



WORLD BANK GROUP

UZBEKISTAN PUBLIC EXPENDITURE REVIEW



Ivailo Izvorski, Eskender Trushin, Ahya Ihsan, Alex Appiah-Koranteng, Aristomene Varoudakis, Ferry Philipsen, Ian Hawkesworth, Roumeen Islam, Sebastian James, Sergiy Zorya, Elvira Anadolu, Janssen Teixeira, and Kenan Karakulah

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(with data as of August 1, 2019)**

ABBREVIATIONS AND ACRONYMS

ANRE	Financial Independence of The Energy Regulator	NAPM	National Agency for Project Management
CBU	Central Bank of Uzbekistan	O&M	Operations and Management
CIT	Corporate Income Tax	OECD	Organisation for Economic Co-operation and Development
COA	Chamber of Accounts	OOPs	WHO Out of Pocket Payments
COFOG	Classification of Functions by the Government	OPCOM	Power Market Operator
DH	District Heating	PAYGO	Pay-As-You-Go
DPF	Direct Payments to Farmers	PEFA	Public Expenditure and Financial Accountability
DTU	Technical University of Denmark	PFM	Public Finance Management
EAP	East Asia and Pacific	PFS	Preliminary Feasibility Study
EBFs	Extrabudgetary Funds	PIM	Public Investment Management
ECA	Europe and Central Asia	PIMAC	Public Investment Management Center
EU	European Union	PIRLS	International Reading Literacy Study
FDI	Foreign Direct Investment	PISA	Programme for International Student Assessment.
FRD	Fund for Reconstruction and Development	PPPs	Public Private Partnerships
GAO	Gross Agricultural Output	QFD	Quasi-Fiscal Deficits,
GDP	Growth Domestic Product	R&D	Research and Development
GFMIS	Treasury Management Information System	RFS	Re-Feasibility Study
GSS	General Support Services	SAMA	State Asset Management Agency
HRM	Human Resource Management	SISQE	Supervision of Quality of Education
I&D	Irrigation and Drainage	SNG	Subnational Government
IFIs	International Financial Institutions	SOB	State-Owned Bank
IOECD	Organisation for Economic Co-operation and Development	SOE	State-Owned Enterprises
IPSAS	International Public Sector Accounting Standards	TALIS	Teaching and Learning International Survey
ISO	International Standards	TFP	Total Factor Productivity
LAC	Latin America and Caribbean	TIMSS	International Mathematics and Science Study
MDAs	Ministries, Departments and Agencies	TPCM	Total Project Cost Management
MENA	Middle East and North Africa	TSA	Treasury Single Account
MOA	Ministry of Agriculture	UFRD	Uzbekistan Fund for Reconstruction and Development
MoEI	Ministry of Economy and Industry	UFRD	Uzbekistan Fund for Reconstruction and Development
MoELR	Ministry of Employment and Labor Relations	UZPSAS	Uzbekistan Public Sector Accounting Standard
MOF	Ministry of Finance	UZS	Uzbekistan Som
MoIT	Ministry of Investment and Trade	VAT	Value Added Tax
MoPE	Ministry of Public Education		
MOWR	Ministry of Water Resources		
MPS	Market Price Support		
MPSE	Ministry of Preschool Education		
MTRS	Medium-Term Revenue Strategy		

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The report uses data and information as of August 1, 2019.

Executive Summary

The authorities embarked on ambitious reforms in 2017, transforming the economy, society, and the government. The key policy measures so far have included liberalizing prices, trade tariffs, and the exchange rate, opening up the economy to private initiative and international trade, reducing the rates of direct taxes on businesses and households, reducing the role of the government in economic activity, and commencing civil service reform. The impressive reforms have delivered results while raising expectations for further progress in boosting the potential of the economy, the vibrancy of the private sector, and the incomes and opportunities for Uzbekistan's citizens.

The next stage of market and institutional reforms the authorities are advancing aims to allow more efficient resource allocation - of labor, capital, land, and other natural resources. The role of the state is being restructured so that the government's presence in the control of factor markets and ownership of productive assets is reduced, while its role in ensuring robust competition, prudent regulation, and delivery of higher quality of education and social services is enhanced. On the former, land and banking reforms are moving ahead, and the authorities are planning to reduce distortionary directed credit and other nontransparent support to state-owned enterprises. Market reforms of agriculture and land would support higher and more inclusive growth. Increased mobility of labor would help alleviate constraints on businesses and allow people to select where they live, work, or study.

The reform agenda is grounded – and should remain anchored – in credible macroeconomic policies that build cushions against domestic and external shocks and support vulnerable households during the economic transformation. Along with it, the government is accelerating efforts to integrate the country into regional and global markets and this progress is providing a welcome boost to economic activity in Central Asia overall. A well-functioning public sector that delivers quality public services and that fosters private sector and market-led growth while managing fiscal resources prudently is considered critical for achievement of inclusive growth.

More efficient government spending, increased transparency, and better institutions for public finance management are essential for delivering high quality public services, maintaining macroeconomic stability, and supporting stronger economic growth. The authorities start from a good position, having maintained fiscal soundness, kept government debt low, and built substantial savings in the Uzbekistan Fund for Reconstruction and Development, the institution that has served as a wealth fund, stabilization fund, and a development bank. Tax reform has streamlined tax policy and administration and reduced several tax rates without jeopardizing government revenues. There is ongoing consolidation of extrabudgetary funds and accounts into the budget. Areas that need to be addressed include large tax and customs exemptions, unpredictable tax changes, large off-budget operations, budget transparency and reporting, oversized government support to state-owned enterprises (SOEs) and state-owned banks (SOBs), and separate investment and recurrent budgets.

This Public Expenditure Review (PER) takes stock of fiscal developments and institutions and analyzes the key issues that bear on the level, composition, challenges, and effectiveness

of government spending and the stance of fiscal policy. Understanding these issues is essential, as new fiscal pressures are emerging in the process of economic transformation and as citizens demand higher quality of education and other public services. The fiscal reform agenda remains extensive but working on it will provide an opportunity to strengthen the effectiveness of government and boost inclusive economic growth. In the process of ongoing economic transformation, the government is facing several challenges in fiscal policy, for which this PER has developed policy options as summarized below and discussed in detail in the chapters.

FISCAL SETUP, GOVERNMENT REVENUES AND SPENDING

Uzbekistan’s government spending is higher than in most of its relevant comparators, split equally between outlays on-budget and off-budget. Consolidated government spending amounted to 35.2 percent of GDP in 2018; including quasi-fiscal losses, spending amounts to at least 41.2 percent. Within off-budget spending, the large share of policy-based – or directed – lending and the quasi-fiscal losses of SOEs reflect the government’s support to capital-intensive industry that generates little employment and foreign direct investment. The authorities are starting to reform policy-based lending and plan to include it in the budget.

Off-budget spending is not subject to the same budget processes, monitoring, or accountability. The authorities do not have a comprehensive view of all government spending when making decisions. In specific cases – for example, public investment – different agencies consider, plan, and engage in spending. Public wages are paid from both budgetary and off-budgetary sources, resulting in disparate compensation for the same work and lack of a level playing field for public sector workers.

The bulk of off-budget spending is carried out by more than 40 extrabudgetary funds. The authorities intend to consolidate most of these funds (EBFs) into the budget from 2020. So far, progress has been not as fast as initially intended, but the process does take time. Some EBFs, such as the pension fund, exist both in Uzbekistan and many other countries, because of a discrepancy between the multi-year time horizon of the fund and the annual horizon of the government budget. In other cases, there may be an attempt to ring-fence certain revenues. The motivations are clear but removing certain operations from ministries or other budgetary units to spur disbursements or for other well-intentioned purposes hurts the capacity building needed in the public institutions and the reform efforts to make these institutions more agile.

The situation is similar with the 20,000-30,000 off-budget accounts. As in most other economies before transition began, the government allowed all budgetary institutions, from ministries, to extrabudgetary funds, to schools and hospitals, to create off-budget accounts. These funds are outside the budgetary control, however, and there is no central monitoring how the money is spent.

Uzbekistan collects more in revenues than lower middle-income countries on average and even more than many highly taxed OECD countries. Ambitious tax reforms in 2019 has not resulted in lower revenues, providing a good financial cushion for the authorities to start restructuring SOEs and bolstering social support to individuals that lose jobs in the process.

Public finance management PFM is being reformed but it still needs to catch up with good practices. The link between the annual budget and the government development strategy is weak. The internal control framework, managed through the MOF, is dominated by control and inspections, with a heavy reliance on punishment. The focus of external audit is on detecting formal violations, recommending corrective actions, and levying penalties, instead of analyzing systemic issues.

Fiscal Setup, Government Revenues and Spending: Summary of Policy Options */

- Consolidate all off-budget spending into the budget.
- Provide regular quarterly and annual reports of the consolidated fiscal program that includes what is currently on-budget and off-budget spending.
- Include estimates of the SOEs' quasi-fiscal deficits and report them regularly at least annually.
- Improve the predictability of revenue and tax policy changes.
- Move all EBFs and off-budget accounts on the Treasury Single Account (TSA).
- Improving the quality and efficiency of spending requires measurement and accountability.
- Strengthen the budget preparation process and public sector accountability and accounting.

*/ See Chapter 1 and Spotlight 1 for the detailed policy options.

TAX EXPENDITURES

Uzbekistan offers numerous tax incentives and exemptions which impose a large direct fiscal cost on the budget. These exemptions were introduced without a cost-benefit analysis whether they were effective in accomplishing their intended goals. Uzbekistan's tax incentive policy creates opacity in the government policy towards enterprises and results in substantial monitoring costs for the government, as the process involves discretionary procedures. The efficacy of these tax incentives is in doubt because they do not appear to have boosted foreign direct investment, domestic investment, or business and job creation at the rates necessary for the rapidly growing population.

Overall tax expenditures amounted to 6.4 percent of the GDP in 2018, almost a third of budgetary revenues. This figure does not include exemptions on imports including customs duties, excises, VAT on imports. The amount of tax expenditures indicates the potential for increasing government revenues if they were abolished. As the authorities advance tax reforms, which include substantial reductions in tax rates, the size of tax expenditures, or foregone revenues, will decrease automatically as the revenue foregone is relative to the actual tax or duty rates.

Tax Expenditures: Summary of Policy Options */

- Reduce and simplify the tax and customs expenditures by conducting a cost-benefit analysis of the main incentives provided.
- Withdraw tax incentives for new investment and impose a minimum tax to ensure that businesses benefiting from tax incentives pay at least a certain minimum amount of tax.
- Prepare public Tax Expenditure Statements as part of the regular budget process.

*/ See Chapter 2 for the detailed policy options.

PUBLIC WAGES AND EMPLOYMENT

The public sector is a large employer in Uzbekistan and the public wage bill accounts for almost half of the government budget. As concerns about the fiscal affordability of the wage bill have increased, the authorities are planning to reform public employment and human resource management to deliver more effective public services at more affordable cost. Reforms need to consider several issues. The current hierarchical salary structure provides little opportunity for horizontal mobility, staff motivation, and career growth in the public sector. The base salary for a position is not linked to performance and is inconsistent with international practice. Allowances and benefits are disproportionately high compared to the base salary. At the heart of these issues is a weak human resource function in the public sector, both in recruitment and promotion, weak performance orientation, and fragmentation of wage bill management responsibilities.

The overall consolidated – on-budget and off-budget – government wage bill amounted to 10.5 percent of GDP in 2018, among the highest in relevant comparators. Uzbekistan's wage bill is as high as the average for the countries of the OECD, resource-rich MENA, and SSA, and well above the average for the other developing regions.

Uzbekistan's public sector employment seems to be like the average for the countries of the Caucasus and Central Asia. Without adequate data to measure the efficiency of workers, it is hard to assess the productivity dividends to the government as employer.

Public Wages and Employment: Summary of Policy Options */

- Develop a common framework grading structure for the different occupational groups.
- Develop a compensation framework that is competitive and fair.
- Consolidate all bonuses and allowances into the base pay.
- Improve the legal framework for civil service management and compensation.
- Carry out Functional Reviews to help improve the distribution of government functions.
- Develop an HR and performance management framework for merit-based recruitment, performance appraisal, promotion, and professional development.
- Develop a human resource management information system.
- Rationalize the number of employees in the public sector through the functional reviews.

*/ See Chapter 3 for the detailed policy options.

STATE-OWNED ENTERPRISES

State-owned enterprises dominate economic activity in Uzbekistan and receive oversized government support. While explicit on-budget subsidies to SOEs are modest amounting to 1 percent of GDP in 2018, off-budget and quasi-fiscal support are extensive. SOEs receive a variety of tax and customs preferences and the public investment program which finances a part of SOEs' investment is not included in the budget. SOEs also depend critically on on-lending by the state-owned banks (SOBs) subsidized by the UFRD and the government that amounts to about 4 percent of GDP a year. Financial discipline of the SOEs is poor and is also reflected in periodic accumulation of inter-enterprise arrears and restructuring of their obligations to the SOBs and the government. Such government support and the economy-wide low input prices for SOEs distort the structure of the economy, the allocation of capital and labor, and fiscal revenues.

Uzbekistan has taken initial steps to modernize SOE governance and management, such as corporatization of some SOEs. Existing corporate governance framework and practices deviate from accepted standards consistent with efficiency and fiscal discipline.

Sustainable public finances require a reduction and then elimination of SOE losses. International experience suggests that SOE reforms are most effective when accompanied by reforms of the State-Owned Banks. For the SOEs, critical reform steps include explicit recognition and consolidation of all financial support to SOEs, imposition of hard budget constraints and better governance and financial reporting of firms, increasing output prices to at least cost recovery levels, and allowing private entry and growth. SOEs' performance depends critically on the existence of a market environment as well as enforced management incentives. As corporate restructuring proceeds, explicit fiscal support to the poor or vulnerable will need to replace support often provided through SOEs, including through prices below cost recovery.

State-Owned Enterprises: Summary of Policy Options */

- Establish a centralized database of state-owned enterprises, using a meaningful definition of SOEs and not just 100 percent central government ownership.
- Disclose all quasi-fiscal activities of SOEs and SOBs, recognize all support to SOEs/SOBs, record it explicitly on budget and on their financial statements.
- Replace the quasi-fiscal and off-budget support to SOEs/SOBs with explicit subsidies, raise prices to cost recovery levels, and introduce support to the vulnerable people.
- Restructure SOEs and SOBs, starting with hardening budget constraints without delay, reorganizing corporate governance, and introducing explicit performance criteria.
- Implement the international accounting and bankruptcy standards for all SOEs.
- Advance privatization.

*/ See Chapter 4 for the detailed policy options.

PUBLIC INVESTMENT MANAGEMENT

The authorities have initiated reforms of public investment management (PIM). This includes shifting the public investment program from an annual to a multi-year perspective from 2020 and developing new procedures for project selection for the upcoming three-year investment program for 2020-2022. However, the development of the Investment Program remains separated from the regular state budget preparation process, essentially delinking responsibilities for capital expenditure from maintenance and other current expenditures.

Public investment amounted to 5.2 percent of GDP in 2018, with just under half of it on-budget. Most off-budget investment funding in the last two years has come from IFIs and bilateral creditors that is off-budget. Greater clarity concerning the roles and responsibilities of the main actors would enhance the PIM process. The new investment process requires a general capacity upgrade over the project cycle in terms of guidance, identification, assessment, selection, and implementation. A better methodology to integrate the assessment of a project regardless of whether it is domestically or foreign-funded is needed. A stronger assessment of projects' value for money, affordability, and potential contingent liabilities is needed, as is a clearer integration of investments into the regular budget process.

Contrary to the practice in many other countries, the Ministry of Finance does not have veto power over projects no matter their quality, risk, or weak public value. The rapidly changing institutional environment, fragmentation and overlap of public investment management functions makes it difficult to ensure that the investment pipeline is the optimal for Uzbekistan. Lack of consistent data on the size and composition of public investment is complicating the process. The provision of expertise and review of (pre-)feasibility studies is different between domestically-funded and foreign-funded investment projects and on whether a project concerns investment in social sectors (social infrastructure) or only investment in the real sectors of economy.

Public Investment Management: Summary of Policy Options */

- Move all investment spending on budget.
- Integrate capital investment budgeting into the overall budgeting process, and establish unified responsibility for asset build-up, management, and maintenance.
- Requests for approval of future investment projects should contain a separate analysis of the future cost implications of the project for the state budget.
- Strengthen the role of the Ministry of Finance in the investment project selection process, unify public investment management functions and streamline procedures and processes across all institutions involved.
- Establish integrated investment project management and control throughout the public investment cycle by unifying public investment management functions and streamlining procedures and processes across all (new) institutions involved.
- Abolish the current differentiation in economic analysis procedures based on the source of funding.
- Ensure that PPPs, concessions and similar investments are fully integrated into the PIM and ordinary budget system.
- Ensure that the processes are integrated and that the MoF budget department has veto power regarding affordability and fiscal risks.
- Develop a policy on how to handle decentralized/SOE investments.
- Effectively apply rigorous and objective selection criteria and use of project appraisal to set up the multi-year project pipeline, establish ex-post review and evaluation stage.

*/ See Chapter 5 for the detailed policy options.

INTERGOVERNMENTAL FISCAL RELATIONS

Effective design and implementation of intergovernmental relations are essential for good delivery of public services at the local level. Subnational governments (SNGs) play an important role in providing public services in Uzbekistan, but they have little autonomy over revenue management and resource allocation and act as an extension of the central government. The intergovernmental system remains highly centralized with discretionary transfers based on political negotiations and historical inertia. The system is based on varying rates of taxes shared and *ad hoc* budgetary transfers. For effective planning and budgeting, subnational governments need predictability for the resources they will receive every year. The absence of rule-based and transparent transfer system discourages efficient and transparent public financial management.

There is no law that regulates functional assignments and administrative sharing between levels of government. The general divisions of responsibility are specified in the Budget Code, but these are not clearly defined and may change during the annual budget process. The deconcentrated expenditure responsibilities assigned to the region and districts/cities include social spending (education, health, and social support) and other outlays, but they involve specific task assignments rather than functional responsibilities.

Intergovernmental Fiscal Relations: Summary of Policy Options */

- Improve transparency and predictability of transfers to SNGs through rule-based system.
- Review and clarify the assignments of functions across government levels.
- Consider providing greater revenue autonomy for subnational governments.

*/ See Chapter 6 for the detailed policy options.

AGRICULTURE

Uzbekistan’s government spends relatively large amount on agriculture compared to other countries – 1.8 percent of GDP in 2018 --with what appears to be limited impact on farm incomes, sustainability, and competitiveness. Most funds are directed to produce cotton and wheat, supporting a *status quo* rather than accelerating transformation and facilitating food value chains. The farm support instruments remain limited to credit supply, irrigation provision, and inspections, the impact of which are largely offset by the lack of other programs and low state procurement prices for cotton and wheat. Globally, farm support is more balanced between direct payments to farmers and provision of general support services, and farmers in most countries benefit from domestic farm output prices that are higher than international prices.

Agriculture: Summary of Policy Options */

- Phase out indirect taxation of large agricultural farmers by aligning domestic farm-gate prices for cotton and wheat with world market prices and strengthen current support instruments.
- Invest in modernization of irrigation and drainage infrastructure.
- Increase the currently very low spending on public good programs such as agricultural R&D and extension/advisory services to drive productivity growth.

*/ See Chapter 7 for the detailed policy options.

THE WAY FORWARD

Economic reforms in Uzbekistan are proceeding apace, transforming the country’s economy and lifting its potential for stronger growth and better living standards. In the process, the authorities are reshaping the role of government as an owner, regulator, and the provider of public goods and services. As a result, public finances are rapidly reformed.

The PER suggests that the among all areas with important needs, priority should be given to the following three:

- Consolidated fiscal program: Consolidate all off-budget spending into the budget, replace quasi-fiscal spending with explicit budgetary subsidies, and move all EBFs and off-budget accounts on the Treasury Single Account. An effective consolidated fiscal program will require more systematic and timely collection and publication of data. The authorities have

made substantial progress in fiscal transparency and will need to sustain it to make the next stage of fiscal reforms a success.

- **Public wages and employment:** Reorganize the management of public wages and employment by creating a competitive and fair compensation system, consolidate all bonuses and allowances into the base pay, develop an HR and performance management framework for merit-based recruitment, performance appraisal, promotion, and professional development, and rationalize the structure of government units and the number of employees through functional reviews. Systematic data collection will be needed for this phase, including data on wage payments from off-budget sources.
- **Public investment management:** Move all investment spending on budget, integrate capital investment budgeting into the overall budgeting process, strengthen the role of the Ministry of Finance in the investment project selection process, abolish the current differentiation in economic analysis procedures based on the source of funding, and ensure that PPPs, concessions and similar investments are fully integrated into the PIM and ordinary budget system.

The other areas reviewed in the PER need to form the foundation for medium-term reform efforts. In particular:

- **Intergovernmental relations** will need to be reviewed thoroughly, as the authorities consider the extent to which to decentralize and deconcentrate the decision making and finances across the country and what kind of fiscal equalization should be adopted.
- **SOEs:** Reforming SOEs and SOBs is one of the main and most demanding challenges of the government. Determined and steady progress is needed in reducing the role of the state in ownership and direction of economic activity while strengthening the role of the government as a prudent regulator and facilitator. Replacing quasi-fiscal operations with explicit subsidies is the path to follow, but more data is needed to assess the full extent of these operations and their full impact on the budget.

The next stage of the public expenditure review will focus on education, health, and irrigation.

- **Education** and **health** are reviewed briefly in the two spotlights in this PER to indicate how essential government spending is for building human capital to fuel Uzbekistan's economy. Additional data will be needed for the effective study of these most important sectors.
- The review of **irrigation** will complement the chapter on **agriculture** in this PER and help optimize and make more effective the substantial resources the government spends on agriculture. Reforming agriculture is a key to the successful transformation of Uzbekistan's economy – and extracting maximum value for the public money while bolstering productivity and incomes is a priority for the government.

THE PER'S POLICY RECOMMENDATIONS

Fiscal setup, revenues, and spending

- Consolidate all off-budget spending into the budget. Subject it to the same planning, execution, and monitoring processes as the current on-budget spending.
- Provide regular quarterly and annual reports of the consolidated fiscal program that includes what is currently on-budget and off-budget spending.
- Move all EBFs and off-budget accounts on the Treasury Single Account (TSA).
- Improve the predictability of revenue and tax policy changes.
- Improve the quality and efficiency of spending requires measurement and accountability.
- Strengthen the budget preparation process and public sector accountability and accounting.
- Develop an overall strategic framework and sectoral approaches.
- Strengthen the fundamental budget preparation process, capacity, and tools. Develop and implement performance indicators to help plan and monitor spending outcomes.
- Develop a debt management strategy.

Tax expenditures

- Reduce and simplify the tax and customs expenditures by conducting a cost-benefit analysis of the main incentives provided.
- Withdraw tax incentives for new investment and impose a minimum tax to ensure that businesses benefiting from tax incentives pay at least a certain minimum amount of tax.
- Prepare public Tax Expenditure Statements as part of the regular budget process.

Public wages and employment

- Develop a common framework grading structure for the different occupational groups.
- Develop a compensation framework that is competitive and fair.
- Consolidate all bonuses and allowances into the base pay.
- Improve the legal framework for civil service management and compensation.
- Carry out Functional Reviews to help improve the distribution of government functions and use them to rationalize the number of employees in the public sector.
- Consider postponing salary increases in excess of inflation until the right-sizing of the public sector is done.
- Develop an HR and performance management framework for merit-based recruitment, performance appraisal, promotion, and professional development.
- Develop a human resource management information system.
- Set up a sound monitoring and evaluation system to track entry and exit of employees. Expand capacity development programs and on-the-job training and mentoring to significantly improve the capability and productivity of public sector workers.

SOEs

- Establish a centralized database of state-owned enterprises, using a meaningful definition of SOEs and not just 100 percent central government ownership.
- Disclose all quasi-fiscal activities of SOEs and SOBs, recognize all support to SOEs/SOBs, record it explicitly on budget and on their financial statements.
- Replace the quasi-fiscal and off-budget support to SOEs/SOBs with explicit subsidies, raise prices to cost recovery levels, and introduce support to the vulnerable people.
- Restructure SOEs and SOBs, starting with hardening budget constraints without delay, reorganizing corporate governance, and introducing explicit performance criteria.
- Implement the international accounting and bankruptcy standards for all SOEs.
- Advance privatization.

Public investment management

- Move all investment spending on budget.
- Integrate capital investment budgeting into the overall budgeting process, and establish unified responsibility for asset build-up, management, and maintenance.
- Requests for approval of future investment projects should contain a separate analysis of the future cost implications of the project for the state budget.
- Strengthen the role of the Ministry of Finance in the investment project selection process, establish integrated investment project management and control throughout the public investment cycle by unifying public investment management functions and streamlining procedures and processes across all (new) institutions involved.
- Abolish the current differentiation in economic analysis procedures based on the source of funding.
- Ensure that PPPs, concessions and similar investments are fully integrated into the PIM and ordinary budget system.
- Ensure that the processes are integrated and that the MoF budget department has veto power regarding affordability and fiscal risks.
- Develop a policy on how to handle decentralized/SOE investments.
- Effectively apply rigorous and objective selection criteria and use of project appraisal to set up the multi-year project pipeline, establish ex-post review and evaluation stage.

Intergovernmental relations

- Improve transparency and predictability of transfers to SNGs through a rule-based system.
- Intergovernmental transfers should be part of a comprehensive fiscal decentralization policy.
- Review and clarify the assignments of functions across government levels.
- Consider providing greater revenue autonomy for subnational governments.

Agriculture

- Align domestic farm-gate prices for cotton and wheat with world market prices to eliminate the negative MPS and ensure that public expenditures can generate impacts on the ground.
- Develop a strategy for modernization of irrigation and drainage infrastructure and management in a cost-effective manner to reduce a long-term budget for this purpose.
- Expand a menu of DPF measures from mainly credit lines to support fixed capital formation through matching grants (not credit), the use of on-farm services, and adoption of climate-smart technologies (the EU-type cross-compliance) to accelerate structural transformation.
- Increase significantly the public expenditures for GSS programs, especially for agricultural R&D and extension/advisory services to drive TFP growth. These programs require not only more budget but better human capacity to effectively deliver services to farmers and agribusinesses.
- Reduce the “miscellaneous” programs by avoiding ad hoc programs and using more strategic budget planning and management.

Chapter 1. Fiscal Setup and Government Spending

Uzbekistan's economy, society, and government are being transformed. Enhanced efficiency and quality of government spending, increased transparency, and better institutions for public finance management are essential for delivering high quality public services, maintaining macroeconomic stability, and supporting stronger economic growth. This note discusses three fiscal policy challenges the government faces. First, to understand the full size of government and implement credible fiscal policy, the authorities need a consolidated fiscal program that covers all public spending. At present, off-budget spending is as large as on-budget spending but information on the former is neither easy for the government to compile regularly nor available publicly. Off-budget spending often does not require parliament approval and does not benefit from government monitoring. The lack of a consolidated fiscal program makes it difficult for the government to have a comprehensive view of government revenue and spending and prepare the sustainable medium-term budgets mapped to clear development priorities. Second, better quality of expenditures is essential for ensuring value for taxpayers' money but the most important spending categories, including education, investment spending, and public employment, lack indicators to assess if spending produces the desired results. And third, government institutions and their operating frameworks still lack the capacity to support a well-functioning public sector. These include budgeting and reporting, fiscal risk assessment, investment management, internal control, and internal and external audit. Public sector laws, regulations, and business processes need to be revamped to bring public financial management in line with good practices.

CONTEXT

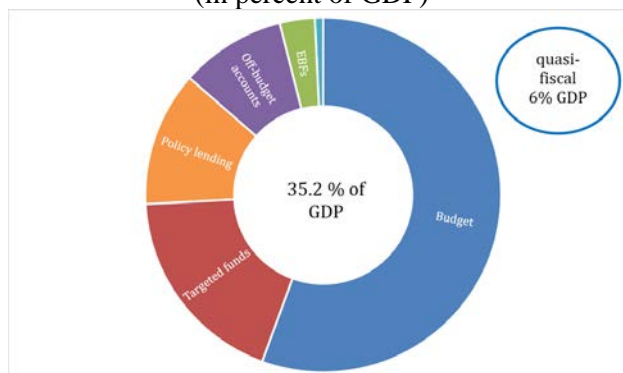
A capable government is crucial for development, but too large a government can overwhelm the economy and make it difficult for a dynamic private sector to develop. In addition, there are areas where the government needs to do more – such as delivering quality services and infrastructure and ensuring a level playing field for private companies, and areas it needs to do less – such as subsidizing unviable enterprises, providing untargeted subsidies to households, or limiting competition.

Uzbekistan's consolidated government spending – spending both on-budget and off-budget -- is substantial and amounted to 35.2 percent of GDP in 2018; including quasi-fiscal losses, spending amounts to at least 41.2 percent.¹ Spending off-budget in 2018 was larger than spending on-budget, underscoring the system of budgeting that the authorities are working to reform (Figure 1.1 and Table 1.1). The expenditures on-budget cover only the central and local governments, including some of the former state-targeted extrabudgetary funds that have been consolidated into the central government in 2018 and 2019. The spending off-budget includes

¹ The calculations in this document use the revised 2018 GDP number. Reflecting largely the inclusion of parts of the non-observed economy, GDP for 2018 is 19.3 percent larger than the projected 2018 GDP used before February 2018. Measured relative to the 2018 GDP projection, the consolidated government spending amounted to 46.7 percent of GDP in 2018.

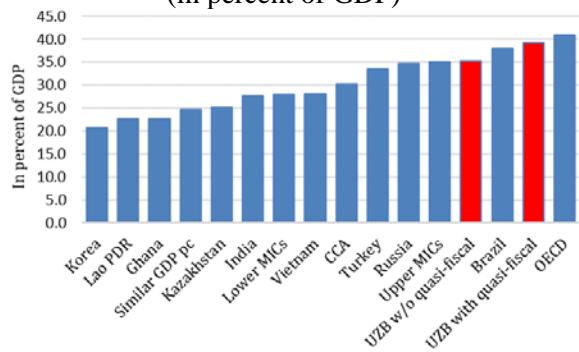
outlays by the remaining extrabudgetary funds (EBFs); the off-budget accounts of budgetary organizations; government investment spending financed by foreign project loans; policy lending by the Uzbekistan Fund for Reconstruction and Development (UFRD), the government, and foreign lenders; and estimates of the quasi-fiscal losses of state-owned enterprises (SOEs).²

Figure 1.1. Uzbekistan: Consolidated General Government Spending, 2018
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: Central and local governments, extrabudgetary funds, off-budget accounts, capital spending financed by foreign loans, policy lending, and estimates of quasi-fiscal losses.

Figure 1.2. Comparisons of Government Spending
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Government spending in Uzbekistan – a lower middle-income country – is higher than in most of its relevant comparators. Consolidated government spending without quasi-fiscal losses is 7 percent of GDP higher than lower middle-income countries on average, as large as the average for upper middle-income countries, and 8 percent above the average for countries with similar GDP per capita (Figure 1.2). To be sure, Uzbekistan’s level of spending reflects the legacy of the economic model that is now being substantially reformed. The starting point underscores both the large role of the government in the economy and the challenges that the authorities must address as they advance their agenda to optimize the government footprint in a way that delivers value for money, supports the building of adequate government capacity, and leave ample room to the private sector.

The large share of policy-based lending and the quasi-fiscal losses of SOEs reflect the government’s support to capital-intensive industry that generates little employment and foreign direct investment. Quasi-fiscal losses of the SOEs amount to at least 6 percent of GDP, the same magnitude as policy lending to SOBs to prop up SOEs. There could be some double counting in these numbers, but the magnitude is modest. Quasi-fiscal losses are likely to be much larger if all SOEs are included in the calculation and the recovery price used as a benchmark includes not just operations and maintenance, but also debt servicing, amortization, and a profit for the SOEs. These are combined with tax expenditures for the benefit of SOEs of about 6 percent of GDP, resulting in fiscal support to government-owned enterprises that is more than a third of consolidated government spending. Reforming the SOEs while rationalizing this extensive

² We use the term “consolidated general government” to denote all on-budget and off-budget spending. The IMF uses that term to denote the budgetary government plus policy lending; this amounts to two-thirds of the fully consolidated government spending.

support will require a determined yet judicious approach, coupled with improved social protection for the vulnerable.

Adequate time series data to analyze the trends in consolidated government spending over time is missing. As a result, most of the subsequent discussion of spending trends uses only part of consolidated spending: spending on budget plus policy lending. These two items amounted to 24 percent of GDP in 2018, or 60 percent of consolidated government spending.

Table 1.1. Uzbekistan: Consolidated General Government Spending, 2018
(in percent of GDP)

	Budget	Targeted funds	EBFs	Off-budget accounts	Foreign financed investment	Policy lending	Consolidated spending without quasi-fiscal losses	Quasi-fiscal losses	Consolidated spending with quasi-fiscal losses
Expenditures	19.5	6.5	1.1	3.4	0.3	4.3	35.2	6.0	41.2
<i>of which:</i>									
wages	9.5			1.0			10.5		10.5
pensions	0.9	4.9	0.0	0.1			5.9		5.9
capital spending	2.4	1.3	0.7	0.6	0.3		5.2		5.2
other	6.8	0.3	0.4	1.7		4.3	13.5	6.0	19.5

Sources: Uzbekistan authorities and staff estimates.

Note: Budget (central and local governments), state-targeted and other extrabudgetary funds, off-budget accounts, capital spending financed by foreign loans, policy lending, and estimates of quasi-fiscal losses.

Trends in the General Government Balance and Spending³

The authorities have kept the budgetary government in surplus since the early 2000s. From near balance in 2003, the surplus of the central and local government surged along with commodity prices by 2010 and fell by 2015. In 2018, the surplus rose to 2.2 percent of GDP, the largest since 2010 and half a percentage points better than in 2017, even though reported growth slowed (Table 1.2). This reflected a larger increase in revenues than in spending because of the exchange rate devaluation and higher commodity prices and restraint not to spend all the improved tax collection.

Because of markedly larger policy-based lending, the deficit of the general government rose substantially from 2003 to 2018. The increase in policy lending reflected stepped-up flows from the government and the Uzbekistan Fund for Reconstruction and Development (UFRD) to banks to onlend to SOEs, one of the authorities' preferred method of supporting public companies. These flows have been augmented by increased housing transfers from the government to SOBs to also onlend and, since the start of reforms, of equity injections by both the UFRD and the government into the banks. In 2018, the increase in policy lending offset the higher budgetary surplus to keep the general government deficit – as measured by the authorities and not the consolidated deficit – little changed.

³ The discussion in this section is based on the general government presentation – the government budget and policy lending.

