

Informal Costs of Doing Business: The Case Study of the Registration and Regulation of Firms in the Kyrgyz Republic*

Maksat Kobonbaev**

The Kyrgyz government has made positive steps in terms of introducing and simplifying the formal laws and regulations to provide incentives for firms to do business according to the formal rules of the game. However, despite the presence of simple and cost-effective formal laws and regulations, firms continue to resort to informal arrangements, incurring additional costs in money and time, which far exceed the legal (official) limits. Moreover, the government bureaucrats continue to reap rents, intervening informally in the economic activities of firms, and discouraging firms from working legally. Thus, the government-business transactions are in the equilibrium point that sustains informal ways of doing business. However, informal ways of doing business are not cost-free. There are long-term effect, associated with uncertainty and externalities, as well as short-term costs associated with bribes and other informal dealings. The paper briefly discusses the possible long-term effects and documents in detail, the short-term costs due to corruption in the areas of registration, and regulation of firms.

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INTRODUCTION

“Laws like cobwebs, entangle the weak, but are broken by the strong”
Ascribed to Solon c.575 B.C.

The advocates of radical reforms and advisors to post-communist governments such as Jeffrey Sachs and David Lipton (Sachs and Lipton 1990) and Anders Aslund (Aslund 1999; 2000) have argued that the Kyrgyz Republic¹, being an island of democracy and economic liberty, would become one of the fastest growing economies among other post-Soviet countries. They even predicted that necessary institutions² would emerge naturally adjusting to the radical market reforms. Having witnessed the failure of radical reforms to create the institutional environment conducive to the formation of the market economy, policymakers finally began to pay attention to the role of institutions.

Two distinct but related fields have increasingly begun to explore the role of law and regulations in providing incentives for firms to operate in a market economy (Stone, Levy and Paredes 1996; De Soto 1989). The field of Law and Development takes a very formalistic approach, arguing that economic growth depends on a system of formal laws and regulations consistent with the market economy. Hernando De Soto (De Soto 1989; 2000), Kenneth Karst and Keith Rosenn (Karst and Rosenn 1975) argue that cumbersome formal institutions are the root causes of the formation of the shadow economy, which negatively affects the overall economic development. They prescribe that the road to success is possible by nurturing transparent and simple laws along with providing consistent enforcement mechanisms.

The field of New Institutional Economics (NIE) also pays much attention to formal laws and regulations but its frontiers go far beyond formal institutions to explore all sets of institutional arrangements on the basis of their empirical impact on economic transactions and performance. Indeed, there are several strands of NIE. The transaction cost economics strand of NIE led by Ronald Coase (Coase 1937; 1960) stresses the importance of proper definition of property rights and emphasizes the impact of institutions on transaction costs. Oliver Williamson (Williamson 2000) argues further that formal laws and regulations are necessary but not sufficient to prevent opportunistic behavior by firms. Douglass North (North 1990) argues persuasively that informal institutions matter as much as formal laws and regulations in determining the costs of doing business. North has showed cogently that the same formal rules imposed on different societies produce different patterns of development depending on informal norms (societal values, cultural heritage, historical experience, past polities, etc.).

It is no longer a question whether institutions shape economic performance. The NIE literature provides vast empirical evidence in favor of institutions. The question is whether the presence of formal institutions consistent with the market economy is sufficient for efficient business operations as the Law and Development literature contends or indeed the mixture of formal and informal institutions help us better

understand the processes shaping the costs of business transactions as NIE claims. The purpose of this paper is to contribute to the understanding of this puzzle.

I have chosen the Kyrgyz Republic because it has simplified the laws, governing business registrations and regulations, and officially prohibited the random involvement by bureaucrats in the activities of the private sector. Furthermore, the Kyrgyz government has minimized the costs and time associated with the government regulations of businesses. Thus, the formal costs in money and time to commence and conduct business in the Kyrgyz Republic are low. According to the Law and Development School of Thought, firms should start up new businesses and run existing firms according to formal rules of the game because they are simple and cost-effective. The paper examines the results of the Regulatory and Business Environment Survey (RBES) conducted in the Kyrgyz Republic after the simplification and introduction of laws that govern: (1) registration of new businesses (entry mechanism), (2) regulation of businesses, and (3) government intervention.

