



Tajikistan Country Economic Memorandum

Nurturing Tajikistan's Growth Potential

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



Tajikistan

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1818 H Street NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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USA
Fax: 202-522-2625

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ABBREVIATIONS AND ACRONYMS

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of May 1, 2019)

Currency Unit = Tajikistan Somoni (TJS)

US\$1 = TJS 9.52

WEIGHTS AND MEASURES

Metric System

AMS	Antimonopoly Service	G&S	Goods and Services
APR	Annual percentage rate	HBS	Household Budget Survey
ATM	Automated Teller Machine	IAS	International Auditing Standards
BEEPS	Business Environment and Enterprise Performance Survey	IFRS	International Financial Reporting Standards
BT	Barqi Tojik Electricity holding	ILSS	Integrated Living Standard Survey
B40	Share of population in the bottom 40 percent of income distribution	IMF	International Monetary Fund
CEM	Country Economic Memorandum	LIC	Low-Income Country
CIS	Commonwealth of Independent States	LMIC	Lower-Middle-Income Country
CPF	Country Partnership Framework	MoF	Ministry of Finance
CS	Communication Service	NBT	National Bank of Tajikistan
DB	Doing Business	NPL	Nonperforming Loan
DSA	Debt Sustainability Analysis	ODA	Official Development Assistance
DTF	Distance to Frontier	PPG	Public and Publicly Guaranteed
ECA	Europe and Central Asia	PPP	Purchasing Power Parity
FDI	Foreign Direct Investment	SME	Small and Medium Enterprises
GDP	Gross Domestic Product	SOE	State-Owned Enterprises
GoT	Government of Tajikistan	SUE	State Unitary Enterprises
		VAT	Value Added Tax

Vice President:	Cyril Muller
Country Director:	Lilia Burunciuc
Country Manager:	Jan-Peter Olters
Practice Director:	Lalita Moorty
Practice Manager:	Sandeep Mahajan
Task Team Leader:	Gohar Gyulumyan

EXECUTIVE SUMMARY

Tajikistan has enjoyed steady growth and poverty reduction since 2000 thanks to favorable external conditions. Real GDP expanded by 8.8 percent on average during 2000–08, supporting a significant reduction in the poverty rate. A post-civil war catch-up—fueled by large inflows of remittances and official donor funding—drove growth. Over two decades, the high growth rate helped to increase average incomes (from \$162 in 2000 to above \$800 in 2017) and reduced poverty (from over 80 percent to 29.5 percent in the same period). These substantial achievements compare favorably with Tajikistan’s regional peers (Figure 1).

However, growth and poverty reduction have slowed as the external environment has deteriorated and past drivers of growth have reached their limits. The global financial crisis of 2008–09 and the resource price shock of 2014 slowed the average growth rate of the Tajik economy to 6.6 percent in 2009–17. Countercyclical fiscal policy measures were put in place to offset a drop in remittance inflows in 2015–16 (down 35 percent), leading to a deterioration in the country’s debt profile (Figure 2).

Tajikistan’s past growth performance was mainly driven by the service and agriculture sectors and supported by private consumption. Since 2000 the services sector—which remains dominated by domestic non-tradable subsectors with low productivity—has contributed almost 43 percent of GDP growth. Although the industrial sector’s contribution to growth has risen in recent years, agriculture remains the economy’s second

Figure 1. Average Growth of GDP and GDP per Capita Growth in Selected Countries (2000–17)

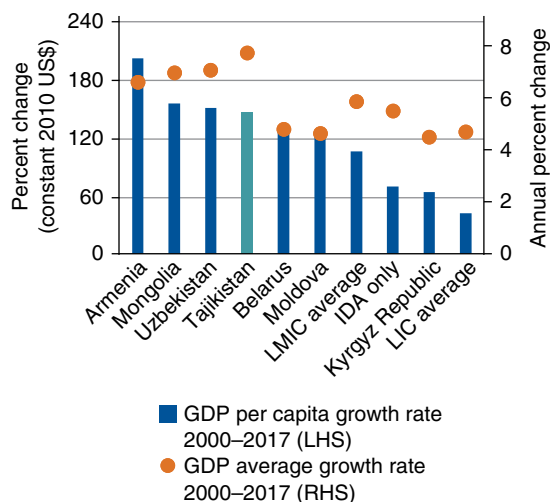
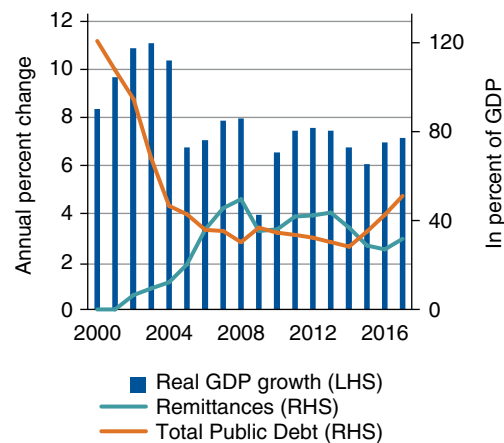


Figure 2. GDP Growth, Public and Publicly Guaranteed Debt and Remittances in Tajikistan (2000–17)



Sources: WDI; World Bank staff calculations based on State Statistics Agency of Tajikistan publications.
Note: LHS = left-hand side; RHS = right-hand side.

largest sector, contributing the bulk of employment but also the lowest productivity. Public and state-owned enterprises (SOEs) continue dominating industrial output, producing around 70 percent of the total. On the demand side, private consumption was the main contributor to growth, especially before the 2014 resource price shock when remittances peaked at nearly 45 percent of gross domestic product (GDP) annually. In 2015–17 growth momentum was underpinned by a large public investment push, stretching fiscal balances to the limits of long-term sustainability.

The Tajik government has an ambitious target of increasing domestic incomes by two to three and one-half times between 2016 and 2030. The National Development Strategy (NDS) for 2016–30 envisages maintaining real GDP growth at 4–5 percent (under the inertial scenario), at 6–7 percent (under the industrial scenario), and 8–9 percent (under the industrial-innovative scenario of development). These scenarios project increases in nominal GDP of 2, 2.7, and 3.5 times, respectively, which will raise GDP per capita (in PPP terms) from \$3,000 in 2016 to \$5,000 (inertial scenario), \$6,500 (industrial scenario), and \$7,500 (industrial-innovative scenario).

Tajikistan has strong growth potential, backed by identifiable comparative advantages. The country is located in proximity to large markets in East, South, and Central Asia, which it can profitably tap into for its metallic mineral, energy, and processed fruits exports. Tajikistan has an abundance of hydro resources, which it is seeking to harness through substantial investment in large-scale hydroelectric generation capacity with a view to trading to regional markets. The country's emerging textile industry, benefiting from the domestic production of cotton, is developing a value chain in partnership with foreign investors. The country's beautiful landscape and imposing mountains provide an opportunity to develop the tourism industry. Finally, its endowment of a young population—with a median age of around 25 years—provides a window of several decades to derive the potential benefits of favorable demographics.

However, these advantages notwithstanding, sustaining high and inclusive rates of economic growth will require addressing some significant policy challenges. Specifically:

- **The current growth model has not been sufficiently job-creating and poverty-reducing.** Tajikistan's strong growth performance of the last decade has not translated yet into corresponding job creation to accommodate the rapid entry of young workers into the workforce. The 6.8 percent average annual growth rate observed during 2007–17 was accompanied by only a 1.1 percent (23,364) annual increase in net jobs, while the working age population increased by about 3 percent per year (1.2 million cumulative) during the same period.¹ Moreover, the growth elasticity of employment fell from 0.33 in 2000–09 to just 0.13 in 2010–14.² Similarly, the 40 percent cumulative economic growth recorded during 2013–17 was accompanied by only a modest decline in the poverty rate (from 34.3 percent in 2013 to 29.5 percent in 2017), reflecting a low growth elasticity of poverty reduction.³
- **Growth has been supported mainly by domestic demand; the Tajik economy has an insufficient outward orientation.** The import substitution policy of the past several years stimulated some domestically oriented industries, including construction materials and food items. However, this cannot continue to be the thrust of future growth. Tajikistan's relatively small domestic economy—with a population size of 9 million and GDP of less than \$10 billion—is unlikely to anchor high growth for long. Moreover, a domestic focus overlooks the potential benefits of the large export markets surrounding Tajikistan. The Tajik economy will need a stronger outward orientation and a competitive export sector to sustain high growth. At 17 percent of GDP, Tajikistan's export basket is relatively small and highly concentrated in extractives (43.5 percent of total exports) and agro-processing.
- **Economic growth has been over-reliant on a few concentrated external sources of funding.** Remittance inflows and private transfers supported over one-third of private consumption in 2013–16. Similarly, official development assistance (ODA) financed more than half of public investment programs in 2013–17.⁴ Remittances are not only high (at 38 percent of GDP in 2017) but also heavily concentrated in terms of

¹ The population growth rate increased significantly from 1.5 percent annually in 2000 to about 2.2 percent since mid-2000s.

² Strokova and Ajwad 2017.

³ The pace of poverty reduction virtually stagnated in 2015–17, when the poverty rate fell from 31.3 percent in 2015 to 29.5 percent in 2017.

⁴ Household Budget Surveys (HBS) by TajStat and State Budget reports by Ministry of Finance.

source countries. This unbalanced and undiversified financing structure deepens the vulnerability to external shocks. Reflecting the slowdown of the Russian economy, remittances to Tajikistan declined by a cumulative 45 percent in 2014–16 (Figure 2), generating a sudden funding shortfall that put the economy under considerable pressure.⁵

- **The domestic private sector has a very modest presence.** The private sector contributes only 15 percent of total investment (3–4 percent of GDP), produces about 30 percent of industrial output, and accounts for only about 13 percent of formal employment.⁶ At the same time, SOEs—which often crowd out formal private sector activity—are inefficient both operationally and financially. The underdeveloped and challenging business environment explains these outcomes. Tajikistan is placed 123 of 190 economies in the 2018 Doing Business (DB) ranking⁷ and 79 of 137 economies in the World Economic Forum’s 2017–18 Global Competitiveness Index.
- **There has been a rapid buildup of macro-fiscal pressures.** Tajikistan countered the two large external shocks of 2008/09 and 2014 with an expansionary fiscal policy. This approach propped up growth but pushed the fiscal deficit to above 7 percent of GDP and doubled the level of public and publicly guaranteed (PPG) debt between 2014 and 2017. The country’s risk of debt distress is high given the elevated levels of PPG debt (53 percent of GDP in 2018) and a medium debt-carrying capacity. Fiscal space is, therefore, extremely limited; in the event of an external shock, the government would not be in a position to play a countercyclical role.

Sustaining high growth in the future will require a new growth model that prioritizes private sector participation and reorients the role and economic functions of the state. The new model would also target greater export orientation and put more emphasis on raising productivity.

A more dynamic and competitive private sector will be a prerequisite for future growth. Recognizing this, the National Development Strategy (NDS) prioritizes private sector development as a cornerstone of its industrial-innovative development scenario. The national strategy document appropriately mentions the following challenges to enhancing the role of the private sector: weak competitiveness of the national economy, an unfavorable business climate (characterized by burdensome and inefficient regulation), pervasive corruption, the excessive tax burden and onerous tax administration, a high level of monopolization, and the weak protection of property rights and the rights of entrepreneurs.

The structural shift of the economic model would be accompanied by a reorientation of the role of the state—from a producer to an enabler, facilitator, and prudent regulator tasked with ensuring transparent rules and a level playing field for all market participants. In such a facilitating role, the state would seek to guarantee macroeconomic stability and sustainability and more strategically target its spending decisions toward the most pressing infrastructural bottlenecks, often in partnership with the private sector, and more equitably providing essential government services.

The state would also need to become a more demanding SOE owner and regulator. SOEs play a significant role in the Tajik economy and are likely to maintain a substantial presence in the foreseeable future (the emergence of a private sector-led growth model will take time). Addressing operational inefficiencies, governance shortcomings, and introducing proper financial and operational oversight of SOEs will be crucial to improve the efficiency of public resource use and enhance the contribution of SOEs to economic development.

In its new role, the state would act as a neutral and effective regulator. This shift begins with diminishing the state’s direct participation in economic activity and extends to ensuring regulatory neutrality and effectiveness in competition, tax, inspection, public procurement, and other core areas of public policy. At present, there are certain sectors (for example, telecommunication and aviation) where the state is both the regulator and a direct market participant—a conflict of interest that distorts the market and compromises the regulator’s role. Addressing this also means using fiscal incentives in a nondiscriminatory and effective manner and progressive withdrawing from commercial activities.

⁵ About 90 percent of remittances to Tajikistan come from the Russian Federation.

⁶ Strokova and Ajwad 2017.

⁷ Tajikistan scores relatively well in enforcing contracts (ranked 54) and protecting minority investors (33) but lags on paying taxes (132) and access to electricity (171).

The state would need to be a more effective guarantor of the rule of law. Guaranteeing the rule of law and minimizing expropriation risk will be a prerequisite for building private sector confidence. Tajikistan's legislation authorizes the seizure of private property in cases where the government identifies procedural violations in the privatization of state-owned assets or determines that a property has been used in anti-government or criminal activities.⁸ The risk of expropriation by the state needs to be carefully mitigated with legislative clarity on the precise circumstance in which the state can seize private property.

Key Findings of the Report

The Country Economic Memorandum (CEM) focuses on a core set of critical policy issues to strengthen Tajikistan's growth potential. These are: (i) macroeconomic stability and sustainability; (ii) a healthier and more inclusive financial sector; (iii) an effective tax policy and administration system; and (iv) a competitive environment for the private sector. There are several other critical issues—such as human capital development, innovation, urbanization, energy and other sector-specific issues, global and regional integration—that remain outside the scope of this report but will be important to cover in future analytical work.

The CEM consists of four chapters, each covering the four mentioned areas of focus:

- (i) **Macroeconomic stability and sustainability.** Ensuring a stable and predictable macroeconomic environment is one of the key prerequisites to gain business confidence and safeguard long-term investments. At present, the government's capacity to respond to shocks is weak and sluggish. The latter refers to the protracted resolution of the banking crisis, inadequate consideration of quasi-fiscal risks emanating from SOEs, and insufficient alignment and integration of short-term policy decisions into the government's medium- and long-term strategic objectives. Moreover, as mentioned, the current growth model is heavily reliant on concentrated sources of external financing, which exposes the economy to external shocks. The high debt burden, poor performance of SOEs, and low efficiency of public investment add to the macroeconomic pressures. Tajikistan's transition to a more modern and resilient economy requires addressing these challenges by (i) lowering the fiscal deficit to facilitate debt sustainability; (ii) improving the operational efficiency and financial discipline of SOEs to level the playing field; (iii) introducing robust public investment management (PIM) practices to increase the efficiency of public investments in the context of fiscal consolidation and adjustment; and (iv) advancing structural reforms to rebalance the Tajik economy toward private sector dominance to accelerate job creation and expand the tax base.
- (ii) **A healthier and more inclusive financial sector.** A sound and efficient banking sector is essential for improving public trust and investor confidence, mobilizing savings, and facilitating business expansion. At present, the financial sector in Tajikistan is small, fragile, and concentrated, and thereby unable to adequately perform these core functions. Raising the level of domestic savings is necessary to reduce the current heavy reliance on external savings. Upgrading financial literacy will form a core element of any effort to introduce new saving products. Strengthening the credit information structures and building a secured and affordable transactions platform and a credible deposit insurance scheme will also be critical. Authorities can look to foster long-term savings by expanding and deepening the government securities market and developing different segments of the insurance and residential mortgage markets. As public confidence in the financial sector strengthens, ways of channeling remittances into private investment activity (as opposed to consumption, as it currently the case) could also be explored.
- (iii) **An effective tax system.** The tax system is struggling to strike the right balance in meeting the dual objectives of mobilizing fiscal revenues while minimizing compliance costs for businesses. At present the cost of tax compliance is high, and collection efficiency is low. The current tax system's complexities need to be addressed by simplifying tax procedures, harmonizing tax rates, reducing reliance on "minor" taxes, improving the VAT refund system, and reducing tax credits. A good start would be discontinuing the current practice of applying different rates for goods and services for the same tax. Another target area would

⁸ See <https://www.export.gov/article?id=Tajikistan-Expropriation-and-Compensation>

be the existence of various nuisance taxes—for example sales taxes⁹ or road user taxes—that translates into double or even triple taxation and thus become inefficient and inequitable. The practice of incentivizing investment through massive tax exemptions also needs a thorough revision to increase the transparency, predictability, and impartiality of the tool. Still-weak taxpayer services, inefficiencies in risk-based auditing, and the failure to attain automatic third-party information (rooted in the bank secrecy law) compromise voluntary tax compliance. The authorities may consider modernizing the tax administration through legislative changes to simplify compliance procedures and strengthen enforcement.

- (iv) **A competitive environment for the private sector.** Enforcing pro-competition policies and ensuring regulatory neutrality will be vital in creating a conducive environment for private sector development. It will also be an essential facilitator of fiscal consolidation: more competitive markets would lower public procurement costs and policies to boost the private sector and would generate new sources of fiscal revenue and economic growth.¹⁰ There are regulatory and implementation gaps that currently reduce the effectiveness of competition policy. These include the suboptimal design of market rules, insufficient tools to identify and deter anticompetitive behavior, limited resources for implementation, and government policies and actions that undermine competition principles. The latter include legally permitted monopolies in potentially competitive markets, price controls, insufficient enforcement of state aid rules, and lack of competitive neutrality. In key sectors for connectivity—namely telecommunications and air transport—competition is hindered by heavy-handed rules and a lack of competitive neutrality in favor of SOEs. Accordingly, effective policy interventions would seek to detect and sanction antitrust cases, improve the surveillance of market dominance, and ensure greater competition in key sectors and cross-cutting policies (public procurement and state aid).

Table 1. Key Findings and Policy Recommendations for Consideration

Topic	Issue	Recommendation	Priority and Timing
Chapter 1: Macro-Fiscal Challenges and Vulnerabilities to Sustained Growth			
Growth	At 3–4 percent of GDP, private investment too low to address challenges of job creation and poverty reduction.	Maintaining high and inclusive growth requires rebalancing of the Tajik economy from import-substitution to export-oriented, and from public investments dominance to a private investment-led growth path. To increase investor confidence and incentives for saving and investing, quality of macro-fiscal policies needs to be improved by keeping the fiscal deficit and public debt at sustainable levels.	High, medium to long term High, continuous
	Efficiency of current growth model is diminishing and requires replacing by a new growth path.	Structural reforms are needed to facilitate Tajikistan's rebalancing toward private sector-led economy.	High, medium to long term
Fiscal policy	Fiscal expansion path and persistently high deficit increased debt burden and depleted fiscal buffers, worsening fiscal vulnerabilities.	Reversal of current expansionary fiscal policy and adherence to fiscal consolidation in the medium term will help to restore macro-fiscal debt stability. Refraining from incurring new non-concessional debt will be an important policy decision to moderate currently high risk of debt distress.	High, short to medium term
	Fiscal consolidation will need to be supported by the prioritization and rationalization of public investment programs (PIP).	Given the small size of the recurrent budget and limited scope of increasing the domestic revenue mobilization effort, the burden of medium-term fiscal consolidation will fall on capital spending. In this context, the efficiency of public investment should be improved to offset the negative growth impact of PIP cuts.	High, short to medium term

(Table continues next page)

⁹ Sales taxes applied to cotton and aluminum.

¹⁰ Simulations based on the structure of the Tajikistan economy suggest that more pro-competition regulatory frameworks in transport and communications would boost GDP growth by 0.33 percentage points per year.

Table 1. (continued)

Topic	Issue	Recommendation	Priority and Timing
Chapter 1: Macro-Fiscal Challenges and Vulnerabilities to Sustained Growth			
SOEs	Weak operational performance leading to high contingent liabilities and dis-saving for the public sector	Consider limiting SOEs to sectors where private players cannot supply the market. Improve governance of SOE management, introduce internal and external oversight, and increase transparency and reporting.	High, medium term
	Lack of a level playing field between SOEs and private competitors	Promote level playing field between SOEs and private competitors through competitive neutrality principles.	High, medium term
Chapter 2: Policies to Improve Financial Inclusion and Raise the Rate of Domestic Savings for Financing Future Growth			
Financial inclusion and savings	Low level of financial inclusion	Enhance public trust toward financial institution and improve financial literacy.	High, continuous
	Lack of long-term saving instruments	Develop different modes of financial products, including the insurance industry, government's securities market, and mortgage products.	Medium, medium to long term
	Lack of trust toward the banking system as a depositor of domestic savings	Enhance the deposit insurance system. Attain macro-economic stability and the trusted business environment.	High, short term
Low level of banking intermediation	Low public confidence associated with recent banking crisis	Resolve the two problem banks by either liquidation or the provision of genuine capital in an adequate amount to satisfy prudential requirements.	High, short term
Chapter 3: Tax System Assessment			
Tax policy	Tax policy changes are introduced without thorough economic and fiscal cost-benefit analysis.	Design a Concept Document to guide tax policy reforms needed to meet the country's strategic development objectives.	High, short term
	Tax compliance cost is high as measured by the time to comply.	Address the complexity of the tax system by simplifying tax administration procedures, harmonizing tax rates for goods and services, and reducing reliance on "minor" taxes.	High, medium term
	Tax incentives are excessive, eroding the revenue base without leading to the intended objectives of investment attraction and employment creation.	Revisit the current approach of using tax exemptions as one of the main instruments for investment attraction.	High, medium term
Tax administration	VAT refund system is dysfunctional.	Revamp the VAT refund system by introducing: (i) a threshold for automatic refund; (ii) a registry of VAT refund claims; and (iii) a risk-based approach to the VAT refund process.	Medium, medium term
	Tax advances and excessive penalties are distortive.	Eliminate the current practice of collecting tax advances and introduce a symmetric system of interest payments on the balance of tax credits.	High, short to medium term
Chapter 4: Competition Policy			
Institutional and legal framework for competition	Lack of independence, and human and financial resources for effective enforcement harm policy effectiveness.	Expand sources of funding and technical resources and restructure institutional design to ensure effective independence. Refocus the use of AMS resources to fighting cartels and deterring abuse of dominance rather than controlling market strategies ex-ante (registering and monitoring companies, monitoring prices). Expand due process guarantees at the administrative level.	High, short term

(Table continues next page)

Table 1. (continued)

Topic	Issue	Recommendation	Priority and Timing
Chapter 4: Competition Policy			
Fighting anti-competitive practices	The Antimonopoly Service (AMS) is not sufficiently equipped to effectively detect, sanction, and deter cartels. Enforcement covers regulation of behavior of firms that would not be considered dominant under international standards. Ineffective and burdensome merger control regime. Low fines with limited deterrence effects.	<p>Improve the legal framework and its implementation to combat cartels.</p> <p>Adjust the legal framework on abuse of dominance and its current emphasis on ex-ante control of commercial decisions and refocus on investigation practices that foreclose entry.</p> <p>Improve the legal framework on merger review and increase transparency and efficiency of review procedures.</p> <p>Update the maximum fines for competition law infringements and apply them effectively.</p>	High, medium term
Cross-cutting policies that affect competition and competitive neutrality	Although AMS has the mandate, competition advocacy is not sufficiently promoted.	<p>Use AMS powers more strategically to help inform government policies that are key for the national agenda.</p> <p>Allocate more resources to assess market functioning, identify barriers to competition and propose pro-competition policy actions.</p>	High, short term
	Price controls are not targeted at markets that need them.	<p>Abandon ex-ante monitoring and control of pricing strategies of firms.</p> <p>Limit the list of economic activities regulated as natural monopolies to those unable to function under competition.</p> <p>Ensure that pro-competition principles are incorporated into the regulatory framework applied to natural monopolies, guaranteeing access to essential infrastructure on nondiscriminatory conditions and at cost-oriented prices.</p>	High, short term
	State aid mandate is incomplete and not enforced. Current incentives may be unduly distorting market competition and efficiency.	<p>Clarify the procedures to issue and review state aid measures.</p> <p>Adopt balancing test based on precise economic criteria and methodologies to evaluate the positive and negative elements of a state aid measure.</p> <p>Create a public registry for all state aid (including investment incentives).</p> <p>Adopt a monitoring and evaluation framework to assess impact of state aid (including investment incentives).</p>	High, medium term
Telecommunications	Lack of competitive neutrality given conflicting roles of the Communication Service (CS) as regulator and strategic operator	Comply with World Trade Organization (WTO) commitments to separate roles.	High, medium term
	Measures to address security concerns restrict competition	Find alternatives to the UCTC or improve the regulation of these monopoly services.	High, short term
	Rules on dominance/price monitoring and taxes increase regulatory burden	<p>Review the tax policy and tax administration in the sector and make necessary amendments in the Tax Code.</p> <p>Refocus CS attention on regulating services when needed.</p>	Medium, short term

(Table continues next page)

Table 1. (continued)

Topic	Issue	Recommendation	Priority and Timing
Chapter 4: Competition Policy			
Air transport	Market access restrictions	Review current policy on bilateral service agreements, particularly for the busiest routes	High, short term
	Inappropriate regulation of input markets	Revise the methodology to set airport tariffs. Allow contestability on the de facto monopoly for jet fuel and identify measures to encourage efficiency.	Medium, short term
Public procurement	Limited participation in tenders and potential bid rigging	Review rules that favor domestic suppliers to encourage participation. Clarify public procurement procedures and expand dissemination of information on tenders. Facilitate collaboration between AMS and Public Procurement Agency (PPA) to prevent, detect, and sanction bid rigging among competitors.	Medium, medium and short term

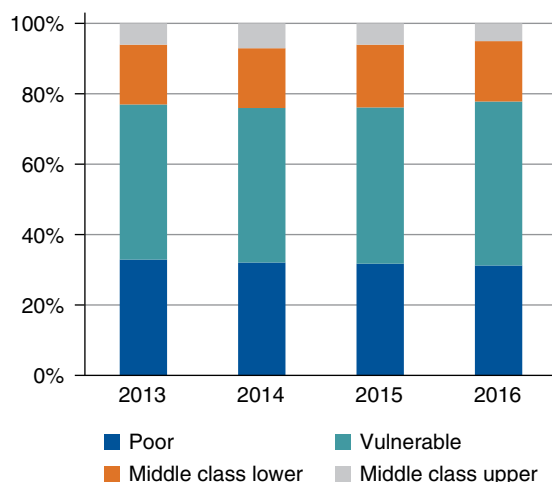
MACRO-FISCAL CHALLENGES AND VULNERABILITIES TO SUSTAINED GROWTH

Introduction

Tajikistan requires higher and more inclusive growth rates to ensure higher standards of living for its citizens. The current growth model generated high rates of GDP growth in the past, however, it is challenging to maintain such high rates of economic growth. Growth continues to rely on external sources of funding, is not outward oriented, has disproportionately small participation of the private sector, and caused macro-fiscal pressures to build up. Social returns from the model have also declined; the pace of job creation and poverty reduction has slowed down considerably in recent years. As a result, the share of the poor and vulnerable population remains stubbornly high at 77 percent of the total population (Figure 3). Also, around 6 percent of the population relies on selling assets to pay for basic needs (Figure 4).

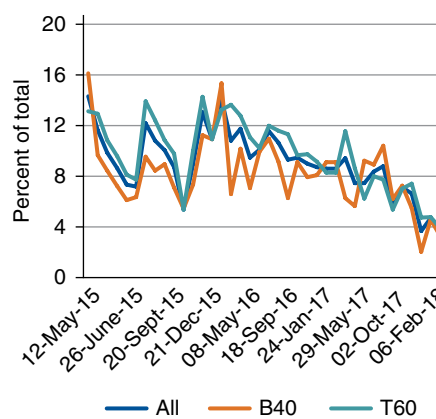
This Country Economic Memorandum (CEM) analyzes a core set of constraints to private sector-led and outward-oriented growth in Tajikistan. The CEM examines first the macro-fiscal environment and the consistency and predictability of macroeconomic policies. The report then reflects on policies and institutional changes required to improve financial inclusion and support a rise in domestic savings to meet the expanding private sector's demand for investment. Further, the report examines the principal deficiencies in the tax regime and its administration and proposes reforms to improve the incentives for investment. Finally, in view of the dominance of the state and of state-owned enterprises in the economy and regulatory gaps to ensure

Figure 3. Poverty, Vulnerability, and the Middle Class in Tajikistan



Source: Tajstat Household Budget Survey.

Figure 4. Need to Sell Assets to Pay for Basic Needs



Source: Tajstat Household Budget Survey.

Note: B40 stands for bottom 40 percent and T60 reflects top 60 percent of the population's income distribution.

a level playing field, the report analyzes the competition policy framework and identifies policy reforms to encourage firm entry and enhance market competition.

The CEM builds on the World Bank's previous reports on Tajikistan, namely the Systematic Country Diagnostics and Jobs Diagnostics.¹¹ The Jobs Diagnostic proposed that the government consider a jobs strategy that (i) facilitates the creation of more jobs, particularly in the formal private sector; (ii) improves the quality of existing jobs, especially in the informal sector; and (iii) facilitates better access to jobs, including transitions from inactivity to employment and from low to higher quality jobs, with a focus on vulnerable workers. The Systematic Country Diagnostic (SCD) identified the main medium-term challenges to Tajikistan's transition to a new, private sector–led growth model. This new growth model would require Tajikistan to address three interrelated binding constraints—lack of robust macro-financial sustainability, weak institutions, and inadequate productive assets (including physical infrastructure and human capital).

The focus of the CEM is also well aligned with the new Country Partnership Framework (CPF) for 2019–23. The CPF proposes that World Bank assistance over the next four years be anchored around the following three pillars: (i) promote private sector–led growth by improving the investment climate and strengthening competitiveness in key sectors to attract investment and create jobs; (ii) promote social inclusion by increasing access to improved social services, including education, health, social assistance, water supply, and sanitation; and (iii) enhance regional connectivity to boost Tajikistan's access to regional markets and global information and knowledge. The CEM aims to reveal policy challenges and spell out recommendations to promote private sector–led growth identified under the first pillar of the CPF.

This report will need to be complemented by analytical and policy work on other critical constraints to private sector–led growth. Such work will include analyses of, for example, the establishment of a rules-based policy setting and creating market-supporting institutions that promote greater economic formalization; unleashing the significant potential of the energy sector; deriving more meaningful gains from deeper international integration, including the access provided by the Belt and Road Initiative (BRI); and investing in human capital.

This chapter of the CEM presents some stylized facts about Tajikistan's growth and describes the key constraints to a higher and more sustainable trajectory, with particular attention to emerging macro-fiscal challenges. Macroeconomic vulnerabilities are building up and the government's capacity to respond to shocks is weak. This considers high levels of public debt, protracted resolution of the banking crisis, quasi-fiscal risks emanating from SOEs, and inefficiencies in public expenditure. Moreover, the current growth model is heavily reliant on concentrated sources of external financing, which exposes the economy to external shocks. Ensuring a more stable and predictable macroeconomic environment may be considered one of the key prerequisites to gain business confidence and safeguard long-term investments and growth.

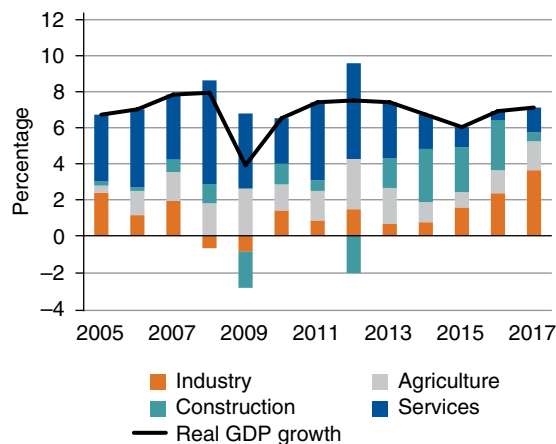
Growth Drivers and Challenges

Main Drivers of Growth

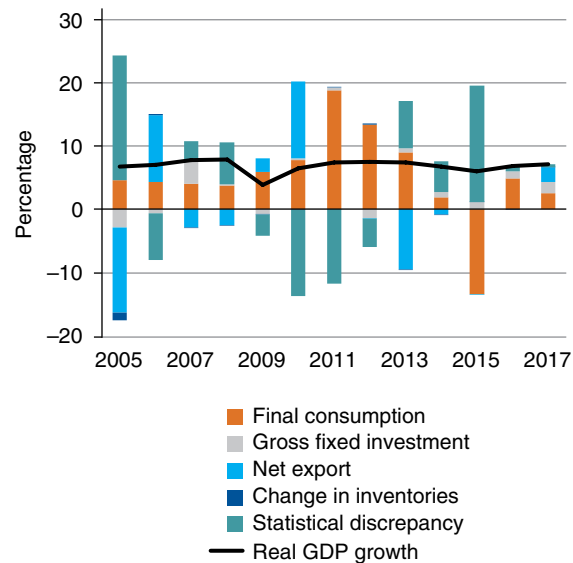
After reaching a peace agreement in 1997, Tajikistan began a process of economic rehabilitation and registered high rates of catch-up growth, significant poverty reduction gains, and other economic benefits stemming from the first generation of transition reforms. Real GDP growth averaged about 9 percent in 1998–08 before easing slightly to an average of 7 percent in 2010–17 (Figure 5), boosting income per capita from \$162 in 2000 to above \$800 in 2017 and reducing poverty from over 80 percent to an estimated 29.5 percent during the same period.

Tajikistan's growth has been largely driven by domestic private consumption and the services sector (Figure 6). On the consumption/demand side, growth has been supported largely by private consumption and, to a lesser extent, public investment (Figure 7). On the production/supply side, the services sector contributed almost 43 percent of growth generated by the Tajik economy during 2000–17. These are mainly subsectors oriented to domestic non-tradable sectors like health and education.

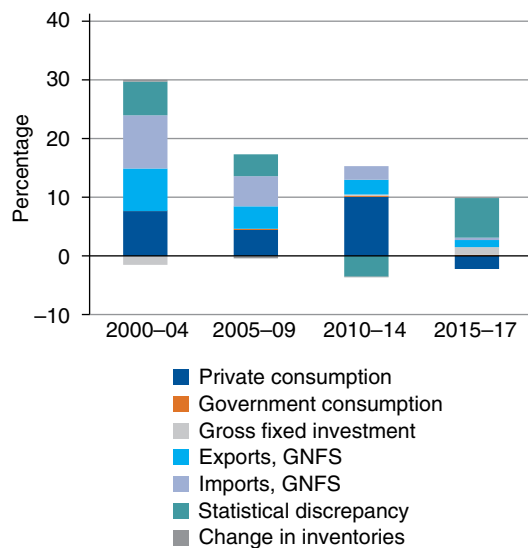
¹¹ Strokova and Ajwad 2017; Kojo and Sattar 2018.

Figure 5. GDP Growth Contribution by Sector

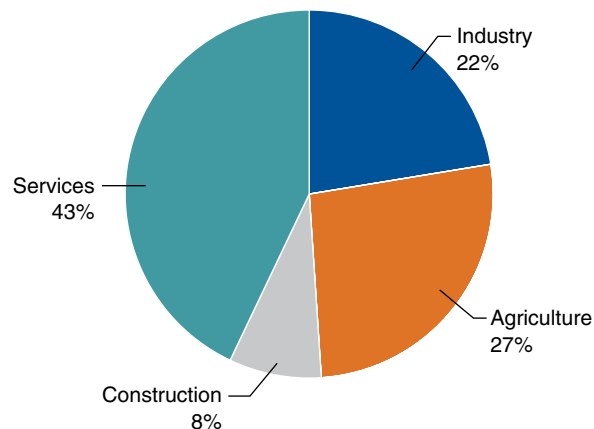
Source: World Bank staff calculations using State Statistics Agency of Tajikistan publications.

Figure 6. GDP Growth Decomposition by Expenditure

Source: World Bank staff calculations using State Statistics Agency of Tajikistan publications.

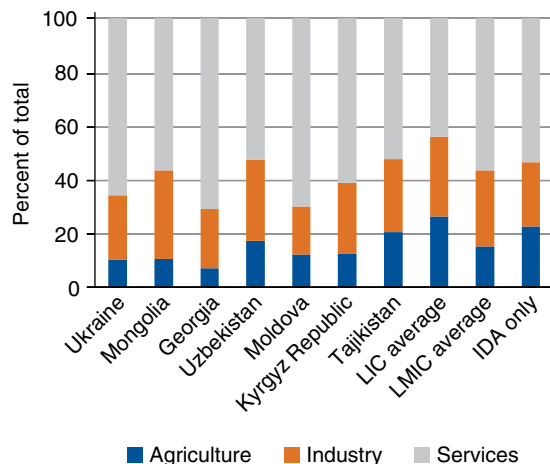
Figure 7. Contribution to GDP Growth by Expenditure, Averages

Source: World Bank staff calculations based on TajStat data.

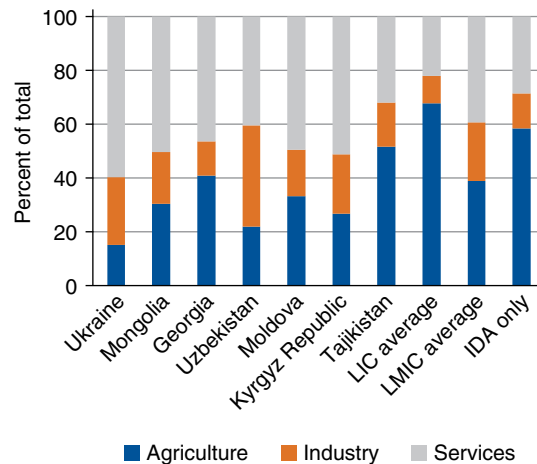
Figure 8. Sectoral Contribution to GDP Growth, 2000–17

Source: World Bank staff calculations based on TajStat data.

Although the growth contribution of industry has risen during the last two years, it still accounts for only 22 percent of GDP and much less when mining and the extractive industries are excluded (Figure 8). Public and state-owned companies form the bulk of Tajikistan's industrial sector, generating more than 70 percent of total industrial output. Agriculture, which employs the biggest share of the labor force but is also the economy's least productive sector, accounts for around one-fifth of the economy (Figures 9 and 10). The economy's high growth performance over a sustained period has not been accompanied with noticeable job creation, firm dynamism, and resource reallocation in the economy. The labor force remains concentrated in domestic non-tradable sectors, mainly in agriculture and public services, indicating a negligible contribution to economic growth by the tradable sectors.

Figure 9. Value-Added by Economic Sector in Selected Countries (2016)

Sources: World Development Indicators; World Bank staff calculations.

Figure 10. Sectoral Employment in Selected Countries (2017)

Sources: World Development Indicators; World Bank staff calculations.

Favorable external factors have buoyed the Tajik economy. Tajikistan's strong growth record in the pre-2014 period relied heavily on public transfers, private remittances, and foreign direct investment (FDI) supported by favorable external conditions and was closely correlated with economic cycles, especially that of Russia. Since the early 2000s, Tajikistan has been one of the largest recipients of remittances relative to income; remittances peaked at 45 percent of GDP in 2013. However, private transfers were heavily impacted by the resource price shock of 2014, which adversely affected the Russian economy. Remittances dropped by 35 percent in 2015–16; had the government not responded by easing fiscal policy to support economic growth, this decline would have had a more significant negative impact on the Tajik economy.

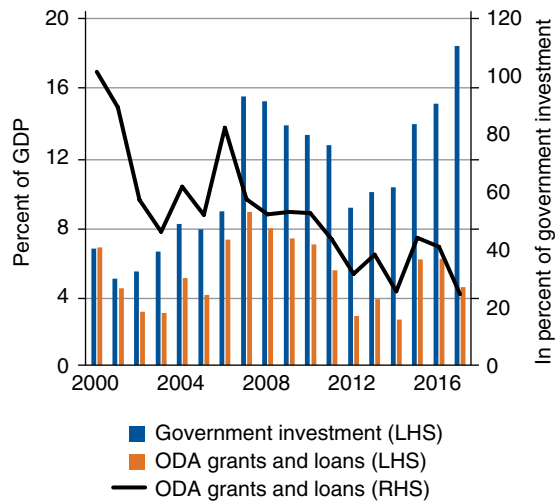
Fiscal stimulus delivered through public investment programs in 2015–17 supported GDP growth but worsened Tajikistan's debt profile and curtailed its fiscal space for future countercyclical and infrastructure spending. The fiscal policy response to the cyclical downturn sharply increased the country's external debt level. The scheduled repayment of over 40 percent of the current debt stock over the next five years now severely limits the country's fiscal space to respond to new shocks and support economic growth. The government will need to adhere to the fiscal consolidation stance to restore the country's macro-fiscal stability in the medium term.

Official development assistance (ODA) has played a major role in sustaining growth and supporting public spending. Tajikistan has been one of the largest recipients of grants and soft loans from the donor community. ODA has been the principal source of fiscal deficit financing and has funded almost 50 percent of Tajikistan's public investment program (Figures 11 and 12). However, as the country rises from low-income status, it may not be eligible for the same amount of budget support grants. Similarly, the country's high debt burden poses serious macro-fiscal constraints to future borrowing, even at highly concessional terms.

