UZBEKISTAN: ECONOMIC TRENDS AND PROBLEMS

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Uzbekistan is a doubly-landlocked country strategically located in the heart of Central Asia. It is the most populous country in the region, rich in resources and has a strong agricultural base. The country has chosen a gradual reform path aimed at social stability and based on strong preferences for national independence, government control and self-sufficiency. However, many independent indicators consistently rank Uzbekistan as a country with limited economic reform and freedom, persistent obstacles to private sector development and significant risks of corruption. Recently some efforts have been made to reduce the scope for administrative interventions by reforming the inspections and permit regimes, reducing barriers to the registration of new businesses and tax code reforming. Energy prices have been increased and energy payment collection was tightened. In agriculture the collective shirkat farms were restructured into private leaseholds, albeit with non-tradable ownership rights. However, there are many areas of concern in the country’s economic policy. Three areas of major concern in Uzbekistan are governance, increased poverty and deeper structural reforms.

Governance: The most immediate problems in this area include the need for greater transparency and accountability, as well as appropriate safeguards for the public sector. The country should provide better statistics on Uzbekistan’s socio-economic development and publish a country page in the International Financial Statistics. This would allow to inform the public and international community about policy choices. A law on public procurement must be drafted and adopted by the Parliament. The country finances some infrastructure projects from public funds and more transparency and accountability is needed here. Acting on these recommendations would lay a foundation for the creation of conditions for civil society, which allows people to play role in debating policy alternatives holding the Government accountable. It would also improve the laws and regulations in public procurement, public financial management and reduce scope for corruption.

There is a clear lack of policy dialogue between the private sector, the international community and the government. One of the challenges is to move toward less centralized and more participative policy-making, improving incentives and performance in the civil service.

The state still retains a dominant role over many areas of economic and public life and therefore it missed opportunities for improving the efficiency and customer orientation of public services. The Government has relied on an internal system of control and sanctioning of public officials to reduce incentives for corruption. Monitoring costs of such system are high as reflected in the employment of an extensive security and police personnel. The Government of Uzbekistan needs to redefine the role of the state and the private sector, address the large bureaucracy, eliminate overlap of government functions. The controversies also include disagreements with the existing trade regime, the extent of government involvement in the financial sector and the scope for further reforms in agricultural sector. Another area in which the government has recognized the urgency of improvement is public financial management. Uzbekistan’s government sector is considerably larger than in other low income transition economies (government expenditures accounts for 32% of GDP). The country does not have a single treasury, the public budget is implemented through a total of 142,000 budget units, each with their bank accounts. There are also extra budgetary funds. Idle cash balances lead to efficiency losses and complicate budget monitoring, and this leads to opportunities for leakages to off-budget accounts.

Poverty issues: The existing structure of public budget is clearly emphasized towards social services. However still the Government could take more measures to adopt clear poverty focus in drafting and implementing policies.

Regional cooperation: Regional cooperation to reduce trade costs is a priority for double-landlocked Uzbekistan and the countries in the region. There are significant trading
complementarities between Uzbekistan and its regional neighbors that remain underexploited because of policy and institutional barriers, including trade-restricting policies and practices, weak cross-border cooperation, limited availability of multi-modal transport operations, high transit costs, and other ‘behind the border barriers to trade’ (UNDP, 2005). Regional cooperation issues include trade, transport, and the water-energy. The challenges in trade policy include reduction of nontariff barriers and border related transaction costs. In transport aspects of regional cooperation the challenge is that transport costs are high and this requires building transport infrastructure as a transit for trade between Europe, People’s Republic of China and the rest of the Central Asia. Governments should promote regional cooperation by assisting in developing regional transport corridor and customs transit to reduce physical and economic distance by intra- and interregional markets. The water energy nexus stems from the uneven distribution of water and energy resources within the region, especially in the Sirdary basin. Another problem for regional energy cooperation relates to transmission access and arises from the interdependence of these countries for transmission of power from one part of a country to another. Physical and economic distance to outside markets should be reduced through efficient transport and customs facilitation.

Investments: One of the challenges is improvement the efficiency and effectiveness of employing productive factors in Uzbekistan. Uzbekistan’s efficiency of investment, as measured by the average incremental capital – output ratio (ICOR) lags behind some other countries in the region. Uzbekistan’s average ICOR in 1996 – 2003 was 7.2 compared with around 4.0 for Kazakhstan, the Kyrgyz Republic, and Tajikistan since the end of their transition recessions (World Bank, 2005). Structural reforms in key sectors are required to reduce the dominant role of the state. Employment growth in the formal private sector will depend upon structural reforms that can facilitate reallocation of resources to more productive and better paying activities. Also increase in competition will improve the use of productive factors. Raising the quality of investment, in terms of higher factor productivity growth and employment for a given rate of investment, will require removal of impediments to the development of a dynamic private sector that can provide new and better-paying jobs. It also requires securing greater efficiency and equity in public expenditures.

Deeper structural reform: This is one of the controversial areas and there are many structural reform challenges. Some of them include the following:

Financial sector reform. The financial sector is small and approximately two thirds of bank assets remain in the three major state-owned banks. More foreign investments must be attracted into existing private banks to increase competition in the banking sector. Large state-owned banks and banks in which the bulk of equity belongs to the state must be privatized. Foreign exchange earnings surrender requirement must be abolished and banks must be allowed to trade foreign exchange on the inter-bank market. All non-banking functions of local banks (tax collection and non-essential reporting requirements) should be eliminated. Mandatory deposits of cash receipts by enterprises must be abolished and distinction between cash and non-cash payments must be eliminated. Increase trust in the banking system by providing full and regular access to cash.

