regular contact with investors, public institutions and other stakeholders to collect different views on existing constraints to investment. It should also be proactive in identifying policies that hinder Kyrgyzstan's competitiveness and achieve national development objectives. The stronger the mandate, the easier it will be to secure cooperation and consensus from investment stakeholders with regard to policy change.

Stage II: Functions to be developed beyond year two

Medium-term development: As the business climate improves and higher quality FDI is attracted to Kyrgyzstan, the IPA will need to develop the capacity and capability to undertake additional core functions. These would include:

Implementation of the investor-targeting strategy.

In this phase, the agency should start proactive investor targeting, based on the strategy discussed above. Targeting would focus on specific investor types and specific investor traits (such as capital investment generation, job creation and process upgrading). A key resource for the IPA will be the creation and maintenance of a high-value, business intelligence database of existing" and potential inward investors. In this regard, the agency should also develop and maintain a lead-tracking database to record and track existing and prospective investors. Accordingly, the agency must have the resources and expertise to undertake high-quality research and analysis directly or through work commissioned with third-party experts.[86]

Investor aftercare.

The IPA will need to develop services to support and accelerate the expansion and upgrade plans of investors and to help address regulatory or efficiency obstacles to the development of the investor's business. The aim is to retain FDI and foster reinvestment. Aftercare services can be delivered at different levels, from a reactive approach dealing with inquiries, obtaining permits and other support services, to a proactive strategic approach, in which the IPA helps firms in their corporate development path in the host region. International best practice indicates that aftercare services are best delivered through the establishment of a dedicated team of aftercare professionals using an account manager system, where officials in the IPA are responsible for a group of investors (MIGA, 2003; UNCTAD, 2007).

Institutional strengthening and partnerships

a) *Improving coordination of investment and export promotion activities.* The Government may *wish* to consider developing joint Government functions that both attract FDI and supports exporters. This is an arrangement that some Governments prefer, including Kyrgyzstan's near neighbour and trading partner, Kazakhstan. This option can prove attractive to resource-constrained Governments that wish to avoid the expense of operating two separate organizations. However, the two activities have both common and different features with regard to key variables (e.g. client and support targets, modes of engagement, staff skills and type of business intelligence performed). There are pros and cons of having both joint or split investment and export-promotion activities, and experience has shown that combining the two in a single organization is not a simple task. Indeed, joint investment and trade promotion does not result in automatic synergies and savings. Therefore, there is no best practice on the specifics of the institutional set-up, and even though investment and export support services should be funded and managed as separate operations, specific contexts will determine whether or not there is a need for separate organizations (UNCTAD, 2009c; UNCTAD, 2013c).

b) *The need to incorporate strategic partnerships in the IPA work programme.* The translation of investment leads into realized investment is a complex and challenging process where the IPA has a lead role to play across the public and private sectors. Harnessing the key inputs needed to facilitate an investment project (e.g. skills, sites and property, power, water, waste disposal, transport and regulatory approvals) can be an especially exacting exercise. Accordingly, the core competence underpinning the success of this process is the ability of the IPA to build productive, long-term relationships with key partners. FEZs, for example, represent an important part of the investor proposition that Kyrgyzstan currently offers and the IPA will clearly need to establish a solid framework of cooperation with the FEZ authorities.[87]

c) *The need for the IPA to become a results-based learning organization through monitoring and evaluation.* Considering that investment promotion involves the use of public funds, IPAs need to demonstrate the impact of their activities. Thus, the systematic dissemination of their performance will help illustrate the achieved results. In addition, monitoring and evaluation (M&E) provide a basis for organizational learning through the dissemination of best practices, knowledge generation and innovation. This often involves

[86] For guidance on the types/sources of business intelligence that will be needed by an IPA see https://www.wbginvestmentclimate.org/toolkits/investment-generation-toolkit/module9-step4-substep2_investor-research-strategies.cfm; https://www.wbginvestmentclimate.org/toolkits/investment-generation-toolkit/module9-step2-substep3_workflow-automation-and-interaction-management.cfm, accessed 1 October 2014.

