



**The World Bank**

Sustaining Market Reforms in Uzbekistan Development Policy Operation (P168280)

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Report No: PGD62

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF US\$ FIVE HUNDRED MILLION TO

THE REPUBLIC OF UZBEKISTAN  
FOR THE

Sustaining Market Reforms in Uzbekistan Development Policy Operation  
May 20, 2019

Macroeconomics, Trade And Investment Global Practice  
Europe And Central Asia Region

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Republic of Uzbekistan

**GOVERNMENT FISCAL YEAR***January, 1 – December, 31***CURRENCY EQUIVALENTS**

(Exchange Rate Effective as of May 13, 2019)

Currency Unit

UZS 8,458 = US\$1.00

**ABBREVIATIONS AND ACRONYMS**

ADB	Asian Development Bank	MOF	Ministry of Finance
CBU	Central Bank of Uzbekistan	MTEF	Medium term Expenditure Framework
CPF	Country Partnership Framework	NAK	National Airways Corporation of Uzbekistan
CPI	Consumer Price Index	OECD	Organization for Economic Cooperation and Development
CPSD	Country Private Sector Diagnostic	PDO	Program Development Objective
DPL	Development Policy Loan	PER	Public Expenditure Review
DSA	Debt Sustainability Analysis	PFM	Public Financial Management
EBRD	European Bank for Reconstruction and Development	PISA	Program for International Student Assessment
ECE	Early Childhood Education	PLR	Performance Learning Review
FDI	Foreign Direct Investment	PMT	Proxy Means Test
FMIS	Financial Management Information System	PPG	Public and Publicly Guaranteed Debt
GDP	Gross Domestic Product	PPP	Public Private Partnership
GFS	Government Finance Statistics	PSIA	Poverty and Social Impact Analysis
GKK	The State Committee for Assistance to Privatized Enterprises and the Development of Competition	RAS	Reimbursable Advisory Service
GNP	Gross National Product	RE	Renewable Energy
GoU	Government of Uzbekistan	SBA	Standards of Budget Accounting
GRS	Grievance Redress Service	SCD	Systematic Country Diagnostic
HBS	Household Budget Survey	SDR	Standard Drawing Rights
IBRD	International Bank for Reconstruction and Development	SISQE	Uzbekistan Inspectorate for Supervision of Quality in Education
ICAO	International Civil Aviation Organization	SOE	State Owned Enterprise
IDA	International Development Association	TA	Technical Assistance
IEG	Independent Evaluation Group of the World Bank	UE	Uzbekenergo
IFC	International Finance Corporation	UFRD	Uzbekistan Fund for Reconstruction and Development
IFRS	International Financial Reporting Standards	UN	United Nations
ILO	International Labor Organization	UNG	Uzbekneftgaz
IMF	International Monetary Fund	US	United States

INDC	Intended Nationally Determined Contributions	USD	United States Dollar
IPSAS	International Public Sector Accounting Standards	UZS	Uzbekistan som
ISA	International Standards on Auditing	VAT	Value Added Tax
IT	Information Technology	WB	World Bank
L2CU	Listening to the Citizens of Uzbekistan Survey	WBG	World Bank Group
LDP	Letter of Development Policy	WTO	World Trade Organization

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**REPUBLIC OF UZBEKISTAN**

**SUSTAINING MARKET REFORMS IN UZBEKISTAN DEVELOPMENT POLICY OPERATION**

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**SUMMARY OF PROPOSED FINANCING AND PROGRAM**

**BASIC INFORMATION**

Project ID	Programmatic
P168280	No

**Proposed Development Objective(s)**

Sustain Uzbekistan's economic reforms and transition to a market economy by (i) increasing the role of markets and the private sector in the economy; and (ii) enhancing social inclusion.

**Organizations**

Borrower: REPUBLIC OF UZBEKISTAN

Implementing Agency: MINISTRY OF FINANCE OF THE REPUBLIC OF UZBEKISTAN

**PROJECT FINANCING DATA (US\$, Millions)**

**SUMMARY**

<b>Total Financing</b>	<b>500.00</b>
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**DETAILS**

International Bank for Reconstruction and Development (IBRD)	500.00
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**INSTITUTIONAL DATA**

**Climate Change and Disaster Screening**

This operation has been screened for short and long-term climate change and disaster risks

**Overall Risk Rating**

Substantial



**Results**

Indicator Name	Baseline	Target
<b>RI1:</b> An increase in the value of horticultural exports.	US\$875 million (2018)	US\$960 million (2019)
<b>RI2:</b> Increase in the number of legal entities registered as wholesale trading businesses.	12,387 (2017)	13,000 (June 2020)
<b>RI3:</b> Banking sector legislation is in greater compliance with Basel Core Principles	Banking sector legislation is non-compliant with the following key Basel Core Principles for Effective Banking Supervision: BCP1, BCP2, BCP5, BCP8, BCP11, BCP19, BCP20 (December 2018)	Banking sector legislation is in increased compliance with Basel Core Principles for Effective Banking Supervision BCP1, BCP2, BCP5, BCP8, BCP11, BCP19, BCP20 (June 2020)
<b>RI4:</b> Competitive tendering of renewable energy projects under the new law.	0 (June 2018)	The Government brings at least 1 RE project to the point of commercial tender announcement. (end-September 2020)
<b>RI5:</b> Number of end-user electricity and cold-water tariff changes made in accordance with new tariff methodology.	0 – Methodology did not exist (December 2018)	At least 1 electricity and 1 cold-water end-user tariff amendments are made in accordance with the new methodology. (June 2020)
<b>RI6:</b> A change in the ownership structure of (i) the national airline, (ii) all airports, (iii) air traffic control services.	All airports under the sole ownership of NAK (June 2018)	Airport ownership separated from NAK into a new entity, and a process is under way to concession at least one airport in Uzbekistan under PPP arrangements following a competitive tender process. (September 2020)
<b>RI7:</b> Number of independent financial valuations of State-Owned Enterprises conducted by the Agency for the Management of State Assets in accordance with International Financial Reporting Standards.	0 (December 2018)	Valuations for Uzbekenergo, Uzbekneftegaz, and at least 5 other SOEs have been completed (June 2020)
<b>RI8:</b> An increase in formal employment as evidenced by the number of private sector employees registered for payroll tax withholding, disaggregated by gender.	Male: 1,712,893 Female: 1,049,837 (end-December 2018)	Male: 1,952,698 Female: 1,207,315 (end-June 2020)
<b>RI9:</b> An increase in the roll out of standardized systematic national educational assessments.	No standardized and systematic national assessments in Uzbekistan (2018)	A new standardized and systematic national assessment is piloted in at least 2 regions (June 2020)
<b>RI10:</b> An increase in the utilization of the unified social registry system, as evidenced by the number of administrative units that have adopted the unified social registry to process applicants' registration, beneficiary selection, program enrolment, and payment orders.	0 - No Unified System in place (December 2018)	10 (September 2020)
<b>RI11:</b> Publication and availability of citizen budget documents.	A pilot Citizen Budget document for the 2018 Budget has been published and is available on the Ministry of Finance Website (November 2018)	Citizen Budget documents for the 2019 and 2020 Budgets have been published and available on the Ministry of Finance Website (June 2020)



**IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO  
THE REPUBLIC OF UZBEKISTAN**

**1. INTRODUCTION AND COUNTRY CONTEXT**

**1. The proposed Development Policy Loan (DPL) supports the ambitious reform program of the Government of Uzbekistan (GoU) to successfully transition to a competitive and more inclusive market-oriented economy.** Reforms supported are organized under two pillars necessary to this transition: (i) increasing the role of markets and the private sector in the economy; and (ii) enhancing social inclusion. The proposed operation is a stand-alone development policy loan in the amount of US\$500 million. It follows a stand-alone development policy credit of US\$500 million, approved by the WBG Board in June 2018, that supported the initial phase of reforms. The proposed operation is central to the World Bank Group's overall engagement with Uzbekistan, as described in the revised 2016-2020 Country Partnership Framework (126078-UZ; June 26, 2018)<sup>1</sup>.

**2. Uzbekistan has already taken a series of meaningful initial steps in its transition journey.** Reforms were launched with a major decision in September 2017 to remove foreign exchange market controls and unify the official and market exchange rates, initially through a 50 percent devaluation of the Uzbekistan som against the US dollar. Since then, authorities have undertaken a wide range of reforms, including an overhaul of the tax system to improve its efficiency and reach; the removal of several price, production, and trading controls; easing of cumbersome bureaucratic processes faced by businesses and citizens alike; lowering of import tariffs and strengthening of trade facilitation to accelerate the WTO accession process; expansion of social safety nets; and simplification of the tourist visa regime.

**3. Greater market-orientation has supported continued robust growth, macroeconomic stability, and improvements in welfare.** Despite the inevitable adjustment costs associated with the transition process (such as higher prices and temporary disruptions in production and trading patterns), economic growth has remained strong at over 5 percent. Macroeconomic stability and debt sustainability have been broadly maintained, although some risks, such as those arising from double-digit inflation and government-directed lending, require closer policy attention. Positive outcomes have ensured widespread public endorsement of the reforms. Data from the *Listening to the Citizens of Uzbekistan (L2CU)* survey<sup>2</sup> show strong support for the exchange rate unification and increased private participation and competition.<sup>3</sup> The survey also showed households' concerns around the slow pace of job creation and elevated inflation.

**4. Robust economic growth, small business development, income from foreign remittances, and an extensive social safety net have driven poverty reduction in recent years.** An estimated 9.6 percent of the population (about 3.2 million people) lives below the \$3.2/day poverty line (2018 L2CU baseline survey)—which is the international definition for lower middle-income countries. Using the Household Budget Survey (HBS), the Government estimated the national poverty rate<sup>4</sup> at 12.7 percent in 2017, unchanged from 2016. Over the longer term, official poverty and inequality measures have fallen sharply. The official poverty rate fell by over 60 percent between 2003 and 2017, and the official Gini coefficient by over a quarter between 2003 and 2013 (the last year in which the coefficient estimate

<sup>1</sup> The CPF was revised following a Performance and Learning Review in June 2018

<sup>2</sup> A collaborative effort led by the World Bank in cooperation with the authorities, non-governmental organizations, UNICEF, the EU and USAID

<sup>3</sup> Most people surveyed saw their own livelihoods increasing, and local economic conditions improving. There was almost universal belief among surveyed households that the country was on the right track, and that the Government was communicating and listening effectively through its citizen engagement platforms.

<sup>4</sup> The national poverty line is measured based on food intake of 2,100 calories per person per day





was reported). In addition to dispersed benefits of strong economic growth that has been sustained over an extended period, social assistance and remittances have also played an important role in mitigating the poverty situation. About 37 percent of the population living below \$3.2/day receives social assistance. The poverty rate would be about 2.5 percentage points higher in the absence of social assistance programs.<sup>5</sup> More than 17 percent of bottom quintile of households receive remittances from abroad, accounting for nearly 60 percent of their income. Income growth and rising remittance inflows are expected to remain the primary drivers of poverty reduction over the medium term.

**5. The transition process has only just begun for Uzbekistan, and challenges are likely to become more complex.** Job creation has been slow, Uzbekistan’s participation in global value chains remains limited, the private sector has a limited presence, and significant gaps remain in Uzbekistan’s social safety net, education and health systems. Moreover, the more visible benefits of market-oriented reforms (for instance, increased participation of private investors) tend to take time and require a strong sequence of complementary reforms. Many of these reforms, such as the restructuring of state-owned enterprises (SOEs) and the banking sector, creation of a more level playing field between state-owned and private enterprises, urban and agricultural land reforms, and the development of more accountable public institutions are also likely to be more politically complex to tackle. The maintenance of a stable macroeconomic environment is also critical to the next phase of reforms. The situation calls for a patient and resolute approach, backed by targeted and adequate external support. Recognizing this, the Government of Uzbekistan has requested the resources, leverage, and technical support that would come with the proposed operation.

**6. The proposed operation is in response to a government request for support in sustaining the momentum of market reforms and the economic transition.** It is designed around two pillars: (i) increasing the role of markets and the private sector in the economy; and (ii) enhancing social inclusion. The first pillar focuses on actions to increase trade and strengthen financial sector efficiency. It also focuses on State institutional reforms that are critical to the transition, and to increasing domestic and foreign private sector investment in the economy. The second pillar focuses on supporting a more inclusive transition through actions that address constraints to formal job creation and skills development, strengthen safety nets, enhance the voice and participation of citizens in the budget.

**7. The overall risk to the operation is substantial, reflecting the institutional and implementation challenges associated with a complex and fast-moving reform agenda.** As was the case in the first DPO, this proposed operation supports some of the most critical reforms that underpin Uzbekistan’s transition to a competitive and market-led economy. These reforms are complex and carry potentially high economic and social adjustment costs if poorly implemented. Drawing from the experiences of other economic transitions, however, the authorities consider these reforms to be necessary – and critical – to an effective transition. The Government has worked closely with the World Bank and other development partners to mobilize considerable technical assistance in quick time to mitigate design risks and minimize dislocation effects, particularly on more vulnerable citizens.

**8. The operation contributes to addressing climate change through actions that generate mitigation and adaptation co-benefits.** The climate and disaster risk screening conducted for the operation highlights that Uzbekistan is vulnerable to the impacts of climate change, particularly in the sectors of agriculture, energy and water resource management. Anticipated climate impacts include increases in monthly maximum temperatures across Uzbekistan, high variability of rainfall across different agroecological and climatic zones (i.e. annual precipitation decline in some central and eastern districts; moderate increase in areas surrounding the Aral Sea), and increased glacier melting with implications for water availability and river flow in the short to long term. In the agriculture sector, climate change is

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<sup>5</sup> Among all welfare quintiles in Uzbekistan, income from hired work is the most important component of total household income. Hired work income shares range from 51 percent of household income for the bottom quintile on average to about 60 percent for the top. The second largest component is pension income which accounts for about 15 percent of household income overall.



increasing the risk with regard to water availability but also pests and diseases. Droughts may become more frequent due to river runoff decreases, specifically from the Amu and Syr Darya Rivers. Areas with increased demand and consumption from economic development and population growth may be impacted with implications for food security. The energy sector is exposed to risks from climate variability that may impact energy supply (e.g. disruptions due to increased extreme weather events) and demand (e.g. due to a rise in annual number of hot days). Water resource management is expected to become more challenging given associated impacts from climate change. The proposed operation intends to support Uzbekistan in addressing some of these vulnerabilities, particularly through adaptation and mitigation measures in the areas of public utility reform (Prior Action 5), renewable energy (Prior Action 6), agriculture (Prior Action 7), and social protection (Prior Action 11). Overall, the operation contributes to building a more resilient population and economy to the anticipated impacts of climate change.

## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1. RECENT ECONOMIC DEVELOPMENTS

**9. Real GDP growth remains strong despite a slowdown in recent years.** Growth in 2018 was 5.1 percent, up from 4.5 percent in 2017 (Table 1), but still significantly lower than the average of over 8 percent for the previous decade. The slowdown in recent years is mostly due to three factors. First, softer global economic conditions caused world commodity prices (and thereby Uzbekistan's terms of trade) to moderate, reducing the dollar value of Uzbekistan's exports and inflows of worker remittances from other commodity-dependent countries such as Russia. Second, periods of unfavorable weather, and a larger-than-usual incidence of pest infestation, have adversely affected production in agriculture, which accounts for about one-fifth of the country's GDP. Third, the production of manufactured goods, such as cars and fertilizers, has slowed from energy and water supply bottlenecks. Slower than expected investment inflows and adjustment costs linked to the ongoing reforms may have also contributed to the moderation in growth. Domestic demand, however, has remained strong from domestic investment, which after years of relatively small changes, increased sharply by about 18 percent and 32 percent in 2017 and 2018, respectively. This surge was driven by large increases in directed credit to SOEs. Private consumption has remained relatively flat since 2016, likely due to a pick-up in inflation that limited real wage growth.

**10. Despite relatively robust growth rates, persistently slow employment generation has been a key area of policy concern.** The number of new jobs grew at an average rate of just 0.75 percent between 2015 and 2018, leading to an increase in outward labor migration and persistence of unemployment at relatively high levels (8.3 percent in 2018).<sup>6</sup> Shortages in the domestic job market have led to a steady increase in registered labor migrants working abroad, whose number increased from 1 million in 2015 to 1.4 million in 2018. The total number of migrants working abroad in 2018, including unregistered migrants, is estimated by officials to be significantly higher at about 2.64 million. Worker remittances, however, have declined to the lowest levels in recent years (at about US\$1 billion in 2017), mostly due to stresses in the Russian economy.

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<sup>6</sup> Official unemployment rates averaged about 5.3 percent between 2014 and 2017. A change in methodology in October 2018 led to a large increase to 9.3 percent. The biggest methodological change involved estimating employment in small-holder (*dehqan*) farms: previously, all working-age members of a household were counted as being employed on the farm in official data, whereas in the revised methodology, only the head-of-household will be counted as employed on the farm. Previous unemployment estimates have not yet been recalculated using the new methodology, but the authorities note that there have been no major changes in actual employment numbers outside the methodological adjustment.

**Box 1: Fiscal Reporting Changes**

As authorities continue to make efforts to improve fiscal transparency, improved data availability on directed lending operations has led to an adjustment by the IMF and World Bank on how the Government's fiscal balance is reported. Two balances are reported:

- (i) **the consolidated fiscal balance**, which comprises traditional fiscal policy (budget) operations; and
- (ii) **the overall fiscal balance** which combines the consolidated fiscal balance with the Government's policy-lending operations into an overall fiscal position, which in turn is useful to understand the broader economic impact of fiscal policy.

**11. Fiscal policy has been broadly prudent, although the volume of extra-budgetary spending remains a concern.**

Reversing a declining trend in recent years, total revenues in 2018 increased by over 3 percentage points of GDP relative to 2017 (Table 2), largely on the back of higher tax collections. Total expenditures increased by about 2.7 percentage points of GDP due to higher than expected wage and public investment spending. As a result, the consolidated fiscal surplus (see Box 1 for definition) was 2.2 percent of GDP, compared with a planned surplus of 1.1 percent at the beginning of the year. The challenge was more on the extra-budgetary side, as policy-based lending from the budget added up to 4.3 percent of GDP in 2018 against planned estimates of 2.4 percent at the beginning of the year. As a result, the overall fiscal balance (the consolidated balance minus policy-based lending) for 2018 was -2.1 percent of GDP, 0.8 percentage points lower than initially planned. Another area of concern is weak financial reporting of extra-budgetary activities and its adverse impact on overall fiscal transparency.<sup>7</sup> Nonetheless, with low levels of public debt (about 21 percent of GDP), the overall fiscal position remains sustainable despite the expenditure expansion.

**Table 1: Uzbekistan: Key Macroeconomic Indicators**

	2016	2017	2018	2019	2020	2021
				(Projected)		
<b>National Income and Prices</b>						
	(Percent, unless otherwise noted)					
Real GDP growth (annual percent change)	6.1	4.5	5.1	5.5	6.0	6.0
Consumer price inflation (end of period)	9.8	18.8	14.3	15.6	12.4	9.1
Real effective exchange rate (levels, 2015=100)	84.3	65.9	60.2	64.6	67.8	72.4
<b>External Accounts</b>						
	(Current US\$ million, unless otherwise noted)					
Export of goods, of which	8,581	9,512	10,939	11,925	12,350	12,951
<i>Gold</i>	2,808	3,260	2,910	3,755	3,861	3,972
Merchandise imports, of which	11,154	12,501	17,679	19,658	20,446	21,199
<i>Machinery and Equipment</i>	5,018	4,552	7,491	8,797	8,348	7,930
Gross worker remittances	1,200	1,200	1,000	1,200	1,300	1,400
Services Balance	-1,610	-2,053	-2,442	-2,150	-2,011	-1,911
Current account balance (percent of GDP)	0.2	1.2	-6.9	-6.5	-5.6	-4.7
Foreign direct investment, net	1,572	1,263	679	1018	1299	1626
Gross international reserves (US\$ billion)	26.5	28.1	27.1	27.5	27.0	27.6
Gross international reserves (months of import cover)	19.2	14.8	13.0	12.6	12.2	11.3
Gross external debt (percent of GDP)	18.6	34.0	34.4	34.0	33.5	32.1
<b>Consolidated Fiscal Accounts</b>						
	(Percent of GDP, unless otherwise noted)					

<sup>7</sup> The authorities have pointed out that the majority of extra-budgetary spending was through directed lending to SOEs to finance imports of machinery. However, some extra-budgetary spending, such as an increase in concessional loans to domestic entrepreneurs, is likely to have contributed to domestic demand.



Revenues	25.4	24.7	27.9	25.4	25.4	25.6
Expenditures	23.8	22.9	25.6	24.8	25.0	25.4
Policy-lending	2.1	3.6	4.3	2.2	2.2	2.1
Overall fiscal balance	-0.5	-1.9	-2.1	-1.6	-1.8	-1.8
Total public debt	8.6	20.2	20.6	23.2	24.7	24.6
<b>Monetary Accounts</b>				<b>(Annual percent change)</b>		
Broad money growth	23.5	40.3	14.4	21.0	20.3	18.5
Credit to the economy	28.4	103.0	50.8	25.0	20.2	18.9
<b>Memorandum Items</b>						
Nominal GDP (som trillion)	242	303	408	523	642	760

Sources: World Bank and IMF staff calculations/estimates based on official data provided by the authorities.

**12. Revenue windfalls from the foreign exchange and price control reforms, and improvements to tax administration, have helped increase overall tax collections.** Authorities made significant efforts to tighten tax compliance and enforcement in 2018, in response to the declining tax collections in recent years<sup>8</sup>, as well as in anticipation of potential changes to tax policy that may dampen revenues in the short run. Emphasis was particularly strong on strengthening VAT administration and improving enforcement of corporate tax obligations. These gains were augmented by strong indirect tax receipts arising from increased trade and consumption following the foreign exchange and other trade liberalization reforms, as well as better outcomes in payroll and social security tax collections (which are ringfenced to fund the pension system and the Road Fund), driving total revenue collections in 2018 to about 28 percent of GDP, the highest level in recent years.

**Table 2: Uzbekistan: Fiscal Operations (percent of GDP)**

	2016	2017	2018e	2019p	2020p	2021p
			<b>(e)stimate (p)rojected</b>			
<b>Total Revenues, of which:</b>	<b>25.4</b>	<b>24.7</b>	<b>27.9</b>	<b>25.4</b>	<b>25.4</b>	<b>25.6</b>
<b>Tax revenues, of which</b>	15.5	15.2	17.4	17.8	18.0	18.2
<i>Income and profit taxes</i>	4.6	4.3	4.2	5.8	6.2	6.7
<i>Value added taxes</i>	4.9	4.9	6.8	6.5	6.6	6.7
<i>Excise taxes</i>	2.6	2.5	2.4	1.8	1.8	1.8
<i>Mining Taxes</i>	1.0	1.1	2.1	2.5	2.2	2.0
<i>Taxes on international trade</i>	0.6	0.7	0.4	0.4	0.4	0.3
<b>Other revenues (tax and non-tax)</b>	<b>2.3</b>	<b>2.2</b>	<b>3.3</b>	<b>3.3</b>	<b>3.2</b>	<b>3.1</b>
<b>Extra-budgetary Funds</b>	<b>7.5</b>	<b>7.3</b>	<b>7.2</b>	<b>4.3</b>	<b>4.3</b>	<b>4.3</b>
<i>Pension fund<sup>9</sup></i>	6.1	5.9	5.9	4.3	4.2	4.2
<i>Road fund</i>	1.0	1.0	0.9	Fund closed		
<i>Other extra-budgetary expenditure</i>	0.4	0.4	0.4	0.0	0.0	0.0
<b>Total expenditures, of which:</b>	<b>23.8</b>	<b>22.9</b>	<b>25.6</b>	<b>24.8</b>	<b>25.0</b>	<b>25.4</b>
Social safety nets	6.0	5.5	5.0	5.2	5.3	5.4
Social and cultural expenditure	9.6	9.2	10.0	9.6	9.9	10.0

<sup>8</sup> Tax revenues as a share of GDP averaged 15.6 percent between 2015 and 2017

<sup>9</sup> The reduction in pension fund revenues is due to a reduction in pension-ringfenced payroll taxes. Pension fund expenditure however, will not be affected under a Presidential Decree committing to funding ringfenced pension fund revenue shortfalls from the general budget.



