ECONOMIC DEVELOPMENT AND PRIVATE SECTOR GROWTH IN THE LOW-INCOME CIS-7 COUNTRIES:

CHALLENGES AND POLICY IMPLICATIONS

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Abstract

The paper examines why economic development has fallen behind in the low-income CIS-7 countries, while private sector activity has grown in absolute terms and as a share of GDP. The paper shows that the problem lies in the quality of the private sector. In the CIS-7, the statistical increase in the private sector is largely due to state assets that were privatized. Since most of the state assets had little economic value other than buildings and land, and were transferred to the "private sector" with weak management and poor governance, "privatization" on its own could not lead the way to a more efficient, higher-valued added private sector. Moreover, pervasive state interference in the business activity has encouraged businesses to remain small in size. Although there is a certain entrepreneurial dynamism in the CIS-7, the private sector has yet to emerge as an independent sector, free to operate on its own. Since large-scale Soviet style enterprises have vanished, the vast majority of private firms are micro- or small-scale—a size distribution that is consistent with the low-income level in the CIS-7— ; the private sector is concentrated in exploiting arbitrage opportunities rather than in country-building activities; and is increasingly involved in the exploitation of natural resources. The paper examines several hypotheses to explain this low-level equilibrium: 1) public sector deficiencies—such as the public sector involvement in purely commercial activities, predatory tax enforcement and provision of ad hoc investment-based tax incentives—undermines private sector development; 2) frequent and piecemeal changes in laws and regulations feed bureaucratic discretion; 3) lack of incentives to operate formally in the business sector weakens the demand for a better investment climate; 4) domestic uncertainty diverts policy-makers' attention away from regional concerns Since the CIS-7 countries started from further back than the Central European countries, they will need more time to absorb policy changes and build up adequate institutions.

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INTRODUCTION

1. In spite of widespread donor assistance and substantial amounts of aid, both in terms of grants as well as loans, growth rates in the low-income CIS-7 countries[1] have been much lower than anticipated. Looking at the official statistics, the CIS-7 countries are economically worse off than they were 10 years ago, at the start of their political independence and the transition process. They have been unsuccessful in "catching up" with the most advanced transition countries of central and eastern Europe and the Baltics. In 2001, real GDP amounted to 29 percent of the 1989 level in the CIS-7 countries, compared to 88 percent in the advanced reformers. Official per capita incomes vary between US$158 (Tajikistan) and US$652 (Azerbaijan), suggesting that the CIS-7 countries rank now among the low-income developing countries[2]; they are all IDA-recipient countries.

2. Growth performances have been disappointing in spite of the remarkable expansion of the "private sector."[3] Private sector activity has grown in size, both in absolute terms and as a percentage of GDP. Official statistics show that the private sector, on average, accounts for 52 percent of GDP. Private sector activity is likely to have expanded in the CIS-7 countries as a result of the privatizations: all of the CIS-7s completed small-scale privatizations; they are more than half way in the privatization of the large-scale enterprises and the sale of strategic enterprises and public utilities (EBRD, 2001).

3. If the private sector has grown during the past ten years and has the greatest potential for economic growth and job creation, why has economic development fallen behind in the CIS-7 countries? More generally, why is the real sector unable to move forward in countries that have completed macro-economic stabilization and undertaken basic structural reforms? Why has economic development stalled in countries that are characterized by a relative political stability?

4. Figure 1 illustrates the policy puzzle that needs to be resolved in the CIS-7 countries. It is true that the CIS-7 countries have, on average, a lower private sector share of GDP than in the advanced reformers of central and eastern Europe and the Baltics. However, there are many countries in the advanced reformers group that have a similar private sector share in GDP and appear on track for growth. Why do the CIS-7 countries lie systematically below the trend line, suggesting that these countries are unable to catch-up with the rest of the region?

5. Initial endowments in the CIS-7 countries were well below those in central and eastern Europe, and the Baltics: the CIS-7 were located far away from industrial markets and advanced economies, had no history of a market economy and were basically rural economies. The challenges in the CIS-7 were far greater for they had to manage the challenges of transition and development simultaneously.

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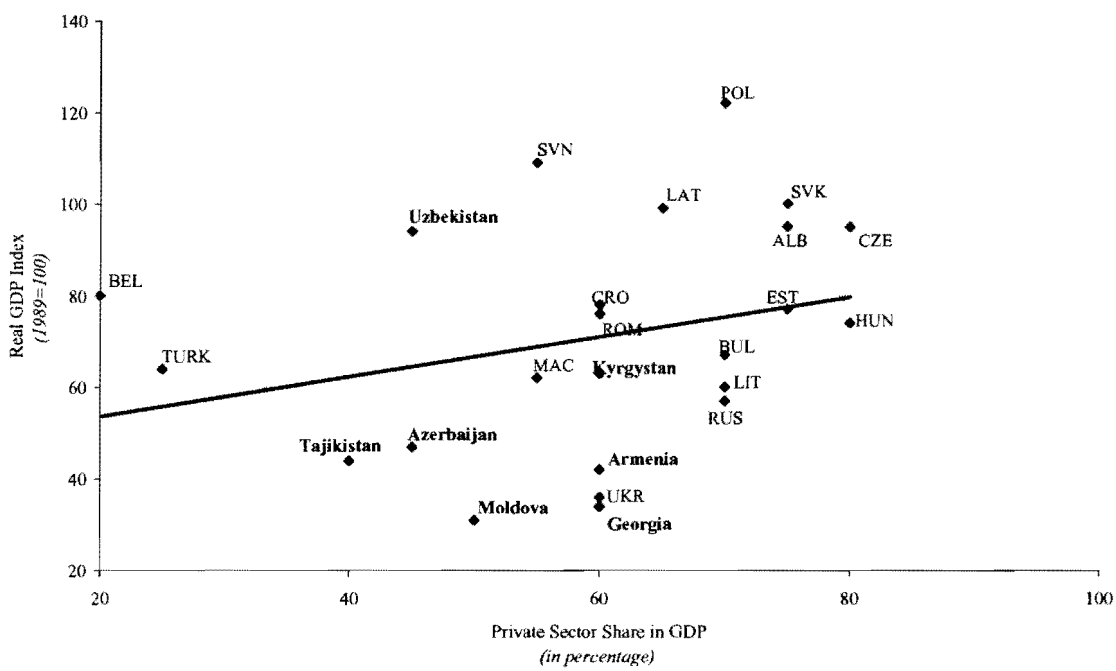
[1] The "CIS-7 countries" includes 3 Central Asian countries (the Kyrgyz Republic, Tajikistan, Uzbekistan), 3 Caucasus countries (Georgia, Armenia, Azerbaijan), and Moldova in Europe.

[2] Alternative indirect indicators suggest that the CIS-7 countries have a much higher per capita income than the low-income developing countries. For example, life expectancy is considerably closer than that of the OECD than to low-income developing countries; the infant mortality rates are substantially lower than rates for the low-income developing countries; literacy figures for adult males are very close to OECD standards; for those countries where statistics are available access to sanitation equals OECD levels.

[3] The private sector includes multinationals, large domestic firms, small businesses and micro-enterprises.

6. The geopolitical setting of the war in Afghanistan has put the CIS-7 countries, especially the Central Asian countries, in the spotlight of the world community. These countries are strategically important countries to the world, especially to Russia, the United States, Iran and China, each of which hopes to maintain or increase its influence in the region. Given historical ties and existing relations, Russia's influence has remained particularly strong. The United States, which had historically limited interest in the CIS-7, having considered these countries as part of the Russia's sphere of influence, has developed a growing interest in the CIS-7: this interest has primarily revolved around natural resources (i.e. oil)[4] and security, especially in Tajikistan and Uzbekistan due to the ongoing conflict in neighboring Afghanistan. Finally, Iran does not only see these states as potential markets for Iranian goods, but also sees relations as an important part of increasing its own ties with the international community, and counterbalancing an increase in Western influence in the region (Petros, 2002). China is increasingly regarded as a major partner in the region, as it courts the Central Asian states to ensure that its own large Muslim populations are not radicalized.

Figure 1. Private Sector Share of GDP and Real GDP Index in ECA Countries, 2000



Source: World Bank Database

7. To respond to concerns about the economic situation in the CIS-7 countries, the Bank, in partnership with the IMF, ADB and EBRD launched the CIS-7 Initiative. Under this Initiative, the international donor community is expected to provide additional resources to the best reformers, coupled with bilateral debt restructuring and possibly assistance under the HIPC Initiative. Furthermore, the CIS-7 Initiative endorses the view that economic development is tied to the promotion of private sector activity in these countries.

[4] For instance, in 1997, the United States invested a total of US$ 1.1 billion in Azerbaijan, out of which US$ 780 million was used in the oil sector. This compares to a combined U.S. investment of $300 million in Armenia and Georgia for the same year.

8. This paper re-examines the path of economic development in the CIS-7 countries, by focusing on the role of the private sector. It identifies policy recommendations that are workable in the context of major long-term CIS-7 problems—weak public and corporate governance, corruption and tight fiscal resources. The CIS-7 Initiative opts to regard these countries as a group, or a region. As such, it abstracts from country specificities and investigates whether, to a similar set of problems (albeit of a different magnitude), a similar set of policies could be recommended.

1. HIGH RISK ENVIRONMENT

1.1 Foreign investors are cautious about the CIS-7's prospects. With the exception of investment in natural resources (e.g. oil, gas, and gold), foreign investors perceive that the risk of conducting business in the CIS-7 countries is excessive; they demonstrate reluctance to assume the political and project risks. This is evidenced by the levels of foreign direct investment in the CIS-7 countries, which are among the lowest in the region.[5] This is also evidenced by the high level of domestic interest rates. Nominal interest rates for hard-currency lending average 25 to 35 percent in the CIS-7 countries. The level of interest rate includes a large premium to compensate for the high risk.[6] Overall, international risk capital is virtually absent or is targeted at the natural resources extraction sector.

1.2 The CIS-7 countries are among the poorest countries of operation for international financial institutions focused on the private sector (IFIs), such as the EBRD and the IFC. IFIs hold a minimal exposure to the CIS-7 countries: with the exception of investment projects in natural resources, IFIs have avoided real sector investment projects and channeled limited resources through credit lines, which are often extended under a sovereign guarantee. Overall, existing investment projects have performed poorly; credit lines have been slow to disburse; the investment climate has not been prone to equity investments; and the performance of regional equity funds has been limited. The low exposure and poor performance of existing projects of IFIs suggest that investing in an advanced reformer like the Kyrgyz Republic, is as challenging as investing in a lagging reformer like Uzbekistan. The expansion of the portfolio of IFIs would require the acceptance of larger risks, both financially and reputationally, as the number of high quality sponsors is limited.

1.3 ***IFC Exposure.*** IFC's exposure to the CIS-7 countries amounts to 1.1 percent of its total portfolio (Table 1). Since the independence of Uzbekistan, IFC invested US$53 million. In the Kyrgyz Republic, a more advanced country in terms of economic reforms and investment climate, IFC invested US$ 40 million. The largest IFC investments, both by number of projects and by value, were made in Azerbaijan (US$132 million) and Georgia (US$59 million); these investments were concentrated in resources extraction (oil, gas and mining).

1.4 ***EBRD Exposure.*** In the aftermath of the September 11 events, the EBRD endorsed an "Action Plan for Accelerating Activity in Central Asia": in the next 12 months, the EBRD expects to sign up to US$ 368 million of projects to the three low-income Central Asian countries (and Turkmenistan and Kazakhstan). So far, the EBRD has invested US$ 1,361 million, or around 10 percent of its total portfolio in the CIS-7 countries (in both public and "private" investment projects). In Tajikistan, for instance, the EBRD committed US$ 32 million. In Uzbekistan, of a total of US$ 435 million of signed commitments (net of cancellations and repayments), 65 percent has been disbursed. More than two-thirds of the commitments were in public or "private" (under a sovereign guarantee) projects. In most of the CIS-7 countries, the EBRD did not reach its private/public target ratio of 60/40. For instance, the private/public ratio is 24/76 in Tajikistan. The relatively high public sector exposure is the result of high private risk, which implies more reliance on sovereign guarantees for financial sector and infrastructure projects.

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[5] This outcome is consistent with the positive correlation that exists between national performances and the behavior of international financial markets.

[6] Such a high interest rate implies that the return on projects has thus to be equal to at least 25 percent, to be financially sustainable. In reality, very few projects have such a high return.

Table 1. Financial Exposure of IDA/IBRD, IFC, ADB and EBRD to the CIS-7 Countries, 1991/2-2002

	IDA/IBRD			IFC	ADB	EBRD
	Commitments	with PSD components	% of direct PSD activities	Commitments	Commitments[1/]	Commitments
	(US$ million)	*(US$ million)*	*(in percent)*	*(US$ million)*	*(US$ million)*	*(US$ million)*
Central Asia						
Kyrgyz Republic	656	303	5.9%	40	478	149
Tajikistan	300	197	30.0%	16	108	13
Uzbekistan	644	120	18.6%	53	405	493
Caucasus						
Armenia	726	323	9.5%	3.6	0	113
Georgia	745	351	21.6%	59	0	163
Azerbaijan	575	187	8.7%	132	0	272
Europe						
Moldova	641	469	41.2%	26	0	158
TOTAL:	**4,287**	**1,950**	**18.5%**	**330**	**991**	**1,361**
(in % of portfolio)	...	...	...	***1.1%***	***4.2%***	***9.7%***
Memorandum Items:						
Russia	13,604	4,214	9.7%	463	0	2,772
Ukraine	4,203	1,887	10.2%	13	0	958

Source: World Bank, IFC, EBRD, ADB and Author's calculation
Note: 1/ 1993-2001 only because no programs started prior to 1993.

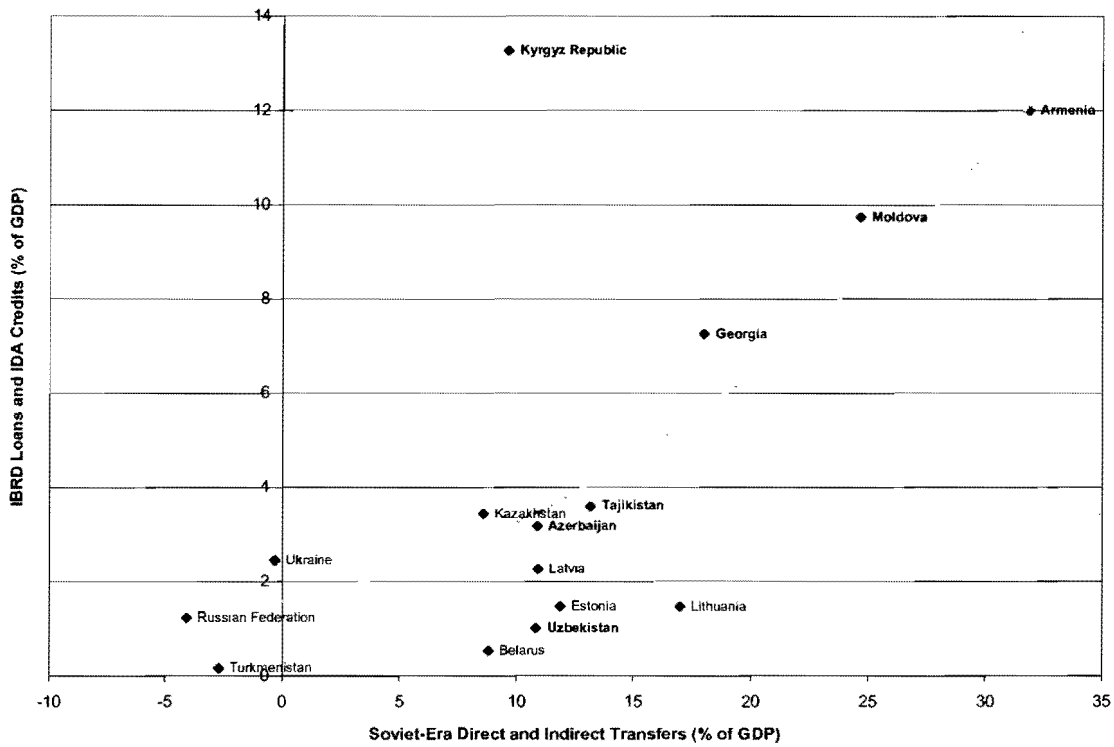
1.5 ***IFIs assistance.*** Other international financial institutions, such as the World Bank (IDA/IBRD) and the IMF, have filled the financial gap left by private foreign investors. In 2000, official capital flows to the CIS-7 accounted for two-thirds of the total official flows to all the CIS countries (including Russia), and exceeded net private flows (see Annex 1). The Bank, for instance, committed US$ 4.3 billion to the CIS-7 countries over the past 10 years. This is equivalent to an average commitment of US$ 620 million per country. The Kyrgyz Republic, for instance, a country of less than 5 million inhabitants, benefited from US$ 660 million of concessional assistance. For comparison, total commitments in Albania, another low-income country in the ECA region, amounted to US$ 569 million.

1.6 ***Inter-CIS Transfers.*** The large inflow of foreign aid from the Bank may have replaced the role of inter-republic transfers that prevailed under the centrally planned system. Figure 2 shows the weighted average of IBRD loans and IDA credits as a percent of GDP (1995-1999) against a measure of direct and indirect transfers in the Soviet Union. The CIS-7 countries are in bold. With the exceptions of the Russian Federation, Ukraine, and Turkmenistan, which were net "donors" of inter-republic transfers under the Soviet system, all other countries were net recipients. Figure 2 shows the positive correlation between the inflow of foreign aid in the 1990s and inter-Republic transfers under the Soviet system. The Kyrgyz Republic, for instance, received the equivalent of 13 percent of GDP in foreign aid, a percentage significantly higher than what it received under the Soviet system (about 10 percent of GDP).

