



# Economic Consequences of the Customs Union for the Kyrgyz Republic

Prepared for the Ministry of Economic Regulation

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## Introduction

The formation of the Customs Union of Russian, Belarus and Kazakhstan (“CU”) is one of the most important factors affecting Kyrgyz foreign trade, as half of the trade turnover of the KR is with the CU countries. In spite of political declarations, prospects of Kyrgyzstan’s accession to this organization are quite unclear. Procedures for admitting new members have not yet been established, there are still a number of other serious contradictions within the CU, and Kyrgyzstan’s WTO commitments may make its joining the CU quite difficult.

Kyrgyzstan is a party to bilateral and multilateral agreements on free trade with member states of the Customs Union. On the basis of statistics for the first seven months of 2010, there is no evidence that creation of the CU will significantly change the terms of access of genuinely Kyrgyz-origin goods to the CU markets. .

However, prior research has shown that informal trade flows through Kyrgyzstan that are not reflected in official statistics make up a considerable share of Kyrgyz foreign trade. Since effective operation of the CU must be accompanied by strengthened control of the external borders of the CU, informal trade flows to the CU member countries are likely to be greatly reduced.

In April 2010, after the coup, some countries bordering Kyrgyzstan (including Kazakhstan) unilaterally closed border crossing points for vehicles and even interrupted passenger traffic between the countries for a short period of time. The consequences of this have been analyzed both to calculate business and government losses due to the closure and to describe the likely control regime to be applied by the Customs Union during its fullscale operation.

This report is the second stage of the study on implications of the Customs Union undertaken with the support of the USAID Regional Trade Liberalization and Customs Project. Its objectives are to define the implications of the CU for Kyrgyzstan on the assumption that Kyrgyzstan does not join the CU, and to provide recommendations necessary to overcome the likely negative effects of the CU on Kyrgyz foreign trade. The study includes:

1. An analysis of the current situation, trends and development of Kyrgyz foreign trade, and their implications for employment levels and the state budget;
2. An analysis of the implications of these trends for employment and the state budget;
3. Consideration of certain problems in formulating an effective trade policy;
4. An estimate of the costs imposed on both business and the state budget as a result of the border closure.

The final section contains recommendations for improving the effectiveness of trade policy and tax legislation, the institutional strengthening of business, and other matters.

Attachments to the report include analytical and descriptive materials on which recommendations are based, as follows:

1. Calculation of indices of revealed comparative advantages for different commodity groups exported from Kyrgyzstan;
2. Analysis of fiscal policy and possible ways for its improvement;
3. Analysis of the procedure and problems in issuing certificates of origin, and compliance with legislation of the Customs Union; and
4. The practice of applying reference prices in foreign trade of Kyrgyzstan and Customs Union member states.

# 1. Tendencies in foreign trade of Kyrgyzstan

## 1.1 State of foreign trade of Kyrgyzstan

Kyrgyzstan is a country with a very open economy, which is confirmed by the correlation between the foreign trade volume and GDP. Growth of foreign trade before 2009 was stimulated by substantial trade liberalization, including accession to the World Trade Organization (WTO). Duty rates were considerably reduced, and national legislation was liberalized to grant equal access to the domestic market.

Foreign trade turnover has grown substantially over the past nine years. From 2001 to 2008 trade turnover increased more than six times, but in 2009 it decreased from \$5.92 billion to \$3.85 billion, largely as a result of the world economic crisis. Trade turnover also declined 15.1% over the first seven months of 2010 it from the corresponding period in 2009 (excluding gold exports).

**Table 1. Indicators of foreign trade (\$ billion)**

Description	2005	2006	2007	2008	2009	2010 (7months)
Foreign trade volume	1.86	2.82	4.11	5.92	3.85	2.5
Export	0.67	0.89	1.32	1.85	1.17	0.85
Import	1.18	1.93	2.78	4.07	2.68	1.65
Balance of trade	-0.51	-1.04	-1.46	-2.21	-1.51	0.8
Foreign trade as % of GDP	72.1	88.7	93.4	110.7	97.9	n/a

Source: National Statistical Committee, official websites of the Ministry of Finance and National Bank of the KR

Major exports include apparel, agricultural goods, gold, energy, and construction materials. Major imports are fuels and lubricants, chemicals, machinery and equipment, and vehicles.

Foreign trade is a major source of employment. According to the National Statistical Committee, more than 220 thousand people are engaged in trade. Moreover, according to World Bank research<sup>1</sup>, the two largest markets in the KR alone - "Dordoi" and "Karasuu" - provide jobs for more than 60 thousand people, with more than 300 thousand people indirectly involved in trade done through these two markets.

Foreign trade is also a major sources of state revenues. In 2009, revenues from foreign trade totalled US\$306.5 million (14.1 billion KGS), or 44.7% of tax revenues. At the same time, analysis reveals a number of internal problems impeding foreign trade, including problems related to fiscal regulation. A review of the taxation system shows that major problems include:

1. a complicated and time-consuming procedure for refund of overpaid VAT; and
2. the imposition of sales tax on exports.

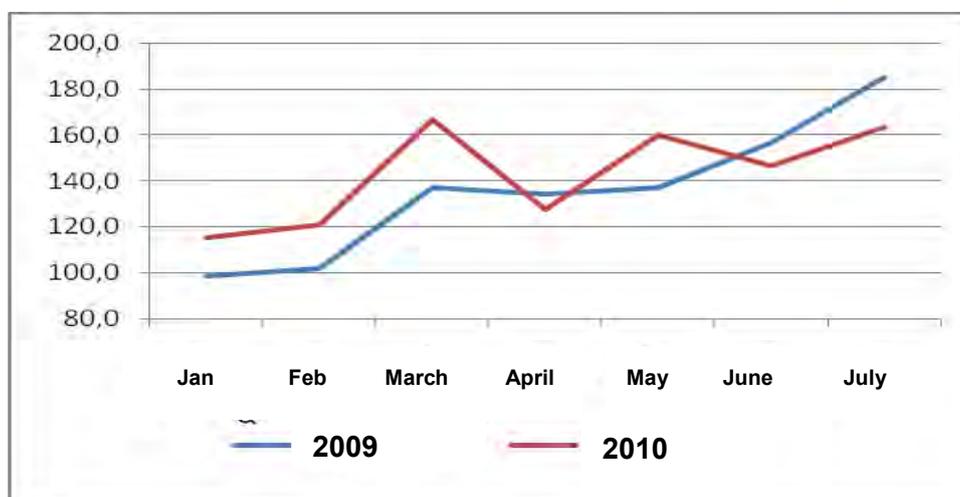
<sup>1</sup> Bazaars and Trade Integration in CAREC Countries. Report prepared by World Bank, May 2009

Many goods are imported under the so-called simplified customs clearance procedure, which provides for a low duty rate calculated simply on the basis of the weight of goods.<sup>2</sup> This simplified customs clearance procedure is very convenient for traders, but it complicates keeping import statistics, as there is no need to record the value and classification of goods.<sup>3</sup> As a result, mirror trade statistics of China and Kyrgyzstan show considerably different figures.<sup>4</sup> Lack of accurate and reliable statistics makes sound foreign trade policy-making much more difficult.

## 1.2 Kyrgyz foreign trade and CU creation

One of the major factors affecting the current situation in foreign trade is the creation of the Customs Union. However, the CU does not appear to have reduced Kyrgyzstan's official trade with CU member states. Trade in certain goods has even increased.

**Figure 1. Volume of trade with member states of the Customs Union for seven months of 2009-2010 (million USD)**



Source: National Bank of Kyrgyzstan

The slowdown in official trade with the CU countries in April was apparently caused by the closure of the Kazakh-Kyrgyz border and by Russia's imposition of export duty on light oil products for Kyrgyzstan. **However, measures taken by the Customs Union to tighten border controls have had an important effect on shadow trade.**<sup>5</sup>

## 1.3 Consequences of the closure of the Kazakh-Kyrgyz border

On April 7, 2010, border crossing points at the Kazakh-Kyrgyz border were unilaterally closed by Kazakhstan. Initially, the ban on border crossing was total, and restrictions remained severe through mid June. The closure was probably grounded

<sup>2</sup> Resolution of the Government of Kyrgyzstan of December 31, 2004, No.976 "On adoption of the Instruction on conveyance of goods and vehicles across the state border of Kyrgyzstan by individuals."

<sup>3</sup> According to the Instruction adopted under Resolution976, the HS code of goods subject to simplified customs clearance procedure is defined only at the two-digit level.

<sup>4</sup> Please see the previous report.

<sup>5</sup> This is discussed in part 1.3. "Shadow trade" refer to unofficial exports of some Kyrgyz goods and to re-export of Chinese goods under fraudulent documents indicating their origin as Kyrgyz.

in political reasons rather than economics, but this study focuses only on the economic issues . First, the study aims to assess the losses of businesses and the Government from the closure during April, May and June. Secondly, we consider the tightened controls after June as likely to be similar to those that will be continued by the CU, and thus to be a more-or-less permanent regime to which Kyrgyzstan must adjust. We thus consider the effects of the border closure and tightened controls on both official and unofficial (shadow) foreign trade flows.

**Methodology of the study**

This section of the study considers only state revenue losses and losses of businessmen (re-exporters and manufacturers) resulting from the closure of the Kazakh-Kyrgyz border.

Losses resulting from the closure of the Kazakh-Kyrgyz border were assessed on the basis of the following:

- Survey among heads of enterprises and individual entrepreneurs;
- Survey among government and business association representatives;
- Official data of the National Statistical Committee, State Customs Service, Tax Service, and Ministry of Economic Regulation;
- Data of international organizations.

To determine the target groups, the assumption was made that losses from the border closure were suffered mainly by entrepreneurs engaged in trade with the Russian Federation and Kazakhstan.

More specifically:

- Enterprises producing and exporting goods mainly to Kazakhstan and Russia (trade between the KR and Russia is conducted primarily through Kazakhstan);
- Enterprises whose activities depend to a great extent on raw materials imported from Kazakhstan and Russia; and
- Enterprises and individual entrepreneurs importing goods to export them to Kazakhstan and Russia (re-exporters).

Analysis of the structure of foreign trade over the last four years shows that the following commodity items prevail:

- In trade with Kazakhstan: construction materials (portland cement), electric power, dairy products, fruits and vegetables (exports); oil products (fuels and lubricants), wheat and flour (imports);
- In trade with Russia: oil products, transport vehicles and equipment (imports); articles of clothing, fruits and vegetables (exports).

Therefore, the study focused on the Kyrgyz clothing, construction, and dairy industries, and on agricultural (wheat, fruits and vegetables), And on the large shadow re-export of (mainly Chinese) goods to Kazakhstan and Russia, (for which there are almost no reliable official statistics).

**Table 2. Number of survey respondents**

Sector	Number of respondents (including experts)
Traders (re-exporters)	60
Clothing industry	40
Dairy industry	7
Construction sector	45
Agricultural sector	55

**Criteria for assessment of losses** – losses of business were assessed by calculating lost profits and extra expenses (wherever possible) resulting from the border closure. The survey among experts and entrepreneurs was conducted in August 2010 using face-to-face interviews.

**Losses of businesses**

Most representatives of the business sector were very reluctant to take part in a survey aimed at assessing their losses. The situation was worsened by the fact that many companies, in particular around 70% of sewing enterprises, do not maintain proper records

**Losses of traders (re-exporters)**  
 Respondents to the survey among re-exporters were entrepreneurs of the Dordoi market, the largest merchandise market in Central Asia. Dordoi is a center for exports of domestic goods and re-

exports.

**Table 3. Description of Dordoi and Karasuu Markets <sup>6</sup>**

Market	Number of trading spots	Employment (thousands)	Share of wholesale trade (%)	Total monthly sales (US\$ millions)	Total design monthly volume of wholesale (US\$ millions)
Dordoi	40300	54.6	80	331	264.8
Karasuu	10200	16.3	80	94	75.2

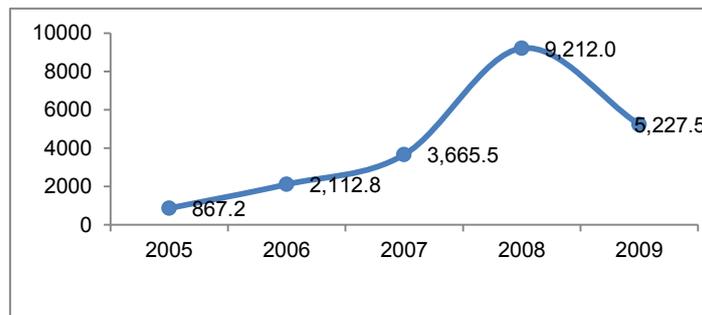
### 1.3.1 Losses of traders

As Table 3 above demonstrates, most sales at Dordoi are wholesale deals. However, our survey showed that wholesale trade decreased from the 80% of sales volume shown in Table 3 to only 30% of sales revenue in the two months of April – May 2010. This apparently resulted from the border closure with Kazakhstan. Since retail sales at Dordoi are for domestic consumption and thus would not be significantly affected by the border closure, we assume that the volume of retail sales was unchanged at about US\$66.2 million.

If wholesale trade decreased to 30% of market turnover, the retail sales of US\$66 million must have been 70% of the total market turnover in April-May 2010. It follows that wholesale trade must have been about US\$28 million.<sup>7</sup> Therefore, we estimate the decrease in sales at Dordoi market as a result of the border closure at about US\$473 million in those two months.

It should be noted that the World Bank research was conducted during summer 2008. At that point, Russia’s and Kazakhstan’s economies, as main consumers of goods offered by Dordoi market, were at their peak. This can also be confirmed by mirror statistics data from China, which show exports to Kyrgyzstan in 2008 of US\$9.2 billion.

**Figure 2. Exports from China to Kyrgyzstan (Chinese official data, US\$ millions)<sup>8</sup>**



<sup>6</sup> Bazaars and Trade Integration in CAREC Countries. Report prepared by World Bank, May 2009.

<sup>7</sup>  $28,4 = (66,2/70)*30$

<sup>8</sup> COMTRADE Data base, available at: <http://comtrade.un.org>

Figure 2 shows that there was a 43% decrease in imports from China in 2009 according to Chinese statistics. It would be reasonable to assume that the Dordoi market trade volumes decreased accordingly. Therefore, decrease in sales at the Dordoi market could be significantly lower than our estimate of USD 472,8 million. In our view, a fair estimate must be calculated based on proportional decrease of import volumes from China to Kyrgyzstan in 2009, specifically, trade turnover of less than USD 200 million. If such an estimate is taken as a basis, then in absolute terms, for the period of two months of border closure (April-May 2010) decrease in trade turnover comprised an amount in a range of **USD 230-260 million**.

Our survey results show that a considerable part of the losses suffered by entrepreneurs were caused by the loss of trade with wholesale customers in Kazakhstan and Russia. As the demand for some categories of goods depends on the season of the year, part of those lost sales resulted in unsellable, non-liquid goods in Kyrgyz warehouses. In turn, this results in a lack of the cash flow necessary for entrepreneurs to fulfill their loan obligations.<sup>9</sup>

### 1.3.2 Losses of industries

#### Clothing industry

According to official statistics, over the five months of 2010 export of garments from Kyrgyzstan made up \$50.7 million, i.e 15% of the total exports which amounts to \$341 million (excluding export of precious metals). 95% of garments are exported to the Customs Union member states, mainly to Russia. According to the National Statistical Committee, in 2009 the clothing industry employed 114.2 thousand seamstresses. The multiplier effect of indirect employment suggest total employment of approximately 300 thousand.

The assessment of losses suffered by sewing enterprises from the closure of the Kazakh-Kyrgyz border reveals different results for different market participants. Depending on the legality and destination of the exported goods and the main channels of distribution, the border closure had a positive impact for some companies and a negative impact for others.

Positive results were cited by producers legally exporting their garments to Russia. Both their production and export volume increased in this period, including during the period when the border was closed. The value of garments exported to Russia in January-May 2010 totalled \$47.8 million, twice the amount in the same period in 2009. Such a dramatic increase has two reasons:

First, a low comparative benchmark due to the low business activity in 2009 resulting from the world economic crisis and closure of the largest market in Moscow (Cherkizovky rynok); and

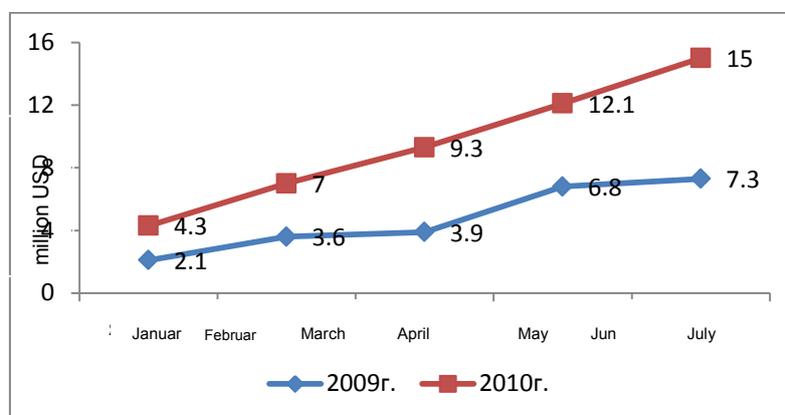
Second, simplification of access of Kyrgyz garments to the market of Russia, with the implementation of preshipment inspection and preliminary declaration of garments to be exported to Russia. A considerable part of the goods have been delivered by companies affiliated with the "Legprom" association. It should be

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<sup>9</sup> According to the National Bank of the Kyrgyzstan, traders are main recipients of loans

mentioned that there is an agreement on preliminary declaration and permit for Kyrgyz garments to enter Russia concluded between the State Customs Service of the KR and the Russian Federal Customs Service.

**Figure 3. Export of textile and knitted goods to Russia<sup>10</sup>**



Source: National Bank of the KR

According to the survey results, Kazakhstan and Russia’s tightened control over goods coming from Kyrgyzstan resulted in the reduction of volume of informal export of garments to the markets of CU member states. According to the estimates of garment manufacturers and experts, up to 40% of Kyrgyzstan’s total garment output goes to Kazakhstan. At the same time, official data for January-May 2010 show that export of garments to Kazakhstan made up \$0.14 million, i.e. less than 0.3% of the total exports of garments. Therefore, it can be assumed that **most garments have been exported to Kazakhstan informally.**

As can be seen from the above, the border closure affected mostly garment producers who exported their products informally, mainly to Kazakhstan (directly or through the Dordoi market). It can be assumed that those informal exports did not take place due to trade restrictive measures and tightened control.

Official exports to Russia and Kazakhstan for January-May 2010 (\$47.9 million), estimated at 60% of the total exports of garments along the “northern route” will be taken as a basis for calculating business losses. This means that 40% of the total exports of garments made up \$31.9 million and, according to the survey results, were exported to Kazakhstan informally. Thus volume of exports for the two months should have been about \$12.8 million.

**Therefore, total decline in sales for the period of April-May 2010 are estimated at approximately \$12.8million.**

### Dairy industry

According to the National Statistical Committee of the KR, 133 enterprises and 273 entrepreneurs are engaged in the dairy industry, of which 22 are large and medium businesses that produce around 80% of total dairy production.<sup>11</sup> Dairy products

<sup>10</sup> Source: Customs statistics “Statistical bulletin of foreign trade” and “Reports and papers”

<sup>11</sup> Classification is based on the number of employees in a factory, in accordance with Government resolution # 78 of February 17 1998. In agriculture and industry, up to 50 employees is a small

account for 20% of total output of the food and food processing industry, 70% of which is exported to Kazakhstan. In 2009, total dairy output by value was 3.5 billion KGS (on average, 291 million KGS per month). Most dairy companies of Kyrgyzstan are oriented to the Kazakh market. The major dairy product exports are dried milk, hard cheese (Dutch and Russian sorts), dairy butter and non-fat cheese.

According to our survey results, the border closure resulted in a 40% reduction (300 million KGS) in dairy production over two months. Some dairy companies stopped producing some kinds of products; as a result, some production lines were idled and employees were granted unscheduled leave. In addition, large volumes of milk were stored at dairy companies, which decreased their purchases of milk from farmers.

According to the Dairy Union of leading dairy companies, **sales volume shrank by 500 million KGS (or 11.1 million USD) during the period the Kazakh-Kyrgyz border was closed.**

The long-term effects of the border closure include the loss of Kazakh market share by Kyrgyz dairy companies. This market share has been seized by competitors from Russia, Belarus and Ukraine, and local Kazakh companies. To regain this market share, Kyrgyz dairy companies now have to undertake measures usually necessary for initial market penetration such as price reduction, various promotional events, advertising and PR campaigns etc., which result in extra expenses.

**Construction materials sector**

For the purpose of assessing losses of the construction materials sector, companies were divided into three groups: producers of construction materials (8), trading and purchasing companies (25) and construction firms (12).

The construction materials market depends to a great extent on the only cement-producing company – Kant Cement Factory (KCF). Producers of articles of cement relate their losses to the shutdown of the KCF, whose peak in production activity was expected to take place at the time of the border closure. The survey results show that sales decline of one company alone (a producer of construction blocks) resulting from the border closure amounted to 7 million KGS, or about \$150,000.

Kyrgyzstan produces and exports the following construction materials: cement, bricks, roofing slate, glass and articles of cement. An assessment of losses sustained by producers of construction materials from the closure of the Kazakh-Kyrgyz border is provided in the table below:

**Table 4. Assessment of losses in the construction sector (thousand KGS)**

Producers of	Unit of measurement	Expected output for Jan-Jun 2010	Actual output for Jan-Jun 2010	Price per ton thousand KGS	Sales decline, million KGS
Cement	thousand tons	316.27	228.30	2.95	259.07
Roofing slate	thousand tons	27.87	11.73	15.00	242.17

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enterprise, from 51 to 200 a medium medium enterprise. In service sectors such as trade and finance, up to 15 employees small, from 16 to 50 medium.

Prefabricated construction elements, made of concrete	thousand tons	38.64	22.87	5.00	78.89
<b>Total</b>					<b>580.1</b>

Source: National Statistical Committee of the KR (section – production of construction materials)

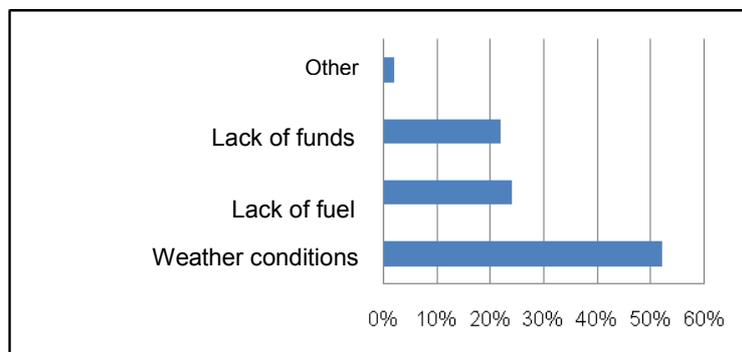
Expected figures were calculated on the basis of retrospective data on the volume of construction materials produced during the last five years. Since producers did not change their prices during this period, **losses suffered by the construction sector from the border closure can be estimated to amount to more than 580 million KGS (\$12.68 million).**

### Agricultural sector

For the purpose of assessing losses of the agricultural sector, a survey was conducted among farmers and experts in animal breeding (25), and in plant growing and agribusiness (30).

The period of the border closure coincided with the sowing season, the most unprofitable period of the year for farmers. In addition, trade in some kinds of crops takes place in the spring, before the first harvests, as prices of those products reach a peak. This helps to collect money for sowing and harvesting. However, 52% of respondents said that delay in sowing was caused mainly by bad weather conditions (there were continuous heavy rains in April 2010).

**Figure 4. Reasons for delay in sowing**



Interviews showed that lack of funds (cited by 22% of respondents) was caused by the impossibility of selling all agricultural products as the border was closed and the domestic market was glutted with agricultural products intended for export.

### Cause-effect chain: consequences of the border closure for agricultural sector



Therefore, losses suffered by agricultural producers were caused by: 1) reduction in prices for agricultural products due to the glut in the market; 2) delay in sowing campaign which will result in poor harvest in 2010.

**Table 5. Losses sustained by farmers from the border closure**

Basic data	Hectares Sown 2009, thousands	Harvest per hectare in 2009	Hectares Sown 2010, thousands	Harvest per hectare in 2010	Harvest 2010 (thousand tons)
Wheat	402	26.3	385.7	22.58	871
Potato	87.1	158.6	83	145.6	1208.48
Calculation of losses to farmers from poor harvest	(Potential) harvest 2010, (thousand tons)	Lost harvest (thousand tons)	Price per thousand ton (million KGS)	Losses from poor harvest (million KGS)	Losses from border closure, (million KGS)
Wheat	1014.4	143.4	10.0	1433.9	315.5
Potato	1316.4	107.9	5.0	539.5	118.7
<b>Total</b>					<b>434.2</b>

Source: Ministry of Agriculture of the KR

Our survey results were used to determine the influence of the border closure. Some 22% of those surveyed stated lack of financing was one of the main reasons for possible decrease in harvest in 2010. Lack of financing seems mainly due to the border closure, because the closure prevented many farmers from selling their goods during the high season (spring) when prices reach their maximum level.

For example, the poor harvest of potatoes can be calculated in the following manner. Lost potato harvest equals the sown area in 2010 x productivity of 2009, less the harvest in 2010; which totals 107,9 thousand tons. The lost harvest of 107,9 thousand tons, multiplied to the potential price of potato during fall 2010, at 5 som per kg, results in KGS 539,5 million.

Data on the sown area and harvest volume were provided by the Ministry of Agriculture of the KR. As the table shows, calculations were made for wheat and potato as these crops occupy 80% of the sown area.

Our survey also showed that there were fluctuations in prices for agricultural products when the border was closed. In particular, prices for potato (a major agricultural product exported to CU countries) declined significantly. The purchase price for milk declined by almost half. Because of the problems with export of dairy products, the volume of milk purchased from farmers was reduced, which resulted in a reduction of prices for milk.

**Table 6. Calculation of losses resulting from fluctuation in price**

Item	Average price per ton, thousand KGS	Average price, border closed, thousand KGS	Sales for 2 months, thousand tons	Share of Chui, Talas and Issyk-Kul	Loss from price drop, million KGS
Potato	15.0	5.0	233.3	69%	1 610.0
Milk	12.0	5.0	100.0	66%	462.0

<b>Total</b>	<b>2 072. 0</b>
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Source:

**Damage to the agricultural sector resulting from the border closure totaled 2.5 billion KGS (or 53.9 million USD).** Total sales decline in these major sectors accounted for \$320-360 million, or 16.5 billion KGS.

### 1.3.3 Conclusions on business losses

In whole, total sales decline in these major sectors accounted for approximately 358 million USD, or 16.5 billion KGS.

**Table 7. Summary of losses suffered by businesses from the closure of the Kazakh-Kyrgyz border in April – May 2010**

Item	million USD
Traders (re-exporters)	220 - 260
Clothing industry	13
Dairy industry	11
Construction sector	13
Agricultural sector	54
<b>Total</b>	<b>365 - 405</b>

As stated above, from the moment the CU started functioning, official trade turnover between Kyrgyzstan and member states of the Customs Union did not decline, but **increased**. Exports rose during April-May 2010. It therefore appears that the border closure and tightened controls had a negative impact mostly on shadow flows, which was also confirmed by our survey results. This mainly relates to goods coming from China and re-exported to the CU with no Kyrgyz value added.

Because tightened controls similar to those applied in April-May are likely to be maintained by the CU, it is unlikely that shadow trade flows from Kyrgyzstan to the CU countries will resume their former volume. This means that the infrastructure supporting those shadow flows is unsustainable. The volume of unofficial flows from China through Kyrgyzstan to the CU countries will reduce by about US\$1.5 billion and the number of the people employed in this trade will reduce accordingly, by not less than 35 thousand people directly employed at the market.<sup>12</sup>

The main conclusion of this section of the study is the need to modify Kyrgyz trade policy, which has been based on trade flows going from China to the CU countries through Kyrgyzstan. All stages of the supply chain from importation to exportation must be changed. According to the opinions of local experts, changes in the trade flows from China to CIS countries could be expected as a result of the CU formation. Such changes would likely increase trade flows via Central Asia rather than the Far East region of the Russian Federation, due to lesser costs.<sup>13</sup> At the same time, “shadow” re-export flows could be replaced by products produced in Chinese factories newly located in Kyrgyzstan.

<sup>12</sup> \$1.5 billion reduction per year derives from losses for two months (US\$220-260 million), employment is calculated proportionally.

<sup>13</sup> According to the United China Logistic Company, cost of transportation (of a wagon of footwear) from Guanzhou to Moscow by rail (Far East) is \$8000, by sea – \$5000, by rail (Khorgos – Kazakhstan) and then by road till Moscow - \$4000.

## 1.4 State revenue losses

To assess revenue losses resulting from the border closure and restricted conveyance of goods across the border, tax revenues for 2009 and 2010, in particular revenues collected from import duties, were analyzed.

**Table 8. Comparative table on tax revenues (billion KGS)**

Budget revenues	Actual for 7 months of 2009	Expected for 7 months of 2010	Actual for 7 months of 2010	Difference 7 months of 2010	Execution of plan (%)	Comparison with 2009 (%)
Tax revenues	19.58	22.69	22.02	-0.67	97.0	112.4
excl. revenues related to Kumtor	18.60	20.24	18.95	-0.13	93.6	101.8
Tax revenues of the Customs Service	7.290	8.59	7.83	-0.76	91.1	107.4
Revenues from foreign trade taxation	2.05	2.38	2.10	-0.28	88.3	102.2
Revenues from flat duty	1.44		1.41			98.4
Tax revenues of the Tax Service	12.29	14.10	14.19	0.09	100.6	115.4
Revenues of the Tax Service (excl. revenues from Kumtor)	11.31	11.65	11.12	-0.53	95.4	98.3

Source :Ministry of Finance, KR

Analysis of the state revenues showed that despite the fact that the figures expected during the period under review were not reached, state revenues for 2010 turned out to be higher than for 2009. According to the KR Ministry of Finance, total tax revenues of the KR for the first seven months of 2010 accounted to 22.69 billion KGS, which was 1.8% higher than the same period in 2009. Customs revenues increased by 0.76 billion KGS, or 7.4% compared to the same period.

In spite of the increase in customs revenues, revenues from the (simplified procedure) flat duty declined slightly due to the reduced revenues from imports of Chinese goods.

Internal tax revenues (excluding revenues from Kumtor) also rose, increasing 1.7% (0.53 billion KGS) compared to 2009. State revenue losses were mainly related to the April and June events.

It should be noted, that according to the current legislation, such areas of the economy as agriculture and agricultural processing enjoy “preferential” taxation. Wholesale trade such as that at Dordoi market is also entitled to preferential taxation, because wholesale trading is included in the list of activities subject to the patent system, with simplified administration and minimal cost which does not reflect actual revenues of wholesale traders.

**Therefore, it can be concluded that losses of the government budget from restrictions at the border were relatively insignificant and affected mainly tax and customs revenues collected from entities importing and selling goods under a preferential tax regime. It might also be pointed out that this “minimal loss” may be because most trade is not captured by government budget.**

## 2. Possible scenarios for the development of KG foreign trade

The present study has focused on the implications of the border closure for Kyrgyzstan. It is reasonable to expect that the tightened controls introduced in April-May of 2010 at the CU border are likely to be very close to what will be the permanent policies on the CU borders.

For Kyrgyz foreign trade, retaining the CIS free trade agreement, which provides tariff-free access to the CU market for Kyrgyz-origin products, is of great importance. Although prospects of revising the free trade agreement remain unclear, recent statements seem to indicate the intent of the CU members to maintain it.<sup>14</sup>

The study focused on analysis of foreign trade flows both originating in Kyrgyzstan and going through Kyrgyzstan as transit goods. It is obvious that a considerable part of these trade flows is unofficial, involving mainly goods from China.

Some export-oriented companies of the KR depend to a great extent on imported raw materials.

Unofficial transit flows go through Kyrgyzstan to the CIS countries in two ways: 1) goods accompanied with certificates stating (falsely) that they are of Kyrgyz origin and therefore entitled to tariff preferences,<sup>15</sup> and 2) goods conveyed across the border illegally or informally by shuttle traders. These unofficial flows have two directions: northern (to the CU countries) and southern (to Uzbekistan and Tajikistan).

The current procedure for issuing certificates of origin gives rise to complaints from customs authorities of the CU member states. Our survey results show that about 40% of traders face problems related to the recognition of Kyrgyz certificates of origin by the CU customs authorities. We deal further with this issue in Appendix 4.4.

It is difficult to determine the volume and composition of unofficial flows due to the lack of detailed import/export statistics. However, it is clear that operation of the Customs Union will have a significant impact on the northern trade flow of Chinese goods. Our study suggests that re-export will be minimized (at least a 70% reduction at the Dordoi market), will remain illegal (smuggling) and will mainly be sold to the population of frontier regions of Kazakhstan because of the low price in Kyrgyzstan. (please see Section 1.3.1).

**In this case, it is necessary to change the focus of trade policy from simple re-export of (mostly Chinese) goods to adding value ( processing) of imports, or localization of production to gain the status of Kyrgyz origin for the goods or getting access to new markets.** Of course, most exports, which are finished goods, cannot be localized. However, Chinese-origin raw materials or semi-finished goods that were further processed in Kyrgyzstan would generally gain the status of Kyrgyz-origin goods and thus be eligible for preferential treatment when exported to the CU.

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<sup>14</sup> Russian Prime Minister Putin stated at a meeting in St. Petersburg on November 19, 2010 that a new treaty on a CIS free trade area should be signed early in 2011. See Times of Central Asia, 25 November 2010, at 9.

<sup>15</sup> More detailed information on issuance of certificates of origin in the KR can be found in the Appendix on certification of origin.

For this strategy to work, raw materials and other input products should be imported to Kyrgyzstan duty-free. However, the simplified customs clearance procedure, which does not classify imports beyond the 2-digit level, makes it impossible to discriminate effectively between raw materials and input products that should be duty-free, and finished goods that should be tariffed both to provide revenue and to protect Kyrgyz producers.

Encouraging the “localization” of production in Kyrgyzstan will obviously require political support from the Government. In addition, the fiscal policy of the Government must also be improved for export-oriented businesses.<sup>16</sup>

A certain volume of goods produced in Kyrgyzstan that are now exported to the CU countries illegally have been affected by the tightened control at the border. Probably, most such goods will begin to be exported legally, as happened to the clothing industry. To facilitate this, there is an urgent need to simplify the procedures for exporting goods to the CU members. To some extent this is already happening; the cooperation between the customs administrations of Kyrgyzstan and Russia with respect to garment exports should be noted. This cooperation facilitated trade by introducing pre-shipment inspection and preliminary declarations, and adjusting the reference pricing mechanism.

In sum, solving the problems related to Kyrgyzstan’s trade with the CU members will require the Kyrgyz Government to take effective action. This is the subject of our recommendations in the following section.<sup>17</sup>

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<sup>16</sup> Please refer to the Appendix on fiscal policy in the context of foreign trade.

<sup>17</sup> This study does not cover the issues related to non-tariff regulation of trade with the CU. Recently, plans to change the procedures for providing the goods with access to the CU market in the context of non-tariff barriers were released. Separate studies should be conducted to develop specific recommendations on this

### 3. Recommendations

Kyrgyzstan should define a package of measures of fiscal and customs policy to encourage production and export of competitive Kyrgyz goods using imported raw materials and semi-manufactured articles. These measures should focus mainly on making shadow trade flows legal through localization of production.

1. Consideration should be given to imposing export duties on certain raw materials that could otherwise be processed in Kyrgyzstan. However, the fact that export duties imposed on unwashed wool in 2009 dramatically reduced exports of unwashed wool but did not result in increased exports of washed wool shows the danger of such measures imposed without thorough consideration of the availability and readiness of processing capacities.
2. For the purpose of encouraging exports and reducing shadow flows, it is recommended that:
  - a. the VAT drawback and refund procedure should be simplified, and rights related to VAT drawback and refund should be extended.
  - b. It should be possible to reallocate VAT due for refund to pay other taxes regardless of the kind and form of the payment.
  - c. The list of companies entitled to simplified VAT drawback and refund procedure should be expanded, and criteria for inclusion should be relaxed. In perspective, the problem of refunding VAT amount to payment of the import tax will be solved through introduction of a single VAT account;
  - d. Sales tax on export should be abolished.
3. For the purpose of simplification of the procedures for getting access to the CU markets:
  - a. It would be reasonable to use successful experience in introducing pre-shipment inspection and preliminary declaration for garments exported to Russia as a basis of simplified procedure for other kinds of goods;
  - b. As foreign trade-related issues are generally the same for all industries and sectors, businesses should develop a consolidated position to support Kyrgyz enterprises abroad, which will become a key strategy for the Government. To this end, it is necessary to create associations that can develop joint proposals for government agencies. A reporting mechanism should be developed for government agencies to report back to businesses on proposal implementation;
  - c. In the context of the Customs Union, the issue of reference prices is crucial. Cooperation between customs administrations aimed at adjusting reference price levels is required;

- d. Reference prices for goods imported to Kyrgyzstan should be revised taking into account the distinction between finished products for consumption and raw materials and input products that will be further processed in Kyrgyzstan.
4. The problem of recognition of Kyrgyz certificates of origin by customs authorities of the CU requires that action should be taken to:
- a. Ensure implementation by the CU countries of existing agreements on recognition of Kyrgyz certificates of origin;
  - b. Reform the procedures for issuing Kyrgyz certificates of origin to ensure they conform with existing agreements;
  - c. Consider extending the procedure applied by Russia and Kazakhstan to establish the fact that the garments are of Kyrgyz origin to other exported goods, especially both raw and processed agricultural products.

## 4. Appendices

### 4.1 Calculation of revealed competitive advantages index for various groups of goods

Establishment of the Customs Union between major trading partners of Kyrgyzstan effective 2011 will result in significant revision of terms of market access to Russia and Kazakhstan. This will require Kyrgyzstan to revise its trade policy to increase exports. In this regard it's important to identify the list of priority goods that have a potential to compete on foreign markets.

An approximate list of such goods can be identified by using the Revealed Comparative Advantage index (RCA).

**The Revealed Comparative Advantage (RCA) index** is usually used to estimate the export potential of a country. Depending on available trade statistics, the index may be used to indicate the competitiveness of specific products. A number of international organizations<sup>18</sup>, including the World Bank, and some research organizations<sup>19</sup>, apply this index, despite some flaws, as a simple calculation tool to describe the competitiveness of the goods at the external market.

RCA index of the product or country is calculated as follows:

$$BC\Pi_{ij} = \frac{X_{ij} / X_{it}}{X_{wj} / X_{wt}}$$

where  $X_{ij}$  and  $X_{wj}$  mean the value of the country exports and the world exports of the product  $j$  respectively, and  $X_{it}$  and  $X_{wt}$  mean the value of total exports of the country  $j$  and total world exports respectively.

If the RCA index value is above 1, it means that the country has a Revealed Comparative Advantage in exporting a given product, whereas an RCA index less than 1 means a comparatively disadvantageous position of the country on the product. If the RCA index equals 1 it means that the given product bears neither advantage nor disadvantage for the country.

Taking into consideration the limitations of Kyrgyzstan's foreign trade commodity nomenclature, the RCA index often either equals zero or is undetermined, because the values in numerator and denominator may be zero or undetermined.

For the purpose of this survey, we used foreign trade data of the International Trade Center (ITC) based on COMTRADE database. The foreign trade commodity nomenclature was considered in HS Code 2002 up to 4-digit lines.

The RCA data for Kyrgyzstan's *conventional* exported commodity groups is presented in the table below. The values of the specified items remain above 1 invariably, however tend to decline.

<sup>18</sup> Case – Research and Analysis #233 – I.Tochickaya, R.Mogilevski

<sup>19</sup> "The World Bank Economic Review", 1999

**Table 9. RCA values for certain Tariff Code Headings<sup>20</sup>**

Product code	Product item	2005	2006	2007	2008	2009
'6203	Men suits, sets, jackets, blazers, trousers, shorts (other than bathing)	2,17	2,65	3,06	2,54	1,80
'6204	Women suits, sets, jackets, blazers, dresses, skirts, split skirts, trousers, or for girls	3,04	7,07	8,91	8,71	6,80
'6206	Women blouses or undershirts	9,26	20,85	26,12	27,15	24,47
'6208	Women underwear	11,10	8,25	4,77	2,34	1,48
'6305	Bags and packaging packets	7,72	11,15	8,92	4,35	1,32
'6810	Ware of cement, concrete or artificial stone, non armoured or armoured	3,76	9,61	9,02	5,28	4,79
'6811	Ware of asbestos-cement, cement with cellulose fibre or of similar materials	233,03	172,69	82,42	48,62	1,02

Generally, the analysis shows that the index value for the goods with RCA indices above 1 for the last five years is reducing. Table 9 shows that the competitiveness of traditional exports of Kyrgyzstan has significantly declined in recent years. Note that the economic crisis peaked just in 2009 for Kyrgyzstan's major foreign trade partners. This translates in a change of RCA of the Kyrgyz goods and proves the high dependence of Kyrgyzstan on the economic situation in Russia and Kazakhstan.

Bearing in mind that the index was calculated based on statistics available before the CU started functioning, its value should not be linked to the terms of market access for Kyrgyz goods. However, taking into consideration the first half-year data, according to which official exports to CU states have not declined, we may suggest that the performance of the Customs Union will not significantly impact the competitiveness of official exports in future, *caeteris paribus*.

#### **4.2 Fiscal policy in the context of foreign trade activity**

Analysis of the country's existing tax legislation and administration shows that there are a number of legislative regulations and administrative systems posing serious impediments to foreign trade and contributing to the maintenance of the shadow economy. In particular, the following problems should be noted:

1. The procedure for confirming export of goods and VAT refund is complicated and time-consuming; and
2. Sales tax is also collected on exporting goods.

Existing tax legislation provides for the refund of VAT on exports only to permanent exporters of goods, and only if VAT is collected on imports. In addition, it establishes a very complicated refund procedure. For example, to get a VAT refund in the amount of more than 300 thousand KGS per month, it is necessary to submit seven confirming documents. Upon submission of the documents, the territorial tax department will determine the eligibility for refund. If the territorial tax department makes a favorable conclusion, the same examination will be carried out by the relevant division of the Central Office of the Tax Service. Then materials are submitted to the special interagency commission for consideration. If the commission makes a favorable decision, the territorial tax department will refund the VAT. The entire refund procedure can take six or more months.

<sup>20</sup> Authors calculations

If the amount of VAT to be refunded is less than 300 thousand KGS per month, the decision will be made by the territorial tax department, which carries out the examination of submitted documents and checks the eligibility for refund.

For some large taxpayers that are frequent exporters there is a simplified procedure for VAT refund (without preliminary examination). The list of large taxpayers and the procedure for including taxpayers in that list is specified by the Government of the KR, which sets a number of excessive and unreasonable requirements. As of today, there are approximately 31 entities in the List.

The list of entities using the simplified procedure for VAT refund is compiled by the tax service and its territorial departments based on the following criteria:

- 1) Engagement in economic activities should be not less than 3 years, including at least two years of exports;
- 2) The net worth of the entity must be at least 15.0 million KGS;
- 3) The entity must have exported at least 50% of its total production over the recent six calendar months;
- 4) Penalties found during tax inspections over the recent 2 years must not exceed 10% of the total amount of tax liabilities in each separate period.
- 5) There must be no criminal actions against the entity for the violation of tax and customs legislation of Kyrgyzstan;
- 6) There must be no tax debts, including customs fees.

The entities shall be included in the List only if they meet all the above-mentioned criteria.

In early 2009, the criteria for including entities in the List became tougher. In particular, the required net worth of the entity became three times higher. Minimum necessary volume of exports was increased from 20 million to 40 million KGS. Moreover, in our opinion, the requirement stipulating that export delivery volume must be not less than 50% of the total delivery volume is a very severe requirement.

Given the difficult economic conditions in Kyrgyzstan, few entities can fulfill the prescribed requirements. The new requirements resulted in the reduction of the number of entities included in the List from 46 to 31.

According to the State Tax Service, over the past two and a half years, the amount of VAT eligible for refund doubled, and as of July 1, 2010 totaled almost 4.7 billion KGS, which implies a VAT refund problem. The new tax code further aggravated the problem, in providing that VAT due for refund cannot generally be used to offset other taxes. The failure to refund VAT in a timely manner (in some cases – long-term “freezing” of VAT refunds) results in a significant reduction in the amount of circulating funds and a slowdown in the turnover of capital, which have a negative impact on the financial position of a trader.

The results of our survey among entrepreneurs confirm the existence of VAT refund problems. Twenty percent of the agricultural producers surveyed said that they claimed a refund of VAT, but only 40% of these received the full or even partial refund of the amount due. Clothing manufacturers are in the same situation; 14% of them claimed a VAT refund, but only half of them received the amount due.

It should be mentioned that producers of primary agricultural products and some processors of agricultural products do not experience VAT refund problems, as they are exempt from VAT in accordance with the legislation of the KR. In addition, clothing manufacturers who carry out their activities on the basis of a patent are also exempt from VAT.

Existing legislative regulations on **sales tax on export** also have a negative impact on foreign trade. Sales tax on export (which is a turnover/cascade tax) significantly increases the fiscal burden of exporters. This results in unequal conditions for Kyrgyz exporters as traders of the neighboring countries do not pay sales tax on exports.

For export of goods, works and services from the Kyrgyzstan (subject to zero rate VAT), sales tax rate shall be:

- a) 2.0% - for trade activities;
- b) 3.0% - for sale of produced goods and works (services).

These problems related to the refund of VAT and sales tax on export are serious impediments to foreign trade and the export of goods. Moreover, the current situation does not provide incentives to come out of the shadow export activities, and to increase value added production. Under current conditions, it is more profitable for entrepreneurs to export goods individually using the simplified (patent) tax system and simplified customs clearance procedure than to clear commercial shipments. Informal exporters make considerable fiscal savings.

Currently, an individual entrepreneur with an annual turnover of less than 4 million KGS (the VAT registration threshold) has the right to pay taxes through the patent system. Having a patent exempts theholder from the payment of profit tax and sales tax. The patent-based taxation regime can also be used by exporters and importers.

According to official data, 272 thousand tons of goods worth 14.7 billion KGS (\$331 million) were imported on the basis of a tax patent in 2009. As the upper threshold for patent-based activities is 4 million KGS per year, it can be assumed that the number of individuals who imported goods on a patent basis (or who were registered as importers) in 2009 was approximately four thousand individuals.

**Table 10. Data on the number of issued patents and volume of goods imported on a patent basis<sup>21</sup>**

Indicator	2007	2008	2009
<b>Import of goods to the KR according to the number of customs receipt vouchers:</b>			
- volume (tons)	334 140	423 055	272 620
- amount (million KGS)	11 868	27 307	14 264
<b>Total number of voluntary patents issued for production and trade in goods and materials:</b>			
- quantity (thousand units);	480	505	384*
- amount (million KGS)	325	490	724*

Note: \*According to the new reporting system, this figure includes trade and services (according to common statistic classification of economic activities).

Given the Customs Union and tightened customs control at the borders of the Union, the Government of Kyrgyzstan should develop fiscal regulations aimed at encouraging export of goods that would:

<sup>21</sup> Official data of the State Customs Service and the State Tax Service

- support existing industries;
- bring illegal exports out of the shadow; and
- encourage entrepreneurs' re-orientation from simple re-export to value-added production using imported raw materials and semi-manufactured goods.

On the one hand, the recently tightened customs controls at the borders of the CU has sharply reduced the possibility of illegal export (including simple re-export of goods); on the other hand, the Government of Kyrgyzstan should create conditions for making illegal export legal through the provision of fiscal incentives. In this connection, it is suggested:

**1) VAT refund procedure should be simplified and rights related to VAT refund should be extended.**

- It should be possible to reallocate unrefunded VAT amount for payment of other taxes; and
- The list of entities eligible for simplified VAT refund procedure should be extended and criteria should be revised.

In particular, the minimum necessary volume of exports should be reduced from 40 million KGS to 20 million KGS, and the required minimum share of exports should be reduced from 50% to 30%. Moreover, the requirement stipulating that tax debts found during tax inspections must not exceed 10% of the total amount of tax liabilities can be abolished, as there are two other sufficient requirements regarding the lack of any debts and criminal actions initiated against the entity.

In the longer term, the problem of immediate reallocation of VAT may be solved by introducing a common VAT account. The current situation is illogical and unfair as a trader who is due a VAT refund still has to pay VAT to the Customs Service on imports, or wait for the VAT refund or reallocation by the Tax Service. The procedure takes several months, especially if it is carried out by the Special Commission.

If a common VAT account were applied, the Customs Service would just clear goods (Customs Cargo Declaration) and submit the CCD to the Tax Service. On the basis of the CCD, the Tax Service will calculate VAT tax in the common VAT account, and the amount due on imports will be automatically paid if the trader is due a refund because of exports.

**2) Sales tax on export should be abolished.**

Abolition of sales tax on export would serve as an additional incentive for export activities through reducing the fiscal burden of exporter. This measure would be a very significant step for our country, as export activities in our trading partner countries are not subject to sales tax. In addition, abolition of sales tax would have little effect on the country's budget (approximately 300 million KGS).

***4.3 Application of the reference price mechanism in Kyrgyzstan, the Republic of Kazakhstan and the Russian Federation***

Our survey of experts and entrepreneurs brought to light serious deficiencies in the record-keeping system of Kyrgyz enterprises exporting goods to other countries. Exporters are often unable to provide documents to confirm the value of goods. In such cases, export tax calculation is carried out on the basis of reserve methods of customs valuation, including the reference price mechanism.

## **Customs valuation and the GATT**

One of the most pressing problems in customs is the proper valuation of goods. Customs authorities have tried several times to establish specific mechanisms for exercising control over the declared value.

Under WTO rules, to which Kyrgyzstan is bound and which have been accepted in principle by the CU members, customs value is determined by the Agreement on Implementation of Article VII of the GATT, also known as the GATT Customs Valuation Code. The GATT (paragraph 2 of Article VII) says: "The value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed, or of like merchandise, and should not be based on the value of merchandise of national origin or on arbitrary or fictitious values". Paragraph 5 of Article VII of the GATT ensures the principles of publicity and stability of the methods for determining customs value. Practical implementation of these principles "enable traders to estimate, with a reasonable degree of certainty, the value for customs purposes."

Under the Valuation Code, Kyrgyzstan, Kazakhstan and Russia are supposed to use the following methods for determining customs value:

- 1) Transaction value of imported goods;
- 2) Transaction value of identical goods;
- 3) Transaction value of similar goods;
- 4) Deductive method;
- 5) Computed method; or
- 6) Fall-back method.

In practice, there are a number of problems related to the incorrect determination of customs value, such as manipulations of customs value, and difficulties in applying the calculation methods specified in the legislation. "Manipulations of customs value" usually mean "understatement of customs value." Such definition seems quite reasonable as the fiscal function of the customs value is to create a basis for collecting customs duties, taxes and other fees; and understatement of the customs value in fact results in lower budget revenues.

Customs authorities must try to reduce the risk of undervaluation. Kazakhstan and Russia use risk management systems that contain risk profiles relating to the customs value. Most of those risk profiles are oriented to customs valuation. In practice risk profiles amount to mechanisms for applying reference prices to determine customs value.

### **Russian Federation**

In Russia, customs value means the value of merchandise determined in accordance with the law of the Russian Federation "On Customs Tariff" (as amended on June 28, 2009). The procedure for determining the customs value of goods is specified in the Resolution of the Government of the RF, No.500, of August 13, 2006 (as amended on October 02, 2009) "On procedure for determining the customs value of goods conveyed across the customs border of the Russian Federation"<sup>22</sup>.

The risk management system (RMS) used by the RF to control the customs value is almost fully automated. Reference prices are presented in the form of indices of customs value determined with the use of a complex method based on internal statistics, information acquired through information exchange between customs administrations of the contracting parties, the above-mentioned methods, etc. Physically, reference prices are average prices for specific types of goods that differ by some factors, e.g. country of origin.

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<sup>22</sup> Information source – web-site of the Federal Customs Service of the RF <http://www.customs.ru/ru/>

The peculiarity of the RMS of the RF is its regulated access to the information contained in risk profiles. As the system is automated, the RMS provides recommendations automatically, without direct participation of a customs officer. This means that a customs officer at the border-crossing point is not aware of the actual amount of price indices, which minimizes the possibility of corruption.

### **Republic of Kazakhstan**

In Kazakhstan, the legal basis for using the RMS is Article 470 of the Customs Code of April 5, 2003, which stipulates that the activity of customs authorities should be based on risk analysis and risk management. The “Rules for determining criteria for risk indicators” with an indication of risks, including customs value, were adopted in accordance with the Order of the Chairman of the Customs Control Committee of the RK No.161, of April 5, 2004.

In addition, the RK adopted the “Law on state control during application of transfer prices” that specifies the measures to be undertaken to prevent the loss of state revenues from international business operations.

Generally speaking, Kazakh customs authorities use price information based on internationally recognized methods, if a declarant does not have the documents required for customs valuation or if the prices indicated in the price information by the declarant is 20% lower than those in reference books of the Customs Control Committee (CCC). The price information is published by the CCC on a quarterly basis in table form with an indication of approximate minimum price for goods (in accordance with the Commodity nomenclature of foreign economic activity) depending on country of origin.

**Table 11. Example of Price information of the CCC for the 1<sup>st</sup> quarter of 2010<sup>23</sup>**

HS Code	Item description	Country of origin	Unit of measurement	Customs value, USD per unit
101 101 000	Purebred breeding horses	Great Britain	unit	<b>4 354.00</b>
101 101 000	Purebred breeding horses	Ireland	unit	<b>4 446.00</b>
101 101 000	Purebred breeding horses	Poland	unit	<b>3 841.00</b>
101 101 000	Purebred breeding horses	Germany	unit	<b>2 852.33</b>

### **Kyrgyzstan**

In Kyrgyzstan, customs value is declared in accordance with Articles 228-232 of the Customs Code. In accordance with the “Procedure for gathering and using information on goods imported to the customs territory of the Kyrgyz Republic” adopted by the Resolution of the Government of the KR No.123, of March 11, 2005, Kyrgyz customs uses available price information if there are no documents verifying the correctness of the declared customs value (in accordance with above Articles), or if there are reasons to doubt the sufficiency and/or reliability of the data submitted by the declarant.

If the customs authority establishes that the declared customs value is lower than that in the price information, the customs authority will have a legal basis to request additional information on the value of goods and to further examine the reliability and correctness of the information for the purpose of making a final decision.

In addition, price information is an anti-corruption tool. Reference prices set minimum levels of price on the basis of which imports can be cleared (if goods are imported on the basis of customs cargo declaration) on condition that administration is carried out properly.

<sup>23</sup> Information source – web-site of the CCC <http://www.customs.kz/exec/stat/stat?tip=0>.

Before 2010, reference prices in Kyrgyzstan were fixed annually, with the possibility of introducing amendments. However, after adoption of the “Law on normative and legal acts”, the price information stopped being updated. Reference prices have not been updated since May 2009. In view of the frequent changes in the price of goods imported to the KR, the accuracy of the price information has decline significantly. The effectiveness of this tool depends to a great extent on its responsiveness to changes.

Reference prices used in Kyrgyzstan may be introduced in the RMS. This will make it possible to avoid the requirements of the law “On normative and legal acts” and to promptly change reference prices as well as criteria values used for the calculation of reference prices.

For Kyrgyz exporters, the reference price mechanism is often the only method of valuation available, because exporters, e.g. agricultural producers, are often not able to provide the required documents for confirming the value of goods.

The most important factor for Kyrgyz exporters is an amount of reference price applied to Kyrgyz exports by the importing authorities. However, as volume of exports from Kyrgyzstan is insignificant, reference prices are generally not defined specifically for Kyrgyz exports. However, due to the efforts of the State Customs Service and relevant associations, prices for commodity groups 62-63 coming from Kyrgyzstan were introduced in the list of reference prices of the Russian Federation, which together with other factors such as pre-shipment inspection has ensured a relatively smooth access to the Russian market.

Therefore, a reference price mechanism applied to Kyrgyz goods may be both an impediment and a favorable factor for promoting Kyrgyz goods to foreign markets, depending on how the reference prices are set and updated, and whether they are applied automatically or at the discretion of the officer at the BCP.

#### ***4.4 Analysis of the system of issuance of certificates of origin in CU member countries and Kyrgyzstan***

Determination of the country of origin of goods is an important tools of foreign trade policy. According to international agreements and national legislation, the country of origin determines both tariff preferences and non-tariff measures such as bans and restrictions. These measures include reduced rates of customs duty, exemption from customs duty, and imposition of tariff quotas for preferential imports/exports.

##### **Certification of Origin for CU Members**

In general, country of origin is determined on the basic criterion of substantial transformation, as measured by value added, and by specific manufacturing or processing operations.

Under the Customs Code of the Customs Union, member states of the Customs Union will abolish certificates of origin in internal trade. For goods exported from the Customs Union to third countries, a common certificate of origin will be used, but the details have yet to be negotiated.

Abolition of certificates of origin in trade between the CU members, and adoption of a common certificate of origin in trade with third countries will complicate the fulfillment of international obligations on issuance of certificates of origin undertaken by the CU members under the CIS agreements and, in particular, under the Generalized System of Preferences (GSP).<sup>24</sup> Russia, Kazakhstan and Belarus enjoy different GSP regimes. For example, the EU countries do not grant preferences to Belarus, and Japan does not grant preferences to

<sup>24</sup> Generalized System of Preferences (GSP) is a system of customs preferences granted to developing countries by developed countries. Developing countries include 77 countries classified as such by the UN, countries of the former USSR, countries of the former socialist camp (non-members of the EU), and China.

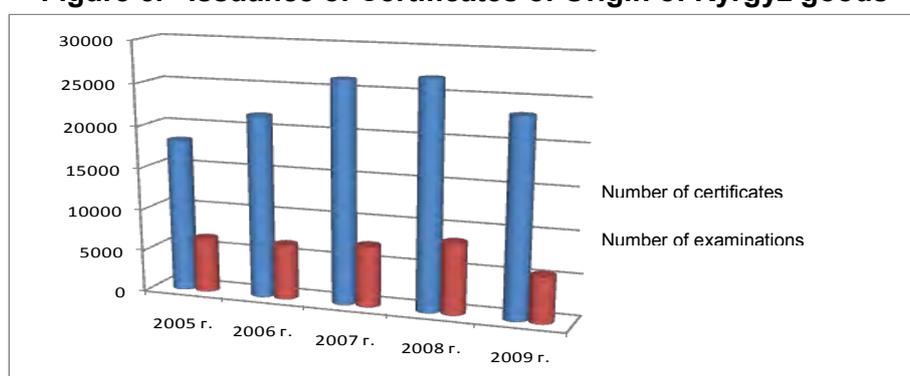
Russia. Therefore, if the Customs Union (not a specific country) were indicated in a common certificate of origin, all members of the Customs Union will be deprived of preferences granted under the GSP. In this connection, the practical application of a common certificate of origin to goods exported from the CU is problematic. Most probably, the CU members will use their own national certificates of origin for export of goods to third countries in the near future.

In the coming years, the CIS members are expected to complete their internal procedures for the ratification of the Decision of the Council of Heads of Government “On rules for the determination of the country of origin” signed on November 20, 2009, which does not change significantly the existing regulations of the CIS countries on issuing certificate of origin. As of July 1, 2010, this agreement has not been ratified by any of the CIS countries. Issuance of certificates of origin still takes place in accordance with the Decision of the CIS Council of Heads of Government of November 30, 2000 “On rules for the determination of the country of origin” adopted by the Resolution of the Government of the KR No.134, of March 27, 2001, and the Regulations of the EU Commission No. 3254\94 of December 19, 1994.

With tightened border controls under the CU, requirements related to rules of origin applied to Kyrgyz exports became stricter. Although there are agreements between the CU countries and Kyrgyzstan regarding mutual recognition of certificates of origin, Kyrgyz traders often meet the problem of non-recognition of Kyrgyz certificates of origin. Customs authorities of the Russian Federation and the Republic of Kazakhstan doubt the reliability of the examinations carried out by the Kyrgyz Chamber of Commerce and Industry (CCI) and certificates of origin issued by CCI to Kyrgyz exporters.

This was confirmed by our survey of entrepreneurs. According to the survey, 48% of respondents (agricultural producers) faced problems related to non-recognition of Kyrgyz certificates of origin by the CU countries.

**Figure 5. Issuance of Certificates of Origin of Kyrgyz goods**



**Table 13. Number of examinations and certificates of origin**

Indicators	2005	2006	2007	2008	2009
Number of examinations	6508	6567	7270	8518	5536
Number of certificates	18231	21662	26270	26860	23307

The situation became aggravated in 2010, when restrictions and tightened control at the Kyrgyz-Kazakh border were introduced.

According to our survey, non-recognition of Kyrgyz certificates of origin is a problem faced mainly by agricultural producers. This problem is less often faced by clothing manufacturers due to the existing system of control agreed between the customs services of Russia and Kyrgyzstan.

Non-recognition of Kyrgyz certificate of origin may be due to a lack of trust in the reliability of certificates issued by the CCI, as some agricultural products with Kyrgyz certificates may actually be of Chinese origin. The procedure for establishing the country of origin by the CCI is a paper exercise only, without conducting an examination in practice.

To our mind, doubts about the reliability of the results of examinations confirming the Kyrgyz origin of goods, and lack of consolidated efforts of the relevant business-structures and government agencies to adapt to the new conditions of foreign trade are the main reasons for the non-recognition of Kyrgyz certificate of origin by the CU countries.

In any case, the problem of non-recognition of Kyrgyz certificate of origin by the CU countries can be solved only if the CU countries are confident in the reliability of Kyrgyz certificates. In this connection, the successful experience of the Legprom Association in solving a similar problem with respect to garments should be considered.

**Conclusion:** it is necessary to develop measures aimed at adapting to the new conditions of trade with the Customs Union members. Specifically, it is necessary to:

1. Develop a common position of businesses and relevant government agencies on support for Kyrgyz enterprise, which will determine the priority areas for government support;
2. Ensure implementation by the CU countries of the agreements on recognition of Kyrgyz certificate of origin;
3. Improve the certificate of origin system of Kyrgyzstan based on new terms of trade and trade policy realities; and
4. Apply the procedure for confirmation of the origin of goods agreed by Russia and Kazakhstan with respect to garments to other exported goods as well, especially to agricultural products.