Agricultural sector. Agriculture is a crucial source of private sector-led growth in the country. Uzbekistan made some progress in restructuring old collective farms by encouraging establishing of smaller farms. However the main constraints on rural development still remains and they could be categorized into the following: incentives, institutions, and infrastructure.

Incentives: The main constraint on higher agricultural productivity and growth is the state procurement system for cotton and wheat that involves state intervention in inputs, financing, outputs, and marketing of these crops. The state order system remains largely in place in cotton and wheat production and this reduces the effectiveness of farm restructuring. High costs of monopolies are widespread in processing and marketing channels of cotton and input supplies. Making better use of the considerable agricultural potential will require giving farmers better incentives and more freedom to decide than under the existing state order system for cotton and
wheat. Pricing and marketing reforms in cotton sector must be accelerated. The net burden of taxation on the cotton sector should be reduced in order to increase farm income.

**Institutions:** The transition to a market-based rural economy will depend on solving the following: (a) insecure tenure rights – contingent nature and nontradability of leases, inability to use leasehold rights as collateral to raise credit, and revocability of leases with inadequate due processes (USAID, 2005). In addition insecure land tenure provides farmers with few incentives to increase productivity. Input supply and marketing institutions are Government monopolies and reinforce the state procurement system. Rural financial institutions are underdeveloped, constrain rural entrepreneurs access to commercial credit. Infrastructural institutions are financially strapped and this results in poor service delivery.

**Infrastructure:** Rural infrastructure deficiencies constrain growth. Insufficient spending on land, and underpricing of water have led to land degradation and inefficient water use. Irrigation and drainage systems, designed to respond to the state procurement system, must be restructured and focused on market-oriented diversified agriculture. The electricity grid has a broad reach but electricity supply is unreliable in remote rural areas. Alternative energy sources suitable for rural areas need to be considered. Land degradation is widespread due to deteriorating irrigation and drainage infrastructure causing water logging and soil salinity. Addressing this requires speeding up environmentally sustainable rural development by supporting: (a) agricultural productivity and growth, specifically market-oriented agricultural policies, improved land and water use management, and land administration reform; (b) private rural enterprises and rural finance; and (c) rural infrastructure and services. Water consumption in agriculture is high and gradually the country should introduce water charges to encourage greater efficiency in water use.

Investment needs to rehabilitate irrigation system are huge. Financial sustainability and improved water management would require introduction of institutions for on-farm water allocation and water use monitoring. Irrigation water could be used more efficiently and this strategy must link investment in on- and off-farm irrigation with liberalized state procurement system for cotton and wheat, expand autonomous financially self-supporting water users’ associations to encourage farmers to use resources more efficiently. In future the economic policy should emphasize strengthening newly created leasehold rights over the land to enable commercial financing and encourage private investment.

**Business environment and trade policy:** There is controversy between authorities and international financial institutions over how the roles of the state and the private sector should evolve during the process of economic development and transition. International donor community has been arguing for quite a long time that a shift in economic strategy is needed for achieving sustained development progress. The controversies also include disagreements with the existing trade regime. This has been and remains controversial area of criticism by international financial institutions, donor community and neighboring countries. Foreign trade remains regulated by high import excises, registration requirements for both exports and imports and frequent delays in access to foreign exchange despite the official adoption of full current account convertibility. The country should abolish differential excises on imports to reduce incentives for smuggling and encourage competition. Trade policy regime must be liberalized to realize export potential.

The reforms in the customs should be implemented to reduce corruption and improve cooperation with neighboring countries. The country’s trade policy should be harmonized within EurASEC and free trade agreements must be adopted. Major opportunities for mutually beneficial trade and inter-regional transit of goods (not only consumer goods, but also commodities, energy products, electric power) remain underexploited.

The business environment is a major constraint on private sector development. The large and increasing informal economy is brought about by the high costs of doing business in the official economy. The room for government discretion and interference into private business activity remains large, and high official rates of taxation drive many businesses into the shadow economy. Licensing and permits issuance procedures in relation to retails and wholesale trade
should be simplified in order to further reduce the entry costs for the small and medium entrepreneurs. The major impediments here are unstable tax legislation, regulatory restrictions relating to export-import operations, problems with access to cash and others. The existing tax code in the country does not meet the challenges of fast changing environment in the country. The revision of the current tax code must be completed and newly adopted tax code should eliminate the room for discretionary changes in taxation by executive decree. The small medium enterprises sector has difficulty accessing credit because of high interest rates, lack of collateral, and paucity of long-term loans. One of the reform priorities should include reducing the costs to private enterprises of operating in the formal economy and stimulating their competitiveness. Focus should be on specific aspects of the business environment affecting competition, including redesigning the competition policy framework. It is expedient that the authorities redefine industrial policy so that it does not hinder competition or increase regulatory burden.

The Government should encourage greater private investment and job creation. Limited private sector job opportunities contribute to poverty due to: (i) poor financial services for SMEs; (ii) weak business environment due to extensive red tape. Time and cost of business registration, time and cost of obtaining permits, licenses, standards and certificates are still considerable. Legal protection of property and contract rights must be strengthened through greater regulatory transparency and accountability of enforcement organs. Realizing potential private sector operations depends on private investment, which, in turn, depends on investor perceptions of the business environment.

References: