



THE SHADOW ECONOMY IN THE KYRGYZ REPUBLIC



***THE SHADOW ECONOMY
IN THE KYRGYZ REPUBLIC:
TRENDS, ESTIMATES AND POLICY OPTIONS***

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FOREWORD

The UNDP has initiated research on the shadow economy (SE) in the Kyrgyz Republic in cooperation with the Ministry of Economics and Finance. There are two aims to the research: to evaluate the size and nature of the SE and to develop policy recommendations to assist the Government to utilize the power of this relatively untapped potential resource.

It should be noted that the SE, broadly defined as the unregulated, non-formal part of the economy that produces goods and services for sale or for other forms of remuneration, is an integral part of advanced economies, as well as transition and developing countries. In second half of 1990s, the SE in developed countries was estimated to be 12% of Gross Domestic Product (GDP) on average, 23% of GDP in transition countries and 39% of GDP in developing countries (Schneider, 2003). The Kyrgyz Republic is no exception. The estimates produced in this report indicate that the levels of the SE in the country are comparable to similar countries in the region.

The SE can no longer be considered to be a temporary phenomenon. If economic growth fails to deliver greater employment levels and higher incomes, the SE does not necessarily shrink. The consequence is that most transition economies are actually experiencing an increase in the levels of the SE, even in the rural areas. The same applies to the Kyrgyz Republic.

A significant level of the SE, such as in the Kyrgyz Republic, has a negative general impact on all areas of state activity. The SE contributes to inefficient macro-economic management. It impacts negatively upon economic growth, leading to a drag on the rate of GDP growth. It also has negative consequences at the micro-economic level. This causes serious social consequences- society loses respect for public institutions, regulations, laws and ultimately, the state as a whole.

Just as it is in the case of poverty, the nature of the SE is complex and multi-dimensional. Making an assessment of the nature and size of the SE is difficult. By the very nature of the phenomenon, firms and others that are active in the SE seek to conceal their activities in terms of registration, payment of tax and other social contributions, etc. In order to arrive at a reliable estimate of the SE in the Kyrgyz Republic, various methods have been applied, leading to a range of estimates. By these estimates, the SE currently accounts for about 53% of GDP in the country.

But estimating the size and nature (sectors and regions) of the shadow economy is only part of the study. Experts agree that the SE offers a significant employment and income generation potential. In this context, the challenge for governments is not to eradicate it, but to develop appropriate policy frameworks that use this potential. Therefore, the main part of this report focuses on a range of recommendations to the Kyrgyz Government for utilizing the SE in the fields of tax policy, business environment, etc.

This analysis of the size and nature of the SE in the Kyrgyz Republic is only the initial step in the process of harnessing the potential of the SE. The much harder step is the process of developing innovative policies and strategies, something that is complex and medium term in nature. Having initiated the process of developing the policy recommendations, UNDP offers its continuing support in the provision of technical assistance to achieve success in this area.



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Chapter 1. Nature of the shadow economy

What is the aim of this report?

The target group of the report is policy makers, rather than experts, and its aim is to raise awareness of the issue of the shadow economy without overwhelming with terminology, methodologies, etc. The basic aim is to raise policy makers' awareness and understanding of the following issues:

- The nature of the shadow economy generally (chapter 1).
- The key characteristics of the shadow economy in the Kyrgyz economy (chapter 2).
- The framework of policy options facing the Kyrgyz Government in the medium term (chapter 3).

What is the shadow economy?

The Shadow economy may be defined in many ways (e.g. by employment categories, location, activities, etc.) but it is generally considered to be different types of economic activity, both productive and non-productive in nature, which yield profit. As such, the shadow economy should not be confused with the criminal economy. It involves legal activities that are concealed to evade taxation and social payments. These non-declared or hidden forms of economic activity are not taxed and thus are not taken into account by official statistics such as the Gross Domestic Product (GDP).

Causes of the shadow economy

The literature highlights the role of certain key factors in the establishment and growth of the SE (Ernste, 2003; Djankov et al, 2002; de Soto, 2000):

- High overall tax and social security burdens: heavy taxation and social security payments lead to an increase in the size of the shadow economy. In advanced economics, an increase in the income tax rate by 1% may cause growth of shadow economy by 1.4% (Schneider and Ernste, 2000). Studies demonstrate that the burden of direct taxes has the most critical impact on the shadow economy, followed by the complexity and intricacy of the tax system and the indirect tax burden (Schneider, 1998; OECD, 2002; Schneider and Ernste, 2000; Eilat and Zinnes, 2000). Basically the higher the difference between the total costs of labour in the official economy and after tax earnings from work, the greater the incentive to operate in the SE.

Table 1.1
Mean size of the shadow economy for developing, transition and OECD countries

Region	Mean size of shadow economy			
	1989/ 1993	1999/00	2001/02	2002/03
Developing countries				
Africa	39,4-43,9	41,3	42,3	43,2
Asia	35,0	28,5	29,5	30,4
Central and South America	38,9	41,1	42,2	43,4
Transition countries				
Central and Eastern Europe	20,7-32,4	38,1	39,1	40,1
Developed countries (OECD)	11,9-15,1	16,8	16,7	16,3
Communist regimes	-	19,8	21,1	22,3
Mean value	32,0	33,6	34,5	35,2

Sources: Schneider and Dominik (2000); Schneider (2005)

Table 1.2

Size of the shadow economy in transition economies

Countries	Mean size of shadow economy				
	1990/1993	1994/1995	1999/00	2001/02	2002/03
Azerbaijan	41,0	49,1	60,6	61,1	61,3
Belarus	31,7	45,2	48,1	49,3	50,4
Georgia	50,8	62,1	67,3	67,6	68,0
Kazakhstan	29,8	38,2	43,2	44,1	45,2
Kyrgyzstan	27,1	35,7	39,8	40,3	41,2
Russia	36,9	39,2	46,1	47,5	48,7
Ukraine	37,5	53,7	52,2	53,6	54,7
Uzbekistan	34,9	29,5	34,1	35,7	37,2
Mean value	36,2	44,1	52,4	53,5	54,6

Sources: Schneider and Ernste (2000); Schneider (2005)

- High intensity of legal and administrative regulations: the greater the intensity of regulations such as business registration, licensing and permitting requirements, labour market restrictions, trade barriers, etc., the greater the incentive for flight into the SE. Research also suggests that law enforcement, not just the intensity of regulations, may be a key issue.
- Lack of trust in official institutions / administrative corruption: scope for such corruption is provided by a slow and inefficient court system, unclear legislation and bureaucracy.
- Lack of access to formal property systems: the lack of clear property rights and title deeds and the inability to collateralize property assets obstructs firms' access to official financial products such as credit lines, insurance, etc.
- Long-term decline in civic virtue and loyalty towards public institutions, combined with a reduction in tax morale. This tend often goes hand in glove with a broad acceptance of illicit work, often sanctioned or tolerated by the state.

International trends

Great attention is paid, worldwide, to the study of the shadow economy. Table

1.1 highlights a comparative analysis of the scale of the shadow economy. Overall, with the exception of the OECD member-countries, the shadow economy demonstrates a constantly rising trend.

Table 1.2 shows that the shadow economy has increased significantly in the former Soviet countries. This was estimated in the USSR to be 3% of GDP (1973), rising to 10-11% (1990-1991) and averaging 36.2% in the CIS countries (1993). Consistent with the international trends, the shadow economy in the Kyrgyz Republic was estimated to be 27.1% (1993) rising to 41.2% in 2003.

Is this a cause for concern?

The fact that over 40% of the GDP may be produced in the SE is indeed a major cause for policy concern. Firstly it erodes the tax and social security bases of the country to the point where a vicious circle can develop of further increase in the budget deficit or tax rates leading to further growth in the shadow economy and a weakening of the country's social fabric. Secondly it creates unfair market conditions in that a growing SE attracts workers away from the official labour market and creates unfair competition for official firms. Thirdly it distorts official

indicators (e.g. unemployment, labour force, income, GDP, consumption, etc.) resulting in policies, including those to do with poverty reduction, that may be ineffective and even counterproductive.

What is the consequence for policy makers?

Governments must acknowledge a number of features about the nature of the SE, namely that:

- It can no longer be considered as a temporary phenomenon - it is an integral feature of the economy and contributes directly to GDP growth.
- It is likely to continue to increase if there is no economic growth or if economic growth is not accompanied by improvements in employment levels and more equitable income distribution.
- It has a significant job and income generation potential, not least because it exhibits significant levels of entrepreneurship.
- It has a poverty dimension in that those working in the SE typically lack income, assets, power and voice, whilst also being vulnerable.
- It has a gender dimension in that women make up the majority of those working in the SE, are more often victimised by government officials, experience the highest wage gaps and are often deprived of the right to own or control property (either due to laws or traditions), thus affecting their security and livelihood (Becker, 2004).

What is the role of Government?

Given that the SE can combat poverty by becoming an effective generator of employment, innovation, income and growth, Governments must acknowledge that the SE is here to stay and, therefore, that they have a responsibility to develop appropriate laws, regulations and policies. These need to recognise the importance of the SE, regulate and restrict it where necessary, but primarily focus on increasing its productivity and improving the working conditions of those who work in it, since efforts to reduce poverty will not succeed without addressing the needs of the SE.

Definition by income and employment potential

Informal enterprises are “informal” because although they provide goods and services whose production and distribution are legal, they do not comply fully with all the requirements relevant to their

activities, such as registration, tax, social contributions, licenses, health and safety requirements, etc. Shadow economy activities may not necessarily set out with the intention of deliberately avoiding taxes or infringe regulations applying to official enterprises, but this is precisely what they typically end up doing. There are many different types of informal business, ranging from modern manufacturing and service enterprises at one end of the spectrum; to transport services and trade establishments; and to street vendors and domestic servants at the opposite extreme.

Different enterprise segments

There are basically three types of informal enterprise, each requiring different policy responses:

- Individuals working informally part-time due to low or irregular wages. This category is not normally considered to be a high policy priority for governments.
- Individuals and households operating informally for survival or subsistence purposes in response to high unemployment, low wages, external shocks, etc., thus enabling them to maximize their principal asset, namely their labour. The costs of formalizing these activities are likely to outweigh the benefits, as well as having a negative poverty impact.
- Unofficial enterprises motivated by the desire to avoid the administrative and financial burden of regulation. The owners tend to be well-educated, non-poor and have sophisticated levels of skill. This should be the principal target group for policies designed to curb the SE, since official enterprises are more likely to be able to withstand registration/ taxation/ social contributions/ regulations, etc.

What is next?

The starting point is to obtain a good understanding of the size and nature of the shadow economy. Based on this, it is possible to develop a palette of policy recommendations to guide Government's efforts to utilize the shadow economy. The remainder of this report sets out:

- The methodology for assessing the size of the shadow economy in the Kyrgyz Republic and the key results of the detailed research.
- The range of policy options to make more effective use of the shadow economy.

Chapter 2. Shadow economy in the Kyrgyz Republic

2.1 Methodology

Which methodology was employed?

By its very nature, estimating the size of the Shadow economy is complicated. The informal (and indeed the criminal) economy involve a measure of concealment from registration, monitoring and control. This means that two main methods are typically used:

- Indirect measurement methods: these are based on the “residual balance technique” involving a specific definition of the shadow economy in order to estimate what is formal/informal.
- Direct measurement methods: these involve using either household surveys or enterprise surveys (on both), ensuring the selection of a representative sample to enable estimation.

Why to use variety of methods?

The accuracy of any particular direct / indirect method is dependent on a variety of issues, all of which can influence the final estimate. Moreover, although there are several internationally agreed methodologies, there is no universal method to calculate parameters of the shadow economy. As a result several methods and sources of data were employed to “triangulate” the results, thus ensuring greater confidence in the estimate. The methods used were:

a) Indirect methods:

- Comparison of tax and statistical information: the aim was to establish the tax base and compare this with the official statistical data, focusing on the emergency and road taxes.
- Electricity consumption indicators: the aim was to use this as a proxy the real scale of economy activity occurring in the country (link between electricity consumption and output production).

b) Direct method:

- Indirect survey of entrepreneurs (1,530 questionnaires of which 742 were completed): entrepreneurs were asked to estimate the size of income concealed by their competitors, rather than themselves. The assumption was that entrepreneurs would be more willing to discuss their competitors, rather than themselves, but would base their responses on their own businesses.
- Direct survey of entrepreneurs (sample of 13).
- Survey of tax inspectors (sample of 20).

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It should be noted that these various methods do not cover the element of the shadow economy generated by the agricultural sector.

2.2 Estimation of the SE using indirect methods¹

Non-Observable Economy

The non-observed economy with respect to production was estimated to be 1.4 billion Som in 1995 but increased dramatically to 14.8 billion Som in 2004. In terms of GDP, its share almost doubled from 8.4% to 15.6% of GDP. The share of agricultural homemade production went up slight from 13.4% of GDP in 2003 to 15.1% in 2004. If agricultural production is taken into account, the share of the non-observed economy is over 30% of GDP.

The (non-agricultural) non-observed economy is concentrated in the trade (75.5%), transportation (34.2%), hotels and catering (20.9%), construction (12.9%) and processing (8.5%) sectors and increased from 8.4% (1997) to 15.3% of GDP in 2004.

Electricity Consumption

The trends to note in the Kyrgyz Republic are that, compared to last year of the Soviet era (1991), total electricity consumption has increased by 6.9% (2004). Given the existence of a relatively constant ratio between electric consumption and long-term output, Table 2.1 shows that, excluding communal services and the social sector, the informal sector appears to account for 33.5% of GDP.

Comparison of tax and statistical information

This section provides an analysis of non-taxable economy using tax estimates for the road use tax and the tax allocation for the prevention of emergencies. Table 2.2 estimates the tax base to be 67.7% (2003) and "non-taxable" turnover amounted to 23.2 billion Som. The tax base in 2004 changed very little (68.5%), as did the "non-taxable" turnover (24.7 billion Som). Based on this method, the "non-taxable economy" was estimated to be 32% of the total production value in 2004. It should be noted that this excludes agriculture, which is taxed nominally (all agricultural producers must pay the land tax).

¹ All data and analysis presented in this chapter have been derived from «Analysis of the scale and nature of the Shadow Economy in the Kyrgyz Republic» (2006).

Table 2.1

Estimate of the value of the shadow economy (2004) using the electricity consumption method (1991=100)

Description	2004 %
Power consumption	106,8
Losses	434
Power consumption without communal services and social sphere	140,9
GDP	87,6
Estimate of the shadow economy (in % to GDP)	33,5

Source: National Statistical Committee and own estimations

Table 2.2

Non-taxable turnover in selected industries (road use tax)

Description	Ratio of tax base and statistical indicator	
	2003	2004
Industries, total (statistical classification 1-N)	67,7	68,5
incl:		
Industry (value of earnings)	61,9	62,4
Transportation	45,2	45,0
Construction	97,7	72,6
Trade and catering (trade, hotels and restaurants)	86,7	110,2
Light industry	19,5	22,8

Table 2.3

Territorial breakdown of the shadow economy

Oblasts	Concealed sales (%)	Concealed profit (%)	Concealed wage bill (%)
Bishkek	41,3	42,8	39,9
Issyk-Kul	49,4	47,5	52,2
Jalal-Abad	28,8	31,6	22,3
Chuy	38,7	35,7	32,5
Osh	35,9	36,0	32,0

Table 2.2 suggests that practically all sectors offer significant scope for enhancing tax revenues, especially in the light industry, transportation and construction sectors. Similar conclusions were drawn following analysis of the prevention and mitigation of emergency tax.

2.3 Estimation of the Shadow economy using the direct Method (Survey)

This section presents an analysis of the indirect survey of entrepreneurs with respect to questions relating to the shadow market for goods and services and concealed labour market. As a rule, the answers to each question were analyzed at national, regional and sectoral level and, in addition, were grouped according to type of business. A firm size analysis was also carried out for the macroeconomic assessment of the shadow economy.