[87] This partnership principle, however, should be extended to all the key partner organizations on whom IPA will rely for support: government ministries responsible for administering tax, customs duties and procedures and all regulatory approvals needed by investors; regional and local authorities; and universities and colleges, research and training institutes, property developers, utility providers, transport and logistics companies, banks and lawyers.

establishing a specialist or focal point in the IPA for evaluation and monitoring. When fully internalized, the lessons from M&E provide a key resource of knowledge and experience that can help improve the overall performance and quality of results of both ongoing and future projects, programmes and strategies (OECD, 2014b; UNCTAD, 2008; UNDP, 2009). A systematic use of monitoring and evaluation by the IPA can also promote a culture of results orientation and transparency across the FDI support network. Over time, M&E activities may bring up the need to reconsider the IPA governance structure. Empirical research (Morriset, 2003) provides a number of insights into the traits of successful IPAs with respect to governance structures. IPAs with strong links to the very centre of Government and with private sector representation on their boards tend to have a better record in attracting investment. IPAs with more autonomous structures (e.g. with a chairperson reporting to a cabinet minister) and freed from overly bureaucratic protocols and internal treasury controls also have greater success. At present, it is recommended that the current structure of IPA promotion in Kyrgyzstan be maintained without adopting a wholly autonomous governance structure for the new IPA. However, this could become an option for the future. Finally, the decision to grant capacities for the review of PPPs in the mandate is not in line with international practice (see above). Thus, the Government should consider removing responsibilities from the recently created IPA and reduce its role to promotional activities.

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Annex 1. A history of Kyrgyzstan's accession to the Eurasian Economic Union

11 April 2011. The Government of Kyrgyzstan decides to initiate negotiations on the accession of the country to the Customs Union of Belarus, Kazakhstan, and the Russian Federation, and the Common Economic Space (CES) of Belarus, Kazakhstan and the Russian Federation. An interdepartmental commission is established to negotiate the conditions of accession (Resolution 150 of 2011).

25 April 2012. The Board of the Eurasian Economic Commission (EEC) (represented by deputy Prime Ministers of the three countries) decides on the establishment of the EEC Working Party on the accession of Kyrgyzstan to the Customs Union (Decision 23 of 2012).

29 May 2014. A decision is made by the Supreme Eurasian Economic Council to approve an action plan (road map) on the Kyrgyz accession to the Customs Union (Decision 74 of 2014). The same day, the Presidents of Belarus, Kazakhstan and the Russian Federation sign the Treaty on the Eurasian Economic Union (EAEU Treaty), which would incorporate the Customs Union and CES to its legal framework after its entry into force on 1 January 2015.

10 October 2014. In Minsk, at a meeting of the Supreme Eurasian Economic Council, the action plan (road map) on the accession of Kyrgyzstan to CES is approved. It takes into consideration the creation of the Eurasian Economic Union (EAEU) and the intention of Kyrgyzstan to become its full member.[88]

23 December 2014. The Supreme Eurasian Economic Council, represented by the Heads of State of Kyrgyzstan, Belarus, Kazakhstan and the Russian Federation sign the Treaty of Accession of the Kyrgyz Republic to EAEU. The following will have important implications for Kyrgyzstan:

- ✓ The Treaty of Accession sets the conditions for accession, including the date of application of the Common Customs Tariff, and the designated order for its entry into force.
- ✓ Its annexes include a specific list of treaties and agreements that make up the Union Law, which will also apply to Kyrgyzstan.
- ✓ Two protocols, specified in the second and third paragraphs of article 1 of the Treaty on Accession, include amendments to the EAEU Treaty of 29 May 2014, as well as transitional provisions for their application to Kyrgyzstan, including for measures contained on certain international treaties.

