

# **A STRATEGY FOR THE ENCOURAGEMENT OF FOREIGN INVESTMENT IN THE KYRGYZ REPUBLIC**

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## **Abstract**

The Comprehensive Development Framework (CDF) of the Kyrgyz Republic indicates clearly the desire and the need to attract additional direct foreign investment to the country. The need for foreign investment is for at least two reasons. First, it is needed to improve the efficiency and competitiveness of the Kyrgyz economy through the introduction of new technology, management know-how and access to external markets in order to stimulate economic growth. Second, it is needed to provide the financial investment in order to help offset the reduction in the level of public investment needed to facilitate macro-economic stabilization and ease the public debt service limitations facing the government

To realize this goal it will require a systematic and organized effort on the part of the government. The factors that are important to direct foreign investors vary considerably given the nature of the activity the investor wishes to engage in. For the purposes of designing appropriate policies it is useful to divide these activities into four general classes. Some of the factors that are important in the design of policies to attract each of these types of foreign investments are reviewed in this paper.

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# **A STRATEGY FOR THE ENCOURAGEMENT OF FOREIGN INVESTMENT IN THE KYRGYZ REPUBLIC**

## **I. OVERVIEW**

The Comprehensive Development Framework (CDF) of the Kyrgyz Republic indicates clearly the desire and the need to attract additional direct foreign investment to the country. The need for foreign investment is for at least two reasons. First, it is needed to improve the efficiency and competitiveness of the Kyrgyz economy through the introduction of new technology, management know-how and access to external markets in order to stimulate economic growth (CDF, section 3.7). Second, it is needed to provide the financial investment in order to help offset the reduction in the level of public investment needed to facilitate macro-economic stabilization and ease the public debt service limitations facing the government (CDF, Section 4.3.5).

To realize this goal it will require a systematic and organized effort on the part of the government. The Kyrgyz Republic has some attractive features, the primary ones being a well educated labor force, mineral deposits, and spectacular natural beauty, however, the quality of many of the institutions that foreign investors need are not as high as many of the other countries that are also competing for this foreign investment.

The factors that are important to direct foreign investors vary considerably given the nature of the activity the investor wishes to engage in. For the purposes of designing appropriate policies it is useful to divide these activities into four general classes. First, there are investments in the natural resource sectors, including mining, petroleum and forestry. The output of these activities are primarily of an export nature. Second, there are those activities that are primarily focused on the domestic market. The most likely types of such activities are of a public-private partnership nature, including electricity, water, roads, and other types of supply of public sector infrastructure services. Investments such as hotels and facilities for the tourist sector could also be included in this investment category. Third, there are direct foreign investments in the manufacturing sector that are focused on the export markets. Fourth, there is the high technology services sector, that is likely to be focused primarily on the production of computer software.

Some of the factors that are important in the design of policies to attract each of these types of foreign investments are reviewed below.

## **II. Foreign Direct Investment in Natural Resource Industries**

This area of direct foreign investment has dominated the total amount of foreign investment made in developing countries for many years. In some ways it is the easiest to obtain, because the country has something very unique to offer, undeveloped natural resource bodies.

This sector typically requires huge initial investments to be able to extract the resource, and will need to operate for many years to recover the initial investments. As these industries sell a rather homogeneous commodity that is widely traded in world markets, they are subject to a high degree of risk associated with the price of the commodity over time. In addition, because each resource body is unique, it is usually subject to considerable uncertainty as to its total size, hence difficult to value in a way that the residents or government of a country can understand before operations start. Hence, there is always considerable political risk that might reduce the expected return of the investment to the foreign investor.

Generally foreign mining companies are highly efficient in this management of geological and market risk. They are highly vulnerable, however, to all kinds of political and fiscal risk. One of the primary sources of such risk is caused by changes in taxation or environmental laws during the time of the operation of the mine. It is important that the government figure out what they want to achieve in these areas and specify them clearly in the concession or contract of work agreement, and be prepared to live with these rules throughout of the life of the agreement.

