I. Introduction: Transition and the Business Environment

Creating a good business environment is a key aspect of the transition from central planning to a market economy. The quality of the business environment also supports economic development and poverty alleviation. Without it entrepreneurial activity is stifled and job creation is held back. A poor business environment can undermine domestic investors and make a country unattractive to foreign investors.

A good business environment has many dimensions. It is linked to the quality of a country’s public and private institutions, government policies and legal and regulatory frameworks that protect private property rights, enforce contracts, and provide other public goods that are needed in a market economy. A sound business environment depends on the integrity of public and private agents and the control of crime and corruption. It requires political and economic stability, a level playing field between market participants and a tax system that is universally applied but not unduly distortionary. Effective infrastructure and a well-functioning financial sector are other important considerations.

This paper looks at the business environment in the seven countries that are part of the CIS-7 initiative: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan. The paper draws heavily on the findings of the EBRD/World Bank Business Environment and Enterprise Performance Surveys (BEEPS) undertaken in 1999 and 2002. The paper compares the findings of the BEEPS with other business environment surveys conducted by the World Bank, national governments and nongovernmental organisations. Section II outlines the BEEPS instrument and sample in detail, and provides an overview of the findings on the business environment across the 26 transition countries included in the survey.

In the following sections, we focus on the BEEPS findings in the CIS-7 countries. Section III looks at access to finance, tax, infrastructure, regulations, the judiciary and crime. Section IV looks more closely at one of the most crucial aspects of the business environment in the CIS-7 countries, corruption. In section V we explain how institutions have shaped the contracting environment in the CIS-7 countries, focusing on trust, the courts and business networks. We conclude in section VI with a summary of the BEEPS findings in the CIS-7 countries, and make some

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recommendations for how the CIS-7 countries could improve their business environments to attract higher levels of domestic and foreign investment.

II. Measuring the Business Environment: the BEEPS

The EBRD and the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) in 1999. The BEEPS asks enterprises to evaluate economic governance and state institutions and to assess how the functioning of the state, physical infrastructure and financial institutions affect their business operations. In 2002 the EBRD and the World Bank undertook a second stage of the BEEPS, surveying close to 6,100 firms across 26 countries of the region. The survey is heavily weighted towards small and medium-sized enterprises (67 percent) and private firms (86 percent). There are some state-owned firms in the sample (14 percent), however, and some larger enterprises (33 percent) with between 500 and 10,000 employees. The sample is stratified to match more or less the productive structure in each country, implying a heavy representation of service firms (61 percent). Table 1 summarises the survey sample in the CIS-7 countries.

Table 1. BEEPS sample in CIS-7 countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Sample size</th>
<th>% private</th>
<th>% SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>171</td>
<td>82.5</td>
<td>86.0</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>170</td>
<td>84.7</td>
<td>85.3</td>
</tr>
<tr>
<td>Georgia</td>
<td>174</td>
<td>84.5</td>
<td>89.7</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>173</td>
<td>84.4</td>
<td>89.6</td>
</tr>
<tr>
<td>Moldova</td>
<td>174</td>
<td>84.5</td>
<td>87.9</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>176</td>
<td>80.0</td>
<td>86.4</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>260</td>
<td>86.2</td>
<td>86.5</td>
</tr>
<tr>
<td><strong>CIS-7</strong></td>
<td><strong>1298</strong></td>
<td><strong>83.8</strong></td>
<td><strong>87.3</strong></td>
</tr>
</tbody>
</table>

The two BEEPS questionnaires asked firms to assess seven broad areas related directly or indirectly to the functioning of the state and public administration. This includes:

- Finance
- Infrastructure
- Taxation
- Business regulation
- The judiciary
- Rule of law
- Corruption

The quality of the business environment was evaluated using both the qualitative perceptions of the business community and quantitative measurements of the obstacles faced by firms. The qualitative measures ask managers to assess the extent to which certain dimensions of the business environment represent an obstacle to the operation and growth of their firm. Qualitative measures benefit from a uniform

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2 This includes all of eastern Europe and the former Soviet Union except Turkmenistan, where implementation was discontinued before the survey was completed.
measurement scale in terms of the extent to which each of its broad dimensions creates an obstacle to the operation and growth of firms (ranging from minor obstacle to major obstacle). However, they lack precision. Because they are based on firms’ perceptions of the business environment, qualitative measures will inevitably be influenced by firms’ recent performance, expectations of future developments, and general assessments of the macroeconomic and political climate. Quantitative measures tend to focus more narrowly on the aspects of the business environment that can be measured numerically (amount of money paid in bribes, amount of time spent with regulators, number of days lost due to infrastructure problems or customs delays, etc.). Quantitative measures thus offer a greater degree of precision, but they often focus narrowly on aspects of the business environment that are amenable to quantitative measurement (often proxy measures for transactions costs). Both have advantages and disadvantages, and it is therefore essential to consider both types of measures in order to develop a balanced understanding of the business environment in the transition countries.³

The structure and results of the two rounds of the BEEPS have been described at length elsewhere.⁴ In brief, the two surveys found that the quality of the business environment varies significantly across countries in the transition region. However, the second round of the BEEPS in 2002 found that in virtually all transition economies perceptions of the business environment had improved, in some cases significantly. Moreover, in some of the less advanced transition economies in South East European (SEE) and the Commonwealth of Independent States (CIS) firms have reported some of the strongest improvements in economic governance, closing the gap with the advanced reformers. The unevenness of the business environment for different types of firms – such as small, newly established private firms and large state-owned enterprises – also diminished over this period. These developments suggest that less advanced transition economies might be able to move beyond partial or incomplete reforms, including insecure property rights, corruption and limited investment, that have held back their progress over the first decade of transition.

Regarding corruption, by and large the countries of the CIS were subject to higher levels of both administrative corruption and state capture than SEE and Central-Eastern European and Baltic (CEB) countries. The surveys also found that there is a strong association between the level of corruption and the size of obstacles to the operation and growth of their businesses that firms face. Finally, the surveys found that state capture significantly boosts the investment and real revenue growth rates of firms that engage in this activity, but holds back the growth performance of other firms.⁵

⁴ A full description of the survey instrument and the key findings of the 2002 BEEPS is provided in Fries, Lysenko and Polenac (2003); EBRD (2002). EBRD (1999), Hellman, Jones, Kaufmann and Schankerman (2000), and Carlin, Fries, Schaffer and Seabright (2001) describe the 1999 survey and summarise its key findings. The full 2002 BEEPS sample also includes Turkey, which plays no role in our analysis.
⁵ For the purposes of this paper, Central-eastern European and the Baltic States (CEB) refers to Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia; central CIS (C.CIS) refers to Russia, Ukraine, Kazakhstan and Belarus; and South-Eastern Europe (SEE) refers to Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Romania and Serbia and Montenegro.
**Limitations of the BEEPS findings**

While the BEEPS provides important cross-country, time series data on the business environment and firm performance in the transition countries, several important caveats must be made clear before we examine the survey findings. As outlined above, all survey-based attempts to measure the business environment are affected by the subjective nature of the qualitative measurements used. Perceptions play a big part in how managers respond to questions in the survey, as can the climate of intimidation and fear of reprisals by powerful state agencies in some of the less reformed states. This can result in findings that fail to capture some of the remaining serious obstacles to doing business in difficult countries.

Another important caveat relates to the short time frame of the two rounds of the BEEPS. Perceptions of the business environment in the three-year period between 1999 and 2002 could have been influenced by such temporary factors as an upturn in the business cycle or the pressures of an election season, and do not necessarily reflect a change in the structure of incentives or other sustainable improvements in the business climate. Similarly, the initial round of the BEEPS occurred in 1999, just after the Russia crisis and at a time when firms (especially in the CIS 7 countries) were most likely to feel nervous about their prospects. Improvements in macroeconomic conditions since that time, along with greater regional political stability and other positive changes in the overall environment, may have contributed disproportionately to the increased optimism expressed by firms in the 2002 survey.6

Finally, there are two distinct issues related to sample selection bias in the survey. First, the survey does not include data from domestic or foreign firms that chose not to enter the market, so it has less direct relevance to the question of barriers to entry for business. Second, the sample in all 26 countries is weighted heavily toward small, private firms (see Table 1). The purpose of selecting a sample of this nature was to replicate the productive structure in developed market economies, and to try to understand the obstacles faced by this sector of the economy in particular. However, in some transition economies, and in the CIS-7 countries in particular, a larger proportion of enterprises remained state-owned: in Moldova and Tajikistan the private sector share in GDP is around 50%, while in Uzbekistan it is 45%. For these countries the findings of the BEEPS on perceptions of the business environment apply more to the private sector and may not be applicable to the business community as whole.7

Despite these limitations, the BEEPS remains a highly useful instrument for comparing obstacles faced by firms, both across countries and through time. In this paper we make primary use of the BEEPS results, while acknowledging where available the supplementary and/or contrasting findings of other reliable studies.

**III. The Business Environment in the CIS-7 Countries, 1999-2002**

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6 Not all perceived improvements in the business environment were due solely to the recovery in the business cycle since the Russian economic crisis of 1998. For a more detailed discussion of this issue and an explicit argument about how corruption affects firm performance, see Fries, Lysenko and Polanec (2003).

7 See EBRD (2003).
This section focuses on the following key aspects of the business environment in the CIS-7 countries: finance, taxation, infrastructure, regulation, the judiciary, and crime. We look at both qualitative and quantitative measures and compare results both within the region and with other transition regions. In section IV, we look at a final dimension of the business environment in the CIS-7 countries – corruption – in even greater detail.

Chart 1 shows the non-weighted average of firms’ assessments of the seven obstacles to their normal operation and growth, comparing the CIS-7 countries with the central CIS, CEB and SEE regions. The smaller the circle, the better the business environment. While it useful to see how the CIS-7 sub-region compares to other sub-regions in the transition countries, it is important to keep in mind that there are wide variations in the quantitative and qualitative indicators of the business environment for individual countries. The paper presents the country-by-country data for each dimension of the business environment, but taken together Chart 1 illustrates that in the aggregate access to finance, tax, and corruption appear to be of particular concern to enterprises in the CIS-7 countries.

Turning to comparisons within the CIS-7 region, the charts below show the seven countries’ individual business environment scores in 2002. As these charts show, Azerbaijan scores the best on most aspects of the business environment, while Uzbekistan has the lowest score on the impact of corruption as an obstacle to the operation and growth of firms. Conversely, Moldova has the lowest scores on these same five aspects of the business environment, while Georgian firms reported the most difficulty with corruption and Tajikistan was ranked lowest on infrastructure.

Chart 2. Obstacles to the Operation and Growth of Business in the CIS-7 Countries, 2002
Among the CIS-7 countries, Uzbek firms reported an unexpectedly favourable business environment, particularly given the limited extent of market-oriented reform, including liberalisation of markets and trade. One interpretation of this finding is that existing businesses are being sheltered from competitive pressures and that they, therefore, have relatively positive perceptions of the business environment. The survey, of course, does not include those enterprises and entrepreneurs that would like to enter these markets but are prevented from doing so by restrictive policies.

Some of these findings are corroborated by other business environment surveys. According to the most recent Government of Armenia/World Bank regulatory and
administrative costs survey, for example, taxes and tax administration, infrastructure and regulation were most frequently cited as moderate or major obstacles by firms. Infrastructure and corruption were rated as moderate or major obstacles by significantly more firms in Armenia than in the rest of the CIS and the rest of the world. In the Kyrgyz Republic in 1999, a study by the Asian Development Bank found that corruption was a more significant obstacle to economic reform than bureaucratic obstructiveness or the non-implementation of laws, similar to the BEEPS findings. A 2000 survey by the Georgian National Statistics Office found that the largest majority of firms indicated that taxes and corruption were the most significant obstacles to business, as the BEEPS also found.

As chart 3 demonstrates, firms’ perceptions of the business environment in the CIS-7 countries have improved in all dimensions in the period 1999-2002, with the greatest improvements in access to finance, the judiciary, the rule of law and corruption.

**Chart 3. Changes in the Business Climate in the CIS-7, 1999-2002**

In general, access to finance is one of the largest problems faced by firms across the transition countries (see chart 4). There is not a great deal of variation in firms’ access to finance among the CIS-7 countries, with the exception of Tajikistan, where firms rate access to and cost of finance as much less significant problems than do firms in other CIS-7 countries. Chart 4 looks in more detail at firms’ perceptions of different aspects of access to finance. As with firms in advanced industrialised economies, the cost of finance is generally more problematic for firms in the CIS-7 countries, although the difference between the two issues is not particularly large.

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11 Special arrangements in cotton financing and directed credits by government may have contributed to Tajik firms reporting fewer problems with access to and cost of financing. Thanks to the country team at the IMF for pointing this out.
Turning to quantitative measures of firms’ access to finance, chart 5 reports the proportion of new investments (such as new buildings, machinery or equipment) that firms across the transition economies finance from internal funds or retained earnings. In the accession countries in CEB, less than 60% of new investment is financed through retained earnings, while in the central CIS and CIS-7 countries this number is closer to 80%, reflecting the unavailability of or difficulty in accessing external sources of finance, such as banks or equity investors. In Moldova and Georgia the figure is closer to the CEB norm, while in Armenia, Azerbaijan, Tajikistan and Uzbekistan between 80% and 90% of all new investments are financed through retained earnings.
Where borrowing does occur, firms in the CIS-7 countries tend to borrow mostly from family and friends of firm owners. More than six percent of total financing across the CIS-7 countries is from this source. At the high end, more than 11 percent of financing for investment in Moldova comes from family and friends, compared with just over ten percent from locally-owned private banks. In Tajikistan and Azerbaijan, the majority of borrowing for new investments comes from family and friends. An equally low percentage of financing for new investments comes from state-owned banks in the CIS-7 countries, although this is likely to reflect the low lending capacity of state-owned banks, as much as the willingness of firms to borrow from the state.

CIS-7 firms’ inability or unwillingness to rely on private banks, and the propensity for using loans from family and friends to finance their new investments, is probably related at least in part to the cost and the terms of loans on offer. As chart 7 shows, the annual real costs of bank loans in the CIS-7 countries exceeds 10% – ranging from almost 25% in the Kyrgyz Republic to negative real interest rates in Tajikistan.12 On average, across the CIS-7 countries real interest rates are more than twice as high as in the central CIS and CEB countries. While this may be a rational rate of interest for some countries in light of monetary policy and risk considerations, it nevertheless points to persistent difficulties in the financial sectors in these countries and problems related to the availability of financial intermediation.

12 The BEEPS asked firms about the nominal interest rates payable on loans they had taken out. The real interest rate was calculated using this nominal interest rate and deflating using the rate of inflation in the year prior to the survey (2001). Although this is not exact, as the BEEPS did not specify when or over which time period the loans had been secured, it is probably a reasonable estimate. Negative real interest rates in Tajikistan and SEE result from high inflation in 2001 (with CPI inflation close to 40 percent in Tajikistan and 90 percent in the then FR Yugoslavia).
Moreover, the duration of loans in the CIS-7 countries compares poorly with both the CEB and the SEE countries, with loan terms averaging just 14 months in the former and 32 months and 27 months, respectively, in the latter. From the survey it would appear that banks in the CIS-7 countries are efficient: loans are obtained more quickly than in the CEB or SEE countries, but this does not lead to more lending to the national economy.

**Tax rates and administration**

One way of assessing qualitatively if tax administration and tax rates create an obstacle to the operation and growth of firms is to examine the extent to which firms seek to avoid taxes. The BEEPS asked businesses to indicate to what extent firms like theirs under-report sales for tax purposes, recognising the difficulty that many firms face in complying with taxes. Chart 8 below shows the average reporting rates by country in 2002 and in 1999, ranked according to the level of unreported sales in 2002. Countries with average rates below 20 percent in 2002 include all CEB countries as well as Bulgaria and Romania in SEE. Average rates below 20 percent were also achieved by three CIS-7 countries (Armenia, Azerbaijan, and Uzbekistan) and all four central CIS countries. However, Georgia, Tajikistan, the Kyrgyz Republic and Moldova have the highest rates of unreported sales in the transition countries, and the CIS-7 countries as a whole average above 20 percent of sales as unreported to the tax authorities.  

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13 This is obviously only a problem for firms that seek loans with longer maturities, which is not true in every case.
Trends from 1999-2002 are mixed. The line in chart 8 plots the change in the level of reported sales between 1999 and 2002 (a negative number indicates a decline in unreported sales, measured on the right axis). In the Kyrgyz Republic, unreported sales went up by 10.0 percent, while in Georgia and Moldova the level remained virtually unchanged. In the rest of the CIS-7 countries the picture was more encouraging. In Uzbekistan, Armenia and Azerbaijan the level of unreported sales fell substantially, indicating a general improvement in the tax-related aspects of the business environment in those countries.

**Infrastructure**

With low levels of government revenues and a legacy of poorly built Soviet-era infrastructure, one might expect that infrastructure would constitute a significant obstacle to businesses in the CIS-7 countries. However, despite persistent problems with services, infrastructure actually rates among the least significant business environment issues for the CIS-7 countries (although it still ranks high, in relation to advanced industrialised economies). This is suggested by the data presented in chart 9, which shows a fairly modest assessment of business obstacles posed by three infrastructure elements: telecoms, electricity, and transport.
Quantitative measurements of the infrastructure dimension of the business climate illustrate the sometime sizeable obstacles created by poor infrastructure. Charts 10 and 11 report on the average number of days required to be connected to fixed line telephone services and mains electricity, and the number of days annually which firms experience outages of electricity, water or mainline phone systems, respectively.

As these charts illustrate, connection delays for electricity and fixed line phone systems in the CIS-7 countries range from very high in the Kyrgyz Republic and Tajikistan to more modest levels in Armenia and Azerbaijan. Chart 11 looks at the reliability of public services infrastructure, and in this respect the poor design and low level of maintenance in the CIS-7 countries comes into focus. Power outages occur...
almost two-and-a-half times more frequently in the CIS-7 countries than in SEE, almost five times more than in the central CIS and almost 13 times more than in the CEB countries. The supply of sufficient water and the availability of mainline phone systems follow a similar pattern. Firms in the CIS-7 countries face almost 29 times more days per year without a sufficient water supply than do firms in CEB countries. As shown in the EBRD Transition Report 2003, the level of service is linked to reform progress. Countries that have advanced least in infrastructure reforms (as measured by the Bank’s transition indicators) experience the highest number of outages and longest waiting times for connection to services.

Clearly, the reliability of these public services is a significant hurdle for firms in the CIS-7 countries, and place them at a competitive disadvantage in relation to both their near neighbours in the central CIS and their more distant competitors in Central and South-eastern Europe. Firms that have to deal with power outages one day out of every six are likely to opt for installing their own generator, at a substantial additional cost to the firm.

**Business regulation**

In some dimensions of the regulatory sphere, firms in the CIS-7 countries rate state regulation as less of an obstacle than firms in the rest of the transition region. This is illustrated in chart 12, which shows that in labour regulations and title or leasing of land, the CIS-7 countries score better than SEE, the central CIS and even the accession countries in CEB.
Tax administration is perceived by businesses in the CIS-7 countries to pose the largest obstacle to their operation and growth, and on this dimension the CIS-7 countries fare worse than the rest of the transition countries. Customs and trade regulations and business licensing and permits are also perceived to be significant hurdles to firms’ operations, while at the opposite end of the spectrum labour regulations and securing land title are seen to be only minor obstacles. The country-level findings are reported in chart 13.

14 However, it is possible that the survey question on “tax administration” was lumped together with “tax” more generally, which firms universally find to be an obstacle to growth.
The assessment of customs and trade regulations is particularly surprising in Uzbekistan, in which both exports and imports have declined sharply since 1993 (see table 2). Indeed, Uzbekistan is the only countries among the 27 transition countries in which total trade (in USD) in 2002 was lower than trade at the outset of transition. This chronic declined in trade levels is largely attributable to autarchic policies of the government, the closure (and mining) of borders, and restrictions on hard currency flows. Thus, it is particularly surprising that Uzbek firms rate customs and trade regulation as well as they do in the BEEPS.

Table 2. Trade Levels in CIS-7 Countries, 2002

<table>
<thead>
<tr>
<th>Country</th>
<th>Imports + Exports (USD), 1993=100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>338.2</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>272.3</td>
</tr>
<tr>
<td>Georgia</td>
<td>103.6</td>
</tr>
<tr>
<td>Kyrgyz Rep.</td>
<td>133.6</td>
</tr>
<tr>
<td>Moldova</td>
<td>159.7</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>139.0</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>76.6</td>
</tr>
<tr>
<td>C. CIS</td>
<td>158.3</td>
</tr>
<tr>
<td>CEB</td>
<td>271.0</td>
</tr>
<tr>
<td>SEE</td>
<td>217.0</td>
</tr>
</tbody>
</table>

Turning to the quantitative assessments of the impact of business regulations, the level of business regulation that firms face is shown by the amount of time senior managers spend in dealing with public officials regarding the application of laws and regulations. The greater the amount of time spent by managers – the so-called “time tax” – the greater is the opportunity cost of complying with laws and regulations. While some cost is inevitable, very high costs can weaken the performance of firms. In 2002, the level of the time tax in the CIS-7 countries was the lowest among the transition countries, averaging just over six percent of managers’ time spent with officials (see chart 14).
Perhaps even more significantly, the largest reductions in time tax rates between 1999 and 2002 were achieved in the CIS-7 countries, with the time tax declining almost 50% from its level in 1999. The sharpest declines were observed in Armenia (76%) and Moldova (55%). In SEE, by contrast, a number of SEE countries (Albania, Bosnia and Herzegovina, FYR Macedonia and Romania) saw an increase in the time spent by managers in complying with laws and regulations over this period.

This data contrasts with other surveys of the business environment in the CIS-7 countries, in some cases, and is supported by other surveys in other cases. In Armenia, for example, a recent World Bank commissioned survey found that managers spent almost 11% of their time dealing with state or local authorities, similar to the level recorded by the BEEPS in 1999 but significantly higher than the 3 percent recorded by the second round of the BEEPS.15 In Moldova, the World Bank’s “Cost of Doing Business” (CODB) Survey found that, on average, managers spent 19 percent of their time in 2001 meeting regulatory requirements – a different variable from that measured by the BEEPS – falling to 17 percent in 2002.16

**The judiciary and crime**

The BEEPS asked firms to rate the quality of the courts according to how often they associated the following five descriptions with the court system: fair and impartial, honest/uncorrupted, quick, affordable and able to enforce their decisions. Answers ranged from never (1) to always (6), with higher scores representing a better assessment of the court system. Table 3 reports the CIS-7 country and transition region averages from the 2002 survey.

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Table 3. Court System in CIS-7 Countries

<table>
<thead>
<tr>
<th></th>
<th>Fair and Impartial</th>
<th>Honest/uncorrupted</th>
<th>Quick</th>
<th>Affordable</th>
<th>Able to enforce</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>2.92</td>
<td>2.85</td>
<td>2.74</td>
<td>3.03</td>
<td>3.12</td>
<td>2.93</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>2.56</td>
<td>2.70</td>
<td>2.85</td>
<td>3.10</td>
<td>3.32</td>
<td>2.91</td>
</tr>
<tr>
<td>Georgia</td>
<td>2.34</td>
<td>2.27</td>
<td>2.13</td>
<td>2.67</td>
<td>2.52</td>
<td>2.38</td>
</tr>
<tr>
<td>Kyrgyz Rep.</td>
<td>2.43</td>
<td>2.21</td>
<td>1.97</td>
<td>2.61</td>
<td>2.78</td>
<td>2.40</td>
</tr>
<tr>
<td>Moldova</td>
<td>2.59</td>
<td>2.55</td>
<td>2.46</td>
<td>2.99</td>
<td>2.90</td>
<td>2.70</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>2.78</td>
<td>2.58</td>
<td>2.58</td>
<td>3.04</td>
<td>3.31</td>
<td>2.86</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>3.46</td>
<td>3.18</td>
<td>2.98</td>
<td>3.34</td>
<td>3.63</td>
<td>3.32</td>
</tr>
<tr>
<td><strong>CIS-7</strong></td>
<td><strong>2.73</strong></td>
<td><strong>2.62</strong></td>
<td><strong>2.53</strong></td>
<td><strong>2.97</strong></td>
<td><strong>3.08</strong></td>
<td><strong>2.78</strong></td>
</tr>
<tr>
<td>C. CIS</td>
<td>2.59</td>
<td>2.52</td>
<td>2.32</td>
<td>3.25</td>
<td>3.25</td>
<td>2.79</td>
</tr>
<tr>
<td>CEB</td>
<td>3.14</td>
<td>3.10</td>
<td>2.07</td>
<td>3.12</td>
<td>3.23</td>
<td>2.93</td>
</tr>
<tr>
<td>SEE</td>
<td>2.89</td>
<td>2.79</td>
<td>2.27</td>
<td>3.08</td>
<td>3.24</td>
<td>2.86</td>
</tr>
</tbody>
</table>

As this table shows, there is not a great deal of variation across the transition region in firms’ assessments on the average of these five dimensions of the courts system, with CEB and SEE scoring only slightly, but not significantly, higher than the CIS-7 and central CIS countries. However, on the issues of fairness, impartiality and honesty of the courts, the CIS-7 countries on average lag well behind the accession countries and also trail the SEE countries. The CIS-7 countries also come out worst on average on both cost and ability of courts to enforce their decisions. At the same time, firms in the CIS-7 countries report that their courts are quicker in making rulings than are courts in the other transition regions. However, the combination of speedy judgements and dishonest judges suggests that corruption may be facilitating greater efficiency in the court system at the expense of justice.

While the CIS-7 average is helpful for comparing this sub-group to others in the transition region and comparing perceptions of different aspects of the legal system country-by-country, it conceals numerous unexplained anomalies in the data. For example, in Georgia and the Kyrgyz Republic, courts are perceived to be both slow and corrupt. Also, firms in Uzbekistan report the best experience of all five dimensions of the court system among this sub-group of countries, outperforming courts in the most advanced transition economies where legal reform has gone the furthest. This is not confirmed by other assessments of the legal system in Uzbekistan.17

With some exceptions already noted, the findings on firms’ perceptions of the court system as a whole are consistent with quantitative measures of firms’ use of courts to settle business disputes and the costs of crime in the CIS-7 countries. Using the proportion of firms that have pursued a legal ruling to resolve a business dispute as a proxy for firms’ trust in the courts, the BEEPS finds that confidence in the legal system among the CIS-7 countries is very low (see chart 15).

17 According to the World Bank’s Governance Indicators, Uzbekistan ranks third from the bottom among CIS-7 countries in Rule of Law for 2002 (http://www.worldbank.org/wbi/governance/govdata2002/index.html); in Freedom House’s Nations in Transit, Uzbekistan has the lowest ranking for Rule of Law among the CIS-7 countries in 2002 (http://freedomhouse.org/index.htm).
In the CEB countries almost 40 percent of firms have used the courts to address contract violations, while in SEE the proportion of firms as plaintiffs is over 30 percent. In the CIS-7 countries, by contrast, just 21 percent of firms have used the courts as plaintiffs. Firms in Azerbaijan are least likely to go to court to resolve a business dispute, with just 7 percent saying they had used the courts as a plaintiff in the past three years. This corresponds to firms perceptions of the fairness and impartiality of the courts in Azerbaijan, where they rank below the CIS-7 average, but not to other measures of the functioning of the court system such as honesty of judges, quickness, affordability and ability to enforce judgements where they rank above the CIS-7 average. More detailed analysis of the court system in Azerbaijan than can be provided here is needed to interpret these mixed results.

Turning to the average losses from crime (theft, vandalism or arson), the CIS-7 countries also score badly. In 2002 average losses from crime exceeded 4.0 percent of sales in ten of the 26 transition countries in the sample, including the seven CIS-7 countries (see chart 16). Perhaps unsurprisingly, the countries of CIS-7 appear to have relatively weaker institutions in the field of crime prevention, detection and deterrence, with the knock-on effects on firm performance that such crime entails.

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18 The remaining three countries were the then FR Yugoslavia, FYR Macedonia and Ukraine.
In the section that follows, we expand on the issue of corruption in the CIS-7 countries and the effect that corruption has had on the general business environment.

IV. Corruption Dynamics in the CIS-7 Countries

The final aspect of the business environment surveyed here is corruption. The two rounds of the BEEPS asked a series of questions about the nature and effects of corruption on firms and on the country’s business climate. The changes in firms’ responses in the three year period between these two rounds allows us to estimate changes in the overall level of corruption in these 24 countries over this period.19

Administrative Corruption

Corruption can impose a significant cost on firms. One measure of this cost is the proportion of sales that are paid in the form of unofficial payments to public officials – the so-called “bribe tax”. According to the 2002 BEEPS, the heaviest bribe taxes among the transition countries are in the CIS-7 countries, which pay on average almost 2.5 percent of annual revenues in bribes, compared to just over 1.5 percent in both the central CIS and SEE regions (see chart 17).20 In the Kyrgyz Republic firms paid more than 3.5 percent of their annual sales in bribes to state officials, while in

19 As discussed in section II above, all survey-based assessments of obstacles faced by firms are inherently perceptions based. This particularly applies to the problems posed by corruption, and therefore the results of the two BEEPS rounds will to a certain extent reflect changes in perceptions of corruption rather than any objective measure of corruption. However, the surveys attempted to minimise the impact of perceptions by asking questions specifically about levels of bribes, as well as asking respondents about their perceptions of corruption as an obstacle to the operation and growth of their businesses. We examine both of these measurements in the paper.

20 The 1999 BEEPS question on administrative corruption asked firms about the level of bribes paid as a proportion of annual sales, according to a set of bands (0%, Less than 1%, 1-2%, 2-10%, 10-12%, 13-25% and Over 25%). We have used the lower end of these bands for the 1999 bribe tax level. The 2002 question was open (without bands), which makes the comparison between the two years difficult because of potential framing bias.
Georgia and Azerbaijan firms paid more than 2.5 percent, significantly undermining these firms’ competitiveness and greatly reducing the attractiveness of the investment climate for all but the most risk-taking foreign investors.

However, more positively, there were significant reductions in the burden imposed by corruption across the transition countries between 1999 and 2002. In 2002 the unweighted average bribe tax rate across the transition countries was 1.6 percent of sales compared with 1.9 percent in 1999. Moreover, the largest reductions in the bribe tax rates were in the CIS-7 countries, falling more than two percent of sales, albeit from high levels. However, as chart 17 illustrates, there is wide variation among countries in this sub-region.

Turning to another quantitative measurement of the level of administrative corruption, both rounds of the BEEPS asked whether it was common for firms “in my line of business” to have to bribe public officials in order to “get things done”. Chart 18 reports the country averages for 1999 and 2002. In the CIS-7 countries the frequency of bribery is on a par with the central CIS and SEE countries and higher than in the CEB countries. In Georgia, the Kyrgyz Republic, Moldova and Tajikistan, the frequency of bribes is significantly above the average in the transition countries. Indeed, the Kyrgyz Republic in 2002 had the highest frequency of bribery among the 26 transition countries included in the survey.
As with the bribe tax, however, the average frequency of bribery has declined more sharply in the CIS-7 countries than elsewhere in the transition region, while in the central CIS the average frequency of bribes has actually increased in this period, and in SEE the average decline has been small. However, this trend is driven largely by the fact that the frequency of bribery fell quite sharply in Armenia, Azerbaijan and Uzbekistan, while in three of the CIS-7 countries – Georgia, the Kyrgyz Republic and Moldova – the frequency of bribery increased slightly, and data are not available for Tajikistan for 1999.21

This finding is confirmed by the way firms ranked corruption among 22 potential obstacles to their operation and growth. Between 1999 and 2002, the significance of corruption fell across the CIS-7 countries by almost 2.5 rank places, and in five of the six CIS-7 countries for which data are available for both 1999 and 2002, corruption became a relatively less significant obstacle. The exception is Moldova, in which corruption increased in importance over this period. Chart 19 shows the ranking of corruption as an obstacle for the CIS-7 countries and averages for the sub-regions in the transition countries. The higher the rank, the less important corruption is perceived by firms to be.

Moreover, the second round of the BEEPS found that the proportion of firms in Moldova reporting that corruption represented at least a moderate obstacle increased over the 1999-2002 period, painting a contradictory picture: the cost to firms of administrative corruption seems to have declined and the more general importance of corruption to firms seems to have declined, while the frequency of bribery seems to have increased slightly. This might be explained by the institutionalisation and routinisation of administrative corruption in the country: firms expect to have to bribe local administrators, and therefore the financial implications of bribery is at least predictable and the impact on their firms therefore comparatively less significant.
However, while the bribe tax and the perceived importance of corruption have come down in most CIS-7 countries over the 1999-2002 period, evidence from the BEEPS indicates that small firms (fewer than 50 employees) continue to pay a higher proportion of annual revenues in bribes than medium-sized and large firms (between 50 and 10,000 employees), further damaging the prospects for growth in this crucial sector of the economy (see chart 20). The gap between small and medium-large firms was well over one percent of sale in both 1999 and 2002. The exceptions to this rule in 1999 were Azerbaijan, Georgia and the Kyrgyz Republic. In 2002 the gap between small and larger firms in the bribe tax costs was greater in the CIS-7 countries than anywhere else in the transition region. Even in the three exceptions in 1999, by 2002 small firms were paying more in bribes than medium-large firms.
We find a very similar story when we look at firms broken down by ownership: across the transition region, and in the CIS-7 countries in particular, privately owned firms face significantly larger costs associated with administrative corruption than do state-owned firms. As chart 21 shows, across the entire transition region, privately-owned firms pay substantially more in administrative bribes than state-owned firms. The only exceptions to this general rule in the region were Azerbaijan and Uzbekistan in 1999, in which state-owned firms paid slightly more in bribes than privately-owned firms.

As with firm size, however, by 2002 the pattern had become uniform across the six of the CIS-7 countries for which we have time series data: privately-owned firms are disproportionately punished by having to pay a higher percentage of their revenues in bribes, thus undermining their competitiveness. Across the CIS-7 countries, state-owned firms paid on average less than one percent of revenues in petty bribes, while for privately owned firms the bribe tax remained above 2.5 percent. Clearly, such differential corruption practices discourage private entrepreneurial activity and slant the playing field in favour of what are often inefficient state-owned firms.

**Chart 21. Administrative Corruption by Firm Ownership**

State capture is defined as “the efforts of firms to influence the contents of legislation, rules, laws, decrees or regulations (i.e., the basic rules of the game) through unofficial payments by private actors to public officials”. The BEEPS asks firms about the extent to which private payments to public officials in six areas have had an impact on their businesses.

Those six areas are:

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- **Parliament**: Private payments/gifts or other benefits to Parliamentarians to affect their votes;
- **Government**: Private payments/gifts or other benefits to Government officials to affect the content of government decrees;
- **Criminal courts**: Private payments/gifts or other benefits to judges to affect the decisions of criminal court cases;
- **Commercial courts**: Private payments/gifts or other benefits to judges to affect the decisions of commercial court cases;
- **Central bank**: Private payments/gifts or other benefits to central bank officials to affect central bank policies and decisions;
- **Political parties**: Illegal contributions to political parties and/or election campaigns to affect the decisions of elected officials.

Countries’ scores on these six measures can be aggregated into an index of state capture. Chart 22 reports the CIS-7 countries’ scores on the state capture index, for both 1999 and 2002, ranked from left to right according to the CIS-7 countries’ scores in this index in 1999.

**Chart 22. State Capture Index**

State capture as perceived by firms across the CIS-7 region has declined sharply in the 1999-2002 period. Only in Uzbekistan has the perceived level of firms’ ability to capture the state and to use it to their own ends increased in this period. The most dramatic decline in state capture occurred in Azerbaijan and Moldova, reflecting a general pattern in which states with higher levels of capture in 1999 had the most significant reductions in capture by 2002. This echoes developments across the transition region, with the exception of SEE, where capture increased slightly over this three year period.

Chart 23 shows the breakdown of the six component parts of state capture in the CIS-7 countries, as well as in the three other transition regions. As this illustrates, the level of state capture in the CIS-7 countries is higher than in the central CIS or CEB.
regions, but significantly lower than in SEE. This chart also highlights the fact that capture is more or less evenly distributed across the six component areas of capture, although it tends to be slightly higher in relation to commercial courts and lower in relation to parliamentary legislation and – perhaps surprisingly – political party finance. Across the board, however, it is important to note that firms report that capture of state institutions by powerful vested interests has at best only very modest impact on firms’ ability to do business.

The BEEPS also asked firms whether they themselves participated in state capture. Chart 24 reports the findings for 1999 and 2002, and shows that the share of firms that have captured institutions of the state (“captor firms”) in the CIS-7 declined very slightly in this period, although this masks large variation within the region. In Azerbaijan and Moldova the share of captor firms fell sharply, while in the Kyrgyz Republic and Uzbekistan the proportion of firms which attempted to influence state policy increased over this period. In all of the other transition regions, the share of captor firms also increased between 1999 and 2002, even while the impact of capture was perceived to decline. In other words, more firms across the region claimed to have some undue influence on state policies and legal practices, while the reported impact of state capture on these firms’ operations declined.23

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23 Only capture in the areas of parliamentary legislation and government decrees seem to have any effect on firm performance. See Fries, Lysenko and Polanec (2003).
Across the transition region the perceived impact of capture on firms has declined while the number of firms engaging in capture has increased. This seems counterintuitive: one would expect *ex post* that the impact of capture would increase as the number of firms engaged in capture increased. The decline in the impact of capture could be explained by the fact that as more firms have become captors, their influence on the state has been diluted and their collective ability to influence policy outcomes has thus declined. One reason for the increase in the number of captor firms may be that capture pays. As chart 25 reports, firms that have captured institutions of the state (“captor firms”) across the CIS-7 countries have significantly higher sales growth than non-captor firms.

![Chart 24. Share of Captor Firms](image)

![Chart 25. Returns to Capture](image)
The imbalance toward captor firms is striking among most of the CIS-7 countries, with captor firms’ three-year sales growth reaching close to 24 percent, while non-captor firms grew their sales close to 17 percent on average across the sub-group of countries. In Azerbaijan and Georgia, captor firms grew almost three and a half times more than non-captor firms, while in the Kyrgyz Republic the ratio between captor firms’ and non-captor firms’ sales growth was more than seven-and-a-half. In Armenia, by contrast, captor firms’ sales actually contracted over the three years to 2002, and in Tajikistan non-captors grew almost ten times more than captors. Moldova and Uzbekistan are much nearer the level of parity between captor and non-captor firms observed in the CEB countries.

In sum, corruption dynamics in the CIS-7 countries present a mixed picture. While the bribe tax has come down in all but one country in the region, the percentage of annual revenues paid in bribes continues to exceed those paid in other transition regions. Moreover, the data on changes in the frequency of bribe payments is far less uniform, with three out of six countries showing an increase in frequency and three a decrease. A similarly complex story comes out of the data on grand corruption. While the effects of capture on businesses were reported to have decreased in all but one country, the number of firms engaging in capture went up in three out of the six.

It is important to bear in mind that the BEEPS only looks at how firms assess the impact of corruption on their business and does not query officials, experts or households as do some other surveys. A large part of the overall corruption picture is therefore missing, and the BEEPS results should not be relied upon as the sole diagnostic tool by governments and donor agencies engaged in studying and remedying corruption problems. The advantage of the BEEPS, however, is that it is the only survey that specifically asks firms in every country in the transition region about their direct experience with corruption, which facilitates comparison, and it has the beginnings of a time series which enables analysts and policymakers to begin studying corruption dynamics. Because it includes such a wide array of questions on different dimensions of corruption it also allows investigators to unbundle corruption in ways that many other surveys do not. This too facilitates the development of more targeted anti-corruption programmes at the country level.