After declining substantially from 2003 to 2017, budgetary government spending (excluding policy-based lending) rose in 2018. The decline in budget spending through 2017 was substantially larger than the drop in revenues during that period and was driven by a reduction in on-budget investment spending, reduced on-budget subsidies, and lower social safety spending (line “Expenditures” in Table 1.2) In 2018, by contrast, almost a year after the start of reforms, budget spending rose substantially and reflected an increase in on-budget public infrastructure outlays and larger disbursements for social programs and rural development.

Table 1.2. Uzbekistan: General Government Budget, 2003-2018
(in percent of GDP)

	2003	2005	2010	2015	2016	2017	2018
Revenues	27.9	25.6	30.8	28.0	25.4	24.7	27.9
Expenditures	27.6	25.4	26.5	26.5	23.8	22.9	25.6
Socio-cultural spending	7.7	8.3	9.1	10.8	9.6	9.2	10.0
Social safety net	6.8	6.8	8.6	6.9	6.0	5.5	5.0
Economy	2.7	2.7	2.1	1.9	1.7	1.7	1.9
Public administration	0.5	0.5	0.7	0.8	0.8	0.9	1.0
Public investment 1/	4.8	3.4	2.8	2.1	1.9	2.0	2.4
Interest	0.4	0.3	0.1	0.0	0.0	0.0	0.1
Other	4.6	3.5	3.6	4.0	3.8	3.6	5.3
Balance	0.2	0.2	4.3	1.5	1.6	1.8	2.2
Policy based lending	0.6	0.4	1.6	2.6	2.1	3.6	4.3
General government balance	-0.4	-0.2	2.8	-1.0	-0.5	-1.8	-2.1
<i>Memorandum item</i>							
GDP (billion Soums) 2/	11,806	19,108	74,153	210,183	242,496	302,537	407,514

Source: Uzbekistan authorities, IMF, and Bank staff estimates.

1/ Includes public investment as in the budget document and spending by the road fund.

2/ 2003-2010 GDP figures are revised up by 20 percent in line with the national accounts’ revision by Uzbekistan authorities for 2015-2018.

Economic Classification of Spending

Lack of data allows only a limited analysis of the economic classification of government spending. Outlays on public wages are clear outliers relative to comparator countries and capital spending would be an outlier if policy-based lending – most of which ultimately supports investment projects – is included.

- **Wages:** Consolidated budget wage outlays amounted to 10.5 percent of GDP in 2018, almost as high as in the OECD on average and larger than in relevant comparators (Figure 1.3). Uzbekistan’s wage bill is as high as the average for the countries of resource-rich Middle East and North Africa and Sub-Saharan Africa and above the average for the other developing regions. Both wage and employment are

drivers of the high wage bill. The wage outlays include spending on salaries explicitly identified this way in the budget (9.5 percent of GDP) and off-budget wage outlays. While there is no comprehensive data on public employment, analysis of some of the ministries indicates that public wage levels are above private wages, but the latter are likely substantially understated. Further work is needed to assess the relationship between outsized spending on wages and the efficiency of public administration. (See the Wage chapter for more details and policy options).

Figure 1.3. Consolidated Wage Spending
(in percent of GDP)

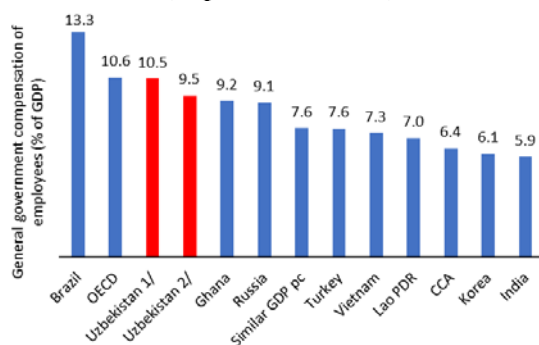
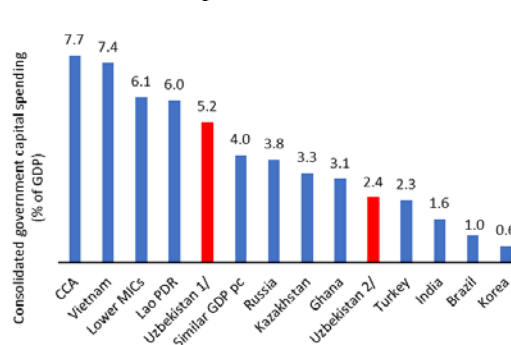


Figure 1.4. Consolidated Capital Spending
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.

Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan. Uzbekistan 1 includes consolidated government wage bill and capital spending and Uzbekistan 2 includes only on-budget wage bill and capital spending.

- Capital spending:** Consolidated government capital spending – both on-budget and off-budget – amounted to 5.2 percent of GDP in 2018. This is lower than the 7.7 percent of GDP average of regional comparators in the Caucasus and Central Asia and at the lower limit of the public investment level that the Growth Commission Report identified as a feature of fast-growing economies.⁴ The government capital spending is not always well-allocated across sectors. In addition to government investment, there is substantial investment by SOEs, most of which is financed by directed lending from the UFRD and the government. The PER’s initial analysis suggests three main priorities for the government. The first is the need to increase public investment both to help repair existing infrastructure and to connect better urban and rural areas. Second, for investment spending to be efficient, the authorities need to streamline the institutional setting of public investment management and reduce the duplication of units for planning, execution, and monitoring. Public investment – using both public or private finance – should be undertaken only if a project provides value to society, it is affordable to the taxpayers and users, and the operation is sustainable once the asset is operating and private investment is not available. (Chapter 5 on Public Investment Management for more detail). Third, all off-budget investment spending must be

⁴ Growth Commission. 2008. Growth Report. Report. <https://openknowledge.worldbank.org/handle/10986/6507>. The report indicated that the governments of the 13 successful countries it studied invested 5-7 percent of GDP.

consolidated into the budget, including government expenditures financed by international financial institutions and government guaranteed disbursements to SOEs.

- **SOE subsidies:** SOEs continue to dominate the economy, employment, and bank credit. As in most transition economies, however, on-budget subsidies to SOEs in Uzbekistan are modest but off-budget and quasi-fiscal support is extensive. Explicit subsidies are small and amount to about 1 percent of GDP. In addition to the on-budget subsidies, support to the SOEs includes: tax and customs preferences and exemptions (Chapter on Tax Expenditures), public investment for the benefit of SOEs funded by the budget under the public investment program, low input prices charged by other SOEs, and subsidized credit funded by the UFRD, the government, or international financial institutions with government guarantees. The large range of support makes it difficult to get a clear and comprehensive picture of government support provided to SOEs and SOBs. There is also no clear picture of any payment arrears between SOEs (Chapter on SOEs). We estimate that quasi-fiscal activities of the SOEs could be as large as 4 percent of GDP based on data from the electricity, natural gas, and water and sewage companies. Quasi-fiscal losses are likely to be much higher if district heating, railroad and air transport, the irrigation companies, and the SOBs are considered (the team does not have data on these companies). As the government moves to put the support to enterprises and the banks on the budget, this would allow the government to understand better the trade-offs in the reform process.

Functional Classification of Spending

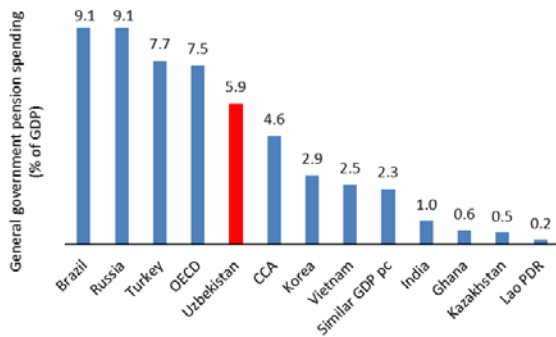
The analysis of the functional classification is similarly limited by lack of data. The salient features of the functional classification are as follows:

- **Education:** Uzbekistan's education spending as a share of GDP is one of the highest in the world. Government education spending amounted to 5.4 percent of GDP in 2017 and 5.9 percent in 2018, more than in Kazakhstan, Russia, Turkey, countries with similar incomes, regional peers, and the OECD. About a third of the government budget is dedicated to education, an amount little changed over the last decade. Even relative to the consolidated government expenditures that are twice as large as the government budget, education outlays amount to about 15 percent of total spending, more than the average for Europe and Central Asia and the OECD. Lack of consistent data on education achievements does not allow the authorities to make a connection between spending and outcomes. A very large share of education spending is dedicated to primary and secondary school education; it will be important for the authorities to pay more attention to pre-school education and improving the technical skills of workers. Allowing more private tertiary education institutions could help achieve better outcomes with same level of overall public expenditures on education (See the Spotlight on Education for more details).
- **Healthcare:** Government spending on health in Uzbekistan is not unlike that in lower middle-income countries and the average for the Caucasus and Central Asia. Both as a share of GDP (2.2 percent) and as a share of budget expenditures (less than 8 percent), health outlays are modest. Relative to the overall consolidated government spending, health outlays are well below any of the relevant comparators and closer to what India

and Lao spend. Health indicators are like those of regional peers and below income peers. Spending more and better on health will be important to boost human capital (See the Spotlight on Health for details).

- Pensions:** Government pension spending in Uzbekistan is higher than in relevant comparators both as percent of GDP and as a share of budget expenditures (Figure 1.5). Uzbekistan spends more on pensions even relative to countries with similar share of older people in the total population (Figure 1.6). Nonetheless, pension adequacy is low and the payroll revenues that financed the PAYGO system have been inadequate given substantial informality. For the first time ever, the government is planning a transfer from the budget to the pension fund in 2019 to offset the loss of revenues resulting from the tax reform. The transfer is planned to amount to 1.2 percent of GDP or 17 percent of pension spending. Analysis of the adequacy, coverage and sustainability of the pension fund could be undertaken in the future. Suffice it to say now that the budget subsidy is changing the nature of pay-as-you-go pensions. Financing social protection from general revenues is an appropriate channel to consider given high informality.⁵

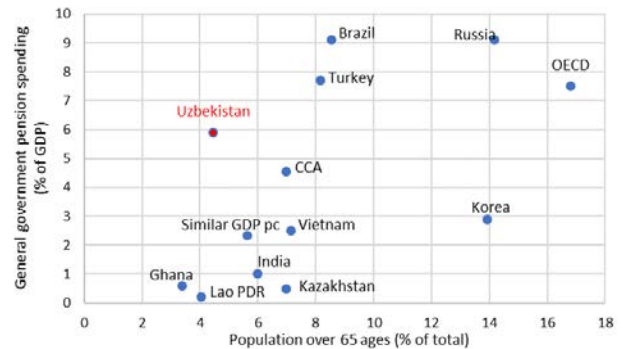
Figure 1.5. Uzbekistan: Pension Outlays
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.

Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Figure 1.6. Comparison of Pension Outlays
(in percent of GDP and age)



Sources: Uzbek authorities and Bank staff estimates.

Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Intergovernmental Relations

Subnational governments (SNGs) play an important role in providing public services in Uzbekistan. Because of the country’s highly centralized structure, SNGs have little autonomy over revenue management and resource allocation and act as an extension of the central government. The intergovernmental system remains highly centralized with discretionary transfers based on political negotiations and historical inertia. This setup does not create the incentives for efficient management of resources and improvements in the quality of public services. To address these challenges, as a first step, the government may consider increasing the predictability of transfers by introducing rule-based allocation mechanism, reviewing and clarifying expenditure

⁵ World Bank. 2019. The Changing Nature of Work. <http://www.worldbank.org/en/publication/wdr2019>

assignment across levels of government, and providing greater fiscal autonomy to subnational governments.

Uzbekistan’s central-local government structure is one of administrative deconcentration. In such a structure, subnational governments play a role as the central government’s agent in the regions and are accountable to the central government. Resources are transferred to the local governments while allowing them little autonomy or discretion in decision making. Uzbekistan’s system of subnational finance has changed little since independence. In contrast, many developing and transition countries have embarked on fiscal decentralization, including Poland and Indonesia, and neighboring peers such as Ukraine, Georgia, and Kyrgyz Republic (Chapter on Intergovernmental Relations for more details).

KEY CHALLENGES

Large Tax Expenditures

Tax incentives and exemptions impose a large direct fiscal cost to the budget. In addition, Uzbekistan’s tax incentive policy leads to substantial monitoring cost for the government, as the process involves discretionary procedures. Most importantly, the efficacy of these tax incentives is in doubt because they do not appear to have boosted foreign direct investment, domestic investment, or business creation. The government appears to provide many tax incentives without a cost-benefit analysis on whether existing incentives have been effective in accomplishing their intended goal.

Large and not Transparent Off-Budget Spending

Off-budget spending is substantial, accounting for half of consolidated general government spending in 2018.⁶ Half of government operations are not subject to the same budget processes, monitoring, or accountability. The Ministry of Finance does not have a comprehensive view of all government spending when making decisions. In specific cases – for example, public investment – different agencies consider, plan and engage in spending. Public wages are paid from both budgetary and off-budgetary sources, resulting in disparate compensation for the same work and lack of a level playing field. While most schools receive broadly similar financing per student from the central government, schools in less affluent areas have smaller off-budget accounts and are not able to compensate their teachers as well as schools in better-off areas.

The bulk of off-budget spending is carried out by extrabudgetary funds (EBFs) which accounted for 27 percent of consolidated general government spending in 2018 and off-budget accounts whose outlays amounted to another 10 percent. Uzbekistan’s extrabudgetary funds (EBFs) – which numbered 47 at the end of 2018 – fall into five categories:

- (1) State targeted funds. These funds are included in the budget document, they are on the Treasury Single Account (TSA) but are not consolidated into the budget. In 2017, there were 7 state targeted funds presented in the budget document not consolidated into the budget. Of these, one fund was consolidated in the 2018 budget

⁶ Data for earlier years are incomplete and not comparable.

and in three more were consolidated in 2019. The three state targeted funds that remain outside the budget are: the pension fund, the employment fund, and fund for support of privatized enterprises. Spending by the four EBFs consolidated into the budget in 2018 and 2019 is equivalent to 13 percent of on-budget spending, indicating the measurable progress achieved by the government in consolidating EBFs.

- (2) Six EBFs not included in the budget document that are on the TSA.
- (3) Twenty-three EBFs outside the budget document but not on the TSA. While their balances and spending are modest – for example, expenditures in 2018 amounted to 0.6 percent of GDP – placing these EBFs on commercial banks has helped support the banking system following the 2017 devaluation. Bringing these EBFs on the TSA is important for transparency and proper cash management, as the authorities may support the banking system in other ways, if needed.
- (4) Fifteen EBFs that belong to various ministries. These include the Fund for Developing Systems for Tax Management, Fund for Basic Education, and others. The authorities have not shared data on these EBFs. Including them in the spending estimates will result in even larger government spending. It is essential that these EBFs are also brought on the TSA.
- (5) In addition, many of the SOEs, especially those that had the rank of ministries until recently and that are transformed into ministries now, such as Uzbekenergo which was transformed into the Ministry of Energy in February 2019, have EBFs that are not on the TSA and not within the scope of the MOF monitoring.

The 2020 budget consolidated on-budget 18 EBFs and the Fund for Reconstruction and Development and intend to consolidate all other EBFs in the future. So far, progress has been not as fast as initially intended, but the process does take time. The authorities are encouraged to make steady progress in this area, including by not creating new EBFs even if they are intended to speed disbursement or are intended to function as little more than disbursement accounts.

In addition to the EBFs, there are as many as 20,000-30,000 off-budget accounts of budgetary organizations. All of these are on the TSA. Spending from these accounts amounted to as much as a tenth of consolidated government spending in 2018. A quarter of the spending from these accounts was for wages, including bonuses and other allowances, and almost as much was for capital outlays, including office equipment.

Why do governments create EBFs or off-budget accounts? Some EBFs, such as the pension fund, exist both in Uzbekistan and many other countries, because of a discrepancy between the multi-year time horizon of the fund and the annual horizon of the government budget.⁷ In other cases, there may be an attempt to ring-fence certain revenues. In recent years, it seems that some new EBFs have been created in Uzbekistan to speed up procedures, cut through red-tape, and provide higher salaries for employees. The motivations are clear but removing certain operations from ministries or other budgetary units to spur disbursements hurts the capacity building needed in the public institutions and the reform efforts to make these institutions more agile. Further,

⁷ Radev, Dimitar and Richard Allen. 2010. Extrabudgetary Funds. <https://www.imf.org/en/Publications/TNM/Issues/2016/12/31/Extrabudgetary-Funds-23841>

adding EBFs increases public employment and the overall public wage bill, without providing competitive salaries to all public employees. We note this is of concern to the authorities. Further, as most of the EBFs are not subject to the normal budget procedures, creating new EBFs this results in a loss of aggregate expenditure control by the Ministry of Finance (MoF) and reduced transparency that may lead to inefficiency or misuse of funds.

The situation is similar with the off-budget accounts. As in most other economies before transition began, the government allowed all budgetary institutions, from ministries, to extrabudgetary funds, to schools and hospitals, to create off-budget accounts. The original idea was simple: originally, under the system of budgeting that prevailed in the region and in Uzbekistan, all revenues were channeled to the Ministry of Finance and every budgetary institution received a subsidy from the budget: budgetary institutions were not allowed to collect their own revenues. This system of budgeting started to be relaxed in recent decades in Uzbekistan and the government allowed budgetary institutions some leeway to raise their own revenues, provided these accounts were on the TSA. These funds are outside the budgetary control, however, and there is no central monitoring how the money is spent.

Public Finance Management Not in Line with Good Practice

PFM is being reformed but it still needs to catch up with good practices. The link between the annual budget and the government strategy is weak. A budget calendar exists, but there is no guidance to line ministries on ceilings for their budget submissions. The concept of development programs is not well-developed and lacks performance information. The internal control framework, managed through the MOF, is dominated by control and inspections, with a heavy reliance punishment. With respect to external audit, the Chamber of Accounts (COA) does not cover material issues and systemic and control risks. The focus of external audit is on detecting formal violations, recommending corrective actions, and levying penalties, instead of analyzing systemic issues. Overall, these approaches heavily emphasize compliance over performance, and thus are not consistent with modern public sector management practices. The lack of financial statements that adhere to internationally recognized accounting standards also limits the performance of the COA. While the COA delivers the audit of annual budget execution on a timely basis, its approach is not in accordance with international auditing standards.

The authorities have made progress revamping weak fiscal reporting and accountability. In late 2018, the MOF created a GFS and Fiscal Transparency Division. The unit has begun compiling GFS-compliant data for the government budget and is collecting information on all EBFs, off-budget accounts, and the unitary enterprises (the SOEs that are fully owned by the central government). The authorities are working on strengthening the medium-term fiscal framework, as well as on strengthening the elaboration of the fiscal policy objective and the analysis of the performance of the budget, especially in the relationship between inputs and outputs. Compiling and publishing a consolidated budget that includes all on-budget and off-budget spending is still in progress, creating challenges for the authorities in executing its fiscal policy, limiting the accountability for public spending, and constraining the transparency of fiscal operations.

The ministries and units involved in public investment management do not have adequate capacity to identify, develop, appraise, execute, and monitor infrastructure projects,

including those financed through PPPs. A fundamental challenge that needs to be addressed is that the development of the Public Investment Program is only weakly linked to the regular budget preparation process, essentially separating the responsibilities for capital expenditures from maintenance, implementation and performance.

POLICY OPTIONS

Tax and Customs Expenditures

Tax expenditures needs to be reduced and substantially simplified. The reduction in tax expenditures will provide substantial fiscal space to accommodate potential spending pressures in the process of enterprise restructuring and to help bolster the social safety net. Besides fiscal space, the reduction in tax expenditures will help reduce the inefficiencies produced by exemptions and incentives granted to individual companies. These tax expenditures not only have not brought additional inflows of foreign direct investment, they likely have stymied new business entry. While motivated by good intentions, many of Uzbekistan's tax expenditures do not make good industrial policy, as they favor large, inefficient, and long-established enterprises.

Customs expenditures are much larger than the tax ones and amount to as much as 10 percent of GDP. The large size of customs expenditures is not a potential revenue source but an opportunity to simplify the levies on imports, reduce the costs of compliance for importers, and the burden of monitoring for the government. The size of the customs exemptions needs further analysis, as general reductions in duties and excises due to international agreements or reductions that apply to all businesses would not be considered tax expenditures. It is only when the individual decrees by which the customs exemptions are analyzed that the authorities can estimate more precisely the customs expenditures.

Expenditures

Improving the quality of spending is essential for the success of Uzbekistan's reform process.

As a priority, the government needs to develop an overall strategic framework and sectoral approaches. Further, improving quality and efficiency requires measurement, accountability, innovation, and incentives. There are two dimensions of efficiency: allocative and operational. On the former, the authorities need to align budget expenditures with strategic priorities and assess the cost and benefits of both the proposed and alternative uses of public funds. Sustainability is crucial: hard budget constraints need to be the norm, with incentives to reallocate spending to higher priorities. For example, the authorities need to decide whether spending two-thirds of public resources on secondary education is optional or more should be shifted to pre-school or higher education. Some of the challenges in strategic prioritization – and in producing quality spending – could also reflect investment-led priorities or undue power of government units

Operational, or technical, efficiency, assessed the relationship between budget inputs and outputs. Without proper objectives and measurement of the outputs, there is a tendency to control the inputs. In education, for example, lack of standardized testing to understand whether spending leads to the desired results makes assessments of operational efficiency or the quality of spending difficult at present. Strengthening external control of the spending by government units would help improve the efficiency. The Chamber of Accounts at present does not cover material issues

and systemic and control risks. The focus of external audit is on detecting formal violations, recommending corrective actions, and levying penalties, instead of analyzing systemic issues. The internal control framework, managed through the MOF, is dominated by control and inspections, with a heavy reliance punishment. Overall, these approaches heavily emphasize compliance over performance, and thus are not consistent with modern public sector management practices.

Fiscal Framework

The priority in reforming the fiscal framework should be placed on consolidating all off-budget spending into the budget and subject it to the same planning, execution, and monitoring processes as on-budget spending. The consolidation does not imply that all EBFs must be dissolved when consolidated into the budget. On the contrary: some of the EBFs may keep their names, functions, and even the segregation of funds from the budget, such as the Pri-Aral Sea Fund and the Pension Fund. But they need to be on budget for consistency, transparency, and so that the MoF has a view of all fiscal operations when designing and executing fiscal policy.

The authorities will be well advised to move all EBFs and off-budget accounts on the TSA. This will allow the government to know its cash position at the end of each day. Although government debt is modest, the authorities may consider a minimum threshold on the government cash in the TSA. This may be called a fiscal reserve account and be intended to secure adequate cash for debt repayment or for financing any contingent liabilities.

All commercial banks that are licensed can service the budget. However, government deposits should not be held in commercial banks to support their balance sheets. Reforming the banking sector will need to be accompanied by the implementation of regulations on how the authorities can support the systemically important commercial banks in exceptional circumstances and how to resolve banks that are not systemically important.

Public Financial Management

The main reforms need to focus on the development and implementation of enhanced frameworks, capacity, and tools in several dimensions. The key ones include budget preparation, public sector accounting, public internal control and audit, external audit, and public investment management. A separate note will be produced on these issues, building on the recently completed PEFA. Efforts need to focus on the following:

- Strengthening the fundamental budget preparation process, capacity, and tools. Units managing current and capital spending need to be tightly linked. Performance indicators need to be implemented to help plan and monitor spending outcomes.
- Changing the culture of the MOF and line ministries from a control-and-command center to a strategic partner for change.
- Designing and implementing Uzbekistan's public sector accounting standard (UZPSAS) based on an International Public Sector Accounting Standards (IPSAS) diagnostics.
- Design of public sector internal audit regulations and procedures, developing a risk-based external audit framework.

- Development of a debt management strategy

These efforts are likely to result in substantial improvements in PFM performance. Budget preparation will change from being an incremental, mechanical exercise to a multi-annual strategy hereby ensuring that the government vision is translated into results. Public finance reports will be more timely, accurate, and relevant based on improved accounting and financial reporting regulations. The authorities' emphasis will be on addressing systemic and critical issues because of new internal and external audit frameworks, with improved effectiveness and efficiency of public services. Improving the quality of financial reports aligned with international accounting standards will result in improved management of fiscal risks.

Spotlight 1. Government Revenues

Uzbekistan collects more in revenues than lower middle-income countries on average and even more than developing ECA. Ambitious tax reforms in 2018-19 do not appear to have resulted in lower revenues, providing a good cushion for the authorities to help tackle enterprise restructuring that may lead to both reduced revenues from SOEs and the need to finance social safety support to individuals that lose jobs in the process. Creating a more predictable tax system remains a priority for the government, as does the need to improve tax collections without necessarily raising tax rates.

CONTEXT AND RECENT DEVELOPMENTS

Budget revenues in 2018 increased to their 2015 level as a share of GDP after declining during 2016-17. The recovery in 2018 was due to the positive impact of the exchange rate devaluation in September 2017 and the comprehensive economic reforms the authorities initiated in 2017 (Table S1.1). Revenues in 2015 and 2018 are little changed from their 2003 level as well, even though revenues in 2018 benefit from the inclusion into the budget of several state-targeted funds (see Chapter 1).

Table S1. 1. Government Revenues, 2003-2018
(in percent of GDP)

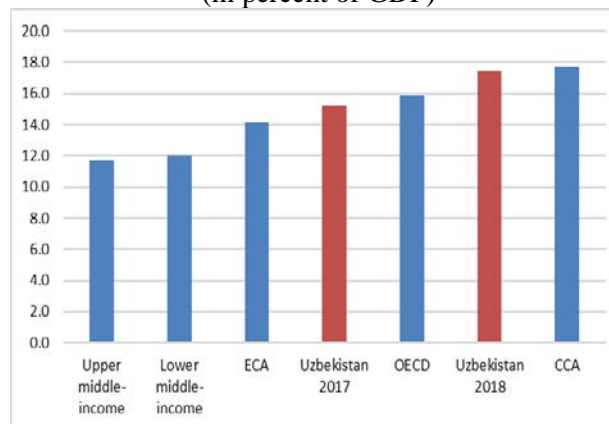
	2003	2005	2010	2015	2016	2017	2018
Total Revenue, incl. extrabudgetary funds¹	27.9	25.6	30.8	28.0	25.4	24.7	27.9
Budget Revenue, excl. extrabudgetary funds²	20.0	18.2	18.4	17.7	16.9	16.4	19.4
Tax Revenues	18.9	17.3	17.2	16.3	15.5	15.2	17.4
Taxes on incomes and profits	5.6	5.2	5.1	4.9	4.6	4.3	4.2
Payable by enterprises	2.9	2.7	2.8	2.8	2.6	2.4	2.4
Payable by individuals	2.7	2.5	2.3	2.1	2.0	1.9	1.8
Taxes on domestic goods and services	11.6	10.5	10.5	9.7	9.2	9.1	11.7
Value added tax	4.5	4.3	5.3	5.2	4.9	4.9	6.8
Sales tax	0.9	1.0	0.5	0.7	0.7	0.6	0.4
Excises	5.9	3.3	3.0	2.7	2.6	2.5	2.4
Mining tax	0.3	1.9	1.7	1.2	1.0	1.1	2.1
Property taxes	1.0	1.1	1.0	1.0	1.1	1.1	1.0
Taxes on international trade and transactions	0.7	0.6	0.6	0.7	0.6	0.7	0.4
Other budget revenue (tax and non-tax)	1.1	0.9	1.2	1.5	1.4	1.2	2.0
Social security contributions (pension and employment funds)	5.3	5.2	6.8	6.9	6.1	5.9	5.9
Other revenues (including the UFRD, road fund, and grants)	2.6	2.3	5.6	3.4	2.4	2.4	2.6

Sources: World Bank staff data revisions for 2003-2015, IMF's database for 2003-2018.

Tax revenues as a share of GDP in Uzbekistan are substantially larger than in ECA on average and in the lower middle-income countries. Uzbekistan's tax revenues are 5.4 percentage points of GDP higher in 2018 than the average of the lower middle-income countries; this difference does not include Uzbekistan's substantial off-budget revenues which are likely to have increased over time (Figure S1.1). Taxes on goods and services (as a percent of revenue) in Uzbekistan in 2018 are on average larger than in ECA and in the lower middle-income countries, while taxes on income, profits, capital gains as well as taxes on international trade are lower than in these comparators. The taxes on international trade in Uzbekistan are lower in 2018 due to large exemptions (see Chapter 2 on tax expenditures).

In 2018-19, the authorities introduced ambitious tax reforms aimed at helping stimulate economic activity, supporting more efficient revenue collection, and simplifying tax administration. The thrust of the reform has been on reducing and unifying the tax burden on small and large enterprises, unifying the rates of corporate profit tax, personal income tax, and the social tax to 12 percent, rationalizing the VAT payments, reducing the number of direct taxes and mandatory payments, and improving tax administration procedures (Table S1.2).¹ Despite the lower tax rates, the tax reform significantly improved compliance -- as expected -- and increased revenues in 2019. The authorities have also begun efforts to transform the customs and pension systems.

Figure S1. 1. Tax Revenues in Uzbekistan and Comparators, 2017-2018
(in percent of GDP)



Source: World Bank, IMF, and Uzbekistan authorities.

Some of the important changes are:

- The government reduced the corporate profit tax rate to 12 percent in 2018, almost half its 2003 level, before increasing it to 15 percent from January 2020.
- A flat personal income tax of 12 percent replaced several bands with a higher top marginal rate.
- Taxation of individual entrepreneurs vary depending on their turnover. A simplified VAT of 7 percent is in effect from January 2019 until January 2022 for firms with annual turnover below UZS 3 billion.
- The government decided to eliminate the simplified VAT and VAT privileges on imports and reduce the VAT from 20 percent to 15 percent from October 2019.
- The government increased import tariffs on some goods and introduced excise taxes on some goods in January 2019 and in January 2020 bringing the average import tariff to 8 percent.
- The property tax rate for individuals was reduced from 1.7 percent in 2016 to 0.2 percent in 2019 and for firms from 5 percent to 2 percent.
- The unified tax for micro- and small enterprises (MSEs) was cut from 13 percent in 2005 to 4 percent in 2019.
- The payroll tax rate was reduced from 31 percent in 2005 to 25 percent for large firms and to 12 percent for MSEs in 2019. From January 2020, the payroll tax was reduced from 25 percent to 12 percent for state enterprises defined as legal entities with a state share in the charter capital in the amount of 50 percent or more.
- The tax on dividends was reduced from 15 percent in 2005 to 5 percent in 2019.

¹ Cabinet of Ministers Resolution #1065 of December 31, 2018.

KEY CHALLENGES

The tax system needs to be more predictable and less complex. Although the Tax Code lays out the key tax bases and the rates for the personal income tax and the VAT, other tax rates are set by the government in the annual budget resolutions, which have become essentially mini-Tax Codes.² While the 2019 tax reform appropriately focused on simplifying taxes, reducing taxes on labor, and broadened the VAT, the further tax reform remains a priority to improve the attractiveness of Uzbekistan for investment. Although the threshold between small and large enterprises was changed from the number of employees to annual turnover, small firms still have strong incentives to stay small, downsize, or split themselves to avoid migrating into the standard tax regime, with implications for job creation.

Table S1. 2. Uzbekistan: Key Tax Rates, 2003-2019
(in percent, at the beginning of each calendar year)

	2003	2005	2010	2015	2016	2017	2018	2019
Corporate profit tax (standard rate)	20	15	9	7.5	7.5	7.5	14	12
Personal income tax								
lowest band	13	13	11	8.5	7.5	7.5	7.5	12
highest band	32	30	22	23	23	23	22.5	12
number of bands	3	3	3	3	4	4	4	0
VAT ¹	20	20	20	20	20	20	20	20
Unified tax for micro and small firms								
manufacturing	12	13	7	5	5	5	5	4
agriculture ²	6	6	6	6	5	5	5	4
Unified social payment ³	37.2	31	25	25	25	25	25	12
Dividend tax	15	15	10	10	10	10	10	5
Property tax	3	3.5	3.5	4	5	5	5	2

Source: The World Bank based on the government's annual budget resolutions.

Notes: (1) A simplified VAT of 7 percent was introduced in January 2019 for firms with annual turnover up to UZS 3 billion; the VAT was reduced to 15 percent from October 1, 2019. (2) Except those paying unified land tax. (3) The sum of contributions paid by firms to the Pension Fund, Employment Promotion Fund and Trade Union Fund. In addition, in 2003 employees paid 2.5 percent of their wages to the Pension Fund, 4 percent in 2010, 8 percent in 2018, and zero in 2019.

With the reforms of SOEs, it is likely that a guaranteed source of tax revenues will decline over the short term. A large share of taxes is currently collected from a relatively small number of SOEs, which greatly simplifies tax administration. But SOEs also receive a wide range of privileges, including subsidized intermediate inputs and preferential access to credit, which enables them to carry an elevated tax burden. As Uzbekistan's economy transitions to market, the number of SOEs and their privileges will decline. At the same time, off-budget revenues and spending and quasi-fiscal operations need to be brought on budget. In the short term, the budget impact may be negative, but over the longer term, the boost to the economy from the structural reforms and increased fiscal transparency are likely to be revenue positive.

² For example, the 2019 budget resolution is 138 pages long, four-fifths of which is dedicated to setting various tax rates.

The revenue fluctuations in recent years and potential decline in revenue in the future pose a risk to policy-makers and underline the importance of a medium-term approach to budget revenue to ensure the sustainability of financing the urgently needed higher public expenditure on infrastructure, education and health care that are critical for economic growth and development. The strategic importance of domestic revenue mobilization by developing a Medium-Term Revenue Strategy (MTRS)³ is to mobilize revenues through a tax system that can secure macroeconomic sustainability, while reflecting distributional considerations and creating appropriate incentives for economic and social development. Although the Uzbekistan’s 2019 annual budget presented estimates of main fiscal indicators for the budget year and the two following years, the projections excluded the off-budget operations and revenues⁴. Moreover, tax reform should be viewed as a multi-year undertaking to meet the revenue needs to have a clearer picture of the likely revenues over a meaningful planning period. The taxpayers and investors also need to have more certainty on how they will be treated and what the tax implications of their investment and other decisions will be.

Paying taxes in Uzbekistan has improved but remains time-consuming. According to the Doing Business 2020, Uzbekistan ranks 69th on the Paying Taxes indicator. Uzbekistan made paying taxes easier and less costly for companies by introducing an electronic system for filling and paying VAT, land tax, unified social payments, CIT, infrastructure development tax, environmental tax, personal pension fund contributions and cumulative pension contributions. It also eliminated some small taxes and significantly reduced the number of payments. However, complying with tax regulations can still be improved: to comply with regulations on taxes in Uzbekistan, a company must spend 181 hours (down from 356 hours in 2010), and pay 40.1 percent of its profit (down from 94.9 percent of its profits in DB 2010). The OECD average on hours to comply is 159.4. However, the pervasive state control and tax enforcement methods such as the use of commercial banks for tax reporting⁵ and collection (e.g., through debiting accounts of tax debtors without the account holder’s acceptance) are among the factors that contribute to the unfavorable business environment in Uzbekistan.⁶

POLICY OPTIONS

Improve the predictability of revenue and tax changes

A medium-term approach to predictability of revenues and the tax system will help entrepreneurs and citizens plan better. Tax reform should also help widen the tax base by reducing exemptions and preferences and encourage firms to expand (see Chapter 2). To mobilize revenues in a sustainable matter, the government should consider adopting a medium-term strategic approach to effectively

³ The need for MTRS was highlighted in the Addis Ababa Initiative in 2015, which aimed to strengthen revenue administration and improve fairness, transparency, efficiency, and effectiveness of the tax systems.