We recommend that the Kyrgyz government develop a model concession, joint venture, and contract wishes to work agreements that fit what they it wants to achieve in terms of its policies, if it invite foreign investors into these areas. It needs to narrow the number of parameters it has to negotiate when arriving as such an agreement. It needs to be very clear about what are the list of items that are the company's responsibilities and what are the government or state enterprise's obligations. An appropriate arbitration procedure needs to be agreed upon in the event of disputes.

At the present time one of the major problems facing natural resource companies is that there is a proliferation of inspectors and authorities that can stop, or in some way influence, the way the natural resource enterprise is operated. Too often the prime motivation is personal financial gain, rather than the welfare of the country. This is costly to the country because as political risks are increased, the foreign investor's actions might also create a situation to create a divergence between what is financial prudent for the operator and what is good for the country.

It is recommended that the country review its mining laws and code to see that they are consistent with modern international practice in these areas, and with the economic and political objectives of the government.

An important contribution the government can make to the success of attracting foreign investor to this sector is to train a number of key staff in the negotiation of these types of agreements and in their important aspects. This training has proven to be highly valuable to many countries, developed, developing, and transitional.

### III. Foreign Direct Investment in Infrastructure

In recent years, governments around the world have once again invited foreign investors to come assist them in the provision of infrastructure services to their residents. This follows a period of about 30 years after most foreign investments in these sectors were either nationalized, or these companies were otherwise driven out the countries where they owned infrastructure assets.

The primary reason for turning once again to foreign investor participation is that these companies are able to operate these services producers at a vastly improved level of efficiency. They often are able to reduce the costs of the service to the consumer, improve the service, and make a profit. In addition, they can internationally mobilize large quantities of capital needed for such investments, perhaps much more efficiently than can the government. At the same time, if various risks are imposed on them, they will insist on being compensated for the cost of this risk, in the contract or agreement that is made. In order to reduce the political risk associated with such investments many of these activities are being structured as public-private partnerships, rather than as private regulated monopolies. Still the record is one of some successes, and many failures.

The nature of the contract and/or regulatory framework is critical to the success of such arrangements. This is an area where a quantitative stakeholder analysis is critical before the project is initiated. The government needs to be involved in providing the proper type of regulation, or as a business partner throughout the life of the agreement with the foreign investor. In these types of activities, political risk is always costly to the country. The foreign investor will charge more for the capital and technology the higher is the political or administrative risk it faces.

Such agreements usually involve many different stakeholders in addition to the government and the foreign investor. The international banks, multilateral financial institutions, suppliers of inputs (eg fuel) all will need to understand how their outcomes are affected by changes in the values of the input, output or operating variables over time.

The government needs to train its key staff in the analysis of such public-private partnership investments, including the key issues of project financing and regulation that are relevant to the sector under consideration. Such training of the governments negotiation team often reduces the number of misunderstandings, and reduces the costs to the country of obtaining these foreign investments and the technology that comes with it.

Such agreements are only as good as the legal structure of the country is able to enforce the agreements. In many situations it might also be advisable to train the judiciary in some the relevant aspects of such public-private partnership agreements.

#### IV. Foreign Investment to Stimulate Manufacturing Exports.

For these kinds of activities, the efficiency of the country's infrastructure in terms of transportation, communications, electricity, and its public institutions such as its customs service and banking infrastructure is very important. In addition, the quality and cost of the available labor force is critical. There is overwhelming evidence that these factors are much more critical than are the kinds of income tax incentives provided by the government.

At the present time the Kyrgyz Republic has a well educated and relatively inexpensive labour force, but it is in a comparative disadvantageous position with respect to many of the other variables, particularly those dealing with customs and tax administration.