1.7 ***"Model Reformers".*** Foreign aid was concentrated in the early 1990s to support macro-economic stabilization and early structural reform efforts. Three CIS countries accelerated their structural reforms in 1991-2 and emerged as the "model reformers" of the CIS: Armenia, Moldova and the Kyrgyz Republic (CIS-3). For those countries, the structural reform achievement index, a measure of progress in key structural reforms increased from 4 percent in 1990 to 37 percent in 1992 (Aslund and Warner, 2002). The growth rate of the Kyrgyz

Republic, for instance, reached 10 percent in 1992. By mid-1990s, the structural reform gap between the CIS-3 and the advanced reformers of central Europe and the Baltics had been reduced to 20 percent, compared to 1990. The CIS-3 continued to implement structural reforms throughout the 1990s, until the Russian financial crisis of 1998.[7]

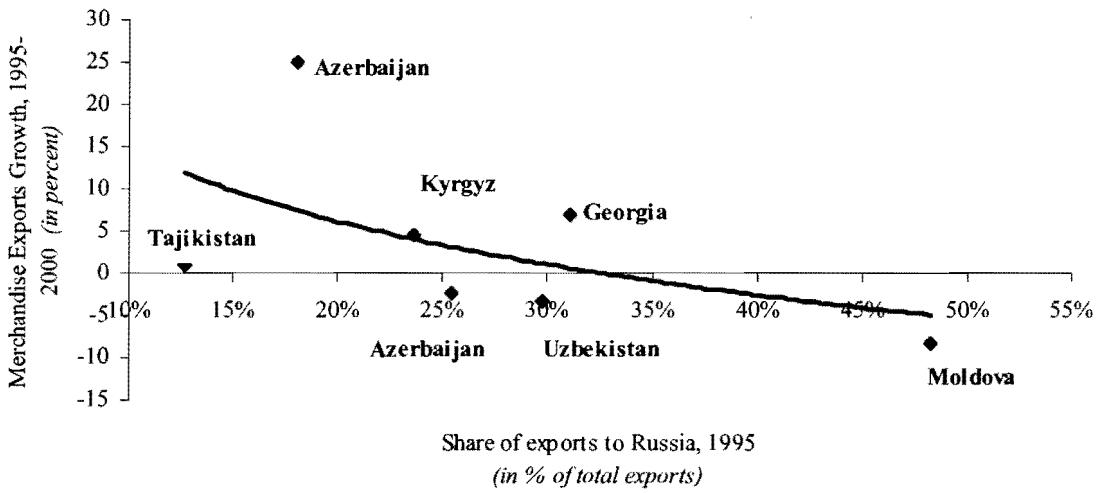
Figure 2: Pre-Transition Transfers and World Bank Lending to CIS Countries



1.8 ***Impact of the Russian Financial Crisis.*** The Russian financial crisis did not have the immediate effect of accelerating structural reforms in central Asia, as some observers had originally expected (IMF, 2001). Rather, the EBRD transition indicators deteriorated for all central Asian countries (except Tajikistan) between 1998 and 1999, suggesting some backsliding in earlier structural reform efforts. The financial crisis had a significant adverse impact on private transfers, investment, economic growth and exports (Michalopoulos, 2002). Figure 3 shows that countries that had the largest export dependency on Russia, also experienced the lowest export growth thereafter (Hudon, 2002). Nascent banking sectors fell apart. Finally, the unfolding of the crisis led to a significant increase in external debt-to-GDP ratios in Central Asia. In the Kyrgyz Republic, for instance, the external debt to GDP ratio rose from 56 percent of GDP in 1997 to 120 percent in 2000 (Pastor and Damjanovic, 2001).

[7] After that, structural reforms have been discontinued. In the Kyrgyz Republic, for instance, the structural reform index declined from 82 percent in 1998 to 79 percent in 2000. The other CIS-7 countries started to catch up with the "model reformers": in 2000, the structural reform gap between the CIS-3 and the rest of the CIS-7 had been halved compared to 1992. In 2000, 75 percent of the structural reforms were completed in the CIS-3, compared to 64 percent in the CIS-4, and 88 percent in the advanced reformers of central and eastern Europe and the Baltics.

Figure 3. Export Dependency of the CIS-7 Countries on the Russian market, 1995-2000



1.9 ***Aid dependent countries.*** In 2002, most of the CIS-7 countries have used up most of the extra policy freedom that access to foreign funds permit. Five out of the 7 CIS are considered as highly indebted, even though some of these countries are endowed with natural resources such as oil, gas and gold. Moreover, the external debt is mainly incurred vis-à-vis IFIs. Having borrowed 100 percent of its GNP, by all commercial and even IFI standards, Moldova, for instance, is "borrowed-up." Had those loans been devoted to productive investment, they would have been sufficient to replace about a third of Moldova's capital stock and virtually its entire stock of productive equipment. However, the low growth rates of capital reveal that these loans were not so used (Holden, 2002). Excessive borrowing from IFIs has transformed some of these countries in aid-dependent countries.

1.10 Such a high level of external indebtedness has seriously impaired the CIS-7 countries' limits for sovereign lending, especially in the Kyrgyz Republic and Tajikistan At the same time, relatively low levels of reserves compared to either OECD or low income countries indicate a high degree of illiquidity and vulnerability to foreign economic shocks.

Recent Economic Performance in the CIS-7 Countries.

The boom in Russia and other CIS energy exporters (Kazakhstan, Azerbaijan, Turkmenistan), coupled with the real appreciation of the Russian rouble vis-à-vis other regional currencies, contributed to a high rate of regional growth in 2001 (Annex 1). The aggregate GDP of the CIS-7 increased by 8.1 percent. With outstanding double-digit GDP growth rates in Tajikistan, growth of 4 to 5 percent (for Georgia and Uzbekistan) appears relatively modest in this high growth region. The performance of the Caucasus economies varied across countries during 2001, reflecting differences in endowments, exposure to conflicts and resulting supply-side disruptions of output, as well as the strength of trade links with crisis-ridden Turkey. In all of them, however, there was a strong recovery of agricultural output during 2001 after the serious drought in 2000. Strong performance of the Armenian economy, for instance, was due more to agriculture and services than to the slow-growing industry. Azerbaijan's GDP growth in 2001 continued a long expansion underway since 1996. Since then, growth has been driven mainly –directly or indirectly – by the oil sector. The uneven pace of growth is illustrated by a 5.9 percent increase in the output of extractive industries, but only 2.8 percent in manufacturing. The Central Asian countries also profited from better harvests; industrial output remained dominated by a small range of commodities. Kyrgystan's economy, relying heavily on gold mining, posted GDP growth of 5.3 percent in 2001, to which agriculture and gold mining together contributed to 3.7 percentage points. However, industrial activity apart from gold mining declined by 1.6 percent, year-on-year data. Annex 2 summarizes the recent developments in the area of privatization of state enterprises and infrastructure.

1.11 ***NGOs presence.*** The CIS-7 countries also benefited from the strong presence of local and international NGOs. Preliminary evidence suggests that there are about 2-3,000 NGOs (including humanitarian) in the Kyrgyz Republic. In Azerbaijan, where NGOs started to establish themselves later than in Georgia and Armenia, there are 1,500 NGOs (out of which 45 are international institutions). In Tajikistan, the 1,241 local and 55 international NGOs channeled US$48.2 million of aid in 2001. However, NGOs have concentrated their activities into second-generation issues: SME financing and technical assistance, and micro-finance. For instance, more than 30 NGOs are providing individual micro-credits in Tajikistan. Mercy Corps International has disbursed the local currency equivalent of $9 million in credit to farmers and small business owners in Tajikistan, the Kyrgyz Republic, Uzbekistan and Kazakhstan. Often, NGOs lack the financial means and/or technical expertise to address first-generation issues, such as investment climate, entrepreneurship, and the restructuring and privatization of state-owned enterprises and utilities. [8]

2. OUTCOMES OF FOREIGN ASSISTANCE AND REFORMS IN PRIVATE SECTOR DEVELOPMENT

2.1 Overall performance of Bank projects in the CIS-7 countries has been poor. Over the 1991-2001 period, the disbursement rate varied between 57 percent (Uzbekistan) and 73 percent (Moldova), raising concerns about the absorptive capacity of concessional assistance in the CIS-7. Four of them are now regarded as LICUS countries ("low-income countries under stress")— Uzbekistan and Tajikistan as "core LICUS" and the Kyrgyz Republic and Azerbaijan as

[8] The absence of private sector development-oriented NGOs would complicate considerably the issue of grant-making in the ECA-LICUS countries.

"intermediate LICUS." LICUS countries are defined as chronically weak-performing borrowers that "have proved highly resistant to change and Bank projects"[9] (World Bank, 2002b).

2.2 According to a recent OED assessment on aid effectiveness in the 77 IDA-recipient countries, the effectiveness of IDA's private sector development (PSD) work has been poor. A lag in private sector development has been a major contributing factor to weak broad-based growth in IDA borrowers. PSD-supported activities account for 27 percent of the total IDA portfolio (World Bank, 2002c). In the CIS-7 countries, direct support to private sector development (i.e. credit lines) has accounted for 18 percent of the Bank assistance. Private sector development has mainly been supported by structural adjustment operations.

NOMINAL CHANGE IN OWNERSHIP

2.3 Official statistics suggest that much progress has been accomplished in the CIS-7 in terms of increasing private sector participation to the economy and transfer of ownership to the private sector. In the Kyrgyz Republic, the private sector contributes to 70 percent of the GDP. In Tajikistan, the poorest of the CIS-7, 98 percent of the trade is in "private hands," while 80 percent of the industrial production is private. Even in Uzbekistan, the lagging reformer in the CIS-7, more than half of the official GDP is produced by the private sector. Indirect evidence suggests that the increase in private sector activity is largely owed to the "privatization" of state-owned enterprises. Indirect evidence suggests that increase in private sector activity is largely through privatization of state owned enterprises, rather than new entry.

2.4 ***Stock of state assets.*** A priori, it is difficult to see how the privatization of state assets could lead the way to high value-added private sector development. With their overhead of excessive staff, with their weak management often carried over from earlier days, with a stock of equipment that is largely fully depreciated and having little economic value, enterprises often have little economic value other than the buildings and land of the factory. Apart from the utilities and agricultural companies, enterprises are often haphazard agglomerations of industries that are not necessarily based in the CIS-7 countries on economic efficiency grounds. For example, in Armenia, there was an extensive group of manufacturing plants serving the Soviet military industrial complex, particularly making components of the construction of nuclear submarines. Many of these plants were not suited for conversion to peace time production; neither are they for efficiency-enhancing privatization. Uzbekistan has a large aircraft manufacturing conglomerate which makes little sense now that its alliance with Soviet airplane production is no longer assured.

2.5 ***Insider-privatization.*** It is generally argued that the privatization led to better outcomes in the advanced reformers of central and eastern Europe and the Baltics than in the CIS-7 countries (World Bank, 2001b). In the advanced reformers, privatizations often involved the sale of assets to strategic, foreign investors, leading to improved post-privatization performance of enterprises. In contrast, the CIS-7 countries attracted few external investors.[10] Privatizations involved either voucher-based programs or generous concessions being made to insiders (workers

[9] For these countries, the Bank's Board approved a new policy, i.e. a significant reduction of Bank credit in these countries, and the substitution of credits/loans by grants, which would be channeled to non-governmental agencies. While there is a substantial difference between a country such as Uzbekistan, which has a basic functioning state apparatus, and a post-conflict country such as Tajikistan with a weak state structure, both countries are considered alike, commanding a similar approach by the Bank.

[10] Domestic markets in the CIS-7 are too small, remote from important industrial markets; and there is little that is intrinsically valuable on its own to purchase.

and managers). In Tajikistan, for instance, a recent private sector survey shows that 100, out of the 140 privatized large and medium SOEs were insider-owned and controlled, where managers and workers owned some percentage of the shares (World Bank, 2001a). In Armenia, in a sample of 145 large joint-stock companies in 1999, on average 2-3 largest shareholders held about 70 percent of company stock. And in almost all cases, these largest shareholders were companies' insiders (World Bank, 2001c).

2.6 ***Firm-level performance.*** However, improvement in economic performance appears to be weakly correlated with the ownership structure/change in the CIS-7 countries. Data on performances for the 100 largest industrial enterprises in Armenia for 1997-98 shows that there has been an overall decline in output, employment and number of firms during that period—irrespective of the ownership structure (fully state, private or mixed ownership). While 64 enterprises were profitable in 1997 (contributing to 71 percent of the industrial output), there were only 30 enterprises left (contributing to 33 percent) in 1999 (World Bank, 2001c). Another study of 50 medium and large private enterprise in Armenia noted that only three of the set had generated any new investment post-sale. For most of the others, the prognosis was for continuing decline and ultimate bankruptcy (CEPRA, 1997). In Tajikistan, recent evidence shows that large state-owned and privatized firms still operate as large (horizontally and vertically) integrated units (World Bank, 2001a).

2.7 Improvements in economic performance seem to have less to do with the ownership structure, than with the level of competition. A 1998 Survey of 92 state- and privately-owned firms in Georgia concluded that it was not private ownership but rather competition and financial discipline that was associated with the restructuring of enterprises (Djankov and Kreacic, 2000).

STATE INTERFERENCE IN PRIVATE SECTOR ACTIVITY

2.8 The State is ubiquitous in the CIS-7 countries: in the Kyrgyz Republic—a concentrated political regime, as much as in Uzbekistan—a non-competitive political regime[11]. Moreover while the ownership may have nominally changed, enterprises have often remained effectively under the umbrella of the State. In Moldova, for instance, the population invested their vouchers into heavily indebted enterprises only to become legal owners of firms that were effectively controlled by their creditors. Owing to tax and energy arrears, the creditors were often the State (World Bank, 1997).

2.9 ***Land.*** Even though land has been privatized, Governments still play an active role in supporting the agricultural sector. In Uzbekistan, the sector is largely state-controlled, with the government setting targets for the production of cotton and grain and fixing the local currency price for these crops. Its control of cotton exports, which account for up to a third of total exports, gives the government of Uzbekistan secure access to hard currency which is used to finance its industrial policy and service the foreign debt (EBRD, 2001). In Tajikistan, the Government has privatized the low-value added agricultural areas and largely kept the high-value areas under state control. In mountainous areas where cotton is not grown and there is no irrigation, land from the former kolkhozes and sovkhozes was distributed fairly equally among individual private farmers—this accounts for 30 percent of arable land. About 40 percent of Tajikistan's arable land remains under the control of unreformed state farms (World Bank, 2001).

[11] Hellman *et al.* (2000) note that these "state interventions" are relatively more widespread in the Central Asian countries than in the Caucasus and Moldova.

2.10 ***Trade Associations***. There is often little distinction between the role of the Government as a policy-maker and regulator, on the one hand, and business shareholder (owner) and manager, on the other. In Uzbekistan, for instance, "Trade Associations," which were established by Presidential Decrees control key sectors of activity. Although the functions of associations vary from sector to sector, they include lobbying to advance "members" interests; rationalizing output, pricing, investment, distribution, input, and foreign exchange allocation decisions; and operating akin to holding companies. In some respects, they are thinly veiled replicas of the line ministries during Soviet times. Most associations are not in favor of their members being privatized and they act to forestall such privatizations. While membership in an association is not legally mandatory, in practice, virtually every firm operating (or seeking to operate) within a given sector is (or becomes) a member of the sector's association (Broadman, 2000). Estimates vary as to the size of membership fees charged, but they appear to be on the order of 10-20 percent of profit (Vandycke, 2002b).

2.11 ***Weaknesses in Shareholders' Voting Rights***. State interference can take more subtle forms. There are legal provisions on Joint Stock Companies (JSC) that ensure that neither minority investors, nor strategic investors have the ability to influence company management or exercise their shareholder rights—or provide any effective supervision on company managers, when the state continues to hold shares in a company.[12] In Uzbekistan, for instance, if the state owns any shares in a company—as it typically does in privatized enterprises—the shareholders' meeting is not valid if the state representative is not present. Furthermore, for 15 days after the shareholders' meeting, the government's agent can defer decisions made by the meeting if such decision "contradicts the interests of the state." By law, where the state holds 25 percent or more of a company's shares, the State Property Committee can unilaterally increase the amount of the charter capital. This could be done by diluting the interests of the shareholders, without compensation to the shareholders and without a vote in a shareholders meeting (Rutledge, 2000a).

2.12 Enterprise-specific examples showing "state interferences" in the business sector abound:

- In Uzbekistan, a private furniture company (JSC), with the State as a minority shareholder, sustains its activities through state orders, allowing the company to cross-subsidize the goods delivered to the private market.

- In the Kyrgyz Republic, a medium private radiator company (JSC) distributes all its profits (through dividends) to the 1,300 shareholders (former and current employees), remaining effectively a socially-owned company.

- In Tajikistan, a private silk processing company (JSC) has to sign yearly contracts with the local and central governments to purchase silk cocoons from producers in the regions, remaining dependent on the State for the supply of inputs. Silk (and cotton) ginneries operate as local monopolies or oligopolies. Local authorities prevent inter-regional trade and act to protect local champions, which are sources of taxes and other payments.

[12] Uzbekistan is alone among the Central Asian countries in maintaining specific provisions to reduce the ability of investors to obtain controlling position in a privatized company. Under the Securities Law, any investor wishing to acquire 35 percent or more of a company's shares must obtain the prior approval of the Anti-Monopoly Office. While the provision does not apply to the original founders of the companies (except where the founders are holding companies or members of financial-industrial groups), it would be sufficient to discourage investors from buying large block of shares on the secondary markets (Rutledge, 2000a).

- In Azerbaijan, the foreign private oil company is "strongly encouraged" to work with Azeri-controlled private (or public) downstream companies.

