2 Uzbekistan

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I. Introduction

Uzbekistan is situated in the heart of hearts of the Euroasian Continent. The total area of the Republic is 447,8 thousand square km. The Republic stretches from West to East to 1425 km, from North to South – 930 km. The total length of the state borderline is 6221 km. Uzbekistan is the third-largest of the Central Asian republics in area and the first in population (estimated at 25.6 million in 2003 and growing at the fastest rate in Central Asia). Uzbekistan is completely landlocked between Kazakstan to the north, Turkmenistan to the south, and Kyrgyzstan and Tajikistan to the east. The territory of modern Uzbekistan was at the center of the rich cultural and commercial developments that occurred in Central Asia over a period of two millennia, especially along the axis defined by the Silk Route between Europe and China. Included in Uzbekistan are the three chief Silk Route outposts of Bukhara, Khiva, and Samarkand.

Historical Background

Uzbekistan, the most populous and arguably the most powerful state in Central Asia, has a long and magnificent history. Located between two rivers--the Amu Darya to the north and the Syrdariya to the south--the region that is modern Uzbekistan has been one of the cradles of world civilization. Some of the world's oldest sedentary populations and several of its most ancient cities are located here. Beginning at the height of the Roman Empire, the region was a crossroads on the transcontinental trade routes between China and the West. Subject to constant invasion and to in-migration of nomads from the great grasslands to the north, Uzbekistan became a region of legendary conquests where various peoples with different traditions have consistently had to live together.

Alexander the Great stopped near Samarkand on his way to India in 327 B.C. and married Roxanna, daughter of a local chieftain. Conquered by Muslim Arabs in the eight century A.D., the indigenous Samanid dynasty established an empire in the 9th century. Genghis Khan and his Mongols overran its territory in 1220. In the 1300s, Timur, known in the west as Tamerlane, built an empire with its capital at Samarkand. Uzbekistan's most noted tourist sites date from the Timurid dynasty. Later, separate Muslim city-states emerged with strong ties to Persia. In 1865, Russia occupied Tashkent and by the end of the 19th century, Russia had conquered all of Central Asia. Russia placed the rest of Central Asia under colonial administration, and invested in the development of Central Asia's infrastructure, promoting cotton growing and encouraging settlement by Russian colonists.

In 1924, following the establishment of Soviet power, the Soviet Socialist Republic of Uzbekistan was founded from the territories including the Khanates of Bukhara and Khiva and portions of the Fergana Valley that had constituted the Khanate of Kokand. During the Soviet era, Moscow used Uzbekistan for its tremendous cotton growing and natural resource potential. The extensive and inefficient irrigation used to support the former has been the main cause of shrinkage of the Aral Sea to less than a third of its original volume, making this one of the world's worst environmental disasters. Uzbekistan declared independence on September 1, 1991.

Before the collapse of the Soviet Union, Uzbekistan was the third largest Soviet republic by population and the fourth largest in territory. Because it has a population that is more than 40 percent of the combined population of the five Central Asian states of the former Soviet Union, and because it has rich natural resources, many experts believe that Uzbekistan is likely to emerge as the dominant new state in Central Asia.

Government and political conditions

State organization of Uzbekistan is democratic Republic. Administrative-territorial division is regional, district. Highest state legislative body is Oliy Majlis (Parliament) of the Republic of Uzbekistan. The representative and executive power on the corresponding territory is headed by the Khokim (governor) of the region, district and town. The Republic of Uzbekistan includes: the Republic of Karakalpakstan, 12 regions, 157 districts, 118 towns. The head of state is the President. Under terms of a December 1995 referendum, the president's first term was extended. Another national referendum was held January 27, 2002 to yet again extend the President's term. The referendum passed and the President's term was extended by act of the parliament to December 2007. The 2002 referendum also included a plan to create a bicameral parliament. Currently, the building to house the new parliament is build. Elections for the new bicameral parliament were held in December 26, 2004 and the new representatives have begun their terms since January 2005.

Defence

Uzbekistan possesses the largest and most competent military forces in the Central Asian region, having around 65,000 people in uniform. Its structure is inherited from the Soviet armed forces, although it is moving rapidly toward a fully restructured organization, which will eventually be built around light and Special Forces. The government has accepted the arms control obligations of the former Soviet Union, acceded to the Nuclear Non-Proliferation Treaty (as a non-nuclear state), and has supported an active program by the U.S. Defense Threat Reduction Agency (DTRA) in western Uzbekistan (Nukus and Vozrozhdeniye Island). The Government of Uzbekistan spends about 3.7% of GDP on the military but has received a growing infusion of Foreign Military Financing (FMF) and other security assistance funds since 1998. Uzbekistan approved U.S. Central Command's request for access to a vital military air base in southern Uzbekistan following the September 11, 2001 terrorist attacks in the U.S.

Population

Uzbekistan is Central Asia's most populous country. Its 25 million people, concentrated in the south and east of the country, are nearly half the region's total population. Much of its population was engaged in cotton farming in small rural communities. The population continues to be heavily rural and dependent on farming for its livelihood. Uzbek is the predominant ethnic group. Other ethnic groups include Russian 5.5%, Tajik 5%, Kazakh 3%, Karakalpak 2.5%, and Tatar 1.5%. The nation is 88% Sunni Muslim and 9% Eastern Orthodox. Uzbek is the official state language; however, Russian is the de facto language for interethnic communication, including much day-to-day government and business use.

The educational system has achieved 97% literacy, and the mean amount of schooling for both men and women is 11 years.

Relative to the former Soviet Union as a whole, Uzbekistan is still largely rural: roughly 60 percent of Uzbekistan's population lives in rural areas . The capital city is Tashkent, whose 2000 population was estimated at about 2.1 million people. Other major cities are Samarqand (population 366,000), Namangan (308,000), Andijon (293,000), Bukhoro (224,000), Farghona (200,000), and Quqon (182,000).

The population of Uzbekistan is exceedingly young. In the early 1990s, about half the population was under nineteen years of age. The growth of Uzbekistan's population was in some part due to in-migration from other parts of the former Soviet Union. Several waves of Russian and Slavic in-migrants arrived at various times in response to the industrialization of Uzbekistan in the early part of the Soviet period, following the evacuations of European Russia during World War II, and in the late 1960s to help reconstruct Tashkent after the 1966 earthquake. At various other times, non-Uzbeks arrived simply to take advantage of opportunities they perceived in

Central Asia. Demographers project that the population, currently growing at about 2.5 percent per year, will increase by 500,000 to 600,000 annually between the mid-1990s and the year 2010. Thus, by the year 2005 at least 30 million people will live in Uzbekistan.

Table 1 Population

(per 1,000 population unless otherwise indicated)

	1997	1998	1999	2000	2001
Population (`ooo; mid-year)	23,561	23,954	24,230	24,900	25,150
Crude birth rate	25.5	23.0	22.3	21.5	20.9
Crude death rate	5.8	5.8	5.3	5.5	5.3
Life expectancy at birth (yr;av)	70.3	70.3	70.3	70.3	70.3
Men	68.1	68.2	68.1	68.1	n/a
Women	72.7	73.1	73.2	73.2	n/a
Urban (% of total population)	37.8	37.6	37.6	37.6	n/a
Rural (% of total population)	62.2	62.4	62.4	62.4	n/a
Population per doctor	328	296	302	306	309
Hospital beds	6.6	5.8	5.6	5.6	5.5
Healthcare spending ,% of GDP	4.0	3.6	3.3	2.6	2.6
Average family size (persons)	5.5	5.6	5.5	5.5	5.4

Sources: IMF, Republic of Uzbekistan-Recent Economic Developments, 2000; UN Development Programme (UNDP), Uzbekistan: Human Development Report, 2000; TACIS, Uzbekistan Economic Trends.

Labor

Literacy in Uzbekistan is almost universal, and workers are generally well-educated and well-trained. However, worsening corruption in the country's education system in the past few years has begun to erode Uzbekistan's advantage in terms of its human capital, as grades and degrees are routinely purchased. Most local technical and managerial training does not meet international business standards, but foreign companies engaged in production report that locally hired workers learn quickly and work effectively. Foreign firms generally find that younger workers work well at all levels. The government emphasizes foreign education and each year sends about 50 students to the United States, Europe, and Japan for university degrees. Some American companies offer special training programs in the United States to their local employees. In addition, Uzbekistan subsidizes studies for students at Westminster University--the only Western-style institution in Uzbekistan. In 2003, Westminster admitted about 360 students and the government funded about half of the students' education.

With the closure or downsizing of many foreign firms, it is relatively easy to find qualified, well-trained employees, and salaries are very low by Western standards. The government has implemented salary caps in an attempt to prevent firms from circumventing restrictions on the withdrawal of cash from banks. Some firms had tried in the past to evade these limits on withdrawals by inflating salaries of employees, allowing firms to withdraw more money. These salary caps prevent many foreign firms from paying their workers as much as they would like. Unemployment is a growing problem and the number of people looking for jobs in Russia, Kazakhstan, and Southeast Asia is increasing each year. According to official Ministry of Labor estimates, around 100,000 citizens of Uzbekistan work abroad.

Table 2 Labour force

(`000 unless otherwise indicated; annual average unless otherwise indicated)

	1997	1998	1999	2000	2001
Agriculture	3,533	3,467	3,220	3,093	3,062
Industry	1,109	1,114	1,124	1,145	1,160
Construction	550	573	640	676	702
Transport and communications	360	362	370	382	394
Trade	715	717	735	754	778
Services	1,965	1,971	2,045	2,182	2,226
Health	500	502	538	587	605
Education	1,070	1,073	1,094	1,146	1,172
Total employment incl others	8,680	8,800	8,885	8,983	9,136
Officially registered unemployment (year-end)	35.4	40.1	45.2	42.0	43.6
% of workforce	0.3	0.3	0.4	0.3	0.3

Source: Interstate Statistical Committee of the Commonwealth of Independent States (CIS), Statistical Yearbook.

Natural and Geographic Conditions

The Republic of Uzbekistan is a region with most favorable natural and geographical conditions. Located in the central part of Central Asia, between the Amudarya and Syrdarya rivers, it stretches for 1,425 km from west to east and 930 km from north lo south.

The total length of the slate border is 6,221 km, of which the border with Kazakhstan takes 2,203 km, that with Kyrghyzstan 1,099 km, with Tajikistan 1,161 km, with Turkmenistan 1,621 km and with Afghanistan 137 km.

The territory of Uzbekistan is a certain combination of valley and mountain surface. The highest point of Uzbekistan is 4643 m above sea level. Uzbekistan has an area slightly larger than that state of California, and is one of two countries in the world that has the dubious honor of being doubly landlocked. (Goods must pass through two other countries to reach a port, the only other country which shares this trait is Liechtenstein.). The majority of Uzbekistan is desert steppe broken by fertile oases along the banks of two great rivers, the Amu Darya and Syr Darya

The ecologically damaged Aral Sea and the vast deserts surrounding it characterize western Uzbekistan and the autonomous Republic of Karakalpakstan. Overuse of the rivers that feed the Aral Sea has led to a severe reduction in the sea's size, destroying the traditional fishing culture of the region. The salt and sand that the receding sea has left behind makes the surrounding land useless for agriculture as well. The entire economic viability of the area is currently in question.

The country has a sharply continental climate, with a large range of temperatures during the day and night, and in summer and winter. Dry weather is typical of the country, which implies a low level of atmospheric precipitation, a low relative air humidity in summer, few clouds and, due to this, a considerable amount of solar radiation. The length of day in summer is about fifteen hours and not less than nine hours in winter.

The coldest month in Uzbekistan is January, when the temperature in the north can go down to minus eight, though in the extreme south, in the region of Termez, temperatures are usually positive. The absolute temperature minimum in winter can be minus 35-38"C. In the north of Uzbekistan, winter lasts almost five months, while in the valleys it lasts for just one and a half to two months.

The hottest month in summer is July and in the mountains it is July and August. In summer, the average temperature on the plains and in the foothills is plus 25-30"C, whilst in the south (Termez and Sherabad) it is up to 31 -32"C, with the absolute level of summer temperatures above 42"C.. A temperature of 42-47"C is normal for all the plains and foothills of Uzbekistan. In the desert, during the hot lest period, the temperature can rise to plus 70°C.

Table 3 National energy statistics(Domestic production)

	1999	2000	2001	2002	2003
Oil M tones `000 b/d	 8.1 162.7	 7.5 150.6	 7.5 144.8	 7.2 145.4	 7.1 142.6
Gas (bn cu metres)	56.0	56.0	57.4	58.4	57.5
Electricity (m kwh)	45,300	46,800	47,100	47,929	n/a
Coal (`000 tonnes)	2,955	2,540	2,711	2,735	n/a

Sources: IMF; World Bank; Petroleum Economist; TACIS, Uzbekistan Economic Trends; UzReport website; Economist Intelligence Unit.

Agriculture and Natural Resources

Agriculture and the agro-industrial sector contribute more than 40% to Uzbekistan's GDP. Cotton is Uzbekistan's dominant crop, accounting for roughly 45% of the country's exports. Uzbekistan also produces significant amounts of silk, fruit, and vegetables. Virtually all agriculture involves heavy irrigation. Farmers and agricultural workers have very low incomes because the government uses the difference between the world prices of cotton and wheat and what it pays the farmers to subsidize highly inefficient capital-intensive industrial concerns, such as factories producing automobiles, airplanes, and tractors.

Minerals and mining also are important the Uzbekistan economy. Gold is Uzbekistan's second most important foreign exchange earner at 22%. Uzbekistan is the world's seventh-largest producer, mining about 80 tons per annum, and holds the fourth-largest reserves in the world. Uzbekistan has an abundance of natural gas, used both for domestic consumption and export; oil almost sufficient for domestic needs; and significant reserves of copper, lead, zinc, tungsten, and uranium.

Table 4 Agricultural production

(`000 tonnes unless otherwise indicated)

	1999	2000	2001	2002	2003
Wheat	3,602	3,522	3,786	4,956	4,550
Cotton (raw)	3,600	3,002	3,275	3,200	2,856
Cotton fibre	1,021	1,000	1,015	1,008	914
Potatoes	658	731	736	730	730
Vegetables	3,201	3,086	3,227	3,166	3,159
Tobacco	19	19	19	18	18
Grapes	344	624	574	570	570
Milk (bn tonnes)	3,626	3,723	3,754	3,637	3,790
Eggs (m tonnes)	69,634	70,389	73,751	75,751	82,750
Wool (m tones)	15,702	15,834	15,912	16,000	16,000

Source: UN Food and Agriculture Organization (FAO).

Privatization

Privatization of the large state industrial and agricultural enterprises, which dominated the economy in the Soviet era, proceeded very slowly in the early 1990s. The initial stage of privatization, which began in September 1992, targeted the housing, retail trade and services, and light industry sectors to promote the supply of consumer goods.

Beginning with the 1991 Law on Privatization, a number of laws and decrees have provided the policy framework for further privatization. A state privatization agency, established in 1992, set a goal of moving 10 to 15 percent of state economic assets into private hands by the end of 1993. Movement in that direction was slowly in 1992, however, with only about 350 small shops being privatized. In the same period, housing was privatized at a somewhat faster pace by outright transfers or low-cost sales of state housing properties. By 1994 about 20,000 firms in small industry, trade, and services had been transferred from state ownership to the ownership of managers and employees of the firms. Nearly all such transfers were through the issuance of joint-stock shares or by direct sale.

Agricultural privatization, which began in 1990, has moved faster. Since the state began distributing free parcels of land that could be inherited but not sold, the number of peasant farms has risen dramatically (cotton-growing lands were excluded from this process). Between January 1991 and April 1993, the number of private farms rose from 1,358 to 5,800, promising a significant new contribution from private farms to Uzbekistan's overall agricultural output (see Agriculture, this ch.). Another government program, initiated in 1993, transfers unprofitable state farms to cooperative ownership. A law permitting the transfer of privately owned land was planned for 1995.

In the mid-1990s, the role of the state was gradually reduced in the productive sectors, except for energy, public utilities, and gold. The government's privatization program for 1994-95 emphasized the sale of large and medium-sized state-owned construction, manufacturing, and transportation enterprises. A set of guidelines for large-scale privatization, which went into effect in March 1994, contained several contradictory provisions that required clarification, and privatization also was slowed by the need to change the monopoly structure of state-owned enterprises before sale.

In mid-1995, the government reported that 69 percent of enterprises (46,900 of 67,700) had been privatized. Most firms in that category are relatively small, however, and all heavy industry remained in state ownership at that stage.

II. Overview of Macroeconomic Activity and Fiscal Position

Economic Policy

An important element of Uzbekistan’s economic policy has been the decision to shun privatization and foreign direct investment (FDI) in favour of industrial development funded by external debt. The government has focused on a policy of import-substituting industrialization (ISI), which entails building up domestic industries so that the economy does not have to import industrial goods. However, the quality of ISI goods is often not high, and development of these industries was aimed at the domestic rather than the export market. As a result, the ISI sector generates only minimal export earnings with which to service the large burden of hard-currency debt. The few ISI industries that do produce exportable goods tend to deliver these to former Soviet markets, thereby generating only soft-currency export receipts. There has been little progress in privatization.

Economic growth is far below potential due to:

-the country's poor investment climate;

-failure to attract foreign investment;

-an extremely restrictive trade regime, implemented in order to meet a strategy of limiting imports of consumer goods;

-failure to reform the agricultural sector of the economy, potentially the engine of economic growth for this largely rural economy; and

-the price system in Uzbekistan, which is not functioning properly due to government intervention in markets

Table 5 Gross Domestic Product

(market prices; based on IMF data, which differ from government data)

	1999	2000	2001	2002	2003
Total (US$ m)					
At current prices	17,043	13,450	11,620	9,687	8,786
Total (Som m)					
At current prices	2,128,660	3,194,504	4,925,000	7,469,300	8,533,460
At constant (1992) prices	447.9	462.7	481.7	497.1	499.0
% change, year on year	3.4	3.3	4.1	3.2	0.3
Per head (Som)					
At current prices	87,852	128,293	195,825	292,601	330,979
% real change, year on year	2.2	0.5	3.1	1.7	-0.7

Sources: IMF, Republic of Uzbekistan-Recent Economic Development, 2000; TACIS, Economist Intelligence Unit calculations.

The government accepted obligations under Article VIII of the International Monetary Fund (IMF) Articles of Agreement on October 15, 2003, establishing full current account convertibility. The government's restrictive trade regime has crippled the economy and the government urgently needs to rescind its draconian trade measures. Substantial structural reform is needed, particularly in the area of improving the investment climate for foreign investors and in freeing the agricultural sector from smothering state control. Continuing restrictions on currency convertibility and other government measures to control economic activity, including the implementation of severe import restrictions and partial closure of Uzbekistan's borders with Kazakhstan and Kyrgyzstan, have constrained economic growth and led international lending organizations to suspend or scale back credits. The closure of the borders with neighboring Kazakhstan and Kyrgyzstan in 2002 almost paralyzed Uzbekistan's consumer market, although some goods are still being smuggled into the country.

The government has made progress in reducing inflation and the budget deficit, but government statistics understate both, while overstating economic growth.

Table 6 Main economic indicators, 2003

Real GDP growth (%)	0.3
Consumer price inflation (%; av)	13.9
Current-account balance (US$ m)	401.6
Exchange rate (Som:US$; av)	971.26a
Population (m)	25.8
External debt (US $ m; year-end)	4,384.4

a-Actual

Source: Economist Intelligence Unit, Country Data.

Table 7 Real GDP growth (%)

	1997	1998	1999	2000	2001	2002	2003
Official statistics	5.2	4.3	4.3	4.0	4.5	4.2	4.4
International estimates	2.5	2.1	3.4	3.3	4.1	3.2	0.3

Sources: Ministry of Macroeconomics and Statistics; IMF, World Economic Outlook.

Table 8 Nominal gross domestic product by expenditure

(Som m at current prices; % of total in brackets)

	1996	1997	1998	1999	2000
Private consumption	304,249 (54.4)	585,948 (60.0)	879,289 (62.1)	1,301,278 (61.1)	2,008,769 (62.9)
Government consumption	127,936 (22.9)	208,193 (21.3)	303,604 (21.4)	460,090 (21.6)	656,230 (20.5)
Gross fixed investment	205,694 (36.8)	329,990 (33.8)	430,230 (30.4)	576,560 (27.1)	797,786 (25.0)
Stock building	-42,536 (-7.6)	-118,349 (-12.1)	-192,715 (-13.6)	-203,658 (-9.6)	-368,004 (-11.5)
Export of goods & services	154,792 (27.7)	264,139 (27.0)	318,587 (22.5)	386,259 (18.1)	800,479 (25.1)
Imports of goods & services	191,064 (34.2)	293,090 (30.0)	322,838 (22.8)	391,868 (18.4)	700,756 (21.9)
GDP	**559,072**	**976,830**	**1,416,157**	**2,128,660**	**3,194,504**

Source: TACIS, Uzbekistan Economic Trends.

Table 9 Gross Domestic product by sector

(% of total)

	1997	1998	1999	2000	2001
Agriculture	28.2	26.4	26.9	30.4	24.1
Industry	15.6	15.0	14.6	13.8	15.6
Construction	7.3	7.5	6.7	6.1	9.6
Transport and communications	6.5	6.2	6.2	n/a	n/a
Trade	8.4	8.5	8.7	n/a	n/a
Other services	21.5	20.6	20.6	n/a	n/a
Net indirect taxes	12.4	14.4	13.4	12.7	19.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: IMF, Republic of Uzbekistan-Recent Economic Developments, 2000; TACIS, Uzbekistan Economic Trends; Economist Intelligence Unit calculations.

Agriculture is the largest sector in the economy. In 2001 it generated 24% of GDP (the most recent full-year data available), and employed 34% of the economically active population. Most agricultural output and much light industrial output is related to cotton, and the crop is grown throughout the country. Lack of reform has stifled the sector, and, combined with several years of drought, this has continued to a 30% fall in the cotton harvest over past decade,, keeping the cotton crop below the government's target of 4m tones/year since 1994. In order to achieve self-sufficiency in food production the government has transferred to grain some of the acreage formerly given over to cotton. Nevertheless, cotton remains Uzbekistan's main source of export earnings.

Gold is the country's second-largest export earner, accounting for an annual average of about 15% of total export revenue over the past five years. Most gold is mined at the giant open-cast Muruntau goldmine in Navoi Region. Industry sources estimate output in 2001 at 86 tonnes, making Uzbekistan the world's ninth-largest producer.

The industrial sector accounted for about 16% of GDP and 13% of the economically active workforce in 2001. Most industrial production is low value added, and the sector has not adjusted to the breakdown of the command economy. To prevent the collapse of the sector the government has used protectionist policies and state-guaranteed loans with the aim of building up production of import substitutes. These policies have not encouraged the development of a broad industrial base. Instead, the sector depends on a few important foreign investments in large-scale manufacturing plants. A car factory in Andijan assembles Daewoo (South Korea) cars, mostly from imported components, and an aircraft Russian and Ukrainian aircraft. Much of the rest of industry makes agricultural machinery and is engaged in limited agro-processing activities.

Table 10 Industrial production by sector

(real % change, year on year)

	1996	1997	1998	1999	2000
Electric power	-4.5	-1.9	-2.8	-0.3	-0.9
Fuel	0.4	4.3	6.4	0.9	0.2
Chemicals & pertochemicals	15.1	0.7	25.9	11.4	9.9
Ferrous metallurgy	30.5	-16.5	-3.3	1.4	18.7
Non-ferrous metallurgy	18.3	4.6	2.3	0.7	2.8
Machinery & metalworking	40.1	44	3.3	3.1	-18.2
Forestry, woodworking, gulp & paper	21.9	5.4	6.6	16	9.6
Light industry	6.4	2.6	-2.1	6.7	16.1
Food industry	1.9	21.0	9.4	9.4	5.4
All industry	2.6	6.5	3.6	6.1	6.4

Sources: IMF, Republic of Uzbekistan-Recent Economic Development, 2000; TACIS, Uzbekistan Economic Trends.

Monetary policy

The aim of monetary policy following independence was to provide cheap finance to the industrial sector and to favoured state-owned enterprises. From August 1996 the Central Bank of Uzbekistan (CBU) kept the benchmark interest rate, the refinancing rate, negative in real terms (using the level of inflation measured by the IMF, which is as much as twice as high as officially recorded inflation). This was an important factor inundermining the exchange rate and keeping bank deposits low. The government acknowledged the need to tighten monetary policy in 2000, when it announced that it would adjust the refinancing rate on a monthly basis as part of an anti-inflationary policy. However, meeting this anti-inflationary target proved difficult, and interest rates were lowered rather than raised, weakening the exchange rate. Monetary policy was not tightened until January 2002, when the SMP began. Credit growth and cheap financing from the budget were curbed, causing a dramatic slowing of inflation in 2003.

Uzbekistan has suffered from high inflation, mainly because the state has continued Soviet-era social protection programs, bank credits for unprofitable enterprises, budget deficits, and price supports that require expanding the supply of money. As inflation has redistributed wealth, many Uzbekistanis have suffered substantial losses of real income. By 1994 annual inflation reached 1,300 percent, but government restrictions in 1995 lowered the year-end figure to 77 percent.

Inflation was approximately 21.9% in 2003. In order to combat inflation, the government has exercised strict currency controls and severe shortages of cash exist in the country. From 1996 until the spring of 2003, the official and so-called "commercial" exchange rate was highly overvalued. Many businesses and individuals were unable to buy dollars legally at these rates, so a widespread black market developed to meet hard currency demand. However, by mid-2003, the gap between the black market, official, and commercial rates had been reduced to approximately 8%. In 2004, the gap between the two rates is negligible. Although the unification of the exchange rates is a positive development, recent government restrictions on the amount of local currency and hard currency that can be carried across the Uzbek border in either direction lessen the effect of currency convertibility on the Uzbek economy. Liberalization of the trade regime, however, is a prerequisite for Uzbekistan to proceed to an IMF-financed program. Outstanding external debt reached $4.6 billion as of the end of 2003. Tax collection rates remained high, due to the use of the banking system by the government as a collection agency. Technical assistance from the World Bank, Office of Technical Assistance at the Treasury Department, and from the UN Development Program (UNDP) is being provided in reforming the Central Bank and Ministry of Finance into institutions that conduct market-oriented fiscal and monetary policy.

Table 13 Money supply

(Som m unless otherwise indicated; end-period)

	1994	1995	1996	1997	1998
Money (M1) including others	**17,736**	**46,725**	**100,793**	**130,127**	**171,751**
% change, year on year	585.3	163.4	115.7	29.1	32.0
Quasi-money	4,777	8,271	16,501	29,479	41,315
Money M2	**22,513**	**54,996**	**117,294**	**170,840**	**218,752**
%change, year on year	725.9	144.3	113.3	45.7	28.0

Source: IMF, Recent Economic Developments; Economist Intelligence Unit.

Table 14 Interest rate

(%; year-end)

	1999	2000	2001	2002	2003
Refinancing rate	42.6	32.2	24.0	30.0	20.0
Three-month Treasury bill at auction (annualized)	17.2a	17.8a	n/a	n/a	n/a

a-Six-month Treasury bill (the three-month Treasury bill has been discontinued).

Sources: IMF, Republic of Uzbekistan-Recent economic Developments, 2000; Economist Intelligence Unit.

Table 15 Exchange rates

(som per unit of currency unless otherwise indicated; annual averages)

	1999	2000	2001	2002	2003
US$ (official rate)	124.9	237.5	423.8	771.0	971.3
£	202	359	610	1,156	1,456
€	133.2	219.5	379.6	728.6	917.8
Rb	5.1	8.4	14.5	24.6	31.0
W	0.105	0.210	0.328	0.616	0.776
¥	1.10	2.20	3.49	6.15	7.75

Sources: IMF, Recent Economic Developments; Economist Intelligence Unit; BISNIS; US Embassy, Tashkent.

Fiscal Policy

The government has tried to balance its aim of keeping the fiscal deficit under control against those of providing subsidies to vulnerable sections of the population and funding industrial development. However, tax collection rates have been high, which is in part a result of continued state control of the leading sectors of the economy. As a share of GDP, both revenue and expenditure are at around 30%.

The government successfully reduced the consolidated fiscal deficit-which includes net lending and off-budget accounts-from the equivalent of 18.4% of GDP in 1993 to 4.1% of GDP in 1995. However, the failure of the cotton crop and balance-of-payments crisis in 1996 pushed the fiscal deficit back up to 7.3% of GDP in that year, according to the IMF. In 1977 the consolidated deficit shrank to 2.2% of GDP, as a result of an improved cotton crop, increased tax revenue, a surplus on extra budgetary funds and cuts in spending. However, the 1998 cotton crop was worse than in 1996, and this led to a widening of the consolidated budget deficit to the equivalent of 3.3% of GDP.

Since then, the government has kept the deficit under control, in part through a combination of a build-up of spending arrears and cutbacks in capital expenditure. The government has also lowered direct tax rates in a bid to improve compliance, reducing the rate of corporate profit tax from a peak of 35% in 1998 to 18% as of the beginning of 2004.

Table 11 Governments finances (% of GDP)

	1997a	1998a	1999b	2000b	2001b
Revenue	30.1	31.1	29.3	28.5	30.1
Privatisation revenue	0.4	0.1	0.4	0.6	0.6
Expenditure	32.5	34.5	31.1	29.5	31.6
Net lending	0.0	1.1	1.1	n/a	n/a
Balance	-2.4	-3.3	-1.8	-1.0	-2.5
Extrabudgetary funds	0.2	0.1	n/a	n/a	n/a
Consolidated balance	-2.2	-3.3	-1.8c	-1.0	-2.5c

Note: Totals may not sum owing to rounding. a-Based on IMF data. b-Government figures. c-IMF estimate.
Sources: IMF, Republic of Uzbekistan-Recent Economic Developments, 2000; Uzbek Ministry of Macroeconomic and Statistics; Interfax; TACIS, Uzbek Economic Trends.

Table 12 Government finances (Som m unless otherwise indicated)

	1996a	**1997a**	**1998a**	**1999b**	**2000b**
Total revenue	**191,551**	**293,676**	**440,140**	**623,697**	**910,434**
Direct taxes:	75,384	109,142	138,674	183,065c	239,588
-Income tax	19,889	38,965	50,569	78,760	105,419
-Income tax from self-employment	0	0	5,104	8,515	15,973
-Corporate profit tax	55,495	70,177	83,001	93,661	118,197
Social security contributions	0	0	0	0	0
Taxes on domestic goods & services:	92,373	132,289	216,205	336,328c	507,926c
-VAT	35,981	73,339	133,076	155,392	226,810
-Excises:	56,392	58,950	83,128	172,421	261,949
Cotton	12,060	5,612	0	0	0
Oil products	37,607	36,071	54,910	n/a	n/a
Land tax	5,661	10,521	19,417	25,544	28,751
Property tax	2,816	7,610	13,236	19,158	28,751
Mining tax	1,081	5,397	6,977	6,386	9,584
Water use tax	0	0	2,337	2,129	3,195
Ecological tax	0	0	10,591	12,772	19,167
Export taxes and customs	3,104	5,519	8,917	8,515	22,362
Profits from the Central Bank	300	1,800	562	n/a	n/a
Total expenditure & net lending:	**222,940**	**317,350**	**488,297**	**659,885**	**942,379**
Expenditure	202,940	317,350	472,244	n/a	n/a
National Economy	26,209	39,898	54,700	76,632	95,835
Subsidies & transfers	22,254	31,064	44,990	61,731	73,474
Investments	39,861	72,170	94,600	140,492	191,670
Social, educational & cultural	69,119	111,180	167,100	244,796	332,228
Education	41,241	69,267	107,484	159,649	223,615
Health including sports	20,727	31,907	44,649	61,731	83,057
Other incl defence & public order	39,382	55,087	90,268	n/a	n/a
Net lending	20,382	0	16,052	n/a	n/a
Balance	**-31,389**	**-23,675**	**-48,157**	**-36,187**	**-31,945**
% of GDP	-5.6	-2.4	-3.4d	-1.7	-1.0
Extrabudgetary funds & external sector balance	-9,666	1,990	1,700	208	n/a
Consolidated balance	**-41,055**	**-21,685**	**-46,457**	**-35,979**	**-31,945**
% of GDP	-7.3	-2.2	-3.3d	-1,7a	-1.0
Memorandum item					
Consolidated balance (% of GDP; official definition)	-2.0	-2.4	-2.0	n/a	n/a

a-IMF data. b-Government figures. c-Does not sum in source. d-Economist Intelligence Unit calculations based on IMF data.
Sources: IMF, Republic of Uzbekistan-Recent Economic Developments, 2000; TACIS, Uzbekistan Economic Trends.

Financial services

Uzbekistan began a movement toward a two-tier banking system. The new structure, which was ratified by the Banking Law of 1991, has a government-owned Central Bank wielding control over a range of joint-stock sectoral banks specializing in agricultural or industrial enterprise, the Savings Bank (Sberbank), and some twenty commercial banks. The Central Bank is charged with establishing national monetary policy, issuing currency, and operating the national payment system. In performing these operations, the Central Bank manipulates as much as 70 percent of deposits in the more than 1,800 branches of the Savings Bank (all of which are state owned) for its own reserve requirements. A National Bank for Foreign Economic Affairs, established in 1991 as a joint-stock commercial bank, conducts international financial exchanges on behalf of the government. The national bank holds Uzbekistan's foreign currency reserves; in 1993 it was converted from its initial status to a state bank.

In the mid-1990s, the banking structure in Uzbekistan was limited to only a handful of primarily state-owned banks, and, compared with Western banking systems, the commercial banking system was still in its infancy. But the establishment in the spring of 1995 of Uzbekistan's first Western-style banking operation--a joint venture between Mees Pierson of the Netherlands and other international and Uzbekistani partners--suggests that this sector, too, may have prospects for change. The Uzbekistan International Bank that would result from the new joint venture is intended primarily to finance trade and industrial projects. The bank is to be based in Tashkent, with 50 percent of ownership shares in Western hands. If successful, this and other similar ventures may reward policy makers' cautious approach to reform by establishing an infrastructure from which economic growth can begin.

However, as a result of government restrictions and controls, financial services are poorly developed. Banks do not act as financial intermediaries. They pay negative real interest rates on deposits, repeatedly confiscate savings, and act as a funnel for government credit and foreign loans to favoured enterprises and sectors, an the basis of bureaucratic decisions. The government taxes banks' profits and wage bills, but does not allow banks to deduct provisions for bad loans from their tax liabilities. Profit tax in Uzbekistan is assessed by the authorities and often bears no relation to actual profit-many enterprises are overtaxed, even accounting for the cuts in the rate of profit tax. Banks are believed by their foreign creditors to be insolvent, with their assets generously overvalued. As part of staff-monitored programme (SMP) that was adopted in January 2002, the government promised the IMF to reform the allocation of credit by preventing bureaucratic interference and by organizing credit auctions at the Central Bank of Uzbekistan (CBU).

Of the 35 banks in Uzbekistan at the end of 2002, 13 small concerns were privately owned. The rest, which are state-owned or state-controlled, have until now worked to priorities determined by the state: the state administratively defines which sectors should receive a credit allocation and the banks then lend to them. Overall, the banking sector is small and relies on inflows of foreign debt to lend to enterprises. Commercial bank assets were worth Som4.4 trn (US$4.4 bln) at the end of 2003, up by 13% year on year in nominal terms. The total outstanding loan portfolio of commercial banks was equivalent to 45% of GDP at the end of 2002, according to the CBU, a 43% year-on-year increase. The CBU claimed that, as of end-2003, 81% of outstanding loans were extended to enterprises on a medium-and long-term basis. What the CBU figures do not reveal is that most of these were foreign credits denominated in hard currency, which had been lent on by domestic banks to local firms. The high ratio of bank assets to GDP is inflated as a result. The level of personal deposits is low. Despite rising by 86% year on year, personal deposits were worth just Som245bn (US$252m) at the end of 2003, equivalent to about Som9.600 (US$10) per head.

The largest bank is the state-owned National Bank for Foreign Economic Activity of Uzbekistan (NB), which controls most of the commercial bank loan portfolio and around 70% of

Uzbekistan's foreign-exchange business. The NB is a foreign trade and foreign-exchange bank, but it also acquires most of the quality loans in Uzbekistan.

The Tashkent Stock Exchange is small and there is almost no foreign involvement. The longest maturity Treasury bill is 364 days, and the benchmark issue is 182 days. Although yields are negative in real terms and the market is small, T-bills are, in the Uzbek context, a liquid and safe asset, and banks can tax deduct their gross earnings from T-bills.

Positive factors

Taking into account its key geopolitical position in Central Asia today Uzbekistan is considered a country with special significance on the political and economic map of the world. The favorable climate, huge mineral resources, the large stocks of strategic materials and agricultural raw materials make Uzbekistan attractive to developed countries. The total mineral-resource potential is worth more than $ 3.3 trillion. In this context the republic holds one of the leading places in the Central Asian region. Almost 75 % deposits of gas condensate of the region, 31 % of oil, 40 % of natural gas and 55% of coal are found here. The availability of a developed transport communications system is also considered an important advantage. Uzbekistan has the highest railway and highway network density in Central Asia. The rail system exceeds 7 thousand kilometers. The existing transport communications system not only connects distant regions and populated area of the republic, but also offers access to international transport systems. Uzbekistan is conveniently located also in terms of international aircraft communication. Lying between Europe and Asia, the republic serves as an important international transport junction. Today Uzbekistan has powerful labor potential. Its labor resources comprise about 50 % of the population.

According to experts of international organizations and regional economic centers, Uzbekistan possesses all the necessary potential for attraction of large-scale foreign investment.

These are:

-the necessary legislative basis defining the legal field for entrepreneurship;
-support infrastructure for the investment process;
-a favorable geographical location;
-rich mineral resources;
-agricultural potential;
-presence of skilled manpower;
-a large market.

Foreign investors and investments only come to a country with the necessary legal basis for their activity and infrastructure to support the investment process, where political risks are low. It is difficult to overestimate the importance of this fact. In any case, this is the prior condition for a foreign investor.

Foreign relations

Uzbekistan joined the Commonwealth of Independent States in December 1991. However, it is opposed to reintegration and withdrew from the CIS collective security arrangement in 1999. Since that time, Uzbekistan has participated in the CIS peacekeeping force in Tajikistan and in UN-organized groups to help resolve the Tajik and Afghan conflicts, both of which it sees as posing threats to its own stability. Uzbekistan is an active supporter of U.S. efforts against worldwide terrorism and joined the coalitions that have dealt with both Afghanistan and Iraq. It is a member of the United Nations, the Euro-Atlantic Partnership Council, Partnership for Peace, and the Organization for Security and Cooperation in Europe (OSCE). It belongs to the Organization of the Islamic Conference (OIC) and the Economic Cooperation Organization--comprised of the five Central Asian countries, Azerbaijan, Turkey, Iran, Afghanistan, and Pakistan. In 1999, Uzbekistan joined the GUAM alliance (Georgia, Ukraine, Azerbaijan and Moldova), which was formed in 1997 (making it GUUAM). Uzbekistan is also a member of the

Shanghai Cooperation Organization (SCO) and hosts the SCO's Regional Anti-Terrorist Structure (RATS) in Tashkent. Uzbekistan also joined the new Central Asian Cooperation Organization (CACO) in 2002. The CACO consists of Uzbekistan, Tajikistan, Kazakhstan, and Kyrgyzstan. It is a founding member of and remains involved in the Central Asian Union, formed with Kazakhstan and Kyrgyzstan, joined in March 1998 by Tajikistan.

The external sector

Trade in goods

Independence put an end to subsidized communist-bloc trade, and turned a trade surplus equivalent to 2% of GDP in1991 into a deficit equivalent to 12% of GDP in 1992. The trade balance returned to surplus in 1994 because of the weakness of the som, which restrained imports, and a surge in the world prices of Uzbekistan's main exports, cotton and gold. In late 1995 and early 1996 Uzbekistan encountered a new trade crisis, when global cotton prices dropped and the stronger som led to pick-up in imports. In 1995 the slowing of the recession stimulated year-on-year import growth of almost 20%. Economic recovery in 1996 boosted imports by more than 30% year on year. In addition, the 1996 grain harvest fell a long way short of target. Uzbekistan had to buy large quantities of grain just as world grain prices were reaching a 20 year high. Foreign reserves, which had been depleted by the unforeseen grain imports, came under further strain when the 1996 cotton and grain harvests failed. The trade deficit grew out of control to more than US$700m in 1996,, pushing the current-account deficit upwards to nearly US$1bln (equivalent to just over 7% of GDP).

To bring the external deficit under control the government formally introduced four authorized exchange rates from January 1997 (there had previously been two) and imposed severe trade restrictions. As a result, the trade deficit fell sharply, and by 1998 trade was in surplus by US$171m. Since then the trade account has remained in strong surplus, owing import compression in 1999-2002, and a pick-up in global commodity prices in 2002-2003. Non cotton exports are also reported to have risen, mainly owing to an increase in metals and automotive exports to Russia. Based on official data, the trade surplus is estimated to have risen to more than US$900m in 2003.

Uzbekistan's main export is cotton fibre, which is processed from the preceding year's cotton crop. In 1991, the first year of independence, cotton fibre accounted for 54% of exports. After peaking at 61% in 1992, cotton's share of exports declined to an average of 44% in 1993-1998. In 1999, according to the Economist Intellegence Unit's estimates, the lower export price and the poor crop of 1998 pushed cotton's share of exports down further to 27%. The position stabilized in 2001-02, at an annual average of 27% of total exports, but fell to an estimated 23% of total export earnings in 2003, following a weak 2002 harvest. Moreover, official data for 2003 imply that the US dollar value of cotton export earnings was about US$725m-almost the lowest since independence.