Territorial distribution of the shadow economy

Turning to the territorial issue, there is a distinct north-south divide, with the relatively more developed economy of the north demonstrating a higher incidence of informal activity. It should be noted that the Naryn and Talas oblasts contribute no more than 10% of the national GDP and are mainly agricultural in nature. They have little or no other activity and have been excluded from the analysis (Table 2.3).

Sectoral Distribution of the shadow economy

Turning to the sectoral dimensions (Diagram 2.1), the following are particularly noticeable: mining, car repairs, trade, real estate and construction. These are sectors where transactions are typically executed primarily in cash and state accounting of volumes of production and profits is dif-

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Diagram 2.1 *Shadow economy and the size of enterprise*

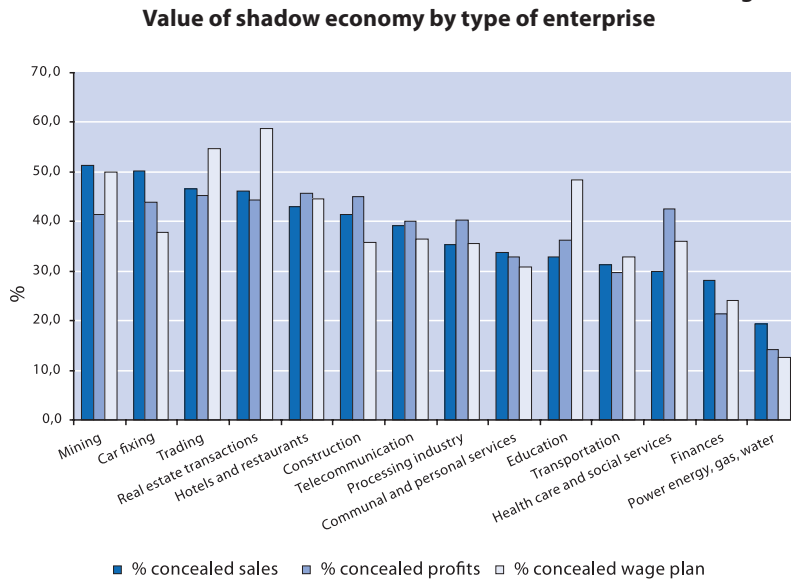


Table 2.5 shows that concealment of incomes and size of the shadow economy is strongly correlated with the size of enterprise: the bigger the enterprise, the more difficult it is to hide its real production values or sales. The greatest concealment happens with individual entrepreneurs (including those who work according to the patent) and private entrepreneurs. However, the medium-sized and large enterprises manage to conceal a very significant proportion of their incomes, sales, profits and wages. This is a policy target group which is likely to be able to pay their dues without being driven out of business. It also suggests that this is where the greatest leakage of revenue is happening and thus where policy measures to harness the shadow economy should be targeted.

Shadow economy by type of enterprise

Description	Concealed sales	Concealed profit	Concealed wage bill
Limited Liability Company	40,6	42,2	37,6
Joint Stock Company	26,8	26,7	30,9
Private enterprise (Pvt.)	43,6	42,1	41,6
Patent	45,0	43,1	42,1
Unregistered	52,7	52,4	38,3
Other enterprises	22,3	27,2	23,2

Note: Other enterprises are non-commercial organizations and public foundations; the data was collected on the basis of what is typical for the sector of activity, rather than the type of enterprise.

Table 2.4

Shadow economy by size of enterprise

	% enterprises not reporting actual incomes	% concealed sales	% concealed profit	% concealed wage bill
Individual entrepreneurs	45,8	43,9	42,8	37,9
Small business	46,3	42,0	43,2	38,8
Medium business	42,3	35,3	35,6	31,3
Large-scale business	29,3	25,5	30,8	28,9

Table 2.5

Individual indicators of the assessment of the shadow economy nationally

	Assessment of the shadow economy, %
Concealed Sales	39,8
Concealed Revenue	40,1
Concealed Wages bill	41,4

Table 2.6

difficult. In some cases, the concealed wages far exceed informal production: trade (+9.4 %), real estate (+14.6%), education (+12.1%) and health care (+6.0%).

also conceal their activities. The organizationally more complex legal type of firms experience, higher levels of scrutiny, especially the limited liability companies and joint stock companies, however, between a quarter and almost half of their sales, profit and wages are concealed. This suggests that the policy focus should be primarily on these enterprises, rather than the other forms which are more subsistence / survivalist in nature.

Different types of enterprise and the shadow economy

Unregistered enterprises exhibit higher levels of concealment (Table 2.4). What is surprising, however, is the extent to which the other forms of enterprises

Assessment of the shadow economy using the results of the survey of firms at country level

Table 2.6 presents data from survey of entrepreneurs by different indicators of the shadow economy. The fact that the total data for the Republic by various cost indicators are very close to each other (the difference is about 2 %) indicates that the assessment of unregistered companies in the shadow economy was defined correctly.

A critical indicator of the shadow economy is the volume of added value produced in the sector. An assessment of the shadow economy has been carried out using two methods of calculating this indicator based on the results of surveys. The first method is based on data about concealed income and total wages, which are components of added value. The second method is based on data about concealed sales volumes and intermediate consumption; the difference between these indicators gives estimated of concealed value added. These two methods were chosen because of the need to make a reciprocal additional examination of the findings.

The results obtained with data on the concealment of income and salaries were chosen as the preferred result for the assessment of the shadow economy (Table 2.7).

Table 2.7 assesses the shadow economy in the context of industries surveyed. In order to obtain data for the shadow economy throughout the Kyrgyz Republic an additional calculation was made and

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Table 2.7

Evaluation of the volume of the shadow economy by industries surveyed (registered companies)

Industry	% of income concealed	% of salary concealed	Added value (data of NSC)	Concealed added value ¹
Mining industry	41,3	50,0	609,6	496,7
Processing industry	40,3	35,5	14459,6	7883,6
Output and distribution of power energy, gas, and water	14,2	12,5	3075,6	455,4
Construction	44,9	35,9	2319,3	1357,9
Trade, fixing cars, household devices, and personal items	45,0	52,1	15072,5	2988,7
Hotels and restaurants	45,6	44,6	1465,2	943,0
Transportation, communications, and telecommunications	34,9	34,6	6045,1	2591,8
Financial sector	21,4	24,1	1795,3	522,3
Property transactions, rent and supply of services to users	44,3	58,8	2514,5	2781,4
Education	36,3	48,4	3328,1	2984,7
Health care and social services	42,5	36,1	5341,0	3126,3
Supply of communal, social, and personal services	32,9	30,8	1802,0	747,6
Other	30,0	17,5	0,0	
TOTAL	40,1	41,4	57827,8	26879,3

Source: NSC data; results of the indirect survey; and own calculations

¹ Calculations were made taking into account data from the survey on concealment of income and salaries, and data from the Table "GDP by types of income in current prices".

during this process the data for the non-observed economy, which were estimated by NSC, were excluded from official NSC data..

The correlation between concealed added value and reported data by companies was extended to the entire economy of the Kyrgyz Republic to obtain the value of the shadow economy.

Table 2.8 shows that the shadow economy for registered companies is 52% of the official volume of added value or 46% of official GDP. It should be stressed that due to the specificity of the survey, it only concerns concealment of added value by registered companies.

The valuations of the shadow economy, which were calculated on the basis of data on the concealment of sales and intermediate consumption, give a greater value of 67 %. However, these data must be considered carefully due to the fact that the question asked regarding intermediate consumption might have been misunderstood by businessmen as shown by the following:

- The interviewers indicated that the participants often required additional explanations for this question.
- Some businessmen (operating on the patent) do not report this indicator (in other words this indicator is new for them).

As a consequence, some of the respondents to the survey either omitted this question or indicated both, under-

Table 2.8
Calculating the value of the shadow economy as a ratio of GDP (registered companies, mln.soms)

1		Added value by industries surveyed (Data of the NSC excluding the value of the non-observed economy)	43072,5
2		Concealed added value (Table 2.7.)	26 879,3
3	3=1+2	Corrected added value	69951,8
4	4=2/1	Share of concealed added value against reported added value	62%
5		Concealed added value in the whole economy (including the share of concealment defined in the line above) (4 lines of NSC data excluding the value of the non-observed economy)	43709,5
6	6=3+5	Corrected added value	113751,39
7		Corrected GDP (7 lines plus net taxes on food)	123304,9
8	8=5/6	Shadow economy/Gross added value	51,5 %
9	9=5/7	Shadow economy/GDP	46,3 %

Source: Data of NSC, results of an indirect survey and own calculations

Table 2.9

Indicators of shadow activity of unregistered enterprises

	Proportion of unregistered enterprises	Added value of registered companies (in % of GDP)	Added value of unregistered companies (in % of GDP)
Individual enterprises	31,8	14,4	4,6
Small enterprises	28,4	9,0	2,6
Total			7,2

Source: NSC, results of an indirect survey and own calculations

estimating and overstating intermediate consumption as a result.

Determining the share of GDP of unregistered enterprises

Assessing the share of productive GDP is quite complicated since these enterprises are, by definition, all operating in the shadows. In order to assess the size of this sector the assumption was made

that the average size of unregistered enterprises (added value) is the same as the average size of registered enterprises. Also, bearing in mind that the smaller the business the larger the volume of shadow economic activity, it was assumed that unregistered enterprises are individual and small-scale enterprises. As was noted earlier, the share of unregistered enterprises is quite large and based on the results of the survey, accounts for 31.8% of indi-

Summary of the shadow economy data

	Gross added value (mln. Som)	% of official GDP
Registered companies	43709,5	46,3%
Unregistered companies	6793,3	7,2%
Total	50502,8	53,5%

Source: Results of the indirect survey and own calculations

Table 2.10

Data verification - direct survey of entrepreneurs and tax inspections.

The direct enterprise survey supported and validated the indirect enterprise survey reported above. The direct survey suggested that the proportion of concealed actual sales and production output is 47.4%. This matches the overall valuation of the informal activity but exceeds mean indicator of the shadow economy by the indirect survey (39.8%). A similar situation applies to the degree of concealment of wages (41.4% Vs 42.9% in the direct survey). The baseline estimates obtained through the direct survey broadly support and validate the results obtained in the indirect survey.

Concealed labour-market by legal form of enterprise

Legal Form	Proportion of illegal employees (%)	Proportion of employees with underreported salary (%)
Limited liability company	28,5	46,0
Joint stock company	18,8	28,8
Private enterprise	29,1	41,9
Patent	37,3	43,1
Unregistered	23,5	45,9
Other enterprises	19,1	22,7

Table 2.11**Table 2.12****Smuggling by sector of activity (2004)**

Sector	% of production	% of consumption
Tobacco goods	1,3	0,8
Vodka and alcoholic beverages	19,2	9,8
Wine	129,6	46,4
Cognac	372,9	65,9
Champagne	957,2	89,9
Beer	38,1	11,0
Fuel-lubricants	61,1	9,9
Incl:		
Gasoline	84,8	5,4
Fuel	138,8	21,1

Source: National Statistics Committee

vidual entrepreneurs and 28.4% of small business. Based on these assumptions the estimate of the value of the shadow activities of unregistered companies is 7.2% of GDP (Table 2.9).

Total valuation of the shadow economy.

Based on the above-stated calculations it is concluded that the shadow economy constitutes 53.2% of official GDP (2004 data) and is worth 50.5 billion Som (see Table 2.10).

Concealed labour market

The survey suggests that almost 30% of employees are employed illegally, however, it is estimated that the share of employees whose salaries are underreported is even higher (41.9%). The highest level of concealment (underreporting of wages) are in the north, especially in the Bishkek and Issyk-Kul oblast, but the highest proportion of illegal workers are to be found in Osh oblast. Entrepreneurs generally prefer to recruit employees officially

(over 70%), but typically pay more than officially reported since recruitment of illegal workers is riskier. Nevertheless, even in the best oblast in this regard, Jalalabad oblast, every fifth employee is illegal. The biggest concentration of such employees is in mining, construction, car repairs, hotel and catering businesses where it is harder for the state to monitor the situation.

Turning to enterprise type, the highest number of illegal employees are in the patent activity (37.3%), followed by private enterprises (29.1%), both of which benefit from a simplified reporting system (see Table 2.11). Nevertheless, limited liability companies lead in terms of underreporting of wages and joint stock companies are not far behind. If the state lacks the administrative capacity to deal with concealment by the numerous enterprises in other legal forms, it would do well to focus its policy efforts on the LLCs and JSCs which are more limited in number and involve significantly higher volumes of potential tax revenue.

In addition, a survey was designed for tax inspectors with a view to cross-referencing the data provided by entrepreneurs with that of those responsible for formalizing enterprise activity. Tax inspectors suggest the following levels of concealment by enterprises: 42.1% of actual production output and sales and 45.3% of actual earnings. In their opinion, total wages are also underreported by 47.8%. Once again, these estimates are broadly consistent with the values obtained through the indirect survey of enterprises, suggesting that the results are robust.

2.4 Further Dimensions of the Shadow economy

Informal production and smuggling

Porous borders and non-transparent customs legislation are the precondition for smuggling activity. It is suggested that the largest amount of concealed production and tax evasion is observed in sectors with the highest tax rates. Based on NSC estimates, a huge quantity of excise goods is smuggled (Table 2.12), especially champagne (89.9%), wine (46.4%), cognac (65.9%) and beer (11%) as a percentage of total sales.

The reliability of these data was tested using the example of alcoholic beverages. The consumption of alcoholic goods was estimated based upon official data. According to the data, the total consumption of alcoholic beverages in 2004 was the same as in 1980. Yet, in the mean time, the population has increased by 1.42 times. More over, level of per capita consumption in 1980 was considerably higher (6.6 L) than in 2004 (4.3 L) and simultaneously, the structure of alcohol consumption has also changed substantially, such a greater consumption of vodka and a significant reduction in wine consump-

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tion, mainly for cost reasons. On the basis of these assumptions, the difference between the sale of alcoholic production and domestic resources (production + import + export) against the output value in 2004 is 94 %, but against the sales value it is 47.9 %. These data suggest that the concealed production and smuggling of alcoholic produce constitutes 83.8% of all alcoholic beverages consumed in 2004.

Remittances by migrants

Although there are currently no comprehensive surveys of the number of Kyrgyz labour migrants living abroad or indeed the impact of their money transfers on the economy, experts assume that remittance (regular money transfers) by Kyrgyz labour migrants has become the single most significant source of the increase in incomes in the last few years. The expert assessments of the labour migration volumes range from 300,000 – 500,000 or about 10 – 18% of Kyrgyzstan's economically active population. The media, however, regularly report that there are 700,000 such migrants (IOM, 2005, Various, 2001).

Remittances by labour migrants are officially accounted for in the Kyrgyz Republic balance of payments and were estimated to be worth 65.2 million USD (2003), increasing dramatically to 163.6 million USD in 2004. These estimates are based on remittances made through bank accounts and international transfer systems, but in reality most labour migrants remit money in cash since many are engaged in seasonal work and/or work illegally. A survey conducted by the Economic Policy Institute "Bishkek Consensus" estimates the true value of migrants' remittances to be closer to 481 – 520 million USD, depending on the assumptions made.

Criminal economy

A clear trend is the growing strength of organized crime and the globalization of crimes such as drugs and weapons production / sale, children and women trafficking and sale of human organs. Production in the criminal economy is growing steadily (Nemira, (2001), Bororkv, (1998), Barov, (2000)).