2.13 ***Cost of becoming prominent.*** State interference in the business sector can preclude official private sector growth, when the incentive structure encourages businesses to remain small in size. Anecdotal evidence suggests that profitable businesses choose either to expand unofficially, or to change the nature of their operations to remain un-noticed.

- In the first instance, the effect on growth is small—even though the transaction costs to circumvent the restrictions are high. In Uzbekistan, for instance, businesses adopt double bookkeeping practices to avoid "excessive" tax payments, circumvent bank restrictions and excessive inspection controls. In Azerbaijan, even banks recognize that they allocate credit on the basis of both official and unofficial accounts. These practices are integrated in the normal functioning of the business sector and do not preclude business growth as such[13].

- However, in the second instance, the effect on growth can be substantial. In Azerbaijan, for instance, an entrepreneur borrowed money to open a small ice-cream business on the sea side. As his business grew on his first year, he decided, for fear of being noticed, to reduce its activity, reimburse the loan and borrow money to open a shoe shop on the second year. The third year, he closed down the shoe shop and started a third business.

INHERENT DYNAMISM OF THE PRIVATE SECTOR

2.14 There is an inherent entrepreneurial dynamism throughout the CIS-7 countries. Evidence shows that the business sector is growing in spite of state interference. One indicator concerns movements of the labor force. Siegelbaum et al. (2000) observe that the labor force has been steadily increasing in newly created enterprises in Azerbaijan, Kyrgyz Republic and Moldova—in comparison with the privatized or state-owned companies. In Tajikistan, the poorest of the CIS-7, indirect indicators of this dynamism, such as the growing number of small cafes, exchange rate offices, mobile phone companies and schedule of flights from Dushanbe to Moscow, show strong entrepreneurial spirit.

Table 2. Size of the Informal Economy in the CIS-7 and Advanced Transition Countries
(as a share of GDP (in 2001) and employment (in 1999))

Country	Share of GDP	Share of Employment
CIS-7 Countries		
Kyrgyz Republic	39.4	29.4
Uzbekistan	33.4	33.2
Armenia	45.3	40.3
Georgia	66.1	53.2
Azerbaijan	60.1	50.7
Moldova	44.1	35.1
Advanced Transition Countries		
Poland	27.4	20.9
Hungary	24.4	20.9
Slovenia	26.7	21.6
Czech Republic	18.4	12.6

Source: Djankov et al., 2002

[13] As discussed below, it ensues that the demand for an improvement in the business environment is ambiguous in the CIS-7 countries.

2.15 This growth reflects ingenuity and pro-activeness on the part of the entrepreneurs in view of an overall collapsing official system (and public sector). In urban areas, businesses often show good knowledge of the tax system and the "rules of the game." For example, evidence shows that, in Uzbekistan, owners of large businesses transformed their companies into joint stock companies during the privatization period and artificially broke them down into smaller units to benefit from favorable and simplified tax requirements[14]. Growth in the private sector is mainly reflected in the informal sector. In the CIS-7, the informal sector can be as large as two-thirds of the GDP (Table 2).

TYPE OF PRIVATE SECTOR GROWTH

2.16 The private sector still has a long way to go before it can emerge as an independent sector, free to operate on its own, without government interference. In simple terms, the private sector in the CIS-7 comprises a large number of "traders," but a lesser number of "real entrepreneurs". The private sector is concentrated in exploiting arbitrage opportunities rather than in country-building activities, and is operating at the interstices between the legal and illegal world[15]. That is a far different kind of private sector that creating new enterprises and competing in the international market place. Unless the private sector matures, the benefits of private ownership/management on economic growth will be minimal.

2.17 ***Size Distribution of the business sector.*** During the 1990s, the size of the enterprise sector shifted from large to small and medium enterprises (SMEs). The large-scale Soviet style enterprises have vanished and SMEs have contributed to an increasing proportion of the economic activity. In Uzbekistan, for instance, the number of active registered large firms declined by 4.7 percent between 1999 and 2001, the number of medium firms declined by 9.3 percent, while the number of small firms grew by 13.7 percent (World Bank, 2002e). This size distribution is consistent with the low-income level in the CIS-7, in which the vast majority of firms are micro- or small scale. [16] Micro-enterprises and SMEs are the emerging private sector in the CIS-7.

SME Profile: Few data. Due to the lack of data, it is difficult to establish the actual size and structure of the SME sector. In Azerbaijan, estimates for the total number of registered enterprises range in between 20,000-30,000 and for the total number of people engaged in entrepreneurial activity but not registered as legal entities between 63,000- 180,000 (Holden, 2002). In Georgia, it is estimated that registered SMEs account for 58 percent of the employment. In the Kyrgyz Republic, registered SMEs may contribute to 36 percent of the GDP and 23 percent of the country's total industrial production. 1,089 thousand people are working in one of the 154,000 active SME. In Uzbekistan, private SMEs account for 16.2 percent of total employment. About 80 percent of SMEs are in the agricultural sector.

2.18 Preliminary evidence for the CIS-7 countries, and indirect evidence derived from neighboring countries, such as Russia, Ukraine and Khazakstan, suggest that the development of small enterprises in post-Soviet countries has been significantly different than the one in the advanced reformers of transition Europe (central and South Eastern Europe and the Baltics):

[14] The statistical increase in the number of SMEs in Uzbekistan may simply reflect this effect rather than an actual growth in the number of new small businesses.

[15] Annex 3 presents a typology of the enterprise sector in the CIS-7 (Djankov *et al.*, 2002).

[16] On average, small scale enterprises play a declining role as countries develop. The exceptions to this rule are found mainly in Asia. In Taiwan, China, for example, the size distribution of firms has remained relatively constant over the past 30 years, even though the level of income has gone up (Hallberg, 2000).

- Density of small enterprises in the economy: In post-Soviet countries, the (official) contribution of small enterprises to value added and employment is generally well below than in the advanced reformers. For example, registered SMEs account for 36 percent of GDP in the Kyrgyz Republic, compared to 58 percent in the Czech Republic. There is some evidence suggesting that there is a threshold –of around 40 percent for the shares of small enterprises in employment and value added—below which economies do not take off (World Bank, 2002a).

- Dynamics over the transition period. Empirical evidence shows that SMEs, which were mostly new, are more productive than old enterprises (World Bank, 2002a). At the start of the transition, the labor productivity differential was significant between new and old enterprises[17]. As the transition proceeded and resources were progressively re-allocated between sectors, the productivity differential was expected to erode. This is shown now in the advanced reformers by a smaller differential between sectors. In the CIS-7 countries, the productivity differential is still expected to be large.

2.19 ***Distortions against SMEs.*** Private sector surveys show that market forces or institutional failures bias the size distribution of firms and put small and medium firms at a disadvantage compared with large firms (Schiffer and Weder, 2001)[18]. For example, the ability of SMEs to enter and compete effectively in export markets is discouraged by the high fixed cost of acquiring information on foreign buyers, distribution channels, quality standards, and new technologies. Also, laws governing the use of property as collateral often exclude movable assets such as machinery or livestock. Since movable assets often comprise a greater share of the assets of smaller firms compared with larger ones, this has a particularly negative impact on access to credit by SMEs (Hallberg, 2000). In Uzbekistan, SMEs have a more restricted access to hard-currency, input and credit, than larger enterprises.

2.20 ***Policy Response.*** Governments in the CIS-7 have actively promoted their development based on social and political considerations rather than on economic grounds. All of the CIS-7 countries adopted "A strategy to encourage the development of SMEs," streamlined business registration procedures, reducing business inspections and simplifying tax and reporting requirements. However, the adequacy of some policy instruments can be questioned. In Uzbekistan, for instance, the Government established a Business Fund with the privatization proceeds. This Fund allocates soft loans to start-ups at an interest rate equal to one sixth of the Central Bank refinancing rate. This credit scheme remedies the lack of finance for SMEs provided by commercial banks. At the same time, by providing credit at interest rates that are significantly below the market rates, this (publicly-funded) credit scheme discourages commercial banks from entering this segment of the market and tends to substitute for financial sector market development (Vandycke, 2002b).

[17] This policy shift is validated by empirical evidence, showing that the performance of "new" enterprises (i.e. green-field investments and restructured spin offs from newly privatized enterprises), as measured by investments, exports, sales and employment, is superior to that in "old" enterprises (Hellman *et al.* , 2000).

[18] Obstacles that did not vary according to the firm size included political instability, uncertainty, infrastructure and the judiciary.

Table 3. Contribution of the World Bank, EBRD and USAID to SME Development in the CIS-7 countries, 1997-2002
(in million of US$)

USAID	248.2
World Bank (IBRD, IDA, IFC)	186.3
EBRD (inc. equity investments)	109.6
TOTAL	**544.1**

2.21 ***Donors' assistance to SME development.*** SME support has been singled out for assistance in the CIS-7—although with little coordination—by bilateral and multilateral donors (Table 3). In 2002, USAID committed more than US$ 70 million for projects, directly or indirectly related to SME development, bringing USAID support to about $250 million over the 1997-2002 period. So far, the World Bank (through IBRD, IDA and IFC) has invested US$187 million. With the EBRD, more than half a billion of US$ was committed for SME development. Donors' assistance has focused on the direct and subsidized provision of financial and non-financial services to SMEs—with a lesser emphasis on creating an enabling environment for SME competitiveness.

2.22 ***The SME-based growth model.*** Although small firms have a higher gross job creation than larger enterprises, they also have a higher gross job destruction rate (Hallberg, 2000). Overall, small firms have a lower capacity to deal with an overall defective environment. For an SME-based pattern of development to deliver high growth, a number of pre-conditions should be met. In China, for instance, these conditions were met:

- A larger-scale sector, which can perform activities that require large fixed investment, such as processing and marketing, and has the capacity to export;
- A well-functioning public sector, which can supply the infrastructure and guarantee the security of transactions;
- A structured market for sub-contracting and supply chain (i.e. good coordination among entrepreneurs).

2.23 In the CIS-7 countries, these conditions are often lacking. In the Kyrgyz Republic, for instance, a recent assessment of the enterprise profile shows that there is no linkage mechanism that bridge the gap between excess production capacity from large privatized enterprises and the need for production capacity from SMEs. On the one hand, large privatized SOEs, which were originally built to be self-sustaining—and are endowed with horizontally integrated production facilities—have a low utilization capacity. All necessary inputs required to manufacture the final product are produced in-house, sometimes even the tools and dies at one extreme, and the packaging and labels at the other extreme. On the other hand, SMEs are in need of production capacity—they suffer from the lack of access to capital equipment and have to import/produce a substantial share of input materials required to manufacture the final product (World Bank, 2002d). Unless there is a structured market for subcontracting, SMEs will not be able to lead the process of economic growth. Most SMEs are "life-style" firms with little potential for sustainable growth.

2.24 So far, in the CIS-7 countries, the increase in the number of SMEs has been insufficient to compensate for the collapse in the activity in the larger enterprises. Several factors can explain this trend. First, as in other in low-income countries, small businesses tend to have much lower

productivity levels than larger firms (Hallberg, 2002). Second, SMEs are often a spin-off of large vertically integrated firms that were broken down into smaller units, but with negligible effect on performances. Third, SMEs are concentrated into low-value added activities.

2.25 ***Profile of activities***. In the CIS-7, the private sector is concentrated in low value-added activities, with minimal potential effect on growth:

- Arbitrage activities. Instead of country-building activities, the business sector essentially focuses on exploiting arbitrage opportunities. In Uzbekistan, for instance, manufacturing companies buy their input from local trade intermediaries, owing to the lack of domestic market for raw material and restrictions on the quantity of imported inputs (due to the lack of convertibility of the hard currency). These trade intermediaries are (informal) companies that make enormous profits on the scarcity of hard-currency and inputs. Manufacturing companies buy their inputs at a highly unpredictable price—contributing to increase the uncertainty on the profits from the sale of their final manufacturing output—and at a significantly higher input price than the official price—the unofficial price can be up to two times the official price. In Azerbaijan, for instance, about two-thirds of a typical bank's portfolio consists of lending for trading activities. For the banking sector, trade lending secures a high turnover and high return. However, the social benefits of trade lending are low.

- Service sector. In Georgia, official statistics show that 51 percent of the GDP is produced by the service sector, out of which less than 2 percent in financial intermediation services.

- The agricultural sector. The 1990s have witnessed an overall process of re-agriculturalization in the CIS-7 economies[19]—and a reversal in the traditional developmental pattern, which predicts the agricultural sector to develop prior to industries. In the Kyrgyz Republic, the production in the agriculture sector grew by 16 percent over the last 10 years, while the real GDP has fallen by 30 percent. As in other low-income developing countries, private farms in the CIS-7 struggle with basic problems, such as access to water, machinery, fertilizer, credit, and access to markets to sell their products.

2.26 ***Strategic sectors***. The CIS-7 countries share with one another a dependency on a limited range of resources. Central Asia has a combination of oil, natural gas, electric power, raw cotton, ferrous and non-ferrous metals, gold and uranium. These materials account for more than four-fifths of all exports from Central Asia. In 1998, gold accounted for one-half of all Kyrgyz exports. Around 85 percent of Tajik exports were in electric power, aluminum, and cotton. A combination of gold, uranium and cotton accounted for 76 percent of Uzbek export earnings (Petros, 2002). Uzbekistan and Azerbaijan have a comparative advantage in the extraction of oil.

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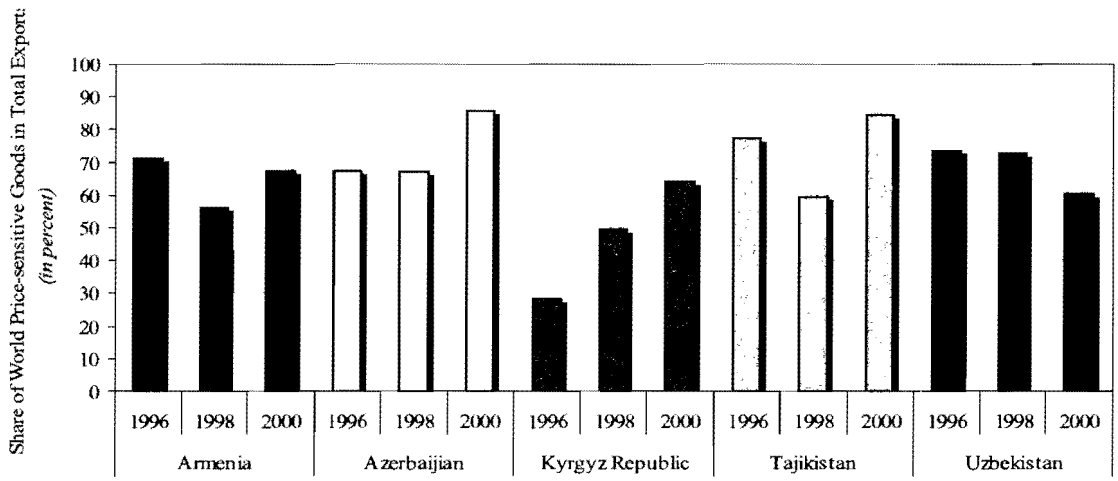
[19] The number of people employed in the agricultural sector *increased* during the 1990s (Petros, 2002). The agrarian sector is the largest employer in both Tajikistan and the Kyrgyz, responsible for 64 percent and 48 percent of the aggregate labor force, respectively. In Uzbekistan, the numbers of employed in agriculture is equal to those employed in the service sector. A similar situation can be seen in the Caucasus and Moldova where agriculture employs a greater number of people than does any other sector of the economy.

Figure 4. Share of World Price-Sensitive Goods in Total Exports, 1996-2000
(in percent)



Source: The Economist Intelligence Unit (2002)

2.27 ***Natural Resources Dependency.*** As shown in figure 4, the dependency of the economy on natural resources has increased in the 1990s.[20] Worldwide experience shows that a development pattern that is based on natural resources has several drawbacks:

- In extractive, resource-based economies, the expansion of domestic,downstream companies is generally limited. Typically, the extracting sector generates a demand for a wide variety of goods and services. Where the extractive sector has been transferred to foreign investors, this demand is often not met by local producers, because producers create well-developed technologies for living without local support. The development of the extracting (rent-seeking) sector often occurs at the expense of the non-tradable sector.

- The economic growth derived from the exports of these resources is virtually determined by the world market—and is vulnerable to world demand and price fluctuations. The economy as a whole becomes dependent on the world market, unless the development in the extracting sector is complemented by an active industrial policy.

2.28 Moreover, investments in the extractive sector are typically of an enclave type, i.e. large enough to support their own infrastructure and sufficiently insulated that they can operate in weak regulatory environments. Evidence shows that this development pattern weakens the overall business environment:

[20] Hudon (2002) found a negative correlation between the share of world price sensitive goods in total exports and the ownership composition of exports in the CIS-7 countries. For instance, in Uzbekistan where a significant share of exports depend on natural resources, only a small share of exports is supplied by private firms. In contrast, in the Kyrgyz Republic, where the export dependency on natural resources is lesser, a larger share of exports is supplied by private firms. See Annex 4.

- Governments grant privileges to foreign companies under well-crafted special agreements, such as Production-sharing Agreement (PSA) in the oil sector[21]. Large Western firms can negotiate the kind of concessions they wish as a condition to entry, despite the character of the legal regime. The advantages of foreign firms—for instance, in bargaining with the government and their power to credibly threaten exit and relocation—dominate over possible disadvantages such as being unfamiliar with local circumstances. This is supported by empirical evidence showing that foreign firms report significantly fewer problems than local firms (Schiffer and Weber, 2001).

- Governments do not extend these privileges to the domestic, non-extracting companies seeking to market goods and services to the upstream companies. Domestic, downstream companies are not only put at a disadvantage vis-à-vis foreign, upstream companies, but are also offered no protection against foreign, downstream companies. In Azerbaijan, for instance, the foreign oil company only works with foreign sub-contractors.