The survey results demonstrate that the mere presence of formal institutions necessary to provide favorable incentives for firms to engage in business activities does not mean that these formal institutions naturally become effective. For example, formally great strides have been made in simplifying the regulations for starting up and conducting business, but, as a matter of fact, the costs and time far exceed the legal (official) limits. Moreover, the government bureaucrats continue to impose burdensome regulations and informally intervene in the economic activities of firms, discouraging them from working legally and making long-term investment commitments.

It is important to note that statistics employed in this paper is mainly descriptive rather than causal and there is the degrees of freedom problem of using only one case study. Thus, the external validity (generalizability) of this study is limited. Therefore, I do not intend to generalize the results to other formerly communist countries.³ However, I briefly compare the results of the cross-country survey, the Business Environment and the Enterprise Performance Survey (BEEPS), conducted to analyze the government-business relations in the twenty formerly communist countries, to test the consistency of the RBES data and, more importantly, to examine whether the firms' informal costs due to corruption are only specific to the Kyrgyz Republic or a part of larger trend in the formerly communist countries.

The results of the BEEPS survey are consistent with the results of the RBES survey, showing the pervasiveness of corruption in the Kyrgyz Republic. Furthermore, the BEEPS results illustrate that the informal costs of corruption are not specific to the Kyrgyz Republic. The BEEPS survey reveals that most firms in all of the formerly communist countries pay bribes without exclusion. The firms resort to informal means to survive the pressure by the government bureaucrats in spite of their increasing appreciation of the formal rules of the game. However, there is a regional variation, showing that firms in Central Asia and Caucasus rank higher than their counterparts in Eastern Europe on the corruption continuum.

THEORETICAL ANALYSIS

The formerly communist countries⁴ present a fascinating laboratory for testing theories of new institutional economics (NIE). The theories of NIE in their turn offer unconventional explanations of the complex processes taking place in these countries. One of these complex processes is the formation of the market economy. To understand it, we, at least, need to understand some of its fundamental components. One of the fundamental components of the market economy is, undoubtedly, the existence of the private sector. The formation of the private sector in the formerly communist countries has seemed a deceptively simple process – radical transformation of the state owned firms into privately owned firms (privatization).

However, the radical nature of privatization during the early stages of the reforms, and the absence of robust formal institutions consistent with the market economy reinforced and created informal norms of doing business, including rent seeking, bribery, tax evasion, patronage and other forms of corruption. This outcome is consistent with the argument that in the absence of well-enforced rules of the game (formal and informal), firms tend to engage in opportunistic economic activities (Williamson 1996; North 1990). It is also argued that in the presence of burdensome formal rules of the game, firms resort to informal ways of doing business (De Soto 1989; 2000). The logic is that when the government imposes onerous regulations, it becomes costly for firms to engage in business activities. Hence, there is no incentive for firms to abide by these regulations.

Overall, in the absence of well defined and in the presence of cumbersome rules of the game, firms tend to resort to informal arrangements of doing business. Unfortunately, informal arrangements become deeply ingrained in the government-business exchange, forming the shadow economy equal to or even exceeding the formal economy.⁵ However, informal arrangements are not cost-free. There are long-term costs, associated with uncertainty and externalities and short-term costs associated with bribes and other informal dealings. Let's firstly focus on the long-term costs.

Firms often evade the rules of the game to benefit in the short run. But it is hard for firms to plan ahead and make long term oriented business commitments in a corrupt and unpredictable environment. Individual entrepreneurs make investments if only they have a certain degree of predictability of future events. In other words, they calculate within their capacity the costs and benefits of investing in certain types of business opportunities. When only there are pay-offs, they may decide to invest. The degree of predictability increases in the presence of simple, transparent and enforced formal rules of the game. Informal arrangements are inherently unpredictable and discriminatory. Although informal arrangements can be efficiency enhancing in the short term,⁶ in the long run they will have perverse effects such as externalities, third party effects, etc. As the economy gets more complex and impersonal, the formal rules become necessary.

Comparing a predictable game (skiing) to an unpredictable one (gambling) can be illustrative. For instance, in downhill skiing, a skier understands the rules of the game; the fastest skier is the winner. There is a predictability component in the game because if a skier loses the game, the skier understands that the faster one skies the more chances there are to win the next time. Thus, skiers can train more to ski faster to win. However, gambling entails an unpredictability component. A player is not certain on how to win because gambling is based on luck and randomness but not on rational calculations.