According to IMF, gold has become an important export earner since 1993, rising from 19% of exports in that year to a peak of 26% in 1996, as the government sold gold reserves to obtain the hard currency needed to pay for grain imports. In 1998 the government cut gold exports to 10% of total exports in value terms in response to falling gold prices and the lower current-account deficit, The Economist Intelligence Unit estimates that gold provided about 14% of total export revenue in 2003, when global gold prices rose to their highest level in seven years.

Import-substituting industrialization (ISI) has successfully eliminated the dependency of Uzbekistan on energy imports, but this has been partly offset by the rising cost of importing foodstuffs and, to a lesser extent, grain. The volumes of imported foodstuffs are volatile. In good years, such as 2002-03, when Uzbek agriculture performs well and world prices move in the country's favour, foodstuffs can account for as little as 13% of imports (based on government figures). When the grain harvest is poor and food prices high, foodstuffs make up a substantially higher proportion of total import costs. For example, in 1996 they accounted for 30% of imports, accounting to government figures.

Russia remains Uzbekistan's largest trading partner, with its share of trade reviving thanks to increased cotton exports. Exports to the rest of Central Asia are mainly accounted for the gas, which is usually paid for late. About 75% of Uzbekistan's export revenue is now generated outside the CIS (Commonwealth of Independent States), with the UK, Switzerland and South Korea becoming important export markets. The first two of these countries are the initial destinations for Uzbekistan's gold and cotton sales, respectively. Much of the trade with South Korea is connected with the activities of the carmaker Daewoo in Uzbekistan. The bilateral trade deficit with South Korea exceeds the value of South Korean direct investment into Uzbekistan.

Uzbekistan did not join the CIS Customs Union between Russia, Kazakhstan, the Kyrgyz Republic, Belarus and Tajikistan, or its successor, the Eurasian Economic Community (Eurasec). However, it is a member of the Central Asian Co-operation Organization (CACO), successor to the Central Asian Community (CAEC). All intra-regional organizations in the former Soviet Union have produced little in the way of concrete results in terms of greater trade cooperation and liberalization, and generally serve more as forums for discussion than as regulatory bodies. Despite having concerns about the country's human rights record, the US has given Uzbekistan normal trade relations status. Similarly, in 1999 the US ratified a partnership and co-operation agreement (PCA). However, ratification of the PCA was delayed for two and a half years. Uzbekistan's restrictive trade arrangements make it ineligible for membership of the World Trade Organization.

There was a massive turnaround in 1996, when the IMF reported that the current-account deficit reached US$980m, equivalent to just over 7% of GDP, driven by a sharp rise in import expenditure. Stringent trade restrictions and falling import prices then slashed the deficit in 1997 to US$584m, or 4% of GDP. Although the current-account deficit was close to balance in 1998, in the first three quarters of 1999 the IMF reported that the current-account deficit grew to US$265m (2.5% 0f GDP for that period). On the basis of data published by the European Bank of Reconstruction and Development (EBRD), the Economist Intelligence Unit estimates that the current-account deficit was equal to 1% of GDP in 1999 as whole, and recorded a small surplus of 0.5% GDP in 2000.

The government put the current-account surplus at US128$m (1.1% of GDP) in 2001 and US276m (3.3% of GDP) in 2002. But, based on the sparse trade data available, Economist Intelligence Unit estimates the current-account surplus at about US$460m in 2003, equivalent to 5.3% of GDP.

Table 16 Exports

(% of total)

	1998	1999	2000	2001	2002
Cotton fibre	38.6	27.3	27.4	28.3	26.6
Energy	7.9	11.5	10.4	11.5	n/a
Metals	5.1	4.3	6.6	7.9	n/a
Machinery & equipment	4.2	3.2	3.4	n/a	n/a
Chemicals & plastics	1.5	3.1	2.9	n/a	n/a
Gold-a	9.6	n/a	n/a	n/a	n/a

a-IMF data

Sources: IMF, Republic of Uzbekistan-Recent Economic Developments, 1998 and 2000; Economist Intelligence Unit; TACIS, Uzbekistan Economic Trends.

Table 17 Imports

(% of total)

	1998	1999	2000	2001	2002a
Machinery	47.2	44.8	35.4	41.2	41.8
Chemical products & plastics	12.4	11.7	13.6	n/a	15.3
Foodstuffs	15.6	13.1	12.3	n/a	12.6
Energy products	0.5	2.1	3.8	n/a	n/a

a-Percentage of imports of goods and services.
Sources: TACIS, Uzbekistan Economic Trends; Economist Intelligence Unit

Table 18 Main trading partners

(US$ m)

	1998	1999	2000	2001	2002
Exports					
Russia	474	423	602	527	311
Ukraine	27	79	162	179	194
Italy	148	137	173	155	134
Tajikistan	207	240	169	137	120
Poland	84	43	37	82	89
Imports					
Russia	533	264	302	400	499
Germany	304	292	233	227	315
South Korea	442	376	253	380	207
Kazakhstan	131	73	153	164	178
US	162	387	183	162	152

Source: IMF, Direction of Trade Statistics.

Trade and Investment

Uzbekistan has adopted a policy of import substitution. The multiple exchange rate system and the highly over-regulated trade regime have led to both import and export declines since 1996, although imports have declined more than exports, as the government squeezed imports to maintain hard currency reserves. Draconian tariffs and border closures imposed in the summer and fall of 2002 led to massive decreases in imports of both consumer products and capital equipment. Uzbekistan's traditional "trade" partners are New Independent States (NIS) countries, notably Russia, Ukraine, Kazakhstan, and the other Central Asian countries. Non-NIS partners have been increasing in importance in recent years, with the U.S., Korea, Germany, Japan, and Turkey being the most active.

Uzbekistan is a member of the IMF, the World Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development. It has observer status at the World Trade Organization (WTO) and has publicly stated its intention to accede to the WTO. It is a member of the World Intellectual Property Organization and is a signatory to the Convention on Settlement of Investment Disputes Between States and Nationals of Other States, the Paris Convention on Industrial Property, the Madrid Agreement on Trademarks Protection, and the Patent Cooperation Treaty.

Uzbekistan's lack of currency convertibility was one of the reasons that foreign direct investment (FDI) inflows dwindled to a trickle. In fact, Uzbekistan has the lowest level of FDI per capita in the Commonwealth of Independent States (CIS). Since Uzbekistan's independence, U.S. firms have invested roughly $500 million in Uzbekistan. Large U.S. investors include Newmont, reprocessing tailings from the Muruntau gold mine; Case Corporation, manufacturing and servicing cotton harvesters and tractors; Coca Cola, with bottling plants in Tashkent, Namangan and Samarkand; Texaco, producing lubricants for sale in the Uzbek market; and Baker Hughes, in oil and gas development.

Table 19 Balance of payment

(consolidated balance; US$ m unless otherwise indicated)

	1995	1996	1997	1998	1999a
Exports	3,475	3,534	3,695	2,888	1,843
Energy	436	277	528	655	538
Cotton fibre	1,504	1,539	1,390	1,198	462
Gold	611	906	738	277	192
Imports	-3,238	-4,240	-3,767	-2,717	-1,855
Machinery	-1,151	-1,542	-1,868	-1,352	-910
Foodstuffs	-618	-1,151	-786	-446	-279
Energy products	-53	-45	-23	-16	-14
Trade balance	**237**	**-706**	**-72**	**171**	**-12**
Transportation	-218	-165	-348	-113	-103
Interest	-26	-73	-175	-101	-140
Other services (incl travel)	-33	-33	-18	-38	-42
Services balance	**-277**	**-272**	**-540**	**-252**	**-284**
Current transfers (net)	19	-2	29	43	31
Current account balance	**-21**	**-980**	**-584**	**-39**	**-265**
Foreign direct investment(net)	-24	90	167	176	138
Loans (net)	491	465	196	666	531
Commercial banks	-3	-1	432	0	21
Other capital flows	-209	80	-507	-802	-561
Capital account balance	**255**	**634**	**103 b**	**40**	**250 b**
Errors & omissions	197	296	-185	0	21
Overall balance	**431**	**-50**	**-480**	**1**	**-15**
Changes in gross reserves	-578	-33	480	-1	29
IMF credit	158	83	0	0	-14
Arrears	-11	0	0	0	0
Memorandum items (% of GDP)					
Current-account balance	-0.2	-7.2	-4.0	-0.3	-2.5
Foreign direct investment (net)	-0.2	0.6	1.1	1.2	0.8
Exports	34.7	26.0	26.0	22.2	17.4
Imports	32.3	-31,2	-26.5	-20.9	-17.5

a-January-September only. b-as in source.
Source: IMF, Republic of Uzbekistan-Recent Economic Developments, 2000.

Capital flows and foreign debt

At independence, Uzbekistan had a 3.3% share of total Soviet liabilities, then worth US$67bn, and a similar share of Soviet assets. Just over a later, in November 1992, having paid nothing towards servicing its Soviet debt, Uzbekistan renounced all claims on Soviet assets and liabilities and became debt free. However, by the end of 2001-according to the most recent data from the World Bank-the demands of the Uzbek government's policy of state-led economic development had pushed the country's total debt stock to US$4.6bn, almost 40% of GDP-a rise of about 160% compared with the end of 1995. Since then, the Economist Intelligence Unit estimates that Uzbekistan's stock of external debt has stabilized at around US$4.4%bn (equivalent to about 50% of GDP), as the pick-up in export earnings resulting from high global commodity prices has reduced the need for new debt inflows.

Foreign Direct Investment in Uzbekistan

Uzbekistan has one of the lowest cumulative inflows of foreign direct investment (FDI) in the former communist bloc. In the past the Uzbek authorities have claimed cumulative FDI inflows of around US$8bn for the period 1992-2000. The discrepancy is partly attributable to the inclusion of foreign debt inflows in FDI figures before 1998. Portfolio investment is virtually non-existent. Until late 2003 the som was not convertible for current-account transactions, and foreigners are barred from the securities markets, which are in any case small and non-transparent. Most lending to Uzbekistan is by official lenders, such as the European Bank Reconstruction and

Development (EBRD), the World Bank and, increasingly, the Asian Development Bank (ADB). Money tends to go into import-substituting industrialization (ISI) projects.

Stocks and Flows

Uzbekistan has been among the least successful of the members of he Commonwealth of Independent States (CIS) in attracting foreign direct investment (FDI). The Economist Intelligence Unit estimates that cumulative net FDI inflows at the end of 2003 amounted to about US$900m, or 10% of GDP. FDI inflows have been declining since 1997, owing to extensive restrictions on currency transactions.

Origin and Distribution

The UK, South Korea, Turkey and the US are the largest investors into Uzbekistan, with FDI directed mainly to the mining, tobacco and automotive sectors. The most sizable foreign investments include the US$300m linked with the project of British American Tobacco (BAT) to rehabilitate the tobacco industry; about US$200m from Daewoo (South Korea) for the Andijan automobile plant; and US$150m in Us foreign investment for the Newmont Mining gold-processing venture.

Determinants

Uzbekistan offers various tax breaks to foreign investors, and existing investments are protected for a period of ten years in the event of a change in FDI legislation. However, in the past, the government has imposed extensive limits on currency transactions to protect its hard-currency resources, thereby deterring foreign investors. The state maintains control over exports of important commodities, such as cotton and gold.

Impact

Figures vary, but independent sources claim that industrial production in Uzbekistan has fallen in recent years, whereas the government claims that it has risen. The decline has been most pronounced among industries with a high share of foreign joint ventures, such as electronics and automotives. These foreign companies curtailed production because of increasingly distorted prices and because of attempts by the government to intervene in management decisions. The state remains a majority shareholder in most large enterprises. Privatization has faltered, and a privatization programme announced in 1997 has still not been implemented. Major sales announced in March 2001-such as those of the state oil and gas companies, a telecommunications company, and two cement factories-attracted little interest, owing to the poor macroeconomic environment and the government's intention not to relinquish management control in the enterprises. Privatization in the oil and gas industry has now been postponed until 2008 at the earlist.

Potential

There is some scope for investment in the agriculture, mining and hydrocarbons sectors. In addition, Uzbekistan has the largest domestic market in Central Asia, with a population of about 25m, and the government claims that it wants to attract significant FDI volumes. However, although the government signed up in October 2003 to the IMF's article VIII relating to current-account convertibility, informal reports suggest that imports are still facing restrictions on access to hard currency. Moreover, the government has not reduced the plethora of restrictions on trade, which act as a serious deterrent to potential investors, as does the pervasiveness of state control throughout the economy, even in those enterprises that are nominally private. The conditions attached to the privatization of Uzbek enterprises are a further factor behind foreign investors' reluctance to enter the Uzbek market. The government embarked on a new privatization programme in mid-2003, in which it professed a willingness to sell enterprises for a zero purchase price if necessary. However, it also declared that investors would need to meet the companies' debts, and to retain the workforce. Concern over the state's heavy involment in the economy and reluctance to cede management control will remain substantial deterrents to most western investors.

Table 20 External debt, World Bank series

(US$ m unless otherwise indicated; debt stocks as at year-end)

	1997	1998	1999	2000	2001
Total medium & long-term debt	2,140	2,833	3,945	3,964	4,046
Public medium & long-term	2,033	2,579	3,476	3,602	3,759
Official creditors	1,182	1,449	1,909	2,057	2,189
Bilateral	973	1,178	1,536	1,604	1,667
Multilateral	209	271	373	454	523
Private creditors	958	1,384	2,036	1,906	1,856
Private medium & long-term	107	254	469	362	286
Use of IMF credit	223	233	202	127	78
Short-term debt	419	147	626	282	503
Interest arrears	0	3	3	3	4
Official creditors	0	0	0	0	0
Private creditors	0	3	3	3	4
Total external debt	2,782	3,213	4,773	4,373	4,627
Principal repayments	325	206	352	625	616
Interest payments	187	143	200	226	217
Short-term debt	14	6	20	23	16
Total debt service	512	350	552	851	833
Ratios (%)					
Debt-service ratio, paid-a	12.3	10.2	16.5	24.5	24.5
Total external debt/GDP	18.9	21.5	28.0	32.5	39.8

Note. Long-term debt is defined as having original maturity of more than one year.
a-Debt service as a percentage of earnings from exports of goods and services.
Source: World Bank, Global Development Finance.