Other country-specific and cross-country surveys can also be useful in this regard. An example of the latter is the Transparency International Corruption Perceptions Index (CPI), which aggregates available surveys on corruption (including the BEEPS) for more than one hundred countries. Because the CPI distils the surveys into a single rating, it is difficult to compare with the various indicators of corruption found in the BEEPS. On the whole, the findings do not overlap but nor are they incompatible. Over the same three year period covered by the BEEPS, the CPI ratings find that perceptions of corruption have grown worse in Georgia, the Kyrgyz Republic and Moldova and improved in Armenia, Azerbaijan and Uzbekistan. The BEEPS findings are consistent with the CPI on Armenia and Azerbaijan, where we see improvements in the six separate indicators of corruption reported in this paper, and

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24 The survey was not conducted in Tajikistan in 1999, so no comparisons can be made with the 2002 data.
25 Transparency International also lacks data on Tajikistan for 1999.
the picture is more mixed on the other countries. In Georgia, the Kyrgyz Republic and Moldova two of the six indicators are negative, while four show improvements. In Uzbekistan, where the CPI ratings suggest a sharp improvement in perceptions of corruption, the BEEPS found improvements only in administrative corruption and a worsening of grand corruption.

V. Institutions and the Contracting Environment

One important aspect of a healthy business climate that is not captured by the indicators we have looked at thus far is trust among business partners. Even in established market economies, trust is an important prerequisite for well-functioning markets. Trust lowers transaction costs and facilitates cooperation among entities that might otherwise view mutually advantageous exchange as too costly or risky. Especially in places where third party enforcement – i.e., the state and its constituent legal and regulatory institutions – is weak or uncertain, a basic belief in a counterpart’s honesty is essential to facilitate business transactions.

Trust can be measured (indirectly) by the level of prepayment (or payment in advance) demanded by firms from their customers. A firm’s willingness to forgo prepayment may be seen as an indication that its directors believe they will be paid fully and on time, either due to trust in the customer or trust in the legal system and its ability to fairly adjudicate business disputes. High prepayment demands, conversely, can be seen as a measure of distrust in a customer and/or lack of confidence in the contract enforcement regime.

Using this metric for trust, chart 26 reports the levels of prepayment demands in the CIS-7 countries, and across the major transition regions, in 2002. As this chart shows, the level of prepayment demanded in the CIS-7 countries, almost 35% of sales, is lower than in the central CIS (over 40% of sales), but dramatically higher than in CEB and SEE countries (less than 10% and 15% of sales, respectively). This indicates that interfirm trust among the CIS-7 countries is significantly lower than in the advanced transition economies in CEB, or than even the countries of SEE.

26 The six include the bribe tax, the frequency of bribes, the time tax, corruption as an obstacle, the impact of capture and the share of firms engaging in capture.

27 Prepayment as a measure of (dis)trust is not without problems. It might be argued that prepayment actually reflects trust by the customer in the supplier delivering the goods after payment has been received. Another potential problem with prepayment is that it may reflect credit market imperfections. Customers need to prepay suppliers to satisfy their demand for working capital. Without prepayment, no goods might be produced at all. Finally, it could be argued that prepayment may be more a function of the type of good being sold than of inter-firm trust – in other words, prepayment may be more prevalent in some industry or service sectors than in others. In the literature on trust and contracting, an alternative measure of trust is trade credit. See Johnson et al. (1999); McMillan and Woodruff (1999); Woodruff (2002).
This high level of interfirm distrust is particularly acute in Azerbaijan, Tajikistan and Uzbekistan, all of which have prepayment levels higher than 40% of sales, and are among the lowest trust countries in the transition region. In Georgia and Armenia, in stark contrast, the levels of prepayment are closer to five percent, and indeed are lower than in the CEB countries, indicating a high level of interfirm trust.\textsuperscript{28}

What creates trust in transition economies? One important determinant might be firms’ beliefs about the reliability, honesty, and accessibility of the court system. Where courts function more effectively, firms could be expected to place more at risk in business transactions, knowing that disputes will be resolved without prejudice by a third party. Conversely, it might be the case that inter-firm trust is high precisely because the courts are corrupt, and firms must rely on effective network-based enforcement of contracts.

The BEEPS asked firms a series of questions about their perceptions of the functioning of the courts. In particular, the survey asked firms to rate the quality of the courts in five key areas:

- Fairness and impartiality
- Honesty/uncorrupted
- Speed
- Affordability
- Ability to enforce their decisions

When we look at trust as measured by the level of prepayment demands and perceptions of the functioning of courts across the transition countries as a whole, we find that trust is higher when courts are perceived to be fair and impartial, honest and

\textsuperscript{28} However, interestingly trade credit is not substantially higher in these countries, reflecting the findings in Raiser, Rousso and Steves (2003) that prepayment is more closely correlated with interfirm trust than is trade credit.
Uncorrupted. Trust is not significantly affected by perceptions that courts are affordable or able to enforce their decisions, however. Where courts are perceived to be quick in adjudicating cases, interfirm trust is actually lower in the transition countries (see chart 27). This suggests that reducing corruption in the courts is probably more likely to build trust than making the courts more efficient.

Previous research has also found a strong correlation between relational contracting and trust at the enterprise level. While efficient for the firm, relational contracting has social costs, because new entrants are deterred and potentially profitable matches are not made. Firms have also been able to rely on reputational enforcement mechanisms, by collecting information on new trading partners from other participants in existing business networks and by sharing with others their own information on the business conduct of their trading partners. In an economy with high barriers to entry for new firms and dominance by a relatively small number of key players in any specific sector, where effective networks exist to circulate information on business conduct, firms will be disciplined to behave in accordance with relevant commercial norms lest they receive a reputation for unreliability. Recent research has found that third party enforcement through networks may be a useful complement to enforcement through the court system.

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29 However, it is interesting to note that this relationship does not particularly hold in two CIS-7 countries. Uzbekistan has the highest score on the perception of the impartiality, honesty and fairness of the courts, and yet the lowest level of interfirm trust among the CIS-7 countries. However, as noted earlier, the BEEPS results on perceptions of the court system for Uzbekistan do not conform to other assessments of the legal system in the country for the same period and therefore the findings should be reviewed with caution. Conversely, in Georgia interfirm trust is very high but the courts are perceived to be relatively corrupt.

30 Johnson et al., 1999; McMillan and Woodruff, 1999.

31 Woodruff, 2002.
In the BEEPS, enterprises were asked to rank the following sources of information from 1 (not important) to 5 (extremely important): family; friends; former employees who now work for a potential supplier/customer; senior managers in a firm previously employed by a potential supplier/customer; existing suppliers/customers; government agencies; business associations and chambers of commerce; and trade fairs and other public sources of information. Because replies were highly correlated across the first and second, and third and fourth categories, we have averaged them into friends and family (or social networks), and employees and managers (or insider networks). In addition, the BEEPS asked firms whether they are themselves members of a business association.