21 May 2015. The Treaty of Accession of Kyrgyzstan to the EAEU Treaty is ratified by the Kyrgyz Parliament (Law 111 of 2015).

12 August 2015. Kyrgyzstan becomes a fully fledged member of the EAEU after the Treaty of Accession comes into force.

[88] The adoption of road maps is the basis for the harmonization of the national legislation of Kyrgyzstan with EAEU, in particular with respect to activities aimed at equipping border checkpoints and at modernizing testing and laboratory facilities.

Annex 2. Summary of recommendations

What to do?	Why?	How?
1. Strengthen the national and international legal framework for FDI	The Law on Investments does not reflect all the key features of the national regulation for FDI. In addition, definitions of investment-related concepts vary among legislations creating confusion notably with respect to access to land for agriculture and real property for tourism in the Issyk–Kul region. At the level of international policy for investment, there are concerns related to guarantees offered to investors and lack of considerations for sustainable development clauses in treaty making.	1.1 Update the Law on Investment to include all provisions on key features of the national regulation with regard to restrictions and incentives as well as the mandate of relevant institutions concerning investment policies, including the new IPA.
		1.2 Undertake periodic reviews of existing restrictions and incentives to achieve Sustainable Development Goals.
		1.3 Harmonize definitions of investment in all legislation. Use the Law on Investment as a benchmark for other regulations containing references to FDI, especially those that concern investments in agriculture and tourism sectors.
		1.4 Consider adopting an approach for IIA negotiations that is more aligned with sustainable development principles. The IPFSD Action Menu could be used for guidance (UNCTAD, 2015).
		1.5 Consider seeking UNCTAD assistance to improve capacity building for IIA negotiations.
		1.6 Reduce exposure to investor–State disputes.
2. Enhance the general business climate	Although the regulatory framework for business is generally modern, institutional weaknesses and implementation challenges in a number of areas have a negative impact on investment attractiveness and are detrimental to the protection of public interests. Institutional reforms are needed to strengthen the rule of law and the judiciary and anti-corruption bodies. Access to land and obtaining electricity remain difficult. On taxation and border controls, the lack of transparency and inefficiencies hinder formalization and harm export competitiveness. Also, the framework for labour relations is not built on multi-stakeholder dialogue and does not address labour market inadequacies and skills development needs. Finally, poor and inefficient monitoring of environmental performance hampers the achievement of sustainable development objectives.	2.1 Move forward with company operations reforms with the goal of reducing administrative barriers and improve coordination among government entities involved in the investment process. 2.1.1 Increase transparency of administrative requirements and consider UNCTAD assistance to improve business facilitation 2.1.2 Work to make the one-stop shop for company registration under the Ministry of Justice fully operational. 2.1.3 Simplify procedures to access electricity. 2.1.4 Continue reforms to improve access to land.
		2.2 Improve the efficiency of the tax and customs administration. 2.2.1 Move forward with the reform to increase the company revenue size threshold to qualify for VAT exemptions. 2.2.2 Promote the practice of e-filing among taxpayers. 2.2.3 Consider adopting a client charter detailing the quality of service expected from government officials. 2.2.4 Establish an external audit of the State Tax Service and adopt transparency focal points in fiscal collection outposts. 2.2.5 Improve border controls through the UAIS project and consider requesting UNCTAD assistance to improve transparency. 2.2.6 Combat corruption at customs administration.