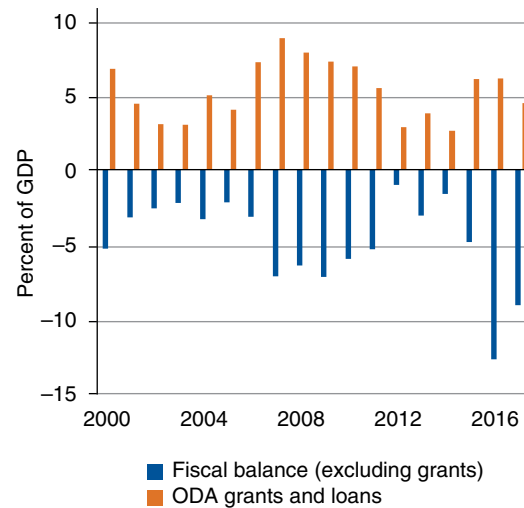
Key Challenges

Despite impressive growth and other achievements of the last two decades, Tajikistan remains the poorest country in the Europe and Central Asia (ECA) region. Most of the poverty reduction gains can be attributed to the first decade of catch-up growth; the recent trend shows a weakened poverty reduction response to growth. During the last three years, the Tajik economy has expanded by more than 20 percent in real terms, but the poverty headcount ratio has fallen by less than 2 percentage points (Figure 13). Growth has also not been accompanied by noticeable job creation, firm dynamism, and labor/resource reallocation in the economy. Resources remain concentrated in domestic non-tradable sectors with low productivity.

Household consumption, a key driver of economic growth, has been supported by high remittance inflows, which are volatile and unlikely to be sustained at current levels. Fluctuations in remittances from

Figure 11. Public Investment and Official Donor Assistance

Source: World Bank staff calculations based on TajStat data.

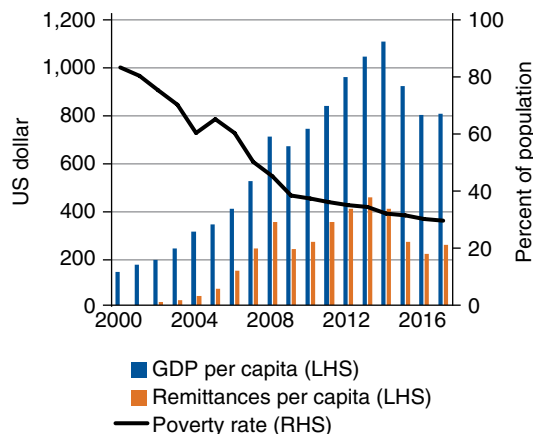
Figure 12. Fiscal Deficit and Official Donor Assistance

Source: World Bank staff calculations based on TajStat data.

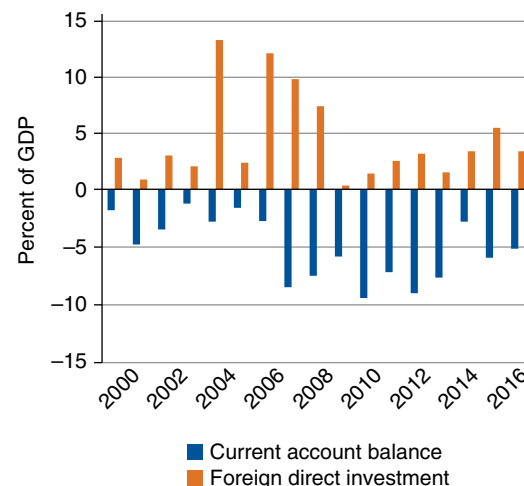
Russia—which is the source of over 90 percent of remittances to Tajikistan—mirror movements in the price of oil in Russia. This presents significant uncertainties and risks associated with geopolitical developments in Russia. Other factors, such as changes to Russia's migration policy, for example, can also increase pressure on Tajikistan's currency and its external accounts. More than 60,000 Tajik migrants have been deported from Russia over the past two years; thousands became more vulnerable following new migration regulations adopted in Russia in July 2018.

Foreign direct investment inflows have weakened considerably. FDI peaked at over 10 percent of GDP in the pre-2008 crisis period but declined sharply after that, reflecting a recovery of global economic conditions and renewed competition for FDI (Figure 14); Tajikistan was less attractive than other emerging markets owing to its slow progress in improving the domestic business environment. Reduced FDI meant fewer opportunities for technology, knowledge, and business-culture transfers—all critical for increasing productivity and reaching Tajikistan's growth potential.

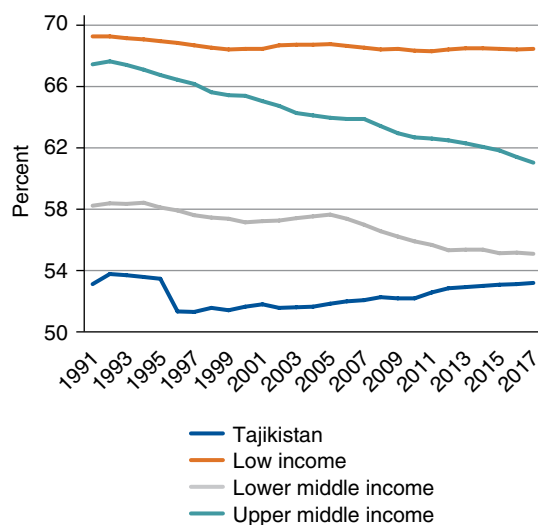
It will be challenging to supplement the incomes of remittance-receiving families without expanding the participation of the domestic private sector in the economy. Household Budget Survey (HBS) data indicate

Figure 13. Poverty Headcount Ratio, GDP and Remittances per Capita

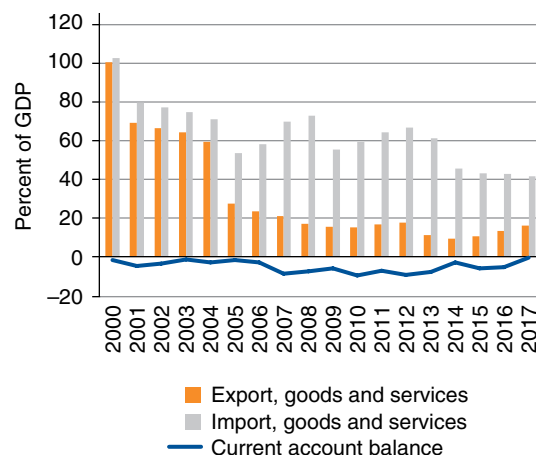
Source: World Bank staff calculations based on TajStat data.

Figure 14. Current Account and FDI Dynamics

Source: World Bank staff calculations based on TajStat data.

Figure 15. Employment to Population Ratio, 15+ (modeled ILO estimate)

Source: World Bank staff calculations based on TajStat data and ILO model.

Figure 16. Exports, Imports and Current Account Dynamics

Source: World Bank staff calculations based on TajStat data and ILO model.

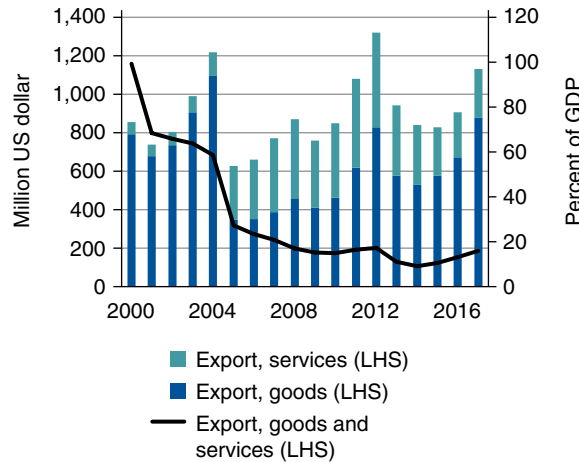
that remittances and private transfers accounted for 27 percent of real income in 2016. Wage income comprises less than 30 percent of real household income in Tajikistan, a low share even compared to other remittance-reliant economies in the region.¹² The importance of wage income is further diminished by the low ratio of employment to total population (Figure 15), which has held down the labor force participation rate at around 62 percent for the past two decades.

One of the constraints to long-term growth in Tajikistan is the insufficient development of the private sector. Private sector investment amounted to only 3–4 percent of GDP. Private sector development is constrained by the insufficiently effective measures undertaken by the state to: (i) create a fair, transparent, and predictable business environment; (ii) adequately invest in the necessary infrastructure and logistics to offset the country's geographical challenges and ease connectivity; and (iii) address policy shortcomings which affect resource allocation in the economy and investors' confidence.

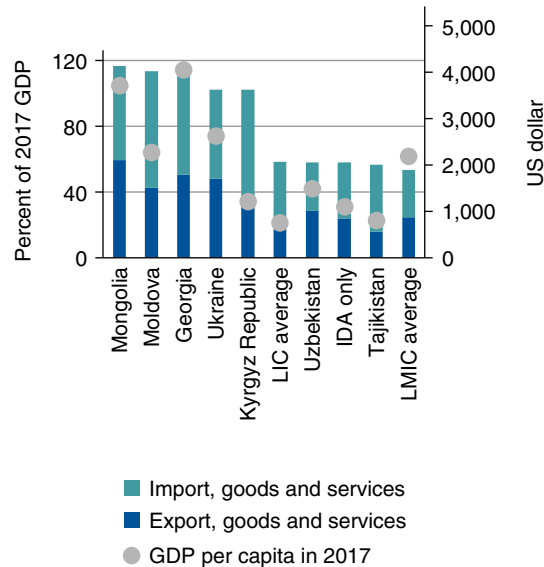
Another shortcoming of Tajikistan's growth model stems from its small, unsophisticated and highly concentrated export basket. At only 18 percent of GDP in 2017, Tajikistan's export basket is the smallest in the region (Figures 16–18). While export volume has expanded from 11 percent of GDP in 2014, it remains below the average value for peers in low-income (20 percent of GDP) and lower-middle-income economies (25 percent of GDP). Exports of minerals and precious and semi-precious metals comprised 72 percent of total exports in 2017, up from 59 percent in 2014. Textiles, including cotton fiber, are the second largest commodity item with about a 15–17 percent share in total exports. The large proportion of commodity exports in total exports is a vulnerability for Tajikistan, as fluctuations in international prices for metal and cotton feed through immediately to export performance and the external balances. Trade in services also remains small and concentrated on the tourism industry on the export side, and on transport and construction on the import side. The government declared tourism as a priority sector; however, it lacks the proper infrastructure and logistics to expand the sector's opportunities. Chapters 3 and 4 discuss tax policy and the regulatory challenges restricting Tajikistan's aviation sector and its connectivity, and thereby also hindering tourism and other services trade.

The current rate of investment is low and inadequate to reach Tajikistan's target growth rate. The rate of total investment averaged 18.4 percent of GDP over the 2007–17 period (Figure 19), which is low compared with other economies in the same income group. Besides the level, the structure of total investment is also a concern.

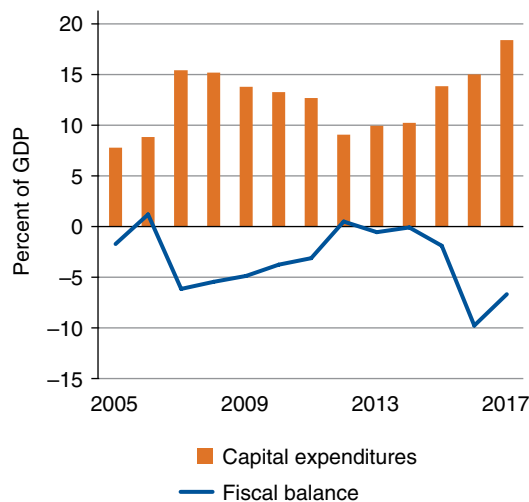
¹² Wage income constitutes above 56 percent of the population's total income in Armenia, 43 percent in Moldova, and about 68 percent in the Kyrgyz Republic.

Figure 17. Export of Goods and Services

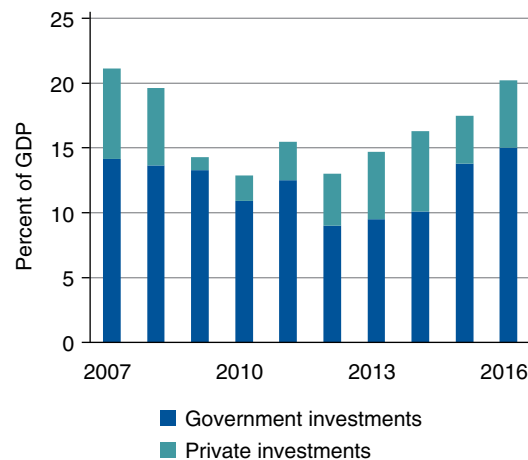
Sources: World Bank staff calculations based on data from Tajstat, the National Bank of Tajikistan, and World Development Indicators.

Figure 18. Export and Import of Goods and Services (2017)

Sources: World Bank staff calculations based on data from Tajstat, the National Bank of Tajikistan, and World Development Indicators.

Figure 19. Fiscal Balance and Capital Spending

Source: World Bank staff calculations based on TajStat data.

Figure 20. Government Investments and Private Investments

Source: International Monetary Fund.

Compared with its peers, Tajikistan has a large share of public investment and hence a relatively large public capital stock as a share of GDP (Figure 20). In contrast, its rate of private investment, at around 3–4 percent of GDP, is extraordinarily low. Such low private investment results in the underutilization of the created public capital and is insufficient to generate sufficient employment for the country's rapidly growing population.

The current characteristics of the Tajik economy also reflect the country's low rate of urbanization. Tajikistan's population is mainly rural. With just 27 percent of its population living in urban areas, it has the lowest rate of urbanization among Central Asian economies. Tajikistan compares unfavorably with other countries in the Commonwealth of Independent States (CIS) region and with the average of the low- and lower-middle-income group (Figure 21).

Toward a New Growth Model

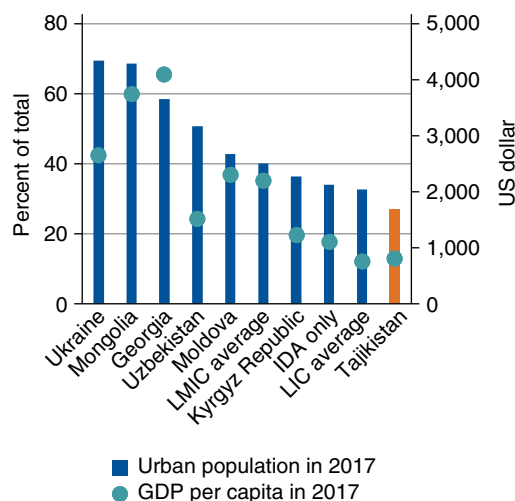
The shortcomings of the current growth model necessitate an upgrade toward a more sustainable, resilient, and inclusive path. Upgrading the growth model implies rebalancing the Tajik economy from its current form—that is, remittance-financed, private consumption-driven, and ODA-supported public investment-led growth—to one characterized by private investment and export-oriented growth. While the latter would ensure a higher and more sustainable growth path, facilitating the transition will require substantial structural reform.

The business as usual (baseline) scenario of development with the current structure of investment composition will lead to socioeconomic outcomes projected by the “inertial” growth path in the NDS.¹³ The relative abundance of public capital in the country suggests that a 1 percentage point of GDP increase in public investment will boost GDP growth by only 0.11 percentage points in the short to medium term. The latter assumes headline GDP growth at around 4.5–5 percent, which will lead to increasing GDP per capita by only 1.55 times by 2030 (compared with 2015) and falls short of the growth rate of the most recent decade of around 6.8 percent. The baseline scenario implies no change in total factor productivity (at 1 percent). It will fall short of delivering targeted outcomes under the industrial development path as the modest growth outcomes generated with the unchanged rate and composition of investment will be insufficient if the present population growth rate (2.2 percent) is sustained. The declining marginal products of public investment will play a role in reducing growth.

The first requirement of an upgraded growth model will be the mobilization of substantial private investment. The high share of public investment in total investment has resulted in a sharp deterioration of the incremental capital-output ratio (ICOR) in Tajikistan (Figure 22), a measure of the efficiency of capital in the economy. To address the challenge of growth and public debt sustainability it will be important to rely much less on debt-financed public investment and shift toward a much greater private investment push. Compared with public investment, the effect of private investment on growth is much higher in Tajikistan,¹⁴ as private capital is relatively scarce and the private capital to output ratio is lagging.¹⁵

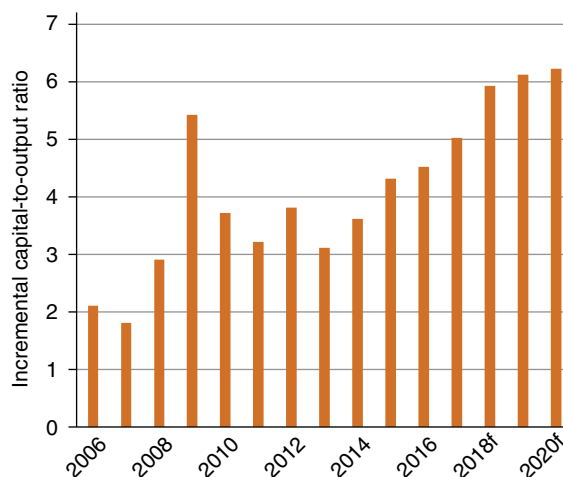
Higher rates of private investment, in turn, call for stronger rule of law, especially regarding property rights and judicial independence. This is necessary to protect investors from expropriation and enforcing contractual obligations. Tajik authorities intensively use tax exemptions as incentives to attract large investments.

Figure 21. Urban Population and GDP per Capita in Selected Countries (2017)



Sources: World Development Indicators; World Bank staff calculations.

Figure 22. Incremental Capital-Output Ratio



Sources: World Development Indicators; World Bank staff calculations.

¹³ The Tajikistan National Development Strategy (NDS) refers to headline growth of 4–5 percent as “inertial” and 6–7 percent as on an “industrial” path. This report uses the latter for growth target simulations.

¹⁴ Background paper “Tajikistan: Rebalancing Towards Private Sector-led Investments.” Devadas and Pennings, 2018.

¹⁵ In Tajikistan, the private ICOR is less than 30 percent of the LMIC average.

However, international evidence suggests that foreign investors are more willing to invest in countries where a robust system of property rights and registration is in place, and asset expropriation risk is low. Significant efforts are needed to create an independent and impartial judicial system in Tajikistan—one of the important preconditions for resolving disputes, protecting business interests, and fostering a culture of compliance.

An increased role of private investment will not lessen the need for public investment, given Tajikistan's large infrastructure gap. The country has dire need to close the electricity deficit during the winter months and to improve access to other critical utilities. Recent household survey data reveal that Tajikistan has made progress in reducing the share of the population relying on surface water (from 33 percent in 2000 to 15 percent in 2016). Although the share of households with access to improved water sources rose from 55 to 74 percent during the same period, further public investment will be needed to address the remaining shortfall.¹⁶ Similarly, the World Bank's study suggests that in 2016 only about 60 percent of the population in urban areas had access to flush toilets connected to a sewage system. While conditions in rural areas have improved and affected 41 percent of rural population, access to flush toilets connected to a sewage system remained chronically low, at only 1.7 percent in 2016.¹⁷ The study suggests that, in general, access to improved water and piped service during 2000–16 was mainly driven by improvements in the lower service tiers with large gaps observed between urban and rural areas and across administrative regions.

Relevant policy and institutional frameworks will need to be enhanced to ensure the success of large infrastructure projects in the energy sector. The Rogun HPP, which became operational in November 2018, could make a substantial contribution to exports and economic growth. However, to capitalize on Rogun HPP's growth potential, Tajikistan needs not only to address its financing and export-enabling infrastructure challenges, but also be able to address the risks of debt distress, enhance macroeconomic policy, and introduce fiscal rules to manage the expected revenue windfall efficiently.

Raising productivity growth will be essential for sustaining high growth beyond the medium term. To capture the long-lasting, positive impacts of private investment and meet the government's set objective of doubling income per capita by 2030 by sustaining average annual growth of 7 percent, total factor productivity (TFP) growth will need to at least double.

The final requirement of sustaining high and more inclusive growth is of an effective and sustainable fiscal policy and improved performance of state-owned enterprises. These are discussed in more depth in the following two sections.

Fiscal Policy and Debt Sustainability

Tajikistan's fiscal envelope has evolved significantly since 2000. The tax collection, which stood at just 13 percent of GDP in 2000, has risen substantially since then, reaching 20 percent in 2011–12, and 23 percent in 2014, before declining slightly to 21–22 percent in 2016–17. The higher collection was driven by economic growth but also tax policy changes and tax administration improvements. The improved tax collection, along with soft financing from external sources, expanded the size of the budget from around 18–19 percent of GDP in the early 2000s to above 30 percent in 2017 (Table 2 and Figure 23).

Massive fiscal expansion in 2015–17 depleted the fiscal space and significantly weakened the government's ability to use fiscal buffers in the case of a new shock. Tajikistan has not saved windfall commodity-related revenues generated during times of boom, opting instead to use such funds to finance in-year public spending. As a result, funds are scarce to smooth the cyclical nature of revenue collection during bust periods. Nontax revenues, such as privatization proceeds, and nonmonetary (gold) reserves have been used as fiscal buffers to manage downturns, but these were insufficient. In the absence of interest rate channels, monetary stimulus has not been a viable option to withstand the impact of shocks. Fiscal stimulus through an expansionary fiscal policy was therefore used extensively to weather external shocks in 2008–09 and 2014.

The fiscal expansion in 2016–17 took the form of a bailout of the domestic banking sector and accelerated construction of the Rogun HPP. Other priority capital spending also placed additional pressure on the

¹⁶ Water Sector Reform Program for 2016–2025. Adopted by the Government of Tajikistan by decree N° 791 on December 30, 2015.

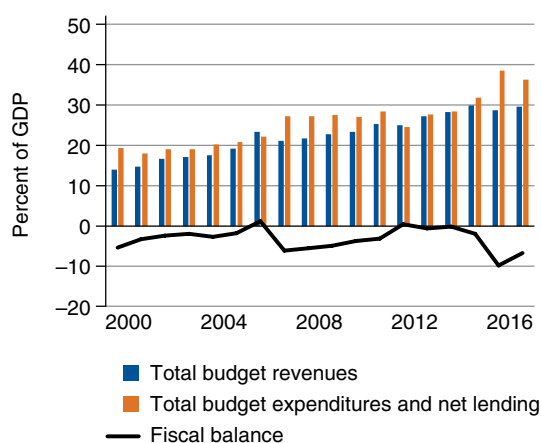
¹⁷ World Bank, 2017c.

Table 2. Fiscal Parameters (in percent of GDP)

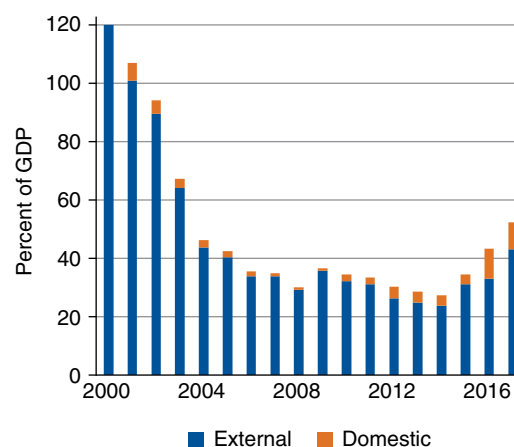
	2000	2002	2004	2006	2008	2010	2012	2014	2016	2017	2018f	2019f	2020f
Overall revenues and grant o/w	14.1	16.7	17.6	23.4	21.8	23.4	25.1	28.4	28.8	28.8	25.8	24.3	24.1
Tax revenues	13.0	14.7	15.1	16.7	18.6	18.0	19.8	22.8	20.6	21.5	21.3	21.4	21.8
Total expenditures and net lending	19.4	19.0	20.3	22.2	27.2	27.2	24.6	28.4	38.5	35.5	31.3	27.4	26.3
Fiscal balance	-5.3	-2.3	-2.7	1.2	-5.4	-3.7	0.5	-0.1	-9.8	-6.7	-5.5	-3.0	-2.3
Financing	6.2	2.8	4.9	3.4	9.8	8.6	4.4	3.5	7.5	7.0	6.7	3.0	2.6
Net external	5.2	0.8	2.6	1.7	5.9	2.8	0.4	0.0	1.3	7.0	0.5	1.9	2.0
Disbursements	6.8	2.8	4.3	2.9	6.9	3.5	1.3	1.1	3.1	8.5	2.1	3.5	3.6
Amortization	-1.6	-2.0	-1.7	-1.2	-1.0	-0.7	-0.9	-1.0	-1.8	-1.5	-1.6	-1.6	-1.6
Net domestic	1.0	2.0	2.3	1.7	3.9	5.8	4.0	3.5	6.2	0.0	6.2	1.1	0.6
Public debt	120	94	46	36	30	35	30	27	49	55	56	55	55
External debt	120	90	44	34	29	32	26	24	39	45	45	44	44
Domestic PPG debt	0	4	2	2	1	3	4	3	10	10	11	11	11

Sources: Ministry of Finance; World Bank staff projections.

Notes: o/w = of which.

Figure 23. Revenues, Expenditures, and Fiscal Balance

Sources: Tajikistan authorities; World Bank staff calculations.

Figure 24. Central Government Debt Dynamics

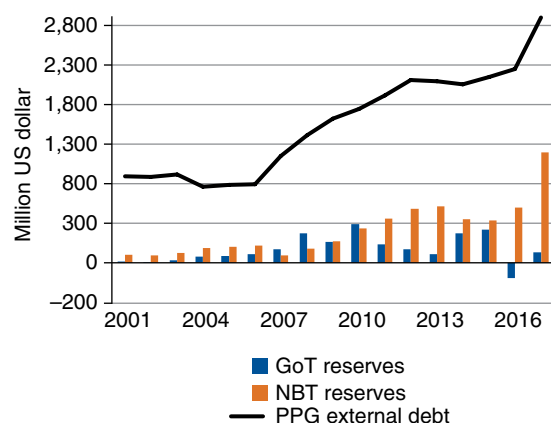
Sources: Tajikistan authorities; World Bank staff calculations.

limited revenue envelope. As a result, the public debt tripled (Figure 24), and fiscal buffers contracted by about three times between 2014 and 2017 (Figure 25), severely depleting Tajikistan's fiscal space.

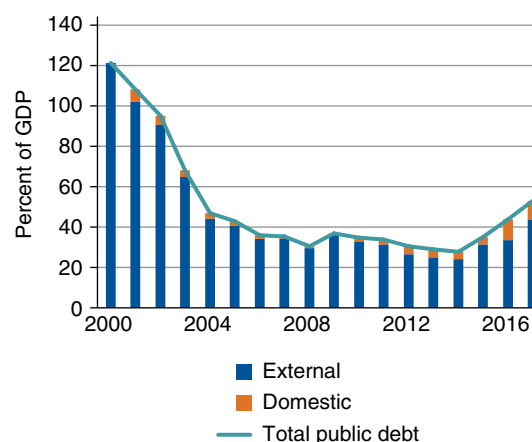
Debt sustainability assessment reveals the risk of debt distress to be high. The public debt-to-GDP ratio remains above 45 percent, suggesting extremely limited fiscal and borrowing space to absorb shocks. Tajikistan's debt profile is particularly sensitive to shocks to non-debt creating flows (SOE contingent liabilities and remittance inflows, for example). Loans for public investment projects (particularly from China), the issuance of domestic debt to support the banking sector, and the issuance of \$500 million in Eurobonds in September 2017 to finance the Rogun HPP were the primary drivers of new debt accumulation,¹⁸ leading to further relaxation of the debt management policy and increasing the public debt burden to above 50 percent of GDP.

Tajikistan's public debt remains mostly concessional from external sources. The structure of public debt has been skewed toward external borrowing, which accounted for between 80 and 100 percent of total public

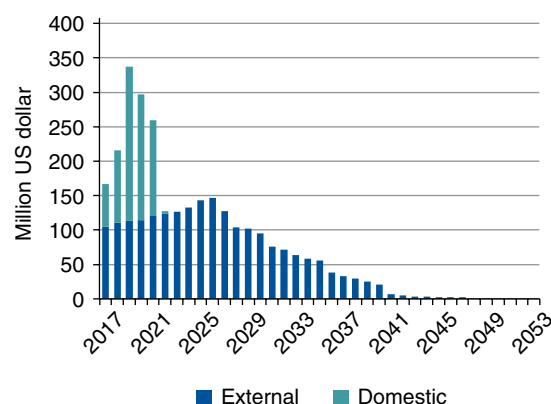
¹⁸ On September 8, 2017, Tajikistan issued \$500 million in 10-year bonds with a yield of 7.125 percent to finance construction of the Roghun HPP. During the Eurobond issuance, Tajikistan's sovereign rating was assessed at B3 by Moody's and B- by S&P, both with a stable outlook.

Figure 25. Fiscal and Monetary Buffers

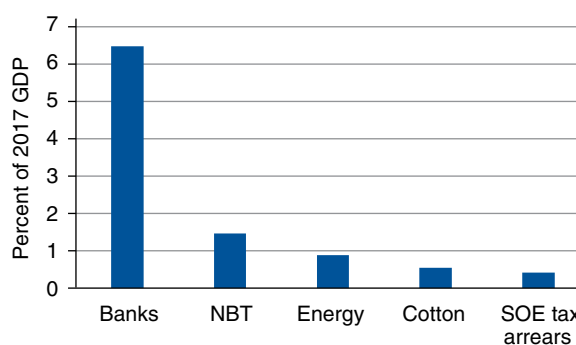
Source: Authorities of Tajikistan and WB calculations.

Figure 26. Public Debt Dynamics

Source: Authorities of Tajikistan and WB calculations.

Figure 27. Debt Redemption Profile

Sources: MoF and World Bank staff calculations.

Figure 28. Outstanding Bailouts by Beneficiaries

Sources: MoF and World Bank staff calculations.

debt (Figure 26). Tajikistan's main creditors are the Exim Bank of China (54.1 percent of the total, and about 80 percent of the country's bilateral debt portfolio), IDA (14 percent), the Asian Development Fund (11.8 percent), and the Islamic Development Bank (5.8 percent). The share of multilateral and bilateral concessional debt is more than 80 percent of the debt stock; 17 percent is non-concessional borrowing from international capital markets, and 2.1 percent is semi-concessional debt. More than 40 percent of Tajikistan's total debt repayments fall due in the next five years (Figure 27). The outstanding domestic debt is mostly attributed to the banking sector bailouts and SOEs in the energy and cotton sectors, which have been a chronic drag on the state budget and led to debt accumulation of about 10 percent of 2017 GDP (Figure 28).¹⁹

Medium-term fiscal consolidation will need to be supported by spending cuts and downsizing of capital expenditures. Given the country's current macro-fiscal context, the debt maturity cycle in the medium term (Figure 26), and the looming challenges of the global economy, Tajikistan should adhere to fiscal consolidation as further delays to fiscal adjustment could render it costlier. To restore macroeconomic stability, Tajikistan needs to cut the fiscal deficit to a macro-fiscally sustainable level of below 2 percent of GDP in the medium term in line with the outcomes of the 2017 Debt Sustainability Analysis (DSA).²⁰ This will imply a

¹⁹ Due to a lack of information, direct budget transfers to SOEs, tax arrears, and debt liability write-offs, especially to the energy sector and other implicit taxpayer bailouts, could not be included in the calculations.

²⁰ The Debt Sustainability Analysis was part of the IMF Staff Report on Article IV consultations and jointly conducted by IMF and World Bank staff in 2017.

large fiscal adjustment at about 4 percent of GDP and is expected to be accommodated mostly by rationalization and improved prioritization of public investment programs.²¹ The latter needs to be accompanied by improvements in public investment management (PIM) practices to mitigate the negative impact of such a sharp contraction in the domestic absorption.

At present, there is no unified framework for managing public investment programs in Tajikistan. The PIM system is fragmented and primarily guided by the rules and regulations of various funding organizations and donors. The introduction of robust PIM practices, which should accompany the upcoming fiscal consolidation and adjustment, should aim to link the PIP portfolio with the Strategic Development Strategies (Medium-Term Expenditure Framework (MTEF), NDS, and so on) and ensure the vigorous appraisal and independent assessment of investment proposals. This would be followed by informed screening, selection, and implementation with potential adjustments if warranted and thorough evaluation. All of these may help to moderate the negative impact of the expected reduction of public investment on the economy.

The current fiscal framework needs to be enhanced to facilitate Tajikistan's economic transformation. The current fiscal situation calls for medium-term consolidation to restore macroeconomic stability and address fragilities. The latter is associated not only with the absence of fiscal buffers and the need to reduce the high fiscal deficit to a more sustainable level but also with the high level of contingent liabilities originating from SOEs that pose a permanent threat to fiscal stability. The next section of this chapter discusses the magnitude of these liabilities.

State-Owned Enterprises as a Source of Contingent Liabilities and Inefficiency

The footprint of SOEs is large in Tajikistan. As of 2016, there were 908 public entities and enterprises with majority equity participation from the state. The central government was the majority shareholder in approximately 700 of these companies; local governments were the majority shareholders in the rest. This figure includes both enterprises carrying out commercial activities and government entities that perform regulatory or social functions. The government does not distinguish between these types of entities.

Lack of competitive neutrality places SOEs in an advantageous position, crowding out the private investment in some sectors. To remedy the situation, it is essential to ensure competitive neutrality in terms of equal treatment of SOEs and private companies with regard to taxes, access to finance, non-fiscal support, and regulation. A first step would be to map the activities carried out by SOEs and state unitary enterprises (SUEs) and identify which perform commercial operations, bear public service obligations, or have a role in sector regulation. Doing so would help to define a more efficient SOE management policy, including in regard to state aid and corporate governance. In the medium term, fiscal and non-fiscal support to SOEs and direct government market participation could be phased out where it does not deliver value for money.

The SOE sector displays weak operational efficiency. Except for Tajik Cement and some SOEs operating in the aviation sector, most SOEs operate at low profitability or are loss-making. According to preliminary data for 2017, 11 of 23 SOEs posted losses that cumulatively amounted to 2.8 billion somoni (4.6 percent of 2017 GDP). Losses have been concentrated in the energy and metal processing sectors—in particular, Barqi Tojik (BT) and TALCO, which accounted for 94.7 percent and 3.7 percent of total losses, respectively. In addition, SOEs account for the bulk of total arrears in the economy, both for receivables (6.3 percent of GDP) and payables (43 percent of GDP).²² Tax arrears to the State Budget and Pension Fund totaled 186 million somoni (0.3 percent of GDP) in 2017, while wage arrears to employees (a relatively small share) amounted to just 47.7 million somoni (0.1 percent of GDP).

Loans and sub-loans incurred by SOEs expose the government to quasi-fiscal risks. In recent years, the government has faced additional fiscal costs owing to the non-repayment of subsidiary loans by SOEs under

²¹ As Chapter 3 on tax system assessment refers, tax expenditures in Tajikistan are high and should be revisited/reduced, but this discussion may take time before leading to any concrete outcomes in terms of expanding the tax base/revenues.

²² This figure includes short-term and long-term accounts payable.

on-lending arrangements.²³ Barqi Tojik and Tajik Trans Gas are among the SOEs that regularly receive on-lending from the Ministry of Finance (MoF) despite being in distressed financial conditions. Similar practices in eight SOEs led to total explicit fiscal liabilities of 7.3 billion somoni (around 9.2 percent of 2017 GDP). Barki Tajik alone accounts for more than 97 percent of total outstanding sub-loans.²⁴ Unfortunately, reports on quasi-fiscal risk produced by the MoF's SOE Monitoring Unit do not provide sufficient details on debt repayments to ascertain whether the debt was eventually repaid by the beneficiary SOEs or by the government. The latter creates a moral hazard issue.

The high concentration of tax arrears in SOEs—which owe half of total tax arrears—is a cause for concern. Arrears of large SOEs rose steadily until 2013, reaching 475 million somoni (1.2 percent of GDP), before declining to below 314.5 million somoni (0.5 percent of GDP) in 2017, comprising about half of total tax arrears.²⁵

SOE payment discipline needs to be addressed sustainably. High arrears on receivables and payables are mainly the result of poor payment discipline between SOEs. The 23 largest SOEs had accounts receivables of 3.9 billion somoni and medium- to long-term accounts payable of 11.4 billion somoni,²⁶ or about 6 and 18.7 percent of 2017 GDP, respectively. Barqi Tojik, which is the single largest debtor SOE, accounts for over 80 percent of total SOE debt to the MoF. BT's MoF debt comprises: (i) 7.9 billion somoni of long-term debt under subsidiary agreements with the MoF, which were signed to on-lend to BT the resources received by MoF from various development partners for investment projects; (ii) 2.5 billion somoni²⁷ of the current portion of long-term debt; and (iii) 2.2 billion somoni in interest payable for MoF loans. At the same time, BT retains a 43 percent share of total receivables, which remain high owing to poor payment discipline by other SOEs and the population at large. Despite improvements in its payment discipline in the last two years, TALCO, BT's single largest client (consuming around 30 percent of Tajikistan's total electricity supply), has a long record of poor payment discipline. In 2017, the population and TALCO alone accounted for 44 and 21 percent of BT's receivables, respectively. The government has been addressing this issue by writing off arrears through the inter-enterprise arrears settlement system. As a result, payment arrears by other SOEs to Barqi Tojik have been offset in exchange for the latter's tax arrears forgiveness to the state budget. However, this approach runs a risk of discouraging any potential improvement in payment discipline which may, in turn, weaken Barqi Tojik's cash position.²⁸

SOE reform should be accelerated to eliminate leakages and prevent the inefficient use of public resources. Further enhancement of the regulatory framework pertaining to corporate governance, accounting, and financial reporting based on International Financial Reporting Standards (IFRS), and audits based on International Auditing Standards (IAS) may help to improve the quality of SOE financial statements and the overall management of SOEs. Key principles of nonfinancial management—including performance management, institutional risk management, and corporate governance—should also be introduced. The current practice of producing Statement of SOE Fiscal Risks could be enriched by including: (i) forward-looking risk

²³ Under on-lending arrangements, the government passes on loans obtained from IFIs to SOEs with an interest rate in the range of 3 to 6 percent, significantly below the cost of a commercial loan.

²⁴ This figure consists of overdue loans and loans for which the maturity date has not passed. The total outstanding amount of sub-loans was 13 billion somoni (23.9 percent of GDP) in 2016.

²⁵ Total tax arrears were around 1.2 percent of GDP in 2017.

²⁶ Total accounts payable, including short-medium and long-term payables, amounted to 26.2 billion somoni (43 percent of GDP) in 2017.

²⁷ Data as of December 31, 2017. For all financial data as of December 31, 2017, the following exchange rates were used US\$1 = TJS8.82; €1 = TJS10.58; ₸ = TJS0.15; and 1XDR = TJS12.53.

²⁸ Energy sector reforms are underway, aiming to improve the efficiency, distribution losses, and profitability of the electricity sector. To improve the accountability, efficiency, and transparency of Barki Tajik, the government (with the support of IFIs) initiated a corporate restructuring program in 2018 to transform Barki Tajik into units with independent generation, transmission, and distribution functions. A concept on tariff regulation in the energy sector was also approved by the government in 2017 targeting improving the tariff policy and cost recovery rates. Under this framework, tariff adjustments in line with the new electricity pricing methodology will be introduced gradually during 2017–20 to achieve cost recovery. Following this goal, during 2017–18 the electricity tariffs for industry and households were raised twice—by 18 and 15 percent, respectively. During the second phase (2021–24) some comprehensive measures will be implemented to achieve financial self-sufficiency under relatively unchanged tariffs. The target period for further development of the energy sector has been set as 2024–28. The government is also implementing a comprehensive plan of financial health measures for BT to reduce arrears in the energy sector and improve collection rates.

estimates; (ii) information on the government's loan repayments made on behalf of failed SOEs to inform and reduce such risks in the future; (iii) systematic monitoring and strengthening of SOEs to avoid frequent bail-outs; (iv) broadening of the coverage of contingent liabilities by including foreign- and domestically-borrowed non-guaranteed debt;²⁹ and (v) identifying an annual ceiling for on-lending to SOEs and reflecting it in the government's Public Debt Management Strategy or in the SOE Fiscal Risk Strategy.

Concluding Remarks

Attaining high growth rates in Tajikistan over a sustained period will require maintaining a stable macro-fiscal environment and implies a shift from external reliance to new drivers of growth. A shift from the current public investment–supported model to private investment–led growth path will be required to secure high and inclusive growth with poverty reduction over the medium to long run. At the same time, fiscal consolidation will be necessary to safeguard macroeconomic stability and regain fiscal/debt space. Growth will need to be powered by external demand to attain external debt sustainability. Two implications flow from this necessary change in the growth model: first, the efficiency of investment needs to rise through structural reforms discussed in this report; and, second, the efficiency of SOE management needs to be improved to level the playing field and reduce barriers for the domestic private sector to emerge and invest.

²⁹ To better monitor loans contracted by SOEs, the MoF could introduce a prior approval practice by requesting that SOEs provide all information on their borrowing plans, expected debt service obligations, and envisaged sources to repay the debt.

