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Global Strategic Analysis

CENTRAL ASIA: Shadow economies hold back development

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Abstract (summary)

The persistence and consequences of informal economies in Kyrgyzstan and Tajikistan.

Informal economies have emerged as the main source of employment and income in Kyrgyzstan and Tajikistan, accounting for as much as half of economic activity. Although 'shadow' economies are common across the post-Soviet space, the sheer size of these activities -- and their resilience -- in Central Asia's poorest states raises questions about the impact on state institutions and the region's long-term development trajectory.

Full Text

SUBJECT:The persistence and consequences of informal economies in Kyrgyzstan and Tajikistan.

SIGNIFICANCE:Informal economies have emerged as the main source of employment and income in Kyrgyzstan and Tajikistan, accounting for as much as half of economic activity. Although 'shadow' economies are common across the post-Soviet space, the sheer size of these activities -- and their resilience -- in Central Asia's poorest states raises questions about the impact on state institutions and the region's long-term development trajectory.

ANALYSIS: Impacts.

Small enterprises play an important role in alleviating poverty, but do not lay the foundation for a vibrant middle class.

A lack of trust in 'legitimate' businesses will seriously hinder the development of banking sectors in Central Asia's poorest states.

Tax evasion and ineffective collection mean that large enterprises will remain the crucial source of capital for state coffers.

According to UN Development Programme (UNDP) studies, the shadow economy constituted 60.9% of GDP in 2005 in Tajikistan, and 53.0% of GDP in 2006 in Kyrgyzstan. While these are the most recent years for which data are available, it is highly unlikely that the informal economy has shrunk in recent years. Elsewhere in Central Asia, the share of informal economic activities is smaller but still significant; this reflects a better business environment in Kazakhstan and more effective enforcement institutions and centralisation in Uzbekistan and Turkmenistan.

From transition to entrenchment.

The informal economy's significance is reflected in the structure of private sectors in Tajikistan and Kyrgyzstan. They are largely split between a few large conglomerates and hundreds of thousands of very small, often unregistered enterprises and private entrepreneurs. Small enterprises are concentrated in trade, services and agriculture, and have played a critical economic and social role since the collapse of the Soviet Union, filling the gap left by the state in the distribution and provision of consumer goods -- and providing many former public-sector employees with a means of survival.

However, unlike in other former Soviet states, very few Tajik or Kyrgyz small businesses have chosen to step into the formal sector, despite ostensibly business-friendly environments. For example, the World Bank's Doing Business report this year ranked Kyrgyzstan 14th best in the world in terms of ease of starting a business. In reality, and contrary to the prevailing view among international interlocutors, informal economic activity is no longer a by-product of the post-Soviet transition period. It instead represents an integral part of two weak states dominated by politically connected business networks.

New actors in an old system.

While the majority of small businesses operate outside the formal sector, they remain in one way or another embedded in the informal networks of patronage that came to dominate the post-Soviet period and to compensate for institutional shortcomings. Patronage networks had traditionally been formed in line with regional or family ties -- they are increasingly formed on the basis of common interests and institutional affiliations (see *UKRAINE/RUSSIA: Gas cut-off unlikely, but risks remain - December 11, 2009*). As in other former Soviet states, patronage networks are usually formed on the basis of access to formal institutions; these can range from favours extended by junior local government officials, to informal political structures led by members of parliament or cabinet ministers.

The dynamics are especially evident in the trade and agricultural sectors, where thousands of small stakeholders are dominated by a few business groups with strong political ties:

Two owners of Dordoi, Central Asia's largest bazaar (located near the Kyrgyz capital Bishkek) also serve in parliament.

Tajikistan's cotton sector is dominated by a group of businessmen closely affiliated with senior officials, as revealed by the Ernst and Young audit of the National Bank in 2009.

Informal arrangements and patronage systems help entrepreneurs start up businesses, reduce costs and cope with the distorted market. However, the very nature of these inequitable and unstable patron-client relationships hampers long-term commercial expansion, forcing many to focus on survival and protection rather than growth and innovation.

Absence of incentives.

As in many other developing economies, businesses in Tajikistan and Kyrgyzstan are driven into the informal sector by excessive taxation, bureaucratic 'red tape' and over-regulation. Governments in both countries have taken some measures to rein in taxes and predatory bureaucracies, but arbitrary law enforcement and weak (or absent) guarantees of property rights still push many businesses underground. When asset-grabs and other arbitrary takeovers are associated with enforcement institutions and political elites, there are no incentives for businesses to enter the legal economy, and there are substantial risks in expanding enterprises beyond informal systems of patronage.

The authorities in Bishkek and Dushanbe are aware of the extent of their informal economies, and have sought to exercise some control over the sector by offering regular capital amnesties and encouraging businesses to use electronic payment systems. While capital amnesties regularly attract significant amounts -- one in Tajikistan in 2007 registered 650 million dollars worth of assets -- these measures rarely tempt small businesses to exit the informal economy. On the contrary, business elites' access to political decisionmakers has the effect of stalling reforms, resulting in state policies that further benefit large conglomerates over small enterprises.

State-society relations.

The prevalence of informal economies will continue to have a deleterious impact on state-society relations, lowering public expectations and reinforcing the unaccountability of state bureaucracy. Blurred lines between public and private interests will reinforce rent-seeking behaviour at every level of government, and widespread tax evasion will reinforce this vicious circle by depriving formal state institutions of much-needed funding. For example, according to the UNDP, small enterprises and individual traders conceal over 40% of their profit in Kyrgyzstan.

While small businesses are largely autonomous from the state, so far there is little evidence to suggest that their weariness with inefficient bureaucracy and corruption can translate into a concrete political agenda. Political mobilisation is largely driven by patronage networks and local communities rather than common political or economic goals, as demonstrated by the mobilisation of ethnic Uzbeks by Kadyrzhan Batyrov (a former member of parliament and prominent businessman) in southern Kyrgyzstan last year (see *KYRGYZSTAN: Crisis may foretell war, state collapse - June 17, 2010*) -- or the spring 2008 demonstrations in Khorog (in the Gorno-Badakhshan region of Tajikistan).

CONCLUSION: Without comprehensive professionalisation of the state bureaucracy and political reforms addressing corruption and weakness of property rights, small enterprises and state institutions will continue to lose out due to the dominance of informal economies. Kyrgyzstan has undertaken significant reforms in the last year, but there is little evidence that the multi-party coalition government has the political will or capacity to carry out such sweeping improvements. In Tajikistan, political apathy and the absence of a meaningful opposition will only reinforce the bureaucracy's lack of accountability to society.

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