⁴ The 2020 budget includes the consolidated indicators for 2020 and indicative parameters for 2021-22. For the first time in Uzbekistan’s history, the budget was approved by the parliament.

⁵ For example, the Central Bank of Uzbekistan (CBU) instruction (issued in 2002) orders that all payment transactions of legal entities over a threshold of a few thousand dollars be reported by commercial banks to the CBU and tax inspectorate. Presidential resolution of June 26, 2018 “On measures to radically improve performance of tax bodies” orders that tax units can stop transactions on banking accounts of any firm and take its tax arrears from bank accounts without consent of that firm.

⁶ There are also reports from businesses about unofficial ad hoc levies collected by local authorities for charity, local infrastructure development, holding various events.

administer taxes. A MTRS would guide and direct the reform agenda of Uzbekistan over the coming 4-6 years. For this comprehensive and multi-faceted endeavor (that includes policy, administration, and legal components) to succeed, it is important to build on current reform efforts.

Strengthen tax collection

Chapter 2 of the PER focuses on tax expenditures. Besides revising the list of tax and customs exemptions, tax collection could be improved by streamlining and unifying IT systems (including to help the authorities compare taxpayers with registered entities), reorganizing the one-stop shop for customs tariff and excise payments, improving services and information to all taxpayers, and strengthening the management of large taxpayers. Implementation of a risk-based auditing system should also help.

Chapter 2. Tax Expenditures in Uzbekistan

Uzbekistan offers several tax incentives and exemptions – called tax expenditures – which impose a large direct fiscal cost to the budget. Further, Uzbekistan’s tax incentive policy leads to substantial monitoring cost for the government, as the process involves enterprise-specific procedures. Finally, the efficacy of these tax incentives is in doubt because they do not appear to have boosted foreign direct investment, domestic investment, or business creation. The government appears to provide many tax incentives without a cost-benefit analysis on whether existing incentives have been effective in accomplishing their intended goal.

CONTEXT AND RECENT DEVELOPMENTS

Definition of Tax Expenditures

Tax expenditures are the revenues forgone due to tax exemptions and incentives. Tax incentives are measurable benefits that governments provide to specific taxpayers or groups of taxpayers, with the goal of encouraging them to invest in favored sectors or regions. Tax expenditures further influence the character of such investment and in some cases, they reduce the tax burden on specific taxpayers. Benefits can sometimes be nontax, such as grants, loans, or rebates to support business development or enhance competitiveness. In Uzbekistan, there are tax expenditures on VAT exemptions, income taxes, and customs duty exemptions. In this report, we use tax incentives and tax expenditures interchangeably, even though tax expenditure is the revenue foregone while tax incentives are the instrument that results in foregoing such revenue.

Tax incentives around the world

Tax incentives in one form or the other are used by nearly all countries in the world. Table 2.1 shows the prevalence of the different tax incentives among the 153 countries surveyed. Tax holidays are prevalent in all regions except the OECD countries. This reflects the gradual move away from the use of tax holidays among the developed countries due to their ineffectiveness in aligning the incentives of increased investment with the tax benefits. Super-deductions – an incentive where deductions are allowed for more than the actual cost of certain expenses – are most prevalent in South Asia mainly to reduce and subsidize the cost of investment, especially investments in R&D and training, and for defraying start-up capital costs.

Tax holidays offered by countries in Eastern Europe and Central Asia (ECA) largely follow those of other regions. There is much higher prevalence of reduced tax rate regimes and all countries use tax incentives within Free Economic Zones or Special Economic Zones. Further, there is a lower prevalence of investment allowances which is a superior form of tax incentive as compared to tax holidays. Investment-linked incentives increase with the investment size while in the case of tax holidays, the tax incentives do not change with the size of the investment. Nearly half of the countries in the ECA region provide tax incentives in a discretionary manner. This means that tax incentives are provided on a case-by-case basis through an administrative process and not automatically through the law and via the filing of tax returns. Discretion on provision of tax incentives reduces the efficacy of the investment policy regime as it creates a barrier for the

investment opportunity because investors need to go through approvals which is costly both in terms of time and money.

Table 2.1. Prevalence of Income Tax Incentives around the World

	# of countries	Tax holiday/ Tax exemption	Reduced tax rate	Investment allowance/ Tax credit	R&D tax incentive	Super-deductions	SEZ/Free zones/ EPZ/Freeport	Discretionary process
East Asia and Pacific	12	92%	75%	67%	83%	33%	92%	83%
Eastern Europe and Central Asia	17	88%	71%	18%	53%	6%	100%	41%
Latin America and the Caribbean	24	92%	33%	50%	8%	4%	71%	42%
Middle East and North Africa	15	80%	40%	13%	0%	0%	80%	40%
OECD	34	12%	32%	65%	76%	21%	68%	35%
South Asia	8	100%	38%	75%	25%	63%	63%	38%
Sub-Saharan Africa	44	80%	64%	77%	11%	18%	66%	77%

Sources: James, S. (2018). "Tax and non-tax incentives and investment: Evidence and Policy Implications," Investment Climate Advisory Services. World Bank Group.

Uzbekistan offers all the incentives commonly used around the world except investment allowances, investment tax credits, and R&D incentives. R&D incentives are becoming increasingly used around the world, including in ECA (Table 2.2), Uzbekistan does provide incentives for "Innovative Techno-parks" with the purpose of encouraging investment into innovative technologies including chemicals, bio-technology and information technology (Appendix 2.1). The country also offers Free Zones as an important part of its investment strategy and uses a discretionary approach in providing tax incentives.

Table 2.2: Tax Incentives in Developing Europe and Central Asia, 2018

	Tax holiday/ Tax exemption	Reduced tax rate	Investment allowance/ Tax credit	R&D incentives	Super deduction	SEZ/ Free Zones/ EPZ/Freeport	Discretion
Albania	x	x		x	x	x	x
Armenia	x	x				x	x
Azerbaijan	x			x		x	
Belarus	x	x		x		x	
Bosnia	x		x			x	
Kazakhstan		x	x			x	x
Kyrgyzstan	x			x		x	
Macedonia	x	x				x	
Kosovo		x				x	
Moldova	x	x		x		x	
Montenegro	x			x		x	
Russia	x	x		x		x	x
Serbia	x		x	x		x	
Tajikistan	x	x				x	
Turkmenistan	x	x				x	x
Ukraine	x	x		x		x	x
Uzbekistan	x	x				x	x
Total: 17	15	12	3	9	1	17	7

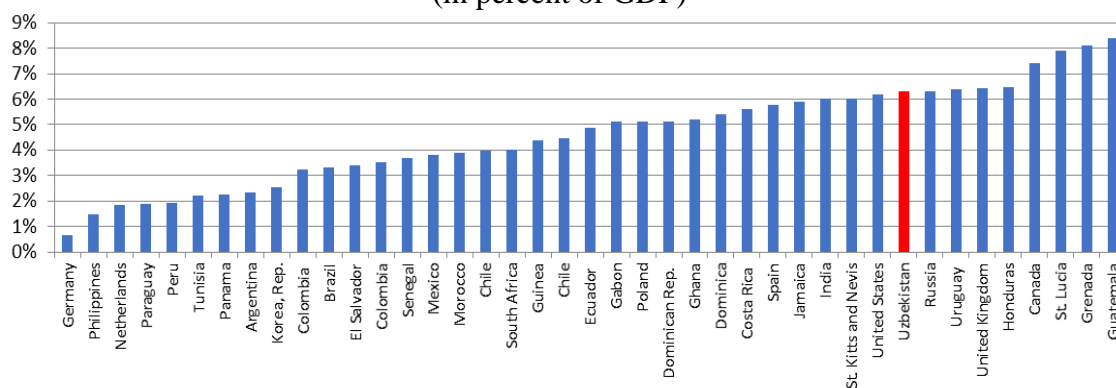
Sources: James, S. (2018). "Tax and non-tax incentives and investment: Evidence and Policy Implications," Investment Climate Advisory Services. World Bank Group.

Revenue cost of tax incentives

Uzbekistan’s overall tax expenditures amounted to 6.4 percent of the GDP in 2018, almost a third of budgetary revenues. This figure does not include exemptions on imports including customs duties, excises, VAT on import accruing to exempt taxpayers or final consumers. In general, the amount of tax expenditures indicates the potential for increasing government revenues if they were abolished. As the authorities advance their tax reforms, which include substantial reductions in tax rates, then the size of tax expenditures, or foregone revenues, will decrease automatically as the revenue foregone is relative to the actual tax or duty rates. However, there will still be a room for reducing the size of tax expenditures by eliminating company- or sector-specific tax incentives.

Tax expenditures vary greatly around the globe, from below half a percent of GDP in Germany to nearly 8 percent of GDP in Guatemala. Russia’s tax expenditures also amount to 6.3 percent of GDP, but this estimate includes all taxes and customs duties (Figure 2.1).

Figure 2.1. Tax Expenditures Around the World
(in percent of GDP)



Sources: World Development Indicators and World Economic Outlook.

As with the overall direction of policy and directed credit, the largest share of tax incentives in Uzbekistan is for manufacturing (largely car production), mining, and finance. The authorities report that 17,246 enterprises benefited from 9.3 billion soms in tax incentives through the tax code, while 21,355 enterprises benefited from 6.4 billion soms in tax incentives through government decisions (Table 2.3).

Officially reported customs expenditures are oversized, as large as 7 percent of GDP in 2016 rising to 10 percent of GDP in 2018. The amount of tax duty exemptions within the overall customs expenditures amounted to 2.8 percent of GDP in 2016 compared with collected customs duties of 0.6 percent of GDP. The large size of customs expenditures, both in percent of GDP and compared to actual customs duty collected, indicates that Uzbekistan’s legislation provides very high rates of customs duties, but presidential decrees and government regulations reduce these substantially.

The large size of customs expenditures should not be seen as a potential revenue source if they are abolished but as an opportunity to simplify the levies on imports and reduce the costs of compliance for importers and monitoring for the government. The size of the tax expenditure on customs exemptions needs further analysis as general reductions in duties due to international agreements or reductions that apply to all businesses would not be considered a tax expenditure. It is only when the individual decrees by which the customs exemptions are analyzed that a more precise estimate of the tax expenditure on customs expenditure could be arrived at.

Table 2.3. Tax Expenditures in Uzbekistan, 2017
(in millions of UZS and percent)

Sector of economy	Amount of incentives	Share (%)	According to the Tax Code		By Government Decision	
			Number of enterprises	Amount of incentives	Number of enterprises	Amount of incentives
Manufacturing	3,660	23.2	800	858	2,072	2,802
Other sectors	3,090	19.6	13,585	1,463	16,745	1,627
Oil/Gas/Mining	2,559	16.2	73	1,226	32	1,333
Finance including banking	2,212	14.0	511	2,194	129	18
Utilities/Power/Gas	1,714	10.9	81	1,714	16	0.3
Transportation	1,455	9.2	102	1,216	31	239
Services	438	2.8	670	339	250	99
Housing and construction	303	1.9	394	14	1,756	289
Agriculture	167	1.1	1,003	165	315	2
Government	157	1.0	27	152	9	5
Total	15,755	100	17,246	9,341	21,355	6,414

Sources: Uzbek authorities and Bank staff calculations.

KEY CHALLENGES

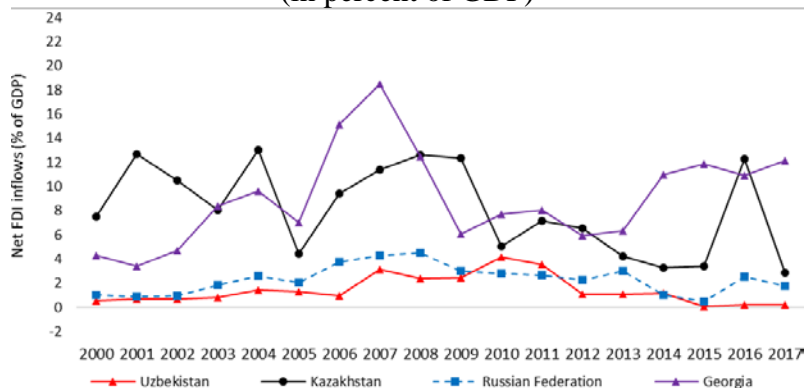
Evaluation of Uzbekistan's tax incentive regime

An evaluation of the tax incentives of Uzbekistan concludes that the country does not meet most good practices for tax incentives. The evaluation assesses both the policy framework and the outcomes of the policy (Table 2.4).

First, Uzbekistan offers many different tax incentives with the aim of attracting investment. Experience around the world has shown that broader investment policy that lowers the overall cost of doing business plays a much more significant role in attracting foreign direct investment (FDI). Investors value a stable economic environment, a strong rule of law, and effective property rights more than the availability of tax incentives. Despite the heavy focus on tax incentives, Uzbekistan attracted much lower FDI in recent years (Figure 2.2).

Second, several tax incentives are offered outside the tax laws: nearly a third of the overall tax benefits are provided by government decrees. The good practice is to have tax incentives provided through the tax laws to reduce the temptation of discretion and misuse. If incentives are provided in the laws, the incentives are subject to parliamentary scrutiny. Taxpayers also have the option of using the tax appeals process to air their grievances when the tax incentives are availed through the usual tax filing process.

Figure 2.2. Inflows of FDI to Uzbekistan and Neighbors (in percent of GDP)



Source: World Development Indicators.

Third, providing tax incentives outside the tax code gives substantial discretion to the investment agencies. If an investor is uncertain whether a certain tax incentive applies, they could seek clarification or an “advance ruling” from the tax agency. A separate process outside the tax agency to scrutinize tax incentives results in duplication and hence is redundant.

Fourth, tax incentives should be automatically available through the filing of tax returns without the need for an additional pre-approval. In Uzbekistan, there are many procedures associated with the tax incentives which is not good practice. While these procedures are aimed at limiting the misuse of tax incentives, they are costly for investors. These procedures could alternatively be provided through the tax administration using a risk-based criterion. Duty exemptions could also be cleared in advance by the Customs committee without the need for a separate agency to pre-approve the duty exemption. Higher authorities could continue to do quality control by monitoring the tax and customs committees on the use and misuse of tax incentives.

Fifth, tax holidays provided either within the Free Zones or for specific sectors are inferior as compared to investment linked incentives and should ideally be replaced by the latter.

Sixth, to properly administer tax incentives, taxpayers need to file tax returns so that the tax agency have the required information to do so even if they do not have any taxable income.

Seventh, the tax administration needs to address any misuse of tax incentives through their audit policy including compulsory audit of any tax payers making claim of tax incentives of large amounts.

Eight, tax policy makers including the parliament need to have the information as to the cost of the tax incentives to the treasury. Just as expenditure budgets are scrutinized, so should tax expenditures need to be scrutinized. To do that, tax expenditure statements need to be prepared as part of the budget process. These tax expenditure statements should cover all tax incentives under all the major taxes including customs exemptions.

Table 2.4. Assessment of the Tax Incentives in Uzbekistan

	Policy Criteria	Score	Comments
1	The tax incentives are used minimally and mainly to address market failures	No	There are many tax incentives provided through the tax laws as well as outside
2	Tax incentives are specified in the tax codes and not in other laws (except in the case of extractive industries)	No	Tax incentives are specified in the tax laws, however discretionary tax incentives are provided outside the tax laws including in decrees
3	Tax incentives are not offered in a discretionary manner outside the law	No	Discretionary tax incentives are offered on a case to case basis
4	Tax incentives provided in the laws are available automatically to the taxpayer	No	Taxpayers must go through an approval process to benefit from certain tax incentives
5	The tax incentives should, as far as possible, be linked to investment and tax holidays should be used as sparingly as possible	No	Tax holidays are one of the main tax incentives provided and investment linked incentives are not provided except via investment levels to qualify for longer period of tax holiday.
6	The taxpayers who benefit from tax incentives should continue to file tax returns even if there are not liable to pay any taxes	Yes	Requirement to file taxes is enforced even when there when there is no taxable income
7	The Tax administration is adequately trained to address issues of transfer pricing and misuse of tax incentives	Partially	No automatic audit of tax incentive cases
8	The tax expenditure statements are prepared on a regular basis to measure the costs of the tax incentives	Partially	The cost of tax incentives is estimated for 2017, however this is not done as a part of the regular budget reporting process

Sources: Framework provided in James (2018).

Outcome of the tax incentives policy

The Uzbekistan incentive policy has not helped increase significantly inflows of FDI. Hence, a rethink may be needed how to structure tax expenditures to produce results.

On a micro level, it is not possible to comment on the efficacy of the tax incentives directed to the various sectors from this data. An assessment of the need for tax incentives for sectors could be made if the return on investment for the specific sector or sub-sector is available. Tax incentives directed to highly profitable sectors could then be considered redundant while those that make marginal investments or first steps worthwhile would be useful.

However, a significant amount of tax incentives goes to the Oil/Gas/Mining sector which is a location or resource-based industry where tax incentives may be redundant. This is because location or resource linked industry is dependent on the location of the resource and tax incentives that generate resource specific rents. Investors who seek those resources would be willing to pay to access the resource. Box 2.1 provides useful guidelines for providing tax incentives. The primary goal is to ensure that the government provides a stable investment climate and make it conducive for businesses to invest and reduce their costs and make the return profitable.

Box 2.1. Checklist for Evaluating Tax Incentives for Investment

Tax incentives have been used as one of the main tools by the government to attract investment. There are several factors to be considered before tax incentives are provided. Justification for a tax incentive needs to pass all the following tests before it is recommended:

1. Would the investment come in anyway?
2. Would the tax incentive put existing businesses at a disadvantage?
3. Would the investment realize tax revenues after the tax incentives are exhausted?
4. Does the investment provide positive externalities?
 - a. Direct jobs
 - b. New technology or skills
 - c. Infrastructure or public goods
 - d. New industry
 - e. Ancillary industries
5. Does the tax incentive create opportunities for tax evasion?
6. Does the investment cause negative externalities such as pollution?
7. Would this result in increasing demand for incentives by other investors?

In general, few investments satisfy most or all these criteria. The goal of the government should be to improve the investment climate and make it conducive for businesses to invest and reduce their costs and make the return profitable. It may be necessary for the government to look at the competitiveness of the overall tax system rather than use tax incentives in specific cases to achieve the same end.

Source: James, S. (2018).

POLICY OPTIONS

Prepare Tax Expenditure Statements as part of the regular budget process and make them public

A comprehensive tax expenditure statement prepared and published every year makes transparent the costs and beneficiaries of tax incentives. The systematic estimation of the revenue cost of the tax incentives in the form of a tax expenditure statement on a regular basis is a good start to highlight the problems and then begin to address them. This would help initiate a dialogue on the effectiveness of the tax incentives among policy makers and citizens and provide the same level of transparency as accorded to the expenditure side of the budget.

Rationalize tax incentives

The government needs to conduct a cost-benefit analysis of each of the tax incentives provided. Based on this study, the government should remove any redundant tax incentives and modify others that are not working to its intended goal. Removing any underperforming tax incentives would create much needed fiscal space for the government. If the government reduces the tax incentives even by 20 percent, this would result in additional revenues of 1.3 percent of GDP. Cost-benefit analysis of the tax incentives needs to be done on a regular basis to assess whether the existing tax incentives have been impactful as well as cost-effective in fulfilling its intended goal.

Impose a minimum tax

An immediate withdrawal of tax incentives would apply only to new investment and the revenue impact would be limited. However, a minimum tax could be imposed to ensure that businesses benefiting from tax incentives pay at least a certain minimum amount of tax which could be a percentage of turnover or assets. This minimum tax could be credited against future tax liability of the business which would respect the government promise on the tax incentive as the government would provide the quantum of the tax incentive but only asks for future tax to be prepaid. This ensures that a level playing field is established across all businesses and reduces any excessive generosity of the tax incentive, if it results in no tax at all during the duration of the life of a business that benefits from a tax incentive. Lastly, it ensures that businesses remain invested after receiving the tax incentive rather than pack up and leave for the next investment destination offering tax holidays.

APPENDIX 2.1: TAX INCENTIVES IN UZBEKISTAN

Tax Incentive Name	Sector	Tax Incentive	Remarks
Foreign Investment into Priority Industry Incentive Presidential Edict № VII-3594 dated 11 April 2005	For Investment in the chemical and petrochemical, engineering, food and alternative energy	Income Tax Holiday from 3 to 7 years; Includes exemption from: <ul style="list-style-type: none"> - Property Tax; - improvement of social infrastructure tax; - National Road Fund; - Integrated Tax for micro and SMEs 	Outside Tashkent Oblast; no state grants used; foreign investment of at least 33 percent; foreign investment made in the form of new and modern production equipment; 50 percent of income generated is re-invested
Foreign Investment into Free Economic Zone Incentive	For Investment in Free Economic Zones	Income Tax Holiday depending on the value of the investment <ul style="list-style-type: none"> - 3 years (from \$300,000 to \$3 million) - 3 year (from \$3 million to 5 million) - 7 years (from \$5 million to \$10 million) - 10 years (more than \$10 million) Includes exemption from exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	Tax stability clauses are also provided so as not to reduce the tax position of these investments
Pharmaceutical industry Investment Incentive Presidential Edict № VII-5032 dated 3 May 2017	For Investment in Pharmaceutical Free Economic Zones	Income Tax Holiday depending on the value of the investment Includes exemption from exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	
Innovative Techno-parks Incentive	For investment in the Yashnabad techno-park for investment in chemical technology, bio-technology and material processing technology And in the Mirzo Ulugbek Innovation Center for innovative IT technology	Income Tax Holiday depending on the value of the investment. Includes exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs; improvement of social infrastructure tax; customs duties on select equipment.	
Tax incentives for Zones and Regions Presidential Decree No. PP-2843 from 17	For businesses in the <ul style="list-style-type: none"> - Karakalpakstan and Khorezm region - Small industrial zones (SIZ) - Samarkand city zone 	For companies producing pharmaceutical products and electrical products, exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	Small industrial zone <ul style="list-style-type: none"> - Invest at least \$75,000 and annual income exceeds \$32,500 (Yangier SIZ) - Invest at least \$97,500 and annual

March 2017; Decree No. PP-2860; pp2973		Small industrial zones Exemption from unified tax and customs duty for 3 years (for Yangier small industrial zone) and 2 years for Tashkent small industrial zone Samarkand City Zone. Includes exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs; improvement of social infrastructure tax; customs duties on select equipment.	income exceeds \$75,000 (Tashkent SIZ)
Oil and Gas exploration and extraction Incentive	For foreign companies carrying out oil and gas exploration works including the foreign sub-contractors	Tax holiday for 7 years if joint venture company is established Exemption from contributions to all non-budget funds during the exploration period Residents supplying equipment or services are treated as exempt from VAT	
Export Incentive Presidential Decree #YII-5587 of 29 November 2018,	For exporters (except certain products) whose exports are more than 15 percent of their total turnover	The tax base for calculating income tax is reduced by the amount of exports	
Exemption from Customs Duties	<ul style="list-style-type: none"> - Property used for production by foreign investors with foreign participation of not less than 33 percent - Goods imported by foreign legal entities that made investments of more than \$50 million provided the products are of their own production - Goods intended for work under a production sharing agreement -Technological equipment from a list of approved items or for inputs used for export 		

Chapter 3. Public Wages and Employment

The public sector is a large employer in Uzbekistan and the public wage bill accounts for almost half of the government budget. Concerns have increased about the fiscal affordability of the wage bill. The authorities are planning to reform public employment and human resource management to deliver more effective public services at optimal cost. Reforms need to consider several issues. The current hierarchical salary structure provides little opportunity for horizontal mobility, staff motivation, and career growth in the public sector. The base salary for a position is not linked to performance and the salary structure is inconsistent with international practice. Allowances and benefits are disproportionately high compared to the base salary. At the heart of these issues is a weak human resource management function in the public sector, both in recruitment and promotion, weak performance orientation, and fragmentation of wage bill management responsibilities.

CONTEXT

Attention to performance is important for achieving a high-performing public service. Performance, in turn, depends on an efficient compensation and human resource management system that is able to attract, motivate, and retain qualified personnel. As the government moves to modernize the public administration, it will be crucial to address several medium- to long-term challenges in the areas of public service compensation, grading, and human resource management (HRM) systems. Currently, compensation levels seem low relative to comparator countries. Public salaries, meanwhile, seem higher on average than the private sector ones, but the latter may be substantially underreported. The public sector wage premium has not been leveraged to improve employee productivity and performance to reduce fiscal stress.

There have been increasing concerns about the fiscal affordability of the increasing public sector wage bill. This stems from two main factors: pressure to increase salaries for certain categories of workers and the creation without a clear roadmap of new ministries and agencies in the process of reform. So far, both the level of public wages and public employment are drivers of the increasing wage bill in Uzbekistan. Higher salaries and the multiplicity of allowances not adequately linked to staff performance and productivity are part of the story. The number of public employees has also increased, in part to help deliver the needed public services in the face of low staff productivity and performance. A partial explanation of why salaries of public servants appear relatively low despite the increasing wage bill is the deliberate policy of keeping base pay low and maintaining a significant size of allowances in total compensation which are not directly linked to performance accountability of employees.

The demand for higher salaries is expected to continue, following recent pay increases for teachers and health sector workers, and boosted by the publication of the salaries of higher-level government appointees, including ministers. If the number of public servants is large and wage increases are out of line with productivity increases, this would result in a substantial fiscal stress and limit scope for other government spending, including on human capital and infrastructure.

Another contributing factor to rapid growth of the wage bill is the ongoing government efforts in creating new ministries and agencies. The process of modernization may indeed

require additional ministries, departments and agencies (MDAs). The sectoral composition of institutions and employment size could change significantly as a result with the demand for wage-bill related costs to implement policies and programs of the newly established institutions.

The government lacks the policies and procedures to determine the salaries for different types of jobs in the government sector. Any form of arbitrary pay increases, including the recent ones for some categories of health and education workers, has the potential to create further distortions and inequities in the salary regime and trigger additional demand for wage increase from other job groups. This could lead to a spiraling growth in the wage bill.

Besides weak pay policies, the authorities have weak HRM systems to manage talent; there is no comprehensive HRM information system to manage public sector remuneration and benefits. The UZ-ASBO system the government uses is geared for accounting and payroll calculations but is limited in providing the seamless functionality of HR elements regarding employee performance, productivity, promotions and professional career development which are needed for managing pay and the overall wage bill.

The legal framework governing public sector pay needs to be guided by a comprehensive and coherent medium- to long-term strategy. The absence of a policy framework to provide systematic and holistic guidance on public administration reform, including remuneration and benefits, could create a situation of continuous non-predictability of the public wage-bill.

KEY CHALLENGES AND INTERNATIONAL EXPERIENCES

Wage Levels

The overall consolidated government wage bill amounted to 10.5 percent of GDP in 2018, among the highest in relevant comparators. This includes the wage bill both on the budget (9.5 percent of GDP) and off-budget. The item identified as “wages” in the government budget is equivalent to about 6.9 percent in GDP, but it includes just a part of the on-budget wage bill. There are other wage outlays in the budget that are classified as part of “other.” Adding these up produces the 9.5 percent of GDP wage figure on-budget.

Uzbekistan’s wage bill is as high as the average for the countries of the OECD, resource-rich MENA, and SSA, and above the average for the other developing regions. It is higher than the average for middle-income countries (8.5 percent of GDP). Even on-budget wage outlays are substantially higher than the average for the Caucasus and Central Asia (Figure 3.1). Uzbekistan’s wage bill is an outlier when considering only on-budget wage spending, as it is almost half of budget expenditures (Figure 3.2). It is in the middle of relevant comparators when the consolidated wage bill and consolidated expenditures are considered.

Wage Structure and Components

The current pay and grading structures of the government consist of twenty-two hierarchical levels with limited opportunity for horizontal mobility. At the same time, all job groups, including political appointees, are on the same base salary spine. This could be used to improve adherence to the key pay principles of fairness, transparency, and equity. The education and health sectors, however, have separate pay and grading structures with little

alignment to the national 22-tariff grid. Compensation structures of the two sectors do not, however, cover employees categorized as auxiliary.

Figure 3.1. Consolidated Wage Spending
(in percent of GDP)

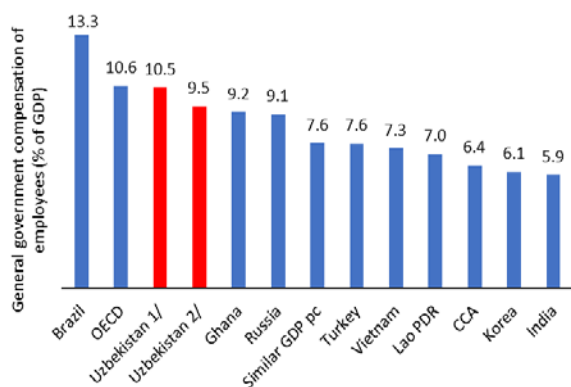
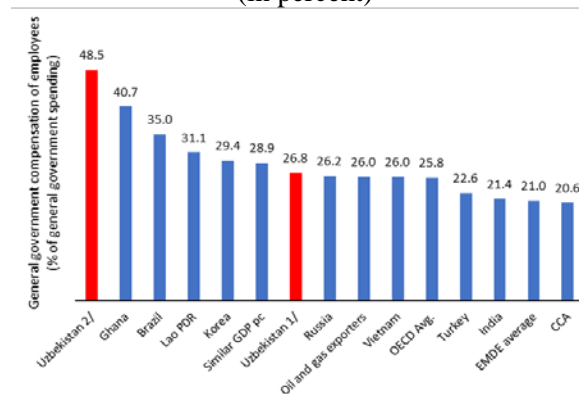


Figure 3.2. Wage Spending Relative to Consolidated Government Expenditures
(in percent)



Sources: Uzbek authorities and staff estimates.

Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan. Uzbekistan 1 includes the consolidated government wage bill spending and Uzbekistan 2 includes only on-budget wage bill spending.

The absence of horizontal steps in the pay structures create challenges to understand the dynamics of salary ranges in the public sector and their impact on public sector performance, career quality and wage-bill management. This has the potential of negatively affecting motivation, professional development, and morale of public sector workers. It also provides performance management and employee appraisal challenges to managers as they plan incentive plans to reward good performance and determine performance improvement zones for weak performers. Sector wages have experienced rapid growth in the last three years, reflecting higher inflation in part driven by the currency devaluation.

The government pay structure has numerous allowances and benefits which, to a large extent, are not linked to employee performance on the job. Some allowances and benefits are paid as rewards to celebrate public holidays such as teachers' day. The basic salary-allowance structure is not in line with good practice, as allowances and benefits in most cases are several times higher than base pay. This situation is entrenched, because salaries and allowances of government employees can be increased by means of budgetary and off-budgetary funds of ministries, state committees and agencies at the discretion of the heads of institutions. In February 2019, the MOF published the monthly wages of public employees including ministers and other senior officials which included various allowances and additional benefits. The report also indicated on-budget and off-budget payouts that included allowances amounting to as much as 115 percent of base pay. Other benefits include: (i) working condition allowance for specified staff category – 20 percent; (ii) labor incentive coefficient – 40 percent of base pay; (iii) performance of full-service term – 20-30 percent of base pay; (iv) long service – 20-30 percent of base pay; and (v) material incentive – 15-25 percent of base pay.

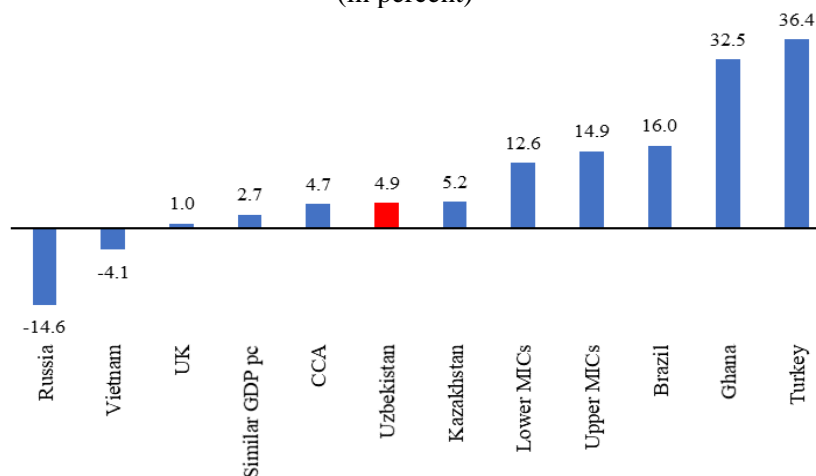
The base salary as a share of the total compensation varies substantially even within one sector. The base salary for primary and secondary teachers accounts for 64 percent of the total salary, but it could be as low as 47 percent for primary and secondary teachers in schools with persons with disabilities. The situation is more striking at the higher education level where the ratio of base salary to total salary from the state budget is about 39 percent. The health sector

has better alignment, with the base salary averaging about 77.5 percent for paramedics, 71 percent for middle level doctors, and 75 percent for doctors in managerial positions including heads of health institutions.

In OECD countries, the base salary accounts for 80 percent of total compensation on average. In some countries like Switzerland, Sweden, Canada, Australia and Iceland the ratio between basic salary and total salary is 100 percent, meaning there are no allowances. A survey conducted in 2002 indicated that the Canadian Government spends as much as one-third of its HR budget on processing allowances. Many OECD countries have since adopted a “clean wage” policy, in which many allowances and perks have been abolished or consolidated into basic pay. Romania presents another good example: in 2009, bonuses and allowances (then averaging about 32-58 percent of total pay) were reduced to about 20 percent across the public sector.

The employee premium is an important component of public wages in Uzbekistan. Public sector employees tend to concentrate in the capital and other big cities where living costs are higher and may require higher wages to attract comparable staff. There is no current comparative data on public-private sector compensation for different occupational groups, but it seems that while senior public sector employees in ministries and agencies enjoy large wage premia, their counterparts in some service delivery sectors including health professionals may be experiencing a wage penalty. Overall, however, the public sector wage premium – although not including all allowances -- compared to all private sector employees was 4.9 percent (2003) in Uzbekistan, 32.5 percent in Ghana, 16.0 percent in Brazil, 5.2 percent in Kazakhstan, and as low as one percent in the UK. There is evidence that in both Brazil and Ghana, public servants on average have better qualification than counterparts in the private sector and enjoy generous conditions of service including generous monetary and non-monetary allowances and benefits. The current public sector wage premium in Uzbekistan could be much higher than the number reported for 2003 due to several salary increases and generous allowances paid to public officials in recent years. During the same period, Russia Federation and Vietnam experienced wage penalties indicating higher salaries in the private sector compared to public sector salaries.