2.29 ***Protection of Property Rights and Lack of Good Corporate Governance Standards.*** In a Western economy, shareholders and their representatives through the Board of Directors provide a check on company managers (Rutledge, 2000a). However, in Georgia, the Securities Industry Association estimates that as many as one-third of reporting companies fail to hold their required shareholders' meeting, which is required for such important issues as making large transfers of assets or amending the company charter. This finding suggests that as many as half of the traded companies are in violation of the basic corporate governance provisions of the company law. At the same time, despite the introduction of international standard of accounting (IAS), financial reports are generally considered unreliable as weak audit practices have allowed "clean audits" to be delivered for companies that were later seen to have been on the verge of bankruptcy (Rutledge, 2001).

2.30 ***Asset Stripping.*** Often, the laws do not prevent company managers to enrich themselves at the expenses of shareholders and other stakeholders, notably creditors, tax collectors, employees and possibly customers. In Uzbekistan, as much as 50 percent of a company's assets can be sold without approval of the shareholders' meeting, and with just the agreement of the supervisory council. Even worse, in Tajikistan, there are no requirements for shareholdes approval of sales of even 100 percent of company assets (Rutledge, 2000a). In Armenia, the Joint Stock Company Law states that assets up to 50 percent of the book value of the company's total assets may be sold or transferred to other parties solely on the decision of the company board (Rutledge, 2000b).

2.31 ***Lack of Transparency.*** Weak corporate governance is also seen in the lack of transparency of joint stock companies, and even financial institutions, including banks, leasing and insurance companies. Neither shareholders, creditors, or regulators can obtain reliable information on the ownership and control of companies and financial institutions. Financial-industrial groups (based on clans affiliations or other relationships) provide capital for member companies within the groups, but almost no financing for enterprises not owned and controlled by the groups. Access to capital remains a major stumbling block for growth of the private sector.

2.32 ***Amendment to Company Charter.*** Typically, a super-majority of two-thirds of the shares should be required for amending the company charter. This is the case in the Kyrgyz

[21] Compared to other oil-producing countries, such as Russia and Kazakhstan, Azerbaijan established an advanced legal framework for the oil sector. Since 1994, for instance, Azerbaijan has signed and enforced more than 20 production sharing agreements (PSA).

Republic. In Armenia, the Joint Stock Company Law allows changes in the company charter to be made by 75 percent of the shareholders participating in the shareholders' meeting (Rutledge, 2000b). In Uzbekistan, shareholders representing as few as 45 percent of the shares can make changes to the charter—and the presence of the state representative, with the power to veto shareholder decisions, to prevent company managers from such corporate governance abuses as transferring the assets to friends and family at fire-sale prices. Tajikistan has neither the requirement of a government representative to be present nor a high minimum number of shares represented at such meetings. These deficiencies provide an opportunity for company managers to make it difficult for shareholders to attend the shareholders' meeting and exercise their rights (Rutledge, 2000a).

3. TRAPPED IN A LOW-LEVEL EQUILIBRIUM

3.1 ***Short-term Time horizon for Decision-making.*** In spite of abundant reforms to "create a favorable investment climate," the environment for economic activity in the CIS-7 remains uncertain and unpredictable. This level of uncertainty is shown in the decisions of all agents in the economy:

- ***Focus on short-term policy remedies and lack of strategic vision by Governments.*** This approach is adopted against the background of a low political turnover (i.e. absence of a change in political leadership (Uzbekistan, Moldova), a few changes only (the Kyrgyz Republic)) or prolonged war or civil conflicts (Tajikistan, Azerbaijan, Armenia, Georgia).

- ***Delays in making irreversible commitments by foreign investors.*** They focus on developing distribution networks, instead of making green-field investments. Investments are either made with a government guarantee or designed as "enclaves" from the investment climate. Foreign investors incorporate the cost of "informality" and uncertainty in contract enforcement in their investment decisions, raising significantly the cost of doing business in the CIS-7.

- ***Short-term decisions by local businesses and banks.*** The example of the private Tajik bank that stopped all its lending activity and used its resources to establish a trading house to channel goods to Afghanistan is significant. Attempts by agents to block specific advances in the reform process that threaten to eliminate the special advantages and market distortions upon which their early reform gains were based is consistent with the short-term decision-making horizon. For example, enterprise insiders have often become new owners only to strip their firms' assets (Hellman, 1998). Overall, uncertainty undermines managerial incentives in maximizing the firm value (Desai and Goldberg, 2000).

PUBLIC SECTOR DEFICIENCIES UNDERMINE PRIVATE SECTOR DEVELOPMENT

3.2 In spite of progress in the private sector, the public sector continues to direct a much larger fraction of GDP in the CIS-7 countries than in the case of high-income OECD countries: gross investment rates, which are clearly a function of the investments of state-owned companies or privatized companies with access to government directed or guaranteed credit, significantly exceed those in high-income OECD countries. Moreover, levels of government consumption, relative to GDP, are high in the CIS-7 countries, substantially exceeding those of low-income developing countries (Holden, 2002).

3.3 ***Public-private Sector Nexus.*** As shown in figure 5, the public-private sector linkage is empirically well-established in the 28 ECA countries: private sector development, as measured by the EBRD cumulative index of PSD (large-scale privatization, enterprise restructuring, competition policy and finance), is an increasing function of the level of public sector effectiveness, as measured by the EBRD cumulative index of public sector development (accountability, political stability, government effectiveness, regulatory framework, rule of law, and control of corruption). This empirical relationship is validated in the CIS-7 countries, which is shown in bold (Desai, 2002). In addition to public services delivery, the State provides the durable basis for competition, investor protection, contract enforcement and financial discipline (Khan, 2002).

3.4 In the CIS-7 countries, the public sector directly undermines private sector development through various channels[22]:

- ***Involvement in purely commercial activities.*** While all CIS-7 countries have constitutionally distinguished the roles of the public sector from the private sector, in practice, there are difficulties in delineating the two. Governments have entered joint ventures with foreign and domestic companies in the delivery of non-public goods and services. Moreover, Governments still hold control over a large share of the enterprise and financial sector. The presence of the State in purely commercial activities contributes to unfair competition vis-à-vis of the private sector. In Uzbekistan, for instance, private banks have to compete against state-owned banks that can lend at a lower interest rate than the market one, because they can get access to cheap budgetary resources.

- ***Predatory tax enforcement.*** Tax enforcement tends to be predatory (i.e. freezing bank accounts or seizing property). Yet, collection rates suffer and taxation is unevenly applied in the CIS-7, with the most efficient firms bearing the greatest burden. Evidence shows that firms often pay 50 to 60 percent of their net income in taxes. This is often the result of the willingness of governmental authorities to tolerate the accumulation of tax arrears by certain firms—especially former state-owned enterprises (Desai, 2002).

- ***Provision of (ad hoc) investment-based tax incentives.*** Attempts to attract foreign and domestic investment by providing tax incentives have contributed to undermine the investment climate. Progress in making the tax code more efficient has been hampered by ad hoc amendments to tax statutes, and frequent reversals on tax holidays and other incentives—most of which were based on short-term assessments of the relative trade-offs between revenue collection and investment promotion. In Azerbaijan, a presidential decree revoked almost all tax privileges previously available to foreign investors. These frequent changes, as with changes in other business regulations, have eroded the credibility of the tax regime rather than promoting investment and employment—a result of the so-called "tax mayhem" in the CIS-7 business environment.

- ***Imposition of multiple and costly licensing requirements.*** In the CIS-7, entrepreneurs have to obtain multiple, sector-specific, licenses to carry out their activity. These requirements, a holdover from state control of all lines of business activity under socialism, often bear no relevance in the context of a market economy: they consume entrepreneur's money and time (since licenses are granted for a short period of time),

[22] Annex 5 describes the major public sector weaknesses in the CIS-7 countries

entertain the bureaucracy and precipitate the business sector into a vicious circle of state control and rent seeking.

Figure 5. The Public-Private Sector Nexus in Transition Countries

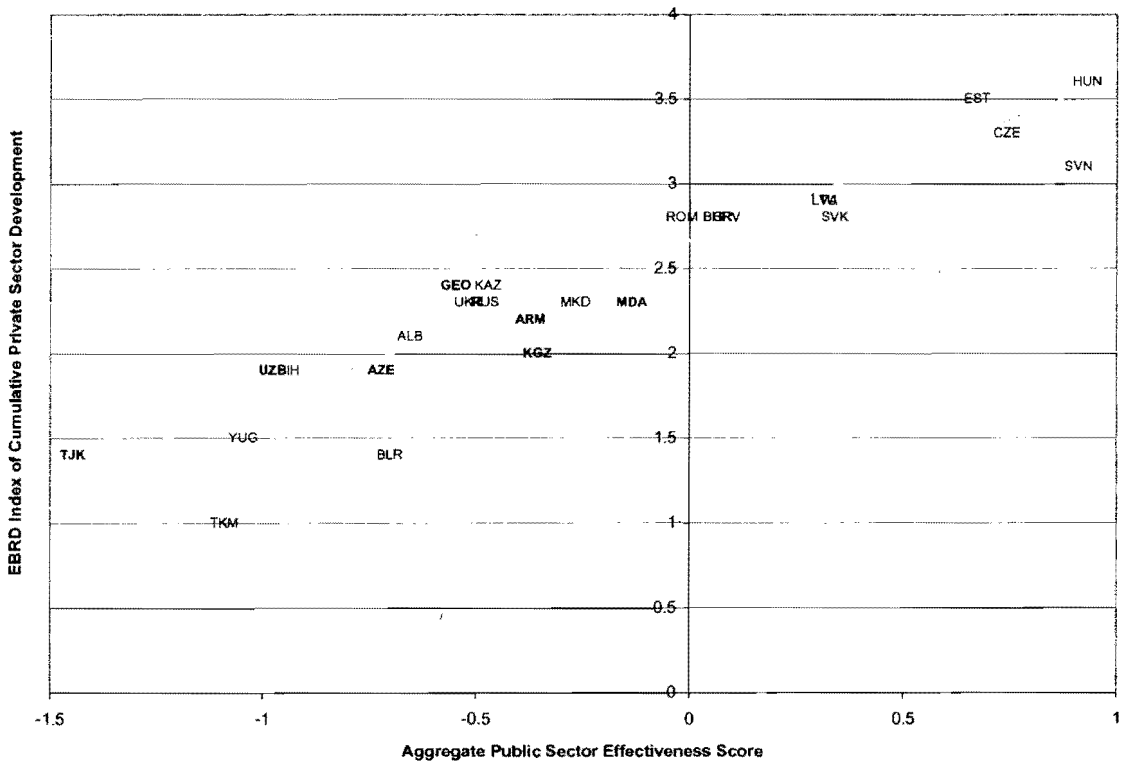


Table 4. Private Sector Effects of Public Sector Deficiencies

	Public Sector Deficiency	Major Problems	Private Sector Consequence
Weaknesses of institutions of monitoring, regulation, and enforcement	Weaknesses of competition-policy making institutions; regulatory discretion	Inability to prevent anti-competitive behavior; Administrative corruption, changing regulatory environment	Problems of new entry; bribe taxes.
	Judicial weaknesses	Weak enforcement, absence of judicial specialization	High transaction costs; over-reliance on court system
Weaknesses of institutions of public expenditure management	Fiscal transparency	Poorly-clarified division of responsibilities between branches and between levels of government; off-budget expenditures and hidden expenses	Unstable fiscal environment for business.
	Tax environment	Limited capacity of tax administrations; toleration of arrears; unevenly applied tax rules; gap between effective and statutory rates.	Multiple taxation, underground economy
Weaknesses of the Public Utilities & Financial Sector	Quasi fiscal activities	System of (extensive) hidden subsidies to loss-making enterprises	Poor financial discipline; prevents exit

Source: Desai (2002).

FREQUENT AND PIECEMEAL CHANGES IN LAWS AND REGULATIONS FEED BUREAUCRATIC DISCRETION

3.5 Many laws and institutions supporting a market economy are now in place. However, the regulatory framework for business, which covers most aspects of licensing, basic operation, taxation, and contracting, is characterized by uneven, contradictory, overlapping, and frequently changing provisions. For instance, ordinary legislation has frequently been "supplemented" by executive decrees. Many of these decrees are, in reality, means by which the executive branch has sidestepped parliamentary laws in order to shelter or protect favored constituents or regions, or to provide benefits to particular groups. Rule by decree also suffers from a lack of accountability, as executive decrees—unlike laws—are not subject to legislative scrutiny or some form of administrative review.

3.6 In Tajikistan, for example, security rights on movable and immovable assets are governed primarily by the Civil Code (Part 1) of 30 June 1999, which entered into force on January 1, 2000. However, the Mortgage Law enacted on June 20, 1994 and amended in 1995 and 1998 also provides regulation of security rights over both movable and immovable property. Since the Civil Code provisions and the Mortgage Law provisions cover much of the same subject matter, there is a great uncertainty over which provisions are applicable (Holden, 2002).

3.7 Frequent and piecemeal changes in laws and regulations have encouraged discriminatory interpretation by public officials. The scope for discriminatory implementation (e.g., regulatory forbearance is often applied to joint-stock companies with government participation) has enabled those in charge to use the regulatory apparatus to channel benefits to, as well as to shelter from

competition, favored groups (Desai, 2002). Intrusive inspections by tax inspectors, police, prosecutors, and other officials is common, and onerous regulations and licensing requirements are a major source of rent-seeking by public sector employees. The main result of the unstable and inconsistent regulatory framework is corruption at all administrative levels.

LACK OF INCENTIVES TO OPERATE FORMALLY WEAKENS THE DEMAND FOR A BETTER INVESTMENT CLIMATE

3.8 The large informal sector is not just a sign of lax enforcement of tax laws; it also reflects an underlying problem in the social framework for private sector development: the lack of benefits from joining the formal sector. When firms choose to stay informal, they are saying that the costs of formalizing outweigh the benefits. Broadly speaking, the costs of business licensing, in terms of time, money, and exposure to taxes and fees, exceed the benefits that most firms expect to receive.

3.9 ***Uncertain benefits of becoming formal.*** Problems faced by businesses seeking to become formal seem not to be so much related to the high barriers that they have to overcome, but to the absence of benefits of becoming formal. [23] In the CIS-7 countries, these benefits are uncertain at best. For instance, in a Western developed economy, the benefits from becoming formal would arise from an expanded access to credit because of the lower risk of doing business with a formal sector lender, from establishing a legal entity that can do business in a modern manner with other legal entities particularly in matters of contract enforcement, and in permitting the enterprise to enjoy advantages of the modern corporation or other limited liability forms. However, in the CIS-7 countries, access to credit does not depend on legal institutions, like collateral; has little to do with formal business registration; it rather depends on the lender's first hand knowledge of the applicant (Holden, 2002).

3.10 ***Ambiguous demand for a better investment climate.*** In an environment in which entrepreneurs do not seem to perceive the benefits of becoming formal and perform activities, irrespective of the external business environment—, the demand for a better investment climate is likely to be minimal. Moreover, demand for improvements in the business environment is unlikely to be driven by businesses themselves. In sum, the dynamics for changes in the investment climate the advanced reformers of central and east Europe and the Baltics is likely to differ from the one in the CIS-7 countries. In the advanced group of reformers:

- There is a demand for market-based institutions, including a better investment climate, protection of property rights and the rule of law, and there is a price associated with improvements in these areas. Improvements in the investment climate are likely to be demand-driven.

- This demand originates from businesses themselves. The objective is to increase the benefits of performing activities in the business environment (e.g. increased allocation of credit by banks, increased inflows of FDI etc...) and reduce the costs of working in this business environment. In contrast, in the CIS-7 countries, improvements in the business environment are likely to be (only) supply-driven.

3.11 ***Negative spill-overs on other sectors of the economy.*** The indirect social costs of a growing informal sector are large:

[23] On the results from the BEEP Survey on the barriers to private sector development, see Annex 6.

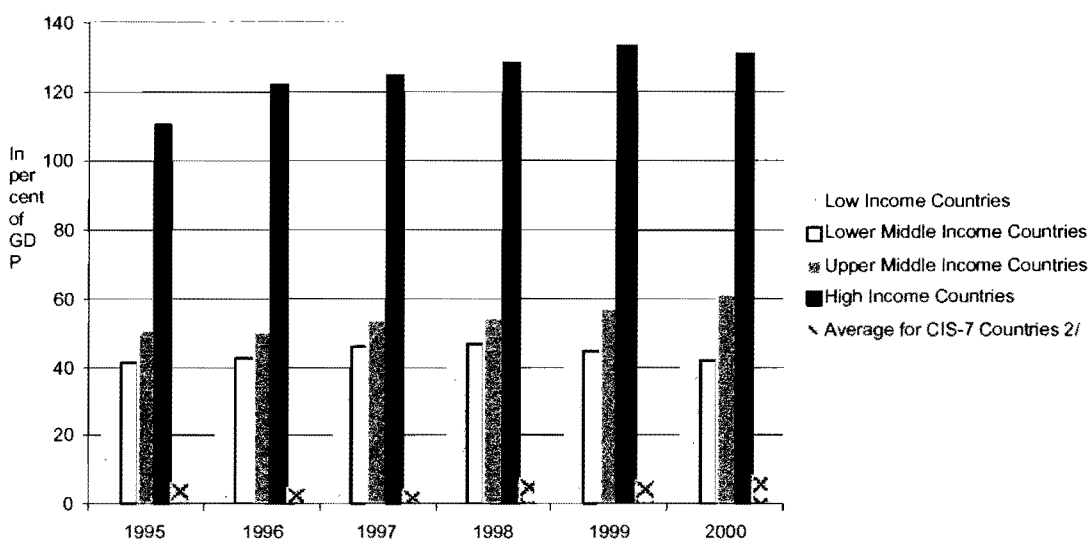
- ***Unfair competition among firms.*** Formal sector companies must compete against companies operating informally which import without paying tariffs or taxes; moreover, they must deal with the delays and high expenses associated with customs.