What to do?	Why?	How?
		2.3 Streamline tax incentives and combat tax avoidance. 2.3.1 Reconsider the contract-based special tax regime and the number of VAT exemptions. 2.3.2 Reduce the use of tax incentives in SEZs and consider transforming them into multiple-facility zones. 2.3.3 Adopt more precise transfer pricing and anti-avoidance rules.
		2.4 Improve labour relations. 2.4.1. Hold regular consultations with trade unions and employers associations to improve labour market conditions and better harmonize university and vocational education with market needs. 2.4.2 Harmonize legislation with ILO commitments on the right to strike and other issues (i.e. child labour and gender). 2.4.3 Improve statistics on labour relations.
		2.5 Facilitate employment of skilled non-resident workers. 2.5.1 Consider substituting the existing quota system by a scarce-skills-list approach that prioritizes sectors where skills are more urgently needed. 2.5.2 Improve transparency of the application process and allocation of the quota. 2.5.3 Consider establishing a skills attraction programme.
		2.6 Enhance efficiency in the commercial justice system. 2.6.1 Enact legislation to reduce the incidence of corporate raiding. 2.6.2 Improve training of judges on commercial justice issues. 2.7 Improve the implementation of anti-corruption policy
		2.7 Improve the emplementation of anti-corruption policy 2.7.1 Bring national legislation in compliance with the United Nations Convention against Corruption. 2.7.2 Improve functioning of anti-corruption bodies and make them accountable to Parliament. 2.7.3 Increase the participation of civil society in anti-corruption strategies. 2.7.4 Improve whistle-blower protection.
		2.8 Improve environmental performance. 2.8.1 Rationalize the legislative framework for EIA 2.8.2 Improve the institutional capacity of environmental authorities 2.8.3. Extend the period of environmental permitting in line with international trends. 2.8.4. Enact legislation on the protection of glaciers.

What to do?	Why?	How?
3. Foster investments in public infrastructure through small FDI projects and PPPs	Improvements in the reliability of electricity supply, as well as road and air connectivity, are a priority to enhance general investment attractiveness. FDI and PPPs could play a crucial role in removing existing bottlenecks affecting public infrastructure.	3.1 Formulate a long-term strategy for the development of the power sector that focuses on exports growth.
		3.2 Work to ensure the independence of the State agency for regulation of the power sector.
		3.3 Promote the long-term development of alternate renewable energy. 3.3.1 Consider setting up incentives for the development of renewable energy. 3.3.2 Adopt policies to increase awareness about energy efficiency among the general public.
		3.4 Adopt measures for an adequate implementation of PPP legislation. 3.4.1 Adopt reforms to harmonize regulations on PPPs across sectors. 3.4.2 Prepare a pipeline of projects in line with a multimodal transport plan.
		3.5 Continue strengthening the institutional capacities for PPPs.
4. Diversify economic activity by attracting FDI into selected industries such as garments and textiles, agro-industries, and tourism	Kyrgyzstan should aim for a mix of FDI projects that could contribute to bolster growth and foster sustainable development. Investments in garments and textiles, agro-industries and tourism are known to have significant potential for job creation, direct poverty reduction and transfer of knowledge to local firms. They should receive priority attention for investment promotion.	4.1 Prioritize targeting mid-size FDI in garments and textiles from the region. 4.1.1 Set up a working group to identify key segments and undertake market intelligence in cooperation with the IPA. The group should also assess the implementation of the programme for development of the textile and garment industry of the Kyrgyz Republic in 2013–2015. 4.1.2 Assess opportunities for promoting FDI in man-made fibres. 4.1.3 Consider adopting an incentives scheme for technological upgrading. 4.1.4 Consider seeking UNCTAD cooperation to promote entrepreneurship.
		4.2 Devise strategic targeting in food processing for segments with competitive advantages (i.e. dairy products, fruits and vegetables). 4.2.1 Consider removing restrictions to foreigners leasing of agricultural land and creating a land bank to allocate specific plots to foreign investors. 4.2.2 Develop an action plan to improve product standards including measures to increase the availability of vaccines and veterinary services and the certification of organic agriculture. 4.2.3 Undertake initiatives to empower local producers (e.g. prepare a model contract based on PRAI principles). 4.2.4 Seek synergies with tourism development (4.3) to approach new airlines to increase flight frequency to Europe and East Asia and negotiate the availability of cargo space for dried food exports. 4.2.5 At the intergovernmental level, international agreements on technical regulation and standardization should be signed with the aim to directly apply in Kyrgyzstan the technical regulations of EAEU countries.