Figure 3.3. Public Sector Wage Premium Compared to All Private Employees
(in percent)



Source: The World Bank Worldwide Bureaucracy Indicators

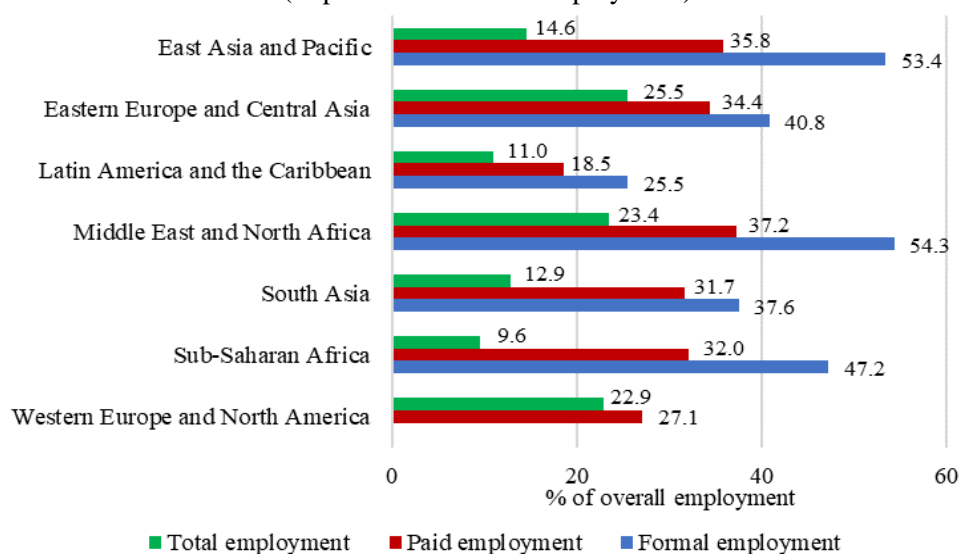
Large premium earnings for public sector employees could distort the equity compensation principle and send the unintended signal that public sector employees are a privileged group. Government payment of excessive public sector premiums could also crowd out spending on other economic and social investment priorities.

There is fragmentation of the wage-bill control function with the potential to inhibit the government’s ability to contain the wage bill growth in the future. Control of wage bill management is currently fragmented among different organizations including the MOF, the Ministry of Employment and Labor Relations (MoELR), and other ministries, departments and agencies. The specific roles of these institutions with respect to pay and employment management policies and processes including data management are not adequately defined. There is no independent institution responsible for setting remuneration and benefits policies and standards based on proper job classification and evaluation and ensuring adequate application of remuneration and benefits principles.

Public Employment Structure and Levels

Globally, the public sector accounts for 15 percent of total employment, 30 percent of wage employment, and about 39 percent of formal employment. ECA has the highest share of total public employment among all developing and developed regions (Figure 3.4). Public employment accounts for more than half of formal employment in EAP and MENA, with SSA close behind at 47 percent.

Figure 3.4. Public Employment Around the World: A Regional Snapshot
(in percent of overall employment)



Source: The World Bank Worldwide Bureaucracy Indicators

Uzbekistan’s public sector employment seems to be like the average for the countries of the Caucasus and Central Asia. There is no evidence that the high level of employment in Uzbekistan contributes any significant efficiency and productivity dividends to the government as employer, however (Figure 3.5 and Figure 3.6)

Figure 3.5. Public Sector Employment as a Share of Total Employment
(in percent)

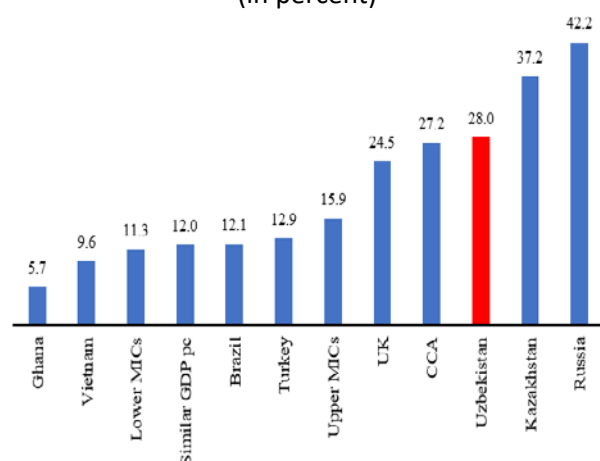
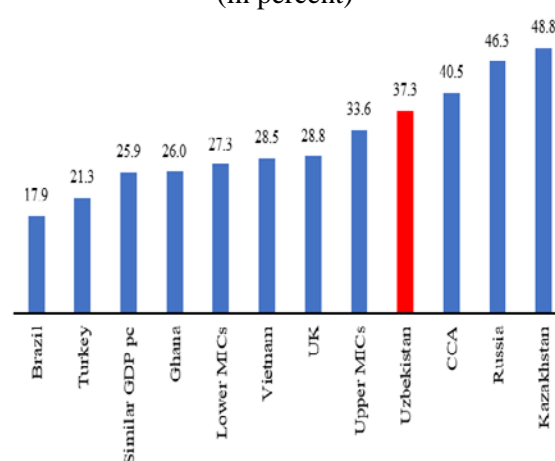


Figure 3.6. Public Sector Employment as a Share of Wage Employment
(in percent)



Source: The World Bank Worldwide Bureaucracy Indicators.

Note: For Uzbekistan, the employment covers only the civil service, education and health workers.

Sector Dynamics of Public Employment and Wages

Sector wages in Uzbekistan have experienced rapid growth in recent years. Wage increases have been large in the central state administration and in sectors such as health and education.

Wages in Central Government Ministries and Agencies

The 22-level tariff grid is mainly applied to central ministries and agencies including their branches and offices at the sub-national level. Table 3.1 shows wage levels in state administration from 2016-2018. Wages from both budgetary and extra-budgetary sources increased more than 20-fold in three years compared with a 34 percent cumulative inflation.

Table 3.1. Uzbekistan: State Administration Salary Payments, 2016-2018
(in Soms)

Institution	2016		2017		2018	
	Budget	Extra-Budget	Budget	Extra-Budget	Budget	Extra-Budget
Ministries	841,803	155,908	313,133	213,466	1,508,118	339,349
State Committees	21,468	2,939	2,503	7,804	656,356	4,705,551
Agencies	4,384	0	0	0	18,899	70,054
State Commissions	648	93	746	105	3,975	0
Centers	2,503	58,478	2,317	39	13,517	3,382
Others 1/	69,605	0	0	0	15,009	930
Total	941,197	217,417	341,209	221,414	17,223,506	5,118,296

Source: Uzbekistan authorities and Bank staff estimates.

1/ State inspection, Tashkent administration, Higher Attestation Commission, Academy of Sciences.

Health Sector Wages

The health sector has its own separate salary structure comprising of eleven tariff grades with little alignment to the national 22-tariff grid. The structure excludes auxiliary and non-medical support staff who are covered under the national 22-tariff grid. In many respects the

health sector salary structure including salary levels is superior to the 22-grade structure of the civil service. This leads to discontent among staff within the sector who have similar qualifications and experience but earn less because they are not physicians or paramedics. There are 8 categories of medical personnel and nurses working in 4 different types of medical facilities that fit into the sector salary structure, with coefficients aligned to grades depending on the type of medical facility. Generally, Head of medical facility is mapped to grades 8-11, Medical Doctor to grades 6-10, Surgical Nurse 2-6 and Paramedic 1-2 (Table 3.6).

Table 3.2. Uzbekistan: Monthly Salaries of Health Personnel Before Tax, 2016-2018
(in Soms)

Personnel Category	Facility Category	Salary		
		2016	2017	2018
Head	General hospital	1,409,120	1,620,470	2,268,510
Head	Emergency center	1,624,150	1,867,750	2,498,950
Head	Specialized hospital	1,435,020	1,650,260	2,30,590
Chief Nurse	Emergency centers	1,306,710	1,502,710	2,106,280
Nurse	Emergency center	1,115,890	1,283,560	1,812,540
Paramedic	Emergency center	758,980	872,820	1,030,760

Source: Uzbekistan authorities and Bank staff estimates.

Education Sector Wages

There are three different ministries responsible for education sector policies and programs. These are the Ministry of Public Education, the Ministry of Higher and Secondary Specialized Education, and the Ministry of Pre-School Education. As in the health sector, the education sector also has its own separate salary structure for teachers and professional employees. Generally, personnel are grouped according to four categories of schools (i) General schools; (ii) Specialized schools; (iii) Schools for challenged children; and (iv) Orphanage schools. Salaries are higher in schools for challenged children and specialized schools than other school categories.

Table 3.3. Uzbekistan: Monthly Salaries of School Teachers (Before Tax), 2016-2019
(in Soms)

Category	Type of personnel	2016	2017	2018	2019
General school	Primary and secondary teachers	1,802,800	2,073,300	2,412,700	2,985,900
	Teachers of high classes	1,622,500	2,030,800	2,412,700	2,985,900
	Directors and deputy Directors	1,546,000	1,778,000	2,092,700	2,437,000
Specialized schools	Primary and secondary teachers	1,822,200	2,095,400	2,717,900	3,369,000
	Teachers of high classes	1,822,200	2,095,400	2,717,900	3,369,000
	Directors and Deputy Directors	2,164,400	2,489,200	2,929,800	3,411,800
Schools for challenged children	Primary and secondary teachers	2,423,700	2,787,300	3,280,700	4,330,600
	Teachers of high classes	2,146,800	2,468,600	3,280,700	4,330,600
	Directors and Deputy Directors	3,323,900	3,882,700	4,499,300	5,444,200
Orphanage schools	Tutor (Instructor)	958,800	1,484,700	1,179,900	1,998,000
	Directors and Deputy Directors	1,291,100	1,102,700	1,697,500	3,133,600

Source: Uzbekistan authorities and Bank staff estimates.

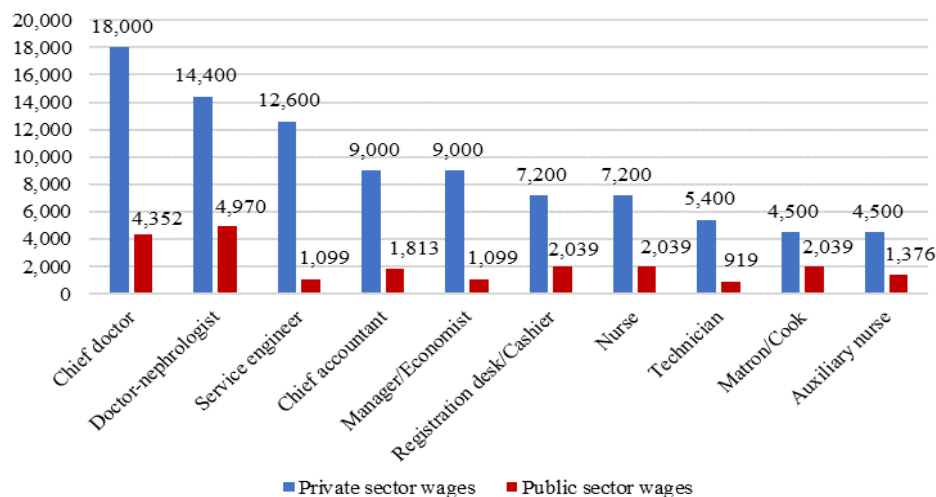
Generally, base salary increases between 2016 and 2019 were below 20 percent for all categories of teachers and managers except for salaries of Instructors and Directors of orphanage schools which increased by 20.8 percent and 24.3 percent respectively. It is

worth noting that base salaries of teachers of high classes and that of primary and secondary schools were at the same level. This means teaching at higher classes which may demand higher qualification and experience could only be differentiated and compensated for through other allowances and supplements. This is not good practice because base salary should be aligned to the functions and responsibilities of the job to be performed and not through supplements. Teachers, however, receive several allowances in addition to base salary including allowances for classroom management, grading of papers and monthly supplements from Director’s Fund up to 40 percent for high education and extra-curricular work, for high performance 25 percent, material incentive 15 percent and in-depth teaching up to 40 percent.

Wage Premium in Sectors

Wage premiums could differ between different occupations in public and private sectors and within same job families depending on the ministry or agency an employee works. For example, in Serbia despite evidence of public sector employee wage penalty, specific professional groups enjoy big premiums including Doctors at 53 percent (doctors in the public sector earn 53 percent more than comparable employees in the private sector in terms of age, education, experience, gender, location, and others). The wage premium for legislators, senior officials and managers is 35 percent, for other health professionals it is 33 percent, and for primary school teachers it is 15 percent. For example, the monthly salary of the Chief Doctor in the private sector is over four times more than that of the public sector at UZS18,000 and UZS 4,352 respectfully. The salary of the Doctor-Nephrologist in the private sector is about 3 times more a Nurse in the private clinic earns over 3.5 times more than the counterpart in the public clinic. The private-public wage disparity for non-medical positions such as service engineer and economist are even higher at 11 times and 8 times respectfully in hemodialysis clinics. There is therefore a huge wage penalty in the public sector hemodialysis clinics.

Figure 3.7: Public-Private Sector Wages in Hemodialysis Clinics in Tashkent, 2019
(in Soms)



Source: Uzbekistan authorities and Bank staff estimates.

Table 3.4. Uzbekistan: Public Employment Level in the State Administration, 2016-18

Institution	Employment Level		
	2016	2017	2018
Ministries	68,217	20,279	80,899
State Committees	23,549	18,651	31,903
Agencies	399	0	956
State Commissions	30	30	120
Centers	659	606	700
Others 1/	3,833	0	4,480
Total	96,828	39,616	119,795

Source: Uzbekistan authorities and Bank staff estimates.

1/ State inspection, Tashkent administration, Higher Attestation Commission, Academy of Sciences.

the base performing functions that could either be outsourced, abolished or further decentralized. The structure could also benefit from redeployment of some category of staff to jobs that would make them more productive than what they currently do. The public sector will continue to remain a significant employer in the economy in the medium-term, employing most graduates with higher education and commanding a big share of total formal employment, the government would therefore achieve significant improvement in the performance of ministries and agencies and the workforce if it implements results-oriented capacity development policies and strategies.

Health Sector Employment

Table 3.5. Uzbekistan: Employment Level of Health Personnel, Latest Available Data

Professional group	Employment Level
Doctors	90,646
Nurses/Medium grade medical personnel	188,436
Paramedical staff	78,372
Auxiliary staff	68,378
Total	425,832

Source: Uzbekistan authorities and Bank staff estimates.

100,000 of the population. In CIS the average for nurses per 100,000 of population is 800. There is currently shortage of critical medical personnel in rural areas and this exacerbates the medical personnel challenges in the health sector. Table 3.5 shows current employment levels of various professional groups in the health sector.

Education Sector Employment

In the education sector, there is a significant difference between funded positions approved in the staff complement schedule and the actual number of staffs working. As evident from Table 3.6 below, the total number of staffs complement and funded rose from 587,962 in 2016 to 676,189 in 2018 an increase of 88,220. There is, however, a gap between the funded staff complement numbers and actual people employed. For example, in 2016 the staff complement was 50,244 but actual number of people employed was 43,686 a reduction of 6,558 staff positions funded but not filled. The gap in terms of funded positions that were not filled was 4,179 and 5,168 in 2017 and 2018 respectively. This means

¹ World Bank World Development Indicators.

Public Employment in Sectors

Ministries and Agencies

Uzbekistan's central ministries and agencies employ significant number of public servants, yet the public sector faces shortages of skills in several critical areas of policy management and service delivery in terms of quality and personnel. The structure of employment is down-heavy with many employees possessing general skills and the middle management level and excessive numbers of semi-skilled workers at

Public employment levels in critical social sectors including education and health are relatively low in Uzbekistan compared to averages in OECD, CIS, and the EU. For example, the number of physicians and nurses in Uzbekistan in 2014 were 264 and 1,250 respectively per 100,000 of the population.¹ In OECD countries on average in 2015, there were 340 physicians and 880 nurses per

the MoF is paying for staff who eventually do not get employed and the funds are not returned to the treasury. The situation is problematic and could be a major source of wagebill increases through bloating of funded positions which may not be needed. There is evidence that the excess funds are used to pay incentives to workers. On face value this may sound like a good proposition but in the absence of optimally functioning organizational structures, performance-oriented job descriptions and credible performance management systems, these funds may be subject to abuse. Public institutions could deliberately apply for a budget to pay the full complement of staff with a pre-determined objective of using the funds for salary top ups or additional allowances for existing staff.

There is further indication of excessive employment numbers in the category of administrative personnel in all types of educational institutions. The government may want to conduct a personnel audit with the objective of reducing the size of employment and cutting out staff that may not be required for permanent employment or consider outsourcing functions that could be better performed by a non-government actor.

Table 3.6. Uzbekistan: Employment Level in Public Education Institutions, 2016-2018

Type of Education Institution		Staff Complement			Actual Employees		
		2016	2017	2018	2016	2017	2018
General	Total Staffing	517,532	547,982	607,221	478,925	522,473	588,026
Secondary	<i>Including:</i>						
Schools	<i>Administrative personnel</i>	201,213	199,382	206,961	156,901	165,269	177,460
	<i>Teachers</i>	316,320	348,600	400,260	322,024	357,204	410,566
	Total Staffing	18,380	19,881	25,066	10,699	12,890	16,569
Boarding	<i>Including:</i>						
Schools for	<i>Administrative personnel</i>	10,774	11,420	14,173	4,402	5,401	7,578
Children	<i>Teachers</i>	7,606	8,461	10,893	6,297	7,489	8,991
	Total Staffing	1,813	1,877	1,962	1,784	1,878	1,945
Orphanages	<i>Including:</i>						
	<i>Administrative Personnel</i>	1,280	1,325	1,389	1,245	1,316	1,364
	<i>Teachers</i>	533	552	573	539	562	581
Optional	Total Staffing	50,245	36,240	41,940	43,686	32,061	36,772
Out-of-School	<i>Including:</i>						
Education	<i>Administrative Personnel</i>	50,245	36,240	41,940	43,686	32,061	36,772
Centers	<i>Teachers</i>	-	-	-	-	-	-
	Total	587,969	605,979	676,189	535,094	569,302	643,312

Source: Uzbekistan authorities and Bank staff estimates.

Human Resource Management and Establishment Control

The HR function in government is weak: there is currently no central agency responsible for setting civil service-wide policies and standards that are applied objectively across the civil service. The lack of clarity in functional responsibilities creates challenges of fiscal control and accountability because the wage-bill is a function of employee numbers and the amount compensated for each role. Public HR data remains fragmented and inconsistent among various MDAs and this limits the ability of government to make sound decisions on wage-bill management, human resource management (HRM) and budget planning. The current situation also undermines efficiency and accountability in staffing which directly impacts wage-bill dynamics in the public sector. There are inadequate coherent policy standards and procedures on merit-based recruitment, promotion, performance management, appraisal and measurement, career development and talent management, and training and competency frameworks that need to be developed/updated monitored and enforced to support achievement of wage-bill management objectives. HR policy framework is required to ensure systematic improvement of functional structuring of public sector institutions and reorient them toward higher

performance and efficiency, and further consolidate HR data to achieve consistency and improve value for money and accountability in staffing.

Job classification, job analysis and evaluation are important elements for pay and grading structuring, functional reviews could provide job descriptions for all key positions on which basis evaluation of public sector jobs will be done. There is currently no evidence of recent work done in these areas. Reorganization including functional reviews of government institutions has not been conducted to determine optimal organizational structures, skills and competencies to perform government functions in a holistic and coordinated manner. Establishment control including hiring the right people for the right jobs is weak and not adequately aligned to performance-based management and budgeting in the public sector. This is a major constraint to establishing a medium-term policy framework for public sector remuneration and benefits in Uzbekistan. Compliance to payroll management controls require further strengthening and capacity building.

Payroll Management

Payroll management controls are in place with reasonably high compliance level. The staff list of civil service positions is prepared manually by the ministry, department and agency and approved by the Head of the respective organization/budget entity. The MoF registers the staffing list and provides the Bill of Expenditure within which the organization may recruit, promote, and incentivize employees. It is submitted to the accounting unit to be entered into the personnel database which is now integrated into a locally developed software system known as UZ-ASBO specialized for accounting and payroll calculation and integrated into the Treasury management information system referred to as GFMIS. The system incorporates all positions with the respective level of remuneration calculated based on approved scale established for each position. Any modification of personnel database entailing remuneration changes is automatically reflected and it is visible in the Treasury system allowing for budget controls to be made. The major weakness of the process appears to be the HRM link which makes the MoF reactive to key personnel decisions of MDAs instead of being proactive through HR policy hearings as part of the budget process.

POLICY OPTIONS

As the government continues to implement pay and employment reforms in the public sector, it would be necessary to adopt a strategic approach in making policy choices. A public sector reform strategic framework is necessary to guide a roadmap for systematic programming and implementation of government's priority interventions.

Remuneration and Benefits

- Develop a common framework grading structure which aligns jobs in different occupational groups into a common salary spine, or pay hierarchy, to enable a comparison of the relative weight or job content across different occupational categories. This needs to be based on common criteria such as specialized knowledge and skills, leadership and managerial requirements, decision-making requirements, level of accountability and others, rather than analyzing and benchmarking each job, for example for different category of physicians, nurses, paramedics, or teachers. Regular checks are needed to ensure fairness across different pay structures.

- Develop a compensation framework that is competitive and fair and supports prudent management of expenditures. Policy choices should include a salary structure with layers, ranges, and bands and appropriate distance between each range. The structure should take account of a hierarchical and horizontal system that enables employees to be promoted from one pay grade to another. There needs to be horizontal mobility that motivates employees' career progression and allows recognition of different rates of pay for performance. At the same time, the pay structure should guarantee a reasonable level of control over internal compression and salary expenditures.
- Consolidate the numerous bonuses and allowances into the base pay to improve transparency and fairness of government pay, address salary inequities, and enforce pay controls.
- The legal framework for civil service management and public sector compensation should be improved. The government should consider the creation of an independent central body to oversee public sector pay policies and standards and a central agency for the civil service and HRM issues.

Public Employment and Human Resource Management

- We invite the government to consider carrying out Functional Reviews that should lead to improved distribution of government functions and implementation of establishment control measures. Some OECD countries are moving from centralized establishment control systems to “running cost” control systems to give more flexibility to managers to choose a mix of staff and resources to implement their programs. For this to work effectively, there need to be functioning systems for effective funds control and performance monitoring and evaluation.
- Develop an HR and performance management framework with adequate integration of career-based common set of rules across the public sector and systems for merit-based recruitment, staff performance appraisal, promotion, productivity improvement, and professional development. Ensure funds from the treasury for payment of salaries are based on actual recruitment numbers and decentralized incentive payments by Head of institutions is based on an agreed public sector-wide performance system with clear criteria and metrics of measurement to reduce subjectivity and increase meritocracy in decisions made by ministries and agencies.
- Develop a human resource management information system (HRMIS) to ensure public HR data is consolidated and improves value for money and accountability. Such an information system will support sound decision-making on wage-bill management, human resource planning and budgeting. The system will need to be integrated with the government financial management system.
- Rationalize the number of support staff and employees in the public sector through the functional reviews by identifying excess ancillary employees in the state administration, education and health sectors and ensure subsequent hiring is done in full compliance with establishment control measures. The government should consider outsourcing administrative ancillary functions that could better and cheaper be delivered by non-government actors.

- The government should consider postponing huge salary increases in excess of inflation until the right-sizing of the public sector is done. Experience of other countries that have carried out successful staff reductions show that better results are achieved, and fiscal and political costs of retrenchments are reduced if employment reductions are first achieved.
- Set up a sound monitoring and evaluation system to track entry and exit of employees. This could be done within the framework of establishment control policy and could be achieved by developing and implementing a 3-year staffing plan with annual reviews as part of the annual budget process.
- Expand capacity development programs and on-the-job training and mentoring to significantly improve the capability and productivity of public sector workers.
- The specific design and sequencing of Uzbekistan's wage bill management reforms should integrate good practice solutions in Uzbekistan country context considering the lessons learned from the extensive experience in reforming the civil service in Europe and Central Asia and other developing regions.

Chapter 4. SOEs and Public Finances

State-owned enterprises (SOEs) dominate economic activity in Uzbekistan and receive oversized government support. While explicit on-budget subsidies to SOEs are modest, off-budget and quasi-fiscal support are extensive. Such backing and the economy-wide low input prices for SOEs distort the structure of the economy, the allocation of capital and labor, and fiscal revenues. SOEs also depend critically on lending by the state-owned banks (SOBs) subsidized by the government. Financial discipline of the SOEs is poor and is also reflected in periodic accumulation of inter-enterprise arrears and restructuring of their obligations to the SOBs and the government.

Sustainable public finances and overall economy efficiency require a reduction and then elimination of the losses of SOE losses and a transformation of their role. Critical reform steps include explicit recognition and consolidation of all financial support to SOEs, imposition of hard budget constraints and better governance of firms, increasing output prices to at least cost recovery levels, and allowing private entry and growth. SOEs' performance depends critically on the existence of a market environment as well as enforced management incentives. As corporate restructuring proceeds, explicit fiscal support to the poor or vulnerable will need to replace support often provided through SOEs, including through prices below cost recovery.

CONTEXT AND RECENT DEVELOPMENTS

The true extent of the state-owned enterprises is unclear but is likely to be substantial. Anecdotal evidence suggests that the Uzbek economy is primarily composed of state-owned enterprises, though more and more private firms operate in some sectors. The authorities use a classification system that categorizes all firms that are less than 100 percent owned directly by the central government as non-state. This definition is inconsistent with international norms and does not provide a proper indication of the extent of either state ownership or control. Under this definition, state-owned enterprises account for just over half of economic activity and more than half of budget revenues, but less than 10 percent of overall employment. Ownership and governance are exercised at various levels of government and through different entities, ministries, and extrabudgetary funds in an opaque manner.

The private sector is in its infancy and is too small to create viable competition for SOEs.¹ Yet, such competition is a critical element of any good governance system. A growing private sector is essential for future growth job creation, and a solid tax base that will help support the transition from a state-dominated economy to one driven by the private sector.

Many non-financial SOEs provide goods and services to consumers or other SOEs at below cost recovery prices set by government without compensating budget subsidies. A complex system of non-market pricing, without regard for profitability, results in an equally complex system of cross-subsidization and arrears between enterprises, with unclear fiscal implications.

¹ The “true private sector” refers to firms that are majority privately owned or where private owners have controlling ownership. Because of the definition of SOEs, enterprises that are not called an SOE (100 percent direct central government ownership) are not necessarily private firms.

Examples of these practices in the utilities sectors include natural gas, electricity, drinking water supply and sewage, centralized communal heating, public transportation, and irrigation water supply and drainage. The government also mandates SOEs to carry out unreimbursed activities that are not in their core business area, such as construction of kindergartens, sports or health facilities, among others.

SOEs receive extensive fiscal support in several ways. These include: (1) economy-wide low input prices for SOEs; (2) on-budget subsidies amounting to around 1 percent of GDP in 2018; (3) a variety of tax and customs preferences (see the chapter on Tax Expenditures); (4) the public investment program which finances a part of SOEs' investment that is not recorded explicitly in the budget (see the chapter on Public Investment Management); (5) the UFRD and government financed concessional loans through SOBs in foreign and domestic currency. This quasi-fiscal activity of SOBs implicit in lending at subsidized rates is estimated at about 2 percent of GDP; (6) Bank deposit rates for some SOEs that are higher than those available to households or private companies; (7) Availability and price of land.

Explicit compensation to SOEs for below cost-recovery pricing or non-core spending is minimal or absent. When the loss of revenue and additional costs are not reimbursed by the government, SOEs incur losses known as quasi-fiscal deficits, QFD (Box 4.1). In Uzbekistan, the quasi-fiscal deficits are substantial, particularly in the gas and water utilities. We estimate the QFDs of SOEs to amount to about 6 percent of GDP a year based on a sample of key sectors, but the amount is likely to be much larger for the economy as a whole.

While Uzbekistan has taken initial steps to modernize SOE governance and management, such as corporatization of some SOEs, the existing corporate governance framework and practices and financial reporting requirements deviate from accepted standards consistent with efficiency and fiscal discipline. The Government's "Program of transformation of state enterprises and other entities with majority state ownership" highlighted the following problems related to SOEs: "(i) participation of government officials in management bodies of SOEs resulting in conflicts of interests, (ii) lack of a well-functioning system of management of the investment process in SOEs, (iii) non-transparency of SOE governance and lack of regular analysis of their performance, and, (iv) inefficiency of the system of education of staff and management of SOEs, particularly in the area of corporate governance."

The current division of roles and responsibilities between the various government stakeholders involved in corporate management and oversight of SOEs is blurred. Executive decision-making power has often been embedded into the government, diluting SOE accountability. Line ministries have primary responsibility for exercising the state's ownership rights with respect to their sectoral SOEs. Until the recent creation of the State Asset Management Agency (SAMA) – where the authorities intend to transfer the government shares in all SOEs – other agencies, including ministries, local governments, and extrabudgetary funds, also controlled shares in SOEs and exercises their ownership rights. These bodies have different functions and do not have mechanisms that allow them to ensure consistency in their oversight or to streamline their oversight mandate. This overlap of functions weakens SOE accountability.

The government intends to advance SOE reform in several directions. In the energy sector, the authorities have adopted methodologies to set prices on a path to cost recovery to reduce QFDs

and attract private investment. Impressive progress has been achieved, with the average electricity price already raised to \$0.043 by late 2019 from \$0.02 at the start of reforms. Secondly, they intend to liberalize trading, including of electricity and gas. Thirdly, they plan to strengthen the governance of SOEs by separating ownership and management, according to the recently adopted corporate governance code. And, finally, they plan to gradually divest government ownership in SOEs.

Box 4.1. The Nature of Quasi-Fiscal Deficits

End-user tariffs set below cost-recovery, non-payment of bills, and high technical losses hurt the financial performance of utilities, creating operating deficits and direct or indirect (“hidden”) needs for subsidies from public budgets to sustain their operations. Usually (but not always) budgetary subsidies cover cost recovery price gaps. In the absence of explicit subsidies cost-recovery price gaps generate “hidden” (or unrecorded quasi-fiscal) deficits. Hidden deficits also result from bill collection failures or from losses due to inefficient operations. The impact of hidden deficits is mainly felt through reduced investments necessary to expand service, delay of essential maintenance, or deterioration of service. Following a methodology developed by the World Bank, QFDs are estimated based on the following three components:

- Pricing gaps: losses from end-user tariffs set below cost-recovery rates. The cost recovery tariff needs to include operations and maintenance and interest on outstanding debt.
- Collection inefficiency: losses from differences between billed and collected revenue;
- Technical inefficiency: losses above normal technical losses from inefficient operations.

Source: World Bank.

KEY CHALLENGES

Sizeable quasi-fiscal deficits of SOEs

Quasi-fiscal deficits of SOEs consist of losses that are not compensated by budgetary subsidies that reflect prices below cost-recovery levels, collection inefficiency, and technical inefficiency². Quasi-fiscal deficits of SOEs are not easy to estimate because of the lack of accurate information on cost recovery prices, as well as the extent of collection and technical losses. Financial information of the key SOEs is also missing, as are the interest costs on SOE debts or debts incurred by the government on behalf of SOEs.

The estimates of the quasi-fiscal deficits in this note reflect cost recovery levels but do not include interest payments. They also do not reflect fully the capital cost of replacing fully amortized equipment. A more comprehensive estimate of quasi-fiscal losses should reflect these costs in full and result in substantially larger QFDs. Cost recovery prices used also do not reflect true costs because the outlays for providing non-market services incurred by several SOEs, such as kindergartens, health services, and sports facilities are not included.

² The technical inefficiency results from underinvestment in maintenance. Note that this definition does not capture revenue needs or “deficits” related to expansion of capital (new investment projects beyond maintenance). The technical inefficiency results in lost output.

In the gas sector, we estimate the QFD due to prices being set below cost recovery at 1.9 percent of GDP. Uzbekneftegaz, the oil and gas company, sets 4 different tariffs for its customers: (i) 320,000 UZS/1,000 m³ for the general population; (ii) 600,000 UZS/1,000 m³ for wholesale customers, such as the electricity company (Uzbekenergo), hot water companies, heating companies, or fertilizer producers; (iii) 800,000 UZS/1,000 m³ for fuel stations (55 per cent of cars run on gas); and, (iv) 1,000,000 UZS/1,000 m³ for construction materials companies. Although the cost-recovery price for natural gas is different for each plant, the company estimates the average cost-recovery price to be around 800,000 UZS/1,000 m³, excluding the financing of the investment program. This is above the tariffs set for the two largest categories of customers — the general population and wholesale customers – which account for two-thirds of domestic gas consumption in Uzbekistan. Using a weighted average tariff for domestic consumption of natural gas, the QFD from the under-recovery of cost is estimated at 1.9 percent of GDP.³ Technical losses in the natural gas sector are estimated at 18 percent. This is equivalent to about 1.2 percent of GDP, using as benchmark the average price of natural gas sold to domestic customers. Commercial losses, reflecting under-collection of revenue because of inadequate metering, are estimated at 7 percent, or 0.4 percent of GDP.

The water utilities also have substantial quasi-fiscal losses. Regulated tariffs were revised up in 2018 to allow for some modernization and development expenses given the high levels of technical losses in the network. Tariffs differ by territory and user. They are the lowest in large urban areas such as Tashkent (280 UZS/m³) and the highest in the arid and isolated region of Karakalpakstan (980 UZS/m³). For businesses, tariffs are double those for the general population. The quasi-fiscal deficit of the water utilities due to under-recovery of costs is 1.1 percent of GDP. Losses from under-collection of revenues amount to about 0.2 percent of GDP and include losses from non-payment, under-billing because of the partial coverage of users by metering.

The electricity company (Uzbekenergo) does not report significant apparent losses from under-recovery of costs – but there are hidden losses. The regulated tariff for individual consumers is 250 UZS/kw and for legal entities it is 330 UZS/kw, while the company reports that cost recovery tariff is estimated at 250 UZS/kw. The cost recovery price indicated does not include all components of the operating cost and does not include debt service. In addition, there are significant hidden losses because 80 percent of electricity generation is from gas, which is cross-subsidized by the gas company (Uzbekneftegaz) through a tariff for wholesale customers (600,000 UZS/1,000 m³) which is set below the cost-recovery level (see above). Had the gas tariff for wholesale customers been set to cover costs, the electricity cost-recovery price would have been higher. Offsetting these losses would have required a budgetary subsidy to the power company, in the absence of which, the company would be running deficits that would eventually need to be covered by the budget. When compared to international norms, losses due to under-collection of revenues are significant in the electricity sector. We estimate such losses at 0.1 percent of GDP. These are lower than the collection losses for electricity in Tajikistan (0.46 percent of GDP), Pakistan (0.27 percent of GDP), or Bulgaria (0.14 percent of GDP), but much higher than in Romania or Vietnam (0.02 percent of GDP).

Quasi-fiscal deficits appear to be large for the district heating companies. They are particularly sizeable in district heating (DH) but are more difficult to calculate because of the

³ Domestic consumption of natural gas was 41.6 bcm in 2017 and 20 bcm was exported.

different conditions prevailing in the various districts and urban areas. Regulated prices have been set at levels significantly below cost recovery, resulting in a dearth of financial resources for investment and maintenance. As a consequence, heating systems in some cities are barely functional. The tariff for DH to residential users is set at UZS83,600 per giga calorie (GC) and at UZS124,500 per GC for commercial customers. The difference between the tariffs for commercial and residential users is subsidized by the budget to the tune of UZS 210 billion in 2018 (0.05 percent of GDP). However, the cost recovery price for the Tashkent DH company is estimated at UZS 194,000 per GC, resulting in a QFD for the Tashkent DH of about 0.2 percent of GDP.

Because of the hidden losses, the Tashkent DH company accumulates arrears to energy suppliers (essentially the electricity company), which are estimated at 1 trillion UZS. At the same time, the company has an estimated UZS 300 billion (0.1 percent of GDP) in receivables because of unpaid bills. The government periodically writes off these arrears. Owing to the lack of maintenance of the DH systems, technical losses are substantial and amount to 0.1 percent of GDP, using as benchmark the subsidized price for commercial users. Commercial losses for Tashkent DH due to the lack of metering are of similar magnitude, estimated at 35-40 percent of the generated energy.

Tashkent accounts for most of the losses in DH. The Ministry of Housing and Communal Services is the owner and provider of DH and water supply services, through its regional branches. Tashkent has a special regime through a DH company, which is owned by the city but regulated by the Government. The largest volume of DH services is sold in Tashkent, amounting to 10 million Giga Calories (GC), corresponding to 85 percent of the total volume. Throughout the country, a total of 12 million GC of DH are produced, of which 10 million are bought from the electricity company (Uzbekenergo) and 2 million are generated by heating stations (boiler houses).

Energy inputs to the DH and hot water companies and to the sanitation enterprises are subsidized. Natural gas used for district heating and hot water, is priced at below cost recovery for wholesale consumers. Electricity used in district heating is also cross-subsidized by the natural gas supply company. Moreover, although electricity used for sanitation water treatment is reflected in sanitation tariffs, the cost recovery tariff would have been higher had electricity prices been set to reflect the cross-subsidy to power generation from cheap natural gas.

Quasi-fiscal deficits are also generated by SOEs operating on a commercial basis, for example, Uzkimyosanoat which produces chemicals and fertilizers. The company does not receive budgetary subsidies but gets subsidized loans and government guarantees for loans from foreign banks. Moreover, Uzbekneftegaz provides a cross subsidy by supplying natural gas to Uzkimyosanoat at the below cost-recovery tariff for wholesale customers. Were this cross-subsidy to be eliminated, the domestic market tariffs for fertilizers would have to increase to prevent losses from pricing below cost-recovery. Uzkimyosanoat sells about 15 percent of its production on the export market at a 50 percent higher price than the domestic price. The price gap indicates the opportunity cost of regulating domestic prices at very low levels and is a subsidy from Uzkimyosanoat to users

The existence of quasi-fiscal activities complicates the design of fiscal policy. First, the reported magnitude of government revenues and expenditures does not provide a good indication of the actual intervention of the fiscal budget in economic activities. Second, quasi-fiscal deficits

generate implicit contingent liabilities for the government to the extent that loss-making SOEs or the SOEs that do not invest to maintain and develop their networks will eventually need to receive financial support from the budget. Third, they also impede the prioritization of government spending and result in substantial misallocation of both public and private resources.

Through government financed or guaranteed directed lending, SOBs heavily subsidize the SOEs

State-owned banks provide sizeable concessional lending to SOEs. There are three main ways in which SOBs provide subsidized support to SOEs: through on-lending of resources provided by the UFRD, the government (for housing), or international financial institutions. Lending on concessional terms, in foreign or domestic currency, represents 55 percent of the total bank loan portfolio; half of that is to SOEs and the rest is under different government programs, including housing, entrepreneurship, youth, large farmers, and others. Three-quarters of concessional lending is in foreign currency. The UFRD lends to four of the SOBs through credit lines for concessional lending according to government priorities. The government lends at concessional rates to one of the SOBs for housing development and guarantees about half of SOBs' lending to SOEs, creating a contingent liability for the budget.

The quasi-fiscal subsidy associated with concessional lending to SOEs can be assessed by using as benchmark the difference between the non-concessional and the concessional interest rates on bank loans. This is approximately 6 and 12 percentage points for foreign- and domestic currency-denominated loans, respectively. Based on the concessional loan portfolio of the banking system, we estimate that the quasi-fiscal lending subsidy amounts to about 2 percent of GDP. There are additional quasi-fiscal losses because of higher-than-market deposit rates some banks pay on SOE deposits. Estimating these will require additional information.

Lending to SOEs in foreign currency increases the risk to SOEs. The devaluation of the currency in 2017 created losses for SOEs, which found it difficult to service their loans from SOBs. Loans to SOEs had to be restructured by lengthening the maturities and changing the amortization schedule. The SOBs had to be recapitalized while dividend payments to the budget were suspended to support the recapitalization. Non-performing loans of the SOBs, assessed using the current methodology, jumped to 10 percent of the total, including the restructured loans. Because of the interconnectedness of SOEs and SOBs and the nontransparent nature of government support to them, it is crucial that reforms of SOEs and SOBs proceed together.

Quasi-fiscal deficits reduce the ability of SOEs to invest

About 90 per cent of SOEs are monopolies in their respective industries and with regulated prices, they do not have proper incentives to improve operational efficiency. The regulated prices for utilities are not only below cost-recovery levels, but also do not account properly for the maintenance costs of the network and the servicing of SOE debt. If these costs were to be included, the quasi-fiscal deficits would be even larger.

However, investment by some SOEs is often funded from the budget under the public investment program. This includes investment in railroads, electrification of railways, purchases of aircraft, and others. These resources have been insufficient to ensure adequate levels of investment in several sectors. This is particularly the case in natural gas, heating, water supply,

and electricity, where technical losses, due to lack of investment for maintenance, are significant and above international norms. Losses in natural gas supply are estimated at 1.2 percent of GDP. Losses in drinking water supply reach 35 per cent of the volume supplied. We estimate the quasi-fiscal deficit generated by these technical losses for water supply at 0.47 per cent of GDP. Technical losses, at 20 percent, are also significant in the transmission and distribution of electricity. We estimate these losses at 0.24 per cent of GDP. They are higher than the technical losses for electricity in comparator countries (Tajikistan with 0.19 percent of GDP, Bulgaria with 0.15 percent, Romania with 0.14, and Pakistan with 0.10 percent).

Summing up: estimates of quasi-fiscal deficits in a sample of sectors

We estimate that the quasi-fiscal deficits of the SOEs in a sample of sectors amounted to nearly 6 percent of GDP in 2018. The estimated quasi-fiscal deficits cover under-recovery of costs, under-collection of revenues, and technical losses above international norms due to under-investment (Table 4.1).⁴ The economywide quasi-fiscal losses are likely to be much larger because of three reasons: (i) our estimates do not include interest costs on debt owned by the SOEs or incurred on their behalf; (ii) lack of adequate information even for the enterprises in the sample makes the estimates tentative; and, (iii) the sample does not include other SOEs with large quasi-fiscal losses, such as the railway company.

Table 4.1. Uzbekistan: Quasi-fiscal deficits of SOEs
(in percent of GDP)

	Under-Recovery of Cost ¹	Under-Collection of Revenue	Technical Losses Above Norms	Total QFD
Natural gas	1.90	0.40	1.20	3.5
Electricity	0.01	0.08	0.24	0.3
Drinking water	1.06	0.19	0.47	1.7
District heating (Tashkent)	0.20	0.10	0.10	0.4
Total 1/				5.9

Source: Uzbekistan authorities and Bank staff estimates.

1/ Because of rounding, the total is not exactly equal to the sum of the components.

POLICY OPTIONS

The evolution of the SOE burden on the budget will depend on several interconnected elements. Firstly, the speed and comprehensiveness of the reform of the pricing for SOEs' goods and services and SOE management. Secondly, the ability of the banks to function as financial intermediaries with no government intervention in the allocation of credit. Thirdly, the divesting (privatization) of SOEs and the ability of the private sector to become the main driver of growth. Fourthly, governance and tax reforms need to reflect the changing roles and circumstances of

⁴ Cross-subsidies between SOEs (for example, from Uzbekneftegaz to Uzbekenerga or to Uzkimyosanoat) are not estimated to avoid double counting. Had, for example, the tariffs of Uzbekneftegaz been increased to full cost recovery, the quasi-fiscal deficit in the natural gas sector would be converted into a quasi-fiscal deficit in the power sector and the fertilizers in the absence of an increase in tariffs in these sectors.

SOEs: they have to be treated as any other economic agent that has to pay taxes and receive reimbursement for services delivered on behalf of the government.

Establish a centralized database of SOEs using a meaningful definition of SOEs. Disclose all quasi-fiscal activities of SOEs.

To get a consistent picture of all activities of SOEs, including those of quasi-fiscal nature, it is essential for the government to establish a centralized, comprehensive, and public database of SOEs and their finances. This database could be set up perhaps in the State Asset Management Agency. At the same time, the government should modify the current definition of what constitutes state ownership. Any enterprise with a controlling government share (including through an extrabudgetary fund or a local government) will be classified as an SOE. Such a controlling share could be less than 50 percent – perhaps 30 percent – if the remaining shares are widely dispersed, so that no other shareholder group can exercise control. Privatized companies would be those that are controlled by private owners and would not include firms which have sold some of their shares to private agents, but not enough to cede control. The remaining private sector would consist of those firms that have never had state ownership.

It is important for the quasi-fiscal activities of SOEs to be properly measured, reflected in the consolidated budget and the financial statements of SOEs, and fully disclosed. Efficient reform of SOEs and SOBs requires, first, a transparent and comprehensive view of the government support extended to SOEs. The disclosure of quasi-fiscal activities should describe the type of activity, the rationale for performing the activity through an SOE rather than directly through budget financing, and the cost of the activity. Mechanisms designed to provide financial support to SOEs, through concessional lending or tax exemptions, should be disclosed and their opportunity cost made transparent.

Replace the quasi-fiscal activities of SOEs and SOBs with budget subsidies

Explicit budget subsidies to SOEs need to replace all quasi-fiscal and off-budget operations. The government can then contract out public service obligations to SOEs under arm's length commercial contracts and signal to non-SOE suppliers the price against which to compete as a future provider of those services. Romania provides an example of well-planned reforms in electricity, which almost eliminated the quasi-fiscal deficits of SOEs in the sector (Box 4.2). Non-core activities of SOEs for social purposes, mandated by the government, should be accounted for separately from commercial activities and these should be devolved into independent activities with privatization wherever possible. In cases where they remain temporarily with the SOEs, the SOEs should be reimbursed for such activities transparently from the budget.

Estimating the cost of quasi-fiscal activities may be challenging, as SOEs have an incentive to overestimate the true costs of public service obligations. If information asymmetries between SOEs and the government are significant, the SOEs may be overpaid for fulfilling those obligations. On the other hand, governments tend to underestimate the cost of public service obligations. Various methods of calculating these costs that generate quasi-fiscal deficits are discussed in the OECD's Accountability and Transparency Guide for State Ownership (2010).

Directed lending to SOEs should be reduced with immediate effect and eliminated over the medium-term. Bank lending should be on the same terms to all companies, public and private. Government support for specific strategic purposes needs to be provided through explicit and transparent budget subsidies and only in limited and well-defined circumstances.

Adopt and enforce rigorous governance arrangement and financial reporting requirements for the SOEs. Advance privatization.

The authorities need to adopt urgently corporate governance arrangements that create incentives for efficient production and good financial performance, contain fiscal risks, help level the playing field for all enterprises. The size and evolution of quasi-fiscal losses depend on a number of elements beyond prices; these are factors that support efficiency, innovation and good corporate management. Establishing appropriate managerial incentives and arms-length management from the regulator is one part of this. Empirical evidence from countries shows that managerial rewards for good firm performance and penalties for poor performance (with metrics set appropriately) are important determinants of SOE profits and therefore the drain on (or profit to) the budget. For example, if SOEs continue to generate losses after financial and operational restructuring, management may be the problem. Financial sustainability requires that managers be provided with appropriate incentives to avoid recurring bankruptcy.

The SOEs need to start publishing audited financial statements. Reporting requirements have to be introduced along with strengthened governance arrangements to ensure transparency and accountability. The authorities need to move to adopting international accounting and financial requirements (see last item).

External incentives in the form of market competition are equally important for improved performance. Empirical research has shown that firm performance depends critically on the degree of competition or contestability in markets, regardless of ownership type. Profitability and productivity are generally higher when competition is introduced in markets. Studies have also found that privatized SOEs are often shielded by the state from facing the same degree of competition faced by de novo private companies. In other words, they continue to face favorable treatment, a factor accounting for worse performance relative to private companies. Competition may be provided by domestic or foreign firms, and by non-traditional firms in previously monopolized sectors. In order to have true competition in markets, regulations that hinder new private firm entry and growth are critical.

Privatization needs to be advanced to help put the private sector in the driver's seat of the economy; unless governance and market structures change, a public monopoly may be replaced with a private monopoly with equally problematic consequences. Privatized firms may capture markets and the state and in so doing, effectively eliminate forces that would support greater productivity, efficiency and innovation. Thus, privatization (and PPPs) will not deliver their goals, unless a regulatory and market structure provides appropriate incentives, promotes competition between firms, and reduces regulatory barriers to growth, such as poor property rights, restrictions on resource reallocation, including on labor mobility. Improving financial sector performance, concurrently dealing with SOBs, ensuring that banks are not captured by particular borrowers, will support improved performance in the new private sector.

Box 4.2. Reducing the Quasi-Fiscal Deficit in Electricity in Romania

Thanks to an ambitious reform program of a gradual adjustment in price levels to cost recovery and improvements in corporate governance, the quasi-fiscal deficit in electricity was reduced from 3.8 percent of GDP in 2000 to 1.3 percent in 2003 and 0.3 percent in 2013. A key driver of the reform was the alignment with EU regulations as part of Romania's bid for EU membership. In mid-2012, key elements of the electricity part of the EU's Third Energy Package were transposed into the Energy Law, which also restored the operational and financial independence of the energy regulator (ANRE).

A roadmap to gradually phase out regulated prices in electricity has been implemented since 2012. The non-residential electricity market was completely liberalized in 2014. Non-residential electricity is sourced through the power exchange run by the Romanian Power Market Operator (OPCOM). For residential consumption, 30 percent of electricity supply had been sourced through the free market since mid-2014 and the remaining 70 percent remained regulated—supplied by the three state-owned generators—but was gradually liberalized through 2018. Competition in the Romanian electricity market was often hindered by non-competitive sale contracts negotiated by energy SOEs for specific customers, often at below cost-recovery levels. Such practices were discontinued in 2012. Budgetary subsidies in the electricity sector have been directed mainly to generation, focused mainly on renewables and thermal (lignite) generation. The direct budget support to thermal generation has been declining over time, with a corresponding increase in the support to renewables.

Source: World Bank.

Provide support to the poor and vulnerable through the budget

To provide room for SOE prices to rise to cost recovery, SOEs to shed unproductive social activities, and for quasi-fiscal activities to be replaced by fiscal subsidies, the authorities need to scale up budgetary assistance to the poor. The mechanisms for such support could include direct subsidies, conditional cash transfers to targeted populations, and vouchers to eligible population groups for the public service provided. For example, rather than paying SOEs to provide low-cost electricity to certain groups of consumers, the government may wish to give electricity vouchers to low-income residents. In this way, the government ensures that the benefit goes to the intended recipient and does not undermine commercial discipline through direct transfers from the budget. In addition, where markets are competitive, consumers can seek the most efficient provider and use the voucher for that provider.

Replacing the quasi-fiscal energy subsidies with direct support to the vulnerable population groups will help achieve the intended social aims of public policy while generating savings for the budget. Estimations indicate that universal energy subsidies benefit disproportionately the wealthier groups of the population as these groups consume more energy than the lower-income groups. According to World Bank estimates, the electricity consumption of Uzbek households at the top quintile of the income distribution is, on average, 220 kwh/month, much higher compared to that of the bottom quintile, estimated at 140 kwh/month. Similarly, wealthier households spend a larger fraction of their energy budget on gas than poorer households. As a result of these differences, universal subsidies to energy consumption accrue disproportionately to the well-off

households. Based on household surveys, the World Bank estimates that 51 percent of subsidized energy tariffs in Uzbekistan accrue to the top 40 percent households in the income distribution. By contrast, only 30 percent of the benefits accrue to the bottom 40 percent of households, with only 13 percent accruing to the poorest quintile.

In the medium to longer term, advance comprehensive SOE and SOB reforms

These include:

- Implement the international accounting and bankruptcy standards for all enterprises, including SOEs.
- Adopt and implement an effective corporate governance system.
- Advance privatization to help create a viable and dynamic private sector.
- Assess SOBs' financial situation, starting with a proper asset quality review.
- Do strategic privatizations of SOBs once a financial sector strategy is in place. Rationalize the role of any remaining SOBs.

Chapter 5. Public Investment Management

The governance of public investment management in Uzbekistan is changing in terms of the main actors, methodologies, and scope. The Ministry of Investment and Trade (MoIT), Ministry of Economy and Industry (MoEI) and Ministry of Finance (MoF) are shifting the annual focus of the public investment program to a multi-year one from 2020. Public investment amounted to 5.2 percent of GDP in 2018, with just under half on-budget. Most off-budget investment funding in the last two years has come from IFIs and bilateral creditors. Greater clarity concerning the roles and responsibilities of the main actors would enhance the process. The new investment process requires a general capacity upgrade over the project cycle in terms of guidance, identification, assessment, selection, and implementation. A better methodology to integrate the assessment of a project regardless of whether it is domestically or foreign-funded is needed. A stronger assessment of projects' value for money, affordability, and potential contingent liabilities is needed, as is a clearer integration of investments into the regular budget process.

CONTEXT

Public investment management in Uzbekistan is changing because of reforms the authorities have initiated. In 2018, the authorities formed the State Investment Committee (now it no longer exists). At the same time, the National Agency for Project Management (NAPM) was assigned an important role reviewing projects and authorizing that they proceed. In 2019, the Ministry of Economy and Industry (MoEI) established and NAPM's role was broadly transferred to the MoEI. MoEI was tasked with developing investment policy¹, assisting in timely implementation of projects, and developing an interdepartmental system for examining projects. The Ministry of Investment and Trade (MoIT) was created at the same time by merging the State Investment Committee and the Ministry of Foreign Trade. A Fund for Financing of Development Programs that was established in 2017 as a *de facto* a treasury for public investment projects appears to have been merged back into the Ministry of Finance in early 2019.

The authorities plan to shift the public investment program from an annual exercise to a multi-year perspective from 2020. It will be based upon detailed multi-year sector, regional and targeted development concepts for 2020-2024², built upon the social-economic development concept for the Republic of Uzbekistan to 2030. The public investment budget was previously based on a Ministry of Finance mandated top down ceiling³ for total investment funded by the

¹ The decree notes that state development programs and investment programs of Uzbekistan are developed considering the strategy of the country's investment policy for the medium term. The Ministry of Economy and Industry will develop an investment policy strategy for the medium-term within the framework of the Concept of socio-economic development of Uzbekistan until 2030, regional and sectoral development concepts, as well as approved programs and decisions of the president and the government.

² Up to 2030 for certain sectors.

³ No information could be obtained yet how the Ministry of Finance determines the overall ceilings, and how this is allocated across different sectors.

state budget⁴. Funding for ongoing projects had to be appropriated annually⁵. Based on the ceilings, line departments would develop and propose projects. Which projects are selected for funding broadly depended on: (i) prior Presidential or Cabinet of Ministers decisions; (ii) whether these projects were in line with development concepts for sector; (iii) the quality of project documentation; and (iv) whether projects are within top-down ceilings. The selection criteria left substantial scope for non-economic judgment about projects.

The development of the Investment Program was separated from the regular budget preparation process, essentially delinking responsibilities for capital expenditure from current expenditures. Estimation of future recurrent cost implications were not required when costing the investment project. Budgeting of expenses for the maintenance of completed investment projects, including expenses for current repairs and maintenance, was supposed to be carried out when the operating organization drafted the annual budget request.

The projects would move from the phases of pre-feasibility, to feasibility, to selection in an iterative fashion were the documentation would be further refined – or the project would not move forward. As in most countries, line ministries undertake formulation and feasibility assessments. There is limited methodological guidance available on economic, sector, analysis methods. A welcome improvement is that NAPM has developed a manual for project, program and project portfolio management based on international standards (ISO). Project results indicators were essentially output-related, and projects appear to have been selected individually, rather than as a complementary package. At the end, a Presidential decision was required for the whole investment program. While it is difficult to have a precise picture of the roles each organization played in the public investment process, it is safe to say that the institutions discussed below were involved in this review process provided their views to the Cabinet of Ministers. **Contrary to the practice in many other countries, the MoF did not have veto power over projects for reasons of poor quality, risk, or weak public value.**

Uzbekistan’s public investment management varies from that in other countries. The provision of expertise and review of (pre-)feasibility studies is different between domestically-funded and foreign-funded investment projects. Procedures differ whether a project concerns investment in social sectors (social infrastructure) or investment in the real sectors.

The State Investment Committee and the NAPM are responsible for performing systematic analysis and monitoring of the projects’ implementation progress, including quarterly submission of information to the President. The assessments are done on a project-by-project basis according to output related indicators. The focus is on the execution rate. Measures to assess the efficiency and quality of public investment are not used. Spending would usually follow a bunching pattern with a rapid ramp up as the fiscal year was closing. Slow implementation remains

4 No information was obtained how the ceilings for investment projects funded by FRD are determined. Investments funded by foreign loans under government guarantee are determined by agreements between the multilateral or bilateral creditor and the Government.

5 Most good practice countries use multi-year appropriations, or equivalent, for capital budgeting in order to concentrate decision-making capacity on new projects. Increasingly OECD countries are moving to funding for the total project cost up-front (39% in 2012 compared to 13% in 2007).

a challenge. At the beginning of 2019 the President mandated execution of projects to a minimum of 35 per cent in the first 6 months of the year and 70 per cent in first nine months.

Box 5.1. Evidence Based Investment and Managing Cost Overruns in Denmark

In 2009, in the wake of the global financial crisis, parliament agreed on the need for substantial transport infrastructure investment in Denmark. The 2009 agreement and an associated fund represent an innovation in Denmark in terms of transport policy. The agreement provides a prioritized list of projects, a dedicated funding source, and a definition of the group of political parties that have a say how the agreement is to be implemented, including how to spend any excess funding. No replacement for the 2009 agreement is envisioned as of now.

A key input that provided the glue for this consensus was the 2008 Infrastructure Commission Report⁶ that identified key transport investment needs. The broad agreement around this objective coincided with the desire to provide economic stimulus in response to the global financial crisis. The convergence of these pressures led to the creation of an Infrastructure Fund endowed with DKK 100 billion to be invested based on the priorities and specific projects identified by the Infrastructure Commission and endorsed by the political parties behind the agreement.

Denmark's system for selecting and prioritizing infrastructure investments is based on a socio-economic cost-benefit analysis methodology. Projects are ranked according to their socio-economic return. In principle those projects with the **highest** scores are prioritized in terms of funding, but, as in other countries, the political level plays a key role in determining which projects go forward.

The system relies on three elements, in particular:

- A **national traffic model** which can model the impact of new infrastructure on traffic projections and its effect on the rest of the network. This modelling approach enables transport planners to consider the system-wide impacts of a particular project when evaluating the benefits of an investment.
- A **catalogue of prices** for different direct and indirect effects of infrastructure. In addition, to the direct time-value of transport, there are prices for indirect effects such as environmental effects (e.g. emissions), and health (e.g. air pollution and road accidents).
- A **science-based methodology** was developed in collaboration with the Technical University of Denmark (DTU) who continue to 'host' the system and are involved in further refining the methodology. For example, the DTU is currently undertaking research on agglomeration effects, which are currently not taken into consideration by the traffic model.

This approach has created an evidence-based point of departure for project prioritization and transport policy.

The model has shown itself to be able to withstand criticism by virtue of being science based, independently hosted and increasingly open to scrutiny. Inevitably, the methodology for ranking projects comes under pressure from various stakeholders who are disappointed that their preferred projects are not ranked as high as they would like. However, by embedding the model and methodology within an independent academic institution, and grounding it in science,

⁶ See <https://www.trm.dk/da/publikationer/2008/infrastrukturkommissionens-betaenkning>

the system benefits from a high degree of legitimacy. This legitimacy contributes to creating acceptance of the results of the ranking as the point of departure for decision-making and reduces the space for contestation. Furthermore, the system is highly transparent, with the ranking, calculations and model all made public. Therefore, projects that generate a high socio-economic return are automatically put at the front of the list when funding is to be decided. Aside from the 2009 agreement, the annual budget negotiations serve as the venue for deciding on which infrastructure investments are to be prioritized and funded. While this system is not entirely immune to various types of more narrow political interests (e.g. regional considerations), most of these types of deal-making concern smaller projects, whereas mega projects and large programs are subject to a more structured process (e.g. multi-year agreements on collective transport).

Most infrastructure is funded via the national budget and user tolls are only used for two large fixed links

Private financing of infrastructure plays a minor role in funding infrastructure development in Denmark, as the government can borrow at the best sovereign rate. The fixed links over Oresund (to Sweden) and Store Baelt are placed in state owned enterprises, financed on the market (with a government guarantee) and are wholly user-funded. This model will also be used in two upcoming fixed links, one of which is the Femern Baelt link to Germany. In general, there is very little appetite among the public for tolls and making any attempt to expand their use would be highly political sensitive. Infrastructure investments are funded from the annual budget or from the Infrastructure Fund. Since 2009 the DKK 100 Billion Infrastructure Fund has provided the bulk of resources for infrastructure investment, but these funds will soon be depleted, and Denmark will need to consider how to fund infrastructure development going forward.

The new approach to budgeting has dramatically limited cost overruns.

In the past, transport projects could turn out to be 40-50% more expensive than originally budgeted for. In 2007, Denmark introduced a new budgeting regime, where the estimate for a project's cost is supplemented with a 50% reserve at the earliest stages of planning and 30 % once the environmental impact assessment has been performed. This total sum must be **budgeted** up front and appropriated by Parliament in the annual budget act. If a project comes in under-budget, the remaining funds can be assigned to other projects. To avoid the risk of overpriced tenders and price-fixing under this approach, a high level of competition must be ensured.

Monitoring and control of the development and implementation of state development programs is carried out by NAPM, State investment Committee together with project implementers each quarter. Project implementers provide a report on the implementation of the portfolio of projects to NAPM. The systematic analysis and monitoring of the projects' implementation progress is performed based on assessing progress in achieving the abovementioned indicators, quarterly and annually. There are no systematic procedures for asset maintenance nor ex post reviews. Data on delays in the execution schedule is monitored by the authorized agencies for the implementation of the investment program.⁷

⁷ Ideally, data on cost overruns and delays would be valuable to assess the project implementation.

The steps for selection of projects for the upcoming three-year investment program for 2020-2022 will be based on new procedures for preparation and financing development programs⁸. However, these new procedures have not yet been approved. The new resolution on procedures for the development of the investment program is expected to be approved in June 2019. According to NAPM, changes are required because feasibility studies were superficial, and outdated methods for project evaluation were used.

PUBLIC INVESTMENT OVERVIEW: IT'S COMPLICATED

Our estimates indicate that overall public investment amounted to 5.2 percent of GDP in 2018, with just under half on-budget and the rest off-budget. The bulk of the part off-budget is through state-targeted funds. While these calculations only highlight public investment, the public investment program mixes funding channels and integrates inflows of FDI and funds to private companies. While much has been improved in recent years, there is still more work to be done. “Public investment” is not defined in any Uzbek regulation. The legislation recognizes only the concept of ‘centralized/decentralized investments’ in the annual investment program. ‘Centralized’ investments comprise investments funded through: (i) the state budget or state targeted funds⁹; (ii) project financing of budget institutions financed by IFIs and bilateral creditors; (iii) project financing of SOEs through IFIs, bilateral institutions or through on-lending of funds from the Fund for Reconstruction and Development (FRD) via commercial banks. ‘Decentralized’ investments comprise (iv) foreign direct investment and private investments.

The Investment program consists of about 3,000 projects in 2019 totaling \$16.6 billion. ‘Centralized’ investment has increased from \$1.8 billion in 2010 to \$3.5 billion in 2016. It declined to \$2.9 billion in 2017 as a result of the currency crisis. However, a surge appeared in the last two years. Expressed in GDP, investments funded through the budget and state targeted funds amount to 1 percent of GDP. In addition, 4.5 percent of GDP is funded through off-budget sources (UFRD policy lending, government housing lending, and IFIs). More granular data will be developed for the final PER chapter. Figure 5.2 presents the sources of funding of centralized investment in the annual investment program in nominal terms and in dollar terms. Remarkably most investment funding in the last two years has come from IFIs and bilateral creditors, and not from the other sources of funding. In fact, in dollar terms state budget and targeted funds have decreased in recent years.

KEY CHALLENGES

There is lack of consistent data on the size and composition of public investment. While the team has calculated the size of public investment in 2018, there is no information that allows such calculation for earlier or later periods. A lot of investment spending is off-budget. Moreover, there is inadequate differentiation of investments by size in the public investment procedures. This

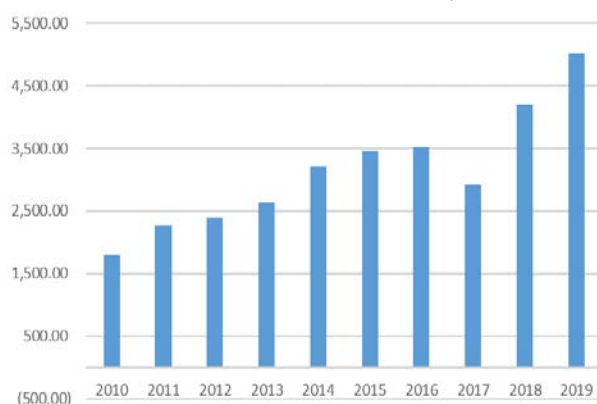
⁸ Resolutions of the President of the Republic of Uzbekistan No. PP-3437, December 18, 2017 and No. PP-3874, July 19, 2018.

⁹ In 2018 and 2019 state targeted funds included in the Investment program comprised: Amelioration Improvement Fund for Irrigated Lands, Republican Road fund, Fund for the development of material and technical base of educational and medical institutions, Clean Drinking Water Fund, and Development Fund of the Aral Region.

makes it difficult to analyze trends, identify needs, and focus on projects whose failure would entail a significant loss for government finances and take appropriate action ex ante.

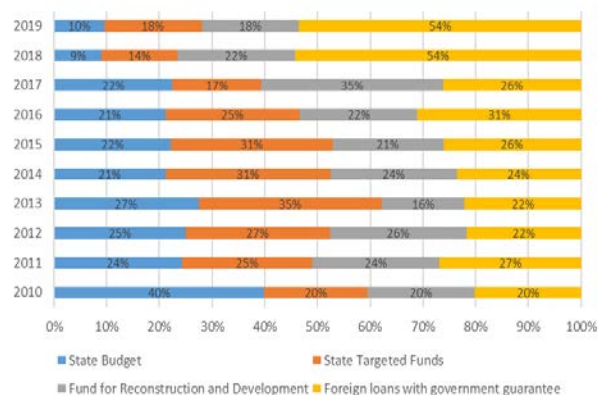
Figure 5.1. Centralized Investment According to the PIP

(in millions of US dollars)



Sources: Staff estimates using National Agency for Project Management data.

Figure 5.2. Sources of Investment Funding
(in percent of total)



The volatile institutional environment and fragmentation and overlap of public investment management functions makes it difficult to ensure that the investment pipeline is the most optimal for the country. The institutional setting of public investment management continues to change as discussed above. This results in several challenges.

- Unclearness about who is responsible for what in the project process, what standards and procedures will be governing the process, what projects will be approved or dismissed.
- There are many different institutions involved and they at times compete.
- Unlike all good practice countries, the Ministry of Finance does not have a blocking authority with regards to project risks, affordability and value for money.
- There is very uneven capacity across the institutions that can develop projects.
- There is no differentiation based on the type of line ministry or project initiator, disregarding the diverse institutional capacity across project initiators.
- There is no specific guidance to assist institutions with limited institutional capacity. This would impact the project implementation and monitoring capacities of these institutions as well.

There are bottlenecks at the different stages of the PIM cycle, including ambiguity in project selection criteria, ineffective use of project appraisals, emphasis on meeting formal procedures, and lack of ex-post evaluation.

Up to now there was inadequate strategic guidance for investment screening and selection. The lack of a concept for the long-term development of sectors and regions has allowed weak projects to go forward, resulting in inefficient spending of financial resources. Recent history shows a weak

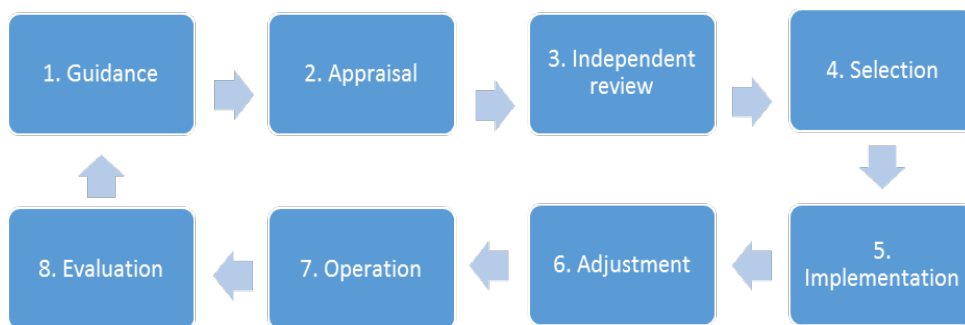
or unproductive link to sectoral strategies. The development of new sector and regional development strategies represents a first good step in providing strategic guidance for the screening of potential investment projects. Nonetheless, there are multiple risks with the current approach:

- Risk that each individual strategy may result in wish lists of possible options instead of well-defined set of priorities that takes into consideration interdependencies between different policy areas and among individual projects within the same policy area;
- Risk that the strategies have been developed without indicative resource constraints or not properly costed;
- Risk that potential investment projects remain insufficiently prioritized or reconciled with multi-year resource envelopes due to the absence of multi-year budgeting practices;
- Risk that PPPs, concessions and similar investments are not fully integrated into the PIM and ordinary budget system.