- ***Weak public sector due to low corporate tax collection.*** A survey in Tajikistan shows that only 59 percent of companies make full disclosure of their taxes to authorities (CARANA, 2000).

- ***Poor development of the financial sector.*** Unless credit is allocated on the basis of both official and unofficial accounts, the credit allocation is severely constrained. This shows in a level of financial development in the CIS-7 substantially below the average of the poorest group of countries. As shown in figure 6, the ratio of private sector credit to GDP in 5 of the CIS-7 was less than 10 percent of GDP in 2000—this is equivalent to about one quarter of that in countries with similar per capita GDP and less than 10 percent of the average level of financial development in high-income countries.

3.12 Preliminary evidence from a recent survey from the Microfinance Centre for CEE and NIS suggests that the informal sector in the region is mostly financed by the NGOs. It is estimated that NGOs provide most of the micro-finance in the CIS-7. In general, NGOs escape from the supervision of banking authorities and are "protected" by the legal status of international organizations and donors, which operate under the umbrella of inter-government agreements (allowing for tax relief and a wider range of commercial activities). This protection is often the only way to escape from the red tape and political influence of some governments (Foster and Pytkovska, 2002).

Figure 6. Credit to the Private Sector - Average for the CIS-7 Countries 1/ 2/



1/ Credit to the private sector from deposit money banks and other financial institutions. Sample of 47 countries.
High income countries are defined as countries where GDP per capita in 1999 was higher than US$10,000;
Upper middle income countries are defined as countries where GDP per capita in 1999 was between US$3,000 and US$10,000;
Lower middle income countries are defined as countries where GDP per capita in 1999 was between US$1,00 and US$3,000;
Low income countries are defined as countries where GDP per capita in 1999 was lower than US$1,000.
2/ Data for Uzbekistan and Tajikistan were unavailable
Source: International Financial Statistics Database and World Development Indicators Database.

FOCUS ON DOMESTIC RATHER THAN REGIONAL POLICIES

3.13 Regional issues are pressing: border conflicts with Uzbekistan, political instability in the Ferghana Valley, conflict over the Nagorno-Karabakh territory, spill-over risks of the war in Afghanistan, and growth constraints due to the small size of domestic markets. For instance, the Caucasus, including Turkey, could offer a potentially attractive market of 110 million inhabitants: the CIS-7 countries count only 57.4 million inhabitants. Instead, each Caucasus country supplies its own internal market (e.g. 3.8 million in Armenia and 5.8 million in Georgia).

3.14 A critical issue concerns the lack of incentives for large, resource-endowed countries, such as Uzbekistan or Kazakhstan, to integrate with smaller, poorer countries, such as the Kyrgyz Republic or Tajikistan. There is also a fundamental conflict to resolve in the approach adopted by the two groups of countries. The model followed by the Kyrgyz Republic (comprehensive approach through CDF supported by large financial flows from IFIs) is very different from the one followed by Uzbekistan (sector targeted approach, with minimal IFIs' involvement). How can these models be reconciled in a fragile region of the world?

3.15 ***Economic Integration.*** Within the CIS as a whole, economic and political relations between member states have generally been established on a bilateral or multilateral basis rather than a CIS-wide basis. Many CIS states have been unwilling to strengthen their links with post-Soviet Russia. Consequently, the CIS has never evolved into a free trade area and some nations formed alliances without Russia, such as GUAM—the political, economic and security alliance of Georgia, Azerbaijan, Moldova and Ukraine. In contrast, the Kyrgyz Republic, Tajikistan, Belarus and Kazakhstan have strengthened relations, forming a customs union with Russia.

3.16 However, the risks involved in relying on integration with Russia were apparent in the wake of the fallout from the August 1998 crisis, which led to economic disturbances throughout the region (EBRD, 2001). While international integration based on free trade can provide significant potential for catch-up growth, it also exposes previously sheltered economies to new types of risk that must be effectively managed. These risks arise from cyclical variations in external demand and private capital flows.

4. CONCLUSIONS

4.1 Ten years after the start of the transition process and the independence of the CIS-7 countries, it is time to step back, look at the record of what has been accomplished and understand the turbulent decade these countries went through. The challenges faced by the CIS-7 countries are of a larger magnitude than those in central and eastern Europe and the Baltics. Some lessons have emerged in the private sector area (Lieberman et al., 2002).

4.2 ***Limit direct state interference in business activity by creating an environment that is conducive to private sector development.*** As economic development unfolds, the state should be removed itself from direct business activities. As a first step, undue registration, licensing and inspections that restrict business operations and encourage businesses to remain underground should be eliminated. Commitments to improve the business environment should be the sine qua non for all private sector operations. Public interventions to support the sector should be limited and well designed. For instance, the direct provision of credit to SMEs through State Funds tends to substitute for markets rather than dealing with the underlying causes of market underdevelopment. Evidence shows that it is the overall business environment that is the most important determinant of enterprise competitiveness and growth.

4.3 ***Creation of new enterprises and promotion of entrepreneurship.*** So far, the private sector has consisted of "life style firms" rather than true entrepreneurial outfits. The challenge is to develop a class of entrepreneurs and improve the quality of the private sector. Institutions that incubate and support entrepreneurial efforts should be supported. These institutions include micro-finance (MFIs) and SME lending institutions preferably as banks, postal banks or non-bank financial institutions. In the case of the CIS-7 countries, there should be extensive efforts to train managers and senior staff and to expose them to how businesses operate under real market conditions. Increasingly, those opportunities exist in central and eastern Europe—countries and firms that have been through the transition process and now operate under market conditions.

4.4 ***Support green-field investments.*** There is a range of potential interventions IFIs, such as the EBRD and IFC, could make in the CIS-7 to improve the basic infrastructure. But so far, extra due diligence has kept them out of many activities in these countries—it is generally argued that much of the locally-owned enterprises have poor corporate governance standards, and that many potential sponsors, would not pass both the screening and credit requirements for they have been part of a corrupt system. In that case, alternative mechanisms to support green-field investments, such as those provided by guarantee programs, should be explored.

4.5 ***Carefully prepare the ground work for privatizations.*** Privatizations have often been pushed through the reform agenda, with the hope that they will result in efficient, well governed enterprises operated by real owners. This suggests that a more gradual approach will need to be taken in the future towards privatization in the CIS-7 countries. This would include, inter alia, the following: structural re-organization of monopoly sectors to provide for new entry and competition in the sector as appropriate; corporatization, defensive restructuring and improvements in corporate governance prior to sale; use of contracting out and concessions more extensively for infrastructure and utility sales when strategic private owners cannot be found; and a search for potential buyers outside traditional western markets. Moreover, for utilities and natural resource companies adequate regulatory frameworks and capacity should be developed prior to sale—all of which calls for a more gradual approach than has been the custom. To make up for deficiencies in basic infrastructure, donors may need to consider greater support for green-field investments, supplementing privatization, utilizing guarantees more extensively to attract private investors.

4.6 ***Encourage "non-traditional" investors in the CIS-7.*** The Western centric view of privatizations and foreign direct investment was well-suited in the context of central and eastern Europe, and the Baltics. The interest of foreign investors in these countries was justified, financially and strategically, by the proximity to the European markets and the accession of these countries to the European Union. However, it is much less clear why they would be interested in investing in the CIS-7 countries. The probability that the CIS-7 will benefit from financial resources, management know-how and technology transfers from Western investors is remote. In that context, foreign investment should be tapped from alternative markets. Typically, investors from India, Pakistan, Malaysia, Indonesia, Korea, Turkey, China and Russia have the capital, a level of business sophistication significantly higher than domestic investors in the CIS-7, and, more importantly, have the ability and experience to deal with complex, difficult, markets. CIS-7 countries will have to take the steps necessary to attract such investors by improving the business environment, previously discussed, and by steps towards regional integration, for example, developing a customs union in Central Asia that will enhance the potential market size for interested investors.

4.7 ***Focus on a consistent legal framework and its enforcement.*** While many studies complain about the archaic and inefficient regulation of business, there is a complete absence of

any economic analysis of the general business regulatory system and positive recommendations about what the CIS-7 countries should do. Moreover, the prolific complaints about the quality of legislation refers in many cases to legislation drafted by consultants from industrial countries working with donor support. Often these laws were drafted by consultants working for the same institution that published the critical review. Where there is any analysis of the legal system, these analyses typically run toward what lawyers find interesting -- bankruptcy laws, laws of secured transactions, copyright laws. Finally, the analyses are usually couched in terms of whether or not laws match laws in industrial countries, not whether they achieve desirable economic end in CIS-7 countries which have very different economic and institutional constraints. They rarely address nuts and bolts questions like what is an efficient regulatory system for hotels, for restaurants or for barbershops. Most transition countries have ended-up with a patch work of legal reforms and little real judicial capacity.

4.8 A private sector strategy will need to be anchored in a legal framework that is sound and that addresses a variety of legal needs—company law, collateral laws, security laws, bankruptcy and anti-monopoly laws. Above all the legal system needs to respect shareholders, creditors and other contractual rights and that judicial enforcement is competent and non-corrupt. Therefore, to attract investors and provide for successful privatizations, to ensure the growth of enterprises and to induce firms out of the shadow economy, the private sector strategy should be complemented by adequate legal and judicial reforms. In order to move towards a consistent system of laws that are central to operating businesses, a careful "line by line" analysis of general business regulation should be undertaken, identifying which laws should be revised and when to revise them.

4.9 In economies like the CIS-7, where the largest share of the business activity occurs through the informal sector—and the quality of the "private sector" can be qualified as poor—it is unlikely that there will be a (open) demand for a better investment climate. Therefore, market-based institutions (including a better investment climate) will have to be supply-driven.

4.10 ***Comprehensive focus on regional integration*** Regional integration efforts are relevant in a context where the individual market size of some of the CIS-7 countries is less than 4 million inhabitants. It is a fact that the costs of statehood are increasingly unsustainable in a global world, and that growth will require businesses to sell beyond domestic markets. However, it is less clear what the integrating factor is for this region of the world. Contrary to the advanced reformers of central and east Europe that will accelerate the pace of reforms because they have the prospect of joining the EU, the CIS-7 countries constitute a diverse group of countries, with no apparent integrating factor. In this context, IFIs have a role to play in encouraging cross-border efforts.

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Annex 1

Statistical Annex

Table 1.1. Gross Domestic Product, 1990-2001

	Real GDP Growth			2000		2001
	1990-95 Average *(in percent)*	1996-2000 Average *(in percent)*	2001 Forecast *(in percent)*	Nominal GDP per Capita *(in US$)*	PPP GDP per Capita *(in US$)*	Real GDP Index (1989=100)
Central Asia						
Kyrgyz Republic	-10.8	5.6	5.3	263	2,524	73.5
Tajikistan	-18.9	2.9	10.0	158	1,082	39.5
Uzbekistan	-2.5	3.3	4.5	561	2,363	102.0
Caucasus						
Armenia	-11.5	5.2	9.7	505	2,713	70.3
Georgia	-19.7	5.8	4.4	567	4,285	33.3
Azerbaijan	-14.9	7.1	9.8	652	2,602	57.1
Europe						
Moldova	-13.9	-2.5	5.9	360	1,916	36.0
Memorandum Items:						
Average CIS-7 (unw.)	-13.2	3.9	8.1	438	2,498	28.1
Russia	-8.5	1.3	5.0	1,720	7,474	67.3
CIS (unweighted)	-11.3	3.3	6.2	738	4,165	64.9

Sources: WEO, UN, Economic Commission for Europe

Table 1.2. Production Shares in GDP, 2000
(In percent)

	Agriculture	Industry			Services
		Total	Manufacturing	Other	
Central Asia					
Kyrgyz Republic	38	27	13	14	36
Tajikistan	19	25	21	3	57
Uzbekistan	33	25		561	43
Caucasus					
Armenia	29	33	23	10	39
Georgia	36	13	8	5	51
Azerbaijan	23	35	6	30	41
Europe					
Moldova	25	22	15	7	53
Memorandum Items:					
Average CIS-7 (unw.)	29	25	14	12	46
Russia	7	38	...	...	56
CIS (unweighted)	24	31	21	10	46

Source: World Development Report, 2002

Annex 2

Recent Developments in the Area of Privatization

of State Assets in the CIS-7 Countries

Country	Enterprises	Infrastructure
Armenia	**Privatization advances despite political divisions and reluctant investors.** Since 1995 Armenia has privatized almost 7,000 small companies and over 1,500 medium-sized and large enterprises, most of them during the early period of mass privatization. In a push to conclude the privatization program, parliament recently approved a final list of over 900 enterprises to be privatized over the next three years. The list includes strategic mining, metal-lurgical and energy assets. However, domestic political divisions over privatization have widened and this has dampened the interest of foreign investors, many of whom were already concerned about Armenia's poor investment climate. Nevertheless, seven of the 14 larger companies included in the 2001 program have been sold, including the Yerevan Jewelry Factory and the Hrazdan cement plant. Bidding or negotiations with strategic investors are ongoing for most others, including the Ararat cement plant, the electronics company Mars and gold producer Armgold.	**Renewed efforts to privatize electricity distribution follow a failed tender.** Armenia's attempt to privatize its four electricity distribution companies foundered in April 2001 when an international tender failed to attract bids. The privatization, which took two years to prepare and was the subject of a fierce internal debate, had repeatedly been delayed. In the event, international investors shied away from a deal they increasingly saw as risky and unattractive as terms had to be amended to appease critics. The need for reform in the energy sector remains urgent and the authorities are committed to the privatization of the distribution companies. The law governing a renewed privatization attempt under revised terms was ratified in August 2001 and, assuming there is sufficient private sector interest, the sale of the four companies is expected by March 2002. Preparation for the privatization of some of the power generation assets also continue. **Controversy continues in the telecommunications sector.** The decision by Armentel, the national telecommunications operator controlled by the Greek company OTE, to raise telephone charges and abandon flat tariffs for local calls, has sparked renewed controversy. The authorities have made their assent contingent on a renewed commitment by OTE to invest US$300 million into the system by 2006. The 15-year exclusivity enjoyed by Armentel is also still the subject of negotiations. Armentel's profits dropped by almost 50 percent in 2000 and in May 2001 its senior management was changed for the fifth time in four years.

Country	Enterprises	Infrastructure
Azerbaijan	**Privatisation of medium-sized and large enterprises is re-launched.** While small-scale privatization is nearly complete, privatisation of larger enterprises has lagged behind. Following the adoption of the second privatisation program in August 2000, 39 cash and 12 voucher auctions had been held by the first quarter of 2001, with 127 state enterprises being offered for sale for the first time. In addition, since case-by-case privatisation began in late 1998, 10 companies has been privatised through competitive tenders. Receipts from privatisation have been modest, amounting to US$118 million from 1996 until the first quarter of 2001 (about 2 percent of GDP). Importantly, an official list of some 450 larger enterprises open for privatisation to both foreign and domestic investors was published in March 2001, including enterprises belonging to the telecommunications, fuel and energy, mechanical engineering, chemical and fishery industries as well as the state-owned airline Azal. **... but additional preparation of major projects is required to ensure success.** Tender results were announced for a long-term management contract for BAGES, the Baku electricity distribution network, in March 2001. However, the absence of an adequate regulatory framework, the poor quality of available information and vaguely formulated tender documents have complicated completion of the transaction with the tender winner. At the same time, though, the tender for a 25-year management contract for Azerbaijan Aluminium was awarded successfully to a Dutch company, Fondel Metal, in March 2001. The foreign company has committed to invest US$500 million over five years while the government has granted concessions on supplies of electricity and natural gas and on the transport of raw materials and equipment until 2005.	**Reform of power and gas is to be initiated.** The large quasi-fiscal deficit in the energy sector was estimated at 13 percent of GDP in 1999, roughly half from electricity and half from gas. The deficit originates from several sources. They include: revenue losses by SOCAR from below-cost prices for fuel, oil and gas supplied to Azerenergy and Azerigaz; low collection rates – only 44 percent of gas and 41 percent of electric power supply billings were collected in 1999 – while several groups of the population are exempt; and technical losses. The accumulation of this deficit has many adverse implications, including the loss of fiscal revenues, distortions at the enterprise level as a result of implicit subsidies and excessive energy consumption from distorted tariffs. The authorities are developing a comprehensive program to resolve these problems, including tighter budgetary control of utilities, a schedule for the eventual unification of domestic and exported oil prices, and privatisation of all distribution networks. **... but reform of all infrastructure sectors is still pending.** Azerbaijan still lacks an adequate legal and regulatory framework to protect the public interest and to encourage private investment in key infrastructure sectors. First steps in this direction have been a decree establishing the Ministry of Fuel and Energy in April 2001 and the planned creation of a Ministry of Transport. In these and other infrastructure sectors, development of appropriate legal and regulatory frameworks is proceeding alongside privatisation plans. The government is expected over the next year to begin privatisation of Aztelecom and the Baku City Telephone Network and to start a program for private participation in the provision of water and waste-water services in Greater Baku.