Some players indeed try to use rationality by cheating to win the game but they are not certain if they will succeed in doing so all the time. Which game do firms prefer to play? It depends on the situation. If a firm is able to evade the rules and benefit much from it, it is likely to prefer gambling to skiing (just like a player who is able to gamble). But even in this case, the firm is not certain if it is able to evade the rules in the same way all the time. It becomes more uncertain for the firm to do business when the government officials start favoring one firm to another (if you gamble, you do not probably want a croupier to participate in the plot with another player against you). What if one does not like gambling at all?

If a firm wants to compete and grow, it is most likely to prefer skiing. The firm wants to be certain that the efforts it puts into the game will “pay off”. For instance, it may make a long-term investment if only it has a certain degree of confidence that, even if the game is not fair, it is at least predictable. In the absence of the fair and predictable game, the firm is unwilling to take a risk. Given that the government complicates the rules of the game to make firms dependent upon it, there are no fair rules of the game and given that, bureaucrats change constantly and depend on super-ordinates in the higher ladder of the government pyramid, the rules of the game become unpredictable.

Evidently, the evasion from the rules of the game can be costly for firms and for the overall economy. Nonetheless, there is a tendency to think that firms benefit from noncompliance in the short-run. The overall perception is that things can be done faster and cheaper through informal arrangements and dealings. But informal arrangements are not cost free in the short run either. There are costs of giving money (bribes), spending time, searching information, and so on. The informal costs can often be higher than the official costs, increasing the opportunity cost of productive activity and generating inefficiencies in the entire economy. The following examination of the results of the regulatory business survey attempts to document the informal costs of doing business in the short run.

ANALYSIS OF THE RESULTS OF THE RBES SURVEY

Pr. Vitaly Nishanov, Associate Professor at the American University in Central Asia and Director of the Professional-Manager Consulting (PMC) kindly provided the Regulatory and Business Environment Survey (RBES), which was conducted at the request of ARD/Chechi and the USAID Regulatory Reform Project in 2000. The survey involved one thousand small and medium-sized enterprises and included both legal

entities (69 percent) and individual entrepreneurs (31 percent). Participants were selected from every major city and business sector in the Kyrgyz Republic (for distribution of respondents by regions and sectors and for other methodological issues, see RBES 2000). The purpose of the survey was to measure the extent to which government regulations on the activities of businesses impact the start-up and development of business initiatives. These regulations include business registration requirements, licenses, permits, certificates and business inspections. Besides, researchers asked additional questions to evaluate the overall state intervention in the private sector (RBES 2000).

THE START UP OF A NEW BUSINESS

Registration is an entry mechanism for individuals or legal entities to start up a new business. Simple registration process is essential for providing incentives for starting up and expanding business activities. In contrast, a complex, costly and time-consuming registration process discourages entrepreneurs from starting up and conducting their business activities. De Soto's famous experiment to set up a small garment firm on the outskirts of Lima following all the complex legal procedures is a case in point. It took De Soto's team two hundred eighty nine days to fulfill eleven requirements and US\$194 direct costs including two bribes they were obliged to pay to fulfill the task (Stone, Levy and Paredes 1996, 105).

Under the pressure of international donors the Kyrgyz government has made great strides in improving the formal registration process for firms and individual entrepreneurs. In the Kyrgyz Republic, the formal time to register a business should not exceed ten days. The survey shows that around 70 percent of individual entrepreneurs were able to register their businesses in two weeks (see Fig. 1, Appendix). It took longer to register legal entities because they had to go through the one more government agency to receive a registration certificate (the Ministry of Justice). On average, it took 15 days to register business in the Kyrgyz Republic.

The formal costs of registering a business are also nominal. Individual entrepreneurs can officially register at the State Statistics Committee (US\$2.93),⁷ the State Tax Inspectorate (US\$1.26) and the Social Fund (free of charge). Legal entities follow the same registration requirements, but first are required to register at the Ministry of Justice, (free of charge) which is obliged to provide a registration certificate within ten days of receipt of all required documents. This is also supposed to be done free of charge (RBES 2000, 10).

Evidently, the formal registration process is fairly inexpensive and prompt. However, formal rules are only part of the story. North (North 1990) reminds us of the importance of informal institutions that frequently shape the actual costs of business transactions. The survey results show that in reality the costs of registration are much higher than they are written in the laws. According to Figure 2, the registration costs including both official and unofficial payments far exceeded the official costs. For example, 31 percent of individual entrepreneurs and 32 percent of

legal entities paid around US\$20 (around 1000 Kyrgyz soms) to register their businesses, which is five times higher than the official cost (US\$4.19). About seven percent of individual entrepreneurs overpaid the official costs 50 times (US\$209) to set up their business activities.