On PPPs specifically, the authorities need to strengthen substantially the PPP unit in the MOF and the legal framework to ensure that PPPs help reduce rather than increase fiscal risks. The MOF needs to be the main gatekeeper for all decisions that might give rise to contingent liabilities and ensure that the projects, and the overall project portfolio, are affordable for users and/or the public purse.

There is an absence of guidance regarding project evaluation and data collection. This makes it difficult to assess whether the procedure is broadly performing or in need of more substantial adjustment. However, the recent PEFA assessment gave the Public Investment Management system only “C” grades across the board. This indicates that there is need for an upgrade across the board.

Figure 5.3. Must-have Features in PIM Systems Crucial for Supporting Effective and Efficient Public Investments



The separate processes for investment planning and the government budget undermine the unity of the budget and prevent a focus on whole-of-life costs. There is currently no practice of estimating future current cost implications of investment projects and integrating these into the decision-making process. There exist no national guidelines for project costing and identification of recurrent costs. The Ministry of Finance examines the whole project costing – statement of expenditure – any cost related to the project until it was completed but does not systemically review

post-completion cost implications. No incentives exist for proper asset maintenance and management as investment decisions are decoupled from asset maintenance costs.

POLICY OPTIONS

Accurately determine the total size of public investment, distinguishing different types of investments and focus on large investments

- Move all investment spending on budget.
- Introduce a clear-cut definition of public investments and introduce that in the (multi-annual) investment program.
- Develop systems for capturing and analyzing key data.
- Introduce differentiation of projects by costs to identify financially important and materially risky projects that which would require closer supervision.

Unify public investment management functions and streamlining procedures and processes across all (new) institutions involved

- Strengthen the role of the Ministry of Finance in the selection process. Project promoters should discuss the affordability of a major project extending outside the medium-term period with the Ministry of Finance in detail before submitting the proposal. The opinion issued by the Ministry of Finance at the pre-selection stage represent an opinion on the potential affordability of the project and fiscal risks for the country's public finances.
- Establish integrated investment project management and control throughout the public investment cycle by unifying public investment management functions and streamlining procedures and processes across all (new) institutions involved.
- Promote stability in the institutional landscape for PIM.
- Abolish current differentiation in economic analysis procedures, based on the source of funding.
- Methods and procedures, monitoring, and post-execution assessment must apply to all public investment projects no matter what their functional nature or funding source, including those financed through PPPs.

Ensure that PPPs, concessions and similar investments are fully integrated into the PIM and ordinary budget system (see Appendix 5.4)

- First determine whether projects make sense, then determine whether to use public and/or private finance.
- Ensure that the processes are integrated and that the MoF budget department has veto power regarding affordability and fiscal risks.
- Develop a policy on how to handle decentralized/SOE investments.

Box 5.2. Project Appraisal Practices in Korea

The Asian Financial Crisis in 1997 led the Korea Government to enhance productivity of PIM systems due to the tight fiscal envelope entailed by the crisis. From the perspective of value-for-money, ‘Preliminary Feasibility Study (PFS)’ was introduced in 1999 to filter out unproductive projects. In addition, the ‘Total Project Cost Management (TPCM)’ introduced in 1989 was upgraded with the ‘Re-Feasibility Study (RFS)’ in 2003. These two systems complement each other and guard the value for money and sustainability of public investments in Korea. PFS are reviewed by a dedicated institute, the Public Investment Management Center (PIMAC) under the Korea Development Institute and Ministry of Economy & Finance. The reviews have filtered out low productive projects, which relieved the workload of the Budget office during formulation of the annual budget.

Pass and Fail results of Preliminary Feasibility Study

	Total	Recent 5 years				
	Since 1999	2014	2015	2016	2017	2018 Aug
Total	838	44	34	39	40	16
Projects						
- Pass	540 (64.4%)	35	25	26	20	11
- Fail	298 (35.6%)	9	9	13	20	5

Source: Ministry of Economy & Finance of Korea

The methodology has undergone some adjustment over the years. Initially, the PFS was only based on economic costs-benefits analysis. This favored urban projects over rural. Consequently, a policy aspect regarding fairness among regions was added in 2003. This resulted in an increase in rural projects being funded. In an attempt to reign in cost overruns, an increase above 20% requires a new (Re) Feasibility study in order to continue implementation.

Effectively apply rigorous and objective selection criteria and use of project appraisal to set up the multi-year project pipeline, establish ex-post review and evaluation stage

- Develop straight forward guidance notes on key investment methodologies and processes.
- Collect and analyze systematically information on the independent review of project appraisals, incl. number of request for adjustments of the economic analysis (by types of adjustments, e.g. to address overestimation of benefits, underestimation of costs, insufficient attention to implementation capacity given past experiences, assessment of likelihood and potential impact of risks), and the number of approvals/rejections (see box below for example).
- According to NAPM, ongoing seminars and training courses aimed at raising the qualifications of personnel of ministries and departments, as well as state local authorities and / or in specialized organizations have been conducted. However, a centralized point of development, support, and monitoring of such capacities would be beneficial for embedding revised methodologies and procedures in the various organizations.

- Consider differentiated planning and implementation capacities of project initiators and implementers, provide additional assistance to low-capacity institutions. The provision of technical assistance would ideally be the responsibility of a single specialized unit, for instance in the Ministry of Investment and Trade, to address capacity bottlenecks in low-capacity institutions.
- Good practice is to have procedures to evaluate projects against value-for-money criteria both ex-ante and ex-post. Strengthening ex post review and evaluation is crucial for an efficient and results-oriented PIM system. Feedback based on systematically collected information will provide valuable inputs to improve future projects as well as identify and address institutional capacity bottlenecks. Especially, the pre-selection stage offers an opportunity to feed lessons from the ex post evaluation of similar completed projects, where available, into the initial design of new projects (e.g. to assess the risks).

Integrate capital investment budgeting into the overall budgeting process, and establishing unified responsibility for asset build-up, management and maintenance

- Ensure that the decision to fund a project is valid for its full implementation, barring significant changes.
- Requests for approval for new investment projects should contain a separate analysis of the future cost implications of the project for the budget. For projects for which a full feasibility study is undertaken, such analysis of cost implications would be drawn from the study. For other projects, it would be a separate analysis. The main information which such analysis should convey is the net additional burden on the budget resulting from the recurrent cost implications of the project in a typical year post-completion. Both operating and maintenance costs need to be considered.
- Each line ministry / budget institution at any government level should include in its annual budget submission information on the expected recurrent cost implications of all ongoing investment projects. These projections of the future recurrent cost implications should be integrated into the medium-term budgeting that is being developed.
- Once a project has been completed and is ready for service, operational and maintenance expenditure would at least need to be reflected in the institution's budget request to demonstrate its responsibility for asset management. The current established procedures and arrangements for asset transfer may be reviewed to assess the institution's responsibility in asset ownership and maintenance. Specific procedures for asset maintenance may be developed.

APPENDIX 5.1. PUBLIC INVESTMENT STEPS FOR THE BUDGET FOR 2019

Step	Who	What
1	Project initiators	Developing, preparing and updating the project portfolios to be included into the Investment program
2	Project initiators	Preparation and approval of design, feasibility and costing documents according to established procedures
3	Ministry of Finance	Development of forecasts for public investments for 2019 and submission to State Investment Committee
4	Project initiators	Submission of the project portfolios to State Investment Committee
5	State Investment Committee	Preparation of the Investment program for 2019 on the basis of project initiators' proposals by way of selecting the projects according to the selection criteria mentioned above.
6	State Investment Committee, Project initiators	Agreement on approvals of figures for the Investment program for 2019
7	State Investment Committee	<p>Obtaining coordinated approvals of figures for the Investment program for 2019 from the Ministry of Finance, the Ministry of Economy, the Ministry of Construction, the State Fund for Financing of State Development Programs under the Cabinet of Ministers, National Agency for Project Management under the President of the Republic of Uzbekistan, the Ministry of Justice</p> <ul style="list-style-type: none"> • National Agency for Project Management performed expert evaluation of design and feasibility documents and financial estimates, and issue their conclusion. NAPM review included checking the compliance of project figures, indicated in the Investment program, with the figures in the approved design, feasibility and costing documents. • NAPM was supported by Center for Complex Examination of Projects and Import Contracts under the Ministry of Economy and Industry is responsible for assessing accuracy and objectivity of project documentation, but is not involved in assessing foreign-financed project as it is the responsibility of the project initiator and the project institute participating in their development. • State Unitary Enterprise "Examination of urban planning documentation" under the Ministry of Construction • The Ministry of Economy assessed compliance of the project figures with the targeted and macroeconomic estimates for social-economic development of the Republic of Uzbekistan up to 2030 as well as with the characteristics of Obod Qishloq and Obod Mahalla state programs. • The Ministry of Finance assessed in terms of determining the sources of funds for repayment of attracted loans (credits), as well as the feasibility and amount of the proposed budget allocations, the provision of additional tax and customs benefits • State Investment Committee conducts assessment of the overall economic feasibility of the project, its compliance with the priorities of investment policy, approved strategy (program) of cooperation with international institutions, and the evaluation document of their projects;
8	State Investment Committee	Submission of draft Investment program for 2019 to the Cabinet of Ministers
9	Cabinet of Ministers	Examine the compliance with requirements for development, submission, coordination and preparation for consideration of the draft of the Investment program for 2019 Submission of the draft of the Investment program for 2019 to the Administration of the President of the Republic of Uzbekistan
10	Administration of the President	Examine the compliance with requirements for development, submission, coordination and preparation for consideration of the draft of the Investment program for 2019

APPENDIX 5.2. NEW PROCEDURES FOR INVESTMENT PLANNING

Steps	No.	Actions	Deadlines	Ministries and agencies in charge
Step I. Development and preparation of development concepts	1	Preparation of long-term sector/regional and targeted development concepts (usually aimed for 10 — 15 years)	till March 1	Coordination Councils under State Investment Committee, Ministry of Economy, Ministry of Finance, sectoral ministries and agencies, local state authorities
	2	Approval of prepared draft development concepts with authorized state authorities including other concerned ministries and agencies	till March 10	State Investment Committee
	3	Approval of draft development concepts with National Agency for Project Management	till March 20	State Investment Committee
	4	Approval of development concepts submitted by State Investment Committee	till April 1	Office of the President of the Republic of Uzbekistan
Step II. Development and preparation of project portfolios	5	Developing, preparing and updating sectoral/regional and targeted project portfolios	till June 1	Initiators (line ministries and agencies, local state authorities), State Committee for Investments, Ministry of Economy, Ministry of Finance
	6	Approval of project portfolios with pre-estimates (charters), including the necessary data confirming the volumes and preliminary financing sources for the projects, with concerned ministries and agencies	till June 15	Initiators (line ministries and agencies, local state authorities)
	7	Approval of project portfolios by National Agency for Project Management	till July 1	Initiators (line ministries and agencies, local state authorities)
	8	Approval of project portfolios submitted by State Investment Committee	till July 15	Office of the President of the Republic of Uzbekistan
	9	Development of detailed implementation schedule for every project included into the project portfolio	till August 1	Initiators (line ministries and agencies, local state authorities)
	10	Approval of detailed implementation schedule by National Agency for Project Management	till August 10	Initiators (line ministries and agencies, local state authorities)
Step III. Development and preparation of state	11	Development and approval of preliminary project documentation (preliminary feasibility study(PTEO)/preliminary feasibility estimate(PTER))	from July 15 till September 1	Initiators (line ministries and agencies, local state authorities)

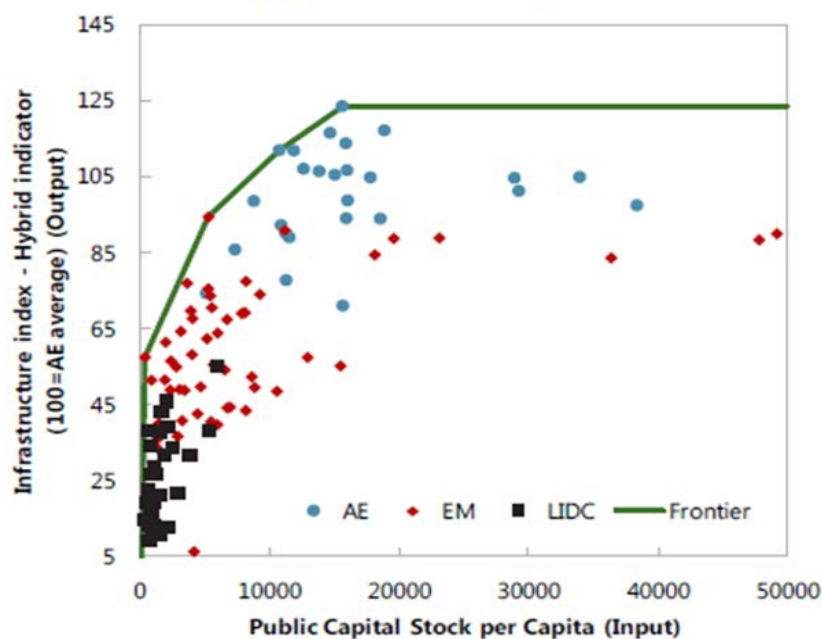
Steps	No.	Actions	Deadlines	Ministries and agencies in charge
development programs	12	Selection of priority projects to be included into state development programs	till September 10	State Investment Committee, Coordination Councils under State Investment Committee, initiators (line ministries and agencies, local state authorities)
	13	Approval of priority projects to be included into state development programs by the Fund for Financing of State Development Programs of the Republic of Uzbekistan under the Cabinet of Ministers of the Republic of Uzbekistan	from September 10 till October 10	State Committee on Investments
	14	Preparation of state development programs and submission for approval to concerned ministries and agencies	till October 20	State Investment Committee, the Ministry of Finance, the Ministry of Economy, initiators (line ministries and agencies, local state authorities)
	15	Approval of state development programs by concerned ministries and agencies	till November 1	State Investment Committee
	16	Approval of state development programs by National Agency for Project Management	till November 10	State Investment Committee
	17	Approval of state development programs submitted by State Investment Committee	till December 10	Office of the President of the Republic of Uzbekistan

APPENDIX 5.3. WHY GETTING PUBLIC INVESTMENT MANAGEMENT RIGHT IS IMPORTANT?

Public Investment Management (PIM) contributes to infrastructure quality and growth:

- A 2015 IMF study shows that countries achieve very different results with their investment in public capital
 - ✓ With the same public capital, infrastructure coverage and quality differs, on average, by 27% for emerging markets and 40% for low income countries (see chart).
 - ✓ For the bottom quarter of performers, this difference rises to over 40% for emerging markets and well over 50% for low income countries—for these latter countries, more than half of the public capital accumulated through public investment does not meaningfully contribute to infrastructure.
- The impact of public investment on growth is twice as high in countries with high efficiency of public capital (in the top quartile) than those with low efficiency (in the bottom quartile).

Figure A3.1. Efficiency of Public Capital



Source:

Therefore, The WBG's PIM Systemic Framework emphasizes eight must-have functions. Emphasis is on functionality, not form. However, all countries do need the eight functions for PIM to be effective and deliver on its objectives. The specific structure, as opposed to the functions, will change over time, reflecting priorities and political realities.

Table A3.1. The Eight Must-Have Functions

1. Investment guidance	<ul style="list-style-type: none">• National and/or sector strategy documents that are specific, coherent, accepted and used to screen new projects
2. Formal appraisal	<ul style="list-style-type: none">• Publicized & transparent guidance• Effective training and deployment of staff
3. Independent review	<ul style="list-style-type: none">• Checks any subjective, self-serving bias in the evaluation• Inventory of appraised projects ranked by priority
4. Project selection & budgeting	<ul style="list-style-type: none">• Transparent criteria for selecting projects• Only selected projects receive funding (gatekeeping)• Adequate financing for selected projects
5. Project implementation	<ul style="list-style-type: none">• Standard Project Implementation guidelines should be developed by countries and distributed to all levels of government• Regular monitoring of financial and non-financial progress• Cost-effective procurement & contracting
6. Project adjustment	<ul style="list-style-type: none">• Review of project's continued justification if there are material changes to project costs, schedule, or expected benefits.
7. Facility operation	<ul style="list-style-type: none">• Process ensuring facility is ready for service delivery• Asset registers are maintained, and asset values recorded
8. Completion Review & Evaluation	<ul style="list-style-type: none">• Formal institutional arrangements for completion review and ex post evaluation• Feedback into future project designs

APPENDIX 5.4. OECD PRINCIPLES FOR PUBLIC GOVERNANCE FOR PUBLIC PRIVATE PARTNERSHIPS

In 2012, the OECD countries officially endorsed 12 principles – organized in three thematic areas -- for public governance of PPPs. While they are not legally binding for the member countries, they form part of OECD soft law and member countries are monitored on the extent to which they live up to them in practice.

Establish a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities

1. The political leadership should ensure public awareness of the relative costs, benefits and risks of Public-Private Partnerships and conventional procurement. Popular understanding of Public-Private Partnerships requires active consultation and engagement with stakeholders as well as involving end-users in defining the project and subsequently in monitoring service quality.
2. Key institutional roles and responsibilities should be maintained. This requires that procuring authorities, Public-Private Partnerships Units, the Central Budget Authority, the Supreme Audit Institution and sector regulators are entrusted with clear mandates and sufficient resources to ensure a prudent procurement process and clear lines of accountability.
3. Ensure that all significant regulation affecting the operation of Public-Private Partnerships is clear, transparent and enforced. Red tape should be minimized, and new and existing regulations should be carefully evaluated.

Ground the selection of Public-Private Partnerships in Value for Money

4. All investment projects should be prioritized at senior political level. As there are many competing investment priorities, it is the responsibility of government to define and pursue strategic goals. The decision to invest should be based on a whole of government perspective and be separate from how to procure and finance the project. There should be no institutional, procedural or accounting bias either in favor of or against Public-Private Partnerships.
5. Carefully investigate which investment method is likely to yield most value for money. Key risk factors and characteristics of specific projects should be evaluated by conducting a procurement option pre-test. A procurement option pre-test should enable the government to decide on whether it is prudent to investigate a Public-Private Partnerships option further.
6. Transfer the risks to those that manage them best. Risk should be defined, identified and measured and carried by the party for whom it costs the least to prevent the risk from realizing or for whom realized risk costs the least.
7. The procuring authorities should be prepared for the operational phase of the Public-Private Partnerships. Securing value for money requires vigilance and effort of the same intensity as that necessary during the pre-operational phase. Care should be taken when switching to the

operational phase of the Public-Private Partnerships, as the actors on the public side are liable to change.

8. Value for money should be maintained when renegotiating. Only if conditions change due to discretionary public policy actions should the government consider compensating the private sector. Any re-negotiation should be made transparently and subject to the ordinary procedures of Public-Private Partnership approval. Clear, predictable and transparent rules for dispute resolution should be in place.
9. Government should ensure there is enough competition in the market by a competitive tender process and by possibly structuring the Public-Private Partnerships program so that there is an ongoing functional market. Where market operators are few, governments should ensure a level playing field in the tendering process so that non-incumbent operators can enter the market.

Use the budgetary process transparently to minimize fiscal risks and ensure the integrity of the procurement process

10. In line with the government's fiscal policy, the Central Budget Authority should ensure that the project is affordable, and the overall investment envelope is sustainable.
11. The project should be treated transparently in the budget process. The budget documentation should disclose all costs and contingent liabilities. Special care should be taken to ensure that budget transparency of Public-Private Partnerships covers the whole public sector.
12. Government should guard against waste and corruption by ensuring the integrity of the procurement process. The necessary procurement skills and powers should be made available to the relevant authorities.

Chapter 6. Intergovernmental Fiscal Relations

Effective design and implementation of intergovernmental relations are essential for good delivery of public services at the local level. Subnational governments (SNGs) play an important role in providing public services in Uzbekistan, but they have little autonomy over revenue management and resource allocation and act as an extension of the central government. The intergovernmental system remains highly centralized with discretionary transfers based on political negotiations and historical inertia. This setup does not create the incentives for efficient management of resources and improvements in the quality of public services. To address these challenges, as a first step, the government may consider increasing the predictability of transfers by introducing rule-based allocation mechanism, reviewing and clarifying expenditure assignments across the different levels of government, and providing greater fiscal autonomy to subnational governments. A clearer delineation of functional assignments will be a key step of a fundamental reform of intergovernmental relations progresses.

CONTEXT AND RECENT DEVELOPMENTS

Uzbekistan has a highly centralized government structure. The administrative division comprises: (i) the central government; (ii) 12 regions (*viloyat*), one autonomous republic (Republic of Karakalpakstan), and one independent city (City of Tashkent); and (iii) 40 cities or urban districts and 162 rural districts, which are further subdivided into towns and villages. The President appoints directly the governors of the regions, who in turn appoint the heads of districts. Community self-governing bodies (*mahallas*) also play key role in carrying out government functions such as community policing and distributing social welfare payments. The regions are accountable to the President and central line ministries.

Figure 6.1. SNGs' Own Revenues as a Share of General Government Revenues
(in percent)

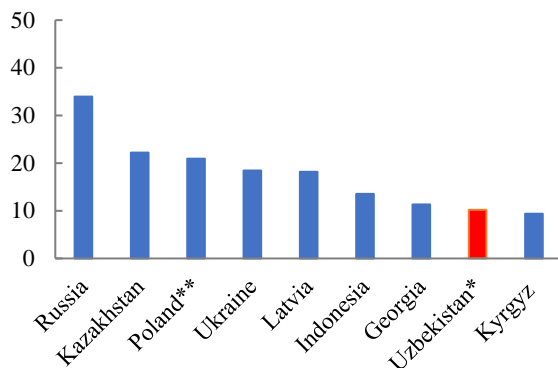
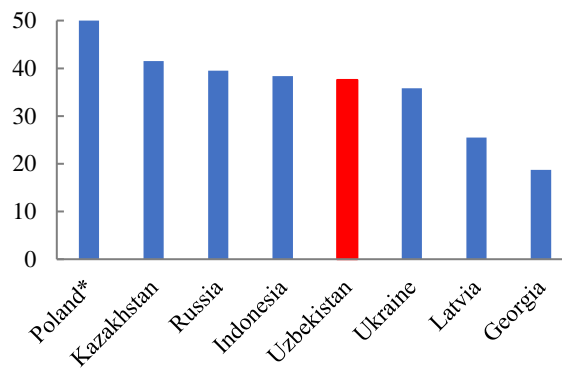


Figure 6.2. SNGs' Expenditures as a Share of General Government Spending
(in percent)



Source: MOF, IMF, and Bank staff estimates.

Note: The figure indicates the level of revenue collection by local governments and does not represent the degree of revenue autonomy (2016). *data are 2018; ** data are local tax revenue.

Box 6.1. Fiscal Decentralization Reforms in Poland

Poland embarked on decentralization reform in two stages (1990 and 1999). The first phase of reforms decentralized central government tasks and some revenue-raising authority, giving local governments limited autonomy regarding real estate taxes, local fees, and other minor taxes. The second phase focused on administrative reforms that reduced the number of local governments (*voivodeship*) from 49 to 16, restored the counties as an additional level of government, and decentralized public programs and services to increase citizen involvement and improve public service delivery. Strong and accountable local governments contributed to Poland's successful transition to a high-income economy. Local governments have been effective across the country, without large regional disparities. They have increased local revenues, legitimized by greater local political accountability, while also absorbing large amounts of EU funds for investment, supporting regional growth. Local governments play a key role in improving education, health, and public investment.

Source: World Bank (2017) *Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status*. Washington, DC.

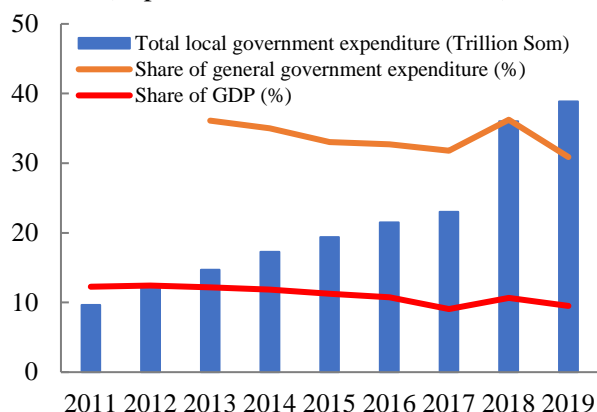
<https://openknowledge.worldbank.org/handle/10986/28960>

Uzbekistan's central-local government structure is one of administrative deconcentration.

In such a structure, subnational governments play a role as the central government's agent in the regions and are accountable to the central government.¹ SNGs, also referred to as local or lower-level governments, have little independence in managing public finances. Resources are transferred to the local governments while allowing them little autonomy or discretion in decision making. Uzbekistan's system of subnational finance has changed little since independence. In contrast, many developing and transition countries have embarked on fiscal decentralization, including Poland and Indonesia, and neighboring peers such as Ukraine, Georgia, and Kyrgyz Republic (Box 6.1).

Figure 6.3. Deconcentrated Subnational Expenditures

(in percent and in trillions of Som)



Source: MOF and World Bank staff estimates.

Uzbekistan's intergovernmental finance system is characterized by large vertical imbalances (limited own revenue sources combined with large spending mandates). Horizontal imbalances do not seem to be an issue, as indicated by the low ratio between the lowest and highest revenue per capita among the regions (about 1.4). This may mask fiscal disparities among districts

¹ Administrative decentralization can take different forms: deconcentration, delegation, and devolution. Under the strongest form of decentralization, the central government devolves functions, that is, transfers the authority for decision-making, finance, and management to quasi-autonomous units of local government with corporate status. For further information see: <http://www1.worldbank.org/publicsector/decentralization/admin.htm>

and cities which cannot be analysed due to data constraints. Given the lack of a system of equalization grants, two instruments are used to equalize financial resources among regions: (i) varying sharing rates across taxes and regions, and (ii) general budgetary support (subvention or targeted transfers). The two instruments aim to close the fiscal gaps between expenditure and revenue forecast prepared by the Ministry of Finance (MOF).²

Transfers -- mostly shared tax revenues -- are by far the most important source of revenues for subnational governments. These account for about 70 percent of subnational revenues. The balanced budget rule is key criterion in determining tax sharing rates and the size of targeted social transfers. This balanced budget rule with gap filling from transfers from the central government does not create local accountability and efficiency in the use of resources. This can create perverse incentives to underestimate revenues (or at least not increase collection of limited own revenues) and overestimate spending. In addition, parameters for both instruments are decided annually and tax sharing types and rates, the amount of targeted transfers, and number of receiving regions varies across years. This highly discretionary approach creates uncertainty for local governments.

Despite a highly centralized administrative structure, subnational governments play an important role in public services provision. During 2013-2019, subnational governments implement around 34 percent of national public spending (56 percent of total national spending excluding extrabudgetary accounts), equivalent to about 11 percent of GDP. These levels are higher than the average level for the rest of the world, which accounts for 25 percent of government spending or 9 percent of GDP (Figure 6.3).³ Subnational spending is concentrated on education (43 percent), healthcare (21 percent), and general public services (15 percent). By expenditure type, on average 53 percent of spending went toward wages and benefits followed by other spending (28 percent). Capital spending accounted for only 7 percent of total subnational expenditure.

The planning and budgeting process are centralized, mainly led by central line ministries and the Ministry of Finance. The regional governments consolidate the lower level governments' requests and submit them to the MOF. SNGs and the Tax Committee in parallel prepare revenue forecasts. The Ministry of Finance reviews both revenue estimates. In addition, the subnational budget preparation process includes a negotiated procedure with the central government where SNGs could argue for higher tax sharing rates or subvention allocation to reduce the projected budget deficit.

KEY CHALLENGES

Uzbekistan's government structure – and the resulting fiscal structure between the central and local governments – is highly centralized. The intergovernmental transfer system lacks proper incentives for efficiency and improved service delivery.

² Expenditure needs are based on forecast using historical spending adjusting for inflation and new programs from line ministries.

³ OECD-UCLG. 2016. Subnational Governments around the World: Structure and Finance.

Transparency and Predictability in the Allocation of Transfers

The current system of intergovernmental finance arrangements is highly discretionary and creates uncertainty for subnational governments. The system is based on varying rates of taxes shared and *ad hoc* budgetary transfers. For effective planning and budgeting, subnational governments need predictability for the resources they will receive every year. The absence of rule-based and transparent transfer system discourages efficient and transparent public financial management. The *ad hoc* approach to resource allocation has additional shortcomings, including: (i) the transfer is likely to be influenced by political manipulation; (ii) subnational governments are perceived as a lower priority and more likely to experience reduction when fiscal retrenchment is needed; (iii) the link between expenditure responsibilities and revenue resources is broken, which can negatively affecting the level of service delivery; (v) subnational governments are likely to be discouraged from increasing efficiency.

Clarity and Certainty in Deconcentrated Functional Assignment to Subnational Governments

There is no law that regulates functional assignments and administrative sharing between levels of government. The general divisions of responsibility are specified in the Budget Code, but these are not clearly defined and may change during the annual budget process. The deconcentrated expenditure responsibilities assigned to the region and districts/cities include social spending (education, health, and social support) and other outlays, but they involve specific task assignments rather than functional responsibilities. For example, the budget code explicitly specifies that only maintenance and renovation of healthcare facilities are the responsibility of SNGs. In education, various level of governments (republic, region, and district/city) are all involved in delivering secondary school services. Unclear functional assignment may undermine local accountability and efficiency of expenditure and service delivery.

Subnational Revenue Autonomy

Subnational governments have little autonomy over revenue collection. Major local taxes have their rate and tax base established and reviewed by the Cabinet of Ministers or in the annual budget resolution.⁴ Local tax rates (except for the property tax, whose rate has been fixed at four percent by the tax code) are subject to annual review by the Cabinet of Ministers.⁵ However, subnational governments are now allowed to keep locally collected revenues (own revenue) that exceeds planned revenues. Nonetheless, limited revenue autonomy, combined with the gap filling features of the transfer system design, reduces the incentives for increasing own revenues.

⁴ According to current legislation, local taxes include property tax, land tax, advertising tax and motor vehicles sales tax. Local fees include the fees for trading licenses (such as fees for goods-specific licenses), fees to register as a legal entity or individual engaged in entrepreneurial activities, fees for motor transport parking and fees for urban and rural development activities.

⁵ Leschenko, Natalie and Manuela Troschke. (2006). Fiscal Decentralization in Centralized States: The Case of Central Asia, Osteuropa-Institut München, München.

POLICY OPTIONS

Improving the overall design of intergovernmental transfers will require careful review of the existing system and comprehensive reforms; even without such reforms, the authorities could take steps to improve intergovernmental relations towards more transparency and predictability. Intergovernmental transfers should be part of a comprehensive fiscal decentralization policy and may not be effective if implemented without reforms of other important elements of intergovernmental fiscal relations such as revenue and expenditure assignments (Box 6.2).

Box 6.2. Features of a Good Intergovernmental Transfer System

There are various approaches for designing transfer scheme depending on program structure, and the method used to divide its funds among eligible subnational governments is ultimately a political choice, but the design of the mechanism should be guided by sound economic principles. Thus, independently of its final structure, all transfer formulas should obey several universal principles.

- **Providing revenue adequacy.** A transfer formula should provide a source of adequate resources to local governments to achieve its policy objective.
- **Preserving budget autonomy.** As much as possible, a transfer system should preserve budget autonomy at the subnational level. While there are sound policy arguments for conditional (targeted) transfers, general purpose **transfers** and equalization funding should be lump-sum in nature and unconditional. After all, the benefits from decentralization arise due to increased flexibility and spending discretion at the subnational level.
- **Enhancing equity and fairness.** The transfer mechanism should support a fair allocation of resources. For instance, an equalization transfer should provide more resources to districts with lower tax capacity and greater fiscal needs. While fairness is a subjective social concept, transfer systems that provide disproportionately more resources to wealthier local governments are often considered “unfair.”
- **Stability.** **Transfers** should be provided in a predictable manner in a dynamic sense. The formula should be stable over a period of years to promote revenue predictability and overall budget certainty.
- **Simplicity and transparency.** Transfer formulas should be, to the extent possible, simple and transparent. An important way to keep transfer programs simple is to limit their objectives and to only pursue one policy objective with **each** transfer program. The formula should also be understandable to all stakeholders, in particular to regional officials and legislators, and not be subject to political manipulation or negotiation in any of its aspects.
- **Incentive compatibility.** The transfer system should not create negative incentives for revenue mobilization by subnational governments, neither should they induce inefficient expenditure choices. To avoid these negative **incentives**, it is critically important that the formulas do not try to equalize actual revenues and expenditures but instead fiscal capacity and expenditure needs.
- **Avoid sudden large changes.** During the introduction of the new transfer mechanism, the transfer system should avoid sudden large changes in funding for local governments.

Changes in the existing formula should strive to hold local government “harmless” during the transition to a new allocation mechanism.

Source: Bahl, Roy, Jamie Boex, Jorge Martinez. 2001. The Design and Implementation of Intergovernmental Fiscal Transfers. <https://www.researchgate.net/publication/265572590>.

Improve transparency and predictability of transfers through rule-based system

Annual decisions on the transfers to SNGs should be predictable and timely to inform budget planning. SNGs need to know the amount of resources they will receive from various sources. This will contribute to better quality budget planning and will help limit the need for budget revisions due to lack of resources. The decisions on transfers involve two dimensions:

- The vertical dimension, which relates to the distribution of revenues between the central government and SNGs. The size of the transfer pool to SNGs can be determined as a share of central government revenues.
- The horizontal dimension, which is the distribution of resources from the pool among the SNGs. Each SNG’s share could be determined based on agreed percentages or a formula based on estimated fiscal gaps.

Review and clarify the assignments of functions across government levels

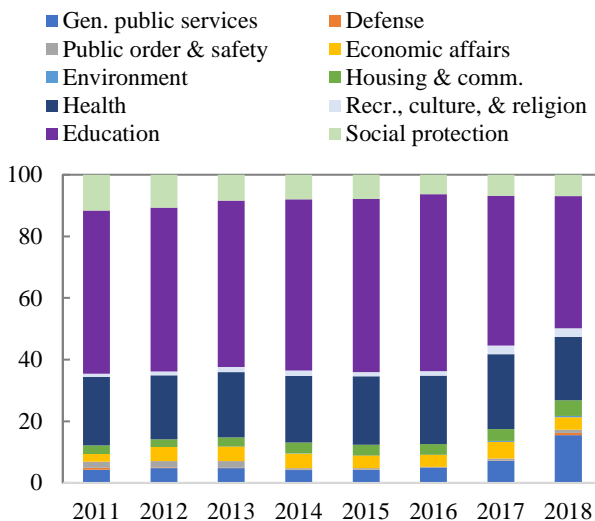
Clear assignment of functions between government levels is critical for improving the efficiency in local service delivery and allowing the central government and citizens to hold SNGs accountable. In addition, clear expenditure assignment is important to inform the design of the subnational financing system, including intergovernmental transfers. To ensure certainty and clarity of expenditure assignments between levels of government, it is preferable that they are regulated by law rather than via decrees, as commonly implemented in other countries. In the case of Poland, the functions of the different levels of subnational governments are defined in legislative acts and in accordance with good practice. Similarly, in Indonesia, functional assignments between levels of government are specified in the law on administrative arrangement between the central government and SNGs.

Consider providing greater revenue autonomy for subnational governments

Consider giving greater local revenue autonomy to SNGs by allowing subnational governments to set different rates for some taxes, at least in cities within certain thresholds. Land and property taxes are good examples. Greater revenue autonomy is expected to make local officials more accountable for the public services that they deliver, leading to better public services and more revenue. The increased fiscal autonomy should be accompanied by reforms incentivizing revenue collection at the subnational level, or at the minimum, limiting the hitherto perverse incentives to underestimate revenues.

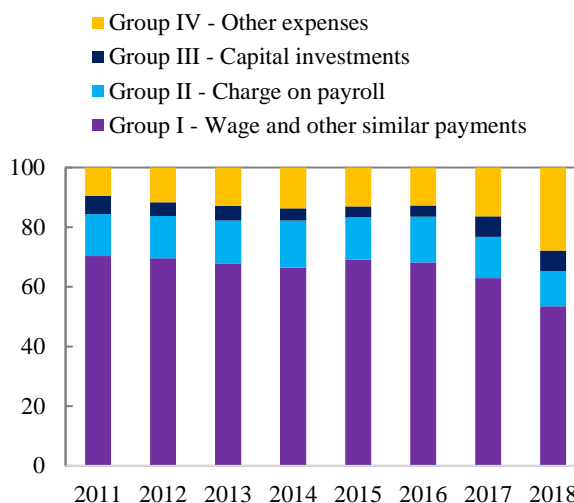
ANNEX.

Figure A6.1. Deconcentrated Subnational Expenditure by Function
(in percent)



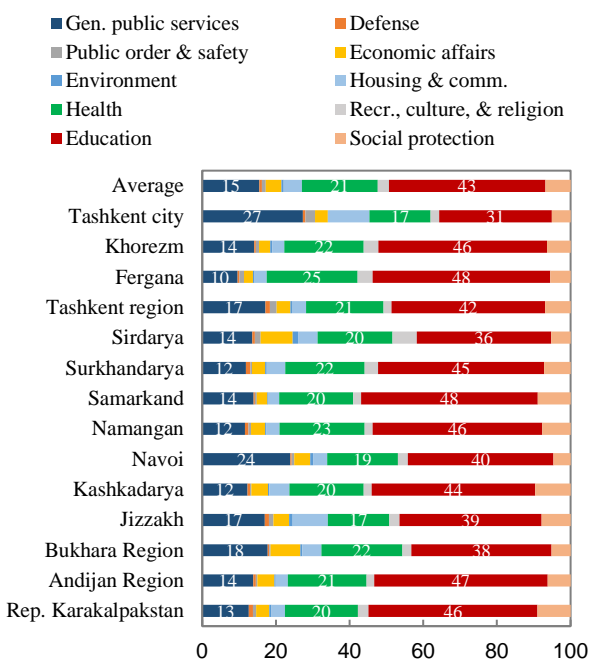
Source: MOF and World Bank staff calculations.

Figure A6.2. Deconcentrated Subnational Expenditure by Type
(in percent)



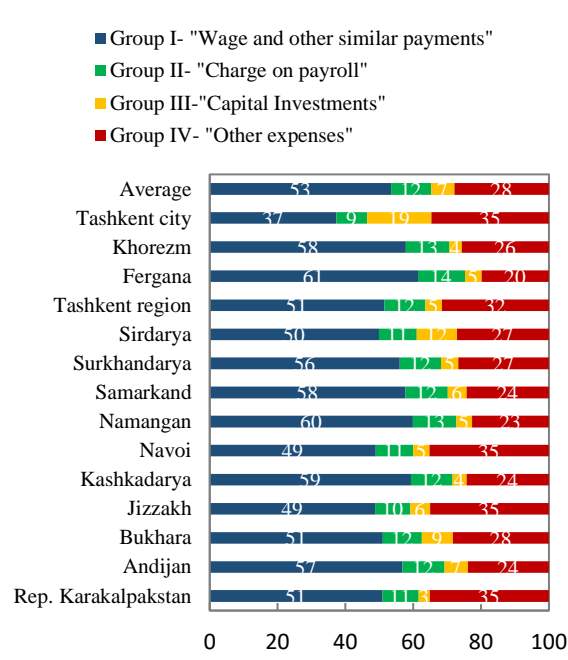
Source: MOF and World Bank staff calculations.

Figure A6.3. Functional Classification of SNG Expenditures, 2018
(in percent)



Source: MOF and World Bank staff calculations.

Figure A6.4. Economic Classification of SNG Expenditures, 2018
(in percent)



Source: MOF and World Bank staff calculations.

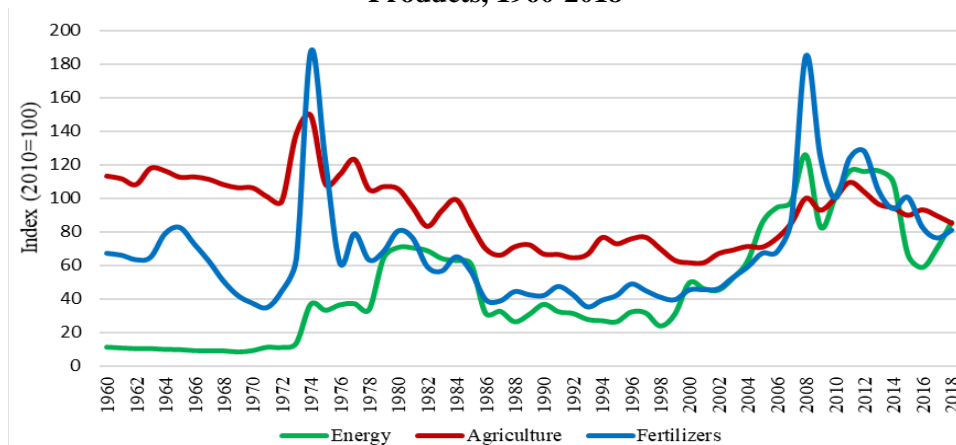
Chapter 7. Agriculture

Uzbekistan’s public spending on agriculture is substantial – 1.8 percent of GDP in 2018 – with limited impact on farm incomes, sustainability, and competitiveness. Most funds are directed to the production of cotton and wheat, preserving a status quo rather than accelerating agriculture’s transformation into higher value-added activities that are part of food value chains. The mix of farm support instruments consists of subsidized credit, provision of irrigation, and inspections, the impact of which are largely offset by the lack of other programs and low – although substantially increased of late -- state procurement prices for cotton and wheat. Globally, farm support is more balanced between direct payments to farmers and general support services. The policy options proposed in this chapter include phasing out indirect farm taxation, strengthening the current support instruments, investing in modernization of irrigation and drainage infrastructure, and increasing spending on public programs that are essential for long-term agricultural development but are currently underfinanced.

CONTEXT

This is the first ever agriculture public expenditure review for Uzbekistan carried out by the World Bank. Public expenditures in other countries matter a lot for agricultural growth and developmental outcomes, while in Uzbekistan, there seems to be a disconnect between large agricultural public spending on one side, and agricultural growth and other developmental outcomes, on the other.¹ The question is, therefore, how to increase the impact of agricultural public spending.

Figure 7.1. World Market Prices of Agriculture and Non-Agriculture Products, 1960-2018



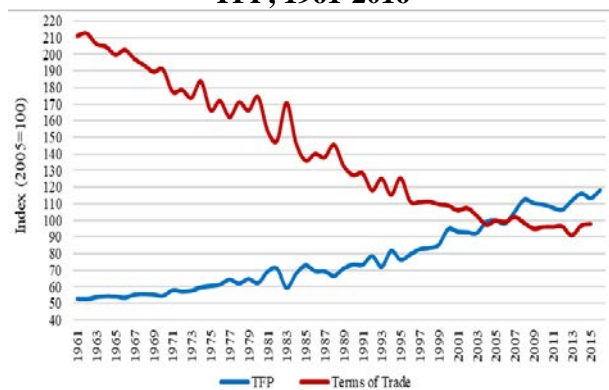
Source: World Bank Commodity Markets Database.

¹ In 2017, the agricultural growth slowed down to 2 percent, from 6 percent during 2014-2016. In 2018, the agricultural growth dropped to only 0.3 percent.

The biggest “farm problem” in the world is price disparity. In the long run, prices of agricultural products have tended to grow more slowly or decline faster than prices of farm inputs. Farmers are said to face declining terms of trade. Even when agricultural prices spiked as was the case in 2008-2009, prices of fertilizers and energy spike even more (Figure 7.1).

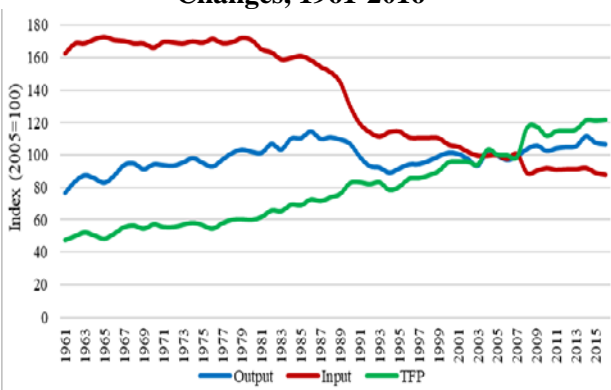
Farmers have responded by using lower amounts of more expensive inputs, increasing the efficiency of using inputs, and selecting more profitable products. In the US, for example, the ratio of farm output to farm input prices declined annually by 1.4 percent during 1961-2016 (Figure 7.2). Yet, total factor productivity (TFP) grew by 1.4 percent during this period. In Germany, a combination of more efficient use of inputs and increasing TFP kept farm output stable during 1961-2016 (Figure 7.3). Because the number of farmers in Germany declined over time, the income per farmer grew even if total output remained unchanged. Thus, an increase in TFP and a reduction in input use made it possible for farmers around the world to keep growing despite the price disparity.

Figure 7.2. US: Price Disparity and Agricultural TFP, 1961-2016



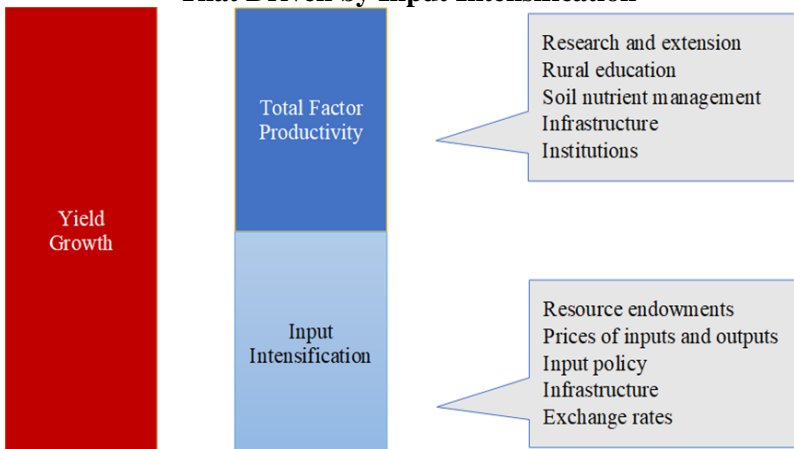
Source: World Bank using data from the US Department of Agriculture.

Figure 7.3. Germany: Input, Output, and TFP Changes, 1961-2016



Source: World Bank using data from the US Department of Agriculture.

Figure 7.4. Growth Driven by TFP is More Sustainable Than That Driven by Input Intensification



Source: World Bank.

Productivity expansion is crucial for agricultural growth. The growth in TFP comes from the knowledge gained to use inputs better, grow better varieties, and connect better to markets. This, in turn, requires investments in agricultural research and development (R&D) and other public goods such as extension, education, infrastructure, and institutions. This is the link between growth and public expenditures.

Having the right level and mix of public expenditures is critical for helping farmers. Several lessons are relevant.

Lesson 1: Public expenditures matter for agricultural growth. A study of ten Latin American countries found that a 10 percent increase in agricultural public expenditures lifted agricultural growth by 0.6 percent during 1985–2000.² The rationale for public investments derives from two fundamental sources: economic inefficiencies resulting from market failures and inequalities in the distribution of goods and services. The benefits from public goods for agriculture, which stimulate growth, can be grouped into four pathways:

- **Generating technology:** Investments in R&D are among the most important public goods and a critical component of agricultural public spending. The returns to R&D include benefits not only to the farm sector but also to the food industry and consumers in the form of more abundant food at lower prices. The private sector tends to underinvest in agricultural R&D, requiring governments to correct this market failure.
- **Disseminating knowledge and building more human capital:** Human capital-enhancing effects can be associated with public spending on extension, training, and information services that transfer knowledge and skills to those engaged in farming.
- **Reducing transaction costs:** Rural roads are a critical element of public infrastructure for agricultural growth. Similarly, institutional investments to overcome barriers to collective action and reduce transaction costs to improve collection, storage, input and output quality control, and price information can optimize supply chain management.
- **Attracting private capital:** The crowding-in effects of agricultural public spending on private capital come about to the extent that public and private investments are complements in production. Examples are public investment: in (i) large irrigation infrastructure such as dams and canals, which then make it profitable for farmers to make small on-farm investments in water management and a wider range of production technologies; and (ii) input quality assurance systems, which help build farmers trust in quality of inputs, leading to higher demand and stronger response from their use.

Lesson 2: To generate long-term agricultural growth, spending on agriculture needs to be done in a fiscally responsible manner. Excessive agricultural public spending can lead to high budget deficits that can create various types of macroeconomic imbalances such as higher inflation and misaligned exchange rates, causing lower economic growth and weaker demand for farm products. Thus, expansion of agricultural public expenditures needs to be balanced with prudence and fiscal discipline.

Lesson 3: Not all public expenditures are productive. Many empirical studies find a low impact of aggregate spending on agricultural growth, implying that all investments are not equal.³ Governments sometimes spend on things that are not public goods, for example output and input subsidies and subsidized credit. In addition, even when clear failures exist in particular markets,

² López (2005): Why Governments Should Stop Non-Social Subsidies: Measuring the Consequences for Rural Latin America: University of Maryland at College Park, Revised version: February 4, 200.

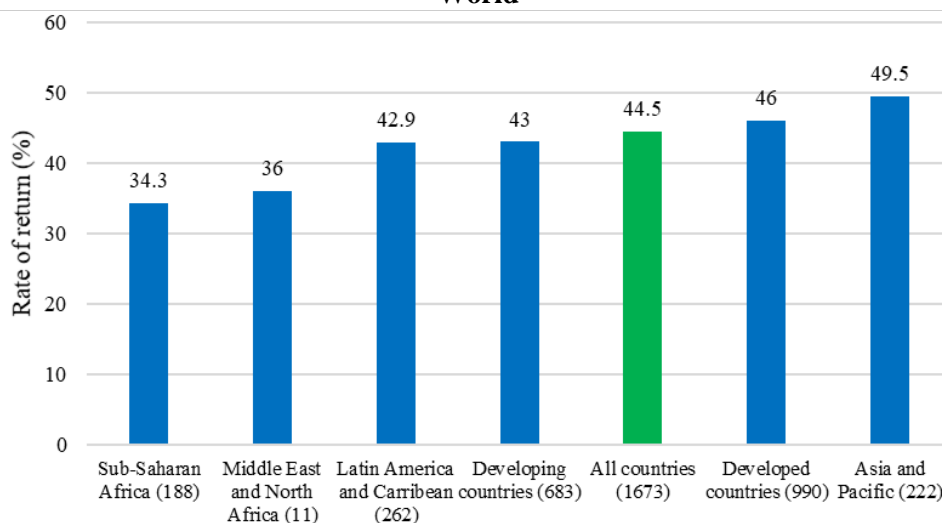
³ Mogues T., B. Yu, S. Fan and L. McBride (2012): The Impacts of Public Investment in and for Agriculture: Synthesis of the Existing Evidence. International Food and Policy Research Institute Discussion Paper 01217, Washington, D.C.

public spending will not necessarily improve the situation. Interventions can sometimes lead to government failures, which exacerbate original problems caused by market failures and produce unintended adverse effects.

The above-cited study of the ten LAC countries during 1985–2000 found that agricultural public spending on public goods was much more productive than public spending on private goods.⁴ The study found that reallocation of 10 percentage points of total public expenditures from subsidies to public goods increased per capita agricultural income by 2.3 percent. This was obtained without increasing total expenditures. Those impacts were significant mainly because they captured both the positive effect of increasing the budget for public goods and reducing the distortions created by subsidies, which negatively affected the quantity and quality of private investments.

Lesson 4: Public spending on agricultural R&D generates high rates of return around the world. The recent study found the rates of return of such investments to average 45 percent, showing high impacts in both developing and developed countries (Figure 7.5). No country in the world could generate long-term growth in agricultural TFP without such investments; they are key to increase yields, and to develop and support adoption of location-specific technologies in farm and off-farm segments of food value chains. Therefore, developed countries spend on average 2.5 percent of agricultural gross domestic product (GDP) on such investments, and many developing countries increasingly prioritize them over other spending.

Figure 7.5. Rates of Return of Agricultural R&D Investments Around the World



Source: IFPRI.⁵

Lesson 5: The economic composition of spending is critical for achieving high impacts. For example, when an entire budget for extension services is spent on salaries and there is no fuel for motorbikes and vehicles for farm visits, large spending on extension is not effective. Likewise,

⁴ López (2005): Why Governments Should Stop Non-Social Subsidies: Measuring the Consequences for Rural Latin America: University of Maryland at College Park, Revised version: February 4, 200.

⁵ IFPRI (2012): ASTI Global Assessment of Agricultural R&D Spending: Developing Countries Accelerate Investments. Washington, D.C.

inadequate spending on operations and management (O&M) for rural roads and irrigation investments reduces the economic value of these assets, leading to higher budget outlays in the longer run. The lesson from around the world is that the agricultural budget needs to be well balanced across subcategories (wages, nonwage recurrent, and capital expenditures) to make agricultural programs effective.

Lesson 6: Quality of implementation affects the outcomes of even justifiable public programs. When delivering public programs, attention needs to be given to: unit costs and value for money; implementers' capacity; a targeting strategy to identify and reach intended beneficiaries; collaboration of various departments within and between ministries; division of labor between central and local governments; and establishment and use of effective monitoring and evaluation. It is also important to pay attention to budget execution, which shows the absorption capacity of the government to utilize allocated funds.

Lesson 7: Investments in public goods combined with better policies and institutions bring about the highest results. Improvements in policy environment through trade and regulatory reforms augment public spending by enhancing incentives for producers and innovators to take advantage of public goods, thereby crowding in private investments. On the other hand, distortions such as input and output subsidies and credit subsidies usually crowd out private investments. A review of the drivers of agricultural growth in East Asia during its economic boom years found that policy and institutional reforms were the strongest contributors to agricultural growth and poverty reduction, outpacing investments in key public goods.⁶

The above global lessons provide a framework for thinking about growth and spending when conducting a review of public spending in agriculture. An adequate, fiscally prudent level of public expenditures, allocated to growth-inducing programs and implemented effectively, would help generate sustainable agricultural growth. Removal of policy constraints and strengthening of institutions would augment public spending. Yet increasing spending on agriculture without improvements in allocative and technical efficiency of public expenditures and in the unproductive agricultural policy environment would bring very little economic and social benefits.

AGRICULTURAL PUBLIC EXPENDITURES: GLOBAL DEVELOPMENTS

This section presents agricultural public expenditures in selected countries. We use the OECD's classification of functions by the government (COFOG). Agriculture spending by the government includes outlays on crops, livestock, fisheries, forestry, and irrigation. It does not include spending on rural development, although many ministries of agriculture have programs aiming at rural development. The comparator data we use covers both OECD and non-OECD countries ().⁷

⁶ World Bank (2017): Myanmar AgPER: Increasing the Impact of Public Spending on Agricultural Growth. World Bank Report AUS17689, Washington, D.C.

⁷ In 2016, in OECD countries the share of agriculture in GDP was on average 3 percent and farm employment 6 percent. For comparisons, in non-OECD countries these figures were 7 percent and 17 percent.

Table 7.1. GDP per Capita in 2018 in Current US Dollars and in PPP US Dollars

OECD Countries			Non-OECD Countries		
	Current US\$	PPP (current international \$)		Current US\$	PPP (current international \$)
Australia	57,374	51,663	Brazil	8,921	16,096
Canada	46,233	48,130	China	9,771	18,237
Chile	15,923	25,223	Colombia	6,668	15,013
EU	36,570	43,738	Costa Rica	12,027	17,671
Japan	39,290	42,797	Israel	41,715	39,919
Korea	31,363	40,112	Kazakhstan	9,813	27,880
Mexico	9,673	19,845	Philippines	3,103	8,951
New Zealand	41,945	41,005	Russia	11,289	27,147
Turkey	9,370	28,069	South Africa	6,374	13,687
USA	62,795	62,795	Ukraine	3,095	9,233
			Vietnam	2,567	7,448

Source: World Bank World Development Indicators.

Over time, GDP growth in OECD countries has exceeded the growth in agricultural public expenditures. Total agricultural public expenditures increased from \$76 billion in 1986-88 to \$163 billion in 2015-17 (Table 7.2). As GDP grew faster, the share of agricultural public expenditures to GDP declined more than by half during 1986-2017, although the total level of spending more than doubled in nominal terms. In 1986-88 the agricultural public expenditures averaged 0.40 percent of GDP, while in 2015-17 it amounted to only 0.18 percent. The share of agricultural public expenditures in gross agricultural output (GAO) remained stable at 14 percent.

Table 7.2. OECD Countries: Level of Agricultural Public Expenditures, 1986-2017

	1986-88	1995-97	2015-2017
Agricultural public expenditures, nominal \$ billion	76	123	163
in percent of GDP	0.40	0.31	0.18
in percent of GAO	13.8	16.7	14.2

Source: OECD.

The reduction in the share of agricultural public expenditures in GDP has also been observed in non-OECD countries. They, as a group, reduced agricultural spending from 0.97 percent of GDP in 1995-97 to 0.71 percent of GDP in 2015-17 (Table 7.3). Without China, which spends more on agriculture than other non-OECD countries, the decline was even bigger, from 0.89 percent to 0.34 percent. Non-OECD farmers depend less on public support than OECD farmers as reflected in the low share of agricultural public expenditures in GAO. This is especially true when China is excluded from the aggregate numbers.

Table 7.3. Non-OECD Countries: Level of Agricultural Public Expenditures, 1995-2017

	1995-97	2015-2017
Agricultural public expenditures, nominal \$ billion	28 [16]	118 [18]
in percent of GDP	0.97 [0.89]	0.71 [0.34]
In percent of GAO	1.7 [11.1]	6.6 [4.4]

Source: OECD.

Note: Figures in parenthesis are without China.

Agricultural public expenditures vary by country. Among the non-OECD countries, which are more suitable peers for Uzbekistan, agricultural public expenditures in GDP ranged from 0.1 percent of GDP in Israel to 0.8 percent in China in 2017 (Table 7.4.). In terms of GAO, the lowest dependency of farms on budget support is in Costa Rica and the largest dependency in Kazakhstan. As with the OECD countries, the share of agricultural support in the non-OECD countries has declined over time. Most non-OECD countries spent more on agriculture in 1995-97 than in 2015-2017. For example, Russia spent 1.8 percent of GDP and Ukraine 1.2 percent.

Table 7.4. Non-OECD Countries: Agricultural Spending by Country

	% of public spending in GDP		% of public spending in GAO	
	1995-1997	2015-2017	1995-1997	2015-2017
Brazil	0.7	0.2	14.4	3.4
China	1.1	0.8	0.7	7.2
Colombia	0.4	0.3	3.6	4.7
Costa Rica	0.1	0.2	0.8	2.0
Israel	0.4	0.1	11.2	5.5
Kazakhstan	0.1	0.9	0.4	10.0
Philippines	0.4	0.6	3.2	6.2
Russia	1.8	0.3	18.1	6.9
South Africa	0.4	0.2	6.3	2.8
Ukraine	1.2	0.3	4.8	2.7
Vietnam	1.0	0.4	4.0	2.6

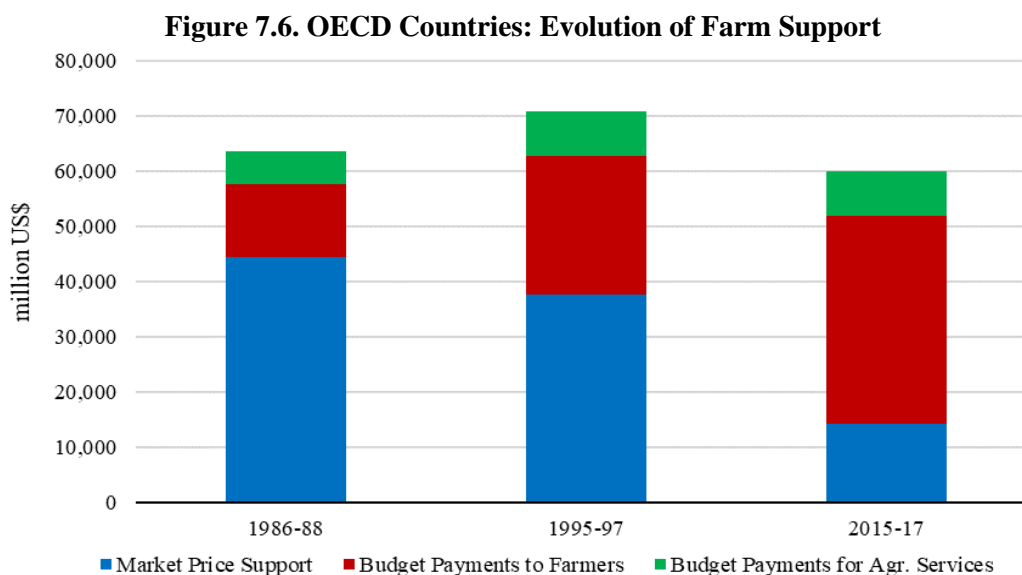
Source: OECD.

Agricultural support instruments can be divided into three groups. They are: market price support (MPS), direct payments to farmers (DPF), and general support services (GSS). In brief:

- MPS is paid by consumers. It represents the difference between domestic and international prices. When domestic prices are above international prices, due to import tariff or non-tariff barriers, MPS is positive. When domestic prices are below international prices, due to the fixed prices for example, MPS is negative. When MPS is negative, farmers face implicit taxation.

- DPF to farmers are paid by taxpayers. They can include: (i) payments based on outputs, inputs, capital investments, and on-farm services; (ii) coupled payments per hectare or animal; (iii) decoupled payments per hectare or animal;⁸ and (iv) other payments.
- GSS is also paid by taxpayers. They include: (i) agricultural knowledge and innovations; (ii) inspections and control; (iii) development and maintenance of infrastructure; (iv) marketing and promotion; (v) cost of public stockholding; and (vi) other programs.

In OECD countries, the importance of different support instruments has changed over time. Total weighted-average farm support decreased from \$64 billion in 1986-88 to \$60 billion in 2015-17 (Figure 7.6). The share of MPS accounted for 70 percent of total support in 1986-88, declining to 24 percent in 2015-17. It implies that domestic farm output prices have gradually declined to align with international prices. MPS was replaced by the increased spending on DPF, the share of which increased from 21 percent to 63 percent of total farm support. The share of GSS grew from 9 percent to 14 percent.



Source: OECD.

Notes: 1/ Figures are weighted averaged by GAO.

2/ The sum of total agricultural budget can be found in Table 7.2.

The structure of DPF includes a mix of measures, importance of each item has also changed over time. In 1986-88, 38 percent of the weighted-average DPF budget was spent on output and input subsidies (Table 7.5). In 2015-17 the share of these payments dropped to 11 percent. These subsidies were replaced by decoupled payments per hectare or animal. Decoupled payments are less distortive than payments for inputs and outputs and coupled payments because they allow farmers to respond to market opportunities rather than respond to the government decisions. They can be considered as income support payments. That is why the OECD countries made these

⁸ Coupled payments require production of subsidized product, while decouple payment does not require production of specific product. Farmers can produce what they and market want while receiving decoupled payment for compliance with good agricultural practices, for example, as in the EU.

changes. In addition, the OECD countries continued spending on capital formation and on-farm services, e.g. two programs with the largest impact on structural transformation. In 1986-88, when farms were less capitalized, the share of these programs was 20 percent, and in more recent years (2015-17), the share of these payments declined to 14 percent.

Table 7.5. OECD Countries: Evolution of the Structure of Direct Payments to Farmers
(in percent)

	1986-1988	1995-1997	2015-2017
Payments based on output	22	9	3
Payments based on variable input use	16	13	8
Payments for fixed capital formation	13	9	8
Payment for on-farm services	7	7	6
Payments per hectare or animal (coupled)	38	52	34
Payments per hectare or animal (decoupled)	1	7	39
Payments based on non-commodity criteria	2	4	2

Source: OECD.

The structure of GSS has also evolved over time in response to the needs of farmers and the society. The OECD countries increased spending on GSS programs as these investments have empirically shown the high rates of economic return (recall Figure 7.5). They boosted investments in agricultural R&D and extension/advisory services (knowledge and innovations), the share of which grew from 18 percent in 1986-88 to 31 percent in 2015-17 (Table 7.6). Development and maintenance of infrastructure remains important, accounting for 45 percent of total GSS budget in 2015-17, but it dropped from its peak in the 1990s. With consumers paying more attention to quality, safety and sustainability of farm and food products, the OECD countries invested more in inspections & control and marketing & promotion, while phasing out strategic food reserves, which became obsolete with the growing income of population, open markets, and changed focus in attaining food security from supply of food to food utilization, food safety, and price stability.

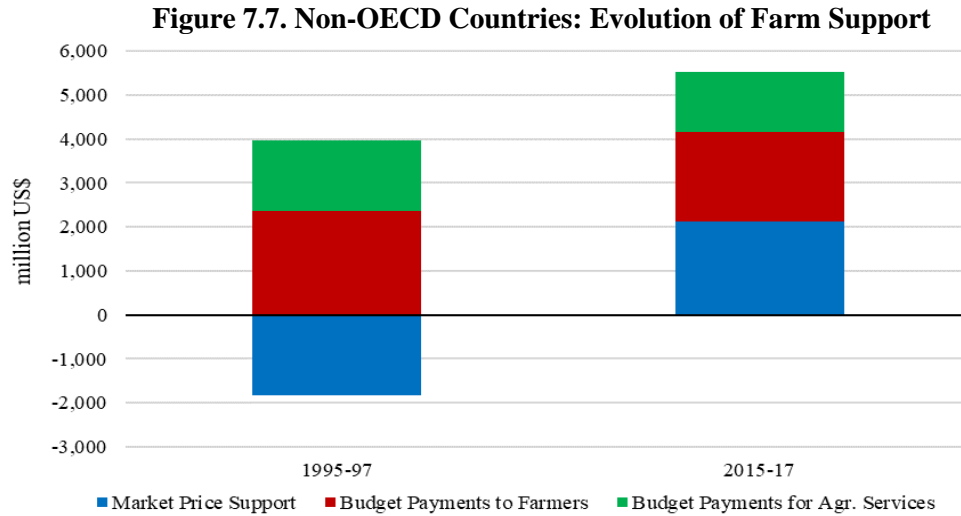
Table 7.6. OECD Countries: Evolution of the Structure of General Support Services
(in percent)

	1986-1988	1995-1997	2015-2017
Agricultural knowledge and innovations	18	18	31
Inspections and control	4	4	9
Development and maintenance of infrastructure	41	54	45
Marketing and promotion	9	12	10
Cost of public stockholding	23	8	1
Miscellaneous	5	4	4

Source: OECD.

In non-OECD countries, the farm support instruments have also evolved over time, with even more dramatic changes than in OECD countries. In 1995-97, farmers in non-OECD countries (without China) were implicitly taxed and their MPS was negative (Figure 7.7). In 2015-17 they switched from taxing farmers to supporting farmers by high prices, the same as in OECD. The weighted-average MPS changed from \$2 billion tax in 1995-97 to \$2 billion support in 2015-17. Total farm support consisted of 39 percent of MPS, 37 percent of DPF, and 24 percent of GSS

in 2015-2017. Note that the share of MPS in total farm support in non-OECD countries (39 percent) significantly exceeded such a share in OECD countries (24 percent).



Source: OECD.

Note: Figures are weighted averaged by GAO.

Regarding the DPF, non-OECD countries in 2015-17 resembled the OECD countries in 1996-98. They spent a lot of funds on payments based on variable input use and did not provide decoupled payments (Table 7.7 7.7). But they spent a lot of funds on promoting fixed capital formation to accelerate structural change and moved to per hectare/animal coupled payments, which are less distortive than payments based on output.

Table 7.7. Non-OECD Countries: Evolution of The Structure of Direct Payments to Farmers
(in percent)

	1995-1997	2015-2017
Payments based on output	11	7
Payments based on variable input use	49	36
Payments for fixed capital formation	33	40
Payment for on-farm services	2	3
Payments per hectare or animal (coupled)	1	11
Payments per hectare or animal (decoupled)	0	0
Payments based on non-commodity criteria	4	2

Source: OECD.

In 2015-17, non-OECD countries spent almost half of GSS budget on agricultural knowledge and innovations. In 1995-97 this share was only 30 percent (Table 7.8 7.8). This is the sign of the increased recognition of the role agricultural knowledge and innovations play in increasing TFP and

strengthening food value chains. Over time, more funds were also being spent on inspections and control, while less on infrastructure and *ad hoc* miscellaneous programs.

**Table 7.8. Non-OECD Countries: Evolution of the Structure of
General Support Services**
(in percent)

	1995-1997	2015-2017
Agricultural knowledge and innovations	30	47
Inspections and control	5	9
Development and maintenance of infrastructure	40	33
Marketing and promotion	1	2
Cost of public stockholding	7	5
Miscellaneous	16	5

Source: OECD.

The key conclusions from analyzing agricultural public expenditures in OECD countries are:

- Agricultural public expenditures are growing in nominal terms, but they are low and declining in relative terms. Average agricultural budget in 2015-17 accounted for 0.2 percent of GDP and 14.0 percent of GAO.
- Over time farm support became less distortive by moving from MPS, input and output subsidies and coupled payments to decoupled income payments and general support services.
- Recognizing the role of government to strength capacity and skills of farmers, about 7 percent of DPF was spent on on-farm services that reduce the cost of technical assistance, accounting, marketing, sanitary and phytosanitary measures, and training.

The key take-aways from analyzing agricultural public expenditures in non-OECD countries are:

- Very few countries left in the world which tax farmers through low prices.
- Average agricultural budget in 2015-17 (without China) accounted for 0.7 (0.3) percent of GDP and 6.6 (4.4) percent of GAO.
- Agricultural budget is well balanced between DPF and GSS. Spending on output and input subsidies declined, while more is being allocated to capital formation and direct coupled payments.
- About 3 percent of DPF is allocated to on-farm services.
- GSS is diverse, with increasing relative budget on knowledge & innovations and inspection & control and declining relative budget on infrastructure.

PUBLIC EXPENDITURES ON AGRICULTURE IN UZBEKISTAN

Agricultural programs in Uzbekistan are executed and financed by many ministries and agencies. In 2017, the Ministry of Agriculture and Water was split in two ministries, namely Ministry of Agriculture (MOA) and Ministry of Water Resources (MOWR), and during that split many MOA departments became separate agencies, committees, and inspections. This AgPER covers the public expenditures executed by MOWR, MOA, MOF (State Fund for Agricultural

Support), Cabinet of Ministers (Veterinary Committee and State Plant Quarantine Inspection), Ministry of Innovative Development and Ministry of Education (research and education), and other state institutions. The agricultural public expenditures include tax expenditures/exemptions. The review period is from 2016 to 2018.

In nominal terms, the agricultural budget increased by 45 percent during 2016-2018. It was 5.0 trillion Soms in 2016 and 7.2 trillion Soms in 2018 (Table 7.9). But in real terms, adjusted for inflation, it stayed flat. In US\$ it even declined, following the liberalization of exchange rate in 2017. As a share of GDP, it averaged 2 percent, which 10 times more than the average spending as a share of GDP in OECD countries and 3 times more than in non-OECD countries. On Figure 7.8. Uzbekistan stands out as the largest spender on agriculture. As a share of GAO, the agricultural budget averaged 3 percent, showing the low dependency of farms on public support. The above estimates for Uzbekistan do not even include projects supported by development partners, which amounted \$2.5 billion (or 21 trillion Soms) and which are discussed later.

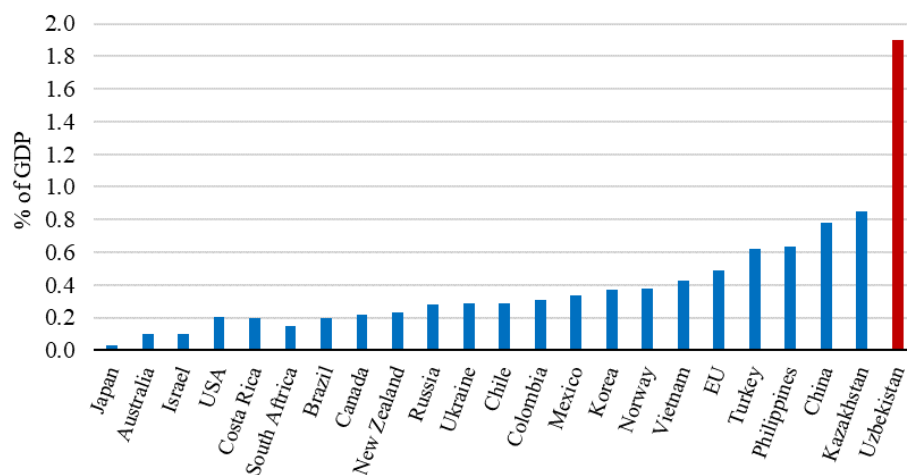
Table 7.9. Uzbekistan: Level of Agricultural Public Expenditures, 2016-2018

	2016	2017	2018
Agricultural public expenditures, nominal billion Soms	4,982	5,663	7,225
Agricultural public expenditures, real billion Soms	4,982	4,585	4,992
Agricultural public expenditures, nominal million \$	1,542	710	881
in percent of GDP	2.1	1.9	1.8
In percent of GAO	2.6	2.9	3.6

Source: World Bank using the MoF data.

Note: Average inflation in 2016 was 8 percent, in 2017 was 12.5 percent and in 2018 was 18.4 percent. Exchange rate in 2016 was 3,231 Soms/\$, in 2017 was 8,120 Soms/\$, and in 2018 was 8,201 Soms/\$.

Figure 7.8. Agricultural Public Expenditures in Selected Countries, 2017
(in percent of GDP)



Source: OECD and MoF.

As the above analysis shows, public expenditure is only one part of farm support, another part is MPS. Uzbekistan is one of the very few countries, who still has a negative MPS caused by the low fixed state procurement prices for cotton and wheat (see Table 7.17 with details of MPS calculation). This negative MPS almost fully negates the impact of public expenditures. In 2016, public expenditures, along with tax expenditures, amounted to 4,982 billion

Soms (Table 7.10). But effective farm support was only 1,791 billion Soms. In 2017, MPS even exceeded public expenditures.

Table 7.10. Uzbekistan: Estimates of Farm Support, 2016-2018

	2016	2017	2018
MPS (cotton and wheat)	-3,191	-10,987	-6,890
DPF (direct payments to farmers)	506	614	866
GSS (general support services)	4,407	5,049	6,192
Tax expenditures/exemptions	69	104	167
Total (billions of Soms)	1,791	-5,220	335

Source: World Bank using the MoF data.

Most public expenditures are allocated to GSS, largely for irrigation and drainage. In 2018, GSS accounted for 86 percent of agricultural public expenditures. DPF accounted for 12 percent and tax expenditures accounted for the remaining 2 percent.

The largest share of funds is being executed by MOWR, which implements irrigation and drainage programs. In 2018, MOA was only the third largest ministry in terms of agricultural budget, trailing behind MOWR and MOF (Table 7.11).

Table 7.11. Uzbekistan: Agricultural Public Expenditures by Ministry

	2016	2017	2018
MOWR	3,036	3,419	4,100
MOA	733	848	655
MOF	231	317	766
Cabinet of Ministers (Veterinary and Plant Quarantine)	0	0	289
Forestry	52	59	69
Research and Education (various ministries)	400	492	410
Other (various ministries)	462	528	732
Total	4,913	5,663	7,058

Source: World Bank using the MoF data.

There are only two kinds of DPF in Uzbekistan. The first is the payments to farmers producing cotton and wheat on low-fertility soils for the state procurement. The second is the subsidized credit (working capital advance at the concessional interest rate) for producers of cotton and wheat under the state procurement system. Regarding the subsidized credit, farmers only benefit from the concessional interest rate, while credit principle must be repaid.⁹ These two payments equaled 506 billion Soms in 2016 and 866 billion Soms in 2018 (Table 7.12). These payments accounted for all support under DPF, which starkly contrast the DPF structure in IOECD and non-OECD countries.

⁹ The benefit to farmers is estimated as loan amount multiplied by interest rate difference (20percent-3percent) and adjusted for 8 months of using the loan (8/12).

Table 7.12. Uzbekistan: Evolution of the Structure of Direct Payments to Farmers

	Uzbekistan, billion Soms			Uzbekistan,	OECD,	Non-OECD,
	2016	2017	2018	percent	percent	percent
Payments based on output				0	3	7
Payments based on variable input use	506	614	866	100	8	36
Payments for fixed capital formation				0	8	40
Payment for on-farm services				0	6	3
Payments per hectare or animal (coupled)				0	34	11
Payments per hectare or animal (decoupled)				0	39	0
Payments based on non-commodity criteria				0	2	2
Total	506	614	866	100	100	100
in percent of GDP	0.2	0.2	0.2			

Source: World Bank using the MoF and OECD data.

Subsidized credit is provided to cotton and wheat farmers by the State Fund for Agricultural Development under the MOF. In 2016, the total credit amounted to 2.2 trillion Soms (\$683 million). In 2018, it grew to 6 trillion Soms (\$728 million), and in 2019 it is projected to increase to 11 trillion Soms (\$1,258 million). The key problem with the current arrangement is the foregone opportunity for commercial banks to earn on lending to cotton and wheat producers and build business relations with them. Moving to a more market-oriented system, when commercial banks provide credit while an interest rate difference is financed by the national budget, would take time to address liquidity constraints.

Similarly, to DPF, GSS in Uzbekistan are heavily skewed towards one program: development and maintenance of irrigation infrastructure. This program accounted for 71 percent of total GSS budget during 2016-2018 (Table 7.13), which is twice as much than the averages for OECD and non-OECD comparators. Only 10 percent of GSS budget was spent on agricultural knowledge and innovations. Spending on agricultural research and education in 2018 was only 0.02 percent of GAO, in contrast with 1 percent for developing countries and 2.5 percent for developed countries. There was no budget for marketing and promotion for agriculture.

Table 7.13. Uzbekistan: Evolution of the Structure of General Support Services

	Uzbekistan, billion Soms			Uzbekistan,	OECD,	Non-OECD,
	2016	2017	2018	percent	percent	percent
Agricultural knowledge and innovations	399	492	448	10	31	47
Inspections and control	309	346	332	7	9	9
Development and maintenance of infrastructure	3,160	3,598	4,471	71	45	33
Marketing and promotion	0	0	0	0	10	2
Cost of public stockholding	0	0	0	0	1	5
Miscellaneous	539	621	951	12	4	5
Total	4,407	5,049	6,192	100	100	100
in percent of GDP	1.8	1.7	1.5			

Source: World Bank using the MoF and OECD data.

Spending on irrigation and drainage (I&D) alone accounted for 1.3 percent of GDP in 2016-2018. This is a large amount in terms of GDP for Uzbekistan and for any country in the world. But a big challenge is that the current level of expenditures falls short of the expected requirements for both capital and recurrent expenditures. The level of capital expenditures is also below

international standards. More than a third of I&D budget is spent on covering electricity cost of water pumping (Table 7.14). Continued underinvestment into I&D infrastructure and management would eventually lead to progressively higher losses of irrigated land.

Table 7.14. Uzbekistan: Irrigation and Drainage Budget

	2016	2017	2018
Capital investments in irrigation	500	443	731
Capital investments in drainage	404	454	541
O&M	2,105	2,483	2,804
including the cost of electricity	1,292	1,489	1,592
Total (billions of Soms)	3,009	3,380	4,076
in percent of GDP	1.2	1.1	1.0

Source: World Bank using the MoF data.

The current level of capital expenditures has been too low to start modernization of irrigation and drainage infrastructure and management. The actual capital I&D investments in 2018 were 1,274 billion Soms or \$35/ha, assuming the irrigated area of 4.2 million ha (Table 7.14). Requirement is to spend at least \$250/ha without irrigation modernization. To secure reliable, adequate, and flexible irrigation water supply, the capital investments would need to increase to \$1,400/ha, and the modernization of the entire I&D infrastructure over 2015-2030 would cost between \$5.5 billion and \$16 billion. More is also required for O&M spending. Actual budget (without electricity cost) is \$40/ha, while the requirement is \$80/ha.

In addition to public expenditures (DPF and GSS), agriculture benefits from tax expenditures. In 2016, tax expenditures for agriculture equaled 69 billion Soms (Table 7.15 7.15). In 2018, this figure grew to 667 billion Soms, or 0.04 percent of GDP and 1.1 percent of total tax expenditures in Uzbekistan. Major agricultural tax expenditures were aimed at reducing the cost of hiring cotton pickers and promoting water-saving technologies.

Table 7.15. Uzbekistan: Tax Expenditures in Agriculture

	2016	2017	2018
Exemption from including social fees in wages of cotton pickers	0	12.7	326.2
Exemption from income tax of individuals picking cotton	66.9	100.8	163.1
Exemption from mandatory social insurance deductions for cotton pickers	0	0	173.9
Exemption from taxes of adopters of water saving technologies	1.6	3.2	3.8
Exemption from taxes for multipurpose farms	0	0	0
Total (billion Soms)	68.5	116.7	667.0
in percent of GDP	0.03	0.03	0.04

Source: World Bank using the MOF and State Tax Committee data.

At last, agriculture also benefits from projects financed by international organizations. They are recorded separately from national public expenditures, and in many cases implemented separately from the national programs. As a result, the lessons learned from many innovative projects do not trickle down to technical departments in MOA and MOWR. As of early 2019, total budget of ongoing agricultural projects was \$2.5 billion (Table 7.16). Further \$862 million were in pipeline for preparation. Most funds are used for projects in horticulture and livestock subsectors, and in irrigation, and many of them finance credit lines. It is not possible at this moment to estimate annual budget allocations for these projects, especially for credit lines with

concessional interest rates, to add them to the public expenditures financed from the national budget, but they may constitute significant resources benefiting agriculture in Uzbekistan.

Table 7.16: Uzbekistan: Donor-Financed Support To Agriculture

Functional breakdown	Ongoing projects	Project in pipeline
Irrigation and drainage	845	0
Horticulture	1,153	297
Livestock	379	100
Regional initiatives	49	0
Other functional areas	58	465
Total (millions of US dollars)	2,485	862

Source: World Bank using the EU estimates.

POLICY OPTIONS

Large agricultural support in Uzbekistan has not led to solid development outcomes, even though Uzbekistan’s public expenditures on agriculture as a share of GDP are three times larger than most non-OECD countries and ten times more than most OECD countries. The proposed recommendations aim to help the authorities achieve better results:

- Align domestic farm-gate prices for cotton and wheat with world market prices to eliminate the negative MPS and ensure that public expenditures can generate impacts on the ground.
- Develop a strategy for modernization of irrigation and drainage infrastructure and management in a cost-effective manner to reduce a long-term budget for this purpose.
- Expand a menu of DPF measures from mainly credit lines to support fixed capital formation through matching grants (not credit), the use of on-farm services, and adoption of climate-smart technologies (the EU-type cross-compliance) to accelerate structural transformation.
- Increase significantly the public expenditures for GSS programs, especially for agricultural R&D and extension/advisory services to drive TFP growth. These programs require not only more budget but better human capacity to effectively deliver services to farmers and agribusinesses.
- Reduce the “miscellaneous” programs by avoiding ad hoc programs and using more strategic budget planning and management.

Table 7.17: Uzbekistan: MPS Estimates

	2016	2017	2018
Cotton			
Raw cotton production, tons	2,842,196	2,900,200	2,465,170
Domestic cotton price, Soms/ton	1,218,000	1,880,000	3,250,000
Export parity price of cotton, Soms/ton	1,760,734	4,734,766	4,723,666
Price difference, Soms/ton	-542,734	-2,854,766	-1,473,666
MPS for cotton, millions of Soms	-1,542,555	-8,279,392	-3,632,836
Wheat			
Wheat production, tons	6,940,000	6,900,000	6,000,000
Wheat output for the state procurement, tons	2,761,000	2,850,000	3,102,000
State procurement wheat price, Soms/ton	503,000	550,000	750,000
Market wheat price, Soms/ton	1,100,000	1,500,000	1,800,000
Price difference, Soms/ton	-597,000	-950,000	-1,050,000
MPS for wheat, millions of Soms	-1,648,318	-2,707,500	-3,257,100
Total MPS, millions of Soms	-3,190,873	-10,986,891	-6,889,936

Source: World Bank using the data from the State Statistics Committee, MOA, and MOF.

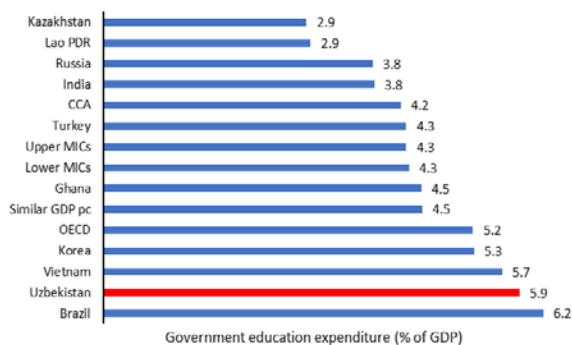
Spotlight 2. Education Expenditures

Uzbekistan spends more on education than regional and income peers. Given the country's substantial share of prime working age population, improving the efficiency of government education spending is part of the challenge of raising education outcomes to bolster human capital and create productive jobs.

Education at all levels in Uzbekistan is undergoing substantial change. Reforms aim to expand access to preschool education and restructure the general secondary and secondary specialized education. By 2021, the government aims to reach 100 percent enrollment in preschool education for students ages 5-7. The government is revamping general secondary education (GSE) to that students have 11 years of compulsory education and the choice of three pathways.

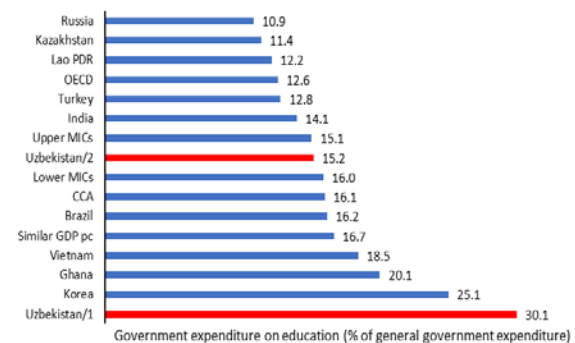
Lack of consistent data on education achievements does not allow the authorities to make a connection between spending on education and outcomes. While some assessments of student outcomes do take place in the country, these are not done under a standardized and systematic approach, so their results cannot be compared over time. Thus, it is not possible to tell whether quality is improving based on the results of current national assessments. The State Inspection for Supervision of Quality of Education (SISQE) has been tasked with improving Uzbekistan's student assessments since May 2018.

Figure S2.1. Government Education Spending, 2018
(in percent of GDP)



Source: World Bank, Uzbekistan authorities, and UNESCO Institute for Statistics (<http://uis.unesco.org/>)
Note: For Uzbekistan, using actual 2018 GDP.

Figure S2.2 Government Education Spending, 2018
(in percent of budget expenditures)



Source: World Bank, Uzbekistan authorities, and UNESCO Institute for Statistics (<http://uis.unesco.org/>)
Note: For Uzbekistan, using actual 2018 GDP.
1/ Relative to the budget spending.
2/ Relative to the consolidated spending.

Uzbekistan's education spending is one of the highest in the world. Government education spending amounted to 5.4 percent of GDP in 2017 and 5.9 percent in 2018, more than in Kazakhstan, Russia, Turkey, countries with similar incomes, regional peers, and the OECD (Figure S2.1). About a third of the government budget is dedicated to education, an amount little changed over the last decade and, again, one of the highest in the world (Figure S2.2). Even relative to

consolidated government expenditures that are twice as large as the government budget – education outlays amount to about 15 percent of total spending. This is more than the average for Europe and Central Asia (11 percent) and the OECD (13 percent).

There are multiples possible explanations for the high public spending on education in Uzbekistan compared to other countries in the region. These explanations relate to the modalities of service delivery, limited participation of private providers, and previous policies on secondary specialized and higher education. While a detailed analysis of the public spending on education is planned for 2020, existing data already shows that:

- Regarding modalities of service delivery, the full-day preschool model, which was exclusively provided in Uzbekistan until the introduction of the half-day model in 2013, was very expensive and a clear barrier to access.
- Concerning private provision, there were very few private preschools, general secondary education schools and universities in Uzbekistan until 2017. This situation changed only recently in preschool education with the ongoing reforms to expand service provision.
- On previously implemented policies, vocational education and training was the single or the most important path for more than 1.3 million students until 2017, which made Uzbekistan’s vocational system large and expensive (a system with more than 120,000 teachers and 1,400 vocational colleges). Given the barriers to higher education because of government quotas, such large and expensive vocational education system was fundamental for many students until the start of the reforms in 2017.

The bulk of education spending – about three-fourths – is for general secondary and secondary specialized education. Even with the recent expansion of secondary education to 11 mandatory years, almost all enrolled students complete secondary education. Just a tenth of them, however, continue to higher education, one of the lowest shares among regional peers and the OECD countries. A more granular analysis of the spending on higher education adjusted for the number of students is likely to show the system’s inefficiencies.

It is difficult to assess whether education spending translates into learning outcomes. At the preschool education level, the Ministry of Preschool Education (MPSE) does not assess children’s development or their readiness for primary education. In GSE, there are no early literacy assessments in Uzbekistan to indicate how well the education system supports literacy in the first years of education. While the Ministry of Public Education (MoPE) regularly conducts national examinations in grades 4 and 9, the results are not comparable across schools and over time because these assessments are not standardized. In fact, the MoPE does not conduct any sample-based standardized assessments under a systematic approach. Additional exams are organized by the SISQE, but results are not used to inform instruction or policy making. Furthermore, Uzbekistan has not participated in any large-scale international assessments such as PISA, the Progress in International Reading Literacy Study (PIRLS), or the Trends in International Mathematics and Science Study (TIMSS) yet, which makes it impossible to compare the performance of its students with those in other countries.

The limited data that are currently available suggest that the quality of GSE and learning outcomes of students at this level remain variable and inequitable. Although enrollment levels in GSE are roughly on par with OECD countries and gender parity has mostly been achieved, measurement of the quality of learning outcomes at this level remains a major challenge. The best available measure of learning outcomes in GSE in Uzbekistan is the National Assessment of Learning Outcomes of Primary School Graduates (NALOPSG), which was applied to grade 4 students in 2013. With the caveat that the NALOPSG was not a standardized assessment of learning outcomes, its results showed that on average, grade 4 students were not able to correctly respond to at least 50 percent of the tested content in native language and reading. This signals a potentially significant shortcoming of the education system as well as a barrier to acquisition of higher-order skills that require proficiency in reading and language. More in-depth analysis is needed based on current data to understand the nature and causes of this learning deficiency. In mathematics, on the other hand, students were able to respond correctly to at least 50 percent of the content tested on average. In the same assessment, urban students consistently outperformed their peers from rural schools in all subjects tested. For mathematics, reading, and native language, students in urban areas scored higher than the average, whereas students in rural areas scored lower than the average.

The lack of reliable data on student learning outcomes makes measurement of human capital development in Uzbekistan challenging. Investment in human capital are increasingly important as the nature of work evolves in response to rapid technological change. Existing evidence shows that in Vietnam, for example, workers able to perform nonroutine analytical tasks earn nearly 25 percent more than those who cannot. By improving their skills, health, knowledge, and resilience—their human capital—people can be more productive, flexible, and innovative. The changing nature of work makes firms demand workers with higher levels of human capital, especially advanced cognitive and socioemotional skills. The government is committed to joining the World Bank’s Human Capital Project as one of its early adopters. However, the first measurement of the Human Capital Index, which is a component of the Human Capital Project, does not include Uzbekistan, given the absence of data on student learning outcomes.

Uzbekistan recently signed an agreement on the country’s participation in PISA 2021 and in the Teaching and Learning International Survey (TALIS). The former decision represents a government commitment to assessing student learning outcomes and using that information to inform policy. TALIS asks teachers and school leaders about working conditions and learning environments in their schools. Although not a direct measurement of learning outcomes, TALIS will provide critical information to the MoPE on important determinants of learning.

Improving the efficiency of education will help improve the quality of human capital and boost Uzbekistan’s growth potential. Some of the options to consider include:

- Developing adequate measurements of education outcomes to help assess whether students are learning and whether the substantial fiscal resources are spent efficiently and effectively. The country is on track to produce reliable data to measure the quality of education for the first time in history.
- Enrolment in secondary education is nearly universal and completion is also nearly universal, as there is no “grade repetition” in Uzbekistan. Enrolment in higher

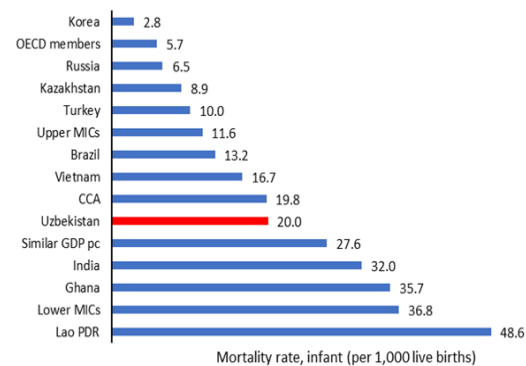
education, however, is very low at about 10 percent. The key question is whether government resources are optimally allocated between universal secondary education and tertiary education, given the demand of a modern economy.

Spotlight 3. Health Expenditures

Uzbekistan’s health outcomes and government health spending are similar to those of its regional and income peers. Stunting is still high. Given the country’s substantial share of prime working age population, keeping adults healthy is also a key requirement for bolstering human capital and boosting productivity.

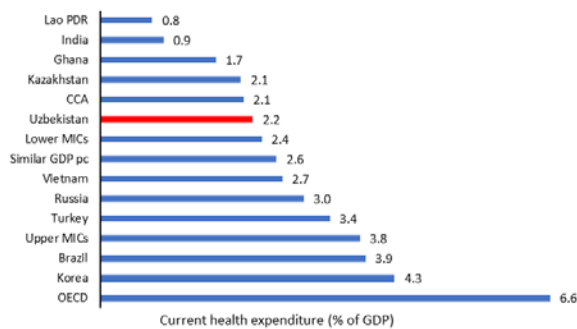
Uzbekistan has achieved significant improvements in key health outcomes. Life expectancy at birth increased from 69.7 years in 1990 to 73.5 years in 2014 and compares with 77.9 years in the EU. Infant mortality declined from 59.4 deaths per 1000 live births in 1990 to 20 deaths in 2017. Uzbekistan’s indicator on infant mortality is in line with the average for countries of the Caucasus and Central Asia and countries with similar income per capita. Uzbekistan does lag Korea, Vietnam and Turkey, however, its aspirational comparators (Figure S3.1). Vaccination coverage is high,¹ but nutritional outcomes are poor, and prevalence of severe and moderate stunting is 20 percent. Growing burden of non-communicable diseases leads to 84 percent of premature deaths in Uzbekistan and presents new health challenges. Mortality from cardio-vascular diseases, cancer, diabetes or chronic respiratory disease between the ages of 30 and 70 was 29 percent in 2015, more than twice the average for EU countries.

Figure S3.1. Infant Mortality Rate Per 1000 Live Births, 2017



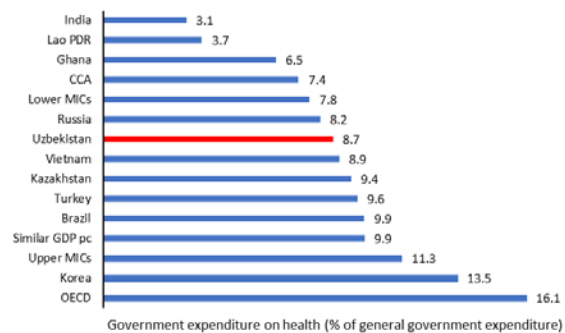
Source: World Development Indicators (2019).

Figure S3.2. Government Health Spending, 2018 (in percent of GDP)



Source: WHO Global Health Expenditure Database (2019)
 Note: For Uzbekistan 2018, for the other countries 2016

Figure S3.3. Government Health Spending, 2018 (in percent of budget spending)



Source: WHO Global Health Expenditure Database (2019)
 Note: For Uzbekistan 2018, for the other countries 2016

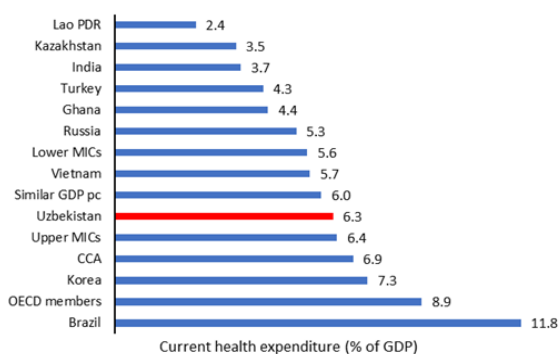
¹ Coverage of BCG, HepB3, DPT, Pol3, and measles was 99 percent in 2017 (WHO vaccine-preventable diseases: monitoring system 2018 global summary).

The Government’s program aimed at strengthening primary and preventive care has been recognized as a priority and its implementation is underway. However, curative care provided at hospitals and specialized outpatient facilities is still the dominant form of service delivery. New approaches to planning and financing are required to improve efficiency of the health care delivery system.

Government spending on health in Uzbekistan is not unlike that in lower middle-income countries and the average for the Caucasus and Central Asia. Both as a share of GDP and as a share of budget expenditures, health outlays are modest (Figure S3.2 and Figure S3.3). However, relative to the overall consolidated government spending, which is almost twice as large as on-budget expenditures, health outlays are well below any of the relevant comparators and closer to what India and Lao spend.

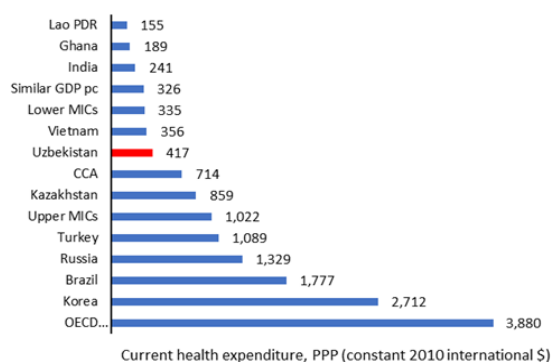
Largely due to higher spending by the government, overall health spending – both public and private – rose from 5.3 percent of GDP in 2007 to 6.3 percent in 2016. Overall health expenditures are little different from that in countries with similar incomes per capita and the upper middle-income countries (Figure S3.4). When measures in PPP terms, expenditure is little changed from the average for the Caucasus and Central Asia and closer to that average of lower middle-income countries in PPP terms (Figure S3.5).

**Figure S3.4. Total Health Spending, 2016
(in percent of GDP)**



Source: WHO Global Health Expenditure Database (2019)

**Figure S3.5. Health expenditure per capita,
2016
(in US dollars, PPP)**

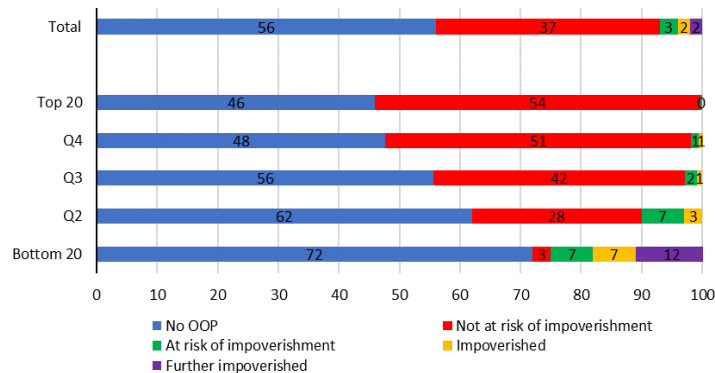


Source: WHO Global Health Expenditure Database (2019)

The share of private, out of pocket health spending is about half of the total health expenditures. Out of pocket payments (OOPs) represent a serious financial risk to the population. Concerns are increasing about the equity of healthcare services and its financing.

For households on social assistance, with disable members in the family or elderly over 65, the health care requires significant extra expenditure, which becomes impoverishing and represents a very significant source of vulnerability. About 7 percent of households from the bottom quintile face catastrophic health expenditures (more than 25 percent of their expenditures on health) and 3 percent of the population from the second quintile (Figure S3.7) are impoverished because of the catastrophic health expenditures (Carraro, Honorati et al., 2018).

Figure S3.6. Share of Households at Risk of Impoverishment Because of Health Expenditure by Quintile

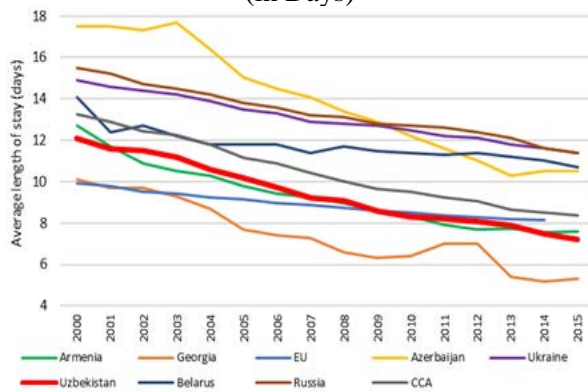


Source: Analysis of Listening to the Citizens of Uzbekistan 2018.

There is substantial room to improve the efficiency of the health system. Consider:

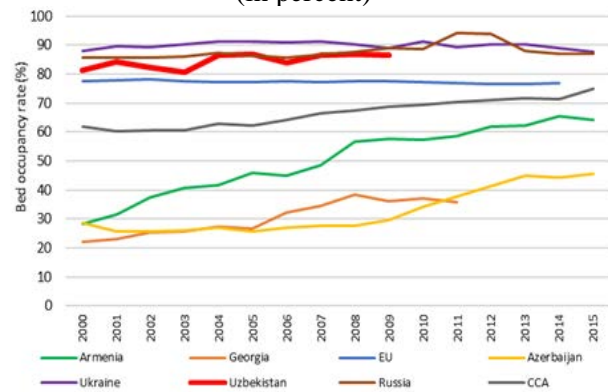
- Improving the quality and efficiency of health spending, and specifically on preventive care, is important to provide better and affordable health care to citizens. The healthcare system is still hospital centered with input-based financing, an extensive network of health facilities with heavy physical structure and staffing. On the positive side, while the average length of stay in hospitals is broadly similar to that in the EU, it is low compared to countries in the region other than Turkey (Figure S3.7). The bed occupancy rate is very high, which may indicate that patients are seeking care at later stages of illness, or that the population is being hospitalized for conditions that could be managed at the primary care level (Figure S3.8).
- In most cases, individuals seek outpatient care at the central regional hospitals. This allocation of resources is inefficient given that outpatient care at central hospitals is more expensive than at the primary care level. Preventive services also appear to be under-utilized.

Figure S3.7. Average Length of Stay, All Hospitals (in Days)



Source: WHO European Health for All (2019).

Figure S3.8. Bed Occupancy Rate, Acute Care Hospitals (in percent)



Source: WHO European Health for All (2019).

- The outpatient contacts per person were 9.7 in 2015, higher than in the EU on average. Further information is needed to understand the location (primary care level or hospital level) of those services. A shift in the health allocation way from hospital care to PHC will be needed, along with the appropriate per capita financing scheme, to improve the motivation for staff to deliver quality PHC services and adequate funds for basic medications and maintenance.
- The health management system has major challenges. Financing and organization of the health system still maintains the Semashko model, based on centralized planning of resources and personnel, primarily public ownership of health care facilities, input-based allocation of funds, and no clear provider-purchaser split. The Ministry of Health is responsible for the provision of services, while the Ministry of Finance and local authorities provide public funding from general revenues. Local authorities, financed by the central government, allocate budgets to health facilities using historical line-item budgeting largely based on inputs (i.e. doctors and beds). Expenses of health facilities are dominated by fixed costs (salaries and utilities), leaving very little space for service provision (including treatments, procurement of medical supplies, and consumables).

Uzbekistan is going through multi-dimensional modernization of all sectors, including the health sector, with the aim to identify areas for potential improvement and more efficient use of resources. A detailed analysis of the health sector through a health PER will review the challenges with the goal of improving health outcomes and providing coverage in an equitable, efficient and sustainable manner.

This short note on health will be followed by a full review of health expenditures in the next phase of the PER. Potential areas for the review, pending confirmation of government interest and data availability, include:

- Assessment of the efficiency of spending (human resources, medicines and inputs, infrastructure)
- Assessment of the efficiency of the service delivery model: spending on inpatient, outpatient specialists, outpatient primary curative, and outpatient primary preventive care.
- Assessment of specific health financing processes: contracting of health personnel, distribution of health personnel, financing modalities, procurement modalities for medicines and inputs.