III. Tax Structure: Institutions and the Reality

1.1 Outline of Tax System in Uzbekistan

The tax service of Uzbekistan is commissioned to implement the state policy in the sphere of taxation. It represents a system of bodies, whose aim to ensure the execution of the tax law. The tax authority of the Republic of Uzbekistan is of the same age as the nation's independence (1991). On June 14^{th}, 1991, the Republic's supreme legislative authority has approved Regulations on the state tax bodies of the Republic of Uzbekistan, followed by Resolution No 217, "On the state tax bodies of Republic of Uzbekistan" issued by the Cabinet of Ministers on August 12^{th} 1991.

Its approved structure has been in place since 1994, when the State Tax Administration operating at the Cabinet of Ministers has been re-organized into the State Tax Committee pf the Republic of Uzbekistan in accordance with a corresponding Presidential Decree.

The State Revenue Administration of the Finance Ministry of the Uzbek SSR and its regional sub-divisions are viewed as the predecessors of the tax authority of the Republic of Uzbekistan. Below, is the structure of the Tax System of the Republic of Uzbekistan

Table 21 The Tax System of Uzbekistan

National Taxes	Local Taxes
-Corporate Income Tax -Individual Income Tax -V.A.T -Excise Tax -Ecological Tax -Tax for using natural resources -Tax for using water resources	-Property Tax -Land Tax -Tax for using gas, gasoline and petroleum -Tax for development social infrastructure -Tax (fee) for registration taxpayers -Other taxes and duties

Source: State Tax Committee of Uzbekistan

The process of formation of the nation's tax system can be divided into three major stages. These are as follows:

I. The first stage covers the period from 1991 up to 1994, when the following tasks have been tackled:
   -the creation and implementation of a system of fundamentally new taxes and payments, capable of meeting the requirements of a transition period;
   -the ensuring of a steady inflow of revenues to the budget at a time when the latter comes under the pressure of inflationary processes, slump in production volumes and, as a result, an increase in the number of loss-making enterprises and so on.
II. At the second stage (1995-1999), the tax system became more stable, with certain taxes and payments inconsistent with the principles of a market-oriented economy being abolished. It should be mentioned that this period saw the introduction of profit tax, which stipulated the granting of numerous privileges and incentives to enterprises investing their own resources in the introduction of new technologies and expansion of production facilities. At the same time, the overall number of taxes was reduced significantly. VAT rates were lowered.
III. A number of tasks aimed at liberalization of all spheres of society, which have been set by the government, constitute the foundation of the third stage in the development of the nation's tax system (starting the year 2000).

Now, the Constitution and Tax Code of the Republic of Uzbekistan is the legal base of imposing a tax. The 51^{st} article of the Constitution of the Republic of Uzbekistan adopted in 1992 on the 8^{th} of December states that "citizens should pay their taxes and local levies, which are fixed by the law". Regulatory documents, such as the Law of the Republic of Uzbekistan "On the state tax service" of August 29th, 1997 and the other Resolutions issued by the Cabinet of Ministers, constitute the legal foundation of the tax authority's activity in Uzbekistan.

Table 22 The Tax System of Uzbekistan

	Group of taxes	Types of taxes	Rates of taxes and dues	Object of taxation
Taxes, dues and payments	**State taxes**	Value added tax (VAT)	20%	Value of production
		Excise tax	Different, on the kind of goods	Value of production, before VAT
		Income tax of enterprises (single tax) Tax on revenue	18, (30, 18, 6) (13%)	Net profit, Total revenue,
		Individual income tax	13, 21, 30%	Income of natural persons
		Tax for using water resources	On the enterprises and on the sources of water resources	Volume of used water resources, kb. M
		Tax for using natural resources	Different on the kind of natural resources	Volume of used natural resources,
		Ecological tax	1%	Cost of production
	Local taxes	Land tax	Level of land	Square of land
		Property tax	For legal persons-3.5%, for individuals different	For legal persons-average value of property, For natural persons-value
		Infrastructure tax	8%	Net profit after paying income tax
		Tax for using gas, gasoline and petroleum	30 sum per liter	Volume of purchasing
		Payment for license trade	3.5 min earnings for month.	-
		License payment for trading the alcohol products	5 min earnings for month	
		Payment for registration the legal and natural persons	5 min earnings for month.	
		Dues for automobile parking	75 sum for hour.	-

Source: State Tax Committee of Uzbekistan

1.2 Tax Administration in Uzbekistan

On August 12th, 1991, the Cabinet of Ministers has approved Resolution No 217, "On the state tax bodies of the Republic of Uzbekistan". Beginning this date, tax bodies have been acting as the state tax service of the independent Republic. In the first year of the new millennium, the nation's tax service, being of the same age as the sovereign Republic of Uzbekistan, celebrates its 13th anniversary.

The system of Uzbekistan's state tax bodies represents an integral centralized system built as a multi-level hierarchical organization, which includes a republican, regional and district level.

Currently we have 12 regional taxation bureaus and 208 city tax offices with over 14500 staff members at present in order to maintain proper and fair taxation and to improve taxpayers' compliance.

The State Tax Committee of the Republic of the Uzbekistan is considered to be the tax service's central body, whose main objective are to implement the state tax policy and to protect economic interests and property rights of the state.

Regional administration are regarded as an intermediate link in the system of tax bodies, designed to ensure both the efficient functioning of the entire tax service and interaction between the administration's central machinery and local tax offices.

Table 23 The Structure of the Tax authority

The Tax Committee of the Republic of Uzbekistan
Regional Taxation Bureaus-12
Tax Offices-208

Source: State Tax Committee of Uzbekistan

1.3 Tax collection

The Uzbekistan tax system is based on self-assessment. It requires taxpayers to compute their tax base and tax liabilities and to file and final returns to district tax inspections. Collection is also primarily achieved through voluntary payments by taxpayers.

With a view to levying taxes, duties and other payments from taxpayers, the tax bodies accept financial accounts and interim calculations of taxes due to be paid, as well as aggregate income declarations from natural entities, who receive income from more than two sources, and income declarations from foreign citizens. Additionally, they issue receipts to natural entities, who are payers of taxes on property, land and motor vehicles, as well as collection orders etc.

District tax offices are involved in collecting a variety of local taxes. They are considered to be functionaries working directly with taxpayers at the place of residence.

With a view to ensuring the accurate collection of the obligatory payments associated with social insurance, decreasing the number of existing administrative structures and improving the efficiency of the use of funds directed to the payment on pensions and allowances, the State Tax Committee, starting January 1st, 2001, is commissioned to collect money funds and to execute control over their transfer to the off-budget Pension Fund, in accordance with a government decision.

Current taxes levied by national and local governments in Uzbekistan. According to the 6th article of the Tax code taxes, which are, collected in the territory of the Republic of Uzbekistan may be adopted and rejected only by the Oliy Majlis (Supreme Assembly). And also, the types of taxes are shown in this article. According to this article, taxes are divided into State and Local taxes. (see Table 21)

The General Account budget covers most of expenditures for the government's primary operations and is mainly financed by tax, duty revenue and non-budget funds, like Pension fund, Road fund and etc.

In FY 2003, the General Account Total Revenue (without special budget funds) was 2342,5 billion sum where 2147,6 billion sum belongs to taxes, 86,1 billion sum to custom duties and 108,8 billion sum to other revenues. The General Account Total Expenditure (without special budget funds) was 2377,1 billion sum where expenditure for the social sphere was 899,9 billion sum, social security - 199,7 billion sum, economic assistance - 286,6 billion, industrial investments - 320,0 billion, provision of government bodies - 46,6 billion, provision of self-control bodies - 11,8 billion and the others - 612,3 billion sum. Budget deficit was 34,5 billion sum.

Analyzing content of the General Account Budget we can say that taxes are the main source of revenue. In FY 2003, the share of direct taxes in the Total Tax Revenue was 585,5 billion sum (27,7%), the share of indirect taxes was 1267,7 billion sum (59,9%) (see Table 4). In 1991 the shares of the direct taxes were very high than other taxes. From 1992 the shares of the indirect taxes have begun to increase.

Besides this, there are other taxes, which are called resource taxes. But in 1991 there wasn't any kind of resource taxes. Later, the shares of the resource taxes also increased in the budget.

1.4 The methods of coordination, planning and organization of check ups

With the purpose of reducing the number of check-ups of economic establishments under all types of ownership and barring both the duplication and ungrounded interference in their activity by the control authority, the august 8th, 1996 Presidential Degree has resolved to entrust the coordination of all check-ups and inspections of the financial and economic performance of economic establishments, including legal and individual taxpayers, to the State Tax Committee.

The October 22, 2000 Resolution issued by the Cabinet of Ministers has laid down that an enterprise's financial and economic performance may be checked by the tax and other control authority no earlier than 24 months after the last check-up has been conducted, provided a positive audit resolution is available.

As a result of the measures undertaken in the year 2000, the number of extraordinary and unfounded check-ups of small and medium-sized businesses has decreased 18 times compared with that held in 1999.

Active work is under way to improve a computer program needed to form plan-schedules of check-ups to be accomplished by the controlling authority.

1.5 International activity

International double taxation may adversely affect the development of the national economy, as it hampers the inflow of foreign investments, which are rightfully viewed worldwide as the fuel for rapid economic growth.

To create a favorable business environment, in which enterprises set up with a share of foreign capital cam operate efficiently, work is under way at the State Tax Committee to reach as many international agreements on the avoidance of double taxation as possible.

For the time being, the number of such agreements signed by the Uzbekistan is follows:

-34 agreements on the avoidance of double taxation, of which 29 have already come into effect and 9-initialed;

-5 agreements on cooperation and mutual assistance as regards the compliance with tax law;

-4 agreements on cooperation and information exchange in the field of control over the violation of law.

The State Tax Committee has been actively cooperating with the German Technical Cooperation Society. The implementation of its projects fosters the activity of the tax colleges based in the towns of Tashkent, Bukhara and Ferghana. Moreover, under these projects, a great number of books on the tax system of Uzbekistan have already been published, and several trips to Germany organized in a move to facilitate the exchange of experience in the income declaration and personnel domains.

1.6 Institutional aspects of taxation

One of the most challenging tasks faced by the countries in transition is the development of an efficient and equitable tax administration. This task is far from simple as institution building takes time and involves changes in the deep-seated incentives and behaviors of taxpayers and public officials.

Table 24 Indicators of efficiency of tax administration in Uzbekistan and selected economies in transition, around 1998

Country	Value added tax			Social Security Taxes			Corporate Income Tax		
	statutory tax rate	VAT/ GDP	E/S ratio[a]	stat utory tax rate	SST/ GDP	E/S ratio	statutory tax rate	CIT/ GDP	E/S ratio[a]
Czech Rep.	22	7.1	0.40	47.5	15.2	0.94	39.0	3.4	0.23
Hungary	25	7.9	0.40	57.0	13.1	0.80	18.0	1.9	0.26
Poland	22	8.3	0.46	48.2	11.0	0.76	38.0	3.1	0.20
Kazakhstan	20	3.5	0.21	32.0	6.2	0.68	30.0	2.4	0.15
Kyrgystan	20	5.6	0.34	37.0	5.9	0.68	30.0	1.1	0.06
Russia	20	7.2	0.43	39.5	9.9	0.71	35.0	4.2	0.33
Tajikistan	20	1.5	0.09	38.0	1.6	0.31	40.0	1.2	0.04
Uzbekistan[b]	**17**	**6.1**	**0.42**	**43.0**	**6.7**	**0.61**	**37.0**	**7.9**	**0.47**
EU15 mean			0.45			0.88			0.24

Source: Schaffer and Turley (2001)

Notes: [a] The effective/statutory ratio (E/S ratio) is a measure of the effectiveness of tax administration. It is obtained by dividing the observed tax yields by the theoretical yields obtainable on the basis of the tax code. If the ratio is equal to one, all the taxable income was collected. A ratio below 1 indicates that the effective tax yield falls short of what the application of the statutory rate would have yield due to tax breaks, arrears, avoidance and evasion. [b] Refers to 1997.

1) Income (profit) Tax for corporations

In the early years of transition, corporate and personal income tax and property taxes constituted the main source of revenue and so contributed to a progressive incidence of the tax burden. (Table 25)

Table 25 Structure of taxation by main tax instruments, 1995-2002

(%)

	1995	1996	1997	1998	1999	2000	2001	2002
Tax/GDP ratio[a]	**34.6**	**34.3**	**30.1**	**32.4**	**29.3**	**27.8**	**26.0**	**25.0**
Tax revenue – total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Corporate income tax	24.5	28.9	23,9	18,8	19.1	12,9	11,1	9.2
Personal income tax	8.1	10,5	13,3	12,6	13,3	13,3	15,0	14.0
Property taxes	4.3	5.0	8.0	12.0	10.9	10.1	9.2	9.6
Value added tax (VAT)	16.5	18,7	24,9	30,2	24,6	27,0	25,4	28.4
Excises and duties	26.6	31.2	21,9	21,0	29,0	30,2	26.5	30.0
Other taxes	20.0	5.7	8.0	5.4	3.1	6.5	12.8	8.8

Notes: [a] Does not include payroll taxes

Source: Derived from Tables

The comparatively good performance of tax collection in Uzbekistan is particularly evident in the case of the corporate income tax. In this case the E/S ratio is high not only because the statutory tax rate was in 1997 a bit higher than in the neighboring countries, but also mostly because tax breaks, arrears, deferrals, write-offs, avoidance and evasion were smaller than in the rest of the CIS and Central European countries.

However, in Uzbekistan, since 1997-8 there was a shift from direct to indirect taxes – while within the direct taxes the emphasis switched from firms to individuals. As a result, the tax burden on corporations declined rapidly so that in 2002 the profit tax accounted for only 9 percent of total tax revenue (excluding payroll taxes), as compared to 25 percent in 1995.

The decline in the profit tax was compensated by an increase in personal income tax and – especially - by a rise in indirect taxes such as VAT and excises that now account for 60 percent of the overall revenue, as against an average of 33 percent in the economies in transition and 28 percent in the high income countries. Growing reliance on VAT, excises, payroll taxes and administrative and registration fees, i.e. taxes that are known to be moderately-to-highly regressive, has likely affected negatively the incidence of taxation by income level. This trend was exacerbated by the fact that while all essential items were in the past subject to a reduced 10 percent VAT rate this was raised to the unified 20 percent rate in 2000.

According to the Tax Legislation of the Republic of Uzbekistan Income (profit) Tax is one of the main sources of the budget income. Yet a receipt of this tax is decreasing during 1996 and 2004 (Table 26). One of the factors of decrease in receipts can be gradual reduction of the rate of this tax from 37% in 1996 to 18% in 2004.

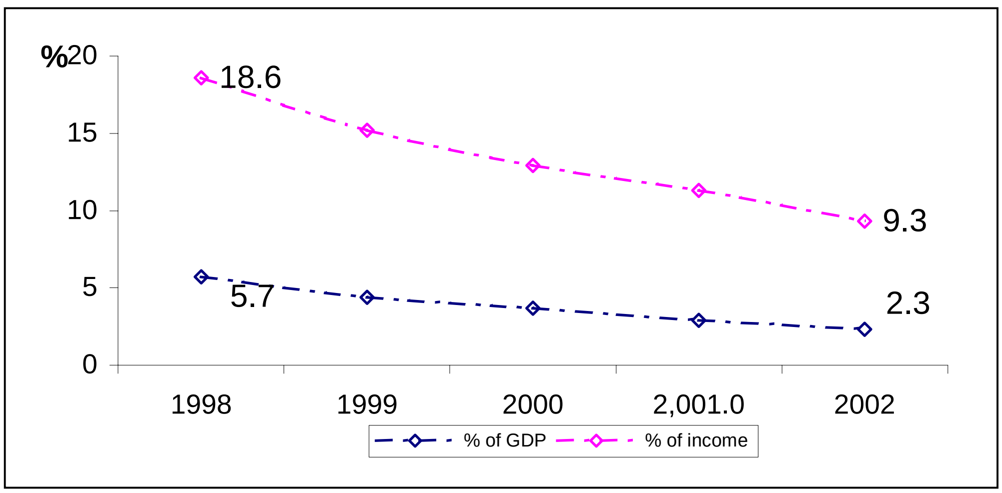
Table 26 Comparative dynamics of changes in Income Tax receipts and its rate

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Tax rate, %	37	36	35	33	31	26	24	20	18

As data demonstrate, policy being conducted in the taxation of the profit is not giving positive results. Even though the rates are reduced; taxable base is not growing, which would secure corresponding growth of receipts.

In order to better determine the relationship between receipts and the rates, it is possible to apply the index of elasticity of receipts to the rates of taxation, which is determined as percentage of changes in tax receipts at corresponding changes in the rates of taxation.

Figure 1 Dynamics of Income Tax receipts



Analysis of dynamics of Profit Tax shows that the weight of this tax in the GDP decreased from 3.6% in 2000 to 2,3% in 2002. It is also necessary to note that, the weight of Profit tax in the structure of the state budget decreased from 13% in 2000 to 9,3% in 2002 (graph 1). It is seen from the graph that, until 1999 inclusive the tax had fiscal character. Transition to the conception of tax regulation that envisages decreasing the tax burden, under taxation of the profit is realized through reduction of the tax rates. However, impact of other factors: worsening of financial position of the enterprises, broadening the practice of granting privileges and presence of fiscal mechanisms of calculating taxes unambiguously led to the decline in Income Tax receipts to the Budget of the Republic.

Receipts of the Income (profit) Tax depend on, mainly, (if the factor of inflation is excluded) two components: taxable base- amount of profit in the economy and costs, included in taxable base in reverse order and on the taxation rate.

Mechanism of Calculation: According to the Tax Code of the Republic of Uzbekistan object of Income (profit) Tax taxation is income (profit), calculated as a difference between total income and deductions, determined according to this Code, and the payers of the Income (profit) Tax are juridical persons, that have taxable income (profit) in that financial year.

In mechanism of determination of taxable base two categories of profit are used:

-profit before payment of taxes;

-taxable profit

Divergence between these two categories is costs, that according to the Act “On structure of the costs…….” Are not subject to deduction from the Gross

Revenue and are subject to inclusion to taxable income that is increase accounting profit up to taxable.

Taxable profit is determined according to following formula:

TP= (GR-D)+CRI-P)*R

Where,

TP- taxable profit;

GR- Gross Revenue;

D- Deductions;

CRI- Costs that are reverse included in the taxable base;

P-Privileges;

R-Tax rate

In composition of gross profit are included a money means for loaded commodity, executed works, doing a service and other operations, being subject to receive by juridical persons.

In calculation the tax for profit in accordance with tax legislation in taxation base at the same time with balance profit include expenses, according to Enclosure №1 "Article of expenditures, including in taxation base".

This is such named, permanent differences, which are not annul in the following periods. At the same time, in "Statute of structure of expenditures on production and realization of products (works, services) and order of forming financial results" drive Enclosure №2, where give list of expenditures, which also subtract from profit of enterprise in calculation net profit, don't expect from taxation base in the moment of their rise, but unlike permanent differences are subject to exception from taxation base in following periods divergence of time or time difference.

Difference in reflection expenditures for the aim of accounting and for the aim of taxation called that the basic aim of accounting, is calculation of expenditures and definition their effective activity and borrowing power. But tax organs are interesting in taxation profit, which are determined by the way adding individual articles of expenditures of enterprises to account profit according to tax legislation.

2) Individual Income tax.

The results of the analysis showed that the share of individual income tax had decreased from 3.7% to GDP in 1999 to 3.1% in 2000, this tendency displayed also in the income structure of the budget.

Table 27 Budget revenue from the individual’s income tax

	1996	1997	1998	1999	2000	2001	2002
%, to the GDP		3.7	3.6	3.7	3.3	3.3	3.1
%, to the budget, revenue		12.4	11.3	12.5	11.6	12.9	12.4

The problem of lowering the level of the tax burden from the profit of natural persons last time is finding paramount meaning in the perfecting of income tax. The wage of workers of budget organizations from the point of view of taxation is the most stable sours even at the high tax burden, in this way the possibility of its receiving excepted practically. What is about the wage in self-financing, commercial organizations, tax burden, first of all, promoted receiving of income and avoiding taxation of real income.

Table 28 Position of salary fund

	1997	1998	1999	2000	2001	2002
Accrual fund of salary, bln sum	170.9	283.1	424.7	602.3	987.9	1330.7
%, to the GDP	17.5	20.0	20.0	18.9	20.3	17.8

Facts of table are testing to tendency to lowing the fund of wage is negative and do not promoting the growth of arrivals income tax in budget.

Level of withdrawal of income tax from profits of natural persons: Dynamic of middle tax rate determine population's income with 5 and more minimum wages. So transition in 2001 to three-level rate of income taxation with maximum rate of 36% for getting more than 8 minimum wages, present of withdrawal of tax lowered: in 10-multiple level of minimum wages from 25.4% in 2000 to 22% in 2001, in 20-multiple level of minimum wages from 32.7% to 29%. Current situation of income tax of natural persons can't be considered satisfying as from the point of present-day level of wage, as the foundation of taxation base, so from the point of achieving of stable fiscal base on this tax. The aim of fiscal policy on taxation of natural persons must be stimulation of growth of population groups with middle and high incomes.

The mechanism of calculation: The physical person constantly living in Republic of Uzbekistan or who is residing in Uzbekistan within 183 days or more, during any period about twelve months beginning or which are coming to an end in financial year, is considered as the resident of Republic of Uzbekistan.

The physical persons – residents of Republic of Uzbekistan are assessed under the incomes received from sources of their activity as in Republic of Uzbekistan, and behind its limits.

The individual who are not being the residents of Republic of Uzbekistan, are assessed under the incomes received from activity in territory of Uzbekistan.

The sums of Uzbekistan, paid outside Republic, on the tax on the incomes of the physical persons are set off at payment of the tax in Republic of Uzbekistan according to the international contracts of Republic of Uzbekistan.

The size of the set off sums should not exceed the sums of the tax on the incomes of the physical persons estimated on the current rates in Republic of Uzbekistan.

Object of the taxation is the gross revenue.

Gross revenue of the physical persons includes money or other funds subject to reception (received) by tax payer, or received by him by gratuitous, including:

The incomes received as payment of work;

The property income of the physical persons;

The income of entrepreneurship activity of the physical persons

To the incomes received as payment of work, the incomes received by the physical persons from job on the labor contract and on the contracts of civil-law character are added.

To the incomes received as payment of work, include also:

1) Negative difference between cost of the goods (jobs, services), sold to the workers and purchase or cost price of these goods (jobs, services);

2) Expenses of the employer on compensation of expenses of the workers which was not connected to its activity;

3) Written off, on the decision of the employer, sum of the debt of the worker before it;

4) Expense of the employer for payment of collections on voluntary insurance of life or health of the workers;

5) Sum paid by the employer on account of payments, subject to deduction from the physical person;

6) Other charges of the employers being the direct or indirect income of its workers.

The incomes on the received interests, dividends, from delivery of property in rent are included to the property income of the physical persons.

All receipts from realization of the goods (jobs, services), other activity, not forbidden by the legislation which is carried out by the individual order are included to the income of entrepreneurship activity of the physical persons minus the charges, obligatory payments, expenses and deductions connected to extraction of the specified income.

From the sums of wages, compensations and other incomes of the physical persons the tax is raised in the following sizes:

Table 29

The size of the gross income	Amount of the tax
Up to the five-multiple size of the minimal salary	13 percent from the amount of the income
From five (+1 soum) up to the ten-multiple size of the minimal salary	the tax with five-multiple + 21 percent from the sum exceeding the five-multiple size of the minimal salary
From ten-multiple (+1 soum) size of the minimal salary and higher	the tax with ten-multiple + 30 percent from the sum exceeding the ten-multiple size of the minimal salary

For the purposes of the taxation the size of the minimal salary is taken into account by an increasing result from a beginning of year (sum of the monthly sizes of the minimal wages for the appropriate period from a beginning of year).

The Cabinet of Ministers of the Republic of Uzbekistan has the right to establish the preferential rates of the tax on the incomes for separate categories of the physical persons engaged at jobs with harmful and heavy working conditions, and also on additional payments connected to job in districts to adverse natural-climatic conditions.

Indirect tax

3) Value added tax

The increase of share of the indirect taxation characterizes the process of shifting tax burden from the manufacturer to the consumer. From indirect taxes, operating in the republic, the most important place in the structure of the incomes of the state budget belongs to: the VAT and excises, which provide about 40-50 % of tax revenues in the state budget of the republics.

Table 30 Dynamics of VAT revenues for the years 1996-2002

	1996	1997	1998	1999	2000	2001	2002
Percentage of VAT to GDP, %	6,4	7,4	9,8	7,2	7,5	6,5	6,0
Percentage rate in state budget incomes	18,8	25,0	30,2	24,8	26,8	25,3	24,0

The actual situation of the economy of the Republic required introduction of tax system with mainly fiscal function, based on indirect taxes. The most important result of the tax reform was the introduction of value added tax with the rate of 30% in the year 1992, instead of the tax from turnovers and tax from sales. In the next year (1993) the VAT rate was reduced to 25 %, and in 1994 has been established at the level of 20 % with simultaneous granting of wide system of privileges. After the Tax Code was accepted, the percentage rate of the VAT has increased by more than 5 percents against 25 % in 1997.

The introduction of this tax resulted in the minimally possible increase of a general level of prices and, combined with politics of the support of low profitable layers of the population has passed without serious consequences. In 1995 the VAT rate was reduced to 18 %, and in 1996 it was reduced up to 17 %. According to the Tax Code that came into force on 1st of January, 1998, the general rate was established at the level of 20 %, besides 10 % rate was established on products of the first necessity, and zero rate was established on export of goods sold for the hard currency and on mineral fertilizers, fuel and lubricant materials delivered to the agricultural enterprises.

The mechanism of calculation

Distinctive feature of the VAT is that it excludes the double taxation and is collected only from the part of cost of the goods which has been formed at the next stage of the goods' movement. During the calculation of this tax, the tax paid at the previous stage is subtracted. The value added tax is a part of the price of goods, and the actual payers of the tax are the consumers of the goods - population.

The order of calculation and payment of the VAT in the republic slightly differs from the European model. In the European model there are no privileges on VAT if differential rates are present. In republic, according to the Tax code, there is a wide system of privileges with up to 36 paragraphs of various exceptions both for the selected goods and categories of the payers.

Before introduction of the Tax Code in republic the goods sold for export, were exempted from the VAT. Thus the amount of the VAT paid for the resources used for the manufacture of export production, was not accepted to offset and related to production expenses, i.e. the price of export production indirectly included VAT.

With introduction of the Tax Code of the Republic of Uzbekistan, taking into account the world practice of the taxation, the mechanism of calculation of the VAT by a principle of purpose of the goods was established in the republic. According to this principle, export of goods (works, services) is taxed at "zero rate ", and import is taxed under the rate operating in the republic. Enterprises, operating in the regime of VAT taxation, pay tax on value, added during the process of manufacture or circulation. As a result, the same added value is never taxed twice, thus the effect of addition on increasing does not occur. Moreover, at the final stage the sum of all added vales during the process, as well as the sum of all differences between sales and purchases is equal to consumer cost a minus the tax. By other words, total amount of the VAT at each stage of manufacture and sale is equaled to the tax collected during the sale of the goods by the seller to the final user or the user.

The amount of the VAT, required to be paid to the budget, is determined by the following formula:

A vat = A ttp - TD

Where,

A ttp- total amount of the tax for the tax period;

TD - tax deductions

The total amount of the tax for the tax period is determined as the amount of the calculated taxes on the taxable turnovers (sale of the produced goods, sale of the acquired goods, processing of the given raw material etc.). Sales' turnover is the shipment of goods, performance of works and provision of services on the basis of the written out invoices.

The total amount of the tax for the tax period is determined under the formula:

A vat = Tt * H / 100

Where,

A vat – amount of the tax, collected from the consumers;

Tt – taxable turnover;

H - rate of the tax.

If goods (works, services) are sold according to the prices and tariffs that include VAT, the tax is determined under the following formula:

A vat = Cg * H / (H + 100)

Where,

Cg - cost of the goods (works, services) that includes VAT.

The deduction of taxes, presented by sellers or paid by customs bodies during the purchase and import of goods (works, services), is allowed if:

The goods (works, services) are purchased for the industrial purposes;

The appropriate expenses are related to the expenses on manufacture and sale of goods (jobs, services);

The tax payer has invoices of the sellers or customs declarations;

The acquired goods are accepted by the tax payer on his balance (works are performed, the services are provided).

According to the established order of calculation of the VAT, the amount of the tax paid during the purchase of material resources, is credited, that is, is subject to deduction from total amount of the calculated tax, and if the balance turns out to be negative (the paid tax exceeds the received tax) is credited for the future payments, and in some cases is subject to be returned from the budget. It is necessary to note, that with the acceptance of the Tax Code the invoices were introduced, which were the basis for offset of the entrance VAT. However, in practice this norm did not work, and the order that was used before the introduction of the Tax code was accepted according to which the amount of the VAT subject to be paid to the budget was determined as a difference between the amount of the calculated tax on taxable turnovers and the amount of the tax subject to be paid according to the received invoices for the actually arrived goods as they were written off for as the production expenses. However VAT crediting only after the material resources were written off as production expenses resulted in the distraction of turnover means of the enterprise and contradicted to the international practice of the taxation. In this connection, since January 1, 1999 the mechanism of calculation of the VAT, subject to be paid to the budget, was changed and in accordance with this change the amount of the tax paid for the acquired material resources, specified in the invoices, is subject to be credited regardless from the time when material resources were written off as production expenses. In this connection the basis for crediting is the amount of the VAT specified in the invoice and this corresponds to the Tax Code of Republic of Uzbekistan. Besides, it has resulted in simplification of the mechanism of calculation of the VAT, and reduction of probability of distraction of turnover means of the enterprises for the payment of the VAT.

In the calculation of taxes, including the VAT is applied a method of deliveries (charges), that is payment of taxes from shipped production. The given position corresponds to world practice. However at presence of non-payments using of deliveries method has also negative consequences, so own current assets are distracted for the VAT payment.

The VAT does not lead to price shifts in the terms, that the number of exempting from the payment is insignificant, and zero rate is used not too widely, if the VAT is applied without exclusions and privileges, the influence on economy will be minimal.

Meanwhile if in the republic has been established 28 types of tax privileges by the Law "About taxes from the enterprises, associations and the organizations "the Tax Code has increased up to 40 positions. It is the rather important problem in VAT taxation so as exempting of the tax considerably deforms actions of this law.

Conclusion: Taking into account the enforcement of role and indirect taxation meaning during the transition to the market system, introduction of new or increasing current rates of indirect taxes should be carried out in view of their influence on manufacturers. Tax loading on the enterprises develops of taxes, the part of it includes in the cost price of production, a part of it is paid from financial results of enterprises activity and indirect taxes, in particular the VAT, which is completely relaying on the eventual consumer. This relaying depends on supply and demand elasticity on corresponding production. There is an immediate reduction of price in decreasing the rates to the value-added tax. Studying and searching of tax rates optimization on the VAT is one of actual problems in the field of upgrading taxation on the value-add cost.

For the providing the stimulating orientation of value-added tax on the development of manufacture, a problem of optimization of tax rates require on the differentiated basis decision and expansions investment activity of enterprises and entrepreneurs on this basis.

4) Property tax

Unlike in most other economies in transition, following the full recognition of private property, the government of Uzbekistan decided to introduce right after Independence a tax on private property and wealth that in 1998 yielded a substantial 3.9 percent of GDP, though it then declined to 2.4 percent by 2002. These included a 2 percent tax (later on raised to 4 percent) on enterprise assets. As for the individuals, the tax concerns houses, buildings and vehicles while both individuals and legal entities have to pay since 1995 a land tax on plots bigger than 1 hectare. The tax is graduated by land type and water availability.

Trade taxes, in contrast, have plaid a limited role and generate a modest share of total revenue. Differentiated import duties were imposed on 26 goods at rates ranging from 5 to 100 percent while all imports were subject to the standard VAT rate. Export duties were retained with rates ranging from 5 to 50 percent. Some key exports – like cotton – have however been taxed also in other ways, e.g. through production excises, low procurement prices and the dual exchange rate mechanism. In this sense, the Uzbek experience is similar to that of developing countries that tax heavily the exports of primary commodities.

The government also tried hard to generate additional revenue by introducing in recent years taxes on foreign exchange transactions, cars and resources use (water and mining) and an ecological tax. Finally, non-tax revenue (which includes privatization receipts) has contributed a comparatively small amount of resources to the state budget, as privatization has mainly consisted of the sale of housing and small state enterprises while the privatization of large state enterprises has so far been disappointing. For instance, in 1998/9 the government launched an ambitious privatization program that allowed 100 percent or foreign ownership to attract foreign direct investments but the results of this initiative was limited.

All these reforms brought about a radical change in the level, structure and impact of taxation. Altogether, the drop in the overall tax/GDP and (and public expenditure/GDP) ratios in Uzbekistan was far smaller than in other CIS countries as shown by an international comparison of the incidence and composition of taxation in the countries in transition. As shown by Table 31, with a 1999-2000 figure of 39.1 percent (inclusive of payroll taxes), Uzbekistan had an overall tax/GDP ratio that was perceptibly higher than that of the other CIS countries and a tax structure that was more akin to that of the countries of Eastern and Central Europe than to that of the Central Asian republics. In terms of sources of revenue, Uzbekistan had higher excises and payroll, personal income and property taxes than the other CIS countries. Only non-tax revenue and import duties seemed to be less important than in the other CIS countries.

Table 31 Comparison of total tax revenue and taxation by source between Uzbekistan and several groups of countries in transition, 1999-2000

	Total revenue	Tax revenue	Non-tax revenue	PIT	CIT	Soc Sec & Payroll	VAT	Excises	Import	Export	Wealth and Property	Other
CIS (late transition)	25.5	22.2	4.9	1.7	6.2	4.5	6.1	2.5	1.1	0.1	0.2	0.6
CIS (early transition)	29.3	24.4	3.2	2.0	3.1	6.2	6.2	2.5	0.5	0.1	0.8	0.3
Uzbekistan	39.1	37.4	1.7	3.9	4.0	10.5	7.3	7.9	0.6	..	3.0	0.2
CEEB(late transition)	37.7	33.0	4.7	5.2	2.1	10.6	8.7	3.4	1.3	0.0	0.4	0.7
CEEB(early transition)	40.8	35.0	5.8	5.3	4.3	11.2	8.4	2.2	2.0	0.0	0.3	0.8
European Union	45.2	39.4	5.8	9.6	2.6	10.8	6.7	3.7	0.0	0.0	1.5	0.9

Source: Mitra and Stern (2002),

Notes: PIT and CIT refer to the personal and corporate income tax. CEEB stands for Central and Eastern Europe and the Baltics.

Mitra and Stern discuss also the concept of optimal taxation in countries in transition and suggest that government revenue should not fall below 22-31 percent of GDP, depending on the country characteristics, as this might reduced the ability of the government to provide public goods and social protection and to develop much-needed market institutions and infrastructure

Uzbekistan's comparatively high tax/GDP ratio has however declined by 4 points between 1999-2000 and 2002 possibly suggesting that - after having avoided budgetary crunch, external indebtedness and collapse of essential expenditures - there was room to lower the tax rate to a more sustainable level.

Table 32 Taxes and Expenditures in percentage of GDP, 1995-2002

	1995	1996	1997	1998	1999	2000	2001	2002
Total Revenue	**34.6**	**34.3**	**30.1**	**32.4**	**29.3**	**28.0**	**26.0**	**25.0**
1. Direct taxes	**11.3**	**13.5**	**11.2**	**10.2**	**8.6**	**7.3**	**7.4**	**6.4**
Corporate Income Tax	8.5	9.9	7.2	6.1	4.4	3.6	2.9	2.3
Personal Income Tax of which:	2.8	3.6	4.0	3.7	4.1	3.7	3.9	3.5
- Income tax on persons	2.8	3.6	4.0	3.3	3.7	3.2	3.3	3.0
- Income tax on entrepreneurs	--	--	--	0.4	0.4	0.5	0.6	0.5
Single tax on SME which apply non expert system of taxation	0.0	0.0	0.0	0.4	0.0	0.0	0.5	0.5
2. Indirect tax	**14.0**	**16.5**	**13.5**	**15.9**	**15.8**	**15.9**	**13.5**	**15.0**
Value added tax (VAT)	5.7	6.4	7.5	9.8	7.2	7.5	6.6	7.1
Excise tax	8.3	10.1	6.0	6.1	8.1	7.7	6.2	6.6
Custom duty	0.9}	0.6}	0.6}	0.7}	0.4}	0.7}	0.7}	0.9}
Custom duties from persons	Incl}	Incl}	incl}	incl}	Incl}	Incl}	incl}	incl}
tax on petrol, diesel and gas	--	--	--	--	--	--	--	0.4
3.Property,land, resource tax	**1.5**	**1.7**	**2.4**	**3.9**	**3.2**	**2.8**	**2.4**	**2.4**
Property-tax	0.7	0.5	0.8	1.0	0.9	0.9	0.8	0.8
Land-tax	0.7	1.0	1.1	1.4	1.2	0.9	0.8	0.7
Mining tax	0.1	0.2	0.6	0.5	0.3	0.3	0.2	0.2
Water use tax	0.0	0.0	0.0	0.2	0.1	0.1	0.1	0.1
Ecological tax	--	--	--	0.7	0.6	0.6	0.6	0.6
4. Tax for social infrastructure development	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.3**	**0.3**	**0.4**
5.Other tax & nontax revenue	**6.8**	**1.9**	**2.2**	**1.7**	**1.7**	**1.8**	**2.4**	**0.8**
	1995	1996	1997	1998	1999	2000	2001	2002
Expenditure - total	**38.1**	**39.9**	**32.5**	**35.9**	**31.0**	**29.0**	**27.0**	**26.6**
1. Social sphere	**12.0**	**12.4**	**11.4**	**12.3**	**11.5**	**10.4**	**10.2**	**10.7**
Education	7.4	7.4	7.1	7.9	7.5	6.7	n.a.	7.4
health protection and sport	3.6	3.7	3.3	3.3	2.9	2.6	n.a.	2.6
culture, science	0.8	0.9	0.8	0.7	0.9	0.7	n.a.	0.6
social security	0.2	0.3	1.0	0.2	0.2	0.4	n.a.	0.1
2.Social protection	**3.3**	**4.0**	**3.2**	**3.3**	**3.0**	**2.2**	**2.1**	**2.0**
Public utility subsidy	1.1	1.3	0.6	1.1	0.8	0.5	0.5	0.4
Family and children allowances	1.4	2.5	2.4	2.0	2.0}	1.6	1.5	1.6}
Low income family allowances	0.9	0.2	0.2	0.2	Incl}	0.1	0.1	Incl}
3.Expenditures on economy	**4.3**	**4.7**	**4.1**	**4.0**	**3.6**	**2.9**	**2.3**	**2.3**
4.Centralized investments	**6.1**	**7.1**	**7.4**	**7.0**	**6.6**	**5.9**	**5.0**	**3.8**
5.State authorities and admin.	**1.0**	**1.1**	**0.8**	**0.8**	**0.8**	**0.7**	**0.6**	**0.6**
6.Autonomous bodies admin	**Inch**	**incl**	**incl**	**incl**	**Incl**	**incl**	**0.1**	**0.1**
7.Interest expenditure	**0.1**	**0.0**	**0.0**	**0.7**	**incl}**	**incl}**	**incl}**	**Incl}**
8. Miscellaneous expenses	**10.6**	**7.0**	**5.6**	**6.6**	**5.7}**	**6.8}**	**6.7}**	**7.1}**
General government deficit	**-3.5**	**-5.6**	**-2.4**	**-3.5**	**-1.6**	**-1.0**	**-1.0**	**-1.6**
Extra budgetary funds	-0.6	-1.7	0.2	0.1	n.a.	n.a.	n.a.	n.a.
Consolidated deficits	-4.1	-7.3	-2.2	-3.4	n.a.	n.a.	n.a.	n.a.

Source: IMF (2000) for the years 1995-98; for 1999-2002, official data provided to the author of the chapter by the Ministry of Finance via CER; 2002 data refer to the approved budget; for the prior years it refers to the executed budget
Notes: The overall tax rates for the years 2000, 2001 and 2002 do not correspond to those found in other current publications. For instance, the Transition Report 2002 of the EBRD suggests that during the last three years the tax/GDP ratio hardly declined.

Expenditure reform and changes in the structure of government expenditure

Public expenditure during the Soviet period accounted for some 33-35 percent of GDP (or more if the expenditure covered by the Soviet Budget were taken into consideration). Public expenditure peaked at an astounding 52.3 percent of GDP in 1991 owing to the rise in the compensation for price increase following the liberalization of prices and the cancellation of consumer and producer subsidies. Public expenditure declined steadily over the next three-four years and by 1997 had returned to 33 percent of GDP (excluding the outlays of extra-budgetary funds). Thus, except for the peak of the early years of transition, the ratio of public expenditure to GDP ratio did not changed much between the Soviet era and the early post-independence period and remained somewhat above the international norm for countries at the same level of development. Since 1999, however, public expenditure fell steadily and by 2002 the public expenditure/GDP ratio reached 26.6 % or 37 percent if the expenditure on pensions is included.

A final point concerns the distributive implications of the present pension system. Pensions (of the 'pay as you go' type) are paid by the Pension Fund that is financed by a steep payroll tax of 40 percent that is born mainly by the employers but that is likely 'translated' on the employees in the form of lower take-home wages. The benefits are quite generous and men who have worked at least 25 years are entitled to retire at age 60 and women who have worked at least 20 years can retire at age 55. This policy favors the elderly in relation to children and poor adults as shown by the trend in the ratio of the average pensions to the average wage in relation to that of the minimum wage (used as a benchmark for the payment of child allowances and social assistance transfers) to average wage.

Table 33 Public expenditure on selected sectors (percentage of GDP), late 1990s

	Education	Health	Social Protection
Central Europe and Baltics	4.6	5.1	13.3
CIS	4.6	3.6	7.4
Uzbekistan	7.4	2.6	12.5 [a]

Notes: [a] including expenditures on the pension fund that accounts for an estimated 10.5 percent.
Source: Alam and Sundberg (2002),

In turn, the expenditure on the national economy (that now focuses mainly on the maintenance of the national irrigation system and other public infrastructure and much less on consumer subsidies) rose from 1.9 percent of GDP in 1991 to 4.3 percent in 1995 but then fell to 3.6 in 1999 and 2.3 in 2002. In turn, expenditure on 'centralized public investment' remained stable at a 6 percent of GDP between 1991 and 2000 but fell to 3.8 percent in 2002 in parallel with the decline in the yields of the profit tax. Until 2000, such type of outlay was rather high when compared with that of other countries at similar levels of development.

Table 34 Evolution of the public expenditure by broad categories

	1991[a]	*1993[a]*	*1995*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Expenditure/GDP ratio	52.7	53.9	38.1	32.5	35.9	31.0	29.0	27.0	26.6
Public expenditure – total [a]	100	100	100	100	100	100	100	100	100
Human capital formation	26.2	37.8	31.5	35.1	34.3	37.1	35.9	37.8	40.2
Social protection	26.9	19.4	8.7	9.8	9.2	9.7	7.6	7.8	7.5
Economic activities	8.7	21.6	11.3	12.6	11.1	11.6	10.0	8.5	8.6
Centralized Investments	11.4	5.7	16.0	22.8	19.5	21.3	20.3	18.5	14.3
Administration	0.9	14.7	2.6	2.5	2.2	2.6	2.4	2.6	2.6
Miscellaneous	26.0	0.1	29.9	17.2	23.7	17.7	23.8	24.8	26.8

Source: elaboration on the data of Tables;
Notes: [a] Does not include expenditures effected from extra-budgetary funds, such as the Pension Fund, Employment Fund and Road Fund. Notes: data for 1991 and 1993 may not be fully comparable with each other and with those for the subsequent years.

IV. Country-Specific Fiscal Issues

Ensuring macroeconomic stability

Despite considerable progress in recent years, macroeconomic stability remains under threat from external shocks, inadequate macroeconomic management in particular in relation to monetary policy, large off-budget fiscal liabilities, and the lack of flexibility in the state dominated formal sector.

Improving Uzbekistan's business environment

Priorities for reform include the reduction in state interference in the operation of enterprises, reforms to the legal environment to effectively protect property rights and draw the informal sector out of the shadow economy, and the elimination of obstacles to foreign trade, including the reduction of excessive tariff protection and non-tariff barriers.

Boosting agricultural productivity

Given the country’s predominantly rural population, agricultural reforms remain key to reducing poverty. Evidence from other CIS countries suggests that the abolition of state dictated cropping patterns, the liberalization of input and output markets, and the reform of agricultural cooperatives into private farms would all help to boost agricultural productivity.

Public policy reform

Priorities include an ending of the dual exchange rate, liberalizing trade, and introducing greater accountability in the public sector. These reforms are essential to reduce distortions in the economy, attract foreign investment, and improve delivery of social services.

Private sector development

With the right business environment in place, the private sector can create jobs and help reduce poverty.

Investment in human capital

Better use of resources for health care and education, plus more targeted social protection will improve the lives of ordinary people.

Investment in irrigation and drainage infrastructure

Maintenance of the country’s huge irrigation and drainage system will improve the productivity and sustainability of the important agricultural sector.

Tax policy issues in Uzbekistan

1) Optimal taxation level.

The optimal level of taxation of a country depends on its level of development, distribution of factors income, age structure, priority attached to social protection and development of public infrastructure, as well as to the need of avoiding the efficiency cost inherent to too high levels of taxation.

As noted before, Uzbekistan has a fairly high overall tax ratio by international standards. During the initial years of transition the government introduced new taxes to sustain public expenditure and keep the deficit within acceptable limits. In the rush to achieve this aim, several taxes with rapidly growing marginal rates were introduced, without anticipating the impact of these measures on work incentives and the distribution of the tax burden across sectors and population groups.

- **A first** question that needs to be raised in this regard is whether the present level of taxation affects work incentives. The preliminary data for 2002 indicate that the overall tax pressure is around 25 percent of GDP, some 7.5 points of GDP less than the peak of 1998. However, if the payroll taxes and social security contributions that feed directly the extra-budgetary funds are taken into account, the effective overall tax rate raises to around 35 percent of GDP, a comparatively high rate for a middle income developing economy such as Uzbekistan

- **A second** problem concerns the possible over-taxation of the formal sector and the efficiency cost caused by such situation in terms of lower labor supply and investments. Despite efforts by the public authorities, the overall tax burden remains distributed in an unequal way between the formal and informal sector. Because of the difficulties in taxing the gray economy (which is estimated to generate a third of the national GDP), a good part of informal sector income escapes any levy, which means that the 35 percent of GDP collected in taxes and quasi-taxes originates predominantly from the formal sector – de facto raising the overall tax rate on this sector to 45-50 percent. In some cases, as in the oil sector, the effective tax rate on gross incomes reaches 80 percent.

This situation reduces net profits and might depress new investment and employment creation in the modern sector. All this calls for some redistribution of the tax burden from the formal to the informal sector. The government is well aware of this and already started shifting the tax burden from the corporate sector to personal income and indirect taxes while trying to strengthen tax collection in the informal sector. In addition, in an attempt to stimulate new investments, the tax code exempts up to 50 percent of the profits reinvested. This measure could be strengthened by fully exempting from taxation all reinvested profits.

A second case of over-taxation concerns the personal income tax.

Indeed, the rapidly increase in the marginal rates of the personal income tax needs to be reconsidered. Above a minimum taxable threshold equal to 3 times the minimum wage (i.e. 15 $ a month in 2002), the tax rate rises rapidly to 15, 25 and 35 percent to reach 45 percent for taxable incomes of over 15 minimum wages (i.e. 75 $ a month). For instance, a person earning an average wage (38 US$ a month) has to pay at the margin a personal income tax of 35 percent. Given that most wages are comparatively low, the poverty impact of the rapid rise in tax rates at comparatively low levels of income needs to be taken into account. This is all the more true as the tax brackets are set on the basis of the minimum wage that has risen more slowly than the average wage, causing in this way a kind of 'fiscal drag'. This situation has a cost. High personal income taxes reduce the incentives to seek formal sector employment or push people to look for a second job in the informal sector with a negative effect on the productivity of the formal sector job.

Taxing the informal sector is a widespread problem in all transition economies. The government of Uzbekistan has already attempted to deal with this situation by introducing a simplified (and unified) taxation procedure for small enterprises, by reinforcing the collection of fees from the bazaars and other informal operators and clamping down on corrupt tax officials. Such efforts could be further strengthened by means of "sectoral studies" that reconstruct in detail the costs and earnings structure of 'typical enterprises' of different sizes and sectors, as successfully done in some industrialized countries.

Another way to promote the "formalization" of informal sector firms could consist in exempting them for a period of, say, 5 years from the payment of payroll taxes. These taxes account for an important part of the tax burden they would have to bear and often discourage newly created firms from operating in the formal sector. This transitory regime would allow these 'infant firms' to raise their productivity to the point to be able to bear also payroll taxes over the medium term. This approach was attempted with some success in Italy where the small and medium enterprise sector (part of which is informal) generates some 20 percent of GDP.

- A third problem of the present tax regime is that it might cause a misallocation of resources across sectors. In principle, all enterprises and sectors of activity ought to be taxed in the same way, with the possible exception of the mining rent. Taxes which differ substantially by sector, size, perceived ability to pay and so on of the enterprises can be distortionary as they artificially shift resources towards sectors chosen by the government. The latter – of course – is obviously free to 'choose' and support the strategic sectors as it may be better placed to solve the 'coordination and planning-horizon problems' faced by the individual enterprises. But the decision to support some sectors ought to be done through transparent income subsidies rather than through opaque 'preferential treatments' in the field of taxes, tariffs, allocations of real exchange and bank credit, i.e. all measures that may lead to misallocation of resources. This approach may also implicitly assign excessive discretionary powers to tax assessors, bank administrators and so on.

In this regard, the number of existing tax privileges and exemptions - often lacking a clear economic rationale - needs to be reduced. An examination of the present tax code illustrates well the myriad of exceptions, exemptions, special treatments and so on existing at the present time in Uzbekistan. All this complicates the application of the tax law, widens the scope of discretionary decisions by the tax assessors and may encourage tax evasion and corruption. In addition, the literature in this area shows that, in most cases, the impact of these measures on performance, inflow of FDI and employment creation is limited, while the loss of revenue is substantial.

-Fourth, the over-taxation of the cotton sector should be sharply reduced. The elimination of the cotton excise in 1998 and the almost complete unification of the exchange rate in early 2003 were key steps in this direction, but attention should be paid also to other factors (such as inputs and state order output prices) that affect the implicit taxation of this industry and the incomes of the rural poor.

-Fifth, the aim of achieving greater overall tax progressivity requires also that tax evasion in the informal sector is reduced (see the prior subsection). Evasion of profit and personal income tax might benefit the self-employed poor but also high-income groups such as micro entrepreneurs and traders.

-Sixth, while inflation has declined to acceptable levels, even the present rate of inflation tends to 'tax' more than proportionately the poor (that are less able of the rich to place their money balances in value preserving assets) and contributes to the aggravation of the regressive incidence of the tax system. In this regard, greater attention to the price inflation would likely generate more benefits for the poor than for the rich.

Public expenditure issues

Overall, public expenditure in Uzbekistan is quite high and relatively progressive. This expenditure pattern has permitted to contain the rise of poverty during the transition and to sustain steady improvements in most areas of human welfare. The suggestions for improvement that follow are therefore to be seen against this favorable background.

1) Overall level of expenditure

At about 37-38 percent of GDP (inclusive of outlays of extra-budgetary funds), public expenditure is higher than in other economies in transition at the same level of development and only 3-5 GDP points below that of the economies in transition of Central Europe that have GDPs per capita 2-3 times higher and a much higher share of elderly in the total population. The financing of this expenditure obviously means that the overall tax pressure (including payroll taxes) is comparatively high, particularly in the formal sector of the economy.

The moderate reduction in tax revenue (e.g. by 2-3 points of GDP) suggested cannot be reflected in a permanent increase in the budget deficit, as this would likely be detrimental to long term growth, and requires therefore an equivalent reduction in public expenditure. Two areas, which could bear part of such cuts, could be centralized public investments and pensions. At the moment, about one fifth of the state budget is absorbed by centralized investments. However, high levels of investments in the past have already created part of the necessary infrastructure, a task that should be continued in the years ahead, particularly in the areas of the poor Southern region. However, for the future, new investments in directly productive activities could be transferred to the enterprises involved. This trend towards a gradual transfer of the responsibility for new investments to the firms has been underway for a few years, as signaled by the fall of public outlays in this area from 7 percent of GDP in 1998 to 6 in 2000 to just below 4 in 2002. This trend could be continued at the margin in the years ahead.

The same can be argued for pensions. The current fairly generous transfers could be partly reduced by raising the retirement age for men at, say 62 and women at 58, as done in all countries where life expectancy is rising (as happened lately in Uzbekistan) or by allowing people to retire at the 60 and 55 but with lower pensions, an alternative that might be chosen by those pensioners (some 15 percent of the total) that continue working after retirement. This would free some resources that could be used for reducing payroll taxes or for poverty alleviation programs, especially in the parts of the countryside where the incidence of poverty is still very high.

V. Conclusion: Where We Stand and Where We Go?

The above analysis has sketched indirectly a few proposals that would improve the poverty impact of tax and expenditure policies. These could be summarized as follows:

1) The tax load might be lowered by 2-3 points of GDP and be distributed more equitably both 'horizontally' (i.e. between the formal and informal sector) and 'vertically' (i.e. placing a proportionately greater burden of taxation on higher income families). All this could be achieved by:

- increasing by 50 percent the threshold above which the personal income tax is applied, correcting for any fiscal drag effect that may have occurred for the personal income tax, and exempting reinvested profits from the profit tax,

- raising the minimum threshold on which the land tax could be applied,

- lowering the payroll taxes (and increasing the retirement age) so as to raise the direct wages of workers and the likelihood that informal firms will register,

- reducing the VAT rate on essential items and raising it on luxury products with inelastic demand consumed by high-income groups or generating negative externalities,

- reducing the para-fiscal taxation of cotton and other primary commodities via the dual exchange rate mechanism and low state procurement prices,

- increasing efforts at presumptive taxation through detailed 'sectoral studies'of informal sector firms while offering them an incentives to 'emerge' by exempting them temporarily from the payment of payroll taxes.

2) Simplify tax administration.

The achievements to date of tax administration in Uzbekistan must be consolidated but efforts should be deployed to reduce the transaction costs borne by taxpayers and small low income entrepreneurs, the collection costs borne by the administration and the scope for corruption. This could be achieved by simplifying the procedures, authorizations, and fees for the establishment of economic activities; simplifying taxation approaches e.g. by reducing the number of income brackets, including in the tax base those incomes which have been excluded to date, and reducing markedly tax exemptions, deductions and privileges that cause losses to the treasury as well as corruption problems; and finally making tax administration less intrusive, e.g. by reducing controls on the small and medium enterprises, eliminating unfriendly tax procedures and minimizing the inspection and harassment by the tax administration.

3) Trim, prioritise and target public expenditure

Public expenditure in Uzbekistan needs to be trimmed by 2-3 percentage points, to match the proposed decline in taxation. This adjustment also needs to be accompanied by an increase in public expenditure in some sectors and its targeting in a few others. All this means that public expenditure on pensions might be reduced by raising the retirement age. It means also that central investments in directly productive firms are eliminated while retaining the central investments on infrastructural development, particularly in the poor rural areas of the country

Finally, there is a need to improve the distribution and targeting of public expenditure on human capital formation. An area where resources can be saved is higher education where subsidies (exemption from the payment of tuition and a monthly salary) ought to be targeted only to children selected on the basis of a nationwide competition and coming from low income families. Some of these resources could be used for reinforcing other branches of education or for strengthening the expenditure on health that has been declining to a low level already for a few years.

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