Country	Enterprises	Infrastructure
Georgia	**Large-scale privatisation has advanced.** Small and medium-scale privatisation was largely completed by the end of 1998. As a condition of a World Bank Structural Adjustment Loan, 29 large industrial companies were to be privatised by early 2001. By September 2001, 12 industrial enterprises had been successfully privatised, including two sold to foreign investors. However, it is unclear whether the remaining large state-owned enterprises can be successfully privatised under current conditions. There is a lack of foreign investor interest, both because of social obligations that are written into privatisation contracts and because of doubts over the potential commercial viability of many of the remaining companies, even if they were to be restructured. Given these factors, the State Property Ministry is currently focusing on privatisation of the main utilities, including power and telecommunications, rather than large industrial enterprises.	**Power sector privatisation moves forward.** In the power sector the Telasi power distribution company (serving Tbilisi) has been privatised through sale of AES (a US power company) along with one thermal power plant. There are plans to introduce private participation in the areas of transmission and dispatch and the wholesale market (a revenue allocation mechanism) under management contracts. If successful, this could lead to a more rigorous approach to the disconnection of large customers for non-payment (under the transmission contract) as well as a fairer system of allocation sector revenues to the generating companies (under the wholesale market contract). The IFC has been appointed advisor for the letting of contracts, bidders have been short-listed, financial proposals have been submitted and a preferred bidder chosen. The remaining state-owned distribution companies need to be transferred to private management in order to raise total collection rates. The IFC has been appointed as privatisation advisor for these companies. Most probably, they will be packaged together and offered for sale under management contracts before the end of 2001. **The telecommunications sector is being prepared for privatisation.** An industry regulator is in place and has in the last year acted to consolidate licenses through a process of re-registration (previously there were too many licenses in existence). The local operator has been offered for privatisation, with bids for a 75 percent stake to be submitted by the end of October 2001. However, the financial viability of the company is unclear, and investor interest appears to be limited. The more lucrative national operator is scheduled for privatisation by the end of 2001 through the proposed sale of a 51 percent stake. **A detailed oil pipeline study is under way.**

Country	Enterprises	Infrastructure
		Following intergovernmental agreements between Georgia, Azerbaijan, Turkey and Turkmenistan, a preliminary study for the Baku-Ceyhan pipeline (linking the Caspian Sea with Europe) has been completed and a more detailed study is now udder way (at a cost of around US$100 million). Questions remain over the commercial viability of the proposed pipeline. In March 2001 Kazakhstan signed a memorandum of understanding with the other countries involved in the pipeline, although this does not amount to a legal commitment regarding the oil transport volumes which would be required for construction to go ahead.
Kyrgyz Republic	**A new privatisation strategy has been announced.** The government has divested most of its company holdings. The state still holds stakes in some 350 companies. State companies are concentrated in the construction sector (40 percent of the total number), transportation (45 percent) and in the energy and telecommunication sectors. In February 2001 the government approved a new state property privatisation strategy for 2001-03. The main objectives are to privatize stakes in Kyrgyz Telekom, Kyrgyzenergo, KyrgyzGas and Kyrgyz Airlines. However, there have been no significant privatisation transactions over the past year.	Privatisation of the main telecommunications provider has been delayed. The national telecommunications company, JSC KyrgyzTelekom, returned to profit in 2000 after a loss of KGS 1 billion (US$20 million) in 1999, due both to tariff increases and to a stronger economy. An attempt to privatize 40 percent of the company by international tender failed last year. The appointed consultant for the tender blamed the government for insisting on unrealistic valuation expectations and reducing the value of KyrgyzTelekom by depriving it of the chance to bid for a GSM license. The government has re-stated its intention to privatize the company and it is included in the list of firms to be privatised by 2003. Reforms in the energy sector are under way. With World Bank support, the state-owned energy company Kyrgyzenergo has been divided into generation, distribution and transmission units. The reform program also involves the rise of electricity and heating tariffs to cost recovery levels, which will be a precondition for any successful privatisation in the sector. The government is to submit to parliament by October 2001 a bill to

Country	Enterprises	Infrastructure
		reduce the number of energy users eligible for special privileges under the existing electricity tariff structure. To mitigate the impact of price increases on the poor, the bill allows for a lifeline tariff for a basic level of electricity consumption. Significant investments in new hydroelectric power stations continue. Electricity output rose last year by 13 percent and exports of electricity in US dollar terms grew by 53 percent to the main markets, Uzbekistan and Kazakhstan. However, the recent move towards substituting electricity for gas in heating to avoid imports from Uzbekistan has strained relations with that country. Increased hydropower generation deprives Uzbekistan of downstream water supplies, essential for its large irrigated agricultural sector.
Moldova	**A privatisation program for wineries and tobacco has been adopted.** In July 2001 the privatisation program, including the sale of 13 wine and tobacco companies, was enacted. The tender for privaisation of the first two wineries has also been announced, with 80 percent stakes in the enterprises being offered for sale. **... While privatisation and registration of land advance.** At the beginning of 2001 the number of private farmers who have received land plots reached 500,000, about 20 percent more than at the beginning of 2000. About half of these farmers shave registered an agricultural enterprise. Those farmers who have not registered their enterprise either cultivate the land themselves or have temporarily transferred their land plots to others. A serious problem that has yet to be resolved is the need to establish a means whereby farmers can mortgage their land with commercial banks in order to obtain longer-term sources of financing.	**A tender commission for energy company privatisation has been established.** The government recently approved a new tender commission for the privatisation of energy companies. It plans to privatize the two remaining power distribution grids, three power stations and the hot water and heating supplier, Termocom. However, in August 2001 the government postponed its plan to privatize the power distribution companies due to a legal dispute with a Ukrainian power company and a lack of investor interest. Termocom is also facing a major challenge in paying debts of US$9 million to suppliers as customer arrears continue to increase. Consumers in Chisinau owe US$23.2 million to Termocom, according to data reported in June 2001. Individual consumers, who account for over 80 percent of the total thermal energy supplied, represent the largest category of debtors (70 percent of the total debt). To impose payment discipline and reduce arrears, Termocom is trying to enforce a system that would enable it to disconnect non-payers from the heating supply networks, and to restart services only upon payment of at least 60 percent of the debt. **... while profitability in privatised energy strengthens with improved collections.**

Country	Enterprises	Infrastructure
		In July 2001 Union Fenosa (Spain), which has a majority share in three power distribution companies, introduced a new system of payment collection for electricity consumers, including the ability to cut off power supplies to non-payers. This move is aimed at reducing the extent of non-payment and theft of electricity. Total collection ratios have risen dramatically over the past year and are now close to 90 percent but only 30 percent is paid in cash. Technical losses and theft, however, remain significant problems. **A privatisation advisor for the sale of Moldtelecom has been selected.** In June 2001 the government selected an advisor for the privatisation of the fixed-line monopoly, Moldtelecom. An international tender to sell a 51 percent stake in Moldtelecom is expected to be launched by the end of this year, a delay of more than one year compared with the original timetable. This delay arose from concerns over the extent of tariff adjustments before privatisation, he unfavorable investment climate and the lack of interest from potential investors.
Tajikistan	**Significant progress has been achieved in enterprise sales.** During 2000, 646 state-owned enterprises were privatised (568 small enterprises and 78 medium-sized and large enterprises) and privatisation revenues of around US$11.6 million (1.4 percent of GDP) were the highest in history. In 2000 the government also auctioned off the remaining 22 state-owned cotton ginneries, mostly to domestic investors. Small-scale privatisation is largely complete and the government is now focusing on larger enterprises. By August 2001, out of 955 enterprises subject to privatisation, 349 medium-sized and large enterprises had been sold. Despite this progress, post-privatisation restructuring is hampered by the lack of investment funds, including from foreign investors, who remain deterred by the security situation. The largest industrial companies, including the aluminium smelter, TADAZ, the power company,	**Organisational reforms shake up public utilities but changes in behavior are slow.** The government is restructuring and reorganizing public infrastructure. With support from international lenders, regulatory and operational functions in transport, telecommunications and power have been or will be separated from operational units. A new transport law and a new energy law were approved in October 2000, leading to the creation of separate transport and energy ministries with the role of formulating policy in their respective areas. An antimonopoly agency was set up at the same time with the task of regulating tariffs of public monopolies. A new telecommunications law is in preparation, providing for the incorporation of Tajiktelecom, the fixed-line operator, as a majority state-owned company (5 percent of shares are owned by

Country	Enterprises	Infrastructure
	Barki Tojik, and all other utilities, remain state-owned. **... but land reform has slowed down.** The land reform process slowed down in 2000 as local government interests have been reluctant to cede control over former collective farms. Under the IMF's PRGF, 30 state and collective farms were to be converted into private farms by the end of 2000 through the issue of land share certificates to private farmers but this target was not met. The government is now committed to issuing private land certificates in 40 farms by May 2002 under the World Bank's second Structural Adjustment Loan and is progressing towards that goal. Existing private farms, however, face significant problems, including persistent government interference, dilapidated irrigation infrastructure and lack of access to finance.	employees) and the creation of an independent regulator. However, these reforms are not likely to lead to a rapid change in behavior. **Deficits in the energy sector are a significant drain on state-owned utilities.** As in many other transition economies, affordability constraints and political resistance to restructuring have led to an increase in non-payments in the energy sector and delays to necessary tariff adjustments. In 2000, average electricity tariffs were raised by almost 70 percent but they are still at only about one-third of cost recovery levels. Non-collection of charges for power and natural gas amounted to 3.8 percent of GDP in 2000, with another 2 percent of GDP in provisions for bad debts from previous years. The energy debts of TADAZ alone are estimated at US$100 million, or almost 10 percent of GDP. Under a sector reform project support by the Asian Development Bank, power tariffs will be gradually increased and the financial autonomy of Barki Tojik will be strengthened.
Uzbekistan	**Large-scale privatisation proceeds slowly.** Large-scale privatisation is still lagging behind the progress made in neighboring countries and the government continues to be reluctant to sell majority stakes. The current large-scale privatisation program includes 38 major enterprises that are to be sold to foreign investors. However, a majority stake (51 percent) is on offer in only one company, the national telecommunications company, Uzbektelekom. An international consortium for this sale has been chosen as financial consultant and the government intends to complete the privatisation by the end of 2002. The list of companies in which only minority stakes are being offered includes most companies in the oil and gas sector. The state holding Uzbekneftegaz has been split into eight companies, which the authorities want to privatise sequentially. In the light of earlier unsuccessful attempts to privatise minority shares, the success of the current privatisation program is	**Uzbektelekom is prepared for privatisation.** In recent years the telecommunications sector has benefited from substantial investments, financed to a large extent by Japanese credits. As a result, the number of digital lines had risen to 700,000 at the end of 2000. Eleven of Uzbekistan's 13 regional capitals have modern digital AMTS lines. However, in terms of lines per capita, Uzbekistan is behind most of its regional neighbors and therefore substantial additional investment in the sector is needed. Having unsuccessfully tried to attract additional foreign direct investment into the sector, the government has now decided to restructure it and raise money through privatisation. In 2000 it merged the national and international provider and formed Uzbektelekom. The Post and telecommunication agency that currently owns Uzbektelekom will regulate the telecomunications sector after privatisation. Interventionist tendencies remain,

Country	Enterprises	Infrastructure
	doubtful. A foreign exchange system that hinders the repatriation of profits continues to be a major impediment to foreign direct investment. In the oil and gas sector the country is increasingly looking to Russian energy companies as a source of investment but it is also implementing Production Sharing Agreements for the first time with Western/Uzbek joint ventures.	however. In early 2001 the licenses of several private internet providers were revoked. **The railway sector monopoly is being broken up.** With the support o the ADB and the EBRD, Uzbekistan has begun breaking up the state railway transport monopoly. A special committee and the State Property Committee will reappraise the company's fixed assets and form a statutory fund, which will include the assets of enterprises and divisions of the current state railway company, Uzbekiston Temir Iullari. Passenger and cargo transport enterprises will be restructu5red as joint-stock companies in 2002-03 with a view to future privatisation. However, rail track operation and maintenance, transport logistics, locomotives and repair and service companies will remain under a state-owned holding.

Source: EBRD, 2001

Annex 3

Typology of the Informal Sector Enterprises

(From Djankov *et al.* 2002)

Informal businesses usually fall into three broad categories: underground enterprises, subsistence enterprises and unofficial enterprises. Underground enterprises comprise largely of criminal activity and are out of the scope and focus of this paper. Subsistence enterprises result from 'coping strategies' adopted by families to compensate for low wages of external shocks (unemployment etc). Unofficial enterprises generally result from the desire to escape or avoid administrative and/or financial burden of regulation (license and permit regimes, taxes, labor regulations, etc.) or political repression.

Firms around the world lie on a spectrum of business activity, ranging from informal to formal. One crucial difference about informal sector enterprises in ECA compared to other parts of the world is the size of the businesses. In most parts of the world, certainly in OECD countries, informal sector enterprises are almost always small in terms of assets and employees, which allows them to remain relatively invisible to authorities. In the ECA region, however, unofficial enterprises can be medium or even large enterprises with sophisticated activities. This happens because an enterprise is able to keep activities 'blended' i.e. part formal and part informal or unofficial. A typology of the informal sector is presented below.

Table 3.1. Typology of informal sector enterprises

	INFORMAL SECTOR			FORMAL
	Subsistence enterprises	Unofficial enterprises	Unofficial Enterprises	Official enterprises
Degree of Informality	100%	High. Proportion of sales undeclared and workers not registered	Some proportion of sales undeclared an workers unregistered. May use outside the official purview (e.g internet to deliver software)	
Type of activity	single street traders, cottage/micro enterprises, subsistence farmers	small manufacturers, service providers, distributors, contractors	small and medium manufacturers, servic providers, software firms	
Technology	labor intensive	mostly labor intensive	Knowledge and capital intensive	
Owner profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticate level of skills	
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche	
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	
Other needs	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services	

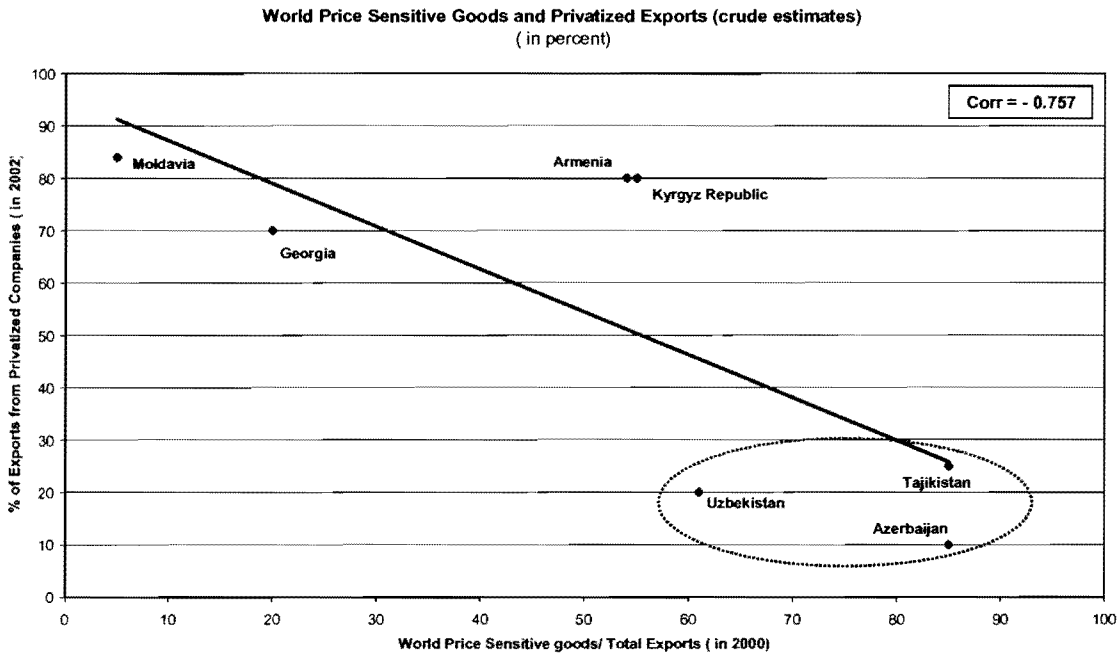
Businesses in the subsistence end of the informal sector spectrum hold little potential for "graduating" to the next levels. Business failure rates are high because of high localized competition and lack of information or access to other markets. Moreover, many of these enterprises are short-lived until the household finds other sources of income that enables it to recover or surpass its living standards.

Unofficial enterprises in the small and medium end of the informal sector whose owners and employees are highly educated and have sophisticated skills hold the greatest potential to 'breakthrough' to the formal sector. This sub-sector is where there is a great deal of mixed activity, enterprises that may be formally registered, but some of their activities or employees are not officially reported. Improvements to the business and regulatory environment will provide incentives for these potentially dynamic enterprises to go formal.

Annex 4

CONTRIBUTION OF THE PRIVATE SECTOR TO EXPORTS

There is a significant negative correlation (-0.757) between the share of exports that depend on world prices (typically, natural resources) and the share of exports produced by private companies in the CIS-7 countries. In countries where exports depend significantly on world market prices—typically, these countries are endowed with natural resources—, the share of exports that is produced by private firms seems to be relatively small. This is the case in Azerbaijan, Tajikistan and Uzbekistan. This group of countries differs significantly from the four other CIS-7 that have a lesser reliance of their exports to world prices and have a larger share of these exports produced by private companies. Further empirical research is required in this area to identify the direction of the causality.



Annex 5

Public-Sector Weaknesses in the CIS-7 Countries[24]

	Business Environment-Related Regulatory and Institutional Issues	Judicial and Court-Related Issues Affecting the Economy	Anti-Corruption Efforts
Armenia	Administrative and legislative barriers continue to affect business and investment; New law to improve competition entered into force Dec. 2000; establishes a Competition Commission	Specialized "economic" courts to be established; centralization of bailiffs system	High-level government commission appointed to combat bribery, reform the civil service
Azerbaijan	The lack of transparent policies and effective laws to establish clear rules and foster competition are particularly serious impediments to investment; bureaucratic procedures contribute to long delays in gaining necessary permits and licenses. Consolidation of five economic ministries and agencies into a new Ministry of Economic Development may address some of these issues. Proposed Investors Council could help identify and remove regulatory impediments to investment and business operations.	No judicial framework for protecting rule of law, or shareholders' rights. EBRD and TACIS TA to streamline the country's laws/ensure enforceability.	Presidential decree "On the Intensification of the Fight Against Corruption" issued in July 2000
Georgia	An early version of Law on Licensing of Entrepreneurial Activities (1998) mandated licensing of a wide range of business activities and granted authority to issue licenses to numerous agencies; Draft law was revised to restrict licensing requirements only to activities affecting public health, national security, and the financial sector. Investors claim that various agencies re-instituted their licensing authority by decree.	Courts considered unreliable for investors seeking judgments on taxation and labor (workers who have been laid off are often reinstated by the courts). WB Judicial Reform Project is underway.	In July 2000, the Government of Georgia created an Anti-Corruption Commission that made its report in the fall of 2000 Anticorruption Coordinating Council was created in summer 2001 to implement recommendations of the Commission.

[24] This summary is from Desai (2002).

	Business Environment-Related Regulatory and Institutional Issues	Judicial and Court-Related Issues Affecting the Economy	Anti-Corruption Efforts
Kyrgyz Republic	Regulatory rules affecting businesses tend to be subject to different interpretations by different implementing agencies. Excessive regulations and licensing are a major source of rent-seeking, and is pervasive. Advisory Council on Investment Policy formed, including representatives of the largest organizations and companies operating in the country	Laws affecting business are not always explicit and no specialized courts exist Court actions are slow, and there is a lack of public confidence in judges; courts do not have the capacity to deal with the broad base of commercial legislation adopted since 1998; judiciary and executive branches are not fully separate	Corruption is being combated via an anti-corruption program launched at the end of 1998; evaluations of the anti-corruption efforts indicate some degree of selective implementation .
Moldova	Further reform of the regulatory environment is indispensable for improving the investment climate Government has responded with commitments to further deregulate the private sector, streamline licensing and registration obstacles, etc. National Agency for Attracting Investment created with powers to assume control over implementation of investment projects made by state institutions.	New civil code adopted by Parliament in 2001—establishes legal framework for defining property rights and contractual obligations;	
Tajikistan	Business climate lacks competition; large SOEs operate as horizontally and vertically integrated units, and have exploited their structural position Regional markets are poorly integrated, and thus there are regionally-based barriers to trade and investment; thus many product lines are localized rather than national (e.g., cotton gins operating as local monopolies) Committee for Anti-Monopoly and Entrepreneurship Support formed as a cabinet-level agency rather than a department under the Ministry of Economy	Implementation of Law on Competition and Law on Natural Monopoly has been weak. Economic court exists, but lacks regulations for implementing certain decisions, e.g., regarding bankruptcy.	
Uzbekistan	Inadequate regulatory framework hampers effective implementation of competition and anti-monopoly	Businesses lack access to international arbitration;	Anti-corruption efforts underway within the tax administration

	Business Environment-Related Regulatory and Institutional Issues	Judicial and Court-Related Issues Affecting the Economy	Anti-Corruption Efforts
	policies Anti-Monopoly Committee mainly uses price controls to regulate competition and lacks independence (is part of the Ministry of Finance) Investors complain that, if they are engaged in a sales or services sector in which either the government, or an SOE a competitor, they face more than the usual amount of bureaucratic hurdles and currency conversion problems.	Arbitration court (and judiciary in general) not independent—in the event of disputes, courts frequently favor firms that are controlled or owned by the state.	

	Tax Administration & Code Changes	Fiscal Transparency	Quasi-Fiscal Sectors
Armenia	Streamlining of previous tax system—replacing corporate tax with progressive scale; 20% flat tax for larger businesses	Law on Budgetary Process (1997) defined legal modalities of conducting monetary and fiscal policy.	Renewed attempt to privatize electricity distribution companies after a failed tender in 2001
Azerbaijan	New tax code adopted in 2001 included improvements in identification of unregistered taxpayers; creation of large taxpayers unit; simplification of forms; avoidance of personal contact between tax officials and taxpayers; enforcement of tax penalties and sanctions; lowering of some marginal rates; At present, the future role of the newly created Tax Ministry (formerly the State Tax Inspectorate) in the area of tax policy is uncertain.	No legislative framework comprehensively defines the fiscal management roles of the three branches of government, nor is there any overarching legislation that defines the fiscal management roles of government agencies. Budget code is under preparation that will comprehensively define the fiscal management roles of all concerned agencies. Law on Financial Principles of Municipalities (1999) states that budgeted expenditures may include other items such as local social protection, socioeconomic development, or environmental protection. This law also defines	Nonpayment by the state-owned gas and electricity companies for the fuel they receive from SOCAR amounts to 7 percent and 19 percent of GDP, respectively. Furthermore, these companies sell at prices considerably lower than world market prices and they also have extremely poor collection rates (e.g. 26 percent) from their customers, which amount to an indirect subsidy for heat and power that is borne by the SOEs in the energy sector.

	Tax Administration & Code Changes	Fiscal Transparency	Quasi-Fiscal Sectors
		local budget revenues which will include subventions from the state budget, but the specific criteria for determining the size of the transfers are not provided. Consolidation of government operations into single treasury accounts; establishment of regional treasuries; elimination of manat and foreign-currency bank accounts of budgetary institutions.	Comprehensive plan is being prepared to resolve problems of the three major firms responsible for most quasi-fiscal activities: Azerigaz, Azerenergy, and SOCAR.
Georgia	Highly inefficient tax administration, with one of the lowest effective tax collection rates in the world; 113 specific code amendments were passed relating to tax rate changes and the broadening or narrowing tax base. Some amendments were dictated by public policy goals of improving tax collection and administration; others by the need to comply with obligations of IFIs; most were an outcome of interest group lobbying. Large Tax Inspectorate (for taxpayers representing over 50% of tax revenue) created; policy of granting tax offsets was eliminated.	Inter-governmental relations remain highly centralized: local governments have no authority to levy own taxes, but are allocated a portion of revenue from various state taxes. Ministry of Finance assumed sub-treasury accounts that were previously controlled by other ministries	Energy sector must bear cost of special discounts and allowances to over 230,000 customers (including enterprises); Sakenergo (wholesale energy trader) conducts almost 80% of operations in offsets and barter.
Kyrgyz Republic	All taxes have legal basis, but there are many amendments and discretionary provisions. Tax Code and Customs Code have been amended numerous times, creating difficulties for taxpayers and tax inspectors. Frequent ad hoc exemptions are granted, and case-by-vase negotiations of tax liabilities between officials and taxpayers is common. Work to simplify and streamline the tax system is underway	Inter-governmental relationships are still unsteady; distribution of expenditure responsibilities and tax powers between levels of government are not fully transparent. Relatively few extra-budgetary funds; renewed efforts to eliminate "special funds" revenues	Implicit subsidy provided by energy, heating, and gas sectors through under-pricing, nonpayment by customers, as well as a wide range of discounts provided to approx. 60% of customers. Most utilities are loss-making (Kyrgyzenergo, Kyrgyzgas) Collection rates have risen from 70% to 87% in 2000

	Tax Administration & Code Changes	Fiscal Transparency	Quasi-Fiscal Sectors
Moldova	Tax evasion and smuggling are endemic, particularly for trade through Transnistria. Large Tax Inspectorate created within the State Tax Inspectorate in 1998 to fight tax evasion, corruption, boost collections.	Treasury system established in 1998, and subsequently extended to 11 regional governments (reduced from 38 according to a lay on territorial organization);	Energy sector is a major source of quasi-fiscal activities, and a large share of energy revenues are collected in-kind; Enterprises and consumers have had difficulties servicing their gas debt; the power sector is the primary non-payer of gas debt, contributing 80% of the debt to Moldovagas; in turn, the heating companies do not pay their debt to power-generation companies. In 2000 electricity distribution companies were sold to a private investor, and tenders were launched for two power distribution companies; parliament has narrowed the range of energy subsidies.
Tajikistan	Several tax "disincentives" for production in the local sector exist, e.g., producers have an incentive to ship raw materials or intermediate goods to neighboring countries in order to import goods that are taxed less, rather than producing for sale in country; Tax collection is automatic through bank settlement accounts, rather than through a system of collections at the source. Cotton and Aluminum sectors were previously subject to a wide range of taxes that often went unpaid (typically paid export "tax") to extrabudgetary funds. All extrabudgetary confiscation of export proceeds has	Intergovernmental fiscal relations are highly centralized, and revenue-sharing is explicitly set out Accurate and timely information about extrabudgetary funds is not available Budgeted subsidies have been reduced sharply, but the absence of a treasury system has meant that the monitoring, reporting and control of expenditures have been hampered. Treasury system being implemented.	Most quasi-fiscal activities are undertaken by the National Bank of Tajikistan under instruction from the government

	Tax Administration & Code Changes	Fiscal Transparency	Quasi-Fiscal Sectors
	been terminated		
Uzbekistan	Tax Committee has improved collections from the informal sector (e.g., streamlining collection of fees from bazaar traders) Tax collections use bank settlement accounts		Significant quasi-fiscal activities undertaken by the National Bank of Uzbekistan, and subsidization of imports through the multiple exchange-rate regime

Source: Desai, 2002

Annex 6

The Business Environment in the CIS-7 Countries – Evidence from the Business Environment and Enterprise Performance Survey (BEEPS)[25]

Sustained economic development and transition to a market economy depends to a considerable extent on the development of a dynamic private sector. In this respect, the CIS-7 countries have lagged considerably behind the more advanced transition economies in Central and Eastern Europe. One reason for the absence of a more dynamic private sector is the weak business environment.

In order to assess the extent to which the business environment represents an obstacle to the development of private businesses and which dimensions of the business environment are the most important, the EBRD and the World Bank have conducted periodic surveys of private businesses in the region. The first such survey was undertaken by the World Bank in late 1996 and early 1997 as part of the World Business Environment Survey (WBES). Building on this work, the EBRD and the World Bank conducted jointly two subsequent Business Environment and Enterprise Performance Surveys (BEEPS) in 1999 and in 2002. Findings from the BEEPS were disseminated in the EBRD's Transition Reports in1999 and 2002 and this note is based on this information. Additional analysis as well as the full 1999 BEEPS dataset is available at www.worldbank.org/wbi/governance. A comprehensive summary of the 2002 results will be available at this site as well as on the EBRD's website: www.ebrd.com by January 2003. The two rounds of the BEEPS allow a direct comparison of how the business climate has changed across the region since 1999.

The BEEPS asks firms to assess how the functioning of various state institutions, of physical infrastructure and of finance affect their operations. Eight broad areas may be distinguished: macroeconomic management, taxation, business regulation, corruption, crime, the judiciary, finance and infrastructure. Firms were asked how problematic were various factors in each of these areas for the operation and growth of their businesses on a one to four scale. A score of one represents a minor obstacle and of four a major obstacle. In addition to these qualitative assessments, the BEEPS also asked respondents for quantitative measures of the quality of economic governance.

An important caveat is in order before turning to results. The qualitative measures of the business climate are – inevitably – subject to significant noise and measurement error. Subjective assessments could be influenced by culture or the prevailing sense of economic optimism and hence could be related to current macroeconomic performance. It turns out that macroeconomic performance indeed has a significant bearing on subjective assessments of the business environment – a factor that needs to be controlled for if meaningful comparisons are to be made across countries. The dataset contains a number of additional useful consistency checks, which suggest that whilst noisy the subjective perceptions data does provide a consistent and useful aggregate picture of the business environment (see *Transition Report*, 2002, chapter 2 for details). To complement this picture, this note also reports results for the quantitative measures of economic governance available in the BEEPS.

[25] This note was prepared by the EBRD based on information available in the *Transition Report* 2002, chapter 2.

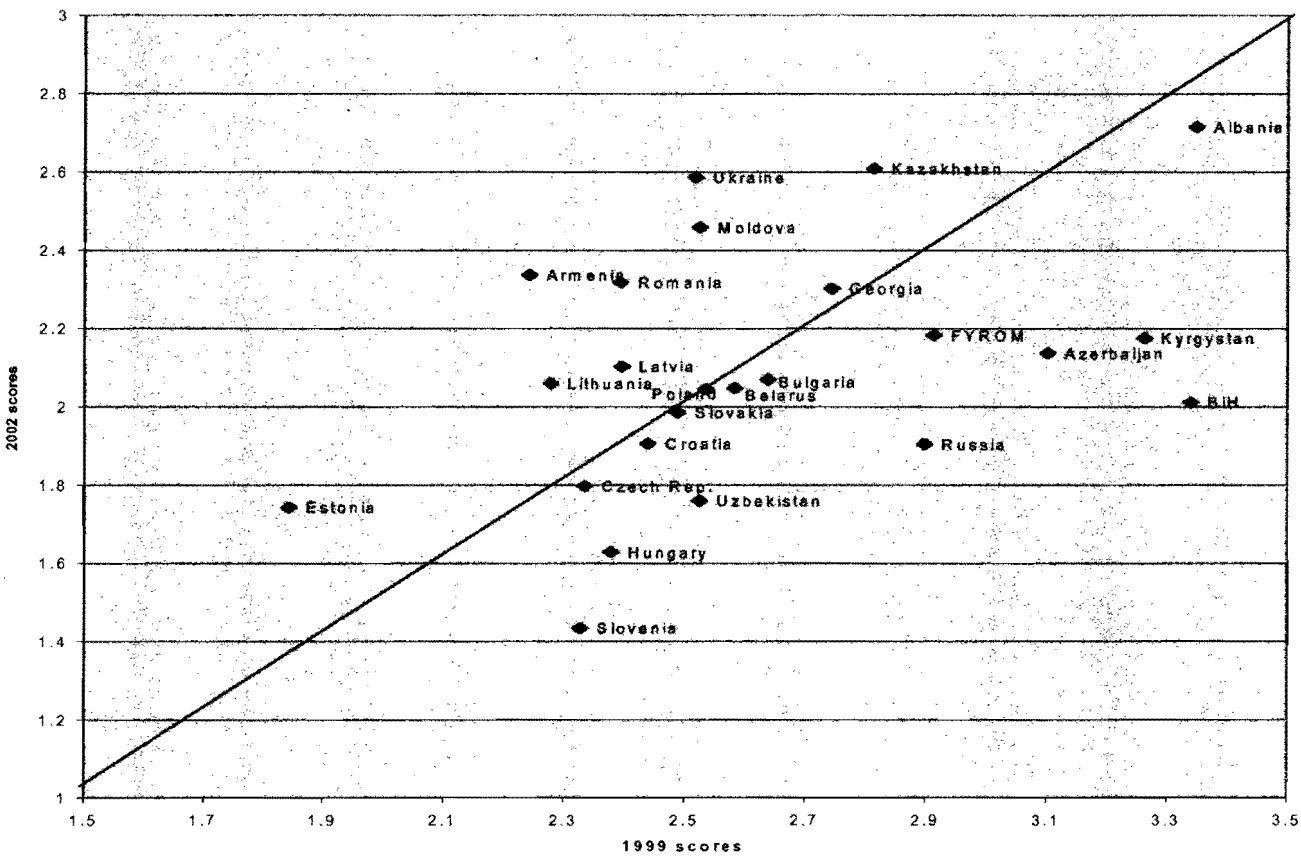
The survey results for the CIS-7 countries may be summarized as follows:

- The CIS-7 cluster into distinct groups as far as their business environment is concerned. Armenia and Uzbekistan tend to have a better investment climate than the other five countries. Azerbaijan lies somewhere in the middle, whilst the remainder have among the worst business environment of all transition economies.
- There has been an overall improvement in the business environment since 1999. This is due in part to improved macroeconomic performance of the region, but also due to a gradual recovery in the capacity of the state to tax, set and enforce the rules of the market place. However, in relative terms Azerbaijan, Kyrgyz Republic and Uzbekistan have improved, whereas Armenia, Georgia and Moldova have lost their relative position. Tajikistan was not covered in the 1999 survey but ranks near the bottom in 2002.
- The most prominent type of business obstacle across the CIS-7 is taxation. In most countries, corruption also ranks as a high obstacle. In addition, in the Caucasus, infrastructure is rated particularly badly, whereas in the Kyrgyz Republic, Moldova and Uzbekistan finance is regarded as a major obstacle.

Figure 1 presents the rank correlation using the average business environment scores for 1999 and 2002. Note that these scores have been corrected for the effects of macroeconomic performance. As one would expect, this tends to improve the relative position of countries such as Moldova and the Kyrgyz Republic, while worsening somewhat the position of Azerbaijan. However, the corrections have no major effect on the rankings of the CIS-7 countries. The vertical axis represents the 2002 ranking, the horizontal axis the 1999 ranking. Armenia was the best performing CIS-7 country in 1999 but has fallen well behind, whereas Uzbekistan has retained its place among the top half of the transition economies. The other CIS-7 countries are consistently clustered at the top right corner of the graph indicating a relatively poor business environment in both years.

