

# Uzbekistan's reform achievements and future challenges

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# Structure

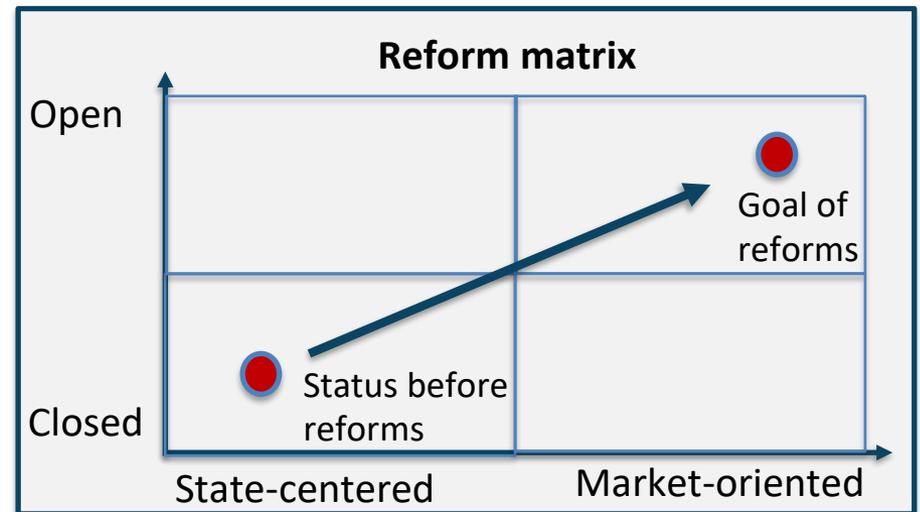
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1. Introduction
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# 1. Introduction

## Background

- Uzbekistan has undertaken major reform efforts since 2017 to transform the country
- The aim of this analysis is to present and evaluate the most important reform steps started so far and to provide suggestions for future priorities
- Reforms can be characterised along two dimensions
  - State-centered vs market-oriented
  - Closed vs open
- The goal of reforms should be to transform Uzbekistan from a predominantly state-centered, closed economy to an open, market-oriented economy



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## **2. Major economic reforms since 2017**

## 2.1 Liberalisation of exchange rate (I)

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### **Situation before reforms**

- Fixed exchange rate and strong overvaluation of national currency
- Strict capital controls limited provision of foreign currency for business and individuals
- Exporters obliged to sell part of foreign currency revenues from exports at official rate to the government

### **Associated problems**

- Discouragement of exports
- Only those with access to foreign currency were able to import consumer or intermediate goods (danger of corruption), fair competition cannot develop
- Capital goods are not imported to the necessary extent; potential investments do not take place
- Foreign (export-oriented) investment unattractive due to restrictions on repatriation of profits and mandatory sales of foreign currency
- Efficient resource allocation not possible

## 2.1 Liberalisation of exchange rate (II)

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### Reforms implemented so far

- Artificial fixing of the exchange rate abolished; exchange rate now defined only by market forces; end of overvaluation of national currency
- Legal entities and individuals can purchase foreign currency from commercial banks without limitations
- Elimination of mandatory sale of foreign currency proceeds

### Progress assessment

- Goals achieved in establishment of liberalisation of exchange rate and granting equal access to foreign currencies
- Data show increase in trade volume, foreign investment and competitiveness
- Very important step to open up the economy and to increase competition

## 2.2 Customs tariff reductions

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### **Situation before reforms**

- Protectionist trade regime with simple average tariff of 14.9%
- Prohibitively high tariff rates for products of key industries, e.g. up to 269% for agricultural products, up to 226% for textiles and 192% for machinery

### **Associated problems**

- Restricted access to inputs for companies
- Restrictions on choice and quality of consumer products
- Highly protected market dominated by state companies, no healthy competition

### **Reforms implemented so far**

- Reduction of 8,000 tariff lines, including complete elimination for 5,000 tariff lines in September 2017

### **Progress assessment**

- Important step to open the economy
- But room for further reductions: some tariffs were raised again, many tariffs still show protectionist character

## 2.3 Simplification of the tax system (I)

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### Situation before reforms

- Two tax regimes for companies
  - General regime includes VAT and many other taxes
  - Simplified regime for SME based on turnover (SME defined by number of employees, up to 25-100 varying by sector)
- High burden of labour income (up to well above 50%)
- Widespread use of subsidies

### Associated problems

- Very different tax burden for simplified tax regime compared to the general regime; no incentive to grow for SME as tax burden would dramatically increase
- Preventing development of value chains due limited usage of VAT, goods taxed at each processing step
- High burden on labor income, causes flight into grey and black employment
- Subsidies affect level playing field and competition
- Complexity of tax system difficult to administer

## 2.3 Simplification of the tax system (II)

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### Reforms implemented so far

- Significant reduction of taxes on labour income
  - Elimination of 8% insurance contribution for extra-budgetary pension fund; introduction flat 12% income tax; reduction of unified social payments to 12%
- Obligation to use VAT for SME, with exception for companies with a turnover of up to UZS 1 bn, in that case voluntary VAT or 4% turnover tax possible
- Reduction of number of taxes and begin of elimination of subsidies

### Progress assessment

- Good progress to reform the tax system
- But very complex process; further efforts required, e.g. to ensure that VAT functions optimally and all unfair subsidies are abolished
- A fair tax system primarily helps the private sector and therefore strengthens market-orientation