POLICIES TO IMPROVE FINANCIAL INCLUSION AND RAISE THE RATE OF DOMESTIC SAVINGS FOR FINANCING FUTURE GROWTH

Introduction

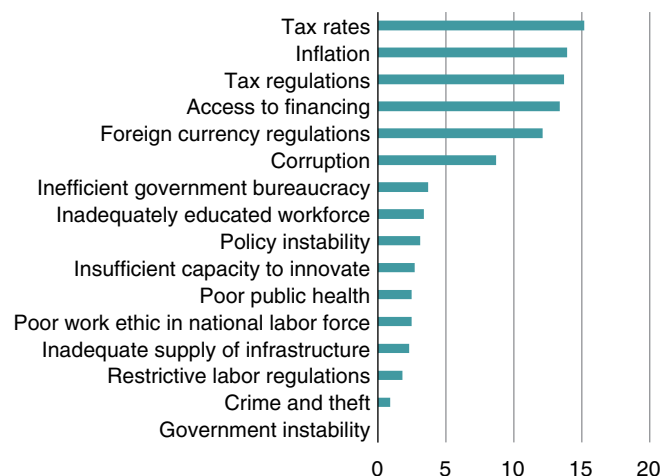
The level of financial inclusion in Tajikistan is among the lowest in Europe and Central Asia (ECA) region.³⁰

Access to financial services remains a challenge and has been one of the major constraints to private sector development in Tajikistan.³¹ According to the World Economic Forum's 2017–18 survey, access to finance remains among the top four more problematic factors for doing business in Tajikistan (Figures 29 and 30). Tajikistan ranked 124 out of 190 economies in the getting credit subcategory of Doing Business 2019 (a deterioration from its 2015 ranking of 116), corresponding with the country's overall ease of doing business ranking of 126 in 2019. The 2015 Financial Sector Assessment Program (FSAP) report identified the lack of long-term funding in local currency, collateral, and financial infrastructure as the most critical obstacles for financial inclusion in Tajikistan. Since 2016, the authorities registered progress in developing the financial infrastructure and advancing the legal framework for expanding the collateral base for accessing to finance. However, the lack of long-term funding in local currency remains a challenge.

A longer view of growth reveals a closer correlation with financial inclusion as a means for promoting domestic savings and investments. Tajikistan has enjoyed a high rate of growth, but it has been highly volatile. As discussed in the previous chapter, the dominant factors behind the high rate of growth were private consumption supported by large remittance inflows (which was closely related to the growth cycle in Russia) and public investment secured by extensive external borrowing. To make future growth drivers more sustainable and predictable, they should rely primarily on endogenous factors—namely domestic savings transmitted to the economy by the financial system. This chapter of the report presents challenges to financial inclusion and discusses policies to improve it and create an enabling environment for promoting new sources of investment by the domestic private sector.

³⁰ IMF 2015a.

³¹ As defined by Atkinson and Messy (2013), “financial inclusion” refers to the process of promoting affordable, timely, and adequate access to a wide range of regulated financial products and services and broadening their use by all segments of society through the implementation of tailored existing and innovative approaches including financial awareness and education with a view to promoting financial well-being as well as economic and social inclusion.

Figure 29. The Most Problematic Factors for Doing Business in Tajikistan³²

Sources: World Economic Forum (WEF), Global Competitiveness Index, Executive Opinion Survey, 2017–18.

Figure 30. Access to Finance Cross-Country Comparison (2016)

Sources: World Economic Forum (WEF), Global Competitiveness Index, Executive Opinion Survey, 2017–18.

Profile of Financial Inclusion in Tajikistan

Financial inclusion indicators for Tajikistan were disappointingly low until recently but have improved since 2017. According to the World Bank's Global Findex database, only 11 percent of adults in Tajikistan had a bank account in 2014. This figure was even lower for women (9 percent) and the poorest 40 percent of the income scale (4 percent). For three comparable economies, these same figures were, respectively, 18, 19, and 15 percent in the Kyrgyz Republic; 18, 19, and 12 percent in Moldova; and 40, 34, and 24 percent in Tanzania. Deposits at banks and microfinancial institutions are the most-used formal savings product. The network of financial institutions is thin, with seven branches per 100,000 adults compared to an average of 26 for the ECA region. There are encouraging signs, however, that point to improving access. In 2016, the percentage of adults with a bank account rose to 55, according to the National Development Strategy. Furthermore, there has been a sharp increase in the number of bank debit cards issued (from 37,000 in 2007 to 1.6 million in 2016). The

latest Findex data (Table 3) indicate that 47 percent of the total adult population and 42 percent of women had a bank account in 2017; 38.5 percent of the poorest 40 percent of the distribution had opened a bank account.

Tajikistan's banking system is small compared to its peers and other Central Asian economies. The financial sector is concentrated, with the three largest banks accounting for over 60 percent of total banking sector assets (and the six largest banks for over 80 percent). Of the 17 banks operating in Tajikistan, one is fully owned by the state and two are partly state-owned; the six majority foreign-owned banks account for 11 percent of total banking sector assets. With domestic credit to the private sector at 14 percent of GDP and a deposit to GDP ratio of 15.2 percent at end-2017, Tajikistan has lagged its regional peers in the last decade (Figures 31 and 32).

Access to finance remains problematic in Tajikistan. It is a major impediment to business as underscored by Tajikistan's

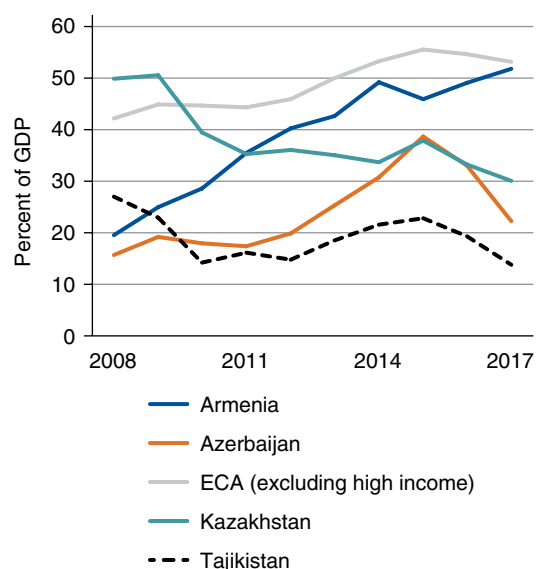
Table 3. Adults with a Financial Product at a Formal Financial Institution (2017) (percentage, age over 15)

Economy	Account ³³	Savings	Loan
Albania	40.0	8.7	8.8
Armenia	47.8	10.0	28.5
Azerbaijan	28.6	4.5	13.1
Georgia	61.2	4.6	23.7
Kazakhstan	58.7	13.9	20.0
Kyrgyz Republic	39.9	3.0	9.4
Moldova	43.8	8.8	9.0
Tajikistan	47.0	11.3	14.7
Uzbekistan	37.1	2.3	2.1
ECA (developing economies)	65.3	14.4	12.8

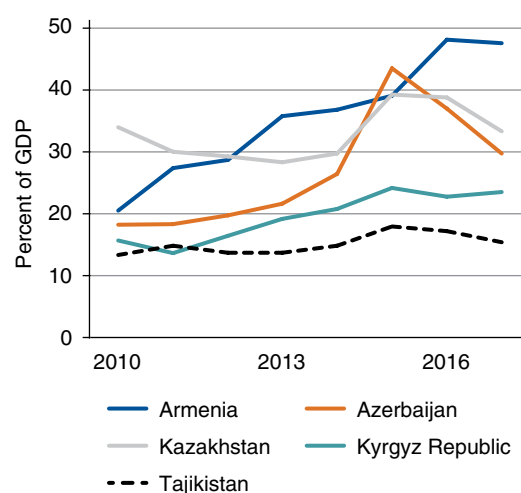
Source: Global Findex 2017.

³² Factors are ranked between 1 (most problematic) and 5 (least problematic). The score corresponds to the responses weighted according to their rankings.

³³ Individual or joint account at a bank, cooperative, MFO, or the post office (if applicable).

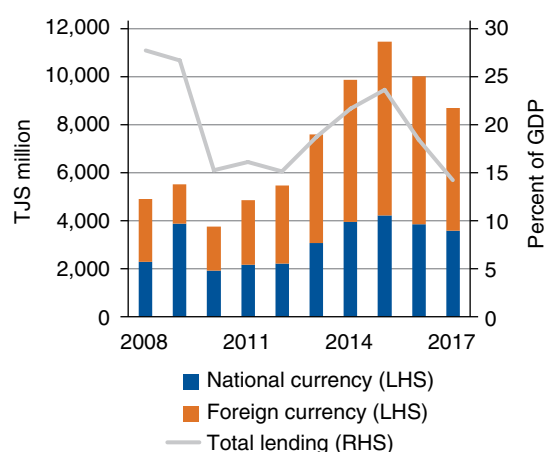
Figure 31. Domestic Credit to the Private Sector

Sources: World Development Indicators 2018; National Bank of Tajikistan; World Bank staff calculations.

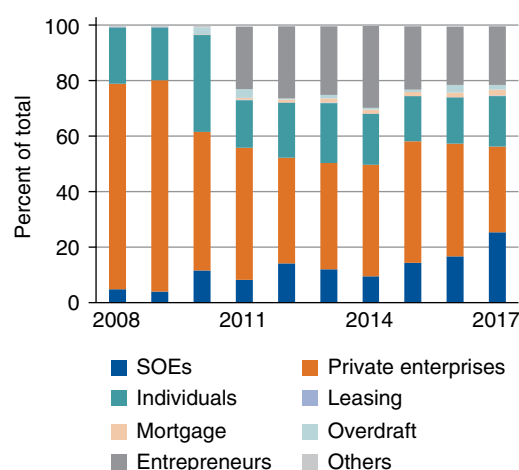
Figure 32. Deposits to GDP Ratio

Sources: World Development Indicators 2018; National Bank of Tajikistan; World Bank staff calculations.

distance to frontier score of 40 for getting credit in Doing Business 2018.³⁴ With access to finance constrained, investment is primarily financed by internal retained earnings and other sources of domestic finance. Lending to the Tajik economy is volatile and follows boom and bust economic cycles—domestic credit shrank from 27.4 percent of GDP in 2004 to 15 percent in 2008 before recovering to 23.4 percent in 2015 and then falling to 14.1 percent in 2017 in the wake of the 2016 banking sector crisis (Figure 33). This dynamic mirrors borrowers' behavior to avoid foreign exchange risk which exposed unhedged borrowers to the depreciation of the local currency. Interestingly, between 2005–18 the share of lending to SOEs more than doubled from less than 10 percent of total lending to about 23 percent (Figure 34). During the same period, lending to private entrepreneurs declined dramatically from 80 percent to 31 percent, partly explained by the increase in borrowing by individuals (up to 20 percent of total loans).

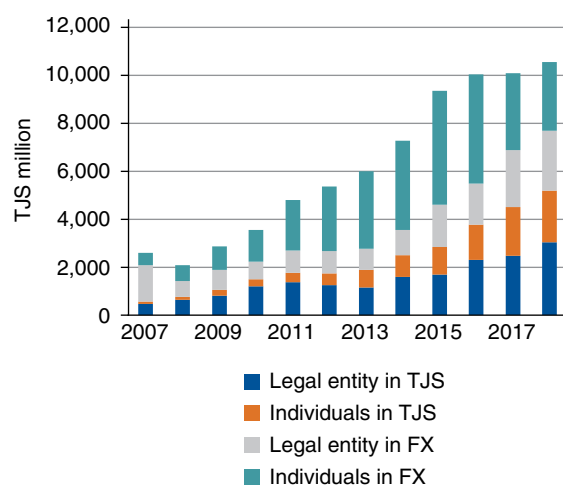
Figure 33. Currency Decomposition of Loans

Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

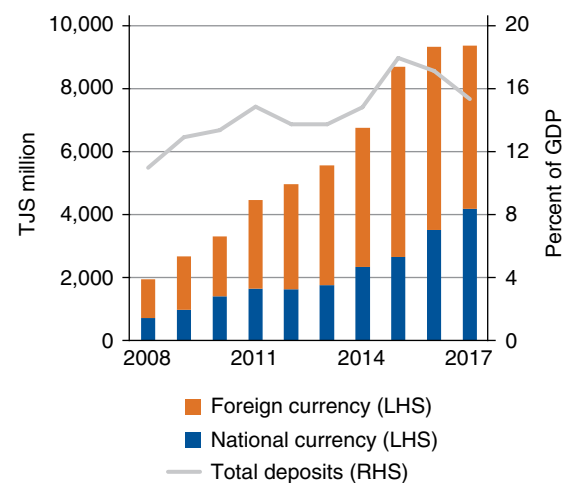
Figure 34. Sectoral Distribution of Loans

Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

³⁴ An economy's distance to frontier illustrates the distance of an economy to the "frontier," which represents the best performance observed on each Doing Business topic across all economies and years included since 2005. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier. Tajikistan also scores worse than its peers in starting a business (with a distance to frontier score of 90); enforcing contracts (63); registering property (63.5); and paying taxes (62).

Figure 35. Structure of Total Deposits, by Holder

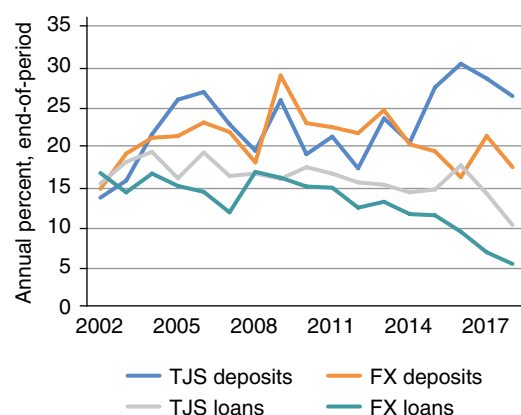
Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

Figure 36. Currency Decomposition of Deposits

Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

Despite high deposit rates, attracting savings remains a challenge because of negative domestic savings and periodic financial sector turbulence. Tajikistan's deposit to GDP ratio is the lowest in the region (Figure 35). During the past 10 years, deposits in credit institutions and microfinance organizations have increased by only 5 percentage points of GDP (from 12.8 percent of GDP in 2007 to 17.8 percent in 2015). However, this modest improvement was reversed following the 2012 and 2016 banking crises and the slow public policy response which reduced public confidence and led to a notable decline in deposits to 14 percent of GDP in 2018. This decline was the result of a more than 35 drop decline in individuals' foreign exchange-denominated deposits, while deposits of legal entities in both national and foreign currencies increased (Figure 36). The next section of this chapter presents a detailed discussion on savings behavior in Tajikistan and its correlation with remittances.

The high cost of attracted resources, low efficiency and profitability of the banking sector, and unhealthy lending practices led to the high cost of lending/borrowing. Until the 2016 banking crisis, deposit rates in the financial sector were quite high (Figure 37). On average, somoni-denominated and FX-denominated time deposits were attracted at 16–17 percent and 14–15 percent annually, respectively. In addition to domestic resources, financial institutions have been borrowing externally in foreign currency to replenish the resource pool. The latter exposed financial institutions to high exchange rate risks and, in a highly-dollarized environment, the foreign exchange (FX) risk exposed unhedged borrowers to the depreciation of the local currency. By the end of 2017, the outstanding short-term debt of deposit-taking institutions stood at 5.5 percent of GDP, most of which was incurred to satisfy the domestic demand for resources (Table 4).

Figure 37. Annual Percentage Rate (APR) on Time Deposits and Credits

Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

Table 4. External Borrowing by the National Bank and Deposit-Taking Institutions, 2017

	USD (million)	Percent of GDP
External debt of the National Bank of Tajikistan, o/w	217.8	3.1
Credits and borrowing	99.4	1.4
External debt of deposit taking organizations, o/w	381.1	5.5
Short terms debt, o/w	381.1	5.5
Credits and borrowing	216.9	3.1

Sources: National Bank of Tajikistan; TajStat; World Bank Staff calculations.

Savings Dynamics in Tajikistan

Tajikistan's substantial private savings deficit—a major barrier to financial inclusion—has driven savings dynamics in the country. The gross domestic savings rate has been significantly negative in the recent past, ranging from –5 percent to –35 percent, reflecting the importance of remittances in supporting consumption in the economy (Table 5). The savings rate shows a close relationship to fluctuations in remittances: when remittances slowed down significantly in 2007–09, domestic savings also fell. Domestic savings staged a recovery in the 2011–16 period as incomes and consumption were supported by expanding public spending and a sharp rise in the fiscal deficit.

Private domestic savings exhibited considerable volatility over the past decade, while public savings showed the effects of a strong relaxation in fiscal policy toward the end of this period to support growth in the face of worsening external conditions (Figures 38 and 39). The strong improvement in domestic savings over this period (of roughly 20 percentage points of GDP) was nearly entirely on account of private savings. In the most recent period, 2015–17, private savings strengthened markedly while the fiscal balance deteriorated sharply.

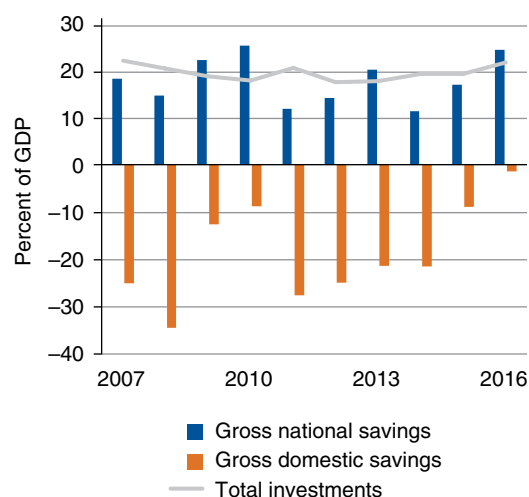
Private savings behavior in Tajikistan is determined by remittance flows and consumption smoothing. There is a negative correlation between remittance inflows and private sector domestic savings (lagged zero to one period). The strong rise in remittances in 2005–07 resulted in a sharp decline in domestic savings in 2007–08, and a fall in remittances between 2008–14 led to a robust recovery in domestic savings over 2009–16 to private domestic savings, though with considerable volatility. Private domestic savings rose to a positive 9.6 percent in 2016, a sharp improvement from negative rates of earlier years.³⁵ This relationship explains the behavior of private domestic savings.

Table 5. Domestic Savings, Private and Public (in percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Private	–20	–30.3	–8.3	–6.5	–26.5	–26.1	–21	–22.4	–7.5	8.2	–1.5
Public	–5	–4.7	–4.7	–2.5	–1.6	1.1	0	0.4	–1.5	–9.2	–5.5
Total	–25	–35	–13	–9	–28	–25	–21	–22	–9	–1	–7

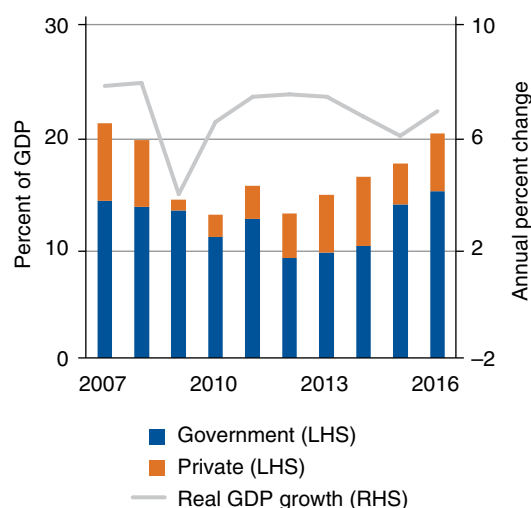
Sources: National data; IMF-WEO database.

Figure 38. Gross Domestic Savings, Investments and Gross National Savings



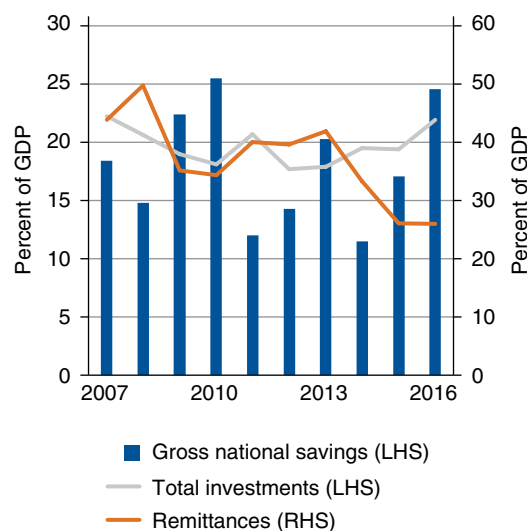
Source: TajStat and World Bank staff calculations.

Figure 39. Public and Private Investment

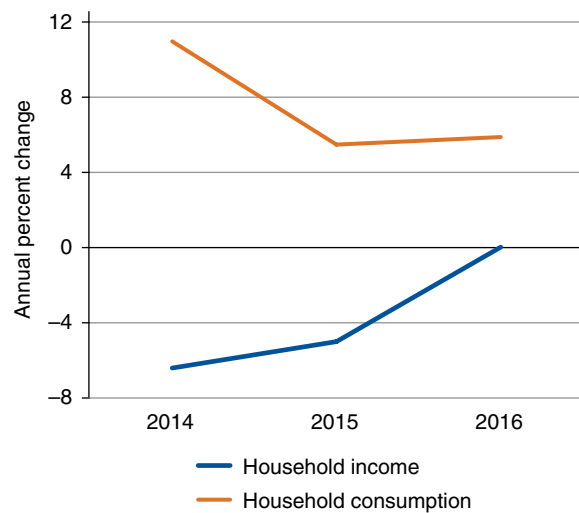


Source: TajStat and World Bank staff calculations.

³⁵ There appears to be considerable noise in the data which suggests that broad trends and period averages provide a more reliable guide as to developments, rather than year-on-year changes.

Figure 40. Savings, Investment, and Remittances

Sources: TajStat, Central Bank of Russia and World Bank staff calculations.

Figure 41. Household Income and Consumption

Sources: TajStat, Central Bank of Russia and World Bank staff calculations.

National savings, which reflect remittances, have been much less volatile than domestic savings. Throughout the 2007–16 period, national savings ranged between 17 to 22 percent of GDP (Figure 40). With minor exceptions, they have fallen short of the investment rate in the economy, with the corresponding current account deficits contributing to the rise in external debt, particularly in the 2013–16 period.

Households rely on savings to smooth consumption patterns. During a prolonged period of rising remittances (2004–08), permanent income may be assumed to have risen strongly, and hence led to a rise in permanent consumption. During this adjustment, domestic savings fell sharply to accommodate the rise in current consumption. In contrast, the sustained fall, followed by moderating remittance inflows from 2008, led to downward adjustments in permanent income, and current consumption fell as a result, with a sharp rise in domestic savings. In summary, as permanent income fluctuated sharply over the 2004–16 period, the pattern of current consumption was smoothed through adjustments to domestic savings (Figure 41).

Infrastructure for Financial Inclusion

Although Tajikistan's payment system infrastructure improved significantly during 2010–17, it remains limited, and the country lags behind other Central Asian economies. Since 2010 payment card market indicators have improved markedly (Table 6). However, Tajikistan remains the lowest performer in the region by the number of cards, number of Automated Teller Machines (ATMs), and the number of terminals per one million population. Among other factors, businesses cite high service fees for the installation and maintenance of electronic terminals, the small number of customers choosing payment card settlements, the widespread practice of cash payments for wholesale transactions, and unreliable Internet service for e-terminal operation.

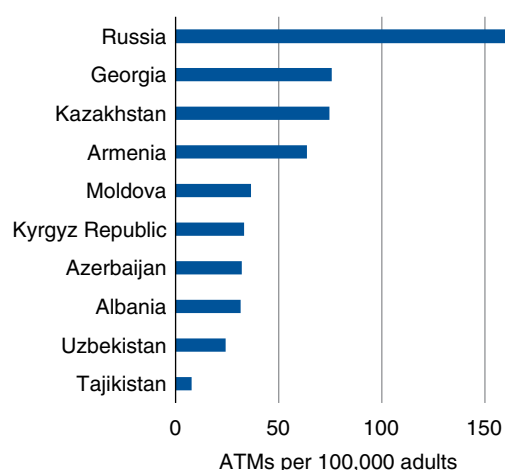
Progress on cashless settlements is slow and faces weak enthusiasm from entrepreneurs. Cash remains the preferred method of payment in Tajikistan. Businesses are reluctant to install electronic terminals and accept payment cards during settlements. The number of card holders has risen rapidly in recent years. However, it remains to be seen to what extent the cards are used to facilitate cashless transactions, as 95 percent of operations with payment cards register cash withdrawals. Physical infrastructure, including the number of ATMs, needs further improvement (Figures 42 and 43).

Leasing operations are often associated with improvements in access to finance. But this small sector is fragmented, unorganized, and unregulated in Tajikistan with no market monitoring or oversight. Stimulating leasing would open new sources of finance to borrowers with little or no credit history, particularly in the underserved agriculture sector. The growing use of mobile telephony and the capacity to make financial

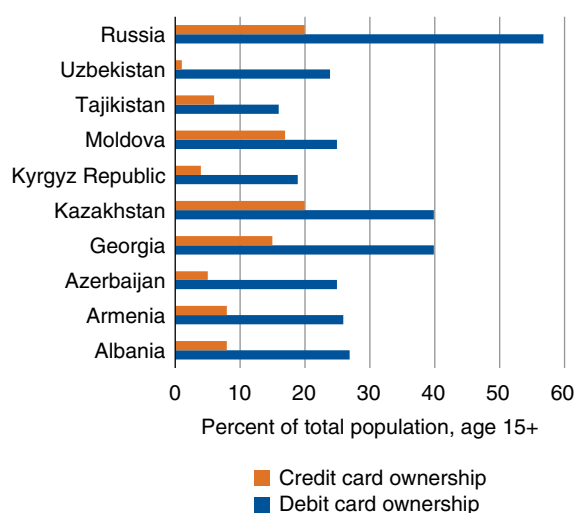
Table 6. Payment Cards Market, Evolution of Main Indicators

Indicator	2010	2017	Development 2010–17 (times)
Total number of payment cards	155,585	1,694,157	10.9
Payment card holders (people)	147,685	1,672,434	11.3
Volume of operations with payment cards (million TJS)	980,900	8,328,600	8.5
Cash withdrawal	904,100	7,941,000	8.8
Payment for goods and services	76,800	387,600	5.0
Number of payment equipment infrastructure (total, end of period)	545	4,010	7.4
For cash offering/acceptance:			
ATMs	220	685	3.1
Cash withdrawal points	231	1,381	6.0
For cashless payments:			
Number of terminals at points of sales and points of services	94	1,944	20.7
Automatic vending machines	—	1,569	—

Source: National Bank of Tajikistan.

Figure 42. Prevalence of ATMs

Sources: IMF Financial Access Survey 2017 (<http://data.imf.org/FAS>); Global Findex 2017; National Bank of Tajikistan.

Figure 43. Debit and Credit Card Ownership

Sources: IMF Financial Access Survey 2017 (<http://data.imf.org/FAS>); Global Findex 2017; National Bank of Tajikistan.

transactions (both receiving and payments) holds the promise of transforming financial inclusion, as international experience shows, particularly in the cases of Bangladesh and Kenya. Together with efforts to improve financial literacy, technological progress in payment systems can have a powerful impact on financial inclusion.

Problems in Banking Intermediation

Stable banks are a key contributor to a stable macroeconomic environment. The stability of the banking system and public confidence in it are critical factors in determining the volume of intermediation and the overall efficiency of banks. Bank accounts are the principal repository of formal short-term savings, though term deposits can stretch up to three years (not significant in Tajikistan). Confidence in the banking system is not only critical for mobilizing short-term savings but is also a pre-condition for the development of long-term

savings instruments outside banks, as the link between the banking and capital markets is strong. Thus, the efficiency of banking intermediation is central to the effort to raise savings in the economy.

A highly vulnerable banking system saps confidence. The vulnerabilities of the banking system have come to the fore over the past two years with the insolvency and closure of two mid-sized banks, and the need to infuse public funds into two large, systemic banks that are operating under restructuring plans.

The principal vulnerabilities to system stability are:

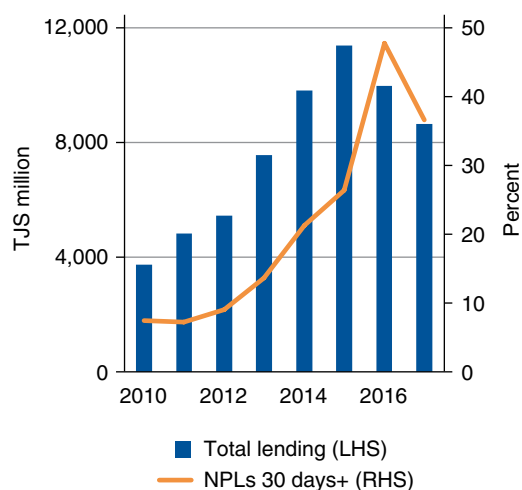
- **High credit and concentration risks.** This vulnerability is partly a legacy of directed credit to SOEs and state prestige projects, although this type of lending has been falling. Risks have arisen from loan concentration, insider lending, and lending to related parties in the major banks, often with poor collateral and dubious bank governance conditions. A large part of loan concentration and related lending consists of nonperforming loans (NPLs). The total NPL ratio rose from 7.4 percent in 2010 to a peak of 47.6 percent in 2016, before moderating to 36.5 percent in 2017 (Figure 44 and Table 7).
- **The high degree of dollarization in the economy.** Although it has declined in recent years, the high level of dollarization remains a foreign exposure risk for banks (Figure 45). Until 2015, the share of foreign currency-denominated loans rose, and the absence of hedging by banks exacerbated risks. Moreover, borrowers were also unhedged. A substantial share of bank liabilities consists of nonresident deposits, loans, or credit lines from foreign institutions. The recent depreciation of the somoni has added to risks.
- **The dominance of SOEs in bank loans.** Public enterprise and government loans account for 31.6 percent of total lending. Large SOEs, such as the electricity company, the aluminum company, and the airline, are in financial difficulties.

The Tajik banking system is inefficient. It registered large losses as measured by returns to assets or equity (Figures 46 and 47), partly because of the high credit risk discussed above, but also because of its high cost structure given its small scale. These factors result in a high interest rate spread that dampens the volume of intermediation.

Burdened with heavy losses and a backlog of nonperforming loans, the banking sector endured a financial crisis in 2016. The authorities intervened at end-2016 to liquidate two small banks and inject public funds into Tajikistan's two largest banks. The deposit insurance fund was used to compensate 1,750 depositors in the two small banks.

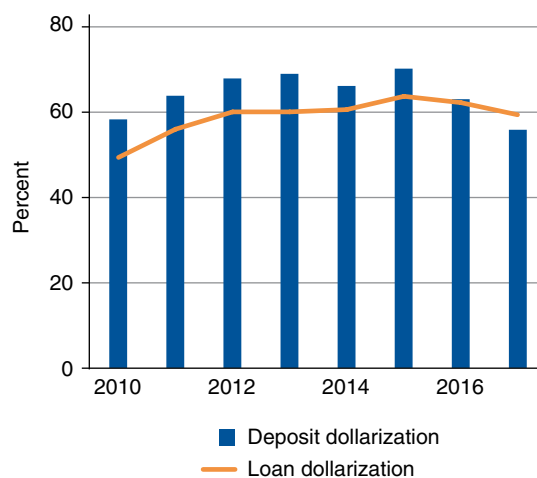
A good-practice bank resolution is essential to raise confidence. The two major banks received injections of government bonds equivalent to 6.1 percent of 2016 GDP, which they subsequently sold to the central

Figure 44. Nonperforming Loans



Source: National Bank of Tajikistan.

Figure 45. Degree of Dollarization in Total Loan and Deposit Portfolios



Source: National Bank of Tajikistan.

Table 7. Financial Soundness Indicators for Banks and Credit Organizations (in percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Capital adequacy									
Regulatory capital to risk-weighted-assets	27.1	24.4	26.8	22.9	16.6	13.1	17.0	22.9	22.1
Regulatory Tier I capital to risk-weighted-assets	23.7	21.3	24.1	21.2	14.2	10.6	26.7	28.1	29.2
Asset quality 1/									
Nonperforming loans to gross loans (overdue by 1 days +)	17.22	14.06	18.21	22.9	27.2	32.3	n/a	n/a	n/a
Nonperforming loans to gross loans (overdue by 30 days +)	7.4	7.2	9.0	13.6	21.2	26.3	47.6	36.5	31.1
Nonperforming loans net of provisions to reg. capital	5.3	3.8	5.3	22.7	38.6	67	105.5	36.6	23.1
Provisions to nonperforming loans	35.9	45.0	43.5	34.7	56.7	45.2	n/a	n/a	n/a
Banks exceeding maximum single borrower limit	0 of 14	2 of 15	1 of 16	2 of 16	1 of 17	3 of 17	n/a	n/a	n/a
Earnings and profitability									
Return of assets (ROA) 2/	1.2	0.2	0.9	2.2	-2.5	0.8	-2.8	0.5	1.9
Return of equity (ROE) 2/	6.3	0.9	4.4	10.7	-14.4	5.5	-21	1.7	7
Interest margin to gross income	50.4	46.4	37.2	47.2	40.6	52.2	63.7	65.2	65.3
Noninterest expenditures to gross income	62.3	86.3	75.5	65.1	63.6	63.8	131.4	61.7	56
Salary expenditures to noninterest expenditures	23.2	14.0	13.5	11.5	8.0	9.0	n/a	n/a	n/a
Liquidity									
Liquid assets to total assets	26	24.5	29.2	22.8	20	24.1	30.9	30.1	30.8
Liquid assets to short-term liabilities	62.5	65.1	84.9	81.1	75.8	70.4	83.9	73.8	72.3
Liquid assets to demand and savings deposits	133.5	105.3	140.0	142.1	113.5	123.2	n/a	n/a	n/a
Liquid assets to total deposits	49.8	40.9	57.8	49.8	43.4	48.4	n/a	n/a	n/a
Sensitivity to market risk									
Net open position in foreign exchange to capital	-0.33	-5.6	-0.1	-2.6	1.7	-17.3	-10	-9.5	-9.6
Additional indicators									
Capital to total assets	18.9	19.3	21.3	19.6	14.8	12	25.5	26.6	27
Large exposures to regulatory capital	60.4	68.1	55.2	79.1	80.1	140.4	132	72.2	62.9
Trading income to total income	9.7	-5.1	24.8	22.6	25.5	11.9	-6.5	11.2	15.7
Personnel expenses to noninterest expenses	55	54.4	51.3	56.1	54.7	56.8	55.3	56.9	57.8
Customer deposits to gross customer loans	105.6	109.9	104.6	76.9	71.2	78.6	96.4	111.8	115.4
Foreign-currency-denominated loans to total gross loans	57.8	64.4	68.3	62.5	62.5	65.3	63.9	61	57.2
Foreign-currency-denominated liabilities to total liabilities	51.5	58.1	67.8	67	65.6	70	67.1	60.3	53.2
Residential real estate loans to total gross loans	1.3	1.4	1.5	1.5	1.2	1.2	1.3	n/a	n/a

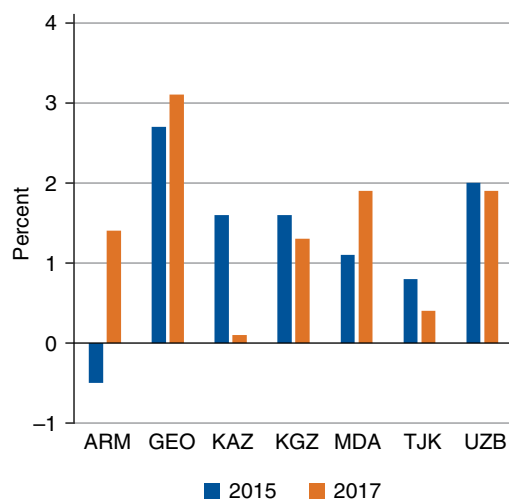
Source: National Bank of Tajikistan.

Note: Financial indicators reflect only banking sector until 2012 and banks and deposit-taking microfinance institutions afterwards.

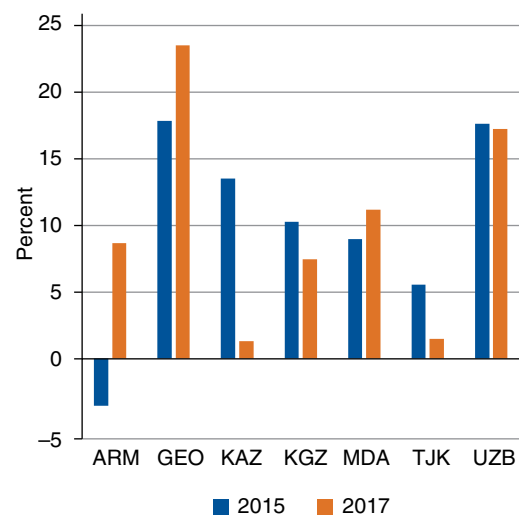
1/ Nonperforming loans include customer and interbank loans.

2/ Annualized net income before tax to average assets or capital.

bank—in effect, the government indirectly borrowed from the central bank to inject funds. This transaction cannot be considered to be an infusion of capital as the government funds were in the form of a five-year interest-bearing repayable bond, which, when repaid in installments, will reverse government support. Moreover, the bonds are a secured (collateralized) claim on the banks, and as a senior claim lack the risk-absorbing properties of bank capital. The interest charge of 2 percent (equivalent to a forced dividend) is a heavy burden given negative profitability; it will further worsen the financial position of the two banks. Finally, the size of the bond and the need for a rapid repayment profile are inadequate to meet the capital needs of the banks if they are to function within prudential guidelines taking account of all the credit risk factors discussed above. Thus,

Figure 46. Return on Assets in Select Economies

Sources: National Bank of Tajikistan; IMF Financial Soundness Indicators (FSI).

Figure 47. Return on Equity in Select Economies

Sources: National Bank of Tajikistan; IMF Financial Soundness Indicators (FSI).

the injection of funds provided only temporary liquidity support to the banks—it was a brief and unsustainable bailout of the banks. As such, the banks remain inadequately capitalized.

Two policy conclusions follow from these developments. First, a viable long-term solution to the difficulties faced by the two largest banks will require either liquidation or the provision of genuine capital in an adequate amount to satisfy prudential requirements. At the same time, if the banks are to be allowed to function, fundamental changes in corporate governance and business practices will need to be implemented. Secondly, the banking crisis has revealed structural weaknesses in banking supervision, the management of NPLs, crisis management, and the bank resolution framework. These issues will need to be addressed promptly, taking account of international good practice. It is assumed that the approval in July 2018 of long-awaited legislative amendments to the banking system laws and regulations will result in a final resolution of problem banks and the enhancement of banking supervision and regulation.

A key source of weakness in supervision lies in its fragmentation; there is no clear responsibility for supervising the financial system as a whole. Related to this fragmentation is the absence of an overall coordinating and decision-making body. The transfer of supervisory functions over the insurance industry to the central bank is a step toward consolidating supervision. The central bank should now also be given supervision over capital markets with a clear mandate for supervision of the financial system. The recent establishment of a Financial Stability Council with representation from key ministries and agencies, supported by a financial stability department in the central bank, is an encouraging step. The Council should develop crisis management contingency plans, followed by the regular issuance of a financial stability report that would serve to disseminate information but also constitute an accountability tool in regard to the financial sector and the public, and, hence, build confidence.

System-wide improvements to the supervision architecture would be needed. The central bank should consider employing macro-prudential credit-related tools that would be particularly effective in the context of Tajikistan, where imprudent loan decisions have been widespread. Examples of such tools are caps relating to a specific sector or class of borrowers, caps on foreign exchange lending, and limitations on loan to value or debt to income ratios or loan to deposit ratios (for liquidity control).

Addressing NPLs will remain a challenge. Further improvements in supervision will require the effective enforcement of prudential standards, refraining from forbearance, improvements in accounting practices, and improving information through a credit registry (discussed earlier). Capacity improvements in the supervisory structure are necessary. The central bank has been working with the World Bank to implement an NPL

workout plan, but a modernization of foreclosure regimes and bankruptcy laws and procedures would assist in developing an effective long-term framework for the resolution of NPLs. The tax treatment of provisioning for NPLs should be corrected.

Governance and political factors are barriers to effective enforcement, especially in large banks in the areas of related and concentrated lending, the identification of ultimate beneficiaries, and the provision and registration of adequate collateral. Over the medium term, efforts must focus on shifting away from a pure compliance orientation and toward a risk-based forward-looking orientation.

Improvements in the crisis management framework center on strengthening bank resolution and emergency liquidity provision frameworks. The bank resolution law and regulations should provide for the central bank as the resolution and liquidation authority and delineate a clear framework for objectives, principles, and triggers for the use of resolution powers, ensure clarity in order of seniority amongst creditors and shareholders in receiving payments, and prescribe procedures for orderly and quick resolution. Supporting changes in the framework for prompt corrective actions with criteria for mandatory actions and the emergency liquidity assistance framework to streamline and speed up decision making and on the use of collateral are required.

Factors Promoting Financial Inclusion and Contributing to Improved Savings Behavior

This section examines the overall environment for promoting financial inclusion and long-term savings in the Tajik economy. The previous section demonstrated the profile of financial inclusion and domestic savings in Tajikistan. It also showed the relationship between private savings and remittances over a cycle of strongly rising and then falling remittance flows. It also noted the critical importance of raising long-term private savings to support a new growth model of rising investments and productivity gains powering exports, if macro-fiscal stability is to be assured.

Macroeconomic stability and the trusted business environment are critical for promoting financial inclusion and stimulating domestic savings. International experience demonstrates the robust relationship between a stable economic environment and growth powered by domestic savings. To boost the long-term savings rate, economic volatility will need to be dampened and inflationary pressures contained through the use of macroeconomic instruments—a clear challenge considering the volatility in the external environment in the face of fluctuating commodity prices. A medium-term framework for fiscal policy that is aimed at expenditure smoothing and stabilizing the debt burden will be important, as is the shift toward inflation targeting in monetary policy conducted by the central bank. A steady policy framework would help to arrest capital flight, which can act as a major drain on the stock of domestic savings available for domestic investment.

As private sector profitability is a key source of savings, sustained improvements in the business environment are critical. In this regard, attention must be paid to the role of the state. Currently, SOEs constitute a significant source of dissaving in the economy, with large losses in the aluminum and electricity sectors. Corporatization or privatization of enterprises would be a significant step toward eliminating dissaving in the economy.

The role of confidence should not be undermined. A sustained rise in the long-term savings rate in the economy—eventually to the levels of 25–40 percent of GDP seen in fast-growing Asian economies—will require improvements to several dimensions of the overall savings environment. Savings are fostered most of all by factors that engender confidence in the stability of the economy and economic policies; in the soundness of institutions and instruments in which savings are held; in property rights, investor protections, and predictability of enforcement mechanisms; in the quality of mechanisms to handle risk and the life-cycle demands of households and firms; and in government agencies playing an appropriate regulatory role to safeguard savings (Box 1). These factors are considered in subsequent sections of this chapter.

Given their critical role in the Tajik economy, remittances can be better channeled to deepen financial inclusion and support growth through private investment. Remittances could be tapped to strengthen Tajikistan's financial sector, diversify financial instruments and products, and engineer a shift in remittance use from consumption to private investment. This could facilitate the shift in the growth model by mobilizing additional resources for funding and expanding private activities in Tajikistan. The latter requires a targeted financial

Box 1. How Do the Poor in Low-Income Economies Save?

Willingness to save. Do the poor in low-income economies demand savings products? Several studies have shown that poor households are willing to pay high prices for savings products that entail little risk, reflecting the high value these households place on being able to save (Wright and Mutesasira 2001).

Banerjee and Duflo (2006) analyzed household surveys conducted in 13 developing countries to document the lives of low-income households. Two groups were studied: the extremely poor, comprising households whose consumption per capita is less than \$1.08 a day; and the poor, who live on less than \$2.16 a day. The authors found that low-income households rarely participated in formal savings and credit markets. For instance, credit activity was high across the surveys, but very few of the poor households got loans from a formal provider. Most borrowed from relatives, shopkeepers, and neighbors, a practice that tends to be more unreliable and expensive. Their savings patterns are no different.

Informal, risky savings. The poor who do save, save informally. In part, this is because the range of products available for savings is limited. In developed countries, even poor households may have access to basic products such as savings accounts or even more complex products such as savings bonds or certificates of deposit. These products are often not available to poor households in developing countries, as Karlan and Morduch (2010) discuss. Those who save therefore often invest in risky assets such as livestock or use informal arrangements such as rotating savings and credit associations or deposit collectors, who charge high fees for holding savings (Rutherford 2000).

Need to tailor savings products. As several randomized experiments have shown, households in developing countries would save more if they were given access to more savings products that better fit their needs (Dupas and Robinson 2009; Brune, Goldberg, and Yang 2011; Dupas and others 2014). Like wealthier households, the poor also need to save to prepare for life-cycle challenges, to protect against emergencies, and to accumulate assets. Because their income tends to come in small installments, they need products that allow them to make small deposits and large withdrawals while offering them safe and convenient places to keep their money and structure their many small deposits.

More and more, practitioners are engaging in various innovations that take these principles to the field. In Bangladesh, for example, the Grameen Bank launched a pension product, called the Grameen Pension Savings, that requires clients to make fixed monthly deposits. After five or ten years, clients receive their accumulated savings with interest. Although this product is intended to prepare households for their old age, these accounts are also being used to save for housing improvements and other commitments (Karlan and Morduch 2010). While more evidence is needed, these types of savings products seem to be increasingly popular in Bangladesh. In a recent survey collected among 2,100 garment workers, about one-fifth reported owning a fixed-term savings account with a bank (Breza, Kanz, and Klapper 2015).

Source: World Bank 2015.

sector development strategy, including confidence building and other dramatic improvements needed to enhance public trust toward the financial sector. Engineering a shift of remittance flows toward private investment may be feasible if the state, as an economic promoter, plays a strategic role (Box 2).

Financial literacy is a critical factor in promoting savings in developing countries where savings products are underdeveloped. As cross-country research has shown, the poor show a high propensity for savings provided instruments that reflect their reward/risk characteristics are available (Box 3). In Tajikistan, confidence and trust in formal financial institutions, including microfinance institutions,³⁶ is low, and an inhibiting factor for mobilizing formal savings. Savings could be raised if ordinary households and firms were given access to products that reflected their needs of security and liquidity. In particular, instruments could be tailored to take advantage of the large remittance inflows.³⁷ Subsequent sections of this chapter elaborate on these points.

The lack of financial awareness and poor financial literacy are barriers to financial inclusion and factors constraining the use of financial products.³⁸ Moreover, financial products may be difficult to understand, and failure to do so can lead to costly mistakes. International experience shows that financial education is most effectively imparted not in large classroom settings covering a broad range of topics, but in the form of

³⁶ Stenga 2010.

³⁷ World Bank 2006.

³⁸ IFC studies.

Box 2. Raising the Growth Impact of Remittances^a

In low-income economies like Tajikistan, inflows of worker remittances typically support private consumption and household investment. In supporting private consumption, remittances play a large role in reducing poverty and vulnerability, raising standards of nutrition and health, and contribution to higher outcomes in education. Spending on private consumption, therefore, contributes to human capital and skills (which can be seen as investments in human capabilities), and, moreover, have multiplier effects on the economy that boost growth.

Typically, investment spending takes the form of housing, investments in farms and small business, and in equipment such as computers or equipment for work. Thus, the quantity and technological level of the overall capital stock is raised. Questions are often floated about whether remittances can be channeled in larger amounts for investment purposes in the wider economy. In particular, governments may wish to capture a share of remittances to finance public investment or the general budget deficit. In Tajikistan, where confidence in government debt or in the financial system may be low, the premium necessary to attract such investment voluntarily may be high. For example, if current bank deposit rates serve as a guide, real interest rates of the order of 10+ percentage points may be necessary to attract such deposits.

In Tajikistan, the role of the state is widely accepted to be too large and the economy is dominated by SOEs that detract from overall efficiency and corporate governance. Under such circumstances, it is doubtful whether incentives should be offered for remittances to flow into the public sector for resources to be channeled into inefficient expenditures. The diversion of remittance resources from private uses to state uses would likely lead to a weakening of economic growth and is inopportune when a shift in the growth model toward a private sector-led growth is called for.

State-organized schemes such as diaspora bonds have succeeded in economies with strong capital markets and a high level of confidence by investors in the financial system (India and Israel, for example). The proceeds of such schemes have been used for long-term, transparent public investments. In Nigeria and India, the state identified and offered credible, functioning public investment projects—such as infrastructure projects—for diaspora funding. These preconditions appear absent in Tajikistan. Reforms to raise the growth impact of remittance flows should be directed at improving the efficiency of financial markets and the use of savings for private investment purposes as discussed in the main chapter of this report. Lowering the transactions costs of remittances (fees, exchange rate spread, the speed and quality of service, the integration of host and recipient country banking systems, in part through correspondent banking relationships) will be important reforms. The broad agenda of improving financial inclusion discussed in the main body of this report is critical to this purpose. The devising of instruments that could be used by the private sector to tap into such savings—such as corporate bonds, mutual funds, and equity funds—would contribute greatly to lowering the capital cost of investments. However, by their nature, these are long-term reforms that will depend on building confidence in the financial system and designing an architecture that protects investors. In summary, it is advisable to build the basics of an efficient financial system, to establish sustainable, stability-oriented macroeconomic policies to win public confidence, and to expand financial inclusion as the optimal building blocks for maximizing the growth impact of remittances.

a. The team appreciates the valuable insights of Dilip Ratha (World Bank Lead Economist on migration, remittances, diaspora bonds, and innovative financing) in the production of this summary.

interventions that use concrete everyday examples to targeted audiences. The latter has been the approach of financial literacy projects in Tajikistan under which the number of individuals with savings accounts has risen (by 6 percent between 2013 and 2017), and awareness of non-cash payments methods has increased.

Financial literacy efforts must be persistent and followed up by the development of financial products that are better suited to middle-class and poor households. An example that has recently gained international attention is the micro-insurance sector, which can combine the need to reduce risk and vulnerability as well as promote long-term savings. In Tajikistan, the scope of micro-housing finance is being explored.³⁹ These topics are discussed later in this chapter. Product development must be supported by regulatory measures to enhance product transparency and consumer protection in financial markets. Complexity can increase with the maturity of the product and needs to be clearly explained and understood; in this regard, consumer protection is critical.

³⁹ IFC 2017.

Box 3. Financial Inclusion and Financial Literacy—Survey Results for Tajikistan, 2017

Financial knowledge. Just one in ten adults in Tajikistan achieved the minimum target score for basic financial knowledge. Seventeen percent of those surveyed responded that they did not know the answer to four or more of the seven questions, and respondents were much less likely than those in other countries to know what would happen to the purchasing power of money if inflation stayed the same (31 percent gave a correct response).^a Surprisingly, few respondents understood the relationship between risk and return (just 31 percent gave a correct response, compared with an average across the seven countries of 67 percent). In addition, women were significantly less likely than men to achieve the minimum target score, and this finding holds even after taking into account other factors. Regression analysis indicated that financial knowledge was lower among women than men. It is also lower in villages and small towns, among those with children at home, those on a low income and those who do not have an education beyond secondary school.

Financial behavior. Slightly more than half of all respondents (53 percent) in Tajikistan achieved the minimum target score for financial behavior. Significantly more men than women achieved this score, even after taking into account other characteristics. Tajikistan had the lowest proportion of adults who take responsibility for household money management and have a budget (44 percent). In addition, fewer than half of adults (48 percent) were active savers at any point in the previous 12 months, suggesting that most adults could be encouraged to be more aware of fundamental money matters and the basic tools to manage income and expenditure. However, adults in Tajikistan were not spending impulsively, suggesting that they used mental accounting to decide whether they could afford to make a purchase. Consumers in Tajikistan were particularly likely to report that speed was important when making a financial product choice (75 percent of those who had recently made a product choice reported this). They were also less likely than average to seek independent information or advice (27 percent), a combination that could signal a risk of choosing inappropriate products. Regression analysis indicates that financial behavior scores were lowest among women, 18–29-year-olds, and those on a low income, and among non-working adults and those with no education beyond secondary school. A booster sample of small and medium enterprises (SMEs) had higher financial behavior scores on average than adults.

Financial attitude. Forty-two percent of adults achieved the minimum target score in Tajikistan for financial attitude, the highest proportion across the surveyed countries. Tajikistan had the largest proportion of adults reporting that they disagreed that they tend to live for today and let tomorrow take care of itself (51 percent); the proportion agreeing is also relatively high (24 percent) indicating considerable variation in attitudes across the population. Regression analysis suggests variation in financial attitudes by community size, with lower scores in small towns than elsewhere. Adults aged 20–29 had higher scores than others. A booster sample of rural populations had higher financial attitude scores than adults on average in Tajikistan.

Financial inclusion. The proportion of respondents in Tajikistan that were aware of at least five types of financial products (45 percent) was the lowest across the seven countries surveyed. Far fewer people in Tajikistan were using payment products (36 percent) than in most other countries, and the proportion of respondents without any of the products listed was 47 percent.

a. The other economies included in the survey are Armenia, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic, and Russia.
Source: OECD. 2018. Levels of Financial Literacy in Eurasia.

Cross-country studies have shown the vital importance of stable macroeconomic conditions to the development of long-term savings markets, and insurance and housing finance markets in particular. Tajikistan is in the process of strengthening legislation across the board in capital markets development and also reforming regulation, for example in the government bonds and insurance markets and in enhancing the overall financial architecture (Box 4).

The Tajik authorities should focus efforts on raising short-term savings while laying the foundations to boost long-term savings. Short-term financial products in less well-developed markets can play an important growth supporting role as they respond to the presence of higher market risks, lower information, and less confidence in the direction of macroeconomic policies. Short-term finance offers more security to savers (lenders) as the rollover risk is shifted to borrowers, moral hazard problems can be better handled, and savers are not locked into longer term contracts with a risk of fluctuating interest rates and, possibly, a higher probability of default. Given market conditions in Tajikistan, policy efforts should be made to stimulate the short-term

Box 4. Strategy to Strengthen the Financial Sector^a

A comprehensive strategy to strengthen the financial sector and to lay the foundations for its long-term development has been outlined by the government and the National Bank of Tajikistan, based on discussions at the Investment Council, a multi-agency forum chaired by the President of the Republic, and with the assistance of development partners. The strategy notes the urgent importance of raising public confidence in the banking system to improve public access to savings instruments and to ensure robust competition in financial markets. It acknowledges the necessity of resolving problems in commercial banks and outlines measures to improve corporate governance in banks to avoid mismanagement, nepotism, and shortfalls in observing prudential requirements. Measures are proposed to permit the securitization of nonperforming loans and the use of flexible mechanisms to deal with illiquidity in bank deposits. To help banks manage foreign exchange-related risks, a hedging mechanism between the central bank and international financial institutions will be developed. Stress tests of banks will be mandatory and the results published. The powers of the central bank as the regulator to deal with problem banks are to be modernized.

The strategy outlines measures to improve the financial architecture in the credit bureau, the collateral system, and the deposit insurance system, and to find extrajudicial ways for enforcement to make collateralized lending more attractive. Important changes are proposed to the tax code to ensure equitable treatment of financial instruments and to reduce the overall burden of taxation on the financial system (tax on bank deposits, tax on bank profits) to stimulate financial intermediation.

The strategy focuses on long-term capital markets as the next stage of financial market development. It outlines measures to create a market price-based government bond market with longer maturities and easier trading conditions and reform of insurance markets.

In summary, this well-developed strategy addresses several key weaknesses in the financial system and identifies areas for further reform and long-term development.

a. Analytical Report: Improvement of the Investment and Business Environment in the Banking and Finance Sectors, prepared by the National Bank of Tajikistan and the Secretariat of the Consultative Council on Improvement of Investment Climate under the President of Tajikistan (Dushanbe, 2017).

savings market, for example by reforming banks and banking supervision, making improvements to the financial architecture, and developing the short end of capital markets, while the policy framework is put in place to stimulate the emergence of long-term financial instruments. A sustained rise in the savings ratio—to the levels necessary to support long-term growth at the official development strategy target of 7 percent annually—will require a supporting legal and institutional framework which allows the enforcement of contracts at low transactions costs and in which economic agents have confidence. In the absence of such a framework, both savers and investors tend to move to the short end of the maturity spectrum, using rollover options as a method of enforcement and discipline; the benefits of longer term transactions are lost. Market development and the lengthening of maturities are also facilitated by active and competitive (or at least contestable) banking systems and by encouraging non-bank activities in intermediation. Here, the financial sector architecture of laws and regulations and a vigorous competition framework are essential to deepening markets and ensuring the availability of a variety of instruments.

Transparency in information may boost confidence and stimulate new savings products. Central to the development of active intermediation instruments is the availability and quality of information on credits and debts, on other factors that determine the creditworthiness of borrowers, and the soundness of financial institutions. Legislative and regulatory steps are necessary to address information asymmetries or market failures in information. Credit reporting systems, collateral registries, reporting by banks and other institutions on their balance sheets, and the enforcement of prudential regulatory standards are critical. In the absence of such essential elements of the financial architecture, saving and borrowing instruments tend to be excessively short term. In recent years, Tajikistan has made considerable advances toward strengthening its financial information architecture, reformed to improve the overall investment climate, fostered financial inclusion, and taken measures to bolster confidence in the financial system through improvements in bank supervision and the institution of a deposit guarantee system. Nevertheless, bank failures and troubled banks have sapped

confidence in the system, as have ceilings on payouts of deposits. There are persistent problems in the banking system with high ratios of nonperforming loans (though declining from their peak in 2016), a significant state presence in banking and the overall economy that undermines competition, and institutional barriers to stimulating savings and developing markets for long-term financing.⁴⁰

The development of a long-term finance market is critical to ensuring investment efficiency and growth sustainability. On the savings side, long-term instruments are essential in permitting households to smooth income and consumption over the life cycle—for example through investments in education, housing, or insurance—and long-term savings products will typically have a higher yield. As such, long-term instruments can have powerful welfare-raising and growth-inducing effects. Moreover, savings products can be used as collateral (for example, life insurance or housing), and that can stimulate investment by households or SMEs. On the investment side, long-term finance is critical to investments in long-gestation projects, plants, and equipment, by reducing rollover risks on the price and availability of capital. Research shows greater firm efficiency and higher growth in economies where firms have access to long-term loans. The development of a long-term financial market is also associated with lower macroeconomic volatility and higher growth⁴¹ and, in particular, with investments in infrastructure critical to supporting growth.⁴² Market distortions and failure are critical factors in determining savings behavior. While these considerations are important for Tajikistan, it is notable that long-term financial markets require not only macroeconomic stability and a high degree of confidence on the part of participants in the predictability of policies, but also a market with minimal distortions or failures. Typically, the length of maturities of savings and investment rises with incomes and depth of financial markets, with ease in the flow of information and a rise in the quality of financial information, and with lowering of transactions costs. Subsequent sections of this chapter trace recent developments in banking and capital markets and provide advice on the development of capital markets.

Confidence-Promoting Factors

Credit Information

Credit reporting systems provide vital information to financial institutions that enable them to make loan decisions, and to regulators that increase the effectiveness of bank supervision.⁴³ Where such systems are absent or function poorly, access to credit and the price of credit are worse. Credit reporting systems address the problem of asymmetric information and thereby lead to a less credit-constrained private sector, particularly for SMEs, where a clean credit history can lead to lending that would otherwise be perceived as too risky. A Bank study demonstrated the improvements in access to credit: in countries with a credit bureau, small firms were 40 percent more likely to obtain bank loans.⁴⁴ Credit registries are vital in supporting the supervision and regulation of financial institutions for compliance as well as for assessments of internal risk management systems in banks. More recently, detailed information in registries permits system-wide risk analysis by supervisors and is a critical tool of macro-prudential supervision.

Addressing credit risk should be a priority in Tajikistan. The primary source of weakness in Tajikistan's banking system is credit risk, which leaves the financial system highly vulnerable (as underscored by the high level of nonperforming loans and insolvency challenges in major and minor banks). Credit risk is high owing not only to a legacy of massive directed lending to SOEs and state-run projects, but also because of lending to connected parties, large single borrower lending, inadequacies in collateral, and other poor practices. In these

⁴⁰ Since 2017 a number of measures have been taken by the NBT to reduce the rate of NPLs. These include: (i) the approval of the NPL recovery plan for 2017–19, which obliged all banks having NPLs in excess of 30 percent of their loan portfolio to report to the NBT on a monthly basis; and (ii) the amendment of the Law on Credit History to stipulate that creditors share information about borrowers with credit bureaus.

⁴¹ Aghion, Howitt, and Mayer-Foulkes 2004.

⁴² Calderon and Servén 2014.

⁴³ Credit reporting systems consist of (i) credit registries, generally publicly owned, where reporting is mandatory, and which is relied upon by regulators in their core supervisory tasks; and (ii) credit bureaus, generally private sector-owned, where reporting is not mandatory but is generally near comprehensive. Financial institutions can access both registries and bureaus.

⁴⁴ Love and Mylenko 2003.

conditions, the adequate and transparent flow of information is critical, as is its timely availability to regulators and all financial institutions. It is, therefore, of concern that there is no functioning credit registry in Tajikistan. This shortcoming is a serious lacuna in the supervisory architecture, which makes off-site supervision particularly challenging. In the future, the authorities may consider introducing countercyclical regulation and targeting on prudential grounds specific types of loans that may pose undue risks to banks or the system as a whole. A credit registry would be necessary to do this. Credit registries also compile information on loan interest rates, which is otherwise unobtainable.

Tajikistan has made notable progress with its credit bureaus. Tajikistan's credit bureaus launched in 2010 and, by collecting data from banks and microfinance institutions, has become a vital part of the credit decision process in the country since. With support from the government and international financial institutions, the two existing bureaus have built institutional strength and capacity and are now widening the credit information they collect to include telecommunications companies, cable television, leasing, utilities, and insurance companies. This reform will allow SMEs and individuals without previous bank loan transactions to build a credit history, thereby broadening access to loans (and incentivizing the timely settlements of consumer telecom and utility bills).

Credit bureaus are attempting to improve reporting to cover loan payment history and loan classification. Other services such as tracking parallel loans and general portfolio analysis are also being offered. A significant recent legislative change was the elimination of the requirement to obtain client consent to provide information to the credit bureau as a part of the general reform that preserved bank secrecy rights while permitting the disclosure of information under appropriate safeguards to improve the functioning of the credit bureau. One credit bureau in the country is seen as one of the most modern and effective bureaus in Central Asia. It has a database covering 95 percent of active financial institution clients, with annual inquiries just below one million in 2017. In 2018, with IFC support, the Credit Information Bureau of Tajikistan (CIBT) joined the Association of Credit Information Providers (ACIP) of Eurasia, which helps members to share credit/bill information among member economies; this is particularly useful given the high degree of movement of people and companies in the region.

An area for further development is the central bank's role as supervisor of the credit reporting system. This supervisory role includes the adoption of clear goals and the instruments to reach them and communicate them to parties. The central bank has promoted consumer financial protection with the establishment of a specialized division within the prudential supervisory structure. Work is proceeding on disclosure of information to consumers, complaints handling, disputes resolution, debt collection, and data protection. Moreover, regular reviews of banks' and microfinancial institutions' observance of consumer protection norms are taking place, as are reviews of information on consumer complaints collected by banks and other bodies to determine whether further regulation by the central bank is required.

In summary, Tajikistan's development of its credit reporting system and its institutional strengthening has been impressive. The improved flow of information will help banks and financial institutions to reach informed decisions. Information will not be as much of a constraining factor in loan decisions, boosting overall banking sector strength. A well-functioning credit reporting system will improve public confidence in financial institutions and, thereby, encourage savings. Over time, it will also contribute to raising the penetration of financial services within the population.

Secured Transactions

Improvements to secured transactions legislation and practices in the recent past have strengthened the framework for bank lending. The collateral provided for loans is typically in the form of property; Tajikistan's legislation governing the use of property mortgage securities is in line with international best practice. The range of immovable assets that can be created as collateral is extensive but, in practice, land user rights are not utilized as collateral. The use of collateral would be greatly eased if out-of-court settlements were to be permitted in a broader range of cases. Presently, enforcement takes place through cumbersome and lengthy court proceedings. In addition, credit collection through auction rates is not effective as rules on selling prices and acquisition prices and on the loan amounts are not well defined, and the law on loan amounts in excess of acquisition prices is unclear.

The legal framework for immovable pledges could be improved in many ways.⁴⁵ For example, the range of assets could be widened, the contradictions across different laws on priority rankings in regard to different pledge claimants could be resolved, and out-of-court settlements could be promoted, thereby avoiding lengthy and expensive court proceedings. The pledge registry is weak and barely functional—it lacks electronic registration, and few pledges are registered. Recent legislative efforts have centered on widening the use of movable property for pledges, clarifying priority rules, and establishing extrajudicial processes. Improvements to regulatory standards in asset valuation are taking place. Finally, the central bank is supporting the development of an online notification-based collateral registry, which will cover both movable and immovable assets.

Deposit Insurance Fund

The deposit insurance guarantee fund has operated since 2003. It covers all banks, except for one state-owned bank, and guarantees only individual (not enterprise) deposits in foreign currency up to somoni 17,500 (around 95 percent of all deposits). Banks pay a premium of 0.25 percent per quarter.⁴⁶ Payouts can be performed only upon a certified bank insolvency established by a court order. Three payouts have been made thus far. With its high coverage percentage of deposits, the deposit insurance fund offers assurance to savers in banks, even though public awareness could be improved, and payout delays may have damaged confidence.

Essential reforms should be implemented, including the widening of the fund's mandate. The deposit insurance fund has a narrow mandate that limits its ability to play a role in financial system stability. At present, it is limited to paying out on insured deposits; there are plans to extend its mandate to providing financial support in bank resolution cases, thereby obviating the need for payouts. It will be necessary for the central bank to provide all information needed to the fund to facilitate this expanded mandate. While this is a significant reform, consideration should be given to extending the mandate such that the fund has comprehensive risk minimizing functions in making risk assessments, exercising early intervention and resolution powers, examining least-cost resolution strategies and if possible—in coordination with the central bank—exercising prudential oversight responsibilities. Such reforms would significantly strengthen the basis for ensuring the security of deposits and contribute to the stability of the financial system.

Several steps are necessary before these reforms can be completed. First, the recent formation of the Financial Stability Council—with members from the central bank, the ministry of finance, the deposit insurance fund, and other line ministries—provides a forum for the fund to exercise its voice and a platform for improved, coordinated approaches to tackling banking sector weaknesses. Second, the fund's credibility needs to be bolstered by making payouts easier and more automatic, clarifying the conditions for the backup credit line from the government, liberalizing the conditions for the investment of its resources, and improving reporting by its members. At present, the fund invests only in government securities, which have too low returns to ensure the fund's financial adequacy. In practice, the fund should invest in high-grade foreign securities. Moreover, the size of the investments has to be raised on the basis of transparent criteria per international principles. The balance of the fund—given recent and likely prospective payouts—is far too low, which may affect its credibility in the eyes of depositors. With the fund inadequate, it is urgent to clarify the rules for exercising the backup line of credit from the government, the terms and conditions, and to be prepared to draw down on it.

International practice suggests that the coverage of the fund should be extended to SMEs. Doing so could support the mobilization of deposits and encourage savings. The fund should be authorized to make payouts

⁴⁵ In January 2019, the President signed the package of secured transaction laws. With the enactment of sweeping amendments to nine different legislative documents, including the Civil Code and the Law on Collateral, Tajikistan incorporated a functional approach to secured transactions, creating a comprehensive regime for the creation, perfection, publicity, and enforcement of security rights based on UNCITRAL principles. The reform allows SMEs to pledge movable assets as collateral for access to finance.

⁴⁶ As part of the foreign exchange risk mitigation mechanism and within the framework of the de-dollarization agenda, the Tajik authorities are using a dual level of coverage in deposit insurance. According to amendments to the Law on Insurance of Individuals' Deposits dated August 3, 2018, the amount of insurance compensation in national currency cannot be higher than 500 indicative measure and increased from TJS 17,000 to TJS 25,000 for somoni-denominated deposits. However, the coverage for foreign currency deposits, which are still predominant in the market, was maintained at the level of TJS 17,500. This dual policy is not in line with international good practice. Also, the banks' contribution for each quarter was set at 0.10 percent for national currency deposits and 0.30 percent for foreign currency deposits.

in foreign currency for deposits denominated in foreign currency, and the liberalization of its investment practices will provide the fund with an appropriate hedge. Finally, the fund has to upgrade its data systems to receive and handle more detailed data on deposits and other variables from banks, as well as to bolster its capacity to exercise its expanded functions.

The deposit insurance system can be a powerful factor in engendering confidence in the banking system and in raising household and corporate (especially SME) savings. The deposit insurance system in Tajikistan has an established performance record, but reforms will be needed to facilitate a more significant contribution to financial system stability.

Fostering Long-Term Savings

This section discusses institutional frameworks for developing long-term savings in Tajikistan. Earlier sections of this chapter have pointed to the imperativeness of sustainably raising the rate of domestic savings to meet the growth targets of national development plans consistent with fiscal and external debt stability. The focus, thus far, has been on mobilizing growing volumes of short-term savings by households and firms, and in analyzing the principal impediments to savings. Policy recommendations have centered on the overall savings environment, with emphasis on banking sector shortcomings, which affect confidence. The need for institutional strengthening in encouraging short-term savings has been discussed. Though the challenges to fostering long-term savings in countries at the same stage of development as Tajikistan are formidable, it is encouraging that the government is initiating efforts to develop the environment for long-term savings, as well as the accompanying instruments, markets, and regulatory framework. The official strategy recognizes that the welfare gains from financial deepening can be considerable.⁴⁷

Reforms will take a decade or longer, but the authorities have been taking encouraging steps. For example, the government has made reforms to the pricing and trading of government securities, the supervision of the insurance industry, and regulation of the stock market that show its desire to make progress toward fostering capital markets.

The benefits for households and firms of long-term markets in the context of Tajikistan's development stage are apparent. Households will benefit from secure long-term financial instruments to achieve higher yields and to plan life-cycle expenditures related to education, health, or housing in a rational manner. Firms will invest their earnings in long-term instruments to earn returns but also to better smooth their surplus and investment needs. Other important suppliers of long-term savings funds will be the insurance companies, which need to invest their reserves; pension funds, which will have long-term liabilities to match; and specialized funds such as the deposit insurance fund. The principal borrowers can be expected to be the government, benefiting from longer maturities with a resulting reduction in rollover risk, especially to fund public investment; private firms, as their investment needs will benefit from better pricing and longer maturities; commercial banks issuing long-term certificates of deposits; and mortgage institutions. Those forces supplying or absorbing funds in the long-term financial markets can be expected to expand over the medium term as incomes per head rise.

Long-term financial markets will bolster economic stability and strengthen monetary control. As long-term markets develop, savings will be stimulated, given the larger variety of instruments and higher returns. As local currency markets grow, exchange rate risk will diminish, reducing the country's reliance on external inflows and its vulnerability to shocks. Public borrowing can be done increasingly in local currency terms, further reducing risk and countering the trend toward dollarization. As the authorities prepare to adopt inflation targeting, the development of money and bond markets will support the conduct of monetary policy and lead to improvements in the transmission mechanism between instruments (interest rates or quantity of public debt) and final goals. Longer term instruments permit the central bank greater scope for exchange market interventions (in support of the inflation target). More fundamentally, through a deepening of financial

⁴⁷ Republic of Tajikistan, NBT 2017.

markets, the efficiency of capital allocation will rise as savers and borrowers find markets more competitive, and requirements for information quality and disclosure boost confidence in markets and stimulate savings.

The Government Bond Market

The Tajik authorities are laying the groundwork for the eventual development of a bond market for private issuers by reforming the government bond market.⁴⁸ International experience indicates that the overall environment for well-functioning capital markets requires a robust legal and transactions framework, efficient infrastructure for issuing and trading bonds, confidence in the issuer—a condition that demands high corporate governance standards—and a diversified investor base. Moreover, attention must be paid not only to the development of a primary market but also to a trading (secondary) market, which is essential for providing liquidity to bonds and permitting new holders to buy securities. The supporting architecture requires appropriate disclosure of information by issuers and a regulatory framework to enforce standards.

Reforms to give more dynamism to the government bond market are essential. The authorities' efforts to resolve problem banks and strengthen governance and prudential standards in banks are critical first steps in developing a bond market. The latter will help to establish a yield curve for use as a benchmark for corporate securities. The government may start issuing debt at a market-determined rate to trigger this alignment and convergence. It will amend existing law to permit secondary trading in central bank and government securities (currently prohibited) and to permit the state social insurance fund and the state pension fund to hold surpluses in these securities. The government will also allow these funds to hold corporate securities with a ceiling of 10 percent of all assets. Government securities currently do not provide liquidity to financial markets, particularly in the absence of a secondary market. The government strategy notes that potential corporate bond issues are handicapped by weak public knowledge, poor disclosure by companies, a lack of public confidence in the statements of companies, and the absence of a rating system. The strategy also suggests that with higher interest rates, the volume of issues will rise, thereby diminishing exchange rate and inflation pressures on the economy, make the funding of the public deficit more secure, and laying the groundwork for the development of financial markets.

Government bond issues anchor corporate bonds. The government strategy recognizes the vital importance of well-functioning money markets and government debt markets as a prerequisite for the emergence of a corporate bond market. Money markets provide liquidity at the short end and price information (interest rates) through trading. Government bond markets perform a similar function for the medium- and long-term durations and—through regular trading and regular issues of instruments to replace expiring ones or to fund net deficits—markets obtain liquidity and can reveal a set of interest rates depending on the maturity, and hence a yield curve can be constructed. Corporate bonds can then be anchored or priced using government securities, with prices determined by the bond's level of risk. Thus, government bonds provide a basis for price and maturity for private issuers, and savers can allocate their savings based on relative prices. The banking system is often an important issuer: in most countries, banks enjoy high credit ratings, underwrite bond issues, and support the secondary market.

These measures would boost public confidence in Tajikistan's macroeconomic prospects. To deepen government debt markets the authorities plan to issue bills in durations of up to 360 days (issues are currently in the 30- to 90-day range), and to issue bonds of one to three years maturity. Treasury bills will be issued on a regular timetable (improving predictability), and their amounts will be increased. Interest rates will also be liberalized. It is envisaged that the annual return on Treasury bills will rise from 1 percent currently to between 10 and 12 percent. Bonds should also reflect this substantial liberalization, which should be followed (after a transition period) by a shift to a system of market-determined interest rates for primary issues.⁴⁹

The sale of government debt will also take place using the platform of the stock exchange. This step will significantly energize the stock exchange and will be an important indicator of market-oriented reforms. The

⁴⁸ Republic of Tajikistan, NBT 2017. Recommendations 22 and 23.

⁴⁹ In a note to the World Bank dated April 2018, the National Bank of Tajikistan states that "... to ensure attractiveness, the ministry of finance needs to bring interest income of treasury bonds closer with that of the market."

government strategy explains that interest rate liberalization and the lengthening of government debt maturities would help diversify debt instruments and broaden the spectrum of debt, improve public debt sustainability, and reduce exchange rate risk. As a consequence, the consistency between fiscal policy on the one hand and an inflation target-based monetary policy on the other would improve significantly.

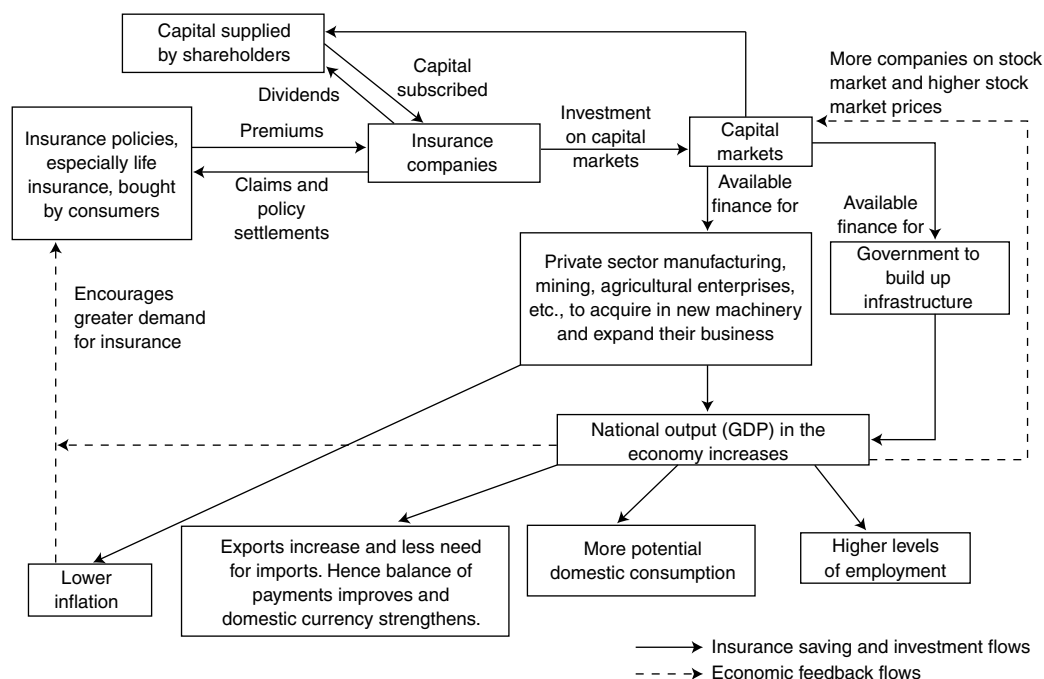
The corporate bond market is immature. A single corporate bond issued is listed on Tajikistan's stock exchange. It was issued in 2017 by a major bank, the Eshkhat bank, in the amount of 20 million somoni (about \$2 million) with a two-year maturity and a yield of 22 percent.⁵⁰ The issue was sold to local financial and non-financial investors and foreign investors.

The Insurance Market

Insurance markets play a significant role in attracting long-term savings in growing economies. However, this requires the provision of long-term savings products, principally in the life insurance sector. Such products support economic growth, not only by raising the rate of savings but also by facilitating the management of risks and, hence, expanding the production possibility frontier. Thus, they make activities possible that would be excluded on the grounds of risk, and they also stimulate the growth of other financial markets such as in corporate and government bonds where they can place their surplus and reserve funds, or the banking industry (Chart 1). Moreover, a growing insurance market is indicative of business climate conditions and public confidence in financial institutions.

Life insurance allows households to smooth consumption and commit to long-term savings, as well as address risks. The welfare effects of well-functioning insurance markets can be powerful even in low-income economies. The indemnification and risk pooling characteristics of commercial insurance make bank lending possible (insured against a variety of risks), as well as investments in a set of activities that would otherwise be considered too risky. Agriculture-related insurance, together with transport and carriage insurance, also expand the production and trading possibility curves. Life insurance entails long-term liabilities, and the

Chart 1. The Benefits of Insurance in Capital Market Development



Source: Dickinson (undated).

⁵⁰ The Eshkhat bank is known for publishing good quality financial statements and for being regularly rated on its credit.

insurance industry typically requires matching long-term assets in the form of long-term investments in infrastructure, plant and equipment, and government bonds and the like, which stimulate the corporate bond market. In low-income economies, in particular, there is a strong case for insuring the poor—who typically face catastrophic risks (death, disability, agricultural failures)—on social welfare grounds as the gap between the affordability of market-priced premiums and the social value of insurance may be too large.⁵¹ Here micro-insurance can play a welfare-boosting role in addressing the high costs associated with the small scale of transactions and informational requirements.

Developing a variety of saving instruments will be important. The design and sale of fairly simple life insurance/savings contracts in Tajikistan—held through regular (monthly) purchases—can drive the development of a large pool of savings instruments that can be deployed in support of long-term market development. In time, savings of this kind can also be used to stimulate the parallel growth of a private pension market. Public policy to stimulate the insurance market is necessary in two areas: (i) regulation and supervision; and (ii) taxation. As a long-term industry, insurance relies heavily on public confidence for success. A sound regulatory system that safeguards the solvency of companies with prudential regulation and the fullness and transparency of information disclosure and marketing, is essential. Regulation must provide for consumer choice and be flexible to allow companies latitude in their choice of investments. Tax incentives for individuals can play a significant role in encouraging long-term savings in insurance products. These typically take the form of tax-deductibility of insurance premiums or tax-free or low-tax treatment for the eventual proceeds of long-term savings.

Key reforms to invigorate the insurance market are still ahead. The insurance industry in Tajikistan is highly underdeveloped, with annual premium income in the \$10 million range, and where life insurance products constitute only 2 percent of the market. The industry has not expanded in line with GDP and suffers from diseconomies of scale. The main activity is in third-party car insurance. The insurance market is not competitive—two large state-owned firms enjoy privileges. Thus, there is a considerable need for market liberalization. The insurance law departs from good practices as given in the insurance core principles,⁵² principally by not enforcing competition and effective, independent supervision, and also through inadequacies in business conduct requirements and prudential requirements. The licensing process should be subject to appropriate regulation, which will add stability to the market that has seen frequent entries and exits, and which will help reap economies of scale. Market infrastructure needs strengthening in encouraging capacity in actuarial, underwriting, and loss adjusting skills, in establishing industry-wide databases, and in reforming tax treatment.

The prospects for the needed reforms in insurance supervision have improved considerably since the central bank was tasked with this responsibility in 2017. The central bank's leadership should help to ensure adequate resources for supervision, the development of modern prudential norms, legislative and regulatory changes to give effective powers to the supervisory authority, and a mandate that goes beyond prudential supervision toward market development. Importantly, the remit of microfinance organizations should be widened to encompass being agents for insurance products, a step that could revolutionize the distribution of such products. Moreover, the administration and management of small-size products in micro-insurance require new skills that microfinance organizations are best placed to supply.

The official financial development strategy provides for adopting the necessary amendments to the insurance legislation and to eliminate barriers that impede the development of the market.⁵³

The Housing Market

The housing finance system is a powerful booster of domestic savings by households and firms. In Tajikistan, demographic forces, as well as the trend toward urbanization, are expected to boost housing demand. An appropriate financial structure supporting the housing market will not only help to satisfy housing demand and stimulate the construction sector but will also be important in developing long-term capital markets.

⁵¹ See Brainard 2008.

⁵² See the website of the International Association of Insurance Supervisors at www.iaisweb.org.

⁵³ Republic of Tajikistan, NBT 2017. Recommendation 8.

The preconditions for a successful housing finance market are similar to those for any long-term financial transaction—enforceable property and collateral rights, comprehensive credit information, strong prudential supervision, diversified credit products, and professional market intermediaries. Mortgage issuing institutions typically sell long-term bonds to savers; these bonds are redeemed from the proceeds of regular (monthly) payments made by mortgage holders. Thus, mortgage markets stimulate savings by offering long-term savers an instrument priced by the market and by encouraging rising volumes of mortgage holders who gradually build equity in their property.

The mortgage market in Tajikistan exists in a rudimentary form, with some lending by banks. The mortgage law is antiquated. Impediments to the development of an active mortgage market are mainly related to collateral (property). The bank does not come into possession of the collateral for an extended period following the issuance of the mortgage as there is no provision or procedure for the simultaneous registration of the mortgage and the transfer of property to the borrower. Foreclosure cannot take place without the consent of the borrower, which is a serious problem. Weak procedures govern the transfer of property if a court orders a foreclosure. More generally, there appears to be insufficient financial literacy amongst notaries, lawyers, and judges on the obligations of the mortgage instrument. Reforms will need to address legislative gaps and establish an appropriate supervisory mechanism for housing finance—ideally in the central bank, possibly in a unit dealing with other long-term instruments such as insurance. Housing microfinance for self-building or self-repairing/rehabilitating or extending homes or small commercial properties holds promise and deserves further exploration by the microfinance industry supported by the international financial institutions.⁵⁴

Concluding Remarks

The persistence of severe weaknesses in the banking sector, the slowness and sub-optimality of resolution efforts, and delays in ensuring liquidity of deposits all hinder financial inclusion and will detract from confidence in banks as repositories of public savings. It will be necessary to build on steps already being taken to regain confidence.

Some ambitious preconditions must be fulfilled before long-term markets can emerge in Tajikistan. These conditions are well-known: a stable macroeconomic framework; a legal and institutional environment that protects investors and property, exercises the rule of law, and enforces contracts at low transaction costs; and supporting financial infrastructure for primary (debt-issuing) and secondary (trading) markets. The strategy for capital markets growth has to consider addressing the significant weaknesses in the doing business environment steadily over the medium term. Financial infrastructure is being strengthened in several areas with external assistance (as discussed earlier) and will need further development in the context of new long-term markets.

⁵⁴ IFC 2017.

TAX SYSTEM ASSESSMENT

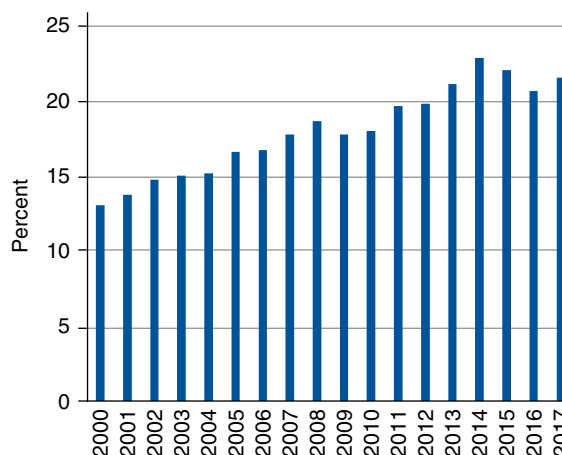
Introduction: Tajikistan's Revenue Performance

As discussed above, Tajikistan's fiscal space will remain strained by the need for fiscal consolidation in the context of accumulated public debt. However, spending pressures will persist and most likely will shift the focus from external borrowing to increased reliance on domestic resources. The country's macro-fiscal context suggests that domestic revenue mobilization will become one of the top policy priorities, not only for facilitating the required fiscal consolidation but also to ensure enough resources to address competing demands for public spending. However, the pressing needs to mobilize more domestic revenues should not undermine the private sector development agenda or the systematic improvement of the business environment.

Revenue performance has improved since 2000 (when the tax to GDP ratio stood at 13 percent). The tax effort has risen sharply since 2000, reaching 20 percent of GDP in 2011–12 and 23 percent in 2014; the tax to GDP ratio declined slightly in 2016–17 to just over 20 percent (Figure 48). Economic growth, as well as tax policy and administration changes, including the enactment of a new Tax Code in 2013, supported this gradual improvement in tax effort. Recent changes in tax administration include improvements in infrastructure for electronic filing of tax returns, the establishment of an appeal committee, streamlining of business registration processes, and so on. On the tax policy side, changes have included: (i) a reduction of the number of taxes (from 21 to 10); (ii) an increase in the value added tax (VAT) threshold (from an annual turnover of TJS 200,000 to TJS 500,000 in 2013, and further to TJS 1 million in 2017); (iii) a reduction of corporate income tax rates (from 15 and 25 percent in 2013⁵⁵ to 13 and 23 percent in 2017); and (iv) an extension of the road user tax through 2021. The revised Tax Code stipulated VAT and customs duty exemptions for imports of technology and equipment for agricultural use. Other changes pertain to the personal income tax brackets and improvements in the calculation methodology for social tax in 2013. A progressive tax scale, ranging from 7.5 to 15 percent, was introduced in 2017 for motor vehicles based on engine capacity.

At 22 percent of GDP, Tajikistan's total tax effort is in the range recorded by lower-middle-income

Figure 48. Tax to GDP Ratio



Source: Tax Committee of Tajikistan.

⁵⁵ The 15 percent tax rate applied to enterprises producing goods and the 25 percent rate to other types of activities.

countries (LMICs). However, it is insufficient to support Tajikistan's robust development agenda of poverty reduction, social service delivery, and infrastructure upgrade and expansion. There is a need, therefore, to stabilize the level of tax intake (which is, in turn, driven by the country's need to raise public spending). Prudent tax policy would support the dual goals of fostering a business and investment-friendly environment while, at the same time, strengthening tax policy and tax administration to capture additional revenue.

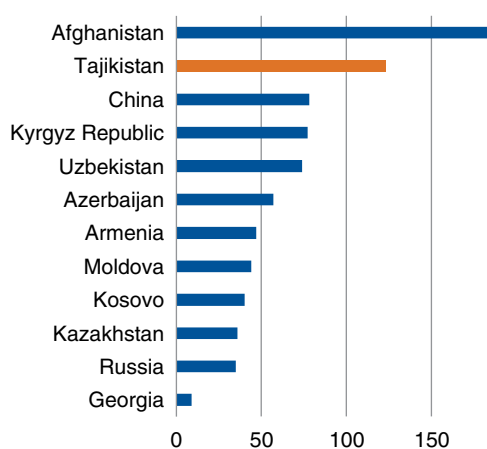
Taxation's Impact on the Investment Environment

According to private sector feedback, both tax policy and tax administration pose major obstacles to business development in Tajikistan. Massive tax exemptions favoring one group of taxpayers over others, ambiguities in tax legislation, frequent and lengthy tax audits, permanent requests for advance payments of taxes, and many other shortcomings and malpractices are challenges commonly faced by ordinary taxpayers.

Paying taxes in Tajikistan remains challenging. Tajikistan ranked 123 of 190 economies on the ease of doing business in the World Bank's 2018 Doing Business survey (Figure 49). Paying taxes is one of two Doing Business areas where Tajikistan lags behind (the other is getting electricity). On the paying taxes indicators, the country ranked 132 in 2018 (although improving from 140 in 2017), and on access to electricity it ranked 171. Tajikistan's distance to frontier (DTF) score for paying taxes in 2018 (Figure 50) ranks Tajikistan above Afghanistan and the Kyrgyz Republic, but well below the sample's best performer, Georgia. The ranking in paying taxes correlates closely with the overall ease of doing business indicator. A typical business incurs a high total effective tax burden and compliance costs that, in turn, lower the country's ranking on the composite ease of doing business score.⁵⁶ Within the peer sample, Tajikistan ranks second from the bottom, higher only than Afghanistan (which ranks 183 of 190 economies) on the ease of doing business ranking.

Medium-size companies face high tax burdens and compliance costs. Figure 51 presents a snapshot of the comparative tax burden across countries in the sample and the country-specific dynamics of the total tax rate between 2017 (the latest year for which data are available) and the five-year average (2013–17). In Tajikistan, even though the total tax rate has fallen rather substantially—from almost 75 percent to just above 65 percent during the last five years—it remains high. Compared with others in the sample, a representative medium-size

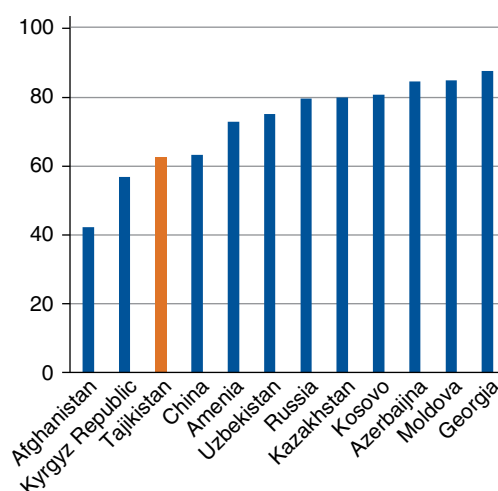
Figure 49. Ease of Doing Business Ranking, 2018



Source: World Bank 2018.

Note: An economy's distance to frontier illustrates the distance of an economy to the "frontier," which represents the best performance observed on each Doing Business topic across all economies and years included since 2005. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier.

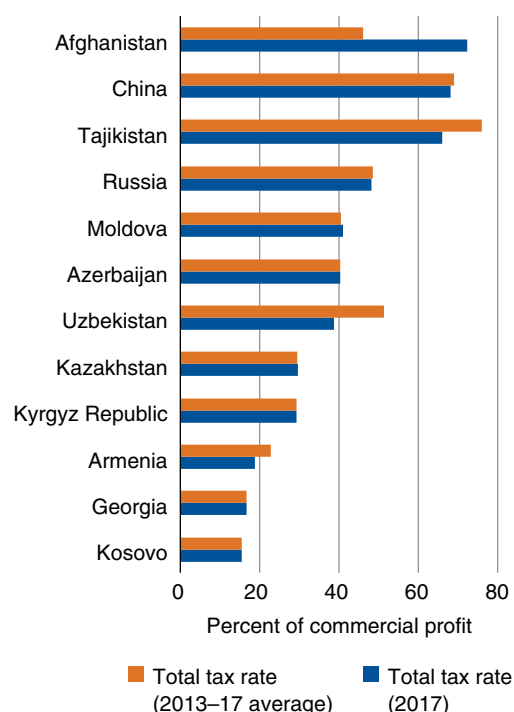
Figure 50. Paying Taxes (distance to frontier score for paying taxes, 2017)



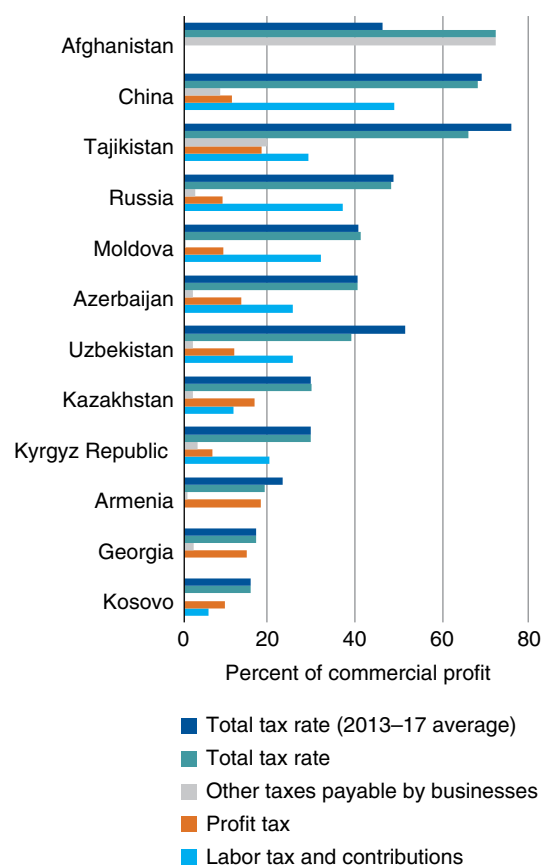
Source: World Bank 2018.

Note: An economy's distance to frontier illustrates the distance of an economy to the "frontier," which represents the best performance observed on each Doing Business topic across all economies and years included since 2005. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier.

⁵⁶ KPMG's Corporate Tax Survey: <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>

Figure 51. Total Tax Rates

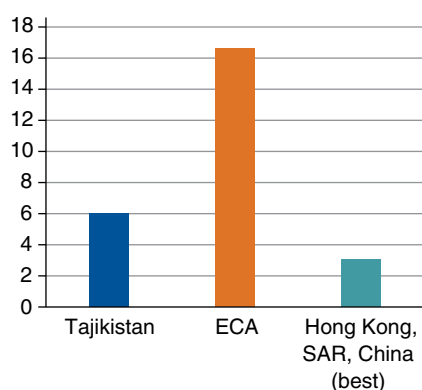
Sources: World Bank 2018c; World Bank staff estimates.

Figure 52. Cross-Country Comparison of Total Tax Rate and Structure, 2017

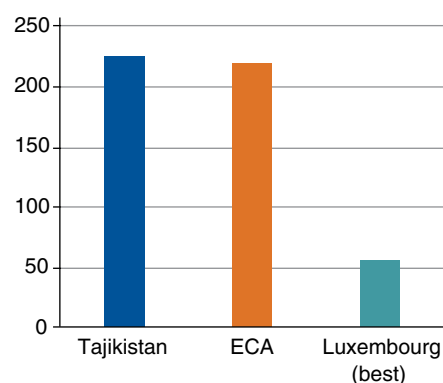
Sources: World Bank 2018c; World Bank staff estimates.

business in Tajikistan would have the third highest effective tax burden. The rate is much higher than in two neighboring countries (the Kyrgyz Republic at 29 percent, and Uzbekistan at 38 percent). Figures 51 and 52 show the detailed structure of the effective tax rate on commercial profits in 2017 and the comparison between the 2017 aggregate total tax rate and the five-year average (2013–17).

The number of tax payments and time to comply with all taxes in a year represent the cost of tax compliance. Tajikistan scores well in the number of payments category—just six tax payments are required, compared to the average of 16 in the ECA region (Figure 53). The figure is closer to the best performer, Hong Kong SAR, China (with three payments). It stands in contrast, however, to the indicator for time to comply (Figure 54). A

Figure 53. Number of Payments

Source: World Bank 2018c.

Figure 54. Time to Comply

Source: World Bank 2018c.

representative medium-size business in Tajikistan spends a total of 224 hours on average complying with tax obligations, well above both the ECA average (218 hours) and the best performer, Luxembourg (55 hours).

The tax structure explains the high cost and time of tax compliance. Businesses in Tajikistan are subject to an unduly high number of ‘minor’ taxes—that is, those taxes not captured in the major categories of labor and profit taxes⁵⁷—and this adds to their tax compliance burden. In 2017, minor taxes and fees accounted for an extraordinarily high share of taxes in Tajikistan (about 30 percent), well above Moldova (the lowest, at 1 percent) and neighboring economies (Uzbekistan at 5 percent; the Kyrgyz Republic at 11 percent; and China at 12 percent).⁵⁸

The Tajik authorities will need to address two complex challenges—closing the revenue gap and, at the same time, improving the business environment to foster private sector development. The next section of this chapter looks at various aspects of the tax structure in Tajikistan to assess its complexity as measured by tax rates and the tax base, as well as tax incentives and efficiency, and revenue losses caused by tax policy and administration gaps. It also reviews tax administration and revenue collection practices and its impact on the cost of compliance for businesses.

Revenue and Tax Policy Challenges in Tajikistan

Buoyancy and Elasticity of Tajikistan's Tax System

The concepts of buoyancy and elasticity are used globally to measure the performance of any tax system. Tax elasticity shows the tax system's response to the growth in the tax base even when the tax structure and tax rate do not change. That way, the tax system would be able to experience the same growth rate as GDP and keep the elements of progressivity. Tax buoyancy is an indicator that measures efficiency and responsiveness of revenue mobilization in response to growth in overall economic activity or national income, inclusive of any changes in the tax system. A tax is buoyant if tax revenues increase at least proportionately (or possibly more than proportionately) in response to a rise in the tax base, namely national income or output/GDP.

Tax elasticity is a better indicator of the robustness of the tax policy, as it reveals whether the tax bases have been appropriately selected and the tax rates rightly chosen and applied. It would have been preferable to estimate the elasticity of the various taxes, but this was not feasible due to lack of data, particularly information on discretionary changes. Therefore, tax buoyancies were computed as a second-best option. In the calculation of buoyancy, the impact of discretionary changes in tax bases and tax rates are automatically incorporated, and it masks whether the tax revenues would be automatically increasing at the same rate as the GDP growth rate, and the tax structure is inherently robust. Otherwise, the increases in revenues might simply be due to changes in the tax structure. To estimate tax elasticity, data on the revenue impact of discretionary changes are required so that the tax revenues could be suitably adjusted for these discretionary changes.

Computations show that the Tajik tax system is mostly buoyant (Table 8). Collections of corporate income tax (CIT), personal income tax (PIT), payroll taxes, and VAT increased faster than the GDP growth rate. The buoyancy of excises is less than 1. This might be explained by the fact that unit tax rates in some cases have not been automatically adjusted for inflation, leading to a declining effective tax rate over time. International

Table 8. Responsiveness/Buoyancy of Tax Revenues to GDP Growth in Tajikistan, 2000–16

	Total Revenue	CIT	PIT	Payroll Tax	VAT	Excises	Patent Fees	Simplified Taxes	International Trade
2000–16	1.14	1.42	1.23	1.17	1.30	0.97	–1.00	1.78	0.61

Source: World Bank staff calculations using data from Tax Committee of Tajikistan.

⁵⁷ Under the Doing Business methodology, the measurement of total taxes includes profit or corporate income tax, social contributions, and labor taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection taxes, vehicle and road taxes, and any other small taxes or fees.

⁵⁸ Minor taxes consist of all the tax obligations imposed on a business, except for those captured in the two main categories of labor and profit taxes.

tax buoyancy is also low at 0.61, and this reflects the fact that international taxes are declining in importance as a source of revenues. The buoyancy of patent fees is negative, which means that revenues are falling as GDP rises. As the number of taxpayers in the patent system is increasing, this suggests that while GDP is expanding, revenue collections from them are stationary or are declining, which is a negative dynamic. To get a clear picture of the patent system, ten-year data on the number of taxpayers and revenues collected from them would be necessary.⁵⁹

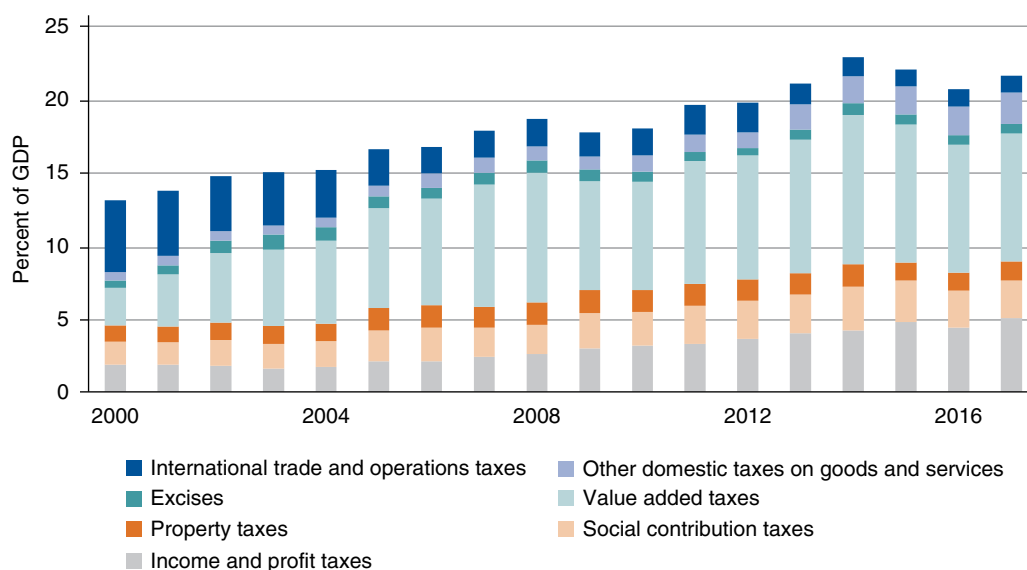
Assessment and Diagnostics of the Current Tax System

The new Tax Code enacted in Tajikistan in 2013 introduced improvements to the tax system. It reduced the number of taxes from 14 to 10 and classified all taxes and levies either as state or local. Under the 2013 tax legislation the main taxes applicable to individuals and investment activities are as follows: (i) corporate income tax; (ii) personal income tax; (iii) payroll-related tax (personal income and social tax); (iv) value added tax; (v) excise taxes; (vi) primary (aluminum and cotton) sales tax; (vii) road users tax; (viii) tax on natural resources; (ix) property and land taxes; and (x) tax withheld at the source of payment from incomes of non-residents (Figure 55 displays tax collection dynamics during 2000–17). The country also employs special tax regimes for small and micro enterprises (simplified) and for the agriculture sector (unified tax).

Despite recent changes, there are many gaps in the Tajik tax system which impose either policy-induced or administration-enforced barriers to private sector development. This chapter of the report discusses some of them and provides recommendations to address them based on the tax legislation and regulation review. It does not cover other factors—such as political economy aspects—affecting the country’s tax performance. A follow-up assessment of informality in Tajikistan will provide more in-depth analyses of the current tax system (which creates disincentives to formal operation).

There are frequent changes to tax policy provisions and tax administration rules which are not guided by a strategic vision. Moreover, tax policy changes are introduced without conducting economic and financial assessments justifying the policy move. Due attention should be paid to the revenue impact of any nontrivial measures. Second, tax assessments should be done at the disaggregated level by looking at revenue performance

Figure 55. Tax Collection Performance



Source: Tax Committee of Tajikistan.

⁵⁹ A similar study by the World Bank in Kazakhstan showed that while the number of taxpayers in the “Presumptive and Simplified Tax Regimes” was increasing every year, tax revenues were consistently declining. See Kostopoulos and Sarsenov (2017).

by economic subsector.⁶⁰ Taking the GDP breakdown by sectors and revenue collections by the same level of aggregation, estimates of buoyancy/elasticity by subsectors—rather than the aggregate level—will indicate where hidden tax revenues might be explored.

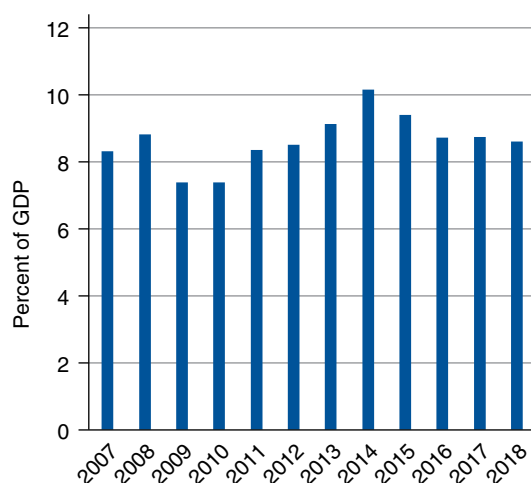
Value Added Tax

The value added tax (VAT) is the largest contributor to tax revenues in Tajikistan, generating more than 40 percent of total tax collections or almost 10 percent of GDP (Figure 56). The high share of VAT in fiscal revenues mirrors Tajikistan's current remittance-financed, import-reliant consumption pattern.

The definition of supplies subject to VAT and the scope of taxable value are appropriate; however, multiple rates for VAT deviate from good practice. The tax rate of 18 percent along with a zero rate is the correct structure of VAT. The zero percent rate applies to export of goods, except for the export of raw cotton, ginned cotton, cotton yarn, initial aluminum, jewel stones and jewelry, and products manufactured in Free Economic Zones (FEZs). The 18 percent rate applies to all other taxable sales of goods, works, and services in Tajikistan. However, in 2017, the VAT rate was lowered from 18 to 5 percent for construction companies, educational facilities, and public catering enterprises. There is a concern that more sectors may request VAT rate reductions, which stands in contrast to the established good practice of setting a single rate plus a zero rate.

The current VAT threshold is too high. With the intention of easing procedures for starting a business in Tajikistan, in 2017 the authorities doubled the VAT threshold (from TJS 500,000 to TJS 1,000,000). The new threshold is too high for the size of the Tajik economy (Table 9). Those VAT payers with a turnover of below TJS 1 million—and who are exempt from paying domestic VAT—switched to simplified tax payments following the reform. As a result, collections of both domestic VAT and simplified tax payments declined in 2017 (expectations of increased collections from the latter failed to materialize). Not allowing taxpayers whose firms fall below the new threshold to register voluntarily is not the right approach. Graduating from a special tax regime to VAT and vice versa is not a smooth process and needs reform. Once a taxpayer's monthly turnover

Figure 56. Value Added Tax Revenue



Source: Ministry of Finance of Tajikistan.

Table 9. VAT Thresholds in Select Economies

		LCU	US\$
Tajikistan	TJS	1,000,000	105,263
Belgium	Euro	25,000	30,023
China	CNY	30,000	4,610
Estonia	Euro	40,000	48,036
Germany	Euro	17,500	21,016
Greece	Euro	0	0
Latvia	Euro	40,000	48,036
Lithuania	Euro	45,000	54,041
Portugal	Euro	12,500	15,011
Singapore	SGD	1,000,000	747,887
Spain	Euro	0	0
Switzerland	CHF	100,000	102,511.53
United Kingdom	GBP	85,000	114,673.50

Source: <https://www.avalara.com/vatlive/en/eu-vat-rules/eu-vat-number-registration/vat-registration-threshold.html>

⁶⁰ Considered subsectors should reflect those of national GDP, typically: (1) agriculture/forestry/fishing; (2) mining and quarrying; (3) manufacturing; (4) electricity, gas, and air-conditioning supply; (5) water supply, sewage waste management; (6) construction; (7) trade and repair; (8) transportation; (9) accommodation and food services; (10) information and communication; (11) financial and insurance; (12) real estate; (13) professional, scientific, and technical activities; (14) education; (15) human health and social work activities; (16) arts, entertainment, and recreation; and (17) other service activities.

exceeds TJS 1 million, it must remain classified as subject to VAT for the next three years, even if its turnover falls below TJS 1 million in a subsequent reporting period.

Zero-rated goods and services are limited to the export of goods, except for the export of raw cotton, ginned cotton, cotton yarn, primary aluminum, jewel stones and jewelry, and products manufactured in Free Economic Zones (FEZs). Normally all exports should be zero-rated, but excluding raw and ginned cotton and cotton yarn along with aluminum, jewel stones and jewelry, and exempting them instead seems to be motivated by the desire to at least partially tax the rents accruing to these sectors. However, this leaves an element of tax in export prices, negatively affecting the export competitiveness of these goods. Also, some of these exemptions appear to be motivated by fear of VAT refund fraud. There is a clear need to strengthen both the VAT administration and the VAT refund system. The rationale for not zero-rating goods manufactured in FEZs, however, is unclear as those are similar to other goods produced and exported in the economy.

Tajikistan's VAT regime grants a wide range of exemptions. Policy makers in Tajikistan introduce exemptions with the intention of providing tax relief to certain commodities or services consumed mostly by disadvantaged groups of taxpayers (goods for disabled people, for example) or those considered as merit goods (education); or to simplify the administration of hard-to-tax sectors (financial services). Theoretically and practically, widespread application of exemptions tends to break the VAT chain and hence compromises both the efficiency and equity of the tax system. Two adverse impacts of exemptions are worth noting:

- First, the ultimate intended impact of tax relief on revenues may be ambiguous—this is the case when exemptions are applied to either the first or intermediary stages of the production-distribution chain. In the first case, taxes in the entire chain remain the same; in the second case, taxes rise due to a ‘cascading effect’.⁶¹
- Second, production efficiency can be reduced—VAT exemptions can make the cost of domestically produced intermediate inputs higher than the cost of imported ones. A better approach might be to tax these imports normally and then automatically credit the taxes when the final product is sold. Exempting some imports (for investment projects, important objects, domestic agricultural producers, primary aluminum, and so on) may also create a misclassification problem.

The list of exempt goods and services needs to be reviewed and thoroughly scrutinized. While most exemptions are justified—such as for financial services,⁶² religious services, works and services of humanitarian aid, and medical services provided by state organizations—others may need to be revisited and reassessed. For example, instead of a blanket exemption for the supply and leasing of real estate, only the leasing/letting of noncommercial immovable property should be exempt, but commercial real estate transactions should be taxed. Even in the area of financial services, fee and commission-based services (insurance brokerage, for example) should be subject to VAT. In education, due to the existence of substantial externalities in the sector, the standard policy and practice is to exempt basic education services and tax higher (tertiary) and more specialized professional education and training provided on a commercial basis by the private sector and the state. As Tajikistan is a developing and transition economy, exempting all education supplied by the state may be an acceptable policy in the short to medium term. Basic education up to the secondary level should be exempt even if provided by the private sector; however, the law currently exempts only state-provided education. Since all education offered by the state is exempt, the same provisions should also apply to the private sector to level the playing field. Similarly, for health services and pharmaceuticals, the best practice is to exempt basic health services (typically including the professional services of doctors and dentists, and the supply of prescribed medicines) while specialized health care may be taxed, irrespective of whether these services are provided by the state or the private sector. Medical services supplied by the state organizations (except for

⁶¹ Some imported materials used in construction or the production of other goods are exempt with the objective of providing relief to these sectors.

⁶² According to the official notification the list of exempt services is restricted to (i) operations related to borrowings; (ii) management of deposits, settlements, and performance of other debt obligations; (iii) transactions related to the circulation of currency, money, and banknotes, the execution of forward contracts, options, and agreements for other derivative and financial instruments; (iv) services related to the management of investment funds; and (v) insurance and reinsurance operations. The list of exempt services does not appear to include fee-based financial services (which is the best approach to follow).

services in cosmetology, dentistry, and health resorts) are exempt (approximate the best practices). However, there is no mention in the law concerning the VAT treatment of services provided by the private sector; this should be scrutinized.

The administration of VAT refunds needs to be fundamentally changed. The VAT refund is a core component of a sound VAT system, and its implementation requires both a sound tax administration and good compliance practices. The government should review the existing policy and put a system in place where VAT refunds are the norm and not an exception. The government may, of course, mandate a waiting period of two to three months for processing refund requests and establish a ceiling below which refunds will not be processed (it should provide for offsetting the refund amount against other tax liabilities). Ideally, the law should treat delays on the part of either party in a similar manner. If the taxpayer is late in making a tax payment, she is subject to an interest penalty on the tax amount. Similarly, if the refund is delayed by the government, the taxpayer should receive interest on the refund amount. Currently, gross VAT receipts are accounted for as revenue in the budget and refunds are considered expenditures. In principle, qualified exporters are owed a VAT refund if input VAT exceeds assessed VAT. Other refunds are hard to get, including VAT paid on capital goods. Total spending on VAT refunds was modest in 2014–17—TJS 24 million in 2014; TJS 20 million in 2015; TJS 18 million in 2016; and TJS 18 million in 2017. Notably, around 50 percent of these amounts were made to embassies and tax-exempt international organizations. An improved VAT refund system needs to be put in place. The current system is characterized by a fear of refund fraud and weak capacity within the tax administration to audit businesses and deter malpractice. The audit system can be strengthened by assigning VAT audits to a separate unit within the audit department. Box 5 presents some international good practices in VAT refunds.

Box 5. International Good Practice in VAT Refunds

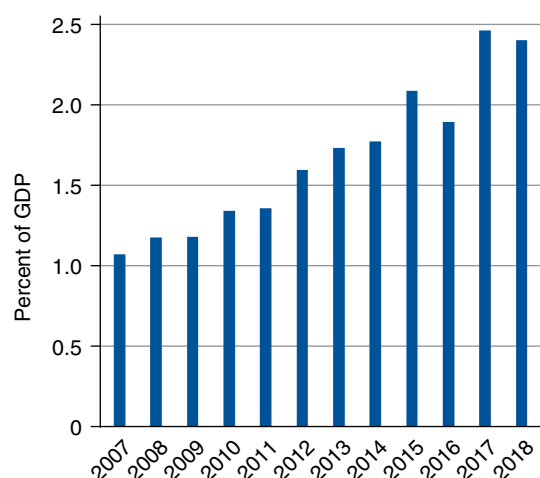
Most advanced tax administrations have budgetary resources allocated for VAT refunds. The accounting of VAT revenue is based on a net of refund basis (the budget would record VAT revenues as gross VAT-estimated refunds). These tax administrations develop efficient and effective risk-based mechanisms to administer VAT refunds. One proven approach is to establish a “gold-silver” scheme, in which refund claimants are grouped into categories—“gold,” “silver,” or “other”—with those in the gold category assigned the lowest level of risk (and therefore able to receive their refunds fastest); the VAT refund claims of those categorized as “others” undergo the most scrutiny. The risk criteria for such groupings can be based on factors such as the claimant’s history of exports, bookkeeping, tax compliance, and a tax records audit by tax officials.

Corporate Income Tax

Corporate income tax (CIT) is the second-largest contributor to total tax revenues in Tajikistan (Figure 57). CIT accounted for around 22 percent of tax collections in 2016–17 (about 4–5 percent of GDP). All Tajik legal entities are subject to CIT unless they meet the conditions of special tax regimes. Tajik resident entities are taxed on their worldwide income, while nonresidents are subject to CIT only on Tajikistan-sourced income. Nonresidents operating through a permanent establishment (PE) are generally subject to the same CIT provisions. Taxable income is defined as the difference between gross income and allowed exemptions and deductions. Professional participants who carry out activity on the Tajikistan stock exchange are exempt from income tax. The tax base is broad as it includes incomes both from sales income and non-sales income. The sales income comprises total proceeds from the sale of goods, works, services, and property rights, while non-sales income includes goods, works, services, and property rights received free of charge. The tax base is defined separately for each type of income for which different tax rates are set. Property and goods received by nonprofit entities and used for noncommercial purposes are excluded from taxable income.

Tajikistan’s CIT structure is sound; however, some changes are advised to improve its administration and align tax provisions with international good practices. Instead of a dual rate system—applying a lower (13 percent) rate for goods and a higher rate (23 percent) for services⁶³—it is advisable to apply a single tax

⁶³ The 17 percent average CIT rate is calculated by taking the weights of goods and services.

Figure 57. Corporate Income Tax Revenue

Source: Ministry of Finance of Tajikistan.

Table 10. Profit Tax Rates in the Region (in percent)

Corporate Tax Rates	2017
Armenia	20
Azerbaijan	20
Kazakhstan	20
Kyrgyzstan	10
Uzbekistan	7.5
Turkmenistan	8/20
Moldova	12

Source: National agencies.

rate on all goods and services. Considering the tax regimes of Tajikistan's neighbors (Table 10), a CIT rate of 20 percent is advised. Corporate income tax applies to the market surplus above normal profits, and there is no justification for differentiating between market surpluses across different sectors. Multiple rates also increase administration and compliance costs. A rate of 20 percent would be very competitive—the numerous tax incentives discussed below may be rationalized because a low rate of 20 percent is a major incentive in itself. A current shortcoming of the CIT administration in Tajikistan is the collection of a minimum corporate tax (1 percent of a company's annual turnover) from legal entities which is applied even if the company ended the financial year with losses. This practice represents a serious impediment to private sector development in Tajikistan.

The loss carryforward rule in Tajikistan is restrictive for businesses as the three-year period is too short. It should be extended to a period between five to seven years. There is no loss carryback. Losses from the sale of property (except property used in business activities or tax-exempt property) are carried forward separately from tax losses from regular activities and can be offset only against profit from similar activities. The rules on loss carryforward vary widely across countries and, in some developing economies, loss carryforward is permitted indefinitely. An indefinite loss carryforward rule would be excessive in Tajikistan and may send the wrong signals to firms. Five to seven years is a reasonable period for firms to offset their losses.

The Tax Code does not explicitly contain transfer pricing (TP) rules, which are important for a country with a large mining sector. However, Article 24 of the Code includes specific requirements on the definition of the market price of transactions. Generally, transfer pricing rules under the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines are applied as needed. According to the categories addressing related parties, the ownership of more than 20 percent constitutes the main criteria for the recognition of a related party. A court can recognize parties as being related on grounds not specified in the law, for example if the relationship between the parties has an impact on a transaction. If it is established that the taxpayer's price differs from the market price, the tax authorities have the right to assess additional tax liabilities, late payment interest, and penalties, based on an amount equal to the market price. Tajikistan uses methodologies similar to the OECD guidelines to determine arm's length prices including: (i) the comparable uncontrolled price method; (ii) the resale price method; and (iii) the cost-plus method. The law provides detailed guidelines on how to apply each method. Preference is given to the first method, while the other two methods may be used only in the absence of information about prices in the relevant markets. The burden of proof that prices do not meet the arm's length principle falls on the tax authorities.

Tajikistan should also strengthen taxation of income earned by foreign entities and establish a separate unit in the Tax Committee for administering transfer pricing rules and base erosion and profit shifting

(BEPS) practices. The latter can be tasked with reviewing whether the transactions are at market price or not between two unrelated parties in the international market. Market prices may be inferred from arms-length prices or prices charged by unrelated parties. Given the complexities of TP and BEPS practices around the globe, the dedicated TC unit should be adequately staffed and trained. While Tajikistan aims to attract FDI and multinational companies, it should ensure that the tax authorities will be able to capture the country's due share of fiscal revenues.

Personal Income Tax

The tax base for Personal Income Tax (PIT) is comprehensive and includes all kinds of incomes including dividends, capital gains, and in-kind income (Figure 58).⁶⁴ The exemptions and deductions are appropriate, but the tax structure needs to be revisited. The basic exemption (non-taxable threshold) is at TJS 50 (\$5.60) per month. The next bracket, between TJS 50 and TJS 140, (\$6–15.8) is taxed at a rate of 8 percent; “excess income” above TJS 140 is taxed at 13 percent. All monthly income over TJS 140 is therefore taxed at the top marginal rate of 13 percent. The monthly minimum wage in Tajikistan is TJS 400 (\$45) without any fringe benefits. Few workers fall into the 0 percent tax bracket or even the 8 percent bracket—these adjustments represent lump-sum reductions in tax payments for almost all taxpayers. The effective tax rate is, therefore, 13 percent for the majority of taxpayers.

There is a need to introduce realistic progressivity in the tax structure by raising the basic exemption from the current TJS 50 and expanding the income range of the 8 percent tax bracket. Furthermore, there is scope for increasing the top PIT rate of 13 percent to approximate with the corporate income tax rate of about 20 percent. Keeping the highest personal income tax at the same level as the corporate income tax rate is good practice, as this fosters parity between the taxation of labor and capital. Together with an increase in the basic exemption and the expansion of the 8 percent bracket, this would improve the fairness of the tax system and help to generate more revenues. However, any change to the personal income tax rate should be discussed in the context of the overall tax burden on labor, including the social tax; the combined PIT and social tax rate seem burdensome in Tajikistan. As part of a labor tax reform, the authorities may consider consolidating PIT and social tax as a single tax with a more progressive structure. Following the current international trend, Tajikistan may also consider aligning the tax rates for residents and nonresidents and bringing both rates to 20 percent.

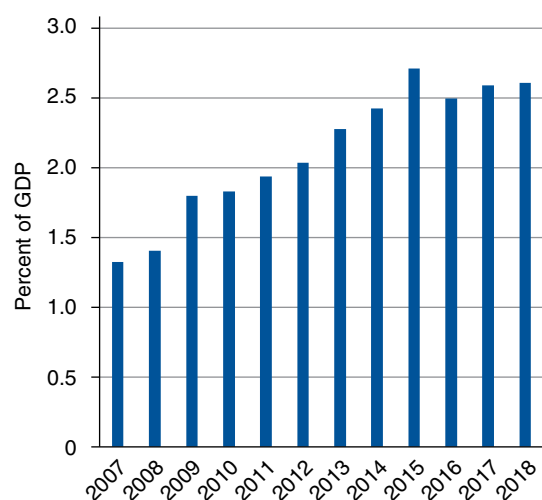
Social Taxes

The social tax, the third largest source of tax revenues, is important as a social security safety net (Figure 59). However, the social contributions—at 25 percent for employers and 1 percent for employees and individual entrepreneurs—appear to be on the high side and could be a significant deterrent to job creation given the high tax rates, particularly for low-earning jobs. A reduction in the rate is hard to justify without analysis of the link between the social contributions and social benefits. One suggestion has been made to allow a basic deduction equal to the minimum wage, particularly for low-wage jobs. Another option could be to review the current rates in the context of the overall pension system.

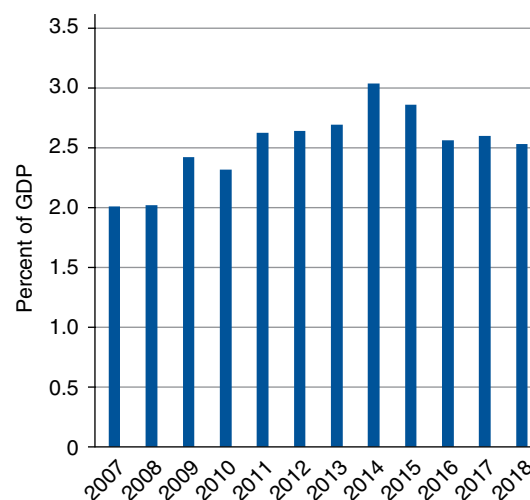
Collections of this tax have declined slightly since the introduction of the new Tax Code in 2013. From 3 percent of GDP in 2014, social tax revenue fell to 2.8 and 2.5 percent in 2015 and 2016, respectively (Figure 59).⁶⁵ Before 2013, the base for the social tax was the regional average salary reported by the statistics office. However, using average salaries was an inappropriate concession that introduced serious inefficiencies and inequities into the taxation of wages at the lower end of the salary distribution. Since 2013, the base for the social tax has been the actual salary; this has encouraged intentional wage underreporting in financial reports. The social tax is important, not only from a fiscal point of view but also from the perspective of its impact on

⁶⁴ In the PIT section, the U.S. dollar figures are based on the exchange rate as of April 29, 2018.

⁶⁵ This is due to the changes in the methodology for selecting the base for the social tax introduced in line with the recommendations of international financial institutions (IFIs) when revising the Tax Code.

Figure 58. Personal Income Tax Revenue

Source: Ministry of Finance of Tajikistan.

Figure 59. Social Tax Revenue

Source: Ministry of Finance of Tajikistan.

the business environment and the social security it provides. These aspects need to be reviewed carefully and comprehensively during the redesign of social taxes.

Excise Tax

Excise tax is payable by companies and individual entrepreneurs manufacturing or importing excisable goods into Tajikistan, as well as carrying out some types of communication services.

The excise tax base is broad, covering alcoholic drinks, tobacco products, transport-related vehicles and fuel, telecommunication services, and some luxury goods. The tax rates are both ad valorem and specific. The advantage of specific tax rates is that these can target the potentially harmful contents in particular products such as cigarettes (nicotine), alcoholic beverages, and pollutants in fuels which can also create negative externalities in the economy.

However, over time specific tax rates lose value with inflation which dilutes their effectiveness and leads to revenue losses in real terms. The tax rates should be indexed to adjust for inflation; otherwise, over time, real revenues will decline. In Tajikistan, specific tax rates may be adjusted periodically, but the tax legislation lacks a provision for the automatic indexation of tax rates. Currently, indexation is based on prices in euros which leads to currency asymmetry as the tax is paid in somoni. Despite a recent increase in excise taxes on tobacco products, these rates are still the lowest in Tajikistan compared to its regional neighbors (Table 11). This leads to concerns on both the fiscal side (potential revenue losses) and on the public health side (affordability remains high).

Table 11. Excise Tax Rates and Cigarette Prices (January 2018)

	Specific Excise Rate per 1,000 Cigarettes		Ad Valorem Excise, %	VAT, %	Price of a 20 Cigarettes Pack of Winston Blue		Price Components (euro)		
	National Currency	Euro			National Currency	Euro	Excise	VAT	Net of Taxes
Tajikistan	11	1.0	0	18	6.5	0.60	0.02	0.09	0.49
Kazakhstan	7,500	18.8	0	12	350	0.88	0.38	0.09	0.41
Kyrgyzstan	1,250	14.7	0	12	60	0.71	0.29	0.08	0.34
Russia	2,123	30.3	14.5	18	125	1.79	0.61	0.27	0.91
Uzbekistan	84,222	8.5–16 (import)	0	20	9,000	0.90	0.32	0.15	0.43

Source: World Bank staff calculations based on Eurasian statistics.

Another general concern with excise tax rates is to ensure that the combined indirect tax rate from VAT and excises is not above the maximum revenue yielding rate unless the objective is to reduce consumption of items such as tobacco and alcohol. The more price responsive the demand of consumers is for a product, the more the tax base shrinks as the excise rate is raised; revenues can start to fall if the rate is raised too high. The revenue maximizing rate for each product can be calculated in precise terms by optimizing the total tax revenue expression with respect to the ad valorem tax rate.

Sales Tax (ginned cotton and aluminum)

Sales tax is applicable to certain transactions involving ginned cotton and aluminum. Currently, only taxpayers that are engaged in the supply, import, and export of aluminum—as well as the legal entities and individuals carrying out the processing of these goods—are subject to sales tax. A 10 percent export tax replaced the sales tax on cotton in 2016. With the elimination of the sales tax on cotton, domestic cotton producers are now subject to VAT treatment. Only cotton fiber exports are subject to the 10 percent sales tax rate. Thus, the elimination of domestic sales tax implies lower input costs (cotton in this case) for the textile industry which will export processed products (yarn, for example) not subject to taxation.

This is an asymmetric provision of the law that disfavors taxpayers in this sector. There is no rationale for keeping Retail Sales Tax (RST) for aluminum while implementing a general credit method VAT. Replacing RST with a regular VAT should be revenue neutral. On the other hand, the introduction of a sales tax on cotton exports is a disincentive to selling raw commodities abroad, as the tax raises the price (making it less competitive in international markets). The exporter will suffer owing to the profit margin reduction. The taxable base is the cost of realized and processed taxable goods, which is calculated based on prices of taxable goods set at the London Non-Ferrous Metal Exchange taking into account the quality of the goods. The sales tax rate is 3 percent for aluminum. Ginned cotton and aluminum are exempt from VAT. The taxpayers reselling the taxable goods after processing are entitled to offset the sales tax paid upon purchase of these goods. If the difference between the amount of VAT payable (upon supplying processed products to the domestic market) and the relevant amount of sales tax is negative, no sales tax refund is made. This difference is, however, payable to the government. The sales tax amount shall not be credited toward payable VAT when exporting processed products.

Road Users Tax

All taxpayers in Tajikistan subject to taxation under the general tax system are liable to pay the road users tax (RUT). Religious, noncommercial organizations, as well as government organizations, are exempt from the road tax. The road usage tax base includes taxpayers' total expenses. If total actual expenses are less than 70 percent of gross revenue, the road tax is applied to the tax base that equals 70 percent of gross revenue. Expenses such as the cost of construction, purchase of fixed assets, and other capital expenses are excluded from the tax base. Since 2015 the road usage tax rates are 0.25 percent for trade, procurement activities, and supply and sales agency, and 1 percent for other activities.

The road user tax is an extremely regressive and particularly distorting tax. The rationale for the tax was that due to accounting deficiencies, the RUT could act as a useful check on spending when calculating the profits tax. As a cascading tax, its burden increases with more transactions in the value chain. It also is a strain on exports, reducing the competitiveness of Tajik companies. This tax is in place to secure tax revenue collections. Initially, the tax code envisaged that the tax would be abolished on January 1, 2017. However, this deadline has been extended until 2021 over concerns that its abolition would result in revenue losses.

Special Tax Regimes

Special tax regimes have been put in place with the dual purpose of bringing small and micro traders and agricultural farmers into the tax net and, at the same time, making it easy for them to comply. However, once taxpayers are in this category, there is a tendency to remain and not return to the regular tax regime. Current provisions do not include a sunset clause for remaining in the simplified tax system nor any incentives to move

to the regular tax regime. The lack of a sound VAT refund system creates another major disincentive to doing so. If large taxpayers decide to shield themselves within these regimes, they can stay there indefinitely while competing with entrepreneurs, adversely affecting the business environment both for domestic and foreign investors. Regular taxpayers, whether domestic or foreign, will face unfair competition. Part 3 of Article 291 of the Tax Code regulates the transition from the general tax regime to the simplified one and back.

Preferential Tax Regimes

The Tax Code envisages preferential tax regimes with additional tax concessions provided to taxpayers investing in priority sectors of the economy. This category includes the taxation of the following activities:

- i. Hydropower station construction
- ii. Newly established enterprises involved in the processing of cotton fiber in finished products
- iii. Poultry farms and bird and animal feed producers
- iv. Tourism sector
- v. Securities market participants
- vi. Production-sharing agreements/contracts
- vii. Free Economic Zones (Box 6)

Box 6. Tajikistan's Free Economic Zones

Four Free Economic Zones (FEZ)—in Sughd, Panj, Ishkoshim, and Dangara—were established by the government of Tajikistan to offer reduced taxes and customs fees to both foreign and domestic businesses with operations in these zones. The legislation governing FEZs has been modified several times, but current law requires a minimum investment of \$500,000 for manufacturing companies, \$50,000 for trading companies, and \$10,000 for consulting and services companies to be eligible for preferential tax treatment. Presently, there are eight small, two medium, and three foreign firms operating at the FEZ in Sughd; six small, fifteen medium, and one large firm operating at Dangara; no firms in Ishkoshim; and one small, three medium, two foreign firms, and one individual entrepreneur operating at the Panj FEZ.

Tax incentives alone cannot attract investment. Sound infrastructure and sensible regulations are more important than tax incentives in the long run. According to the International Finance Corporation (IFC), Tajikistan's slow progress in expanding investment in its free economic zones is also the result of the requirements imposed on firms seeking to operate in them.

Tajikistan's FEZs have had limited success in promoting new industries. Until recently, the FEZs did not meet established requirements. For example, the sites lacked adequate physical boundaries (fencing), and customs clearance was unavailable for imports and exports. Furthermore, FEZ operators continue to carry out business activities both inside and outside the zones. Other issues include the following:

- Industrial sites are not adequately prepared; there is no good supply of electricity, water; the roads are poor and transportation is lacking.
- The majority of activities are oriented to processing products and imports to Tajikistan, not for export; they are therefore subject to import taxes and duties and cannot exploit the real tax benefits of a FEZ.
- Large investors are not attracted to the FEZs because Tajikistan's domestic market is small (except for Chinese operations in the Dangara FEZ, which are focused on processing oil extracted in Tajikistan and exporting products to Afghanistan).
- The FEZs are not profitable for domestic investors because customs and tax authorities tightly control activities. The control is simple and easy at the border of the FEZ, but tax control is relatively lax elsewhere in Tajikistan.
- At the equivalent of \$500,000, the minimum investment requirement for production activities is high.
- At least 90 percent of production and technological equipment must be imported.
- The age of imported production and technological equipment should not exceed three years.
- Investments for export-import activities should not be less than the equivalent of \$50,000.
- Investments for the provision of services should be at least equivalent to \$10,000.
- Production of products must commence no later than three years from the date of state registration.

To promote the further industrialization of FEZs and foster transparency, the authorities should publicize the benefits provided, including the specific entitlements and the list of beneficiaries for these different types of preferential tax regimes through its website and other means of communication.

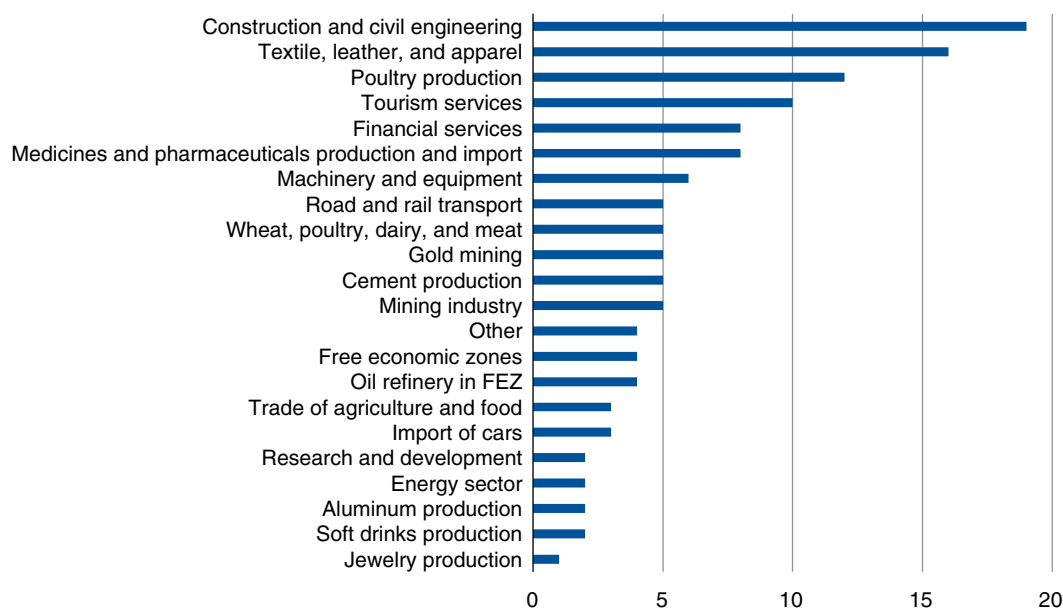
Investment Incentives in Tajikistan⁶⁶

Investment incentives in Tajikistan are used as a main policy instrument to promote industrialization and economic development by attempting to attract investors, develop domestic production, and stimulate economic activity in the priority sectors of the economy.⁶⁷ The fiscal incentives include tax and customs concessions, while the non-fiscal incentives comprise financial (provision of soft loans, subsidies to agro-industrial producers, permission to engage foreign workers beyond prescribed quota) and regulatory incentives (provision of specialized services and any other types of public support). According to the December 2016 State of the Union Address, incentives totaling 20 billion somoni (for the previous six years), and 4 billion somoni for 2016 alone, were granted for facilities construction and the import of the latest equipment and technology.

The majority of incentives are sector specific instead of general.⁶⁸ The government provides numerous incentive schemes (direct financial and fiscal incentives, excluding regulatory concessions or subsidized use of infrastructure) both to state-owned and private sector firms engaged across various economic activities in the manufacturing and services sectors (Figure 60).⁶⁹ Two-thirds of incentives are available in manufacturing and one-third in services; only 8 percent of incentives are cross-cutting while 92 percent are sector-specific. More than 30 types of new tax exemptions were introduced in 2018 increasing the number of incentives from 61 to 97 during the 2014–18, period and covering the import of new technology for the pharmaceutical industry, medical diagnostics, and technology for the production of poultry feed and new automobiles.⁷⁰

The concentration of tax preferences within economic activities has increased over time (Figure 61). Information provided by the Tax Service as of July 2017 shows that tax expenditures for Corporate Income Tax

Figure 60. Number of Investment Incentives by Sectors



Source: World Bank's Markets and Competition Policy Team's analysis based on IFC incentives database (2018) and investment agreements.

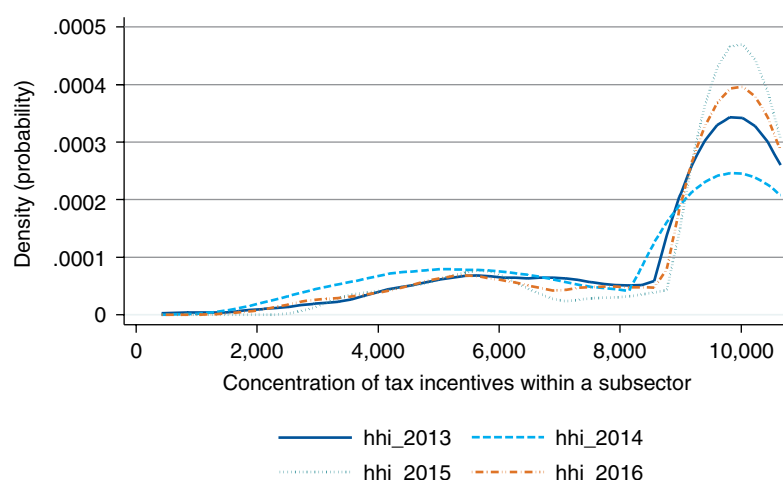
⁶⁶ See also section on investment incentives and competition in Ch. 4, page 66.

⁶⁷ As evident from an analysis of the following strategic documents: National Development Strategy 2016–30, Medium-Term Development Strategy 2016–20, Budget Law, and Annual State of the Union Address to Parliament.

⁶⁸ As revealed through analysis of an updated incentives database (IFC, March 2018, Investment Agreements, State Budget Law 2016–18).

⁶⁹ The following sectors are cited as beneficiaries of such preferences: modernization of aircrafts; international airports; railways operated by the national state-owned companies; textile manufacturing; local food production including poultry and dairy; cattle breeding; agro-processing; domestic cotton processing and textile production; local cement; construction materials; construction services; mining and subsoil exploration; and financial services.

⁷⁰ <https://news.tj/ru/news/tajikistan/economic/20180208/biznesu-predostavyat-bolee-30-nalogovih-preferentsii-byudzheta-nedopoluchit-150-millionov-somoni>

Figure 61. Concentration of Tax Preferences within Economic Activity, 2013–16 (kernel distribution across sectors)

Source: World Bank staff calculations.

Note: Concentration calculated using the Herfindahl-Hirshman Index formula for 70 economic activities according to Tajikistan's sector classification. Estimations based on tax expenditures for CIT, RUT, SFT, and SPT provided by the Tax Service.

(CIT), Road User Tax (RUT), Social Protection Fund Tax (SPT), and simplified regime for small enterprises (SFT) became more concentrated within economic activity in 2015 and 2016 compared to 2013 and 2014. A recent IFC study on investment incentives in Tajikistan finds that a small number of firms absorb most of the total tax expenditure for CIT in agriculture (four firms), construction (nine firms), and basic metals (one firm).⁷¹ This would be the result of more selectivity in the granting of incentives.

Tax exemptions for select firms, mostly SOEs and SUEs, are specified in the annual Budget Law.⁷² From the analysis over the last three years, it is evident that such exemptions are multiple, often repetitive over the years, and granted for extended periods. SOEs that benefit from tax exemptions include the Dushanbe municipality and Tajik Railways. Furthermore, selected foreign construction firms are granted exemptions, as well as the contractor for the National Theater. As per the database on CIT, RUT, SPT, and SFT, the bulk of tax exemptions by monetary value are granted to the construction sector.

Different government agencies grant investment incentives without a systematic cost-benefit analysis.⁷³ Most investment incentives (64%) are provided at the discretion of state authorities.⁷⁴ International good practice is that a single entity in the government awards incentives, and the Ministry of Finance is best suited for this task. Other agencies should send their recommendations to the ministry. Currently, the Antimonopoly Service (AMS) is mandated with reviewing the preferences granted to firms to prevent distortions on competition and the level playing field, but state aid control is currently not enforced in practice (see Ch. 4, page 68 for more details). Also, incentives should only be applied based on prescribed and reasonably justified grounds. Otherwise, in the absence of transparent and clear eligibility criteria, incentives tend to be awarded at the discretion of government bodies and encourage arbitrary interpretation of the statutory provisions; such discretionary incentives are often suboptimal. Also, investment incentives are more effective if information about incentives and their eligibility criteria is well publicized. Information on most investment incentives is published on official websites. However, these publications are mostly in the form of regulatory legal texts in the local language—not in a user-friendly format to make it easier for investors, particularly for foreign investors—and

⁷¹ IFC (2018), Tajikistan Incentives Report.

⁷² Budget Laws for 2016, 2017, and 2018 are posted at <http://minfin.tj/downloads/zakon01032016.pdf>, http://base.spininform.ru/show_doc.fwx?rgn=91678 and http://base.spininform.ru/show_doc.fwx?rgn=102479

⁷³ Of 97 investment incentives, 51 were awarded by the Tax Committee, 24 by Customs Services, seven by the State Committee on Investment and State Property Management, two by the Ministry of Economic Development and Trade, four directly by the Government of Tajikistan (GoT), one by the Fund for Support of Entrepreneurship, one by the Ministry of Agriculture, and seven by the Committee for Tourism Development.

⁷⁴ “Discretion” in this context means the right of a state body to decide, on its own account and within the limits prescribed by the law, whether an incentive is to be given or withheld.

usually lack information on benefits, including the number and amounts of additional investment or revenues foregone due to these incentives.

Investment incentives are not a determining factor in investment decisions. International experience shows that investors are primarily guided by factors such as investment guarantees, natural resource availability, the possibility of acquiring the title to immovable property, and the terms of taxation, particularly the stability of the tax system. Exemptions often result in fiscal losses owing to the non-collection of taxes (tax expenditure), rent-seeking by firms engaging in nonproductive behavior to obtain an incentive, tax planning and evasion by the private sector, administrative costs for both firms and the government through cumbersome procedures for granting and monitoring incentives, economic distortions resulting from reallocating resources to sectors benefiting from incentives, and retaliation against new or more generous incentives by competing investment locations.⁷⁵ The following factors need to be addressed in the context of investment incentives:

- Free access to comprehensive information about available incentives and opportunities.
- Automatic entitlement to incentives and clear timeframes for decisions taken at the discretion of a government body in case of discretionary award of incentives and provision of exhaustive justifications for withholding an incentive.
- Need for more non-fiscal incentives, primarily provision of concessional loans to support entrepreneurial activities; simplification of administrative procedures associated with reporting and obtaining of licenses, permissions, and other documents; and provision of advisory services to facilitate investors' activities.
- Correct discrepancies and fill gaps in legislation in consultation with entrepreneurs and make more specific provisions of laws and regulations governing taxation, customs procedures, land use, and so on.

The application of Tajikistan's incentives regime is not being monitored properly. There is a need to shift the focus from fiscal incentives to non-fiscal and regulatory incentives that minimize distortions to a level playing field. These findings have been validated by a recent study commissioned by the G20, which concludes that factors other than incentives are more important and that targeted incentives are more effective (Box 7).

Concluding Remarks

A review of Tajikistan's tax policy and legislation suggests that it is not always consistent with the government's policy objectives stated in national development strategies about transforming Tajikistan into an industrial-innovative economy and simplifying business operations to promote export-oriented, private sector development. The authorities should aim to review and harmonize the country's tax legislation (the Tax Code) to reflect its current developmental priorities. Further review and simplification of the existing complex tax structure to eliminate nuisance taxes—in concurrence with a rationalization of tax incentives—would enhance both efficiency and equity. Major elements of future reform may refer to:

- Eliminating dual rates for the same tax as these have a detrimental impact, not only on the efficiency of tax collection but also on the cost of compliance and administration, and create undue complexity of some taxes both in terms of rate and base structures. These refer to different VAT and CIT rates for different sectors, including for the production of goods and the provision of services. In addition, the minimum corporate income tax at 1 percent of company turnover should be revisited and eliminated.
- Revisiting the sales taxes (on cotton and aluminum) and road user taxes; these are inefficient and inequitable taxes that translate into double or even triple taxation of businesses.
- Reassessing tax incentives and discontinuing the current practice of overreliance on incentives to attract investment in 'protected sectors'.
- Creating a platform dialogue between the state and private sector representatives to ensure direct bottom-up messaging of the challenges faced.

⁷⁵ World Bank 2017b.

Box 7. Tax Incentives—International Experience

At the request of the G20 Development Working Group, a report on Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment was prepared by officials from the IMF, OECD, the United Nations, and the World Bank in October 2015. The main findings of this research are summarized below.

- There is ample room for more effective and efficient use of tax incentives in developing countries: tax incentives generally rank low in investment climate surveys, and are often redundant (that is, investment would have come irrespective of the incentives). Their fiscal cost is generally high, reducing the resources that should have gone for spending on infrastructure, public services, or social support programs which would have attracted more investment.
- Effective and efficient use of tax incentives requires that they are carefully designed and monitored. While many countries use costly income tax exemptions and tax holidays to attract investment, investment tax credits and accelerated depreciation could be more efficient and bring more investment per dollar spent. It is easier to link these incentives to the quantum of the new investments.
- Tax incentives targeted at sectors producing for domestic markets or extractive industries generally have little impact, while those applied to export-oriented sectors and mobile capital appear to be more effective.
- Enabling conditions such as good physical and social infrastructure, macroeconomic stability, a stable tax system, and the rule of law, are important.
- Good governance of incentives is important for their effectiveness and efficiency. The main factor is transparency that facilitates accountability and reduces opportunities for rent-seeking and corruption.
- Tax incentives should be granted based on rules rather than discretion. Also, it is better if these are approved by the legislature and consolidated under the tax law, rather than granted by diverse entities like an Investment Promotion Board or different line ministries. The actual approval process of tax incentives may involve several players, but the best approach is that this is consolidated under the Ministry of Finance and enforced and monitored by the tax administration.
- The fiscal costs of tax incentives should be estimated annually and included in the general budget as an item of tax expenditure rather than occasionally as a one-time exercise by a consultant. Doing so would generate debate and discussions among the stakeholders about the efficacy and continuation of the incentives.

The main reason behind the proliferation of incentives is competition for attracting more investment, even if it means a race to the bottom. Regional coordination can help to mitigate this, but it will require understanding and commitment at the political level. In the case of Kazakhstan, for example, this coordination could take place at the level of the Eurasia Economic Union (EEU); in Asian economies such coordination could take place through the Association of Southeast Asian Nations (ASEAN).

Source: IMF 2015b.

Important changes should be introduced to address weaknesses in tax administration.

- The revenue 'target'—set annually with the goal of reducing gaps with expenditures—fosters an unsettled mindset among taxpayers about the certainty of the tax system.
- Making penalties and fines a "regular" source of revenue collection harms taxpayers' incentives to comply voluntarily.⁷⁶
- Improvements to the VAT refund system for exporters and the introduction of an automatic, streamlined refund procedure for claims below a certain threshold would be a good step to facilitate exports.
- Advanced payment of taxes or various forms of alternative minimum tax may kick in, even when businesses are incurring operating losses.

⁷⁶ Planned collections from penalties and fines ranged from 2.5 to 3.2 percent of total tax collections in 2012–17. Moreover, the calculation index—a basis for calculating several taxes and penalties—was raised by 25 percent from TJS 40 to TJS 50 in 2017; it is envisaged to increase to TJS 55 in 2019.

- Voluntary compliance tends to be compromised due to the dual problems of (i) poor taxpayer service and weaknesses in risk-based auditing inherent within the Tax Committee (TC); and (ii) failure of the TC to obtain third-party information automatically, externally rooted in the existing bank secrecy law.
- Furthering the tax administration modernization with a balanced set of measures to change the legislation with a focus on simplifying tax compliance procedures and strengthening enforcement.
- The pressure applied by the TC on compliant taxpayers to pay a portion of their tax obligations in advance. This is perhaps less of an issue than a few years ago, but nevertheless, the authorities recognize that such behavior can harm the profitability of businesses.

COMPETITION POLICY

Introduction

Over the last two decades, significant reform efforts have been undertaken to open up the Tajik economy and introduce market-based mechanisms. The authorities have carried out reforms to streamline business registration, ease the burden of licensing and inspections, and improve the taxation and competition regimes. Soon after independence, the Parliament passed its first Law on “Curtailing Monopolistic Behavior and Development Competition” on December 27, 1993,⁷⁷ followed by the Law on Natural Monopolies in 1997 that set a framework for regulating certain activities designated as natural monopolies. Since then, both pieces of legislation have been updated.⁷⁸ The Law on Protection of Competition (the Competition Law) sets out the current basic principles and rules of the Tajik competition framework regulating abuse of dominance, agreements that restrain competition, and mergers (antitrust rules), and areas such as state aid, public procurement, and anti-competitive actions by government authorities.

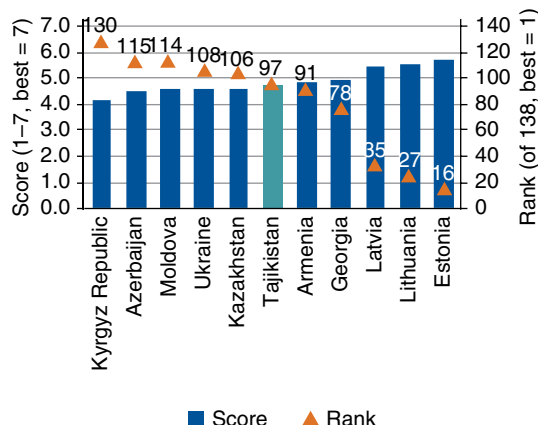
However, even though the government has made progress in developing a competition legal framework, its effective implementation remains problematic. Although Tajikistan has advanced its competition framework⁷⁹ and business climate regulation, several regulatory obstacles persist. Particularly on its competition framework, there are important gaps that affect its effectiveness, including the suboptimal design of rules, insufficient tools to identify and deter anticompetitive behavior, limited resources for implementation, and government policies and actions that undermine competition principles. The latter include legal monopolies over potentially competitive markets, price controls, insufficient enforcement of state aid rules, and lack of competitive neutrality. Therefore, there is a need to adjust policies to create an open and competitive environment that will foster greater investment and private sector development across the economy.

The challenges in implementing the antitrust regime and competition policies, in general, can help to explain the weak performance of Tajikistan in various indexes of perception of competition. Tajikistan ranks 97 among 138 economies, and six among 11 CIS and Baltic economies for the intensity of local competition

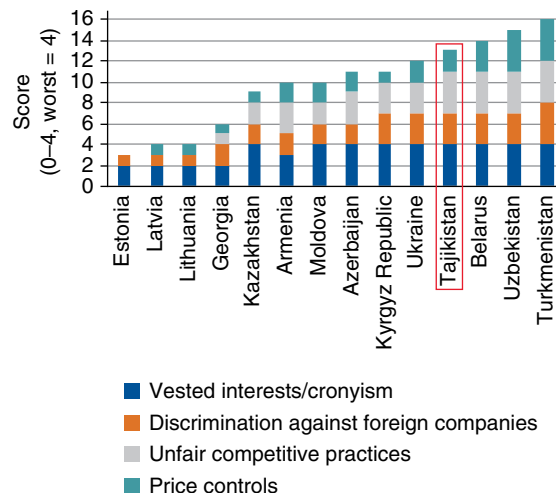
⁷⁷ Khabibov 2006.

⁷⁸ The competition law was reformed in 2000, 2006, 2012, and 2017. Similarly, the Law on Natural Monopolies was reformed in 2007 (Law of the Republic of Tajikistan from March 5, 2007, of No. 235 about Natural Monopolies).

⁷⁹ The Antimonopoly Service (AMS) has also developed regulations to implement the competition law, in particular: methodological recommendations for determining types of agreements; regulations on the procedure for carrying out inspections on compliance with antimonopoly legislation of the Republic of Tajikistan by state bodies and local executive authorities; and regulations on the procedure for submitting petitions and notifications to the antimonopoly authority. However, the AMS has also developed regulations on topics that are not in line with international practices. These include regulations on the procedure for determining prices (tariffs) of economic entities or maximum prices of dominant firms, procedures for the regulation of prices for manufactured products and goods, services provided by economic entities having a dominating position and monopolists, and procedures for determining monopolistically high and monopolistically low prices on the financial market of the Republic of Tajikistan.

Figure 62. Perceptions of Intensity of Local Competition

Source: Global Competitiveness Report, 2016–17.
 Note: The highest score is 7.

Figure 63. Business Risks Related to Weak Competition Policies

Source: Economist Intelligence Unit 2017.
 Note: The highest rank for each component is 4.

in the Global Competitiveness Report 2016–17 (Figure 62).⁸⁰ Tajikistan's rank deteriorated in the following year, placing 99 among 137 economies in 2017–18. Tajikistan also performs poorly on indicators of operational business risks generated by weak competition policies. The Economist Intelligence Unit ranks Tajikistan in the bottom (11 of 14) among other CIS and Baltic economies. Unfair competitive practices and vested interests that distort business decisions—both ranked at four out of four—are the top factors that increase business risk (Figure 63). Furthermore, Tajikistan is ranked second from the bottom in the ECA region for antimonopoly policy implementation.⁸¹

Indicators point to the need to improve the basic functioning of the market economy through improved market regulations. Tajikistan's lack of progress—and even a slight deterioration in indicators on the design and implementation of anti-monopoly policy, and the organization of markets and competition—as well as the country's low score in the Bertelsmann Stiftung's Transformation Index (Tajikistan scores 4 out of 10), reflect the still-weak introduction of market and competition principles in government policies and other interventions in the economy.

The objective of this chapter is to assess and support the strengthening of the competition policy framework in Tajikistan. This note includes recommendations (i) to facilitate the implementation of the antitrust dimension of the competition framework; (ii) to adjust economy-wide policies that might limit competition on a level playing field, such as price controls, state support to firms, and SOE policy; and (iii) to boost competition in selected sectors (telecommunications, aviation, and public procurement). The sectors covered have been chosen given the importance of their performance for connectivity and competitiveness of other economic sectors. Competition in public procurement markets is briefly analyzed given its relevance to reducing its burden on the fiscal situation in the context of the ongoing fiscal consolidation. Selected areas of reforms are prioritized to underpin a strategy to promote well-functioning markets and support the government's strategy to increase private investment.

⁸⁰ For more information on Tajikistan's performance in the Global Competitiveness Index 2016–17, see http://reports.weforum.org/pdf/gci-2016-2017/WEF_GCI_2016_2017_Profile_TJK.pdf

⁸¹ BTI 2016.

Competition Law Enforcement to Curb Anticompetitive Practices

In Tajikistan, the Law of Protection of Competition touches on a wide range of topics covered by a sound antitrust law.⁸² The scope of the law covers both private and public operators, including government authorities (Article 1.1), regulates anticompetitive agreements (Articles 5, 6, 7, and 8), abuses of dominance (Articles 4 and 9)⁸³ and mergers (Articles 12, 13, 24, 25, 26, and 27). The law also establishes the Antimonopoly Service (AMS) as a separate authority with powers to enforce the law against anticompetitive practices and conduct competition advocacy (Articles 21 and 22). Among other responsibilities, AMS's advocacy mandate includes participation in the privatization of SOEs and providing analysis of the competitive impact of the introduction, change, or termination of customs tariffs or non-tariff measures.

The law includes powers that go beyond typical antitrust frameworks. The AMS can control the price behavior of dominant firms (Articles 10 and 11)⁸⁴ and regulate prices in the wider economy (Article 15). In terms of public procurement, the law goes beyond the prohibition of bid-rigging in public tenders to regulate aspects typically covered by procurement laws, such as irregularities in the behavior of public officials in dealing with tenders (Article 17). Regarding state aid, the law gives extensive powers to the AMS. For example, any granting of public support, (at both the national and local level) requires the prior approval of the AMS (Articles 18 and 19). If an AMS order is violated, it can enforce its decision before judicial courts (Article 20). The next section of this chapter includes an analysis of these aspects of competition policy. If implemented effectively, these powers would help boost competition.

Following the basic elements of a competition law in comparison to the current legal framework in Tajikistan, six issues stand out. These issues are (i) insufficient tools to detect and deter cartels; (ii) restrictive definition and control of market dominance; (iii) incomplete merger control regime; (iv) insufficient fines; (v) gaps in institutional setup; and (vi) lack of human and financial resources for enforcement and implementation.

Strengthening the Fight against Hardcore Cartels

Since cartels are the most harmful anticompetitive practice, jurisdictions generally consider them illegal under any circumstance.⁸⁵ However, this is not the case in Tajikistan. Price-fixing cartels generate overcharges of 49 percent on average,⁸⁶ and sales affected by cartels can reach as high as 6.4 percent of GDP.⁸⁷ In Tajikistan, cartels are not considered *per se* illegal⁸⁸ and, as of March 2018, the AMS had not handled cases on agreements among competitors. The competition law (Article 7) should be modified and clarified through regulations to separate *per se* prohibitions on hardcore cartels from other agreements that can be pro-competitive and require an assessment of their effects on markets. Further, the AMS can implement a compliance and advocacy

⁸² Law of the Republic of Tajikistan on Protection of Competition. Approved by the Resolution of Madjlisi Namoyandagon of February 1, 2017, N. 686; Approved by the Resolution of Madjlisi Milli of February 18, 2017, N. 383.

⁸³ The Law also covers unfair commercial practices (Article 16), which are different from the anticompetitive practices typically covered by an antitrust framework.

⁸⁴ This capacity is facilitated by the power to keep a registry of dominant firms (Article 22).

⁸⁵ Most jurisdictions treat hardcore cartels as objective or *per se* violations of the law owing to their negative impacts on competition and welfare. On one hand, this encourages compliance by stating clearly to market players that hardcore cartels are objectively illegal under any circumstance. On the other, it allows competition authorities to target resources to the unveiling of cartels rather than proving their known negative effects.

⁸⁶ Connor 2014.

⁸⁷ Initial evidence based on a selected number of cartels in developing economies between 1995 and 2013. See Ivaldi, Jenny and Kimich, "Cartel Damages to the Economy: An assessment for developing countries" in WBG-OECD (2017).

⁸⁸ The terms '*per se*' and '*hardcore restriction*' refer to conduct that is strictly illegal without any consideration of its effect (or lack thereof) on competition, markets, or any other relevant factors. International practice and economic theory currently agree that is theoretically unfeasible or extremely unlikely to find a hardcore cartel that is pro-competitive. A hardcore cartel can be defined as "an anticompetitive agreement, anticompetitive concerted practice, or anticompetitive arrangement by competitors to fix prices, make rigged bids (collusive tenders), establish output restrictions or quotas, or share or divide markets by allocating customers, suppliers, territories, or lines of commerce." Considering the negative impact of the practice, and its unlikelihood to promote either competition or welfare, most jurisdictions treat hardcore cartels as objective or *per se* violations. See International Competition Network (2005).

program to discourage cartels, allow firms to become clean, and save both public and private expenses on investigation and litigation.

Besides considering cartels as per se illegal, the law should develop effective mechanisms to detect, deter, and sanction hardcore cartels. It is important to develop a transparent and effective mechanism for search and seizure.⁸⁹ The Law on Inspections of Operational Activities also covers the mandate of the AMS, but it generally demands that the authority inform affected entities about upcoming inspections in advance, which can facilitate evidence tampering. Furthermore, since January 2018, antimonopoly inspections under this law have been suspended for manufacturing firms for two years,⁹⁰ constraining government powers to obtain evidence of secret anticompetitive agreements. Once the law clearly identifies hardcore cartels, assigning per se illegality, and the AMS starts using its powers to detect and prosecute cartels, the subsequent development of a leniency⁹¹ framework will be a key step in the process of strengthening the fight against hardcore cartels. Capacity building on the use of these tools, economic analysis to screen for markets that might be prone to stable agreements, and how to build strong investigations would help the AMS to prosecute cartels effectively.

Redefining Market Dominance to Avoid Discouraging Firm Expansion

A structural definition⁹² of market dominance appears to burden the private sector unduly and may interfere with competition on the merits. The structural approach to define dominance only based on market shares at a point in time is particularly problematic because it can lead to classifying nondominant firms as dominant. Since the AMS has a mandate to keep a registry of dominant firms, and these firms are subject to special rules that affect business ability to compete, this creates an undue regulatory burden.⁹³ A quick assessment of the firms listed in the registry of dominant firms in 2016⁹⁴ shows risks to reduce the incentive of firms to compete, expand, and gain market share. Among the 140 companies listed in the registry of dominant firms, 60 percent have a market share below 35 percent. The number of firms in the registry has risen steadily (from 55 in 2011 to 140 in 2016). Furthermore, the criteria to define the market are unclear since some of the markets are defined narrowly (“oranges” “kiwi” and “bananas”) while others are broad (“machinery equipment”). Depending on the market definition, the market share will vary, directly affecting the presence (or absence) of the company in the registry of dominant firms. The concept of dominance informs the regulation of abuse of dominance (Article 9) and price behavior (Articles 10 and 11). Therefore, companies that do not hold significant market power—using economic and internationally accepted legal standards—and are not likely to abuse are unduly prevented from engaging in normal business practices (such as reducing prices or bundling products to attract consumers) that would otherwise be perfectly procompetitive.

⁸⁹ The AMS has drafted regulations on the procedure for carrying out inspections on compliance with antimonopoly legislation of the Republic of Tajikistan by state bodies and local executive authorities. These regulations will help to establish more legal certainty, although the issue of not conducting unannounced inspections would persist.

⁹⁰ See Law of the Republic of Tajikistan No. 1505 of February 21, 2018, “On Moratorium on Inspection of Business Entities Operating Engaged in Production Activities.”

⁹¹ Leniency refers to the possibility that companies providing relevant information about a cartel in which they participated receive full or partial immunity from fines. For a detailed discussion on leniency programs see Chapter 2 of the International Competition Network Manual on Cartel Enforcement: “Drafting and Implementing an Effective Leniency Policy” (May 2009). Available at <http://www.internationalcompetitionnetwork.org/uploads/library/doc341.pdf>

⁹² Dominance may be defined in behavioral, structural, and durability terms. The behavioral definition, commonly used in the EU, Canada, the U.S., and Australia, among others, takes into account whether firms can to some extent act independently from the competitive constraints of the market. A structural definition takes into account market share as the core issue to establish dominance. Since market shares by themselves cannot determine whether a position is dominant, apart from South Africa and some jurisdictions in Asia, few jurisdictions use this approach to deem firms as dominant. Finally, some jurisdictions, such as the U.S., the EU, Canada, and New Zealand, include some analysis about market dynamics and require firms to maintain their position for a given period. This durability test constitutes an additional element to the behavioral and structural analysis. See ICN 2007.

⁹³ Article 22.1 gives power to AMS to set rules on (i) determining a dominant position of a business entity, (ii) identifying monopolistically high and monopolistically low prices in the market of financial services (e.g., applied by dominant firms), and (iii) regulating prices for manufactured products and goods, services provided by the business entities enjoying a dominant and monopolistic position in the market.

⁹⁴ List of dominant firms, AMS (based on the information received from Customs Committee), 2016.

Box 8. The Elimination of the Registry of Dominant Firms in Armenia

Until 2011, Armenia's State Commission for the Protection of Economic Competition (SCPEC) maintained a centralized log (registry) of economic entities with a dominant market position.

In practice, however, the registry was perceived as counterproductive. First, courts had ruled that companies must be registered to be prosecuted for abuse of dominance. In this context, rather than increasing the level of information available to SCPEC, the registry ended up limiting the capacity of the SCPEC to prosecute abuses of dominant position. Second, as a reaction to the registry, companies were transferring activities to shell entities once they had been registered as dominant, meaning the SCPEC had to keep evaluating market share and monitoring new entities.

Following a reform modernizing Armenia's legal framework, the registration of business entities with a dominant or monopoly position in the commodity market was discontinued. The Commission now examines cases when there is a concrete case of abuse of dominant position in specific commodity markets.

Source: The State Commission for the Protection of Economic Competition of the Republic of Armenia; Republic of Armenia Law on Protection of Economic Competition.

A framework that reflects economic principles and case law to determine dominance will refocus AMS resources toward cases and investigations with larger impact on the market and eliminate the adverse effects on the business environment, particularly for growing firms. This will imply the elimination of the registry of dominant firms allowing AMS to improve the business environment and reduce undue regulatory burden. Armenia, for example, has eliminated a similar register (Box 8).

Calibrating Merger Controls to Unburden Market Players and Save Public Resources

The current merger control framework may unduly increase the costs of doing business in Tajikistan. An effective merger control policy focuses on merger transactions that have the potential to significantly lessen competition, minimizing the burden of administrative procedures on businesses and avoiding market disruptions. The entry, growth, and exit of firms are natural in a competitive business environment; therefore, merger regulations should not obstruct these efficient processes. However, potentially low notification thresholds, control of corporate transactions without competition impact, unclear procedures and short periods for review, and a lack of clear criteria for analysis may affect AMS's ability to focus efforts on stopping changes in market structure with potential anticompetitive effects.

Although the 2017 reform introduced important changes, there is still room for improvement. The recent change in the law introduced objective (turnover and transaction value) notification thresholds, detailed concepts of corporate control (direct and indirect), and a nexus between the merger and the Tajik economy. These changes are aligned with a more effective merger framework. However, merger control still affects transactions that by nature cannot affect competition, such as simple corporate reorganization, liquidation, or creation of companies. The magnitude of the various financial thresholds for notification may create unnecessary confusion and an undue regulatory burden given the low thresholds (starting at approximately \$146,000 asset value for liquidation or segregation, up to approximately \$585,000 for mergers and acquisitions). The AMS can reject a merger if it results in increased dominance; this could imply that merging companies with a market share of 35 percent or more—as well as those with lower participation but in a market with other relatively large companies—could be forbidden to merge even if efficiency gains can be demonstrated or competition is effective. Finally, the AMS 10-day period to decide on a notification and the lack of a fast-track procedure for simple mergers can also harm the effectiveness of the framework.

Supporting Compliance through Proportionate Fines

Antitrust fines should meet the dual policy objectives of imposing penalties on infringing firms and ensuring that the threat of such penalties deters anticompetitive business practices. Fines should, in effect,

offset the expected illicit gains associated with anticompetitive behavior. Considering their extended operating time—and the associated accumulation of gains from overcharges—some of these activities, hardcore cartels, in particular, should be fined based on market variables (annual turnover, for example).⁹⁵ In Tajikistan, maximum fines (under the Code of Administrative Violations) are in absolute terms: approximately \$17,500 for cartels and \$11,700 for abuse of dominance.⁹⁶ In contrast, many jurisdictions (such as China, the European Union, Germany, South Africa, and the United Kingdom) set maximum proportionate fines, for example, a fine of 10 percent of the firm's annual turnover of the previous fiscal year. In addition to moving to a system of proportionate fines, Tajikistan needs to develop guidelines or rules on how to calculate such fines.

Strengthening Institutional Setup for Independent and Transparent Enforcement

Effective competition enforcement demands institutional frameworks that provide the competition agency with functional independence and sufficient investigatory powers while guaranteeing fair rules of procedure for affected parties. Tajikistan faces challenges in this area. Tajikistan has a competition authority that reports to the government; this does not provide functional, financial, or operational independence from the executive. Its budget is allocated through a combination of legislative assignment and direct collection (merger notification fees, for example). Limited due process may create uncertainty and reduce policy accountability. Even though the law does establish the right to appeal to the judiciary, it offers limited due process guarantees on the (i) right to be informed and access files; (ii) right to be heard, produce evidence, and be represented by counsel; (iii) right to appeal procedural decisions at the administrative level; (iv) obligatory publication of final decisions; and (v) protection of confidential information.

Refocusing Resources to Safeguard Competition in Tajik Markets

Although the competition law sets a broad antitrust mandate for the AMS, enforcement has not targeted anticompetitive practices. Since its establishment, AMS enforcement against anticompetitive behavior has been timid, with no cartel cases to date and few abuses of dominance cases according to international practice. Enforcement by the AMS has focused on determining firms that are dominant and should be included in the register and evaluating the level and variation of prices set by dominant firms. On mergers, the AMS has assessed an average of 10 operations per year at the national level and 20 at the local level. Between 2016 and 2017, the AMS conducted market inquiries on food products, aviation, construction materials, cargo transport, transport of fuel, telecommunications, aviation fuel and air navigation services, mobile phone payments, construction materials, higher education tuition fees, and the private health sector. However, these analyses often lack an evaluation of barriers to competition and recommendations on actions to improve market conditions rather than controlling prices. Finally, the AMS has been active in advocacy: in 2017 alone, the AMS received between 25 and 35 requests for competition review of draft laws, regulations, and tariff changes. A similar number of price review evaluations (including telecommunications, water, electricity, and jet fuel, among others) occurred in 2016.

A substantial portion of the AMS' limited resources is dedicated to monitoring and supervision of prices, which explains its low enforcement against anticompetitive practices. The AMS allocates significant resources to monitor, review, and control excessive pricing.⁹⁷ In 2016 the AMS conducted 43 such inspections;

⁹⁵ See ICN 2008.

⁹⁶ Fines are up to 2,000 indicators for calculation in the case of abuse of dominance and up to 3,000 indicators for coordinated practices. For this exercise, one indicator for calculation values TJS 50 and \$1 values TJS 8.55 (World Bank data, official exchange rate LCU per US\$, period average, 2017).

⁹⁷ In 2017, for example, AMS enforcement on price controls included: fines issued for Barki Tojik and some of the regional energy utilities due to price increases above justified levels; action on the complaint letter sent by an individual to the Executive Office of the President regarding excessive prices on local food commodity markets; fine of TJS 11,500 for unjustified service charges (3 percent) by mobile companies for topping-up an account using remote payment terminals; decisions to allow increases in tariffs for air navigation services, railway tariffs, and heating and water tariffs for residents; a decision to allow marginal increase for electricity tariffs by Pamir Energy (PPP company in Eastern Tajikistan, GBAO); and review and clearing of prices for air tickets on various itineraries from Dushanbe airport.

22 were planned for 2017. Rather than focusing on gathering evidence of anticompetitive behavior (for example, cartels), these inspections gather information on prices and other types of government control over business activity.⁹⁸ Having almost half of its staff occupied with these monitoring capacities may help to explain why the AMS has not prosecuted anticompetitive practices so far or sanctioned other types of misconduct covered by the competition law.

In addition to reforming the competition framework to facilitate the implementation of the strong powers and broad mandate of the AMS, it is vital to ensure appropriate financial and human resources. Limited staff and budget have an adverse effect on the technical strength of the AMS's decision and its power to enforce the law. More strategic use of resources could help the AMS position itself as an enabler of private sector participation and a protector of consumer welfare. The AMS receives an annual budget of approximately \$123,000 compared to an average of \$122,000 in jurisdictions in Africa and \$427,000 in a sample of 33 established competition authorities worldwide. The AMS had a total staff of 38 at the national level in 2017 who were responsible for the enforcement of the AMS's mandate on antitrust, unfair commercial practices and consumer protection, and controls on state aid. Of these, seven staff are dedicated to antitrust and seven to the regulation of natural monopolies.

Cross-Cutting Policies That Distort Competition on a Level Playing Field in Tajik Markets

A good investment climate is achieved when state involvement in business operations—both as a market player and regulator—is neutral to competition and does not hamper private sector participation in sectors where it is viable. Typically, governments can influence markets either through direct participation (as a market maker or as a buyer or supplier of goods and services) or through indirect influence in markets where private sector operates (through regulation, subsidies, or taxation). While the degree of state involvement in markets is the prerogative of each country, it is good practice to limit state involvement to the extent needed to address specific market failures and only when the benefits of such intervention are greater than the costs.

In Tajikistan, the competition framework could improve its effectiveness and contribute to a better investment environment by (i) boosting competition advocacy, (ii) limiting price controls and reassessing its natural monopoly policy under a pro-competition perspective, (iii) implementing state aid control, and (iv) leveling the playing field between SOEs and private players.

Integrating Competition Principles into Government Interventions across the Economy

In Tajikistan, the Competition Law sets extensive advocacy powers to the AMS, including the power to issue opinions and binding orders to cancel or revise anticompetitive acts or actions of public authorities, but these powers have not been used systematically. The AMS can provide opinions on the draft laws and other regulations relating to the market operation and development of competition; issue binding decisions to cancel or revise acts, agreements, and legislation; tender procedures which are inconsistent with the antimonopoly legislation; and sanction government officials who failed to prevent the breach of the antimonopoly legislation. In practice, these provisions have been used by the AMS to review some of the decisions taken by enforcers of the competition law under regional governments, and the AMS has provided opinions at the request of other government institutions (for example, on certain investment agreements).

Such a powerful advocacy mandate could be used to embed competition principles in a wide range of public policies and regulations to address the root of competition issues that reflect on market outcomes

⁹⁸ The AMS inspection plan for 2017 included 22 inspections—four inspections of natural monopolies; five inspections regarding consumer rights protection issues; and 13 inspections of companies in the dominant companies registry (competition related). Examples of inspections carried out in 2017 include (i) price monitoring at Dushanbe's main food markets (three markets), four times per year plus ad-hoc inspections prior to major holidays; (ii) monitoring of prices for domestically produced school uniforms (boys and girls) in line with the recommendation of the Ministry of Education that every school-age child wear a domestically produced school uniform; and (iii) inspection of Tajik Medical University including the tuition and fees charged, which concluded with a recommendation to lower the tuition and fees according to the cost base to avoid placing an excessive burden on poor students. The review and recommendations were sent to the Ministry of Justice and the Government of Tajikistan.

(such as **higher prices or limited entry**). The AMS could use its powers more strategically to help inform government policies that are key for the national agenda. More capacity and resources to assess market functioning, identify barriers to competition, and propose pro-competition policy actions would be needed to implement this mandate. The AMS can start exercising this role within its own institution complementing its role as monitor of market dynamics and price regulator with deep analysis of issues that can increase the likelihood of anticompetitive practices or noncompetitive outcomes due to government policies, regulation, or participation in markets.

Phasing Out Pervasive Price Controls

Price controls can have unintended negative effects on markets.⁹⁹ They can act as a focal point for collusion and can lead to an inefficient allocation of resources and high costs for governments to sustain the policy. Price ceilings can lead to reductions in supply or shortages that would harm consumers rather than be beneficial to them and may reduce quality or innovation. Minimum prices, on the other hand, prevent more efficient firms from competing in the price dimension. Generally, price regulation—to mimic a competitive outcome—is only used in markets where there is a natural monopoly. In cases where competition is limited as the result of regulations or other government interventions, it would typically be more effective to find less distortive alternatives to those regulations (for example, remove import restrictions, eliminate monopoly rights) than to control prices.

In Tajikistan, the AMS regulates prices through at least three different mechanisms. The AMS monitors and regulates price variations of products and services provided by dominant firms. It also can monitor and regulate an “unjustified price increase” even in the absence of dominance (for a list of important products).¹⁰⁰ The AMS also regulates prices of a list of services predefined as natural monopolies by the Law of Natural Monopolies.¹⁰¹

Risk of Excessive Control of Prices of Firms Considered as Dominant

Rules that regulate price changes can chill market competition by banning low pricing and strategic pro-competitive pricing by allegedly dominant firms. Low prices are generally a sign of market competition; thus, competition authorities consider with caution challenging practices that result in lower prices. The law affirms that a price is excessively low if a dominant firm reduces its prices when costs have not fallen. Without further guidance on under what circumstances either high or low prices could be anticompetitive, such a general rule can discourage pro-competitive price drops and reduce incentives to productivity growth. The prohibition of dominant firms to practice low prices is even more problematic in Tajikistan, given that dominance is defined by the AMS on the basis of market share, constraining the commercial decisions of firms that lack significant market power. For example, all mobile operators have to submit their final consumer prices, even in case of price reductions, for AMS approval.

To avoid discouraging pro-competitive price behavior, Tajikistan could align its framework with other jurisdictions that intervene, after assessing whether the level of prices would have adverse effects on competition dynamics, for example by driving competitors out of the market to raise consumer prices afterward. Before controlling or sanctioning pricing behavior, authorities analyze anticompetitive effects in the market and require more than a mere change in final prices, such as (i) pricing below a certain measure of costs (for

⁹⁹ For example, in a recent study on the impact of targeted price controls for supermarket products in Argentina from 2007 to 2015, results show that, contrary to common beliefs, firms compensate for price controls by introducing new product varieties at higher prices. See Aparicio and Cavallo (2018).

¹⁰⁰ Recently, the government published a list of products subject to this provision: flour (grade 1 and 2), bakery products (from flour grade 1 and 2), pasta, wheat, rice, potatoes, vegetables (carrots, onions, cabbage), sugar and granulated sugar, vegetable oil (cotton, sunflower) and butter, dairy products (milk, kefir, sour cream, cottage cheese), lentils, peas, buckwheat, beans and barley, meat (beef, mutton, poultry), chicken eggs, salt, tea (black and green tea), and baby food.

¹⁰¹ Law of the Republic of Tajikistan, March 5, 2007, of N. 235.

example average variable costs), (ii) possibility of recouping the losses,¹⁰² and (ii) predatory intent.¹⁰³ Even if these elements are present, efficiency defenses based on the balancing of pro- and anticompetitive effects are also considered.¹⁰⁴

Risks of Using Price Controls on Socially Important Products Instead of Fixing Market Failures

The current framework does not consider competition as one of its principles and lacks rules to define which prices could be regulated, under what circumstances, and for what period, as well as the method to define the regulated prices. When considering what products will be affected by such regulation, the government should consider what could be supplied by private players under prevailing market conditions, whether there is an external shock that has created temporary imbalances in the market, and what requires public intervention. The recently published list of products accounts for a significant proportion of the food consumption basket, but the basis for the selection of products is not clear. Even the full list of socially sensitive products that can have their prices regulated covers a wide range of goods and services that can be provided by private players under free market conditions, such as matches and haircuts. Regulations have been issued for the AMS to implement the control of “unjustified” price increases (Decree No. 257 of 2018), stating that price regulation is triggered if prices increase by more than 20 percent in a month. The AMS monitors prices to ensure compliance with these rules and, so far, prices of goods under regulation have not been controlled. To find a sustainable solution to issues of high prices, it would be advisable to conduct in-depth market assessments to identify the root causes of potentially high prices in Tajikistan and advocate for reforms to boost competition (import restrictions, for example, can result in higher prices).

Regulation of Prices of Natural Monopolies

The regulatory framework for natural monopolies does not account for pro-competition principles and current market dynamics. Technological progress is changing the cost structure of many formerly regulated natural monopoly industries, leading worldwide to a deregulation trend. There is thus no bright line between industries that are natural monopolies and those where competition can develop. In Tajikistan, the list of economic activities regulated as natural monopolies spans markets, where competition could develop depending on supply and demand characteristics, such as electricity generation and supply, Internet data transmission, and domestic air transport.

It would be advisable to evaluate the possibility of limiting the list of economic activities regulated as natural monopolies to those that exhibit such characteristics in the context of Tajikistan. The AMS can exclude entities from the register based on results of analysis of the relevant service market, confirming the absence of natural monopoly conditions. In practice, given that there has been limited progress in unbundling in the energy, railway, and telecommunication sectors, activities that can be provided in competition are currently bundled with activities that have natural monopoly characteristics and are legally granted as monopolies. In this situation, it would be necessary to regulate not only access prices but also final prices in the downstream market until the services are unbundled and regulations that enable competition in downstream markets are in place.

The regulation of natural monopolies goes beyond calculating final tariffs for consumers. It is important to decide what services to regulate and what methodology to use in order to introduce market/incentives-based principles. Network industries pose a challenge to authorities: they must be regulated to

¹⁰² Brooke Group Ltd v Brown & Williamson Tobacco Corp 509 US 209 [1993] p. 226: “Evidence of below-cost pricing is not alone sufficient to permit an inference of probable recoupment and injury to competition.”

¹⁰³ Intent is relevant in the following jurisdictions: Brazil; Bulgaria; Canada; the Czech Republic; Denmark; the European Commission; France; Germany; Ireland; Japan; Jersey; Kenya; the Republic of Korea; Latvia; Lithuania; Mexico; New Zealand; Norway; Peru; Singapore; Switzerland; Taiwan, China; Turkey; and the United Kingdom. It is neither relevant nor required in Chile, Hungary, Italy, Jamaica, Russia, South Africa, and the United States. However, in Italy, intent is relevant for quantification of fines. Agencies having to prove market effects include Brazil; Canada (for civil cases); Chile; the Czech Republic; the European Commission; France; Hungary; Ireland; Italy; Jamaica; Japan; Jersey; Korea; Latvia; Norway; Peru; Russia; South Africa (for conduct evaluated under 8(c)); Taiwan, China; the United Kingdom; and the United States.

¹⁰⁴ See, for example, Brazil, Bulgaria, Canada, Chile, Denmark, the European Commission, France, Germany, Hungary, Ireland, Italy, Jamaica, Japan, Korea, and Mexico.

ensure competition and nondiscriminatory access to the infrastructure while providing enough incentives for companies to invest. It is also crucial to ensure that natural monopolies do not engage in anticompetitive practices that may hinder related markets that are open to competition; this is provided by the Tajik law. However, the AMS should also ensure that pro-competition principles are incorporated into the regulatory framework applied to natural monopolies, that is that access to essential infrastructure is granted on nondiscriminatory conditions and at cost-oriented prices. Regulation of natural monopoly prices must distinguish between the regulation of final services to consumers and access pricing. Regulations on natural monopoly need to be updated to allow the AMS to regulate these firms properly and mimic the outcomes of effective competition. The methodologies used to set tariffs are not up to date and do not incorporate aspects to incentivize cost reduction, efficient investments, or productivity of natural monopolies. Depending on the current context and characteristics of each regulated market, progressive steps can be taken toward adopting methodologies, such as cost-based pricing considering an efficient firm model, economic costs rather than accounting costs, and a market-based cost of capital in order to reduce monopolies' incentives to overinvest and transfer the costs to consumers or fiscal accounts.¹⁰⁵ Rewards for improved performance—for example due to a reduction of technical losses—can also be considered.

Replacing Price Controls for Market-Oriented Solutions

Specific price controls can be used to address market failures, and the AMS should focus on those; this requires stronger technical capacity, resources, and political support. Table 12 lists the typical cases in which price controls may be warranted—such as natural monopolies and short-term price hikes. If there is a need to control prices given these situations, there are mechanisms to minimize potential distortions. Overall, the restrictions to competition and innovation that can result from price controls often outweigh their benefits, but in a transition phase toward the elimination of these controls, governments can assess their impact to gather concrete evidence for their removal. In Tajikistan, the AMS could focus price controls on natural monopolies, including tariffs for essential facilities, and conduct in-depth market assessments to identify the root causes of potentially high prices of certain products in Tajikistan and advocate for reforms to boost competition. In order to implement these mandates effectively, AMS staff should benefit from specialized training on tariff regulation in network industries and competition and market assessments, as well as additional resources and support to contribute to national discussions on this agenda.

Table 12. Economic Considerations to Minimize the Negative Effects of Price Controls

Situations in Which Price Controls May Be Warranted	Guidelines for Setting and Reviewing Price Controls
Natural monopolies	Set independently of producers
Short-term issues in which competition cannot be relied on to determine market price (such as supply shocks)	Analyze alternatives: targeted subsidies and analysis of potential restrictions to competition
	Time bounded: price controls should not be indefinite
	Review periodically to determine whether levels are optimal
	Analyze impacts on on-price competition

Source: World Bank 2016.

Enforcing State Aid Control to Minimize Distortions to Competition

Governments provide state aid to businesses to achieve development goals. State aid can be defined as government economic incentives that provide an economic advantage to certain private or state-owned firms that carry out economic activities. Investment incentives are an example of state aid. State aid encompasses tax exemptions, loan guarantees, grants, government resources provided at prices below market levels (such as land, spectrum, or water), subsidies, cash transfers, accelerated depreciation allowances, and capital injections,

¹⁰⁵ For example, in the case of electricity, a first step can be to establish full cost-recovery tariffs based on accounting costs and move progressively toward an incentive-based tariff regulation system.

among others.¹⁰⁶ Goals can include creating jobs, reducing pollution, investing in research and development, and increasing access to services or goods, among others.

However, state aid can be detrimental to productivity, creating advantages to dominant firms, facilitating anticompetitive behavior, and driving efficient players out of the market. First, support measures to firms can facilitate *anticompetitive behavior*; they can create or protect dominant players in markets, unduly incentivize firm consolidation (which increases the risk of cartel formation), and create barriers to entry that prevent future competition. Second, they can generate *market inefficiencies*; incentives can discourage beneficiaries from enhancing productive efficiency and innovating and can drive out of the market more or equally efficient firms that do not benefit from the incentive scheme. Both channels lead to noncompetitive market outcomes such as lower affordability, access, product variety, or quality, and to lower investment, productivity, innovation, or output.

Many jurisdictions put in place a specific state aid control framework to minimize distortions to competition. Competition policy in the European Union (EU) and some Eastern European and Central Asian economies provide for state aid control.¹⁰⁷ The EU uses a balancing test based on precise economic criteria and methodologies to evaluate the positive and negative elements of a state aid measure. The amount, intensity, duration, frequency, and selectivity of the instrument are considered as well as the channels through which competition is affected.

Improving the State Aid Regime in Tajikistan

In Tajikistan, the 2017 competition law has significantly improved the regulation of state aid compared to the competition policy framework established in 2006. First, it added a general prohibition for the national and local government on the adoption of acts or performance of actions that discriminate between the activities of specific business entities.¹⁰⁸ Second, when defining what type of government support needs prior approval from the AMS, the competition law included the previously missing link between illegal government support and the discrimination of market players and potential negative effects to competition. Public authorities are not allowed to provide unreasonable benefits to one or more business entities that are likely to give them predominance in the commodity market as compared to other business entities. Every “public preference”—meaning state support with the capacity to discriminate between business entities and harm competition—demands prior approval by the AMS. The competition law allows for aid associated with public interest and emergencies and explains that state aid can be granted for agriculture production, labor protection, and SME promotion.

Nevertheless, the competition framework lacks sufficient regulation on how the mandate on state aid control is enforced, and in practice, the AMS has not enforced these provisions. The law assigns mandatory review for all aid, in all levels of government, but only gives two months for AMS review. There is no clarity on how the procedure starts and develops.¹⁰⁹ Furthermore, there is no clear incentive for government entities to comply with state aid review by the AMS. As per the 2017 law, even the preferences granted through the budget law have to be reviewed by the AMS, and affected parties can also request a review of “illegal” aid. In practice, state support measures are provided through various tax exemptions, applicable mostly to specific economic activities or firms, and other measures that are mainly available to SOEs (such as subsidies, concessional loans, tax write-offs, and reduced cost of energy). Tajikistan could consider the experience of Moldova (Box 9) to create a state aid control system.

¹⁰⁶ Under the EU framework, state aid is selective by definition and therefore excludes measures that apply to the economy as a whole, such as lower income tax rates for SMEs.

¹⁰⁷ For more information on state aid control in the EU see http://ec.europa.eu/competition/state_aid/overview/index_en.html

¹⁰⁸ See Article 14.

¹⁰⁹ Regulations on the Procedure for Providing Public and Local Assistance from December 30, 2015, No. 813, applicable to the law of 2006, covered these topics in detail.

Box 9. Adopting a State Aid Framework in Moldova

State aid granted in Moldova accounted for around 4 percent of GDP in 2013, a decrease from 5.2 percent of GDP in 2011, according to the latest data on state aid compiled for the period 2011–13.

Moldova's government directs state aid to support regional development, services of general interest, SMEs, research and development, and other policy objectives. While most of the country's state aid schemes are meant to target a broad number of beneficiaries, a lack of transparency in the process has resulted in state aid benefiting only a few market players. For example, on average, around 68 percent of total aid granted during 2011–13 was documented as aid to individual firms, but much more individual aid was likely granted as unplanned or ad hoc aid. In addition, around 82 percent of state aid was in the form of tax exemptions and reductions—instruments that, when combined with a lack of transparency, can be used to provide highly selective benefits and may have the most distortive effects in the market.

To account for such distortions the government adopted the Law on State Aid in 2012, which regulates procedures for authorizing, granting, monitoring, and reporting state aid provided to various national entities in line with EU rules on state aid.

Since then, a key achievement in the implementation of state aid control is the creation of an online state aid portal to help state aid monitoring, strengthen collaboration (between CCRM, the Moldova competition council, and other state-aid granting public entities) and increase transparency on how public resources are spent. The portal has been a success both in terms of its application by the government and relevant agencies on the ground and its potential replicability in other countries.

State aid transparency has improved in recent years. More than 170 public entities reported state aid to the Competition Council in 2014—compared with only a handful in 2011/12—while a similar number of public officials from the Competition Council and the central and local administrations were trained in state aid design, analysis, and reporting. Meanwhile, citizens, grantors, and beneficiaries of state aid can track the state support measures available, which levels the playing field for all firms, including new entrants and SMEs.

Source: Global Investment Climate Project on Competition—Pilot Technical Assistance Project on Strengthening the State Aid Control Framework in Moldova (2013–15).

*Investment Incentives as a Risk to Competition in Tajikistan*¹¹⁰

Investment incentives are most likely to lead to a distortion of resource allocation both across and within specific sectors given the lack of safeguards to limit effects on competition. The conditions to access most investment incentives are nontransparent (85 percent) and they are granted in a discretionary way.¹¹¹ No specific rules regulate how the interested entities and the general public can access information on the benefits conceded by the government, which is a key factor in promoting a level playing field and accountability. No registry of available state aid and recipient firms exists. Additionally, the legislation and regulations could improve on the criteria used to assess what market failures in agriculture, labor, and SMEs would warrant the provision of state aid. Finally, the law is silent on monitoring and ex-post evaluation, although certain incentives (for example, those under investment agreements) require reporting for monitoring.

A significant share of investment incentives (66 percent) is provided to specific firms, with the majority (67 percent) granted for an indefinite period.¹¹² Furthermore, there is an increased trend of concentration of tax preferences within economic sectors. Such practices may result in market distortions for potential competitors—both current and future—and the elimination of incentives for the firm to be more productive,

¹¹⁰ See additional information on the concentration of tax exemptions across firms within sectors in Ch. 3, page 51.

¹¹¹ A broad definition of investment incentives transparency: investors should have easy access to information on available incentives, qualification and documentation requirements, maximum amounts, the procedure and decision criteria for the award, the length of the procedure, and the authority in charge. Non-lenient definition of transparency: investors should have access at least to eligibility criteria; contact details application forms; and approval procedure. Discretion means the right of a state body to decide, on its own account and within the limits prescribed by the law, whether an incentive is to be given or withheld, as the case may be. A wide range of incentives awarded at the discretion of government bodies, in the absence of transparent and clear eligibility criteria, encourages arbitrary interpretation of statutory provisions and discretionary application of the law on the part of relevant government bodies. Based on IFC Investment Incentives in Tajikistan (2015, 2018).

¹¹² Specifically, under the investment agreements signed by the State Investment Committee.

considering that most of the incentives are not time bound. In the case of investment agreements, fiscal incentives in the form of various tax and custom duty exemptions have a higher potential to distort competition when provided to one firm in sectors where other firms operate, as in the case of textiles, food manufacturing, oil refinery, cement manufacturing and mining, soft drinks, and transportation. In these sectors, there is already some level of competition in the market, and incentives mostly target a specific firm (as opposed to any operating firm).

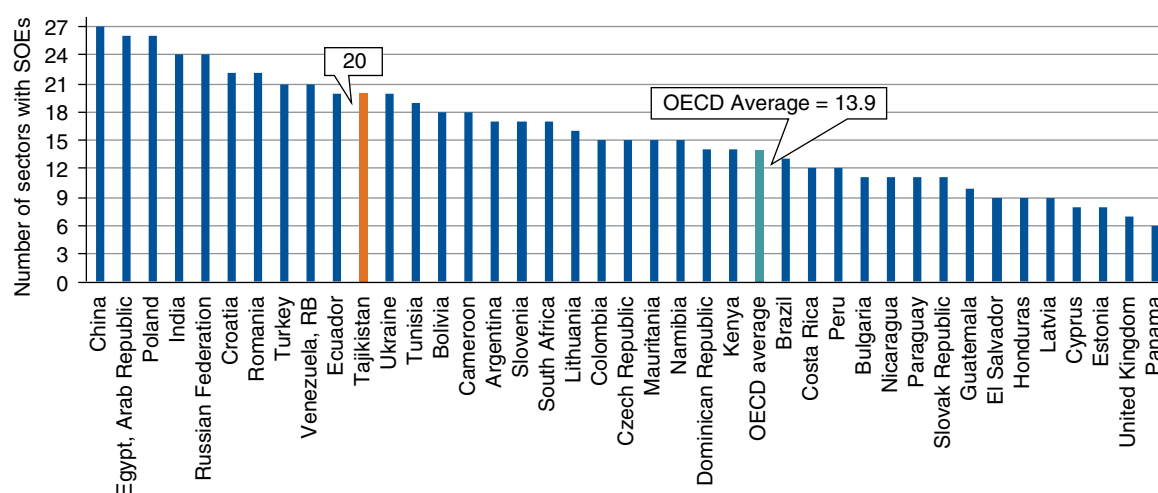
A relevant missing element in the Tajikistan state aid and investment incentives framework is monitoring and ex-post evaluation. The ex-post evaluation of an aid measure aims to determine whether the scheme has achieved its goals while limiting distortions on markets (trade and competition). The impact of an aid measure (tax incentives, for example) can be assessed at different levels—on the beneficiaries, the policy objective, and market outcomes.¹¹³ In the case of Tajikistan, clarifying the specific policy objectives of state aid and collecting more detailed firm-level data would be needed to assess the effectiveness of state aid and its effects on markets.

Levelling the Playing Field for Efficient SOEs

SOEs are active in sectors of Tajikistan's economy where private participation is possible and economically viable. The chapter on macro-fiscal challenges discussed the SOE sector as a source of quasi-fiscal liabilities; this chapter analyzes this segment of the Tajik economy from the competition angle. Although Tajikistan underwent a privatization program, some companies are still totally or partially owned by the state (SOEs and SUEs), and the government continues to be involved in commercial activities that could be handled by the private sector. Out of 28 sectors in Tajikistan, 21 are characterized by the presence of SOEs,¹¹⁴ well above the OECD average of 13.7 (Figure 64).

The presence of SOEs in infrastructure sectors is not unusual in many economies, especially in sectors that require intensive capital investments (such as electricity transmission and road infrastructure). However, Tajikistan has state monopolies in these sectors—as opposed to SOEs that are subject to market forces

Figure 64. Number of Sectors with SOE Presence across Economies



Source: OECD PMR database 2013; OECD-WBG PMR database for non-OECD countries 2013-2017; WBG Markets and Competition Policy Database.

Note: Figure includes only middle-income economies and economies among the five that have the lowest number of sectors with SOEs.

¹¹³ For a general framework of assessment, see European Commission (2014).

¹¹⁴ For this statistic, a SOE is defined as a company in which national or subnational governments (not including local governments or municipalities) hold, either directly or indirectly through a government-controlled company, the largest share of the firm's equity capital. Publicly controlled firms also include government entities that are not organized as companies but operate in businesses and carry out commercial activities.

through private competitors—and has SOEs in other areas (including banking, retail trade, accommodation, and manufacturing) that in other countries would be led by private companies.

Unlevel Playing Field between SOEs and Private Players

SOEs are essential players in key markets, and therefore their performance has spillover effects across the economy. SOEs hold monopolies in critical infrastructure—energy, transportation, and telecommunications—services that are essential to the business operating environment and determine Tajikistan's overall competitiveness. Tajik Telecom holds a monopoly in national telephone landlines and fixed backbone infrastructure, while Tajik Rail Road Company dominates in the rail sector. In the energy sector, Barki Tajik holds a monopoly in the generation, transmission, and distribution of electricity. As shown below, Tajik Telecom affects the performance of other sectors that use its services, such as mobile phone companies and Internet Service Providers (ISPs). In air transportation, protections that benefit Tajik Air impact overall sector performance, affecting connectivity. In general, the quality and cost of telecommunications, transportation, and electricity directly impact the business environment, the competitiveness of Tajik goods and services, and the attractiveness of Tajikistan as an investment destination.

State participation in commercial activities and competition with the private sector require special attention given their potential adverse effects on attracting investment to ensure sustainable growth. Although the government may have other objectives (for example, boosting job creation, reducing inequality in income and asset ownership, or ensuring security), value-for-money principles can be applied to compare the benefits of state ownership with the cost of impairing economic efficiency, productivity growth, and fiscal sustainability. Moreover, alternative instruments—such as regulatory and governance reforms that attract private investments and different types of Public-Private Partnerships (PPPs)—could be used to achieve government objectives at a lower cost.

Tajikistan's current legislation provides the freedom to invest in any form and perform any entrepreneurial activity unless prohibited by specific laws. In exceptional cases, restrictions can be imposed on some investment activity for reasons of national security. Additionally, the government has a list of infrastructure and social services which are restricted to government provision and not open to PPPs—including the production of baby food for medical entities and air traffic control—activities that are open to private investment in other countries.

How state aid is granted to firms (public and private) affects the level playing field and competition, in addition to generating a fiscal burden. The legal framework does not explicitly regulate the provision of any direct subsidies or cash transfers to support SOEs. The majority of Tajikistan's SOEs are loss-making despite receiving substantial government aid; many SOEs have accumulated large quasi-fiscal deficits (QFDs). The resulting liquidity problems, operating losses, and growing indebtedness of SOEs are absorbed by accumulating arrears, lax financial discipline, subsidized loans, and debt write-offs. As a result of inefficiencies, poor management, and inadequate pricing, a small number of SOEs have a significant negative fiscal impact.

Some of the largest SOEs receive financing that is unavailable to private companies, and repayment rules are lenient. Short-term loans are provided from budget funds to large SOEs for specific projects at interest rates of about 10 percent. In 2017 total outstanding debt on direct credits to SOEs from the budget totaled TJS 75 million (approximately US\$8.4 million). Under on-lending arrangements, the government passes on loans obtained from IFIs to SOEs with an interest rate in the range of 3 to 6 percent, thereby making it a cheaper source of finance than a commercial loan. Over the last several years, the Ministry of Finance has experienced an accumulation of fiscal costs through non-repayments of loans obtained by SOEs via on-lending arrangements. Total explicit liabilities held by the eight largest SOEs stood at TJS 5 billion in 2016 (the equivalent of around 9.2 percent of 2016 GDP). Barki Tajik alone accounts for about 97 percent of total outstanding sub-loans. SOEs may also access lending from state-owned banks.

SOEs can also benefit from favorable treatment that is not available to private firms, such as writing off on tax arrears and other liabilities, allowing for artificially low prices that can discourage private projects. Government authorities have been addressing the issue of large arrears accumulated by SOEs through the inter-enterprise arrear's settlement, in which arrears are written off among different parties. Deferrals of tax payments have been granted as well. Barki Tajik alone accounted for more than the entire improvement in tax

arrears observed during 2017—mainly due to a write-off related to a multiparty arrears settlement—but still accounted for nearly 14 percent of total outstanding tax arrears in 2017. There is a risk that the current government practice of offsetting arrears or tax deferrals will become an indirect subsidy to those SOEs facing financial difficulties, thereby creating few incentives for nonperforming SOEs to reduce arrears as they anticipate that the government will always guarantee their survival.

SOEs also benefit from lower energy costs. Tajik Aluminum Company (TALCO), one of the country's largest SOEs, consumes between 25 and 50 percent of all electricity produced in Tajikistan. TALCO also enjoys lower rates which are not based on specific tariff studies (to establish that the price reflects actual delivery costs or accounts for any other economic explanation). Its current electricity tariff rate is TJS 7.2 per kWh (from May to September), and TJS 11.8 (from October to April) compared to TJS 40.99 per kWh for other industrial users (that generally connect at lower voltage networks). Barki Tajik also offers a lower price to state-owned organizations (TJS 16.85 per kWh). According to the US State Department's Office of Investment Affairs' Investment Climate Statement, SOEs also enjoy preferential access to land and raw materials.

The blurred separation between the administration of SOEs and policy making and regulation of sectors where SOEs operate facilitates advantages for SOEs. Preferential treatment can stem from both laws and regulations and the administrative practices of regulators. For example, under the Law on Insurance Activities (July 23, 2016, No. 1349) compulsory insurance (life, health, and property, mainly on motor vehicles, which accounts for the largest share of insurance policies in Tajikistan) can only be carried out by a SOE. In telecom, the decree on the Unified Communication Transit Center (UCTC) requires that all ISP and mobile operators pass all internet traffic through the center operated by Tajik Telekom, a SOE. In postal services, the regulator (Communication Service) did not renew licenses for international postal companies (DHL and UPS) in July 2017 and instead created an international postal company. In the area of technical testing, although there seems to be no restriction on private laboratories performing such services, most of the companies are still associated with the regulator and government, except for a limited number of private and better-equipped independent firms that have been registered through technical assistance from international donors.

In the current context where SOEs operate in competition with private firms, rules to ensure competitive neutrality (that is, a level playing field) could be explored in sectors where private solutions are important to Tajikistan's competitiveness. Successful practices in other countries could be tailored to the Tajikistan context considering the government's development goals.¹¹⁵ Regarding competitive neutrality in regard to SOEs, areas to advance implementation include: (i) streamlining the operational form of the government business (corporatization and separation of commercial and non-commercial activities); (ii) identifying the costs of commercial and noncommercial activities (proper cost allocation); (iii) achieving a commercial rate of return to avoid undercutting private competitors; (iv) transparently compensating for public service obligations; (v) tax neutrality to ensure all firms are subject to the same tax burden; (vi) regulatory neutrality to ensure rules are applied to all private and public firms; (vii) debt neutrality to ensure equivalent interest rates for private entities in the same circumstances; and (viii) competitive and nondiscriminatory public procurement.

Weak SOE Governance

Stronger SOE corporate governance can address competitive neutrality issues while helping to improve SOE performance. However, Tajik SOEs do not follow internationally accepted guidelines on corporate governance.¹¹⁶ SOEs are present in Tajikistan in two forms: as Joint-Stock Companies (JSCs) and State Unitary Enterprises (SUEs). JSCs have formal boards of directors, and some JSCs report to the finance ministry's SOE Monitoring Department, but there is no consistent guidance on how the government is represented on their boards of directors, or on how the board's decisions are governed or reviewed by internal control procedures. SUEs can be national, regional, or municipal. At the national level, a SUE may fall under the oversight of a line ministry or other government body, but it does not have a formal board of directors, and legal ownership is held by the State Committee on Investments and Management of State Property. Oversight by line ministries that also have policy and regulatory functions in the sector and affect the investment environment, lack of

¹¹⁵ For example, see Australia (1996); OECD (2012).

¹¹⁶ OECD 2015a; OECD 2015b.

clarity on rules to appoint boards, and limited accountability and transparency on SOE performance are some features of the current corporate governance framework.

There is no single government entity with full oversight decision making or accountability for SOEs in Tajikistan. Oversight responsibilities are spread across various line ministries and agencies; the State Committee on Investments and Management of State Property manages all state enterprises undergoing privatization. Some key strategic entities, such as Tajikistan Aluminum Smelter (TALCO) and TALCO Management, remain under the direct responsibility of the Office of the President. Line ministries monitor SOEs, but without established guidelines on how to monitor and supervise them. SOEs do provide periodic data to line ministries and report to the State Statistics Committee or the Ministry of Finance. However, consolidated information on SOE operations and their financial positions is not available at the Statistical Agency, Ministry of Finance, or the State Committee on Investments and Management of State Property. There is no centralized monitoring of SOE financial performance or the extent to which they achieve their intended economic, social, or other goals.

Tajikistan will benefit from having a clear policy that defines the role of SOEs in the economy and improving SOE corporate governance to ensure SOEs achieve their goals while allowing the private sector to contribute to growth. The economic and social rationale for commercial and noncommercial objectives should be clearly defined, and SOEs should be proportionately compensated for the costs of any public service mandate. Progressively, SOEs can crowd in investment in sectors where the private sector is sufficiently capable or private solutions for social projects are possible, and when there is no compelling social rationale for a SOE. Actions are essential to level the playing field between SOEs and private firms to mitigate distortions across and within sectors. Efforts to strengthen the corporate governance of SOEs would contribute to this, particularly with more explicit rules regarding SOE decision making, transparency of performance, and accountability. Such efforts would be particularly important in telecommunications, energy, and transportation.

Sectoral Policies That Affect Competition and the Performance of Tajik Markets

Competition concerns are present in various sectors, but telecommunications and aviation are particularly important for connectivity to serve the domestic market and for regional integration. Given the state's presence in the economy, public procurement is a key area to attract private sector participation.

Telecommunications Sector

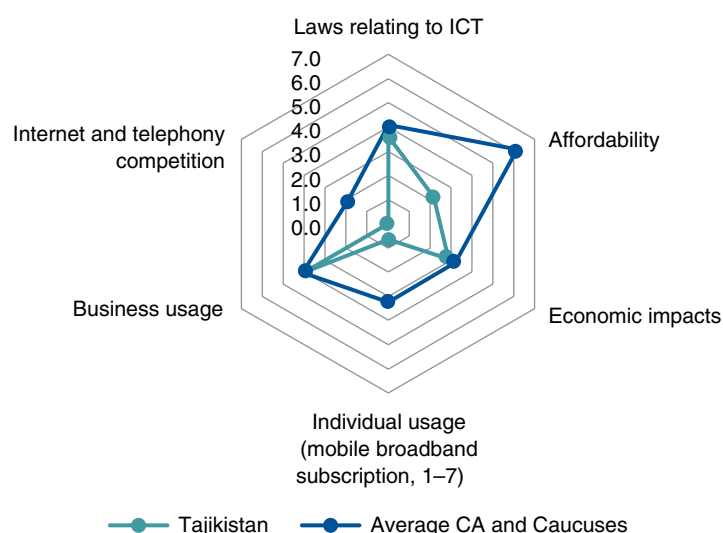
The telecommunications sector is critical for promoting development, and competition policies are necessary to ensure the even distribution of the benefits of the digital economy. Tajikistan has declared its commitment to boost the expansion and performance of this sector. There is consensus that strategies for achieving digital development must be broader than information and communication technology (ICT) and create the conditions and incentives for firms to compete and provide better telecom services. An increase in broadband subscriptions of 10 percentage points can lead to up to a 1.4 percentage point increase in GDP growth rates.¹¹⁷

Despite the government-declared interest in the performance of the sector, Tajikistan lags its peers in Central Asia and the Caucasus in competition, affordability, and individual usage. Tajikistan performs relatively well for its ICT legal environment, business usage, and ICT sector economic impact, but falls behind for competition, affordability, and individual usage compared to its peers in the CIS region (Armenia, Azerbaijan, Georgia, Kazakhstan, and the Kyrgyz Republic) (Figure 65). According to the World Economic Forum's Networked Readiness Index, Tajikistan ranks 114 of 139 economies with a score of 3.3 on a scale from 1 (worst) to 7 (best).¹¹⁸

ICT has been one of the fastest growing sectors in Tajikistan in the first decade of 2000s, as reflected by increased penetration rates. As the Communication Service (CS) reported in February 2015, sector revenue grew by about 15 percent annually until 2013 and gross revenue accounted for 6.5 percent of absolute nominal GDP. The ICT sector, which employs 20,000 people, has attracted \$370 million in private investment since

¹¹⁷ World Bank 2016b.

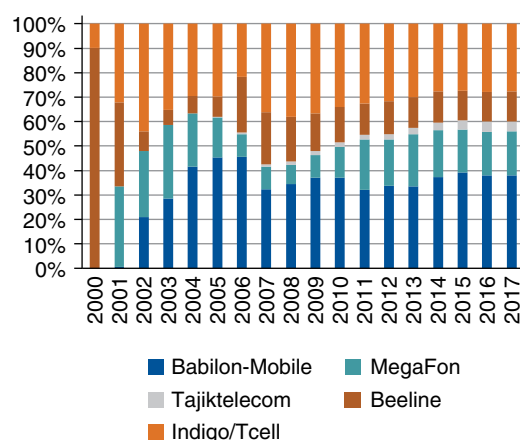
¹¹⁸ See http://www3.weforum.org/docs/GITR2016/WEF_GITR_Tajikistan_2016.pdf

Figure 65. Networked Readiness Index: Tajikistan and Central Asia and Caucasus

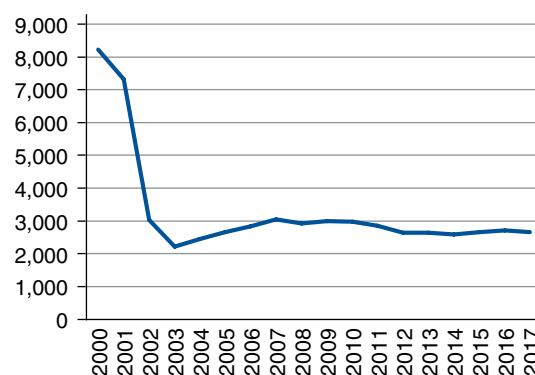
Source: World Economic Forum 2016.

2007. Tax contributions of ICT companies represent a significant source for the state budget, accounting for 4.8 percent of annual tax revenue in 2014. Mobile penetration rose from 82 percent in 2012 to 113 percent in 2017, accompanied by a strong increase in mobile broadband penetration (from 6 percent in 2013 to 25 percent in 2017). However, Tajikistan's broadband market is still in its infancy; penetration remains relatively low and prices high compared to neighboring Central Asian economies (Figure 65).

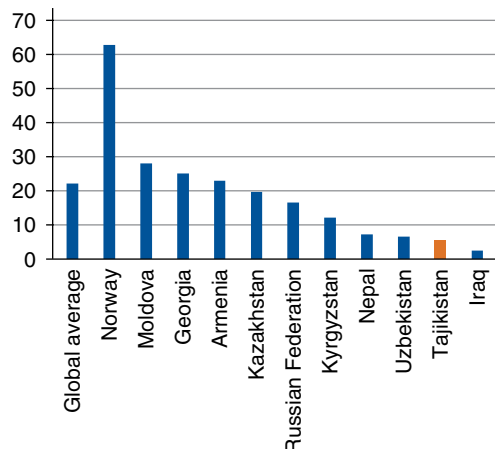
Shifts in market shares across time and the adoption of different advanced technologies underscore the dynamism of Tajikistan's mobile market (Figure 66). As of March 2018, there were five major operators in the Tajik mobile market: Tcell, Babilon-Mobile, MegaFon, Tacom/Beeline, and Tajik Telecom. A smaller operator, TK Mobile, had limited operations. With 37.8 percent of customers, Babilon-Mobile has the largest overall market share, followed by Tcell (27.5 percent), Megafon (17.9 percent), Beeline (12.2 percent), and state-owned Tajik Telecom (4.1 percent). As measured by the Herfindahl-Hirschman Index of market concentration, progress has been made since the 2000s (Figure 67), although the withdrawal of international investors from the market in 2017 and 2018 could reverse this trend. All mobile operators have launched 3G services since 2005, and these are gradually expanding outside the capital, Dushanbe. Babilon-Mobile, Tcell, and Megafon offer 4G services, while Babilon-Mobile stands ready to introduce 5G.

Figure 66. Mobile Market Evolution (market shares)

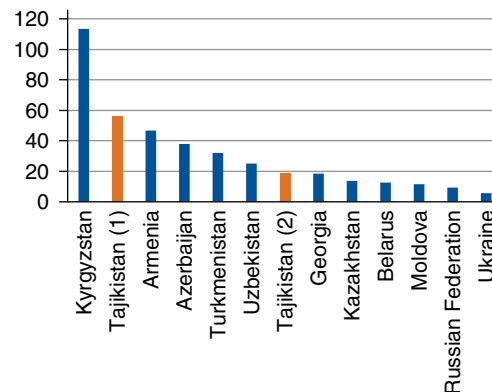
Source: GSMA (2017).

Figure 67. Herfindahl-Hirschman Index of Market Concentration (concentration, max = 10,000)

Source: GSMA (2017).

Figure 68. Mobile Broadband Speed (download, Mb/s), February 2018

Sources: Speedtest Global Index, February 2018. Cable.co.uk, as of October 2017.
 Note: (1) Lowest price for unlimited data connection; (2) Average of 21 packages including the lowest speed.

Figure 69. Fixed Broadband Prices (USD/month)

Sources: Speedtest Global Index, February 2018. Cable.co.uk, as of October 2017.
 Note: (1) Lowest price for unlimited data connection; (2) Average of 21 packages including the lowest speed.

The situation is different in the data market, where international data transmission constraints negatively impact speed and prices. Despite modest improvements to international bandwidth (to about 6–8 Gbps), Tajikistan's data transmission speeds remain the slowest among regional peers and other small, landlocked countries. Data speeds are directly hindered by a lack of competition and Tajik Telecom's monopoly over Internet traffic. Such slow international bandwidth speeds (Figure 68) cannot support significant increases in trade in services, the development of a knowledge economy, or reposition Tajikistan as a regional hub. International connectivity is limited, in part, as a result of Tajikistan's geography and topography; however, efforts to improve data connectivity with regional markets have been blocked by the CS. Other landlocked countries such as Armenia and Moldova have overcome this constraint and have significantly increased their international connectivity levels by opening up their markets and allowing local networks to connect with global carriers. Restrictions on this market—together with the mandatory local transit through the Unified Communication Transit Centre (UCTS)—have also affected the prices of broadband services paid by consumers (Figure 69). The price of unlimited monthly access to the Internet in Tajikistan is the second-highest in CIS countries.

The telecoms sector, which was a source of dynamic growth amid open competition in the early 2000s, has become overregulated and less competitive. In contrast to its declared official strategy to develop a more competitive and dynamic telecoms industry,¹¹⁹ through its regulator, the CS, the government has tightened the regulatory environment. There are concerns regarding conflicts of interest involving the sector regulator (which also manages SOEs in the sector) and the designation of Tajik Telecom as an unregulated monopoly for the transit of Internet traffic and international calls gateway. The CS—which functions as a hybrid ministry/policy maker, regulator, and operator of Tajik Telecom—has been stifling private investment and putting a hold on the development of Internet markets in the country. For years, the CS has prevented companies from connecting across the border into Afghanistan and has blocked a fiber-optic connection to China, which would have dramatically reduced connection costs and improved quality and speed. The CS granted permission to one company to construct a fiber-optic network into Afghanistan but later canceled the permit. The CS has also prevented mobile network companies from jointly constructing a fiber-optic network in the east of the country to improve service quality and coverage. Furthermore, with the establishment of the Tajik Telecom-operated UCTC in January 2016—and the CS requirement that all ISP and mobile operators in Tajikistan pass all Internet traffic through the center—all other operators were put at a disadvantage; they were required to use

¹¹⁹ As stipulated under the National Development Strategy 2030 and the Law on Electronic Communication.

a competitor's facility. Other regulations tightened by the CS include those on SIM cards (a maximum of two cards are allowed when there are four mobile operators and no number portability), a ban on providing international Voice over Internet Protocol (VoIP) communications, regulations governing card retailers, control of Wi-Fi access, and most recently, attempts to set a statutory high price for SIM cards. Chart 2 outlines these and other measures taken by the CS that have had adverse consequences for competition in the telecoms sector. In addition to those measures, the government attempted to increase SIM card prices in August 2018, tightened controls on access to SIM cards and requirements for SIM card selling points in February 2019, and attempted to establish high minimum prices for data and voice services in March 2019.

Across all indicators for regulatory conditions in the telecoms sector, Tajikistan ranks as one of the lowest globally. The country ranks lowest (with a score of 0) for its telecom's competition framework. Tajikistan's rank further deteriorated from 177 in 2007 to 187 in 2016, putting the country at the bottom of the list of 190 economies globally.¹²⁰

The Law of Electronic Communications (drafted in 2002 and subsequently amended in 2006, 2008, and 2016) governs the sector. Articles 9 and 10 outline the functions and powers of the regulator—to provide for fair competition between telecommunication operators, high-quality telecommunication services, equal access of all users to telecommunications services, licenses for the use of radio frequencies, and to prevent anticompetitive activities (in cooperation with the AMS). The regulatory principles and main regulatory framework included in the law are generally in line with international standards. However, the law does not provide sufficient separation between the roles of the CS as policy maker, regulator, and telecoms operator. As a result, the CS lacks independence and accountability.

The AMS also has a role in the regulation of the telecoms sector: controlling prices and sanctioning anti-competitive practices. Antitrust rules apply to all sectors, including telecoms, and the law of natural monopolies gives AMS the mandate to regulate prices for both final and access services provided by Tajik Telecom. In practice, the CS forwards the suggested prices for AMS review and approval. Furthermore, the AMS has included all five mobile operators in the registry of dominant firms. Therefore, these operators have to submit prices for AMS approval and provide the AMS with an explanation of the source of any price variation. Given the dynamism of the sector and the structure of the market, price controls on competitively provided services should be abolished. In other countries, a detailed analysis of whether an operator has significant market power is necessary before deciding to regulate operator prices, but in Tajikistan, the AMS relies on market share formulas. This creates an additional regulatory burden on firms that would not qualify as dominant under international standards and creates a risk of potential fines for non-compliance.

Applicable taxes and tax administration can constitute significant barriers to expansion, thereby dampening network investment and potentially discouraging telecommunications operators from upgrading or expanding their networks. According to the 2016 Networked Readiness Index, Tajikistan is ranked second from the bottom (137 out of 139 countries), in terms of tax burden (Figure 70).¹²¹ As reported by the Association of Mobile Operators of Tajikistan, the overall share of taxes in gross profit of mobile companies increased from 26 to 45 percent between 2011 and 2018. This jump followed the introduction of excise (3 percent), UCTC interconnection costs, and VAT (18 percent) for all incoming calls. Total taxes and fees constitute about 87 percent of mobile company gross profit, of which 26.5 percent are direct and 60 percent are indirect taxes.¹²²

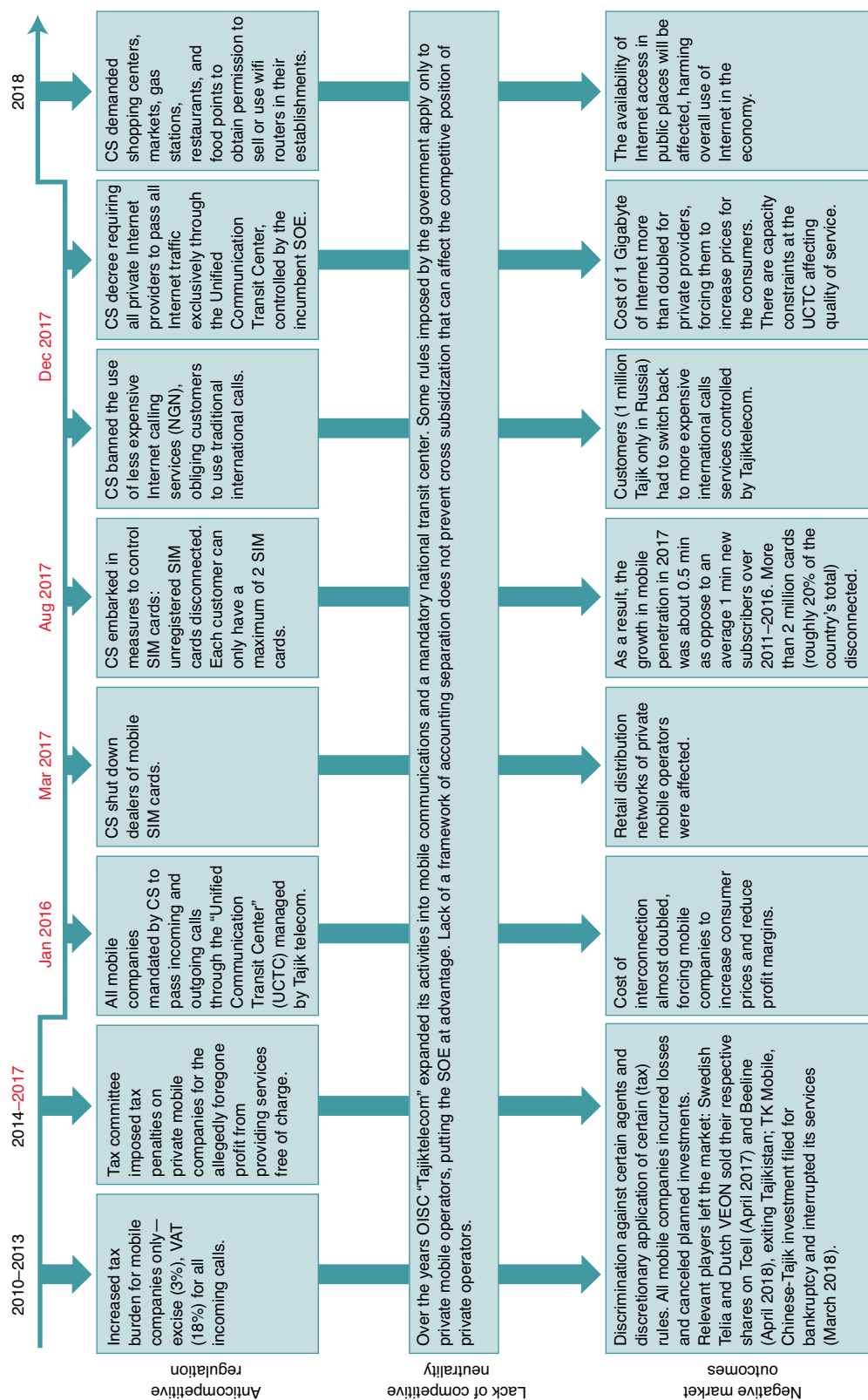
As major taxpayers, recent decisions by the Tax Committee have had direct consequences for the main mobile and Internet providers in Tajikistan. The latest series of decisions include the imposition of tax penalties on the foregone revenues of private mobile companies providing services free of charge. These changes led to the exit of a shareholder of the largest player in the market (Telesonera sold its shares in Tcell), a reduction in the profits of all mobile operators, and the cancellation of planned investments into the expansion and improvement of services (Figure 71). A dispute with the tax authorities delayed and almost led to the

¹²⁰ ITU, 2017, ICT Regulatory Tracker.

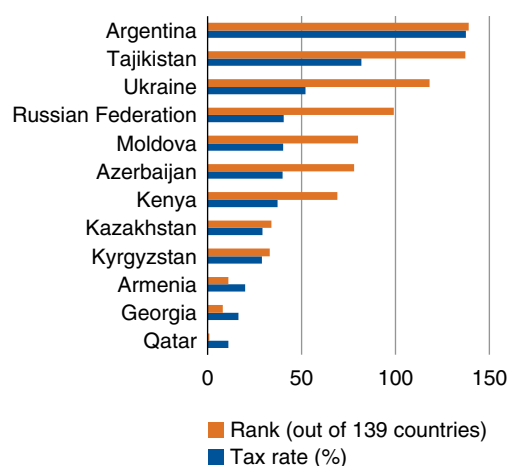
¹²¹ The total tax rate in the telecoms sector is the sum of profit tax, labor tax and social contributions, property taxes, turnover taxes, and other taxes, as a share of a company's commercial profits.

¹²² CEM competition chapter mission, February 5–9, 2018, interviews with mobile companies.

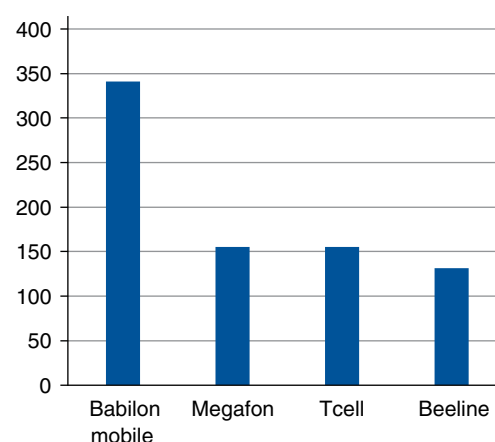
Chart 2. Major Regulatory Restrictions and Competition Issues in Tajikistan's Telecommunication Sector



Source: World Bank staff based on a review of media sources and interviews conducted in Dushanbe with ICT companies and business associations during February 5–9, 2017.

Figure 70. Telecoms Sector Tax Rates

Source: Networked Readiness Index 2016.

Figure 71. Tax Penalties Imposed on Mobile Operators (TJS million)

Source: News reports and firm-level information.

cancellation of a deal to transfer control of Tcell to a new owner,¹²³ and Veon and MegaFon have publicly considered withdrawing from Tajikistan over similar disputes with the tax authority.¹²⁴ Eventually, VEON (the main Russian shareholder of Beeline) sold its shares to local investors (ZET Mobile) as a result of incurred losses due to the inability to settle tax fine liabilities of TJS 45 million imposed by the Tax Committee.¹²⁵ Taxes are estimated to add 33 percent to the cost of Internet connections in Tajikistan, undermining access to the Internet in a country where affordability is already challenging.

Urgent measures are needed to restore confidence in the telecoms sector, reduce regulatory risks, and take advantage of international connectivity initiatives such as the Belt and Road Initiative. Doing so will require a more predictable regulatory environment to attract investment to the sector. The current Electronic Communications Law (2010) is technically sound on the principles and regulatory areas needed to promote competition and boost sector performance. However, implementation is lacking. The government needs to commit to implementing the law with a view to allowing for private participation and boosting competition to deliver the best deals for Tajik consumers. Alternatives to address security concerns, for example, could be evaluated to phase out the operation of the UCTC, and access pricing and rules could be updated under the natural monopoly law to minimize distortions to competition. Amending the law to create a clear separation between the mandates of policy making and regulation—as well as separating the commercial and regulatory functions of the CS—would be a next step. Doing so would help Tajikistan comply with its World Trade Organization commitments on telecommunications. The Communication Service Regulations (2011) could also be amended to adjust the institutional setup, include a collegiate body as the decision maker (instead of vesting all power to the Chief), define maximum terms for board members, and clarify the selection process of board members. Improved corporate governance and results-based monitoring of Tajik Telecom could help improve its performance and reduce the need to rely on regulatory instruments to maintain the company's market position. Other complementary measures include reviewing the tax policy and administration of telecommunications services and improving the monitoring and evaluation of market dynamics in the sector.

¹²³ Telia. 2017. "Tcell Appeals Illegal Tax Claim in Tajikistan." *News*, 17 January. <http://www.teliacompany.com/en/news/news-articles/2017/Tcell-appeals-illegal-tax-claim-in-Tajikistan/>

¹²⁴ "Business of Megafon and Vimpelcom in Tajikistan is under threat." *RusLETTER*, 16 February 2017. http://rusletter.com/articles/business_of_megafon_and_vimpelcom_in_tajikistan_is_under_threat

¹²⁵ <https://news.tj/ru/news/tajikistan/economic/20180418/investori-pokidayut-tadzhikistan>

Aviation Sector

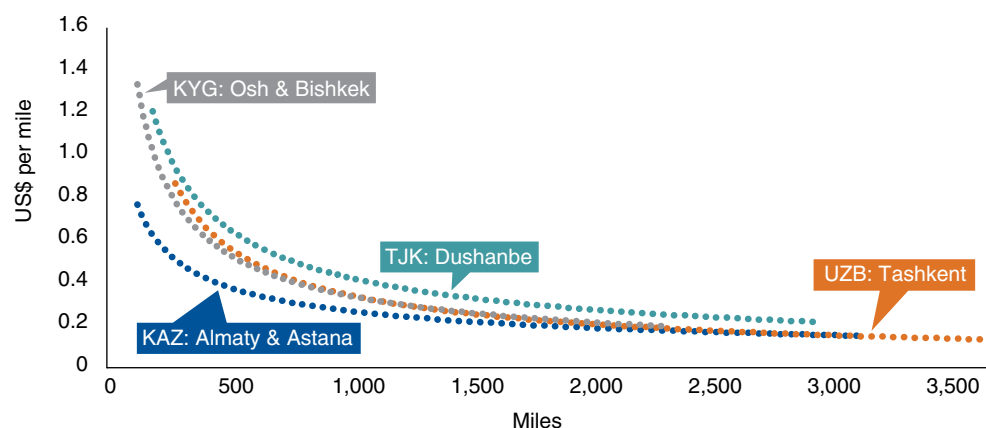
The government carried out important reforms in the mid-2000s to improve the performance of air transportation, a key sector for connectivity. Following the unbundling of the Tajik State Air Company (TSA), the airports, airlines, and air navigation services were separated into distinct Open Joint Stock Companies (OJSCs), wholly owned by the State Committee on Investment and State Property Management. Fuel provision was also separated from the TSA and converted into the OJSC Toplivo-Zapravochnaya Kompaniya (TZK), the only authorized private fuel provider to Tajik airports. Policy making functions remained within the Civil Aviation Agency, a subordinate body to the Ministry of Transport, while safety oversight was entrusted to the State Service for Transport Supervision and Regulation. Some regulatory functions have been delegated to the AMS, an autonomous agency charged with the enforcement of competition.

Despite having approved a National Aviation Policy that pledged a gradual liberalization of international aviation travel, market access remains restricted, adversely impacting connectivity and airfares. The difficulties experienced by Tajik Air have reduced its market share. A private carrier, Somon Air, currently holds about 30 percent of Tajikistan's total seat capacity, whereas Tajik Air has only a 19 percent share. International carriers hold the rest—the three largest Russian airlines account for almost 40 percent of the Tajik market. In terms of destinations, Moscow represents 46 percent of the seats offered in the market, whereas domestic air travel is negligible. From Dushanbe, the smallest airline share in the ten largest markets is 42 percent. In six of those ten routes, at least three carriers offer seats. However, of the 22 routes operating from Dushanbe, 12 are served only by one carrier.

The Moscow-Dushanbe route was tightly protected and agreed capacity was left unchanged for almost 10 years, constraining market growth and inflating airfares. Following the resolution of bilateral disputes, only three additional frequencies were added from Dushanbe to Moscow's Zhukovsky International Airport. Some capacity expansion was allowed from secondary airports to Moscow, but these were quickly curtailed to prevent a diversion of air traffic from Dushanbe. Tajikistan also maintains a protective stance with Turkey, possibly due to the presence of one of the local carriers that also operates the route; this translates into limited services and aircraft types serving the route. Moreover, there is evidence that traffic rights are restricted to regional hubs (Almaty, Urumqi) to prevent traffic loss, connecting to their final destination via any of these airports. As a result, airfares from Dushanbe are the highest in the region (Figure 72).

In the air transport sector, the AMS is responsible for the regulation of natural monopoly activities, particularly for tariff regulation of airport and air navigation infrastructure services, as well as domestic air transport services.¹²⁶ The AMS regulates charges for air navigation services, aeronautical, and

Figure 72. Average Lowest Available Airfare



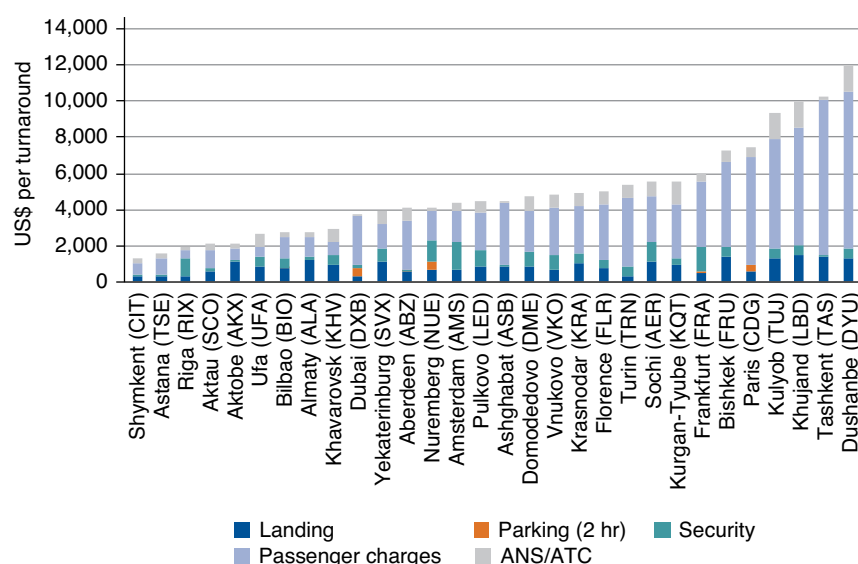
Source: World Bank staff calculations based on airline websites.

¹²⁶ Key components of this framework include (i) Article 5 of the Law of the Republic of Tajikistan "About natural monopolies;" (ii) Resolution No. 210 of Government of Tajikistan (dated May 12th, 1999) "About provisions on calculation of cost of goods, works and services at enterprises and organization of the Republic of Tajikistan," and (iii) AMS instructions for determination, approval (enforcement) and setting tariff-costs for goods, works, and services provided by natural monopolies.

aeronautical-commercial charges in international airports. Under the current “cost-plus” regulatory model, tariffs of domestic transport organizations (airports, airlines, air navigation company, fuel) are allowed to support up to a 35 percent profit margin. The present environment lacks incentives for cost efficiency seeking, as all costs can be transferred downstream, regardless of their economic justification.

As a result of Tajikistan’s current regulatory approach, prices of key inputs for air transportation services are high. Weaknesses of the price regulation model render tariffs for infrastructure services high. Turnaround infrastructure costs (fees levied on carriers and passengers for international flights) in Dushanbe, Khujand, and Kulyab International Airport are in the top four most expensive airports in the region (Figure 73). The de facto monopoly for jet fuel has also contributed to high prices despite price regulation by the AMS. Fuel prices are the second most expensive after Tashkent (Figure 74). As a result, an increasing number of passengers are reportedly using airports in neighboring countries to fly to Moscow.¹²⁷

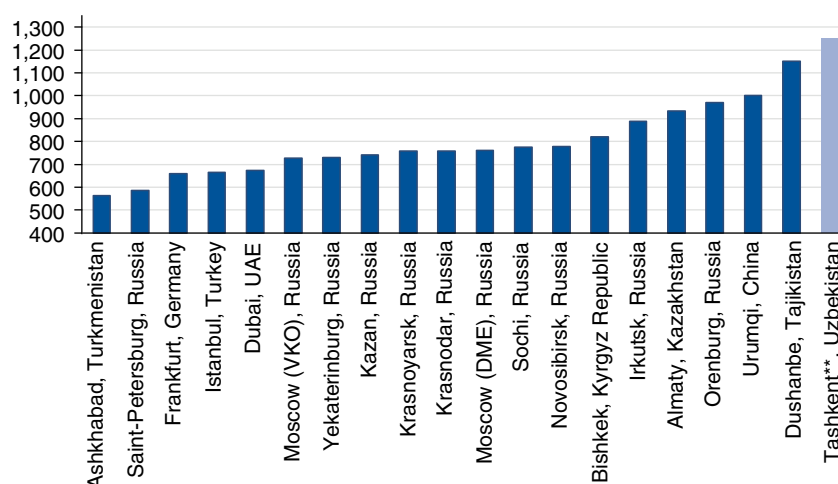
Figure 73. Infrastructure Turnaround Costs Levied on Passengers and Airlines



Source: World Bank staff calculations based on information provided by airports and their websites.

Note: ANS/ATC are charges for air navigation services and air traffic control.

Figure 74. Jet Fuel Price, December 2017 (US\$ per ton)



Sources: World Bank staff calculations based on data from the Russian Federal Agency for Air Transport (Rosaviatsiya) and information provided by the airlines.

** Feb/March 2018 quote

¹²⁷ Asia-Plus News Agency publication, September 18, 2018.

Table 13. Deregulation of Air Transport Services in Selected Economies

Economy	Deregulation and Market Outcome
United States	Deregulation in 1978 spurred the emergence of hub and spoke systems, low-cost carriers with nationwide route networks (Southwest Airlines, for example), new entrants, and integrated cargo carriers.
European Union	The liberalization of the European air market was associated with rapid growth in the entry of limited liability companies (LLCs). From 1996 to 2003 the market share of LLCs grew from almost zero to one-fifth of the total market. Low cost carriers such as Ryanair and Easyjet expanded rapidly.
Armenia	Unilateral open skies policy and sector reform (started in 2013) allowed for the entry of new carriers, expansion of traffic, frequencies and destinations, and lower airfares.
Brazil	Domestic deregulation in the 2000s led to growth of low-cost carriers such as Gol and Azul.
Czech Republic	New Czech carriers, such as Smartwings (which started operations in 2008), entered the market following liberalization.
Georgia	Deregulation in 2005 granted foreign carriers unrestricted access to Georgian markets, leading to substantial growth of the country's air transportation market (traffic increased by approximately 67 percent).
Turkey	Turkey's first LLC, Pegasus Airlines (which began operations in 2005) provides an example of a small carrier that succeeded despite the presence of a dominant incumbent (Turkish Airlines) and concerns over competitive neutrality.
Morocco	Reforms started in 2004 included the renegotiation of existing Air Service Agreements (ASAs) to remove limitations on capacity, frequency, and pricing as well as the signing of newer, more liberal agreements. Twenty-two foreign airlines and three Moroccan low-cost carriers subsequently entered the Moroccan market.

Despite market protection, the efficiency and profitability of Tajik carriers have not improved. Local carriers have amassed increasing debt with the infrastructure providers, namely airports in Tajikistan and Tajik Air Navigation Company, all wholly owned by the state. In the past, government decrees have been used to write off accumulated arrears from the airlines' balance sheets. Tajik Air also enjoys government guarantees for the financing of aircraft. Despite honoring only some of its commitments, the airline has failed to achieve a sustainable profitability record or introduce productivity gains.

More open policies in international air transportation accompany improved sector performance. The experience of various countries illustrates that a liberalized environment stimulates the entry of new carriers (including low-cost carriers) and has positive effects on passenger traffic, quality of service (frequency and connectivity), and airfares (Table 13). In turn, this can have positive impacts on overall GDP growth, trade volumes, investment decisions by foreign investors, and sectors such as tourism.¹²⁸ Tajikistan could enjoy those benefits if the implementation of its National Aviation Policy progresses in that direction.

A more market-oriented policy in Tajikistan would entail regulatory and policy changes regarding market access for international routes, regulation of input markets for air transportation, and the role of SOEs in the sector. The government could adopt more liberal bilateral service agreements to relieve the constraints on market growth in key routes (such as Dushanbe-Moscow). The AMS could update the methodology to set prices for essential infrastructure services for air transport to provide incentives for efficiency. The current framework that maintains jet fuel provision as a de facto monopoly could be reviewed to make the market more contestable. Finally, enforcement of the state aid control framework to minimize market distortions, analysis on areas to refocus direct state participation in commercial activities, and improved rules to enhance accountability and encourage productivity of SOE would also help promote efficiency and improve sector performance.

Public Procurement

Competition in public procurement allows governments to deliver key goods and services for the population and businesses. The government acts as a consumer of goods and services, making purchases on behalf of

¹²⁸ See, for example, PWC (2013); Poole (2010); IATA (2006); InterVistas (2006); Myburgh, Sheik, Fiandeiro, and Hodge (2006).

its citizens. When competition is suppressed in public procurement markets due to anticompetitive practices, weak pro-competition public procurement rules, and ill-designed selection processes, the purchasing power of public funds is eroded due to higher costs; overcharges due to bid rigging can be at least 20 percent over four years.¹²⁹ In Tajikistan, despite continued fiscal pressure, public procurement expenditure was around 3–4 percent of GDP in 2011–17, accounting for an important share of public spending. In 2017 alone, the government spent 3.3 percent of GDP (or TJS 2.15 billion, the equivalent of \$240 million) on the procurement of goods, works, and services. Many OECD economies saved as much as 40 percent on public procurement by using competitive specifications and procurement practices, which encourage competition between different producers and using innovative processes to promote vendor competition.¹³⁰ Therefore, encouraging competition in these markets could reduce the pressure on fiscal accounts.

One of the main problems in public procurement in Tajikistan is the low level of participation. Preferences for domestic contractors and a lack of procedural details on procurement rules discourage participation and limit competition.¹³¹ Even though announcements of tenders with unlimited participation of applicants are published in mass media, and the share of single source procurement is 9.3 percent from the total procurement volume,¹³² in most purchases the number of suppliers (contractors) vary from one to three participants. In some cases, particularly when the value of a procurement is small, suppliers are uninterested in participating.¹³³

Transparency—which is critical to ensure open competition—remains problematic. The preliminary assessment of privilege resistance in different areas including procurement suggests that many weaknesses remain despite recent reforms.¹³⁴ While many good practice public procurement transparency measures are provided for in the law, the availability of procurement-related information (such as on tender invitation and contract award) is available online for only a subset of procurement processes. According to a survey conducted by the Public Procurement Agency (PPA) on Risks of Corruption in Public Procurement, 81 percent of respondents were not aware of the annual procurement plans of the major procuring agencies, while 40 percent of all respondents indicated that weak competition is due to the fact that potential suppliers (contractors) remain uninformed about forthcoming public procurement tenders.¹³⁵

The authorities have proactively engaged in reforms to the public procurement system. The government has been implementing its e-procurement system as part of its e-procurement program 2013–15. Its online platform lists legislation, procurement plans, and appeals, and the information needed to apply for advertised public contracts or to appeal government decisions on tenders. As stipulated in the e-procurement program, once fully implemented, the system will provide for a significant improvement in the level of transparency in procurement procedures. It will also provide equal and unrestricted access to participation, a reduction in procurement prices (due to increased competition), a reduction in procurement procedures and costs, increased state and public control, and the creation and provision of access to electronic databases of procuring entities, suppliers (contractors), and concluded contracts.

However, the new e-procurement system is limited, and a significant number of procurement selections are excluded, including single-source contracts and large procurement contracts by SOEs. Furthermore, the bid opening process for state investment projects financed by various donors and IFIs has been centralized since 2011. The State Investment Committee must clear all bid evaluation reports for procurement under such projects before they can be submitted to the relevant financing institution. In addition to reducing the ownership and accountability of implementing agencies for the outcomes of these investments, this arrangement has unnecessarily increased the time needed for completion of the bidding process. Of the 6,229 bids issued by the

¹²⁹ Froeb, Koyak and Werden 1993. For additional examples of the costs of lack of competition in public procurement in various other countries such as Mexico, South Africa and Russia, see WBG-OECD (2016).

¹³⁰ OECD 2011. <http://www.oecd.org/daf/competition/sectors/48315205.pdf> (OECD, Competition and Procurement, 2011)

¹³¹ WB, CSPR, 2013.

¹³² Republic of Tajikistan, PPA 2017.

¹³³ For more information on Tajikistan's Government Electronic Procurement Program 2013–15 see <http://zakupki.gov.tj/en/legislation/eprocurement-program/>

¹³⁴ IFC 2017.

¹³⁵ Republic of Tajikistan, PPA 2017.

Box 10. Promoting Competition in Public Procurement in Russia

Russia has strengthened its efforts to fight bid rigging and improve competition in public procurement in the country. In recent years, the Federal Antimonopoly Services (FAS) of Russia has engaged in enforcement, advocacy, and international cooperation on the topic.

- **Sanctioning bid rigging.** In 2016, the FAS revealed a cartel between Pharm SKD Ltd and NoVo pharm JSC on state bids for the supply of medicines, medical products, disinfectant products, and therapeutic food. These companies are among the largest suppliers of drugs for the treatment of HIV, infectious hepatitis B and C, and cancer. The FAS established that the collusion affected more than 400 bids worth more than 6.5 million euros.
- **Streamlining regulations.** The FAS advocated for the elimination of unnecessary product specifications that restrict competition and facilitate collusion in the pharmaceutical procurement markets. Since January 2018, Federal Decree n. 1380 of 2017 prohibits government entities at both the national and local levels to set tender rules in a way that pre-selects specific manufacturers. Competition is expected to increase the availability of medicines for Russian citizens and the efficiency of budgetary spending on medicines through the reduction of prices.

Source: The International Competition Network (ICN) and World Bank Group 2017–18 Competition Advocacy Contest; OECD 2017; Federal Antimonopoly Service of the Russian Federation official website.

PPA in 2017 (totaling TJS 1.85 billion), the share of electronic procurement amounted to TJS 569.4 million as procured from 611 procuring organizations registered as qualified entities via the electronic public procurement portal.¹³⁶

Overall, the government has a tremendous opportunity to use procurement spending more effectively as a tool to promote private sector development. First, building on the recent introduction of the e-procurement platform, new rules on contract opportunities should be introduced and disseminated to potential bidders to encourage more active competition. Second, steps can be taken to promote registration of both local and foreign firms, and to encourage bidding. Third, improving competition on larger tenders would provide greater effectiveness, value for public money, and competition. Lastly, improving the detection of bid rigging and discouraging such practices would help to boost value for money in public investment to support productivity growth. For this, collaboration between the AMS and the PPA is essential. The experience of Russia in combating bid rigging can be relevant to the AMS and PPA (Box 10).

Concluding Remarks

To increase the effectiveness of policies aimed at creating better-functioning markets, the Tajik authorities could consider refocusing their work on improving market regulation of key sectors to support competition and efficiency, embedding competition principles in cross-cutting economic policies, and laying the groundwork to develop an effective competition authority to combat anti-competitive practices and advocate for the removal of anti-competitive government rules. More specifically:

- The performance of the telecommunications sector—in terms of prices, accessibility, and growth—has been affected by weaknesses in the implementation of competitive neutrality principles. Two main negative influences have been the role of the CS as policy maker, regulator, and manager of the SOE that holds the monopoly in certain segments, and an unpredictable and burdensome regulatory framework that discourages private participation.
- Despite previous reforms in air transportation to unbundle airport services, air navigation, and air transportation, the current aviation policy remains restrictive: rules prevent entry and expansion in the provision

¹³⁶ Republic of Tajikistan, PPA 2017.

of international passenger transport, jet fuel provision is not contestable, and regulation of monopoly services—particularly airport services—is ineffective to incentivize efficiency and reduce transport costs.

- Ensuring competition in public procurement—through broader implementation of the e-procurement system, rules to facilitate dissemination of supply opportunities, and collaboration across institutions to fight bid rigging—will allow for broader participation of firms and cost reductions for the government.
- In the case of price controls, there is a need to target regulation to those services that are natural monopolies and use pricing methodologies that can help mimic the outcomes of competitive markets. A detailed understanding of the root causes of price behavior, including government rules that shield markets from competition, should inform government interventions to control price movements.
- State aid, including fiscal and non-fiscal support to private firms and SOEs, is an important policy area to promote competition on a level playing field and efficient markets. However, the government does not generally assess the effects of the investment incentives policy on markets in line with the competition law, and safeguards are not in place to guarantee competitive neutrality in markets where SOEs operate.
- Finally, improving the effectiveness of the competition authority through a stronger legal and regulatory framework, additional resources and capacity, greater independence, and broader policy support to introduce market discipline across economic sectors will set the basis for an environment where anti-competitive practices and undue regulatory protection are discouraged.
- Improving competition will generate benefits throughout Tajikistan's economy, positively impacting the well being of citizens and allowing competitive network industries to fuel GDP growth.

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