Table A. Formal vs. Informal Time and Cost of Registration

	Total Official	Average Official and Unofficial
Cost of Registering (U.S. \$)	US\$4.17	US\$59.12
Time to Register (days)	No more than ten days	15 days

Although the actual duration of registration was only slightly longer than the official duration, the actual costs of registering a business far exceeded the official costs. According to Table A, firms on average spent about 14 times higher than the official costs, indicating a high degree of rent seeking among registration authorities. About 27 percent of respondents admitted they were forced to make unofficial payments to registration authorities in the form of bribes, gifts and rendering other services along with official registration payments (RBES 2000, 13). Interestingly enough, the highest average costs were in the retail trade (US\$72.46), transportation (US\$67.99) and wholesale trade (US\$67.4) in which individual entrepreneurs predominate (see Fig. 3). The lowest average costs were in consulting and construction. The same sectors that spent more money, also spent more time to commence their businesses (compare Figs. 3 and 4).

Moreover, the lack of information on the cost, time and procedures of registration can explain the difference between formal and informal payments. The survey respondents pointed out that they were not well informed about the registration process or considered it perplexing. Of the total number of businesses, only 29 percent were fully aware of the registration procedures while 39 percent had insufficient information, and the remainder knew nothing about registration process (RBES 2000, 10).

REGULATION OF BUSINESSES

Stone, Levy and Paredes argue that regulation and bureaucratic red tape are one of the main obstacles to economic efficiency. They stated, that “excessive regulation may create a generalized drag on all businesses or may favor some kinds of businesses over others, either as an integral consequence of implementation or as a result of the structure of costs imposed by regulations” (Stone, Levy and Paredes 1996, 106). Regulation can take different forms in different countries. In the Kyrgyz Republic, the main forms of regulations are licenses, permits, certificates, business inspections and other forms of government intervention.

Licenses are required for certain businesses to legally commence their operations in certain activities. These activities are listed in the Law of the Kyrgyz

Republic “On Licensing,” which was just amended on January 18, 2001. The new Law on Licensing reduces the number of activities subject to licensing from 62 to 29 (RBES 2000, 16). By the time the survey was conducted, the previous law was in effect, meaning there were 62 activities subject to licensing. The survey revealed that licensing was a pervasive requirement for many business activities. Over 60 percent of respondents indicated that they had to receive a license or licenses for the type of business activity they conducted. Some respondents indicated that, by law they were required to receive it but found it more expedient to continue working without a license by bribing supervisory government bodies. Researchers excluded these respondents from the analysis and examined those respondents who were directly involved in the process of obtaining a license or licenses (RBES 2000, 16).

Nearly 60 percent of licensed businesses considered the requirements and procedures of licensing the most difficult problem, followed by the cost, time and renewal of licenses (RBES 2000). The average time for obtaining a license was 21 days and the average cost was about US\$76 with the most expensive licenses in transport, construction, manufacturing and food processing sectors. In the construction and transport sectors more than 25 percent of respondents paid above US\$160 to obtain licenses (RBES 2000). In addition to these formal payments, 42 percent of respondents admitted that they were required to make non-official payments, while almost 20 percent of them admitted they directly paid officials who were in charge of issuing licenses. It was mainly because entrepreneurs preferred paying bribes to going through complicated procedures each time when the licenses could only be issued for a short period of time (Fig. 5 shows that 74 percent of respondents had a license or licenses only for a year).

Overall, obtaining licenses in the Kyrgyz Republic is more problematic than the registration process. The registration agencies and procedures are clearly identified as well as the cost and time of registration are fixed. In contrast, each licensing agency determines separately the costs of licenses. Some licensing bodies have fixed costs while others require applicants to receive the approval of on-site inspections, experts’ opinions, different signatures, etc. In other words, the licensing is highly uncoordinated providing incentives for each agency to compete for rents by creating onerous regulations and obligations to be able to collect as much rents as possible.