Public investment	0.9	1.1	1.3	0.8	0.8	0.8
Wages and wage-related expenditure	8.0	7.2	6.9	7.8	8.0	8.2
Interest expenditure	0.0	0.0	0.1	0.1	0.2	0.2
<b>Consolidated Balance</b>	<b>1.6</b>	<b>1.8</b>	<b>2.2</b>	<b>0.6</b>	<b>0.4</b>	<b>0.3</b>
<b>Policy-based lending, of which</b>	<b>2.1</b>	<b>3.6</b>	<b>4.3</b>	<b>2.2</b>	<b>2.2</b>	<b>2.1</b>
Fund for Reconstruction & Development	0.8	1.9	2.2	0.8	1.1	1.0
Equity investments	0.0	1.2	0.6	0.4	0.1	0.1
Other policy lending	0.5	0.0	0.9	0.6	0.5	0.5
Externally financed policy lending	0.8	0.5	0.7	0.4	0.5	0.5
<b>Overall fiscal balance</b>	<b>-0.5</b>	<b>-1.9</b>	<b>-2.1</b>	<b>-1.6</b>	<b>-1.8</b>	<b>-1.8</b>
<b>Statistical discrepancy</b>	<b>-0.4</b>	<b>-0.3</b>	<b>0.8</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Financing, of which</b>	<b>0.0</b>	<b>1.6</b>	<b>2.9</b>	<b>1.6</b>	<b>1.8</b>	<b>1.8</b>
Domestic	-0.7	0.2	-1.2	-3.0	-2.2	-0.3
External	0.7	1.4	4.1	4.7	4.0	2.0

Sources: Ministry of Finance, IMF and World Bank staff estimates.

**13. After steadily declining between 2015 and 2017, total expenditure as a share of GDP (excluding directed credit) increased by 2.7 percentage points in 2018.** A significant share of the increase was to finance a range of social and public investment programs – largely in public infrastructure and social sectors linked to the delivery of commitments in the Government’s 2017-2021 reform program. About 0.5 percent of GDP was also budgeted for an increase in social safety net expenditures to safeguard poor and low-income households from reform adjustment costs, such as those arising from increases in energy and bread prices. Slow budget execution rates, stronger expenditure controls, and lower-than-expected safety net expenditures mitigated some of the expenditure side pressures. Two factors contributed to lower safety net expenditures: (i) the total non-pension safety net envelope was smaller than expected as major price increases and administrative price removals were either deferred to later in the year or phased over a longer timeframe relative to budget policy estimates; and (ii) expenditures from the pension fund were lower than expected as more pensioners remained in the workforce.<sup>10</sup>

**14. While external balances have been remained sustainable, a surge in public spending created an unexpectedly large current account deficit in 2018.** After years of surplus, a surge in imports of machinery<sup>11</sup> (mostly by SOEs and financed by public investments and government-directed loans from extra-budgetary funds) and consumer goods, and weak export performance led to a current account deficit of around 7 percent of GDP in 2018. The sharp increase in imports was matched (and driven) by an acceleration in public investments in economic infrastructure, especially in the energy sector.<sup>12</sup> Consumer imports also increased sharply after years of import suppression.<sup>13</sup> Total goods imports grew by around 40 percent year-on-year in 2018. Exports of gold and other commodities were significantly below projections. Exports of non-commodities such as fertilizers and metals, which

<sup>10</sup> Under current rules, pensioners that remain active in the workforce are only eligible for a partial pension payment.

<sup>11</sup> Imports of machinery and equipment jumped to 14.8 percent of GDP in 2018, about 90 percent higher than in 2017.

<sup>12</sup> A significant proportion of machinery and equipment imports were in the energy sector, where about 2000 MW of generation and downstream grid infrastructure was upgraded and/or newly installed over the course of 2018. Imports of railways and air transport acquisitions and chemical plant infrastructure were other significant sources of machinery imports.

<sup>13</sup> Consumer import growth was largely driven by recent reforms that have increased foreign exchange availability, reduced average customs tariffs, and increased tax-free import thresholds for personal imports.



were expected to benefit from the real exchange rate depreciation and removal of market controls, were significantly weaker than expected despite relatively strong production in 2018. Lower-than-projected international gold prices in 2018 led to postponements of anticipated gold sales by the authorities, further widening the current account deficit for the year. The deficit was financed by a drawdown on external reserves, which remains comfortable at US\$27 billion (or 13 months of import cover).

**15. Inflation, which rose sharply in 2017 following the exchange rate devaluation and the removal of administrative price controls, moderated in 2018.** After years of single-digit inflation, average annual CPI inflation hit double-digits in 2017, reaching 18.8 percent in December 2017. After peaking in January at about 20 percent, year-on-year CPI inflation fell steadily in 2018, reaching 14.3 percent in December 2018. Large volumes of imports had already been using parallel market exchange rates prior to the unification, which partially mitigated inflation effects. The GDP deflator, which provides a broader measure of goods and services produced in the economy, increased by an average 28.1 percent for the year, largely due to the significant increase in the price of exported goods.

**16. Monetary policy was tightened in response to inflationary pressures, but an insufficient magnitude of the response and weaknesses in the transmission mechanism limited its effectiveness.** The CBU raised the refinancing interest rate in September 2018 from 14 to 16 percent to contain inflationary pressures. Even so, real interest rates were negative for most of 2018. More concerning was the large expansion in credit to the economy, which grew by an annual 51 percent in 2018. While this was significantly less than the 103 percent increase in 2017, it remains well above the average of 25 percent in the preceding three years. Most of this increase – about 60 percent – was from government sources, with about half of the government-directed lending to SOEs at preferential interest rates. Despite efforts by the CBU to contain inflationary pressures<sup>14</sup>, the effectiveness of domestic monetary policy transmission was significantly curtailed by the market distortions caused by policy-based and other forms of government-directed lending, the absence of an interbank lending market, and by high dollarization in the economy.

**17. Although the banking sector is thin and distorted by the dominance of state assets, it remains stable and well-capitalized.** Large capital injections by the UFRD prior to the 2017 foreign exchange unification have helped banks remain well capitalized despite the large growth in credit over 2018. Regulatory capital to risk-weighted assets were about 16 percent at the end of 2018. Reported non-performing loans are low at about 1.4 percent of gross loans, largely due to the recent restructuring of debts from energy SOEs to state-owned banks to extend grace periods.

## 2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

**18. Economic growth is expected to continue picking up and converge to about 6 percent over the medium term.** The projected pickup in growth is based on easing of intermediate input bottlenecks following capital modernization projects under way and a return to historical weather norms. A first round of effects from structural reforms are also likely to support higher growth, through increased growth in tourism<sup>15</sup> and horticulture. These projections are subject to downside risks described at the end of this section. They are also subject to some upside risks, particularly of an improved response from domestic and foreign private investors arising from recent reforms.

**19. Inflationary pressures are projected to persist in 2019, but gradually subside thereafter.** There are four major drivers of inflation over the medium term : (i) average fuel and utility tariffs<sup>16</sup> were increased across the board in November 2018, with another pre-announced round expected in mid-2019, and expectations of further adjustments

<sup>14</sup> For example, broad money growth falling to just 14.4 percent compared with 40.3 percent in 2017 and an average of around 22 percent between 2014 and 2016

<sup>15</sup> Significant reforms to the visa regime were enacted in 2018 and 2019 introducing visa-free access for major tourist-sending countries and simplified electronic registration processes.

<sup>16</sup> Electricity, natural gas, hot water, and cold-water utilities were all increased in November 2018





until full cost-recovery is achieved; (ii) the 2018 bread price liberalization and further measures to remove administrative price controls; (iii) recent and future above-inflation increases to public sector wages<sup>17</sup>; and (iv) the effects of unsterilized<sup>18</sup> credit growth from large government-directed lending to SOEs. These factors, many of which are temporary, are projected to keep average annual CPI inflation in 2019 at about 15.5 percent, tapering off to 10.5 percent by 2021.

**20. Continued investments to modernize machinery and equipment will elevate the current account deficit over the forecast period.** The current account is expected to remain in deficit of around 6 percent over the medium term on the back of growing investment (and continued growth of imports of machinery and equipment). The deficit is projected to eventually moderate as imports of capital goods ease and export growth picks up steam with improvements in the country’s competitiveness and stronger private sector participation (including FDI investors). While the projected deficit is high<sup>19</sup>, it is expected to be sustainable for the following reasons: (i) the deficit is largely due to productive imports of machinery and capital equipment to spur domestic investment growth; (ii) the projections are based on conservative estimates of investment inflows that are subject to upside risks; (iii) the deficit, currently projected to be financed by a combination of FDI inflows, debt, and development assistance, is backed by ample reserves (12-13 months of import cover over the medium term); and (iv) the imports are funded by state-directed lending, which could be reduced should external risks emerge.

**Table 3: External Financing Requirements and Sources (percent of GDP)**

	2017	2018	2019	2020	2021
		Est.	Projected		
<b>Financing Requirements</b>	<b>1.7</b>	<b>6.9</b>	<b>7.9</b>	<b>6.6</b>	<b>4.6</b>
Current Account Deficit	-1.2	6.9	6.5	5.6	4.7
Repayment of commercial debt	0.1	2.0	0.8	0.5	0.2
Change in reserves	2.8	-2.0	0.6	0.5	-0.3
<b>Financing Sources</b>	<b>1.7</b>	<b>6.9</b>	<b>7.9</b>	<b>6.6</b>	<b>4.6</b>
FDI and portfolio investments	2.2	1.3	1.7	1.8	2.0
Public / Public Guaranteed Debt	1.6	5.0	5.7	4.9	2.9
Other flows (net)	-3.6	-0.8	-0.5	-0.7	-0.9
Gold sales and revaluations	3.2	1.1	1.0	0.6	0.6
Errors and omissions	-1.7	0.3	0	0	0

Sources: World Bank and IMF staff calculations

**21. Monetary policy will need to be further tightened in the medium term; over time it will become more effective as institutional reforms are implemented to strengthen the transmission mechanism.** Growth in broad money and banking sector credit to the economy – the two primary tools available to the CBU – is expected to tighten over the medium term, reflecting the bank’s intent to contain inflation. In addition, the CBU’s focus over the next two to three years must be on developing and implementing new monetary policy and financial sector legislation and regulations following reforms enacted in 2017 by the Government to increase CBU’s mandate and autonomy. These reforms would need to be accompanied by structural measures to resume open market operations in 2019, establish an interbank market for more effective liquidity management, and gradually reduce the high levels of dollarization in

<sup>17</sup> Average wages were increased by 15 percent in November 2018, with lower-earning civil servants given larger increases than higher-earning civil servants.

<sup>18</sup> Although the majority of this funding has been directed to imports of machinery, increases in directed lending to entrepreneurs and households in 2018 to stimulate economic activity is likely to have inflationary effects in 2019.

<sup>19</sup> Estimates by the IMF show that Uzbekistan’s projected deficit over the medium term, at around 6 percent of GDP, is slightly above the median deficit level of other transition economies at similar stages of transition.



the economy. Inflation outcomes will also depend on the government's plans to scale back policy-based directed lending from extra-budgetary sources.

**22. A thin and distorted banking sector will continue to constrain efficient allocation of resources, while remaining vulnerable to external shocks.** Of the 28 banks operating in Uzbekistan, 15 are state-owned and hold over 80 percent of total banking sector assets. Deposits account for only 40 percent of total bank liabilities, with a large portion of these being Treasury and SOE deposits. Most of the remaining liabilities consist of loans from public sector entities, including the UFRD, some of it in foreign currency. Banks lend those public resources to priority sectors (e.g. agriculture, low-income housing, SMEs) and investment projects at preferential rates (mostly negative real interest rates), creating significant distortions in the commercial lending market. Large shares of foreign-currency-denominated lending (about 40 percent of total lending), including to unhedged borrowers and financially weak SOEs poses system-wide risks. In the face of a major external shock, economic deceleration, exchange rate depreciation, and higher interest rates could present liquidity and solvency risks for the banking system. While stress tests indicate that additional capital requirements to manage such risks are relatively modest, the situation could further jam the banks' ability to extend credit and thereby impact economic growth.

**23. Although creating some short-term administrative challenges, the significant changes to tax policy which took effect in January 2019 are likely to lead to a more conducive environment for the private sector.** The most significant reductions were to payroll and turnover tax rates that fund the social security system. Corporate and personal income tax rates were also reduced, while the corporate tax base has been significantly expanded through the inclusion of a larger number of businesses into the formal corporate tax regime<sup>20</sup>. The previously progressive personal income tax system has been merged into a flat personal income tax rate of 12 percent<sup>21</sup>. The changes to the tax system are expected to bring significant efficiency gains for businesses and distribute the tax burden more equitably across factors of production. Although the tax reforms were expected to reduce revenues in the short-term by around 4 percent of GDP, revenue collections remained strong in the first quarter of 2019. Tighter enforcement, combined with changes to the regime that make it easier to administer, are likely to have contributed to this outturn. Overall, the net revenue impact of the tax policy changes is expected to be revenue neutral or modestly revenue positive over the medium term<sup>22</sup>.

**24. Expenditure as a share of GDP is likely to remain at current levels over the medium term to sustain recent increases in health and education spending, safeguard the pension system following payroll tax reductions<sup>23</sup> and absorb higher wage costs.** The Government is expected to sustain its 2018 expansion in social spending on health, education and non-pension safety nets (e.g. job guarantees), over the medium term. As part of the reductions in payroll taxes, the Government is required to safeguard pension expenditure and ensure any shortfalls in (extra-budgetary) revenues to the pension fund are compensated by budgetary resource transfers. Similar commitments have been made to safeguard health and education infrastructure programs that were funded by higher payroll taxes.

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<sup>20</sup> These firms were previously subject to small-business tax of 5 percent of turnover, but will now be subject to a 20 percent VAT, 12 percent corporate income tax, and corporate land and water taxes.

<sup>21</sup> Standard deductions to taxable personal income remain progressive – those previously taxed lower than the 12 percent rate are entitled to generous substantial deductions to mitigate the new higher income tax rate. Most higher income brackets are not entitled to any deductions.

<sup>22</sup> Based on WB staff estimates provided to the authorities in mid-2018

<sup>23</sup> Payroll taxes are ringfenced to pay for extra-budgetary expenditure with most resources going to the Pension fund. Until 2018, payroll taxes also funded improvements to roads, education and health infrastructure, and irrigation improvements. Following the reduction in payroll taxes, the remaining payroll tax (employer tax of 15 percent of the wage bill) will be fully directed to the Pension Fund, although revenues to the Fund will still be significantly lower.





The higher wage bill from above-inflation salary increases in 2018 will also contribute to sustaining high spending levels over the medium term.

**25. The consolidated fiscal surplus (excluding extra-budgetary activities) is projected to gradually dissipate over the medium term, mostly due to a decline in payroll and social security taxes.** The consolidated balance is expected to fall from a surplus of 2.2 percent of GDP in 2018 to a surplus of 0.6 percent of GDP in 2019, and eventually to a zero balance in 2021. This will leave the government with less fiscal space over the medium term to deal with growing pressures to increase public sector wage levels (especially of specialized technical staff), mitigate potential negative social impacts of future reform-related adjustment costs, and limit on-budget resources available for public investments. The overall fiscal balance, combining budget and extra-budgetary activities, is projected to remain in deficit of around 1.7 percent of GDP over the medium term.

**26. Government-directed lending from extra-budgetary sources is projected to decline, but the current approach significantly increases fiscal and inflationary risks.** Credit expansions in 2017 and 2018 fueled by the directed lending, for the most part, have been used to finance SOE imports. These expansions, along with increased government investment, have contributed to the significant worsening of the current account balance. If the situation persists beyond the medium term, the risk of persistently large current account deficits has the potential to spill over to inflation if the exchange rates come under pressure. Directed-lending from extra-budgetary sources could also be used to fund domestic spending in the future, which would have a more direct impact on inflation. The macroeconomic uncertainty created under these circumstances could also undermine a key goal of the reform agenda: to attract greater foreign capital and investment to Uzbekistan. A challenge over the medium term is to move away from directed lending in favor of a smaller-scale and more transparent on-budget direct fiscal subsidy. The adoption of such an approach would increase fiscal transparency, and significantly reduce financial and macroeconomic distortions.

**27. Reforming the use of directed credit remains one of the most important priorities to sustain macroeconomic stability.** The Government's current approach to using directed credit is complex and lacks sufficient transparency, elevating macroeconomic risks and constraining the effectiveness of broader structural reforms. Ending directed lending, in favor of a more rationalized, transparent (on-budget), and results-focused subsidy system will make public resource management more sustainable and accountable. It would also strengthen the coordination of macroeconomic policymaking by allowing fiscal institutions to focus on effective public expenditure, and financial sector institutions to focus on effective and efficient credit allocation. It would further help the authorities achieve their goals of improving the performance, governance and accountability of SOEs, and lower pressures on inflation and on external balances.

**28. Fiscal deficits would be financed through the establishment of domestic and external debt issuance programs, and from development partner assistance.** The first domestic T-bill issuance took place in December 2018, which the Government plans to institutionalize with a more regular domestic debt issuance program. The domestic program was complemented by a debut US\$1 billion sovereign Eurobond issuance in mid-February 2019, comprising two US\$500 million issuances with five and ten-year maturities respectively. The remainder of the deficit will be financed through development partner assistance, including from resources proposed under this operation (Table 3).

**29. Debt levels in Uzbekistan are moderate by lower middle-income country levels.** Almost all government debt is externally sourced. Public and publicly guaranteed debt (PPG) was 20.5 percent of GDP<sup>24</sup> (Figure 1). Total external

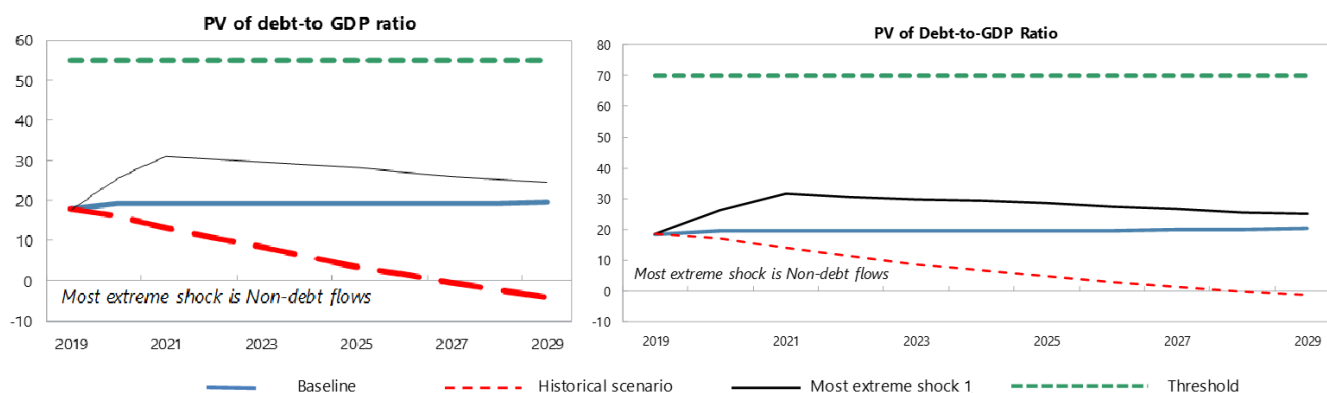
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<sup>24</sup> PPG debt rose increased from 10.5 percent of GDP in 2016 to 24.5 percent of GDP in 2017, almost entirely due to the revaluation of the debt stock following the exchange rate unification.



debt, including PPG and commercially non-guaranteed external obligations, is also relatively low at just above 34 percent of GDP.

Figure 1 - Debt Sustainability Analysis



30. **The risk of debt unsustainability is low.** A joint Bank-Fund DSA for Uzbekistan (published with the IMF’s Article IV Consultation in May 2019) noted the following:

- **Public debt.** The PPG-to-GDP ratio is expected to remain at around 25 percent of GDP (Table 4) for the next 10 years under a baseline scenario. This is relatively low by international standards for a lower-middle income country with a strong level of debt carrying capacity.
- **Total external debt.** The overall stock of external obligations (including PPG) is also envisaged to remain sustainable. The DSA shows that total external debt will be well-contained at around 30 percent of GDP over the next decade under the baseline. While the exchange rate devaluation triggered an increase in the external debt service-to-exports ratio in 2017, the external debt service payments are expected to be just under 12 percent of export revenues, and well-covered by the projected overall reserve buffers.<sup>25</sup>

31. **Continued prudence will be key to preserving Uzbekistan’s debt sustainability over the long term.** The risk of sovereign default is low given Uzbekistan's explicit commitment to fiscal restraint, low external debt stock and high international reserves relative to its external financing requirements, which far exceed total liabilities (not just public liabilities). All solvency and liquidity indicators are projected to remain below their respective thresholds under both the baseline and stress scenarios. Uzbekistan faces a moderately low risk of external debt distress and low risk of overall debt distress. A follow-up DSA is planned during the next Article IV in February/March 2020.

32. **Fiscal risks from contingent liabilities associated with SOE debt are closely monitored by the Ministry of Finance (MoF), and corrective actions are taken quickly every year to mitigate such risks.** Most public companies and banks have access to external borrowing without explicit government guarantees, and their financial performance is monitored by the MoF. As a result, risks associated with contingent liabilities appear to be limited and manageable. Over the longer term, bringing large SOEs into cost recovery and financial sustainability will be critical to enhance fiscal and debt resilience.

33. **Uzbekistan’s macroeconomic policy framework remains supportive of the major economic transition that is under way and is adequate for the proposed operation.** Economic growth is expected to remain relatively strong

<sup>25</sup> External public and PPG debt has been serviced fully and there are no external arrears, including by SOEs.



over the medium term, with sustainable twin (external and fiscal) balances with identified deficit financing, judicious debt management, and greater flexibility in exchange rate management helping to maintain a sufficiently large forex reserve cover and moderate levels of public and private external debt. While inflation remains high, it is expected to gradually moderate over the medium term. This outlook would be supported by strengthening the autonomy and operational and research capacity of the CBU, including for liquidity management through open-market operations, and scaling back policy-based directed lending. This outlook, however, remains vulnerable to a range of downside risks, including: (i) continued government-directed credit at current levels, which could have significant consequences to macroeconomic stability over the medium term; (ii) external economic shocks (e.g. from slowdowns in trading partners) impacting domestic economic performance and financial sector stability<sup>26</sup>; (iii) large increases in contingent liabilities arising from a number of planned Public Private Partnership transactions if contractually linked economic conditions do not materialize; (iv) adverse weather conditions and (v) the occurrence of a major natural disaster<sup>27</sup>.

**34. The World Bank's support to the reforms is carried out in close consultation and coordination with the IMF, which also has an extensive ongoing monitoring and technical assistance program.** In addition to increased staff monitoring, the IMF is providing technical assistance in the areas of Central Bank legal reform, monetary operations and policy, external statistics, national accounts, GFS, fiscal transparency, tax policy and administration.

### 3. GOVERNMENT PROGRAM

**35. The Government remains committed to implementing its 2017-2021 Development Strategy.** Announced by President Mirziyoyev in February 2017, the strategy focuses on greater economic, social and political openness and on transitioning to a competitive and market-oriented economy. The strategy has five pillars: (i) enhancing state and public institutions; (ii) securing the rule of law and reforming the judicial system; (iii) promoting economic development; (iv) fostering social development; and (v) ensuring personal and public security through inter-ethnic and religious tolerance and constructive foreign policy.

**36. The main economic reform priorities under the strategy focus on achieving high and sustained rates of inclusive economic growth and job creation and improving public service quality and efficiency.** Focus areas include improved economic competitiveness and export-oriented growth, industrial diversification, and the reduction in the role of the state in favor of private and market-led production. To achieve these, the Government has prioritized efforts to strengthen fiscal, monetary, and financial sector policies, reduce the tax burden, address external and internal price distortions that constrain the formation of markets, and strengthen and develop the banking and financial sector. The Development Strategy also sets out intentions to modernize agriculture to help ensure food security, while encouraging the use of more climate-adapted crops (reduce water consumption). To increase social development, the strategy places a heavy emphasis on inclusivity, through a strong focus on raising real incomes, the creation of more and better jobs, overhauling the social safety net system, improving education and healthcare services, and strengthening the role of women in society.