What to do?	Why?	How?
		4.3 Promote niche markets in ecotourism, cultural and adventure tourism, while maintaining and promoting the image of Kyrgyzstan as a country favourable for leisure and business tourism. 4.3.1 Draw up a tourism development plan and reform the legal and institutional framework for the sector in line with the plan. 4.3.2 Set up better channels to communicate with tourism stakeholders by establishing a national tourism board. 4.3.3 Prepare guidelines for sustainable tourism investment to be applied in rural areas. 4.3.4 Engage in joint promotion with regional partners, including through PPPs. 4.3.5 Work to establish and develop direct air connections with a number of foreign countries from/to the airport in Issyk–Kul.
5. Enact policies for sustainable mining and linkage development	The expansion of mining activities has been subject to major controversies involving overall governance challenges, environmental protection and social issues. In order for this sector to become a pillar of growth, contribute to sustainable development and generate needed tax revenues to foster economic diversification, a series of measures are needed concerning licensing, fiscal policy, community consultations and linkage development (for environmental protection, see 2.8).	5.1 Move forward with reforms to increase transparency in licensing. 5.1.1 Set up objective conditions for the selection of licence winners. 5.1.2 Consider introducing technical and financial capacity requirements on applicants to address passive speculation.
		5.2 Expand the regime of expert examinations for extraction licences comprised in the Law on Subsoil to include community consultations.
		5.3 Include the need of community development programmes at the time of evaluation for the granting of extraction licences.
		5.4 Ensure that further changes in legislation on the stakes reserved for the State in mining activities are based on clear definitions. These should specify objective criteria to be applied at the time of granting extraction licences as well as the conditions that may trigger ownership changes.
		5.5 Aim for a more stable taxation regime.
		5.6 Consider taking active measures that can tame the impact of commodity price volatility. 5.6.1 Consider setting up funds for long-term development (e.g. SWFs)
		5.7 Consider setting up a linkages programme to improve the capacity of local firms to become suppliers of MNEs and reduce reliance on imported goods and technologies.
		5.8 Consider drafting a mining code that provides comprehensive regulations for the sphere of subsoil use.

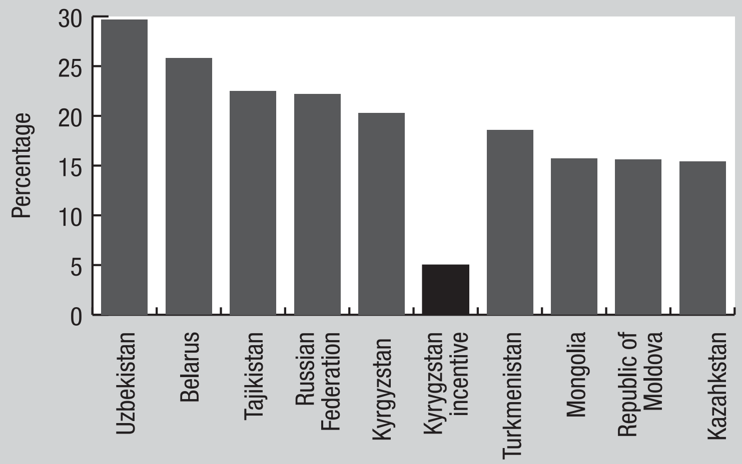
What to do?	Why?	How?
6. Build institutional capacities for investment promotion and adopt a plan for the phased development of IPA functions	The newly created IPA will have a central role to play in setting up investment attraction goals at the general and sector-specific levels. A plan for the phased development of its investment promotion functions is proposed.	Provide appropriate funding for the phased development of the IPA functions (see 6.3).
		6.2 Reconsider the responsibilities for the review of PPP projects granted to the IPA.
		6.3 Move forward with the phased development of the IPA. 6.3.1 Functions to be developed between years one and two: • Investment facilitation • International branding and image building • Development of an investor-targeting strategy • Investment policy advocacy 6.3.2 Functions to be developed beyond year two: • Implementation of the investor-targeting strategy • Investor aftercare • Incorporating strategic partnerships