Certification is another form of the government regulation. Certification requirements encompass a host of imported and exported goods and services. The main certifying body is Kyrgyzstandard (formerly Gosstandard). Kyrgyzstandard can also accredit other government agencies to perform certifying functions. According to the survey, almost 49 percent of respondents were required to obtain certificates from various state bodies and almost half of all respondents were required to obtain from one to four certificates with the average of six (RBES 2000, 22). Officially, certificates could be received less than in one week but in many instances it took from one to four months. The average cost of certification was around 80 percent. The highest costs were in the transportation (US\$160) and wholesaling (US\$110) sectors (see Fig. 6). Moreover, certificates were given for a short period of time meaning that businesses had

to repeat the process regularly, which increased the opportunities for certifying agencies to engage in rent seeking and provided incentives for businesses to bribe certifying agencies. The RBES (2000, 27) concludes that, although certification is a necessary mechanism to protect health and safety of citizens, it is complex and expensive (for the most difficult aspects of certification process, see Fig. 7). Furthermore, certification serves no useful purpose if there are ways of overcoming them. If the goods do not comply with the required standards, entrepreneurs pay bribes to overcome this obstacle. 40 percent of respondents paid unofficial costs to obtain certificates and in many cases simply avoided them altogether by paying bribes to certifying agencies.

In addition to licenses and certificates, there are other government requirements such as health and sanitary permits, fire permits, architecture and construction permits, land use permits and a variety of other regulation requirements (RBES 2000, 28). These government requirements are often not included in official normative documents and thus create additional uncertainties for entrepreneurs. The most difficult permits to obtain are those issued by the Sanitary and Epidemiological Stations (SES) and Kyrgyzzalko (agency regulating businesses that produce or distribute alcohol beverages) (RBES 2000). Both the SES and Kyrgyzzalko are considered to be the most corrupt agencies. Interestingly enough, businesses required to obtain permits from the SES and Kyrgyzzalko are also considered to be as the most corrupt. Overall, the average cost of permits was around US\$77. The process of issuing was nontransparent and in many cases arbitrary in its application. It is no wonder therefore, that about half of the respondents admitted that they made unofficial payments to receive permits.

GOVERNMENT INTERVENTION

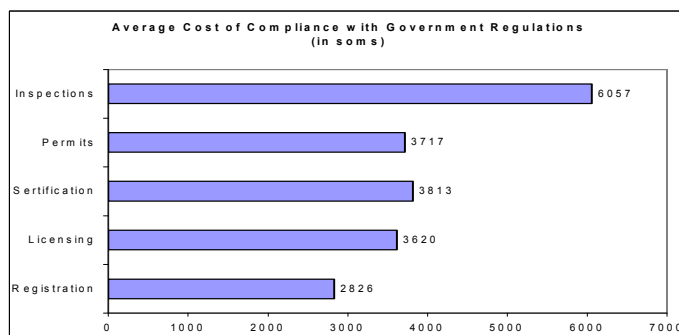
The Kyrgyz government has introduced legislation limiting planned inspections to only five government agencies and requiring all other agencies to conduct inspections in case of a citizen complaint (RBES 2000, 35). The National Commission for the Protection and Development of Competition (CPDC) is established to issue an inspection permit for government agencies. Besides, inspecting agencies are forbidden to conduct more than one inspection per year on a single business entity. This formal regulation aims at limiting government intervention and is supposed to be enforced by the introduction of an Inspection Logbook that each agency or inspector is obliged to complete after the inspection (RBES 2000).

Although formally the rules of inspection are fair enough, in reality inspections are very onerous. In particular, respondents were concerned with the taxation and SES inspectors who were also the most frequent visitors (see Fig. 8). The average costs spent in six months for inspections by firms were around US\$126, with the most expensive payments made by entrepreneurs in the transport sector (amounting to US\$400 on average). Although legally inspectors are obliged to receive permission from the CPDC, inspectors conduct inspections without permission all

the time. The presence of the CPDC seems nominal from the results of the survey. Most respondents simply did not know about this procedure and never asked inspectors if they had the permission to inspect. 39 percent of the respondents knew nothing about the CPDC and 29 percent were pessimistic about proving anything. 42 percent of businessmen did not appeal unjustified decisions because they were afraid of negative consequences, and the other 42 percent were concerned about large court expenses and did not trust courts at all. Those, who appealed to courts, were unsuccessful in any ways (RBES 2000). Because inspectors can easily impose very high transaction costs, entrepreneurs pay bribes regularly and try to establish relationships with the inspectors.

In addition to inspections, the government officials intervene in the private sector in many other ways. Professor Nishanov calls them – “informal or subtle forms of intervention” (RBES 2000). Despite the fact that formal inspections on each business entity can be done only once a year, they are done once every three weeks on average (see Fig. 9). Not surprisingly, the tax inspectors have the highest rate of visits. 52.7 percent of respondents considered tax inspections as the most disruptive form of interference, followed by permits (43.8 percent) (See Fig. 10).