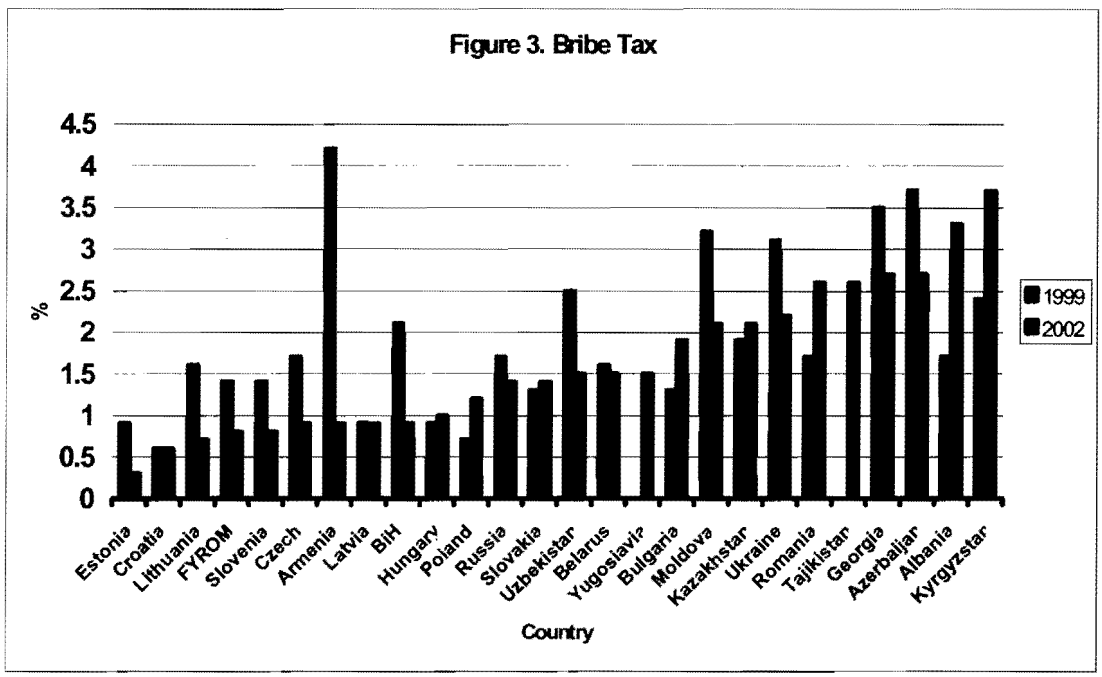
By drawing a 45 degree line through the middle of Figure 1, one can make further observations

Figure 1. Rank correlation of average business environment scores, 1999-2002



on which countries have improved their relative position and which have worsened. Armenia, Moldova has fallen behind, whereas Azerbaijan, the Kyrgyz Republic and Uzbekistan have improved in relative terms. Georgia's relative position remains unchanged.

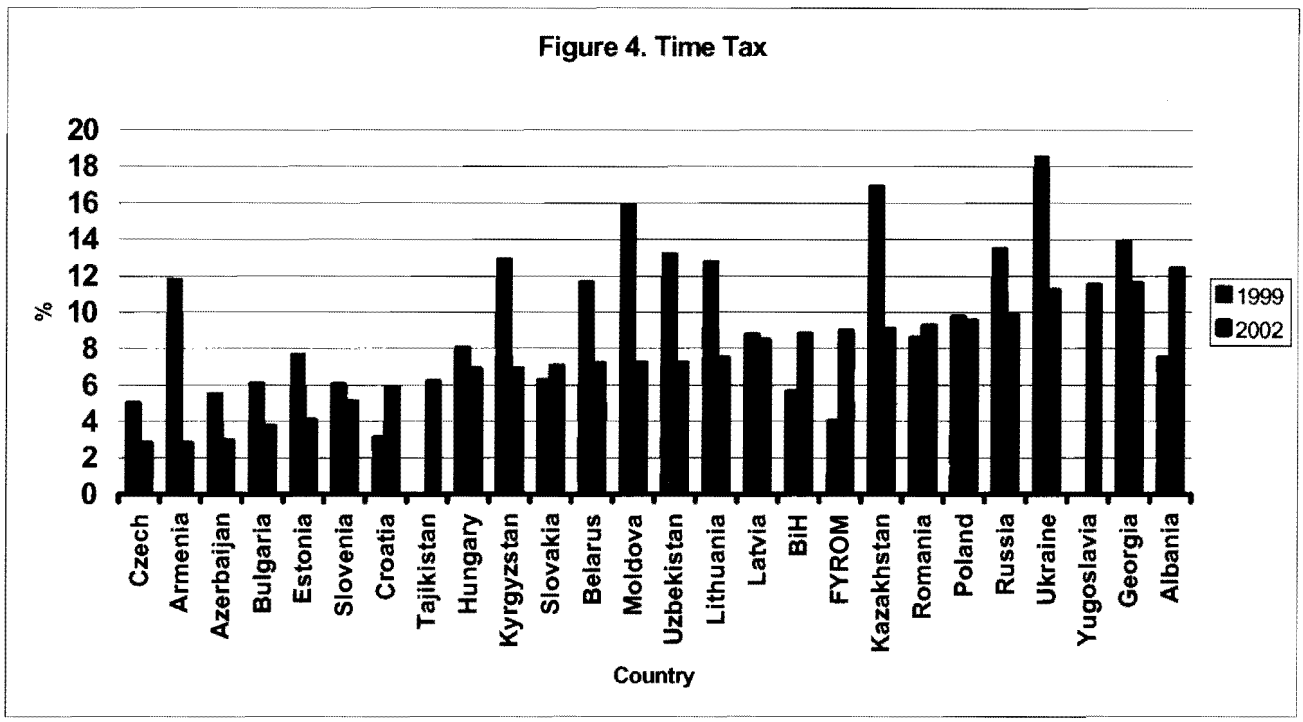
Figure 2 shows the business obstacles in the CIS-7 countries by major dimensions.



Since these scores are again corrected for the influence of macroeconomic performance, macroeconomic management as a business obstacle has been removed from the presentation.[26] The shape of the septagon in each case points towards the most important business obstacle. In all countries except Tajikistan, taxation (both tax rates and tax administration are included in this category) is regarded as the most serious obstacle, as shown by the spike in the shape of the figure. This was the case both in 1999 and in 2002. Corruption is seen as a relatively important obstacle in Armenia, Azerbaijan, Georgia, Moldova and Tajikistan. Georgia and Moldova also have particular problems in the area of crime and the judiciary according to the 2002 BEEPS. Finance is emphasized as an obstacle in the Kyrgyz Republic, Moldova and Uzbekistan, while infrastructure is badly rated in Azerbaijan and Armenia. Again the patterns in Figure 2 divide the CIS-7 countries into distinct clusters, with the Kyrgyz Republic and Uzbekistan for instance showing a rather similar shape, Azerbaijan and Armenia looking similar and Georgia and Moldova paired up by the similarity of their business environment.

Another insight that can be gained from Figure 2 is in which areas the business environment has improved particularly strongly and where it has worsened since 1999. The most interesting changes can be observed in the case of Armenia and Moldova. In the former, infrastructure and regulation have become more burdensome constraints on businesses, whereas crime has become less of an obstacle. In Moldova, infrastructure has recorded a significant improvement, while regulation has become much worse. In most other cases, the relative importance of the seven areas of the business environment has not changed dramatically since 1999.

[26] It is important to note that this is the one dimension, along which the business environment in Uzbekistan is perceived to be at least as bad as in the other CIS 7 countries.

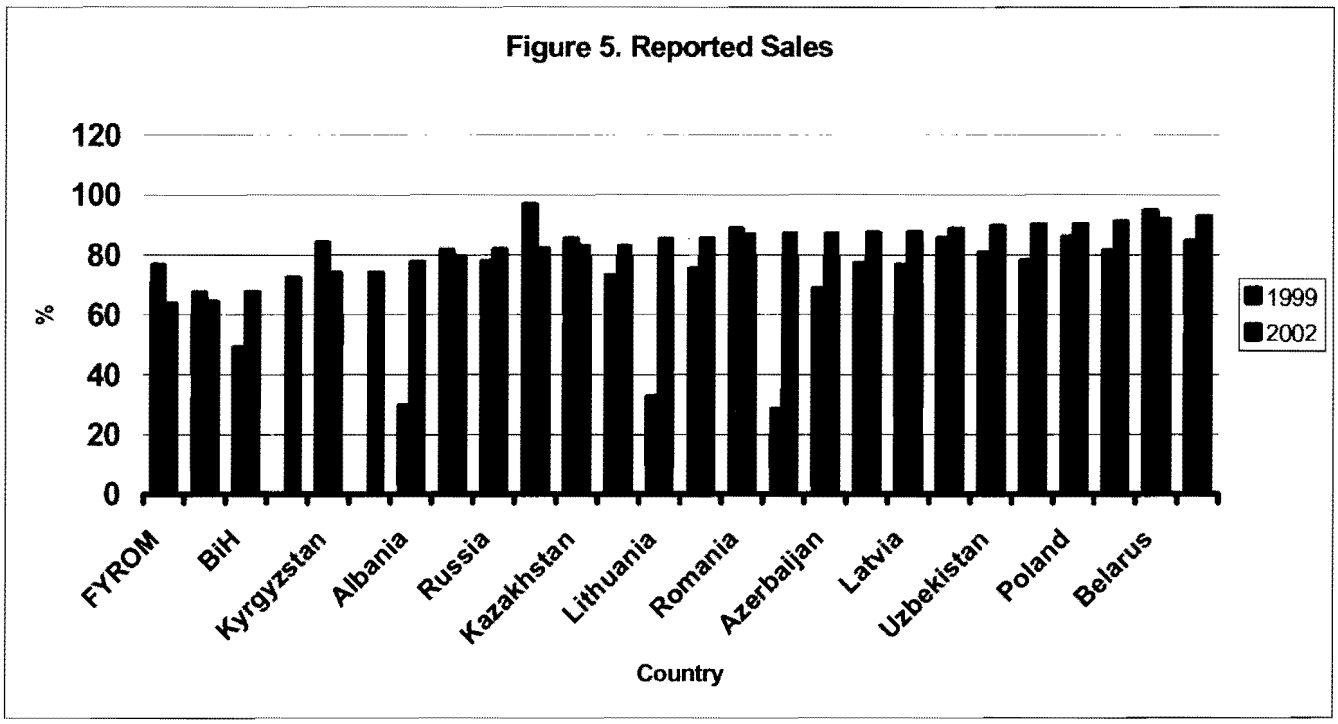


Finally, Figures 3-5 show the quantitative measures of economic governance along three critical dimensions: corruption, bureaucratic red tape and tax administration. The measures are i) the share of sales paid in unofficial payments (bribe tax), ii) the proportion of management time spent with government officials (time tax) and iii) the extent of underreporting of sales to avoid tax. A few remarks on interpretation of the data are in order. First, for the bribe tax and the extent of underreporting of sales for tax purposes, enterprises were asked to report how much firms "like theirs" would "typically" pay or underreport – an indication of how widespread these practices are. Second, the 1999 BEEPS asked firms to report bribes in terms of ranges. To make data comparable with 2002, where specific values were reported, the 1999 results were converted using the minimum point of the reported ranges.[27] Third, high tax avoidance is interpreted here as a measure of the constraint on businesses imposed by tax rates and tax enforcement practices, as it is assumed – in line with considerable evidence from around the world – that firms would prefer not to operate informally if the regulatory and tax system were adequate.

The results confirm the broad country clusters that emerged above within the CIS 7 group. The time and bribe tax were low in Armenia and Uzbekistan in 2002, although in both countries this was not the case in 1999. In both countries, business respondents also reported the highest share of sales on average. The highest bribe tax and the lowest reported sales were recorded by Georgia, the Kyrgyz Republic, Moldova and Tajikistan. Azerbaijan presents a mixed picture with high bribes, relatively high reported sales and a low time tax. The BEEPS also asked firms, how frequent the practice of making unofficial payments was. In Kyrgyzstan over 40 per cent of firms report that bribes are paid frequently, more than 30 per cent do so in Georgia, Moldova and Tajikistan, over 20 per cent in Azerbaijan and Uzbekistan and 14 per cent in Armenia. Finally, it is worth noting that small firms suffer disproportionately more from weaknesses in economic

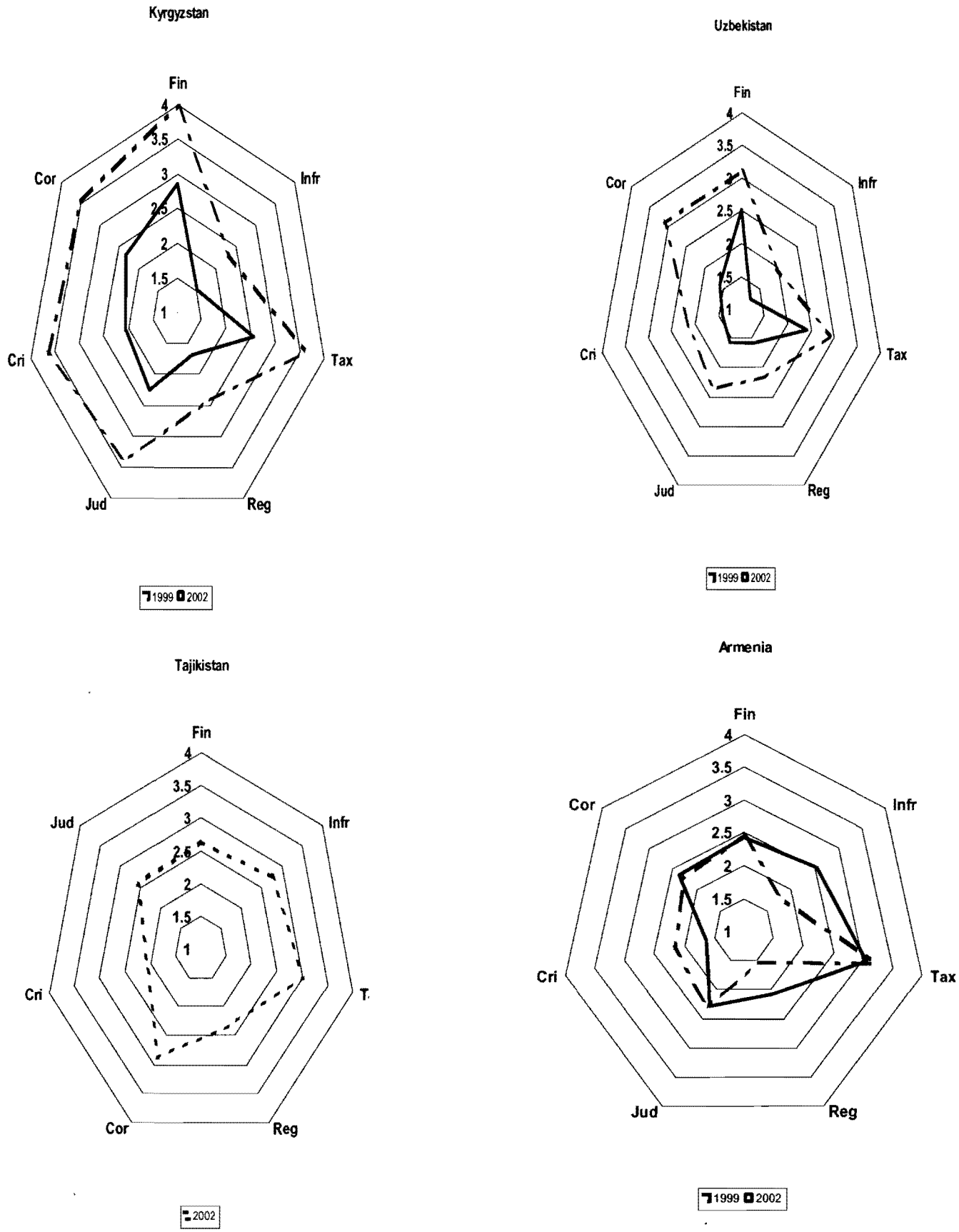
[27] The 1999 *Transition Report* reported data based on the mid-points of ranges, which yield significantly higher means for the bribe tax – the cross-country average using mid-points was 6.9 per cent in 1999.

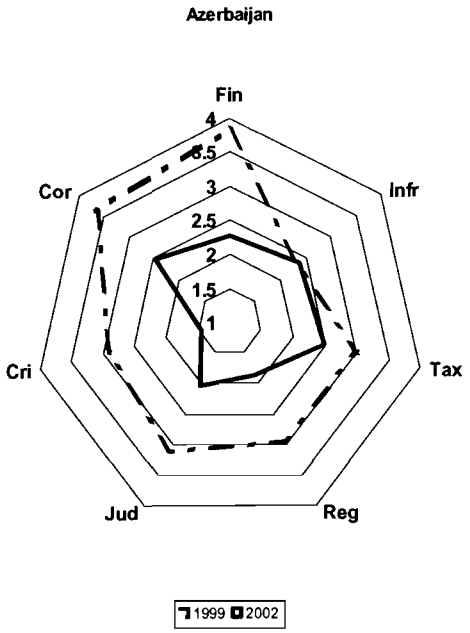
governance along the three dimensions presented here than large firms, although the differences across firm types seem to have diminished between 1999 and 2002.



The overall picture emerging from the BEEPS is thus one of regional variation within the CIS-7 group but overall a predictably weaker business environment than in Central and Eastern Europe. More analysis on the detailed obstacles to business development available in the BEEPS is needed to arrive at a fuller characterization and derive specific policy recommendations. This work is ongoing at the EBRD and the World Bank. Perhaps the most hopeful conclusion from the currently available information is that things have improved across the region, including in the CIS-7. However, to what extent these improvements will be sustained were macroeconomic performance in the region to deteriorate, and to what extent they have already been reflected in higher business investment and restructuring remains a topic for further investigation.

Figure 2. Business Obstacles in the CIS-7 Countries

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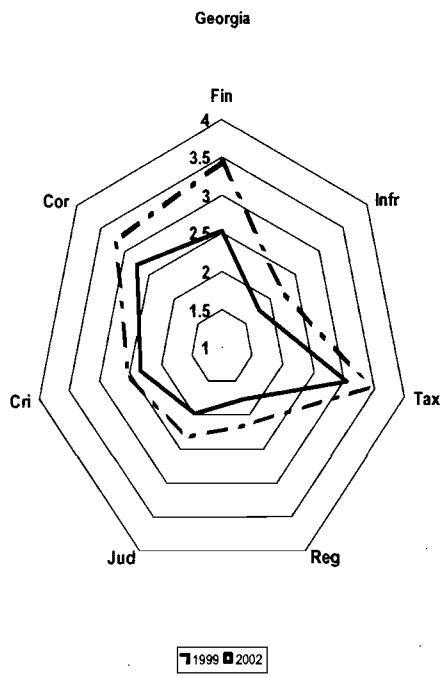
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