Annex 3. Comparison of tax regimes in selected industries

The UNCTAD tax methodology is a useful tool to compare countries' taxation regimes. It measures the amount paid in corporate taxes as a percentage of the total cash received from the project by a foreign investor, in net present value terms (see annex 4 for more details on methodology). When applied to three industries (i.e. agro-processing, manufacturing and tourism) in Kyrgyzstan, comparisons with countries in the region or competing locations for the selected industries, the model gives the results below.

In the agro-processing sector (figure A.1), the present value of tax as a percentage of the project cash flow (PVT) is 20 per cent in Kyrgyzstan. This is substantially lower in comparison with Uzbekistan or Belarus but moderately higher than Turkmenistan, the Republic of Moldova and Kazakhstan. However, when considering the incentives of the special economic zones, PVT decreases by three quarters to 5 per cent.

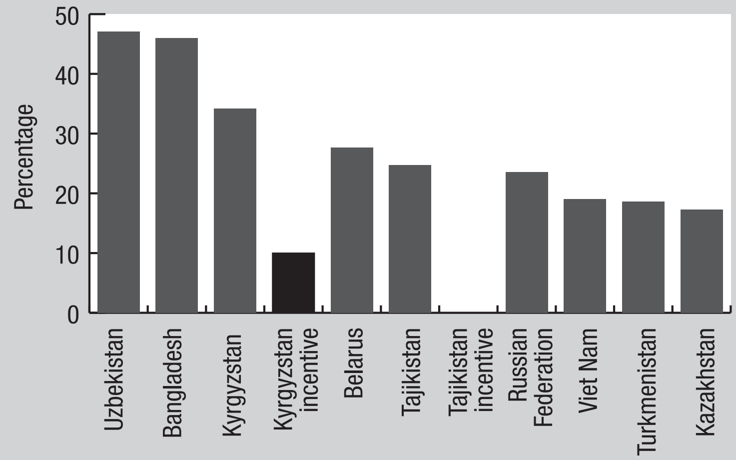
Figure A.1. Tax burden in the agro-processing industry



Source: UNCTAD.

The tax burden in the Kyrgyz manufacturing sector (figure A.2) is relatively high at 34 per cent; and makes it less advantageous than most of the countries in the sample, except for Uzbekistan and Bangladesh. Although the latter is a major textile and garment producer, it is however not a direct competitor in CIS markets. Belarus, Tajikistan, Turkmenistan, the Russian Federation and Kazakhstan have more competitive regimes. This is due to a large extent to less favourable depreciation rates in Kyrgyzstan. Only when applying the incentives given by the FEZ regime does Kyrgyzstan become a competitive regional location; with the present value of the tax set at 10 per cent.

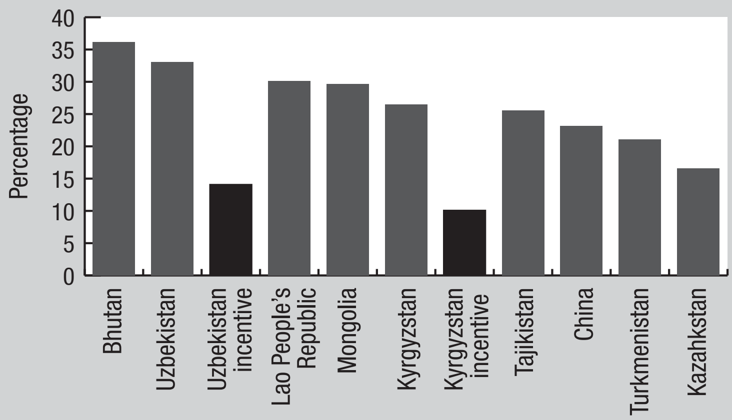
Figure A.2. Tax burden in the manufacturing industry



Source: UNCTAD.

Finally, tourism represents a case of relative competitiveness. Figure A.3 shows that the Kyrgyz tax burden of 26.5 per cent is at the median level of the group of countries, all of which are in Asia and some also within the Silk Road region. When applying the incentives of the special economic zones regime, the present value of tax falls to 10 per cent, the lowest in the group, although this advantage is irrelevant if investments are sought in remote rural areas.

Figure A.3. Tax burden in the tourism industry



Source: UNCTAD.

The analysis shows that from a fiscal point of view, the country overall remains advantageous even without applying FEZ incentives. In the long term, there seems to be a certain rationale for gradually removing and transforming this type of targeted incentives in line with suggestions included in chapter 1. In the case of tourism, authorities should also seek regional cooperation with other Silk Road taxation and promotion authorities to avoid a race to the bottom on the setting of general tax rates, as there are mutual advantages of joint promotion. Finally, in the case of manufacturing, the existing rate is more clearly uncompetitive. Although accession to the Customs Union will create pressures against a rapid removal of incentives, especially from garment manufacturers in special economic zones, it is also important to target a more competitive regime beyond FEZs. A shift towards a more tax-friendly regime for capital intensive industries in light manufacturing could be considered, as suggested in chapter 2.

Annex 4. Methodology of international corporate tax comparisons

Taxation affects the cost of investment and its profitability, and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed, rates of capital allowances (tax depreciation), availability of tax credits, investment allowances and tax holidays, loss-carry-forward provisions and taxation of dividends. Together, these make up the overall fiscal regime that affects the cost of and return on investment.

The UNCTAD model uses hypothetical business plans in selected sectors and enables international comparisons on a comprehensive and objective basis, going well beyond simple comparisons of headline corporate income tax rates. The modelling is based on projects fully financed by a foreign investor, which means that withholding taxes on dividend payments abroad play an important role, in addition to income taxes paid at the company level.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner that facilitates comparison between countries. The tax variables included in the analysis are as follows:

- Corporate income tax;
- Rate of tax including tax holidays, if any;
- Loss-carry-forward provisions;
- Capital allowances, investment allowances and investment credits;
- Tax on dividends.

VAT, sales tax and import duties are not considered in this analysis.

Financial models of project investment and financing, revenues and expenses are utilized for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Kyrgyzstan and the chosen comparator countries for each sector are applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor, assuming that the company pays out all residual profits after tax (100 per cent dividend payout) and that the investor gains the residual value of the company, which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the present value of tax (PV tax percentage). PV tax percentage is the total of taxes collected by the Government over the 10 years as a percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10 per cent per annum. PV tax percentage thus measures how much of an investor's potential project return is taken by the Government in taxes and duties. The higher the PV tax percentage, the more the fiscal regime burdens investors and reduces the incentive to invest.

Annex 5. Taxation of mining activities

Box A.1 presents the key aspects of taxation of the mining sector in Kyrgyzstan. Gold mining activities deserve particular attention for which a new fiscal regime was approved and came into force on 1 January 2013. The replacement of the standard corporate tax (based on profits) for a revenue-based corporate tax based on a sliding scale is a key feature of this new regime. The applicable rate has 14 bands and increases with the price for a troy ounce of gold. The tax base is the combined sales and non-sales income (e.g. interest income, dividends, royalties, forex gains, rents, subsidies) for the earnings received. In addition to revenue taxation, the Government also levies a sales tax on gold exports, which acts de facto as an additional royalty tax for most companies engaged in gold mining activities.

Because one of the specificities of the gold mining sector is that the production costs grow significantly in the early phases of production, the imposition of a tax on revenues regardless of profits may substantially reduce the profitability of companies in the short run, especially small and medium-sized companies. In the long term, the Government could aim at creating more uniform tax rates that increase predictability. Changes may include creating a more homogenous royalty tax and regulations for current non-tax contributions implicit in State contracts and production-sharing agreements. The Government could also consider improving consultation mechanisms with all stakeholders involved before adopting tax rate changes in the future.

Box A.1. Key aspects of the tax regime for mining in Kyrgyzstan

- All licences are subject to a one-time bonus payment, which is negotiated on a case-by-case basis and is based on the deposit size (overall it has been deemed to be high by investors). A change in ownership of 10 per cent or more of a private company holding a licence will also trigger the payment of a bonus (the calculation is proportional to the change in share ownership). This does not apply to companies listed on a stock exchange.
- Royalty: different rates apply. For gold, silver, and platinum, it fluctuates between 1 per cent and 5 per cent of sales depending on the size of the deposit.
- Sales tax: 2 per cent of revenue for gold exports.
- Other taxes: All licence holders are subject to the standard corporate tax (except for gold) sales tax, property tax, land tax and social security contributions. Export taxes may be levied on certain subsoil resources sold abroad.
- For gold mining: Since 2013, a new revenue-based tax applies (replacing the standard corporate tax). The percentage is calculated every month based on the average world gold price for the month. The applicable rate has 14 bands and increases with the price for a troy ounce of gold. This ranges from 0 per cent (when the gold price is at or below $1,201 per ounce) to 20 per cent (when the gold price averages at or above $2,50 per ounce).
- Licences obtained through tenders for fields of national importance may be required to pay social package contributions to local communities pending secondary regulations.
- The use of stabilization agreements is envisioned in the Law on Investments (2003) but it has not been regulated.
- The State may engage in production sharing agreements or concessions that involve non-tax payments, but there is no uniform legislation regulating these conditions.

Sources: Tax Code, Law 158 of 2012, and Mining Strategy of Kyrgyzstan.

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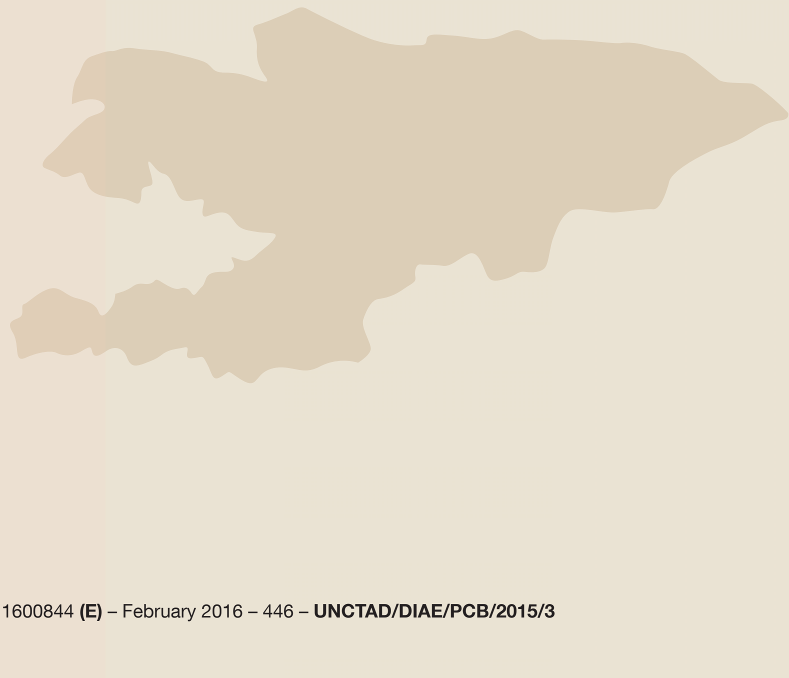

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