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## 3. Current reforms

# 3.1 Banking sector (I)

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## **Situation before reforms**

- Dominance of state-owned banks (around 85% of assets)
- Business model: banks received loans from state funds (e.g. from UFRD) and channelled them to SOEs and investment projects
- Funding and lending provided below market rates terms

## **Associated problems**

- Difficult access to finance for the private sector as state banks have little incentive and knowledge to provide “normal” lending
- Lack of competition and financing has adverse effect on economic development

## **Reform goals**

- Strengthening the private sector in banking system (privatisation of 8 banks with 52% of assets until 2025)
- Enhancing quality of banks balance sheets
- Improve legal framework (e.g. for digital banking) and level of professionalism

## 3.1 Banking sector (II)

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### Progress assessment

- First steps of very ambitious reform agenda undertaken
  - Directing government loans through state-owned banks largely terminated
  - Cooperation with IFIs in privatisation of banks, which consists of two steps
    - Improving the corporate governance and institutional reorganisation
    - Sale of government shares to strategic investors
- Success will ultimately depend on whether strategic investors can be found
- Privatisation will strengthen the market-orientation in the sector and access to finance in the private sector

## 3.2 Agricultural sector (I)

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### **Situation before reforms**

- Dualistic farm structure
  - Smallholder dehkan farms operate independently and focus on horticulture and livestock
  - Farms produce cotton and grain based on state orders
- Inefficient public administration and services due to lack of personnel and infrastructure
- Restriction of exports through state export monopoly and minimum export prices

### **Associated problems**

- Extensive government control and lack of market signals hinders development of sector

### **Reform goals according to 2030 strategy**

- Ensure food security, improve agribusiness climate and develop value chains
- Reduce the role of the state, ensure sustainable use of natural resources and improve public administration
- Diversify public expenditure, develop science, education and information services in agriculture
- Strong economic growth and strong growth of exports

## 3.2 Agricultural sector (II)

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### Progress assessment:

- Important goals reached
  - Abolishment of state export monopoly and minimum export price
  - Elimination of state orders for wheat and cotton
  - Elimination of forced labour
- However: complex reform process ahead; general agreement on what needs to be done but devil is in the details, e.g. creation of cotton “clusters” not necessarily international best practice as farmers cannot choose a cluster, no competition for farmers
- Additionally: many key projects largely run by outside consultants; need to increase ownership by Uzbek authorities
- Priority should be given to investments in human capital and institutional structures for long-lasting benefits
- Reforms will, once fully implemented, boost openness and market-orientation

## 3.3 Privatisation of SOEs

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### **Situation before reforms**

- Around 2,500 SOEs currently active in Uzbekistan, corresponding to an estimated 55% of GDP; state monopolies control crucial sectors like mining and energy

### **Associated problems**

- High level of state involvement in economy hinders creation of competitive markets

### **Reform goals**

- Reduction of number of SOEs by 75% until 2025, improve supervision for the remaining SOEs, e.g. increase number of independent members in supervisory boards to 30%

### **Progress assessment**

- Crucial first steps
  - Relevant agencies established, around 600 companies identified for privatisation
  - New laws “on privatisation” and “management of state assets” in development
- Uzbekistan is well advised to rely on international experience
- Quality and transparency of processes should take precedence over speed

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## **4. Recommendation of future priorities**

# 4.1 Rule of law and corruption

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- Rule of law and low levels of corruption at the very core for the development of sustainable economic growth and attracting investment
- Currently Uzbekistan is No. 92 (out of 128) in the WJP Rule of Law Index and No. 146 (out of 180) in Corruption Perception Index, thus there is room for improvement
- Fighting corruption is a priority since 2017, some measures in place
  - Anti-corruption agency established in 2020, supported by international donors
  - Recent presidential decree introduces strict measures for civil servants
    - Establishment of open register with persons found guilty of corruption; prohibition to enter civil service, employment by SOEs and bidding in privatisation of state assets
    - Obligatory declaration of property for civil servants and management personnel of SOEs, including spouses and minor children; prohibition to have assets outside of Uzbekistan

## **Progress assessment**

- Promising first steps, Uzbekistan is improving in relevant indices, but long way ahead

## 4.2 Role of the state in economic policy

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- As a legacy of centralised planning and great importance of SOEs, decisions on economic development currently hand-steered by political decision-makers
- Within the framework of the ordo-liberal economic system (like social market economy in Germany), the role of the state is limited to setting framework conditions
- This approach promises the best results in the long-term and is based on
  - Competition policy (market liberalisation, anti-trust, state aid and merger control)
  - Industrial policy (develops overarching national economic objectives, but should be respectful of sound competition principles)
  - Innovation policy (creates legal and economic incentives for innovations)
  - Trade policy (clear standards, free trade)
- We recommend that with a progressing privatisation process the government should focus on setting framework conditions
- This would support openness and market-orientation

## 5. Conclusion

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- Uzbekistan shows a very high pace of reforms and achieved considerable progress and tangible results in a very short period of time
- However, many reforms implemented so far (e.g. FX flexibilisation) were relatively easy to implement compared to current challenges
- Current reforms are often more complex, more difficult to define and implement
- They will also likely not to show immediate results
- This needs to be considered for the assessment, it will take perseverance to achieve sustainable changes
- The good news: the international community stands ready to support Uzbekistan along this path

# About the German Economic Team



Financed by the Federal Ministry for Economic Affairs and Energy, the German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.

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