When a country is internationally competitive with respect to labor and infrastructure costs, it still must get its fiscal system operating properly. To the degree possible exporters should not have the burden lured on them of either domestic indirect taxes or import duties on inputs.

Given the level of compliance costs caused by the customs and tax officials and other inspectors, it is might be advisable initially to give foreign investors of any genuine manufacturing activities a complete holiday from most taxes. While not a long term solution, it might also be necessary to place these activities initially inside free trade zones, or at least bonded factories. Without this level of protection from the inefficiencies of the bureaucratic, it is going to be difficult at this time for foreign investment dealing with manufacturing exports to operate in the Kyrgyz Republic.

Free trade zones are neither a long-term or efficient solution for attracting foreign investors. However, when the country and its administration is not able to deal with foreign business and provide the kind of services they need, and in the manner that is required by these investors, then the location of foreign export business in export processing zones with a special dedicated administrative structure, is a good way to get started. The primary reason a foreign business operator would come to such a zone is to be able to use abundant, educated, and cheap labor.

The recommended path to follow is for the government to also set up a duty exemption scheme and a bonded factory or bonded warehouse scheme to compliment the export processing zones.

In what follows is the description of the types of institutions that might be useful for the Kyrgyz Republic to consider as ways to facilitate foreign investments that wish to engage in manufacturing export activities.

## **V. Relief from the Burden of Trade Taxes on Imports for Exporters**

### **Conceptual Framework**

Experience has taught us that the expansion of manufacturing exports is one of the most important vehicles for economic growth in developing countries. To be successful in international markets, exported goods must be competitive in terms of both quality and price. In order to achieve this objective, governments should pursue a general policy to ensure that their exported goods and services are also free of indirect domestic and trade taxes.

To ease the administration costs of the system of import duties, we recommend that a single rate of import duty be imposed on all imported good, both inputs as well as finished goods. This would also greatly ease the burden of removing the burden of import duties paid on any imported inputs used to produce exports.

To do this, as it was also recommended, the government must either exempt or refund the import duties imposed on business inputs through the VAT. This would, in effect, remove the tax burden that is embodied in the cost of inputs used to produce exports

In theory, imported machinery and equipment, if they are to be used in the production of exports, should also obtain a refund of import duties paid in the same manner as raw materials. Since capital goods are often used to produce both taxable (including exported and domestically taxable goods) and exempt products, the government may find it cumbersome to separate the two uses in order to estimate the correct amount of rebate. In addition, manufacturers use capital goods over a long period of time and it is very difficult to forecast whether firms will continue using the capital items to produce for export into the future. Again the complexity of calculating the portion of import duties levied on capital goods used only in the production of exports is likely to makes a system of refunded cumbersome.

### **Alternative Schemes and Operations**

The objective is to provide relief from import duties on inputs only to those firms producing goods (and sometimes services) that are being sold abroad. It is also very common for some firms to simultaneously produce goods for sale in the domestic market. The government should tax this type of firm on the imported inputs used to produce the goods sold domestically in the same manner as they tax imported inputs used by firms producing solely for the domestic market. Otherwise, an unequal treatment will occur.

To facilitate an efficient administration of the VAT system and to protect the government revenue, registrants are required to maintain records to substantiate their entitlements for the taxes paid on the purchase of raw materials and intermediate inputs used in the production of taxable supply. In other words, registrants must provide to the tax authority a satisfactory invoice or other document reporting taxes paid on business inputs.

In administering either the duty draw back or exemption system, it is important for the government to develop computerized records of imported inputs and export sales. With this system, the proper accounts and records in terms of import duties payable and drawbacks claimed must be well maintained. In addition, the importer should be required to supply as a guarantee government bonds or securities issued by a financial institution in the amount equal to the duty payable. The interest rate associated with these bonds or securities should be payable to importers. This would minimize the cost to importers as well as protect the tax revenues for the government. It is generally advisable for Customs to administer this system, as they are the organization that should have the necessary import and export information. Alternatively, this system can be privatized through the purchase of the services of a pre-shipment inspection company or a company providing such services.