International experts suggest that only 1 – 3% of drugs circulating are actually seized. It is possible to estimate the total volume of illegal drug turnover in Kyrgyzstan by adjusting the volume of the drugs seized by 97% (i.e. non-seized drugs). In monetary terms, the estimated volume of illegal drug turnover amounts to USD 71.8 million. It is estimated that Kyrgyzstan

Table 3.1
Possible actions to reduce number of enterprises in the shadow economy

Actions	% of enterprises
Corruption reduction	14,2
VAT reduction	12,5
Profit tax reduction	11,1
Social Fund payment reduction	8,3
Reduction in the number of patents and permits	7,4
Income tax reduction	7,0
Escalation of war against criminals	6,9
Improvement in the effectiveness and transparency of legislation	6,9
Other tax reduction	6,9
Strict measures against enterprises that evade tax	5,2
Improvement of salaries of public officials, especially controlling agencies, in order to reduce corruption	5,1
Enforcement of full customs duties; tax collection from goods imported which compete with national products	5,0
Reduction in the number of state standards required	3,4

drug export makes up over 86% of the illegal drug turnover (about USD 62 million).

Bribe Tax

Corruption in Kyrgyzstan is a common problem in all spheres of public activity. The average bribe paid to officials by businesses is ca. 5,000 Som. The average bribe varies significantly depending on the type of business. An average bribe of ca. 10,000 Som is typical for companies engaged in production of utilities and finances. Next, ca. 6,000 Som was paid by firms engaged in processing, construction and telecommunications. Typically, a bribe of 3,500 to 4,700 Som is paid by companies engaged in trade, health, education, services, car repairs and hotels. The lowest bribes (900 to 1,400 Som) are paid by firms engaged in transport and mining. (Analysis of the scale and nature of the Shadow Economy in the Kyrgyz Republic, 2006)

This excessive level of corruption was thought to be the main cause of the shadow economy.

The average bribe paid by joint stock companies and limited liability companies were respectively 6,000 and 6,400 Som, whereas the bribe paid by unregistered companies is approximately half that amount. Therefore, although unregistered enterprises avoid the bribe tax to some degree, they are not immune to them. This also suggests that rather than being "hidden," public officials are very well aware of their existence. According to the indirect survey, bribery occurs once or twice per annum, which effectively means that a business relationship is established between bribe payers and recipients in medium and large enterprises. Smaller companies pay more frequently, albeit less.

Chapter 3. Conclusions and policy recommendations

3.1 Key Conclusions

The size of the shadow economy is estimated to be 53% of GDP, based on various direct and indirect methods of estimation. If the agricultural sector were to be added to the estimate, the size of the shadow economy would be significantly higher.

The Kyrgyz Republic is not unique from the point of having an extensive shadow economy. This is a standard feature of transition / developing, as well as advanced economies.

What is alarming, however, is the continuing, albeit decelerating, growth of the shadow economy. Moreover, from an international perspective, the size of the shadow economy in the Kyrgyz Republic is now in the upper range of the estimates available.

The main reasons driving the shadow economy in the Kyrgyz Republic are the high levels of tax and social security contributions, as well as the ineffective tax administration, combined with excessive level of business regulation, non-transparent regulations, corruption and bribery.

This is a major cause for concern since it erodes the tax and social security bases of the country, creates unfair market conditions, distorts official indicators (e.g. unemployment, poverty, etc.) and leads to inappropriate policy making.

The shadow economy (SE) can not be considered to be a temporary phenomenon. It is here to stay and Governments have a responsibility to develop appropriate laws, regulations and policies to ensure that the SE is used to combat poverty

and continues to generate employment, income and growth.

Whilst recognising the importance of the SE, the Government needs to regulate and restrict it where necessary, but primarily focus on harnessing it and increasing its productivity, while at the same time seeking to improve the working conditions of those who work in it.

The remainder of this report focuses on a range of policy recommendations to utilize the potential of the SE without at the same time destroying it. This is a very difficult policy balance to strike. Although there are many countries which are trying to do just this, there are presently no best practice “handbooks” to draw on, as the policy environment is so different in every country.

3.2 Suggestions from the private sector

The starting point in gathering information is to listen to those that generate the SE in the first place. The Indirect survey asked entrepreneurs: “In your opinion which actions undertaken by the Government will be the best to reduce number of enterprises operating in the shadow economy and decrease the underreporting of volume of production (sales) and profit?” Their views are summarized in Table 3.1 below.

The entrepreneurs were offered a menu of 14 options, out of which five priority recommendations emerged. Entrepreneurs believe that the root cause of the SE is the high level of corruption in the country (14.2%). Consistent with international experience, high taxation is the second main problem: as a solution, firms propose a gradual reduction in VAT (12.5%), Corporate Income Tax (CIT) (11.1%) and the social security contributions (8.3%). Despite the recent reduction of income tax to 10% and the payments to the Social Fund to 29%, entrepreneurs still call for a reduction in taxes, which means that either they have yet to notice the benefits of the reduction or that they look at the overall tax burden, as well as the levels of corruption. The next set of recommendations focus on regulatory issues - they propose decreasing the number and complexity of licenses and permits required (7.4%) to undertake business activities, Improvement in the effectiveness and transparency of legislation (6.9%) and various other measures.

3.3 Agenda for harnessing the shadow economy

Therefore, the situation in the Kyrgyz Republic broadly mirrors the international experience in terms of the causes of the SE (see Chapter 1 above), namely:

- Lack of trust in official institutions / administrative corruption;
- High overall tax and social security burdens;
- High intensity of legal and administrative regulations;
- Long-term decline in civic loyalty and tax morale combined with a broad acceptance of illicit work, often sanctioned or tolerated by the state;
- Lack of access to formal property registration systems, etc.

Given the above, Government policy should seek to reduce the costs and increase the incentives of formality, whilst at the same time increasing the ability of informal agents, as well as the formal business sector to influence government policy (“voice”). This in turn suggests that there is a need for broad and balanced policy responses focusing on the key issues, tailored to the local situation. An attempt to utilize the SE amounts to a medium to long-term agenda which has to be customised to the particular policy environment in the Kyrgyz Republic and pushed by the Government. It would involve a range of line ministries operating in tandem to ensure that policy reforms are not only created but also implemented. It is crucial for the policy reforms to involve the private sector if they are to be credible and followed.

As previously discussed, there are basically three types of informal enterprise:

- Individuals working informally part-time due to low or irregular wages, such as civil servants;
- Individuals and households operating informally for survival or subsistence purposes in response to high unemployment, low wages, external shocks, etc;
- Unofficial enterprises motivated by the desire to avoid the administrative and / or financial burden of regulation.

The principal focus of Government policy should be the unofficial enterprises, especially the medium to large enterprises (LLCs and JSCs). As previously discussed, these are currently able to conceal a large proportion of their sales, wages and profits. Their owners are typically well-educated, non-poor and have poses sophisticated skill levels. They are also

more likely to be able to withstand registration/taxation/social contributions/regulations, etc. Moreover, these enterprises are relatively visible, accessible and the proportion of tax revenue that could be recovered would be significant compared with the smaller scale, subsistence activities, even if the latter are more visible and numerous.

Policy Recommendations

Therefore, the following policy priorities are proposed for the period up to 2010. This palette of policy options is designed to be consistent with the wider Country Development Strategy for 2006-2010.

3.3.1 Increase “Voice”

1. Integration with the Country Development Strategy (CDS)

There is a need to integrate the Programme to curb and utilise the shadow economy with the Government’s wider programme for reform, namely the Country Development Strategy. This would serve to raise the importance, profile and Government commitment to implement the Programme of reforms.

2. Establish a Task Force to Harness the SE

For better coordination of the activities for harnessing the shadow economy a Task force should be established. It should be comprised of representatives of civil society and governmental bodies². The Task Force’s main responsibility will be to prioritise a programme / action plan reform and implementation of reforms and would have the following structure:

- Minister of Economy and Finance (Chairman)
- National Statistics Committee
- Ministry of Trade and Industry
- Ministry of Justice
- Committee for Employment and Migration
- Customs Agency
- State Tax Inspectorate
- Social Fund
- Chamber of Commerce and Industry
- Kyrgyz Exporters’ Association

² Extensive meetings have already been held with the public and private sector for the creation of the Task Force and there is already broad agreement about its nature and composition.