Table 4 shows that on average across the transition countries, trust is positively associated with reliance on social networks and networks of existing business contacts for information on new customers and suppliers, but negatively associated with reliance on insider networks or government agencies. In other words, networks based around personal ties – family and friends – and business associations seem actively to promote the development of trust, while business networks based on enterprise insiders and government agencies do not.32

When looking at the CIS-7 countries on their own, social networks are even more strongly associated with trust between firms, but reliance on existing suppliers or customers is not associated with higher levels of trust at the country level. In the CIS-7 countries, social networks seem to be the only type of interfirm relationships that are correlated with higher levels of trust at the country level. One can conclude that business relationships are much more personalised in the CIS-7 countries, and therefore there are higher opportunity costs associated with the nature of business networks.

Table 4. Determinants of prepayment: business networks

<table>
<thead>
<tr>
<th></th>
<th>Social networks</th>
<th>Insider networks</th>
<th>Existing suppliers/customers</th>
<th>Govt agencies</th>
<th>Business assoc.</th>
<th>Public sources/trade fairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average prepayment as a percentage of sales</td>
<td>-0.23</td>
<td>0.37</td>
<td>-0.20</td>
<td>0.66</td>
<td>-0.12</td>
<td>-0.22</td>
</tr>
<tr>
<td>CIS-7</td>
<td>-0.34</td>
<td>0.75</td>
<td>0.38</td>
<td>0.77</td>
<td>0.56</td>
<td>0.33</td>
</tr>
<tr>
<td>Other transition countries</td>
<td>-0.24</td>
<td>0.28</td>
<td>-0.29</td>
<td>0.62</td>
<td>-0.44</td>
<td>-0.35</td>
</tr>
</tbody>
</table>

These findings suggest that it is important to distinguish between different types of networks, when examining their effects on trust and contracting arrangements between firms. In particular, in the CIS-7 countries, networks based on the personal

32 These findings seem to contradict the argument forwarded by Fukuyama (1995), that social networks based on personal ties tend to prevail in low-trust societies, and can thus be seen as a symptom of, rather than a solution to, a low level of trust. However, the very existence of social networks entails a high level of trust among the participants in the social network. This network-dependent interpersonal trust is the social equivalent of interfirm trust in societies with weak third party contract enforcement.
contacts of enterprise insiders or on contacts with government seem of little help in building trust, whereas social networks would appear to be the key to high levels of trust between firms.

VI. Conclusions and Policy Recommendations

This paper has described the business environment in the CIS-7 countries, drawing primarily on the EBRD’s Business Environment and Enterprise Performance Survey, conducted in 1999 and 2002. The paper has focused on seven key dimensions of the business environment: access to finance, infrastructure, tax, regulations, the judiciary, the rule of law, and corruption. According to the BEEPS, the CIS-7 countries are well behind the advanced transition countries of central eastern Europe and the Baltics. The CIS-7 countries are generally on a par with, and in some cases ahead of, the central CIS and south-eastern European transition countries. The paper has shown that, across the CIS-7 countries, there is a great deal of variation on both quantitative and qualitative indicators of the business environment. The BEEPS results show a marked improvement in the business environment in most of the CIS-7 countries from 1999-2002, especially in the areas of access to finance, the judiciary, control of corruption and rule of law. However, there is much more to be done to improve the business environments in these countries, and one should also bear in mind the methodological complications that arise in comparing the 1999 and 2002 BEEPS results.

Access to finance and the functioning of public institutions – corruption and the judiciary – are of particular concern to enterprises in the CIS-7 countries. The availability and cost of finance is one of the largest problems faced by firms across the transition region, while firms also report that tax rates and tax administration are a significant obstacle to their operation and growth. On corruption, the BEEPS results suggest that administrative corruption is still a severe problem in the CIS-7 countries, which have the heaviest bribe taxes among the transition countries. The paper also found that small firms and privately-owned firms continue to pay a higher proportion of annual revenues in bribes than medium-large firms and state-owned firms, further damaging the prospects for growth in this crucial sector of the economy. Both administrative corruption and state capture have come down from 1999 levels on average, however the CIS-7 countries continue to show the highest levels of corruption in the transition region. Similarly, while there has been a significant strengthening of the judiciary in these countries, there is nonetheless continued urgent need for reform of the courts.

Infrastructure and state regulation are still significant problems in the CIS-7 countries, when measured in terms of business days lost due to service interruptions or dealing with red tape. However, given the magnitude of other concerns, and the long experience dealing with bottlenecks and bureaucrats under the old system, firms in the CIS-7 actually rate infrastructure and state regulation among the least significant business environment issues.

Finally, the paper focused on trust between firms and the institutions that support the contracting environment in the CIS-7 countries. The paper found that the level of interfirm trust in the CIS-7 countries, measured as a function of the level of
prepayment demanded by firms, is higher than in the central CIS but significantly lower than in CEB and SEE countries. The paper found that on average trust is higher in countries where courts are perceived to be fair and impartial, honest and uncorrupted, but is not significantly affected by perceptions that courts are affordable and fast. The paper also argued that, in the CIS-7 countries, networks based around personal ties and business associations actively promote the development of trust, while business networks based on enterprise insiders and government agencies do not.

Due to the short time span between the two rounds of the BEEPS and other methodological issues, the findings presented here are more suggestive than conclusive. On the basis of the tentative conclusions outlined above it would be inappropriate to develop detailed policy recommendations or action plans for improving the business climate. Nevertheless, the following general suggestions flow from the paper’s conclusions:

- Facilitating firms’ access to finance is crucial across the CIS-7 countries. Availability of longer term finance would facilitate higher levels of intermediation than currently exist, as firms in the CIS-7 countries rely predominantly on retained earnings and family to finance their operations.
- Corruption – in the forms of both administrative corruption and state capture – is a significant hurdle to firms in the CIS-7 countries, and poses particular problems for small and privately owned firms. Tackling corruption in a systematic and sustained manner is the only way to level the playing field to allow small private firms to flourish.
- Urgent reform of the courts is required in order to strengthen firms’ beliefs in the ability and willingness of the state to defend property rights and adjudicate impartially in business disputes.
- However, courts reform must be well-targeted: reducing corruption in the courts in the CIS-7 countries is more likely to build trust and facilitate commerce than making the courts more efficient.
- Developing civil society by promoting social networks based on professional and business associations, trade organisations, and non-economic groups would be complementary to strengthening the courts and law enforcement in building high levels of trust between firms.

33 Two notable exceptions are Georgia and Uzbekistan.
References