Figure A. Costs of Different Forms of Business Regulations



Source: Regulatory and Business Environment Survey 2000.

Note: 47.8 Kyrgyz soms equal to US\$1 (exchange rate in 2000).

According to Figure A, firms incurred the highest costs from inspections. On average entrepreneurs spent around US\$419 to comply with government regulations. This does not include the opportunity costs spent by businesses in terms of human resources allocated on recurring permit and certification costs. It is important to note that more than US\$400 dollars a year spent by small enterprises may easily drive them out of business or push them to operate in the shadow economy (RBES 2000). Thus, the potential costs placed on small sized enterprises are high. The costs are especially high when entrepreneurs deal with inspections and permits.

COMPERATIVE SUVREY: COUNTRIES IN TRANSITION

Joel Hellman, Geraint Jones, Daniel Kaufmann and Mark Schankerman (Hellman, Jones, Kaufmann, and Schankerman 2000) summarize the results of the Business Environment and Enterprise Performance Survey (BEEPS)⁸ across 20 transition economies,⁹ assessing governance and corruption from the perspective of firms. The survey was extensively piloted in each of the countries to ensure that respondents understood the questions correctly.¹⁰ Researchers selected firms randomly from business directories and conducted the initial screener questionnaire by telephone to identify firms fulfilling the quota restrictions (for quota restrictions, see Hellman et al. 2000, 4). They also made all efforts to include different types of firms including ex-state firms, new-private firms, firms with foreign direct investment and firms from different regions (for the sample composition and other methodological issues, see Hellman et al. 2000).

I use the results of this survey for a comparative purpose to test for validity of the RBES survey results and generalize the findings to other post-Soviet countries. The survey questions have two parts: (1) questions related to institutions and policies at the macro level; and (2) questions related to bureaucracy, state intervention and corruption at the micro level. The focus of this paper is on the interaction of the state with firms at the micro level. However, let's briefly describe the interaction between the state and firms at the macro level. Firstly, the BEEPS results verify the proposition that firms participate in corrupt activities all the time in the post-Soviet societies.¹¹ Secondly, the BEEPS show that firms prefer the rule of law to uncertainty and corruption.¹² Thirdly, firms view the government as the main obstacle for doing business.¹³ It is also clear that the state and firms view differently the role of market institutions and rules. The state is reluctant to change the existing status quo, but firms want to work on different modus operandi. Unfortunately, the legacy of the power of the state in all of the formerly communist countries makes the desire of the firms to change the status quo almost impossible, or, at least, incremental at this point. However, the change in the perception of the firms to value the rule of law is a positive trend.

John Nye, Professor of Economics at Washington University in St Louis, reminds us of the importance of the micro-level analysis for understanding broad issues such as corruption (Nye 2003). In verification of Pr. Nye's words, the analysis of the RBES survey has showed that the microanalysis of separate forms of interaction of government agencies with the private sector through registration, regulation and government intervention has allowed us to examine the variation of corruption from one area to another, which we could in no way capture by looking at the macro level data such as a corruption index or a composite of corruption indexes, etc. Indeed, the question is no longer about whether corruption exists or not, but it is about the magnitude of corruption, and only the questions asked at the micro level can capture this magnitude.

The RBES has already showed that individual entrepreneurs and legal entities face the problem of incomplete information on registration process and government

regulations. The BEEPS results confirm that 40 percent of firms in the Kyrgyz Republic agreed that it was hard to obtain information, while only 11 percent of firms agreed that they could obtain information easily (see Fig. 14). The Kyrgyz Republic is ranked third in terms of the lack of information on government regulations. In other formerly communist countries less than 40 percent of firms agreed that information was lacking (except Lithuania and Ukraine).

The RBES has showed that in the Kyrgyz Republic, the state intervention is one of the major obstacles to the operation of the private sector. In particular, the government inspections, permits, licenses and certifications were the most onerous. Hellman et al (2000, 32) notes, that the opportunity cost is high for senior managers in spending their time dealing with government agencies because the time can otherwise be allocated to productive activity. Figure 15 shows that the Kyrgyz Republic is ranked seventh after Ukraine (1), Kazakhstan (2), Moldova (3), Russia (4), Lithuania (5), and Uzbekistan (6) in terms of the average percentage of time spent dealing with government officials. The situation is better in Eastern Europe and the Baltic States (except Lithuania) than in Central Asia.