Several alternative approaches have been undertaken to deal with this issue of relieving import duties. Below we will briefly discuss some of these approaches.

### **Duty Drawback System**

The duty drawback system is the classical and the most common method of providing relief from import duties imposed on goods used for the production of exports. Virtually all countries that provide incentives to export-oriented firms have a duty drawback system. Because the duties are paid upon importation, importers, exporters, or manufacturers of exported goods may claim refunds. In general, firms must meet several conditions before the government can refund duties. First, the firms have to paid the import duty in cash. Second, the firms have to export the final products. Third, the amount of duty drawback is based on the amount of duty paid on imported inputs used in the total production of the exports destined for the foreign markets. The imported goods eligible for duty drawback are usually only raw materials. Sometimes the list of eligible inputs may be extended to include fuel, packaging materials, machinery and equipment.

Similarly, domestic manufacturers who produce goods and services used by exporters should also be eligible for the duty drawback on the tariffs they pay for imported inputs. These producers are a kind of indirect exporter, and a question arises as to the number of prior stages of manufacture before the final agent should be allowed. Korea, Taiwan, Mexico and Kenya are all examples of countries, which have allowed indirect exporters to claim duty-exempt imports. The most difficult issue becomes calculating the refund on import duties to indirect exporters. In the case of Taiwan, a sophisticated input-output coefficient was developed and calculated for each line of production. This ensured the precise amount of hidden tax in the exported goods but it was undoubtedly cumbersome and the government had to employ a great number of personnel to deal with this program. In the other extreme for the sake of simplicity, Kenya had adopted a single fixed coefficient for all goods. But inequities among goods became obvious and it was eventually forced to change its system.

Corruption is a universal theme surrounding the administration of a duty drawback system. The nature of the problem that a duty drawback is supposed to address, and the administrative procedures it entails, incubates corruption. There are several reasons for this. First, when the goods are first imported, there is no information recorded by the Customs Administration that these items will be used to produce exports. Hence, in most countries, Customs will not be able to trace the actual import entry of the items that are embodied in the exports. Generally, the duty drawback administration will have to rely on customs documents that the exporter provides at some later date. Here there is an opportunity for the exporter, perhaps with the collusion of some customs officers, to exaggerate the amount of duties actually paid on the imports.

Second, only the exporters know the quantities of materials used in the production processes. Due to differences in models, sizes, and quality of the items being produced, the duty drawback administration will have to either take the exporters values for the inputs used, negotiate the quantities, or specify arbitrary (and usually inaccurate) input-output coefficients for each item produced. These input-output coefficients are derived on an ad hoc basis through a process of negotiations between the producers and customs officials in the audience of a few engineers.

In the industrialized countries, the solution to the above two problems is to have a system of professional audits of the books and records of the exporting firm, combined with sound technical information on the manufacturing processes. Unfortunately, the usual recommendation of exports from advanced industrialized countries is not to put in place a detailed auditing system for the duty drawback administration in developing countries implementable. Developing countries do not have the available professional auditors, nor is the government able to pay wages competitive with the private sector for such skills. Even if they could obtain professional auditors, they would most likely be needed in areas of greater priority. When one finds professional auditors working in the duty drawback area, it is often because they are attracted to the area by the amount of bribes they expect to receive.

The third reason for the failure in implementation of duty drawback systems is because there is a great reluctance on the part of Customs to return the duties paid.

The revenue administrators, and especially Customs, have no incentive to refund duties in a timely fashion, since refunding this money makes it harder for them to meet their revenue targets. As a consequence, many governments do not treat duty drawbacks as a reduction in revenue, but as an explicit expenditure item in the budget. Unfortunately, this procedure puts the duty drawback refunds under the same constraints and uncertainties as all other discretionary budgetary expenditures.

Due to the likely disputes over the amounts of drawback refunds that are to be properly refunded, and the risk of error that might prove embarrassing to the administration, the usual reaction is to delay payments. In order to overcome the reluctance of the bureaucracy to actually make the refunds legitimate, exporters make side payments to the duty drawback administrators in practically every developing country in the world. Once

the payment of bribes by legitimate exporters becomes a “normal” operating procedure in order to obtain tax refunds, then the administration of the duty drawback system usually becomes an arbitrary process. All aspects of the duty drawback refund system, from the amount of inputs used, the amount of tariffs paid on the imported input, and the amount of goods actually exported, is subject to the influence of bribes and negotiation.

### **Duty Exemption System**

Sooner or later, as the compliance costs mount, it becomes obvious that the duty drawback system is not an effective way to relieve exports from the duties paid on their imported inputs. As a consequence, other ways of providing duty relief need to be substituted for a duty drawback system. A common characteristic of these alternative methods is for the exporter to make no payment to Customs at the time the imports initially enter the country and none are refunded later.

In the duty exemption schemes, the government sets up an account-offset system so that import duties can be held in suspense as a liability. The liability is then cancelled upon export. Because the specific importer accounts for the liability, the importer himself can only claim the account-offset. Usually, an importer shall apply for a record of accounts with the Department of Customs. Upon the exportation of the finished products, the refundable amount is credited to the payer’s account.

Both the duty drawback and the exemption systems operated concurrently in Taiwan, but the exemption scheme has been the instrument that has been more important since the 1970s. This is also the case in Malawi where the duty drawback program did not work well because the government delayed refunding the import duties and surtax imposed on imported and domestically purchased inputs, creating a cash flow problem.

With the duty exemption system, the administration’s problem of determining what has been imported, and what duties have been suspended, is usually solved by the normal entry procedures of customs. The abuse of the system comes when exporters have not exported the goods produced by the inputs and at the same time are not voluntarily prepared to pay the duties that were suspended. To prevent this form of tax abuse under the suspense system, the importer is should be required to supply the government with a guarantee. Common forms of such a guarantee are the purchase by the exporter of government bonds or negotiable securities approved by the Ministry of Finance, or bank drafts issued by a financial institution in the amount equal to the duty payable. In this way, the government is assured of receiving the revenues it is owed, while at the same time the firm will receive an interest rate on the amount of funds it invests in government bonds. Alternatively, if the firm purchases a bank guarantee, usually a percentage each year of the amount of the guarantee, it will incur its cost but it does not need to make the entire cash outlays needs to purchase the financial asset. This was the system undertaken in Taiwan and became very popular especially with large businesses.

In Mexico, the exemption system was adopted but it was widely abused because initially there was no requirement for bonds or bank guarantees. As a result, the government of

Mexico introduced a system of Customs Bank Accounts in 1999. Under this new system, the direct and indirect exporters are required to deposit an amount of funds equal to the taxes under suspense in interest bearing accounts in banks. The Customs Authority will release the funds back to the firms upon approval of claim for duty remission on the inputs used to produce exports.

Corruption has been much less prevalent in the duty exemption systems. This is due to the fact that a record of the transaction is captured by Customs for the purpose of the duty exemption system, right at the point when the imported inputs enter the country. When an accounting entry is made by both the firm as well as the customs system at the beginning of the process, without money having to change hands, what is being imported and for what purpose becomes much more transparent. Often the duty exemption is given only if the firm already has an export order for the items being produced. The interest bearing bank deposits or guarantees reduces the incentive for the private exporters to pay bribes to the administration officials. At the same time, the involvement of the banks that are often working with the businesses in much more important ways, such as the financing of firm's investments, reduces the incentives for the firm and the government officials to engage in corrupt practices. Simply put, the duty exemption system drastically reduces the power of the government officials over the resources of the firm, and also reduces the financial stakes for the firm and its incentive to pay facilitation payments.

### **Export Processing Zones**

Use of export processing zones (EPZs) to promote export has played a very important role in many developing countries around the world. For example, they were particularly important in Sri Lanka, Taiwan, and Dominican Republic. Some countries have used them successfully but not all.

EPZs are a type of free trade zones established to process goods for exports exclusively. The zones are usually located in the vicinity of harbors or other forms of international transportation. A physical wall to ensure that goods will be taxed when leaving the tax-free zones areas for domestic markets surrounds them. The administrative operations in this bonded area are theoretically simple, straightforward and all trade-related activities can be handled in the zones. As such, foreign investors do not have to deal with the domestic bureaucracy's specific regulations, rules, foreign exchange transactions, etc. and thus business transaction costs are greatly reduced.

With the EPZ, no import duties are levied on materials and other intermediate inputs, or on any are equipment parts and components used to produce exports within the EPZ. The EPZs in Taiwan and the Dominican Republic are regarded as being successful, and important vehicles for promoting exports. It is important to note, however, that the share of total exports from Taiwan that originated from the EPZs, only reached a peak of 9 percent once in the 1970s. Thus other institutional arrangements to provide duty relief, such as its accounts based duty exemption system, has been much more important in the promotion of exports.

It is also interesting to observe what has been happening in Kenya with respect to EPZs. Although they have been built at great expense they have been characterized by excess capacity. The fundamentals of international trade such as the small size of the regional Common Market for Eastern and Southern Africa, inadequate infrastructure in Kenya, and appreciation of the domestic currency and rising labor costs, have kept international trade flows much smaller than anticipated.

In a situation where a country has very high tariffs, inadequate infrastructure for modern industries to function, and a full blown rent seeking bureaucracy, the use of EPZs are often the only way that reform minded policy makers can get an export oriented growth strategy started. However, the traditional concept of public sector EPZs with their high fences and customs officials riding trucks going in and out of the premises is an idea whose time is quickly passing. EPZs are expensive to build and usually only serve well the needs of footloose industries, such as garment and shoe manufacturing, and some forms of electronics. They also make it expensive for local manufactures to get into the business of exporting if they have to relocate their export manufacturing activities to the EPZ in order to get themselves free of indirect taxes and a rent seeking bureaucracy. With the rapid fall in the cost of information technology and accounting systems, the bonded factory or warehouse that is not tied to a specific location seems to combine the best features of the EPZ and the duty exemption schemes.

### **Bonded Factory or Warehouse**

Unlike the EPZs, the customs bonded factories or warehouses can be set up anywhere at the convenience of the producers. The functions are essentially similar to those of EPZs so that the bonded factory can reduce congestion in the EPZs and also offer some flexibility for firms to be close to resources used in their production. However, unlike the EPZs, the bonded factory is usually allowed to get imported raw materials and intermediate inputs duty free. The government levies on equipment or parts used for maintenance of the factories. This is due to the dual function of such production facilities.

To reduce the level of fraud caused by the selling of duty free imported inputs out of the bonded warehouse, it is usually necessary for the firms to post some type of guarantee bond, or bank guarantee or government security. In some countries, the firms that have a clean track record are allowed to post only a promissory note with collateral. In such cases cars and trucks owned by the consumers makes excellent collateral.

Although the bonded factories were set up for exports, the products may also be sold to domestic customers. When this occurs, the factories in countries such as Taiwan are required to pay duty only on the imported materials used to make the goods sold domestically. This places the bonded factories on an equal footing with other domestic manufacturers. Because these firms are able to be competitive enough to export these items, the prices of goods sold on the domestic market will tend to get bid down to their fob prices, plus the tariffs paid on imported inputs.

Korea and Kenya's system for equalizing the playing field is very different. Instead of disallowing tax exemption for imported materials, Korea and Kenya impose final goods tariff rates on any of the final products sold in their domestic market. This provides these firms with the same level of effective protection as a pure domestic supplier selling in the local market. As a consequence, the economic efficiency cost of domestic protection is much higher with the system used in Korea and Kenya as compared to the system used in Taiwan.