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- International Business Council
- Business association Congress
- Chamber of Tax Consultants
- Legprom (textile) association

Note: the President / Prime Minister will be involved, as required.

The Task Force will meet formally four times a year and more frequently if required. It will establish an annual work programme involving no more than 4-5 priorities per annum (based mainly on palette of policy options presented in this report) and then create Working Groups around those priorities. These will lead to recommendations, reforms, regulations, laws, etc. to be implemented by the members of the Task Force. Donors, international bodies, etc. will have an observer status and support the work of the Task Force and its Working Groups through the provision of technical assistance. The Task Force will be run by a Secretariat based at the Ministry of Economy and Finance. The Secretariat will need to be adequately staffed if it is to make effective progress.

The members of the Secretariat will need to possess a range of specialist skills, such as taxation, labour market analysis, corporate governance, regulatory reform, etc.

3. Business Associations

Voluntary business associations would be established in the key sectors of informal activity to represent their members vis-à-vis the Government as, for example, successfully achieved by the Textile Association. The principal sectors which might benefit from this approach include: car repairs, trade, real estate, construction, hotel and catering and transportation. Where such business associations already assist, they would be assisted to improve their lobbying and advocacy role and, in particular, strengthen their capacities in relation to formalizing their members' activities.

4. National Campaign

As previously discussed, one of the causes of the increase in the SE is the long-

term decline in civic virtue and loyalty towards public institutions, combined with a decline in tax morale. Society begins to accept the SE as a "normal" part of life and this is compounded by a wide-held perception that such activities are tolerated and even sanctioned by the state. Such attitudes would be counteracted through a National Awareness Raising Campaign focusing on the SE and exploring issues such as:

- Why the SE matters to everyone: % of GNP in the SE, issue of the legitimacy of the state, etc.
- The government's role: to utilize the entrepreneurial potential offered by the shadow economy (distinguishing between subsistence and unofficial enterprises such as LLCs and JSCs).
- The government's activities to use the SE, such as the Task Force.
- The costs and risks of operating in the SE Vs a legal business (see Box 1).
- The benefits and the assistance provided to those who wish to legalise their businesses.
- Shadow economy Hotline / Home Page to provide detailed information about the SE policy, how to register, provision of necessary forms, ombudsman for harassed firms, etc.

Such campaign can be either a general awareness raising initiative or targeted at particular sectors or types of enterprise, such as unofficial firms with LLC and JSC status.

3.3.2 Reduce Cost

Taxation

1. Simplify tax regimes and reduce the overall tax burden

Even though the Corporate Income Tax or profit tax (CIT) rate is low (10%) by international standards, the tax regime is complicated and the overall tax burden is considered to be excessive by both registered and non-registered enterprises. As a consequence 30% of firms are not registered and 40.1% conceal profits. A further reduction in the CIT will not automatically improve the situation. It is the interaction between the VAT, CIT, patent and simplified business tax systems currently that provides massive scope for tax evasion. Therefore, there is a need to:

- Unify the tax system as far as small, medium and large enterprises are concerned, applying a standard tax regime based on CIT and VAT for all companies above a minimum threshold.

Box 1: Negative Aspects of the Shadow economy

Disadvantages of informal activity

- Lack of access to health and safety standards in the workplace.
- Loss of various employment rights such as annual and other leave, sickness pay, redundancy, training.
- Low job security.
- Inability to get an employer's reference.
- Lack of access to a range of other legal rights such as tax benefits.
- Inability to gain access to credit.
- Inability to build-up rights to the state pension and other contributory benefits.
- Lack of bargaining rights.
- Loss of employability, due to the lack of evidence of engagement in employment.
- Fear of detection and risk of prosecution due to their activities being illegitimate.
- Pressure into exploitative relationships with the formal sector.
- Lack of legal protection (e.g. contracts) relative to legitimate businesses.
- Problems developing and growing a business due to difficulties in getting access to capital and securing the support available to formal businesses.

Problems for legitimate businesses

- Unfair competitive advantage of firms who use informal labour.
- Emergence of 'micro-level de-regulatory cultures' where formal businesses feel compelled to informalise to compete.
- Competition between informal and formal workers and businesses generates 'hyper-casualisation' in the labour market, in other words sporadic self-employment and informal employment supported by fraud.

Broader societal costs

- Fraudulent activity deprives the state of Income Tax, Social Security Contributions and VAT revenues.
- Social cohesion affected by reduced resources available to governments to pursue social integration.
- Leads to weakened trade union systems and collective bargaining powers
- Leads to a loss of regulatory control over the quality of jobs and services provided in the economy.
- Encourage a more casual attitude towards the law if a significant proportion of the population is routinely engaged in illegal activity.

Source: Small Business Council, 2005

- Enable micro enterprises, which represent the overwhelming majority of enterprises, to benefit from a simple tax regime, for example, based on a lump sum tax or a fixed rate of turnover.

2. *Revise the patent tax system*

The creation of a tax system that is stable, clear and simple is essential for small businesses with limited capacity to devote to onerous fiscal administration procedures. The patent tax is a simplification that has been utilised in various transition countries such as Kyrgyzstan, Moldova, Ukraine, etc. with some success since the burden of registration and associated cost is minimal. The experience of such countries is generally positive in terms of increasing the number of registered economic activities. Moreover, these have generally led to an increase in the tax revenue generated. The patent tax can also have a positive effect in terms of encouraging small scale informal operations to formalise their activities. Given the very high levels of the shadow economy in transition economies, this is a particularly useful policy aspect of the patent tax. However, the patent also brings disadvantages. The tax revenues tend to remain relatively low since the patent costs, by definition, are low. Moreover, there may also be unintended consequences, such as encouraging economic activities to remain small, stimulate firms to encourage employees to take-up patents instead of contracted employment, thus avoiding paying social contributions, etc. (Stability Pact, 2006). Over time, countries operating the patent tax must consider reforms to the system and the same applies to the Kyrgyz Republic:

- Review the patent tax system, covering issues such as the number of activities to be covered; mandatory Vs voluntary patents; methodology for determining patent costs; regulation of import-export patent activity; compulsory billing; etc. Such a review would be designed to generate greater tax revenues and stimulate patent enterprises to development and grow.

3. *Reduce total wage costs, especially social security contributions*

The social security contributions burden in the Kyrgyz Republic is 29% (8% paid by employees; 21% paid by employers). Both employers (due to competition) and employees (due to a lack of confidence in state's capacity to provide for their future pension and health needs) consider this to be excessive compared with the benefits,

with the consequence that the social security contributions system in the Kyrgyz Republic is not sustainable. Depending on the legal form, between 19-37% of the firms employ staff illegally and between 23-46% underreport the salaries paid. In both cases, firms are not paying the right level of social security contributions. This is compounded by the lack of capacity to enforce social contributions payments, since enforcement is not the responsibility of the Social Fund. The experience of OECD countries suggests that there is a need to:

- Further reduce the social security contribution rates from their high current level (29%), at the same time as seeking to broaden the tax base (through a shadow economy strategy focusing primarily on unofficial businesses rather than subsistence activities). However, reductions in the social security contributions will not solve the problem on their own.
- Establish an incentive system in order to increase the collection rate. The current social security contribution collection rate is more likely to be increased if the Tax Inspectorate has an incentive to do this, over and above performing their existing duties and responsibilities.
- Introduce an effective voluntary third pillar (private pension funds) in relation to pension provision in the Kyrgyz Republic.

4. *Strengthen the Tax Inspectorate*

The litmus test of the Government's determination to drive out corruption and stimulate the process of encouraging the formalization of the SE is its willingness to reform and strengthen the Tax Inspectorate. It is not surprising that the 15,000 inspections (10,000 legal entities and 5,000 private persons) carried out in 2005 only raised 3.7% of the revenues (only 0.13% of which was raised from private persons (Analysis of the scale and nature of the Shadow Economy in the Kyrgyz Republic, 2006).

Although there appears to be some checks and balances on their activities, in practice these are ineffective and work to the detriment of both registered and unregistered enterprises, as well as society as a whole. There is an urgent necessity to:

- Develop a more effective tax inspectorate which does operate in a transparent and accountable manner as far as enterprises are concerned. In particular, there is a need to establish a clear agenda for the inspection process without non-

transparent departmental regulations or amendments.

- Improve tax administration, in particular design methods of risk assessment for non-payment of taxes, increase targeting of inspections (e.g. an incentive system to encourage greater levels of revenue collection from LLCs and JSCs), thus reducing the number of tax inspections to 5-10% of registered enterprises selected transparently, restrict direct contacts by tax officials with firms, establish a code of conduct for tax officials, introduce monitoring and evaluation of tax inspectors, etc.
- Raise both the income and professionalism levels of the Tax Inspectorate since the low wages are a key driver of rent seeking behaviour by state officials.
- Ensure that the Tax Inspectorate has strong powers to penalise non-compliant companies (warnings, leading to tougher fines and legal action), ultimately pushing recurrent non-complying firms out of the market. At the same time, the right of firms to recourse / appeal needs to be strengthened and made transparent.
- Revise the existing draft law "On order of inspections of business entities by authorized bodies," taking into account the opinion of entrepreneurs, ensure that it also covers the Tax Inspectorate, and that it is prioritised by Parliament and implemented in full.
- Review the number of state controlling bodies with a view to merging or coordination them and their activities, clearly defining their functions, duties, and responsibilities to avoid duplication.
- Establish a Hotline where entrepreneurs and consumers can report to the tax administration both non-complying firms (help curb unfair competition and isolate companies that do not follow fair business practices) as well as tax inspectors (thorough ombudsman).
- Optimize the working with big taxpayers³.
- Input the tax on immovable property after the final approval of the mechanisms of its levy⁴.
- Revise the land tax to lands of non-agricultural setting in its direction of increase⁵.

3 Addition of Ministry of economics and finance

4 Addition of Ministry of economics and finance

5 Addition of Ministry of economics and finance

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5. Improve Tax Administration

One of the main drivers of the SE is the overly complicated tax system, with a multiplicity of taxes, exceptions and regulations. A key complaint by entrepreneurs is that the tax regime is constantly changing, poorly administered and placing significant cash-flow strains, especially on smaller firms.

- Abolish all charges related to forms / applications for tax administration and submissions and make them readily available on paper and through the Internet.
- Improve VAT refunds: VAT avoidance is widespread partly because its administration places severe cash flow strains on businesses. In the case of the Kyrgyz Republic, the expectation is that VAT repayment will not be made despite the law which states that VAT should be reimbursed within one month. In addition to the cash-flow problems caused by this issue, the relatively high inflation rate results in significant real costs to enterprises and is particularly problematic for export-oriented or capital-intensive enterprises. A system of timely reimbursement of VAT should be developed as soon as possible. This should be administered on the same basis for all types of enterprise, regardless of size, sector, etc.
- Introduce electronic tax submissions and payments: the use of IT in relation to issues such as submission of tax forms, returns and payments could significantly simplify and accelerate the process, as well as reduce scope for bribery and corruption.

Business Environment

6. Streamline registration and deregistration

As many as 30% of enterprises are not actually officially registered with the relevant state bodies. It is widely believed, among such small businesses, that the relevant state agencies do not even attempt to register them, preferring instead to "milk" or obtain a "bribe tax" from such companies once they are discovered (50% of such firms pay a bribe tax). While a certain proportion of firms may not wish to register their activities, many are simply deterred by the significant barriers that exist for registration (and de-registration) as well as the complexity and cost associated with the exercise. The World Bank's latest comparative analysis (Cost of Doing Business 2006) illustrates the depth of the problem. Opening a business (LLC)

involves 8 procedures, takes 21 days and costs 10.4% of income per capita. Closing a business involves 46 procedures, 492 days and costs 48% of the debt. Both entry and exit stimulate the SE.

- There is a need to simplify, accelerate and reduce the cost of business entry (registration) as well as exit (de-registration). In this respect, it is necessary to introduce an effective "one-stop shop" system throughout the country.
- Attention needs to be focused on information provision, special training for one-stop shop staff and development of accelerated registration procedures for micro enterprises in sectors that are known for having a large share of unregistered enterprises.

7. Strengthening of customs administration⁶

At present it is necessary to take measures that will help to increase the effectiveness and transparency of administration of customs fees.

It is highly recommended that the Government:

- Revise in the direction of simplification procedures of customs checks at the border;
- Conduct full automation of customs registration and control and other processes of exchange of information. Provide an option to electronically file import/ export declaration forms.
- Improve customs legislation in accordance with the WTO standards.
- Change the system of human resources training, stimulate the institutionalization of customs brokers, customs transporters, customs warehouses under the condition of control for violation of free competition in this sphere.
- Provide transparency of customs services through expanding access to customs information for all interested persons, development of partnership of customs and fast exchange of information between customs services and its main trade partners and management bodies of Kyrgyzstan.

8. Streamline licenses and permits

The system for business licenses and permits has improved over time but remains one of the most problematic aspects as far as enterprises are concerned and contributes directly to the size of the shadow economy. The World Bank's lat-

⁶ Addition of the Ministry of Economy and Finance

est comparative analysis (Cost of Doing Business 2006) illustrates once again the depth of the problem: obtaining a licence involves 20 procedures, takes 218 days and costs 510,4% of income per capita. This does not reveal the true extent of the problem, since in addition to the legal requirements, there are often various orders, directives, instructions etc., which are issued by governmental bodies which are not even registered with the Ministry of Justice. Such a situation leads to complexity and duplication, costs firms time and money and creates numerous opportunities for rent seeking by officials.

- Streamline the licenses and permits system, starting with adoption of new law "On Licensing."
- The draft new Licensing Law should be approved by the Parliament and implemented in full.

9. Ensure protection of rights of workers in the shadow businesses

The labour legislation is generally considered to be one of the most significant constraints to businesses in the Kyrgyz Republic. The new Labour Code was designed to be more business friendly, however, the legislation on labour entry and exit needs considerable streamlining. The Labour Code establishes rights and responsibilities of employers and employees, including termination of contracts, wages, leave, conflict resolution, etc. and is relatively pro-employee (e.g. stringent legislation on terminating contracts, lack of enforcement mechanisms to protect workers' rights, poor health and safety, etc.). These factors combined with the high contributions to the Social Fund, mean that employers and employees prefer to operate partly or fully off-the books, thus fuelling the shadow economy.

- Review the Labour Code to ensure a proper balance between employee and employer rights and responsibilities, consistent with international best practice and the reality of the Kyrgyz economy.
- Protect those working informally since the SE will not disappear in the short to medium term. The lack of legal protection of workers' rights in the shadow economy is an issue of major importance, consistent with the ILO International Labour Conference (2002) where basic workers' rights, access to work and social security and organisation and representation are all identified as being elements of decent work which should also be enjoyed by workers in the shadow economy (see ILO Decla-

ration on Fundamental Principles and Rights at Work).

3.3.3 Increase Attractiveness

1. Strengthen property rights

De Soto (2000) has championed that thesis that the poor in developing nations often have assets (such as shacks and informal businesses) but lack formal property rights to their assets. This prevents them from unlocking the true potential of their assets: producing capital (for example, through using them as collateral for borrowing) and connecting them to the formal economy. The thesis points to the importance of securing property rights as the foundation of modern markets – without effective property rights, private sector development is constrained both in the informal and formal economy. The situation is similar in Kyrgyzstan⁷.

- 87% of the firms are not sure that their property will not be illegally expropriated by the state.
- More than 80% believe that in Kyrgyzstan equal protection of all forms of property is not ensured.
- 90% are aware of cases of abuse of private property rights in Kyrgyzstan.
- 69% believe that the existing procedures for registration of real estates do not ensure full protection of rights of owners

In this context it is necessary to:

- Expedite property registration and land titling procedures, as well as reduce the costs of the procedures (according to the World Bank's Cost of Doing Business report of 2005, there are 7 procedures, take an average of 10 days and costs 5.3% of the property value).
- Simplify the procedures required to register property as collateral.

2. Reduce corruption, focusing on state bodies

The Government has made it a top policy priority to tackle the levels of corruption in the country. From the analysis it appeared that the high levels of SE in the country are not merely linked to the level of corruption, corruption is itself a key "driver" of the SE. Various initiatives are underway to tackle this issue. The fight against abuse by state officials such as the Customs Agency, Tax Inspectorate and

other inspecting agencies should be prioritised. The following actions are required:

- Reform the system of staff recruitment, training and Human Resource Management, in particular the "sale" of positions in state bodies should be abolished as a matter of priority.
- Reform the wage structure of state inspectorates and local governments to reduce the incentive to participate in bribery and corruption.
- Reform the concept of "corruption" in the Criminal Code and law "On the fight against corruption."
- Reform the Criminal Code and Criminal Procedure Code to identify incomes / funds of criminal enterprises to ensure compliance with the UN Convention against Corruption.
- Abolish the practice of state controlling bodies "earning" money by obtaining special funds for exercising of their supervising functions, such as tax forms and construction inspections. These activities should be funded through the state budget.

3. Reduce smuggling

A key issue is the huge and increasing volume of contraband evident in the Kyrgyz economy, which is significantly underestimated in official statistics. Although contraband is not included in the estimates of the size of the shadow economy, its presence is a key indicator of the concealed economy since it drives informality. Reforms to the Custom Administration are required.

- Ensure full observation of the Customs Code by customs officials, especially at the local level.
- Ensure greater transparency of customs services and procedures through open access by firms to relevant information, including a partnership between customs and the business community.
- Provide all customs check points, including remote ones, with legal documentation.
- Develop a capacity building programme for customs officials.
- Minimize personal contact between import/export firms and customs officials via the use of customs broker services as a means of reducing scope for rent seeking by customs officials.

4. Maximise the potential of remittances

Remittances are a form of money transfer from workers (whose place of

work is outside of their originating country) which serves as vital income to the receiving family or communities. In common with other countries, the officially transferred remittances, as seen in the balance of payments data, appear to grossly underestimate the actual level of remittances. Although the official estimate of the scale of remittances in the Kyrgyz Republic was 163.6 million USD (2004), independent research suggests that the true value may be closer to 500 million USD. Remittances tend to be used primarily for daily expenses such as food, clothing and health. They are often also used to build / improve housing, buy land / cattle and purchase consumer durables such as cars and televisions. Only a small proportion of remittances is used for savings and productive investment. In other words, little of it seems to be invested in income and employment-generating activities with multiplier effects, such as starting a business (Russell 1997).

The Government should, therefore, develop policy measures to influence not only the attraction of remittances but also the pattern of use of remittances. Channelling remittances into productive investment is increasingly seen as an essential ingredient in the promotion of economic growth in labour exporting countries (Puri and Ritzema, 1999). Policy initiatives should focus on:

- Facilities to allow migrants to import machinery and equipment at concessional rates of duty.
- Business counselling and training to assist start-ups.
- Entrepreneurship programmes to encourage returned migrants to use their money productively.
- Stimulate micro-finance institutions to use remittances and transfer saved funds to entrepreneurs (via social funds, savings and credit schemes, as well as investment instruments).

3.3.4 Balanced use of "sticks and carrots"

In trying to develop a programme or framework for encourage firms to formalise their activities, it is useful to distinguish between "push" and "pull" factors or what has often been termed "sticks" and "carrots". The initiatives designed to reduce cost, increase participation and increase voice are only part of the equation. These should be complemented by a range of "sticks" and "carrots" to help firms to formalise their economic activities.

⁷ Investment Roundtable (2006) Policy Report for Government "Issues on protection of property and recommendations for providing guarantees and mechanisms of protection and immunity."

THE SHADOW ECONOMY IN THE KYRGYZ REPUBLIC

1. Push factors (“sticks”)

The objective of Government policy should be, over time, to shift as much economic activity as possible into the formal economy. Punitive measures and increasing detection rates can be used as sticks by ensuring that the expected cost of being caught and punished is greater than the potential economic benefit. Without effective reform of the Tax Inspectorate, the “sticks” are unlikely to be effective but such measures include:

- Increasing sanctions for employers and/or employees (fines, deregistration, imprisonment, etc.).
- Creating a graduated system of sanctions (warnings, leading to progressive higher fines, legal action and ultimately closure of the business).
- Intensifying controls / field checks by the tax administration.
- Increasing co-operation and data exchange between state authorities (e.g. registration, tax, etc).
- Introducing fraud Hotlines to discourage LLCs and JSCs from engaging in the shadow economy.
- Excluding businesses making use of shadow economy from public tenders, etc.

- Confidential telephone lines providing advice to people wanting to leave the shadow economy.

2. Pull factors (“carrots”)

Since the aim is not to eradicate the SE but to encourage its transfer to the formal sector, “pull” factors are also needed. These proactive measures might include:

- Social benefit reforms: for example, to encourage the unemployed to become legally self-employed.
- Formalisation of vouchers: using vouchers to encourage employers to employ formal rather than informal labour.
- Business advisory services: to help informal businesses to formalise their activities via confidential support in relation to issues such as tax and social contribution rules and regulations, bookkeeping, access to finance, etc.
- Business start-up grants: focusing on issues such as business planning and access to finance.
- Coaching, training and advice (for employers and employees) in fulfilling formalities.
- Campaigns to change behaviour and attitudes (see “voice” above).
- Targeted tax/income amnesties for informal firms (e.g. tax fraud) and workers (e.g. benefit fraud) to declare themselves.

SUMMARY

The analysis of the shadow economy based on the application of different methods to obtain a reliable estimate of the size of the SE dimension in the Kyrgyz Republic shows that it currently constitutes 53% of GDP. The size of the SE is actually increasing and while the size of the SE is also rather large in similar countries, the estimate for the Kyrgyz Republic is in the very upper part of the range.

A significant level of the SE, such as in the Kyrgyz Republic, has a negative general impact on all areas of state activity. It contributes to inefficient macro-economic management. It impacts negatively upon economic growth, leading to a drag on the rate of GDP growth. It also has negative consequences at the micro-economic level. Moreover, it causes serious social consequences - society loses respect for public institutions, regulations, laws and ultimately, the state itself. The research suggests that the main reasons for the high levels of the SE are lack of trust in official institutions, heavy taxes and social contributions, ineffective tax administration, poor legislation and corruption.

Given that the SE have a high potential to reduce poverty by becoming an effective generator of employment, innovation, income and growth, the Government must acknowledge that the SE is here to stay and, therefore, it has a responsibility to develop appropriate laws, regulations and policies. The primary focus of the Government policies should be on creating favourable conditions that will increase the SE productivity and improve the working conditions of those who work in it, while aiming at gradually integrating the SE into the formal economic sector. Without prioritizing the needs of the SE, the country will not be able to tackle the issues of poverty reduction and economic stagnation.

LIST OF ACRONYMS

BAC-	Business Association Congress
CIS -	Commonwealth of Independent States
EU –	European Union
fez –	free economic zone
GDP –	Gross Domestic Product
GNP –	Gross National Product
GVDA –	Gross Value Added
IBC –	International Business Council
ILO –	International Labor Organization
IOM –	International Organization for Migration
JSC –	joint stock company
LLC –	limited liability company
Mass-media –	Mass communication
NSC –	National Statistical Committee of the Kyrgyz Republic
OECD –	Organization for Economic Cooperation and Development
Pvt. –	private entrepreneur
SNA –	System of National Accounts
UN –	United Nations
UNDP –	United Nations Development Programme
UNODC –	United Nations Office on Drugs and Crime
USA –	United States of America
USSR –	Union of Soviet Socialist Republics
VAT –	value added tax
WTO –	World Trade Organization

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