**37. Economic reforms are complemented by a strong focus on improving public institutions and regional relations.** The Development Strategy aims to overhaul public administration and public services (especially judicial,

<sup>26</sup> About 40 percent of lending is in foreign currency, most of which is unhedged and owed by weak SOEs. Any exchange rate effects of external shocks could impact bank portfolio and capital quality, with resultant fiscal risks since most of this debt is state-owned.

<sup>27</sup> An earthquake in 1966, with its epicenter at the heart of Tashkent, measuring 5.1 on the Richter scale with a depth of 3km, killed between 15 and 200 people, left over 300,000 homeless, and destroyed most buildings in the city including an estimate of between 75,000 and 95,000 homes.



legal and political institutions) to make them more citizen-centric. The Strategy also includes commitments to decentralize power and financial resources to local authorities, deregulate the economy and society, and increase the state's transparency, and openness. Planned reforms cover economic issues such as contract enforcement, guarantees and protections of property rights, and the use of PPPs. They also address important social issues such as criminal and civil law, human rights, discrimination, freedom of movement, and the provision of legal and citizen advisory services. The Strategy also sets out an ambitious agenda to strengthen regional political relations, and to improve regional economic integration, particularly in the energy sector<sup>28</sup>.

**38. In early 2019, the Government officially adopted a 2019-2021 “Reform Roadmap” that sets out further details on how it will achieve its economic development strategy over the medium term.** The Roadmap's objective is to further accelerate the implementation of the 2017-2021 Development Strategy. It sets out a comprehensive program of reforms covering five focus areas: (i) maintaining macroeconomic stability; (ii) accelerating the market transition; (iii) strengthening social protection and citizen services; (iv) transforming the government's role in the market economy; and (v) preserving environmental sustainability. The Roadmap was prepared by the Government in close partnership with the World Bank, drawing on relevant lessons learned from other transitions.

**39. Uzbekistan's development strategy also includes strong commitments to improving energy efficiency and reducing fossil fuel use intensity—consistent with the Government's commitment to climate change mitigation.** Uzbekistan's voluntary commitments on climate change mitigation and adaptation under its INDC (Intended Nationally Determined Contribution, submitted to the United Nations Framework Convention on Climate Change on April 18, 2017) focus on improving energy efficiency and reducing the fossil fuel intensity of the economy. In its INDC, Uzbekistan committed to decrease specific emissions of greenhouse gases per unit of GDP by 10 percent by 2030 (compared with 2010). This commitment assumes financial and technical support from international organizations and financial institutions, access to advanced energy-saving and environmentally-sound technologies, and climate finance. Uzbekistan also committed to continuing efforts toward climate change adaptation, to reduce the risk of adverse climate change impacts on various economic sectors, the social sector, and the Aral Sea coastal zone.

## 4. PROPOSED OPERATION

### 4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

**40. The development objective of this proposed operation and the associated prior actions are closely aligned with Government priorities in the 2017-2021 Development Strategy and the 2019-2021 Reform Roadmap.** The two pillars of the development objective of this proposed operation are closely aligned with the Government's focus on accelerating sustainable, inclusive and market-led growth. They are also aligned to the Government's intentions to transform and overhaul the role of the State in the economy, away from a model dominated by SOEs in favor of greater private sector led activity, and towards a role as an effective and efficient public investor, and provider of high-quality public services to all citizens. Reforms supported under the first pillar aim to strengthen the role of markets and private sector in the economy by boosting trade and exports, increasing private sector activity and job creation, liberalizing state dominated sectors of the economy, and strengthening legal and regulatory frameworks for greater investment in the energy and financial sectors. The second pillar of the proposed operation focuses on social inclusion through measures to lift tax, labor mobility and skills constraints to formal job growth, reduce fragmentation and inefficiency in the social safety net system and increase citizen participation in local budgetary processes.

<sup>28</sup> For example, Uzbekistan resumed purchases of electricity from Tajikistan in 2018 after a nine-year interruption.



**41. The proposed operation supports a deepening of the historic reforms achieved under the first DPO.** The first DPO, which was approved by the Board in June 2018, focused on measures to reduce price and market distortions, address weaknesses in fiscal and financial sector management, boost trade and agricultural productivity, and tackle constraints to inclusive growth in the labor market and safety net system. The reforms supported in the first DPO represented an important first phase of reforms that helped put Uzbekistan on a sustainable and inclusive path to a competitive private-sector led economy. This proposed operation, while supporting similar themes as the first operation, focuses on deepening the reform agenda to accelerate the achievement of Uzbekistan’s goal of achieving a sustainable and inclusive market transition. This operation also supports the Government’s strong interest in making early investments to increase social inclusion and shared prosperity.

**42. Consistent with the Government’s priorities and the emphasis of the first DPO, the Program Development Objective (PDO) of the proposed operation is to sustain Uzbekistan's economic reform program and transition to a market economy by (i) increasing the role of markets and the private sector in the economy; and (ii) enhancing social inclusion.** Under the first pillar of the PDO, the operation supports measures to accelerate the transition process by reducing market constraints to greater trade and investment, addressing legal and regulatory gaps limiting private sector growth and greater private investment, and supporting a transformation of the state’s role in the economy. Under the second pillar of the PDO, the operation includes measures to address tax, labor mobility and skills constraints to formal job growth, and strengthen safety nets and increase the voice of citizens. Measures in both pillars also aim to strengthen mitigation and adaptation to the effects of climate change and natural disasters.

#### 4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

##### Pillar 1: Increasing the role of markets and the private sector in the economy

**43. Addressing institutional and market constraints to private sector growth, and reducing the state’s control over the economy, are critical to Uzbekistan’s transition goals.** Reforms enacted in 2017, and supported by the first DPO, such as the unification of the exchange rate and the removal of administrative price controls and trading restrictions on a range of commodities, were significant first steps to allow for price mechanisms to play a greater role in resource allocation and consumption choices. Reforms in this pillar focus on sustaining the market transition by deepening these initial reforms in three ways: (a) by further reducing controls that inhibit the formation of competitive markets, (b) by addressing institutional gaps that constrain private sector growth and investment in key sectors, and (c) by supporting the State in moving away from its role as the dominant economic producer and monopolist in key growth sectors.

##### *Agriculture*

***Prior Action 1: To increase agricultural exports and incomes for farmers, the Borrower has (i) removed mandatory pre-payment and minimum export price requirements for horticultural exports, (ii) removed controls on the sale price of shaped bread; and (iii) increased the state farmgate procurement price offered to farmers for the 2019 wheat harvest.***

**44. The horticulture sector has shown significant potential, but realizing its full extent requires reforms and investments to remove remaining production and export barriers.** Horticulture’s high external competitiveness, profitability, and labor intensity – relative to cotton and wheat – create an opportunity for “quick” reform results that could lead to rapid income growth, job creation, and poverty reduction. The Government recognizes this and has implemented major reforms to get some early gains for the broader population. It started in 2017 with making more



land available (well beyond the commitments taken under the first DPO) for horticultural and fodder production through reductions in mandatory cotton and wheat growing areas.<sup>29</sup> This was complemented by a range of other actions in 2017 that contributed to a 35 percent increase in the value of horticultural exports in 2018 compared to 2017. The reform efforts continued in 2018, with two especially impactful measures. First, Presidential Resolution PP-3978 removed minimum export price requirements to allow exporters to benefit from price arbitrage and better manage global price volatility.<sup>30</sup> Second, Presidential Decree UP5495 lifted the preferential export regime for exporters using the state-owned export finance corporation (Uzagroexport).<sup>31</sup>

**45. Further improvements to support growth in horticultural exports remain demanding in terms of the reform requirements.** Next generation reforms and investments to tackle key impediments include: (i) high costs and inefficient logistics; (ii) poor organization of value chains, with major producers of horticultural products – the small dehkan farms – not linked to anchor firms; and (iii) a lack of effective public programs for seed quality, pest and disease control, product standards, food safety, and traceability. Addressing these impediments would require long-term public investments in logistics, productive partnerships between farmers and agribusinesses, enhancements in food safety, phytosanitary measures, seed quality, and traceability in a way to crowd in private investments using the Maximize Finance for Development (MFD) approach.

**46. Having more irrigated farmland available for horticulture production is also critical to further support growth in horticulture exports.** Lifting wheat yields up through improved incentives to wheat farmers is critical to continue shifting more farmland from this food security crop to horticulture. The Government has announced its intent to fully remove price controls in the wheat value chain and has adopted a sequenced approach to achieve this over the medium term. In September 2018, the Government, through the issuance of Cabinet Resolution 731, took a first step in lifting the administrative price controls on the sale of social types of bread<sup>32</sup>, allowing sellers to set prices based on market fundamentals. As a result, social bread prices have roughly doubled, which was the first increase in bread prices in the last two decades. To mitigate the effects of this price increase on the most vulnerable consumers, the Government simultaneously expanded safety net payments to low-income families and pensioners and maintained price controls on the wholesale price of flour.<sup>33</sup> The liberalization of bread prices was a necessary first step to support wider reforms in the wheat sector. In November 2018, through Cabinet Resolution 959, the Government increased the state procurement price<sup>34</sup> of wheat by 60 percent<sup>35</sup> for the 2019 season and added an additional mark-up of 10-25 percent for farmers with yields above the national average of 4 tons/ha. This measure considerably reduced the

<sup>29</sup> The cotton and wheat growing areas are projected to have declined by 350,000 ha between 2016 and 2019, twice as much as committed under the first DPO (a shift of 175,000 ha of cotton and wheat growing area by 2021).

<sup>30</sup> For example, in early 2018 the Government announced a minimum price of US\$4/kg for the export of fresh cherries, against an April 2018 minimum price of US\$1/kg, in the largest export markets (Russia and Kazakhstan). This led to significant losses for many horticultural producers and created uncertainty about the prices of other horticultural products. In response to complaints from the industry, the Government eliminated the minimum export prices for all horticultural products through a Resolution of the Cabinet of Ministers in August 2018.

<sup>31</sup> Enterprises registered with Uzagroexport were, until recently, not subject to a mandatory 100 percent pre-payment requirement and could export on a consignment basis. Other firms did not enjoy these benefits and had to either receive full payment prior to exports or surrender an equivalent amount in escrow. This requirement was lifted through a Presidential Resolution on October 17, 2018.

<sup>32</sup> Certain types of bread are classified as “social” and were previously price controlled to ensure affordable access to bread for vulnerable and poor citizens.

<sup>33</sup> Bread and bread products are an important part of household expenditures and the wheat sector is critical to national food security. Bread expenditures as a share of household budgets range from 4 percent in Tashkent to 11 percent in the Kashkadarya region.

<sup>34</sup> Under the state quota arrangements for wheat, farmers must sell half of their output at the set prices and the remaining half at market prices.

<sup>35</sup> 750,000 UZS/ton (US\$93/ton) in 2018 to 1,200,000 UZS/ton (US\$143/ton)





gap between state and market prices<sup>36</sup>. The higher state procurement price in 2019 is expected to increase average farm income by 50 percent (assuming 2018 production costs). The Government is now in the process of preparing to liberalize in 2019 the price of flour produced from wheat that is procured under the state quota. This will likely to lead to a further moderate increase in bread prices, which would also be supported by safety net adjustments. The Government plans to eventually fully liberalize farmgate wheat prices and shift to a more market-oriented approach of enhancing food security through a mix of increasing wheat production by rising yields and maintaining steady wheat imports.

**47. The measures supported by this prior action will help boost private investment, jobs, and productivity in the agriculture sector, as well as generate significant climate co-benefits.** The horticultural sector reforms are expected to increase exports and farmer incomes and increase the sector’s appeal to both private sector investors and job seekers. The wheat sector reforms are expected to significantly increase farmer incomes through improved competition at the farm-gate, setting the stage for full wheat sector liberalization and improvements in food security. Anticipated impacts of climate change include the increase in climate variability with implications for growing food (e.g. increased droughts and decreased water availability may lead to crop failures). The measures under this prior action are contributing to improved climate resilience, particularly of the poor and vulnerable who often rely on horticultural products for their livelihoods. Better incentives for producing horticulture products are expected to generate multiple climate co-benefits, both mitigation and adaptation. This is especially relevant to fruits. First, agricultural water use efficiency is much higher for producing fruits than wheat (thereby contributing to climate mitigation). Second, the common practice in Uzbekistan, observed in the Horticulture Development Project supported by the IBRD loan, is to adopt drip irrigation for intensive new orchards with capacity to simultaneously fertilize soils, as high-productivity orchard seedlings can’t grow under flood irrigation, a tradition watering practice for traditional orchards. This practice reduces the use of both water (thereby supporting adaptation through better water resource management) and fertilizers, the causes of CO2 emissions (thereby contributing to climate mitigation). And third, fruit trees play an important role in agro-ecological systems through helping restore soil fertility and provide land or wind breaks to reduce soil erosion, contributing to improved resilience of the land and carbon sequestration.

### **Domestic Trading**

***Prior Action 2: To reduce market entry barriers and increase competition in domestic trading activity, the Borrower has removed: (i) licensing requirements to start and operate wholesale domestic trading and itinerant trading businesses; and (ii) mandatory advance payment requirements for commercial trading transactions between entities whose Government ownership is less than 50 percent.***

**48. Despite significant efforts in the last two years to improve the business climate, commercial trading activity remains constrained by complex mandatory requirements and procedures.** In 2002, the Government established additional licensing requirements for wholesale trading businesses, to safeguard downstream businesses from poorly equipped or financially vulnerable suppliers. To obtain a license, firms had to demonstrate minimum capital levels, obtain permissions from local authorities, and provide proof of ownership of adequate warehousing facilities and technical equipment. Licenses could be revoked for violations of wholesale trading rules, or on the recommendation of the State Tax Committee, with limited legal recourse. Itinerant traders – those with no fixed physical place of operation, such as mobile sales kiosks or businesses operating in seasonal fairs – are some of the smallest businesses in the country but faced even more onerous registration and licensing requirements. To improve financial solvency and ensure the timeliness of payments, businesses that performed work or provide goods and services to consumers and other businesses had to receive an advance payment of 15 percent of the cost of those

<sup>36</sup> The market price in 2019 is projected to range between 1,600,000 UZS/ton and 1,800,000 UZS/ton (US\$190-210/ton).



goods and/or services and that needed to be paid in full within 90 days of completing the transaction. Traders failing to follow the licensing and financial settlement rules were liable for heavy financial penalties and, in certain cases, criminal prosecution. According to the Government's own estimates, the considerable red tape involved in obtaining licenses, the high risks of license loss, and the severe penalties for violating prepayment and arrears regulations have significantly curtailed the growth of the formal trading sector, limiting domestic competition and job growth.

**49. In October 2018, the Government enacted measures to address these constraints.** Following the issuance of Presidential Decree UP-5564, from January 1, 2019, wholesale trading businesses and itinerant traders are no longer required to obtain licenses beyond normal business registration requirements. The 15 percent advance payment requirement and the associated sanctions regime for pre-payment and arrears delays have been abolished for all entities except those whose State ownership exceeds 50 percent. The measures also removed export permit requirements and foreign exchange payment controls on invoices below US\$5,000 and eliminates an onerous tax accounting requirement for businesses selling excisable goods (e.g. cars and vegetable oil) in the domestic market.

**50. Further work is needed to remove various other constraints on small and medium commercial trading businesses.** The Government recognizes that the above-mentioned reforms are only initial steps and has prioritized the removal of other constraints on business operations in the 2019-2021 Roadmap. For example, the Roadmap includes removing mandatory cash surrender rules that require businesses to surrender physical cash from sales into a commercial bank account. While these surrender requirements have been gradually eased – from requiring all businesses to surrender cash multiple times per day, to requiring most businesses to surrender cash periodically during the week – they remain a source of significant inefficiency in business operations.

### **Banking Sector**

***Prior Action 3: To improve financial sector efficiency and stability, the Borrower has submitted a new banking law for Parliamentary approval that gives sufficient powers to the Central Bank of Uzbekistan to conduct effective oversight and enforcement, establishes a comprehensive and transparent licensing framework, and strengthens corporate governance and transparency requirements for commercial banks.***

**51. The legal and regulatory framework for oversight of the financial sector is outdated and needs to be upgraded to comply with international standards.** The existing regulatory framework was designed largely to ensure that the Government had adequate powers to enforce its directed lending and credit targets, rather than to create a level playing field for commercial banks and ensure that risks were properly managed to protect depositors and ensure financial stability. Numerous regulations have mandated banks to conduct activities outside core banking functions. Significant examples include the facilitation of tax collection and maintenance of exchange rate controls that were in place until mid-2017. The legislation and regulations relating to banking, insurance and securities regulation and supervision, and financial intermediation (i.e. civil code, bankruptcy law etc.) all need significant revisions to support financial sector development and a move to an effective, risk-based supervision regime. Alongside these institutional reforms, supervisory staff need training in how to supervise Uzbekistan's financial sector in line with international best practices.

**52. The Government has formulated a financial sector reform program and roadmap, which has been supported by the World Bank Group through advisory services and the previous DPO.** A Presidential Decree adopted in mid-2017 outlines Government intentions for broad reforms that improve the way in which banks operate. It commits Government to removing non-core administrative functions from banks, strengthening prudential oversight, and continuing to improve financial infrastructure to facilitate private sector access to credit. The 2019-2021 Reform Roadmap sets out many actions to transform the financial sector along these lines.





**53. Revisions to the Banking Law and the Central Bank of Uzbekistan Law are being developed to allow more meaningful financial sector reforms to take shape.** Both are key pieces of legislation and are expected to be approved by Parliament by the third quarter of 2019<sup>37</sup>. They provide a framework for conducting monetary policy and providing banking services. Together, they aim to enhance the autonomy and powers of the central bank to perform its functions, expand the range of tools available to it, and increase its transparency and accountability. The new banking law provides a modern legislative framework for the provision of banking services to ensure a level playing field and enhance the protection of financial consumers. It introduces important reforms to facilitate sound banking sector development and supports measures to consolidate sector activity to increase efficiency and expand the sector by increasing clarity for new market entrants. The new law will create a framework<sup>38</sup> for: (i) stronger supervisory and sanctioning measures that ensure the CBU has the necessary tools to identify risks, and sufficient legal powers to apply proportional measures and sanctions to address these risks; (ii) comprehensive and transparent licensing framework; (iii) requirements to ensure the quality of the shareholders and transparency in the ownership structure; and (iv) provisions to ensure independent and transparent corporate governance in banks.

**54. The new laws represent a significant step forward prepare the foundation for the Government to decrease its directive role in the financial sector while strengthening its supervisory and regulatory functions, thereby increasing financial stability.** In the short-term, the laws are expected to improve the compliance of Uzbekistan's banking regulatory framework with international standards. Over time, they are expected to create a foundational platform for greater efficiency and stability in the financial sector. The readjustment of the State's role in the banking sector, in tandem with SOE reforms, will be critical to Uzbekistan's transition to a market economy. By curtailing directed lending, and by restructuring state-owned banks, the Government would help direct more resources towards growing and productive firms, and away from less productive and less efficient firms. Reforms to state-owned banks need to proceed in parallel with reforms to SOEs, as state banks are among SOEs' largest creditors. Upgrading financial infrastructure would support the development of new financial products and services and improve system resilience. Lessons learned from past episodes of financial liberalization also underscore the importance of early investments in a strong supervisory regime of financial activities to protect financial consumers and avoid a financial crisis with its associated economic and social costs. To help address these policy issues, the Government has requested the World Bank's support to develop a financial sector strategy that will serve as a blueprint for financial sector reforms.

### **Renewable Energy**

***Prior Action 4: To increase private sector investment in the energy sector, the Borrower has taken measures to establish a legal framework for the development of renewable energy and to adopt procurement procedures for the selection of potential renewable energy providers.***

**55. Uzbekistan has high potential for renewable energy, opportunities to realize this potential have been constrained by distortions and the absence of an institutional framework.** Renewable energy development is a high priority for Government, both to address immediate energy needs and to reduce the power sector's environmental impact as part of Uzbekistan's contributions to mitigating climate change. Renewable energy will also support a shift away from depleting stocks of natural gas reserves (which also have high export value) and help bridge gaps in electricity demand and supply. Renewable energy accounts for around 15 percent of total generating capacity, almost all of it hydropower. Less than 0.5 percent of total generation potential from renewable sources has been

<sup>37</sup> The new Banking Law was developed as a wholesale revision to the existing Banking Law (#216-1, 1996) and was submitted via a transmittal 02/1-66 from the Office of the Prime Minister to the Parliament of Uzbekistan on April 16, 2018.

<sup>38</sup> Some issues, such as licensing, will require secondary legislation and regulations. The new banking law will serve as the legal framework for the development of these subsidiary instruments.



utilized, with the two biggest sources – solar and wind energy – virtually untapped. Constraints on further renewable energy development include an inadequate institutional framework, subsidized pricing of existing energy services, and financial weakness of Uzbekenergo, the state energy company. The most significant institutional challenges are the absence of (i) a clear legal framework for the renewable energy sector, and (ii) an effective regulatory framework that allows energy generated by renewable sources to integrate with existing national energy infrastructure.

**56. A new Renewable Energy law will provide a legal framework for the development of the renewable energy sector.** In early 2017, the Government adopted a renewable energy and energy efficiency program<sup>39</sup> to establish institutional, policy, legal and regulatory frameworks for renewable energy and increase private sector investment in the sector. The launch of this program was followed by a Presidential Decree in mid-2017 to set out a revised policy framework for renewable energy development, with an explicit focus on increasing private investment in renewable energy generation. As part of this process, a new renewable energy law was submitted in June 2018 for Parliamentary approval to provide a legal framework for this policy and allow the development of secondary legislation and technical standards. Following a first reading of the law, the law was revised by the Government<sup>40</sup> in order to strengthen requirements around competitive procurement for the selection of new renewable energy developers. Once approved by Parliament, the revised law (#П3-384) will be complemented by the recent establishment of a new Ministry of Energy, which will be responsible for policymaking for and regulation of the entire energy sector, including renewables.

**57. The new law addresses a fundamental institutional gap for the transparent and competitive development of the renewable energy sector in Uzbekistan; over time, it will enable greater private sector investment in renewable energy and create opportunities for climate change mitigation and adaptation.** The draft law sets out key rights for private renewable energy producers, including guaranteed access to the power grid. It also stipulates the creation of a special fund<sup>41</sup> to incentivize renewable energy development by providing financial support for the introduction and scale-up of clean, renewable energy technologies. These changes will support a shift away from more carbon-intensive energy sources such as gas. In addition, embedded renewable energies provide adaptation co-benefits by reducing distribution requirements and help bridge gaps in electricity demand and supply (thereby improving reliability and supply). The Government is simultaneously moving ahead in developing the sector's institutional infrastructure and is working with the World Bank and other partners to establish an enabling environment for the renewable energy deployment. This will include restructuring the energy sector, introducing a transparent and competitive procurement framework for renewable energy, preparing grid-integration codes and sustainable pricing frameworks, and reducing investment risks to promote private sector participation. These measures are essential to greater private investment, and to greater exploitation of renewable energy in Uzbekistan as an alternative to help mitigate and adapt to the effects of climate change.

### **Public Utility Tariffs**

***Prior Action 5: To achieve financial sustainability of energy and water utility companies, the Borrower has adopted revised tariff methodology, consistent with principles of full cost-recovery, for the provision of electricity and cold-water services.***

### **Electricity**

<sup>39</sup> "Program for Further Development of Renewable Energy, Improvement of Energy Efficiency in Sectors of Economy and Social Sector in 2017-2021".

<sup>40</sup> As evidenced in a transmittal from the Ministry of Finance to the Parliament (#AX/19-01-29/832)

<sup>41</sup> Which will be established on-budget.



**58. Uzbekistan’s energy system is relatively inefficient and unreliable due, in part, to the rapidly-aging supply infrastructure that was mostly constructed during the Soviet era.** Gas supply losses are estimated to be over 30 percent of production, and electricity losses around 20 percent of net generation. Gas losses are more than 15 times, and electricity losses about three times, the OECD averages. Low reliability of electricity supply is a symptom of aging infrastructure as electricity transmission and distribution lines are about 30 years old, on average. Uzbekistan is also one of the most energy-intensive countries in the world. While the country’s energy intensity declined by about 45 percent during 1998–2013, its energy use per unit of GDP is over three 3.1 times the average for the Europe and Central Asia region. Compounding this issue has been the deteriorating position of Uzbekenergo (UE) and Uzbekneftegas (UNG). The financial situation of both organizations has been weakened by limited loss reductions, ad-hoc tariff adjustments and pricing policy; and poor collection rates. This was compounded by their foreign exchange debt exposure following the September 2017 devaluation of the som. Both companies received Government budgetary support to cover foreign exchange losses post-devaluation, while also being subject to Government plans to strengthen their financial and operational transparency<sup>42</sup>. Climate change impacts are expected to put further pressures on the country’s energy system as a result of increased climate variability and extreme weather events.

**59. As part of a broader strategy to address weaknesses in the energy sector, the Cabinet of Ministers issued a resolution [#308] that adopts a new electricity tariff methodology to strengthen the robustness of the tariff setting process, improve financial viability in the sector, and improve environmental sustainability and resilience to climate change.** The Resolution establishes a separate tariff commission under the Cabinet of Ministers and sets out a path for tariffs to be adjusted to full cost recovery levels<sup>43</sup>. The primary goal of this reform is to move away from what has been a largely ad-hoc process of tariff setting, in favor of a more robust approach to that considers full costs and revenue requirements, service quality and performance levels, and compliance with regulatory standards. The measures are part of a broader energy sector reform strategy launched in October 2018, which led to the creation of a new Ministry of Energy in January 2019 that will be responsible for energy sector (electricity and gas) policymaking and regulation. In March 2019, the Government also announced measures to split UE into three separate entities to separate production, transportation and distribution of electricity. Efforts are also under way to identify new greenfield projects (several of which will be renewable energy projects) as well as rehabilitate existing infrastructure through direct private investments or PPPs. The Government also intends to introduce advanced electricity metering infrastructure nationwide by December 1, 2021 to reduce energy system losses, increase energy efficiency, and improve transparency and accountability in the sector.

**60. Over time, measures to strengthen electricity tariff methodology are expected to play a strong complement to the broader modernization and institutional reforms under way, while also bringing significant climate co-benefits through improved energy efficiency and reliability.** The new Commission is expected to be staffed in the next few months, and the new framework and methodology will be used to evaluate tariff changes commencing from the 3<sup>rd</sup> quarter of 2019. Although electricity tariffs have been regularly revised biannually in recent years, these revisions have been somewhat ad-hoc, linked to maintaining firm viability against recurrent costs. A clear and systematic tariff methodology, and the creation of a separate body to recommend<sup>44</sup> tariff changes based on systematic criteria, are important institutional reforms that will, over time, increase the resources

<sup>42</sup> Uzbekenergo’s adoption of International Financial Reporting Standards (IFRS) was a prior action under the first DPO. Uzbekenergo has made good progress in implementing IFRS standards, with the company’s first-ever IFRS-compliant audited financial statements for 2015 having been prepared and submitted to the World Bank. Audits for more recent years are expected to be completed by August 2019.

<sup>43</sup> While the Decree does not establish a timeline for full cost recovery, this is expected to happen over 2-3 years.

<sup>44</sup> The body will be a separate institution but will not have full independence to set tariffs. It will instead recommend tariff increases, which must be approved by Cabinet, based on the new tariff policy and methodology,



available for sector modernization. The effective implementation of these measures, and further reforms that could increase the independence of the final tariff decision, could also significantly increase private investor confidence in the sector. The alignment of tariffs to true costs will also significantly contribute to the Government's wider campaign of improving energy efficiency and loss reduction, which in turn could have significant climate mitigation co-benefits in addition to adaptation co-benefits through increased reliability.

**61. The Government is considering similar measures to reform the natural gas sector and gas tariffs and has taken first steps to reform UNG and strengthen sector policy.** Although progress in reforming UNG has been less visible, work is under way to modernize assets and strengthen financial transparency. Measures are under way to evaluate the full financial position of UNG, and options for corporate restructuring are being developed with the support of the Asian Development Bank. Some initial measures, such as the adoption of IFRS standards, and the sale of UNG's vast portfolio of non-core assets, is already under way.

### **Water**

**62. Although water tariffs have increased in recent years, they remain too low to cover the real costs of operation and maintenance (O&M), attract specialized talent, or accumulate funds for investment.** The average unified tariff for domestic consumers in 2018 was around 0.08 US\$/m<sup>3</sup>, well below regional comparators and requirements for cost-recovery. The current tariff structure also discourages metering and efficient water use – customers without meters are charged flat rates that reduce incentives to install meters and encourages overconsumption and waste. An ad-hoc tariff-setting process and the absence of a clear policy framework perpetuates the weak O&M cycle by preventing Suvokovas<sup>45</sup> from engaging in long-term planning based on steady, predictable revenues, instead relegating them to short-term, one-year planning cycles that are dependent on transfers from the central government.

**63. Following a phase of institutional reforms that have now been sufficiently embedded, Cabinet of Ministers Resolution #310 adopts a new tariff policy framework and methodology to improve financial sustainability and water usage efficiency.** Full cost recovery will strengthen the financial sustainability and investment environment for Suvokovas and increase the transparency and credibility of the tariff-setting process. The new framework will also improve customers' incentives to adopt meters, which is likely to have a large positive impact on the efficiency of water use. Improved water resource management also brings co-benefits in terms of climate adaptation. Tariffs in the new policy will reflect both costs and levels of service, allowing for a fairer tariff-setting process – particularly in rural areas that currently face both higher costs and significantly lower service quality than urban areas.

**64. The introduction of IFRS-based accounting standards for water and sewerage utility service providers will improve make the tariff-setting process more rigorous and strengthen the Suvokovas' financial transparency and accountability.** The gradual adoption of IFRS by all Suvokovas over the medium term will enable full costs to be more transparently determined, ensuring greater rigor in the tariff-setting process. It will also enable utilities to more effectively set aside reserves for asset maintenance and renewal through improved accounting procedures to determine depreciation and capital charges. Currently, nearly all major water sector infrastructure has zero book value according to national accounting standards, resulting in the exclusion of depreciation costs from the tariff-setting process. The adoption of IFRS standards will revise this approach to allow for more effective asset management and replacement. The World Bank is working closely with government agencies on the development of the tariff policy and the adoption and rollout of IFRS to Suvokovas over 2019-2020.

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<sup>45</sup> Suvokovas are regional water utility companies created in 2016 through the merger of urban and rural service providers.



## Aviation

**Prior Action 6: To increase private sector participation in the aviation sector, the Borrower, has (i) separated the Borrower's airline management, airport management, and air traffic control functions, and (ii) separated its policymaking, technical regulatory, and operational functions in the aviation sector.**

**65. Despite its double-landlocked yet strategic location, Uzbekistan has limited air transport connectivity.** High transportation costs and long distances to reach major economic centers have limited Uzbekistan's ability to export agricultural produce to large consumer markets in Europe and East Asia and participate in global value chains. Limited air connections and high air travel costs to and from Uzbekistan are also a major constraint to tourism growth. Uzbekistan's air transport sector has grown by just 2 percent a year since 2010 despite strong and rising demand, and the country received only about 2.8 million visitors by air in 2017, well below its estimated potential<sup>46</sup>. Only 15 international carriers serve Uzbekistan. The national air carrier (NAK), which also owns the airports and enjoys favorable discounts on fuel and airport charges and fees, accounts for 75 percent of total passenger seats. Tashkent Airport is one of the most expensive in the developing world in terms of operating costs and fees.

**66. Uzbekistan's aviation sector has a vertically integrated structure with the national airline, airports and air traffic control bundled under a single entity – NAK Uzbekistan Airways.** Current aviation sector policies and governance structure are set up to limit the access of international airlines to the country and to protect NAK from meaningful external competition. The NAK has a complete monopoly on local air transport and airport services and owns and operates all commercial airports in the country. Safety oversight has been separated from the NAK and transferred to GosAviaNadzor, consistent with International Civil Aviation Organization (ICAO) recommendations; however, it is still funded by the NAK. The current monopoly arrangement and lack of competition has resulted in inadequate services at high prices. Worldwide best practices in air sector governance provide for the separation of policymaking, regulatory oversight, and airline operations and airport operations.

**67. In November 2018, the Government announced its intentions to reform the aviation sector through a strategic restructuring of NAK Uzbekistan Airways and measures to dismantle regulatory and structural barriers and monopolistic protections that limited private sector entry into the sector. Through its issuance of Presidential Decree 5584, the Government:** (i) reorganized NAK into separate companies to manage the airline, airports, and air navigation services; (ii) transferred policymaking and sector regulatory responsibilities to central government (currently under the Cabinet of Ministers, with the possibility of a separate Ministry of Transport being established over the medium term); and (iii) announced the Government's intentions to establish PPPs to operate and manage Uzbekistan's main airports. The Decree also commits to the development of further measures to liberalize Uzbekistan's aviation sector over the medium term. A working commission recently appointed by the Government to coordinate the implementation of the sector reforms will work jointly with the World Bank Group to develop the Road Map that will be delivered as part of the current advisory service. Immediate next steps include reorganization of NAK, developing a new aviation sector policy, and establishing the new entities stipulated in the Decree.

**68. The implementation of these reforms will help level the playing field in the aviation sector, helping to attract greater private sector participation and investment in the sector and to provide a strong enabling environment to step up growth in high-potential sectors of the economy.** The unbundling of sector operations, and the transfer of policymaking functions to central government, will help align regulatory and public investment decisions in the aviation sector with the Government's overall economic reform objectives. The announcements of the unbundling and potential airport PPP transactions have already begun to generate emerging interest from international airlines that are interested in operating services to Uzbekistan.

<sup>46</sup> Uzbekistan Country Private Sector Diagnostic (WB/IFC, 2018)





***Prior Action 7: To improve the financial transparency and accountability of State-Owned Enterprises, the Borrower has created a new Agency for the Management of State Assets, reporting to the Prime Minister, to be responsible for the management of state-owned enterprises and the implementation of an open and transparent process for the privatization of state assets.***

69. The State's dominant role as a producer in the economy is underpinned by its ownership of, and shareholdings in, around 2,000<sup>47</sup> registered business enterprises; however, oversight of and financial information on these enterprises is very limited. Until recently, responsibilities for SOE oversight and governance was heavily fragmented: the monitoring of SOEs, and privatization, were the responsibility of a department under the State Committee for Privatization, Demonopolization and the Development of Competition (GKK), and share ownership and SOE reporting lines were spread across various government agencies. The delineation of monitoring and shareholding agencies, and GKK's broad mandate<sup>48</sup> limited effective oversight of SOEs. Furthermore, no single government ministry or agency possesses complete information on all SOEs operating in the country. The absence of critical data such as the number of employees, income, turnover, profit margins, and the holding structure, constrains the Government's ability to make informed decisions on a critical reform agenda that also involves significant political and social considerations. It also reduces the quality of official estimates of the overall contribution of SOEs to GDP and employment and constrains the Government's ability to take stock of quasi-fiscal and cross-government subsidies, making it more difficult to understand the full economic and social benefits and costs of sustaining existing SOEs.

70. In January 2019, Presidential Decree UP 5630 disestablished GKK and created a new entity for each of its three previous functions, including a new Agency for the Management of State Assets that will be the central government focal point for SOE ownership, management, and privatization. As part of the Decree, shares of 39 large SOEs were transferred to the new Agency with immediate effect. The shares of a further 123 SOEs were inherited from GKK, resulting in the centralization of ownership of all central government-owned Joint Stock Companies and Limited Liability Corporations under a single agency<sup>49</sup>. Although the Government has not yet made a final decision, the Agency is also expected to gradually acquire ownership of sub-nationally owned JSCs as well as unitary enterprises. The Agency's immediate priority is to develop, by March 2019, a draft government SOE ownership strategy for Presidential consideration. This strategy will outline the key strategic sectors in which the Government will maintain its presence through SOEs and set out – at a high level – its intentions on how it will divest its ownership (through liquidation, PPPs or privatization) in non-strategic sectors. The Decree also requires that complete comprehensive independent financial valuations and inventories of all agencies under the ownership of the new Agency be completed by the end of 2019. The Agency is now preparing an initial inventory and is expected to launch a competitive process to identify and appoint experts to undertake the financial valuations based on International Financial Reporting Standards (IFRS). Under the implementation arrangements for the recent Presidential Decree on land privatization,

<sup>47</sup> Estimates of this number vary depending on classification criteria. Recent estimates by the Government, in close discussions with the IMF and World Bank, suggest that the number of Joint Stock Companies (JSCs), Limited Liability Corporations, and Unitary Enterprises in Uzbekistan with a Government share greater than 50 percent is around 2,000.

<sup>48</sup> Under the old model, GKK played a critical role in determining changes to the vast system of administrative price controls in the economy, and most institutional resources were directed to managing this complex responsibility.

<sup>49</sup> The mandate of the new agency currently covers JSCs and LLCs, but not state unitary enterprises. There are currently 606 registered JSCs, but a significant number of these are subsidiary JSCs of larger enterprises; some are also owned by provincial and district authorities although the exact number is unclear.



the Agency will also own all urban land in Uzbekistan that is currently unallocated and undeveloped and will be responsible for the sale of this land for urban development under legislation that is being drafted.

**71. The Government has also created an institutional framework for the development and management of Public Private Partnerships (PPPs).** An October 2018 Presidential Decree created a PPP agency under the Ministry of Finance. The agency is now has been established, and it is finalizing, with support from the World Bank Group, and a new PPP law was approved Parliament in May 2019. The new law provides a consolidated legal framework for PPP investments, reducing risks and increasing clarity for investors and the government.

**72. Openness and transparency in the processes to strengthen and divest SOEs and enter into PPPs, and sufficient policy regard for social and environmental safeguards, are critical not only to the success of the Government's efforts to transform the State's role, but to the sustainability of the whole reform agenda.** The Presidential Decree on SOE reform requires that the new SOE agency conduct all valuations, divestitures and leasing processes transparently, and that SOEs remaining in State ownership be reformed to strengthen efficiency and financial transparency. Similar provisions are in place in the Decree on Public Private Partnerships.

**73. The establishment of the SOE and PPP agencies are important first institutional steps toward reducing the State's presence in the economy, but further work is needed to advance the Government's SOE reform and PPP investment intentions in a systematic way.** The immediate focus of the new agencies is to develop subsidiary legislation and regulations to implement their mandates. The SOE Agency's immediate priorities also include a comprehensive inventory and independent valuation of existing assets and ownership. These measures are essential to a systematic approach to SOE reform and PPP development, and carry significant fiscal, social, and political risks if hurried or poorly executed. Although the Government has strong ambitions to deliver reform outcomes as quickly as possible, it is aware of these risks and has dedicated significant administrative resources to these new institutions. The Government has reached out to the Uzbek diaspora as a source of human capital to complement and strengthen local administrative expertise. It is also working closely with the World Bank and other development partners to ensure that the new agencies are designed and will operate in line with international good practices.

### **Pillar 2: Enhancing Social Inclusion**

**74. Better jobs and skills, higher incomes and shared prosperity are among the highest priorities of the 2017-2021 Development Strategy.** From the start of the reforms in 2017, inclusive growth has been an important policy dimension for all major reforms enacted by the Government. Although Uzbekistan enjoyed strong macroeconomic gains in the last fifteen years, these gains accrued through capital-intensive production from state enterprises, creating high social costs through rising unemployment and emigration. The rapid creation of more and better jobs, particularly in the face of a large and rising youth bulge, is a priority for the Government. Equally important is the need to ensure wide access to high quality public services, especially health and education, as well as ensuring that people are not left behind in the economic transition. The Government recognizes that an early emphasis on inclusivity is critical to maintaining public support for the reforms, an important part of ensuring reform sustainability. The Government also recognizes that achieving more inclusive growth involves a transformation of the way it provides services to citizens. As the State starts to step away from its role as a producer in the economy, this transformation requires moving to more direct forms of support to encourage inclusive growth and safeguard vulnerable citizens. The reforms under this pillar of the proposed operation support the Government in achieving these objectives.

#### ***Increasing formal employment***



***Prior Action 8: To encourage firm growth and formal employment, especially of women, the Borrower has adopted a turnover-based definition of small businesses for tax and value-added tax registration purposes.***

**75. Segmentation in the tax system has created incentives for firms to stay small and cap the number of formally hired employees.** Prior to 2019, firms in Uzbekistan were categorized into standard and simplified tax regimes based on the number of employees, with smaller firms (less than 100 employees) enjoying significant tax benefits from a simplified regime. This segmentation seems to have significantly limited firm size and job growth. Larger firms that exceeded the employee threshold carried an excessive tax burden. Smaller firms had strong incentives to stay small or try to migrate from the standard to the simplified regime by downsizing or splitting themselves. As a result, and as confirmed by the available employment statistics, job creation in recent years was concentrated in family and other small businesses.

**76. The complexity of the tax system has in part contributed to the decline in Uzbekistan's tax revenues as a share of GDP over the last decade, despite robust economic growth.** Tax revenues fell from 21.5 percent of GDP to 18.5 percent between 2008 and 2017, before picking up in 2018 after a significant improvement in tax collection effort and enforcement. The contribution of direct taxes remains small, while consumption taxes are the main source of domestic revenue. The tax system is complex, with non-uniform effective tax rates that depend on business size, activity, and location. The tax legislation grants numerous discretionary tax exemptions tailored to individual companies and products. This all raises the compliance costs for small and medium-sized firms and creates a disincentive for formalization. The efficiency of Uzbekistan's VAT regime remains below the averages for all regions except the Middle East and North Africa, according to IMF estimates. This low ratio points to tax compliance gaps due to ineffective tax administration.

**77. Changes to the tax system effected in January 2019 through Presidential Decree UP-5468 revised the way in which firms were segmented, addressing a major constraint to small business hiring.** Rather than using employee headcounts as the threshold, firms with less than UZS1 billion in annual turnover are now subject to the simplified regime, but also have the option to voluntarily enter the standard regime to be part of the VAT system. This allows smaller businesses – which previously did not have the option to voluntarily register for VAT – to supply larger businesses that benefit from trading with other VAT-registered firms. After these changes, over 30,000 businesses operating under the simplified regime have already transitioned to the new standard regime, with many remaining small businesses expected to join as well. In addition to being VAT-registered, firms whose turnover exceeds UZS1 billion are also subject to the full corporate taxation regime, which includes income, dividend, and land taxes. In addition to removing incentives to hire fewer workers, the net revenue from the reclassification of small businesses is expected to be significantly revenue positive, to help balance other reductions such as the cut to payroll taxes.

**78. The changes to the tax system, and the concurrent push by the Government to improve tax administration, are expected to lead to more formal job creation, increased revenue collections, and a broadening of the tax base.** In addition to addressing the issue of firm size and segmentation, the tax changes announced under UP-5465 significantly reduce the tax burden on wage earners and businesses. Large reductions in employer and employee payroll taxes are expected to further improve incentives for businesses to increase formal employment. A major tax administration reform program is also under way and will be supported by the World Bank and IMF. In addition to institutional reforms, planned reforms include an overhaul of the tax code, systems and technological upgrades, improvements in taxpayer transparency and appeals processes, and improvements in the audit regime. While the adoption of a flat income tax as part of these changes has reduced the progressivity of the tax system, the Government has committed to reviewing the tax system within 2-3 years to ensure that it is working the context of Uzbekistan's economic transition.





**Prior Action 9: To create better conditions for formal employment in urban areas, especially of women, and enhance labor mobility, the Borrower has removed restrictions limiting employers from hiring workers who do not have a local residence permit (“propiska”).**

**79. Despite recent reforms to Uzbekistan’s internal residential registration system (*propiska*), strict restrictions on the issuance of permits to reside in the Tashkent City area have constrained worker mobility, business growth, and urban development.** Uzbekistan inherited the *propiska* regime from its Soviet legacy, and the system of registration is an important tool for the Government to administer social services and manage internal migration. Citizens wishing to move to another region for more than a short visit require a registration permit for the new location. Since independence, two major policy objectives contributed to relatively strict *propiska* controls: (i) limiting rural depopulation, to maintain enough manpower to attain agricultural harvesting and production targets; and (ii) avoiding the overcrowding of Tashkent City. Not having the proper *propiska* is a legal offence carrying administrative and criminal penalties and is grounds for the denial of all essential public services, including health and school enrolment. Importantly, most employers cannot offer employment to people who do not already have the appropriate registration permits<sup>50</sup>.

**80. Building on a series of reforms to the *propiska* regime since 2017, the Government recently made a major policy change that allows employers to hire workers without requiring local registration.** Since the start of the market reforms in 2017, many steps have been taken to ease the previously strict *propiska* regime. These include removing quotas and limits on the issuance of permits in all areas outside Tashkent City and region, reducing the legal sanctions for citizens who do not have appropriate permits, and removing requirements to have a *propiska* to obtain certain basic services such as health and education. The registration system for visiting tourists, who are also subject to *propiska* requirements, has been completely overhauled to allow automatic electronic registrations by hotels and landlords. This addressed one of the biggest constraints to tourism development and legalized the home sharing (e.g. via services such as AirBnB) market. In January 2019, as part of a broader series of reforms to enhance sustainable urbanization, the Government removed rules barring employers hiring workers without local *propiska*.

**81. The changes to the *propiska* regime, combined with a legal change in mid-2018 guaranteeing local registration for citizens with signed employment contracts, are likely to have a significant positive impact on labor mobility.** Law ZRU-514 amended the Uzbekistan Criminal Code to remove restrictions limiting employers from hiring workers without *propiska*. These restrictions have been especially constraining in Tashkent, where businesses have cited these restrictions as a constraint on business growth<sup>51</sup>. Although these changes do not remove the *propiska* regime, and the validity of local registrations for Tashkent under this new system will remain limited by the duration of the employment contract<sup>52</sup>, they are likely to have a large positive impact on the formalization of jobs in the Tashkent City area. The Government has timed this measure to coincide with the significant reductions in payroll taxes to maximize – at an early stage in the reform process – opportunities for businesses to increase formal job growth and shift away from the (illegal) use of informal labor contracts.

**82. The Government is in the process of developing an urbanization strategy that will identify the next phase of labor market reforms.** One of the core responsibilities of the new Urbanization Agency (supported under Prior Action 7) will be to develop a labor market reform plan to identify and implement reforms that increase formal job

<sup>50</sup> A very small number of government agencies and specified high-level government positions are exempt from this rule, including in Tashkent city.

<sup>51</sup> SCD 2016, *Uzbekistan Growth Diagnostics 2019*

<sup>52</sup> Registrations can be permanent or temporary. Permanent registration in Tashkent City is severely restricted and can only be obtained through ordinary due process under certain conditions, such as the investment of a minimum amount of money, the purchase of property, or for holders of certain essential positions listed by Presidential Decree.



growth in urban areas. Initial discussions with the Government indicate a strong interest in continued reforms to the *propiska* regime to ensure that it can continue to meet other Government internal migration policy objectives, while not constraining job growth in the transitioning economy.

**83. Collectively, these reforms are expected to increase formal employment in the economy and help narrow the gap between male and female employment in the formal sector.** Estimates suggest that informal unemployment in Uzbekistan could be as high as 54 percent<sup>53</sup> of total employment. The participation of women in the labor force, at 48 percent, is low by OECD standards. Of this, only a small fraction – 14 percent – of working-age women are employed in full-time formal jobs<sup>54</sup>. Most women work in the informal sector, and in low-paid seasonal or contract jobs. A range of constraints contribute to gender inequality in the labor market, including laws restricting the industries where women can work, gender disparities in property ownership, and traditional cultural stereotypes of the roles of women and men in society. Low formal employment and insufficient property rights contribute to significant gender disparities in access to bank financing. These constraints were aggravated by limited incentives for employers to formalize jobs in the previous tax system, and the restrictions on labor mobility. The Government has prioritized the reduction of the gender gap in the labor market as part of the 2017-2021 Development Strategy, and the tax and labor mobility reforms are likely to make a meaningful contribution to this effort. These measures will be complemented by a wider program to increase the participation of women in the economy. For example, the Government recently announced its intentions to scrap laws limiting female employment in certain industries.

### Education

***Prior Action 10: To improve educational standards and increase the quality of the labor force, the Borrower has (i) signed a participation agreement with the OECD to participate in the 2021 PISA, and (ii) created a National Center for International Research on Quality Assurance in Education which, along with the Ministry of Public Education, will be responsible for conducting national standardized and systematic student assessments of educational achievement.***

**84. Education expenditure in Uzbekistan is among the highest in the world, but education quality is significantly constrained by the lack of data.** At around 5.9 percent of GDP in 2018, Uzbekistan’s expenditure on education is higher than countries in the region, those with similar income levels, and the OECD. However, recent analytical work has shown that it is difficult to assess whether spending has translated into learning outcomes. The study shows that improved data on education quality is the single most important input for the comprehensive review and reform of Uzbekistan’s education system<sup>55</sup>. Limited information and capacity to monitor education quality hinders policymaking at the preschool, primary, and general secondary levels. While the Government does undertake some assessments, these are not done in a systematic and standardized way, instead serving as “spot” checks that cannot be compared over time to measure progress. In addition to being sporadic, the current assessments measure students’ achievements against government standards, which are not internationally comparable and do not meet well-established education data quality criteria. In 2017, the Government established the State Inspection for Supervision of Quality in Education (SISQE) reporting directly to the Cabinet of Ministers. In May 2018 the SISQE was tasked with improving the Government’s approach to assessments by bringing them in line with international best

<sup>53</sup> 2013 Jobs Skills and Migration (CALISS) Survey for Uzbekistan; official estimates place informal employment at 38 percent of the labor force.

<sup>54</sup> EBRD Uzbekistan Country Diagnostics (2018); ADB: Uzbekistan Country Gender Assessment (2018).

<sup>55</sup> World Bank: Uzbekistan Education Sector Analysis 2019



practices, introducing standardized national assessments, and adopting measures to enable Uzbekistan's participation in international comparison assessments such as the PISA.

**85. The Government has prioritized education sector reform and has made rapid progress in advancing institutional reforms to strengthen assessments of educational achievement.** Recognizing the importance of early investments in human capital as part of the transition, the authorities have prioritized education sector reforms under the 2017-2021 Development Strategy. In November 2018, the Government of Uzbekistan signed a PISA Participation Agreement with the OECD to be a part of the PISA process, commencing from the 2021 PISA. In December 2018, the Cabinet of Ministers issued Resolution #997, reconfirming Uzbekistan's participation in PISA and other major international assessments and creating a specialized agency – the National Center for Quality Education – to govern student assessments. An immediate first step for the new agency will be to develop, pilot, and roll out – with assistance from the World Bank and other development partners – a new framework for systematic, standardized, and regular national assessments. The implementation arrangements attached to the Cabinet of Ministers resolution require the agency to finalize and pilot the new framework in 2019 and roll it out nationally by mid-2020. Over the medium term, the new framework, and the results from Uzbekistan's participation in PISA and other international assessments, are expected to significantly improve data on education quality and enable policymakers to make better-informed and more targeted decisions on how to improve educational performance. Over time, this is likely to make a strong contribution to the Government's efforts of raising education standards and creating more productive jobs in the economy.

**86. The Government is also identifying and implementing broader measures to ensure that the education sector can support economic growth and the economic transition effectively.** Vocational education needs to become more flexible and better-aligned with evolving labor market needs. The tertiary education sector faces more complex challenges, with significant limitations on access to higher education and on the quality of institutions. With an overwhelming majority of public funds dedicated to preschool, primary, and secondary education, limited resources and a lack of policy attention have led to declining higher education standards and a shortage of graduates. Additionally, fields of study have remained largely the same over time, limiting the ability of new labor market entrants to seize opportunities offered by the economic transition. The participation of women in tertiary education also remains significantly lower than regional and international averages. The Government recognizes these challenges and is considering measures like rebalancing funding shares across education sub-sectors, increasing the availability of scholarships to address skills shortages, and inviting greater private sector participation in tertiary education. It has also announced intentions in recent months to address constraints limiting the entry of women into tertiary education<sup>56</sup>. It has also joined the World Bank's Human Capital Project as an early adopter, sending a strong signal about its commitment to improve outcomes in education (and health) at an early stage of the reform process.

### **Social Safety Nets**

***Prior Action 11: To improve the efficiency and effectiveness of social safety nets for low income families, the Borrower has approved the creation and development of a Unified Social Registry of Social Protection***

**87. Uzbekistan's existing social protection system, and the progressivity of its social assistance benefits, offer a strong platform for further reforms that achieve the Government's social protection policy objectives.** The social

<sup>56</sup> In January 2019, President Mirziyoyev outlined the Government's intentions to reform the system of preferential access to university education for (male) voluntary military service conscripts who successfully complete their conscription term. This preference has been widely cited as being an active constraint to greater female tertiary enrolment, particularly in technical subjects such as science and engineering.



protection system in Uzbekistan – which includes social assistance, social insurance, and labor market programs – supports about 55 percent of the population. Eighty percent of this coverage is through social insurance; for example, the pension system covers about 38 percent of the population, and 85 percent of those over 65. Despite the progressivity of social assistance, there is considerable scope to improve targeting and coverage of the poor. Only 16 percent of the population is covered by safety nets to support the poorest and most vulnerable, and it is estimated that only one out of three poor people receives any form of social assistance. Despite the social assistance system being generous relative to regional comparators (family allowances are equivalent to about 40 percent of poor households' consumption), the system's contribution to poverty reduction is only 2.5 percentage points due to its low coverage of the poor. Furthermore, family allowances are almost entirely implemented through local government bodies (*mahallas*), raising issues of transparency in procedures and fairness across different locations.

**88. The unification of the social registry system is a critical first step to modernizing Uzbekistan's social safety net system – one of the Government's highest reform priorities.** Improving the robustness of the social safety net system has been consistently identified by the Government as a high strategic priority to complement the economic reforms. Current government policies require all major reforms and draft resolutions that have a large poverty and social impact to incorporate adequate measures to minimize the impact on the poorest and most vulnerable, who are generally also adversely impacted by climate change. These measures usually involve using existing safety nets and expanding budgetary allocations to *mahallas* to increase allowances and coverage numbers.<sup>57</sup> In 2018, the Government expanded the combined coverage of family and low-income allowances by over 30 percent from the previous year and increased the budgetary allocation by about 37 percent. For 2019, the Government increased the budget by a further 50 percent, though most of this increase is to cover larger payments for each allowance (rather than an increase in coverage). To improve targeting and coverage, the Government has been working with the World Bank and other partners to develop a unified social registry.

**89. The approval and rollout of this new registry will accelerate the Government's efforts to improve the transparency and administrative efficiency of social assistance through more rigorous selection processes, the consolidation of social benefits and allowances, and improved targeting.** The approval of the creation of the unified social registry, through Cabinet Resolution #309, will help the Government to collect and verify individual level data that would then be used to develop a more objective and transparent poverty-based targeting mechanism. The first pilot phase of the unified social registry is planned for July 1, 2019, with a national rollout starting in 2020. The main objectives are to: (i) increase coverage while maintaining fiscal discipline and reducing administrative costs; (ii) improve transparency in the identification and selection of beneficiaries, and (iii) increase the system's flexibility to respond to changing conditions. Improving targeting will allow the Government to increase the total number of poor and vulnerable households supported by social benefits, thereby generating potential adaptation co-benefits, while reducing the number of non-poor families receiving benefits. As a result, the registry is expected to increase both the absolute number and share of poor households assisted by family allowances (coverage of the poor) and the proportion of cash allowances received by the poorest 40 percent of the population (targeting accuracy).

**90. The implementation of the single social registry is a critical, but first, step in the process of modernizing Uzbekistan's social safety nets.** Ongoing engagement between the World Bank, other development partners, and the Government is intended to complement the establishment of the registry by: (i) developing and implementing improved targeting mechanisms based on declared incomes, assets and proxies (PMT); (ii) increasing the equity and efficiency of family allowances by consolidating benefits into a single means-tested benefit and by revising the benefit structure to support families according to their composition and economic situation; and (iii) expanding the

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<sup>57</sup> For example, increased budgetary allocations to *mahallas* to minimize the impact of foreign exchange liberalization measures was a prior action in the first Development Policy Operation.



scope and functionalities of the unified social registry to include not only the family allowance benefit system but also other social and employment benefits.

### *Fiscal Transparency*

***Prior Action 12: To increase fiscal transparency and improve citizen engagement in the budgetary process, the Borrower has required the Ministry of Finance to (i) annually publish citizens budget and budget execution reports, and (ii) ensure that at least ten percent of each municipal district budget is allocated via input from a community-level participatory process, commencing from the 2019 Budget.***

**91. Insufficient fiscal transparency amplifies fiscal risks and compounds the challenge of effective SOE management in Uzbekistan.** Public resources to fund central government operations in Uzbekistan are collected, expended, and accounted for in a highly complex way that involves multiple legal frameworks, accounting systems, reporting lines, and transparency requirements. Adding to the complexity are various transactions and directed lending operations involving government agencies, government extra-budgetary funds and off-budget accounts (including the Fund for Reconstruction and Development), state owned banks, and SOEs.

**92. Until recently, there were no legal requirements for the Government to publish its annual budget, or for citizen input to be regarded in the budget-making process.** Uzbekistan’s Budget Code does not contain a requirement to publish the budget. In previous years, only extracts of the approved budget have been made available publicly. Until recently, there were no formal mechanisms for public input into the budget preparation or review processes. These limitations have constrained efforts by the government to strengthen fiscal transparency and improve the citizen-centricity of public services and government institutions.

**93. In August 2018, the Government announced a broad set of measures to improve public transparency of the budget and introduce participatory budget setting processes based on citizen engagement.** Presidential Decree PP-3917 outlines measures to improve the openness of the budget, strengthen Parliamentary oversight, and require public engagement and input into the budget preparation and review processes. Specifically, it requires the Ministry of Finance to – for the first time – regularly publish pre- and post-approval budgetary documents, as well as budget execution reports. It also requires the publication of “citizen” versions of these documents that are written in simple language and can be easily understood by non-technical readers. The Decree also requires at least 10 percent of district-level budgets to be prepared based on feedback from citizens<sup>58</sup>.

**94. The measures are part of broader intentions to increase fiscal transparency and improve fiscal risk management.** PP-3917 requires the eventual closure of all extra-budgetary funds and the integration of activity from those funds into the regular budget. In 2019, the Government has closed 3 extra-budgetary “targeted” funds and integrated their activity into the general budget. The closed funds represent 9 percent of budgeted expenditure and 13 percent of total (non-UFRD) expenditure outside the budget. It expects to close the remaining funds, except for the pension, employment and privatization funds<sup>59</sup>, by the end of 2019. The Government is currently undertaking a comprehensive review of extra-budgetary funds to prepare the necessary legislative and regulatory amendments to close the remaining extra-budgetary funds and integrate them into the general budget. It is also identifying ways to integrate estimates of off-budget account activity into the main budget by the 2020 Budget. The Presidential Decree

<sup>58</sup> The exact process is not specified and can vary. For example, one district in Tashkent published its budget concept on Facebook and sought consultative feedback online. Other approaches rely on processes organized by mahallas or local committees.

<sup>59</sup> These funds will continue to be ringfenced funds to strengthen public visibility around sensitive areas of spending (e.g. pensions, privatization) and will be presented in the budget documentation as separate funds.





also ambitiously commits to a formal Parliamentary appropriation system from the 2020 Budget, which will impose Parliamentary fiscal authority on expenditure, and require Parliamentary processes to be followed for within-year changes and supplementary budgets (currently not required). This system will also require significant expansions to the current presentation of the budget to allow for detailed Parliamentary scrutiny.

**95. Further improving fiscal transparency remains a priority for the Government which is working closely with the World Bank, IMF, and other development partners to identify suitable measures.** The Government has been working closely with the IMF to assess gaps in fiscal transparency and the IMF and World Bank are providing technical assistance to identify the most critical areas for further reforms. In addition to improved fiscal reporting, the Government adopted a basic aggregate medium term framework for the preparation of the 2019 Budget and plans to roll out a formal medium term fiscal framework starting from the 2020 Budget. The process of preparing and developing this framework is expected to gradually remove weaknesses in fiscal forecasting and budgeting. Initial work is under way to improve fiscal risk analysis and management by strengthening the Ministry of Finance’s information base on SOE financial activity and improving risk reporting. The Government is also working closely with the IMF and the World Bank to improve debt management systems. The United Nations Development Program has worked closely with the authorities to support the preparation of citizen budgets and continues to support further measures to strengthen citizen participation in the budget process.

**Table 4: DPF Prior Actions and Analytical Underpinnings**

Prior Actions	Analytical Underpinnings
<b>Operation Pillar 1: Increasing the role of markets and the private sector in the economy.</b>	
<p><b>Prior Action 1:</b> To increase agricultural exports and incomes for farmers, the Borrower has (i) removed mandatory pre-payment and minimum export price requirements for horticultural exports, (ii) removed controls on the sale price of shaped bread, and (iii) increased the state farmgate procurement price offered to farmers for the 2019 wheat harvest.</p>	<p>World Bank Country Private Sector Diagnostic for Uzbekistan identified the horticulture actions as the top two immediate policy constraints for removal to stimulate horticulture export growth and investment; Uzbekistan Growth Diagnostics report (2018); World Bank draft agriculture modernization strategy recommends liberalization of farmgate prices and to move away from the state being the only procurement agent. IMF Article IV report (2018) and subsequent staff visit concluding statements recommend liberalization of prices, consistent with advice provided in the World Bank Reform Roadmap 1 (2017) and 2 (2018) exercises.</p>
<p><b>Prior Action 2:</b> To reduce market entry barriers and increase competition in domestic trading activity, the Borrower has removed (i) licensing requirements to start and operate wholesale domestic trading and itinerant trading businesses, and (ii) mandatory advance payment requirements for commercial trading transactions between entities whose Government ownership is less than 50 percent.</p>	<p>IMF Article IV (2018) and subsequent staff visit concluding statements, World Bank Reform Roadmaps 1 (2017) and 2 (2018), and the Systematic Country Diagnostic (2016) refer to the need to increase domestic competition. World Bank TA on strengthening the business environment refers to the need to dismantle restrictive licensing practices.</p>
<p><b>Prior Action 3:</b> To improve financial sector efficiency and stability, the Borrower has submitted a new banking law for Parliamentary approval that gives sufficient powers to the Central Bank of Uzbekistan to conduct effective oversight and enforcement, establishes a comprehensive and transparent licensing framework, and strengthens corporate governance and transparency requirements for commercial banks.</p>	<p>World Bank TA reports on financial sector development and strengthening banking regulations; IMF Article IV and subsequent staff visit concluding statements. WB Reform Roadmap 1 (2017) and 2 (2018). WB has been involved in supporting the development of the draft law.</p>



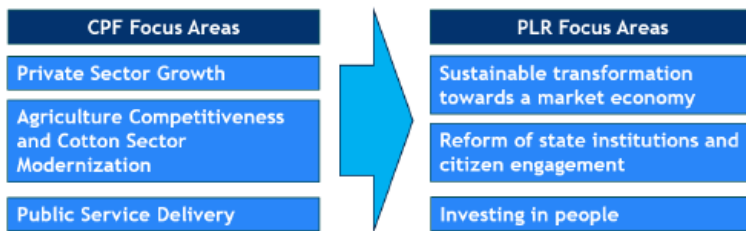
<p><b>Prior Action 4:</b> To increase private sector investment in the energy sector, the Borrower has taken measures to establish a legal framework for the development of renewable energy and to adopt procurement procedures for the selection of potential renewable energy providers.</p>	<p>World Bank TA on energy sector development, industrial energy efficiency, and IFC analytical work on renewable energy development in Uzbekistan.</p>
<p><b>Prior Action 5:</b> To achieve financial sustainability of energy and water utility companies, the Borrower has adopted a revised tariff methodology, consistent with principles of full cost-recovery, for the provision of electricity and cold-water services.</p>	<p>WB TA in energy (industrial energy efficiency, energy sector development, and energy SOE reform) and water sectors make recommendations for the need for clear tariff policy frameworks, better accounting standards to ensure that full costs are captured, and a policy commitment from Government to full-cost recovery.</p>
<p><b>Prior Action 6:</b> To increase private sector participation in the aviation sector, the Borrower has (i) separated the Borrower’s airline management, airport management, and air traffic control functions, and (ii) separated its policymaking, technical regulatory, and operational functions in the aviation sector.</p>	<p>World Bank Aviation sector RAS (2018), and Country Private Sector Diagnostic (2018) recommend unbundling as the most important and immediate constraint to tackle.</p>
<p><b>Prior Action 7:</b> To improve the financial transparency and accountability of State-Owned Enterprises, the Borrower has created a new Agency for the Management of State Assets, reporting to the Prime Minister, to be responsible for the management of state-owned enterprises and the implementation of an open and transparent process for the privatization of state assets.</p>	<p>Creation of SOE and PPP agencies: World Bank and IFC TA on PPP frameworks and SOE Reform, Reform Roadmaps 1 and 2 (2018); Lessons from other SOE reform experiences: State Owned Enterprises in Emerging Europe (IMF 2017); PPP risks and potential poverty/social impact: Evaluation of PPPs (WB IEG report 2014).</p>
<p><b>Operation Pillar 2: Enhancing social inclusion</b></p>	
<p><b>Prior Action 8:</b> To encourage firm growth and formal employment, especially of women, the Borrower has adopted a turnover-based definition of small businesses for tax and value-added tax registration purposes.</p>	<p>IMF Review of Uzbekistan’s tax system 2018; WB TA aide-memoires to support tax reform and modernization. Both make strong recommendations on redefining business size based on turnover.</p>
<p><b>Prior Action 9:</b> To create better conditions for formal employment in urban areas, especially of women, and enhance labor mobility, the Borrower has removed restrictions limiting employers from hiring workers who do not have a local residence permit (“propiska”).</p>	<p>L2CU analysis (2019); OSCE analysis on registration reforms in Central Asia; UNICEF “<i>Protecting Vulnerable Families in Central Asia</i>” (2013); WB “<i>Social Development in Europe and Central Asia – Issues and Directions</i>” (2003)</p>
<p><b>Prior Action 10:</b> To improve educational standards and increase the quality of the labor force, the Borrower has (i) signed a participation agreement with the OECD to participate in the 2021 PISA, and (ii) created a National Center for International Research on Quality Assurance in Education which, along with the Ministry of Public Education, will be responsible for conducting national standardized and systematic student assessments of educational achievement.</p>	<p>UNICEF 2017 Annual Report for Uzbekistan and 2016 Regional Analysis Report; WB SCD and TA on improving pre-primary and general secondary education, Uzbekistan Center for Economic Research report, “<i>Improving the quality of general secondary education in Uzbekistan</i>” cite lack of reliable assessment data as a major constraint to education sector improvements and human capital development.</p>
<p><b>Prior Action 11:</b> To improve the efficiency and effectiveness of social safety nets for low income families, the Borrower has approved the creation and development of a Unified Social Registry of Social Protection</p>	<p>Fragmentation of existing system and need for new unified system: Preparatory analytical work for Social Safety Nets Project; Strengthening the Social Protection System (P166447); Global evidence on effectiveness of social registries: State of Social Safety Nets Report (WBG 2014); Evidence of from Eastern</p>



	European Transitions in Social Registries and Beyond – A Guidance and Assessment Tool (WBG 2017).
<p><b>Prior Action 12:</b> To increase fiscal transparency and improve citizen engagement in the budgetary process, the Borrower has required the Ministry of Finance to (i) annually publish citizens budget and budget execution reports, and (ii) ensure that at least ten (10) percent of each municipal district budget is allocated via input from a community-level participatory process, commencing from the 2019 Budget.</p>	<p>IMF TA reports on fiscal transparency (2018), WB TA on national citizen engagement recommendations on participatory budgets (2017/2018).</p>

**4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY**

96. **This proposed DPO is fully consistent with the new focused areas following the 2018 Performance and Learning Review (PLR) of the 2016-2020 Country Partnership Framework (126078-UZ; June 26, 2018).** Adjustments to the CPF were made following a clear signal from authorities about its intentions to undertake a faster, deeper and broader program of economic and social reform. The overall objective of the operation – to support a sustainable transition – is consistent with the first focus area in the revised CPF (supporting a Sustainable Transformation toward a Market Economy). The first pillar of the proposed operation’s PDO focuses on deepening the Bank’s engagement and support in sustaining the market transition, as well as reforming institutional settings. The second pillar of the PDO is supports the revised CPF focus areas of strengthening citizen engagement and investing in people. Both the revised focus areas, and the pillars of the PDO, are fully consistent with the findings of the Systematic Country Diagnostic.



97. **The proposed operation is fully consistent with the WBG’s strategy aimed at eradicating extreme poverty and promoting shared prosperity.** The program pillars are designed to support a systematic and sustainable transformation to a competitive market economy, and that the transformation is underpinned by long-term economic stability and social cohesion. These are key preconditions for sustained poverty reduction. This operation also supports the Government’s decision to make early reform investments in areas such as agriculture, education, and health, which are likely to contribute to a more inclusive reform agenda that supports greater shared prosperity.

98. **The proposed operation is complemented by several operational, analytical, and policy engagements by the World Bank Group in support of the revised focus areas of the CPF.** These include (i) the Reform Roadmap which has helped underpin the overall medium term reform program of the authorities; (ii) analytical projects in the energy and water sectors has supported institutional and regulatory reforms of public utilities; (iii) a proposed Agricultural Modernization project and existing projects to strengthen horticulture, which are supporting modernization of the agriculture sector; (iv) the proposed Institutional Building Loan project which will strengthen key fiscal and financial sector institutions and support SOE reforms; (v) the Uzbekistan Tax Reform Support project which is supporting an





ambitious program of policy and administrative reform; (vi) the Early Childhood Education project which includes components to strengthen educational assessment institutions; (vii) analytical work on citizen engagement, including the L2CU survey which provide support to improve citizen engagement platforms; (viii) a Reimbursable Advisory Service project in the aviation sector which has supported institutional strengthening and reforms to critical network sectors; and (ix) a range of IFC analytical and advisory programs, including the recently completed Country Private Sector Diagnostic for Uzbekistan, which underpin our engagement and support for private-sector focused reforms that maximize financing for development. Analytical findings and policy recommendations from all these complementary engagements have contributed to this proposed operation.

#### 4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

**99. A strong platform of stakeholder consultation and citizen engagement has supported the preparation of this operation.** Almost all prior actions in this operation were completed by the Government after a period of public consultations on the Government’s draft regulations portal. Citizen feedback has contributed to sometimes significant changes to finally approved resolutions and laws, with a notable example being the final resolution on changes to the tax system. This regulatory consultation system is further supported through an extensive system of virtual “receptions” for public engagement and face-to-face office hours where members of the public can meet with senior government officials and members of the Cabinet. These changes were introduced in 2017 – the “Year of Dialogue with Citizens”. The Virtual Reception has been used so far by more than one and half million citizens and the Government is currently working on ways to distill and analyze the data that is emerging. The Government has expressed a strong interest in further strengthening its citizen engagement. The authorities continue to work closely with the Bank in this area.

**100. The proposed operation has been prepared in close collaboration with a range of partners that are supporting Uzbekistan’s economic and social transition.** These include the IMF, the ADB, the EBRD, the European Union, a range of agencies within the United Nations System, and the Governments of France, Japan, Switzerland, the United Kingdom and the United States of America. Cooperation between International Financial Institutions has strengthened since the last operation. The IMF and Bank work closely to assess the adequacy of the macroeconomic framework that anchors our respective operations and engagements. Both agencies are committed to tightening cooperation further to ensure that technical assistance is well-coordinated and ensure complementarity and effectiveness. The Bank also works closely with ADB, the EU, and the Government of France, who are also providing budget support to the authorities. There is strong interest in exploring harmonized approaches for subsequent operations. The Bank is also working closely with EBRD and the ADB on energy, SOE, PPP, and financial sector reform, and with the European Union on agriculture and rural development. There is close collaboration with the Governments of Switzerland and France on water sector development, and with USAID on the trade and WTO reforms. Importantly, the Bank and the International Labor Organization (ILO) share a strong relationship and common interest in eradicating forced labor and improving labor market outcomes

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1. POVERTY AND SOCIAL IMPACT

**101. Overall, actions in this proposed operation are expected to improve the efficient deployment of government resources and increase the progressivity of the fiscal and regulatory system.** Of the twelve proposed actions, six



have clear, significant, and direct poverty and/or distributional implications. Four have expected positive poverty and or distributional implications, including relaxing constraints to internal mobility, introducing a unified social registry, and reducing licensing /advance payment requirements. Two actions are expected on net to increase the short-term incidence of poverty and/or entail short-term social impacts that are sensitive, while at the same time generating progressive distributional outcomes. These relate to policy actions increasing tariffs for utilities including electricity, gas and water, and removing the price ceiling for bread. Detailed PSIA analysis was conducted for these two actions, and the results demonstrate the potential scope and incidence of negative impacts. In neither instance is the effect unprecedented or irreversible, and mitigation measures through the social protection system (and being considered as part of future utility tariff reforms) could moderate the expected poverty impacts relating to these actions.

### **Utility Tariffs**

**102. Consumer tariff increases adopted or anticipated by April 2019 are expected to have positive distributional effects<sup>60</sup>, alongside a small increase in poverty incidence.** These effects are expected to be limited by the relatively small magnitude of the tariff changes after adjusting for inflation, and by anticipated mitigation measures being considered by the Government. In the absence of mitigation measures, applied and expected short-term electricity and gas tariff changes (in two steps of 9.3 and 10 percent nominal increases) are expected to result in a small rise in the household budget share (.3 percentage points among bottom decile households), and an uptick in the poverty rate measured at the \$3.2/person/day line by .02 percentage points. Electricity poverty – defined as for a household when it spends 10 percent or more of their budget on electricity – is expected to rise by a small amount (.5 of a percentage point) from a low level. The Government is working with the World Bank to develop options to mitigate these effects and is piloting a small social tariff program in Tashkent City. Tariff increases for commercial and non-residential users were also enacted in 2018 and 2019, and these are expected to have further indirect household and poverty effects. Assessing these impacts is under way and will be available in July 2019.

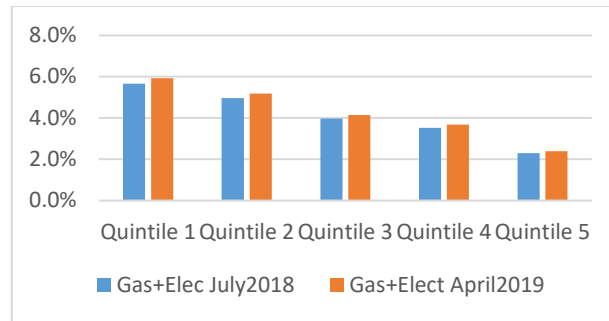
**103. Larger distributional and poverty-related effects are foreseen if tariffs increase to levels consistent with full cost recovery.** Detailed tariff simulations for full cost recovery are not currently available. However, preliminary analysis (Figure 2) suggests that increases of roughly 30 percent for electricity and gas (in inflation-adjusted terms) may be required. Absent mitigation, such increases would be expected to increase the national rate of poverty measured at \$3.2/person/day by 0.61 of a percentage point (approximately 197,000 people). Mitigation options such as a lifeline tariff, block tariff approaches, or targeted social assistance payments currently under consideration could reduce this impact, all of which are being evaluated by the Government ahead of future increases to tariffs.

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<sup>60</sup> Rising utility tariffs are expected to be modestly distributionally progressive as the status quo benefit incidence of low electricity, water, and gas tariffs is regressive (i.e., the poorest 40 percent receive a smaller share of the subsidy than the remaining 60 percent).



Figure 2 - Simulated Increase in Budget Share of Electricity + Natural Gas Expenditure

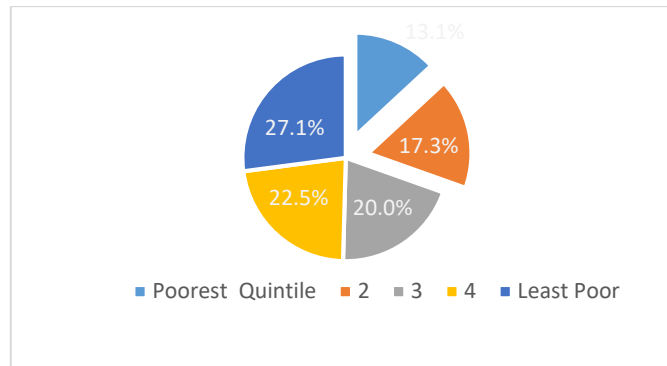


### Agriculture Sector Reforms

**104. The proposed horticultural reforms and increase in wheat prices are expected to have a direct positive poverty and distributional impact, while the liberalization of bread prices is expected to have a positive distributional impact but a negative impact on poverty.** Although there is insufficient data to reliably estimate the magnitude of the effects of the horticulture reforms, the poorest 40 percent of households in Uzbekistan predominantly reside in rural areas and are more reliant on income from agricultural activities. Prepayment requirements were a constraint to growth in the sector that limited the ability of small producers to enter the market and reduced the competitiveness of horticulture in comparison to less productive agricultural activities. Minimum price requirements further distorted the market by artificially limiting the number and types of horticultural goods that could be profitably exported.

**105. The effect of the bread price liberalization has been assessed using L2CU data.** On average, the increase in unit values of bread consumed (a proxy for price) were on the order of 48 percent after adjusting for inflation over this period. Simulations (Figure 3) suggest that the reform resulted in increases in the budget share allocated to bread for all households – about 1.2 percentage points for the poorest decile, and about 1 percentage point on average among the poorest 40 percent. Compared to a scenario with no price increase and before mitigation measures, the change is estimated to have increased the poverty rate (assessed at US\$3.2/day/person) by about 0.78 of a percentage point (about 251,000 people) and increased the poverty gap ratio from 1.78 to 1.98. Mitigation measures to increase low-income allowances are expected to have reduced the poverty impact somewhat and such transfers are significantly better targeted. However, incomplete coverage (63 percent of the poor measured at US\$3.2/per person day do not receive social protection benefits according to the L2CU baseline) suggests that contemporaneous increases in benefit amounts did not entirely offset the increase among the majority of poor and B40 households. However, the simulation results suggest that the reform was progressive in nature, as past price controls on bread were regressive and poorly targeted in terms of providing benefit for low-income households – only 13 percent of the of value of subsidy is estimated to have gone to the bottom quintile, while 70 percent went to top 60 percent. The regressive nature of the subsidy was due in part to the fact that wealthier households on average consume more bread, and poorer households consume more flour.

Figure 3 - Share of Simulated Subsidy Incidence by Quintile of Total Per Capita Consumption



### **Domestic Labor Mobility**

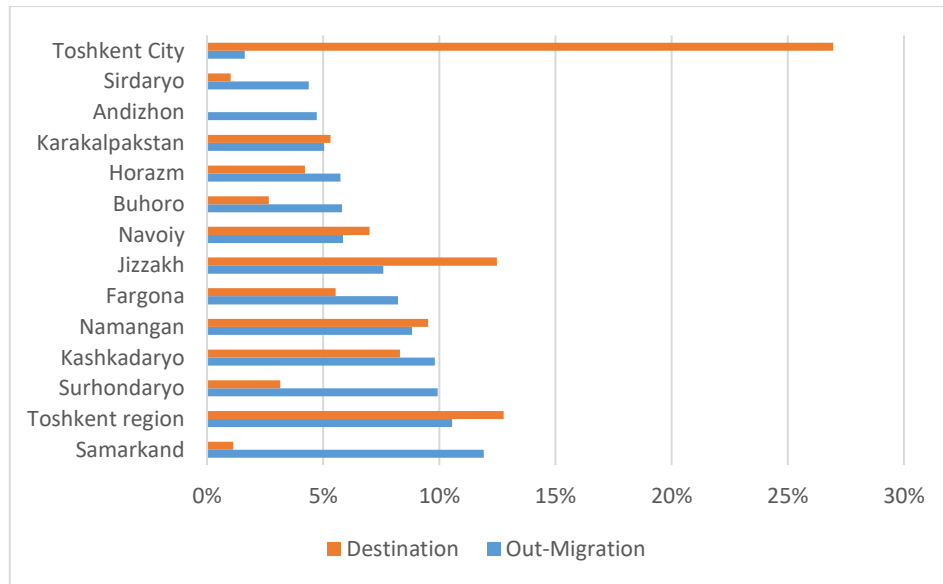
**106. Given prevailing trends in domestic migration, freer movement of people is expected to have large positive social and economic benefits for the poor and bottom 40.** Internal migration trends are dominated by rural-to-urban relocations, with Tashkent city the primary destination among recent migrants (Figure 4). This reflects in part the strength of the labor market in Tashkent, with an employment-to-population ratio of 57 (compared to a national average of 42). About 68 percent of households residing in Tashkent reported some higher wage income in the month preceding the L2CU baseline, in comparison to about 50 percent nationally, and total household income from wages (among those with some wage income) was about 85 percent higher in Tashkent than the national average. Individuals that recently migrated to Tashkent report higher incomes and better employment outcomes than the national average. The initial steps taken under these reforms are expected to move the country closer to an open system allowing free mobility, and as such are expected to be positive, though of limited direct impact on poor households due to remaining limitations on movement with respect to obtaining formal employment. Further reductions in formal and informal impediments to internal mobility would be expected to lead to even larger reductions in poverty and progressive distributional outcomes.

### **Social Safety Nets**

**107. The adoption of a unified social registry is expected to have positive poverty, social, and distributional impacts.** Analysis of L2CU data (Figure 4) suggest 63 percent of the poor (defined in terms of consumption) are not reached by low-income allowances. A unified social registry is expected to reduce exclusion errors due to inadequate information on potential beneficiaries. However, a complete PSIA of the distributional effects of a new social register and consolidation of existing safety nets is not possible in the absence of additional details on changes in the program design and estimates of the share of eligible families excluded due the lack of a unified social registry.



Figure 4 - Migration Flows of Last Change of Residents among L2CU Respondents 2018



### 5.2. ENVIRONMENTAL ASPECTS

**108. On balance, actions supported by the proposed operations are either positive or neutral for the environment, assuming environmental requirements are adequately integrated into the Government’s decision-making framework.** Actions in the proposed operation are likely to indirectly generate a series of positive environmental benefits but based on the application of the provisions of the World Bank Toolkit<sup>61</sup>, actions pertaining to agriculture and trade liberalization will require careful integration of environmental policy issues to avoid longer-term adverse environmental impacts. While these actions could generate positive effects, such as strengthening environmentally friendly practices, improved natural resource management, and the use of climate change adaptation technologies, there are also risks of land degradation, soil and water pollution, or occupational hazards. These negative effects are sometimes associated with areas considered priorities for agricultural development in Uzbekistan: intensive orchards and/or vineyards expansion, construction and operation of new greenhouses, construction and/or rehabilitation of irrigation schemes, construction and operation of new agro-processing enterprises. Similarly, if increased investments in renewable energy (especially in small hydropower, wind turbines or biogas production) are made without considering environmental requirements, these could also lead to negative environmental and health impacts and risks. The Government is aware of these environmental risks and impacts, and as part of the 2017-2021 Development Strategy, is committed to mitigating these risks by improving regulatory and institutional settings, enforcement, and public awareness. The World Bank will support these actions through the ongoing Horticulture Development Project and the proposed Agricultural Modernization and Competitiveness Project.

### 5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

<sup>61</sup> “Assessing the Environmental, Forest, and Other Natural Resource Aspects of Development Policy Lending” [http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/08/18/000356161\\_20100818054032/Rendered/PDF/561680WP0Box3411C10WBDPLToolkitCRA1.pdf](http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/08/18/000356161_20100818054032/Rendered/PDF/561680WP0Box3411C10WBDPLToolkitCRA1.pdf)



**109. The 2018 PEFA assessment highlights the strength of Uzbekistan’s upstream PFM system in contrast to relatively weaker downstream systems.** 15 indicators out of 31 were rated A or B, while 16 - mainly downstream indicators - were rated C or D respectively. Transparency of public finance has progressed through the citizens budget and other initiatives. Progress in other areas has been slower, including procurement, audit, financial reporting, legislative scrutiny of the budget, financial reporting, subnational government transfers, and the production of adequate performance information for service delivery. There are also some weaknesses in the management of public assets and liabilities. The PEFA also highlighted the weak areas related to policy-based fiscal strategy and budgeting, such as macroeconomic and fiscal forecasting, fiscal strategy, medium term fiscal management, and the budget preparation process.

**110. The Government is taking credible steps to develop a revised PFM reform strategy based on the findings of the 2018 PEFA.** This MoF-led strategy covers a range of measures aimed at strengthening budget preparation and execution, public sector accounting, treasury systems as well as improving legislative base for PFM reforms. The Treasury Single Account has been introduced and made functional. In addition, the Government made a progress on implementation GFS-2001 compliant Chart of Accounts, and interim FMIS. The Government also introduced eProcurement system, with an internal portal established to post information related to tendering processes.

**111. The Government has also taken steps to improve public access to fiscal information by publishing the state budget and execution reports on the MoF website to provide budget transparency required by the Budget Code.** In 2017, a pilot Medium Term Budget for 2018-20 was developed and adopted at a municipality level. In 2013-14 the Government implemented "Budget system reform in Uzbekistan" project aiming also at public sector accounting and reporting reforms. Namely, twelve draft Standards of the Budget Accounting (SBA), based on IPSAS, have been prepared, while even gradual implementation of IPSAS still remains a challenge due to capacity constraints and substantial resources required in staff training and rolling out of the standards.

**112. The Chamber of Accounts (CoA - the country’s Supreme Audit Institution) is still in the initial phases of its development.** Currently a new law on Chamber of Accounts is being developed, further there is a need for developing and aligning auditing practices with International Standards of Supreme Audit Institutions, starting with introduction of the structured, and where relevant IT based financial and compliance, followed by introduction of performance (value for money) audits. This will also require a comprehensive reform approach including capacity building of the CoA staff to enable them to step up the level from basic financial information validation audits to compliance and performance audits, introduction of the IT based tools and solutions for strategic and annual audit planning, fieldwork, reporting, monitoring of recommendations, and audit quality control.

**113. Foreign Exchange Control Environment at the Central Bank of the Republic of Uzbekistan (CBU) is assessed to maintain overall adequate operational control over its exchange reserve management. The CBU has been audited regularly by internationally recognized audit firms and received satisfactory audit reports.** In particular, the 2017 audit of CBU’s consolidated financial statements was conducted by an international audit firm, which issued an unmodified opinion on the financial statements, however financial statements are not prepared in accordance with IFRS but rather in accordance with internal accounting and reporting procedures issued by CBU. The audit was conducted in accordance with International Standards on Auditing (ISA). The audited financial statements of CBU are not made publicly available and the Audit report is of restricted use.

**114. Meanwhile, as no IMF safeguards assessment for the CBU has been conducted yet, the Bank will apply additional mitigation measures to mitigate fiduciary risks.** This will involve opening a dedicated foreign currency account for the operation. The Bank will also require that the dedicated foreign exchange account is audited by an auditor acceptable to the Bank, on terms of reference acceptable to the Bank. The audit report will be submitted to the Bank within six months after fiscal year ending in December 31.





**115. DPO funding would be made available to the Republic of Uzbekistan upon the effectiveness of the Loan Agreement and the submission of withdrawal application for the Loan.** The proceeds of the Loan will be disbursed into a dedicated foreign currency bank account that will form part of the country's official foreign exchange reserves held by the CBU and will be opened in the name of the Ministry of Finance. The Borrower shall open, prior to furnishing to the Bank the first request for withdrawal from the Loan Account, and thereafter maintain a dedicated account in USD ("Foreign Currency Dedicated Account") at the CBU; and all withdrawals from the Loan Account shall be deposited by the Bank into the Foreign Currency Dedicated Account. Within 30 days following the deposit of the amount of the Loan into the Foreign Currency Dedicated Account, the Borrower shall transfer the Loan amount into the Treasury Single Account (US dollars and/or Uzbekistan som). The Borrower, within thirty (30) days after the withdrawal of the Loan from the Loan Account, shall report to the Bank: (i) the exact sum received into the Foreign Currency Dedicated Account; (ii) the details of the account to which the equivalent of the Loan proceeds will be credited; (iii) the record that an equivalent amount has been accounted for in the Borrower's budget management systems; and (iv) the statement of receipts and disbursement of the Foreign Currency Dedicated Account.

**116. The MoF will be responsible for the operation's administration and for preparing the withdrawal application, maintaining the dedicated foreign currency bank account as well as the local currency bank account.** The MoF, with the assistance of the CBU, will maintain records of all transactions under the DPL in accordance with sound accounting practices, and the proceeds of the DPL will be promptly accounted in the country's budget management system using the country's regular procedures for such accounting.

**117. If after depositing funds in the dedicated foreign currency bank account, the proceeds of the loan are used for ineligible purposes as defined in the General Conditions, these proceeds will be refunded to the World Bank.** As stipulated by the General Conditions, amounts refunded to the Bank in respect of ineligible expenditures will be cancelled from the loan.

#### **5.4. MONITORING, EVALUATION AND ACCOUNTABILITY**

**118. The Ministry of Finance is responsible for the implementation of the program supported by the proposed operation.** As the main implementing agency, the Ministry of Finance will coordinate with other government agencies involved in the implementation of the operation, including the Presidential Administration, the Office of the Cabinet of Ministers of Uzbekistan, the Central Bank of Uzbekistan, the Ministry of Economy, the Ministry of Agriculture, the State Tax Committee, the Ministry of Investment and Foreign Trade, the General Directorate of State Inspection for Supervision of Quality of Education, the State Committee for Assistance to Privatized Enterprises and Development of Competition, the Office of the Cabinet of Ministers of Uzbekistan, and the State Committee on Statistics. The Ministry of Finance will work with these institutions to collect the necessary data of assess implementation progress and evaluate results. The technical capacity of these institutions is adequate to perform regular monitoring of the indicators and outcome measures shown in the monitoring and results framework of the policy matrix (Annex 1).

**119. Data availability have improved significantly, and improvements include the release of detailed household budget survey data available to the Bank; this will help strengthen the poverty and social impact of this proposed operation.** Improvements in data availability since the last DPO, and results from the Bank's Listening to the Citizens of Uzbekistan survey, have been used to estimate poverty and social impacts of prior actions. In addition to making available detailed household budget survey data to the Bank, the Government has also requested assistance from the Bank to strengthen the quality of Uzbekistan's household budget survey data, as well as overall support to strengthen statistics institutions. Gender disaggregated data, however, remains a major constraint. Although the Government



has recently launched a new gender statistics portal<sup>62</sup>, several globally identified indicators of gender gaps in the economy and society (e.g. employment, property rights, access to resources) are not yet available.

**120. Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org)

## 6. SUMMARY OF RISKS AND MITIGATION

**121. The overall risk to the operation is substantial.** Uzbekistan's ambitious reform program is now entering a second, and more challenging, phase. The reforms supported through this proposed operation tackle complex issues such as wheat prices, land rights, and SOE reforms, which carry substantial economic, political and social risks. Supporting the effective implementation of reforms in these areas, including the mitigation of social risks, is critical to the sustainability of the reform agenda. The Government recognizes these risks and is working closely with the World Bank Group and other international development partners to obtain robust analytical advice and implementation guidance before major decisions are taken. The pace and comprehensiveness of the reforms continue to generate substantial implementation risks that require careful monitoring (Table 5). The most relevant risks for this operation are political, sectoral, institutional capacity, and social risks. Others are assessed moderate or low.

**122. Political, governance and social risks remain substantial.** Political risks remain elevated given the ambition and pace of the reforms being attempted. Although popular support for the reforms continues to be strong, recent measures such as the increases in bread prices and measures to privatize urban land are highly complex and have generated public discussion and debate. As experiences of other transition economies demonstrate, such complex reforms – if poorly implemented and inadequately socialized – can create significant social disquiet and threaten the sustainability of the reform agenda. The Government is well aware of these risks and has taken a number of positive measures to mitigate them. It has established an economic council to ensure that major reforms are enacted based on expert advice and robust information. It has also maintained a strong focus on an open and inclusive reform process and has prioritized reforms that help quickly deliver tangible and visible progress to citizens, through reforms in sectors like horticulture, and improvements in public services – especially utilities, increases to farmgate prices, and measures to expand social safety nets. All major reforms go through a process of public consultation<sup>63</sup>, and ones with large poverty and social impact – such as the liberalization of bread prices, and increases in utility tariffs, have been accompanied by social safety net increases (both in the value of payments and in the number of beneficiaries).

**123. Implementation capacity and sector risks are substantial due to the significant pace of reforms, and the formative stage of many critical government institutions.** Institutions remain under significant pressure to respond

<sup>62</sup> <http://gender.stat.uz/ru/>

<sup>63</sup> All major reforms are circulated in draft on [www.regulation.gov.uz](http://www.regulation.gov.uz) for public comment and input. This process has led to revisions and improvements in a number of major reforms.



to the pace of the reform agenda. Staff are currently working long hours, seven days a week to meet milestones set out in the ambitious reform strategies for different sectors. But the situation is slowly changing – more sector line ministries are being created to take pressure of central agencies and allow sector strategies and policies to be developed by dedicated institutional capability. But these institutions are new, and it will take time to identify and recruit expert talent in sectors that have long been managed through the dominant SOE in the sector. It will also take time for these new institutions to develop clear sector strategies and policies, and to enforce strong governance over the sector. The Government is activity making efforts in the short-term to attract global diaspora talent to return to Uzbekistan for temporary assignments, increasing knowledge and expertise in-house. The Government is well-aware of these risks and is also working closely with the World Bank and other institutions to receive expert assistance and policy advice. The economic council will help improve coordination of this work.

**124. Macroeconomic risks are moderate and have eased since the last operation.** Although price and exchange rate liberalization measures have led to higher inflation, the effects of the changes were less costly to the economy than had been expected during the first DPO. Uzbekistan remains comfortably positioned to deal with macroeconomic risks as foreign reserves remain high and debt remains low. While the current account deficit is projected to remain elevated over the medium term, most of the projected deficit is expected to finance productive investments to modernize capital and address infrastructure gaps. The deficit may also attract additional FDI, which is critical to the transition. Directed credit, and more broadly the Government’s approach to extra-budgetary fiscal policy, continue to remain the biggest source of domestic risks, but the authorities have expressed a strong commitment<sup>64</sup> to significantly reducing this risk through improved fiscal transparency and measures to reduce preferential lending over the medium term. External risks, such as softening economic activity in major trading partner economies such as Russia, and weakening global commodity demand, also remain present. Uzbekistan’s external buffers remain adequate to mitigate this risk. Data transparency has also improved significantly since the last operation, and the publication of a sovereign rating will help enforce discipline around continued data transparency.

**Table 5: Summary Risk Ratings**

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<sup>64</sup> For example, Presidential Decree No. PP-4141 issued in January 2019 commits the Government to ending the practice of directed credit.



Risk Categories	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● Moderate
3. Sector Strategies and Policies	● Substantial
4. Technical Design of Project or Program	● Low
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Moderate
7. Environment and Social	● Substantial
8. Stakeholders	● Low
9. Other	
<b>Overall</b>	● Substantial



**ANNEX 1: POLICY AND RESULTS MATRIX**

Prior actions and Triggers		Results	
Prior Actions under DPO	Indicator Name	Baseline	Target
<b>Pillar 1: Increasing the role of markets and the private sector in the economy</b>			
<b>Prior Action 1:</b> To increase agricultural exports and incomes for farmers, the Borrower has (i) removed mandatory pre-payment and minimum export price requirements for horticultural exports, (ii) removed controls on the sale price of shaped bread, and (iii) increased the state farmgate procurement price offered to farmers for the 2019 wheat harvest.	<b>Results Indicator #1:</b> An increase in the value of horticultural exports.	US\$875 million (2018)	US\$960 million (2019)
<b>Prior Action 2:</b> To reduce market entry barriers and increase competition in domestic trading activity, the Borrower has removed (i) licensing requirements to start and operate wholesale domestic trading and itinerant trading businesses, and (ii) mandatory advance payment requirements for commercial trading transactions between entities whose Government ownership is less than 50 percent.	<b>Results Indicator #2:</b> Increase in the number of legal entities registered as wholesale trading businesses.	12,387 (2017)	13,000 (June 2020)
<b>Prior Action 3:</b> To improve financial sector efficiency and stability, the Borrower has submitted a new banking law for Parliamentary approval that gives sufficient powers to the Central Bank of Uzbekistan to conduct effective oversight and enforcement, establishes a comprehensive and transparent licensing framework, and strengthens corporate governance and transparency requirements for commercial banks.	<b>Results Indicator #3:</b> Banking sector legislation is in greater compliance with Basel Core Principles	Banking sector legislation is non-compliant with the following key Basel Core Principles for Effective Banking Supervision: BCP1, BCP2, BCP5, BCP8, BCP11, BCP19, BCP20 (December 2018)	Banking sector legislation is in increased compliance with Basel Core Principles for Effective Banking Supervision BCP1, BCP2, BCP5, BCP8, BCP11, BCP19, BCP20 (June 2020)
<b>Prior Action 4:</b> To increase private sector investment in the energy sector, the Borrower has taken measures to establish a legal framework for the development of renewable energy and to adopt procurement procedures for the selection of potential renewable energy providers.	<b>Results Indicator #4:</b> Competitive tendering of renewable energy projects under the new law.	0 (June 2018)	The Government brings at least 1 RE project to the point of commercial tender announcement. (end-September 2020)



Prior actions and Triggers		Results	
<p><b>Prior Action 5:</b> To achieve financial sustainability of energy and water utility companies, the Borrower has adopted a revised tariff methodology, consistent with principles of full cost-recovery, for the provision of electricity and cold-water services.</p>	<p><b>Results Indicator #5:</b> Number of end-user electricity and cold-water tariff changes made in accordance with new tariff methodology.</p>	<p>0 – Methodology did not exist (December 2018)</p>	<p>At least 1 electricity and 1 cold-water end-user tariff amendments are made in accordance with the new methodology. (June 2020)</p>
<p><b>Prior Action 6:</b> To increase private sector participation in the aviation sector, the Borrower has (i) separated the Borrower’s airline management, airport management, and air traffic control functions, and (ii) separated its policymaking, technical regulatory, and operational functions in the aviation sector.</p>	<p><b>Results Indicator #6:</b> A change in the ownership structure of (i) the national airline, (ii) all airports, (iii) air traffic control services.</p>	<p>All airports under the sole ownership of NAK (June 2018)</p>	<p>Airport ownership separated from NAK into a new entity, and a process is under way to concession at least one airport in Uzbekistan under PPP arrangements following a competitive tender process. (September 2020)</p>
<p><b>Prior Action 7:</b> To improve the financial transparency and accountability of State-Owned Enterprises, the Borrower has created a new Agency for the Management of State Assets, reporting to the Prime Minister, to be responsible for the management of state-owned enterprises and the implementation of an open and transparent process for the privatization of state assets.</p>	<p><b>Results Indicator #7:</b> Number of independent financial valuations of State-Owned Enterprises conducted by the Agency for the Management of State Assets in accordance with International Financial Reporting Standards.</p>	<p>0 (December 2018)</p>	<p>Valuations for Uzbekenergo, Uzbekneftegaz, and at least 5 other SOEs have been completed (June 2020)</p>
<p><b>Pillar 2 – Enhancing Social Inclusion</b></p>			
<p><b>Prior Action 8:</b> To encourage firm growth and formal job creation, especially of women, the Borrower has adopted a turnover-based definition of small businesses for tax and value-added tax registration purposes.</p>	<p><b>Results Indicator #8:</b> An increase in formal employment as evidenced by the number of private sector employees registered for payroll tax withholding, disaggregated by gender.</p>	<p>Male: 1,712,893 Female: 1,049,837 (end-December 2018)</p>	<p>Male: 1,952,698 Female: 1,207,315 (end-June 2020)</p>
<p><b>Prior Action 9:</b> To create better conditions for formal job creation in urban areas, especially of women, and enhance labor mobility, the Borrower has removed restrictions limiting employers from hiring workers who do not have a local residence permit (“propiska”).</p>			





Prior actions and Triggers	Results		
<p><b>Prior Action 10:</b> To improve educational standards and increase the quality of the labor force, the Borrower has (i) signed a participation agreement with the OECD to participate in the 2021 PISA, and (ii) created a National Center for International Research on Quality Assurance in Education which, along with the Ministry of Public Education, will be responsible for conducting national standardized and systematic student assessments of educational achievement.</p>	<p><b>Results Indicator #9:</b> An increase in the roll out of standardized systematic national educational assessments.</p>	<p>No standardized and systematic national assessments in Uzbekistan (2018)</p>	<p>A new standardized and systematic national assessment is piloted in at least 2 regions (June 2020)</p>
<p><b>Prior Action 11:</b> To improve the efficiency and effectiveness of social safety nets for low income families, the Borrower has approved the creation and development of a Unified Social Registry of Social Protection.</p>	<p><b>Results Indicator #10:</b> An increase in the utilization of the unified social registry system, as evidenced by the number of administrative units that have adopted the unified social registry to process applicants' registration, beneficiary selection, program enrolment, and payment orders.</p>	<p>0 - No Unified System in place (December 2018)</p>	<p>10 (September 2020)</p>
<p><b>Prior Action 12:</b> To increase fiscal transparency and improve citizen engagement in the budgetary process, the Borrower has required the Ministry of Finance to (i) annually publish citizens budget and budget execution reports, and (ii) ensure that at least ten percent of each municipal district budget is allocated via input from a community-level participatory process, commencing from the 2019 Budget.</p>	<p><b>Results Indicator #11:</b> Publication and availability of citizen budget documents.</p>	<p>A pilot Citizen Budget document for the 2018 Budget has been published and is available on the Ministry of Finance Website (November 2018)</p>	<p>Citizen Budget documents for the 2019 and 2020 Budgets have been published and available on the Ministry of Finance Website (June 2020)</p>



## ANNEX 2: FUND RELATIONS ANNEX

### **IMF Executive Board Concludes 2019 Article IV Consultation with the Republic of Uzbekistan May 9, 2019**

On May 6, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Uzbekistan.

In 2018, GDP growth picked up moderately to 5 percent as adverse weather impacted agriculture and bottlenecks in energy and water slowed economic growth, despite strong investment growth. Consumer inflation had fallen to 14½ percent by end-2018, but rapid credit growth, price liberalization, public wage adjustments, and high inflation expectations will maintain price pressures in 2019. A shift towards more liberal exchange rate and trade regimes in 2017 along with expansionary credit policies in 2018, pulled in additional imports causing a decline in Uzbekistan’s current account balance from a small surplus in 2017 to a 7 percent of GDP deficit in 2018. Nonetheless, Uzbekistan has substantial external buffers with reserves at 13 months of imports and external debt a moderate 35 percent of GDP at end-2018.

The fiscal stance remained prudent in 2018 with the overall fiscal deficit, which includes policy lending, staying around two percent of GDP and public debt remaining at 20 percent of GDP. VAT and mining revenues surged but were offset by higher social expenditures and policy lending. In 2019, the authorities began implementing a major tax reform designed to simplify taxes, expand the standard corporate tax regime and value added tax, while reducing the tax burden on private firms and workers.

The central bank tightened monetary policy in 2018, raising the refinancing rate from 14 to 16 percent and using foreign exchange sales to sterilize liquidity generated by substantial purchases of domestic gold. Following nominal depreciation of 60 percent in 2017, the exchange rate remained relatively constant in 2018 and appreciated in real terms. However, credit to the economy grew more than 50 percent driven in part by a substantial increase in policy lending. State banks account for about 85 percent of banking system assets and their main function is to support government investment and development plans. Nonetheless, bank soundness indicators continue to look reassuring. The central bank has begun using macroprudential tools to more actively contain risks, while continuing to upgrade its supervisory capacity and intervention tools.

Progress continued on structural and institutional reforms, but the reform agenda remains large. Currently, the government is accelerating state enterprise reforms by creating an asset management agency, unbundling responsibilities in the energy and transportation sectors, and identifying enterprises for restructuring or privatization. Other reforms focus on additional price liberalization, improving labor skills, implementing land reforms, streamlining regulations, and improving public governance. Uzbekistan has embraced the Sustainable Development Goals, with a focus on education, health, gender equality, infrastructure, and financial inclusion.

#### **Executive Board Assessment**



Executive Directors welcomed the implementation of a first wave of economic reforms, including foreign exchange liberalization and tax reform, which has supported robust growth and helped transition toward a more open and market-based economy. Looking ahead, Directors encouraged the authorities to sustain and prioritize the reform momentum to maintain macroeconomic stability, boost inclusive growth, and spur private sector job creation.

Directors encouraged the authorities to continue their tight monetary policy to contain inflation, while bringing credit growth in line with external and internal stability requirements. Containing credit growth and phasing out directed credit would help limit inflationary pressures, avoid excessive external deficits, and prevent a potentially costly boom-bust cycle. Directors supported continued exchange rate flexibility, which would allow the economy to adjust in line with economic fundamentals. They encouraged the authorities to implement greater central bank independence.

Directors welcomed the authorities' prudent fiscal policy, which has kept the overall fiscal deficit and public debt at moderate levels. They supported the authorities' intention to reduce policy lending in 2019 and welcomed the commitment to include all off-budget fiscal operations in the 2020 budget. While Uzbekistan has significant investment needs, Directors agreed it would be important to resist pressures to scale up spending, which could have a procyclical economic impact. Directors commended the authorities' decision to proceed with a major tax reform, and advised its careful implementation, while standing ready to introduce additional measures as needed, particularly in the event of reduced revenues from state enterprises.

While reported bank soundness indicators are strong, Directors considered that state-owned banks need to address lingering balance sheet issues and improve governance. They supported the authorities' efforts to develop a strategy to restructure the banking sector, upgrade supervisory capacity in line with international best practice, and use macroprudential tools more actively.

Given the challenging structural reform agenda, Directors encouraged the authorities to prioritize reforms to address distortions and boost job creation. They supported efforts to improve the business environment, including by reducing the cost of doing business and strengthening public governance. Directors stressed the need to reform state-owned enterprises by improving corporate governance and allowing privatization or minority stakes. Streamlining and making the regulatory framework more predictable would encourage private entrepreneurship and stronger foreign investment. Directors strongly supported Uzbekistan's efforts to tackle corruption by boosting public education and legal, regulatory, and institutional reforms. They urged the authorities to continue to improve the quality and transparency of economic data.

Directors welcomed the authorities' agenda for inclusive growth anchored by the Sustainable Development Goals, including plans to help vulnerable groups by improving skills training, boosting funding for active labor market programs, providing greater support for migrants, and reforms to the labor market.



Uzbekistan: Selected Economic Indicators, 2016-21						
	2016	2017	2018	2019	2020	2021
			Est.	Proj.	Proj.	Proj.
<b>National income 1/</b>						
Real GDP growth (percent change)	6.1	4.5	5.1	5.5	6	6
GDP per capita (in U.S. dollars)	2576	1810	1550	1832	2095	2353
Population (in millions)	31.6	32.1	32.6	33	33.5	34
<b>Prices</b> (Percent change)						
Consumer price inflation (eop)	9.8	19.8	14.3	15.6	12.4	9.1
GDP deflator	8.7	18.4	28.1	21.7	15.6	11.7
<b>External sector</b>						
Current account balance (percent of GDP)	0.4	2.5	-7.1	-6.5	-5.6	-4.8
External debt (percent of GDP)	18.6	34.1	34.5	34	35.5	32.2
Exchange rate (in sums per U.S. dollar; eop)	3231	8120	8340	...	...	...
Real effective exchange rate (2015=100 ave, - = dep)	84.3	65.9	60.2	...	...	...
<b>Government finance</b> (Percent of GDP)						
Budget revenues	24.4	23.7	26.6	24.1	24.3	24.7
Budget expenditures	24.3	23	26.1	24.8	25.3	25.7
Budget balance	0.1	0.7	0.5	-0.6	-0.9	-1
Revenues (adjusted) 2/	25.4	24.7	27.9	25.4	25.4	25.6
Expenditures (adjusted) 2/	23.8	22.9	25.6	24.8	25	25.4
Consolidated fiscal balance	1.6	1.8	2.2	0.6	0.4	0.3
Policy-based lending	2.1	3.6	4.3	2.2	2.2	2.1
Overall fiscal balance	-0.5	-1.9	-2.1	-1.6	-1.8	-1.8
Public debt	8.6	20.2	20.6	23.2	24.7	24.7
<b>Money and credit</b> (Percent change)						
Reserve money	22.2	84.8	-0.8	14.4	16.5	15.9
Broad money	23.5	40.3	14.4	21	20.3	18.4
Credit to the economy	28.4	103	50.8	25	20.1	18.8
1/ In March 2019, the government revised national accounts data for 2014-2018.						
2/ IMF staff adjusts budget revenues and expenditures for extrabudgetary funds (primarily the Fund for Reconstruction and Development), lending and borrowing, and externally financed expenditures.						



ANNEX 3: LETTER OF DEVELOPMENT POLICY

O'ZBEKISTON RESPUBLIKASI  
VAZIRLAR MANKAMASI



CABINET OF MINISTERS  
REPUBLIC OF UZBEKISTAN

« 10 » avgust 2019 y.

№ \_\_\_\_\_

100008, Toshkent shahri, Hukumat uyi  
Government House, Tashkent, 100008

Президенту  
Группы Всемирного банка  
Г-ну Давид Малпасс

**Уважаемый господин Малпасс!**

Настоящим я хотел бы сообщить Вам последние новости, касающиеся исторических социально-экономических преобразований, продолжающихся в Узбекистане, и реализации нашей Стратегии действий по дальнейшему развитию Республики Узбекистан на период 2017 – 2021 гг.

Начало реформ, ознаменовавшихся в 2017 году принятием исторических мер по унификации валютного рынка, сегодня ощущается как что-то, произошедшее очень давно. Под руководством Президента Республики Узбекистан мы вступили в третий год реформ, направленных на повышение конкурентоспособности экономики и улучшение условий для осуществления частных инвестиций, и за прошедшее с 2017 года время также осуществлены другие важные реформы. Цель этих реформ остается как никогда острой и актуальной в мыслях каждого государственного служащего: создание новых высококачественных рабочих мест и экономических возможностей, улучшающих жизни всех граждан Узбекистана.

Правительство Узбекистана как никогда более привержено вопросу достижения этой цели и устранения трех серьезных препятствий:

во-первых, данная цель не может быть достигнута в условиях экономики, доминирующую роль в которой играет государство;

во-вторых, данная цель не может быть достигнута в условиях, когда наши молодые предприниматели и бизнес-структуры не могут преобразовать свои идеи в новые возможности;

в-третьих, данная цель не может быть достигнута, если мы не обеспечим, чтобы все наши граждане, особенно самые малоимущие и наиболее уязвимые, получали ощутимую выгоду от реализации реформ, и имели равные возможности для участия в построении современной экономики.





Эти три принципа – сокращение присутствия государства в экономике, улучшение условий для частного сектора и построение всеобъемлющей повестки реформ – остаются в числе главных приоритетов реформ. Именно они определены в качестве наиболее важных приоритетов в недавно утвержденной **Дорожной карте реформ на 2019-2021 гг.**, подготовленной в сотрудничестве с Группой Всемирного банка. В оставшейся части письма я постараюсь вкратце описать основные политические приоритеты Правительства, связанные с каждым из этих направлений.

#### ***Сокращение присутствия государства в экономике***

Планы Правительства по сокращению присутствия государства в экономике будут делать упор на два критически важных вопроса – деятельность государственных предприятий (ГП) и реформирование финансового сектора.

Реформа ГП состоит из трех элементов. Во-первых, в отраслях, где ГП являются монопольными поставщиками услуг, правительством начаты реформы по разделению операционных функций ГП и функций по развитию и регулированию отрасли. Уже приняты соответствующие меры в авиационной и транспортной отраслях, в которых созданы новые министерства, и функции управления ГП, осуществляющими деятельность в этих секторах, были отделены от функций руководства новыми правительственными министерствами.

Во-вторых, Правительство привержено вопросу улучшения и корпоратизации управления ГП. За этот процесс будет отвечать недавно созданное Агентство по управлению государственными активами. Агентство наделено полномочиями, связанными с корпоратизацией управления, а также повышением финансовой прозрачности ГП в Узбекистане в соответствии с передовой международной практикой. Уже начата работа по оценке финансового положения и устойчивости ГП.

Новое агентство также отвечает за третье направление реформирования госпредприятий – оптимизацию структуры собственников государственных активов. В настоящее время Агентство готовит проект стратегии государственного владения активами. В этой стратегии будут определены ключевые отрасли, в которых государство и в дальнейшем будет сохранять свое присутствие в лице ГП. Госпредприятия, осуществляющие деятельность в этих отраслях, будут реструктурированы и трансформированы таким образом, чтобы обеспечить их экономическую эффективность и осуществление деятельности с показателями, сравнимыми с международными ориентирами. В других отраслях, не имеющих стратегического значения, новое агентство будет отвечать за реализацию государственных активов





в отрасли – либо путем приватизации, либо через организацию государственно-частного партнерства. Правительство очень хорошо понимает, насколько важны прозрачность и открытость этого процесса. Они критически важны с точки зрения привлечения высококачественных инвестиций и создания рабочих мест в Узбекистане. Правительство также делает большой упор на обеспечение того, чтобы любые социальные и экологические последствия приватизации тщательно изучались и компенсировались для того, чтобы процесс реформ был действительно всеобъемлющим и устойчивым.

Правительство также продвигает реформы в финансовом секторе. Помимо разработки новых законодательных актов о банковской деятельности и Центральном банке, Правительство и Всемирный банк будут тесно сотрудничать в ближайшие месяцы в вопросе разработки дорожной карты реформ в финансовом секторе, а также будут разрабатывать стратегию повышения доступности финансовых услуг для всех граждан. Эти реформы будут делать упор на сокращение доли государства в банковском секторе, углубление рынков капитала и создание конкурентоспособного и прозрачного финансового сектора, служащего двигателем предпринимательской деятельности и создания рабочих мест в экономике Узбекистана. Реформы также будут делать акцент на реформирование применяемых подходов в вопросе целевого кредитования и заимствований средств правительства в адрес ГП, что имеет целью как повышение экономической эффективности использования этих средств для Правительства, так и обеспечение поддержки самых лучших и ярких предпринимателей, осуществляющих деятельность в экономике страны.

#### ***Улучшение условий для частного сектора***

Узбекистан обладает громадным потенциалом на глобальном рынке в вопросах экспорта плодоовощной продукции, конкурентоспособного экспортера химической продукции или в качестве важного туристического центра. Имеется несчетное количество других еще не освоенных источников роста, которые могут помочь диверсифицировать экономику с отказом от сырьевой зависимости. В качестве движущей силы, которая может преобразовать этот потенциал в ощутимые выгоды для граждан, не должно выступать государство. Эту роль должен играть предприниматель.

Давать возможность отечественным и иностранным предпринимателям процветать в Узбекистане – вот в чем заключается второе приоритетное направление наших реформ.

Наши усилия в этом вопросе продолжают делать упор на улучшение среды для ведения бизнеса путем устранения



бюрократии, снятия барьеров, мешающих торговле, и путем интеграции в глобальные рынки.

Достигнуты значительные результаты в вопросе улучшения условий для ведения бизнеса и осуществления торговли внутри страны, а также улучшения условий для осуществления экспорта продукции. Наиболее важным из них является внедрение нового режима налогообложения, значительно сокращающего налоговое бремя, ложащееся на бизнес и на рынок труда.

Реформы также направлены на меры по сокращению регулирования бизнеса, в том числе отмену требований касательно лицензирования деятельности, сокращение регламентов, ограничивающих управление денежными средствами и устанавливающих ограничения, связанные с осуществлением предоплаты за товары и услуги, позволяющие с большей свободой торговать товарами на рынке. Эти реформы и в дальнейшем будут приоритетными для Правительства, в том числе в рамках нашего сотрудничества с Группой Всемирного банка.

Еще один набор реформ направлен на улучшение инвестиционной среды в сельском хозяйстве. В добавок к крупнейшему экономическому и экспортному потенциалу, это та самая отрасль, в которой реформы могут принести быстрые и видимые выгоды для граждан, учитывая, что в секторе занята значительная часть населения. Последние реформы акцентированы на устранение барьеров, мешающих экспорту в плодоовощной продукции, создание частных хлопководческих кластеров, а также постепенную либерализацию контроля за ценами на разные виды продукции, включая пшеницу. Ожидается, что эти меры помогут оживить рост сельского хозяйства после нескольких лет снижения показателей, а также привести к росту доходов фермеров. Вдобавок к ним будут реализованы дальнейшие реформы, которые улучшат среду для осуществления инвестиций в сельском хозяйстве. Правительство в настоящее время разрабатывает стратегию модернизации сельского хозяйства и тесно сотрудничает со Всемирным банком в вопросах идентификации следующей фазы реформ в этой отрасли.

После объявления о нашем намерении возобновить процесс вступления в ВТО, Правительством достигнуты хорошие результаты в вопросе подготовки к повторному запуску переговоров о присоединении. В настоящее время Правительством дорабатывается Меморандум об отношениях во внешней торговле для дальнейшей передачи в Секретариат ВТО. Это позволит возобновить обсуждения вопросов, связанных с присоединением к организации, с Рабочей группой ВТО по Узбекистану. В то же время, осуществляемые по





улучшению деловой среды и условий для осуществления торговли позволят ускорить готовность Узбекистана к вступлению в ВТО. Узбекистан – это страна с населением, превышающим 303 миллионов жителей, разделяющих намерение сделать все, что в их силах для того, чтобы преуспеть на глобальном рынке, и мы уверены, что страны-участницы ВТО по достоинству оценят эти намерения и благоприятно отнесутся к нашему вступлению в организацию. Мы полагаемся на дальнейшую поддержку и участие Всемирного банка в этом процессе.

#### ***Обеспечение выгод от реформ для каждого гражданина***

Благодаря наличию природных ресурсов и трудолюбивого населения, Узбекистану удалось создать мощные бюджетные и внешние буферы. С самых первых дней реформ были предприняты меры, обеспечивающие тщательную оценку любых реформ, которые могут оказать значительное социально-экономическое воздействие, на предмет рисков с выработкой мер по их смягчению. Данная политика привела к расширению систем социальной защиты и к утверждению серьезной программы полного пересмотра систем социальной помощи, обеспечивающей ее достаточность, эффективность с точки зрения поддержки лиц, наиболее уязвимых в ходе осуществления реформ. Первым шагом этого пересмотра явится создание единого социального реестра, который позволит правительству обеспечить получение помощи теми гражданами, которые нуждаются в ней более чем другие. Правительство продолжит активно работать со Всемирным банком в вопросах усиления систем социальной помощи и реформирования политики на рынке труда, обеспечивающих реализацию эффективных мер по поддержке рабочих в период перехода к новой рыночной экономике.

Отличительной чертой всех успешных экономических преобразований является как можно более раннее осуществление инвестиций, направленных на усиление человеческого капитала и повышение качества государственных услуг. Эти инвестиции также критически важны для сохранения поддержки реформ со стороны общественности. Всеобъемлющий характер этих инвестиций также очень важен для обеспечения того, чтобы каждый гражданин мог принимать участие в жизни экономики и общества.

Правительством принята программа совершенствования социальной политики и инвестирования в модернизацию системы оказания государственных услуг в Узбекистане. Например, важные меры политики, принятые в последние месяцы в образовательной сфере, включают решение о присоединении к системе оценки PISA ОЭСР, начиная с 2021 года, а также меры по дальнейшему совершенствованию системы высшего образования. Эти реформы политики сопровождаются



инвестициями в инфраструктуру, направленными на строительство и ремонт учебных заведений по всей стране. Всемирный банк продолжает выступать в качестве важного стратегического партнера в образовательном секторе. Примерно такие же меры политики и инвестиции реализуются с целью усиления системы здравоохранения, коммунальных служб и совершенствования базовых услуг, оказываемых населению государством.

Для реализации повестки всеобъемлющего роста, принятой Правительством, ключевую роль будет играть сокращение размеров неформальной экономики. Высококачественные рабочие места практически всегда создаются именно в формальных секторах экономики. В последние месяцы правительством предпринят ряд шагов, направленных на улучшение условий для создания рабочих мест в формальной среде. Реформы включают меры по устранению барьеров, мешающих внутренней мобильности рабочей силы, усилению планирования городов и реформированию налоговой системы со стимулированием роста формальной занятости. Правительство уверено, что эти меры приведут к тому, что повестка реформ станет еще более инклюзивной и будет приносить пользу более широким слоям населения.

При том, что правительство выбрало три ключевых направления, предусмотренные в нашей повестке реформ, соответствующие целям и задачам предлагаемой Операции по поддержке политики развития (DPO), Стратегия действий по реформированию Республики Узбекистан на 2017-2021 годы является намного более обширной и амбициозной, не ограничиваясь только упомянутыми направлениями. В числе прочих приоритетов – повышение прозрачности бюджетов и пользования природными ресурсами, улучшение инфраструктуры сообщений, усиление процессов развития в регионах и в сельской местности, усиление регионального сотрудничества, повышение показателей и обеспечение безупречности государственных служащих. Реформы в этих областях также продвигаются хорошо и будут сохранять актуальность в рамках нашего политического диалога и реализации операций DPO со Всемирным банком.

Как видно из этой краткой справки, правительство Узбекистана твердо намерено улучшать уровень жизни своих граждан наиболее открытым, прозрачным образом, с участием самих граждан в принятии решений. При том, что мы все еще находимся на активной стадии реформ, мы наблюдаем все более многочисленные свидетельства того, что граждане и международное сообщество приветствуют наш подход. Как показывают результаты социологического исследования Всемирного банка «*Слушая граждан Узбекистана*», свыше 95 процентов респондентов поддерживают выбранное направление реформ.



Полученные недавно результаты на рынке государственных облигаций показывают, что инвесторы демонстрируют такую же степень уверенности в правильности выбранного нами направления.

Но мы не должны останавливаться на достигнутом. Нам еще предстоит долгий путь реформ, на котором присутствует множество рисков, которые мы должны компенсировать за счет тщательной проработки действий и высокой экономической дисциплины. Все еще остается множество незавершенных дел, которые помогут закрепить корни реформ и видение, инициированные Президентом Республики Узбекистан для обеспечения еще большего процветания Узбекистана.

Всемирный банк выступал и выступает в качестве важного партнера в ходе осуществления наших реформ, и мы уверены, что наше дальнейшее сотрудничество внесет вклад в устойчивые и всеобъемлющие экономические преобразования. Мы полагаемся на Вашу дальнейшую поддержку и с нетерпением ждем возможности продолжить работу с Вами и Вашей командой в ближайшие годы.

С уважением,

**Джамшид Кучкаров**

**Заместитель Премьер-министра,  
Министр финансов Республики Узбекистан**





**[Letter of Development Policy - Unofficial Translation]**

The President  
World Bank Group  
Mr. David Malpass

Dear Mr. Malpass,

I am writing to update you on the historic socio-economic transformation that continues to take shape in Uzbekistan, and on the implementation of our Development Strategy 2017-2021.

The start of the reforms, which began with historic measures in 2017 to unify the foreign exchange market, are now beginning to feel more distant in our memory. Under the leadership of the President of the Republic of Uzbekistan, we are now in our third year of reforms to improve the competitiveness of the economy and the environment for private investment, and significant further reforms have been achieved since 2017. The goal of these reforms remains razor-sharp in the minds of every civil servant: the creation of new high-quality jobs and economic opportunities that improve the lives of all citizens of Uzbekistan.

The Government of Uzbekistan remains strongly committed to achieving this goal, and to removing three major constraints. First, this goal cannot be achieved in a state-dominated economy. Second, this goal cannot be achieved in an environment where our young entrepreneurs and businesses are not able to convert ideas into opportunities. And third, this goal cannot be achieved without ensuring that all of our citizens, especially the poorest and most vulnerable, benefit from visible gains as a result of the reforms, and are given equal opportunities to participate in building a modern economy.

These three principles – reducing the state’s presence in the economy, improving the private sector environment, and building an inclusive reform agenda – remain the major areas of focus for the reforms. They are the most important priorities in the recently approved *Reform Roadmap* for 2019-2021, which was prepared in collaboration with the World Bank Group. I will use the remainder of this letter to outline the Government’s main policy priorities in each of these three areas.

***Reducing the presence of the state in the economy***

The Government’s plans to reduce the state’s presence in the economy will focus on two critical issues, the operations of State-Owned Enterprises (SOEs), and the reform of the financial sector.

There are three areas for SOE reform. First, in sectors where SOEs are monopoly service providers, the Government has begun reforms to separate the operation of SOEs from the development and regulation of the sector. Measures have already been implemented in the aviation and transportation sectors, where new ministries have been created, and management of SOEs in these sectors has been separated from leadership of the Government Ministries.

Second, the Government is committed to improving and corporatizing the management of SOEs. The recently created Agency for State Asset Management will be responsible for this process. The agency has





a mandate to corporatize the governance and management, and improve the financial transparency of SOEs in Uzbekistan, in line with international best practices. Work has already begun to evaluate the financial position and strength of SOEs.

The new agency is also responsible for the third area of SOE reform – optimizing the ownership of state assets. The agency is in the process of developing a draft strategy for state ownership of assets. This strategy will outline the key sectors where the Government will continue to maintain a presence through SOEs. In those sectors, SOEs will be restructured and transformed to ensure that they are delivering value for money, and that they are performing at levels consistent with international benchmarks. In other sectors that are not strategic, the new agency will be responsible for divesting Government ownership of assets in the sector, either via privatizations or via Public Private Partnerships. The Government firmly recognizes the importance of transparency and openness in this process. It is critical to attracting high quality investment and jobs to Uzbekistan. The Government has also placed a strong emphasis on ensuring that any social and environmental impacts of privatization are carefully studied and mitigated to ensure that the process of reform is inclusive and sustainable.

The Government is also moving ahead with reforms in the financial sector. In addition to developing new banking and central banking legislation, the Government and the World Bank will work closely together in the coming months to develop a roadmap for reform in the financial sector, and to develop a strategy for increased financial inclusion. These reforms will focus on reducing state ownership in the banking sector, deepening the capital markets, and on creating a competitive and transparent financial sector that serves as the engine for entrepreneurship and jobs in Uzbekistan’s economy. The reforms will also focus on reforming the current approach to directed credit and lending by the Government to SOEs, both to improve the value for money that the Government receives from these investments, as well as to ensure that the best and brightest entrepreneurs in the economy can be supported.

### ***Improving the Private Sector Environment***

Uzbekistan has immense potential in the global market in horticultural exports, as a competitive exporter of chemicals, or as a major tourism center. There are countless other untapped sources of growth that can help diversify the economy away from a dependence on commodities. But the engine that can transform this potential into visible benefits for citizens is not the state. It is the entrepreneur. Enabling our entrepreneurs, and those from other countries, to thrive in Uzbekistan is the second major focus area of the reforms. Our efforts in this area continue to focus on improving the environment for doing business, by cutting red tape, removing barriers to trade, and integrating with the global market.

There has been significant progress in improving both the domestic business and trading environment, as well as the environment for exports. Most important among these has been the establishment of a new tax regime, which significantly reduces the tax burden on businesses and on the labor market. Reforms have also focused on reducing regulations on businesses, including the removal of licensing requirements, reducing regulations on cash management and advance payments, and allowing more commodities to be freely traded in the marketplace. These reforms will continue to be a priority for Government, and for our engagement with the World Bank Group.

A second set of reforms has focused on improving the investment environment in agriculture. In addition



to having immense economic and export potential, it is an area where major reforms could generate quick and visible gains for citizens given the significant proportion of people employed in this sector. Recent reforms have focused on the removal of export barriers for fruit and vegetables, the introduction of private cotton farming clusters, and the gradual liberalization of price controls in areas such as wheat. These measures are expected to help revive agricultural growth after recent declining performance and increase farmer incomes. They will be accompanied by further reforms that strengthen the environment for investment in agriculture. The Government is in the process of developing a modernization strategy for agriculture and is working closely with the World Bank on identifying the next phase of reforms in this area.

Since communicating our intentions to resume the WTO accession process, the Government has made good progress in preparing to recommence accession negotiations. The Government is currently finalizing a revised Memorandum of Foreign Trade Relations to the WTO secretariat. This will enable the resumption of discussions with the WTO Working Party for Uzbekistan's accession. Simultaneously, ongoing improvements to the business and trading environment will also help accelerate Uzbekistan's readiness to join the WTO. We are a country of over 30 million people that are determined to work hard and prosper in the global market, and we are confident that WTO members will recognize these intentions and support our entry to the Organization. We seek the World Bank's continued support and engagement to make this possible.

### ***Ensuring that the reforms benefit every citizen***

Through the blessing of our natural resources and the hard work of our citizens, Uzbekistan has managed to build strong fiscal and external buffers. These buffers afford Uzbekistan a unique opportunity to implement a structural economic transformation in a way that does not leave anyone behind and invests early in the potential of future generations. Ensuring an inclusive transition is one of the highest priorities of President Mirziyoyev and the Government of Uzbekistan.

A hallmark of our culture is to take care of the poor and vulnerable, and to support their full participation in the economy and society. From the very start of the reforms, measures have been put in place to ensure that any reforms that have significant social and environmental impacts are carefully evaluated for risks and properly mitigated. This policy has led to an expansion of safety nets, and to a major program to overhaul the safety net system to ensure its adequacy, effectiveness, and efficiency in supporting those most vulnerable to the reforms. The first step of this overhaul will be the establishment of a unified social registry, which will allow the Government to ensure that assistance is received by those citizens who need it more than others. The Government is working closely with the World Bank to strengthen the safety net system and reform labor market policies to ensure that effective measures are in place to support workers in transitioning to a new market economy.

A hallmark of other successful economic transitions is the importance of early investments in strengthening human capital and the quality of public services. These investments are also critical to maintaining public support for the reforms. The inclusivity of these investments is also important in ensuring that all citizens can participate in the economy and society. The Government has an ambitious program to improve social policies and invest in modernizing public service delivery in Uzbekistan. As an example, in the education sector, major policies adopted in recent months include a decision to join the



OECD PISA process from 2021, and measures to further reform higher education. These policy reforms have been matched by infrastructure investments to build and renovate schools across the country. The World Bank continues to be an important strategic partner in the education sector. Similar policies and investments are in place to strengthen healthcare, utility services, and core government services.

Reducing the size of the informal economy is critical to the Government's inclusive growth agenda. High quality jobs are almost always in the formal sectors of the economy. In recent months, the Government has taken a range of steps to strengthen the environment for formal job creation. Reforms include measures to remove constraints to internal labor mobility, strengthen urban planning, and reform the tax system to encourage formal job growth. The Government is confident that these measures will lead to a more inclusive reform agenda that benefits a larger share of the population.

While the Government has chosen to showcase the three key areas of the reform agenda most consistent with the proposed Development Policy Operation (DPO), the Government's 2017-2021 Development Strategy is much broader and more than just these areas. Other priorities include increasing fiscal and natural resource transparency, improving connective infrastructure, increasing development in our regions and in rural areas, strengthening regional cooperation, improving the performance and integrity of the civil service. Reforms in these areas are also well advanced and will remain important to our ongoing policy dialogue and DPO engagement with the World Bank.

As this brief overview demonstrates, the Government of Uzbekistan is on a determined mission to improve the lives of citizens in a way that is open, transparent, collaborative and participatory. While we are still in the active stages of reform, there is emerging evidence that our approach is taking root with citizens and with the international community. As the World Bank's *Listening to the Citizens of Uzbekistan* shows, over 95 percent of survey respondents are supportive of the direction of reforms. Recent results in the international bond market shows that investors are expressing a similar level of confidence in the direction we are taking.

But we should not stop there. We still have a long road of reforms, with many risks that we are committed to mitigating through careful management and good economic discipline. There is much unfinished business that remains to firmly embed the roots of these reforms and the vision of the President of the Republic of Uzbekistan for a more prosperous Uzbekistan. The World Bank has been, and is, an important partner in our reforms, and we are sure that our continued collaboration will contribute to a sustainable and inclusive economic transition. We look forward to your continued support, and to working closely with you and your team in the coming years.

Sincerely

Djamshid Kuchkarov

Deputy Prime Minister and Minister of Finance of the Republic of Uzbekistan



## ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS

### *Government and World Bank collaboration to address environmental and social effects of the reforms*

**The Government of Uzbekistan and the World Bank have worked closely to address potential environmental, poverty and social effects arising from the market transition.** Ensuring a sustainable transition is a key priority for the authorities. The Government has measures in place to ensure that all major reforms are evaluated for negative impacts and include mitigation strategies. Simultaneously, the proposed *Strengthening the Social Protection System* project would help strengthen the safety net system and increase access to jobs for groups vulnerable to the ongoing reforms. This project, and a range of other analytical and operational engagements underpin the close collaboration between GoU and the World Bank to address environmental and social issues.

**Significant progress has been made in ending child labor and forced labor in Uzbekistan.** Since 2015, the World Bank has partnered with the International Labor Organization (ILO) to conduct third party monitoring of the cotton harvest, raising awareness, and building capacity. ILO's report for 2018 harvest concludes that "systematic recruitment of students, teachers, doctors and nurses has ended". The ILO has also concluded that systematic child labor has been eradicated in Uzbekistan. The report noted that recruitment of staff from state institutions, agencies and enterprises still occurs at the local level. While progress has been significant, more effort is needed to improve labor relations and working conditions, including through further capacity building and support for national counterparts (including civil society), stronger labor rights in Uzbekistan's agriculture sector, and measures to advance freedom of association, social dialogue, occupational safety and health.

**The L2CU project is helping to improve the Government's understanding of the impact of the reforms, especially on groups most at-risk from adjustment costs.** The project uses information drawn from a baseline survey of 4000 households across all regions of Uzbekistan, monthly interviews of 1500 randomly selected households, comprehensive administrative sources, and qualitative information from focus groups, local experts, and leaders of local communities (mahalla). The study has found broad and continued public support for the reform agenda but also highlights some of the effects of increasing prices, particularly on low-income and, in some cases, female-headed households. Continuous data from L2CU is used by the World Bank to provide analysis and design recommendations to the Government ahead of major changes such as recent reforms to public utility tariffs and the ongoing reforms to improve the targeting and adequacy of social benefits. The L2CU data also informed the preparation of World Bank operations such as the *Strengthening the Social Protection System* project and this proposed operation.

**As more complex reforms are considered, the World Bank is working closely with the Government to enhance the quality of environmental assessments (EAs).** Uzbekistan's existing legal and administrative frameworks for EAs are relatively well-developed and in line with international practices. However, the EA regulatory framework needs further improvements to improve international compliance, particularly in areas such as plan preparation, supervision and monitoring, and the level of transparency and public participation in EA decision making. Effective implementation of EA frameworks also requires strengthened capacity. The World Bank is addressing these gaps through existing projects such as *the Rural Enterprise Support Project; the Horticulture Development Project; the Livestock Sector Development Project; and the Climate Adaptation and Mitigation for Aral Sea Basin project*. Forthcoming projects such as the proposed *Institutional Building project and the Agricultural Modernization project* are also expected to have strong environmental components. Other development partners such as the UN are also working to further reform Uzbekistan's EA system.

**Summary table of Environmental, Poverty and Social Analysis:**



Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
<b>Operation Pillar 1: Increasing the role of markets and the private sector in the economy</b>		
<p><b>Prior Action 1:</b> To increase agricultural exports and incomes for farmers, the Borrower has removed (i) mandatory pre-payment and minimum export price requirements for horticultural exports, (ii) controls on the sale price of shaped bread, and (iii) increased the state farmgate procurement price offered to farmers for the 2019 wheat harvest.</p>	<p><b>This PA could have both positive and negative environmental effects.</b></p> <p>Agricultural production and exports liberalization would stimulate a significant increase of investments in the domain, which might have a series of positive environmental effects (increased financial resources and awareness of better natural resources management or climate smart adaptation technologies), and, on the other hand, if not adequately designed and implemented these investments might also cause negative impacts such as: land degradation, soil and water pollution, occupational hazards, etc., due to planting new intensive orchards and/or vineyards, construction and operation of greenhouses, construction and/or rehabilitation of irrigation schemes, construction and operation of new agro-processing enterprises and overall increased pesticide and mineral fertilizers use in agriculture.</p> <p>Similar to PA4, these require further strengthening of the country’s Environmental Assessment system, aimed at integration of environmental requirements into the investments decision making process.</p> <p>Secondly, to ensure an efficient land and water resources management and preventing harmful impacts of agro-chemicals use and food safety, the country needs to undertake large public awareness and training campaign and institutional capacity building in these sectors.</p> <p>The forthcoming in FY 2020 Agriculture Modernization and Competitiveness project will in part focus on good pest management practices as well as on improving sanitary and phytosanitary standards (SPS). Additionally, assistance is being provided under ongoing WB operations: (HDP AF; Livestock Sector Development Project; Climate Adaptation for Aral Sea project).</p>	<p>(i) <b>positive</b> poverty and distributional impact.</p> <p>(ii) <b>negative</b> poverty impact but positive distributional impact.</p> <p>(iii) <b>positive</b> direct impact on poverty and distribution, with ambiguous indirect effects through higher flour and bread prices with negative poverty implications.</p>



<p><b>Prior Action 2:</b> To reduce market entry barriers and increase competition in domestic trading activity, the Borrower has removed (i) licensing requirements to start and operate wholesale domestic trading and itinerant trading businesses, and (ii) mandatory advance payment requirements for commercial trading transactions between entities whose Government ownership is less than 50 percent.</p>	<p><b>Neutral</b></p>	<p><b>Positive</b> impact on poverty and distribution.</p>
<p><b>Prior Action 3:</b> To improve financial sector oversight and stability, the Borrower has submitted a new banking law for Parliamentary approval that gives sufficient powers to the Central Bank of Uzbekistan to conduct effective oversight and enforcement, establish a comprehensive and transparent licensing framework, and strengthen corporate governance and transparency requirements for commercial banks.</p>	<p><b>Neutral</b></p>	<p><b>Likely diffuse positive</b> poverty welfare implications, but detailed PSIA results are not available due to data limitations.</p>
<p><b>Prior Action 4:</b> To increase private sector investment in the energy sector, the Borrower has taken measures to establish a legal framework for the development of renewable energy and to adopt procurement procedures for the selection of potential renewable energy providers.</p>	<p><b>This PA could have both positive and negative environmental effects.</b></p> <p>Promoting renewable energy through legal and economic incentives would have both (a) long term beneficial environmental and climate effects (less GHG emissions and environmental pollution) as a result of increased proportion of alternative energy and switching from fossil fuel; and (b) adverse environmental effects (environmental pollution; land, water and biodiversity degradation; occupational hazards) in case renewable energy subprojects (for biogas production; construction of small hydropower stations; construction of wind turbines) are implemented without adequate integration of environmental requirements into the project design.</p> <p>Requires further strengthening of the country’s overall EA system. Furthermore, the process of awarding licenses to the private sector, and selecting and appraising specific investments, should include upstream clear guidance on managing environmental and social impacts, especially for hydropower projects where land use and cumulative impacts need to be assessed at the watershed/basin level. This will be done by applying strategic regional assessment, including sectoral and regional assessment at the basin level in the case of such types of projects, based on the new law which is currently under the preparation with UN assistance.</p>	<p>Neutral poverty and distributional impact.</p>





<p><b>Prior Action 5:</b> To achieve financial sustainability of energy and water utility companies, the Borrower has adopted a revised tariff methodology, consistent with principles of full cost-recovery, for the provision of electricity and cold-water services.</p>	<p><b>Likely positive</b></p> <p>Positive environmental effects due to expected more efficient use of resources and services provided by public utilities.</p>	<p><b>Positive</b> distributional effects, small increase in poverty incidence, mitigated by inflation and safety net measures.</p>
<p><b>Prior Action 6:</b> To increase private sector participation in the aviation sector, the Borrower has (i) separated the Borrower’s airline management, airport management, and air traffic control functions, and (ii) separated its policymaking, technical regulatory, and operational functions in the aviation sector.</p>	<p><b>Likely Positive</b></p> <p>Private sector competition in the economy will be mostly beneficial in terms of environment as it would stimulate new and more advanced technologies, including those associated with pollution control.</p>	<p><b>Modestly positive</b> poverty and social impact.</p>
<p><b>Prior Action 7:</b> To improve the financial transparency and accountability of State-Owned Enterprises, the Borrower has created a new Agency for the Management of State Assets, reporting to the Prime Minister, to be responsible for the management of state-owned enterprises and the implementation of an open and transparent process for the privatization of state assets.</p>	<p><b>Neutral</b> implications at this stage of the reform process. To ensure no negative environmental effects will occur during privatization process, the new Agency should have in place special procedures to manage issues of past environmental liabilities for the assets to be subject of further privatization. The WBG has extensive experience in dealing with these issues particularly in the context of the transition of East European countries in the 90s and will provide to the GoU necessary TA assistance through the Institutional Building Loan (P168180).</p>	<p><b>Neutral</b> poverty and social implications at this stage of the reform process.</p>
<p><b>Operation Pillar 2: Enhancing social inclusion</b></p>		
<p><b>Prior Action 8:</b> To encourage firm growth and formal employment, especially of women, the Borrower has adopted a turnover-based definition of small businesses for tax and value-added tax registration purposes.</p>	<p><b>Neutral</b></p>	<p><b>Modestly positive</b> social and poverty impacts. Detailed estimates not available due to data limitations.</p>
<p><b>Prior Action 9:</b> To create better conditions for formal employment in urban areas, especially of women, and enhance labor mobility, the Borrower has removed restrictions limiting employers from hiring workers who do not have a local residence permit (“propiska”).</p>	<p><b>Neutral</b></p>	<p><b>Large positive</b> poverty and distributional effects.</p>
<p><b>Prior Action 10:</b> To improve educational standards and increase the quality of the labor force, the Borrower has (i) signed a participation agreement with the OECD to</p>	<p><b>Indirect Positive</b></p> <p>Proposed actions would contribute to better education of students, including possibly in environment related fields. In addition, better educated population is</p>	<p><b>Neutral or diffuse positive</b> indirect poverty and distributional effects.</p>



<p>participate in the 2021 PISA, and (ii) created a National Center for International Research on Quality Assurance in Education which, along with the Ministry of Public Education, will be responsible for conducting national standardized and systematic student assessments of educational achievement.</p>	<p>generally more environmentally aware.</p>	
<p><b>Prior Action 11:</b> To improve the efficiency and effectiveness of social safety nets for low income families, the Borrower has created a Unified Social Registry of Social Protection.</p>	<p><b>Neutral</b></p>	<p><b>Large positive</b> poverty and distributional effects.</p>
<p><b>Prior Action 12:</b> To increase fiscal transparency and improve citizen engagement in the budgetary process, the Borrower has required the Ministry of Finance to (i) annually publish citizens budget and budget execution reports, and (ii) ensure that at least ten percent of each municipal district budget is allocated via input from a community-level participatory process, commencing from the 2019 Budget.</p>	<p><b>Indirect Positive</b></p> <p>Improving fiscal transparency overall would have positive environmental effects due to increased public awareness on public spending on environmental problems in the country. Indirectly this can also stimulate additional resources that can be directed towards environmental quality improvement and natural resources management, and/or on energy efficiency and climate adaptation.</p>	<p><b>Positive</b> social impact.</p>