The RBES has also provided evidence that in the Kyrgyz Republic unofficial payments are high in the areas of inspections and permits. The BEEPS demonstrates that in the Kyrgyz Republic, firms spent 53.5 percent of the proportion of bribes on tax inspections plus 7.4 percent on health and fire inspections. The procedures on licenses were simplified and, therefore, in the Kyrgyz Republic firms paid fewer bribes on licenses than firms in Kazakhstan and Uzbekistan (see Tab. 2).

Table B: The Average Proportion of Bribes Spent on Each Service

Regions	Licenses	Taxes	Contracts	Courts	Legislation Influence
Central Asia	18.8	33.9	9.1	7.5	1.1
Eastern Europe	26.6	8.6	23.1	8.16	3.3

Note: for detailed information, see Table 2

The problem of corruption is pervasive in the government-business interactions in the formerly communist countries. Figure 16 illustrates, that most of the time firms paid bribes to government officials. Overall, most firms in all of the formerly communist countries paid bribes without exclusion, Central Asia and Caucasus, ranking the highest and Eastern Europe, ranking the lowest on the corruption continuum. The Central Asian countries, in general, paid more bribes on taxes, while Eastern European countries spent fewer bribes on taxes but more bribes on courts, legislation influence and licenses (see Tab. B above). The economic backwardness of the Central Asian countries may partially be due to the inability of the governments to establish the transparent and effective tax system which could generate revenues for the government to invest in physical, human and institutional capital of the countries.

CONCLUSION

The survey results show that the mere presence of formal laws and regulations are only a part of the story in understanding the business-government transaction costs. It is obvious that informal constraints determine the bulk of costs on entrepreneurs in the Kyrgyz Republic. However, it is still unclear whether the full enforcement of formal regulations can reduce the level of corruption but it is obvious that it is too costly to enforce all formal institutions and indeed the informal norms or internalization of these norms should accompany formal institutional reforms.

In spite of the existence of the simple formal rules and regulations in certain areas such as registration, entrepreneurs resorted to informal arrangements especially in making payments. However, the registration process was the fastest and the least burdensome among other forms of the government business relations. Indeed, the mixture of cumbersome regulations, uncoordinated regulatory activities with opportunities for rent seeking, especially in such areas as tax inspections and permit issuance, increased substantially the costs and time of doing business. Thus, the relationship between simplicity and inefficiency can be spurious because the lack of transparency and availability of formal rules undermine the effectiveness of simple formal rules and regulations. In a corrupt environment it is unclear whether the simplification of rules decreases the actual costs in government business interactions but it can at least speed up the process as it is the case in registering businesses in the Kyrgyz Republic. Overall, the combination of simple, transparent, available (accessible) and enforced formal rules and regulations seem to decrease the costs of doing business.

Obviously, the state plays a crucial role in institutional change by enforcing simple, transparent, and accessible formal institutions as long as these institutions become dominant modes of political, social and economic activity. However, the state should be exempt from corruption and rent seeking itself before it enforces formal rules on others. Unfortunately, corruption and rent seeking are deeply ingrained in the higher echelons of the government pyramid in the Kyrgyz Republic. The state is a political organization that can create institutions and enforce rules of the game. However, it is costly for the state to enforce all the rules of the game. In fact, in advanced capitalist societies, firms comply with most of the rules even if the government does not control, forming a favorable and transparent informal institutional environment. This indicates that the pure formalistic approach offered by the Law and Development literature is not a guarantee of efficient business transactions. Indeed, the role of informal norms is significant according to the survey results.

Firms should view compliance with the rules more beneficial in the long run. This is not the case in the Kyrgyz Republic. Even if the simple and well understood formal rules exist, the government bureaucrats complicate the rules to seek rent and exercise their power over firms. Although the formal rules have become more or less consistent with the market economy, the informal state interventions and

regulations make firms evade the rules and involve in different types of corrupt activities.

Therefore, under this noncompliant system, the shadow economy is the main way of economic life; and unpredictability, favoritism, and instability are norms rather than exceptions. Overall, the noncompliant system has more costs than benefits on all members of the society. Unfortunately, the incentive structure that fosters noncompliant behaviors continues to dominate in the Kyrgyz Republic, resulting in lost output and a growing disparity in wealth. The prevalence of predatory activities is the main obstacle to the healthy functioning of the private sector. When the main custodians of law such as the government officials and lawyers constantly engage in non-compliant behaviors, the system becomes unpredictable and unstable. They take it as it is and if possible participate in the creation of new mechanisms of noncompliance. This is a self-sustaining system that ensures the survival of those who are part of this predatory environment. Thus, the both the state and firms are in “vicious circle”.

ENDNOTES

¹ For a detailed description of the Kyrgyz Republic, see Appendix, Map 1 and Tab. 1.

² Institutions in a society provide the rules of the game that shape the incentives for individuals to engage in productive or destructive activities. Institutions can be formal and informal. Formal institutions are written or codified rules and informal constraints are unwritten norms of conduct. In other words, formal institutions are rules that humans devise to provide a framework within which human interactions take place. Informal constraints are norms and codes of behavior that humans naturally follow (North 1990).

³ The World Bank and the Office of the Chief Economist at the EBRD jointly developed the BEEPS questionnaire for the transition economies (Hellman et al. 2000, 4).

⁴ By the formerly communist countries, I mean the formerly socialist countries of Eastern Europe and the U.S.S.R. By the post-Soviet countries I mean specifically the former countries of the U.S.S.R.

⁵ De Soto (2000) calls the shadow economy an extralegal sector that constitutes a major bulk of the GDP in most developing countries. He reports that the extralegal market in Russia and Ukraine accounts for 50 percent of GDP and 62 percent in Georgia. There is no exact data on the extralegal market in the Kyrgyz Republic but if one walks down the streets of the Bishkek city, capital of the Kyrgyz Republic, one cannot avoid seeing extralegal cafes, shops and other services. To see the representation of extralegality in its full fashion, one should visit the “Osh bazaar” (the biggest market in the capital city). Thus, it will be no surprise if the extralegal sector in the Kyrgyz Republic approximates or exceeds those of Russia, Ukraine or Georgia.

⁶ Leitzel (1997) reminds us that the violation of rules which constraint the voluntary exchange in the absence of negative third party effects may actually have positive economic effects. For example, some scholars argue that corruption can be efficiency enhancing. They argue that corruption allows firms to avoid burdensome regulations or confiscatory tax rates and thus decreases the transaction costs for the firms that bribe. The problem is that it does not take it into account the long-term effects that the practice of corruption can have on the broader reforms. For instance, in most cases corruption has third party effects such as the costs can fall disproportionately on smaller firms and externalities far exceed the benefits in the long run. Firms may also choose to evade both cumbersome and good regulations, causing a shift of economic activity from the formal into informal sector (World Bank 1997).

⁷ According to the National Bank of the Kyrgyz Republic the average exchange rate of Kyrgyz som/\$US during the year 2000 was 47.8. However, it is important to note that the purchasing power parity is not considered and thus the value of a dollar is higher than it may seem in the paper.

⁸ The World Bank and the Office of the Chief Economist at the EBRD jointly developed the BEEPS questionnaire for the transition economies (Hellman et al. 2000, 4).

⁹ The survey examines the following countries: Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, The Kyrgyz Republic, Lithuania, Moldova, Poland, Romania, the Russian Federation, the Slovak Republic, Slovenia, Ukraine and Uzbekistan.

¹⁰ A sub-sample of respondents was telephoned on the following day and the responses to key questions checked for consistency as a quality-control measure (Hellman et al. 2000, 4-5).

¹¹ For the first time, the survey measures grand corruption defined as “private payments to public officials to influence the content of the basic rules of the game (i.e. legislation, rules, laws or decrees” (Hellman et al 2000, 19). Figure 11 shows the degree of sale of parliamentary votes on laws and presidential decrees to private interests. The presence of this practice is an indication of grand corruption. Obviously, grand corruption is present in all transition countries with particularly high indication in Azerbaijan and Ukraine.

¹² Figure 12 indicates the desire of firms to eliminate corruption, crime and regulations in almost all of the transitional countries. It means that firms want to operate under transparent formal rules rather than under corruption, crime and excessive bureaucratic regulations. Hellman et al (2000) admit that the responses to the question in Figure 16 in reality underestimate the true costs imposed on firms by the institutional failures.

¹³ Figure 13 also illustrates the general dissatisfaction of firms with the central government. For instance, about 85 percent of the firms in the Kyrgyz Republic consider the central state very unhelpful, 25 percent consider mildly unhelpful in comparison with about 9 percent that think that the central government is helpful and less than two percent that consider it very helpful. It is evident that the central government poses a huge hindrance to firms.

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