The bonded factory is a self-administered system. In order to function properly, each factory must have comprehensive accounts for materials, finished products and information on the amount of materials required to produce each finished product per unit. Imported materials taken out for the manufacturing process need be carefully monitored. The system operates in such a way that detailed records of the quantity of imported materials are kept. When the firms export finished products, they reduce the corresponding imported materials used to produce the products in the account.

There is an informal automatic policing mechanism built into the bonded factory or warehousing system that reduces the incentive for firms to leak duty free imported inputs without paying taxes. If such sales should occur, competing suppliers who have already paid import duties will complain immediately, since it places their livelihood in jeopardy. The most common form of sanction against the operator of the bonded warehouse or factory is to have the license to operate such a facility revoked. This is a severe economic punishment, and one that the operator of the bonded warehouse facility is very reluctant to risk. Furthermore, if they are in the business of manufacturing for export and domestic sales, a sideline of smuggling is not particularly appealing when the probability is high that competitors whose silence is difficult to purchase will catch them. This informal policing system no doubt goes a long way toward explaining why, in countries such as Malawi and Ghana, very little fraud from the sale of duty free imports is reported, despite the fact that these countries' controls over in-bond facilities are rather rudimentary.

The number of bonded factories is large in countries such as Malaysia, Taiwan, Mauritius, Korea, Kenya and Pakistan. They have been quite successful in promoting exports.

The concept of the bonded factory was extended to the science-based industrial parks in countries such as Taiwan in order to promote the development of science and technology in the island. The tax incentives provided to the parks are in fact the same as those in the EPZs but focus on computer, automation, and scientific research. The firms in the parks appear to have made a significant contribution to the recent economic growth in Taiwan, especially in electronics and other high-technology goods.

## **VI. Institutional Arrangements**

Removing duties on imported inputs for use in the production of exports is very important for the Kyrgyz Republic to compete in international markets. In fact, the duty

remission -- either duty drawback or exemption -- has been shown to be the most important policy measure for the Taiwanese exporter in the 1970s and 1980s. However, development of the mechanisms and institutional arrangements to implement this policy is equally essential for a successful export promotion and economic growth. Without proper institutions and an effective administration, the export promotion policy may not lead to economic growth.

The most common mechanism to eliminate duties from inputs is the duty drawback system. The administrative complexity of this mechanism is a major deterrent to its use. It can relieve import duties paid and embodied in the production of indirect exporters for small exporters or irregular exporters. It is a necessary but far from a sufficient mechanism to provide relief to exporters from the burden of import duties on inputs.

In administering either the exemption or suspense system, it is important for the government to develop computerized records of imported inputs and export sales. With this system, the proper accounts and records in terms of import duties payable and drawbacks claimed must be well maintained. In addition, the importer should be required to supply the government with government bonds or securities issued by a financial institution in the amount equal to the duty payable. The interest rate associated with these bonds or securities should be payable to importers. This would minimize the cash flow cost to importers as well as protect the tax revenues for the government. Customs should administer the duty exemption system, as information from customs transactions is critical. The system implemented in the Philippines whereby a One Stop Shop authorizes and issues Tax Credit Certificates is not one to be emulated. It is extremely difficult to keep track of what is or is not exported, and the implementation of such systems often results in major fraud.

The EPZs may in theory appear to be conceptually ideal, and they are often the only way to start a manufactured export promotion program quickly. In the longer run they have proven to be expensive and inappropriate for many industries, particularly those that already have a domestic operation. The bonded factories or warehouses are much more efficient as they can be located individually anywhere in the country, so long as Customs carefully maintains records on import duties payable and credits claimed for inspection by Customs personnel. The system has a fair amount of self-policing built into it but randomly targeted inspections by government officials will always be required.